

## **Section-by-Section Analysis and Explanation of the "Statutory Pay-As-You-Go Act of 2009"**

### **Summary.**

The legislation reestablishes a statutory pay-as-you-go rule (PAYGO), requiring that new mandatory spending increases or tax reductions be fully offset, or "paid for."

The PAYGO Act would apply to legislation enacted through the end of 2013, so it would cover five fiscal years, 2010-2014. For legislation enacted during this period, the Office of Management and Budget would estimate its cost over a ten-year period under the estimating rules specified by this Act. The average annual cost (or savings) over this ten-year period would then be entered in the appropriate columns of the "PAYGO ledger."

As in the statutory PAYGO rule that was created by the Budget Enforcement Act of 1990 and expired in 2002, this new PAYGO rule would be enforced by sequestration. If new legislation increasing mandatory spending or reducing tax revenues were not fully paid for by the time Congress adjourns, the President would be required to reduce non-exempt mandatory programs by an amount sufficient to pay for the net mandatory spending increases or tax reductions; the sequestration would offset the average debit or net cost recorded on the PAYGO ledger.

The Act specifies how the sequestration, if one were necessary, would run. As under the 1990 law, a number of accounts – including Social Security, most benefits for veterans, refundable tax credits, and programs focused on low-income populations – would be exempt from sequestration. The remaining mandatory spending would be cut by a uniform percent sufficient to pay off the debit in the budget year, with the exception that Medicare would be limited to a four percent reduction.

In four policy areas – the Medicare sustainable growth rate formula (SGR), the estate tax, the Alternative Minimum Tax (AMT), and the 2001 and 2003 income tax reductions – "current policy" deviates substantially from "current law." In each of these areas, the policies currently in place are set to expire or substantially change within the next 18 months in ways that unrealistically reduce costs – for instance, payments to doctors under Medicare are scheduled to be cut by 21 percent next year under the SGR, and the 2001 and the 2003 tax cuts are scheduled to expire entirely at the end of 2010. For these four areas, the PAYGO statute would not require a continuation of current policy to be paid for.

In 2007 both houses of Congress took an important step toward restoring fiscal discipline by using congressional rules to restore enforcement of the PAYGO principle. This PAYGO statute is meant to serve as a supplement to these rules, providing an enforcement mechanism, sequestration, that is unavailable without statutory PAYGO. Sequestration is designed to be a threat, not a remedy; it is intended to increase the number of persons and groups who have a stake in maintaining the PAYGO principle rather than allowing its violation. The combination of congressional PAYGO rules and statutory PAYGO would better facilitate the hard decisions necessary to maintain fiscal discipline than either of these mechanisms alone.

## **Section-by-Section Analysis and Explanation.**

Sections 1 through 8 of the legislation create a freestanding law defining terms, setting forth rules for scoring and measuring tax and mandatory spending legislation, and providing for a sequestration if the legislation is not budget neutral in net. These sections are based on the PAYGO provisions enacted in 1990, but largely replace rather than revive the 1990 statute. Sections 9 through 12, however, amend the 1990 law with respect to the baseline, the list of mandatory programs exempt from sequestration, and some other matters; the freestanding provisions enacted in section 1 through 8 operate in part by cross-reference to existing or amended portions of the 1990 law.

**Section 1** creates a short title, the Statutory Pay-As-You-Go Act of 2009, and lays out a table of contents.

**Section 2** states the purpose of the Act, re-establishing a statutory procedure to enforce a rule of budget neutrality on new tax and mandatory spending legislation. This section also sets an expiration date of December 31, 2013, for Sections 1 through 8. Sections 9 through 12 would be permanent. Because this Act employs the threat of sequestration through fiscal year 2014, if a sequestration for that year is required, the Act would continue to operate with respect to that sequestration order for as long as that order remains in effect. Because sequestrations in a few programs (such as crop support payments and Medicare) operate on a 12-month basis that does not necessarily correspond to the fiscal or calendar year, a sequestration for FY 2014 might remain in effect through the end of calendar 2014 and possibly into the beginning of 2015.

**Section 3** sets forth definitions. Many terms are defined by simple cross-references to the standard definitions used in other budget laws. A number of these definitions deserve further comment.

- **Budgetary effects.** PAYGO applies only to legislation with "budgetary effects." "Budgetary effects" are here defined as the amounts by which PAYGO legislation changes mandatory outlays or revenues relative to the baseline; thus, PAYGO is limited to these areas. Note that off-budget effects (e.g., Social Security) and debt service effects are not counted as budgetary effects.
- **Mandatory outlays.** The term "mandatory outlays" is essential to the definition of "budgetary effects." As defined in the Act, it refers to outlays flowing from: (A) budget authority provided by laws other than appropriations Acts; (B) entitlement laws; or (C) the Supplemental Nutrition Assistance Program.
- **Entitlement law.** The key to the definition of entitlement law is that an entitlement exists when a provision of law mandates that payments be made even if the funding needed to make those payments, to be provided in a subsequent law, is inadequate or nonexistent.<sup>1</sup>

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<sup>1</sup> Sometimes the same law that establishes a mandate in one provision conditions that mandate on the availability of funding – and then provides the funding in a separate section of the same law. In this case, the law is an entitlement

- **PAYGO legislation or a PAYGO Act.** Laws increasing or reducing revenues or increasing or reducing the cost of mandatory programs are PAYGO laws. The changes in the estimated or projected levels of revenues and mandatory spending are measured relative to what revenues or mandatory spending would otherwise have been if not for the legislation, as measured by the baseline defined in the 1990 statute, section 257 of the Balanced Budget And Emergency Deficit Control Act (BBEDCA) of 1975 as amended (including as amended by section 9 of this legislation<sup>2</sup>).

In addition, this term defines the treatment of legislative language contained in appropriations bills: if an appropriations bill contains changes to tax or mandatory law, those changes are considered discretionary in the current and budget years, since the Appropriations Committees can offset the costs or use the savings by adjusting funding levels for discretionary programs in the current and budget years. But any outyear effects of such tax or mandatory program language are considered PAYGO legislation.

- **PAYGO ledger.** The PAYGO ledger is defined as covering five fiscal years, from 2010-2014. As described in section 5, the net sum of "budgetary effects" of PAYGO legislation entered on the PAYGO ledger determines whether a sequestration is triggered in these years. That is, each fiscal year is a column on the ledger, and if the sum of the entries in the column is a debit – because net mandatory spending increases exceed net revenue increases, or net revenue losses exceed net mandatory spending reductions – then a sequestration must be ordered.
- **Timing shift.** To prevent gaming of the PAYGO system, the Act defines "timing shifts," which are not counted for purposes of PAYGO. A "timing shift" involves a shift of costs from within the PAYGO window to outside the window (or savings from outside the window to within the window). More technically, the term is defined to refer to a delay of the date on which mandatory outlays would otherwise occur from the ninth outyear (the last year taken into account in the PAYGO calculation) to the tenth outyear (not taken into account in the PAYGO calculation) or an acceleration of the date on which revenues or offsetting receipts or collections would otherwise occur from the tenth outyear to the ninth outyear.

**Section 4** describes how estimates for purposes of PAYGO are to be made and details how the PAYGO ledger works.

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if the first provision is a clear mandate *aside from* the conditionality, but is not an entitlement if the first condition merely establishes the purposes for which the funding provided elsewhere in the statute is authorized to be used.

<sup>2</sup> There are a few cases in which the 1990 baseline does not literally follow "current law," that is, law as it is currently scheduled to be in effect in each future year.

The Office of Management and Budget (OMB) is assigned the responsibility of maintaining the PAYGO ledger, as it was under the 1990 law.<sup>3</sup> This Section imposes a number of important requirements on how the ledger is to be kept:

- **Release of PAYGO estimates.** The PAYGO ledger maintained by OMB is to be publicly available and regularly updated. No more than seven days (excluding weekends and legal holidays) after the enactment of any PAYGO legislation, OMB is to enter on the ledger its estimate of the legislation's budgetary effects. OMB must explain any significant deviations between its estimates and those of the Congressional Budget Office (CBO), which is required to submit its estimates of PAYGO legislation to OMB as soon as practicable.
- **Basis of estimates.** All estimates of budgetary effects of PAYGO legislation are to be done on the basis of the economic and technical assumptions underlying the latest President's Budget. The estimates will use probabilistic methods where appropriate, e.g., in evaluating "one-sided bets," in which costs increase on one side of a boundary or threshold but do not decrease symmetrically on the other side. Once entered onto the ledger, budgetary effects are only to be changed in order to correct an error in the original estimate – but not, for instance, in light of new economic or technical assumptions.

Estimates are to be prepared in conformance with scorekeeping guidelines determined after consultation among the House and Senate Committees on the Budget, CBO, and OMB. Since 1990, the Executive and Legislative Branches have chosen to employ nearly identical scorekeeping procedures, concepts, approaches, and guidelines.

- **Averaging.** For the budget year and any remaining years (columns) on the PAYGO ledger, OMB is to enter the ten-year annual average budgetary effect associated with PAYGO legislation. This ten-year window covers the budget year and the nine years that follow.

For instance, a bill that pays for itself over ten years will have a total, and thus average, score of zero, so zero would be entered in each column of the PAYGO ledger. If a bill enacted in 2009 costs a net of \$10 billion over 2009-2019, OMB would insert +\$1 billion in each of the five columns on the PAYGO ledger (FY10, 11, 12, 13, and 14). If a bill enacted in 2011 *saves* a net of \$5 billion over the period 2011-2021, OMB would insert \$-0.5 billion in the remaining three columns of the PAYGO ledger (FY12, 13, and 14).

- **Look back.** To take into account any budgetary effects of PAYGO legislation in the current year (i.e. the year of enactment), a "look back" rule is included. The rule provides that budgetary effects in the current year are to be treated as if they were budgetary effects in the budget year (which is the year subsequent to the current year). This is why

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<sup>3</sup> In holding the 1985 version of the BBEDCA unconstitutional, the Supreme Court ruled in 1986 that a legislative branch agency such as GAO or CBO cannot make determinations, such as bill cost estimates, that would have the effect of changing law, as a sequestration would do. Therefore, the 1987 and 1990 versions of BBEDCA, and this proposal, lodge estimating authority in OMB.

- **Timing shifts.** As noted, the PAYGO legislation would prevent gaming of the PAYGO rules via timing shifts. Timing shifts, as defined in Section 3, would not be taken into account for the purposes of estimating budgetary effects to be entered on the PAYGO ledger. Since the PAYGO ledger represent an average, timing shifts between any two years within the window do not affect the average in any case. This is why the proposal defines timing shifts to be those that occur between year ten and year eleven – that is where the possibility of gaming arises.
  
- **Treatment of program conversions.** The PAYGO statute is not meant to either encourage or discourage the budget-neutral conversion of programs from discretionary to mandatory or vice versa. But, without a special rule, the statute would treat the conversion of a program from discretionary to mandatory – even if projected outlays would remain exactly the same – as a cost to be entered on the PAYGO ledger. And the opposite conversion – from mandatory to discretionary – would be treated as a savings, even if no net savings would be produced once the additional discretionary spending were taken into account. To avoid this, the proposal provides that:
  - *Mandatory to discretionary conversion.* The conversion of an identifiable element of a mandatory program into a discretionary one would not be scored as reducing mandatory outlays.
  
  - *Discretionary to mandatory conversion.* The conversion of an identifiable element of a discretionary program into a mandatory one would be scored as having a budgetary effect equal to the difference between the amount by which the conversion increases mandatory outlays and the discretionary baseline outlays associated with the converted element of the discretionary program.

This treatment is consistent with scorekeeping rule #13, previously agreed to by Congress and the Executive, but that rule has not always been adhered to.

- **Emergency legislation.** The statute allows Congress and the President to declare emergency exceptions to the PAYGO rules. For such an emergency exception to be declared, Congress must, in statute, designate the relevant legislation or portions of it to be an emergency, and the President must separately do so as well; his signature on the statutory designation does not by itself constitute a presidential agreement that the cost is an emergency. If both these requirements are met, the budgetary effects of the emergency legislation are displayed as an addendum to the PAYGO ledger and are not entered into the ledger itself. Note that the President and the Congress might declare some provisions of a statute to be emergencies and others not, in which case only those provisions that both agree are emergencies are excluded from the PAYGO ledger. In the early 1990s, Congress and the President agreed that a temporary continuation of extended unemployment benefits while unemployment was exceptionally high because of a recession was an emergency.

**Section 5** defines the timing of the annual PAYGO report and, if one is needed, the sequestration order.

- **Annual report.** OMB is to produce an annual PAYGO report. The report is to include an up-to-date PAYGO ledger, as well as other information, such as about estimating differences between OMB and CBO (also required under Section 4) and about any sequestration if required. The report is to be released no more than 14 days (excluding weekends and legal holidays) after Congress adjourns to end a session.
- **Sequestration order.** If the annual report shows a debit (i.e., net budgetary cost) on the PAYGO ledger for the budget year, the President is required to issue an order sequestering obligation authority from non-exempt mandatory programs sufficient to fully pay off that debit. If the President issues this order, then the PAYGO annual report must contain its details, including such information as the outlay reductions that would occur in the budget year and the subsequent fiscal year for each affected account.

**Section 6** describes how sequestration is to be implemented if triggered. It should be noted that most mandatory programs, such as Social Security, veterans' disability and related benefits, and major low-income entitlements such as Supplemental Security Income and Medicaid, are totally exempt from sequestration. (Section 12 updates the 1990s list but does not change its approach or character.) With the exception of Medicare, *non-exempt* mandatory programs would be cut by a uniform percent, such that the outlay savings produced in the budget year and the subsequent fiscal year would be sufficient to fully offset the budget-year debit on the PAYGO ledger. Medicare can be cut by at most four percent. If a larger cut than four percent is needed to offset the debit on the PAYGO ledger, the uniform percentage cut to the other non-exempt mandatory programs would be increased so that the sequester of Medicare and the other non-exempt programs would together produce sufficient savings to offset the budget-year debit.

Sequestrations are temporary, not permanent, and with a few exceptions occur only in the budget year. Some points are worth noting.

- The uniform sequestration percentage is intended to reduce mandatory obligations in non-exempt programs by a specified percent over the course of the entire fiscal year. If a sequestration starts a month or more into the fiscal year because Congress adjourns in November or even December, then the reduction during the *remaining* 9, 10, or 11 months of the fiscal year will be a bit larger than the uniform percentage so that the average sequestration over the year equals the required uniform percentage.
- In the case of Medicare, the sequestration lasts for a full 12 months even if it takes effect after the beginning of the fiscal year, in which case it will run into the start of the next fiscal year. This approach means that the uniform percentage cut in payments to providers or insurance plans will not be higher at any time than the four percent limit (or the calculated uniform percentage, if lower).<sup>4</sup>

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<sup>4</sup> If sequestrations are required in two consecutive years, there will be no overlapping sequestration; the second will start no earlier than the first ends.

- In the case of price support payments for crops, the sequestration for any given crop will start at the beginning of the next crop year. As a consequence, sequestrations for crops will not all be running concurrently, and some sequestrations may occur partly in the following fiscal year.

**Section 7** establishes a temporary scoring rule for purposes of statutory PAYGO, to adjust for the substantial deviation between "current policy" and "current law" in four policy areas: Medicare's "Sustainable Growth Rate" for paying physicians under Part B, the estate tax, the AMT, and the 2001 and 2003 income tax cuts. As noted in the summary, the policies currently in place in each of these areas are set to expire or substantially change in the coming years in ways that unrealistically reduce costs – scheduled cost reductions that in most cases are quite unlikely to occur. For these four areas where current law does not reflect current policy, the PAYGO statute would not require a continuation of current policy to be paid for.

Note that this scoring rule would apply only for the purposes of statutory PAYGO. For other purposes, including the Congressional Budget Act and the congressional PAYGO rules, such legislation would still be scored as it is currently.

- **General approach.** The statute defines a "current policy projection" and an "initial current law projection" with respect to the SGR, estate tax, AMT, and Bush tax cuts. The current policy projection equals 2009 or 2010 policy made permanent, while the "initial current law projection" represents the projection under the laws in place as of now. The policy assumption behind these two projections would not be affected by the enactment of later legislation, and the two projections are independent of the §257 baseline against which PAYGO legislation would otherwise be scored.

If a bill in one of the four areas is enacted and its costs in a given fiscal year fall between the two projections, the bill is considered to have zero cost or savings for that fiscal year. If the bill is more costly than the current policy projection, the excess cost is a PAYGO cost and is recorded on the PAYGO ledger. If it is less costly than the initial current law projection, the savings is scored. (Note, though, that the system works somewhat differently for the estate tax in 2010. This is because, in 2010, the initial current law projection is more costly than the current policy projection, so the relationship between the initial current law projection and current policy projection is reversed for that year.)

- **Duration.** The two projections, and the attendant scoring, remain in effect through the end of 2010. At that point, they cease to exist, and any new legislation in these areas would be measured, like other legislation, relative to the standard baseline under §257 of BBEDCA.

As an exception, if the President determines that "legislation substantially consistent with current policy" has not been enacted in any one or more of these four areas by the end of 2010, the two projections and the special scoring will remain in place with respect to that area or those areas for one more year or until such legislation has been enacted, whichever comes sooner.

The expectation is that within the next few years, the sharp divergence between current policy and current law with respect to those four areas of the budget will be resolved by legislation that constitutes a permanent policy without artificial sunsets or cliffs. After this occurs, that new legislation will be the base against which future legislation is measured, because the standard §257 baseline will again be the benchmark against which legislation is measured.

In short, for a temporary period, legislation in these four areas is scored (and the scores entered on the PAYGO ledger) only to the extent that its costs fall outside a range bounded by current policy on the one hand and current law on the other. As noted, there are four policy areas to which this section applies:

- **Medicare's SGR formula.** Under Medicare's SGR formula, Medicare's payments to physicians under Part B would automatically be cut by 21 percent next year, when this year's temporary fix expires. For purposes of Section 7, the "current policy projection" for Medicare Part B instead assumes that the nominal payment rates to physicians and related policies in effect for 2009 are permanently continued. Thus, under Section 7, legislation providing relief from the scheduled SGR cut would only be scored for PAYGO purposes to the extent that it costs more than this current policy projection (or less than the "initial current law projection").
- **Estate and gift tax.** Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate tax exemption was gradually increased and the tax rate gradually lowered until, as of this year, the exemption stands at \$3.5 million for an individual and \$7 million for a couple, and the rate is 45 percent for amounts above the exemption level. Under EGTRRA, the estate tax is scheduled to be entirely repealed in 2010, but then with EGTRRA's expiration at the end of that year, return to the parameters under pre-2001 law, with an exemption of \$1 million and a 55 percent rate.

Section 7 defines the "current policy projection" for the estate and gift tax as assuming that the tax rates, nominal exemption amounts, and related parameters in effect for tax year 2009 remain in effect thereafter. The "initial current law projection" assumes that the estate tax expires as scheduled in 2010 and then returns to its parameters under pre-2001 law thereafter.

For 2010 (when the estate tax is entirely repealed), legislation would only be scored to the extent that total revenues are lower because the legislation produces less estate and gift tax liability than under the initial current law projection or are higher because the legislation produces greater estate and gift tax liability than under the current policy projection.

For years thereafter, the relationship between the current policy projection and the initial current law projection reverses, with the former then producing less estate and gift tax revenue than the latter. So, for these years, legislation would only be scored to the extent that total revenues are greater because the legislation produces greater estate and gift tax



liability than under the initial current law projection or are lower because the legislation produces less estate and gift tax liability than under the current policy projection.

Because of the major behavioral interactions between the estate and gift tax and the income tax with respect to savings versus giving versus consumption, the test to see if policy falls outside the range is applied with respect to estate and gift tax liability in a tax year, but the scoring applies to the amount of total revenues over the a series of fiscal years caused by the incremental amount of estate and gift-tax liability in the tax year or years.

- **Alternative Minimum Tax.** With the expiration at the end of this year of the current AMT patch, which provides an increased AMT exemption for 2009, the number of AMT taxpayers would rise from about four million to about 30 million. The "current policy projection" assumes that this does not occur and that, instead, the AMT's 2009 exemption amounts and related parameters are continued thereafter, indexed to inflation.

As long as Section 7 is in effect, AMT relief or reform would only be scored for PAYGO purposes to the extent that, as a result of that legislation, income tax revenue would be lower than under the current policy projection or higher than under the initial current law projection.

- **2001 and 2003 tax reductions.** The 2001 and 2003 income tax reductions enacted under EGTRRA and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) are scheduled to expire at the end of 2010. The "current policy projection" assumes that these expirations do not occur and that the income tax provisions in EGTRRA and JGTRRA as amended by later legislation (other than those provisions made permanent in the Pension Protection Act of 2006) are continued in future years as they are scheduled to be in effect in 2010.

Under Section 7, legislation relating to any of the provisions or rates set under EGTRRA or JGTRRA would only be scored for PAYGO purposes to the extent that income tax revenue is, as a result, estimated to be lower than under the current policy projection or higher than under the initial current law projection. Note that EGTRRA and JGTRRA included amendments dealing with refundable tax credits such as the Child Tax Credit, and those tax credits are considered increase in outlays rather than reductions in revenues. Therefore, a more precise statement is that scoring for PAYGO purposes occurs to the extent that income tax revenues are lower than, and outlays for refundable tax credits are higher than, under the current policy projection. The scoring with respect to the initial current law projection is analogous.

In the case of the AMT and EGTRRA and JGTRRA, it is plausible or likely that a single bill may address more than one of the provisions of these laws. In that case, this proposal requires that the wedge between the current policy and the initial current law projection is calculated separately for each provision of the AMT, EGGTRRA, and JGTRRA.<sup>5</sup> Thus, tax legislation will be scored to the extent that any one (or more) of its individual provisions falls outside the wedge

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<sup>5</sup> For this purpose, each individual income tax rate is considered to be a separate provision.

associated with that provision, even if the bill as a whole produces revenues that are inside the "sum of all wedges."

Because of relationships among the AMT, tax rates, and other tax provisions such as Pease and PEP, there also needs to be an estimating and scoring rule that accounts for interactive effects in determining which provisions (if any) have costs that fall outside their respective wedges. This proposal provides that, in estimating a bill dealing with a *single* provision of the AMT, EGTRRA, or JGTRRA, it is assumed that the other provisions of those laws are as under the §257 baseline, i.e., as they are actually scheduled to apply. And in estimating a bill dealing with *more than one* of the AMT and a provision or provisions in EGTRRA or JGTRRA, the AMT provision is stacked (and tested against the AMT's wedge) first, and each subsequent provision is then scored assuming the enactment of the proposed AMT provision and the enactment of each provision in that legislation already scored.

**Section 8** makes the list of exempt accounts in section 255 of BBEDCA, the special sequestration rules in §256 of BBEDCA, and the baseline rules in §257 of BBEDCA apply to this new PAYGO statute, just as they applied to the original PAYGO statute. It accomplishes this by overriding the expiration of those three sections of BBEDCA for the purposes of this proposal, and by interpreting some terms, and cross-references to other provisions of the original PAYGIO law, contained in those three sections as applicable to the analogous terms and provisions in this proposal.

**Section 9** amends the baseline in §257 of BBEDCA. Because §257 has a life of its own, these amendments could affect other applications of the baseline.

- The rule for the baseline treatment of entire mandatory programs that expire is returned to the form it took in 1990, which treats all such entire programs with annual costs greater than \$50 million the same; when such a program is created or extended "temporarily," the costs are assumed to be permanent.
- The standard practice OMB and CBO have used for entitlement benefits in insurance programs (Social Insurance, Deposit Insurance, Pension Insurance, and so on) is to assume that the benefits will be paid even if the resources of the trust, special, or revolving fund that pays them are inadequate. This long-time approach is codified.
- The rule for reflecting the BA needed to renew expiring multiyear housing contracts (for which there was no BA in the base year because the contracts were enacted before the period covered by the baseline) is clarified to provide that the renewal contracts should be assumed to be 12-month contracts. The previous rule was not clear about the duration of the assumed renewal contracts.
- A new rule is created to bring consistency between the scoring of the Pell program as a discretionary program and its projection as a discretionary program.<sup>6</sup> CBO and OMB

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<sup>6</sup> The Administration proposes to convert the Pell program to an entitlement. If and when that occurs, this language would no longer govern the projection of Pell grants, which instead would be projected consistent with the requirements of the entitlement law. But until that occurs, this proposed language would govern.

score the amount of discretionary BA for Pell grants as though it were a quasi-entitlement; the amount of BA scored is not necessarily the amount actually appropriated, but rather the amount estimated to be needed given any shortfalls or surpluses, and given the level of the "maximum award" specified in law (usually in that appropriations bill).<sup>7</sup> The projection rule would be made similar: BA would be projected based on any shortfall or surplus, and based on the cost of the programs given the award level in law (which would not be inflated). Thus, BA would grow with caseload rather than with inflation, and the base level would be the level actually needed in the base year, which may not be the same as the level provided in appropriations.

- The existing rule for annualizing pay raises when projecting Federal funding for salaries and expenses is repealed; that rule turned out to be in error and overstated baseline costs.
- A new rule for projecting the Federal costs for natural disasters is created. Under existing projection rules, whatever amounts happen to have been appropriated in the base year are projected forward. This could produce massive overstatements of future disaster costs (e.g., in the year after hurricane Katrina) or noticeable understatements if no disasters had yet occurred in the base year. The new rule inserts, in lieu of the inflated level of base-year BA, a probabilistic estimate (which CBO and OMB will have to make based on their best analysis and research) of the Federal exposure to the risk of major natural or man-made disasters that have not yet occurred. This type of approach to considering the costs of future disasters has been recommended by GAO.

**Section 10** corrects a few typographical errors in the text of the original law that is referred to in this proposal.

**Section 11** makes conforming amendments to section 256 of BBEDCA, the special rules for sequestration for those programs that are subject to sequestration and for which it is not enough to know that a percentage cut would apply to funding or benefits.

Of the mandatory programs that are subject to sequestration, many are simple grants to States. In those cases, a sequestration would do no more than reduce the size of an annual grant by the uniform percentage. Thus, if the sequestration percentage were two percent, the total amount of a grant paid to a State during the fiscal year of the sequestration would be reduced two percent. If grant payments to a State are made monthly (for example) and the sequestration does not start until one or more months into the fiscal year, the percentage reduction in payments would be slightly higher in each of the remaining months of the fiscal year so that the total cut would equal two percent for the entire fiscal year. As discussed earlier, cuts to Medicare providers are handled differently; in the case of Medicare, if a sequestration starts one or more months after the start of the fiscal year, it remains in effect for a total of 12 months and so can continue into the start of the next fiscal year. This way, the required percentage cut (which is capped at four percent in any case) does not increase slightly during the remaining months of the fiscal year.

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<sup>7</sup> One reason this scoring rule was adopted in recent years is that the level of BA, even if inadequate, did not restrain programs spending because the programs could "borrow" against the next year's appropriation. Thus, since BA was not a constraint on spending, it made sense to score the amount BA consistent with expected costs.

(Because a Medicare sequestration of 12 months can extend beyond the end of a fiscal year, there is an additional rule that if two successive sequestrations occur, the second does not start until the first ends.)

**Section 12** restates the list of exempt programs and activities, correcting account names and numbers where they have changed, and adding some accounts enacted since 1990.

During the 1990 development of the original PAYGO statute, a considerable amount of time, attention, and concern was devoted to the exemption list. Hindsight reveals that the exemption list may be of less significance than meets the eye. Recall that sequestration is not conceived of as a desirable outcome or a remedy, but rather as a threat or penalty designed to promote compliance with the PAYGO rule. From 1990 to 1999, that conception proved valid; Congress complied with the PAYGO rule and there was never a PAYGO sequestration. Starting in 1999 and lasting through the expiration of the statute in 2002, Congress began to violate the rule, first in small ways and then large ways. In each such case, though, Congress also enacted legislation exempting the violations from PAYGO enforcement – again, there was no sequestration. This history – in which a PAYGO sequestration never occurred – suggests that a program's presence or absence from the exemption list is a less important question than it might appear at first.

The approach in this proposal is to remain as consistent as possible with the exemption list that was created in 1990. Therefore, accounts or programs that were fully exempt in 1990 remain exempt, and those subject to sequestration remain so.

This proposal would amend the exemption list, however, for a number of reasons. To begin with, many accounts have changed their names or account numbers since 1990, or have been merged or have divided; for this reason the list needs to be updated, even though this does not change the status of the programs concerned. In addition, there are a considerable number of new accounts that have been created since 1990 or since the last update in 1997. This proposal treats new accounts the same way that analogous prior accounts were treated. For example, in the 1990 law the major low-income programs such as Medicaid were exempted from sequestration. The Children's Health Insurance Program (CHIP), new since 1990, is placed in the same category as Medicaid and therefore added to the exempt list.

There are four special cases that deserve mention. In section 6, the sequestration mechanism is described; all non-exempt accounts are subject to a single, uniform percentage cut if a sequestration is required (except Medicare, where the cut is limited to four percent). This approach is a notable simplification of the 1990 law, which placed four programs at the head of the line to be sequestered; if a small sequestration was needed, those four programs would be the first ones sequestered and the sequestration would be a specified amount unrelated to the size of the PAYGO violation. With a very small violation and therefore very small sequestration, those four programs would be reduced while the programs in the general pot could be completely spared. The four programs are special milk, vocational rehabilitation state grants, student loans, and foster care / adoption assistance. The proposal moves the first three of those programs to the general pot, removing them from the head of the line, and exempts the foster care program on the grounds that it is like other low-income programs that were exempted from sequestration in the 1990 law.