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BORROW-AS-YOU-GO

ANOTHER DEBT CEILING INCREASE, BEHIND THE PAY-GO FACADE

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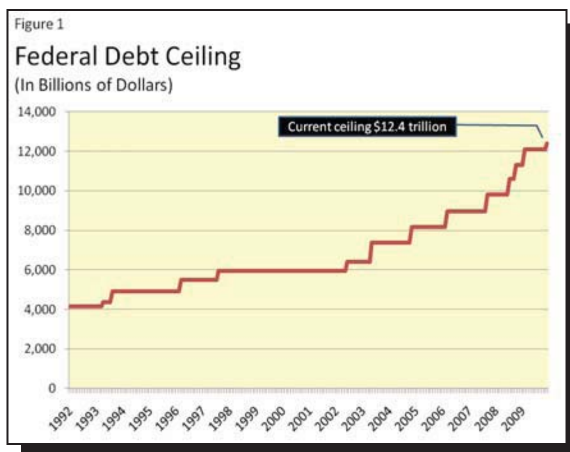
Following the Senate's approval last week, the House is expected to vote Thursday on a record $1.9-trillion increase in the Federal Government's statutory debt limit (H.J. Res. 45), clearing the measure for the President's signature. It would be the *fifth* such increase in the past year-and-a-half alone, pushing the government's total debt ceiling to $14.3 trillion – roughly the size of the entire U.S. economy.

To help win passage of this staggering increase in the Nation's indebtedness, the Senate tacked onto the legislation a "pay-as-you-go" [pay-go] provision. Pay-go is, at best, an empty slogan. Since it was reinstated as a rule in 2007, when Democrats took control of Congress, the deficit has swollen from $161 billion to $1.6 trillion. Pay-go has been waived or circumvented for $1.3 trillion in deficit increases; and when applied it has been used mainly to justify chasing higher spending with higher taxes.

The discussion below analyzes both the debt and pay-go components of H.J. Res. 45.

DEBT SUBJECT TO LIMIT

Raising the debt limit is a necessary evil. Failure to approve an increase in the debt limit would hamstring the Treasury and prevent it from making good on the government's financial obligations. But the necessary increase is also symptomatic of the torrid pace of government spending and borrowing, and a grave reminder and warning of some of the serious risks associated with exploding U.S. debt. With the Treasury borrowing between $30 billion and $40 billion *each week*, the slated increase would need to be renewed early next year. This week's action conveniently buys enough time to avoid another debate on the government's unsustainable fiscal course before the midterm elections.



Mindful of growing public alarm about the increasing debt, the Senate added to the legislation the pay-go mechanism (discussed below) as an ostensible gesture toward fiscal discipline – even as the government's borrowing and debt continue to swell.

Authorized by .... **Paul D. Ryan, Ranking Republican**

Some of the principal concerns related to the government's growing debt are the following:

The President's Budget for Fiscal Year 2011. The President's budget continues an unsustainable pace of borrowing and spending: under the administration's policies, debt held by the public,[1] measured as a share of the economy, will reach 69 percent of gross domestic product [GDP] next fiscal year, and will exceed 77 percent by the end of the decade. The U.S. has not seen these debt burdens since the end of World War II. Even the countries of the European Union, hardly exemplars of fiscal rectitude, are required to keep their debt levels below 60 percent of GDP.

Flirting With a Debt Crisis. Such levels of debt, if sustained over time, invite potentially dire economic consequences. Foreign investors, who are holding more than half of the U.S. debt, may start to demand sharply higher interest rates if they begin to question the U.S. commitment to a sustainable budget path. With yearly borrowing needs approaching $2 trillion, higher interest rates could worsen an already precarious fiscal situation. In a worrisome development, Moody's Investor Services noted in December that the U.S. may "test the boundaries" of its AAA sovereign credit rating in coming years if it fails to shore up its debt levels.

As investors sense the very real possibility of an extended, debt-driven economic malaise, they may preemptively reduce their purchases of U.S. securities, which would also weaken the dollar. As the dollar fell, prices of imported goods and services would rise. This mix of higher interest rates, a falling dollar, and higher inflation would have drastic consequences for the economy.

Interest rates are currently at historic lows, and the Obama administration's alarming debt projections are based on rates much lower than those of the 1980s and 1990s, when debt was much lower as a share of the economy. To illustrate the Federal Government's huge exposure to higher interest rates, the Congressional Budget Office [CBO] has analyzed the impact of higher rates under three different scenarios, and found the debt would increase by $1.3 trillion to $5.6 trillion over 10 years.[2]

Weakening America's Standing in the World. In the wake of the President's budget release this week, both *The New York Times* and *The Wall Street Journal* ran prominent stories suggesting that rising deficits and debt could soon begin to erode U.S. political power in the world and threaten national security. High indebtedness weakens U.S. independence and potentially makes the country beholden to foreign creditors. The U.S. is expected to issue $9.3 trillion in debt over the next decade. If trends continue, China alone will finance roughly $1 trillion of that debt.

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[1] CBO's definition reads as follows: "Debt: In the case of the Federal Government, the total value of outstanding bills, notes, bonds, and other debt instruments issued by the Treasury and other Federal agencies. This debt is referred to as Federal debt or gross debt. It has two components: debt held by the public (Federal debt held by nonfederal investors, including the Federal Reserve System) and debt held by government accounts (Federal debt held by Federal Government trust funds, deposit insurance funds, and other Federal accounts). Debt subject to limit is Federal debt that is subject to a statutory limit on the total amount issued. The limit applies to gross Federal debt except for a small portion of the debt issued by the Treasury and a small amount of debt issued by other Federal agencies (primarily the Tennessee Valley Authority and the Postal Service)."

[2] The CBO estimates are presented in a letter to Congressman Paul D. Ryan dated 30 June 2009. http://www.cbo.gov/ftpdocs/104xx/doc10416/RyanLetterInterestRates.pdf

PAY-GO: A DEEPLY FLAWED PROCEDURE

Forced to adopt this huge debt increase, House and Senate Democrats are groping for some means of appearing fiscally disciplined at the same time. They have turned to their favorite procedural stand-by: pay-as-you-go.

Pay-go is sold to the public as a means to "control" budget deficits. It is supposed to require that any legislation increasing mandatory spending or reducing taxes be "paid for" with offsetting spending reductions, tax increases, or a combination of both. In this way, new entitlement spending or tax cuts are not allowed to increase deficits.

When there is a bipartisan agreement on spending and taxes, as with the Balanced Budget Act of 1997, pay-go can be a useful tool to enforce a deficit-reduction measure. But standing on its own, pay-go is deeply flawed and vastly over-rated.

First, pay-go has become a distraction from the real problem: spending. Congress can pass any amount of entitlement spending increase without violating pay-go – as long as the spending is offset, and does not increase the deficit. This creates a great incentive for Congress to raise taxes to "pay for" popular spending proposals, and thereby appear fiscally "responsible." *Indeed, pay-go has become a means of justifying higher taxes to chase higher spending.*

Second, pay-go does not reduce deficits – it just maintains them at their current level. It does not apply to current law, so it will do nothing to address the unsustainable rate of spending growth in *existing* entitlement programs.

Third, it is rife with loopholes and has been circumvented through various gimmicks. Pay-go does not apply to annually appropriated discretionary spending, which represents more than $1 trillion of the budget. Nor does it affect mandatory spending provisions included in appropriations bills.

Four examples illustrate the manipulations used to get around pay-go:

- The $787-billion "stimulus" bill (now estimated by CBO to be $862 billion) was designated as an "emergency," so pay-go did not apply to it.

- According to CBO, H.R. 3961, adjusting the sustained growth formula [SGR] for Medicare physicians (the "doc fix"), will cost more than $200 billion; but Congress dodged pay-go in this case by burying this cost in the budget baseline. Thus, relative to the pay-go baseline, this $200 billion in real spending and deficit increases disappeared.

- The State Children's Health Insurance Program expansion (H.R. 2) provided an increase of $74 billion over 10 years. So Congress wrote into the bill a spending "cliff" – a provision that cut SCHIP spending by 65 percent in 2014, meeting pay-go's requirement with a reduction that will never occur.

- In 2008, the war supplemental (H.R. 2542) included $66 billion in mandatory spending that otherwise would have been subject to pay-go.

The best evidence of pay-go's weakness can be seen in the numbers. Pay-go has been part of the Rules of the House since the beginning of 2007, when Democrats assumed the Majority. It did not prevent the deficit from rising from $161 billion in fiscal year 2007 (the last budget from a Republican Congress) to an estimated *$1.6 trillion* this year – an increase of more than ten-fold.

In short, pay-go is no substitute for real policy reforms that slow the growth of spending. Attached to the huge debt increase contained in H.J. Res. 45, it gives only an illusion of budget discipline where none really exists.

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Technical Description of the Pay-Go Mechanism in H.J. Res. 45

Summary. The legislation rewrites the statutory pay-as-you-go system that expired in 2002. It is effective on the date of enactment and would become permanent law.

- It requires that legislation reducing taxes or increasing entitlement spending relative to the pay-go "baseline" (described below) must be offset by spending reductions, tax increases, or a combination of the two so as not to increase the baseline deficit.
- Offsets are calculated by a system of cost "averaging" (described below).
- The legislation does not apply to discretionary spending, and there are numerous exemptions.

Scoring. Legislation is scored using Congressional Budget Office [CBO] estimates. To address the problem posed by the INS v. Chadha Supreme Court case (which prohibits legislative branch agencies from executing laws), the bill provides a procedure to insert by reference the CBO cost estimates into each bill that affects mandatory spending or revenue. If a CBO cost estimate is not included, the administration's Office of Management and Budget [OMB] estimates the cost of the legislation.

Deficit Averaging. The pay-go mechanism requires OMB to keep two "scorecards": one to reflect the average deficit impact of legislation over the first 5 years; the second to show the average deficit impact over the 10-year period. If at the end of a session of Congress either of the two scorecards shows a net deficit increase, OMB issues a sequester order (across-the-board reduction in non-exempt spending) to eliminate that deficit. If there is a net cost on both the 5- and 10-year scorecards, OMB sequesters the larger deficit amount.

Baseline Adjustments. The legislation modifies the baseline to assume extension of 2001 and 2003 tax relief except for tax brackets affecting those with higher incomes ($200,000 for single filers, $250,000 for joint filers), and the estate and gift tax is assumed to be extended at 2009 levels. The legislation also modifies the baseline to extend the alternative minimum tax [AMT] "patch" and the "doc fix" (with the latter freezing physician payment rates under Medicare instead of reducing them as scheduled under current law).

Exemptions. More than 160 spending programs are exempt from pay-go or operate under special rules. The legislation adds a number of new programs to the exemptions carried over from the previous version of pay-go.

- The bill continues the exemptions for Social Security, Medicaid, most veterans benefits, refundable tax credits, and programs focused on low-income populations, such as food stamps.
- Added to the list are the State Children's Health Insurance Program, Pell Grants (which are converted from discretionary spending to mandatory spending in the President's budget), and other programs created since the law expired in 2002.
- Congress can also exempt legislation designated as an emergency, and Congress can apply the designation unilaterally. If a bill or joint resolution includes an emergency designation, the question as to whether it should remain in the bill is voted on in the House and the Senate.
- The bill specifically exempts the Community Living Assistance Services and Supports Act – a new long-term care program in the health care bill.