EXTENDING THE *BUDGET ENFORCEMENT ACT*: REVISION OF PAYGO RULES NECESSARY FOR BETTER TAX POLICY

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Abstract

In the Federal budget process, the pay-as-you-go (PAYGO) principle as set forth in the *Budget Enforcement Act* (BEA) requires that all enacted direct spending and tax legislation for a fiscal year must be deficit-neutral in the aggregate. PAYGO rules have been generally praised by proponents for restraining new spending and for encouraging legislators to provide reasons for their budget decisions. Opponents have pointed to unconstrained federal spending, and frequent budget artifices as examples of the failure of PAYGO. In addition, the PAYGO rules raise excessive procedural hurdles for tax relief legislation. Numerous scholars and practitioners in the field have addressed the pros and cons of PAYGO, including the need for changing PAYGO rules or eliminating them altogether. The current PAYGO provisions are set to expire with the BEA after fiscal year 2002.

This paper concludes that if the PAYGO requirements as set forth in the *Budget Enforcement Act* are to be extended, then at a minimum a compromise approach be adopted to reform PAYGO: to permit dynamic revenue analysis of tax legislation, or at the very least allow legislation providing appropriate tax deferrals (such as contributions to IRAs) to be exempt from PAYGO requirements. This paper discusses budget enforcement and the PAYGO concept, then identifies the problems associated with PAYGO and how PAYGO often leads to counterproductive tax policy decisions. The paper also reviews the mixed success of PAYGO in controlling federal spending. The paper then demonstrates how a reform that would allow legislation providing appropriate tax deferral to be exempt from PAYGO rules would allow both fiscal responsibility and good tax policy by promoting incentives for taxpayers to save and invest, and potentially increasing revenue to the government.

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> Because the context for the coming debate about extending the BEA is likely to be quite different from the context in earlier years, it may prompt a wider look at the budget process and related issues.
>
> *Dan L. Crippen*[1]

I. IN PURSUIT OF FISCAL DISCIPLINE, THE PAY-AS-YOU-GO REQUIREMENT

A Tool to Constrain Deficit Spending

In response to growing federal spending over the past two decades, policymakers have created an elaborate framework of procedures to control federal spending.[2] One such procedure aimed at reining in federal deficit spending is the pay-as-you-go (PAYGO) mechanism. Congress established the pay-as-you-go requirement with the passage of the *Budget Enforcement Act of 1990* (BEA),[3] as part of a previously existing law, the *Balanced Budget and Emergency Control Act of 1985*.[4] The PAYGO mechanism was originally designed with a sunset date of fiscal year 1995. However, PAYGO has twice been extended, first through FY1998[5] and again through FY2002.[6]

Although currently scheduled to expire at the end of FY2002, the PAYGO process would still remain in effect through FY2006 to capture the out-year effects of legislation enacted prior to the end of FY2002, and therefore still subject to PAYGO rules. The Bush Administration has credited the PAYGO mechanism as an effective means of restraining federal spending growth and recommends extending the PAYGO mechanism.[7] Additionally, Mitch E. Daniels Jr., director of the Office of Management and Budget

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[1] Statement of Dan L. Crippen. Director, Congressional Budget Office, before the Committee on the Budget, U.S. House of Representatives, June 27, 2001.

[2] Edward Davis, "The Evolution of Federal Spending Controls: A Brief Overview," *Public Budgeting & Finance*, Fall 1997, page 10.

[3] Title XIII of P.L. 101-508, *Omnibus Reconciliation Act of 1990*.

[4] Title II of P.L. 99-177.

[5] Title XIV of P.L. 103-66, *Omnibus Budget Reconciliation Act of 1993*.

[6] Title X of P.L. 105-33, *Balanced Budget Act of 1997* and *Budget Enforcement Act of 1997*.

[7] Executive Office of the President, Office of Management and Budget, *A Blueprint For New Beginnings – A Responsible Budget For America's Priorities, Fiscal Year 2002*, Washington, DC, February 2001, pages 170-173.

(OMB), testified before the House Budget Committee "the (BEA) has served very well and should continue in some amended fashion."[8]

Numerous scholars and practitioners have studied the effects PAYGO rules have had on budget and tax processes and policies, addressed concerns with PAYGO requirements, and suggested remedies or repeal.[9] While PAYGO rules seek to restrain fiscal spending, the focus on deficit control inherent in PAYGO often leads to unintended and perverse effects on both tax and expenditure policy.

Budget Enforcement and PAYGO

The *Budget Enforcement Act of 1990* (BEA) classifies spending into two types: discretionary spending and direct spending. Discretionary spending is controlled through annual appropriations and includes such items as defense spending, operating costs of federal agencies and many grants to state and local governments. Direct spending, or mandatory spending as it is more commonly called, is controlled by permanent laws and includes federal entitlement programs such as Social Security, Medicare, Medicaid, and unemployment insurance benefits.

Discretionary spending is divided into separate categories. For each fiscal year a dollar limit on total discretionary spending is outlined for each category. These limits are more commonly known as spending "caps." If the amount of budget authority provided for a given year exceeds the caps, or if actual outlays in a given year are estimated to exceed the outlay caps, then the BEA requires a budget sequestration. Under a budget sequestration, spending for programs in a defined budget category that has exceeded the caps generally is reduced by some uniform percentage.

With respect to mandatory spending and revenue, the current budget procedures do not cap mandatory spending or require a certain level of revenue. Instead, the budget rules require that all laws enacted through FY2002 that affect direct spending or receipts be budget neutral, or enacted on a "pay-as-you-go," or PAYGO basis. Otherwise, a sequestration (sometimes called a "PAYGO sequestration" to distinguish from a sequestration of discretionary spending) would be triggered at the end of the session of Congress in the fiscal year in which an increase in the deficit would otherwise occur. The sequestration procedures generally require a uniform reduction of direct spending from such programs that are not classified as exempt from sequestration or subject to special rules. Programs that are exempt from sequestration include Social Security,

[8] *Tax Notes*, "Budget Heads Say PAYGO, Spending Caps Need Updated," June 28, 2001.

[9] See, for example: Edward Davis, "The Evolution of Federal Spending Controls: A Brief Overview," *Public Budgeting & Finance*, Fall 1997; Michael J. Graetz, "Paint-by-Numbers Tax Lawmaking," *The Columbia Law Review*, April 1995; Robert D. Reischauer, "Taxes and Spending Under Gramm-Rudman-Hollings," *National Tax Journal*, September 1990; Eugene Steuerle, "Fair Budget Policy, Bad Tax Policy," *Tax Notes*, July 24, 1989; and "Interview with Martin Feldstein – 'Dynamic Scoring' for Sounder Budget Policy," *Challenge*, May/June 1995.

interest on the federal debt and many entitlement programs. A special rule, for example, limits the potential sequestration of Medicare spending to four percent. As a result of exemptions and special rules, only about *three percent* of all direct spending is subject to sequestration.[10]

PAYGO means that if mandatory spending legislation or tax legislation is passed that either increases the deficit or reduces a surplus in the budget year or any of the four following years, another law must be enacted with an offsetting reduction in mandatory spending or an increase in revenue for each year that is affected.[11] Revenues are included under the same rules that apply to mandatory spending because, like mandatory spending, they are generally controlled by permanent laws. For purposes of determining a sequestration, PAYGO balances are kept on what is termed a PAYGO scorecard. The scorecard is maintained on a rolling basis and accumulates the budgetary effects of laws passed during a congressional session and for prior years beginning with FY1992.[12]

In general, PAYGO rules are designed to protect the current law budget baselines, a concept that itself has been subject to criticism. PAYGO rules protect these baselines because these rules do not apply to increases in direct spending or decreases in revenues that *are not* the result of new laws. PAYGO is designed to ensure that new legislation will be deficit neutral on net, not necessarily to reduce the size of the deficit. If spending for mandatory programs increases due to a rise in the eligible populations or an increase in the cost of living, then the PAYGO provisions do not apply. Likewise, if tax revenues decrease due to an economic downturn, then the PAYGO provisions also do not apply.

Specifically, with respect to tax legislation, any measure that results in a static[13] reduction of tax receipts over the course of a budget window is considered a "revenue loss," even if the tax proposal provides for a deferral, and not the elimination, of future tax revenue. Therefore, on net, any static revenue loss must be offset with either increases in other taxes or a reduction in direct spending equal to the estimated revenue loss. This is required even if the tax measure under consideration would result in a revenue increase if its dynamic macroeconomic effects were considered.

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[10] Executive Office of the President, Office of Management and Budget, *The Budget System and Concepts Fiscal Year 2003*, Washington, DC, February 2002, page 5.

[11] In practice, a procedural point of order can be raised in the House or Senate to enforce budget resolution policies that can impose PAYGO-like requirements during the consideration of legislation rather than after the session ends. For a more detailed explanation, See, for example: Executive Office of the President, Office of Management and Budget, *The Budget System and Concepts*, Washington, DC, April 2001; Robert Keith, "Pay-As-You-Go Requirement for FY2002: A Procedural Assessment," Congressional Research Service, Updated December 18, 2001; and Elizabeth Garrett, "Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process," *University of Chicago Law Review*, Spring 1998, page 510.

[12] Robert Keith, "Pay-As-You-Go Requirement for FY2002: A Procedural Assessment," Congressional Research Service, Updated December 18, 2001, page 2.

[13] In this context, "static" refers to revenue estimates made without incorporation of macroeconomic effects.

II. WHAT'S THE PROBLEM?

Proponents argue that budget enforcement rules, such as pay-as-you-go (PAYGO) requirements, restrain new spending and encourage legislators to provide reasons for their budget decisions.[14] However, opponents maintain that legislators are often forced to accept second- or third-best solutions to problems in an effort to stay within budget enforcement requirements.[15] Further, critics cite erroneously optimistic economic and technical assumptions and budget provisions adopted so that revenue and expenditure estimates appear to stay within budget enforcement requirements, even though they are being circumvented.[16]

Additionally, PAYGO rules have been criticized on the grounds that they inhibit legislators from enacting tax legislation that improves fairness, efficiency and simplicity in the tax system.[17] Furthermore, PAYGO rules make it more difficult to enact changes to the tax code that promote individual saving and investment. Such individual saving and investment are considered by many to be critical to the long-term health of our economy and to the financial well being of Americans who need to save for their future and retirement.[18]

One reason for these criticisms applies to the PAYGO relationship between mandatory spending and revenue. The rationale offered for this pairing is that permanent laws generally control revenues, like direct spending. Therefore, any legislation that results in a static revenue loss has to be offset, on net, with either a reduction in direct spending outlays or a revenue increase unless the budget rules are waived. This requirement prohibits Congress from reducing spending in discretionary spending programs in order to offset the static revenue loss associated with legislation that reduces taxes. Thus, the current PAYGO mechanism is biased against tax cuts. To offset the static revenue loss associated with a tax cut and to balance the PAYGO scorecard, Congress has to either raise taxes somewhere else or reduce direct spending in politically popular entitlement programs, instead of being allowed to reduce spending from discretionary programs.

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[14] Elizabeth Garrett, "Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process," *University of Chicago Law Review*, Spring 1998, page 504.

[15] Robert D. Reischauer, "Taxes and Spending Under Gramm-Rudman-Hollings," *National Tax Journal*, September 1990, page 223.

[16] Michael Bopp, "The Roles of Revenue Estimation and Scoring in the Federal Budget Process," *Tax Notes*, September 21, 1992; and Robert D. Reischauer, "Taxes and Spending Under Gramm-Rudman-Hollings," *National Tax Journal*, September 1990.

[17] Michael J. Graetz, "Paint-by-Numbers Tax Lawmaking," *The Columbia Law Review*, April 1995, pages 670-671; Steuerle, Eugene, "Fair Budget Policy, Bad Tax Policy," *Tax Notes*, July 24, 1989, page 455.

[18] For a discussion of this issue and helpful references, See: Brian W. Cashell, and Gail Makinen, "Saving in the United States: How Has It Changed and Why Is It Important?" Congressional Research Service, February 28, 2001.

Lastly, there is some historical confusion as to whether or not PAYGO rules even apply under budget surpluses. This becomes relevant if the government projects a surplus for any fiscal year over the budget horizon. This confusion arises over the original PAYGO requirement, which refers only to legislation "that increases the deficit."[19] Jacob Lew, then Director of the Clinton Administration Office of Management and Budget, indicated, "we believe that PAYGO does apply when there is an on-budget surplus."[20]

Bad Tax Policy

Tax policies are often evaluated based on three criteria: efficiency, equity and simplicity. An efficient tax policy is one that raises a given amount of revenue while causing the least economic distortion. Equity implies that people with similar incomes and circumstances should pay the same amount of tax. Tax simplicity suggests that tax policy be relatively simple to understand and comply with, or reduce the complexity of an existing tax policy.

One problem with PAYGO is that it constrains legislators in their ability to pass tax laws that increase efficiency and equity and make the tax system less complex. As stated previously, the current PAYGO mechanism is biased against tax cuts. To offset the static revenue loss associated with a tax cut and to balance the PAYGO scorecard, Congress has to either raise taxes somewhere else or reduce direct spending in politically popular entitlement programs, instead of being allowed to reduce spending from discretionary programs. Additionally, the PAYGO process shifts some power and responsibility for making revenue decisions away from elected Members of Congress and to non-elected budget analysts and economists who necessarily have to make numerous educated guesses and assumptions as to the revenue costs associated with various legislative proposals, often using defective analytical assumptions.

Elizabeth Garrett provides a detailed analysis of the PAYGO process and its implications for tax legislation. She comments that "Congressional budget procedures affecting tax legislation have assumed greater importance during the past two decades as several economic and political developments have constrained available revenue."[21] She further notes that the zero-sum nature of the PAYGO provisions has resulted in a heightened awareness among legislators and that this awareness is "perhaps the most important

[19] Section 252(a) of the *Balanced Budget Act 1985*, as referred to in: Robert Keith, "Pay-As-You-Go Requirement for FY2001: A Procedural Assessment," Congressional Research Service, December 6, 2000, page 2.

[20] Letter to Congressman John Spratt, ranking minority member of the House Budget Committee, April 6, 1999, as referred to in: Robert Keith, "Pay-As-You-Go Requirement for FY2001: A Procedural Assessment," Congressional Research Service, December 6, 2000, page 3.

[21] Elizabeth Garrett, "Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process," *University of Chicago Law Review*, Spring 1998, page 502.

change in modern federal budgeting."[22] The structure of the PAYGO process within the budget framework encourages legislators to provide reasons for their decisions, thus increasing their accountability to the electorate, Garrett argues.[23]

Garrett contends that PAYGO rules restrain new spending.[24] PAYGO rules do not, however, directly affect spending for previously enacted tax legislation and entitlement programs. Although she observes that many believe the partial restraint on new spending to be a benefit of PAYGO, this seems to be the only positive attribute. She also explains that many have criticized PAYGO on tax policy grounds.[25] Others have also asserted that budget rules unnecessarily increase the complexity of the tax law, and that PAYGO rules conflict with tax policy goals such as equity and efficiency.[26]

While PAYGO requirements may have contributed to the current budget surpluses, the PAYGO mechanism has also resulted in bad tax policy or prohibited good tax policy from being enacted. Eugene Steuerle asserted this position back in 1989 when discussing the original PAYGO provision as set forth in the *Balanced Budget and Emergency Deficit Control Act of 1985*.[27]

> Since passage of the *Tax Reform Act of 1986*, policymakers have shifted their emphasis toward other governmental reforms, such as welfare reform, catastrophic health insurance, childcare, and deficit reduction. In tackling these issues, Congress has operated under a set of rules that typically require increased revenue to accompany expenditure increases, or some amount of tax increases to accompany a deficit reduction package. As a matter of budget policy, these rules have succeeded in gradually reducing the budget deficit, although not as much as desired. *As a matter of tax policy, however, the rules have not worked well, and the tax code is again being made more complex and more unfair with the passage of each new act*.[28]

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[22] *Ibid*., 503.

[23] *Ibid*., 504.

[24] *Ibid.*, 506.

[25] *Ibid*.

[26] See, for example, Bernard M. Shapiro, "Complexity in the Tax Legislative Process: Problems and Proposals; Role of Congressional Staff and Taxpayer Representatives," in *Tax Management*, "Proceedings of the Invitational Conference on Reduction of Income Tax Complexity", United States Government Printing Office, Washington, DC, 1990; and Eugene Steuerle, "Fair Budget Policy, Bad Tax Policy," *Tax Notes*, July 24, 1989.

[27] Title II of P.L. 99-177.

[28] Eugene Steuerle, "Fair Budget Policy, Bad Tax Policy," *Tax Notes*, July 24, 1989, page 455. Emphasis added.

Robert Reischauer, former Director of the Congressional Budget Office (CBO) and currently the President of the Urban Institute, argued that budget mechanisms designed to rein in federal budget deficits have led Congress to "attempt second- or third-best solutions to problems in an effort to stay within its short-term budget constraints."[29] Reischauer further suggests that the *Gramm-Rudman-Hollings Act* (GRH), which set forth procedures for sequestration of budget authority if deficit targets are not achieved, "encouraged reliance on overly optimistic economic and technical assumptions and transparent budget gimmickry."[30] Since, GRH I, GRH II[31] and the adoption of PAYGO rules to accompany sequestration, the criticism is often made.

Michael Bopp looked at PAYGO and its effects on revenue estimation.[32] He comments that revenue estimation is to tax legislation what the scoring of outlays and budget authority is to direct spending proposals. Revenue estimation is nearly always a crucial element of deliberations over tax legislation precisely because the revenue effects of such legislation are often unclear. Further, Bopp notes that the revenue estimate often drives the specifics of tax legislation, i.e., "that the actual drafting of a tax bill takes place after the relevant committee has made its decision."[33] This means that often the analysts responsible for developing the revenue estimate base their analyses on general provisions without necessary legislative specifics that are then modified to produce desired results. The specifics come later once the tax writing committees are fully aware of the measured revenue impacts. Lastly, PAYGO rules also provide legislators with an incentive to resort to budgetary artifices so that the revenue estimates comply with PAYGO requirements.[34]

Michael Graetz, echoing Reischauer and Bopp, also asserts that PAYGO requirements provide incentives for lawmakers to resort to budget artifices by over emphasizing revenue estimates.[35] Graetz claims that the central role of revenue estimation became heightened with the passage of GRH I in 1985 and continued with the PAYGO

[29] Robert D. Reischauer, "Taxes and Spending Under Gramm-Rudman-Hollings," *National Tax Journal*, September 1990, page 223.

[30] *Ibid*.

[31] *Balanced Budget and Emergency Deficit Control Act of 1985* and *Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987*, respectively.

[32] Michael Bopp, "The Roles of Revenue Estimation and Scoring in the Federal Budget Process," *Tax Notes*, September 21, 1992.

[33] Michael Livingston, "Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes," *Texas Law Review*, 1991, as cited in Michael Bopp, "The Roles of Revenue Estimation and Scoring in the Federal Budget Process," *Tax Notes*, September 21, 1992, page 1634.

[34] Robert D. Reischauer, "Taxes and Spending Under Gramm-Rudman-Hollings," *National Tax Journal*, September 1990, page 223.

[35] Michael J. Graetz, "Paint-by-Numbers Tax Lawmaking," *The Columbia Law Review*, April 1995, pages 670-671.

requirements of the *Budget Enforcement Act of 1990*.[36] Graetz argues that this over-reliance on revenue estimation forces lawmakers to ask the "wrong questions" with respect to tax legislation. Instead of focusing on "traditional normative concerns of taxation – fairness, economic efficiency, and simplicity" lawmakers may become more concerned with "making the revenue numbers 'come out right'." [37]

Lack of Enforcement Regarding New Spending

A number of analysts have identified a variety of procedural and enforcement problems with PAYGO. For example, James A. Thurber details several major reforms that the congressional budget process has undergone in the last 20 years and how these reforms have failed to provide fiscal discipline.[38] Legislative reforms include the *Congressional Budget and Impoundment Control Act of 1974*, the *Balanced Budget and Emergency Deficit Control Act of 1985 and 1987* (GRH I and II) and the *Budget Enforcement Act of 1990* (BEA), which set forth the current PAYGO rules. Thurber states that supporters of these acts suggested that their passage would promote more discipline in congressional budgeting, reduce deficits, control runaway spending and force the appropriators to make more timely and effective decisions. However, adoption of these reforms has not abated concerns about spending, taxing, deficits, debt, and the budget process itself.

By requiring that new expenditures be linked to cuts in expenditures for existing programs or to tax increases, Thurber argues that PAYGO reforms were not necessarily intended to reduce the deficit, but to limit growth in spending and deficits. Therefore, PAYGO limits the power of the legislators to establish new mandatory spending programs or expand existing programs through new legislation.[39] Reischauer stated "…this pay-as-you-go requirement has proved to be an effective poison pill that has killed a number of legislative efforts to cut taxes and expand entitlements."[40] This illustrates how some budget decisions have come to resemble a zero-sum spending game, which some would see as its great virtue.

The first budget submission to Congress by the Bush Administration suggests that PAYGO rules helped contribute to the control of federal spending and, at the time, the

[36] *Ibid*.

[37] *Ibid*.

[38] James A. Thurber, "Congressional Budget Reform: Impact on the Appropriations Committees," *Public Budgeting & Finance*, Fall 1997.

[39] While the PAYGO provision in the *Budget Enforcement Act of 1990* has limited the power of authorizers on the mandatory spending side, others, such as Aaron Wildavsky, suggested that on the discretionary side of the budget the BEA "should be called the revenge of the appropriators." (Wildavsky 1995, page 518). This is because the discretionary budget caps established under the BEA provided for generous spending caps that were protected against direct spending and economic cycles.

[40] James A. Thurber, "Congressional Budget Reform: Impact on the Appropriations Committees," *Public Budgeting & Finance*, Fall 1997, page 68.

elimination of the federal budget deficit.[41] However, Edward Davis reviewed spending controls in the federal government over the past two decades and notes that federal spending has grown significantly, despite budgetary controls, including PAYGO requirements.[42] For example, with the first budget surplus in 1998, President Clinton and Congress avoided PAYGO rules and other budget enforcement mechanisms. For fiscal year 2001, Congress and the Clinton Administration waived the PAYGO requirement for $17 billion in spending.[43]

The PAYGO mechanism's biggest enforcement tooth is the threat of sequestration, or the automatic cancellation of budgetary resources provided by discretionary appropriations or mandatory spending law. The sequestration process was originally established in the *Balanced Budget and Emergency Deficit Control Act of 1985*[44] and was retained by the *Budget Enforcement Act of 1990*.[45] Although a complete review of the sequestration process is outside the scope of this paper, it is necessary to note that the Office of Management and Budget (OMB) is required to keep a "scorecard" that accumulates the budgetary effects of laws enacted during the current congressional session and in prior years.[46]

The OMB director is required to issue to Congress sequestration reports throughout the fiscal year. If the final sequestration report indicates that spending and revenue levels have incurred a net cost for the fiscal year on the PAYGO scorecard, then the President must immediately issue a sequestration order requiring automatic spending reductions to bring federal spending down to a level that is in balance with the PAYGO scorecard.

However, according to the Congressional Research Service, there are many ways to sidestep the potential bite that sequestration might impose on the budgetary flesh.[47] One approach is called "directed scorekeeping." With directed scorekeeping, provisions are enacted into law that instruct the director of the OMB *not* to count certain direct spending increases or revenue reductions on the PAYGO scorecard. Another option is simply to pass a law that mandates no sequestrations occur for a given fiscal year. Yet another

[41] Executive Office of the President, Office of Management and Budget fice, *A Blueprint For New Beginnings – A Responsible Budget For America's Priorities Fiscal Year 2002*, Washington, DC, February 2001, pages 170-173.

[42] Edward Davis, "The Evolution of Federal Spending Controls: A Brief Overview," *Public Budgeting & Finance*, Fall 1997.

[43] Executive Office of the President, Office of Management and Budget, *A Blueprint For New Beginnings – A Responsible Budget For America's Priorities Fiscal Year 2002*, Washington, DC, February 2001, page 172.

[44] Title II of P.L. 99-177.

[45] P.L. 101-508, *Omnibus Reconciliation Act of 1990*.

[46] Robert Keith, "Pay-As-You-Go Requirement for FY2001: A Procedural Assessment," Congressional Research Service, Updated December 18, 2001, page 2.

[47] *Ibid*.

technique is to instruct the OMB director to "reset" the balances on the PAYGO scorecard "…to avoid having to deal in the future with the long-term effects of its legislative actions."[48]

It is also possible to avoid sequestrations by designating various spending or revenue provisions as "emergency requirements," which effectively remove them from the PAYGO scorecard. In addition, as mentioned earlier, many entitlement programs are already exempt from sequestration. As a result, only about *three percent* of all mandatory spending is subject to sequestration.[49] All of these budget practices make the PAYGO process all bark and little or no bite. More importantly, the increasing lack of transparency caused by the extreme complexity and many budget loopholes furthers the disdain that the public has for the federal budget process.

III. REFORMING THE PAYGO PROCESS

This paper has maintained that, at the very least, some reform should be adopted to assist passage of tax legislation allowing the tax system to be fairer, more equitable and less complex. Furthermore, in order promote better tax policy that encourages individual saving and investment, reform of the PAYGO requirements is appropriate.

Advocates of the PAYGO process can be found in both parties, and whether or not PAYGO rules should be extended after the requirement is set to expire in FY2002 is debatable. Furthermore, since the PAYGO process may give the *appearance* of fiscal responsibility and the Bush Administration has proposed its extension,[50] Members of Congress may feel pressured to extend the PAYGO procedures. However, because an abundance of technicalities allow legislators to avoid the bite of PAYGO enforcement and sequestration, numerous articles have addressed the need for reforming PAYGO rules or eliminating them altogether.[51]

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[48] *Ibid., 7.*

[49] Executive Office of the President, Office of Management and Budget, *The Budget System and Concepts Fiscal Year 2003*, Washington, DC, February 2002, page 5.

[50] See for example: Executive Office of the President, Office of Management and Budget, *The Budget System and Concepts Fiscal Year 2002*, Washington, DC, April 2001, page 4; Executive Office of the President, Office of Management and Budget, *A Blueprint For New Beginnings – A Responsible Budget For America's Priorities Fiscal Year 2002*, Washington, DC, February 2001, pages 171 –173; and Executive Office of the President, Office of Management and Budget, *The Budget System and Concepts Fiscal Year 2003*, Washington, DC, February 2002, page 4.

[51] See for example: Elizabeth Garrett, "Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process," *University of Chicago Law Review*, Spring 1998; Robert D. Reischauer, "Taxes and Spending Under Gramm-Rudman-Hollings," *National Tax Journal*, September 1990; and Eugene Steuerle, "Fair Budget Policy, Bad Tax Policy," *Tax Notes*, July 24, 1989.

Besides allowing the budget enforcement mechanisms of the *Budget Enforcement Act* to expire, some basic reforms could be adopted. One reform would be to allow static revenue losses associated with tax reduction legislation to be offset with reductions from the discretionary side of the budget. This would remove one of the biases against tax cuts by not forcing legislators to cut spending from popular mandatory spending programs. Two other reforms are discussed below: dynamic scoring and deferral.

<u>Dynamic Scoring</u>

One such reform would be to allow for dynamic scoring. Alissa Rubin and Martin Feldstein address an important debate over whether or not dynamic scoring should be implemented in calculating the revenue estimates from tax legislation.[52] They point out that static scoring, the current practice in use, only looks at the micro level of revenue estimation, or how people's behavior will change as a result of tax changes.[53] A dynamic scoring approach would also take into account how changes in tax policy will affect the overall economy, including macroeconomic variables such as GDP and employment. As many economists, such as Martin Feldstein, have argued, taking macroeconomic effects into account (dynamic scoring) could significantly reduce revenue cost estimates of tax proposals, such as marginal rate reductions or elimination of estate taxes.[54]

For example, under a static model, a 50 percent cut in the capital gains tax would result in a net revenue gain for the Treasury over the first few years (due to what is called the "lock-in effect" or people not realizing their capital gains until a lower rate is available) and then result in a revenue loss of $56 billion thereafter.[55]

Adoption of dynamic scoring would arguably make it easier for many proposed changes in the tax code to fall within PAYGO requirements. However, while the dynamic effects of tax changes are often debatable, static effects of significant tax changes are often definitely inaccurate. For example, capital investment accelerates economic growth by simultaneously increasing the quantity of capital available and the productivity of labor. Increasing the after-tax rate of return to capital stimulates capital investment and economic growth. Thus, lowering taxes on capital, such as capital gains, is likely to increase economic growth and revenues in the long-term.

[52] Alissa J. Rubin, "'Dynamic Scoring' Plan Exposes Deep Divisions Within GOP," *Congressional Quarterly Weekly Report*, December 10, 1994; and "Interview with Martin Feldstein – 'Dynamic Scoring' for Sounder Budget Policy," *Challenge*, May/June 1995.

[53] In this context, "static scoring" refers to revenue estimates made without incorporation of macroeconomic effects.

[54] "Interview with Martin Feldstein – 'Dynamic Scoring' for Sounder Budget Policy," *Challenge*, May/June 1995.

[55] Alissa J. Rubin, "'Dynamic Scoring' Plan Exposes Deep Divisions Within GOP," *Congressional Quarterly Weekly Report*, December 10, 1994, page 3502.

A previous Joint Economic Committee study illustrates a failure of static revenue estimates.

> In an attempt to estimate the revenue effects of a capital gains tax cut, the Joint Committee on Taxation (JCT) used Congressional Budget Office (CBO) estimates of capital gains realizations under the 28 percent tax rate for the 1990-95 period. The JCT concluded that a capital gains tax reduction would cost the government billions of dollars.
>
> This JCT analysis, however, was based on grossly inaccurate data…. For the period 1990-94, CBO overstated capital gains realizations by $737 billion. The use of a massively overstated baseline led forecasters to overestimate the extent of revenue loss associated with a tax cut."[56]

The faulty CBO assumptions failed to take into account two primary factors. First, higher capital gains rates cause realizations to decline and many investors refrain from realizing capital gains due to the high tax penalty. This is referred to as the "lock-in" effect. The CBO model failed to take this into account, resulting in a $737 billion overestimation of capital gains realizations.

Conversely, a reduction in the capital gains rate lowers the tax penalty associated with realizing a gain and can remove the lock-in effect. Hence, many taxpayers choose to realize capital gains once a reduction in capital gains rates takes effect. This tax reduction causes an *increase* in the amount of capital gains taxes paid to the government. Thus, in the first few years after enactment, a capital gains tax cut can actually *increase* the amount of capital gains taxes paid.

Second, CBO did not account for the macroeconomic effects that result from a reduction in the capital gains tax rate. Namely that lowering taxes on capital increases the return to capital investment and is therefore likely to increase economic growth and revenues in the long-term.

In testimony before the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan stated, "…most economists will agree that, in evaluating the effects of various different fiscal policies, it would be far better to use what we call dynamic scoring – that is, the ability to get the interaction of the effect as well as the initial impact."[57] Chairman Greenspan further testified that in some of the Federal Reserve's economic models "…the secondary impacts of tax and spending programs are zero. Now, we know that to

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[56] United States Congress, Joint Economic Committee, *The Economic Effects of Capital Gains Taxation*, June 1997, page 6.

[57] Testimony of Alan Greenspan, Chairman, Federal Reserve Board, before the Senate Banking Committee, U.S. Senate, March 7, 2002.

be false. But, we are making those judgments because we have no alternative."[58] Chairman Greenspan's testimony supports the argument that properly modeled dynamic scoring can be more accurate than a static model. Therefore, further research should be conducted on applying dynamic scoring models to the budget process.

Deferral

Another approach that has not yet been appropriately addressed is to allow for tax legislation promoting appropriate tax deferral to be exempt from PAYGO rules. Given the divisions over the use of dynamic scoring, reforming the PAYGO rules to exempt selected tax legislation that proposes appropriate *deferral* of taxation could be a workable compromise with benefits to both taxpayers and the government.

With a deferral, the U.S. Treasury may forgo revenue on a cash-flow basis over the course of a set budget window, but does not actually lose revenue as it might under tax legislation that would either eliminate taxes, reduce marginal tax rates, or especially with legislation that would increase government expenditures.

Deferral of tax revenue results in collection of tax at a future time. Whether a tax deferral actually results in a wash, a gain, or a loss to the Treasury, on a net present value basis, is dependent upon the tax rates in effect at the time of the deferral and at the time the tax payment is made, and the rate of return the deferral creates for the taxpayer. A rate of return greater than that of U.S. Treasury Bills would result in a net gain to the government, as well as the taxpayer, all else being equal. Early research by Irving Fisher offered a mathematical proof on how a deferral could eventually increase revenue for the government (a more current example is provided later in the paper).[59]

Current scoring rules do not treat tax deferrals any differently than permanent tax revenue losses with respect to PAYGO requirements. But subjecting appropriate tax deferrals to PAYGO requirements results in unnecessary complexity in the management of the budget and our tax system. This decreases the transparency of the budget process and inhibits congressional attempts to legislate changes to the tax code that would reduce inefficiencies that would benefit both taxpayers and the government. Examples of tax changes that result in appropriate tax deferrals, as opposed to tax losses, include creation or expansion of IRAs and 401(k) plans, and deferring the taxation of mutual fund capital gain distributions, all of which are designed to encourage individual saving and investment. Allowing for the deferral of capital gain distributions by mutual funds actually provides a "real-life" example of recent legislation that proposes appropriate deferral of taxation that would increase efficiency in the tax system and would promote tax equity and simplicity.

[58] *Ibid.*

[59] Irving Fisher, "Paradoxes in Taxing Savings," *Econometrica*, vol. 10, issue 2, April 1942.

IV. POLICY ILLUSTRATION: ATTEMPTING TO CHANGE THE TAX TREATMENT OF MUTUAL FUND INVESTORS

As has been discussed throughout this paper, PAYGO rules can inhibit the ability of legislators to pass new tax legislation that that would encourage saving and investment, and promote equity, efficiency and simplicity in the tax system. As an example, a congressional attempt to change the tax treatment of mutual fund investors provides an illustration of how the pay-as-you-go requirement might hinder the passage of legislation that would fix a provision of the tax system that is unfair, inefficient, complex, and acts as a disincentive to saving and investment. This next section of the paper will provide a background of the importance of this issue and a related tax proposal currently under consideration in the 107th Congress.

Background

Mutual funds have become an important vehicle for households to invest in the stock market and save for the future. Mutual funds pool investment money from numerous shareholders and invest in a diversified portfolio of securities to minimize risk and maximize returns. Over the past two decades, the number of families investing in mutual funds has increased 1,000 percent, from 4.6 million households investing in mutual funds in 1980, to a high of 50.6 million in 2000.[60] For many families, mutual funds are a primary saving vehicle for retirement. However, mutual funds have one major drawback: the annual taxation of capital gains distributed by the mutual fund to its shareholders.

Mutual fund investors fall into two basic categories: those who pay taxes annually on the distributions of fund dividends and capital gains, and those that hold their shares in qualified retirement plans (such as IRAs and 401(k)s). Assets held in qualified retirement accounts offer tax-deferred benefits on reinvested dividends and capital gain distributions and asset accumulation. But for shareholders holding mutual fund shares outside of qualified retirement accounts, the annual tax bite levied on their annual distributions can significantly reduce fund performance.

According to a study by KPMG Peat Marwick LLP, taxes due on the annual distributions made by mutual funds can decrease the performance of a mutual fund by up to 61 percent, or 7.7 percent percentage points a year.[61] The median loss due to taxes was 16.5 percent or 2.5 percentage points per year.[62] Over a ten-year period, on a $10,000 initial investment, a 2.5 percentage point reduction in the performance on a mutual fund earning

[60] Investment Company Institute, *Fundamentals: Investment Company Institute Research In Brief*, Vol. 9, No. 4. Washington, DC: August 2000.

[61] KPMG Peat Marwick LLP, *Tax-Managed Mutual Funds and the Taxable Investor - 2000 Edition*, pages 18 and 19.

[62] *Ibid.*

an annual pre-tax return of 10 percent would amount to a loss of over $5,000. The loss would be almost $25,000 over twenty years and $87,000 over thirty years.[63]

Throughout the course of a mutual fund's normal operations, fund managers buy and sell securities attempting to maximize returns to shareholders. In order to eliminate corporate income tax liability on the gains earned from the sale of securities, mutual funds must distribute to their shareholders all of their ordinary income and net capital gain. The gains mutual funds distribute to individual shareholders are subject to capital gains taxation on the individual's federal and state tax returns. Any undistributed profits of the mutual fund are taxed at the corporate rate.

Even if individual shareholders do nothing more than buy and hold mutual fund shares, they could still be hit with potentially large tax liabilities due to the distribution of gains from their mutual funds. Shareholders are then either forced to sell assets to pay the tax liability, or must divert capital from other potentially more productive uses in order to pay the tax. This is economically inefficient and creates an opportunity cost to the shareholder and can result in considerable economic losses due to compounding.

Although direct owners of stocks pay taxes on dividends received, they do not have to pay taxes on the appreciation of their securities until they sell their shares and actually realize a gain. For direct ownership of stocks, the realization point that triggers a tax liability is the selling of securities by the individual owner. In the case of mutual funds, one realization point that triggers a tax liability for shareholders is the selling of securities by the mutual fund, generating taxes on unrealized gains at the individual level. This treatment violates the economic principle of horizontal equity, which holds that taxpayers with the same amount and type of income should be taxed the same amount and in the same manner.

Direct owners of stocks are allowed to defer taxation on the appreciated value of their stock shares, while mutual fund shareholders may be forced to pay taxes yearly even if they don't sell (i.e., redeem) any of their mutual fund shares. The current tax treatment of mutual funds is an unfair economic disadvantage to households who invest in mutual funds because many cannot afford the relatively large amounts of capital necessary to build their own diversified portfolio of stocks.

Proposed Legislation

H.R. 168, introduced in the 107th Congress by Rep. Jim Saxton (R-NJ) addresses this problem. The bill would allow a deferral of capital gain distributions up to $6,000 for married taxpayers filing a tax return jointly and $3,000 for all other taxpayers. The exclusion amounts would be indexed for inflation. Mutual fund companies would still

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[63] United States Congress, Joint Economic Committee, *The Taxation of Mutual Fund Investors: Performance, Saving, and* Investment, April 2001, page 2. Amounts are calculated on a pre-liquidation basis.

make distributions, as required under current law. However, under H.R. 168, reinvested capital gain distributions would be deferred from taxation.[64]

The deferral provision in Rep. Saxton's bill would provide substantial tax and saving benefits to taxpayers who invest in mutual funds. As highlighted in the table below, for a hypothetical taxpayer with an initial $10,000 investment in a mutual fund that returns 10 percent a year, the deferral on capital gain distributions would amount to $15,055 over a 30-year period. This represents almost a 15 percent greater *after-tax* return than would be achieved under the current law which taxes mutual fund capital gain distributions. The $15,055 increase in *after-tax* return that would arise under the deferral provision of Rep. Saxton's bill is equivalent to approximately 150 percent of the original $10,000 investment. The benefits of capital gain distribution deferral would significantly aid American families saving for their future.

Mutual fund capital gain distributions are taxed at a long-term capital gain rate of 20 percent. As long as the long-term capital gain tax rate remains the same or higher, and the market returns a rate better than that offered on U.S. Treasury Bonds over a given investment period, the net present value of a deferral will be greater and the government will take in more tax revenue as well. Given the same tax rates, if taxpayers earn a greater return, *ceteris paribus*, then taxpayers will pay more in taxes.

Benefit of Deferral to the Mutual Fund Investor

$10,000 Initial Investment

Time Horizon	**5 - Years**	**10 - Years**	**15 - Years**	**20 - Years**	**25 - Years**	**30 - Years**
Pre-Liquidation Value With Deferral on Capital Gain Distributions	$15,499	$24,023	$37,235	$57,713	$89,452	$138,646
After-Tax Redemption Value	$14,659	$21,880	$33,073	$50,420	$77,308	$118,984
Pre-Liquidation Value Without Deferral on Capital Gain Distributions	$14,940	$22,320	$33,345	$49,817	$74,426	$111,191
After-Tax Redemption Value	$14,585	$21,436	$31,670	$46,960	$69,802	$103,929
Difference - After-Tax Benefit of Deferral ($)	$74	$445	$1,403	$3,461	$7,506	$15,055
Difference - After-Tax Benefit of Deferral (%)	0.5%	2.1%	4.4%	7.4%	10.8%	14.5%

Note: Hypothetical Example - Assumes (1) an annual 10% rate of return; (2) of which dividends account for 30% of return and capital gains distributions account for 40% of return (3) distributions are reinvested net of taxes due. Hypothetical example is similar to that used by KPMG 2000 and do not account for state taxes.

As highlighted in the table above, over a 30-year period the taxpayer receives over $15,000 more after taxes with the deferral provision than without it. The federal government, however, would receive an additional $11,784 in nominal tax revenue with the deferral provision as well. Only under current budget rules can an *additional* $11,784 in nominal dollars be scored as a revenue loss.

Preliminary scoring by the Congressional Joint Committee on Taxation (JCT) in 2001 estimated that the provisions in H.R. 168 would result in a static revenue loss to the

[64] For more detailed information see the following Joint Economic Committee staff studies: *Encouraging Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains* (June 2000); *The Taxation of Mutual Fund Investors: Performance Saving, and Investment* (April 2001); and *Mutual Fund Investors: A Reflection of Middle America* (November 2001).

federal government averaging approximately $4.5 billion per year.[65] However, given the recent state of the equities market and the sharp decline in capital gain distributions, the static revenue loss associated with the bill will be lower.[66] This might seem like a drop in the proverbial bucket compared with the forecasted $2.3 *trillion* ($2,317.7 billion) in average annual receipts the government is expected to collect.[67] Nonetheless, the estimated "cost" of the deferral provision in H.R. 168 is subject to PAYGO requirements.[68] Hence, if this bill were to pass as is, Congress would have to find additional revenue or cut direct spending from politically popular entitlement programs to meet PAYGO requirements. This real-life example illustrates how good fiscal intentions can lead to bad tax policy.

It is important to note that exempting legislation that results in appropriate tax deferral from PAYGO rules that is proposed in this paper is not a switch to dynamic scoring. Static revenue implications could still be used to "score" the effects of any deferral. However, since a tax deferral would eventually result in more tax revenue to the government, appropriate deferral provisions should not be scored as revenue losses.

V. Conclusion

This paper has discussed how numerous scholars and practitioners in the field have addressed the need for changing PAYGO rules or eliminating them altogether. This paper has also addressed how PAYGO rules can result in bad tax policy. Pay-as-you-go (PAYGO) requirements have been generally praised for restraining new spending and for encouraging legislators to provide reasons for their budget decisions. However, PAYGO rules have also been criticized on the grounds that legislators are often forced to accept second- or third-best (or no) solutions to problems in an effort to stay within PAYGO requirements. Further, overly optimistic economic and technical assumptions and budget artifices are often adopted so that revenue and expenditure estimates stay within PAYGO requirements.

Additionally, PAYGO rules have been criticized on the grounds that they inhibit legislators from enacting tax legislation that would make the tax system fairer, more efficient and simple. This criticism stems in part because PAYGO rules do not affect previously enacted tax and direct spending legislation, but do affect passage of new

[65] Letter to Congressman Jim Saxton from the Joint Committee on Taxation, April 4, 2001.

[66] Elizabeth Stanton, "A Big Drop in Distributions: '01 Capital Gains Tally Lowest Since '95," *The Washington Post*, April 7, 2002.

[67] Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2003*, Washington, DC, February 2002, page 55. Receipts based on projections for 2003 – 2007.

[68] PAYGO rules require revenue offsets over a five-year period.

legislation, which can result in the entrenchment of status quo programs and tax laws. Furthermore, PAYGO rules place substantial obstacles in the path of new tax legislation, many of which are designed to promote saving and investment. Lastly, the myriad budget practices that are used to circumvent the enforcement of PAYGO only furthers to inhibit the transparency of the federal budget process and reduce the ability of taxpayers to hold legislators accountable for their budget and tax policy decisions.

The PAYGO mechanism has been extended twice since its original passage in 1990. It is currently scheduled to expire in fiscal year 2002, and debate over whether PAYGO should be expanded or discontinued is likely. Furthermore, since the PAYGO process may convey the desire for fiscal responsibility, and the Bush Administration has proposed its extension, Members of Congress may feel inclined to extend the PAYGO mechanism.

In order to promote better tax policy that would promote saving and investment, dynamic revenue analysis should be utilized. At the very minimum a compromise approach to reforming PAYGO with respect to appropriate tax deferral is recommended. If PAYGO were not permitted to expire in fiscal year 2002, then dynamic scoring and exemption of appropriate tax deferral would provide ways to improve incentives for saving and investment without destroying fiscal responsibility.

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