Executive Summary

"We'd love to cut taxes, but we can't—it's against the rules!"

Experience tells us that politicians will use almost any excuse to increase spending or to deny tax cuts, but this latest line is getting ridiculous. Yet that's exactly how politicians and government budget experts have responded to calls for tax cuts in light of the large and growing federal budget surplus.

When they say they are not allowed to cut taxes, what the budgeteers refer to is a budgetary regime referred to as "Paygo," or, "pay-as-you-go." Passed as a deficit control measure, the Paygo rules were intended to prevent Congress from cutting taxes unless they cut spending by an equivalent amount. It sounds prudent, but as written and as practiced Paygo is a bad idea even in time of deficits. But in an era of budget surpluses, Paygo is an albatross around the neck of those who want to reduce a historically-high tax burden in the face of enormous excess tax collections by Washington.

"Paygo applies only during times of budget deficit, and is inoperative during times of projected budget surpluses."

Analyst George Pieler has studied Paygo for the Institute for Policy Innovation, and has found that in the plain and simple language of the Paygo rules, *Paygo applies only during times of budget deficit, and is inoperative during times of projected budget surpluses*. It is clear from the internal language of the rules that Paygo is for deficits, not surpluses.

But plain and simple language didn't stop the Washington budget elite from distorting reality to prevent tax cuts. The head of Congress' own Congressional Budget Office (CBO) says that Paygo still applies in times of a surplus, because a surplus is still a deficit—just a negative one. Yes, she really said that.

According to Pieler, Congress could leave Paygo intact, and still return all or a portion of the budget surplus to taxpayers. But better yet, Congress should make significant changes to the Paygo rules as part of a new budget process that better serves an era of fiscal stability. Having learned the lessons of the deficit era, it's time for a new budget regime. And the place to start is with Pieler's suggestions in this paper:

Don't take their word for it. In addition to the input of CBO and Joint Tax, Congress should also consider the forecasts of experts outside of government. The dismal track record of government forecasts gives new meaning to the joke about "good enough for government work."

"By now everyone should recognize that deficits are a function of federal spending, not revenue shortfalls."

Stop relying on a budget elite. Their intentions may be good, but government forecasters are only a resource to Congress—they are not themselves charged with the fiscal policy of government. That's Congress' job.

End Baseline Budgeting. The use of baseline budgeting has put the growth of government programs on autopilot, and has made it impossible to discuss spending "cuts" with integrity.

End Paygo, or apply it only to spending. While a Paygo-type rule could be useful in controlling spending, it should not apply to tax policy. By now everyone should recognize that deficits are a function of federal spending, not revenue shortfalls.

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Direct all inquiries to:
Institute for Policy Innovation
250 South Stemmons,
Suite 215
Lewisville, TX 75067

(972) 219-0811 [voice]
(972) 874-5144 [fax]

Email: **ipi@ipi.org**
Website: **www.ipi.org**

Budget Rules for Good Times: Ending the Budget Game As We Know It

By: George A. Pieler

For years Congress and the President have struggled to reduce, if not eliminate, burgeoning federal budget deficits. They have fought over the role of federal spending, tax policy, and budget rules and procedures in causing (or correcting!) fiscal imbalances. Much partisan (and bipartisan) blood has been spilled in wrangling over the causes of deficit spending. At its most primal level, this has been a fight between those politicians who blame deficits on over-exuberant tax-cutting (a.k.a. "Reaganomics") and those who blame excessive federal spending.

"…fiscal policy seems frozen in a deficit-fighting posture just when it needs to be retooled for a new era of fiscal stability…"

Now, over the space of just a year, this debate has been transformed into a battle over the size of federal *surpluses* and the proper policy response to a radically different fiscal situation. Yet the battle-lines in the budget debate are the same as ever, and fiscal policy seems frozen in a deficit-fighting posture just when it needs to be retooled for a new era of fiscal stability, sound money, and a fundamental shift away from failed policies of centralized government and in favor of local autonomy, individual initiative, and independent action by families, communities, and voluntary associations.

Surely it's time for a change—and the place we have to start is with an obsolete set of rules, procedures, and practices that put the federal government in a fiscal straightjacket and place strong barriers against tax cuts. This is what is known as "the federal budget process." Just what does that process accomplish?

Nostrums for the Nineties

For purposes of our analysis the critical year is 1990. That's when Congress and President Bush, fearful that persistent deficits reflected fundamental "structural imbalances" in the U.S. budget and eager to avoid what they considered the "mistakes" of the Reagan years, adopted an entirely new budget regime. This regime, binding both the legislative and executive branches (albeit in different ways), replaced the 1985 Gramm-Rudman law with a two-part system of procedural controls on the federal budget: "caps" on discretionary spending (the money Congress appropriates annually for miscellaneous programs), and a "pay-as-you-go" rule for entitlement spending and taxes.[1]

"The 1990 budget law was a decisive U-turn from Reaganomics."

The 1990 budget law was a decisive U-turn from Reaganomics, and is perhaps best remembered by George Bush's notorious abandonment of his "no new taxes" pledge. But while the same legislation that overhauled the budget rules also raised taxes, it is the *procedural* changes that have had the more profound and lasting impact. They reflect a kind of '90's Zeitgeist where budget, spending, and tax policy are concerned. Since these rules dominate federal budgeting to this day, it is important to examine the mindset that led to their creation.

The post-1990 budget regime, and particularly the pay-as-you-go rule (hereinafter "Paygo"), reflects a very specific set of assumptions about fiscal policy and policymaking in general:

- It assumes that *keeping most of the government on automatic pilot is an effective and appropriate way to run fiscal policy.* The budget regime doesn't touch entitlements or revenues unless major legislative changes are proposed, so they essentially are on automatic pilot. And discretionary spending is restrained only after Congress agrees on an "appropriate" level for each spending pool—then they are O.K. as long as they stick to that level.
- It assumes that *tradeoffs between discretionary spending and entitlements and revenues are to be discouraged*. If Congress wants to reduce appropriations and cut taxes instead, it has to jump through procedural hoops to do so.
- It assumes that *there is a moral and functional equivalence between cutting taxes and increasing entitlements.* Tax cuts and legislated entitlement increases face exactly the same procedural obstacles under Paygo, presumably on the theory that both pose an "equal" risk of increasing future deficits.
- Finally, it assumes that *the size and scope of government, and of government spending, are irrelevant to responsible budgeting*. The budget regime provides no incentives to control, or even monitor, overall federal spending (much less other kinds of government intrusion, such as regulation) or taxes.

"…a causal relationship can be reasonably demonstrated between the budget rules and the slow but steady growth of taxes and spending during the 1990's."

This post-1990 budget regime has largely been characterized in the media (and by most politicians of both parties) as one of "fiscal restraint," and has been hailed for helping produce the first federal budget surplus since 1969 (for FY 1998, the current fiscal year; surplus estimates range from $63 billion to $100 billion). Its impact on the size of government and the level of taxation has largely been ignored.

That's too bad, because while no one can prove that the budget process really did (or did not) help produce the surplus, a causal relationship *can* be reasonably demonstrated between the budget rules and the slow but steady growth of taxes and spending during the 1990's. The reason for this is simple—steady economic growth is (unarguably) the key factor in generating the surplus, and the relation between that growth and the budget process is ambiguous at best. Yet the incentive system embodied in the budget regime (entitlements and revenues left on automatic pilot) would lead an objective observer to *expect* both spending and revenues to climb gradually.

And that's just what happened. Let's look at the record.

The Era of Big (Domestic) Government

As Figure 1 demonstrates, overall federal spending rose from $1.3 trillion in 1991 (the first year affected by the 1990 budget law changes) to an estimated $1.7 trillion in 1998. Over the same period, defense spending went from $273 billion down to $260+ billion, while "all other" federal spending went from about $1 trillion to over $1.4 trillion. Total federal revenues followed a similar track, rising from a bit over $1 trillion in 1991 to $1.7 trillion in 1998, and only this year finally overtaking federal spending and thus producing a surplus.

It would of course be a logical fallacy to conclude that, just because this fiscal trend appeared in the wake of the 1990 budget law revisions, it was

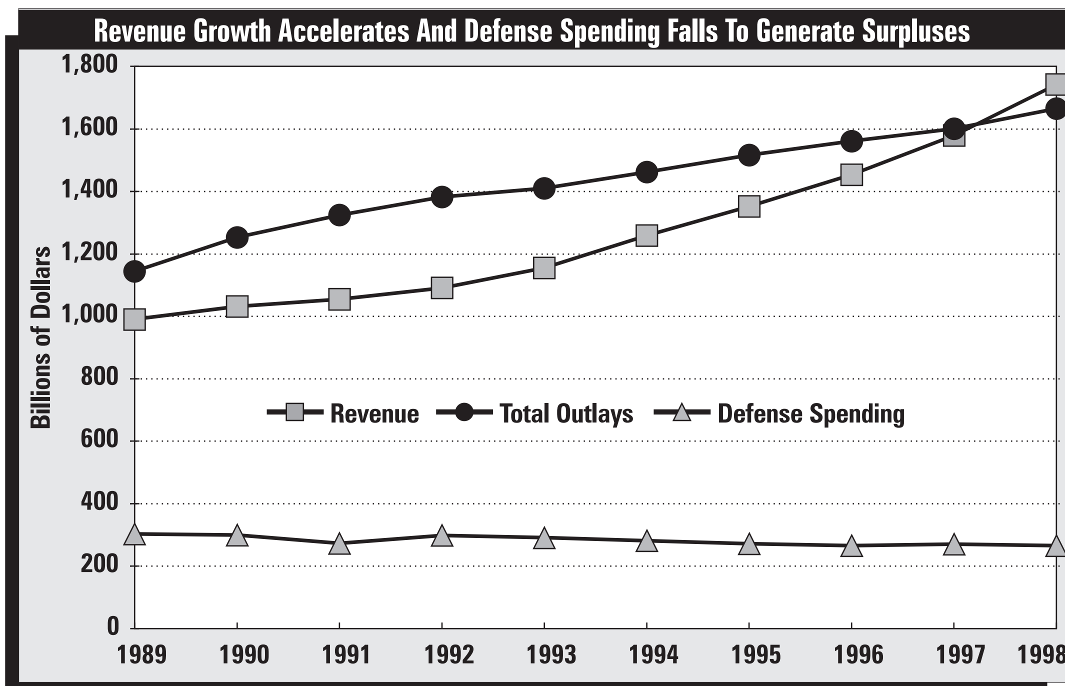


Figure 1
Revenue Growth Accelerates And Defense Spending Falls To Generate Surpluses

caused by those revisions. Nevertheless, as indicated above, it is certainly true that the post-1990 budget regime points logically towards this result. Setting aside the issue of discretionary appropriations for the moment, there are two main reasons why this is so.

First consider *entitlements*. These are programs, authorized by statute, that allocate funds (usually to individuals) based on a set formula. Although these authorizing laws can of course be changed, the year-to-year budgeting for these programs simply involves a statistical projection of utilization rates for the budget year in question, along with a determination of the unit cost of the benefit in question. That's why these programs (such as Medicare and food stamps) are called "uncontrollable"—they grow automatically each year based on the population served, and all the federal budget experts can do is gauge as accurately as possible what they are likely to cost.

"The entitlement problem is aggravated by both the methodology and nomenclature of federal budgeting."

The entitlement problem (if you agree it *is* a problem, as most serious budget reformers do) is aggravated by both the methodology and nomenclature of federal budgeting. For purposes of budget analysis, the "steady state" or "baseline" budget is assumed to include the cost of all entitlement programs implied by the governing authorization statutes. So if a program's eligible population is projected to grow, or demand for its services to increase (as in the case of an economic downturn, for example), that cost is automatically built into the budget—and anything less than that is characterized as a "cut."[2]

Obviously this approach creates serious public relations problems for anyone who wants to propose even modest restraint on the growth of entitlements. The classic example in recent times is the 1995 war between Congress and President Clinton over Medicare changes designed to pull the Medicare trust fund closer to long-term solvency. Congressional proposals to reduce the rate of growth in the cost of the program were blasted as "cuts" by the Clinton administration and congressional opponents, and most of the proposed changes were abandoned as a result (only to be revived and enacted, at least in part, under the terms of the 1997 budget deal).

"…any meaningful legislative assaults on deficit spending have been made for policy reasons, and were not due to the supposed efficacy of the budget rules."

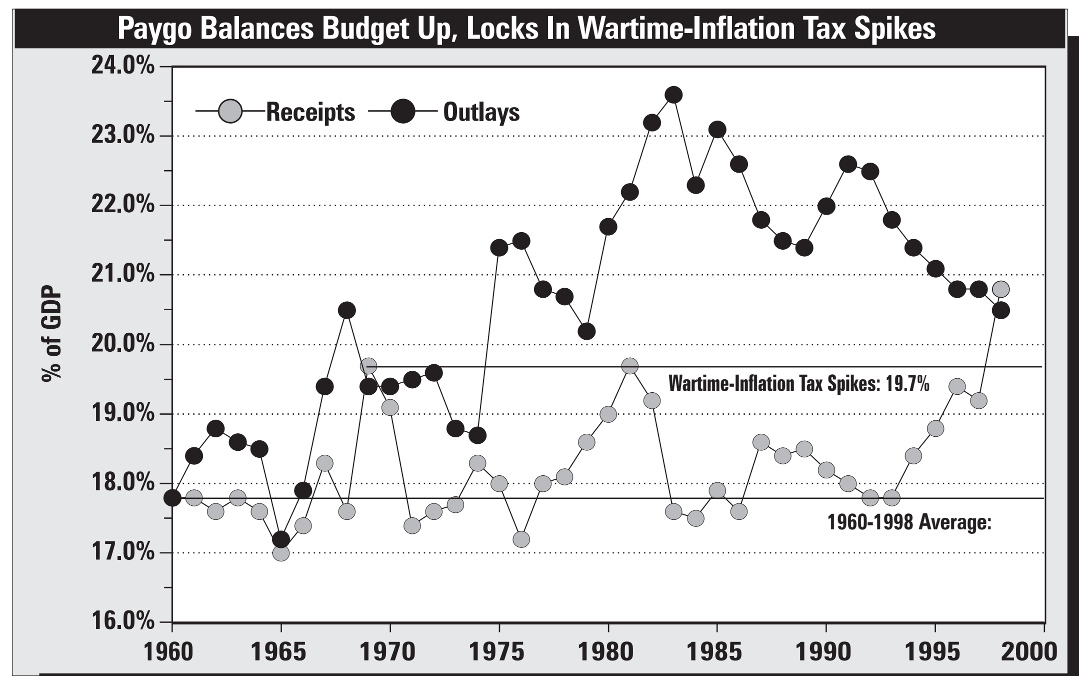
Thus so-called "baseline" spending on entitlements grows automatically from year to year without any action by Congress or the President. And since the pertinent budget rules (Paygo) only come into play if new legislation *adding* program costs is proposed, the much-vaunted budget process has *absolutely no effect on this phenomenon*. One seldom-discussed truth about budget policy in the 1990's is that, whenever any politician has proposed major spending changes (whether cuts, or reductions in the growth rate), particularly in entitlements, those proposals have been *entirely outside the scope of the 1990 budget law revisions*. They are not required by the discretionary caps (unless they are offsets to other changes that would break the caps); and they certainly are not called for by the Paygo rules. In short, any meaningful legislative assaults on deficit spending have been made for policy reasons, and were not due to the supposed efficacy of the budget rules.

A corollary problem (and in this author's view, a more serious problem) exists with regard to federal revenues. Our tax system as it exists on the books is not brought into play by the budget process *per se*. Only new legislation to change the rules of taxation is affected by Paygo, and then only if that legislation is deemed to reduce the *baseline* level of revenues projected under current law. And that's where the problems arise.

The federal government has myriad sources of revenue, the most important of which are the income tax and payroll taxes (which fund Social Security and Medicare). Many of these sources are responsive to changes in the economy and the workforce, i.e. revenues received by the government rise and fall in response to overall economic conditions as well as patterns of saving, consumption, and investment. The income tax is particularly responsive to these changes, since it is structured as a "progressive" tax—you have more taxable income, you pay a higher rate of tax.

This means that the government's revenues rise automatically, both in absolute terms and as a percentage of national income (GDP), in periods of steady economic growth. The present prolonged economic expansion illustrates this effect dramatically, with federal revenues rising from 18% of GDP in 1991 to an estimated 21+ % in 1998—a peacetime record for federal tax collections [as illustrated in Figure 2].

Figure 2
Paygo Balances Budget Up, Locks In Wartime-Inflation Tax Spikes



Again, it is important to keep in mind that all of this happens without any triggering event under the post-1990 budget regime. Yet this revenue surge is clearly the single largest contributing factor to bringing the budget into balance. As has been noted by commentators such as Larry Hunter, Steve Moore, and Larry Kudlow,[3] the phenomenon of "real bracket creep" has done yeoman work in boosting the government's take of GDP. As Dr. Hunter in particular has demonstrated, the official budget forecasters (primarily the Congressional Budget Office) have grossly underestimated the revenue trends of recent years (whether due to flawed methodology, extreme caution, or political motivation is unclear).[4] Over the past two years alone CBO has underestimated revenues by a total of $147 billion; projected over five years, the shortfall in CBO's projections was a staggering $781 billion—according to CBO itself, which recently issued a July 1998 update that (for the first time) acknowledges that the economy is generating surpluses that will exceed half-a-trillion dollars over the next five years (a projection that is still way too low, by the way).

"…the government's revenues rise automatically, both in absolute terms and as a percentage of national income (GDP), in periods of steady economic growth."

All of this would be interesting and entertaining for public policy wonks, if it did not have serious real-world consequences. But it does—when taken together with the Paygo rules, it poses serious barriers to reducing the government's tax take below its present record levels. For reasons discussed below, it also inhibits legislative action to fundamentally reform federal taxation, or to overhaul the Social Security in light of impending demographic disaster.

The Great Tax Scam

Aside from any restraints imposed by the budget process, many "fiscally conservative" policymakers have argued for years that tax-cutting was irresponsible unless the federal budget was balanced. Partly reacting against the Reagan tax cuts of the 1980's, they maintained that *any* policy action that risked increasing the deficit was inappropriate, whatever merits it might otherwise have.

I do not agree with that premise (it ignores, for one thing, the fact that unrestrained taxation makes it very difficult to restrain spending even in the best of times), but it is a legitimate point of view. And it is that viewpoint which underlies the Paygo rules on taxation: no "net tax reduction" can be allowed if it increases the projected deficit; tax proposals that would do so must be "paid for" with offsetting revenue increase, or by enacting savings in entitlement programs.

It is one thing, though, to oppose tax policies that might increase the need for federal borrowing. It is quite another matter to interpose procedural obstacles to legislation that would reduce taxes based on "expert" *projections* that revenues would not grow as fast as they otherwise might. Yet that is exactly what Paygo does on the revenue side of the budget equation—and as mentioned above, the "expert" projections have been quite wide of the mark in recent years. The upshot is that meaningful tax reduction has been *effectively barred* (unless Congress is willing to jump over the procedural hurdles, about which more below) so long as *someone* predicts it would cause the deficit to increase. And as we have seen, in a period of steady growth, this means a steadily-rising tax burden on the American people.

"…meaningful tax reduction has been effectively barred so long as someone predicts it would cause the deficit to increase."

All of that is questionable as budget policy, and as economic policy. But the only justification for such a regime *always* has been that the federal deficit is too large. Once the deficit is erased, the justification for any procedural restraints on tax-cutting is removed.

Isn't it?

Not according to the Washington budget establishment!

Let's Write A Law

We now come to the unfortunate juncture where it is necessary to undertake some legal analysis; specifically, the category commonly known as "legislative interpretation."

It is clear that, ever since the prospect of a budget surplus appeared on the (seemingly distant) horizon in 1997, both Congress and President Clinton have been trying to find a way to deal with the unfamiliar situation of justifying their tax and spending decisions in an era of robust fiscal health. The rules of the game seemed to be changing even as they reached their much-touted "budget deal" in the spring of 1997.[5]

A debate over how to deal with (and dispose of) any budget surplus has been raging at least since the fall of 1997, with much of the candid discussion going on behind the scenes. By early 1998, it appeared the political parties had staked out their positions: President Clinton demanded that (regardless of budget rules) any surplus be "reserved" for future Social Security reforms; Republicans, while somewhat divided, seemed committed to a split between tax cuts, retiring public debt, and Social Security reform, with a bit of cash set aside for spending on infrastructure. House Ways and Means Chairman Bill Archer went so far as to promise significant tax legislation to reduce or eliminate the marriage penalty, simplify and reduce capital gains taxes, and repeal the estate tax, among other items.

Then, rather abruptly, the tax cut screen went dark. Chairman Archer announced that budget law constraints (i.e. Paygo) prevented him from promising more than a very modest tax bill—sorry, folks! From that point on no serious effort was made in either house of Congress to move a major tax cut that would return the looming budget surplus to taxpayers. Instead, the budget committees went to battle over competing tax cuts that would unleash between $30 billion to (at most) $101 billion in revenues over five years—this, when cumulative (revenue-generated) budget surpluses over the same period are estimated to be between a half-trillion to a trillion dollars.

"…if receipts exceed outlays, the amount of the deficit is negative."

—June O'Neill, CBO Director

What's more, those (relatively minor) tax cuts would be "paid for" under the Paygo rules by, preferably, making offsetting spending cuts.

What went wrong? We've got a surplus here, after all, not a deficit! Here is where the budget law, and its expert interpreters, come in.

On October 29, 1997, CBO Director June O'Neill wrote to Senate Budget Committee Chairman Pete Domenici in response to a set of questions concerning the application of the budget law to a situation in which a surplus is projected. Her letter, while straightforward in some respects, is quite remarkable in others. Ms. O'Neill says in part:

> "We find that the procedures for computing the amount of a pay-as-you-go sequestration are clearly specified in the law and in no way depend on the projection of a deficit or surplus."

Ms. O'Neill goes on to cite:

> "section 3(6) of the Congressional Budget Act, which defines 'deficit' as 'the amount by which outlays exceed receipts' during a fiscal year. Under that definition, if receipts exceed outlays, the amount of the deficit is negative."

O'Neill goes on to cite a General Accounting glossary of budget process terms which says in part "*sometimes* a deficit is a negative surplus" (emphasis added).

It is important to realize just what happened on October 29. The Congressional Budget Office rewrote the budget law to define "deficit" as "surplus," thereby keeping the Paygo regime operative in the minds of Congress. And nobody challenged the interpretation (aside from the Office of Management and Budget, which didn't make a big deal of it).

"If Congress meant 'deficit' to mean 'surplus,' it would not have provided an unambiguous, independent definition of that term."

On this exceptional interpretation hangs all of the supposedly insurmountable procedural obstacles to returning the surplus to taxpayers and reducing taxes as a percentage of GDP.

Lest the reader think this is an exaggeration, consider how far CBO had to reach in order to call a surplus a deficit. Ms. O'Neill herself cites a very clear, straightforward definition of the term "deficit" written right into the budget law. She then reinterprets that term (in light of GAO's glossary) to say it also means "surplus."

A common rule of statutory interpretation (which is all we are dealing with here) is that if the statute's language is plain on its face, there is no need to inquire further (whether into the motives of the legislators, or into possible expansions of what the words mean). The Budget Act definition of "deficit" is about as straightforward as they come—it's the excess of outlays (spending) over receipts (taxes). If there is no such excess, there is no deficit. And if there's no deficit, there's no Paygo rule.

Then there's the *other* definition in the budget law, the one June O'Neill didn't mention to Senator Domenici. Immediately following the statutory definition of "deficit" is—a statutory definition of "surplus!" As you might expect, it defines a surplus as an excess of receipts over outlays (section 3(7) of the Budget Act). If Congress meant "deficit" to mean "surplus," it would not have provided an unambiguous, independent definition of that term.

"And if there's no deficit, there's no Paygo rule."

In short, there is no legally plausible interpretation of the budget law that would require (or even authorize) imposing the Paygo rules against tax bills in a period of budget surpluses. Trying to stand the law on its head, as CBO attempts in its October 29 letter, doesn't cut the mustard.

So the way is clear to cutting taxes, right? Well, yes—but not quite.

OMB Strikes Back

As mentioned above, the President's Office of Management and Budget is the only entity that publicly disagreed with CBO's October 29 interpretation (and, while Congress enforces the Paygo rules by imposing procedural obstacles—points of order—against measures deemed to violate them, the law actually entrusts OMB with the statutory duty of deciding when Paygo applies). As reported by the Bureau of National Affairs *Daily Tax Report* on November 4, 1997, OMB spokesman Lawrence Haas said that "Pay-as-you-go rules apply to a world of deficits, not a world of surpluses." However, Haas went on to cite another provision of the budget law that gives special treatment to the Social Security trust funds, and indicated that OMB would expect Paygo to continue in effect at least until the federal budget was in surplus independent of Social Security (as an accounting matter the Social Security trust funds, measured on an annual cash flow basis, presently show a surplus larger than the likely unified budget surplus for 1998).

OMB appears to be on stronger legal ground than CBO in citing the special treatment of Social Security as a reason for continuing Paygo (in fairness, CBO cited this provision in its October 1997 interpretation as well, but didn't find it necessary to address the issue given their expansive interpretation of the word "deficit"). While there are several special rules in the budget law governing Social Security (Congress frequently votes to "save" Social Security from fiscal restraints imposed on the rest of the budget), the section OMB is probably referring to is section 13301 of the U.S. Code. That section states that "receipts and disbursements" of the Social Security trust funds "shall not be counted as new budget authority, outlays, receipts, or deficit or surplus for purposes of…the Balanced Budget and Emergency Deficit Control Act of 1985." That includes the Paygo rules.

"The budget (based on present trends) will be in surplus independent of Social Security as early as next year, and no tax reduction would likely take effect before then anyway."

While this language is not as artfully phrased as one might wish (what does it mean to "not be counted as deficit or surplus?"), it clearly seems designed to take Social Security out of the budget equation for purposes of Budget Act enforcement procedures (Social Security always was exempt from automatic cuts, or sequestration, under the old Gramm-Rudman law, and continues to be so, independent of the section cited above). Even so, there is some ambiguity here—it is one thing to protect Social Security from budget enforcement, and quite another to say that *other* enforcement measures affecting different parts of the budget (i.e. Paygo) depend on whether a surplus is generated without counting Social Security. It would not have been difficult to say that directly in the law, if that was the clear intent. But for the sake of argument, let us assume that the budget law does imply that the Paygo rules continue until the government has a surplus independent of Social Security.

Even assuming that, there is no truly serious obstacle to tax-cutting. The budget (based on present trends) will be in surplus independent of Social Security as early as next year, and no tax reduction would likely take effect before then anyway. All you need to get out of the Paygo box is a reasonable *projection* of a budget surplus—something even CBO is doing lately. And once you're out of Paygo, you're out—unless you can once again project a budget deficit on the horizon (something that appears unlikely now, not based on any credible forecasts).

Out of the Budget Box

To put a final nail in the Paygo coffin, remember that the entire budget law was passed by Congress, and binds it only to the extent it wants to be bound. It is true that the Paygo sequestration mechanism is out of Congress' hands (entrusted to OMB). But it is highly unlikely the Clinton administration would threaten a sequester under present conditions, rather than negotiate a legislative "fix" for any budget law problem that might arise (there has been no serious threat of a sequester since the 1990 budget law changes, whereas there were several serious ones under the old Gramm-Rudman law).

In fact, Congress has several ways to escape the budget box, even if the extreme CBO interpretation of Paygo is accepted. All the budget law does is require a special vote (usually waiving a procedural point of order) to get around one of its provisions. There may be political and "moral" reasons for not doing that, but surely those reasons vanish along with the deficit. In the House, most budget points of order can be waived by a simple majority vote, and in many cases the Rules Committee can provide a waiver in the rule governing floor consideration of a bill. In the Senate, a waiver

usually means a two-thirds vote—but when Congress really wants to do something, it usually can muster that, and more.[6]

The real problem seems to be that Congress lacks the will to tackle the surplus issue head-on, and hides behind the budget law as a way to avoid accountability to advocates of lower taxes and limited government (most of them Republicans). There has been a dramatic shift on this issue in recent weeks, as CBO's belated acknowledgment of large surpluses has encouraged leaders like Newt Gingrich to urge tapping the surplus for significant tax relief. Yet many other GOP leaders are balking, citing the Paygo regime as well as political concerns about being accused of "draining" the Social Security "surplus." In June, House Budget Committee Chairman John Kasich was forced to abandon plans to tap at least part of the budget surplus to inaugurate private, individual retirement accounts as a down payment on reforming Social Security (although Social Security is treated as exempt from most budget rules, it also has special rules that, e.g., interpose a point of order against legislation that could be scored as reducing the trust fund surplus).

"…there is no legally plausible interpretation of the budget law that would require (or even authorize) imposing the Paygo rules against tax bills in a period of budget surpluses."

When he brought his budget to the floor, Chairman Kasich was obliged to drop his provision dealing with private retirement accounts—not because the budget law "demanded" it, but because key members (particularly Wisconsin Rep. Mark Neumann) objected to both the policy and the political message—that the surplus *can* be tapped to promote innovative ideas, at least on the tax side.

As a result, Congress was deprived of an interesting, open, honest debate over the Kasich idea (which had been seconded by many other members, including House Speaker Newt Gingrich, and now is being pitched in the Senate by Sens. Domenici, Gramm, and others). Clearly we are at a point where the budget law fig leaf is impeding serious policy debate, not advancing sound fiscal policy at all.

The Shock of the New

Nowhere is this more true than in two of the most interesting policy issues in the public arena—tax reform and Social Security.

As the Kasich Social Security proposal illustrates, major reforms often cost money. In the case of Social Security, any fundamental reforms will require some means of addressing the actuarial imbalance between the cost of benefits promised (particularly to the baby boom generation) and the revenue stream implicit in current law. Generating a budget surplus is one quite sensible way to financing the transition to a reformed system, whether by facilitating the creation of private accounts or giving beneficiaries some kind of property interest in their promised benefits. If the budget law is continually raised as an objection to these kinds of initiatives, urgent policy changes will be deferred until well into the next millennium (and their cost will be much higher).

The same analysis applies to any fundamental tax reform worthy of the name. A transition to a radically new system inevitably brings uncertainty in the revenue stream and the likelihood of some ups and downs in revenue realizations from year to year. A Paygo regime that is interpreted to bar such reforms just because some revenue decline is implied makes no sense whatsoever—it would not be in the long-term economic interest (much less the fiscal interest) of the nation to foreclose serious debate over taxation because of an absurd interpretation of a (not terribly restrictive) budget rule.

The only fair explanation is that Congress is suffering from future shock—unprepared to grapple with the issues of the decade (and millennium) ahead, it hides behind a nearly-obsolescent budget law to cling to the status quo. Congress can vote that it would be a good idea to overhaul the tax code early in the next century, but it can't muster the courage to take any of the initial steps that will get us there. Congress (and the President) can "spend a year" chewing over Social Security, but they can't tap the budget surplus to actually begin the process of giving working Americans some control over their Social Security investment, not to mention a fair rate of return.

"All you need to get out of the Paygo box is a reasonable projection of a budget surplus—something even CBO is doing lately."

At bottom the so-called Paygo barrier to innovative tax and fiscal initiatives is just so much hogwash. If Congress can't change the law, it certainly doesn't need to bind itself with an interpretation that goes against the common meaning of the words. Or it can sidestep the law procedurally—or it can try to muster the votes necessary to override the law as interpreted (a truly significant policy initiative would make this feasible—such as a major tax cut—or at least give Congress a huge political advantage in fighting the strict interpretation).

One solution to the Paygo problem, then, is simply get Congress off its collective duff. Short of that, however, what can be done (in both the short- and long-terms) to escape the dead hand of the budgetary past?

What Is To Be Done?

If the goal is to institute a truly pro-taxpayer, anti-deficit, limited government budget regime, there are several steps which are *sine qua non*. There are very hopeful signs that this may be happening, in response to CBO's dramatic (but still underpowered) reestimate of future budget surpluses. These essential steps are discussed below, followed by some thoughts on broader-gauge, long-term reforms that could produce much more positive results.

The Essentials.

Don't take their word for it. Even though the budget rules are being stretched wildly out of shape in order to manufacture a Paygo "obstacle" to returning surpluses to taxpayers, the practical result is the same as if the law DID clearly bar net tax reduction, regardless of fiscal circumstances. That's because Congress is in lockstep agreement with CBO and the professional budget elite that the law DOES interpose such a barrier, and there is little outsiders can do to force Congress to exercise the powers it does have in the tax area.

The only thing that might make a difference is for public pressure to be applied (to both Congress and the administration), dramatizing the truth about the budget law, and emphasizing the urgency of scaling back the record-high federal tax burden (as well as tackling tax reform and Social Security). But to accomplish that, independent observers, and particularly taxpayer advocacy groups, have to recognize that there's a problem, and hammer away at it. That is not being done, presumably in part because such organizations are reluctant to challenge a Republican Congress with which they normally are allied. But unless that challenge is made, and repeated over and over, there will be no change in a deeply flawed budget regime.

Stop relying on an expert elite. Congressional reliance on a professional elite of budget forecasters, estimators, and interpreters has become an increasing problem as we move from a deficit to a surplus regime. These

well-intentioned, honorable people, whether in the Congressional Budget Office, the Joint Tax Committee, or the Office of Management and Budget, no doubt try to do their jobs in a sound and reliable fashion. But they remain bound by the budget traditions of recent history (including static forecasting, baseline budgeting, and the presumption of inherent growth limits for both the economy and revenues) that have thrown our budget projections (and the budget debate) far out of whack.

"The real problem seems to be that Congress lacks the will to tackle the surplus issue head-on, and hides behind the budget law as a way to avoid accountability to advocates of lower taxes and limited government."

The fact is that these experts should not have to carry the weight of making decisions that fundamentally are political, and which have profound consequences for government and the economy. In recent months we have witnessed the spectacle of the Speaker of the House denouncing his own Congressional Budget Office for "underestimating" the revenue effects of capital gains tax reform, and scrambling for alternative estimates that would enable him to "pay for" a modest capital gains tax change. This is ridiculous—he shouldn't have to "pay for" the change, and he surely should have the power to use independent professional estimates to justify his policy recommendation.

One partial solution would be for Congress to rely on a consensus of leading (independent) forecasters to estimate budget effects. Another approach could be to create an oversight board of independent forecasters that could second-guess and critique the government professionals, and give legislators a basis for using alternative estimates. Yet another idea would be to sanction CBO and other government forecasters for a recent track record of inaccuracy (such as we have seen in revenue estimates in the last few years). For instance, if revenue estimates have proven to be understated by 10%, Congress could require CBO to adjust its estimates upward by an equivalent percentage for the upcoming budget year.

End baseline budgeting. As we have seen, the use of budget baseline assumptions that automatically incorporate substantial growth in both entitlements and revenues, coupled with a Paygo regime that is read to inhibit tax cuts, tends to ratchet up the size of government and the concomitant tax burden without the need for any action by Congress. Not since the bad old days of bracket creep in the late '70's have we seen government grow so fast, on automatic pilot.

We should end baseline budgeting as we know it. So long as Congress employs a budget process that requires a baseline reference point, that baseline should be as simple and straightforward as possible, unbiased in favor of higher spending and higher taxes. That means either using an historical rolling average for both spending and revenues (which would give rough justice, but less distortion than we have now); or a baseline that incorporates last year's spending on discretionary accounts, coupled with a steady-state estimate for entitlements (present law benefits, strictly defined, with a modest allowance for growth in population served), and for revenues (current law, with a fixed allowance for growth and elasticity).

In 1995 Congress made an initial stab at dealing with the baseline problem, and several members (including Rep. Chris Cox and a budget task force appointed by Speaker Gingrich) have made sound legislative recommendations that improve things at the margin. But more fundamental change is needed here.

End Paygo. Whatever interpretation you put on the current budget rules, there is no policy justification for continuing Paygo in a surplus situation (whether it even makes sense in a deficit situation is questionable). At a

very minimum, Paygo should have *no application* to tax legislation. The federal deficit problem, now, always, and forever, has been a function of federal spending, not revenue shortages. Even fiscal fanatics should recognize that procedural incentives to keep taxes high just give Congress another excuse to spend more. That's not a sound fiscal regime. Besides, as we have seen, a "progressive" tax system ratchets up the tax burden even faster than the economy grows. Imposing the Paygo regime on tax legislation is just a recipe for bigger government.

The spending side is more complex, because there is something fundamentally appealing about the notion that new spending should be authorized only if old spending is reduced. If that's what Paygo actually did, it would be a fairly reasonable rule. But as we have also seen, Paygo affects only legislated new spending, while spending that is on automatic pilot is untouched. What's more, Paygo doesn't affect appropriated accounts, which are covered by the adjustable "caps" Congress sets each year. Those caps are a real constraint, but it would be hard to make the case that Congress has been starved for discretionary funds to spend under the post–1990 regime.

"At bottom the so-called Paygo barrier to innovative tax and fiscal initiatives is just so much hogwash."

If Congress wants to use a Paygo system, it should be:

❶ coupled with the baseline reforms discussed above,

❷ applied to *all* spending, including discretionary accounts, and

❸ imposed on *any* spending increase over the baseline, whether legislated or due to unanticipated costs of existing laws.

This is, after all, primarily a system of accountability, and Congress and the President should be on the record for *all* the spending increases associated with their legislative actions.

So much for the practical essentials of budget reform. What about the larger picture?

Some Deep Thoughts

One of the ironies of the post-1990 budget regime is that it has corrupted the whole notion of procedural and institutional restraints on budgeting, a long-standing interest of conservatives and advocates of limited government in general. Here we are operating under a fairly thorough set of budget rules and procedures that claim to limit spending—and we actually see an end to federal deficits—but at the cost of record-high taxes, a bigger domestic government (largely accommodated by a smaller defense budget), and more federal intrusion into citizens' lives than ever before.

The response should not be to abandon the idea of institutional restraints on government power, including spending and taxation, but to rethink the concept in the light of experience. Along those lines, there are two analytical approaches that might bear fruit:

Emphasize clear, bright-line, understandable and enforceable rules. One problem with the existing budget system is that it is buried in obfuscation, manipulation of estimates, secret in-house interpretations, and is unintelligible to the public. Surely we can have a more open and accountable process.

Institutional restraints on spending and taxes, whether imposed by statute or constitutional amendment, should be simple, clear, and understandable for most citizens. For example, a limit on taxation could say that federal revenues shall not exceed 19% of GDP, and could be enforced by looking back to the last completed fiscal year rather than relying on projections.

Emergency exceptions and supermajority overrides could be allowed, but the rule should remain easily comprehensible both to the public, and to members of Congress who will know what the constraints on their fiscal decisions are, and when and how they are triggered.

On the spending side, a comparable rule could be established; alternatively, any spending increase over a (conservatively defined) historical baseline could be subject to supermajority votes, a Paygo requirement, or some combination of the two. In *all* cases of drafting fiscal rules, their potential interaction with automatic spending programs and "progressive" taxation needs to be carefully analyzed, with a decisive bias in favor of rules that do not accommodate automatic growth in either spending or taxes.

Of course, reforms outside of the budget process would make a big difference as well. A single-rate federal tax system, whether imposed on income or consumption, would eliminate much of the built-in bias towards revenue growth that exists under the present system. Similarly, devolution of more entitlement programs to the states (as has been done with welfare reform) would mitigate the huge impact entitlement spending has on the federal budget.

"At a very minimum, Paygo should have no application to tax legislation."

Functional reform of the federal government. Another approach to the issue of fiscal restraints on the federal government is to attack at a more fundamental, albeit indirect, way—by undertaking a top-to-bottom review of the functions Washington has assumed in post-New Deal America, measuring them against the original constitutional powers of the federal government, and jettisoning those that do not make the cut. The 104th Congress appeared ready to make initial steps in this direction, when it focused on eliminating cabinet agencies dealing with education, energy policy, and like. But that assault never really got off the ground, and it was argued more on political grounds than on fundamental issues of what is right and proper for the federal government to do.

One way to revive this entire issue area might be to create a high-powered congressional commission along the lines of the old Hoover Commissions on government reorganization. The difference would be that *this* commission would focus not on management efficiency (à la Al Gore), but on fundamental issues of power and authority; the role of the federal government as compared with state government; approaches to devolving authority to states, localities, and individuals; and the limits that should be imposed on government's power to regulate individual and corporate behavior, and to delegate power to quasi-independent and nongovernmental entities.

Epilogue

Legislators and government officials are not perfect, and they should not be expected to be. A sound fiscal regime assumes that these individuals have the normal human frailties, and nudges them gently in the right direction without excusing them for accountability for the cumulative effect of their decisions.

Unfortunately, the regime we now have not only minimizes that accountability, it plays to the weaknesses of politicians by making it easy for them to hide behind "budget procedures" rather than face up to critical policy decisions. That's not just bad from the standpoint of fiscal conservatives and anti-tax advocates: it's bad for the body politic as a whole, and it makes the budget process seem like a partisan game with no good guys playing at all. It's time we did better, guided by the principles of honesty and accountability to the public.

Endnotes

1 The 1990 changes actually amended the Gramm-Rudman law, as well as the original Budget Act of 1974, and retained major elements of each. But Gramm-Rudman used specific deficit targets and the threat of automatic, across-the-board spending cuts to enforce those targets against the budget as a whole. The 1990 law (usually known as the Budget Enforcement Act) abandoned the targets and broke the budget down into several categories of discretionary spending, entitlements, and revenues, each with its own set of rules.

2 Dean Stansel, *The Unkindest Cut of All: The Welfare State on Auto-Pilot Through Current Services Budgeting*, Institute for Policy Innovation, March 1995. http://www.ipi.org/issue_briefs/csb.pdf

3 Lawrence Kudlow and Stephen Moore, *Congress' $1 Trillion Opportunity*, Institute for Policy Innovation, May 13, 1998. http://www.ipi.org/issue_briefs/IBtaxcut.pdf

4 Lawrence A. Hunter, *The Case for a Trillion-Dollar Tax Cut*, Institute for Policy Innovation, August 1, 1998. http://www.ipi.org/issue_briefs/trillcut.pdf

5 That spring CBO notoriously " discovered" $225 billion in projected revenues that made cinching the deal much simpler; the first of many revenue " windfalls" the budget experts have been slow to catch up with….

6 Part of the difference is that some of the Senate constraints were enacted into the budget law itself, while House action is generally governed by its own internal rules.

About the Author

George Pieler is Washington representative for the National Tax Limitation Committee and a free-lance writer. Mr. Pieler was born in Chicago, Illinois and is a graduate of Princeton University and Columbia Law School. He has worked in a variety of government and public-policy related positions since moving to Washington, D.C. in 1976, beginning with a stint in bank regulation with the Legal Division of the Federal Reserve.

In the early 1980's Mr. Pieler served on the tax staff of the Senate Finance Committee under the leadership of Ranking Member (and then Chairman) Robert J. Dole. In 1985 Senator Dole asked him to join in the Office of Majority Leader as Deputy Counsel, a position Mr. Pieler held through the end of 1986.

Mr. Pieler also has served as a government relations consultant on a wide range of regulatory and tax-related issues, and in the Department of Education under the Reagan and Bush administrations. In 1993 he co-founded The Washington Scholarship Fund, which raises money to enable needy families in Washington to send their children to private elementary and secondary schools.

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