FISCAL POLICY

6. *Toward a New* Fiscal *Constitution*

For the first 140 years of U.S. history, the federal budget was effectively constrained by two fiscal rules: the formal limits in the Constitution (the enumerated spending powers) and an informal rule that the government could borrow only during recessions and wars. At the end of the 1920s federal expenditures were 2.6 percent of gross domestic product, and most of those expenditures were for the military and the deferred costs of prior wars. And the characteristic budget surplus during peacetime recovery years constrained the federal debt to 16 percent of GDP. The constraints on federal spending and borrowing also contributed to the conditions that led to a roughly stable general price level over that long period.

Over the past six decades, however, federal expenditures have increased to over 23 percent of GDP, and most of those expenditures are for new forms of services and transfer payments. Larger and more frequent budget deficits (continuous since 1969) have increased the federal debt held by the public to an amount equal to about 50 percent of GDP. And the general price level is now about nine times the level at the beginning of the period. That dramatic change in fiscal and monetary conditions occurred without one amendment to the Constitution that would authorize a change in the fiscal rules. Our effective Constitution has been transformed into one under which Congress and the president may authorize any type or amount of expenditures and taxes, subject only to the voting rule for routine legislation.

The Erosion of the Fiscal Constitution

The Constitution (article 1, section 8) grants to Congress only 18 rather narrowly defined powers, only a few of which—such as the powers to "establish Post Offices and post roads," "raise and support Armies," and "provide and maintain a Navy"—involve the potential for substantial expenditures. There were numerous minor breaches of those limits from the earliest years, but the aggregate effect of the breaches was not substantial.

After the Supreme Court ruled that some of the major regulatory initiatives of the early New Deal were unconstitutional, Congress and the

Roosevelt administration switched to a transfer payment strategy. When the Social Security Act was approved in December 1935, however, there was still considerable doubt whether the Court would rule it unconstitutional. That issue was indirectly resolved by the Court's decision in *United States v. Butler* in January 1936. Although that decision ruled, on narrow grounds, that the Agricultural Adjustment Act of 1933 was unconstitutional, it provided the judicial opening for the developing welfare state by asserting that "the power of Congress to authorize appropriations of public money for public purposes is not limited by the direct grants of legislative power found in the Constitution." That first major accommodation to the New Deal saved the Court from Franklin Roosevelt's threat to pack it with more acquiescent justices, but it effectively destroyed the fiscal constitution. In effect, each Congress may now write its own fiscal constitution, subject only to the restraint that the appropriations must serve some vague concept of public purpose.

The rest is history. The major new spending programs of the New Deal were not challenged on constitutional grounds. As late as the Eisenhower administration, there was still some deference to the enumerated powers, but only to justify new activities; the first major federal highway and education programs, for example, were both rationalized on national security grounds. Starting with the Johnson administration in the 1960s, however, the enumerated powers no longer commanded even rhetorical deference. There is no longer any reason for rejecting demands for new federal services or transfer payments on the grounds that the federal government has no constitutional authority to finance them, a condition that makes federal politicians appear hardhearted if they fail to respond to demands for additional services and transfer payments.

The fiscal constitution of the United States is now only a parchment barrier, and Americans have no legal recourse to enjoin a continued expansion of the services financed by government. The demand for some of the new services, probably including Social Security and unemployment insurance, may have been sufficient to approve amendments to the Constitution to authorize those services. However, without any such test of constitutional consent, Congress may now authorize many other services as well. The substantive limits on federal expenditures are no longer binding.

The conditions that led to the erosion of the informal but effective rule on federal borrowing were similar, except for the absence of any role for the Supreme Court. Politicians have long had an incentive to borrow to finance current expenditures, primarily because the interests of children and future generations are not adequately represented in legislatures. However, the folk wisdom supporting balanced budgets has been and remains quite strong. In this case, the economics profession must bear part of the blame for undermining the borrowing rule. For about 40 years, from the second Roosevelt administration through the Nixon administration, Keynesian macroeconomists provided a rationale for increasing spending without increasing taxes as a means to reduce involuntary unemployment. The federal budget had a surplus in only 12 years during that period, but economic growth and increasing inflation reduced the ratio of the public debt to GDP from World War II to the mid-1970s. The amount and frequency of federal borrowing during that period may have been undesirable, but they were at least sustainable. That perspective finally fell victim to the new classical macroeconomics, the developing empirical evidence, and confusion about tfie appropriate Keynesian response to the stagflation of the late 1970s.

Soon after, the new supply-siders provided a rationale for reducing taxes without reducing expenditures as a means to increase the incentives to work, save, and invest. The fiscal and economic record during the period has included continuous large deficits and a continuous increase in the ratio of the public debt to GNP. The record of federal borrowing during the period was and is clearly unsustainable. At some time, some action will be necessary to stabilize or reduce the ratio of the federal debt (or interest payments) to GDP.

On two occasions, Congress bound itself by new fiscal rules in an attempt to reduce the deficit: the Gramm-Rudman rules approved in late 1985 and the budget agreement approved in late 1990. The Gramm-Rudman rules proved to be moderately effective for several years but finally fell victim to the explosion of savings-and-loan deposit insurance liabilities, the increased demand for domestic spending, and the 1990-91 recession. The rules approved by the budget agreement in 1990 seem unlikely to survive another recession. Congress appears unable to bind itself to a sustainable borrowing rule, at least in a low-inflation environment.

The Case for a New Fiscal Constitution

The erosion of the fiscal constitution is a cause for concern because majority rule is not a sufficient constraint on decisions affecting federal expenditures, taxes, and borrowing.

All of us are willing to delegate many decisions within a family, firm, and other voluntary organizations to realize the benefits of comparative advantage and the reduction of decisionmaking costs. For the same reason, many nations have chosen a representative government with a majority voting rule. Such delegations, however, are almost always subject to substantive, quantitative, or procedural constraints on the group to which the decisions are delegated. Moreover, there is an important relation between the voting rule and the several types of constraints: the lower the voting rule, the more important the constraints on the authorized powers of the organization.

For governments, the realistic alternatives are to authorize a narrow range of powers and a majority voting rule or a broader range of powers and a supermajority rule. The national governments of the United States and Switzerland are examples of the first alternative. The governments of the American states and the Swiss cantons and the national government of Finland are examples of the second alternative. Many American states and Swiss cantons, for example, require either a supermajority of the legislature or a referendum to increase taxes or to issue new debt. Finland's constitution requires a two-thirds vote of the parliament to increase taxes for more than one year and a five-sixths vote to approve any measure that restricts property rights. One should not be surprised that the relative size of government is generally smaller in federal systems, although governments have grown rapidly almost everywhere. The alternative most likely to lead to fiscal trouble in a democracy is a national government with plenary powers and a majority rule, but the effective structure of most national governments, including that of the United States, is unfortunately evolving in that direction.

The design of the U.S. Constitution was to limit federal expenditures to the enumerated powers defined in article 1, section 8, with the amount of such expenditures to be determined by the normal voting rales for appropriations. There is a reasonable case that such substantive limits may be preferable to a supermajority rale on the budget totals. Such substantive limits, for example, permit a federal politician to respond to constituent pleas by saying, "I would like to help you, but the Constitution does not authorize Congress to finance this service." But that genie is already out of the bottle. Most of the current activities of the federal government have no constitutional basis in the enumerated powers, and there is no prospect of a constitutional consensus on the original substantive limits or on some new set of substantive limits.

The case for a new fiscal rale affecting the authority of the federal government to borrow is based on three observations. First, the current pattern of federal expenditures and receipts is not sustainable. Second, it is preferable to stabilize the ratio of the federal debt (or interest payments) to GDP sooner than later, at levels closer to the present one than at a higher level; net interest payments, already the third largest component of federal expenditures, are also among the most rapidly growing components. Third, Congress has demonstrated no ability to bind itself or a subsequent Congress to a sustainable borrowing rule.

The absence of obvious near-term adverse effects of the federal deficit, however, has contributed to the erosion of the political discipline necessary to enforce a sustainable fiscal policy; if some adverse effects had been more apparent, the normal political incentives of Congress would probably have been sufficient to reduce the growth of the federal debt. The primary problem of federal borrowing is a moral problem: we are passing an increasing part of the cost of current government services to our children—without their consent. Federal net interest payments are now about $2,000 per taxpayer; each new generation of voters and taxpayers would clearly prefer that less borrowing had been authorized in prior years. The case for a new constitutional rule on the authority to increase the federal debt is to protect our children from our own lack of fiscal discipline.

The appropriate response to the erosion of the substantive limits on federal fiscal powers is to approve more constraining voting rules on decisions affecting the budget totals. One should reject out of hand the argument that such rules are inherently inconsistent with democratic government. The U.S. Constitution requires a supermajority to approve several measures. Congress has established a supermajority rule for several other types of measures, now including proposals to reduce taxes. Almost all of the states have some form of special rule on the issue of new debt. Many of the states require a supermajority of the legislature or a referendum to increase taxes. And the constitutions of some other countries, like Finland as mentioned above, require a supermajority to increase taxes or restrict property rights. Majority rule has instrumental value—it is the minimum voting rule that avoids inconsistent decisions on the same vote—but it does not have normative value in and of itself. There is a strong case for requiring a higher voting rule on more important decisions, such as overall levels of taxation and the public debt.

Two other concerns about the federal fiscal constitution have been the focus of increasing attention in recent years. First, state and local governments are increasingly burdened by federal mandates for which there are no or insufficient federal grants to cover the necessary costs.

The cost of uncompensated mandates is uncertain, but it may now be up to $100 billion a year. Congress has increasingly used such mandates to meet federal objectives in response to the perception that the federal budget is increasingly "tight" (even though real per capita federal spending has never been higher). State and local officials, in turn, are concerned that a serious effort to balance the federal budget would lead to even more uncompensated mandates. For that reason, there is a good case to include a ban or limit on any new uncompensated mandates in an amendment that would change other fiscal rules. Since any new amendment must be ratified by the legislatures of at least three-fourths of the states, a mandate provision may also be a necessary condition for ratification.

Second, for many years presidents of both parties have asked for a line-item veto, the authority to reduce or eliminate spending for specific activities or programs included in a more comprehensive appropriation bill. The objective of such authority is to force Congress to vote on the specific activity or program identified by the president. The governors of 43 states have some form of line-item veto; the experience of the states suggests that that authority has not significantly reduced total spending but that it can be effective in reducing spending for activities that benefit only small constituencies, the type of spending often described as "pork." The case for a tine-item veto is much weaker than that for the three other proposed changes in the fiscal constitution. The new Republican majority in Congress is best advised to authorize a line-item veto by statute for an experimental period, probably in the form of enhanced rescission authority. Consideration of constitutional authority for a line-item veto should be deferred, pending an evaluation of this experiment.

A Proposed "Fiscal Responsibility" Amendment

For those who accept the analysis to this point, there are still two other important questions: What new fiscal rules merit consideration? And is there a potential constitutional consensus for those rules?

The arithmetic of the federal budget indicates that two new fiscal rules would be sufficient to address the concerns about total spending and the deficit: total outlays minus total receipts equal the deficit, which in turn equals the increase in the public debt. Rules that limit any two of those variables also limit the others. The considerations that bear on the design of a proposed amendment include the choice of the two variables to limit, whether the limits should be on the expected or the actual levels of those variables, and the vote ratio required for changing the limits. One additional rule, of course, would be necessary to address uncompensated mandates.

The most efficient way to summarize the issues that bear on the choice of rules is to start with my preferred version of a fiscal amendment and then to explain my reasons for choosing the specific proposed rules. I have been involved in the design of proposed fiscal amendments (a few of which have been approved) for over 20 years, and the following proposed amendment reflects that experience and some evolution of my views.

The Fiscal Responsibility Amendment

Section 1. Congress may not increase the limit on the public debt of the United States without the approval of three-fifths of the members of each House.

Section 2. Congress may not levy a new tax or increase the rate or base of an existing tax without the approval of three-fifths of the members of each House.

Section 3. State and local governments must be compensated for the necessary additional costs of any new federal mandates specific to those governments. In the absence of such compensation, state and local governments need not implement such mandates.

Section 4. Sections 1 through 3 of this Article shall be suspended in any fiscal year during which a declaration of war is in effect.

Section 5. This Article shall be effective beginning in the second fiscal year after ratification.

The primary consideration that leads me to prefer a focus on debt totals and increases in tax rates is to avoid the problems of a direct vote on the budget totals. Congress does not (and should not) vote to approve the actual levels of total outlays, receipts, and the deficit, because each of those variables is subject to errors of both estimation and forecast. Since 1976, based on the Congressional Budget Act of 1974, Congress has voted to approve a budget resolution establishing target levels of total outlays, receipts, and the deficit and the allocation of outlays among the major programs. That resolution, however, has no force of law and has not been sufficient to constrain the growth of the budget totals. Requiring a supermajority rule to approve the budget resolution would only increase the controversies about possible biases of the forecast of outlays and receipts. My preference is to focus the supermajority votes on two types of bills that Congress has addressed since the dawn of the Republic: bills to authorize an increase in the limit on the public debt and on any bill to increase any tax. Those rules are substantially invariant to changes in budget accounting and national income accounting, avoiding the problem of other more formulaic versions of the rules.

A firmer limit on the public debt would constrain annual deficits without requiring either an estimated or an actual balance of outlays and receipts in any fiscal year. Moreover, that approach would ease the problems of transition from the current large deficit to an expected balance; before the effective date of the amendment, Congress could set a limit on the public debt that would permit a transition to an expected balance over a period of years. At such time that an expected balance is in prospect, the limit on the public debt should be set to permit borrowing to finance the unexpected increase in outlays and decline in receipts that have been characteristic of U.S. recessions. There is a legitimate concern that a limit on the public debt would be "gamed" by declaring some types of borrowing to be outside the limit or by forcing an increase in the limit to avoid an outlay reduction or tax increase during a recession, but that problem seems smaller than our current deficit problem.

My proposed tax limit would require a supermajority vote to increase any tax, which would avoid the controversies about whether a specific tax change or set of tax changes would increase total receipts. Of course, the federal tax code is far from perfect, and the proposed rule would also increase the vote required for a revenue-neutral tax reform. That seems like a small price to pay, however, to reduce the continuous rent-seeking and rent-defending costs of a tax code that is subject to frequent revision. The proposed limit would provide much-needed stability to the structure of the tax code. My preference would be to include tariffs in the limit, but not user fees. The limit would also be subject to some gaming, primarily affecting the definition of user fees, but again the problem should be relatively minor.

Although not explicit, the proposed supermajority rule to increase the debt limit or any tax is effectively three-fifths of each House *plus* the president. If the president does not support changes, of course, the Constitution already authorizes the president to force a two-thirds rule on both issues. The amendment must use the same supermajority rule for both the debt limit and taxes, but there is no strong case to increase the voting rule to two-thirds of each house.

The objective of the mandate rule, of course, is to prevent the federal government from exploiting the state and local tax base for federal purposes. The specific wording of the proposed rule is also chosen to prevent state and local governments from exploiting the federal tax base. Compensation is required only for *new* mandates after the effective date of the amendment. Compensation must cover only the *necessary additional* costs of meeting a mandate, not whatever a state or local government might spend for a general objective. And compensation is required only for mandates that are specific to state and local governments, not for laws or regulations of general application to which individuals and private organizations are also subject. The proposed rule would be enforced primarily by allowing state and local governments to not implement mandates if the prescribed compensation is not made.

The case for the last two sections of the proposed amendment is simpler. Any potential aggressor should be warned that the limits would be suspended upon the declaration of war; that would also increase the incentive to force a declaration of war as a condition for authorizing a major military activity. And some lag between ratification and the effective date of the amendment is necessary to permit the administration and Congress to adjust to the new fiscal rules.

Is there a potential constitutional consensus for a change in our fiscal constitution? The following evidence is offered to suggest the potential for such a consensus. Public opinion polls have long indicated around 80 percent support for a balanced-budget amendment. The legislatures of more than 30 states have endorsed resolutions requesting Congress to approve a balanced-budget, tax-limitation amendment and authorizing a constitutional convention to draft such an amendment if Congress fails to act. More than two-thirds of the Senate approved a balanced-budget, tax-limitation amendment in 1982. (Our current fiscal problems would be substantially smaller if that amendment had been ratified and become effective in the mid-1980s.) And a similar amendment, with a stronger balanced-budget provision and a weaker tax-limit provision, failed to pass the House by only seven votes in 1990. The several proposed amendments considered by Congress were crudely drafted, unduly complex, and far too wordy. History provides a plausible case that Congress would approve binding itself to a new set of constitutional fiscal rules, especially if the proposed amendment were better drafted and supported by the legislatures of a few more states. The new Republican majority in the 104th Congress has made a balanced-budget, tax-limitation amendment its first order of business. And most of the governors would support the amendment if it included a ban on new uncompensated mandates. Now is the time for a new fiscal constitution. Do it right. Seize the day!

—Prepared by William A. Niskanen