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Obama Gets a Tax Issue Right—Is Congress Next?

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On June 10, President Obama announced his proposals to impose greater discipline on the federal budget process. The President's announcement was largely met with bipartisan incredulity and guffaws after he proposed a budget that raises spending over 10 years by $2.7 trillion and after he advocated and signed a $787 billion fiscal stimulus bill, thereby embracing a 2009 budget deficit that will approach nearly $2 trillion.

The President's profound shift in attitude toward the deficit does not detract, however, from the valid substance of some of his proposals. In particular, one and a half of these proposals merit applause. The meritorious "half" is earned by the President at least paying lip service to the return of pay-as-you-go (or PAYGO) budgeting, which disappeared in 2002. The President may get full credit here if he gets the details right. The second proposal, the one deserving of full praise, corrects the way PAYGO is applied so that existing tax and spending policies are treated fairly.

Budget Rules Rule. Congresses—more so even than Presidents—dislike making tough choices, especially when it comes to taxes and spending. Yet budgeting is inherently about making choices, and there are few responsible easy ones. Given the opportunity, Congress will often readily increase spending on the policy de jour—as long as it does not have to pay for that spending with reduced spending elsewhere or higher taxes.

For example, the Bush Administration pushed through a nearly $400 billion budget-busting Medicare Modernization Act creating the new drug benefit. The legislation passed by only a few votes, but if Congress had to offset the legislation with tax increases or other spending reductions, the legislation would never have reached first base.

The real purpose of budget rules is to guide the budget process into places where it is slightly harder for Congress and the President to avoid tough choices. The budget rules could be written so as to make it much harder to avoid tough choices, but Congress is too smart for that. The specific purpose of a sound PAYGO rule is to make it more difficult for Congress to raise entitlement spending without reducing other entitlement spending or raising taxes. Given all the massive spending initiatives working their way through Congress, most especially cap and trade and health care reform, a PAYGO rule with real teeth may be the only thing standing between responsible fiscal policy and ruinous levels of national debt.

When Is a Cut a Cut? Defining a spending cut or a tax increase in federal budgeting is a tortured exercise. Everything depends on the starting point and, in typical Washington style, the starting point is up for grabs. One obvious starting point is that spending increases when spending goes up. But because of inflation and the unfortunately broad

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range of activities undertaken by the federal government, it is more appropriate to use current spending *policy* adjusted for inflation as the starting point. This is essentially what the Office of Management and Budget (OMB) in the White House and the Congressional Budget Office (CBO) use as their baseline, or starting point, for spending.

For no sound reason, taxes have been treated differently. The revenue baseline follows the level of current tax receipts adjusted for inflation and growth in the economy. Adjusting for inflation naturally parallels the treatment of the spending baseline; however, adjusting for growth in the economy builds in a natural tendency to accept as normal *and appropriate*—i.e., baseline—the fact that revenues should increase with rising incomes.

The greater problem arises in that Congress frequently enacts temporary tax policy. Witness the R&E tax credit, the Bush tax cuts, and the AMT "patch." These policies, often in effect for years, expire and then the tax system reverts to a previous form. When Congress enacts temporary spending policies, OMB and CBO sensibly construct their spending baselines on the assumption that the policies will be extended. They have done this with the State Child Health Insurance Program, the highway bill, and all discretionary spending. But when Congress enacts temporary tax policies, OMB and CBO revenue baselines reflect the expirations rather than assuming current policy is extended. Thus, the spending baseline reflects *current policy* while the revenue baseline reflects *current law*. This oddity has often contorted congressional deliberations.

For example, in recent years, the Congress has had to extend the AMT patch repeatedly.[1] The patch prevents the AMT from raising taxes on millions of taxpayers. The CBO revenue baseline assumed the patch would expire. This meant that extending the patch and preventing a tax hike was shown in the official revenue tables as a tax cut. To avoid raising taxes, Congress had to pass a tax hike. Up is often down in Washington.

Fixing a Broken System. Candidate Obama was very clear in recognizing that the traditional calculation of the revenue baseline was unfair and unreasonable.[2] President Obama's PAYGO proposals suggest the revenue baseline be fixed. His proposal merits appreciative applause. Congress should now direct the CBO to reform its procedures for calculating the revenue baseline so that it reflects current tax policy, just as the spending baseline reflects current spending policy.

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1. See J. D. Foster, "AMT Patch Bill Disguises a Tax Hike, Again," Heritage Foundation *WebMemo* No. 1968, June 25, 2008, at *http://www.heritage.org/Research/Taxes/wm1968.cfm.*
2. See J. D. Foster, "Obama to CBO Revenue Baseline: Nuts—And He's Right!" Heritage Foundation *WebMemo* No. 2019, August 11, 2008, at *http://www.heritage.org/Research/Budget/wm2019.cfm*.