Kay Bailey Hutchison, Chairman
Bill Hughes, Staff Director

347 Russell Senate Office Building
Washington, DC 20510
202-224-2946
http://rpc.senate.gov

SENATE REPUBLICAN POLICY COMMITTEE

July 15, 2008

Lost in Translation: PAYGO Treatment of Spending versus Tax Cuts

Executive Summary

- PAYGO is prejudiced against extending current tax law because the baseline treats existing tax cuts differently from existing mandatory entitlement programs.

- The baseline assumes that nearly all mandatory spending proposals that are scheduled to expire don't actually expire but instead continue forever. Conversely, any tax reduction requires a PAYGO offset to be extended.

- The practical effect of this difference is that current tax laws must be paid for *again* and *again* simply to keep rates where they are, while existing entitlement programs are allowed to continue *indefinitely* without needing offsets.
    - During this current Congress, this bias creates an additional and unfair roadblock for extending a host of popular bipartisan tax provisions, routinely referred to as "tax extenders."

- While most would argue that the mandatory programs assumed to continue are worthy programs, it is not clear why they should be treated as more important, necessary, or beneficial than the expiring tax extender provisions.

- Senate Republicans have publicly discussed an alternative to end the stalemate on the extenders, one that pays for the extenders but in the form of <u>decreased spending</u>, not <u>increased taxes</u>.

- Even with the disparate treatment of tax and spending programs under PAYGO, the Democratic Congress still has been unable to abide by their *own* rules and has chosen to effectively waive PAYGO again and again to increase spending without insisting on offsets.
    - In the instances where Democrats have attempted to abide by their PAYGO rule, increased taxes have been heavily preferred to offset increased spending.

- Lawmakers should stop using PAYGO as a mask of fiscal responsibility, ignoring increases in spending, and holding continuations in spending programs and current tax law to different standards.

The Democrats' Pay-As-You-Go (PAYGO) rule embraces a bias toward a tax-and-spend philosophy while masquerading as fiscal responsibility. Rules only require offsets for *new* or expanded spending programs relative to the baseline and do not apply to the extension of existing mandatory programs, even those scheduled to expire. Conversely, any tax reduction requires a PAYGO offset to be extended. Therefore, PAYGO does not require a reexamination of past spending policy decisions, only past revenue policy decisions that are set to expire.

PAYGO is prejudiced against extending current tax law because the baseline treats existing tax cuts differently from existing mandatory entitlement programs. The baseline assumes that nearly all mandatory spending proposals that are scheduled to expire don't actually expire but instead continue forever. Budget precedent requires that all direct spending programs created before 1997, and that have annual outlays of more than $50 million, are assumed to continue even if they expire under current law. This encompasses a variety of very expensive programs, including (costs over ten years 2009-2018):

- Food Stamps ($445 billion);
- Temporary Assistance for Needy Families ($134 billion);
- Commodity Credit Corporation ($119 billion);
- SCHIP ($45 billion);
- Veterans' Compensation Cost Of Living Adjustment ($55 billion); and
- Child Care Entitlements to States ($23 billion).

All told, the baseline assumes that nearly $1.3 trillion in mandatory programs that are set to expire will continue and won't have to be paid for under PAYGO rules.

In contrast, most revenue provisions that are scheduled to expire under the baseline are assumed to in fact expire. The practical effect of this difference is that current tax laws must be paid for *again* and *again* simply to keep rates where they are, while existing entitlement programs are allowed to continue *indefinitely* without needing offsets. Under this disparate and biased treatment, Congress must find savings to keep tax rates at current levels, yet does not have to pay for extension of many expiring mandatory programs.

During this current Congress, this bias creates an additional and unfair roadblock for extending a host of popular bipartisan tax provisions, routinely referred to as "tax extenders." These widely popular tax breaks include, but are not limited to:

- The Alternative Minimum Tax (AMT) patch, which if left un-patched would raise taxes on 25 million families;
- The research and development credit, a vital component to success, competitiveness, and innovation of American businesses;
- The college tuition deduction, a deduction on which families struggling with the soaring costs of education depend;
- The state and local sales tax deduction option; and
- The teacher classroom expenses deduction, which many teachers rely on in order to provide their classrooms with needed materials throughout the year.

Also included in the extenders package are numerous tax cuts for renewable energy sources. Renewing preferable tax treatment for sources of renewable energy represents a commitment to diversified energy sources, as well as support for research, development, and utilization of a renewable energy future.

Looking ahead to the next Congress, continued application of these biased PAYGO rules will make it much more difficult to continue current tax policy such as marriage penalty relief, lower rates on capital gains and dividends, lower marginal rates, estate tax relief, and the child tax credit, all set to expire on December 31, 2010.

While most would argue that the mandatory programs assumed to continue are worthy programs, it is not clear why they should be treated as more important, necessary, or beneficial than the expiring tax extender provisions. For instance, mandatory spending for the Veterans' Compensation Cost of Living Adjustment (COLA) is automatically assumed to continue and is not subject to PAYGO rules, but the military tax extender provision, the Combat Pay in Earned Income for Refundable Credit, is assumed to expire and must be offset. Additionally, spending for Child Care Entitlements to States is automatically assumed to continue, but educational tax extenders for Qualified Education Expenses and Teacher Classroom Expenses are assumed to expire and must be offset. These tax provisions are every bit as important to the soldiers, teachers, and families who benefit from them as the spending programs are, and the provisions should not be subject to different offset requirements simply to fulfill a particular spending agenda.

Extenders: A lesson in appropriate offsets

Recently, the tax extenders bill has garnered debate from both sides on the need for offsets due to the Democrats' insistence on complying with PAYGO. Republicans have always held the belief that increasing taxes to pay for extensions of current law does not make for sound economic policy. However, Democrats' insistence on using tax increases as offsets has led to a stalemate over the future of the extenders.

Erroneously, Republicans have come under attack for being against all offsets, yet this assertion has no merit. Senate Republicans have publicly discussed an alternative to end the stalemate on the extenders, one that pays for the extenders but in the form of <u>decreased spending</u>, not <u>increased taxes</u>. To further illustrate the Republican position and in an attempt to break the impasse on the time-sensitive tax extenders, Senate Republican Leader Mitch McConnell wrote a letter to Senate Majority Leader Harry Reid and Speaker Nancy Pelosi. According to the letter dated July 3, 2008:

> "The Senate Republican Conference will agree to offset the revenue lost from new tax relief policy with spending reductions or revenue raised from appropriate tax policy proposals. In exchange, the House and Senate Democratic Leadership would revise the desired new non-defense discretionary spending in the 2009 Congressional budget downward to a level sufficient to offset the cost (relative to the Congressional Budget Office baseline) of extending expiring tax relief. If agreed to, extension of expiring tax relief, including extension of the AMT patch and expiring energy tax incentives, could be accomplished in a way that achieves

> your stated goal of being deficit neutral, but without the unstated and unwarranted result of increasing the size of the federal government."

Thus, appropriate offsets, such as cuts in non-defense discretionary spending, are clearly on the table and to assert otherwise is disingenuous.

At a time when the economy is fragile, enacting tax increases in order to offset the extenders to satisfy a biased PAYGO rule would only exacerbate the current economic hardships. According to an editorial from the *Wall Street Journal* by two well-known economic experts, "A good rule of thumb is that a $1 tax cut includes $1 to $2 of additional economic *growth*. Conversely, tax increases are bad because they impair economic growth, making people worse off by several multiples of the extra amount of tax revenue the government collects. Generally speaking, each additional $1 of tax revenue cost the economy not only the $1 of tax but an additional $1 to $2 in *lost income*."[1] [Emphasis added]

Democrats pick and choose when to ignore their own PAYGO rules

Even with the disparate treatment of tax and spending programs under PAYGO, the Democratic Congress still has been unable to abide by their *own* rules and has chosen to effectively waive PAYGO again and again to increase spending without insisting on offsets. Yet it should be noted that these similar waivers from the majority are much more difficult to come by with regard to tax policy.

This year and last year alone, the Senate considered $355 billion in new legislation (excluding the 2007 AMT patch) without paying for it by using budget gimmicks and violations to circumvent PAYGO. Of the $355 billion of PAYGO avoidance, $66 billion was the result of blatant PAYGO violations. Additionally, Democrats have repeatedly used the emergency designation to exempt spending from being subject to PAYGO, totaling $201 billion, and they used a series of budget gimmicks to avoid PAYGO for legislation totaling $88 billion.

Because emergency spending is not subject to PAYGO rules, the emergency designation was used to avoid PAYGO violations for increased mandatory spending in several instances in 2007 and 2008.

Notable instances where PAYGO was ignored or waived under the Democratic-controlled Senate include (costs over ten years):

- 2008 Emergency Supplemental (H.R. 2642)
    - Unemployment insurance extension – $8.2 billion
    - Veterans education benefits – $62.8 billion
- 2008 Stimulus rebate checks (H.R. 5140) – $125.5 billion
- Foreclosure Prevention Act of 2008 (H.R. 3221, as passed by the Senate 4/10/08) – $26.4 billion

---

[1] Ernest S. Christian and William E. Frenzel, "The Fiscal Bottom Line," *Wall Street Journal*, April 16, 2007.

- 2007 Emergency Supplemental (H.R. 1591)
    - Extended county payments and Payments in Lieu of Taxes, declared "emergency" – $4.1 billion
- Immigration Reform (S. 1348, Democrats' substitute amendment) – $30.3 billion
- Energy Act of 2007 (H.R. 6, Democrats' substitute amendment) – $4.2 billion
- Mental Health Parity (S. 558) – $2.8 billion

Even in the instances where Democrats have attempted to abide by their PAYGO rule, increased taxes have been heavily preferred to offset increased spending—cutting spending is frequently not an option for the Democratic majority. For instance, recently when a $63 billion increase in veterans education benefits was considered as part of the 2008 Emergency Supplemental (H.R. 2642), House Blue Dogs insisted that the increased spending be offset. However, instead of considering a cut in existing or future spending to pay for the new program, they included a new marginal tax rate increase of 0.47 percent on individuals earning more than $500,000 a year (which they dubbed the "patriot tax").

A further illustration of the Democrats' tax and spend mantra is magnified in the Democrats' proposed energy bill, S. 3044, the Consumer-First Energy Act of 2008. S. 3044 established a punitive windfall profits tax on major integrated oil companies. Instead of using the proposed increased revenues for deficit reduction, the money collected from taxing these oil and gas companies was immediately designated to fund an Energy Independence and Security Trust Fund. The "Fund" would be available to spend with only minimal direction on new spending programs.

In addition, it is important to remember that PAYGO only applies to mandatory spending—it does not apply to the more than $1 trillion that Congress will appropriate for discretionary spending for 2009, or the $316 billion increase in non-defense discretionary spending that the Democrats' budget resolution assumes over the next ten years. The Congressional Budget Office (CBO) baseline already assumes an increase in non-defense discretionary spending at the rate of inflation after 2008, but the Democratic budget resolution which was recently passed assumes an additional $316 billion in increased spending *on top of inflation*. Because this spending is discretionary, these spending increases also will be allowed to occur without being subject to PAYGO rules, and without requiring any offsets.

Although the future discretionary increases are not specified for particular programs, this year's increases provide some guidance for how the money may be spent over the next ten years. In FY 2009 alone, the Democrats' budget assumes $5.4 billion in increased non-defense discretionary spending over the baseline. Senator Kent Conrad indicated that the spending increase was intended to increase such things as weatherization assistance ($450 million), the Great Lakes Legacy Act ($175 million), and the Health Professions program ($369 million), all of which were either significantly cut or eliminated in the President's budget.

It is clear that some citizens will find these programs valuable. However, it is unclear why these programs should be funded as part of an un-offset $316 billion increase in discretionary spending, while equally valuable tax provisions face expiration if they aren't paid for.

Conclusion

At a time when businesses and individual taxpayers are relying on Congress to pass an extenders bill in a timely manner, Democrats' insistence on abiding by PAYGO has put a virtual hold on quick passage. As Senator Charles Grassley wrote in a memorandum to reporters and editors on June 10, 2008:

> "The Democratic leadership's notion of proper budgeting is that expiring spending and appropriations get a free pass, but current law levels of taxation must go up. This double standard is like a game of billiards. In this billiard game, the taxpayer sits in the path of the pay-go "8 ball" and the big spenders hold the cue stick. The position of the Democratic Leadership is that this double-standard favoring spending and disfavoring the American taxpayer must be enforced with this year's expired and expiring tax relief provisions."

Lawmakers should stop using PAYGO as a mask of fiscal responsibility, ignoring increases in spending, and holding continuations in spending programs and current tax law to different standards.