Quick Study

A Policy Report Summary by the Institute for Policy Innovation

Budget Rules for Good Times:

Ending the Budget Game As We Know It

A Summary of IPI Policy Report #146

By: George A. Pieler

For years Congress and the President have struggled to reduce burgeoning federal budget deficits. Now, over the space of just a year, this debate has been transformed into a battle over the size and use of federal *surpluses*. Yet fiscal policy is still geared toward deficits, with an obsolete set of rules, procedures, and practices that put the federal government in a fiscal straightjacket and place barriers against tax cuts. This is what is known as "the federal budget process."

Nostrums for the Nineties

In 1990 Congress and President Bush, eager to avoid what they considered the "mistakes" of the Reagan years, adopted an entirely new budget regime. This regime replaced the 1985 Gramm-Rudman law with a two-part system of procedural controls on the federal budget: "caps" on discretionary spending and a "pay-as-you-go" rule for entitlement spending and taxes.

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 it is the procedural changes that have had the more profound and lasting impact.

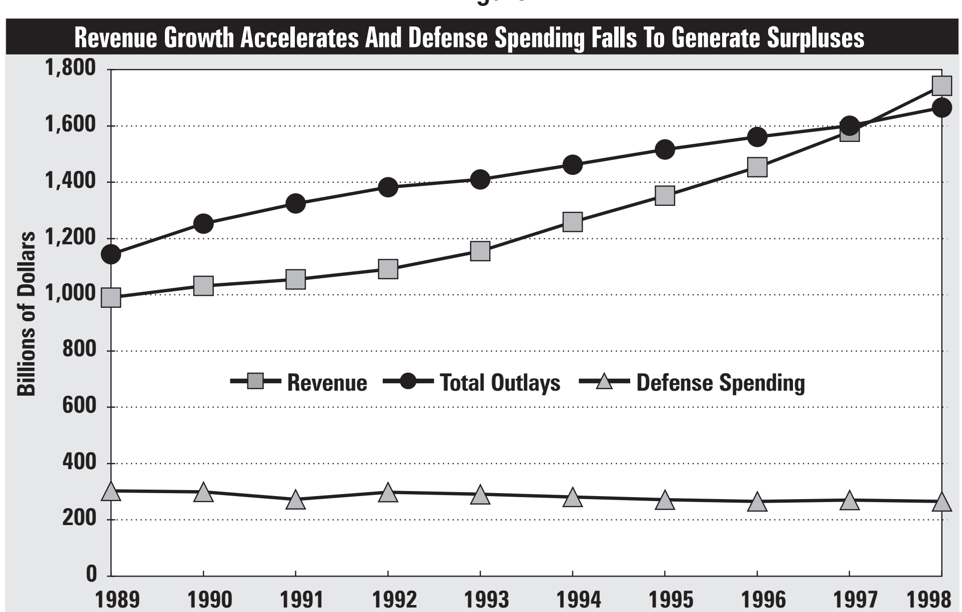
This post-1990 budget regime has largely been characterized as one of "fiscal restraint," and has been hailed for helping produce the first federal budget surplus since 1969. Its impact on the size of government and the level of taxation has largely been ignored.

That's too bad, because 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 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

Figure 1



finally overtaking federal spending and thus producing a surplus.

Rather than getting the credit for fiscal restraint, Paygo has been ineffective at restraining spending.

Paygo has no effect on entitlements. 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.

The entitlement problem is aggravated by "baseline" budgeting, which 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, that cost is automatically built into the budget—and anything less than that is characterized as a "cut."

The federal government has myriad sources of revenue, the most important of which are the income tax and payroll taxes. 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.

This means that the government's revenues rise 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].

All of this happens without any triggering event under Paygo. Yet this revenue surge is clearly the single largest contributing factor to bringing the budget into balance. The phenomenon of "real bracket creep" has done yeoman work in boosting the government's take of GDP.

The Great Tax Scam

Many "fiscally conservative" policymakers have argued for years that tax-cutting was irresponsible unless the federal budget was balanced. They maintained that any policy action that risked increasing the deficit was inappropriate, whatever merits it might otherwise have. It is this 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.

The upshot is that meaningful tax reduction has been effectively barred 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.

The only justification for such a regime always has been that the federal deficit is too large. But once the deficit is erased, the justification for any procedural restraints on tax-cutting is removed.

Isn't it?

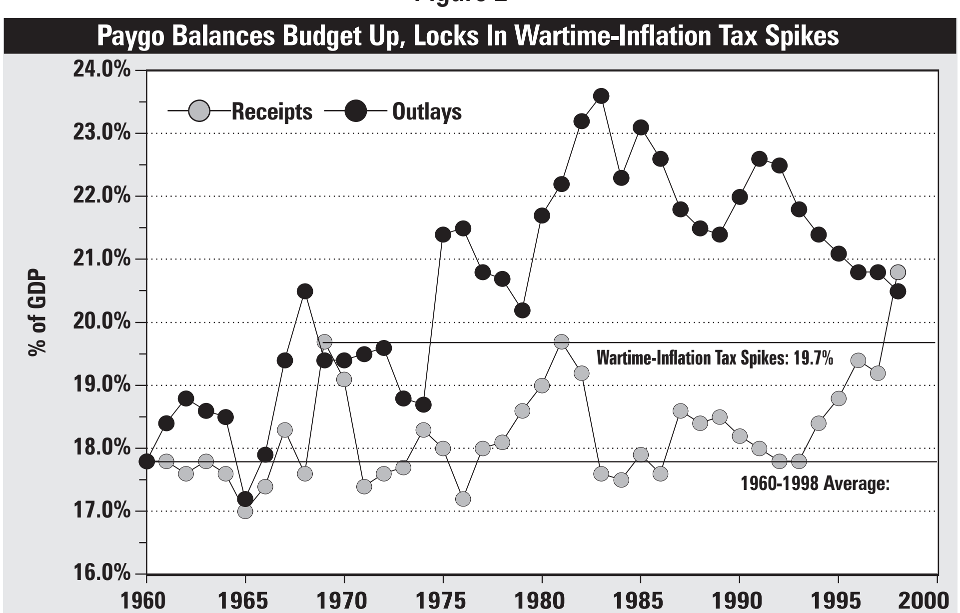
Let's Write A Law

A debate over how to deal with any budget surplus has been raging at least since the fall of 1997. House Ways and Means Chairman Bill Archer promised 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, Chairman Archer announced that budget law constraints (i.e. Paygo) prevented him from promising more than a very modest tax bill. 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.

What went wrong?

Figure 2



On October 29, 1997, CBO Director June O'Neill wrote to Senate Budget Committee Chairman Pete Domenici concerning the application of the budget law to a surplus. Her letter is quite remarkable. 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."

In other words, the Congressional Budget Office interpreted the budget law to define "deficit" as "surplus," thereby keeping the Paygo regime operative.

A common rule of statutory interpretation is that if the statute's language is plain on its face, there is no need to inquire further. 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.

In short, there is no legally plausible interpretation of the budget law that would require imposing the Paygo rules against tax bills in a period of budget surpluses.

OMB Strikes Back

The Office of Management and Budget is the only entity that publicly disagreed with CBO's October 29 interpretation. OMB spokesman Lawrence Haas said that "Pay-as-you-go rules apply to a world of deficits, not a world of surpluses." However, Haas indicated that OMB would expect Paygo to continue in effect at least until the federal budget was in surplus independent of Social Security.

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.

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. 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. 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.

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. 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.

As a result, Congress was deprived of an interesting, open, honest debate over the Kasich proposal. Clearly we are at a point where the budget law fig leaf is impeding serious policy debate, not advancing sound fiscal policy at all.

What Is To Be Done?

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 remain bound by the budget traditions of recent history that have thrown our budget projections far out of whack.

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.

End baseline budgeting. 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 and for revenues.

End Paygo. 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. 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.

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

- coupled with the baseline reforms discussed above,
- applied to all spending, including discretionary accounts, and
- 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.

Want More Info?

This study is a summary of IPI Policy Report # 146, *Budget Rules for Good Times: Ending the Budget Game As We Know It*

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IPI Quick Study

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