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MAKING BUDGET RULES BITE

By David M. Primo

MERCATUS CENTER
George Mason University

President Barack Obama's 2011 budget proposal forecasts massive spending increases and deficits for the foreseeable future. In fiscal year 2011, for instance, the president's budget estimates that spending will be 25.1 percent of GDP, and U.S. debt will be 68 percent of GDP. In 2020, the administration predicts spending will be 23.7 percent of GDP, and U.S. debt will jump to 77 percent of GDP. Because the administration also forecasts that the economy will grow at a rapid clip, these figures obscure the fact that its budget sees spending increasing in absolute terms by 49 percent, and debt by an astonishing 77 percent.[1] A fiscal crisis looms.

There are three ways to avert this crisis: Cut spending, raise more revenue, or take on more debt.[2] This last option is increasingly risky: Moody's, a credit-rating firm, argues that the United States's AAA rating is in jeopardy.[3] Tax increases are unpopular, hamstring economic activity, and fail to address the root cause of the nation's fiscal problems: runaway spending.

State and local governments also face significant budgetary challenges, and they too could benefit from reforms. Meaningful budget reforms, whether at the federal, state, or local level, must place limits on legislators' and executives' desire to spend. They also have to pack a one-two punch, first dealing with the immediate spending problems and then preventing a relapse into irresponsible fiscal policy.

BUDGET RULES

Because there are no painless solutions to budget problems, governments tend to put off the hard decisions. When they do offer "solutions" to these problems, they often take the form of budget rules that purport to place restraints on government. These rules rarely go far enough, however, and often suffer from severe flaws—intentional or not—that render them ineffective.

Budget rules have two key features: design and enforcement.[4] Design refers to what the rule is set up to do—reduce spending, eliminate deficits, cut wasteful programs, etc. Enforcement refers to giving the rule "bite" so that breaking the rule has serious consequences.

Constructing a well-designed, enforceable rule is challenging, but a set of principles guiding the design of budget rules—broad scope, few escape clauses, and minimal accounting discretion—could address the fundamental problems the United States currently faces. In addition, rule enforcement has to feature a credible enforcer with limited discretion. In some cases, a rule designer may also enhance enforcement by embedding the rule in a constitution.

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BUDGET RULE DESIGN

Broad Scope

Federal budget rules often focus on small portions of the budget. President Obama recently signed into law a reinstatement of the 1990 "pay as you go," or PAYGO, law, which requires that tax increases or budget cuts match new entitlement spending.[5] By focusing on new spending and entitlement programs, rather than existing spending and discretionary spending, the rule ignores all current spending and a significant portion of potential new spending. Given that many of the country's fiscal problems stem from projected increases in Social Security and Medicare spending, any rule that ignores these programs will accomplish little.

It shouldn't be surprising that budget rules often focus on small portions of the budget. By supporting such limited rules, legislators can take credit for being fiscally responsible without actually addressing the difficult decisions that responsible budgeting necessitates. By applying a budget rule to all spending categories, the rule's creators limit the potential for accounting gimmicks (see below) and force legislators to place all spending on the table for cuts.[6]

Few and High-Hurdle Escape Clauses

Escape clauses, such as supermajority voting rules that permit a rule to be waived, are tailor-made for legislators looking for an easy way out when they have to make hard decisions about spending. For instance, the most recent serious attempt at a constitutional balanced budget amendment in 1995 permitted deficits to be run with a three-fifths vote.[7] This supermajority (60 percent) is far too small to inhibit regular circumvention of the rule.

To be effective, legislators should not able to waive a budget rule except in extraordinary circumstances. At the federal level, a reasonable escape clause permits Congress to waive the rule in a time of war, and this clause was included in the 1995 balanced budget amendment.[8] As states do not have militaries, however, they ought to have no escape clause in their budget rules, except perhaps an exceptionally high voting threshold (say, 90 percent) that could trigger a waiver of the rule in truly unique circumstances.[9]

Minimal Accounting Discretion

Writing a rule that eliminates accounting discretion is the most challenging principle in rule design because those individuals subject to a rule have incentives to find ways around them. A rule creator has to anticipate attempts at circumvention that take the form of new spending categories or revenue types not subject to the rules. The PAYGO rule mentioned above includes an exception for "emergency" spending, which Congress must approve. Unfortunately, history demonstrates Congress is willing to declare "emergencies" to avoid constraints on spending.[10]

The states often avoid limits on debt or spending by creating "off-budget" entities not subject to those restraints, and their governments have developed creative ways for working around expenditure limits. For instance, after Californians enacted Proposition 4, a spending limit rule, charges and fees in the state spiked. The proposition limited expenditures from revenues derived from taxes, but California does not categorize charges and fees as tax revenues.[11]

BUDGET RULE ENFORCEMENT

A Credible Enforcer

A rule has bite if those tempted to violate it believe that the person or group charged with enforcing the rule are monitoring deviations from the rule and will actually hold violators accountable. In the case of budget rules, enforcement is either internal in the form of legislative enforcement, or external in the form of enforcement by courts or, potentially, public outrage.

The problem with internal enforcement is that legislators facing hard budget choices have strong incentives to violate rules that force those hard choices. When the 1980s budget rule, known as Gramm-Rudman-Hollings, required significant cuts in federal spending to achieve required deficit targets, legislators changed the requirements instead of enforcing them.

Congress actively resists external enforcement despite its advantages. For instance, the 1995 attempt at a balanced budget amendment to the U.S. Constitution included a clause reading, "The Congress shall enforce and implement this article by appropriate legislation, which may rely on estimates of outlays and receipts." Disputes about whether this language permitted court involvement prompted the Senate to add the following clause to the proposal: "The judicial power of the United States shall not extend to any case or controversy arising under this Article except as may be specifically authorized by legislation adopted pursuant to this section."

Rather than rule out court involvement, Congress could have strengthened this amendment by clarifying how to treat violations and leaving enforcement to the judiciary. While judges may differ in interpretation of a constitutional rule, few would ignore a clear requirement that budgets be balanced and would be very likely to implement the prescribed penalty if Congress violated the requirement. Furthermore, the threat of judicial involvement in spending and taxing decisions would be a powerful motivator for Congress to engage in successful self-enforcement.

Limited Enforcement Discretion

A rule designer must limit enforcement discretion regardless of whether a rule is enforced externally or internally. With a specified enforcement procedure, enforcers have less leeway to interpret the rule creatively. Moreover, rule designers, not the courts, should set the parameters for bringing budgets in line with rules.

This problem is not an abstract one. Many state constitutions are packed with entitlements. The Nevada Supreme Court, for instance, changed the legislature's constitutionally mandated voting rule on the budget from a supermajority to a simple majority because, it argued, a delay in budget passage due to a lack of votes violated a constitutional provision mandating that the state fund education.[12]

To avoid allowing judges to determine that a provision in the constitution guaranteeing some government function, such as education, overrides a budget rule, the rule should specifically supersede any other provisions of state law or constitutions. The goal, again, is to make it very clear what role an enforcer should play. In the case of a balanced budget rule, a clear enforcement policy would permit courts to require legislators to enact spending cuts or tax increases within a fixed number of days from the date a decision is reached.

Rule Embedded in a Constitution

In many cases, legislators would be more likely to follow a rule if it were embedded in a constitution. Placing a budget rule in a constitution provides at least two benefits. First, violating a constitutional budget rule may be more politically costly than violating a statutory one. The higher costs might be enough to keep legislators in line when they are tempted to violate the rule.

A second benefit to embedding budget rules into the constitution is lock-in. Even if a budget rule is externally enforced, repeal can render it null and void. A statute is much easier to eliminate than a constitutional provision. Making a budget rule constitutional helps reduce the legislature's temptation to eliminate the rule during challenging economic times.

This stickiness has a potential danger, though. By making the rule constitutional and therefore hard to change, designers run the risk of locking in poorly designed rules. Rule writers must therefore craft constitutionally designed rules even more carefully than statutory ones in order to avoid this situation.

A CHECKLIST FOR EVALUATING BUDGET RULES

Rule Design

Broad Scope: Does the rule have a broad scope, or does it focus on such a small part of the budget that it will not address the overall fiscal health of a government?

Few and High-Hurdle Escape Clauses: Are legislators permitted to waive the rule for any reason, or are there strict requirements for waiving a rule?

Limited Accounting Discretion: Does the rule anticipate inevitable attempts to circumvent it through the creation of new spending or revenue categories?

Rule Enforcement

A Credible Enforcer: Is the individual or group charged with enforcing a rule going to be a faithful arbiter, or is the enforcer likely to have an incentive to permit violations?

Limited Enforcement Discretion: Does the rule give the enforcer clear guidelines in the event of violations, or is the rule vague enough that violations can be ignored with creative interpretations?

Rule Embedded in a Constitution: Is the well-designed rule embedded in a constitution, thereby creating a "lock-in" effect and also increasing the political costs of violations?

CONCLUSION

There are no "one-size-fits-all" budget rules. No rule will work in all situations at all times. Even as rule creators follow the precepts laid out here, they need to ensure that the rule matches the specific budget problem at hand. For instance, if a state is controlled by legislators who historically have demonstrated a willingness to raise taxes when faced with budget problems, then a balanced budget rule may not be as effective as a limit on spending.

But one thing all effective budget rules must do is force fiscal discipline into perpetuity. Spending needs to come down, and it needs to stay down. Legislators must write budget rules that prevent them from reneging on the rules' provisions when things start to turn around, so that the pattern seen during the 2000s—when budget surpluses turned into huge deficits—does not become an eternal one. Applying the principles of rule design and enforcement just discussed can help legislators do that.

ENDNOTES

1. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011* (Washington, DC: Government Printing Office, 2010).
2. There is a fourth option for national governments: printing enough money to close a deficit. This action would wreak havoc on currency values, of course, and this option is not considered here.
3. Judith Burns, "Moving the Market: Geithner on Defense of U.S. Bond Rating," *The Wall Street Journal*, February 8, 2010, C2.
4. For further reading on rule creation, see David M. Primo, *Rules and Restraint: Government Spending and the Design of Institutions* (Chicago, IL: University of Chicago Press, 2007).
5. *Public Debt Limit Increase*, Public Law 111-139, *U.S. Statutes at Large* 124 (2010).
6. Of course, a broad scope is not needed if the goal of a budget rule is to target waste in a particular government program. Base closing commissions, for instance, worked well to eliminate unneeded bases.
7. *Proposing a Balanced Budget Amendment to the Constitution of the United States*, HJ Res. 1.EH. 104th Cong, 1st sess, 1995.
8. Ibid.
9. An escape clause of this form, tied to no particular event, is risky, though, because legislators could engage in "vote buying" to build a supermajority coalition. This, paradoxically, could make matters even worse, as a budget would need to be loaded with even more spending to achieve supermajority support.
10. See Allen Schick, *The Federal Budget: Politics, Policy, Process*, 3rd ed. (Washington, DC: Brookings Institution Press, 2007).
11. Thad Kousser, Mathew D. McCubbins, and Ellen Moule, "For Whom the TEL Tolls: Can State Tax and Expenditure Limits Effectively Reduce Spending?" *State Politics and Policy Quarterly* 8, no. 4 (2008): 331–361.
12. *Guinn v. Legislature*, 71 P.3d 1269 and 76 P.3d 22 (Nev. S. Ct. 2003).

David M. Primo is an associate professor of political science at the University of Rochester. His current research focuses on the value of legislative "pork" for reelection, the politics of judicial appointments, and the connection between formal models and data analysis.