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# WORKING PAPER

MAKING BUDGET RULES WORK

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## **Making Budget Rules Work**

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### **Introduction**

The United States faces severe fiscal challenges that can no longer be ignored. Entitlement spending, especially Medicare, is a ticking time bomb that must be defused. Increasing deficits and a growing debt burden place the country's pristine debt rating in jeopardy, as ballooning deficits and debts raise concerns about the government's ability to pay back debt without strangling economic growth or causing significant inflation. These threats reflect the inability of legislators and the president to make the hard choices needed to restore fiscal responsibility to the U.S. system.

Legislators on both sides of the aisle are aware of this problem. House Majority Leader Steny Hoyer (D-MD) writes, "The course we're on will lead to public debt that will exceed the size of our entire economy, and a government that will eventually exist to do only two things: fund entitlement programs and make interest payments."<sup>1</sup> Senate Minority Leader Mitch McConnell has called the national debt an "emergency," arguing that "the time is long since past to reverse this dangerous trend [of increased debt]."<sup>2</sup> Legislators have proposed several solutions, ranging from Rep. Paul Ryan's (R-WI) alternative budget proposal that requires significant spending cuts and ultimately leads to a federal budget surplus (albeit not for decades)

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<sup>1</sup> Hoyer, Steny. 2010. "Shared Sacrifices Will Solve the Debt Crisis." *Wall Street Journal*, April 28, p. A15.

<sup>2</sup> McConnell, Mitch. 2010. "Extenders Package." *Congressional Record* 156(81):S4398.

to a spending cap proposed by Reps. Jeb Hensarling (R-TX), Mike Pence (R-IN), and John Campbell (R-CA).<sup>3</sup>

Meanwhile, President Barack Obama has pledged to put the country “on a fiscally sustainable path.”<sup>4</sup> To do so, the president has promised to freeze non-security discretionary spending for three years, a move he claims “will require a level of discipline with Americans’ tax dollars and a number of hard choices and painful tradeoffs not seen in Washington for many years.”<sup>5</sup> The president also signed into law a budget rule that prevents legislators from creating new programs unless taxes are increased accordingly or cuts are made elsewhere (known as a pay-as-you-go, or PAYGO, rule), and he recently proposed a line-item veto that permits the president to propose specific cuts to bills, subject to congressional approval.<sup>6</sup> Finally, the president has created a National Commission on Fiscal Responsibility and Reform “to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run”; the commission’s proposals are non-binding.<sup>7</sup>

Unfortunately, Rep. Ryan’s alternative budget proposal and Reps. Hensarling, Pence, and Campbell’s spending cap have not gained traction, and the president’s proposals are largely smokescreens that distract attention from the truly hard choices that have to be made. (If the president believes that simply not increasing spending will be anguishing, the prospects for sticking to his pledge to halve the deficit by the end of his first term in office seem dim.<sup>8</sup>)

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<sup>3</sup> Ryan, Paul D. 2010. *A Roadmap for America’s Future, Version 2.0*. Accessed June 7, 2010 at [www.americanroadmap.org](http://www.americanroadmap.org); H.J. Res. 79--Proposing an Amendment to the Constitution of the United States to Control Spending , 111<sup>th</sup> Congress, 2<sup>nd</sup> session.

<sup>4</sup> Office of Management and Budget (OMB). 2010a. “President’s Budget Message.” In *Budget of the U.S. Government, Fiscal Year 2011*. Washington, DC: Government Printing Office, p. 4.

<sup>5</sup> *Ibid.*, 4

<sup>6</sup> Public Debt Limit Increase, Public Law 111-139, U.S. Statutes at Large 124 (2010); H.R.5454 -- Reduce Unnecessary Spending Act of 2010, 111<sup>th</sup> Congress, 2<sup>nd</sup> session.

<sup>7</sup> Obama, Barack. 2010. Executive Order 13531: National Commission on Fiscal Responsibility and Reform. February 18.

<sup>8</sup> Obama, Barack. 2009. “Address to Joint Session of Congress.” February 24.

Even before stimulus spending began in the wake of the economic downturn, the United States government faced a precarious financial situation that politicians made little progress in improving. Why is such progress so difficult to achieve? The short answer is that Congress faces two sets of problems, a commitment problem and an enforcement problem, that prevent well-meaning legislators from effecting change. In this paper, I argue that budget rules are one mechanism for addressing both of these problems, but not all rules are created equal. Some, like the president's line-item veto proposal, will do little and may even be counterproductive. Others, like a spending cap that limits increases in spending, are excellent starting points for reform.

This paper proceeds as follows. First, I discuss the nature of the looming fiscal crisis facing the country. Then, I show why Congress is having such difficulty implementing meaningful budget reforms. Next, I propose a set of principles that should guide rule designers at the federal level. I conclude by discussing the potential risks of implementing rules that satisfy those principles.

### **The Country's Looming Fiscal Crisis**

Any meaningful discussion about rules must presuppose that rule designers—typically legislators—acknowledge that spending and/or deficits need to be reduced. Perhaps because the issue is on the radar screens of voters—with the federal government debt's tied with terrorism as an “extremely serious” threat according to one recent survey,<sup>9</sup> and nearly two-thirds of voters preferring that government restrict attempts to improve the economy if it helps keep deficits down<sup>10</sup>—politicians are paying more attention to the issue. If too few legislators share this perspective, though, there can be no progress made on rule design. It is useful, therefore, to begin by specifying the nature of the problem that all legislators should be concerned about.

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<sup>9</sup> USA Today/Gallup Poll, May 24-25, 2010.

<sup>10</sup> NBC/NBC News/Wall Street Journal Survey, June 17-21, 2010.

The United States is in the early stages of a severe fiscal crisis. The federal debt has exceeded the nation's economic output in only three fiscal years during U.S. history—1945 through 1947.<sup>11</sup> President Obama's FY 2011 budget estimates that beginning in 2012, the gross federal debt will exceed gross domestic product (GDP) for the foreseeable future.<sup>12</sup> The budget also predicts that the nation's debt will more than double between FY 2009 and FY 2020, reaching an astonishing \$25.8 trillion.<sup>13</sup> Assuming that there are about 128 million households in 2020, each household would owe over \$200,000.<sup>14</sup> To place these numbers into context, GDP in 2009 was about \$14 trillion.<sup>15</sup> Figures 1 and 2 display the trends graphically. These high levels of debt carry with them serious consequences. As Reinhart and Rogoff show, debt levels above 90 percent of GDP are a drag on economic growth,<sup>16</sup> and as the Congressional Budget Office notes, interest-rate increases would place severe strain on the U.S. government due to an increase in interest payments.<sup>17</sup> This effect is magnified, of course, as the debt outstanding increases. These debt levels, combined with current deficit figures, exceed the 60 percent debt-to-GDP ratio and 3 percent of GDP deficit target required by the European Union's Maastricht Treaty before EU members can adopt the euro.

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<sup>11</sup> Data accessed at [http://www.usgovernmentspending.com/federal\\_debt\\_chart.html](http://www.usgovernmentspending.com/federal_debt_chart.html) on June 8, 2010.

<sup>12</sup> Office of Management and Budget (OMB). 2010b. "Summary Tables." In *Budget of the U.S. Government, Fiscal Year 2011*. Washington, DC: Government Printing Office, p. 146, 178.

<sup>13</sup> *Ibid.*, 178.

<sup>14</sup> Estimates based on household projections calculated by Arthur C. Nelson and population projections calculated by the U.S. Census Bureau. Nelson projections accessed July 28, 2010 at [http://www.usatoday.com/news/nation/2010-05-06-household\\_N.htm](http://www.usatoday.com/news/nation/2010-05-06-household_N.htm). U.S. Census Bureau projections accessed July 28, 2010 at <http://www.census.gov/population/www/projections/files/nation/summary/np2008-t1.xls>.

<sup>15</sup> *Ibid.*, 146.

<sup>16</sup> Reinhart, Carmen M., and Kenneth S. Rogoff. 2010. "Growth in a Time of Debt." *American Economic Review: Papers & Proceedings* 100: 573–578.

<sup>17</sup> Congressional Budget Office. 2010. "Federal Debt and the Risk of a Fiscal Crisis." Economic and Budget Issue Brief, July 27.

**Figure 1: Projected Federal Spending, 2010–2020**

<b>Year</b>	<b>Projection (billions)</b>
2010	\$3,721
2011	\$3,834
2012	\$3,755
2013	\$3,915
2014	\$4,161
2015	\$4,386
2016	\$4,665
2017	\$4,872
2018	\$5,084
2019	\$5,415
2020	\$5,713

Source: Obama Budget Table S-1, p. 146

**Figure 2: Projected Federal Debt, 2010–2020**

<b>Year</b>	<b>Projection (billions)</b>
2010	\$13,787
2011	\$15,144
2012	\$16,336
2013	\$17,453
2014	\$18,532
2015	\$19,683
2016	\$20,837
2017	\$22,011
2018	\$23,197
2019	\$24,450
2020	\$25,777

Source: Obama Budget Table S-14, p. 178

Moreover, these figures do not reflect the unfunded liabilities from Social Security and Medicare commitments to current and future participants in these programs.<sup>18</sup> These liabilities have a total net present value of over \$50 trillion and represent about 8 percent of GDP for the foreseeable future.<sup>19</sup> In other words, it would take \$50 trillion dollars right now, given assumptions about the future, to fund these programs into perpetuity after accounting for the taxes that would be collected for them under current law. (The situation is even worse if we consider other liabilities, such as pensions, as well as any obligations associated with the new health care bill.) By way of comparison, *total* federal spending is about 25 percent of GDP right now, and this has already led to an unsustainable level of deficit spending.<sup>20</sup> Moreover, estimates of the growth in Medicare costs are continually revised upwards.<sup>21</sup>

There are three sources of the emerging fiscal crisis. First, existing levels of government spending, including discretionary spending, are too high relative to tax revenues (and, many would argue, on absolute grounds). Second, commitments to future retirees are unsustainable, as evidenced by the estimated unfunded liabilities related to Social Security and Medicare. These first two problems, if left unchecked, will produce a third problem: a staggering level of government debt that will necessitate massive interest payments each year or, in the extreme, more severe consequences, such as a debt default or “monetization of the debt” (i.e., the printing of money to pay off the debt, which will produce significant inflation).

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<sup>18</sup> Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds. 2009. *Annual Report*. Washington, DC: Government Printing Office; Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds. 2009. *Annual Report*. Washington, DC: Government Printing Office. The Medicare Trustees set unfunded obligations for Part B and D at 0 because they are guaranteed funding from general revenues. However, the portion of Part B and D that comes out of general revenues can reasonably be construed as an unfunded liability, since specific revenues are not allocated for this spending (as opposed to Social Security, for which there is a dedicated fund); if these costs are accounted for, unfunded liabilities exceed \$100 trillion dollars.

<sup>19</sup> These figures reflect the net present value of unfunded obligations through the infinite horizon, and therefore include current as well as future participants in Medicare and Social Security.

<sup>20</sup> OMB, *op. cit.*, 146.

<sup>21</sup> de Rugy, Veronique. 2009. “Chart: Projected Medicare Spending Increases Over Time.” December 21. Mercatus Center at George Mason University.

Any solution to this crisis must accomplish three things: First, discretionary spending has to be pared down. Second, Social Security and Medicare expenses have to be stabilized and future promises have to be limited. Third, future politicians must be prevented from undoing any reforms that are implemented. This solution is easier to lay out hypothetically than to enact in reality, because it requires substantial adjustments to programs that many value. As the next section will show, budget rules can help members of Congress achieve these ends.

### **Congress's Commitment Problem**

To understand how rules can help Congress act in the nation's best interests, we must first identify why Congress struggles with spending, even as many members understand the nature of the problems facing the federal government: Congress's commitments to responsible budgeting lack credibility. Even legislators who want to reduce the size of government budget, the debt, or the deficit will find it difficult to take actions toward those ends. Three factors produce this problem and stack the deck against reform:

- The growing federal budget and associated increases in deficit and debt levels are “creeping risks.”
- The electoral benefits of fiscal responsibility are typically outweighed by the benefits of securing funding for one's district or state.
- Pledges made today will be hard to keep tomorrow.

Creeping risks, also referred to as slow failures, develop gradually over time, with any single event having a small but real effect on risk severity.<sup>22</sup> As enough events occur, the risk ultimately manifests itself in catastrophic ways. For example, one day of unhealthy eating will

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<sup>22</sup> Global Risk Network of the World Economic Forum. 2010. *Global Risks 2010: A Global Risk Network Report*. Geneva, Switzerland: World Economic Forum.

have a minimal long-term effect on an individual's health, but years of unhealthy eating may lead to a serious health problem. A bullet in the chest presents an immediate risk; unhealthy eating habits represent a creeping risk. Because of the incentives they face, legislators are much more likely to respond, effectively or not, to the fiscal equivalent of a bullet to the chest than to less-immediate concerns.

The World Economic Forum identifies fiscal crises as one of the major creeping risks facing the world today, and the recent debt crisis in Greece is an excellent example of a creeping risk manifesting itself suddenly.<sup>23</sup> The U.S. fiscal situation, though perhaps not as dire as Greece's right now, is headed in the same direction. Because the risks associated with U.S. government debt and spending are developing gradually over time, the short-term costs of ignoring the risk at any given point are minimal—the U.S. is unlikely to default on its debt by the end of 2010—while the short-term costs, both fiscal and political, of addressing the risks are large.

The calculus changes when the long-run is factored in. Unless a sudden debt crisis (which is no longer viewed as a virtual impossibility) emerges, the United States may be able to wait a decade to reform entitlement programs, eliminate deficits, and bring down the nation's debt, but it will be far cheaper and beneficial to society to start now. Moreover, each year of increased spending creates a new baseline for the size of government, increasing expectations about the services the federal government will provide and making reform that much harder to achieve. If one adopts a short-run perspective, then doing nothing may be the most beneficial course of action. But if the long-run is factored in, then immediate action is necessary.

Unfortunately, short-run considerations tend to dominate in Washington due to the realities of electoral politics. Legislators are ill-equipped to handle creeping risks because the

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<sup>23</sup> Ibid.

fixes require short-term pain for long-run gain. This trade-off is a difficult sell politically, especially when many politicians and pundits refuse to acknowledge the severity of the risk.<sup>24</sup> If the choice is between a big deficit and lots of perks for his district or a small deficit and sizeable cuts to programs constituents like, a legislator will be hard-pressed to choose the latter. Tough budget votes are difficult to explain to constituents, especially for amorphous goals like a reduced government debt. As I will argue below, the current political environment may present a rare opportunity for long-run considerations to triumph.

A second, related, calculus enters into legislators' decisions. The benefits of government programs are typically much more concentrated than the costs of those programs.<sup>25</sup> If spending and taxes are reduced by \$1 billion dollars through cuts to construction projects, each citizen receives about \$3 in benefits through lower taxes, but the beneficiaries of the construction projects lose far more per capita.

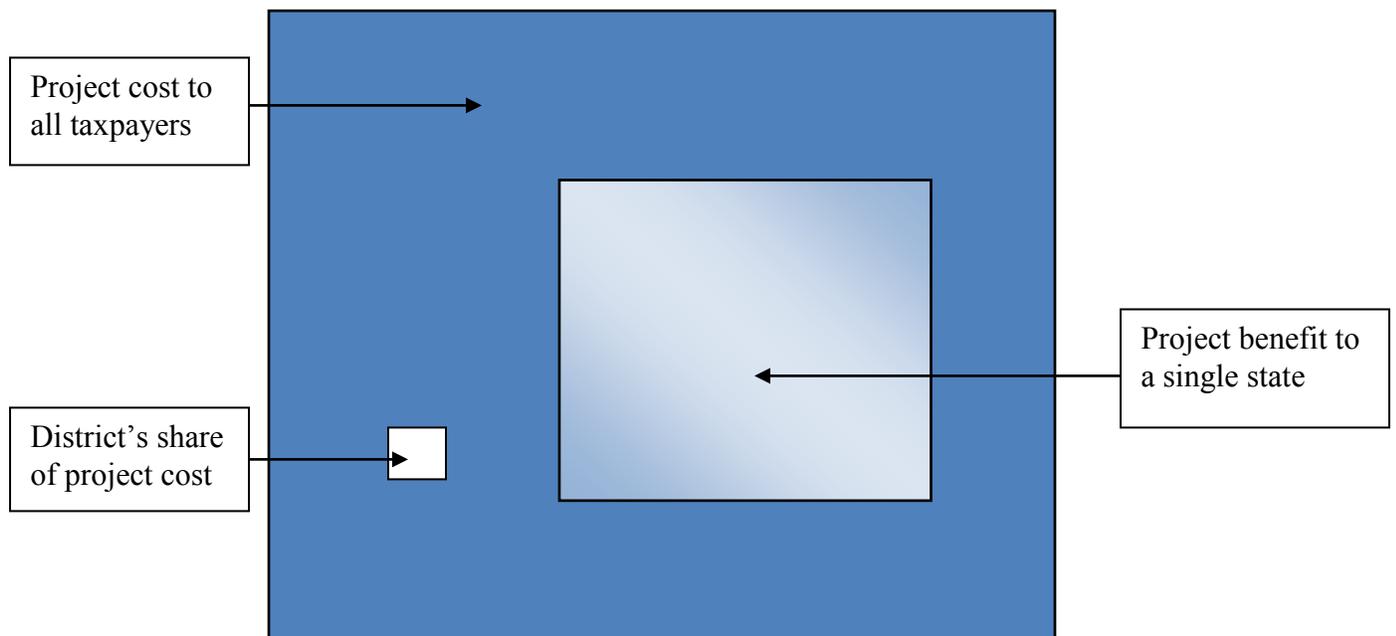
Figure 3 illustrates this “distributive politics problem.” Imagine a project that provides benefits to a congressional district (the small square) but imposes costs on all taxpayers (the large square). The costs of most projects exceed the benefits due to the distortionary effects of taxes and other inefficiencies. This project should not be funded, because the benefits to the state are smaller than the costs to taxpayers. Yet, such a project often is funded. Why? Notice the small square in the figure. That is the district's share of the project costs ( $1/435^{\text{th}}$  of the project's cost). The project is a great deal for that district. If a member can find a way to insert the project into legislation, it is rational to do so.

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<sup>24</sup> See, for example, Krugman, Paul. 2010. “Fiscal Scare Tactics.” *New York Times*, February 5, p. A25.

<sup>25</sup> Wilson, James Q. 1980. *The Politics of Regulation*. New York: Basic Books and Lowi, Theodore J. 1964. “American Business, Public Policy, Case-Studies, and Political Theory.” *World Politics* 16:677-693.

**Figure 3: The Distributive Politics Problem**



The politics of deficit reduction and spending cuts, then, are stacked in favor of beneficiaries over taxpayers. Typically, beneficiaries will be the winners and taxpayers the losers. Curiously, though, economists have found that elected officials who spearhead fiscal adjustments (a sustained decrease in deficit-to-GDP or debt-to-GDP ratio) are not typically punished at the ballot box.<sup>26</sup> This is a puzzle until one realizes that fiscal adjustments are “endogenous,” or chosen strategically by politicians. Researchers have also shown that fiscal adjustments are often spurred on by crises, when the public may be willing to accept tough medicine.<sup>27</sup> So, in the face of an active crisis (or the perception that a crisis is imminent), the political calculi that prevent reform may be adjusted in favor of taxpayers.

Even if the opportunity for fiscal belt-tightening presents itself, the reforms needed to bring spending and debt in line will require years of sustained budget cuts, necessitating long-

<sup>26</sup> Alesina, Alberto, Roberto Perotti, and Jose Tavares. 1998. “The Political Economy of Fiscal Adjustments.” *Brookings Papers on Economic Activity* 1998(1):197-266.

<sup>27</sup> Alesina, Alberto, Silvia Ardagna, and Francesco Trebbi. 2006. “Who Adjusts and When? The Political Economy of Reforms.” *IMF Staff Papers* 53(Special Issue):1-29.

term commitments to fiscal responsibility. Suppose, though, that enough legislators join forces to create a long-term solution to the country's fiscal problems. For such a plan to work, spending cuts would have to continue for many years. While a representative may want to commit today to cutting spending next year (and the following year, and so on), when next year comes, the representative (and her constituents) may value spending over the cut, especially if the cut is painful. In other words, the same pain the legislator is trying to avoid today will manifest itself next year, forcing the same difficult choice.<sup>28</sup> Congress finds it difficult to commit to fiscal responsibility, then, because the risks of inaction are creeping, tough budget votes are hard to explain to constituents, and a pledge made today will be hard to keep tomorrow.

### **Congress's Enforcement Problem**

One way to manage Congress's commitment problem is to specify a rule requiring or prohibiting particular actions. Congress could, for instance, enact a spending cap requiring that spending increase at a rate no greater than inflation or that budgets be balanced each year (or both). In Congress's case, however, this solution introduces a new problem, constitutional in nature. Article I, Section V of the Constitution reads in part, "Each House may determine the rules of its proceedings." This single line poses a major obstacle for a legislator attempting to manage the commitment problem outlined earlier. It means, in essence, that Congress has extraordinary leeway to write budget rules, even statutory ones, and then choose to ignore them. It is the proverbial judge, jury, and executioner.

There are good reasons for granting the House and Senate so much leeway. One would not want judges or presidents intervening in every legislative dispute over parliamentary

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<sup>28</sup> The time inconsistency problem is magnified by the inability of members of Congress to bind future members in the absence of a constitutional rule. The legislators making decisions five years from now may have very different preferences than the members making decisions today.

procedure, after all. But Article I, Section V also makes it difficult to construct rules addressing commitment problems, because those rules can be undone by a determined majority. If the purpose of a rule is to help solve a commitment problem, members must not be able to change or ignore the rule very easily. As Rep. Alcee Hastings, D-FL, bluntly put it, “I wish that I had been there when Thomas Edison made the remark that I think applies here: ‘There ain’t no rules around here—we’re trying to accomplish something.’ And therefore, when the deal goes down, all of this talk about rules, we make ’em up as we go along.”<sup>29</sup>

Due to this constitutionally granted freedom, successful enforcement of budget rules from within will be rare. Instead, to be successful Congress will typically need to rely on external enforcement. External enforcement might occur informally through public opinion and associated electoral threats. If legislators ignore a balanced budget requirement, for instance, public outrage could be so significant that electorally secure incumbents become vulnerable. This sort of enforcement often will not work, though, necessitating a different approach. Specifically, Congress has to relinquish some control over the enforcement of its rules to a third party that can restrain Congress when it refuses to engage in self-restraint.

The problem is, just as Congress controls the rules of its proceedings, it controls the enforcement of its rules. So, even if Congress hired an external enforcer, it would have the ability to fire this enforcer. The legislature faces the same commitment problem with regard to rule enforcement as it does with regard to spending restraint. The only way to guarantee some measure of external enforcement is via the Constitution. The Constitution is difficult to change, and if the rule is designed properly, other branches of the government will intervene if the rule is

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<sup>29</sup> Statement made during U.S. House Rules Committee Meeting, March 20, 2010. Transcribed from <http://www.c-span.org/Watch/Media/2010/03/20/HP/A/30894/House+Rules+Committee+Weekend+Meeting.aspx>, accessed June 8, 2010.

violated. This solution is not without risks, though, and in the roadmap that follows, I address both the pros and cons of constitutional rules.

There is an additional advantage to external enforcement. Nobel Prize winner Thomas Schelling, in writing about bargaining power, advocates for binding rules which amount to external enforcement.<sup>30</sup> Schelling famously gives the example of an army burning bridges to signal to opponents that surrender is not an option. Externally enforced budget rules, following the same logic, can transmit information, acting as a signal to outsiders (such as financial markets) that the United States is serious about budget reform. To sum up, a carefully constructed budget rule can help self Congress's commitment problem, and external enforcement can help solve its enforcement problem.

### **A Roadmap for Effective Budget Rule Design**

Thus far, I have established that Congress faces two interrelated problems: a commitment problem and an enforcement problem. Well-constructed rules that are enforced externally can help alleviate both of these problems. So, how should Congress create these rules? Following are actionable principles, tailored to the current fiscal situation, to guide budget rule design.<sup>31</sup>

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<sup>30</sup> Schelling, Thomas C. 1960. *The Strategy of Conflict*. Cambridge, MA: Harvard University Press.

<sup>31</sup> In Primo, David M. 2010. "Making Budget Rules Bite." *Mercatus on Policy No. 72*, I delineated three principles for rule design—broad scope; few and high-hurdle escape clauses; and limited accounting discretion—as well as three principles for rule enforcement—a credible enforcer; limited enforcement discretion; and embedding the rule in a Constitution. While the current paper is organized differently, all of these principles are reflected in what follows.

1. *Legislators should design budget rules to change the terms of the debate.*

For reasons already discussed, members of Congress have both the incentive and the power to avoid hard budget choices. A budget rule should alter the mindset in Congress away from *whether* budgets will be controlled to a focus on *how* they will be controlled. For instance, if a budget rule requires spending cuts for the next decade followed by spending increases at no greater than the rate of inflation, then waiting to act, or debating whether to act, will be off the table. Of course, many members who are unwilling to make hard budgetary decisions will also be unwilling to vote for rules forcing them to make these same hard decisions. However, once enacted, rules can be liberating. If enough electorally secure members had the will to enact a tough rule, the rule could then be used as political cover for other members.

A bargaining process that begins with both parties knowing that some spending has to be cut from the budget, or some entitlement reform must occur, is very different than one in which keeping the status quo in place is an option. A budget rule like PAYGO, which in theory, at least, limits new government programs by requiring them to be offset by equivalent cuts or tax increases, or the line-item veto, which allows the president to eliminate small items in the budget, are not useful for large-scale reform because they do not change the terms of the debate. A member wanting to add new spending to the budget can circumvent PAYGO by finding another budget line to cut or a tax to increase (or simply declaring the spending an “emergency”). In this way, the federal budget can continue to increase dramatically under PAYGO.<sup>32</sup> Similarly, the line-item veto will not change the upward trajectory of Medicare or Social Security outlays, since it can only be used on non-entitlement spending, and any cuts are subject to the approval of Congress. A budget rule that required spending cuts of, say, 30

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<sup>32</sup> For an introduction to the problems with PAYGO, see de Rugy, Veronique, and David Bieler. 2010. “Is PAYGO a No-Go?” Mercatus on Policy No. 73.

percent by 2020, on the other hand, would alter how the budgeting process was viewed. With such a rule, members would have no choice but to make major cuts in discretionary spending programs as well as entitlements.

Earlier I noted that the present political situation may represent a rare opportunity for legislators to overcome the political calculi that limit support for real reform. The deficit, for the first time in recent memory, is on the radar screen of voters, so much so that members of both parties are concerned about its impact in the November 2010 midterm elections.<sup>33</sup> If pollsters, pundits, and politicians are reading the nation's mood correctly, 2010 may be a rare occasion when legislators have an incentive to create meaningful budget rules to send a message that they understand the severity of the country's fiscal situation.

*2. Legislators should design budget rules that are permanent and apply to the entire federal budget.*

A temporary budget rule, or one that applies to small parts of the budget, is unlikely to address the nation's long-run fiscal problems. For decades Congress has been doing a poor patching job with rules that tinker at the margins (e.g., PAYGO) or are created to achieve a (relatively) short-term goal (e.g., the Gramm-Rudman-Hollings deficit reduction legislation of the 1980s). Solutions that have proven effective in small domains for one-time decisions (e.g., the Defense Base Closure and Realignment Commission<sup>34</sup>) can't fix the structural problems in the budget because future politicians have to be committed to the same structural reforms. Even if changes are made in the short term, the risk of limited reform is that a future Congress will

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<sup>33</sup> See, for example, Kellman, Laurie. 2010. "Election Spooks Lawmakers, Curbs Congress Spending." *Associated Press*, Wire Story, June 7.

<sup>34</sup> For a discussion of this reform, see Brito, Jerry. 2010. "Running for Cover: The BRAC Commission as a Model for Federal Spending Reform." Mercatus Working Paper No. 10-23, May. Note, however, that in the case of base closings, Congress always had the option to reject the recommendations of the commission.

simply revert back to old ways, creating new government programs and running large deficits, once the economy improves. By creating rules that focus on the entire budget, legislators cannot exempt entitlements, or decide that certain spending categories are off limits, as they have in the past.

### *3. Legislators should design budget rules that focus on spending.*

One of the most popular budget reforms is a balanced budget rule. It is simple and has intuitive appeal (“my family has to live within its means, why shouldn’t the government?”). And, it undoubtedly helps prevent massive deficits (though as the states have learned, not all balanced budget rules are created equal). The problem is, a budget that comprises 40 percent of GDP can be as balanced as a budget that consumes 10 percent of GDP, so long as sufficient revenues are raised. In other words, if a legislator’s goal is to bring spending levels down, a balanced budget rule may not be enough. To be sure, tax increases are politically unpopular, so balanced budget rules tend to have a downward effect on spending. My research on state governments has shown that states with effectively enforced balanced budget rules spend about 4 percent less than states with balanced budget rules that are not as effectively enforced.<sup>35</sup>

A balanced budget rule would probably have a larger effect at the federal level because no restrictions are currently in place regarding deficit spending (in the state-level study the comparison was between different types of balanced budget rules). Still, given the size of deficits at the federal level, a balanced budget rule in isolation would probably lead to hefty tax

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<sup>35</sup> Primo, *op. cit.* I equated a spending limit with a state-level balanced budget rule in *Rules and Restraint* because of empirical evidence that states handle budget shortfalls on the expenditure side rather than the revenue side. The term spending limit in the current paper is used in the more traditional sense, and balanced budget rules are treated separately.

increases alongside spending cuts, and in the long run, spending reductions are more beneficial than tax increases for two reasons.

First, once enacted, a tax increase has a greater potential to produce permanent increases in government spending, compared with a spending cut. To see why, we only need to return to the logic of concentrated benefits and distributed costs. Suppose that a deficit is closed by increasing taxes. Those taxes pay for government programs that typically have narrow constituencies willing to lobby for them. Any attempt to reduce the scope of government will have to overcome this lobbying. Moreover, legislators are unable to use the budget rule to justify the cuts, since the budget was balanced in through tax increases.

Now suppose that a rule is structured to focus on spending. Surely, there will be a fierce lobbying battle over what gets cut, but *something* will have to be cut. The spending cut serves two purposes: it both reduces the scope of government and it reduces the deficit, assuming taxes are held constant. If the budget rule requires spending cuts that are deep enough, eventually the government will run surpluses, which will either justify tax cuts or reduction of the national debt. A focus on tax increases as an instrument for budgetary responsibility works only on the deficit side, not on the spending side. Spending cuts, on the other hand, are more powerful because they both reduce spending and reduce deficits, if present.

There is a second reason for focusing on spending cuts over tax increases: they are very likely better for the economy. Economists have shown that fiscal adjustments are associated with higher levels of growth, while tax increases are associated with lower levels of economic growth.<sup>36</sup> Though the precise mechanism explaining this relationship is difficult to discern statistically, the following logic is compelling: Governments that face the need for fiscal

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<sup>36</sup> Alesina, Alberto, and Silvia Ardagna. 2009. "Large Changes in Fiscal Policy: Taxes Versus Spending." Working Paper, Harvard University.

adjustment typically are spending and taxing at excessive levels. A reduction in spending helps bring spending back to a level that reduces crowding out of private sector activity without preventing a government from performing tasks that are beneficial for economic growth (e.g., providing for the rule of law, national defense, and basic infrastructure), while tax increases have just the opposite effect. So long as spending cuts do not pare vital government services, they should be favored over tax increases as a means for imposing fiscal discipline, even though some tax increases may be necessary in combination with these spending cuts.

*4. Legislators should pay careful attention to “starting points” when constructing budget rules.*

Budget rules related to spending often peg permissible increases to values such as inflation, GDP growth, or population growth. This construction, however, is problematic if at the time of enactment budgets are already at unsustainable levels. For instance, a spending cap for the federal government that permits increases pegged to inflation but uses the 2010 budget as a starting point will not be very useful for bringing spending down to pre-stimulus levels (assuming this is the goal).

The Hensarling-Pence-Campbell proposal mentioned in the introduction avoids this pitfall by capping spending at 20 percent of GDP. In FY 2010, for instance, federal spending rose to about 25 percent of GDP, so this proposal, if enacted immediately, would force a severe ratcheting down of federal spending. Moving forward, increases in spending would be limited by the size of the economy. There are two drawbacks to pegging spending to GDP. First, an increase in the economy may not justify in an increase in the scope of government. If the economy grows by 10 percent, for instance, it is not clear that defense spending needs to grow by 10 percent. Second, GDP growth fluctuates, leading to problems if spending has to be cut

considerably in a year (or multiple years) due to a drop in GDP, or providing opportunities for budget increases if the economy booms over multiple years. For these reasons, a spending cap that initially requires a reduction in spending levels and then pegs future increases to inflation with some allowance for population growth may be more appealing.

*5. Legislators should fight against faux fiscal discipline and resist the temptation to compromise on rule design.*

As mentioned in the introduction, the Obama administration has attempted to claim the mantle of fiscal responsibility by promising to freeze certain kinds of spending for a limited amount of time, imposing PAYGO rules to make it more difficult to create new spending programs, and proposing a line-item veto. These are just three ideas floated by legislators and the president that represent faux fiscal discipline. Another recent proposal would have placed caps on discretionary spending for the next five years.<sup>37</sup> This bipartisan proposal, which did not make it through the legislative process, capped nondefense discretionary spending at over \$500 billion for the fiscal years 2010 through 2014, reflecting the current, stimulus-laden budget as a baseline.

Proposals like these ought to be opposed, not because they won't alleviate budgetary stress at the margin, but because they fail to address the structural problems in the budget. By claiming that these proposals are steps in the direction of real reform, politicians contribute to the public's misunderstanding of budget issues. Legislators who are serious about dealing with the federal government's enormous fiscal problems, then, should fight against these rules and explain why they are doing so.

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<sup>37</sup> Senate Amendment 3308 to the Joint Resolution H.J. Res. 45, 111<sup>th</sup> Congress, 2<sup>nd</sup> session.

In addition to fighting against these kinds of rules, legislators should also resist the temptation to compromise on rule design. Many practitioners will question this prescription, noting that politics is about compromise and “the art of the possible.” In some cases, this may be true. But in the area of budget rules, a compromise has dangerous consequences for several reasons. First, one reason a legislator requests a compromise on the design of a rule is to weaken the rule or creates loopholes, and such a compromise can be enough to render a rule ineffective. A compromise of the form “let’s cut spending by 22 percent instead of 25 percent” is one thing. But, a compromise that exempts certain spending from a rule should be rejected, in part for the reasons just discussed about fiscal discipline. Second, if an ineffective budget rule is enacted, this may constrain legislators who wish to enact tougher rules in the future. Third, if a budget rule is placed into the Constitution and is ineffective due to political compromise, it will be difficult to change.

*6. Legislators should design rules that are precise and prevent the use of loopholes or gimmicks.*

Budget rules ostensibly designed to accomplish the same goal, perhaps even with the same name, can have very different effects depending on how they are implemented. Yet, budget rules are often (intentionally) written in vague terms, with the details left to be worked out. Or, the wording of the rule permits evasion relatively easily. The details can make-or-break a rule’s effectiveness, since the entire purpose of rules is to encourage elected officials to take actions that they have incentives not to take. If a group of legislators can find ways to avoid a rule, they are likely to do so. Norcross (2010) places these sorts of behaviors into a larger class of activities she refers to as “fiscal evasion.”<sup>38</sup>

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<sup>38</sup> Norcross, Eileen. 2010. “Fiscal Evasion in State Budgeting.” Working Paper No. 10-39, Mercatus Center at George Mason University.

Definitions are crucial in this regard, as some real-world and hypothetical examples will demonstrate. Let's first consider actual rules: Congress allowed itself to determine on a case-by-case basis what constituted an "emergency" that permitted caps on spending or PAYGO laws to be waived.<sup>39</sup> This is but one of many loopholes and gimmicks in federal budgeting; others include the Social Security "trust fund," the timing of spending, and the strategic use of budget forecasts.<sup>40</sup>

The U.S. states act in a similar fashion. First, consider the case of California's 1979 Proposition 4 (known as the Gann limit), which set a cap on expenditures of revenues from taxation. Unfortunately for supporters of the proposition, taxation was defined in such a way that the user fees and other non-tax taxes could be used to skirt the rule.<sup>41</sup> Second, states that wish to get around limitations on "full faith and credit" debt have the option of issuing nonguaranteed debt. More generally, to get around a budget rule, governments can create "off-budget entities," which are separate entities created by governments to spend and borrow and that are often not subject to the same debt and budgeting rules as the creating government.<sup>42</sup> (By way of comparison, Enron used the term "special purpose entities" to mask the true state of its

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<sup>39</sup> Saturno, James V. 2007. "Emergency Spending: Statutory and Congressional Rules." CRS Report for Congress, RS21035, July 24.

<sup>40</sup> de Ruy, Veronique. 2010. "Budget Gimmicks or the Destructive Art of Creative Accounting." Mercatus Working Paper No. 10-30.

<sup>41</sup> Specifically, the limit defines "proceeds from taxes" as follows: "Proceeds of taxes' shall include, but not be restricted to, all tax revenues and the proceeds to an entity of government, from (1) regulatory licenses, user charges, and user fees to the extent that those proceeds exceed the costs reasonably borne by that entity in providing the regulation, product, or service, and (2) the investment of tax revenues" (California Constitution, Article 13B, Sec. 8(c)). The upshot: governments can create user fees for distinct government services and not have them count as taxes, so long as they do not exceed the costs of providing the service. California did just that, and research by Kousser et al. finds that 15 of 23 states that enacted similar tax-and-expenditure limits also saw increases in charges and fees following their enactment. Kousser, Thad, Mathew D. McCubbins, and Ellen Moule. 2008. "For Whom the TEL Tolls: Can State Tax and Expenditure Limits Effectively Reduce Spending?" *State Politics and Policy Quarterly* 8(4):331-361.

<sup>42</sup> James T. Bennett and Thomas J. DiLorenzo called this "underground government." See Bennett, James T., and Thomas J. DiLorenzo. 1983. *Underground Government: The Off-Budget Public Sector*. Washington, DC: Cato Institute. As these authors note, off-budget entities are all around us; just witness the raft of commissions, boards, authorities, and other quasi-governmental groups in most any state.

books.) In other words, to get around a limit on government spending, governments classify the spending as something else.

In light of the accounting creativity of elected officials, definitions matter. Yet, current proposals suffer from the same problems as actual rules. The Hensarling-Pence-Campbell spending cap proposal discussed earlier defines “total outlays” as “all outlays of the United States government, except for those for repayment of debt principal.”<sup>43</sup> This definition begs the question: What is an “outlay” of the United States government? For this proposal to have any teeth, outlay has to be defined very carefully, yet it is left undefined in the proposal. Since the amendment leaves the definition ambiguous, there is nothing to stop Congress from finding a way to define certain sorts of spending as a category other than outlays or attribute them to some other entity besides the United States government. Such loose language in rules is a serious problem, because it creates opportunities to not only weaken the rules, but to render them virtually meaningless.

Another fear regarding reforms that focus directly on spending is that legislators will use “tax expenditures” to skirt the caps. A tax expenditure is a deduction, credit, or other tax benefit that directs funds to particular groups. So, if a subsidy to group X is cut from the budget to satisfy a spending cap, Congress can create a tax deduction for group X members of an equivalent amount. In this way, Congress can satisfy a spending cap while continuing to provide benefits to group X. Tax expenditures are very common already,<sup>44</sup> and their use would likely increase if a spending limit did not address tax expenditures in some way.

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<sup>43</sup> H.J. Res. 79-- Proposing an Amendment to the Constitution of the United States to Control Spending , 111<sup>th</sup> Congress, 2<sup>nd</sup> session.

<sup>44</sup> For a critique of current tax expenditure practices in Congress, see Kleinbard, Edward. 2010. "The Congress Within a Congress: How Tax Expenditures Distort Our Budget and Our Political Process" *Ohio Northern University Law Review* 36(1).

As these examples demonstrate, wording matters. Because legislators have strong incentives to circumvent the rules, it is important the details be worked out at the time of enactment. Leaving these types of decisions for later creates an opportunity to weaken a rule. Important legislation often delegates definitional matters to regulatory agencies and, by extension, courts that rule on challenges to agency rulemaking. There are often legitimate justifications for delegation—expertise of agencies being one reason—but in the case of budget rules, delegation to a future Congress is not justifiable.

*7. Legislators should design rules with limited, carefully constructed exit options.*

Even as legislators design rules to prevent budget gimmicks and accounting tricks, they must also build in some sort of exit option to account for emergencies. If the United States were to face a new war, for example, exceeding a spending cap might be justifiable; similarly, a flu pandemic swept the nation, a widespread government response might be needed. Economic fluctuations are a more common occurrence that necessitate some flexibility. During a recession, tax receipts typically drop, but many economists would not support the significant tax increases (or spending cuts) during a recession that a balanced budget rule (or spending cap) may require.

This last type of “emergency” is specifically addressed in many European budget rules, including those in Switzerland and, most recently, Germany, which adopted changes to its constitution that require near-balanced budgets by 2016.<sup>45</sup> Budget rules in these countries permit transitory deficits during recessions but place an upper bound on accumulated deficits. These rules are steps in the right direction, but they contain problematic escape clauses permitting a

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<sup>45</sup> Bodmer, Frank. 2006. “The Swiss Debt Brake: How it Works and What Can Go Wrong.” *Schweizerische Zeitschrift für Volkswirtschaft und Statistik* 142:307–330; German Basic Law (Constitution), English translation accessed August 20, 2010 at [http://www.servat.unibe.ch/icl/gm\\_\\_indx.html](http://www.servat.unibe.ch/icl/gm__indx.html).

bare majority of legislators to waive the rule. Such escape clauses permit legislators to insert extraneous spending into the budget.

A third solution requires fiscal discipline over the long run but also allows for special circumstances. Specifically, the government could create a special “emergencies” account which would be the only “off-budget” account permitted under the budget rule. Congress could declare an emergency with a very large supermajority—say, 90 percent. The emergency designation would be good for only one fiscal year and would have to be renewed each year. In addition, the funds spent out of that account would have to be paid back using funds taken from general revenues over a fixed time period—say, 10 years—with spending to pay down this debt being subject to budget rules.<sup>46</sup> Moreover, any spending out of this account that is not directly tied to the emergency would be a violation of the budget rule. To prevent legislators from shifting a large portion of government spending to this emergencies account on a regular basis, the size of the account could be limited.

There are several advantages to this approach. First, it requires that emergency spending ultimately fall under the auspices of the budget rule, but at a gradual pace so as not to cause major disruptions. Second, it avoids this account becoming a piggy bank for legislators by setting an extraordinarily high bar for its use and requiring new authorizations each year. Third, it allows the government to pay for emergencies gradually, but forces it to do so in a reasonable amount of time. Fourth, it does not force legislators to mandate significant tax increases or draconian budget cuts when recessions occur.

The risk of this proposal is that legislators will come together each year and find spending they nearly all can agree on, and place this amount into the special account. However,

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<sup>46</sup> Germany’s waiver policy is very similar to my proposal, as it requires amortization of excess spending. However, the amortization time period is not specified in the German rule, and the threshold for engaging in such spending—a simple majority—is very low.

this problem would occur with any exit option, regardless of whether monies are placed into a special account. By creating this distinct account, the specific items legislators are calling emergencies would be transparent.

*8. Legislators should consider the use of a commission as a supplement to, not a replacement for, a budget rule.*

The budget rules I have discussed do not help Congress decide where to cut the budget. This is where a commission may prove useful. A typical view of commissions is that they, along with committees, are where issues go to die. Bills languish in committee and commission reports gather dust in an archive. Typically, though, commissions are not dealing with issues on which immediate action is required. So, when commissions come back to the president or Congress with politically unpopular proposals, they can safely be ignored. Suppose, however, that some action is required on an issue. In this case, the commission's proposals can serve as a starting point for negotiation. A budget rule can require action on spending or deficits, and in this way give a commission's proposals some heft.

Consider the present state of affairs: The current presidential commission addressing the deficit will present a report to Congress, if it can reach agreement, but its proposals are non-binding, and Congress is not required to vote on them. The commission's work might be viewed very differently, however, if some spending cuts or deficit reduction is required by a budget rule. If members of Congress must make cuts, a commission may provide them with the political cover to do so and may help prioritize among government programs.

9. *Legislators should get constitutional.*

Amending the U.S. Constitution is a serious matter that should not be undertaken as a substitute for legislation. Because budget rules relate to a fundamental constitutionally granted congressional prerogative—the power of the purse—and because self-enforcing rules face special challenges in Congress due to the constitutional leeway provided to legislators with regard to rules, constitutional rules deserve careful consideration.

If members are able to agree on a rule that requires them to take tough actions, they need to give the rule bite. Unlike a statute, which a determined Congress can easily change, a constitutional budget rule would require years to change. Members who wish to evade a constitutional rule do not have the luxury of altering it on the fly.

This relative inflexibility is both a blessing and a curse. If well designed, the rule will have an important positive impact. If poorly designed, however, it may negatively influence the budget process for many years, as mentioned earlier. For this reason, it is better to have no constitutional amendment than an easily evaded or poorly constructed one.<sup>47</sup>

Suppose members can agree on a robust budget rule that helps solve Congress's commitment problem. Will the same rule help Congress solve its enforcement problem? Unless specifically prohibited in its text, a constitutional rule would raise the specter of Supreme Court (and even presidential) intervention in budgets. One also has to wonder whether the enforcer can be trusted. Will the Supreme Court, for instance, overstep its bounds on budgetary matters? This is always a risk.

Robert Bork, in criticizing proposals to enshrine budget rules in the Constitution, writes

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<sup>47</sup> Because past congressional attempts at constitutional budget rules were typically filled with loopholes, I proposed in my book *Rules and Restraint* that the states call for a constitutional convention to create a constitutional budget rule. This approach would not be necessary, of course, if pressure on Congress led it to create a well-designed budget rule.

Since economists are in the forefront of those advocating constitutional economics, it may be thought ironic that so little attention has apparently been paid to the institutional problems involved, including the incentive structure that judges face and how that structure may influence their interpretations of law. Having identified the incentive structure confronting legislators as the source of the problem, it is odd that economists should advocate moving the policy into the courts without a similar inquiry. The defects of the legislative process do not of themselves render the judicial process perfect or even preferable.<sup>48</sup>

Another issue is more practical. Namely, will the budget process devolve into chaos with lawsuit after lawsuit stymieing the legislative process? On this issue, Bork writes,

Also troubling is the problem of enforcing such a constitutional provision. In the early stages of discussion, a lot of people, including most economists, apparently thought this was no problem: if Congress exceeded the constitutional limits on spending, someone would sue. That much is true. The result, however, would likely be hundreds, if not thousands, of lawsuits around the country, many of them on inconsistent theories and providing inconsistent results. By the time the Supreme Court straightened the whole matter out, the budget in question would be at least four years out of date and lawsuits involving the next three fiscal years would be slowly climbing toward the Supreme Court. It is quite possible that it would be necessary to narrow the class of possible plaintiffs significantly and to create a special, and final, court to handle this litigation. Unless attention is paid to the institutional problems involved, a constitutional amendment would become in practice a nullity—either that, or the budgetary process would pass into the hands of the courts, an outcome desired by no one.<sup>49</sup>

While Bork is correct that one ought to treat judges as strategic actors and that court enforcement would not be perfect, the experience in the U.S. states, nearly all of which have constitutional balanced budget rules, does not suggest gridlock each year due to a rash of lawsuits. Moreover, state constitutions are much more likely to read like statute books, with state constitutions averaging well over 100 amendments. The more detailed a constitution, the more likely its provisions are to conflict, and therefore to admit judicial interpretation. For instance, a Nevada court set aside a supermajority budget rule because it was delaying the

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<sup>48</sup> Bork, Robert H. 1983. "On Constitutional Economics." *Regulation* 7(5):14-18, p. 18.

<sup>49</sup> *Ibid.*, 18.

passage of education funding, which the court ruled violated another provision in the constitution regarding a guaranteed education.<sup>50</sup>

Fortunately, rule designers can be proactive in limiting judicial overreach. Courts could be authorized to require only certain sorts of remedies—for instance, the court could only mandate spending cuts to satisfy a balanced budget rule, not tax increases. Standing of citizens could be limited to avoid frivolous lawsuits. And, the clearer the rule, the less leeway the courts will have in interpreting it.

Constitutional scholar Kathleen Sullivan, a skeptic of amending the U.S. Constitution, notes that the Constitution’s strength lies in its generality. A rule that is too specific, Sullivan points out, is unlikely to capture all contingencies, and it is better to let judges and legislators address issues with an amendment unanticipated events arise. On the other hand, Sullivan points out, a general budget rule may lead to constitutional conflicts, with the president or the courts arrogating authority over budgetary matters, using the amendment as justification.<sup>51</sup>

The hypothetical dangers outlined by critics of constitutional reform have to be balanced against the very real danger that Congress will not be able to abide by the rules it sets out for itself, or will change them when the going gets tough. There is ample evidence historically that Congress will do just that.<sup>52</sup> For instance, when it became clear that Congress would not be able to meet the deficit reduction targets set out in the 1985 legislation popularly known as Gramm-Rudman-Hollings legislation, it scuttled the law rather than make the required spending cuts.

While constitutional rules are far from perfect, the alternative—self-enforcement—is a proven failure. Constitutional rules, on the other hand, help Congress address both its

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<sup>50</sup> Nevada Supreme Court. 2003. *Guinn v. Legislature*. 71 P.3d 1269 and *Guinn v. Legislature*. 76 P.3d 22.

<sup>51</sup> Sullivan, Kathleen. 1995. “Constitutional Amendmentitis.” *American Prospect Magazine* 6(23).

<sup>52</sup> For further details about enforcement challenges, see Primo, David M. 2007. *Rules and Restraint: Government Spending and the Design of Institutions*. Chicago, IL: University of Chicago Press.

commitment problems and its enforcement problems. The fears of overzealous courts may in fact serve as a further incentive for adherence to budget rules.

## **Principles Summary**

To summarize, then, budget rule designers should adhere to the following principles:

1. Legislators should design budget rules to change the terms of the debate.
2. Legislators should design budget rules that are permanent and apply to the entire federal budget.
3. Legislators should design budget rules that focus on spending.
4. Legislators should pay careful attention to “starting points” when constructing budget rules.
5. Legislators should fight against faux fiscal discipline and resist the temptation to compromise on rule design.
6. Legislators should design rules that are precise and prevent the use of loopholes or gimmicks.
7. Legislators should design rules with limited, carefully constructed exit options.
8. Legislators should consider the use of a commission as a supplement to, not a replacement for, a budget rule.
9. Legislators should get constitutional.

Most rules discussed in this paper fail on several of these dimensions. Notably, with one exception (the Hensarling-Pence-Campbell proposal), none are constitutional and none addresses the entire federal budget. Many of the rules have exit options that render them almost meaningless. Rule designers should use the roadmap provided in this paper to design and improve budget rule proposals. To show how this might be done, the appendix constructively critiques the Hensarling-Pence-Campbell proposal on the dimensions I laid out.

## **Potential Problems with Strict Budget Rules**

The discussion about constitutional reform points to a more general issue: even if legislators take into account all of the suggestions in this paper, problems are still likely to arise

as a result of strict budget rules being enacted. First, there will undoubtedly be some loophole or gimmick that legislators will construct in response to the rule. If the principles above have been followed, though, the effect of these loopholes will be minimized.

Second, if a budget rule forces dramatic cuts at the federal level, legislators may simply impose more responsibilities on the states by cutting completely a politically popular program and thereby placing pressure on the states to fund it, or otherwise changing any “matching” agreement by reducing the match. There may be a silver lining to any action of this sort. Specifically, if the spending decisions are performed at the state level, the costs are internalized to a greater degree, which prevents overspending induced when legislators can secure spending but pay for the spending out of a much larger tax base.

Third, severe disruptions could result from dramatic and sudden cuts made to satisfy a budget rule. This potential problem reinforces the need to implement new budget rules immediately, since the earlier legislators begin ratcheting down spending, the more gradual the cuts can be. Viewing this problem from another perspective, consider the consequences of not cutting and waiting until a full-blown crisis hits; this (in)action would have far more severe consequences such as hyperinflation and the potential collapse of the market for U.S. debt.

## **Conclusion**

Major adjustments to the federal budget are necessary to stanch the increase in the federal debt and reduce the deficit without hurting the economy. Incremental steps in the budgetary arena have achieved little, and more dramatic actions are needed. This paper has provided policy makers with a roadmap to designing budget rules that will help them restore fiscal responsibility to the federal budget process.

The current political environment may represent a rare opportunity for legislators to implement meaningful budget reform, with voters paying closer attention to government spending in the wake of the economic downturn and the associated stimulus plan that caused the deficit to balloon. By implementing a rule today, legislators can help force hard decisions tomorrow. No budget rule will be perfect, and problems will undoubtedly arise from any rule enacted through the legislative process. Inaction, though, is simply not an option any longer.

## Appendix

111TH CONGRESS  
2D SESSION

# H. J. RES. 79

Proposing an amendment to the Constitution of the United States to control spending.

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IN THE HOUSE OF REPRESENTATIVES

MARCH 3, 2010

Mr. HENSABLING (for himself, Mr. PENCE, and Mr. CAMPBELL) introduced the following joint resolution; which was referred to the Committee on the Judiciary

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## JOINT RESOLUTION

Proposing an amendment to the Constitution of the United States to control spending.

Constitutional Rule +

Focus on Spending +

1       *Resolved by the Senate and House of Representatives*  
2 *of the United States of America in Congress assembled*  
3 *(two-thirds of each House concurring therein), That the fol-*  
4 *lowing article is proposed as an amendment to the Con-*  
5 *stitution of the United States, which shall be valid to all*  
6 *intents and purposes as part of the Constitution when*  
7 *ratified by the legislatures of three-fourths of the several*  
8 *States within ten years after the date of its submission*  
9 *for ratification:*

“ARTICLE—

Focus on total budget +

Why tether spending to a target that is usually increasing? -

1  
2 “SECTION 1. Total annual outlays shall not exceed  
3 one-fifth of economic output of the United States of Amer-  
4 ica, unless two-thirds of each House of Congress shall pro-  
5 vide for a specific increase of outlays above this amount.

Threshold for exit option too low. -

What exactly are outlays of the United States government?

6 Total outlays shall include all outlays of the United States  
7 Government, except for those for repayment of debt prin-  
8 cipal.

Too narrow. -

9 “SECTION 2. The Congress may waive the provisions  
10 of this article while a declaration of war is in effect.

You shouldn't count on future Congresses to enforce the rule. -

11 “SECTION 3. The Congress shall have the power to  
12 enforce this article by appropriate legislation.

Why so long? -

13 “SECTION 4. This article shall take effect beginning  
14 the fifth fiscal year after its ratification.”.