IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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PAYGO DISPUTE SEPARATES HOUSE AND SENATE BUDGET RESOLUTIONS

The House and the Senate Budget Resolutions would renew, in two different ways, an expired pay-as-you-go (PAYGO) provision aimed at reducing the federal budget deficit. Conference awaits. The expired provision provided that any legislated expansion of entitlement spending or any tax reduction be matched by offsetting changes in those same two areas. That is, an expansion of entitlement spending would require either a matching cut in other entitlements or a tax increase; a reduction in taxes would require either a matching tax increase or a cut in entitlements.

In renewing the provision, the Senate keeps the same general form; either a tax cut or an increase in entitlement spending would have to be offset one way or another. The House version would require an offset to an entitlement increase, but would allow a reduction in taxes without an offset. The House version is aimed at accommodating the Administration proposal to make permanent the 2001 and 2003 tax reductions for individuals that are due to expire over the next few years.

The obvious political differences aside, a sensible question to ask is, "Does one or the other plan to extend PAYGO make more technical economic sense?" The answer is a qualified "Yes, the House version, but only if it is applied with care."

If one were to approach the issue verbally, like a lawyer, accountant, or abstract philosopher, one might argue that a) the object is to keep the deficit from rising (because everyone says that is the objective), and b) the deficit is "outlay less revenue", and both "outlay" and "revenue" are equally valid concepts and both can be expressed in dollars, so c) it makes no difference whether both are unchanged, or outlays and revenues rise together, or outlays and revenues fall together. In all cases, the deficit would remain the same. That analysis might get a passing grade if you are in a semantics course or arguing in moot court, but go to the rear of the class if the subject is economics.

Outlays and taxes affect the economy in different ways, and not chiefly by altering the budget deficit. Tax and spending changes affect the economy by altering incentives to work, save or invest, or by raising or lowering the cost of goods and services needed by the private sector, not by giving people money to spend or by pumping up "demand". Any non-trivial demand effects of a tax cut or spending hike not financed by money creation are offset by equal and opposite increases in federal borrowing.

The outlays that have the most economic impact are not even covered by the PAYGO provision. Increased government spending on goods and services is likely to have a negative impact on economic activity, whether it is paid for by taxing or by borrowing. Chiefly in the category of discretionary spending, these outlays take real resources such as manpower, material, land, and energy away from the private sector, raising its costs and making that sector shrink. It has been decades since sensible economists regarded government spending as expanding, rather than reshuffling, GDP (except in those rare cases where some infrastructure actually passes a cost-benefit test, i.e., has a higher return than other uses of the money, which most pork barrel outlays, including many highway projects, do not). Controlling the Congress's inherent tendency to overspend in this category requires a discretionary spending cap. PAYGO doesn't apply.

Entitlement spending is covered by PAYGO. Increased entitlement spending, mostly transfer payments, usually decreases GDP. Promising people government retirement benefits and medical care reduces the need to save or to buy private insurance, and raising their taxes to pay for the transfers makes it harder to save and more expensive to attract labor to the work force. Means testing imposes implicit marginal tax rate spikes on the recipients because they lose benefits if they try to earn additional income, reducing their incentive to work or save. Less saving and labor force participation reduce GDP.

Marginal tax rate reductions, or provisions that avoid double taxation or overstatement of taxable income, increase the after tax reward to working an additional hour, week, or year; encourage additional saving, or additional investment in one's business; and encourage an expansion of corporate investment, research and development. These provisions increase the amount of labor and capital available for production and boost total national output and income. The increase in GDP from a reduction in the tax burden on added output is in contrast to the effect of government spending, which merely rearranges or even reduces GDP.

Not all tax cuts are created equal, however. Some tax cuts help the economy, while others are more in the nature of social policy and have little, or no, or even adverse economic effects.

The expiring provisions that have the clearest beneficial incentive effects work "at the margin". They include the bonus expensing provision, the marginal tax rate cuts, the reduced tax rates on dividends and capital gains, the estate tax elimination, and the expansion of IRA and retirement savings plan limits. These provisions encourage additional work and hiring, additional saving and investment, and additional entrepreneurial activity. Unfortunately, the most important of the lot, the bonus expensing provisions enacted in 2002 and 2003, were billed as a temporary counter-cyclical shot in the arm (which is seldom good policy), and the Administration has not asked for their renewal. In fact, the expensing increase was the single most important tax provision for turning around the slump in investment that triggered the last recession, and failure to renew it will create a jump in the cost of capital on January 1, 2005. That could derail the recovery, and will certainly not boost U.S. competitiveness in the global marketplace. Failure to extend the other incentive provisions would also retard growth.

Most of the other expiring provisions have either a mixed effect or are purely social in nature. The wider 15 percent bracket billed as marriage penalty relief would have a modest incentive effect only insofar as it dropped some couples from the 25 percent to the 15 percent tax bracket on their last dollar of income. Ditto for the increase in the standard deduction for married couples, which might knock a few couples down a bracket. They produce a non-trivial share of the GDP, so giving them the added incentive to work and save would have some beneficial impact on output. The expansion of the 10 percent bracket would have a tiny incentive effect, because most people have incomes that exceed the upper limit of that bracket and would get no incentive "at the margin" to work longer, and those who are affected "at the margin" by that bracket produce less than 2 percent of GDP. The child credit has virtually no incentive effect and must be viewed as a transfer payment done through the tax code. Phase-outs of various expanded credits actually reduce work incentives at the margin for people who face the loss of the added benefits.

Extension of some expiring tax provisions is needed to ensure continued strong economic growth. Protecting tax cuts under a Budget Resolution would allow passage by a simple majority vote. If the Senate version is the best version of PAYGO to be had, the provision should be dropped from the Budget Resolution. There would be no net tax relief under the Senate version, and the tax provisions the Senate is keenest to extend are not those that are most likely to benefit the economy. If the Senate insists on including its provision, it would be better to have no Budget Resolution at all. There is always next year. If the House version is accepted, the House and Senate should be careful what tax cuts they adopt. With limited tax cutting authority, only the most pro-growth of the tax cuts should be extended.

Stephen J. Entin
President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.