



PAYGO's Continued Relevance in Economic Recovery and Strategic Budgeting

Introduction

Economic conditions have deteriorated to the point where some form of additional fiscal stimulus is clearly justified — even though such action would increase an already bloated federal budget deficit. This does not mean, however, that all forms of fiscal discipline must be tossed aside. Specifically, it does not mean that pay-as-you-go rules (PAYGO) are no longer relevant. Indeed, the fact that we will be taking on substantial new debt in the near-term makes it all the more important to prevent long-term fiscal policy from drifting further out of balance.

Fortunately, there is no need to assume a trade-off between fiscal stimulus and fiscal responsibility. All that is needed is the vision to recognize a distinction between the two and the political will to enforce this distinction in choosing among policy options. Doing so will be a key test for President-elect Barack Obama and the incoming Congress as they formulate economic recovery and fiscal sustainability plans. PAYGO can, and should, play an important role.

A brief history of PAYGO: 1990-2008

An assessment of PAYGO's role in future policy planning must begin with an understanding of its value and its limitations. It is neither as inflexible as its detractors allege, nor as beneficial as its advocates sometimes assume. The success of PAYGO, like all budget enforcement tools, depends on its proper utilization. History has shown that PAYGO is most effective when used to enforce an agreed upon policy goal and less effective, though still valuable, as a guiding principle.

The rule has its roots in the Balanced Enforcement Act of 1990 (BEA), negotiated between Republican President George H. W. Bush and the Democratic leaders of Congress. In its original form, PAYGO was a *statutory* requirement providing that any legislation to lower revenues or expand entitlement spending be offset with corresponding revenue increases or entitlement spending cuts. It did *not* apply to increases in discretionary spending (appropriations), which were controlled by spending caps. Its basic purpose was *not* to balance the budget, or even to reduce the deficit in general, but to enforce a specific deficit reduction agreement between the President and Congress. As described by former CBO Director Douglas Holtz-Eakin, “lawmakers set rules that would hold them accountable for changes in the deficit due to new

legislation — but not for the budgetary effects of economic and other factors outside of their immediate control.”¹

Violations of PAYGO were enforced by entitlement spending cuts, referred to as “sequestration.” Relevant to today’s circumstances, PAYGO provided an *exception for economic emergencies*. This allowed for temporarily higher deficits without losing track of the underlying need for discipline. It is exactly this dual-track strategic thinking that is needed in the current environment.

PAYGO was later extended in the 1993 deficit reduction legislation and again in the 1997 Balanced Budget Act – when it was extended through 2002. During this time, PAYGO was generally successful. The major exception was passage of the 2001 tax cuts. In that case, Congress simply ignored PAYGO and passed legislation directing that no sequestration take place. This had the effect of allowing the tax cuts to take effect without PAYGO offsets. A contributing factor to this decision was the widely held, yet overly optimistic, belief that PAYGO was no longer necessary because budget surpluses were projected for “as far as they eye could see.”

In 2002, PAYGO expired as many Republicans, worried that the law would prevent the tax cuts from becoming permanent, refused to extend it. A new version of PAYGO was approved as a Senate rule, but it exempted any policies assumed in the budget resolution, including new tax cuts and the Medicare prescription drug benefit.

When Democrats regained control of the House and Senate in 2007, PAYGO was restored by rule, not by legislation, in both chambers. Like its former statutory version, the current PAYGO rules require that any new legislation to increase entitlement spending or cut taxes, including policies assumed in the budget resolution, be offset with some combination of tax increases or entitlement spending cuts. However, the House rule is easily waived by majority vote and the Senate rule can be waived with 60 votes. The rules are also substantially weaker than the statutory version because there is no sequestration requirement to enforce violations.

The new PAYGO rule has had mixed success. Because the rule no longer represents a consensus policy goal, enforcement has been difficult. Budget resolutions passed by the Democratic Congress in 2007 and 2008 have generally adhered to the PAYGO principle, however, it has become increasingly difficult to find the large offsets needed to pay for expiring tax cuts, including relief from the Alternative Minimum Tax (AMT). As a result, in 2007 and 2008, Congress waived PAYGO to provide AMT relief totaling \$112 billion and an expansion of veterans education benefits totaling \$20 billion over five years. Other legislation, while technically in compliance with PAYGO, has included scoring gimmicks such as timing shifts and “sunsets” to evade the spirit of the rule. PAYGO was also waived for legislation containing the \$700 billion rescue plan for the financial sector, which was designated as an emergency exception.

¹ Statement of Douglas Holtz-Eakin, *Reforming the Federal Budget Process*, House Committee on Rules, Subcommittee on Legislative and Budget Process, March 23, 2004, p.4.

These recent actions, combined with the fact that deficit spending now seems justified in the face of an economy in recession and a crisis in the financial sector, have raised the question in some circles whether PAYGO is still a useful fiscal policy tool. We believe it is.

PAYGO in the current environment

A key distinction must be drawn between short-term and long-term goals. Policy makers are facing three distinct problems: (1) an economic downturn; (2) a financial sector crisis; and (3) the long-term unsustainability of current fiscal policy. While there are linkages among these issues — most specifically the debt increase all three portend — they represent different ailments and should be treated with different remedies. The Obama Administration will need to calibrate fiscal policy to accommodate these differences. Short-term stimulus need not and should not increase the long-term structural deficit, just as reducing the long-term structural deficit need not and should not impede economic recovery.

The first thing to keep in mind about PAYGO is that it does not, and never has, applied to non-entitlement spending. Thus, certain forms of spending, such as an infusion of money for construction projects, are not subject to the rule. It is legitimate to debate whether such spending should be deemed economic stimulus or an investment in future productivity and whether it should be deficit financed or reprogrammed from less productive uses, but the PAYGO rule itself does not enter into the equation.

More significantly, fiscal stimulus is intended to provide a *temporary* boost to consumption in a lagging economy, not a *permanent* dose of new spending or revenue loss. If the main function of today's PAYGO rule is to prevent the long-term structural imbalance between spending commitments and revenues from growing larger, then there is nothing inconsistent with exempting, as a response to an economic emergency, anything that is truly designed as short-term (i.e., temporary) stimulus. It is relevant in this regard that the statutory PAYGO rule contained an exemption for periods of economic downturn. Thus, recognizing such an exemption in the current circumstances does not undermine the overall rationale of the rule.

Where the Obama Administration and Congress could get into trouble is if they begin waiving PAYGO for *permanent* spending or tax cuts in the name of fiscal stimulus. This legitimate concern, however, is not one inherent to PAYGO but one that is inherent to the political process. Short-term gratification is always more tempting than long-term discipline. Rather than inhibiting actions aimed at stimulating the economy, a strong commitment to PAYGO would mitigate the political temptation to use the current crisis as an excuse to enact long-term agenda items that should be paid for.

Similar, but slightly different, logic applies to the \$700 billion sum (and any additional amounts) approved for propping up the financial sector or other ailing industries. The prospect, and in some cases the reality, of failing banks and other major institutions is sufficiently threatening to the entire economy that a temporary PAYGO waiver is justified. Moreover, the expectation, and probability, is that eventually the businesses now in crisis will be restored to health and there will be a "payback" for taxpayers' investment. An important provision in the legislation approving

the \$700 billion rescue fund requires an accounting after five years of the money spent and the return on that money. If there is a deficit, the President is required to submit legislation closing the gap. While not as strong as a formal PAYGO requirement, this accounting serves a similar purpose and should be enforced at the appropriate time.

This leaves the third major fiscal problem facing the new administration — long-term sustainability. Whatever the justification for short-term stimulus or aid to the financial sector, the long-term fiscal outlook remains as daunting as ever, and it is in this arena that PAYGO retains its overwhelming relevance.

The situation is summed up as follows by the Government Accountability Office (GAO): “Recently the President, the Congress, and the American people have been focused on addressing problems with financial markets and the appropriate response to a weakening economy. However, once the current challenges are resolved, the next President, the next Congress and the nation will need to focus with the same intensity on the nation’s long-term fiscal challenge...[O]ur updated simulations [September 2008] continue to show escalating and persistent deficits that illustrate the long-term fiscal outlook is unsustainable.”²

The CBO’s September 2008 update of its Budget and Economic Outlook also warned that, “the budget remains on an unsustainable path. Unless changes are made to current policies, growing demand for resources caused by rising health care costs and the nation’s expanding elderly population will put increasing pressure on the budget.”³

A look at the projections shows why ignoring PAYGO would have dire consequences for the budget and the economy’s growth potential.

The budgetary consequences of ignoring PAYGO

Under current law, most of the tax cuts enacted in 2001 and 2003 are scheduled to expire on December 31, 2010. Moreover, current law does not provide further relief from the AMT. It will take an act of Congress and President Obama’s signature to change that fact. Waiving PAYGO for such legislation — in effect, voting to borrow the money to cover the lost revenue — would increase the deficit by \$5.1 trillion over 10 years, including added debt service costs. Waiving PAYGO for additional tax cuts or new entitlement spending would simply dig the hole even deeper.

Looking beyond the 10-year window, as one must do for programs such as Medicare and Social Security which are traditionally evaluated over 75 years, the situation is even worse. As noted by GAO and CBO, over this longer time frame current fiscal policies are clearly unsustainable. This is true regardless of whether the Bush tax cuts and AMT relief are extended or allowed to expire. No amount of fiscal stimulus or private sector “bailout” money will change that, because the problem is a structural mismatch of spending and revenues, not a cyclical problem caused by the current economic downturn.

² GAO, *The Nation’s Long-Term Fiscal Outlook: September 2008 Update* (GAO-09-94R), p.1.

³ CBO, *The Budget and Economic Outlook: An Update* (September 2008), p.xii.

In July 2008, at the request of Senate Budget Committee Chairman Kent Conrad (D-ND), the CBO examined two scenarios: an extended-baseline scenario in which all expiring tax cuts including AMT relief are allowed to expire (consistent with current law); and a second scenario in which the income tax provisions of the 2001 and 2003 tax cuts are extended and the AMT is indexed to inflation without offsets (non-PAYGO).⁴

The results show a stark contrast. In the extended-baseline scenario, the budget deficit stays relatively constant, falling slightly from 1.2 percent of the gross domestic product (GDP) in 2007 to 1.0 percent in 2030. Debt held by the public falls from 37 percent of GDP to 12 percent over this time, because the economy grows faster than the debt. Even under this optimistic scenario, however, the pressure of rising health care costs and population aging drives the debt to 50 percent of GDP by 2050 and to an unsustainable 240 percent of GDP by 2082.

In the non-PAYGO scenario, deficits and debt rise much faster. By 2030, the deficit rises to 6.1 percent of GDP and debt held by the public roughly doubles to 63 percent of GDP (as opposed to falling to 12 percent under the extended-baseline scenario). By 2050, the debt rises to 190 percent of GDP, and by 2082 it reaches 602 percent.

In both scenarios, “primary” spending, which excludes net interest on the debt, rises steadily from 18.2 percent of GDP in 2007 to 21.8 percent in 2030, 25.7 percent in 2050 and 32.5 percent in 2082. This spending growth comes from a combination of rising health care costs, an aging population, and increasing longevity. It demonstrates the urgent need for cost-saving reform of the three largest entitlement programs—Social Security, Medicare and Medicaid—which are primarily responsible for this growth.

PAYGO is insufficient to control such spending because it only applies to *new* spending, and not to the autopilot growth of programs that already exist. However, PAYGO is very relevant to the path of revenues because extending the expiring tax cuts would require new legislation to which PAYGO would apply. A decision must be made to either extend the tax cuts through deficit financing (waiving PAYGO), pay for them (complying with PAYGO) or simply allow them to expire (letting current law stand).

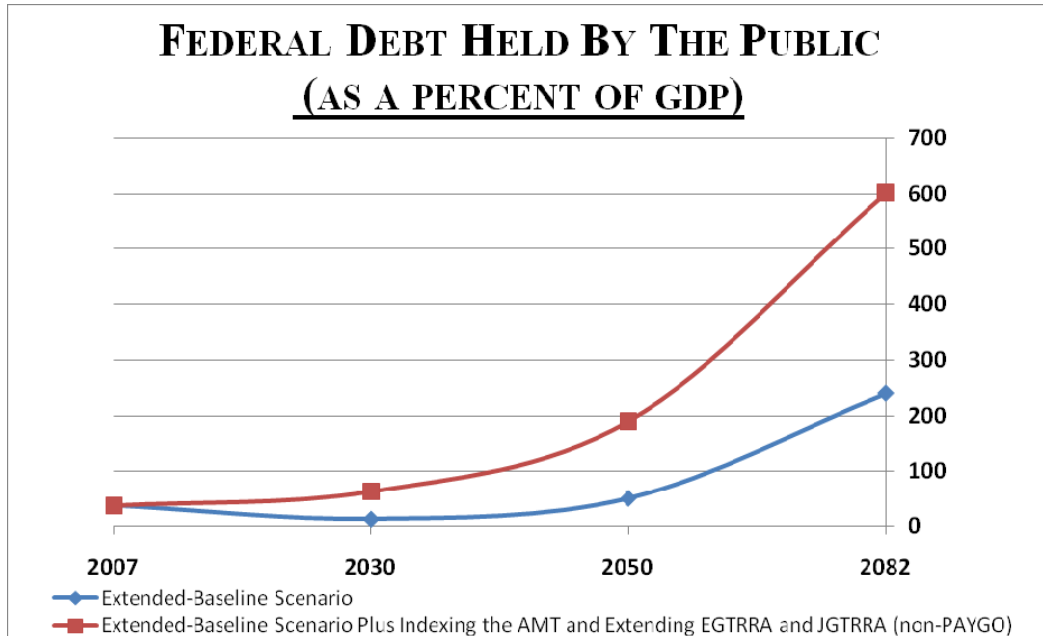
In CBO’s extended-baseline scenario, revenues steadily rise from 18.8 percent of GDP in 2007 to 21.4 percent by 2030, 23.5 percent by 2050, and 25.5 percent by 2082. This is the result of letting current law take effect. In the non-PAYGO scenario, revenues still rise, but not by as much—growing from 18.6 percent of GDP in 2030, to 19.5 percent in 2050, and 21.3 percent in 2082.

The growing budget gap in the two scenarios is reflected in the interest payments on the added debt. Under the extended-baseline scenario, interest payments shrink from 1.7 percent of GDP in 2007 to just 0.6 percent in 2030 before rising again to 2.3 percent in 2050 and 11 percent in 2082. In the non-PAYGO scenario, however, interest costs rise to 3 percent of GDP in 2030, 8.8

⁴ CBO, *Long-Term Effects of Indexing the Alternative Minimum Tax and Extending the Tax Reductions of 2001 and 2003* (July 17, 2008).

percent in 2050, and 28.1 percent in 2082. To put this in context, the entire federal budget has averaged 20.8 percent of GDP over the past 25 years, and revenues have averaged 18.3 percent.

In the end, what these numbers illustrate is that there are enormous budgetary consequences to ignoring PAYGO even under the current law baseline. If additional permanent deficit financed policies are enacted, whether on the tax or spending side of the budget, the long-term outlook would deteriorate further. PAYGO is thus a valuable, but not sufficient, tool for dealing with our long-term fiscal challenge.



Source: Congressional Budget Office

The economic consequences of ignoring PAYGO

The budgetary implications of the two scenarios outlined above are also relevant to the prospects for economic growth in the future. CBO Director Peter Orszag detailed the problem in his letter to Senator Conrad:

CBO projects unsustainable budget deficits even under its extended-baseline scenario, largely the result of rapidly increasing spending for Medicare. Enactment of the tax changes discussed here, without other changes in policy, would add significantly to those deficits, which would affect the economy. Growing budget deficits would absorb funds from the nation's pool of savings and reduce investment in the domestic capital stock and in foreign assets. As capital investment dwindled, the growth of workers' productivity and of real (inflation-adjusted) wages would gradually slow and begin to stagnate. As capital became scarce relative to labor, real interest rates would rise. In the near term, foreign investors would probably increase their financing of investment in the

United States, which would help soften the impact of rising deficits on productivity in the United States, but borrowing from abroad would not be without its costs. Over time, foreign investors would claim larger and larger shares of the nation's output, and fewer resources would be available for domestic consumption. Budget deficits that grew faster than the economy would ultimately become unsustainable.⁵

In their analysis, CBO presents “illustrative calculations” of the economic cost of choosing to deficit finance an extension of the tax cuts—compared with a scenario where the costs of extension are paid for with a “balanced” combination of increased tax revenues and decreased government spending. CBO finds that if the costs of extended AMT relief and extending the 2001 and 2003 tax cuts are not offset but are deficit financed, real per capita incomes would be reduced by 13 percent in 2050 and by an unsustainable amount beyond 2073. Despite the dire scenario implied by their economic model's inability to calculate the effects of an exploding debt, CBO warns that the quantitative estimates that do emerge from the model are by no means a worst-case scenario, as the model assumes people do not anticipate future changes in debt and hence do not exhibit the kind of disorderly behavior that might arise from such speculation.

The country has not yet reached a consensus on the question of whether projected spending is too high or projected revenues are too low. But there is no question that the projected gap between revenues and spending, and the resulting debt burden, would put our nation's economic security in serious jeopardy and increase exposure to the uncertainty of global capital markets.

So far, there is little evidence that the bond markets are concerned about the potential borrowing needs of the United States government over the long term. Long-term Treasury rates remain comfortably at or below levels seen throughout the last 40 years. That has prompted some to believe that the projected fiscal gap does not matter because an ample supply of willing lenders exists to fill the gap. However, this seems an optimistic assumption, particularly given recent events in the global economy.

The currently-still-favorable interest rate conditions are likely to persist only as long as the markets doubt the likelihood of serious, unsustainable federal deficits over the long-term. If, however, they have reason to question that assumption, the market's reaction could be swift and costly. There will be no forbearance as policy makers attempt to remedy the perception. Acting proactively—not waiting for markets to react—would allow a more gradual shift to the policy adjustments that will have to be made.

Whatever the world economy looks like two, three, or four decades from now, the United States will have greater room to maneuver if it acts now to limit the growth of future debt. Hard as it is, adopting a more disciplined stance toward the budget will be easier now rather than later when the magnitude of required policy adjustment is likely to be greater and far more disruptive to the American economy and the American people.

⁵ CBO, *Long-Term Effects of Indexing the Alternative Minimum Tax and Extending the Tax Reductions of 2001 and 2003* (July 17, 2008).

Looking ahead — the case for keeping PAYGO

Sometime in the spring of 2009, President Obama will present his first budget to the Congress. In that budget, he will have to decide what recommendation to make about the fate of PAYGO. As detailed above, this is no mere “baseline” technicality. Aside from short-term emergency measures to deal with the current recession, an essential step on the road to economic and fiscal sustainability would be to include in his proposals a firm commitment to PAYGO budgeting.

The most fundamental issue to confront in this regard is the treatment of expiring tax cuts. Should they be paid for through spending cuts or other revenue increases, deficit financed, or allowed to expire as scheduled? There is no avoiding this crucial choice and its long-term implications.

For the past several years, Democrats in Congress and many fiscal policy experts have made the case that permanent extension of the Bush tax cuts, if enacted without corresponding and contemporaneous offsets, would have a harmful effect on the economy.

For example, in an October 2004 report, Brookings Institution economists William Gale and Peter Orszag (now CBO Director) wrote: “Making the tax cuts permanent is likely to reduce, not increase, national income in the long term unless the reduction in revenues is matched by an equal reduction in government consumption. And even in that case, a positive impact on long-term growth occurs only if the spending cuts occur contemporaneously, which has decidedly not occurred, or if models with implausible features ... are employed.”⁶

The reason for this is simple. Tax cuts must ultimately be paid for. As economists like to point out, there is no free lunch. Deficit financing does not “pay for” tax cuts; it merely shifts the cost to the future with added interest.

During his campaign, Obama pledged to honor PAYGO, but his preferred version of the rule would, as advocated by President Bush, exempt legislation to extend expiring tax cuts and AMT relief from its application. Should he follow through on this approach in his budget, he would put his administration at odds with the letter of the current PAYGO rules and their application by Democrats in the past two budget resolutions, which assumed that PAYGO would apply to legislation enacting such policies.⁷

One reason Obama may prefer to assume extension of the Bush tax cuts without PAYGO is that it would allow him to claim rolling back a portion of these tax cuts as offsets for new initiatives. Without that assumption, he would be left with a big spending increase and no offset to pay for it. However, assuming an extension of the Bush tax cuts—contrary to current law—would game the system. It would transform a PAYGO liability—tax cut extensions—into PAYGO assets (offsets). Meanwhile, the deficit would continue to go up as if the tax cuts were still in place because the money would be simply shifted from one use to another.

⁶ William Gale and Peter Orszag, *Bush Administration Tax Policy: Effects on Long-Term Growth*, (October 18, 2004). The authors note a distinction between the effects of tax cuts on short-term stimulus and long-term growth.

⁷ The Concord Coalition, *Setting Expectations: Why Baselines Matter in the Presidential Campaign and for the Fiscal Future* (September 11, 2008).

Aside from promising to extend, without offsets, the Bush tax cuts for individuals making less than \$200,000 and families making less than \$250,000, Obama proposed several new targeted middle class tax cuts and an expansion of federal government health care spending. All of these are subject to PAYGO under current rules.

Obama's proposed offsets would not comply with PAYGO because they would not produce a savings relative to current law. In other words, there is no new money. Democrats will have to grapple with the fact that the "Obama tax cuts" and spending proposals could have the same effect on the deficit as the "Bush tax cuts."

Relative to current law (the current PAYGO standard), Obama's tax proposals would decrease government revenues by nearly \$1 trillion over the next five years—and nearly \$3 trillion over ten years.⁸ The proposals would reduce revenues from a current-law level of 19.9 percent of GDP in 2013 down to 18.1 percent—*below* the 40-year historical average of 18.3 percent, which has proven to be insufficient to pay for federal spending over that same 40-year history.

Conclusion

The Concord Coalition encourages President-elect Obama to pursue measures that strengthen budget enforcement even as he pursues short-term fiscal stimulus. Specifically, reinstating statutory PAYGO—enforced through sequestration—would be a good beginning. Statutory PAYGO would put additional teeth into the PAYGO rule by establishing a mechanism that cannot be easily waived. In addition, because levels established in the Congressional Budget Resolution would be written into law, it would force the Executive branch to play an earlier role in the congressional budget process.

It is important to note that while PAYGO can provide positive incentives for fiscally responsible action, it is not a substitute for political will. No strategy for fiscal sustainability will succeed over the long-term unless we find a way to reduce projected costs, particularly for health care. Ideally, PAYGO should be enacted along with a new bipartisan fiscal policy agreement. As noted above, the original PAYGO law came out of the 1990 bipartisan budget negotiations between President George H.W. Bush and the Democratic Congress. Such a new agreement should contain policy measures and budget procedures to promote closure of the long-term gap projected to arise between spending and revenues. A realistic strategy will likely require some mix of spending reductions and revenue increases aimed at preventing total spending, taxes or debt from reaching levels that could reduce economic growth and future standards of living. Consistent with PAYGO, the agreement should explicitly waive timely, targeted and temporary stimulus measures.

Yet even in the absence of such an agreement, which may take some time to negotiate, enforcing PAYGO as it already exists — whether through spending cuts or tax increases — would send a signal that Washington has begun to take its long-term fiscal challenge seriously. Enforcing

⁸ Tax Policy Center, *A Updated Analysis of the 2008 Presidential Candidates' Tax Plans* (September 15, 2008).

PAYGO would keep the long-term outlook from getting worse and also force an explicit acknowledgement of the obvious—someone always pays for increases in entitlement spending and tax cuts, even when deficit financed—if not within the five to 10-year budget window, then in the future through higher taxes or reduced federal programs, benefits and services.

If the current crisis in the financial sector has taught us anything, it is that over-reliance on escalating debt is not a sound strategy. The implication for Washington policy makers is that a realistic fiscal sustainability plan must be developed before a crisis hits. The immediate choice is whether to reclaim a measure of fiscal discipline through the budget process while a more substantive plan is negotiated, or to sit by while deficits drift higher in the absence of any procedural hurdles designed to rein them in. In Concord's view the choice is clear. We believe that reinstating long-term budget enforcement rules, such as PAYGO, remain the best step that can be taken immediately to stop digging the fiscal hole deeper.

Those who would use today's crisis as an excuse to jettison PAYGO are wrong. Short-term economic stimulus and a long-term commitment to PAYGO budgeting are compatible and necessary for the health of our economy.