Joint Economic Committee
Republicans
Representative Kevin Brady
Vice Chairman

REPUBLICAN STAFF COMMENTARY

Maximizing America's Prosperity

Lessons on Fiscal Rules from Other Developed Countries and U.S. States

June 21, 2011

Highlights

- A balanced-budget amendment to the U.S. Constitution is unlikely to counteract the bias toward higher federal spending unless it is combined with explicit spending limitations.
- Constitutional balanced-budget provisions are not self-executing and must be supplemented by other statutory fiscal rules.
- Government spending caps expressed as a percentage of GDP have been successful in countries that have undergone fiscal consolidations.
- The U.S. government needs a **statutory spending cap with a credible enforcement mechanism** regardless of whether a constitutional balanced-budget amendment is ratified.
- The **item-reduction veto** has reduced the growth of spending in U.S. states by strengthening the role of the governor relative to the legislature in making spending decisions.
- **Sunset** provisions have been effective by eliminating inefficient and unnecessary programs and agencies in U.S. states.
- The effectiveness of **tax and expenditure limitations** in U.S. states has varied greatly based on their design.

INTRODUCTION

Spend Less, Owe Less, Grow the Economy

The Joint Economic Committee (JEC) Republican Staff Commentary *Spend Less, Owe Less, Grow the Economy* reviewed the economic evidence about fiscal consolidation programs (i.e., programs to reduce government budget deficits and stabilize government debt as a percentage of Gross Domestic Product (GDP)) in developed countries – our economic competitors – since 1970. *Spend Less, Owe Less, Grow the Economy* demonstrates that fiscal consolidations based entirely or predominately on government spending reductions are more successful in achieving their goals of reducing government budget deficits and stabilizing government debt as a percentage of GDP than fiscal consolidations in which tax increases play a significant role. *Spend Less, Owe Less, Grow the Economy* also demonstrates that fiscal consolidations based entirely or predominately on government spending reductions, in addition to laying the ground work for long-term economic growth, are likely to provide a significant short-term boost to economic growth. This JEC Republican Staff Commentary follows up by identifying the kinds of fiscal rules that would enable Congress to reduce federal spending, return to a fiscally prudent budget, and boost economic growth.

Biases Toward Higher Government Spending

Despite these economic benefits, the United States and other developed countries have often been unable to implement sustainable reductions in government spending as a percentage of GDP. For over 60 years, a school of economic thought known as public choice has attempted to explain this type of fiscally irrational behavior through applying the tools of economic analysis to elections, legislatures, bureaucracies, and politics. Public choice economists, including Nobel Laureate James M. Buchanan, George Mason University economist Richard Wagner, and Australian University economist Geoffrey Brennan, as well as others that also have a public choice perspective including Nobel Laureate Milton Friedman, Stanford University economist John B. Taylor, and Harvard University economist Martin Feldstein have identified a number of biases in fiscal decision-making that tend to cause democratic governments to increase spending relative to the size of the economy over time. Some of these biases include:

- **Concentrated benefits – dispersed costs**. The benefits of government programs are often concentrated on specific individuals and firms, while the costs of government programs are widely dispersed to all taxpayers either through current taxes or future taxes in the form of government debt. In practice, this means recipients of government largesse have a significant financial incentive to organize and spend resources lobbying policymakers to maintain or increase their benefits. While every taxpayer benefits, at least indirectly, from some government spending, there is less incentive to take any significant action to reduce or eliminate specific programs. The savings would be spread across all taxpayers, amounting to pennies on the dollar relative to the cost incurred. Consequently, it is easier for policymakers to agree to special interest demands for more government spending than adhere to the general public interest for spending restraint. For example, a NFL football team seeking taxpayer financing of a new football stadium is more likely to generate the funds necessary for a successful lobbying campaign than stadium opponents to defeat the effort.

- **Opaque opportunity costs**. Governments often separate spending decisions from taxing and borrowing decisions. Consequently, additional government spending may appear to the public to come at little or no cost. Many people believe that the $2.6 trillion of nonmarketable federal debt securities in the Social Security trust fund represent real assets when they are, in fact, merely claims on future federal tax revenues. This creates an impression that $2.6 trillion of funds are readily available to pay current and future benefits.

- **Progressive taxes and benefits**. A progressive income tax system, including refundable tax credits in excess of tax liabilities, reduces the number of individuals with "skin in the tax game," thus creating the illusion among the public that someone else – usually businesses or "the rich" – will pay for additional government benefits. A recent OECD study found that the top 1 percent of U.S. taxpayers pay a greater share of the tax burden than the bottom 90 percent combined. Moreover, the federal government's fiscal policies currently redistribute more than $826 billion annually from the top 40 percent of families to the bottom 60 percent.[1]

Fiscal Rules

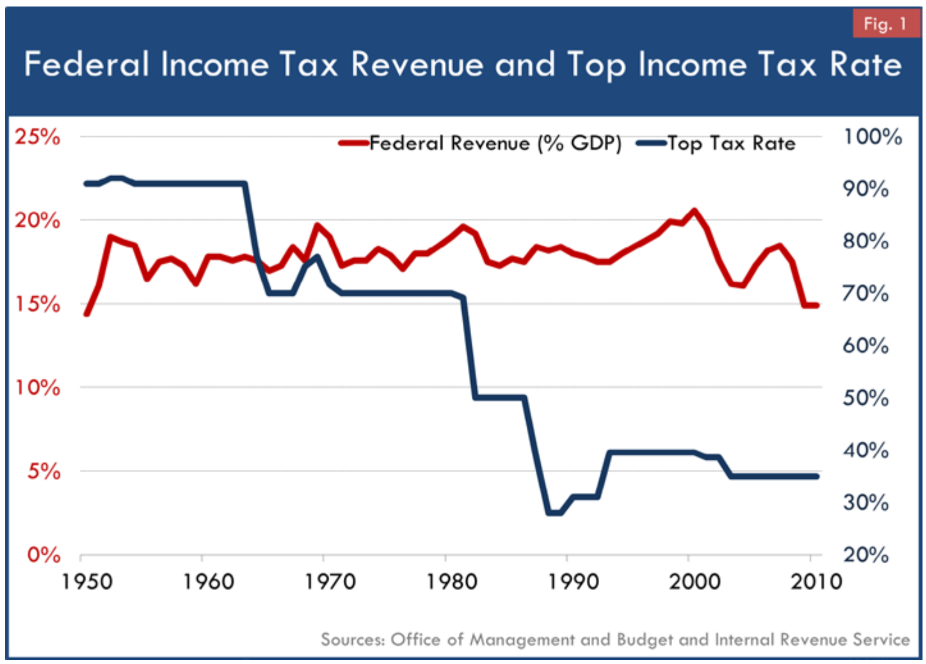
To overcome these and other biases toward higher government spending, public choice economists advocate the adoption of fiscal rules that constrain the level of government spending, taxes, budget deficits, and debt, and force policymakers and the public to make trade-offs among competing priorities. Fiscal rules include both substantive limitations (e.g., a cap on government spending as a percentage of

GDP) and procedural requirements (e.g., a requirement for a super-majority vote in a legislature to increase taxes). Fiscal rules may be constitutional or statutory.

Since the income tax had not yet been invented and government transfer payments were rare, these public choice biases toward higher spending were not readily apparent to many of our founding fathers when they drafted the U.S. Constitution and established the federal government during the late 18th century. Consequently, the U.S. government is relatively unconstrained by fiscal rules. However, other developed countries and U.S. states, many of whose constitutions were written or substantially revised after public choice ideas became apparent, have developed and implemented a number of different fiscal rules. The experience of other developed countries, as well as U.S. states, provides federal policymakers with "real world" knowledge to draw upon when crafting fiscal rules for the U.S. government.

CAUSE OF U.S. FISCAL PROBLEMS: EXCESSIVE FEDERAL SPENDING

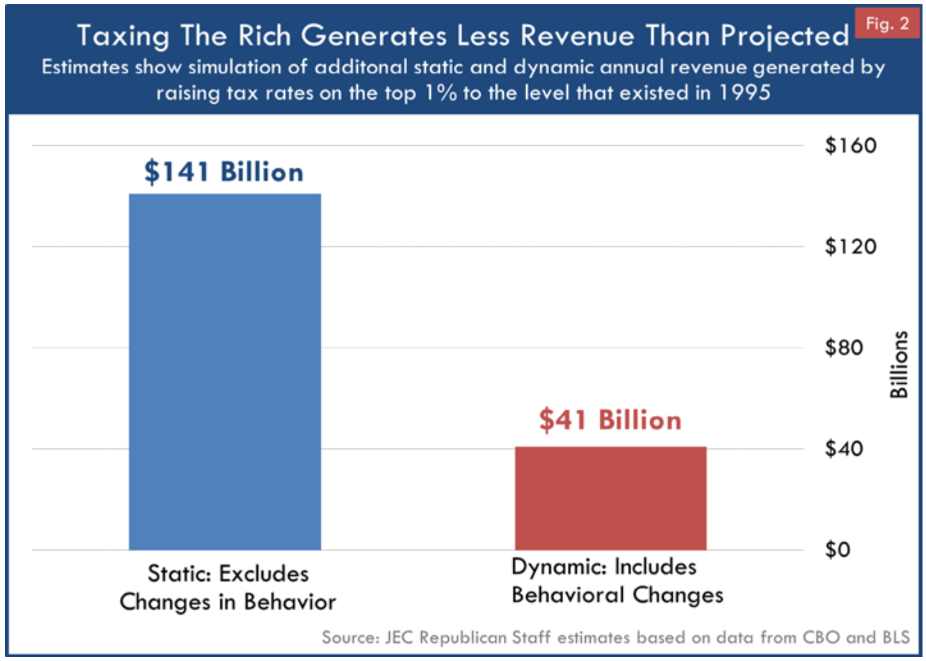
Hauser's Law: Effective Limit on the Ability of the Present Federal Tax System to Raise Revenue



The result of behavioral responses to high marginal income tax rates is negative; it slows economic growth and job creation. In examining tax receipts as a percent of GDP over the years 1946 to 2007, Stanford University economist W. Kurt Hauser found an empirical relationship which became known as Hauser's law. He found that under a tax increase, the denominator, GDP, will rise less than forecast, while the numerator, tax revenues, will increase less than anticipated. Therefore the quotient, the percentage of GDP collected in taxes, will remain the same. Hauser found, "no matter what the tax rates have been, in postwar America tax revenues have remained at about 19.5 percent of GDP."[2] If Hauser's law holds that federal revenues are loosely constrained at a level of 19.5 percent of GDP, it is far better to collect 19.5 percent of a larger GDP buoyed by lower marginal income tax rates than to collect 19.5 percent of a smaller GDP depressed by higher marginal income tax rates.

Even though the top marginal federal individual income tax rate has been as high as 91 percent and as low as 28 percent, federal tax receipts in the United States have remained surprisingly stable at approximately 18.9 percent of GDP (the average from fiscal years 1947-2011) (see Fig. 1).

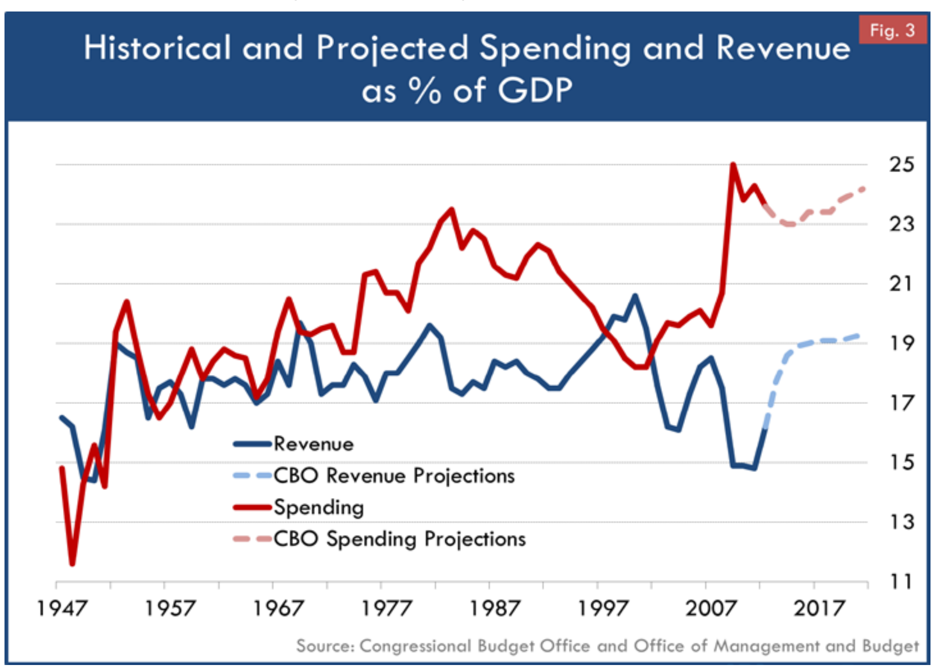
Fiscal and tax policy debates are often misleading because static budget analysis does not take into account dynamic behavioral responses to taxes. Large marginal income tax increases on the so-called "rich" can be wrongly perceived to increase federal receipts substantially. However, economists have provided strong evidence for the negative effects of high marginal tax rates on the productive behavior of individuals and firms. The result of higher income tax rates is slower economic growth, reduced employment, and lower-than-projected tax receipts.



Analysis by the JEC Republican staff based on historical data confirms the negative effects of higher marginal tax rates.[3] If the effective tax rate on only the top one percent of earners were increased to the highest rate that existed under President Clinton, a static analysis (such as that done by the Congressional Budget Office (CBO) and Joint Committee on Taxation (JCT), and upon which all official budget revenue projections rely) suggests that annual tax receipts would increase by $141 billion ($1.4 trillion over 10 years). However, taking into account changes in behavior, historical data suggests that revenues would increase by only $40 billion per year ($400 billion over 10 years) (see Fig. 2 on previous page). So, more than 70 percent of the projected tax receipts would <u>not</u> be realized because individuals would change their behaviors—they would work less, save less, invest less, shift taxable activities abroad, and do whatever they could to avoid taxes—and thus shrink the economy. Tax policy should aim to encourage, not discourage, productive behavior, which will help to grow our economy and create jobs.

The Disease—Excessive Federal Spending

Large persistent federal budget deficits and a rising level of federal debt as a percentage of GDP are often identified as the fiscal "illness" afflicting the United States. However, federal budget deficits and federal debt are merely the symptoms of the real disease – excessive federal spending. A danger of focusing on federal budget deficits and federal debt is that federal policymakers may attempt to treat these symptoms while leaving the underlying disease to fester.



During fiscal years 1947 to 2008, federal budget deficits averaged 1.7 percent of GDP (See Fig. 3). During the last three fiscal years, however, federal budget deficits have skyrocketed, reaching an expected 9.3 percent of GDP in the current fiscal year. Federal budget deficits over the next ten fiscal years are projected to average 3.4 percent of GDP under the CBO baseline, and 4.8 percent of GDP under the President's proposed budget.[4] Whereas gross federal debt has exceeded 100 percent of GDP in only three fiscal years (during and immediately after WWII), CBO projects that gross debt will reach 100 percent of GDP this year and will continue to rise thereafter.[5] As economists Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University show, gross government debt in excess of 90 percent of GDP reduces economic growth.[6] And lower economic growth produces lower tax revenues, further exacerbating budget deficits.

How did the United States get into such a precarious fiscal situation? The recent recession certainly hastened the fiscal crisis, but the nature of the U.S. political process and the lack of effective fiscal rules are what have enabled federal policymakers to enact irresponsible budgets that appease special interests at the expense of future generations. The problem is not that the U.S. government collects too little in taxes—indeed, federal tax receipts are expected to grow over the long term. Rather, the problem is excessive and unsustainable federal spending.

Table 1. From CBO Projected Federal Budget Surpluses to Actual Federal Budget Deficits (Fiscal Years 2002-2011)

	$ Billions	Percent of Swing
CBO Projection of Cumulative Federal Budget Surpluses for Fiscal Years 2002-2011 in January 2001	$5,610	
Tax Reduction	-$2,809	24%
Spending Increases	-$5,629	48%
Economic and Technical Changes*	-$3,330	28%
Actual Cumulative Federal Budget Deficits Fiscal Years 2002-2011	-$6,241	
Total Swing	-$11,851	

*Economic changes are mainly due to March 2001 to November 2001 recession and the December 2007 to June 2009 recession. Technical changes are due to errors in assumptions about such factors as what proportion of eligible individuals and families will participate in benefit programs, how sound financial institutions will be, and how health care providers will behave.

In January 2001, the CBO projected cumulative federal budget surpluses of $5.6 trillion for fiscal years 2002 to 2011. However, these projected cumulative federal budget surpluses rapidly turned into cumulative federal budget deficits of $6.2 trillion for fiscal years 2002 to 2011, a swing of $11.9 trillion (see Table 1). Some critics blame President Bush's tax cuts in 2001 and 2003 for upending these surpluses. According to the CBO, however, tax reductions (including tax reductions enacted or renewed under President Obama) accounted for only 24 percent of the swing from projected federal budget surpluses to actual budget deficits during fiscal years 2002 to 2011. Higher federal spending accounted for 48 percent of the swing from projected federal budget surpluses to actual deficits during fiscal years 2002 to 2011, while other economic and technical factors, including the effects of 2001 recession, accounted for another 28 percent of the swing from projected federal budget surpluses to actual deficits. Clearly, federal spending must be cut in order for the United States to secure fiscal stability in the future.

Even absent President Obama's proposed tax increases, revenue under his budget proposal is projected to be $37.9 trillion over the next ten fiscal years.[7] However, President Obama's budget would spend $46.2 trillion during same period.[8] The President claims his budget "lays out a path for how we can pay down [the] debt."[9] With such an incomplete solution to a very real problem, and with the extreme opposition and criticism towards serious solutions, federal policymakers are unlikely to restore the fiscal discipline necessary to save our country from economic deterioration or demise. The U.S. government needs clear, enforceable fiscal rules that will force federal policymakers and the public to make tough choices to constrain federal spending. Establishing clear and enforceable fiscal policy rules and creating the tools needed to enforce those rules will help restore confidence in the U.S. fiscal outlook and will force federal policymakers to make the tough decisions necessary to maintain America's prosperity.

FISCAL RULES IN OTHER DEVELOPED COUNTRIES

Fiscal rules—the constitutional provisions and laws under which governments plan, approve, and implement their budgets—can play an important role in the size and composition of budgets, and in the likelihood of persistent budget deficits. Laws that prescribe numerical targets or limits and laws that prescribe procedural rules can help improve budget outcomes.[10]

Evidence shows that the most effective fiscal rules are predicated on three conditions: (1) public understanding of the need for such rules, including education and outreach to achieve this understanding (e.g., Argentina, Brazil, New Zealand, European Union) ; (2) political debate leading to broad consensus for the introduction of such fiscal rules (e.g., Germany, Switzerland, United States); and (3) a clear, well-planned, and preannounced path of convergence in key economic indicators (e.g., Argentina, New Zealand, Peru, Switzerland, European Union).[11]

In a parliamentary system, fiscal decision-making is centralized in the prime minister and his or her cabinet. Votes on fiscal matters are always confidence votes. If the legislature does not approve the prime minister's budget exactly as presented, the prime minister must resign or call a new parliamentary election. A straight "up-or-down" vote on the budget severely limits the ability of individual legislators to add local "pork barrel" projects. In a parliamentary system, the majority party or parties in the legislature are fully responsible for the budget and accountable to the voters for its economic effects.

Fiscal rules are even more important in the United States than in other developed countries. In our separation–of-powers system, the President and the Congress share the responsibility for fiscal decision-making. Shared decision-making and differing election cycles for Representatives, Senators, and the President encourage legislative logrolling, force compromises, and blur accountability for the economic effects of the budget to the voters. It is far more difficult for the United States to make rational fiscal decisions that limit the growth of spending in the absence of fiscal rules than it is in other developed countries with parliamentary systems.

Canada's Experience: Large Spending Reductions

In 1993, Canada faced a fiscal situation similar to what the United States faces today. After more than two decades of high federal budget deficits, Canada's net federal debt reached 67 percent of GDP (the U.S. projected federal debt held by the public for the end of fiscal year 2011 is 69.4 percent).[12] Convinced that cutting federal spending was the key to solving Canada's fiscal crisis, then-Finance Minister Paul Martin relied upon increased transparency to raise public awareness about the need for serious spending reductions.[13] With the support of Prime Minister Jean Chretien, Martin announced federal spending limits and implemented aggressive spending cuts that went beyond just trimming the rate of growth in programs and instead cut spending below the previous fiscal year's level. To assure that the spending and budget deficit reduction goals were met, Canada relied on conservative assumptions and created a contingency reserve in case the economic forecasts proved too optimistic.

Contrary to Keynesian beliefs, massive cuts in federal spending from 22.3 percent of GDP in Canadian fiscal year 1993 (begins on April 1, 1993 and ends March 31, 1994) to 16.2 percent in Canadian fiscal year 2000 and federal budget deficits from a $29.8 billion deficit in Canadian fiscal year 1993 to a surplus of $13.3 billion in Canadian fiscal year 2000 were not economically catastrophic. Instead, GDP growth averaged more than 4 percent from 1994 to 2000 compared with an anemic 0.8 percent average from 1989 to 1993.[14]

While some argue that the federal government must increase taxes on the rich to confront its unsustainable fiscal outlook, Canada demonstrates that this is not the case. The Canadian deficit reduction consisted of six dollars in spending cuts for every one dollar in tax increases, and those tax increases resulted from the elimination of some "nickel-and-dime" special interest tax preferences, not from increases in marginal income tax rates.[15] Ultimately, the deficit reduction measures were so successful that Canada was able to cut the corporate tax rate by 7 percent, reduce income taxes and the share of capital gains subject to taxation, and raise the contribution limit for retirement accounts.[16] For federal policymakers seeking to enhance U.S. competitiveness by reducing the federal corporate tax rate, the Canadian experience serves as an ideal example of how federal spending and budget deficit reduction can allow for such a policy course.

Other Developed Countries

A comprehensive study by the Mercatus Center comparing the fiscal stability efforts of 26 countries found that while fiscal rules can effectively restrain political incentives for excessive government spending and budget deficits, fiscal rules do not guarantee success.[17] For example, although most member-states within the European Union originally adhered to the limits for annual government budget deficits of 3 percent of GDP and government debt of 60 percent of GDP set forth in the Stability and Growth Pact, many member-states began to ignore the limits because they lacked the necessary enforcement mechanisms. Hence, rules of the pact, such as a "no-bailout" policy, have been violated.[18] However, IMF economist Paolo Manasse found that government budget deficit limits are particularly helpful in achieving fiscal discipline if the limits are tight and the expected sanctions for exceeding them are high.[19]

FISCAL RULES IN U.S. STATES

U.S. states with reputations for fiscal prudence enjoy higher and relatively more stable growth.[20] The following is a list of policy options and fiscal tools from U.S. states that our federal government might emulate to get the United States back on track towards sustainable fiscal prudence.

Line Item-Reduction Veto

A line item-reduction veto allows a governor to either (1) veto a particular item within an appropriations bill like a line-item veto, or (2) reduce the amount of funding for a particular item within an appropriations bill, unlike a line-item veto, without vetoing the entire appropriations bill. Economic studies have found that the item-reduction veto is an effective tool for controlling excessive increases in state spending.[21] Just fourteen states have the line item-reduction veto, while 29 states have the line-item veto.[22]

A line item-reduction veto strengthens a governor's power relative to the state legislature in making spending decisions. The flexibility to trim an appropriations item without vetoing the underlying bill altogether makes a governor more likely to use an item-reduction veto than to use either an entire bill veto or a line-item veto. Because governors are elected statewide, while state legislators are elected by smaller geographically-segmented constituencies, governors have a statewide perspective. Over time, governors are more likely to focus on their state's overall fiscal status and are less tolerant of local pork projects than state legislators.[23]

In a study spanning all 50 states over eight years (1979 to 1986), economists Mark Crain and James C. Miller demonstrate that among all the institutional controls identified as reducing spending, line item-reduction veto cuts the rate of state spending growth over a two-year period by 2.7 percent. Alternatively, the simpler line-item veto had an insignificant effect on spending growth. Crain and Miller further estimate that if Presidents Carter and Reagan had an item-reduction veto, the real growth rate of federal spending would have been cut in half over the same eight-year period.[24]

Sunset Provisions

State-level sunset provisions demonstrate the effectiveness of this tool as a method to curtail growth in the size, scope, and cost of government and reinforce performance-based budgeting decisions. Though their designs vary considerably, twenty states have active sunset provisions in place to continually reevaluate programs and determine whether the continued existence of each government program is justified.[25]

The design of a sunset process is important. Broadening the reach of a sunset process increases its chances of success; no program or agency should be considered exempt from periodic review. Establishing a regular review process administered by a commission with clear performance measures and transparent reporting methods also increases the effectiveness of a sunset process. Furthermore, in designing an effective sunset process, an agency undergoing sunset review that is recommended to be abolished should be automatically abolished unless the legislature passes a bill to preserve it.

Texas has proved to have the most successful sunset provision among the states. Since its inception through 2009, the Commission has abolished 58 agencies and consolidated another 12, accruing $784 million in savings. In 2009 alone, Texas' Commission reviewed 25 state agencies, recommended significant changes to 21 continuing agencies, abolished two agencies outright, and abolished two agencies by transferring their functions to other agencies. The Texas Legislature adopted all of the Commission's recommendations.

In Texas, a 12-member Sunset Advisory Commission (a combination of legislators and public members appointed by the Lieutenant Governor and Speaker of the House), established in 1977, regularly reviews over 130 state agencies, with 20-30 agencies undergoing the sunset process each legislative session. The Commission's report on a particular agency must include a recommendation to abolish or continue the agency, and if recommending to continue, draft legislation for the Legislature to continue the agency for up to 12 years. Otherwise, a state agency is automatically abolished unless the Legislature passes legislation sustaining it. For every dollar spent on the sunset process, Texas taxpayers have received $27 in net benefit due both to increased revenues and decreased costs.[26] The Texas experience has been largely positive due to several key elements: broad reach, strong legislative support, clear performance measures, and transparent reporting methods.

While there are many studies that suggest performance-based measures would help the federal government to operate efficiently at lower costs, federal policymakers have been immobilized when it comes to adopting such suggestions. A sunset commission at the federal level could bring about the mechanism needed to shed duplication and waste while saving money. Because a sunset commission is not a one-time consolidation effort, it can continue to hold agencies at the federal level accountable to perform services identified as crucial and cost-effective.

Balanced-Budget Rules

Nearly all states have a balanced-budget rule, but there is much variation in the institutional design, including whether they are constitutional or statutory. Forty-four states require the governor to submit a balanced budget (32 of which are constitutionally-mandated), 37 states require the governor to sign a balanced budget (31 of which are constitutionally-mandated), and in 41 states, legislatures must pass balanced budgets (34 states are constitutionally mandated to do so).[27]

In general, balanced-budget rules appear to improve fiscal sustainability and are associated with smaller state budget deficits, lower state debt, higher credit ratings, more rapid adjustment to fiscal shocks, and deterring political manipulation of budgets. Roughly half of all states possess the most stringent form of a balanced-budget rule, the "no-carry-forward" rule prohibiting carrying forward a deficit into the following budget year. Prior studies have demonstrated that a no-carry-forward rule, applied to the entire budget, reduces fiscal balance cyclical variation by approximately 40 percent. Further, constitutionally-mandated no-carry-forward rules are associated with smaller deficits.[28]

A strict, enforceable, and constitutionally-mandated balanced budget at the federal level will increase the credibility of a fiscal consolidation plan. As University of Rochester political scientist David Primo describes, however, Congress faces three factors that work against reform: (1) "creeping risks" in the federal budget; (2) benefits of securing funding for one's state or district that outweigh the benefits associated with fiscal responsibility; and (3) promises made today are hard to keep tomorrow. For the federal level, Primo recommends that budget rules be constitutional, apply to the entire federal budget, focus on spending, take care when constructing "starting points" (increases pegged to inflation for example), resist compromise on rule design, use carefully constructed and limited exit options, and create precise rules lacking loopholes and opportunity for budget gimmicks.[29]

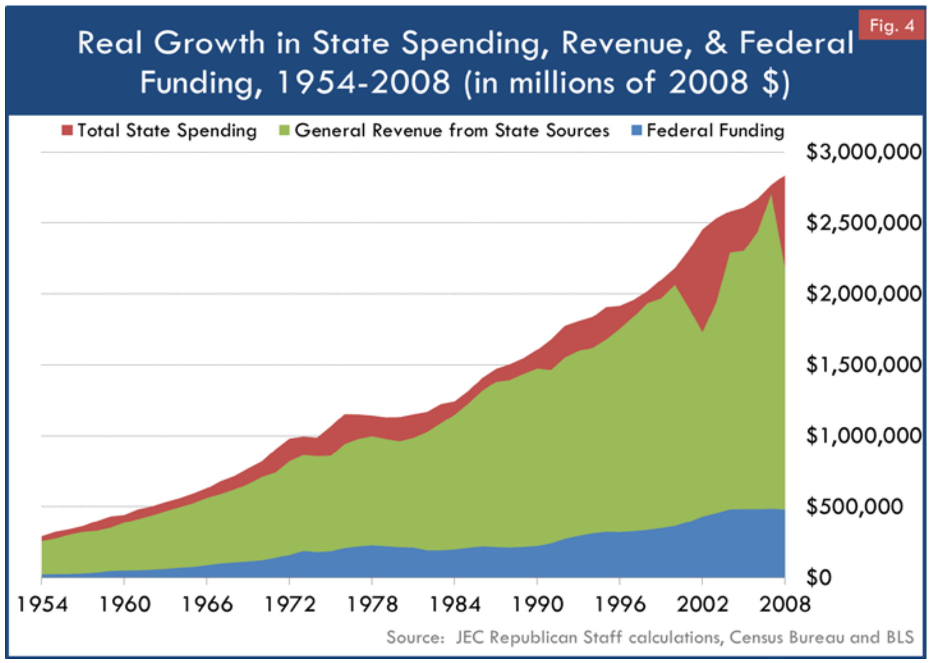
Tax and Expenditure Limitations

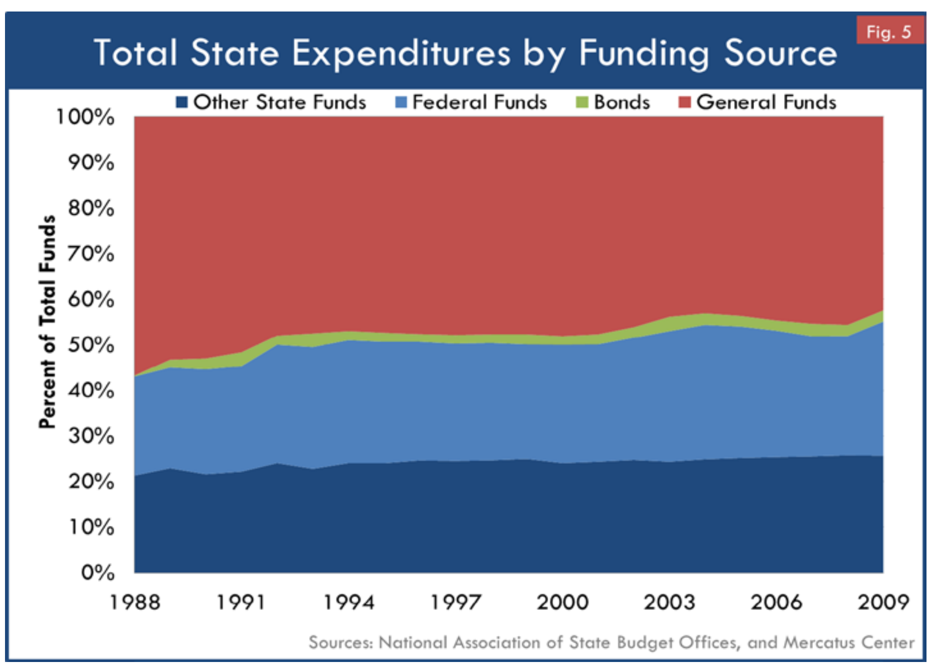
The implementation of a tax and expenditure limitation (TEL) can improve the effectiveness of fiscal rules by limiting growth in government spending and increasing overall budget stability. TELs offer an effective mechanism for overcoming the concentrated benefits – dispersed costs bias toward higher spending by limiting the ability of special interests to press for higher outlays. TELs typically work by indexing revenues or expenditures to certain rates of growth. For example, TELs may be linked to personal income or a combination of population and inflation (wages, consumer prices, producer prices). The index can be a moving average of earlier years, or based on the last year's growth figures. Currently, thirty states have at least one form of a TEL.[30] Twenty-three states have spending limits, four have tax limits, and three have both. About half are in the form of constitutional provisions, and the other half are required by statute. Maine, Ohio, and several other states have statutory spending or tax limit mechanisms, while states such as Colorado, have TELs embedded in their state constitutions.[31] Yet like other fiscal rules, the design and institutional setting of such a limit is imperative to its success. The state-level experience with TELs has yielded mixed results.

Poorly constructed TELs enable legislators to use evasive measures to get around the limitations. California passed its first TEL (Proposition 13) in 1978, limiting appropriations to personal income growth and population. Within the following year, it passed a second TEL (Proposition 4)—known as the Gann Limit—limiting appropriations on tax proceeds. However, the effectiveness of these limitations has diminished over time due to the ability of California voters to directly alter via ballot measures the types of taxes subject to the limit and even the benchmark of the limit.[32] Colorado's TEL, once considered the strictest in the country, succumbed to a similar fate in the referendum process.[33]

Studies that examine the various structures of TELs have found that certain TELs can be effective, but the details are critical. For example, a study by University of Alabama economist Michael J. New, an expert on state government budgets, identified three particular characteristics associated with effective TELs: (1) it limits spending growth to inflation and population growth; (2) it refunds surpluses to taxpayers automatically; (3) it adjusts automatically when states pass power to other levels of government.[34] Furthermore, studies have shown that a TEL in combination with a strict balanced-budget requirement can increase the TEL's effectiveness. In fact, if the states with the worst budget gaps in the last two years had restrained per capita spending growth to inflation-adjusted 1995 levels, 12 of the bottom 14 states would have had no gap for fiscal year 2009.[35] In general, this variety of TEL results in 3 percent less state and local spending as a share of state income relative to the average state and local spending share.[36]

Concerns about the effectiveness of TELs led to additional measures such as the use of super-majorities for tax and expenditure increases. A super-majority (sometimes referred to as an extraordinary majority) requires a higher percentage of member votes to pass than a simple majority (one-half plus one of the members voting). Super-majority requirements increase the difficulty of taking action by requiring a three-fifths, two-thirds, or three-fourths majority vote. Sixteen states currently require super-majorities to pass tax increases. Empirical studies by Crain and Miller (1990) found that super-majority requirements on state fiscal programs reduced the growth of state spending by about 2 to 4 percent. Crain (2003) found that super-majority voting requirement for a tax increase lowers per capita spending by 4 percent.[37]





Making Fiscal Rules More Effective

In spite of the many rules in place amongst the states, a decades-long trend in growth in state spending exists relative to many measures. Over the past 50 years state spending has increased nearly tenfold (see Fig. 4). Since World War II, state and local spending has increased 34 percent faster than the private sector and 37 percent faster than the federal government.[38]

Much of this is due to a greater reliance on federal funds for specific programs requiring fund matching and mandates such as Medicaid rather than relying on general funds. In 1988 general funds accounted for 56.7 percent of total state expenditures, in 2009 general funds only accounted for 42.5 percent. Meanwhile federal funds have increased from 21.7 percent to 29.5 percent from 1988 to 2009 (see Fig. 5).[39]

The standard "ratchet theory" suggests that the federal government permanently grows larger in the long term; however, research reveals that current federal expansion also causes permanent expansion in the size of state and local governments. State and local governments tend to fill the void in funding once federal grants end by increasing taxes and other revenue sources, making for a large, long-term burden on state taxpayers. Estimates from West Virginia University economists Russell S. Sobel and George R. Crowley suggest that future state tax burdens are "ratcheted up" as high as 42 cents for every dollar of federal aid received by a state.[40]

All levels of government must address this phenomenon to slow government spending and size, and by doing so, enable state fiscal rules to be more effective. Recognizing these effects, however, many governors are now refusing federal funding. Governors Rick Scott of Florida, Scott Walker of Wisconsin, and John Kasich of Ohio have all refused a combined $3.6 billion in federal funds relating to high speed rail projects, citing exorbitantly higher costs that their respective states cannot afford.

Conclusion

Recent experience confirms the bias in democratic governments in developed countries toward higher government spending as a percentage of GDP over time. To correct for this bias in fiscal decision-making, public choice economists advocate fiscal rules to constrain policymakers.

Governments in other developed countries and U.S. states have implemented a variety of fiscal rules. Their experiences provide federal policymakers with a guide to the fiscal rules that may effectively constrain the federal government.

- **Spending caps**. A spending cap expressed as a percentage of GDP is one of the most effective tools for correcting the bias toward higher spending. By directly addressing the problem of excessive spending, a spending cap forces advocates for various programs to compete against each other for available funds instead of allowing legislators to logroll to increase overall government spending.

- **Enforcement procedure**. Spending caps are important, but absent a viable enforcement mechanism, they will do little to control the growth of government spending. The enforcement procedure should be automatic if the spending cap is breached. The enforcement procedure must be perceived by policymakers and the public as fair (generally all agencies and programs should be treated equally with few, if any, exceptions) and reasonable (any additional spending reductions imposed by the enforcement procedure should not be so large as to threaten the existence of an agency or a program or unduly harm program beneficiaries). If the enforcement procedure is both fair and reasonable, it will be credible. A credible enforcement procedure strengthens a spending cap, making it more likely that federal policymakers will make the tough decisions necessary to abide by it. This procedure should also be politically difficult to ignore or change. Ideally, any enforcement procedure should require a super-majority vote of both House of Congress to waive or change it.

- **Line item-reduction tool**. In a government based on separation of power, strengthening the role of the executive relative to the legislature in budgetary affairs reduces the growth rate of government spending over time. In U.S. states, one of the most effective means of constraining spending growth has been the item-reduction veto, which allows a governor to eliminate or reduce an item in an appropriations bill without vetoing the entire bill. While giving the President a line item-reduction veto would require a constitutional amendment, Congress can effectively create a similar line item-reduction tool for the President through enhanced rescission authority.

- **Sunset provisions**. In many U.S. states, sunset laws require state legislatures to review all existing state agencies and programs on a periodic basis. Agencies and programs that the legislature does not reauthorize before their sunset date are automatically terminated. These sunset provisions help governments identify and eliminate ineffective or duplicative programs and unnecessary agencies. Recent General Accountability Office (GAO) reports indicate the potential for savings from sunset legislation. The GAO was required to identify federal programs or functional areas where unnecessary duplication, overlap, or fragmentation exists; the actions needed to address such conditions; and the potential financial and other benefits of doing so. The GAO was also required to highlight other opportunities for potential cost savings. For example, GAO found the Department of Defense could save $460 million annually by restructuring its military health care system. The GAO also developed a range of options that could reduce federal revenue losses by up to $5.7 billion annually by examining potentially duplicative policies designed to boost domestic ethanol production. Collectively, these savings and revenues, as well as similar findings in other agencies, could result in tens of billions of dollars in annual savings, depending on the extent of actions taken.

- **Balanced-budget requirements**. While nearly all U.S. states have some form of a balanced-budget requirement, their effectiveness in restraining the bias toward higher government spending varies. The most effective requirements for balanced budgets (1) are constitutional rather than statutory, (2) require both the governor to submit a balanced budget and the legislature to enact appropriations bills that comply with the requirement, and (3) prohibit any unanticipated budget deficit from being carried forward into the next fiscal year.

    - An inherent problem with balanced-budget requirements is that they target government budget deficits rather than government spending. Under balanced-budget requirements without an explicit cap on government spending, government spending may continue to increase relative to GDP. Instead of higher government debt, rising government spending would instead be financed through higher taxes that slow economic growth and job creation.

    - Constitutional provisions for balanced budgets are not self-executing. They require statutory fiscal rules to be implemented successfully.

- **Tax and expenditure limitations.** The effectiveness of tax and expenditure limitation provisions in U.S. states varies greatly depending on their design. At the federal level, a constitutional requirement for a super-majority vote for Congress to levy new taxes or increase existing taxes would be beneficial.

If federal policymakers are sincere in their stated desire to address the United States' looming fiscal crisis, they will seize the opportunity to implement a series of well-designed, workable, and automatically enforceable fiscal rules.

---

1 "Growing Unequal? Income Distribution and Poverty in OECD Countries," Organization for Economic Cooperation and Development, 2008. p. 112. http://dx.doi.org/10.1787/422013187855. Here income taxes refer to both personal and social insurance taxes.

2 W. Kurt Hauser, "The Tax and Revenue Equation," *The Wall Street Journal*, March 25, 1993. Reprinted in: W. Kurt Hauser, *Taxation and Economic Performance* (Stanford, California: Hoover Institution Press, 1996).

3 "Atlas Shrugs: The Diminishing Returns from Taxing the Rich," Republican Staff Commentary, Joint Economic Committee, May 5th, 2011, http://jec.senate.gov/republicans/public/?a=Files.Serve&File_id=57640966-99f0-4330-8d16-9da99f011eb7.

4 Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012*, April 2011, http://www.cbo.gov/ftpdocs/121xx/doc12130/04-15-AnalysisPresidentsBudget.pdf.

5 Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, January 2011, http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf.

6 Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt," Prepared for the *American Economic Review Papers and Proceedings*, December 2009, http://www.aeaweb.org/aea/conference/program/retrieve.php?pdfid=460.

7 Office of Management and Budget, *Technical Budget Analyses of President's Budget Proposal for Fiscal Year 2012,* February 2011. http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/technical_analyses.pdf ; see also: *Infra,* at endnote 3.

8 *Id*.

9 Barack Obama, "The Budget Message of the President," contained in *Fiscal Year 2012 Budget of the U.S. Government*, Office of Management and Budget, February 14, 2011, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf.

10 Alberto Alesina and Roberto Perotti, "Budget Deficits and Budget Institutions," in *Fiscal Institutions and Fiscal Performance*, University of Chicago Press, January 1999, http://www.nber.org/chapters/c8021.

11 George Kopits, "Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?" *IMF Working Paper*, September 2001, http://cartac.org/Userfiles/file/L7-Kopits.pdf.

12 David R. Henderson and Jerrod Anderson, "Learning from Canada's Budget Triumph," Mercatus Center at George Mason University, September 2010, http://mercatus.org/sites/default/files/publication/Canada's%20Budget%20Triumph.MoP_.pdf.

13 Timothy Lewis, *In the Long Run We're All Dead: The Canadian Turn to Fiscal Restraint*, UBC Press, 2004.

14 JEC calculations in US dollars based on data from "Fiscal Reference Tables October 2009," Department of Finance Canada, http://www.fin.gc.ca/frt-trf/2009/frt09-eng.asp.

15 *Agriculture and Agri-Food Canada, Corporate Income Tax Rate Database*, Canada and the Provinces, 1960-2005, http://dsp-psd.pwgsc.gc.ca/collection_2007/agr/A38-4-9-2007E.pdf.

16 RBC, "RRSP Contributions 1968 to 2008…and beyond to 2020," January 2010, http://www.rbc.com/economics/market/pdf/RRSP.

17 Christina Forsberg, Stefanie Haeffele-Balch, and Maurice McTigue, "The Factors and Motivations of Fiscal Stability: A Comparative Analysis of 26 Countries," Mercatus Center at George Mason University, January 2010, http://mercatus.org/sites/default/files/publication/The%20Factors%20and%20Motivations%20of%20Fiscal%20Stability.pdf.

18 Barry Eichengreen, "Institutions for Fiscal Stability," *Working Paper PEIF-6*, May 3, 2003.

19 Paolo Manasse, "Deficit Limits and Fiscal Rules for Dummies," *IMF Working Paper*, May 2005.

20 Art Laffer, et. al. *Rich States, Poor States,* American Legislative Exchange Council, 2010, http://www.alec.org/AM/PDF/tax/10RSPS/RSPS2010-Final.pdf.

[21] Leonard Gilroy and Jonathan Williams, "State Budget Reform Toolkit," American Legislative Exchange Council, 2011, http://www.alec.org/am/pdf/tax/Budget_toolkit.pdf.

[22] Shanna Rose, "Institutions and Fiscal Sustainability," *National Tax Journal* 63, December 2010: 807-838, http://ntj.tax.org/wwtax/ntjrec.nsf/009a9a91c225e83d852567ed006212d8/2d18cc5340065934852577fc00584f64/$FILE/Article%2011-Rose.pdf.

[23] Robert Krol, "The Role of Fiscal and Political Institutions in Limiting the Size of State Government," *Cato Journal* 27, no. 3, Cato Institute, Fall 2007, https://store.cato.org/pubs/journal/cj27n3/cj27n3-8.pdf.

[24] W. Mark Crain and James C. Miller, "Budget Processes and Spending Growth," *William and Mary Law Review 31*, Iss. 4. 1990, http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1983&context=wmlr.

[25] Ken Levine, "The Sunset Process: Still Effective After All These Years?" NSCL Annual Meeting: Legislative Effectiveness Committee Meeting Summary, National Conference of State Legislatures, August 2001, http://www.ncsl.org/default.aspx?tabid=16228; see also: Chris Edwards, "'Sunsetting' to Reform and Abolish Federal Agencies," Cato Institute, April 26, 2002, http://www.cato.org/pub_display.php?pub_id=3455.

[26] Ken Levine, "Guide to the Sunset Process," Sunset Advisory Commission, December 2009, http://www.sunset.state.tx.us/guide.pdf.

[27] Scott D. Pattison. "Budget Process in the States." National Association of State Budget Officers. Summer 2008. http://www.nasbo.org/LinkClick.aspx?fileticket=AaAKTnjgucg=&tabid=80; see also: Raymond C. Scheppach. "The Fiscal Survey of States." A Report by the National Governors Association and the National Association of State Budget Officers. Fall 2010. http://www.nasbo.org/LinkClick.aspx?fileticket=EQnlICsAJD8%3d&tabid=38

[28] *Infra*, at endnote 22.

[29] David M. Primo, *Rules and Restraint: Government Spending and the Design of Institutions,* American Politics and Political Economy Series, Chicago: University of Chicago Press, 2007.

[30] Matthew Mitchell, "Spending Restraint: The Path Not Taken," *Working Paper Series No.* 10-48. Mercatus Center at George Mason University, August 2010. http://mercatus.org/sites/default/files/publication/State%20Spending%20Restraint%20An%20Analysis%20of%20the%20Path%20Not%20Taken%20corrected.%2010.1.10_0.pdf.

[31] Bert Waisanen, "State Tax and Expenditure Limits—2008," National Conference of State Legislatures, December 2008, http://www.ncsl.org/IssuesResearch/BudgetTax/StateTaxandExpenditureLimits2008/tabid/12633/Default.aspx.

[32] "Tax and Expenditure Limitation in California: Proposition 13 & Proposition 4." Institute of Governmental Studies. University of California Berkeley, 2003, http://igs.berkeley.edu/library/research/quickhelp/policy/finance/tax_spend_limits_2003.html.

[33] Emily Washington and Fred Sautet, "Tax and Expenditure Limitations for Long-Run Fiscal Stability," *Mercatus on Policy No. 61,* Mercatus Center at George Mason University, October 2009, http://mercatus.org/sites/default/files/publication/Tax_and_Expenditure_Limits.pdf.

[34] Michael New, "Limiting Government Through Direct Democracy: The Case of State Tax and Expenditure Limitations." *Policy Analysis* 420, 2001; see also: Michael New, "Proposition 13 and State Budget Limitations: Past Successes and Future Options." *Cato Institute Briefing Papers* 83, 2003.

[35] *Infra*, at endnote 30.

[36] Matthew Mitchell, "TEL IT LIKE IT IS: Do State Tax and Expenditure Limits Actually Limit Spending?" *Working Paper No.* 10-71, December 2010, http://mercatus.org/sites/default/files/publication/TEL%20It%20Like%20It%20Is.Mitchell.12.6.10.pdf.

[37] *Infra*, at endnote 24; see also: Mark Crain, *Volatile States: Institutions, Policy, and the Performance of American State Economies*. Ann Arbor: University of Michigan Press. 2003.

[38] *Infra*, at endnote 30.

[39] Matthew Mitchell, "Total State Expenditures by Funding Source," Mercatus Center at George Mason University, January 2011, http://mercatus.org/publication/total-state-expenditures-funding-source.

[40] Russell S. Sobel and George R. Crowley, "Ratcheting Taxes," *Mercatus on Policy No.* 82, October 2010, http://mercatus.org/sites/default/files/publication/Do%20Intergovernmental%20Grants.MoP_.Sobel_.10.25.pdf.