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POLICY BRIEF
June 2005
Policy Brief #141

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Can the U.S. Government Live Within Its Means? Lessons From Abroad

ALLEN SCHICK

When George W. Bush leaves office in 2009, the federal government will owe at least $15,000 more for every American than it did when he became president eight years earlier. This unprecedented build-up of public debt will result from budget deficits projected to average more than $250 billion a year during the Bush presidency, plus more than one trillion dollars borrowed from social security trust funds. Although this budget projection may be high, there is far greater risk that actual deficits will exceed current estimates than that they will be lower.

The enormous accumulation of debt has been an inevitable by-product of the tax and spending policies promoted by the Bush administration and approved by Congress. The absence of fiscal rules promotes this behavior. This policy brief argues that fiscal rules are an essential instrument for governments determined to stay on a prudent, sustainable fiscal course, and the federal government should reimpose them in order to correct the imbalances that threaten the economic health of the United States.

The United States can learn from the experiences of other countries, including New Zealand, that have successfully implemented fiscal rules by assuring that fiscal restraint laws are supported politically.

Fiscal rules are laws or regulations that set targets for budget aggregates (total revenue, spending, deficit or debt) or bar government actions that would breach preset limits. As this broad definition suggests, fiscal rules come in various forms. Some are indicative, others are binding; some cover a single fiscal year, others extend to the medium-term or longer. During the past two decades, the federal government has had considerable experience with fiscal rules. The Gramm-Rudman-Hollings laws (GRH) enacted in 1985 and 1987 purported to limit annual budget deficits; the 1990 Budget Enforcement Act (BEA) capped annual appropriations and required that any legislation increasing the deficit—or decreasing the surplus—be offset. BEA expired at the end of fiscal 2002, but some of its rules have been reimposed in congressional budget resolutions. These have not been effective.

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THE CASE FOR FISCAL RULES

When modern budgeting emerged during the nineteenth century in Europe and the early twentieth century in the United States, it was assumed that a comprehensive process that pits claims on government finances against each other in competition for scarce public resources would suffice to produce favorable outcomes. Today, however, there is broad recognition that political biases push governments to spend more and tax less. These biases come in several forms: the benefits of spending are concentrated among program recipients but the costs are dispersed among current or future taxpayers; most current beneficiaries are eligible to vote, but future payers are not yet eligible; politicians are opportunistic agents driven by self-interest rather than the interests of those who elect them; as a common resource, the budget gives claimants incentive to draw more than is prudently available; and the spread of mandatory entitlements has made public expenditure stickier while increasing the political cost of stabilizing the budget.

At one time, virtually all democratic regimes embraced balanced budget norms. The operative rule was that spending during a fiscal year should not exceed that year’s revenue. In some countries, such as Germany and Japan, budgetary balance was inscribed in law; in others, including the United States, it was inscribed in behavior. The norm did not distinguish between periods of economic growth and stagnation, nor did its time horizon extend beyond a single year. Because it was rigid, the norm was not always adhered to. Few countries managed to keep total spending within revenues during wartime or recession; some even had difficulty during good times. Although the norm was often dishonored in practice, governments paid it lip service as the right thing to do. Even when their budgets were unbalanced, governments used the norm to constrain spending demands or win approval of tax increases.

The rigid balance norm was superseded after World War II by norms that allowed budget aggregates to accommodate cyclical changes in economic conditions. Policymakers applied active fiscal management in a variety of ways. One version called for government to maintain balance over an economic cycle; another dictated that total spending should not exceed the revenues the government would take in if the economy were at full employment. Governments also differed in the extent to which dynamic fiscal response relied on built-in stabilizers—such as the automatic fall in revenue when the economy weakens—or discretionary policy changes. Over time, dynamic fiscal policy came to mean that government should strive to close the gap between actual and potential output.

The shift in norms changed the way governments budgeted. With fiscal constraints loosened, claimants had a stronger hand in demanding more from government. In most democratic countries, the composition of the budget changed, with much more spent on transfers driven by statutory formulas rather than on consumption and

investment determined by discretionary budget decisions. Fiscal discipline was a casualty of these changes. Government outlays soared in virtually all democratic countries. In industrialized countries, they averaged 28 percent of Gross Domestic Product (GDP) in 1960, and about 40 percent two decades later—a growth rate of more than one half percentage point a year.

This accommodating fiscal posture was called into question by deteriorating economic performance after the oil shocks of the 1970s. Chronically high deficits were viewed as structural problems that persist even when the economy recovers, not as cyclical responses to short-term disturbances. National governments in many developed countries, including the United States, concluded that stabilizing the budget requires adopting aggregate constraints before spending bids are considered.

To strengthen fiscal discipline, governments devised new approaches that differ from both the balanced budget rule and accommodative fiscal policy. A strict balanced budget rule was deemed unworkable because the budget is hostage to economic fluctuations—enforcing it when output falls and unemployment rises would worsen the country's economic woes. Accommodating fiscal policy was regarded as imprudent because it impelled the relentless expansion of government and produced deficits that may be justified in bad times but are not liquidated in good times.

Contemporary fiscal rules are hybrids: like the balanced budget norms, they rely on preset constraints; like dynamic fiscal policy, they are set by governments, not by unbending doctrine. In most cases, these rules are made and enforced by the affected government, though there are notable cases, such as International Monetary Fund conditionalities and the European Union's Stability Pact, which limits annual budget deficits of member countries to 3 percent of GDP and public debt to 60 percent.

First-generation fiscal rules (in the late 1980s and early 1990s) generally favored the restrictive approach; more recent rules have taken the "responsibility" route.

When they are determined by the government, the rules may have strong political commitment. Externally imposed rules, by contrast, may lack domestic political support, thereby easing the path to violate them when the constraints are regarded by political leaders as overly restrictive.

EXPERIENCE WITH FISCAL RULES

Contemporary fiscal rules have branched in two directions. One path assumes that good budget outcomes depend on preventing politicians from behaving in a fiscally irresponsible manner; the other assumes that favorable budget outcomes depend on giving politicians incentives to adopt responsible policies. The first ties their hands, the second holds them politically accountable for their actions.

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The EU's Stability Pact exemplifies the first approach; New Zealand's Fiscal Responsibility Act, which requires the government to announce fiscal targets and to explain any deviation from them, exemplifies the second.

The early rules were influenced by research that found that fiscal institutions strongly affect budget policy. The most prominent of these studies, by Jorgen von Hagen for the European Commission, concluded that centralized institutions—such as when the finance minister or prime minister sets and enforces fiscal targets and the legislature is barred from amending the budget or increasing total expenditure—produce more disciplined budget outcomes than do fragmented arrangements.

A decade of experience with fixed, unbending rules and recent research have provided a more nuanced understanding of the conditions required to sustain fiscal prudence. For one thing, rigid rules have the same flaw as the balanced budget rule; they focus on a single fiscal year and fail to distinguish between periods of economic vigor and weakness. For another, while these rules have generated some fiscal constraint—as evidenced by the actions taken by various countries in the run-up to the introduction of the Euro—they also give beleaguered politicians incentive to lie about the budget's true condition. Recent country performance, which has deviated significantly from expectations generated by von Hagen and similar models, have prompted observers to question the rigid rules.

The death knell for rigid rules may have been sounded by the European Union in March 2005, when it voted to modify the Stability Pact to exempt "special" costs, such as the unification of Germany and reconstructing pensions and social security, as well as some investments, international development, and military expenditure. The fiscal targets were not changed, but enforcement of them has been vitiated by the exceptions. This artful compromise—retaining the rules while rewriting them—enabled both prudent and profligate countries to claim victory.

The second approach, which assigns political responsibility for the government's fiscal performance, is exemplified by the Netherlands, an unlikely candidate for fiscal probity. Throughout its democratic history, the government has been formed by coalition parties, making it impractical to entrust the finance minister with authority to override the budget demands of sectoral ministers. Fiscal discipline is further weakened by the fragmentation of the budget into twenty-three separate bills, each of which may be amended by Parliament. Nevertheless, the Dutch Government has managed to steer a prudent fiscal course since the early 1980s by fashioning the coalition agreements negotiated after each election into detailed policy roadmaps that cover the next four years, the new government's full term.

Recent coalition agreements have not targeted the deficit; rather, they cap expenditure in each major budget sector—the core budget, health care, and social security. The caps are set in real terms and are adjusted each year for inflation. Coalition agreements also

establish "firewalls" between revenue and expenditure, as well as rules for adjusting the budget for significant windfalls or shortfalls. When the economy performs better than was projected, preset percentages of the surplus are allocated to tax cuts and deficit reduction. In the case of overruns, the Netherlands assigns responsibility to the relevant minister to keep spending on course.

Although coalition agreements have been effective in stabilizing the government's fiscal position, there have been some strains, especially during expansionary times when revenues have outrun budget estimates. But enforcement of the agreement has been taken seriously. Today, the main budget task of the finance minister and the Cabinet is to police and adjust the agreements. Detailed budget matters have been devolved to the spending ministries, which have broad discretion in managing their finances.

THE NEW ZEALAND MODEL

In contrast to the Netherlands, New Zealand has anchored the process for setting and changing fiscal targets in law. Its 1994 Fiscal Responsibility Act has been a model for a growing number of countries, including Australia, Britain, Brazil, and India, which have adopted similar arrangements during the past decade.

New Zealand's version sets forth principles to guide fiscal policy, and requires the government to announce medium, and long-term fiscal objectives and to explain both changes in its objectives and variances from them. New Zealand's principles of responsible fiscal management are: reducing public debt to a prudent level, maintaining the Crown's net worth at a level that buffers the country against adverse shocks, managing financial risks, and maintaining a reasonable degree of stability and predictability on tax rates.

New Zealand's principles are operationalized in a series of reports issued by the government each year, principally an annual budget policy statement that discusses the long-term consequences of current policy and a fiscal strategy report that analyzes progress in implementing the principles and provides long-term economic and budget projections. During the period immediately prior to national elections, which occur every three years, the government must account for the future budget implications of campaign pledges.

In New Zealand and other countries that have embraced the fiscal responsibility model, the rules do not tie the hands of government or dictate budget outcomes; instead they require that the government be open and honest about the impact of its policies on public debt, the tax burden, future deficits, and spending levels. Government is free to act, but it must be accountable.

During the decade that the rules have been in place, New Zealand has maintained operating budget surpluses and has improved the Crown's net worth while reducing the public debt ratio. However, the government has failed to reduce public expenditure and has boosted the expenditure/GDP target from 30 percent to 35 percent. The government

has established a process for measuring the budget impact of policy initiatives and assuring they do not exceed the level set in the fiscal framework. Coalition agreements and fiscal responsibility rules have been more effective in protecting surpluses or controlling deficits than in limiting public expenditure. This pattern may be due more to strong economic performance, which enables the government to spend more money and still reduce the deficit, than to the rules themselves.

RECENT U.S. EXPERIENCE

Both the fiscal constraint and the fiscal responsibility models have been tried in the United States. Fiscal responsibility was the basis for the Congressional Budget Act of 1974 (CBA), which empowered Congress to take whatever budget action it prefers, provided it does so within the framework of the budget resolution process. The CBA did not prescribe surpluses or deficits, nor did it limit spending or revenue legislation. Although soaring deficits were due more to economic weakness at the time than to legislative profligacy, deteriorating budgeting conditions undermined confidence in the notion that Congress would behave in a responsible manner if it were accountable for its action.

Barely a decade after CBA, Congress embraced fiscal constraint in the Gramm-Rudman-Hollings laws (GRH) which prescribed maximum deficit levels and sequestration procedures to hold the deficit within the legislated levels. The 1990 Budget Enforcement Act (BEA) also hewed to the fiscal constraint model, though it shifted from directly constraining the deficit to limiting congressional action on revenue and spending legislation.

The prevailing assessment of GRH is that it was a failure. Its deficit targets were breached every year (1986-1990) that the law was in effect, but the deficit did decline (from 5.1 percent of GDP in 1985 to 2.8 percent in 1989). Most of the improvement was due to an economic upswing and the end of the Reagan-era defense build-up. GRH was not a fair test of fiscal constraint, for it had serious design flaws that spurred politicians to behave irresponsibly. One flaw was that it targeted projected, not actual, deficits; another was that the decisive projection was issued fifteen days into the fiscal year. Nothing that happened afterwards was relevant to calculation of the excess deficit. GRH encouraged politicians to lie about the budget at the start of the fiscal year and to be forthright the remaining 350 days.

BEA has been appraised much more favorably, but it was not uniformly effective throughout the dozen years it was applied. It went through three distinct phases. At the outset, BEA was accepted by Congress because it was accompanied by a significant, upfront boost in appropriations. During its middle years (1993-98), BEA restrained tax and spending policy, and a $290 billion deficit was turned into a $70 billion surplus. Finally, the promise of growing surpluses loosened fiscal discipline and gave the president and Congress license to waive or breach rules. Commitment to fiscal prudence evaporated with projections of mega-surpluses.

The three rules all concentrated on legislative action. CBA created a new congressional budget process, GRH empowered the president to sequester funds when congressional action (or inaction) resulted in an excess deficit, and BEA limited spending and revenues legislation. The clear implication is that Congress is culpable when the federal government produces unwanted deficits. However, a full accounting of the government's difficulty in maintaining fiscal discipline must reckon with the president's critical role in budget policy. During the past half century, most presidents have been drivers of government expansion, as well as the main proponents of major changes in tax policy. Fiscal rules cannot effectively constrain Congress if they do not rein in the president's budget ambitions.

U.S. fiscal rules have been impaired by their short-term perspective. GRH was predicated on a snapshot of the next (or new) year's budget deficit; BEA operated through annual spending caps and a five-year scorecard for revenue and direct spending legislation. Neither addressed the long-term imbalances that face the country. Some glimpses of these imbalances appear in the thirty- to fifty-year scenarios produced by the Congressional Budget Office, the seventy-five-year actuarial reports issued by the social security and Medicare trustees, the federal balance sheet published in annual budget documents, and the generational accounts constructed by academic researchers. These adverse projections have been ignored in making budget decisions that adversely affect the long-run outlook. Congress and the president have been informed by the various projections, but they have not been constrained or induced to behave more responsibly.

CAN ANYTHING WORK HERE?

U.S. and foreign experience suggests that fiscal rules work only when they are fortified by political commitment to behave in a responsible manner. If this conclusion is valid, the fiscal responsibility model may yield more favorable outcomes than arrangements that seek to constrain political action. But if good behavior depends on the willingness of politicians to take unpopular actions, why are the rules needed at all? What discipline do they add to budgeting?

Rules work in two ways: by tying the hands of budget makers so that they are impeded from acting in ways that do not improve the government's budget discipline; and by raising the political cost of failing to maintain budget discipline. The first corresponds to fiscal constraint rules, the second to fiscal responsibility rules.

The federal government lacks meaningful enforcement because it is bereft of strict accounting standards and its budget actions are not independently audited. One can conjecture that budgeting would be more prudent if the comptroller general (or some other authority) was empowered to restate the budget so that it complies with generally accepted accounting principles. Budget discipline would certainly be strengthened if the various loopholes for emergencies and other purposes were tightened, and if revenue and spending actions were scored to show their adverse effects on future budgets.

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Fiscal responsibility rules rely principally on self-enforcement. For these to be effective, politicians have to make "credible commitments," a term introduced by the economist Oliver Williamson. In the context of fiscal rules, a commitment is credible if the target is realistic, the government takes appropriate steps to achieve it, and politicians believe that it will be costly for them to breach it. To be credible, fiscal commitments also need accounting rules to assure transparency and inhibit political opportunism, but the key factor is the determination of politicians to fulfill their promises.

In the Netherlands, coalition agreements became social contracts because the government of the day resolved to live by their terms. In New Zealand, the fiscal responsibility law was invested with political stature because the government used it as a guidepost for budget policy.

All fiscal rules decay over time. The 1990 Budget Enforcement Act, for example, succeeded only until surpluses emerged.

It is necessary to periodically review fiscal rules, to give them new credibility and support. It may be that fiscal responsibility works better than fiscal constraint because it is freshened by new commitments. Given the dire fiscal prospects of the United States, policymakers should try both paths, so that constraints can be fortified by commitments. B

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