tax notes℠

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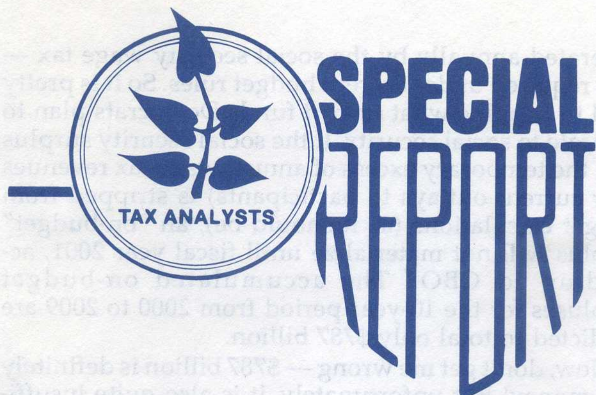

PAYGO AND THE POLITICS OF THE SURPLUS

by Sheldon D. Pollack

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In this article, Pollack discusses some of the important tax and fiscal issues that await the 106th Congress. There is consensus among Democrats and Republicans that actuarial balance must be restored to the social security trust fund. Beyond that, there is little agreement. Most important, the political parties disagree over what to do with the budget surplus that is projected for coming years. Democrats want to "dedicate" the surplus to social security — whatever that means — and as usual, Republicans want to use the surplus to finance significant tax cuts. The latter requires repeal of the so-called PAYGO rules enacted in 1990. Pollack considers the case against PAYGO. He describes how the requirement for revenue neutrality has had a perverse effect on tax policymaking. Tax policy suffers on account of the odd balancing of revenue raisers and targeted tax cuts imposed on congressional policymakers by PAYGO. The result is double damage as unwarranted tax preferences are coupled with dubious revenue raisers. In the good old days, we just had tax preferences and the deficit to worry about. Nevertheless, Pollack concludes that the 1990 budget rule should not be repealed. PAYGO is important because it checks the natural instincts of Democrats to spend without limit and Republicans to cut taxes beyond reason, thereby imposing a measure of fiscal restraint on an otherwise unwieldy budget process.

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During the opening weeks of the 106th Congress, legislators have been tied up determining the fate of President Clinton. Nevertheless, Congress will eventually get back to business — which includes enacting new "reform" provisions that further complicate and mangle the federal income tax. Remember, it was a Congress intent on reform that produced the Taxpayer Relief Act of 1997 — perhaps the worst tax legislation enacted since 1971.[1] This year, Congress may even take significant measures to "fix" social security. The last such major effort occurred in 1983 and resulted in the largest tax increase of the 1980s.[2] Unfortunately, it only forestalled the collapse of the system by a decade or two. Don't count on the 106th Congress having any greater success than its predecessors. Focusing on the long-term insolvency of social security is difficult for politicians, what with reports of impending surpluses dominating most discussions of the budget. Propelled by these reports, our representatives are discovering all sorts of new and creative ways to spend the extra billions on pet projects. This is a whole new experience for politicians, as budget surpluses have been as rare in Washington in recent decades as thoughtful tax articles in *Hustler* magazine.

At any rate, congressional policymakers undoubtedly have already begun to take up important tax and fiscal policy issues. None of these are new; none will be resolved. Still, such exercises are important, if only

[1]I have in mind the Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497, which Stanley Surrey once called the "worst measure in many a decade from the standpoint of the integrity and fairness of the tax system." Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973), p. 175.

[2]The 1983 legislation raised the wage tax rates and tax base, and it also imposed income tax on one-half of social security benefits in excess of certain income thresholds (such benefits having previously been treated as wholly exempt from income taxation). In addition, the bill postponed the retirement age for social security recipients from 65 to 67 (with a gradual phase-in scheduled to begin in the year 2000 and continue until 2022). These tax increases amounted to $85 billion per year, representing the largest tax increase of the decade. An excellent account of the turbulent politics behind this legislation is Aaron B. Wildavsky and Joseph White, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and Los Angeles: University of California Press, 1989), pp. 310-30.

because Congress can always make matters worse. Here is a brief account of what looms ominously on the horizon — and I am not referring to Al Gore.

Surplus and Social Security

Ever since predictions of an imminent budget surplus began circulating Washington in the spring of 1997, politicians of all political stripes have been concocting plans to spend the excess revenue attributable to nine years of unprecedented economic expansion.[3] The economic prosperity has resulted in record receipts under the federal income tax; for the first time ever, the income tax (corporate and individual combined) raised over $1 trillion in fiscal year 1998 and total federal receipts topped $1.72 trillion.[4] Largely due to this surge in tax revenue (as opposed to any great success by the Republican controlled Congress in reducing federal expenditures), the federal budget ran a surplus in fiscal year 1998 for the first time in almost 30 years. The Congressional Budget Office has just revised its prior estimates upward and concluded that the surplus for fiscal year 1999 will be $107 billion, and over the next 10 years surpluses will total some $2.6 trillion.[5] The economic train keeps rolling, and the question that keeps politicians awake at night is, What to do with all that money?

Democrats in Congress have generally followed President Clinton's lead in declaring that surplus revenues be "dedicated" to social security.[6] It is not exactly clear what Democrats mean by this — probably, nothing in particular. The conceptual problem is that the entire budget surplus realized to date is attributable to the social security wage tax and hence, is already included among the assets of the social security trust fund. As is well known (but conveniently forgotten), estimates of a surplus reflect the inclusion in the consolidated budget of an extra $100 billion or so generated annually by the social security wage tax — as is required under current budget rules. So it is pretty hard to imagine what *current* funds Democrats plan to dedicate to social security. If the social security surplus (i.e., the temporary excess of annual wage tax revenues over current outlays to participants) is stripped from budget calculations (as it should be), an "on-budget" surplus will not materialize until fiscal year 2001, according to CBO.[7] The accumulated on-budget surpluses for the 10-year period from 2000 to 2009 are predicted to total only $787 billion.

Now, don't get me wrong — $787 billion is definitely real money! But unfortunately, it is also quite insufficient to "save" social security, which faces an estimated $3 trillion revenue shortfall over the next 75 years.[8] Furthermore, such 10-year predictions of surpluses (as well as deficits) must be taken with a grain of salt. CBO predictions assume that *current* economic conditions and tax receipts will remain constant over the next two years — a feat that is next to impossible.[9] Indeed, unless the law of business cycles has been effectively repealed (which some foolishly suppose to be the case), a recession will eventually arrive, and with it tax revenues will decline precipitously. So don't bet the house on the predicted trillion dollar surplus ever being realized — just as CBO's predictions earlier in the decade of 10 years worth of deficits (based on then current economic conditions) never materialized. To paraphrase John Nance Garner's description of the vice presidency, a position he knew something of, 10-year budget predictions aren't worth a pitcher of warm spit.

At any rate, if the "on-budget" surplus alone cannot save social security, at least politicians and the public are finally recognizing that there is a serious problem with social security — namely, that the social security trust fund will be depleted within the next three decades. If people are starting to understand that, there is much that still confuses them. For instance, many seem genuinely shocked to learn that the nearly $700 billion of accumulated assets of the social security trust

[3]For a reasoned discussion of the various arguments over what to do with the projected surpluses, see Herbert Stein, "At Sea With Surpluses," *Wall St. J.*, May 19, 1998, p. A22.

[4]U.S. Treasury Department, *Final Monthly Treasury Statement of Receipts and Outlays of the United States Government for Fiscal Year 1998.* According to the most recent figures in the IRS Statistics of Income Bulletin, adjusted gross income reported on individual tax returns rose 8.3 percent, and total individual income taxes rose 12 percent for 1996. Much of the increase was attributable to a surge in net capital gains — up 48 percent over 1995. These trends certainly continued throughout 1997 and into 1998.

[5]Congressional Budget Office, *Economic and Budget Outlook: Fiscal Years 2000-2009* (Washington, D.C.: Government Printing Office, January 1999).

[6]Plans have been sketchy. Last year, the president was proposing to dedicate 100 percent of the surplus to social security. In his recent State of the Union address, Clinton proposed that 62 percent of the budget surplus over the next 15 years be used to "save" social security, while another 15 percent should be devoted to the trust fund for Medicare, and some 11 percent used to shore up the military and other "pressing national problems." William Jefferson Clinton, "Address Before a Joint Session of the Congress on the State of the Union" (January 19, 1999).

[7]Congressional Budget Office, *Economic and Budget Outlook: Fiscal Years 2000-2009* (Washington, D.C.: Government Printing Office, January 1999). This latest prediction of an on-budget surplus in 2001 revises CBO's prior prediction that such would not be realized until the year 2005. The on-budget surplus excludes revenue (and losses) from the social security trust funds and the much less significant revenue from the Postal Service.

[8]United States General Accounting Office, "Social Security: Different Approaches for Addressing Program Solvency," (GAO/HEHS-98-33) Washington, D.C.: U.S. General Accounting Office, July 1998.

[9]CBO's 10-year estimates assume that current economic conditions will persist during the first two years of the period and take into account the "possibility of booms and recessions" during the final eight years of the period. However, current economic trends are incorporated into long-term projections. For example, in its revised January 1999 forecast, CBO takes into account a "greater projected strength of the economy" and accordingly, boosts its estimate of 1999 revenues by $3 billion and 2008 revenues by $39 billion compared with its projections of just five months ago.

fund is not sitting in a vault somewhere or hidden under the mattress of Kenneth Apfel, Commissioner of the Social Security Administration, but rather is invested in government debt obligations. Excess receipts attributable to the social security wage tax are borrowed and used by the federal government to fund other programs. Now the rate of return on those government debt obligations may not be as great as the performance of the S&P 500 — although it just might be in future years.[10] (Remember, even Warren Buffett occasionally loses money in the stock market, and the great currency speculator George Soros apparently lost a small fortune when the ruble crashed in 1998.[11]) But lending to Uncle Sam is considerably less risky than investing in the stock market or the Ruble, as the "full faith and credit" of the federal government stands behind repayment of its debt obligations. While the full faith and credit of the U.S. government is worth something less than that of Bill Gates, it runs a close second. Of course, the convenient arrangement between social security and the Treasury necessitates that the federal government eventually repay its debt to social security — either by raising taxes or cutting benefits at some future date. Since the latter is not a very attractive political option, and the social security wage tax is pretty much at its upper limits, which will most likely leave income taxes to be raised. That is when the crunch will really hit!

Of course, if the Treasury stopped borrowing from social security (and the trust fund, seeking higher returns, invested in the stock market), the government either would have to raise taxes or cut expenditures *today*, otherwise the Treasury would have to borrow from sources other than the social security trust fund (i.e., sell some more bonds to the public). One way or the other, the government must borrow (either now or later) to the extent that there remains a budget deficit — albeit one masked by the temporary positive cash-flow from social security. At the same time, "dedicating" the on-budget surplus to social security just means that general tax revenue is financing the social security program. There just is no free lunch — except for the parents of us Baby Boomers, who have enjoyed social security payments far in excess of their contributions to the system.[12]

Presumably, what Democrats intend is to somehow enhance the ability of the social security system to meet its commitments after the trust fund's cash flow goes negative by 2013 or after the trust fund is actually exhausted by 2032.[13] If that is their intention, then it would be most prudent to dedicate surplus revenues (both the current social security surplus and any future on-budget surpluses) to paying down the $5.6 trillion national debt. To the extent this is done, the government will be forced to finance current non-entitlement programs from general revenue, necessarily raising taxes today and thereby, freeing future generations from at least some portion of the debt service on the national debt. As economist Herbert Stein (one of the true voices of reason in the universe, to say nothing of the American Enterprise Institute) advises, we should use the current social security surplus and any future on-budget surpluses to "reduce the federal debt, add to national savings and increase the ability of future generations to meet the demands they will face."[14] Certainly, one of the greatest demands that future generations of Americans will face is the $3 trillion revenue shortfall that awaits the social security system over the next 75 years. Indeed, it is only because federal budget calculations do not employ concepts of accrual accounting that we can conveniently ignore this unfunded long-term liability and speak of budget surpluses in the first place.

So "fixing" social security requires much more than half-baked notions of dedicating surplus funds to the social security trust fund.[15] It is much easier to

[10]In calendar year 1997, interest earnings on the invested assets of the combined OASI and DI Trust Funds totaled $43.8 billion, representing an effective annual rate of 7.5 percent. *1998 Annual report of the Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Funds*, April 28, 1998.

[11]Allegations have been made that Soros caused and profited from the collapse of the ruble. However, one recent report concludes that the claim of the chief investment strategist at Soros Fund Management that the Russian crisis cost Soros close to $2 billion is highly credible. Chrystia Freeland, "Idle Speculation: Did George Soros Really Kill the Ruble?" *New Republic*, Feb. 8, 1999, 17-19.

[12]The best account of the inter-generational redistributive effect of social security is found in Laurence J. Kotlikoff, *Generational Accounting* (New York: Free Press, 1992); *see also* C. Eugene Steuerle and Jon M. Bakija, *Retooling Social Security*

(Footnote 12 continued in next column.)

for the 21st Century: Right and Wrong Approaches to Reform (Washington, D.C.: Urban Institute Press, 1994), pp. 106-113 (summarizing authors's conclusions with respect to inter- and intra-generational transfer effects of social security system).

[13]Even after the Old Age and Survivors Insurance ("OASI") Trust Fund is exhausted by the year 2032, in-coming tax revenue from the wage tax will be sufficient to pay about 3/4 of programs costs (i.e., benefits), declining to 2/3 by the year 2073. The Hospital Insurance ("HI") and Disability Insurance ("DI") Trust Funds are in much worse financial condition and will be exhausted well before the OASI Trust Fund.

[14]Herbert Stein, "Why I am a Republican," *Wall St. J.*, Dec. 29, 1998, p. A12. Stein's new book, *What I Think* (Washington, D.C.: American Enterprise Institute, 1998), is a must-read — notwithstanding its pompous title.

[15]The president claims that dedicating 62 percent of the (unified) surplus to social security over the next 15 years will postpone bankruptcy until the year 2055, but he is really "double-counting" that portion of the surplus which already belongs to the social security trust fund — namely, the $2.7 trillion that will be accumulated over the next 15 years from the social security wage tax and invested in Treasury debt obligations that already will be assets of the trust fund. For a biting critique of the shoddy accounting behind this "budget sham," see Martin Feldstein "Clinton's Social Security Sham," *Wall St. J.*, Feb. 1, 1999, p. A20; *see also* Matthew Miller, "Slick: Saving Social Security With a Pencil," *New Republic*, Feb. 15, 1999, pp. 14-15 (describing Clinton's plan as a double-counting "accounting scam"); Gene Steuerle, "'Spending' the Surplus: Counting the Ways," *Tax Notes*, Feb. 1, 1999, p. 715 ("Essentially, the administration has proposed to run a non-social security deficit of about $2 trillion to be

(Footnote 15 continued on next page.)

proclaim one's devotion to social security than actually take the hard choices necessary to put the system in actuarial balance. As economist Henry Aaron and his colleague at the Brookings Institution, former director of CBO Robert Reischauer, have put it in their new book, *Countdown to Reform: The Great Social Security Debate*, there really are only three choices for accomplishing that goal, and all three may be necessary: benefits to participants must be cut in some fashion, a tax increase of some sort (whether income or wage tax) must be adopted, or returns on the trust fund must be increased.[16] While the third option was very popular six months ago, enthusiasm seems to have cooled since last summer's mini-stock market crash.[17] Similarly, the first two choices are not very inviting for those who have to face constituents in November. Thus, we hear the empty political rhetoric of dedicating the social security surplus to the social security trust fund. Or even worse!

There is no shortage of innovative plans that purport to save social security without either cutting benefits or increasing taxes. The most popular of such plans is that advanced by Harvard University economist Martin Feldstein, former chairman of President Reagan's Council of Economic Advisers. Under Feldstein's plan, which Senate Finance Committee Chairman William Roth, R-Del., and House Budget Committee Chairman John Kasich, R-Ohio, both favor in some form or another, the surplus would be used to fund individual (tax-free) social security accounts for workers. As individuals earn $1 of investment return on these accounts, their social security benefits would be reduced by 75 cents, providing a windfall to both the government and the worker. In the worse case scenario, if a worker loses his entire individual account (say, on account of a crash in the stock market, or because he invested in the ruble), his social security benefits would be no less than under the current system. Of course, the government would be much worse off. Feldstein's plan relies on the stock market and booming economy to bail out the government and reduce its $3 trillion unfunded liability to future social security beneficiaries. But if the economy and stock market do not perform as anticipated (which is highly possible), the government will be left with the same $3 trillion social security shortfall, the surplus will be spent, and the national debt will remain undiminished. Then taxes would need be raised or social security benefits cut. As Jonathan Chait of the *New Republic* has put it: "This isn't a solution to social security's problem — it *is* social security's problem."[18]

The president has proposed his own plan for new retirement savings accounts. Universal Savings Accounts (or "U.S.A. Accounts") are intended for those with incomes below certain thresholds (most likely, somewhere between $80,000 to $100,000). The new savings accounts are to be funded by the government, using some 11 percent of the surplus (over the next 15 years) to match the contributions made by an estimated 100 million participants. The accounts would be under the control of the individual participants, rather than the government.[19] While purporting to create incen-

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able to finance both the additional transfer to social security and its other spending and tax proposals."); *but cf.* Henry J. Aaron, "The Phony Issue of Double-Counting," *Tax Notes*, Feb. 1, 1999, p. 717 (concluding that "the double-counting issue is bogus.") Aaron's point is that while the president's plan does in a sense "double-count" that portion of the surplus to be "dedicated" to social security and accordingly, will result in an increased deficit under "traditional unified budget accounting" rules, this "extra" contribution to social security will reduce by an equal amount the federal government's "shadow debt" (e.g., the government's unfunded liability for future social security and Medicare payments in excess of the present value of future wage taxes at current rates).

[16]"Investing social security's reserves in a broad mix of private and public assets would strengthen the programs' financial position substantially. But additional measures — benefit cuts or tax increases — are required to fully address the programs' long-run imbalance." Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform: The Great Social Security Debate* (New York: Century Foundation Press, 1998), pp. 13-14. Federal Reserve Chairman Alan Greenspan recently expressed his view that any "permanent" solution to social security will require either benefit cuts or tax increases. Martin Crutsinger, "Greenspan Says Social Security to Need Tax Increase or Benefit Cuts," *Philadelphia Inquirer*, Jan. 29, 1999, p. A2. The difficulty of "fixing" social security with tax increases or cuts in benefits while preserving the overall (albeit ambiguous) features of the social security program (such as the progressivity of the distribution of benefits) is the central theme of the best account of reform policy, Steuerle and Bakija, *Retooling Social Security for the 21st Century*. The political campaign to "save" social security out of existence by "privatizing" accounts is discussed in Jonathan Chait, "Security Risk," *New Republic*, Jan. 18, 1999, pp. 22-25. A new academic study of privatization is Lawrence S. Seidman, *Funding Social Security: A Strategic Alternative* (New York: Cambridge University Press; forthcoming 1999).

[17]The idea is still pretty popular with Republicans. Furthermore, President Clinton has proposed dedicating some $2.8 trillion (or 62 percent of projected surpluses) to social security over the next 15 years. Of this, some $650 to $700 billion would be invested in stocks, rather than Treasury debt instruments. William Jefferson Clinton, "Address Before a Joint Session of the Congress on the State of the Union" (January 19, 1999). The day after the president's State of the Union address, speaking before the House Ways and Means Committee, Alan Greenspan, Chairman of the Federal Reserve Board, expressed his reservations about the president's plan for the government to enter the private securities markets in such a big way. He also advised against

(Footnote 17 continued in next column.)

Chairman Bill Archer's suggestion that a big tax cut is needed. David Wessel, "Greenspan Frets Over Outlook for Stocks: Fed Chair Opposes Plan by Clinton to Invest Part of Social Security Fund," *Wall St. J.*, Jan. 21, 1999, p. A3. Free-market economist Milton Friedman suggests that government investment of the trust funds in the stock market would lead to "socialism." Milton Friedman, "Social Security Socialism," *Wall St. J.*, Jan. 26, 1999, p. A18.

[18]Chait, note 16 *supra*.

[19]Budget of the United States Government, Fiscal Year 2000 (submitted to Congress by President Clinton, February 1, 1999). Specifics of the plan are hard to come by, even in

(Footnote 19 continued on next page.)

tives for savings, U.S.A. accounts are really little more than new entitlements for the middle class. The new retirement accounts have been aptly referred to as "some sort of government-endowed Orwellian defined contribution plan."[20] Already, suggestions have been made that the new savings accounts should be made available for uses other than retirement — e.g., education expenses, home ownership, medical expenses, etc. Rather than something new, the president's plan just reflects the same shoddy thinking that got us into the mess with social security in the first place. Nevertheless, Democrats will like the plan because it is targeted at lower income workers. Republicans will like it because it returns some portion of the surplus to taxpayers and leaves investment of the funds in the hands of individuals, rather than the government. Reportedly, aspects of the plan are even agreeable to free-market types at the CATO Institute and conservatives at the Heritage Foundation.[21] That's when you really know it's trouble!

PAYGO Must Go?

For their part, Republicans have offered little more than Democrats across the aisle — and perhaps a whole lot less. Leaders of the GOP in the House (at least, those who have so far survived the impeachment of the president) have proposed private investment of social security trust funds as the cure for the social security shortfall and tax rate reduction as the solution to the budget surplus. The latter sentiment was most evident in the failed September 1998 House tax bill, which would have provided $80 billion of targeted tax cuts over five years.[22] House Budget Committee Chairman Kasich and Senate Budget Committee Chairman Pete Domenici, R-N.M., have been meeting for weeks to work out a budget deal for some $500 billion in tax cuts over the next 10 years.[23] The Republican response to President Clinton's 1999 State of the Union address called for an across-the-board 10 percent tax cut — which would be the largest tax cut since the Economic Recovery and Taxpayer Relief Act of 1981 (ERTA).[24] But Republicans also support dedicating some portion of the projected surplus to fund a host of new tax preferences, including tax credits for educational expenses, including private school tuition, and a further reduction in the preferential rate for capital gains.[25] The GOP's campaign for such "targeted" tax cuts is partially motivated by the politician's need to constantly curry favor with constituents — who in the case of the Republican Party happen to own considerable capital investments, send their kids to private schools, and earn a whole lot more than most of us. It also reflects a deep-rooted ideological aversion to governmental intervention in the private lives of the citizenry via the federal income tax. As Kasich puts it: "The end game here is to strip the government of the financial means for butting into the lives of Americans, and thus, returning power and responsibility to families and localities."[26] This is the kind of sentiment that has motivated Republican attacks on the Internal Revenue Service over the past few years, culminating in Senate Finance Committee hearings in 1997 and 1998 on purported "abuses" of taxpayers committed by the IRS. Those hearings, in turn, culminated in the Internal Revenue Service Restructuring and Reform Act of 1998.[27]

For his part, President Clinton has responded to Republican proposals for tax cuts with his own scheme, most recently a proposal for a new $1,000 tax credit intended to induce families to care for elderly or dependent relatives.[28] (Previously, only so-called social conservatives expounded the view that economic incentives are necessary to induce American families to care for their loved ones, adopt children, and presumably, engage in the very act of procreation itself.) House Republicans were quick to support the president's proposed tax credit, pointing out that they thought of it first and had included a comparable plan in their 1994 campaign manifesto, the Contract With America.[29] Such bipartisan support for a tax preference seldom bodes well for the Treasury or the integrity of the tax code.

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the Treasury's 198-page description of the president's revenue proposals — the so-called Green Book. Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999). The day the president's budget was released, Deputy Treasury Secretary Lawrence Summers was quoted as saying that the "vast majority" of Americans would be affected by the USA Accounts. Tom Herman and Karen Hure, "New Retirement Plans, Tax Breaks Are Offered in Clinton's Proposal," *Wall St. J.*, Feb. 2, 1999, p. C1.

[20]Christopher Bergin, "The Sounds of Cheers and Silence," *Tax Notes*, Jan. 25, 1999, p. 397.

[21]Leslie Wayne, "U.S.A. Accounts Are New Volley in Retirement Savings Debate," *N.Y. Times*, January 24, 1999, sec. 3, p. 4.

[22]Joint Committee on Taxation, "Estimated Budget Effects of H.R. 4738, As Passed by the House of Representatives on October 12, 1998," JCX-72-98 (October 13, 1998).

[23]Alan Fram, "GOP Lawmakers Seek Wide-Ranging Tax Cuts in 2000 Budget," *Philadelphia Inquirer*, Jan. 8, 1999, p. A19.

[24]*See* computation in Martin A. Sullivan, "Budget Outlook: We're in the Money," *Tax Notes*, Feb. 1, 1999, p. 581.

[25]In a series of particularly cogent and compelling editorials, the editors of the generally pro-business *Wall Street Journal* chide Republicans for supporting such targeted tax cuts and advocates a 10-percent across-the-board tax reduction. "Republicans Rediscover Growth," *Wall St. J.*, Jan. 24, 1999, p. A10; "Tax-Credit Mania," *Wall St. J.*, Jan. 18, 1999, p. A18.

[26]Quoted in David Hess, "Congress to Ponder Tax, Education and Social Security Bills," *Philadelphia Inquirer*, Jan. 6, 1999, p. A11.

[27]Pub. L. No. 105-206, 112 Stat. 685.

[28]The credit (effective for taxable years beginning after December 31, 1999) would be phased out for married taxpayers filing a joint return with income in excess of $110,000, and at $75,000 for single taxpayers. Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999), p. 1.

[29]The president's tax credit actually goes beyond prior Republican proposals.

Clinton's proposal for the costly $1,000 tax credit was part of a broader package of assistance to further long-term care for the elderly. It also was just the beginning. Soon after, the president announced a slew of other new tax credits intended to implement the White House's social policy agenda. Included in the package (earmarked for the fiscal year 2000 budget) is a new tax credit for disabled workers; a tax credit to encourage investment in underdeveloped urban and rural areas; a tax credit to induce consumers to buy a new breed of fuel-efficient automobiles; a tax credit for employers who improve adult literacy; a tax credit for the purchase of rooftop solar energy equipment; and another tax credit to encourage employers to retrain blue-collar workers.[30] The administration would also exempt $2,000 of severance pay for workers and extend the welfare-to-work tax credit for one more year. Finally, the administration has proposed a new tax credit to aid the ailing U.S. steel industry. That proposal would allow steel manufacturers to carry back net operating losses for five taxable years, instead of the current two.[31]

The Byrd rule and PAYGO have been highly effective in blocking the inclusion of new tax cuts and tax expenditures in budget bills.

Unfortunately for all politicians (Republicans and Democrats alike) who believe that the tax code is the perfect vehicle for making social policy and distributing goodies to constituents in their home district, there is one significant obstacle to enacting these targeted tax cuts — the so-called pay-as-you-go (or PAYGO) rule. PAYGO was adopted by the Budget Enforcement Act of 1990,[32] amending the Congressional Budget and Impoundment Control Act of 1974.[33] Under the 1990 budget rules, any tax reduction must be offset by a comparable revenue increase or cut to "direct" discretionary spending programs; annual net revenue losses from all new legislation must be offset by revenue enhancement or direct spending cuts.[34] Even more important, the PAYGO rules expressly bar Congress from so using a budget surplus to finance tax cuts (both across-the-board tax cuts and targeted tax preferences).[35] You cannot simply cut taxes to make the surplus go away. Nor can you give tax credits to family members who care for Gramps without coming up with offsetting revenue.

Under the 1990 budget rules, if there is a revenue loss for the fiscal year as a whole, determined by reference to the annual fiscal-year budget baseline set by the Office of Management and Budget (OMB), sequestration of discretionary spending is imposed automatically. (Social security, a so-called entitlement program, is unaffected.[36]) The Budget Committee is authorized to report a "pay-as-you-go reconciliation directive" in the form of a concurrent resolution whenever any legislation creates a net revenue reduction for any fiscal year — in other words, when there is no revenue offset "within the same measure."[37] This PAYGO rule, which requires *annual* revenue offsets, was translated by then Ways and Means Committee Chairman Dan Rostenkowski, D-Ill., and then Senate Finance Committee Chairman Lloyd Bentsen, D-Texas, into a practice within both tax committees whereby any single legislative proposal that costs revenue must be coupled with an offsetting revenue raiser *in the same bill*. The tax committees have followed this procedure in the years subsequent to the departures of Rostenkowski and Bentsen from the Congress. In the Senate, the so-called Byrd rule applies in addition to the PAYGO requirement for revenue neutrality. This rule, devised by West Virginia Senator Robert Byrd, requires that any "extraneous" provision in a budget bill (i.e., one not having significant revenue or spending impact) be stricken unless 60 senators vote on the floor of the Senate in favor of retaining such provision.[38] The Byrd rule and PAYGO have been highly effective in blocking the inclusion of new tax cuts and tax expenditures in budget bills.

To solve the dilemma imposed on politicians by these restrictive budget rules, a number of leading con-

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[30]The entire package is included in the Budget of the United States Government, Fiscal Year 2000 (submitted to Congress by President Clinton, February 2, 1999), and is described in detail in Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999).

[31]According to Treasury, the current 20-year carryforward period would not be changed and only losses related to activities incurred in the manufacture or production of steel and steel products would be eligible for the 5-year carryback. Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999), p. 91. For an account of the politics behind the proposal, see Bob Davis, "White House Proposes Some Tax Breaks for Steel Industry, Pressures Japan," *Wall St. J.*, Jan. 8, 1999, p. A2.

[32]2 U.S.C.A. section 601 *et seq.* (Title 6, "Budget Agreement Enforcement Provision").

[33]Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-433.

[34]*See* 2 U.S.C.A. sections 633(c), (f), and 902.

[35]2 U.S.C.A. sec. 601 *et seq.* (Title 6, "Budget Agreement Enforcement Provision"). The Budget Enforcement Act of 1990 also provided for adjustable spending caps and caps on discretionary spending. These are easily avoided, as witnessed by the president's fiscal year 2000 budget. *See* David Wessel, "How Budget Maneuvers Around Spending Caps," *Wall St. J.*, Feb. 2, 1999, p. A8.

[36]For a discussion of the problems of budgeting for entitlement programs such as social security, see Joseph White, "Budgeting for Entitlements," in *Handbook of Government Budgeting*, Roy T. Meyers, ed. (San Francisco: Jossey-Bass Publishers, 1999), pp. 678-698.

[37]2 U.S.C.A. section 604(a).

[38]The Byrd rule is described in greater detail in Allen Schick, *The Federal Budget: Politics, Policy, Process* (Washington, D.C.: Brookings Institution, 1995), p. 85; *see also* Christopher Georges, "Byrd Procedural Rule Is Threatening to Derail Substantial Portions of the Republican Agenda," *Wall St. J.*, Nov. 8, 1995, p. A22.

gressional Republicans have been calling of late for the abandonment or modification of the offending provisions. In particular, Rep. Kasich has proposed repealing PAYGO so Congress can enact deep tax cuts.[39] Along similar lines, two influential members of the Senate have called for modifying the 1990 budget rules. Senators Roth and Domenici both have expressed interest in relaxing these budgetary rules to allow for tax cuts funded by surpluses. According to Roth, "We have surpluses and the rules ought to be updated to meet the current situation."[40] (Basically, this means, whether by dumb luck or good fortune, we have successfully created the illusion of a surplus, so let's spend it now, while we can, before the social security shortfall hits the fan.) Meanwhile, Domenici has suggested changing the rules to allow any on-budget surplus (not including surpluses arising from social security) to be devoted to tax reductions.[41]

Senator Roth is consistent in expressing such sentiments, as he has had a long and distinguished career championing tax cuts. Recall that nearly 20 years before rising to chair the Finance Committee, Roth and then Representative Jack Kemp introduced a proposal ("Kemp-Roth") calling for a 33 percent reduction in the tax rate for individuals and a reduction in the corporate rate of 3 percentage points. In the spring of 1981, newly elected President Reagan introduced his own legislative proposal for somewhat more modest tax rate reductions styled on Kemp-Roth.[42] The Reagan plan eventually blossomed into the Economic Recovery and Taxpayer Relief Act of 1981 (ERTA).[43]

As opposed to Roth's unwavering support for tax cuts, Domenici's position represents a significant about-face. For years, he has been a bulwark within the GOP for fiscal responsibility — an increasingly quaint and all but extinct tradition once popular among congressional Republicans, especially those from the Northeast, but definitely not among the new breed of Republicans from Texas. Domenici's new-found enthusiasm for tax cuts gives the anti-tax wing of the GOP an important boast, while simultaneously undermining the anti-deficit position he himself advanced for decades. It also turns the tables on debate over the 1990 budget rules. In another one of those delicious ironies of politics, ranking Democrat Frank Lautenberg of New Jersey and six other Democrats on the Senate Budget Committee (none of whom would be referred to as "bulwarks of fiscal responsibility") recently wrote to chairman Domenici urging him to refrain from abandoning the PAYGO rules on the grounds that to do so would "undermine Congress's fiscal discipline."[44] Talk about the Old Switcheroo! Apparently, a bulwark isn't what it used to be.

> ***'PAYGO must go!' This could be the new mantra of the GOP in 1999. Unfortunately, with the repeal of PAYGO will go any hope of a 'real' surplus ever materializing.***

So with the old-time fiscal conservatives gone from the Senate (Where are you now, Bob Dole?), and fellow travelers such as Domenici realigning themselves with the House crusaders for tax cuts (most notably, Ways and Means Committee Chairman Bill Archer, R-Texas, newly re-elected Majority Leader Dick Armey, R-Texas, and Kasich), a challenge to the 1990 budget rules will surely be mounted in the 106th Congress — most likely during this year's expected budget process reform hearings. Changing PAYGO is a must for the GOP since it is impossible to finance such tax cuts within the framework of the current budget rules. There simply is not enough "fat" left in the federal budget for expenditure reductions to finance significant tax cuts, and likewise, it is getting virtually impossible to come up with new revenue to offset even minor tax expenditures, let alone the sort of large-scale tax cuts envisioned by the antitax wing of the Republican party.

And so, "PAYGO must go!" This could be the new mantra of the GOP in 1999. Unfortunately, with the repeal of PAYGO will go any hope of a "real" surplus ever materializing. The point lost on the critics is that the very success of the 1990 budgetary rules has, along with the booming economy, made possible the budget surplus that they are now looking to give back to the taxpayers through tax cuts — as opposed to using it to pay down the national debt. Abandoning PAYGO *before* the on-budget surplus even arrives will merely ensure that there *never* is any extra cash to play around with, as the heightened discipline achieved in the budget process during the 1990s was largely attributable to PAYGO.

The main achievement of the 1990 budget rules was to impose a new framework for responsible policymaking on those in Congress entrusted with writing our tax laws. PAYGO checks the natural impulse of

[39]For an account of Kasich's position, see Jonathan Chait, "Honest John," *New Republic* (July 13, 1998), pp. 22-25.

[40]Jacob M. Schlesinger, "Senate Leaders Call for Easing of Rules Limiting Tax Cuts and Spending Increases," *Wall St. J.*, Dec. 7, 1998, p. A3.

[41]Domenici's position is discussed in Greg Hitt, "Surplus Converts Chief GOP Deficit Hawk to Tax Cuts," *Wall St. J.*, Feb. 1, 1999, p. A22; Heidi Glenn, "Senate Budget Committee to Look at Pay-As-You-Go Rules," *Tax Notes*, Dec. 28, 1998, p. 1593. Domenici initially argued that the rules already allow an on-budget surplus to be used for tax reduction — a position flatly disputed by departing CBO director June O'Neill. *See* Heidi Glenn and Daniel Tyson, "Clinton Throws Out First Tax Cut Chip," *Tax Notes*, Jan. 11, 1999, p. 159. In late January, Domenici introduced legislation that would put Congress on a two-year budget cycle as well as permit on-budget surpluses to finance tax cuts or direct spending increases.

[42]The original Reagan proposal called for 10 percent rate reductions in each of three successive years, retroactive to January 1, 1981. That would have amounted to an overall 27 percent reduction in the tax rate for individuals.

[43]Pub. L. No. 97-34, 95 Stat. 172.

[44]"Senate Budget Dems Urge Leaving Pay-As-You-Go Rules Unchanged," *Tax Notes*, Dec. 28, 1998, p. 1647.

Democrats to spend more than the governmental actually takes in, and likewise, restrains the deep-rooted instinct of Republicans to shelter its well-heeled constituents from the income tax. In this respect, the 1990 budget rules were a great success as politicians of both parties were forced to work within the framework of budget neutrality. Nevertheless, just because PAYGO checks the instincts of politicians to run up deficits does not mean that the budget process is working the way it should.

> ***The real problem with PAYGO is that the requirement for revenue neutrality has imposed a very peculiar and undesirable pattern of policymaking on the federal income tax.***

First of all, critics are right in suggesting that if the government continually raises significantly more than it spends, something must be out of whack. Indeed, if surpluses become large enough as a percentage of GDP, they can inflict adverse affects on the economy.[45] If surpluses persist over time, it is one indication that the government is either taxing too much or not spending enough — for example, not spending enough on public goods that are desired and necessary for maximum economic efficiency.[46] The current crop of Republicans has had little experience dealing with such "problems." The last time that a Republican Congress faced the dilemma of how to spend surplus revenue was during the 1880s and 1890s, when the tariff generated perennial budget surpluses. In 1883, the eclectic economist Henry George pointedly observed that on account of the revenue brought into the federal Treasury by the tariff, "the great question before Congress [was] what to do with the surplus."[47] The GOP's solution then was to get rid of the excess cash by continually increasing the pensions of Civil War veterans — at least, those who wore blue uniforms. It is doubtful that the modern Republican Party would find such a scheme very inviting. These days, tax cuts have much greater appeal within the GOP.

If Republicans are short-sighted in abandoning PAYGO for tax cuts, they are not mistaken in calling for a re-examination of the continuing vitality of the 1990 budget rules — they are just focusing on the wrong issue. The real problem with PAYGO is that the requirement for revenue neutrality has imposed a very peculiar and undesirable pattern of policymaking on the federal income tax. The adverse effect on tax policymaking, *not* the need to implement massive tax cuts, warrants a reconsideration of the budgetary rules adopted in 1990. This may or may not dictate modifications or even abandonment of PAYGO altogether. Surely it will be a close call as to whether the benefits of the budget discipline derived from PAYGO outweigh the adverse effects resulting from revenue neutral tax policymaking. Appraising the success and continued usefulness of the PAYGO rule requires an assessment of what revenue neutrality has done to tax policymaking over the past decade. To understand just what is wrong (as well as right) about the PAYGO budget rule, it is necessary to step back and recall the particular political and economic context in which they were adopted — namely, perennial budget deficits and a mounting national debt. Of course, such recollection requires a memory that extends back beyond the current fiscal year — something sadly lacking in Washington these days.

Does Anyone Remember the Deficit?

The origins of the 1990 budget rules can be traced to the significant budget deficits that followed in the wake of the tax reductions implemented under ERTA.[48] Almost as soon as ERTA was enacted in 1981, congressional tax policymakers began to shift course in the wake of new and gloomy forecasts of increased budget deficits attributed to the ERTA tax rate cuts. The problem was that the administration had not reduced spending to counteract the impact of the ERTA tax cuts. In fact, overall spending (especially that earmarked for defense) increased even faster than the economy expanded. As economist Barry Bosworth of the Brookings Institution has described the outcome, the fiscal stimulus from the anticipated budget deficits, coupled with the "large capital borrowing that it entailed, collided with a monetary policy intent on restricting the supply of credit and economic activity to reduce inflation. The result was a sharp increase in interest rates that overwhelmed the investment incentives of the tax cut."[49]

When the Reagan administration took no decisive action on the budget deficit, Congress responded with its own deficit-reduction legislation. Interesting enough, this legislative initiative was advanced by Senator Robert Dole, R-Kan., from his helm at the Finance Committee. Representing the traditional wing of the Republican Party and raised on principles of fiscal conservatism, Dole balked at the supply-side notion of reducing taxes to raise revenue. He became increasingly concerned about the budget-deficit crisis

[45]Exactly when surpluses would push the economy to recession is an open question. Most economists believe that the Federal Reserve Board will be able to offset the contractionary effect of the currently projected surpluses through lower interest rates.

[46]Even the looniest supply-sider, Jude Wanniski, once acknowledged that some level of taxation and public spending is necessary to achieve the optimal level of desired public goods and services. Jude Wanniski, "Tax Revenues and the Laffer Curve," *The Public Interest* (Winter 1978), pp. 4-5.

[47]Quoted in John H. Makin and Norman J. Ornstein, *Debt and Taxes* (New York: Random House, 1994), p. 75.

[48]In the discussion that follows, I draw heavily on my account of tax policy in the 1980s in *The Failure of U.S. Tax Policy: Revenue and Politics* (University Park: Penn State Press, 1996).

[49]Barry P. Bosworth, *Tax Incentives and Economic Growth* (Washington, D.C.: Brookings Institution, 1984), p. 187.

that loomed on the horizon. On the floor of the Senate, defending the revenue-raising provisions of the bill, Dole declared that "the roots of this evening's debate actually go back to February [1982], when the President [Reagan] released a budget calling for deficits in excess of $700 billion over the next three years. Those deficits were unacceptable by any criteria."[50] The irony of Senate Republicans acting to repudiate and reverse the Reagan tax policy enacted just the prior year was not lost on either Speaker of the House Tip O'Neill or Ways and Means Committee chairman Rostenkowski, both of whom were delighted with the prospect of a Republican civil war.

Dole, with the support of other Republican members, reported out of the Finance Committee a $100 billion revenue bill in late June 1982. The legislation passed the Senate on July 23 with voting following strict partisan lines — with Republicans voting *for* the tax increase. The House adopted the bill soon after, with both Republicans and Democrats in the House divided. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[51] implemented modest deficit reduction, of which 70 percent was attributable to tax increases. Two years later, additional modest deficit reduction was achieved under the omnibus revenue bill known as the Deficit Reduction Act of 1984 (DEFRA).[52] The overall effect of TEFRA and DEFRA was to raise modest amounts of new revenue, mostly through tax increases, with few cuts to expenditures.[53] While the deficit crisis was hardly resolved by TEFRA and DEFRA, these bills generally reversed the worst trends established by ERTA, although hardly to the satisfaction of either those who demanded more significant spending reductions or those who supported tax cuts as for stimulating investment. Congress made another significant effort toward reversing course on budget deficits when it enacted the Balanced Budget and Emergency Deficit Control Act of 1985, commonly referred to as Gramm-Rudman-Hollings (GRH).[54]

GRH provided for gradual reductions in the deficit over the period from fiscal year 1986 through 1990 and a balanced budget by 1990. In 1987, the target balanced budget was postponed to 1993. At the heart of GRH was a formidable provision providing an automatic sequestration of funds if the projected deficit exceeded the allowable target for that fiscal year. According to Joseph White and the late Aaron Wildavsky: "The essence of GRH was budgetary terrorism."[55] Despite the threat of monetary emasculation, GRH proved ineffective in reducing the deficit precisely because it required only that the *projected* deficit be within the target, rather than restricting the actual deficit. As a result, policymakers found easy ways around the GRH targets. According to budget expert Allen Schick: "Reliance on projected rather than actual deficits led to manipulation of budget estimates, bookkeeping tricks in lieu of genuine savings, and deficits much higher than had been budgeted."[56]

The art of budget manipulation was perfected during the years under GRH and now is commonly applied to avoid the adverse effect of the 1990 budget rules.

If GRH was less than successful in reversing the perennial budget deficits, an important lesson was learned about how to cook the books to reduce projected deficits. The art of budget manipulation was perfected during the years under GRH and now is commonly applied to avoid the adverse effect of the 1990 budget rules. Revenue loss can be pushed back to later fiscal years through manipulation of the impact of a tax cut or expenditure. Likewise, revenue raisers can be created out of thin air through tax provisions that generate revenue in the current fiscal year, even while losing money for the Treasury in subsequent years. As long as the adverse effects of a provision are pushed into the future (e.g., beyond OMB's annual fiscal-year baseline), sequestration is avoided, politicians are happy, and life goes on in Washington as usual. Tax reduction for capital gains provides the most obvious example of such a manipulative budgetary device. These are scored as revenue-raisers in the short-term, but revenue-losers in the long-term. But as long as the revenue loss is beyond OMB's baseline, the tax cut looks pretty attractive.[57]

On the brighter side, policymakers also learned an important lesson during the mid-1980s from their experience with the most massive tax reform legislation

[50]*Congressional Record*, 97th Cong., 2d sess. (Aug. 19, 1982), 128, pt. 16, 22408.

[51]Pub. L. No. 97-248, 96 Stat. 324.

[52]The DEFRA tax provisions were enacted as the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494. Division A of the Deficit Reduction Act of 1984 is the Tax Reform Act of 1984, while Division B is the Spending Reduction Act of 1984.

[53]The staff of the Conference Committee estimated that TEFRA would close the deficit by $115.8 billion over three years. The 1984 act was projected to raise $50.7 billion over five fiscal years, 1984-87. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Washington, D.C.: Government Printing Office, 1985), p. 1256.

[54]Titles 9 and 10 of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-282.

[55]Aaron B. Wildavsky and Joseph White, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and Los Angeles: University of California Press, 1989), p. 431.

[56]Allen Schick, *The Federal Budget: Politics, Policy, Process* (Washington, D.C.: Brookings Institution, 1995), p. 39.

[57]OMB's annual fiscal-year baseline is determinative for purposes of whether sequestration is triggered under the PAYGO rules. Congress relies on revenue estimates from the Joint Committee on Taxation (JCT) when considering new legislation. CBO is responsible for estimating future revenues under current law as part of its 10-year baseline budget projections. If legislation affecting revenues is enacted, JCT estimates the revenue effects and CBO incorporates those estimates into its next baseline revenue projection.

ever enacted — the Tax Reform Act of 1986 (TRA '86).[58] As part of the agreement that brought together supply-side conservatives looking for lower marginal tax rates and liberal Democrats intent on stripping the tax code of loopholes and preferences, policymakers adopted a framework of "revenue neutrality" for the bill. It was agreed that the bill as a whole would neither raise nor reduce revenue overall, nor would the burden (or incidence) of taxation be shifted among taxpayers of varying income levels.[59] This framework of revenue neutrality imposed a new set of constraints and created a new pattern for policymaking that "effectively prevented many of these [special] interests from uniting against reform."[60] The result was that marginal tax rates were significantly reduced (to the delight of the supply-siders) and abundant tax expenditures were eliminated from the tax code (to the delight of everyone *except* the beneficiaries of those preferences). The success of revenue-neutral tax policymaking in 1986, although never replicated, provided a model for controlling a budgetary process seemingly out of control.

The Budget Rules of 1990

Notwithstanding efforts by Congress in the 1980s to check the excessive spending habits of its own members, budget deficits actually increased as a percentage of GDP by the end of the decade. By 1990, the economy was sliding toward recession, and concern over the federal deficit heightened. The deficit as a percentage of GNP had fallen from a peak of 6.3 percent in 1983 to some 3.4 percent in 1988. However, it then rose again to 4.1 percent for fiscal year 1990 and was estimated to be 5 percent by the close of the year.[61] There was an emerging consensus that more drastic changes in the budget process were necessary.

Propelled by its inability to persuade Congress to impose further spending cuts, the Bush administration entered into budget negotiations with Democratic congressional leadership in May 1990 in an effort to achieve reconciliation. The Bush administration was pushed into these negotiations by the looming presence of a worsening economy and the threat of a sequester of government spending mandated under GRH. The president's initial budget projections were for a $40 billion deficit, but that figure began to skyrocket as the economy declined. At the budget summit, negotiators agreed on a target of $40.1 billion in deficit reduction for fiscal year 1991 and a $500 billion deficit-reduction package spread over five years.

There were few guiding principles behind the 1990 budget negotiations. In many respects, this reflected President Bush's own lack of strong principles on tax policy — other than his infamous "no-new-taxes" 1988 campaign pledge. This permitted the congressional tax committees to maintain control over the negotiations, much to the detriment of the administration. Pressure was also imposed on Bush, as well as reluctant members of Congress, by the threat of a GRH sequester requiring the shutdown of the federal government. This pressure increased as the October 1 deadline for a new budget approached. When the deadline came and went without agreement on a congressional resolution authorizing the government to continue to spend money, operations were effectively shut down after October 5, for the Columbus Day holiday weekend.

PAYGO imposed on Congress revenue neutrality with a vengeance, and like it or not, significantly altered long-standing patterns of tax policymaking.

Much has been written of the political hay made by Democrats over the administration's many strategic blunders in the negotiations.[62] The administration interpreted the president's pledge not to raise taxes to apply only to *income* taxes, allowing agreement to be reached over increased user fees and a 10-cent increase in the gasoline tax. Eventually the White House also gave in and accepted an increase in the top individual tax rate from 28 percent to 31 percent, with the tax on long-term capital gains capped at the 28 percent rate as a compromise. Conservatives have never forgiven Bush. Budget negotiators in 1990 can also be blamed for such ill-conceived revenue raisers as the "phaseout" of personal exemptions and the reduction of certain miscellaneous deductions above thresholds of adjusted net income. The final tax bill to emerge from the negotiations, the Omnibus Budget Reconciliation Act of 1990,[63] achieved deficit reduction by increasing taxes more than cutting expenditures. Approximately 45 percent of the total deficit reduction from the legislation was derived from tax or user-fee increases, as opposed to reductions in expenditures. The bill was

[58]Pub. L. No. 99-514, 100 Stat. 2085.

[59]In fact, the distributional effect of TRA was slightly progressive *if* corporate taxation is distributed to high-income taxpayers. Henry J. Aaron, "The Impossible Dream Comes True," in *Tax Reform and the U.S. Economy*, ed. Joseph A. Pechman, (Washington, D.C. Brookings Institution Press, 1987), p. 10.

[60]C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* (Washington, D.C.: Urban Institute Press, 1992), p. 107.

[61]Congressional Budget Office, *The Economy and Budget Outlook: Fiscal Years 1991-1995* (Washington, D.C.: Government Printing Office, January 1990), app. E, table E-2.

[62]*See, e.g.*, Alan Murray and Jackie Calmes, "How the Democrats, With Rare Cunning, Won the Budget War," *Wall St. J.*, Nov. 5, 1990, p. A1; Donald F. Kettl, *Deficit Politics: Public Budgeting in Its Institutional and Historical Context* (New York: Macmillan, 1992), pp. 3-12. An interesting assessment of the budget agreement is found in Aaron B. Wildavsky and Joseph White, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and Los Angeles: University of California Press, 1989), pp. 577-89; *see also* C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* (Washington, D.C.: Urban Institute Press, 1992), pp. 173-84.

[63]Pub. L. No. 101-508, 104 Stat. 1388.

projected to raise $137 million of additional revenue over the five fiscal years 1991 through 1995.[64]

One additional outcome of the infamous 1990 budget summit was agreement on the principles that were then codified under the Budget Enforcement Act of 1990. Therein the principle of revenue neutrality that had guided policymakers in 1986 during negotiations for TRA was fixed into a hard rule for budgeting. PAYGO imposed on Congress revenue neutrality with a vengeance, and like it or not, significantly altered long-standing patterns of tax policymaking.

Revenue Neutrality and Tax Policy

Operating within the strict framework of revenue neutrality formally adopted as a budget rule in 1990, members of Congress are forced to weigh the respective equities between various preferences for special classes of taxpayers, rather than just offer preferences without regard to the consequences for the deficit. This limits the options available to those making tax policy: "[R]evenue neutrality altered the tax-writing process. Prior revenue bills were often constructed through political logrolling, whereby special interest provisions were added one to the next, until a winning coalition was achieved. As intended, revenue neutrality converted this process into a 'zero-sum game': each interest was in competition with all others."[65] Thus, the traditional mode of tax policymaking was altered as "the constraints of producing a revenue-neutral bill forced the distributive politics of taxation into a redistributive mold."[66]

The zero-sum game for revenue bills that is mandated of the congressional tax committees by the 1990 budget rules is the hallmark of contemporary tax policy. It makes it considerably harder for Congress to enact tax preferences. This is the beneficial side of PAYGO. Unfortunately, the new revenue-neutral policymaking has also produced some pretty strange-looking tax legislation. This has been illustrated numerous times since 1990. A look at some of the more dramatic, peculiar, and perverse products of revenue-neutral policymaking will help make the case against PAYGO. At the same time, it must be admitted that tax policymaking often has been unprincipled and ill-conceived throughout the postwar era. So while it may be tempting to blame PAYGO for all that is wrong with contemporary tax policy, that is too extreme. PAYGO just has made things a bit worse.

[64]Estimates of expenditure cuts and revenue effects are from Congressional Budget Office and Joint Committee on Taxation, "Budget Reconciliation (H.R. 5835) — Revenue Provisions as Reported by the Conferees," Oct. 26, 1990 (JCX-45-90).

[65]Timothy J. Conlan, Margaret T. Wrightson, and David R. Beam, *Taxing Choices: The Politics of Tax Reform* (Washington, D.C.: Congressional Quarterly Press, 1990), p. 101.

[66]*Id.* at 234.

PAYGO and Perverse Revenue Raisers

Remember that PAYGO requires that every tax cut or tax expenditure must be offset by a reduction in spending or an offsetting revenue raiser, and the tax committees operate under a rule requiring that every reduction in tax be offset by a matching revenue raiser in the same bill. This all makes for revenue neutral legislation and revenue neutral budgeting. However, as a framework for tax policymaking, revenue neutrality has produced very different outcomes than that realized in 1986. Then, revenue neutrality translated into lower marginal tax rates as policymakers eliminated tax preferences. For each special provision (i.e., deviation from a "normal income tax") stripped from the tax code, marginal rates were reduced accordingly. The overall result was a single omnibus tax bill pursuant to which a significant number of tax expenditures were removed from the income tax code and marginal rates were dropped from 50 percent to 28 percent — at least for a while. But the PAYGO rule has had a very different impact on tax policymaking in the 1990s.

During the 1990s, politicians returned to their "old" (pre-1986) habits, regularly giving in to the instinctual urge to dream up new tax preferences for constituents and to implement partisan policy agendas through the tax expenditure budget. But now, for each revenue loser created, a matching revenue offset must be found. In the largely Democratic tax bills of 1990 and 1993, the offsetting revenue was achieved through raising the marginal tax rate — a reversal and unwinding of the "reform" policymaking of 1986. That was bad enough. But in the wake of the new Republican majority that emerged following the November 1994 elections, it became political suicide to propose tax rate increases. And so, where is the revenue to come from to finance new tax preferences? In some of the strangest places, that's where! Government benefits are eliminated to groups that politicians deem an easy target. Modifications to existing tax provisions are enacted with no justification, logic, or guiding principle other than to squeeze a few million bucks out of the tax base. Deductions are trimmed, phased out for upper-income taxpayers, or deferred for no other reason than to raise revenue, even if the tax code is needlessly complicated and the very computation of taxable income is thereby distorted. The worst of it is that revenue-neutral tax policymaking results in double damage: *both* the proposed tax preference and the offsetting revenue raiser mangle the income tax. In the good old days, we just got tax preferences and the deficit.[67] We now have a balanced budget and a tax code that is being destroyed twice as fast by the odd coupling of unwarranted tax preferences and misconceived revenue raisers.

[67]Before PAYGO, tax expenditures resulted in increasing deficits. As a result, there was increased pressure to raise marginal rates and eventually, increased pressure for "tax reform" — defined as stripping preferences out of the tax code. This has led some to speculate on the cyclical nature of tax reform. *See, e.g.*, Irene S. Rubin, *The Politics of Public Budgeting: Getting and Spending, Borrowing and Balancing* (Chatham, N.J.: Chatham House, 3d ed. 1997), p. 30.

This point can be illustrated by focusing on a few of the more dubious revenue raisers of the 1990s. One of my favorite examples is found in the bill that grew out of concern that many American families that hire a nanny or babysitter end up breaking federal law — as had Zoe Baird, President Clinton's failed first nominee to be Attorney General. The failure to withhold income taxes and social security wage tax from domestic workers is widespread and common among otherwise law-abiding citizens. To avoid creating a nation of tax cheats, in 1994 Congress amended the treatment of domestic workers for purposes of social security wage tax — the so-called nanny tax reform bill.[68] The revenue loss attributable to this reform was minor, but under PAYGO required a revenue offset. Congress found one by limiting the payment of social security benefits to incarcerated criminals and the criminally insane confined to mental institutions by court order. Policymakers found these an easy target, lacking both political clout and financial resources. These people also don't vote very often! And so, a few million dollars were raised to get middle-class tax cheats off the hook by cutting the social security benefits of gray-haired cons and the criminally insane. Perhaps, one day Congress will even have the nerve to take on some tough "special interests" (say, the AARP) — but I doubt it.

There was major tax legislation in 1997: the Taxpayer Relief Act of 1997[69] and the Balanced Budget Act of 1997,[70] both signed into law by President Clinton on August 5, 1997. The legislation reads like a Christmas-list of special tax provisions targeted at constituents of the Republican Party. For example, the 1997 tax act reduced the maximum tax on capital gains for individuals to 20 percent (a perennial goal of Republicans since the preferential rate for capital gains was repealed in 1986), lessened the burden of the corporate alternative minimum tax and eliminated it altogether for small business corporations, and increased current exemptions to the federal gift and estate tax — as well as creating an entirely new $700,000 exemption for owners of small businesses and farms. The Republican bill also included provisions expanding the availability of Individual Retirement Accounts (IRAs) and creating a new "Roth IRA" (named after Finance Committee Chairman Roth, who now has the dubious honor of being the only individual having a section of the tax code named after him). Because any tax bill requires a broad nonpartisan coalition behind it, Republicans were forced to make concessions to Democrats. The Clinton administration was behind several new education tax credits, a provision that effectively eliminates tax on the sale of a home, and proposals to shut down certain "abusive" financial transactions designed by Wall Street investment firms to allow clients to defer gain realized on stock and securities. These provisions had been originally proposed by the Clinton administration in 1995 in response to the GOP's Contract With America tax bill (which the president vetoed in December 1995), and were included in the 1997 tax bill as a compromise to secure the president's support for (or at least, tacit acceptance of) the bill.

Revenue-neutral tax policymaking results in double damage: both the proposed tax preference and the offsetting revenue raiser mangle the income tax.

The 1997 tax act also included a $500 child tax credit which was by far the most expensive item in the legislation — $183 billion over 10 years (amounting to over 60 percent of the total cost of the bill).[71] The many changes to the tax treatment of capital assets (all of which benefit taxpayers) alone cost the Treasury $21 billion over 10 years. Changes to tax-deferred savings accounts (including the creation of the Roth IRA) carried a total cost of $20.2 billion, and reduction in the estate and gift tax cost $33 billion over 10 years.[72] These many tax preferences included in the bill required revenue offsets. A number of these were the aforementioned reform measures suggested by Treasury and aimed at perceived abuses of the corporate reorganization provisions of the tax code. These corporate reorganization reforms raised $2.3 billion over 10 years. That this kind of technical revision of the tax laws designed to shut down abusive transactions also raises revenue for the Treasury makes them popular in Washington and greatly increases the chance that they will be included in tax legislation. So there is a silver lining to revenue-neutral policymaking. But once again, a significant number of dubious revenue raisers also made their may into the tax code via the requirement for revenue neutrality.

By far the most significant revenue raisers in the 1997 tax act were extensions and modifications to expiring federal excise taxes, in particular the domestic air passenger ticket tax ($61.5 billion over 10 years) and the international departure tax ($11.9 billion over 10 years). By the slight of hand of renewing and modifying these previously enacted excise taxes scheduled to expire under prior law, Congress magically "raised" some $88.5 billion of "new" revenue over 10 years. Imagine if Congress had actually enacted the Tax Code Termination Act (H.R. 3097, sponsored by Rep. Steve

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[68]The Social Security Domestic Employment Reform Act of 1994, H.R. 4278, Pub. L. No. 103-387, 108 Stat. 407. The bill raised the threshold for employer withholding from $50 per quarter to $1,000 and exempted altogether from social security taxation and coverage household workers under the age of eighteen whose primary occupation is not household employment.

[69]Pub. L. No. 105-34, 111 Stat. 788.

[70]Pub. L. No. 105-33, 111 Stat. 251.

[71]Joint Committee on Taxation, "Summary of Revenue Provisions of H.R.2014 (Taxpayer Relief Act of 1997)," August 1, 1997 (JCX-40-97); Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement on the Revenue Provisions of H.R. 2014, the "Taxpayer Relief Act of 1997," July 30, 1997 (JCX-39-97).

[72]*Id.*

Largent, R-Okla., and co-sponsored in the Senate by Majority Leader Trent Lott, R-Miss.), which would have "sunset" the federal income tax by July 4, 2002. (The House approved the bill in June 1998, by a 219-209 vote, but it never made it out of the Senate Finance Committee.) Subsequent legislation repealing the sunset legislation (i.e., reinstating the income tax) could then be treated as a $1 trillion revenue raiser, supporting the biggest GOP tax cut ever!

In comparison to the excise tax extensions, all the other revenue raisers in the bill amounted to peanuts. But they do illustrate how tinkering with existing provisions can raise some money for the Treasury. Of greatest significance was the reduction of the five-year carryback period for net operating losses to two years, which raised $1.67 billion over 10 years (even while increasing the carryover period to 20 years). Modifications to the tax treatment of company-owned life insurance policies raised another $2.2 billion over 10 years. A companion bill, H.R. 2015, contributed $16.6 billion over 10 years through an increase to the federal excise tax on tobacco products.

The recently enacted Internal Revenue Service Restructuring and Reform Act of 1998[73] also included a host of bizarre revenue-raisers. The original legislative initiative that emerged from committee was typical of the grab-bag tax legislation enacted in recent years as Republicans succeeded in turning the IRS restructuring measure into an omnibus tax bill.[74] At the heart of the bill is the IRS reorganization plan. The legislation also included several new taxpayer protections (i.e., provisions expressing the GOP's wrath for the IRS). None of this was very expensive. However, some other provisions that found their way into the legislation carried a significant cost. For example, a provision originally included in the bill at the instigation of the Treasury altered the taxation of employer-provided meals. Lobbyists for the gaming and hospitality industries opposed this measure, and a greatly watered-down version was substituted. Unfortunately, this carried a cost of $316 million over 10 years, as estimated by the Joint Committee on Taxation.[75] The final version of the bill ended up providing more favorable tax treatment of employer-provided meals than that afforded under pre-1998 law.[76]

Another significant provision was added to the 1998 act at the last minute in Conference Committee. This provision altered the holding period for long-term capital gains that had been adopted only the year before under the 1997 tax act.[77] During the final stages of negotiations over the 1997 bill, at the insistence of Treasury Secretary Robert Rubin, the holding period for the new preferential 20 percent rate for long-term capital gains was raised from 12 months to 18 months. This created a complicated three-tier system under which gains were taxed at three different rates, depending on the applicable holding period, as well as the classification of the underlying capital asset itself. On 1997 returns, tax professionals and taxpayers alike found the system a nightmare of complexity. Ways and Means Committee Chairman Bill Archer had promised to repeal the 18-month holding period, and he kept his word in the 1998 legislation. Reducing the 18-month holding period to 12 months carried a cost of more than $2 billion over 10 years.[78]

Archer also attracted attention when he blocked inclusion of a "technical correction" to the 1997 tax act.[79] The drafters of that legislation had apparently inadvertently altered the tax rate structure for the federal estate tax, and thereby reduced the tax burden for those few wealthy individuals with estates greater than $17 million. Archer rejected the technical correction on the grounds that it would implement a "tax increase" and hence, had no place in the bill. Democrats in Congress were apoplectic. House Minority Leader Richard Gephardt, D-Mo., denounced Archer's maneuvering to kill the technical correction an "abomination," and Senate Minority Leader Thomas Daschle, D-S.D., fumed. But in the end, silence from the White House left congressional Democrats dangling and undercut Democratic opposition in the Conference Committee; the 1997 provision stood. The inadvertent estate tax cut was estimated to cost the Treasury some $880 million over 10 years.[80]

The 1998 tax act was notable for several other provisions that did *not* make it into the final legislation. The influence of special interest is often evidenced as

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[73]Pub. L. No. 105-206, 112 Stat. 685.

[74]*See* Greg Hitt, "Lawmakers Strike Deal on IRS Overhaul," *Wall St. J.*, June 24, 1998, p. A2.

[75]Joint Committee on Taxation, "Estimated Budget Effects of Internal Revenue Service Restructuring and Reform Act of 1998," June 24, 1998 (JCX-51-98).

[76]House Ways and Means Committee member John Ensign, R-Nev., was successful in slipping into the IRS restructuring bill a proposal that he had introduced in the House in May. That bill, the Worker Meal Fairness Act of 1998, was co-sponsored in the House by Speaker Newt Gingrich, R-Ga. For an account of Ensign's lobbying, as well as the impact of the provision, see Amy Hamilton, "IRS Reform's Flying Circus — Tales of One Last-Minute Change," *Tax Notes*, July 13, 1998, p. 145; David Lupi-Sher, "Employer-Provided Meals — The Gaming Industry vs. the IRS," *Tax Notes*, Dec. 28, 1998, p. 1599.

[77]For an account of how the reduction of the holding period for capital gains was included in the IRS restructuring bill, see Richard W. Stevenson, "Break in Capital Gains Tax Is Added to I.R.S. Overhaul," *N.Y. Times*, June 24, 1998, p. A1.

[78]Joint Committee on Taxation, "Estimated Budget Effects of Internal Revenue Service Restructuring and Reform Act of 1998," June 24, 1998 (JCX-51-98).

[79]The story of Archer's opposition to this technical correction is found in David E. Rosenbaum, "A Mistake Prevails, as Certainly as Death and Taxes," *N.Y. Times*, June 24, 1998, p. A21.

[80]The president's fiscal 2000 budget includes a provision that would restore the phaseout of the unified credit for large estates, thereby correcting the inadvertent estate tax cut for the wealthy. Budget of the United States Government, Fiscal Year 2000 (submitted to Congress by President Clinton, February 1, 1999). For a description of the proposal, see Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999), p. 162.

much by those provisions that are excluded from a tax bill as by those that are included in the legislation for their benefit. For example, the White House had proposed revenue-raising provision that would have changed the way life insurance companies calculate reserves, regulated the use of family limited partnerships in reducing federal gift and estate tax liabilities, and eliminated the use of *Crummey* powers in planning for the gift and estate taxes. All of these reform measures, which had their origins in the Treasury Department, faced strong opposition from well organized business interests — most particularly, the insurance industry. This political pressure turned out to outweigh the revenue pressure exerted by PAYGO. In the end, congressional Republicans succeeded in excluding all three proposals from the final bill.

Finally, it was notable that the 1998 bill failed to include even modest relief from the so-called marriage penalty. This issue became a central theme of social conservatives who were enraged to discover that some married couples (e.g., those in which one spouse has a high income and the other a low income) would pay greater income tax filing on a joint tax return than they would if they were unmarried individuals with the same incomes filing separately. (The reason for this result is the progressive tax rate structure, which pushes joint taxpayers into a higher marginal tax bracket.[81]) Provisions to eliminate the marriage penalty were not included in the 1998 tax act because they were so expensive. (Republicans also might have realized that because a majority of couples filing joint returns actually enjoy a marriage tax *bonus*, the political appeal of this issue is questionable.) A watered-down provision was included in the September 1998 tax bill, but that never made it beyond the House. Because of the strong commitment to the issue, more will be heard on this in 1999. Once again, the revenue cost will be the main obstacle. Odds are that when confronted by the increasingly difficult task of finding new sources of revenue to finance tax relief for high-income, two-earner married couples (i.e., those married persons most likely to suffer the marriage penalty), Republican legislators will again balk. Another plus for PAYGO!

Funding for the many revenue losers included in the 1998 tax act (which the Joint Tax Committee scored as costing a total of $13 billion over 10 years) was achieved largely through two measures. The first, and most dishonest, liberalized the rules for converting a traditional IRA into a new Roth IRA for senior citizens earning more than $100,000. By so relaxing the conversion rules, more taxpayers will qualify for the conversion and more money will come out of their traditional IRAs and into new Roth IRAs. That there is little evidence to suggest that Roth IRAs or tax-preferred savings account of any kind produce any increase in investment or savings for retirement is irrelevant to staunch proponents of these tax expenditures. Ideology is the driving force behind these tax preferences.[82] Beyond such devotion lies another motive behind Congress's decision to aid Senator Roth's personal crusade to expand eligibility requirements for the new IRAs. The conversion was so inviting because it actually raises revenue as income tax is triggered on the withdrawal of savings from traditional IRAs. In the long-run, conversions cost the Treasury as the funds reinvested in a Roth IRA are afforded a more favorable tax treatment. Conveniently, the long-term cost of the new conversions will show up outside the time-frame of federal budgeting. Thus, the conversion provision was scored as a revenue raiser bringing in over $8 billion over five years.[83] This is the kind of ingenious provision that defeats the purpose of PAYGO and leaves future Congresses paying for today's indulgences. The new conversion rule finances the many ill-conceived tax preferences included in the bill, and thus, double damage is done to the tax code.

Searching for 'abuses' to shut down to raise revenue to finance targeted tax cuts for the steel industry makes for some pretty misguided tax policy, even by today's standards.

The second major revenue raiser overturned the much criticized decision of the U.S. Tax Court in *Schmidt Baking Co. Inc.*[84] In that case, the tax court had allowed the company to deduct more than $2 million of accrued (but unpaid) vacation and severance compensation that was secured by a standby letter of credit. Legislative repeal of *Schmidt Baking* was projected to raise some $3.2 billion over five years.[85] It is possible that Congress was sincerely offended by the treatment afforded the taxpayer in *Schmidt Baking*. But the more cynical among us will suspect that some clever staff member on Ways and Means or Finance grasped the true importance of overturning the Tax Court: raising revenue to pay for the many tax expenditures included in the 1998 tax act.

The avalanche of perverse revenue raisers continues. The tax credits recently proposed by President Clinton in his fiscal year 2000 budget carry a significant price tag. His proposal for the $1,000 tax credit is estimated by the Treasury to cost $5.0 billion over five

[81]For a comprehensive explanation and historical account of the marriage penalty, see Michael J. Graetz, *The Decline [and Fall?] of the Income Tax* (New York: W.W. Norton, 1997), pp. 29-40.

[82]Tax-preferred retirement plans (employer plans, Keoghs, and IRAs) constitute the largest single tax expenditure, valued by the Treasury at $92.3 billion for fiscal year 1999. Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 1999-2003," December 14, 1998 (JCs-7-98).

[83]Joint Committee on Taxation, "Estimated Budget Effects of Internal Revenue Service Restructuring and Reform Act of 1998," June 24, 1998 (JCX-51-98).

[84]*Schmidt Baking Co. Inc.*, 107 T.C. 271, *96 TNT 223-13* (1996).

[85]Joint Committee on Taxation, "Estimated Budget Effects of Internal Revenue Service Restructuring and Reform Act of 1998," June 24, 1998 (JCX-51-98).

years, with additional provisions in the long-term care initiative pushing the total to $5.8 billion.[86] This is by far the most expensive tax expenditure in the president's budget package. The tax credits to encourage investment in underdeveloped urban and rural areas are estimated to cost $1 billion over five years. The rest of the package includes a host of lesser, although collectively significant revenue losers: tax credits for consumers who buy fuel-efficient automobiles; tax credits for employers who improve adult literacy (costing $100 million over five years); and tax credits to encourage employers to retrain blue-collar workers. On top of this, the administration's proposed tax credit to aide the ailing U.S. steel industry with a five-year NOL carryback carries a cost of $500 million over five years.

One thing the president certainly never mentioned in announcing his new package of targeted tax cuts was that the carryback period for NOLs had just been reduced to two years under the 1997 tax act. Could it be that Clinton now realizes that he made a "mistake" in reducing the carryback to two years, just as he finally came to understand that he made a mistake when he raised taxes on the rich in 1993? It is doubtful.

Obviously, the original choice of a carryback period was arbitrary. The tax accounting rule itself was designed to allow businesses with varying income from year to year to more accurately compute taxable income by carrying back losses to prior years when tax was paid, or by carrying losses forward.[87] When the provision was originally enacted in 1918, losses could be carried back only one year and carried forward one year. In subsequent years, the carryback period was changed to two years, reduced again to one, eliminated altogether during the 1930s, reinstated a few years later as two years, and eventually increased to three years for taxable years after 1957. All of these decisions were made for revenue reasons. Likewise, the decision in 1997 to shorten the carryback period to two years was driven strictly by the need for revenue to finance the 1997 tax cuts. Suddenly in 1999, the administration has concluded that a five-year carryback period must be established — although only for the steel industry. (Apparently, other ailing industries are not worthy of this special tax treatment. Or perhaps they haven't donated enough to the president's legal defense fund, yet.) Talk about trying to micromanage the economy!

Of course, the current proposal to extend the carryback period for the steel industry costs money (as do all the other proposed new tax credits), and so yet another revenue raiser is needed to finance *this* new tax preference. There are a number of sources of new revenue in the president's proposed budget, totaling $78.4 billion over five years. The bulk of the revenue comes from more taxes on tobacco users and producers ($34.5 billion over five years). Other revenue raisers include: an increase in the penalty for large corporations for a substantial understatement of tax ($657 million over five years); taxing previously untaxed profits of stock life insurance companies currently accounted for in an undistributed "policyholders surplus account" (PSA) ($1.0 billion over five years); and the taxation of investment income of trade associations ($1.4 billion over five years). The administration has also stumbled on several new revenue raisers of even more dubious merit. One of the president's proposals would deny a business deduction to a taxpayer who pays punitive damages, whether on a judgment or in settlement of a claim. Even worse, to the extent that the punitive damages are covered by insurance, any amount recovered from the insurer would be included in the gross income of the taxpayer.[88] These are the kind of provisions that raise additional revenue for the Treasury by squeezing just a bit harder on previously identified and tapped sources of revenue.

But beware! Eventually, you can squeeze a bit too hard on taxpayers' pressure points and end up triggering a behavioral response. For example, there is a limit on how much tax revenue can be raised from tobacco users before they switch to clove cigarettes. Our experience with the 1990 excise tax on luxury commodities suggests that there are limits inherent to raising revenue through a commodity-specific tax imposed on nonessential luxury items — although it helps if the consumer is addicted to the product. (This is what economists refer to as very "inelastic" demand.) In the case of the 10-percent luxury tax on furs, jewelry, yachts, private planes, etc., projected revenues failed to materialize, and the tax was soon dismissed by the Bush administration as "counterproductive." The tax has mostly been repealed since then (other than on high-end automobiles).

To raise additional revenue for the fiscal year 2000 budget, administration officials reportedly have been "scouring the tax code for months in search of perceived abuses."[89] This search for "abuses" to shut down is motivated more by the need for some $34 billion of revenue to finance the president's package of new tax goodies, and less by a deep-rooted concern for defending the integrity of the tax code. However, this is the

[86] The proposed credit would phase out for married taxpayers at income ranges between $110,000-$130,000 and for single taxpayers between $75,000-$95,000. Budget of the United States Government, Fiscal Year 2000, Table 5-6 ("Effects of Proposals on Receipts").

[87] According to the United States Supreme Court: "[The NOL rules] were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year. By emphasizing the ability to carry losses forward, Congress also intended to assist new businesses, whose formative losses can be used to offset income in subsequent more profitable years." *United States v. Foster Lumber Co., Inc.*, 429 U.S. 32, 42-43, 76-2 USTC para. 9740 (1976), 1976-2 C.B. 72.

[88] This proposal is estimated to raise some $622 million over five years. Budget of the United States Government, Fiscal Year 2000, Table 5-6 ("Effects of Proposals on Receipts").

[89] Greg Hitt, "Tax Plan Targets Use of Offshore Losses: Clinton Considers Proposal to End Business Practice As Way to Find Revenue," *Wall St. J.*, Jan. 8, 1999, p. A2.

"good" side of revenue-neutral tax policymaking: it puts a premium on antiabuse provisions that raise revenue, but otherwise might not find sufficient political support to be included on the policy agenda. Many of Treasury's antiabuse revenue provisions correct unintended loopholes in subchapters K and C, devised by those who pounce on every glitch in the arcane partnership and corporate tax statutes and readily manipulate them for the benefit of their clients.[90] Another antiabuse revenue raiser would restrict the ability of U.S. corporations to make use of losses of a foreign corporation in which the U.S. corporation has acquired a 10-percent or more interest.[91] Other proposals would "crack down" on corporate tax shelters.[92] No doubt many such gimmicks are peddled by Wall Street firms to corporate America for multi-million dollar fees. I leave it to Lee Sheppard to explain the particular abuses that Treasury is presently attacking and determine whether the administration's proposals will really do the trick.[93] I only suggest here that searching for "abuses" to shut down to raise revenue to finance targeted tax cuts for the steel industry makes for some pretty misguided tax policy, even by today's standards.

Conclusion

Reports of forthcoming decades of surpluses have thrown budget and tax policymakers into a tizzy. Notwithstanding that there won't be an on-budget surplus for three years, if then, the president and most in Congress are already spending the "excess" revenues. Whether used to fund tax cuts or tax expenditures, the surplus is the politician's best friend. And in this case, the PAYGO budget rule is his worst nightmare. But from the perspective of fiscal conservatism, the 1990 budget rules have had an important impact on the budget and tax policymaking processes — mainly, by restraining the profligate impulses of congressional policymakers, both Democrat and Republican alike. The downside is that PAYGO has contributed to the glut of unwarranted, unfathomable, and complex revenue raisers enacted in the 1990s. Not that Congress did not pass this kind of tax provision before 1990, but PAYGO has definitely contributed to the increased volume.

Nevertheless, the benefits of PAYGO outweigh the adverse effect of ill-advised revenue raisers. PAYGO checks the natural instincts of Democrats to over-spend and Republicans to slash taxes for their constituents. The result has been a dose of fiscal restraint for the budget process; budget surpluses, and consequently, paying down some portion of the national debt, are now a real possibility. We even are entitled to a brief moment of celebration. But not for too long! Until we can cover the $3 trillion unfunded liability of social security and pay off some of the $5.6 trillion national debt, we should not make too many demands on the projected budget surplus. Certainly, repealing PAYGO at this time would be imprudent. But who knows what imprudence the political process may dish out? If Republicans have their way, PAYGO and President Clinton will be history. Most likely, Clinton will stay, PAYGO will be modified with respect to on-budget surpluses, and *both* tax cuts and new tax credits will be enacted. Of course, predictions about the course of Washington politics should be treated much the same as 15-year budget projections — with more than a few grains of salt and considerable skepticism.

[90]These provisions include: taxation of the issuance of so-called tracking stock; modification of the antiabuse rules requiring the taxation of "boot" on the assumption of liabilities pursuant to the contribution of property for stock of a controlled corporation; and denying the benefit of the dividends received deduction for distributions on certain nonqualified preferred stock. These antiabuse provisions are described, respectively, in Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999), pp. 117, 129, 132.

[91]The president's fiscal year 2000 budget includes an antiabuse proposal that would provide taxpayers with a "fresh start" by eliminating tax attributes (including built-in losses) and marking-to-market bases when an entity or an asset becomes "relevant" for U.S. tax purposes. Department of the Treasury, *General Explanation of the Administration's Revenue Proposals* (Washington, D.C.: U.S. Department of the Treasury, February 1999), p. 108.

[92]The administration's campaign to crack down on corporate tax shelters is described in Jacob M. Schlesinger, "Clinton Seeks Crackdown on Firms' Tax Shelters," *Wall St. J.*, Jan. 29, 1998, p. A3.

[93]Indeed, Ms. Sheppard has already described one of these abuses and suggested the antidote in "How to Stop Loss Importation at the Borders," *Tax Notes*, Jan. 18, 1999, p. 283. Other anti-abuse provisions in the president's fiscal 2000

(Footnote 93 continued in next column.)

budget are discussed by Sheppard in "Business Revenue Raisers: Cleaning Up and Necessary Fixes," *Tax Notes*, Feb. 8, 1999, p. 760. Most likely, several Letters to the Editor of *Tax Notes* are already in the mail from investment and tax advisers who peddle such dubious "shelters" to clients and squeal every time Ms. Sheppard snitches on them to the tax authorities.