



## The Pay-As-You-Go Rule: A Return to Fiscal Responsibility

### ***Large and Persistent Deficits a Threat to Progress on National Priorities***

The goal of Congress' Pay-As-You-Go rule, also known as PAYGO, can be likened to the often-said adage about how to get out of a hole: first, stop digging. The PAYGO rule bars legislation that would increase the federal deficit. It requires new tax cuts or new entitlement spending to be offset by revenue increases or cuts in entitlement spending.

The U.S. faces real negative consequences from large deficits. At the start of this decade, the United States had a healthy \$5.6 trillion in projected surpluses over the next ten years.<sup>1</sup> But just six years later, those healthy budget projections reversed into deficits of \$2.9 trillion, with reduced federal revenues due to tax cuts playing a large role.<sup>2</sup> In FY 2007 alone, \$139 billion went towards paying interest on the national debt — tax dollars that did not go to productive investments such as improving transportation or health care reform.<sup>3</sup>

High levels of chronic federal debt are also harmful to our economy. Federal Reserve chairman Ben Bernanke testified to Congress that budget shortfalls “reduce national saving and therefore imperil, to some extent, the future prosperity of our country.”<sup>4</sup>

If federal deficits continue to grow, Minnesota will likely suffer. A growing share of the federal budget will be devoted to paying interest on the debt, leaving less money for federal funding for states. This will add more stress to Minnesota's budget because close to one in every four dollars of the state budget comes from the federal government. Minnesotans may also face economic hard times, because the high levels of federal debt will eventually damage the economy.

We can and must avoid these negative outcomes, and the PAYGO rule is an important part of the solution.

### ***What is the Pay-As-You-Go (PAYGO) Rule?***

In 2007, the Congress adopted a strong PAYGO rule for the first time since 2002. PAYGO is not a law, but a rule that the U.S. House and Senate can impose on themselves in order to encourage fiscal discipline and discourage growth in deficits. Under a strong PAYGO rule, any Congressional proposal to either increase entitlement spending or cut taxes must be paid for by corresponding spending cuts or tax increases so that the proposal does not increase the federal deficit. For example, a proposal to cut the federal income tax by \$30 billion would have to be offset by a \$30 billion increase in other taxes, a \$30 billion cut in spending, or a combination of the two. The rule can be waived, but only with widespread agreement.<sup>5</sup>

The PAYGO rule only applies to tax cuts and entitlement spending. Entitlement spending includes Medicare, Medicaid, Social Security and veteran's benefits. PAYGO does not apply to domestic discretionary spending, which includes such areas as education, highways, housing assistance and biomedical research. Growth in domestic discretionary spending is limited by a separate process: a cap in the budget resolution.

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<sup>1</sup> Unless otherwise noted, data from this analysis comes from the Center on Budget and Policy Priorities, *Reinstatement of PAYGO is a Welcome Step Toward Fiscal Responsibility*, [www.cbpp.org/12-20-06bud.htm](http://www.cbpp.org/12-20-06bud.htm), and the *Economic Effects of the Pay-As-You-Go Rule*, [www.cbpp.org/3-19-07bud.htm](http://www.cbpp.org/3-19-07bud.htm).

<sup>2</sup> Center on Budget and Policy Priorities' calculations based on Congressional Budget Office data, assuming continuation of the President's tax cuts and AMT relief, funding of the President's defense requests and a gradual phasedown of operations in Iraq.

<sup>3</sup> Congressional Budget Office, *Monthly Budget Review*, May 2008, [www.cbo.gov/ftpdocs/91xx/doc9195/05-2008-MBR.htm](http://www.cbo.gov/ftpdocs/91xx/doc9195/05-2008-MBR.htm).

<sup>4</sup> Hearing before the House Financial Service Committee, February 15, 2006.

<sup>5</sup> In the Senate, it takes 60 votes to waive PAYGO. In the House, only the Rules Committee can waive PAYGO.

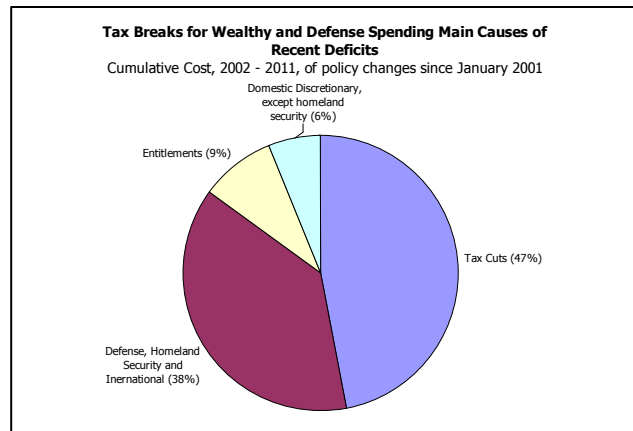
## ***PAYGO Rule Proven to Help Reign in Deficits***

The PAYGO rule has a proven track record of helping restrain Congress and the President from enacting tax cuts or entitlement spending increases that would increase the deficit. Congress adopted a strong PAYGO rule in 1990 that helped enforce bipartisan agreements to reduce mandatory spending and increase taxes during a period of high deficits. For the next seven years, Congress enacted spending and tax laws that did not add to the deficit. Thanks to this fiscal restraint and a strong economy, by 1998 the nation had achieved a budget surplus.

In the past two years, the reinstated PAYGO rule has blocked many irresponsible tax cuts that would have increased the national debt or crowded out domestic spending.

In contrast, after the strong PAYGO rule expired in 2002, policy changes were made that greatly increased the deficit. Tax cuts since 2001 had a direct cost of \$1.3 trillion.<sup>6</sup> Unpaid for tax cuts and defense, homeland security and other international spending account for 85% of policy changes since 2001 that added to the deficit.<sup>7</sup>

In contrast, increases in domestic discretionary spending, which includes such areas as education, highways, housing assistance and biomedical research, account for only 15% of the cost of legislation enacted since 2001. In fact, domestic discretionary spending, as a share of GDP, has fallen to its lowest levels since 2001.<sup>8</sup>



## ***Congress Should Maintain Strong PAYGO Rule: What's Worth Doing is Worth Paying For***

While it is possible for the Senate or the House to waive the PAYGO rule, the bar for setting aside the rule should be set high. Waiving the PAYGO rule should be reserved for unforeseen emergency situations. For example, the need to respond to a natural disaster, such as Hurricane Katrina, can override the need for deficit reduction. The tremendous damage wrought by a natural disaster can not be anticipated or planned for, and the additional burden on the budget is temporary. In this case, waiving PAYGO is logical. A temporary and well-targeted stimulus plan in response to an economic downturn may also warrant setting aside PAYGO.

PAYGO should not be waived for most tax cuts, especially considering the large role that recent tax cuts have played in increasing the deficit. In 2007, Congress waived PAYGO in order to enact a one-year fix for the Alternative Minimum Tax (AMT). This tax cut added \$51 billion to the deficit.<sup>9</sup> However, the growth in the AMT was neither accidental nor unexpected. Instead, it is largely a result of a budgeting device that hid the true cost of the 2001 tax cuts. Congress simply did not want to make the hard tradeoffs of cutting spending or increasing taxes that PAYGO would have required.

House rules must be renewed each year. House members should reenact a strong PAYGO rule when they convene the 111<sup>th</sup> Congress in January 2009. And as it makes decisions about entitlement increases or tax cuts, Congress should adhere to the PAYGO rule. It is a critical component of restoring fiscal responsibility to our national budget debate.

<sup>6</sup> Through Fiscal Year 2007. Center on Budget and Policy Priorities, *Extending the President's Tax Cuts and AMT Relief Would Cost \$4.4 Trillion Through 2018*, [www.cbpp.org/1-31-07tax.htm](http://www.cbpp.org/1-31-07tax.htm).

<sup>7</sup> Center on Budget and Policy Priorities, *Federal Budget Outlook*, [www.cbpp.org/budget-slideshow.htm](http://www.cbpp.org/budget-slideshow.htm).

<sup>8</sup> Center on Budget and Policy Priorities, *Bush Budget Would Cut Domestic Discretionary Programs by \$20 Billion in 2009*, [www.cbpp.org/2-20-08bud.htm](http://www.cbpp.org/2-20-08bud.htm).

<sup>9</sup> Center on Budget and Policy Priorities, *The AMT's Growth Was Not "Unintended,"* [www.cbpp.org/11-30-07tax.htm](http://www.cbpp.org/11-30-07tax.htm).