FISCAL RULES THAT WORK

Congress should

- adopt a spending cap–based balanced-budget rule to reduce the ratchet of federal spending and avert a long-run fiscal crisis caused by demographics and entitlement programs.

The COVID-19 pandemic caused another round of explosive growth in government borrowing. Federal debt held by the public increased from 79 percent of gross domestic product (GDP) in 2019 to 100 percent just two years later. As a result, the accumulated federal debt burden now stands just below its highest level relative to the size of the economy, which was seen just after World War II.

After 1945, the federal government slashed spending as the country demobilized. Strong growth prospects and damaging inflationary bursts helped further erode the effective federal debt burden. But this time the context is different: the United States entered the pandemic with a budget deficit, as federal government spending exceeded tax revenues by 4.7 percent of GDP. With unchanged policies, an aging population will require additional entitlement spending that will drive up red ink further.

As a result of the interaction of entitlement eligibility with these demographic trends, the Congressional Budget Office estimates (on cautious assumptions relating to unchanged policies) that the federal debt burden relative to GDP could near double again over the next 30 years.

Such debt levels would be truly unprecedented and, as such, bring unpredictable consequences. We might worry about a fiscal crisis with borrowing costs that spiral as bond investors doubt the federal government's ability to repay its debts. Another possibility is just very slow economic growth, which means poorer living standards for Americans. Either way, it is prudent to avoid such risks. Doing so effectively requires more fiscal discipline—sooner rather than later.

The Need for Long-Run Spending Restraint

Although today's budget numbers are grim, the outlook for the future is truly unsustainable. The cause is clear and obvious: rising spending, not falling tax revenues, is putting upward pressure on debt.

Between 1960 and 2019, federal spending averaged 20.2 percent of GDP per year while federal revenues averaged 17.3 percent. With unchanged policies, overall federal spending is forecast to rise to 23.2 percent of GDP by 2032, even as tax revenues hold relatively steady at 18.1 percent of GDP. This is entirely driven by increased obligations to Social Security and Medicare, a trend that is projected to accelerate further in the following decades.

Direct reforms of these entitlement programs are the best way to fully defuse this long-term debt time bomb. But experience globally suggests that fiscal rules that cap the growth of federal spending can provide a helpful budgeting framework to incentivize a gradual adjustment to ease these pressures on the government debt burden.

Fortunately, devising spending caps that achieve these objectives need not result in harsh austerity. Even if the economy is weak, past experience suggests nominal economic output will expand by an average of about 4 percent annually (meaning about 2 percent "real" GDP growth). That means about 4 to 5 percent more tax revenue every year. It's possible to slowly control—and eventually shrink—the burden of federal debt if policymakers can figure out ways to ensure outlays grow more slowly than nominal GDP.

The Debt Limit Does Not Limit Debt

If rising debt is the concern, some might ask: Does it not make sense to limit its accumulation directly? The federal debt is already notionally restrained by the debt limit, or debt ceiling, which was created in 1917. This is a cap on the total amount that the federal government is authorized to borrow to meet its existing obligations.

But the debt limit has not been an effective means of limiting either the debt run-up or the unsustainable future entitlement promises. Congress has raised, extended, or revised the debt limit 80 times since 1960. This is not surprising: breaching it would represent a failure to finance existing commitments—effectively meaning a form of default, either to creditors directly or on promises to citizens. That's why economists think the debt ceiling is bad policy: 97 percent of them in an Initiative of Global Markets poll opposed the debt ceiling as a fiscal control measure.

On occasion, the debt limit has certainly been a useful tool for bringing attention to our fiscal plight. Its proponents would point out that, since 1985,

most of the major deficit reduction laws we have seen have been attached to a debt limit increase. But in recent years the debt ceiling has clearly been used for political brinkmanship, rather than prudent policy. Any deficit reduction commitments arising from debt limit standoffs have not proven to be lasting.

Rather than asking politicians to vote to finance spending commitments they have already made, we need a rule that binds their hands and confronts them with the tradeoffs associated with new spending *before* they vote for it.

Balanced Budget and Deficit Rules Are Not Enduring

Advocates of fiscal responsibility have traditionally focused on the need for a balanced-budget constitutional amendment, or balanced-budget rule, as a way of preventing federal deficits—the difference between spending and revenues—adding further to debt.

A constitutional reform against annual borrowing would help indirectly limit federal spending for a given level of tax revenues and effectively bar new debt (outside exceptional circumstances). Some proposals for this type of amendment would tie the balanced-budget requirement to provisions for a maximum tax burden, too, as a means of using the rule to limit the overall size of the federal government.

There are steep hurdles to delivering a balanced-budget amendment and undesirable consequences of insisting on year-to-year balance in practice. Constitutional reform would require two-thirds support in both the House and Senate, followed by support from three-fourths of state legislatures. This high bar would be even more difficult to achieve if the amendment explicitly constrained the overall size of government by capping the level of tax revenues too.

What's more, unless they are extremely tightly written, balanced-budget rules, or even just deficit targets, also tend to be abandoned or watered down in practice, with politicians finding ingenious ways around them. Looking at the states, 49 out of 50 have some sort of balanced-budget requirement already. Those rules have not protected states such as California, Illinois, and New Jersey from either bloated public sectors or large levels of debt.

A similar story is seen around the world with rules that target balanced budgets or low deficits. In the European Union, the so-called Maastricht rules (also known as the Stability and Growth Pact) were imposed to prevent nations from having budget deficits of more than 3 percent of GDP. These rules have not prevented unaffordable welfare states or rising levels of red ink in countries such as France, Italy, and Greece. The UK used deficit targets to reduce its borrowing through the 2010s but then never quite balanced the books before abandoning the rules entirely.

The U.S. federal government's own experience with statutory deficit targets shows that they tend to be abandoned. A constitutional grounding would give any such rule more teeth, of course. But even if this practical experience could be altered, constitutional restrictions seeking balance year-on-year could bring undesirable economic harm.

The Boom-Bust Cycle and Ratchet Effect

The simple reason that pure balanced-budget amendments or strict deficit rules tend to fail is that they do not prove to be robust to the business cycle.

When a recession occurs and revenues drop, a balanced-budget mandate or low-deficit rule requires politicians to tighten budgets quickly at a time when they are especially reluctant to either raise taxes or slash spending. Such a reaction can be economically costly anyway: volatile tax rates, for example, can create needless uncertainty and bad incentives for work, saving, and investment. There are virtues to so-called tax smoothing.

On the flipside, when the economy is enjoying strong growth and producing a lot of tax revenue, a balanced-budget requirement or low-deficit rule doesn't impose much restraint on spending either. Together, this creates an unfortunate cycle. Politicians spend a lot of money during the good years, creating expectations of more and more resources being available for various interest groups. When a recession occurs, an annual balanced-budget rule or low-deficit rule means the politicians are supposed to slam on the brakes.

Usually, they are unwilling to do so, creating an overall "deficit bias," with each crisis or recession raising the overall level of debt. Even if they do cut spending in the aftermath of crises, it is rarely reduced to the same level seen prior to the upswing. Some tax rises are also included as part of the anti-deficit efforts. Over the long run, these cycles therefore create a ratchet effect, with the burden of government reaching new plateaus and debt levels jumping.

The Case for Spending-Based Rules

Given the poor track record of rules that attempt to eliminate deficits or enforce balanced budgets, it is better to focus on the underlying problem of excessive federal spending.

To do so effectively, any spending rules must incorporate provisions to deal with recessions. Requiring spending to just equal tax revenues every single year is too inflexible, as it would lead to extremely volatile spending and tax rate changes, which politicians are rarely willing to deliver and which risk exacerbating economic output volatility.

A better rule would therefore simply seek to cap overall expenditure each year in advance of budgeting decisions, in a way that is not linked to the business cycle. A gradually falling debt-to-GDP ratio can be delivered through balancing government spending and revenues over the economic cycle. This can be roughly achieved by capping spending each year to a trend in tax revenues: for instance, by setting an annual spending cap equal to the average of tax revenues over the past three years, adjusted upward by population growth and inflation.

Alternatively, one could adopt a technocratic estimate of what tax revenues would be if the economy was operating at its full potential and then cap spending to that level. By design, these sorts of rules would allow for deficits in downturns and enforce surpluses when the economy is strong. It would smooth spending around a medium-term revenue trend.

To minimize gaming, as much government spending as possible should be covered within the annual cap. Given it is the major source of upward spending pressures in the United States, it is especially important that entitlement spending on seniors is covered. The only forms of spending you might want to omit would be the purer automatic stabilizers, such as unemployment insurance.

To be robust to all circumstances, such a fiscal framework must still be well designed. While inevitably it must include an escape clause for genuine emergency situations (such as wars or pandemics), this provision should require a high-threshold congressional vote, with a well-defined path back to structural fiscal balance.

Ordinary within-year deviations in spending from caps should not be ignored either. If spending comes in higher than expected, the future spending caps should adjust downward to ensure that the overall budget really does balance over the economic cycle, and vice versa.

Formulaic rules, which use the hard data of observed trends in tax revenues, tend to be the most honest and transparent way of setting spending caps. Not having to rely on forecasts about the future has two key benefits. First, it prevents government overoptimism about future economic health that often leads to huge increases in current spending. Second, it forces politicians to raise taxes in advance of passing significant new spending programs in later years, thus bringing the price of government action to the attention of the public.

If this type of fiscal rule were passed and adhered to, then the U.S. debt-to-GDP ratio would practically be guaranteed to fall over time, albeit with emergency periods lifting the level of debt at semi-regular intervals. If it were in place for a prolonged period, politicians would eventually be forced into entitlement reform as the structural pressure on budgets caused by an aging population grew.

Unless constitutionally grounded, such a rule would be just as susceptible to the changing political tides as any deficit target. While the best form of fiscal rules, spending caps are only as good as political commitment to deliver them. But in order to obtain credibility for such a rule, the politicians introducing it would at least need to get to a stage where it was operational. That means providing a glide path toward structural balance, given that federal spending is now far in excess of the revenue trend.

The Swiss Spending Cap–Based Rule

Very few governments have imposed direct spending caps as their main fiscal rule. But where these types of rules have been in place, the results are promising.

In Switzerland, voters used a referendum in 2001 to impose a constitutional "debt brake," which operates functionally as a spending cap, in turn delivering a structural balanced budget over time. A large proportion of annual federal spending is capped to estimated tax revenues multiplied by a business cycle adjustment factor. The consequence is that spending remains largely independent of the near-term state of the economy and so is stabilized around a smoothed trend in revenue.

Since it was introduced in 2003, World Bank data show that Swiss general government net debt, despite the financial crisis and then COVID-19, has fallen from 44.4 percent of GDP in 2004 to an estimated 22.6 percent in 2020. Prior to the pandemic, overall Swiss government expenditure was lower (as a share of GDP) in 2019 than in 2004. One academic study compared outcomes in Switzerland to a synthetic control of similar countries. It found that, by 2010, central government debt was around 10 percentage points of GDP lower than it would have been because of the debt brake's introduction.

One of the reasons the Swiss brake has been successful is that politicians are constrained from boosting spending during boom years when tax receipts are strong. As a 2011 government report on the debt brake explained:

> In the past, economic booms tended to contribute to an increase in spending. . . . This has not been the case since the implementation of the fiscal rule, and budget surpluses have become commonplace. . . . The introduction of the debt brake has changed the budget process in such a way that the target for expenditures is defined at the beginning of the process, which must not exceed the ceiling provided by the fiscal rule. It has thus become a top-down process.

Evidence for Spending Caps

The Swiss rule has teeth because it is constitutionally grounded. It is effective in controlling spending in part because the main tax rates in Switzerland are constitutionally restricted and require a complex process for adjusting, but also because the rule is precise, the scope of spending broad, and the sanction mechanisms clear. As outlined, the U.S. process for constitutional amendments is itself arduous. Without that backing, a spending cap enforced by law will only last as long as there remains political buy-in for fiscal restraint.

Such a commitment clearly does not exist right now, especially in the aftermath of the COVID-19 pandemic. In fact, fiscal discipline is out of vogue. But if, in the coming years, the political environment does become more conducive to such laws, there's strong supportive evidence from the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) that spending caps are more effective than deficit rules or other fiscal targets to control red ink.

In February 2015, the IMF delivered this favorable assessment:

> Expenditure rules have a better compliance record than budget balance and debt rules. . . . The higher compliance rate with expenditure rules is consistent with the fact that these rules are easy to monitor and that they immediately map into an enforceable mechanism—the annual budget itself. Besides, expenditure rules are most directly connected to instruments that the policymakers effectively control. By contrast, the budget balance, and even more so public debt, is more exposed to shocks, both positive and negative, out of the government's control.

The IMF especially emphasized the way in which a spending cap–based rule imposes discipline in the boom years:

> One of the desirable features of expenditure rules compared to other rules is that they are not only binding in bad but also in good economic times. . . . In contrast to other fiscal rules, countries also have incentives to break an expenditure rule in periods of high economic growth with increasing spending pressures. . . . Two design features are in particular associated with higher compliance rates. . . . Compliance is higher if the government directly controls the expenditure target. . . . Specific ceilings have the best performance record.

In July 2015, the OECD wrote:

> Well-designed expenditure rules appear decisive in ensuring the effectiveness of a budget balance rule. Carnot (2014) shows also that a binding spending rule can promote fiscal discipline while allowing for stabilisation policies. . . . Spending rules entail no trade-off between minimising recession risks and

minimising debt uncertainties. They can boost potential growth and hence reduce the recession risk without any adverse effect on debt. Indeed, estimations show that public spending restraint is associated with higher potential growth.

The United States has not recently used broad spending caps. However, the 2011 Budget Control Act did set notional caps on discretionary spending that worked in reducing discretionary spending levels relative to GDP significantly between 2013 and 2017. Since then, various budget deals have busted the caps by wide margins, showing that, absent a constitutional amendment, laws are only as binding as the political support for them. In the coming decades, the scale of rising entitlement obligations means that caps on discretionary spending will be insufficient as a means of controlling overall spending.

Conclusion

The United States faces a grim debt outlook over the coming decades, which will require significant federal spending restraint to avoid. Provided there is first a political consensus that rising debt is a problem, evidence suggests that spending caps are the best means of framing budgets to avoid this upward ratchet in spending and debt.

Spending caps tend to be more enduring than deficit targets in reducing borrowing because the latter get completely abandoned when economic downturns or recessions hit. A federal spending cap that incorporates entitlement spending and provides a temporary escape clause for genuine emergencies would be simple and easy to understand, while targeting the real driver of our growing debts: excessive spending.

If the United States could ratify a constitutional amendment like the Swiss debt brake, which operates as a spending cap–based balanced-budget rule over the economic cycle, then that would be ideal. Absent that, Congress should introduce a law to similar effect that could shape budgeting decisions for legislators.

Suggested Readings

Bourne, Ryan. "Budget Restraints That Work: Lessons from Chile, Switzerland, the United Kingdom, and the United States." Cato Institute Tax and Budget Bulletin no. 81, February 21, 2018.

Merrifield, John, and Barry Poulson, eds. *A Fiscal Cliff: New Perspectives on the U.S. Federal Debt Crisis.* Washington: Cato Institute. October 2020.

Miron, Jeffrey. "COVID-19 and the U.S. Fiscal Imbalance." Cato Institute Policy Analysis no. 905, December 8, 2020.

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