

Cato Handbook *for* Policymakers

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24. Fiscal Rules That Work

Congress should

- adopt a spending cap to shrink the burden of federal spending and avert a long-run fiscal crisis caused by demographics and entitlements.

For the 2016 fiscal year, federal government spending reached an all-time high of about \$4 trillion. That means Washington consumed more than 21 percent of the economy's output. That's higher than the average of less than 19 percent of gross domestic product (GDP) between the end of World War II and 2008 and far above the average of less than 5 percent during America's first 150-plus years.

A rising burden of federal spending means ever-higher tax burdens and ever-larger amounts of government borrowing. A public sector that has grown too large is America's main fiscal challenge. A rising tax burden and growing levels of red ink are symptoms of the underlying disease of big government.

The Need for Long-Run Spending Restraint

Although budget numbers are grim today, the real challenge will be in the future. Because of an aging population and poorly designed entitlement programs, the federal government in the absence of reform is going to get much larger, redistributing greater and greater amounts of national income. The long-run fiscal outlook in the United States is just as bad as it is in many European welfare states. The only difference is that governments in those nations have a head start on the path to economic stagnation and fiscal crisis.

Figuring out how to restrain the growth of government spending is critically important. Fortunately, it shouldn't be that difficult. Even if the

economy is weak, nominal economic output will expand by an average of about 4 percent annually (meaning about 2 percent “real” GDP growth). And that means about 4 percent to 5 percent more tax revenue every year. It’s possible to slowly but surely control—and eventually shrink—the burden of federal spending if policymakers simply figure out some way to impose a spending cap so that outlays grow at a modest rate, say 2 percent annually.

Balanced Budget Rules Are Not Successful

When looking at rules to control federal spending, advocates of fiscal responsibility traditionally focused on some form of balanced budget amendment. A well-designed constitutional reform, restricting both red ink and the tax burden, would be a welcome change and could indirectly limit the size of the federal budget. But why focus on the symptom of red ink rather than the underlying problem of excessive spending? Shouldn’t the real goal be to directly cap the growth of spending?

Looking at the states, 49 out of 50 have some sort of balanced budget requirement. Those rules have not protected states such as California, Illinois, and New Jersey from either bloated public sectors or large levels of debt. In the European Union, 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 and overall debt of more than 60 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.

It might be possible to tighten these balanced budget rules and impose more effective restrictions on red ink, but that would be a major challenge, particularly in the United States. Constitutional reform here would require two-thirds support in both the House and Senate, followed by support from three-fourths of state legislatures. Given the poor track record of rules that attempt to restrict deficits, it would be better to focus on rules that seek to directly address the real problem of excessive government spending.

The Boom-Bust Cycle and Ratchet Effect

There’s a very practical reason to focus on capping long-run spending rather than trying to balance the budget every year. Simply stated, the “business cycle” makes the latter very difficult.

There are two major determinants of tax revenue. The obvious one is the overall tax rate, but the size of the economy (i.e., the tax base) is

equally relevant. A weak economy won't generate much additional tax revenue; a strong economy means that there are more wages to tax and more profits to tax. Thus, when a recession occurs and revenues drop, a balanced-budget mandate requires politicians to make dramatic changes at a time when they are especially reluctant to either raise taxes or impose spending restraint. Then, when the economy is enjoying strong growth and producing lots of tax revenue, a balanced-budget requirement doesn't impose much restraint on spending.

All of which creates an unfortunate cycle. Politicians spend a lot of money during the good years, creating expectations of more and more money for various interest groups. When a recession occurs, the politicians suddenly have to slam on the brakes. But even if they actually cut spending, it is rarely reduced to the level it was when the economy began its upswing. Moreover, politicians often raise taxes as part of these efforts to comply with anti-deficit rules. When the recession ends and revenues begin to rise again, the process starts over—this time from a higher base of spending and with a bigger tax burden. Over the long run, these cycles create a ratchet effect, with the burden of government spending always reaching new plateaus.

Spending Caps

Having some sort of rule to limit annual spending avoids the logistical problems of balanced-budget requirements. A spending cap tells politicians they can increase spending by, say, 2 percent when the economy is in recession. They like that better than a balanced-budget rule that would require actual cuts when revenue is dropping. But a spending cap also tells politicians they can increase spending by only 2 percent when the economy is growing quickly and revenues are rapidly increasing.

The challenge is to design an expenditure rule that works. There are many ways to design a spending cap, including reforms that would limit federal government spending to a certain share of overall economic output (18 percent of GDP, for instance). Scholars at the Mercatus Center have [reviewed](#) various rules and found that good results can be achieved with a simple approach that limits spending so it grows no faster than the population plus inflation:

The effectiveness of [tax and expenditure limits (TEs)] varies greatly depending on their design. Effective TEL formulas limit spending to the

sum of inflation plus population growth. This type of formula is associated with statistically significantly less spending. TELs tend to be more effective when they require a supermajority vote to be overridden, are constitutionally codified, and automatically refund surpluses. These rules are also more effective when they limit spending rather than revenue and when they prohibit unfunded mandates on local government. Having one or more of these characteristics tends to lead to less spending. Ineffective TELs are unfortunately the most common variety. TELs that tie state spending growth to growth in private income are associated with more spending in high-income states.

Professor Michael New [reached](#) a similar conclusion, pointing out that the relatively strict limits in Colorado have been especially effective.

Why has Colorado’s [Taxpayer’s Bill of Rights] been more effective than other fiscal limits? . . . Colorado’s Taxpayer’s Bill of Rights . . . established a limit of inflation plus population growth. . . . [S]trong TELs have been able to restrict government growth. Holding other factors constant, strong TELs annually reduce growth in both state expenditures and state revenues by over \$100 per capita.

The Swiss “debt brake,” which functionally operates as a spending cap, has also been successful. It is described in a [2011 government report](#):

The Swiss “debt brake” or “debt containment rule” . . . combines the stabilizing properties of an expenditure rule (because of the cyclical adjustment) with the effective debt-controlling properties of a balanced budget rule. . . . The amount of annual federal government expenditures has a cap, which is calculated as a function of revenues and the position of the economy in the business cycle. It is thus aimed at keeping total federal government expenditures relatively independent of cyclical variations.

One of the reasons the Swiss brake has been successful is that politicians are constrained from boosting spending during boom years when lots of tax revenue is generated.

The debt-to-GDP ratio of the Swiss federal Government has decreased since the implementation of the debt brake in 2003. . . . 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.

The Keynesian Case for Spending Caps

The underlying theory of Keynesian economics is that deficit spending should be increased during a recession to “prime the pump” of the economy. That theory doesn’t make much sense since the government can’t pour money into an economy unless it first borrows the money out of the economy.

That being said, a spending cap should appeal to Keynesians because it allows federal outlays to increase even during recession years when revenue is falling. Since Keynesians (at least in theory) claim to support surpluses during boom years, they should like the fact that a spending cap limits spending during those periods, thus ensuring that rising revenues will be used to reduce red ink.

Real-World Evidence

The bad news is that very few governments have imposed spending caps. The good news is that there have been very positive results when such policies are in effect. In Hong Kong, Article 107 of the Basic Law (the jurisdiction’s constitution) states, “The Hong Kong Special Administrative Region shall . . . keep the budget commensurate with the growth rate of its gross domestic product.” This sensible policy helps explain why total government spending averages less than 20 percent of GDP, significantly lower than the total burden of spending in America and far lower than in Europe’s welfare states.

In Switzerland, voters used a referendum in 2001 to impose the aforementioned debt brake, which operationally functions as a spending cap. Outlays have expanded by only about 2 percent annually since the constitutional reform was implemented. That restraint has led to a modest reduction in the burden of spending relative to GDP and a big reduction in government debt as a share of economic output.

Even International Bureaucracies Agree

Surprisingly, even organizations such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) have concluded that spending caps are the most effective type of fiscal rule. That development is rather remarkable given that these bureaucracies normally have a statist orientation on fiscal policy.

In February 2015, the IMF [issued](#) a very favorable assessment of spending caps:

[E]xpenditure 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.

Also important, a spending cap imposes discipline during 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. . . . [T]wo design features are in particular associated with higher compliance rates. . . . [C]ompliance is higher if the government directly controls the expenditure target. . . . Specific ceilings have the best performance record.

Another [IMF study](#) from March 2015 noted the problem of too much spending during years with robust revenue growth.

An analysis of stability programs during 1999–2007 suggests that actual expenditure growth in euro area countries often exceeded the planned pace, in particular when there were unanticipated revenue increases. Countries were simply unable to save the extra revenues and build up fiscal buffers. . . . This reveals an important asymmetry: governments were often unable to preserve revenue windfalls and faced difficulties in restraining their expenditure in response to revenue shortfalls when consolidation was needed. . . . The 3 percent of GDP nominal deficit ceiling did not prevent countries from spending their revenue windfalls in the mid-2000s. . . . Noncompliance has been the rule rather than the exception. . . . The drawbacks of the nominal deficit ceiling are particularly apparent when the economy is booming, as it is compatible with very large structural deficits.

So what’s the solution? The report says spending caps work.

[T]he expenditure growth ceiling may seem the most appealing. This indicator is tractable (directly constraining the budget), easy to communicate to the public, and conceptually sound. . . . Based on simulations, Debrun and others (2008) show that an expenditure growth rule with a debt feedback ensures a better convergence towards the debt objective, while allowing greater flexibility in response to shocks. IMF (2012) demonstrates the good performance of the expenditure growth ceiling.

In July 2015, the OECD [wrote](#):

[T]he adoption of a budget balance rule complemented by an expenditure rule could suit most countries well. . . . [T]he combination of the two rules responds to the two objectives. A budget balance rule encourages hitting the debt target. And, 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 OECD also addressed the issue in a [November 2015 report](#). The highlights here include a warm embrace of the Swiss debt brake:

The European Union’s Stability and Growth Pact . . . proved largely ineffective in protecting countries from the effects of the fiscal crisis. . . . Simple and clear fiscal anchors—e.g., the Swiss and German debt brake rules—appear to have been more effective in influencing effective fiscal management. . . . A combination of a budget balance rule and an expenditure rule seems to suit most countries well. . . . [W]ell-designed expenditure rules appear decisive to ensure the effectiveness of a budget balance rule and can foster long-term growth. . . . 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.

In December 2015, the European Central Bank issued a [report](#) on fiscal rules. A key point was that deficit-oriented rules don’t bind politicians during growth years: “[D]uring a boom phase, fiscal rules do not prevent fiscal policy from turning expansionary.” Once again, spending caps got the highest marks.

Regarding the different types of fiscal rules, we find particularly strong coefficients for expenditure rules, possibly reflecting the fact that expenditure rules are easier to monitor and are thereby more credible. . . . If a country had a fiscal rule in place for the past ten years, the average fiscal space for those years is around 22% of GDP higher. The coefficient is proportional to the number of years in which a fiscal rule has been in place. . . . [I]f governments have fiscal rules in place, the results suggest that governments can no longer fully use their fiscal space and (on average)

are even forced to reduce their current expenditures. . . . [E]xpenditure rules . . . are correlated with a lower coefficient for fiscal space on procyclicality. This is in line with our findings . . . that expenditure rules might restrict discretionary expenditures.

Conclusion

When even the IMF and OECD agree that spending caps are effective, that's a remarkable sign that all other options do *not* work. But there really wasn't any other possible conclusion. Requirements for balanced budgets in 49 out of 50 states haven't prevented wasteful spending and more debt. Maastricht anti-deficit and anti-debt rules in the European Union haven't blocked bloated welfare states and fiscal crisis.

Spending caps are simple and easy to understand, and they directly address the real problem of excessive spending. And in the few places they've been tried, the evidence shows that dealing with the underlying disease of too much government automatically fixes the symptom of red ink. The United States could avert a very bad long-run fiscal crisis by copying the wise policies of Switzerland and Hong Kong.

Suggested Readings

- Mitchell, Daniel J. "America's Greek Fiscal Future." *Cato at Liberty*, June 19, 2015.
- . "Balanced Budget Requirements Don't Work as Well as Spending Limits." *Cato at Liberty*, May 26, 2015.
- . "By the Numbers: America's Unfortunate Fiscal Evolution from Madisonian Constitutionalism to Wilsonian Statism." *Cato at Liberty*, September 14, 2015.
- . "Even the IMF Agrees that Spending Caps Are Effective." *Cato at Liberty*, March 16, 2015.
- . "Hong Kong's Remarkable Fiscal Policy." *International Liberty*, October 14, 2014.
- . "If You Want Good Fiscal Policy, Forget the Balanced Budget Amendment and Pursue Spending Caps." *Cato at Liberty*, March 2, 2015.
- . "Maintaining and Enforcing Spending Caps Is a Huge Test of GOP Credibility on Fiscal Policy." *Cato at Liberty*, August 11, 2015.
- . "Proven Reforms to Restrain Leviathan." *Cato at Liberty*, May 28, 2015.
- . "The Simple Solution to America's Deteriorating Fiscal Outlook." *Cato at Liberty*, January 26, 2016.
- . "The Six Most Important Takeaways from CBO's New Long-Run Fiscal Forecast." *Cato at Liberty*, July 13, 2016.
- . "A Swiss-Style Spending Cap Would Have Prevented the Current Fiscal Mess in America." *International Liberty*, December 20, 2012.
- . "Switzerland's 'Debt Brake' Is a Role Model for Spending Control and Fiscal Restraint." *International Liberty*, April 26, 2012.

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