Executive Memorandum
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MAKING PAY-GO PAY OFF

Rules governing how Congress writes tax and entitlement legislation (known as pay-go, for pay-as-you-go) are to be extended under the recent budget agreement between President Bill Clinton and congressional leaders. The current rule makes tax cuts more difficult than necessary and fails to limit discretionary spending. Before extending pay-go in the reconciliation process, Congress should address these flaws.

House Budget Committee Chairman John Kasich (R–OH) has recommended altering pay-go to eliminate the bias against tax cuts. Expanding it to cover discretionary spending would achieve that goal, help control spending, begin to refocus the budget process on limiting spending and taxes rather than on balancing the budget without regard to the size of government, and help ensure that the budget really is balanced in 2002.

How Pay-Go Works. The pay-go rule applies to legislation to cut taxes and laws to increase entitlement spending. New or expanded entitlements (benefits for a class of people) must be paid for either through limits on existing entitlements or through higher taxes. Tax cuts are prohibited unless other taxes are raised to maintain projected revenue, or unless planned entitlement spending is reduced by a corresponding amount.

The rule was intended to prevent lawmakers from voting for politically popular measures without addressing their effect on the deficit, but it has had little practical effect on entitlement legislation because there is a political consensus that entitlements need to be restrained. It does make it far more difficult, however, to cut taxes and, by restricting certain deficit calculations to tax and entitlement categories, encourages Congress to increase discretionary spending (funds appropriated each year to operate the government) by raising the deficit.

It was the pay-go rule that set Congress up for the charge that it was cutting Medicare to fund a tax cut for the rich, by requiring that tax cuts be combined with limits on entitlement spending. No matter how much Congress cut the deficit by reducing discretionary spending, the iron link between taxes and entitlements made an attack on tax cuts mathematically plausible. Entitlements and taxes were linked because budget negotiators did not trust Congress to keep promises about future cuts in discretionary spending; cuts that Congress had promised in several budget agreements during the 1980s simply never materialized.

Spending Caps. Congress can be disciplined to control discretionary spending, however. If it exceeds the discretionary spending caps established in law by the 1990 and 1993 budget agreements, an across-the-board sequester reduces every discretionary account to remain within the targeted level. Congress has observed these caps for seven years, but this year's agreement would raise the last cap, set in 1993, for spending next year. Discretionary spending restraint, properly enforced, is the surest way to reduce the deficit; the deficit effects of tax and entitlement changes are projected and often uncertain, but savings from discretionary spending caps are predictable and certain.

Under the current pay-go rule, Congress has little incentive to limit discretionary spending. The goal of cutting the deficit is honored in theory, but politicians tend to prefer spending or tax cuts that are readily identifiable by voters. Thus, even conservatives are tempted to raise spending rather than reduce the deficit. But if Congress could balance tax cuts with discretionary spending reductions, the congressional side in the recent budget negotiations would have had reason to press for spending restraint to fund pro-growth and family tax cuts; President Clinton would have found it more difficult to balance his domestic spending increases, including those for education, with proposed education tax benefits; and both sides would have been encouraged to limit discretionary spending to secure their tax goals.

Budget Agreements and Tax Reform. Pay-go is to be extended for the five-year life of the current budget agreement, but history indicates that the agreement is likely to be renegotiated in two or three years. Thus, however it is extended, the rule will have a major impact on future budget negotiations. Perhaps more important, however, extending the current rule for another five years would make it very difficult to achieve fundamental tax reform. Because the economic results of significant tax changes are difficult to predict, opponents will insist on rates higher than those really needed to avoid increasing the deficit. A pay-go rule that allows for discretionary spending caps would give lawmakers more flexibility in reforming the tax code while ensuring against higher deficits. Any gray areas in revenue projections, for example, could be backed up by spending cap reductions that kick in only if tax payments fail to meet expected levels. The current pay-go rule would require entitlement cuts instead.

Reform or Expand Pay-Go? In *The Wall Street Journal*, Chairman Kasich recently observed that the budget deal leaves open the exact form of the pay-go extension, vowed to "push to allow tax cuts to be funded through cuts in any program," and pointed out that he "wrote legislation to that effect that was approved by the House in the last Congress." An even better step would be to subject discretionary spending to the pay-go rule as well. In addition to providing greater flexibility in crafting tax cuts, this change would prevent Congress from increasing discretionary spending by increasing the deficit.

Critics complain that the 1997 budget deal allows for too much growth in spending and that future Congresses will not make the cuts promised to bring the budget into balance in 2002. Under expanded pay-go, because Congress could not spend more than currently planned unless it cut other categories of spending or increased taxes, it would be far more likely to stick to the 1997 plan and balance the budget as promised.

The budget agreement commits congressional leaders to extending the pay-go rule. Simply renewing the current law would make tax cuts less attractive, discretionary spending increases more likely, and fundamental tax reform more difficult. Expanding pay-go to cover all parts of the budget would have the opposite effects. In the interests of tax reform, spending restraint, and balanced deficit reduction, pay-go should be expanded to include discretionary as well as entitlement spending.

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