A Blueprint for Fiscal Sanity in the U.S.: Rules Based Solutions to the Debt Crisis

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Closing the Fiscal Gap

The Fiscal Gap
Introduction

The most recent Congressional Budget Office Long Term Forecast reveals that federal fiscal policies are not sustainable. Debt held by the public is projected to increase to levels exceeding national income over the next decade, and to a level double national income over the next three decades. As debt increases to these levels the country will experience retardation and stagnation in economic growth, and be exposed to financial crises and economic instability.

The U.S. has emerged as one of the most heavily indebted countries in the world, and now faces fiscal constraints that it has never encountered in the past. Like other major debtor countries, the U.S. now has little fiscal space to pursue macro-economic stabilization policies. If the U.S. responds to a recession with deficit spending, as we did in the recent financial crisis, interest rates will likely increase very sharply. Lack of confidence in the ability of the U.S. to meet these financial obligations risks default on the debt. Such a debt crisis would result in financial market instability far beyond that experienced during the recent financial crisis.

Since the Gramm-Rudman-Hollings Act was passed in 1985 Congress has enacted statutory fiscal rules designed to limit deficits and balance the budget. That Act has been amended many times over the years. In some years these fiscal rules have been effective, and in the late 1990s the federal government eliminated deficits and balanced the budget. But since then the fiscal rules have failed to constrain deficits and debt. Each year the debt burden grows, and the challenge of stabilizing and reducing debt becomes more formidable. At this point the path to a sustainable fiscal policy is not clear.

It is possible that elected officials will meet this challenge by enacting and enforcing effective fiscal rules. Congress could begin by enforcing the current statutory fiscal rules calling for a balanced budget and imposing a debt limit. Congress could also amend the current fiscal rules to strengthen these statutory constraints on fiscal policy. With reforms to statutory fiscal rules it would be possible for the federal government to again balance the budget and stabilize the debt-to-GDP ratio. There is certainly a precedent for this statutory approach to the debt crisis in other countries such as Sweden, where elected officials have designed fiscal rules to stabilize and reduce debt levels. However, this path to a balanced budget is less promising today because of a breakdown in the budget process.

While the debate over defense and non-defense spending is renewed in every budget cycle, the outcome has been unconstrained growth in total spending. The absence of a spending constraint allows elected officials to avoid difficult choices. They avoid resolution of disagreement over spending priorities, resulting in rapid spending growth. Reductions in tax rates are enacted, accompanied by increased deficits and debt accumulation. Elected officials pay lip service to
constraining spending and balancing the budget, but the tradition of balancing the budget and reducing debt has clearly been abandoned.

If our fiscal rules have failed, the question is what reforms are now necessary to build the framework for sustainable fiscal policies. Given the limited success with statutory fiscal rules in the U.S., some argue that we can no longer wait for elected officials to address the debt crisis. There is a renewed effort by citizen groups to enact a balanced budget amendment to the U.S. Constitution. Under Article V, a balanced budget amendment can be proposed either by Congress or by the states through an amendment convention. A balanced budget amendment has been proposed many times in Congress, but never achieved the requisite two thirds vote in both chambers to submit the amendment for ratification. The states have also proposed a balanced budget amendment through an Article V amendment convention, but have not reached the two thirds required for Congress to call the convention. However, the dramatic rise in debt levels in recent years has renewed the efforts to add a balanced budget amendment to the constitution.

Other developed countries have enacted constitutional fiscal rules to address their debt crisis. The rules limit discretionary fiscal policies, prohibiting their governments from incurring deficits and accumulating unsustainable levels of debt. Fortunately, we have learned a great deal from experience with new fiscal rules enacted at the national and subnational levels, and this literature should inform the debate about fiscal rules in the U.S.

This study is a contribution to the debate regarding fiscal rules in the U.S. In the first part of the study we explore the failure of fiscal rules now in place and various proposed reform of those rules. In the remainder of the study we propose a new set of fiscal rules that has proven to be successful in addressing a debt crisis, and could provide a fiscal framework for a sustainable fiscal policy in the U.S.

A fiscal framework to solve the debt crisis in the U.S. must also be consistent with other objectives of fiscal policy. Government expenditures must be adjusted to meet the demand for government services in the long run. A major challenge in the U.S., as well as other developed countries, is providing pension and health benefits to an aging population. In the medium term the government must also have the flexibility to respond to shocks such as financial crises and recession. The government must be able to respond to emergencies such as natural disasters and military conflicts. The budget must also provide for investments in infrastructure.

To achieve these multiple objectives, we propose a combination of new fiscal rules. Because there is a structural deficit, the fiscal rules must constrain all expenditures. In the medium term, budgets must conform to the targets imposed by the new fiscal rules. In the long run budget reforms must reduce the debt-to-GDP ratio to a sustainable level. Budget processes must be adapted to this rules-based approach to fiscal policy.

In designing new fiscal rules, policy makers must make a series of decisions that are described in this study. The rules proposed are unique to the U.S., reflecting the magnitude of the debt crisis. The proposed new rules are more stringent than that in other countries with lower levels of debt. There are tradeoffs in the design of fiscal rules that will become apparent as we explore this decision process. The decision process results in a set of interrelated fiscal rules.
Chapter 1. An Introduction to Fiscal Rules in the U.S.

In this study, we propose a rules-based path to a balanced budget. With a balanced budget in place it will be possible to stabilize the debt-to-GDP ratio, which is a precondition for a sustainable fiscal policy. However, stabilizing the debt-to-GDP ratio at current levels is not a sufficient condition for a sustainable fiscal policy. Because the current gross debt exceeds our national income, stabilizing the debt-to-GDP ratio at current levels will result in slower economic growth, and will expose the country to more financial crises. In the long term, the goal of this rules-based approach to fiscal policy must be to reduce the debt-to-GDP ratio to historic levels, i.e. less than 60%. At these lower levels of debt, the country can restore long run rates of economic growth, and also provide fiscal space to pursue countercyclical economic policy, stabilizing the economy over the business cycle. At that point the fiscal rules can allow for a cyclically balanced budget, with surplus revenue in periods of economic expansion offsetting deficits in periods of recession.

There is an historical precedent in the U.S. for fiscal rules balancing the budget and reducing debt in the long term (Merrifield and Poulson 2017). For two centuries this was the outcome of the ‘old time fiscal religion’ of balanced budgets practiced at the state and national level. The country might incur deficits and accumulate debt in periods of war, but in peacetime the government was expected to balance the budget and use surplus revenue to pay down the debt. This ‘old time religion’ of balanced budgets was practiced until well into the post-World War Two period. During World War Two, the debt-to-GDP ratio reached an all-time high. In the three decades following World war Two the debt-to-GDP ratio was reduced below 60%. In these years, the country experienced economic growth rates averaging about 3% per year. The government was able to pursue a countercyclical economic policy without accumulating unsustainable levels of debt.

Over the past half century, however, the government abandoned the ‘old time fiscal religion’ of balanced budgets. With the exception of a few years in the 1990s, the government has consistently incurred deficits and accumulated debt. Over the past two decades the higher levels of debt have been accompanied by retardation and stagnation in economic growth. As debt levels have soared, the fiscal room to pursue countercyclical fiscal policy has disappeared. The country experienced the worst financial crisis since the Great Depression, and is now exposed to even greater economic instability.

To understand why the government has abandoned the ‘old time fiscal religion’ of balanced budgets, it is important to understand the sources of deficit spending and debt accumulation over the past half century. The cause is not the historic pattern of debt-financed military spending. Even during the Cold War, defense spending was not the major source of deficits and debt

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1 Milton Friedman was a strong supporter for a rules based approach to fiscal as well as monetary policy (Friedman 1948, 1953, 1963). The authors have launched the Friedman Project, to stimulate debate about fiscal rules, similar to the debate about monetary rules. The Friedman Project is supported by a grant from the Koch Foundation.
growth. Defense spending as a share of the total federal budget declined over most of the period, and in recent years reached an all-time low.

The major source of deficits and debt over the past half century has been income transfers. Since the Great Society programs enacted during the 1960s income transfers have continuously increased as a share of the total budget. Expenditures for Social Security, and major health care programs now account a little more than half of non-interest federal spending. Over the next three decades those entitlement programs will account for two thirds of all noninterest spending.

These trends in debt financed expenditures help to explain why the country now pursues an unsustainable fiscal policy. Throughout most of our history there was a consensus supporting the ‘old time religion’ of balanced budgets. Citizens understood that during war times the federal government could not finance military spending by raising taxes. Elected officials incurred debt to finance military spending, knowing that in peacetime those expenditures would be cut, and they were expected to balance the budget and pay down debt.

The growth in income transfers over the past half century has undermined this consensus over fiscal policies. As spending for mandatory entitlement programs has displaced spending for other federal programs, including defense spending, political parties have become increasingly polarized. The Republican Party fights to restore defense expenditures, while the Democratic Party defends expenditures for domestic programs and entitlements. Game theorists describe this as a negative sum game in which the political parties are trapped in a prisoner’s dilemma. The failure to reach consensus on the budget leaves the government trapped with suboptimal fiscal policies.

In the following discussion we explore the different fiscal rules that have been enacted over the years, and the limited impact these rules have had in constraining debt in the long run. We also explore some of the proposed reforms in these rules designed to impose more effective constraints on debt.

The Debt Limit

The constitutional basis for a debt limit was stated in Article VI which begins, “all Debts contracted and Engagements entered into, before the Adoption of this Constitution, shall be as valid against the United States under this Constitution, as under the Confederation.” This provision of the Constitution places responsibility for the national debt in Congress (Congressional Research Service. 2016C).

The first debt limit was imposed by Congress during World War I. That statutory limit on debt was designed to simplify and facilitate borrowing by the federal government. Prior to that law Congress had to approve each issuance of debt separately. That law allowed Congress to borrow up to a maximum limit that remained in place until 1939. During World War II and throughout the post War period Congress adjusted the limit upward.

The Congressional Budget Act of 1974 required Congress to include the levels of debt implicit in the spending and revenue levels set in the budget resolution. In 1979 the House adopted a rule that allows the Legislature to approve a debt limit increase without actually voting on it. The rule “provides for the automatic engrossment and transmittal to the Senate of a joint resolution
changing the public debt limit, upon the adoption by Congress of the budget resolution”. Since then debt ceiling increases have usually been attached to the budget resolution legislation and other deficit reduction policies or processes. Legislators have approved temporary debt ceiling increases when necessary to avoid the risk of default as part of the budget reconciliation negotiation.

In 2011 and again in 2013 Congressional Republicans threatened to block increases in the government’s borrowing authority. In these clashes with a Democratic President and Senate controlled by the Democratic Party, the debt limit was either increased or suspended to avert default on the debt.

Theoretically, the debt ceiling imposes a cap on the amount that the federal government can borrow, but the debt ceiling has not been an effective limit on borrowing (Congressional Research Services 2016; Committee for a Responsible Federal Budget 2015). Failure to raise the limit risks default on U.S. debt that could do substantial harm to the nation’s creditworthiness in international financial markets (Knudson 2013, 2014). Debates surrounding increases in the debt limit have imposed costs and reduced the flexibility of the Treasury in managing the debt (United States Government Accountability Office 2011b).

Reforming the Debt Limit

Numerous proposals have been made to manage the debt ceiling by linking it more closely into the budget process, but none of these reforms has been enacted (Austin and Levit 2013, United States Government Accountability Office, 2015).

Some critics argue that the debt limit serves no purpose and only leads to fiscal brinksmanship. They argue that the debt ceiling adjustments “should be automatic or be made part of the annual budget process, ensuring that the government will meet its financial obligations”. One option is to include a debt ceiling adjustment with budget estimates in an annual budget resolution”.

On the other hand, defenders of the debt limit argue that the rule is important because it helps to hold Congress and the President accountable for their tax and expenditure decisions. The rule requires an explicit debt limit vote to allow increased federal borrowing when the federal government spends more than it takes in in revenue.

However, it is clear that in its present form the debt limit is an ineffective constraint on spending and taxation in the long run. The House Budget Committee proposed new debt limits as part of the proposed rework of the 1974 Congressional Budget Act (Price 2016). Long term limits on debt would be imposed for fiscal years 2024, 2030, 2036, and 2042. The debt targets set for these years would be based on debt as a percentage of GDP and would reflect a declining trajectory over time to reach levels consistent with historic norms. The Office of Management and Budget (OMB) would be charged with determining whether the debt is on a path to reach the specified limit.

The House Budget Committee proposed that enforcement of the debt limit would be through enhanced reconciliation or through automatic savings (Price 2016). If the OMB determined that debt in any year exceeded the target level, then an automatic reconciliation process is triggered which allows Congress and the President to enact savings required to bring debt into line with the required target. If Congress and the President failed to agree on the requisite savings then the OMB would be required to order automatic budget enforcement. The debt target would be
adjusted through the joint resolution and triggered by the adoption of a concurrent resolution on the budget. If the debt to GDP ratio exceeded the target, the Secretary of the Treasury would be prohibited from borrowing additional funds until new debt targets are enacted into law. With this debt limit in place the debt limit would not have to be raised as long as the outstanding ratio of debt to GDP remained below the target levels.

The debt limit proposed by the House Budget Committee would require a new budget process to achieve fiscal sustainability in the long term. The government would need to adopt a series of long-term declining debt targets – enforceable by enhanced reconciliation. Should that fail the debt targets would have to be achieved through an automatic enforcement mechanism. The Committee recognized that achieving the debt targets would require constraints on long term spending. David Addington and Patrick Knudsen from the Heritage Institute argue for linking explicit debt limit votes to constraints on spending. “Relief from the debt limit makes sense only if that relief is an integral part of a plan to drive down spending and borrowing so that the country lives within its means.”

The debt limit proposed by the House Budget Committee would be similar to the quantitative debt limits imposed by the European Union (EU) (Price 2016). The EU debt limits set a tolerance level as a share of GDP, with automatic enforcement mechanisms mandating explicit reductions in deficits required to bring the actual debt/GDP ratio below tolerance levels within a specified time period.

The House Budget Committee proposal leaves so much discretion to the legislature that it is not clear that this is an improvement over current law. The proposal would leave it up to legislators to set the target levels of debt each year, as well as the long-term debt level. The proposal refers to historic norms for the debt/GDP level, but it is not clear whether this refers to the low levels reached in the nineteenth century or the higher levels experienced in the post-World War II period. The enforcement procedures call for reconciliation between the Congress and the President, but it is not clear why reconciliation would be easier to reach with this debt limit compared to current law. An escape clause would allow Congress to raise the target debt level as an alternative to automatic budget enforcement. We should expect Congress to exploit this loophole, just as they do in circumventing sequestration when Congress and the President fail to reach agreement on the budget. Putting OMB in charge of determining when debt targets are met, and empowering automatic budget agreement seems to empower the executive relative to Congress in the budget process.

The debt limit proposed by the House Budget Committee would be a statutory measure, enacted by Congress. Some critics question whether Congress would enact more stringent fiscal rules that effectively limit their power to tax and spend. More ambitious proposals would incorporate debt limits as a constitutional amendment. One of these measures is the balanced budget amendment proposed by the Compact for America (CFA) (Guldenschuh 2015). This is a balanced budget measure that allows for debt, with strict controls on the magnitude of that debt. Congress would have to refer measures to the state legislatures for approval of the debt by a simple majority vote. The CFA proposal also provides for enforcement of the debt limit by the President through executive powers of impoundment.

The debt limit proposed in CFA does not directly constrain federal spending. To constrain spending and the size of government the debt limit would have to be linked to other fiscal rules.
This flaw in the CFA proposal may in part explain the limited success in gaining approval for this resolution in state legislatures.

The CFA also proposes four separate legislative acts as amendments to the constitution. While this resolution has been introduced in a number of states, at this time only four states have passed the resolution. The limited success in getting this measure approved in state legislatures thus far suggests that this ‘all in one approach to amending the constitution will be an uphill battle.

**Statutory Fiscal Rules**

Historically the budget process in the U.S. relied on the discretion of Congress to set limits on total spending as well as the different categories of spending. In the absence of fiscal rules limiting that spending Congress could choose to enforce or waive these limits at its own discretion. In the 1970s the rapid growth in federal spending, accompanied by deficits and debt accumulation, generated support within Congress to enact explicit limits on spending. Since then a number of statutory laws set statutory limits on federal spending, combined with enforcement mechanisms requiring automatic reductions in spending when those limits are breached (Congressional Research Service. 2016B).

The 1974 Congressional Budget Act was an important benchmark not only in restoring Congressional control over the budget process, but also in imposing constraints on federal spending (Committee on the Budget 2016A). For the first time Congress was required to consider the budget as a whole, rather than the piecemeal process within individual committees. Individual spending and tax bills were written pursuant to a Congressional Budget Resolution. The President’s budget still came first in the budget process, and the President retained the power to sign and veto spending and tax bills; but the Congressional Budget Resolution became the formal basis for fiscal policy.

The Congressional Budget Act was the first serious attempt by Congress to impose constraints on taxing and spending (Committee on the Budget 2016B). Fiscal rules were imposed in the form of points of order required for Congress to consider legislation. The Act established a revenue floor and an overall spending limit (Congressional Budget Act 311). It prevented legislation with budgetary implications from being considered until a Budget Resolution was adopted (Congressional Budget Act 303). The Act imposed controls on four types of mandatory spending: new entitlement authority, contractual authority, credit authority, and borrowing authority (Congressional Budget Act 401). Finally, the Act prevented increases in mandatory spending in the current year, and in the four and nine subsequent years (House Rule XXI clause 10). The latter rule, known as ‘cut as you go’, allows for near term spending increases in exchange for future cuts.

The Congressional Budget Act of 1974 has been amended many times, to establish statutory controls over spending and taxation. The outcome is a complex set of rules governing the budget process (Price 2016). While these rules are sometimes enforced, and at least for short periods of time have been effective, in the long run they have failed to constrain federal spending, and the
deficits and debt accumulation resulting from that spending. For a brief history of statutory fiscal rules see the Appendix to this chapter.

There is an extensive literature exploring the flaws in America’s fiscal rules and failures in the current budget process. Perhaps the major flaw in these statutory fiscal rules is the failure of Congress to follow the procedures mandated by the rules. Critics argue that the 1974 Congressional Budget Act and the various amendments to the Act have created a complex and time-consuming budget process (Price 2016). The rules incorporate many loopholes that make it easy for Congress to circumvent or simply waive the rules. For example, during the 114th Congress, budget rules were waived 42 times, about one fourth of the bills considered under the law.

The points of order provisions of the Congressional Budget Act could impose effective limits on federal spending. But spending limits and sequestration requirements are frequently waived or modified to allow higher levels of spending. When sequestration is imposed, many federal programs are exempt from the spending limits. When the requirements allow for near term spending increases in exchange for future cuts, often spending is increased, but the future cuts do not occur.

Budget resolutions should set the framework for fiscal policy, but Congress has frequently failed to adopt a budget resolution, or to pass appropriations on time. Congress relies increasingly on continuing resolutions to fund government programs, allowing legislators to postpone decisions on controversial spending issues. Then they rely on a single omnibus spending bill late in the year that does not allow for much input from Congress as a whole.

Discretionary spending bills are often ad hoc short-term budget agreements between legislative leaders and the executive. When Congress and the President can’t agree on these measures the result is a threatened or actual shut down of government agencies and activities considered non-essential for health, safety, and national security. The failure of Congress to pursue regular order and to control the budget process has increased the power of the President, in effect vetoing budget measures agreed on in Congress. This budget process lacks transparency and accountability, and leads to public perceptions of gridlock.

Mandatory spending, principally entitlement programs, has grown rapidly in recent decades (Committee on the Budget. 2016E). When the 1974 Congressional Budget Act was passed, mandatory spending (excluding interest) accounted for 41 percent of the total budget. Mandatory spending is projected to absorb 78 percent of the budget over the next ten years.

Entitlements and other mandatory programs are not part of the annual budget process. These programs are created from what are in effect permanent authorizations. The programs pay benefits without an intervening appropriation by Congress. Spending for the programs is determined by factors such as caseloads, economic conditions, inflation, etc.

Theoretically Congress has the power to limit mandatory spending, but in practice Congress has abdicated this power. Congress routinely waive the 1974 Congressional Budget Act rules that grant Congress that power as part of resolutions for consideration of bills relating to entitlement
spending. In effect this abdication of responsibility for control of mandatory spending also shifts power over the budget to the President; decisions to limit mandatory spending is left to Presidential veto.

The Gramm Rudman Hollings Act of 1985 and the Budget Control Act (BCA) of 2011 imposed spending limits enforced through sequestration. The purpose of those statutory limits on spending was to impose a more effective constraint on spending than would occur if that decision was left to the discretion of Congress. The effectiveness of statutory spending limits depends upon the specific means by which a fiscal rule brings about spending reductions. If the President and Congress are in agreement that spending should be reduced, then it is not clear that a statutory limit is required to achieve that result. The President and Congress may reach agreement on spending cuts in order to avoid the automatic reduction in spending required by sequestration. Sequestration would be triggered in those circumstances when the President and Congress fail to reach agreement on spending cuts.

The problem with these statutory limitations on spending is that Congress has found many ways to circumvent the limits. In some cases, Congress simply suspends the limits and then sets higher limits to sanction increased spending. Congress uses optimistic projections of revenue to justify higher levels of spending. Congress also uses gimmicks to circumvent the limits while appearing to satisfy the letter of the law. The most commonly used tactic is to set aside revenue earmarked for expenditures exempt from the limit. Congress may increase spending above the limit in some categories with a promise to decrease spending in other categories, a promise that is never kept. When the spending limit applies over several years, Congress may increase spending, with a promise to decrease spending in later years, a promise that is always broken.

The effectiveness of these statutory spending limits is also complicated by uncertainty in revenue and expenditure forecasts, unforeseen events, and especially the complex nature of direct expenditures for entitlement programs (Merrifield and Poulson 2017). Critics argue that Congress should not relinquish control over the budget by imposing arbitrary quantitative limits on spending, but rather should pursue policy reforms to achieve the desired budgetary objectives. Despite the many limitations of these statutory spending limits, if implemented as they were originally designed, these fiscal rules have the potential to constrain spending.

Reforming Statutory Fiscal Rules

There is now an extensive literature on reforming statutory fiscal rules to address the debt crisis (Congressional Research Services 2016b; Price 2016). In 2016, the House Committee on the Budget, Chaired by Representative Tom Price, conducted a comprehensive analysis and made recommendations for reform in the rules governing the budget process. These recommendations addressed many of the problems with current budget rules, and also explored new fiscal rules, including the new rules enacted in other OECD countries.

The Price Committee proposed to restore regular order in the budget process created by the Congressional Budget Act. Agreement on a budget resolution would be a prerequisite to consideration of any appropriation bill. The budget resolution would incorporate spending caps to impose an effective constraint on spending. With an effective budget cap in place bipartisan
agreement would be required on spending priorities as the basis for budget appropriations. The basic flaw in statutory fiscal rules is that they are applied in an ad hoc manner, and have therefore have not been effective in constraining spending, deficits and debt in the long term. The proposed reforms would strengthen the effectiveness of the statutory rules and restore regular order to the budget process.

In recent years, a pattern of accounting practices has allowed Congress to increase spending caps. By defining some expenditures as ‘emergency’ spending, Congress has shifted programs off budget and therefore not subject to the limits. For example, Congress identified defense expenditures through the Overseas Contingency Operation (OCO) account as emergency spending making the program exempt from spending limits. The Price Committee recommended that all emergency spending, including OCO expenditures, should be subject to the spending limit.

The spending limits are enforced through sequestration (Congressional Research Services 2013). Sequestration is an automatic across the board spending reduction triggered to enforce the spending limits. Sequestration is also triggered by the Statutory Pay-As-You Go (PAYGO) Act of 2010. Under PAYGO rules, sequestration is designed to prevent enactment of mandatory spending and revenue legislation that would increase the federal deficit. When the net cost of such legislation exceeds net total savings, sequestration occurs.

The effectiveness of sequestration as an enforcement mechanism has been weakened by exemptions and special rules written into these Acts. Most exempt programs are mandatory expenditures, including Social Security and Medicaid. Exemptions are also provided for refundable tax credits and transfer payments for Children’s Health Insurance, Supplemental Nutrition Assistance, and Temporary Assistance for Needy Families, and Supplemental Security Income. The rules also limit reductions in Medicare spending triggered by sequestration to no more than 2%. To enhance the effectiveness of sequestration the Price Committee recommended eliminating all of these exemptions. An important precedent was set in imposing sequestration on Medicare; and the Price Committee recommended that sequestration be applied to all entitlement and transfer programs.

The analysis and recommendations of the Price Committee were very clearly focused on solving the debt crisis in the long run. The Committee recommended consideration of new fiscal rules that have proven to be successful in addressing the debt crisis at both the state and national level. In particular, the Committee noted the success of new fiscal rules adopted in the European Union. In those countries, a debt target is set at a sustainable level. An expenditure limit is then imposed to achieve that debt target within a medium-term time frame. Annual budgets are adjusted based on the expenditures limit and the debt target. Guardrails are imposed in the form of deficit and debt brakes. When deficits or debt approach tolerance levels a more stringent spending limit is imposed.

The Price Committee noted the success of European countries, such as Switzerland, that have imposed the new fiscal rules for several decades. These countries reduced debt levels significantly over this time period. This has given them more flexibility to pursue a discretionary
fiscal policy in response to recessions and financial crises. The Swiss rules require a cyclically balanced budget with deficits in periods of recession offset by surplus revenue in periods of expansion. An emergency fund allows them to exceed the spending limit in response to unforeseen events. The Committee noted that over this time period the U.S. has incurred higher levels of debt, which will make it more difficult to impose these fiscal rules. But, the Committee concluded that failure to address the debt crisis with current fiscal rules underscores the need for the U.S. to consider new fiscal rules that have proven to be successful in other countries.

In 2018 the House appointed the Joint Select Committee on Budget Process Reform. Nita Lowey, the Democratic co-chair of that Committee submitted a Budget Process Reform Proposal to the Committee. She proposes that Congress enact legislation to raise the 2020 spending caps, and allow the caps to expire after 2021. However, loopholes created in the caps, such as OCO and disaster relief, would be retained even after the caps are allowed to expire. Another proposal would facilitate passage of appropriations, even when a budget resolution is not adopted. Representative Lowey proposes that the debt ceiling be repealed entirely; but, failing that, Congress should in effect shift responsibility for the debt ceiling to the President. Specifically, she proposes that after adoption of a budget resolution, Congress should send the President a joint resolution suspending the debt ceiling. The debt ceiling would then be reinstated to match debt automatically. If the debt ceiling is within 30 days of being reached, the President should be granted the authority to suspend it.

It remains to be seen what budget process reforms the Joint Committee will recommend to Congress. The proposals offered by Representative Lowey signal that Congress is likely to weaken the fiscal rules now in place. While spending caps and the debt ceiling have failed to constrain the growth of debt in the long term, these rules have at least slowed the growth of debt and required a more deliberative budget process. The Joint Committee has made it clear that they will focus on annual budget issues, and will not make any recommendations to address long term budget issues. This is in contrast to the Price Committee that analyzed and made recommendations on a wide range of budget issues, including the debt crisis.

**Balanced Budget Rules**

The United States is unique in the extent to which balanced budget rules were incorporated into state constitutions (Merrifield, J., and B Poulson. 2014). Every state but Vermont has a constitution that requires a balanced budget. It is not hard to understand why the citizens drafting these state constitutions took the unusual step of requiring their state government to balance expenditures and revenues. During the colonial and early national periods virtually all the state governments abused the power to finance expenditures through borrowing. Prior to the formation of a national government the debt issued by the colonies was heavily discounted. The assumption of these debts by the new national government established the credit of the states and the national government in international financial markets. Citizens drafted state constitutions with balanced budget provisions to prevent this abuse of credit and the related instability in capital markets. Over time, most states fulfilled this commitment to balance their budgets, although some states, such as Illinois, have found ways to circumvent their balanced budget rules, and are paying the penalty of poor credit ratings in issuing their debt.
The U.S. Constitution does not provide for a balanced budget at the federal level. In this regard the U.S. is not unique. In their survey Asatryan et al (2016) found that, until recently, few developed countries incorporated balanced budget provisions in their constitutions. They found only two developed countries with constitutional balanced budget rules in the nineteenth century, Germany and Portugal. Over the past century many developed as well as developing countries incorporated balanced budget provisions in their constitutions.

The new balanced budget rules enacted in Switzerland and Germany are important because they have been used as models for these fiscal rules at both the national and supranational (European Union) levels (Merrifield, J., and B Poulson. 2016). Both countries combined their balanced budget rules with fiscal rules constraining expenditures. The German balanced budget rule was enacted in 1949 and amended in 2012. The Swiss enacted their balanced budget rule in 2001. In both countries, the initial balanced budget rules did not, adequately, constrain expenditures and revenue. But the more recent amendments linking the balanced budget rule to expenditures limits have proven to be effective. In the case of Switzerland, the expenditure rules are incorporated as detailed statutory provisions. In Germany, the expenditures rules are included in the constitution as well as statutory provisions.

In the U.S., throughout the 18th and 19th centuries, despite the absence of a written balanced budget rule and an ad hoc budget process, the universal acceptance of the balanced budget principle imposed fiscal discipline on the federal government (Merrifield, J., and B Poulson. 2016). There were periods of prolonged deficits after the Civil War and during the depression of 1893, but in periods of peace the federal government ran budget surpluses to pay down the debt.

New Balanced Budget Rules

With the onset of World Wars and the Great Depression in the 20th century it became clear that the commitment to an unwritten balance budget principle was failing; and this led to the first attempts to draft a written rule requiring the federal government to balance the budget. In 1935, Senator Millard Tydings introduced a statute requiring the federal budget to be balanced (S.J. Res 36). That resolution was not enacted, and in the following year Representative Harold Knutsen introduced the first resolution calling for a balanced budget amendment to the constitution (H.J. Res 579), a measure that also failed (Istook, E. 2011).

Since the failure of these resolutions in the 1930s, dozens of proposals for a balanced budget rule have been introduced in Congress (Congressional Research Services 2016D). Several bills introduced in the House would have required the President to submit and for the House to consider a balanced budget. These measures did not require Congress to adopt a balanced budget nor end the year with a balanced budget. The Senate took no action on these bills. Some of these proposals have been in the form of statutory rules, and some have been resolutions to incorporate a balanced budget amendment in the constitution. Some of these have been stand-alone measures requiring a balanced federal budget; more recently these proposals have linked the balanced budget rule to other fiscal rules, such as debt limits, expenditure limits etc.

The statutory approach to a balanced budget rule was renewed in 1978 by Senator Harry Byrd (P.L.95-435 stat. 1053) (Congressional Research Service. 2016D). Enacted as an amendment to a measure providing for U.S. participation in the International Monetary Fund, it stated that “Beginning with Fiscal Year 1981, the total budget outlays of the federal government shall not exceed receipts.” Because there was no enforcement mechanism, the statute was ineffective. The
The statute was later modified to replace the specific commitment for FY 1981 to a general affirmation of balanced budgets as a goal. (Footnote Lynch p27)

The first successful attempt by Congress to enact a balanced budget requirement was the Balanced Budget and Emergency Deficit Control Act of 1985 (also referred to as the Gramm Rudman Hollings Act). As amended in 1987, the law mandated annual reductions in budget deficits to achieve a balanced budget by 1993. This process required the President to cancel budget authority necessary to reduce deficits to the level mandated by the law. This process was modified in 1987 with an automatic trigger for sequestration to be implemented.

The Gramm Rudman Hollings Act was amended by the Budget Enforcement Act of 1990 (P.L. 101-508, 104 Stat. 1388-573 through 1388-630). The new law retained deficit targets, but allowed for adjustment of the targets for changing economic and other conditions. This Act shifted the focus from achieving specific deficit targets to limiting Congressional actions that would increase deficits. The Act was subsequently amended, extending the target deficits and enforcement mechanism to 2002. Neither this Act nor amendments to the Act required a balanced budget.

For half a century, Congress debated whether a balanced budget rule should be incorporated as an amendment to the constitution (Congressional Research Service. 2016D). Many resolutions calling for a balanced budget amendment to the constitution were introduced and debated in the House and Senate Judiciary Committees. Some of these resolutions received floor votes, but none achieved the two thirds vote in both houses required to submit the proposed amendment to the people for ratification. A comprehensive survey of this legislation is provided by the Congressional Research Services (2016D). In this brief summary, we highlight the most important of the balanced budget resolutions.

The first time that a resolution calling for a balanced budget amendment to the constitution passed in Congress was in 1982 (Congressional Research Service. 2016D). The Senate approved S.J. Res 58 introduced by Senator Strom Thurmond. A companion measure was introduced in the House by Representative Bill Alspander. It would have required the President to submit a balanced budget, and for Congress to adopt a statement in which “total outlays are no greater than total receipts.” That measure would not have required a year end balanced budget. Although the measure was approved by a majority of the House, it did not receive the requisite two thirds vote, and the balanced budget effort failed.

In the 1980s and 1990s the House and Senate Judiciary Committees considered many resolutions calling for a balanced budget amendment to the constitution (Congressional Research Service. 2016D). The Senate Judiciary Committee approved none of these resolutions and reported this to the full Senate. The House Judiciary Committee submitted four of these resolutions for a floor vote, without Committee support. None of these proposed resolutions received the requisite two thirds vote in both Houses.

The high point in this effort to incorporate a balanced budget amendment in the constitution was in the 104th Congress (Congressional Research Service. 2016D) Congress. Republican leadership

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2 Voting on these balanced budget measures in Congress suggests a strategy to maximize the number of legislators who could say they voted for it, without letting it pass; and that no votes were from legislators in the safest districts.
in the House included a balanced budget constitutional amendment as part of the “Contract-With-America”. H.J. Res 1 was amended to require a majority vote in each house to increase taxes. The House approved this resolution 300 to 132, the first proposed balanced budget constitutional amendment to be approved in the House by the requisite two thirds vote. This was a high point in bipartisan support for a balanced budget amendment in the House. In 1996, the Senate vote on H.J. Res 1 failed by one vote from reaching the requisite two thirds vote. An amendment by Senator Dole called for achieving the budget balance without affecting Social Security receipts or payments. This amendment proved to be a stumbling block in getting the votes required for passage in the Senate.

After this attempt to pass a resolution calling for a balanced budget amendment to the constitution failed, interest in Congress waned (Congressional Research Service. 2016D). A resolution was again introduced in 1997 but that measure failed to reach the requisite two thirds vote in either house. In the late 1990s, the federal government balanced revenues and planned spending for a few years, and the effort to enact a balanced budget amendment in the constitution suffered from benign neglect.

The discontinuous increase in deficits and debt over the past decade renewed interest in a balanced budget amendment (Congressional Research Service. 2016D, Istook 2011). In contrast to earlier measures, the latest resolutions lacked bipartisan support. Indeed, both parties proposed resolutions linking the balanced budget amendment to other fiscal rules. That widened the gap between the parties and decreased prospects for passage of a balanced budget resolution.

H.J. Res 1 was introduced by Republican Bob Goodlatte in the 112th Congress. This resolution included requirement for a three-fifths vote in each chamber to allow a budget with outlays in excess of receipts, or to agree to increase the debt limit. That measure also required a two-thirds vote in each chamber to increase revenue or to allow outlays to exceed 18 percent of GDP, regardless of whether the budget balanced. When H.J. Res 1 was introduced all 47 Senate Republicans said that they favored the proposed balanced budget amendment. A balanced budget amendment caucus was organized by a bipartisan group of legislators with more than 60 members.

In 2011 the House passed H.R. 2560, referred to as Cut, Cap, and Balance. That resolution provided for an increase in the debt limit, only if Congress agreed to a balanced budget amendment, a spending limit as a share of GDP, and a requirement that tax increases be approved by a two thirds vote in each chamber. The Democrat controlled Senate voted to table that resolution.

After extensive negotiations between the President and Congress, in 2011 a bill to increase the debt limit, S. 365 the Budget Control Act of 2011, was enacted (Congressional Research Service. 2016D). That Bill required both Houses to vote on passage of a joint resolution proposing a balanced budget amendment to the constitution. In that year H.J. Res 2 a balanced budget amendment proposed by Representative Goodlatte was approved in the House but failed to achieve the two thirds requisite vote. A companion measure S.J. Res 10 introduced by Senator Hatch was rejected by the Senate.

In 2011, Democratic Senator Mark Udall introduced S.J. Res 24. This resolution would have required three-fifths of each chamber to allow outlays to exceed revenue. But it did not impose this requirement for debt limit increases or revenue increases. It also exempted Social Security
from the balanced budget rule. Finally, it prohibited Congress from passing any measure that would reduce income taxes for those earning over one million dollars if this would result in a budget deficit.

Since 2011 resolutions proposing a balanced budget amendment to the constitution by Republicans have become more stringent, while those introduced by Democrats became more watered down (Istook 2011). Republican resolutions included such provisions as a supermajority vote requirement to raise taxes; limits on the level of federal spending as a share of GDP; tighter exceptions to the balanced budget requirement; and limits on the potential for judicially imposed tax increases as a means of enforcement. Democrat resolutions included provisions to exempt Social Security from balanced budget requirements; waiving balanced budget requirements in periods of recession, military conflict, or other emergency; and provisions to allow Congress to borrow to finance investments in physical capital that provides long term benefits.

The outcome of this widening gulf between the political parties on provisions for a balanced budget amendment reduced the probability that the parties would reach the two thirds requisite vote in both houses. For that reason, proponents of a balanced budget amendment have turned to the alternative route to constitutional amendment provided in Article V.

**Article V**

The Federalist Papers note that the debates surrounding Article V yielded a compromise that granted states, as well as Congress, the power to propose amendments to the Constitution. Article V provides that “on the application of two thirds of the several states, Congress shall call a convention for proposing amendments.” Citizens are using the alternative route provided in Article V to pursue a balanced budget amendment through an amendment convention.

Proposals for an Article V convention date from the early years of the Republic (Neale 2016; Durbin 1995). More than 700 of these petitions have been submitted to Congress since 1789, encompassing 47 different issue areas. Some of these petitions called for a general convention, and others called for an amendment convention focused on a single issue. Most of the petitions called for an amendment convention to propose amendments limiting the fiscal powers of the federal government. Many of the petitions from state legislatures called for an Article V convention to propose a balanced budget amendment (Neale 2016; Durbin 1995).

By 1983, in the 100th Congress, 32 states had passed resolutions calling for a constitutional convention to propose a balanced budget amendment. In that year, four other states, California, Illinois, Kentucky, and Montana enacted resolutions calling on Congress to propose a deficit spending limit, but not proposing a balanced budget amendment convention. Despite this impetus, the states failed to reach the 34 states that would have required Congress to call an amendment convention. And by the end of the 100th Congress two states, Alabama and Florida, had rescinded their resolutions calling for an Article V convention to propose a balanced budget amendment. In 1986 proponents came within one state in reaching the requisite two thirds of the states required to call a balanced budget amendment convention. This path to amending the Constitution was again tried unsuccessfully in 1995.

Passage of the Balanced Budget and Emergency Deficit Control Act in 1985, and the Budget Enforcement Act of 1990, took the wind out of the sails of these efforts to enact a balanced budget amendment through an Article V convention. In 1994, Republicans gained control of both the House and the Senate. When President Clinton vetoed their budget resolution, this
resulted in a brief shutdown of the federal government. The Republican “Contract with America” called for a balanced budget amendment. In 1995 a balanced budget amendment resolution passed the House, and came within one vote of passing the Senate. A number of balanced budget amendment resolutions have since been introduced in Congress, but none were enacted (Natelson, 2013b).

When Congress was able to balance the budget for a few years in the late 1990s, interest in a balanced budget amendment waned. In addition to Alabama and Florida, ten other states rescinded their applications for a balanced budget amendment convention.

In recent years, with unprecedented growth in the public debt, there is renewed interest in a balanced budget amendment convention (Neeale 2016; Satullo and Lynch 2011). The Balanced Budget Amendment Task Force is the most successful organizations advocating an Article V convention. One of the reasons for their success is that they began with 16 valid balanced budget amendment resolution from prior years. Since 2008 this organization has succeeded in enacting thirteen new state resolutions calling for a balanced budget amendment convention, and is working to enact this resolution in a half dozen other states (Guldenschuh 2015).

The Article V movement is much broader in scope than this effort to incorporate a balanced budget amendment in the Constitution (Congressional Research Service. 2016A, Guldenschuh 2015). Other organizations want to use the Article V process to limit the power of the federal government, and restore the balance of power between the federal government and the states. A good example of this new federalist movement is the Convention of States (COS) which has enacted resolutions in four states, calling for a state led Article V convention (www.conventionofstates.com). COS identifies a number of amendment topics to be addressed by the proposed convention:

- Balanced budget
- Redefinition of the Welfare Clause
- Redefinition of the Commerce Clause
- Limits on executive orders
- Limits on Federal regulations
- Term limits
- Upper limit on taxation
- Sunset existing federal tax laws and replace with newer fairer tax

Other organizations, such as the American Legislative Exchange Council, are also pursuing an agenda to limit the power of the federal government, and restore the constitutional rights of the states and citizens (www.ALEC.org). Natelson (2013b) drafted ALEC’s model legislation for an application under Article V for a balanced budget amendment convention:

“Section 1. The Legislature of the State of __________ hereby applies to Congress, under the provisions of Article V of the Constitution of the United States, for the calling of a convention of the states limited to proposing an amendment to the Constitution of the United States requiring that, in the absence of a national emergency, the total of all
Federal appropriations made by the Congress for any fiscal year may not exceed the total of all estimated revenues for that fiscal year, together with any related and appropriate fiscal restraints (Natelson (2013 p.7)).”

Note the provision “together with any related and appropriate fiscal restraints.” This provision would allow delegates to the amendment convention to incorporate additional fiscal rules, including the fiscal rule proposed in this study, necessary to balance the budget. Switzerland relies on a similar combination of fiscal rules in implementing their debt brake.

David Guldenschuh (2015, 2017) has become the unofficial record keeper of the Article V movement (a chapter appendix describes the different Article V advocacy groups). He publishes the Article V Convention (AVC) Legislative Progress Report on the status of legislation proposed by different groups (Guldenschuh 2017). Guldenschuh’s tally reveals that resolutions calling for a balanced budget amendment, having passed in 29 states, is closest to this goal. A number of these states have also passed Delegate Selection Limitation Bills. These two measures are complementary, and are often introduced together in state legislatures. The latter Bills provide additional assurance against a runaway convention, which some state legislators view as a prerequisite to passing the balanced budget amendment resolutions. Other single subject amendment resolutions, such as term limits, have passed in only a handful of states.

Guldenschuh’s tally shows that the only other Article V proposal that has made significant progress in the states is the Convention of the States (COS) Project, having passed in nine states. However, COS has been rejected in several states, including Arkansas, South Dakota, Utah, and Wyoming. Opposition to the COS proposal focuses on the broad nature of the call to limit the power of the federal government. COS Founder, Michael Farris, argues that the problems in the structure of the federal government have become so serious that a single subject amendment application is insufficient to address the crisis (Guldenschuh 2015). In the fall of 2016 the sponsor of COS, the Texas based Citizens for Self-Governance (CSG) sponsored a simulated convention of the states. That convention proposed six amendments, including: public debt; acts of war and violent insurrection; term limits; the abrogation of federal laws; taxation, including income, duty, and excise taxes; and federal regulation.

Critics on both the left and the right question whether such a broad application would constrain an Article V convention from proposing a wide range of amendments. Patrick Basham, Director of the Democracy Institute, concludes that the most likely outcome of the COS campaign would be a failed convention, in which delegates propose a number of constitutional amendments beyond the convention’s actual mandate (Basham 2017). COS supporters argue that the subject matter specified in state applications would limit the scope of the convention. But, Simon Dross Cohen observes, “That the subject matter of the resolutions will prevent a runaway convention may make sense in response to the BBA whose resolution focuses specifically on the balanced budget amendment, but when applied to the Convention of States agenda, the argument fails as the subject of the resolutions includes broad language to curb the power and jurisdiction of the federal government” (Cohen2016).

It is increasingly clear that U.S. citizens have lost control of federal fiscal policies (Committee on the Budget 2016D). The constraints imposed on the federal government by the U.S. Constitution have eroded, and the statutory fiscal rules enacted by Congress have had small, temporary effects on federal spending. The growth in deficits and accumulation of debt in recent
decades have put the federal government on a path of unsustainable fiscal policy (Committee on the Budget. 2016D).

A growing number of U.S. citizens view the federal government as no longer functioning within the framework established by the U.S. Constitution. They advocate amendments to the Constitution to limit the power of the federal government and to restore a federalist system closer to that envisioned by the Founders (Guldenschuh 2015). The Founders envisioned just such a constitutional crisis when they provided two methods for amending the constitution under Article V (Congressional Research Service. 2016A). The first method, in which Congress with two thirds of both houses concurring, is the basis for the twenty-seven amendments to the constitution adopted to date. The states have sent hundreds of amendment applications to Congress, but none of these applications has triggered an amendment convention. When the states sent an amendment application to Congress calling for a convention to require the direct election of Senators, Congress responded by proposing the Seventeenth Amendment.

In his survey, Guldenschuh concludes that the Balanced Budget Amendment Task Force is the only group to gain bipartisan support for their resolution in state legislatures. With the current GOP control of both chambers in a number of state legislatures, he argues that the Balanced Budget Amendment Task Force’s path to 34 states remains realistic, and easily represents the best opportunity among the Article V advocacy groups to reach a convention.

It is not clear that a balanced budget amendment to the U.S. Constitution will be proposed by either route provided for in Article V. It is possible that proponents of a balanced budget amendment will succeed in passing resolutions in the 34 states required for Congress to call an amendment convention. Some scholars predict that if the number of states proposing a balanced budget through an Article V amendment convention approaches the two thirds required for Congress to call the convention, Congress will pre-empt this effort by proposing their own balanced budget amendment (Fenno 1973). Congress has an incentive to do so in order to preserve power, and to enhance the electoral prospects for members. The Constitution has never been amended through an Article V amendment convention, but there is an important precedent for this effort. In 1912 twenty-seven states called for a constitutional convention to propose an amendment providing for the popular election of U.S. Senators by the people of the states. Similar resolutions were introduced in other states, which would meet the requisite two thirds required to call the amendment convention. Congress responded by proposing the amendment which then was ratified as the Seventeenth Amendment (Russum 1999).

Appendix: Brief History of Statutory Fiscal Rules

The Balanced Budget and Emergency Deficit Control Act of 1985
The first statutory limit on federal spending was imposed by the Balanced Budget and Emergency Control Act of 1985, also referred to as the Gramm-Rudman-Hollings Act. This Act set statutory deficits targets that were enforced by an automatic spending reduction referred to as sequestration (Congressional Research Service. 2016B).

The Gramm Rudman-Hollings Act threatened across the board spending cuts through sequestration if deficit targets are not met. Senator Phil Gramm, cosponsor of the Act, states that “It was never the Objective of Gramm-Rudman to trigger sequestration. The objective of
Gramm-Rudman was to have the threat of sequestration force compromise and action”. However, this threat did not always work. Sequestration was triggered in FY 1986 and again in FY 1990. Clearly there are times when it is easier for the President and Congress to allow an automatic enforcement mechanism to take effect, rather than to negotiate a budget agreement.

However, some analysts argued that the threat of sequestration has led the President and Congress to negotiate a budget agreement that might not have been reached in the absence of that threat. In 1990 President George H.W. Bush and Congress reached agreement on a significant reduction in spending in the Omnibus Budget Reconciliation Act of 1990. Failure to reach agreement would have triggered a sizable across the board cut in spending.


The most common way for Congress to circumvent the constraints on spending has been simply to increase the limits. When Congress failed to meet the deficit targets set in Gramm-Rudman-Hollings, it passed the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987. That Act significantly revised deficit targets upward, and extended the period required to achieve a balanced budget. In some years Congress has simply suspended the spending limit or passed a bill easing sequestration (Consolidated Appropriation Act for FY 2000; Military Construction Appropriations Act for FY 2001; Defense Appropriation Act for FY 2002).

The Budget Enforcement Act of 1990

The Budget Enforcement Act [BEA] of 1990 replaced the maximum deficit limits originally in the Deficit Control Act with annual limits on discretionary spending and controls over increases in the deficit, calculated by adding together, for each fiscal year, increases in direct spending and decreases in revenues – a process termed “pay-as-you-go.” Under pay-as-you-go, if the cumulative effect of legislation enacted through the end of a session of Congress increased the deficit, the amount of that deficit increase for the fiscal year following that session would cause a sequestration of direct spending by that amount. As with the deficit targets before it, most spending defined as “direct” was exempt from any reductions. Other spending programs had limitations on the reductions. For example, spending decreases in the Medicare program, under pay-as-you-go, were limited to 4 percent of the program costs.

When laws provide exemptions for emergency spending or other programs then significant spending can occur that is not subject to the limits. The Budget Enforcement Act of 1990 exempted emergency defense and non-defense spending from the statutory limits. Over the decade that the law was in effect emergency expenditures increased from several billion dollars to $47 billion.

The Balanced Budget Act of 1997

This legislation modified the discretionary spending limits for fiscal year 1998 and extended them through fiscal year 2002. The pay-as-you-go requirements were extended for legislation enacted through the end of fiscal year 2002. The sequestration enforcement mechanism lasted through the end of fiscal year 2006 for such legislation, but it was turned off by Public Law 107-312, enacted 2 December 2002.
The Statutory Pay-As-You-Go-(PAYGO) Act of 2010
This Act was signed as part of Public Law 111-139, which raised the statutory limit on the public debt. The measure amended sections of Gramm-Rudman-Hollings, including the sequester base, but it did not establish new discretionary spending limits. Under PAYGO rules sequestration is designed to prevent enactment of mandatory spending and revenue legislation that would increase the federal deficit. If the net cost of such legislation exceeds net total savings, sequestration is triggered.

Budget Control Act of 2011
The Budget Control Act of 2011 (BCA) temporarily resolved a confrontation between the House of Representatives and the President over whether, and by how much, to raise the statutory debt limit, which was about to be breached. The legislation set statutory controls on spending, primarily making Gramm-Rudman-Hollings permanent in its entirety, and it re-established discretionary spending limits for fiscal years 2012 through 2021. The BCA also authorized an increase in the public debt limit.

The BCA included additional procedures that had the effect of altering discretionary spending limits. It established a Joint Select Committee on Deficit Reduction tasked with reporting legislation to reduce the Federal deficit by an additional $1.5 trillion over a 10-year period ending in fiscal year 2021, which would have been considered under procedures limiting amendment and debate.

Under the BCA, if legislation reported by the Joint Select Committee reducing the deficit by at least $1.2 trillion was not enacted, then a sequestration would be ordered, adjusting the discretionary spending limits downward and calculating an amount of reductions in direct spending necessary to achieve this amount (or a portion thereof if legislation from the Joint Committee achieving some deficit reduction was enacted).

The Joint Select Committee failed to report any proposals reducing the deficit by any amount, and no legislation to that purpose was enacted. That triggered the automatic spending reduction process and the Joint Select Committee ceased to exist.

This Act set new spending limits over the period FY 2013 to FY 2021. Sequestration provisions to enforce the spending limits were imposed on mandatory as well as discretionary spending. The CBO estimated that the discretionary spending limits imposed by this law would reduce the deficit by almost a trillion dollars over the period. Unfortunately, like the previous statutory limits Congress has found ways to circumvent the constraints imposed by this law in subsequent years.

The American Taxpayer Relief Act of 2012
The American Taxpayer Relief Act of 2012 reduced sequestration in FY 2013 by $24 billion, and lowered the spending limits for fiscal years 2013 and 2014 by $4 billion and $8 billion respectively.
The Bipartisan Budget Act of 2013
The Bipartisan Budget Act of 2013 increased the spending limits in fiscal years 2014 and 2015, and provided $63 billion in sequestration relief in these two years. The sequestration relief was to be offset by reductions in direct spending elsewhere in the budget.

The Bipartisan Budget Act of 2015
This pattern was repeated in the Bipartisan Budget Act of 2015. The Act increased spending limits in fiscal years 2016 and 2017 by $50 billion and $30 billion respectively. This increase in spending was to be offset by reduced spending elsewhere in the budget. In this recent legislation the outcome of budget negotiations was to increase spending limits in the short run, with a promise to reduce spending elsewhere in the budget or over the long term. The budget negotiations between President Obama and Speaker Boehner in 2015 were especially bitter. The budget bill they negotiated was supported by only 79 of 246 House Republicans voting.

The Budget Resolution FY 2016
For six years, Congress had failed to adopt a Budget Resolution as required by the Congressional Budget Act of 1974. Finally, in March 2015, the House and the Senate agreed on Budget Resolution FY2016 that would balance the budget within ten years, with no increase in taxes. Over that period, the spending caps imposed by the Budget Control Act of 2011 would be imposed. With those spending caps in place, total spending would be reduced $5.5 trillion compared to the CBO baseline projections.

If the Budget Resolution for FY 2016 were the basis for serious budget negotiation in Congress, we could view this as an important milestone toward solving the nation’s fiscal crisis. Unfortunately, the Budget Resolution for FY 2016 was not the basis for serious negotiation; as Minority leader Harry Reid (D, Nevada) stated, ‘That’s why we’re saying to Sen. McConnell today, ‘drop this sham process and start serious negotiations.’” What a majority of Congress agreed on was that the spending caps imposed by the Budget Control Act of 2011 should be lifted.

The Budget Resolution FY 2016 continued a pattern of accounting procedures that allowed the Congress to circumvent the spending caps imposed by the Budget Act of 2011. The Resolution allocated $96 billion in defense funds to the Overseas Contingency Operation (OCO) Account, which is not subject to the budget cap. The OCO account was originally created to fund the wars in the Middle East. By shifting defense funding into this off-budget account, Congress could pretend that it met the budget caps.

The Budget Resolution FY 2016 also proposed to reduce spending by abolishing the Affordable Care Act, with a savings of $2 trillion over the next decade. But the budget projections assumed the increased revenue generated by Obamacare taxes and fees. The Resolution proposed an additional $2 trillion in savings by imposing constraints on other entitlement programs, including Medicare, Medicaid, and Food Stamps. None of these proposals was acted upon.

Concurrent Resolution on the Budget for Fiscal Year 2017:
As Paul Winfree (2015, 2016) argued, Congress seemed to be setting itself up for failure in these budget negotiations. Even with the higher spending caps agreed to in the budget negotiations the budget resolution for fiscal years 2017 and 2018 would exceed the spending caps in those years.
This would trigger an automatic sequestration under the Budget Control Act. Budget negotiations seemed to be heading for another fiscal cliff, with the potential for another government shutdown if the President and Congress could not reach agreement.

In Concurrent Resolution on the Budget for Fiscal Year 2017 new battle lines were drawn for budget battles in Congress. The Resolution narrowly focused on repealing the Affordable Care Act (ACA) with no change in other parts of the budget. Discretionary spending for FY 2017 was set at the spending cap level for that year, all other spending and revenue was set at baseline levels. The Resolution “exempts future health care legislation replacing the ACA from certain budget rules meant to impose fiscal discipline.” The Resolution instructions required committees with jurisdiction over spending and revenue in the ACA to report legislation achieving $1 billion in deficit reduction over the ten years, i.e. by reporting legislation repealing ACA with budgetary effects. Repeal of ACA legislation would be considered under special reconciliation procedures that prevent filibuster in the Senate.

The Resolution also created two reserve funds to accommodate new legislation repealing ACA. Replacement legislation could use all but $2 billion of the net savings from ACA repeal for new spending or tax breaks for health care coverage. Replacement legislation that costs no more than the savings from ACA repeal, minus $2 billion, would be exempt from the Senate PAYGO rules, and also exempt from the Senate short run deficit point of order that prohibits the deficit by increasing more than $10 billion in any year, and from the Senate long term deficit point of order that prohibits legislation from increasing the deficit by more than $5 billion in any of the four decades beyond the ten year budget window. The inclusion of these exemptions suggested an expectation that the costs of replacement legislation would exceed the savings from repeal by more than the $10 billion in some of the years within the ten year window, and that the combination of repeal and replace legislation would increase the long term deficit beyond the ten year budget window.

New health care legislation replacing ACA would be exempt from the Senate PAYGO rules. With government expenditures for health care absorbing a larger share of the federal budget, this carve out meant that less spending would be constrained by the statutory rules in place. Setting aside reserve funds to finance new health care legislation meant that more federal money would be ‘off-budget’ and earmarked for specific spending programs.

The CBO analysis of the resolution bill repealing ACA identified a number of reforms in health care that could be enacted with significant cost savings. The $1 billion in savings proposed in the bill is a drop in the bucket compared to these potential savings in ACA reform. In fact this Resolution proposes to increase total spending from $3.2 trillion to $4.9 trillion over the next decade. This increase in spending would be accompanied by a roughly doubling of deficits to more than $1 trillion dollars by the end of the decade. Total debt would increase by half, from about $20 trillion to $29 trillion.

We will not know the full impact of these policy proposals to reform and replace ACA because Congress did not pass the resolution bill repealing ACA and legislation with replacement policies.

The 2018 House Resolution called for balancing the budget over the next decade. The Resolution called for a minimum of $200 billion in savings in the current budget year. The budget that Congress passed through reconciliation provided a token $15 billion in savings in a few
programs. Republicans and Democrats agreed to increase the statutory spending caps by $300 billion over the next two years. Republicans opposed cuts in defense spending, and Democrats opposed cuts in domestic programs, so they agree to boost spending by $150 billion in both. The tax and spending bills passed by Congress over the past year will increase deficits by $1.5 trillion over the next decade.

Chapter 2. Designing New Fiscal Rules for the U.S.

Since the financial crisis, a new generation of fiscal rules has been enacted in OECD countries. The most successful of these fiscal rules take a holistic approach, establishing a fiscal framework for the budget process. A combination of fiscal rules is anchored by a debt objective to preserve fiscal sustainability. A well-anchored fiscal framework is designed to reduce and stabilize debt at a sustainable level in the medium term.

Operational fiscal rules link the debt anchor to fiscal policies. Expenditure limits have proven to be the most effective rules in this fiscal framework. Expenditure limits may target a fiscal surplus, or a cyclically adjusted balance, with deficits offset by surpluses in the medium term. Once fiscal rules have reduced and stabilized debt at a sustainable level, countries have more fiscal room to pursue macro-stabilization policies.

The fiscal rules must be flexible in responding to business cycle fluctuations. In addition to automatic stabilizers, the rules must allow a margin of error, i.e. fiscal room for elected officials to incur deficits. The rules must also provide for an emergency fund to respond to natural disasters, and military conflicts. An escape clause would suspend limits on spending and deficits in a declared war.

The fiscal rules must also provide a feedback mechanism to prevent fiscal policies from drifting off the path toward a sustainable debt level. A deficit/debt brake provides guardrails for the fiscal framework. As deficits and debt approach critical levels the deficit/debt brake imposes more stringent limits on expenditures. The deficit/debt brake strengthens the link between the debt anchor and the expenditure limit.

Supporting institutions have played a crucial role in the success of new fiscal rules. In some countries fiscal councils have assumed a central role in the budget process, providing both transparency and accountability. New institutions have been created to analyze the impact of trends, such as an aging population, and rising health care costs, on fiscal sustainability in the long run.

The U.S., as a high debtor country, faces a formidable challenge in establishing such a rules based fiscal framework. The fiscal rules now in place, including debt limits and spending limits, are routinely suspended or circumvented, such that they have failed to constrain spending and

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4 For a recent survey and analysis of fiscal rules in the U.S. see Merrifield and Poulson 2016, 2017
deficits in the long term. In the absence of effective fiscal rules, elected officials have pursued discretionary fiscal policies increasing debt to unsustainable levels. In this study we propose new fiscal rules, proven to be effective in other OECD countries, to be incorporated in the budget process in the U.S. While we have learned a great deal from the experience with fiscal rules in other OECD countries, new fiscal rules must be adapted to the unique budget institutions encountered in the U.S. The fiscal rules we propose, the Merrifield/Poulson rules, are also based on the experience with fiscal rules at the state and local level in the U.S.

Setting Clear Targets for Fiscal Policy

Setting Clear Targets for a Sustainable Fiscal Policy in the Long Run

Following the precedent set in the European Union, clear targets should be set for a sustainable fiscal policy in the long term. Fiscal rules should then be designed to achieve these long range targets as part of the budget process (IMF 2009, 2015, 2018a, 2018b; Lledo et al 2017).

The European Union, and the OECD, have set the target debt/GDP ratio at 60%. When debt exceeds that target, fiscal rules imposed by the European Union, and by the individual countries, impose constraints on fiscal policy designed to reduce debt to sustainable levels below 60%.

U.S. fiscal policies are on an unsustainable path. The total debt/GDP ratio is now in excess of 100%, and is projected to increase to 150% over the next three decades. The U.S. has emerged as a major debtor country that must now pursue fiscal policies to reduce debt to sustainable levels.

Fiscal rules should be incorporated in the budget process designed to reduce the debt/GDP ratio below 60%. The fatal flaw in the current statutory debt limit is that it is not part of the budget process. As debt is incurred, the statutory debt limit is routinely increased to accommodate discretionary fiscal policies. Despite several government shutdowns, or threatened shutdowns, the statutory debt limit has had little if any impact in constraining debt in the long term.

The proposed fiscal rules for the U.S. must provide for a transition period during which fiscal policies first stabilize the debt/GDP ratio, and then reduce that ratio below the 60% target. During the transition period annual debt/GDP targets should be set consistent with the long term targets, and fiscal policies adjusted accordingly.

Setting Clear Targets for Budget Stabilization in the Near Term

In a coherent budget process, annual budgets must be consistent with debt targets (IMF 2009, 2015; Lledo et al 2017). In low debtor countries, such a Switzerland, the fiscal rules to achieve the debt targets are straightforward. The Swiss debt brake mandates that in the near term, budget deficits must be offset by budget surpluses. The Swiss maintain a notional account in which budget deficits are offset by budget surpluses within a three-year time frame. In recent years the Swiss have incurred budget surpluses, but they anticipate that budgets will conform to the budget balance in coming years.
High debtor countries, such as the U.S. must incorporate a combination of fiscal rules in the budget process to achieve the debt targets during a transition period. The CBO projects budget deficits in excess of 3% per year over the next two decades. A reasonable goal could be to reduce and eliminate this structural deficit and achieve a budget balance over the next decade. Over the next decade the goal could be to stabilize the debt/GDP ratio at current levels. Continuing along this sustainable fiscal path for two decades the U.S. could reduce the debt/GDP levels to a sustainable level, i.e. less than 60%, and eventually to levels comparable to that prior to the financial crisis. In the long run it is not unreasonable to set an aspirational goal, as Thomas Jefferson did, to eliminate federal debt entirely.

Following this path of sustainable fiscal policies could both maximize economic growth, and provide macro-stability over the business cycle. As these debt targets are reached the U.S. will have the fiscal room to pursue countercyclical fiscal policies. At that point, balancing the budget in the near term, with deficits offset by budget surpluses, will keep fiscal policies on a sustainable path in the long term.

Expenditure Limits are the Centerpiece of a Fiscal Framework

Expenditure Limits in the Long Term

The centerpiece of fiscal rules in other OECD countries is an expenditures limit (Cordes et al 2015; Andrle et al 2015; Fall and Fournier 2015; Fall et al 2015a, 2015b; Ayuso-Casals 2012; IMF 2018a, 2018b). The expenditures limit is designed to achieve debt targets in the long term, and budget stabilization in the near term.

A number of alternative designs are possible in long term expenditures limits. The Swiss, for example, designed an expenditure limit that increases at the rate of long term economic growth. High debtor countries, such as the U.S., must impose a more stringent spending limits to achieve debt targets within a reasonable time frame. An expenditure limit that has proven to be effective at the state level in the U.S. links the rate of growth in expenditures to the rate of growth of population plus inflation.

The expenditures limit in the long term must also reflect the demand for government services. Like other OECD countries, the U.S. budget will be impacted by an aging population, and rising costs for health care services. To accommodate increased expenditures for pension and health benefits for retirees, the expenditure limit could be adjusted upward in the long term. For example, an expenditure limit multiplier could be set at unity in the near term, and then gradually adjusted upward to accommodate increased government expenditures in the long term.

A Deficit/Debt Brake

A deficit/debt brake can provide the guardrails for a coherent budget process (Eyraud et al 2018). The purpose of the deficit/debt brake is to keep fiscal policies on track to achieve debt targets. The precedent set in the European Union is to set tolerance levels for deficits and debt. The tolerance level for deficits is set at 3% of GDP; the tolerance level for debt is set at 60% of GDP.
As deficits approach the tolerance level a deficit brake is applied, reducing the expenditures cap. And, as debt approached 60% of GDP a debt brake is applied, reducing the expenditures cap.

Implementing these fiscal rules in the current fiscal environment would result in very stringent caps on expenditures. With deficits projected well above 3%, and debt well above 60%, the deficit/debt brake would cap spending growth at less than 1% per year over the next two decades. If elected officials had enacted fiscal rules several decades ago, as other OECD countries did, they would have more fiscal room to pursue discretionary fiscal policies today.

**Emergency Funds and Escape Clauses**

One of the reasons for the success of the Swiss debt brake is the provisions for a carefully designed emergency fund and escape clause that allows for spending in excess of that permitted by cyclically adjusted revenues (Geier 2011, 2012). The Swiss ‘extraordinary budget’ functions like a budget stabilization or ‘rainy day’ fund (Merrifield and Poulson 2017).

The Swiss debt brake has achieved a budget that is close to balance over the long term (Beljean, and Geier 2013; Bodmer 2006; Kraan and Ruffner 2005). A cyclical adjustment factor is used to offset deficits with surpluses over the business cycle. The extraordinary budget provides for deviations from this cyclically balanced budget rule. The Swiss recognize that emergencies, such as natural disasters, financial crises, and military expenditures, may result in sharp temporary increases in spending. The Swiss rules account for these expenditures in the extraordinary budget, separate from the primary budget. Any deficit in the extraordinary budget must be offset by surpluses in the primary budget in the short term.

Prior to the recent financial crisis, the Swiss accumulated a surplus in the extraordinary budget. That surplus was expended during the financial crisis to stabilize expenditures around the revenue trend. The debt incurred in the extraordinary budget during the financial crisis was offset by surpluses in the primary budget. Over the course of that business cycle the Swiss did not increase debt, one of the few countries able to impose such fiscal discipline.

The experience of the Swiss, as well as other OECD countries has resulted in a consensus regarding emergency funds and escape clauses in the successful implementation of fiscal rules. Fall et al (2015) summarize this consensus as follows:

“Tail events happen, but they need not undermine credibility. Clear escape clauses should be set allowing the temporary suspension of fiscal rules. A temporary suspension should be conditional on exceptional events such as natural catastrophes or a sharp output contraction. However, the definition of these escape clauses must be clear to make sure they cannot be used in normal times. Determining the existence of exceptional circumstances can be delegated to a body outside the government or submitted to a validation by qualified majority in the parliament. To cope with tail events, a “rainy day” fund can underpin the respect of the rule over the cycle and would allow greater room for fiscal stabilization. Unexpected surpluses would be saved and used later to finance unexpected deficits and/or short-term stabilization policies (Fall et al. 2015 p.37-38).
In the U.S. under current law, the caps imposed on spending have often been waived in order to fund emergency expenditures. For example, the spending caps imposed by the Budget Enforcement Act of 1990 have been waived for disaster relief, military spending, overseas contingency spending, and program initiatives (Schick 2007, 2010). Exempting these expenditures for emergencies tends to undermine the effectiveness of this fiscal rule. This also begs the question of what is an emergency expenditure; the broader the definition of an emergency, the less effective the caps imposed on discretionary spending.

A broad consensus has supported emergency expenditures for disaster relief (Schick 2007, 2010). Expenditures for disaster relief over the past decade could be used to provide a benchmark for the magnitude of emergency funds required to meet these needs.

A broad consensus has also supported expenditures for military emergencies (Schick 2007, 2010). Defense expenditures over the past century suggest an important distinction between military expenditure during World War II and expenditures for military conflicts since then. Emergency spending for military conflicts of the magnitude of World War II would certainly require deficit spending and debt beyond the limits imposed by the cap on emergency fund. One way to distinguish such military emergencies is to suspend the cap on the emergency fund and allow unlimited borrowing while a declaration of war is in place.

At the same time, we would distinguish between the claims on federal spending in such a declared war, and the expenditures for military emergencies without a declaration of war, such as the Iraq and Afghanistan wars. Our analysis reveals that expenditures for these latter military emergencies could have been financed from an emergency fund, while meeting other emergencies such as natural disasters and financial crises. The War Powers Resolution limits troop deployment by the President without a formal declaration of war. The constraints imposed by an emergency fund cap could add a budgetary as well as a troop limit to the authority granted to the President under the War Powers Resolution. Provisions of the emergency fund would have to provide flexibility to the President to respond to a military crisis, e.g. waiving the emergency fund cap during the first sixty days of a military conflict.

**Capital Investment Funds**

A major issue in applying fiscal rules is whether investment spending should be subject to expenditure caps. Many countries practice what is referred to as the ‘Golden Rule’. The basic principle in the ‘Golden Rule’ is that borrowing is limited to investment spending. This means that budget deficits are capped at the level of investment expenditures. In applying the ‘Golden Rule’ some countries, such as Sweden, separate investment spending from other expenditures, and apply their expenditure caps only to non-investment spending (Andersen 2013).

Switzerland, on the other hand rejects the ‘Golden Rule’ (Geier 2011). The problem with the Golden Rule is that it requires a distinction between investment spending and government consumption. The Swiss view this requirement as a loophole; the question is whether investment spending is narrowly defined or includes R&D expenditure, education, health care, etc. The Swiss expenditure limit is applied to a comprehensive measure of spending, including investment expenditures. Money is allocated to an infrastructure investment fund as part of the ordinary budgetary Process. That fund is narrowly defined to include investments in railroads, highways and bridges. The infrastructure fund is not permitted to incur a deficit. This means that
infrastructure investments must be prefunded, i.e. a pay as you go requirement. The infrastructure investment fund flexibly adjusts to peaks in investment spending linked to major infrastructure projects in the long run.

The Swiss have chosen fiscal rules that are straightforward and transparent, recognizing the tradeoffs compared to more complex fiscal rules introduced in other European countries (Bodmer 2006; Beljian and Geier 2013). Critics argue that the Swiss rules are likely to result in underinvestment. If investment spending becomes a target for spending cuts in periods of recession and revenue shortfall, the result is an underinvestment bias in fiscal policy. The Swiss, though, defend their investment policies, pointing to stability and growth in investment spending in the years since the rules were introduced (Beljian and Geier 2013).

Fiscal Responsibility Councils

To ensure that new fiscal rules are implemented, OECD countries have created new institutions that are an integral part of the budget process (Wyplosz 2005; Debrun and Kumar 2007; IMF 2013; Beetsma et al 2017). Independent fiscal responsibility councils provide both transparency and accountability. These councils monitor compliance with the fiscal rules to be sure that they are not circumvented or manipulated. When the fiscal rules are violated the councils communicate this to elected officials and chart a path back to compliance following the breach. The councils may also be charged with macro-economic analysis, and operational guidance to policymakers. The new fiscal rules have been refined to more precisely target the ‘fiscal effort’ required for elected officials to achieve the budget goals. Fiscal councils may also be charged with long term sustainability assessments and policy analysis. Fiscal councils can also play an important role in enforcing compliance with the fiscal rules. Formal enforcement mechanisms, such as the sequestration provisions in recent budget laws in the U.S. have proven to be unpopular and ineffective. Other countries have had more success relying on fiscal councils to improve transparency and accountability for fiscal rules, thus increasing the reputational costs when elected officials choose to disregard the rules.

Chapter 3. The Merrifield/Poulson Fiscal Rules

The United States faces a considerable challenge to achieve a sustainable fiscal policy. With debt in excess of $20 trillion, and a debt/GDP ratio in excess of 100%, the U.S. has emerged as one of the major debtor countries in the OECD. To follow the guidelines set for OECD countries, fiscal consolidation would require the U.S. to reduce the debt/GDP ratio below 60%. Fiscal consolidation must be achieved while satisfying traditional objectives of fiscal policy to stabilize the economy over the business cycle, objectives incorporated in the Employment Act of 1946, i.e. full employment and price stability.
It is clear from our previous discussion that the U.S. cannot achieve this fiscal consolidation under current fiscal rules; the deficits and debt projected under current law are unsustainable. For half a century current fiscal rules have failed to halt deficit spending and the accumulation of debt. Fiscal policies have been biased toward short run stimulus, and as a result the country has virtually abandoned long run fiscal stabilization.

The new fiscal rules for the U.S. proposed in this study, the Merrifield/Poulson (MP) fiscal rules, follow the precedent set in other OECD countries that have successfully enacted fiscal rules to achieve fiscal consolidation and stabilization in the long term. The most successful of these is the Swiss debt brake that has served as a model for new fiscal rules adopted in the European Community and in other OECD countries. The new fiscal rules we propose are also modeled after the Swiss debt brake, however, there are key differences in the deficit/debt brake that we propose.

The common elements between our proposed fiscal rules and the Swiss debt brake are debt reduction relying on a deficit brake and a debt brake to limit expenditures growth. Our proposed rules combine a deficit and debt brake, with a deficit tolerance level at 3% of GDP, and a debt tolerance level at 60% of GDP. As either or both deficits or debt near the tolerance levels, braking lowers the cap on discretionary spending growth. The spending cap is a multiple of population growth plus inflation. Our research on tax and expenditure limits at the state level shows that this is the least volatile, plausible grounds for a spending growth cap (Merrifield and Poulson 2014).

Our deficit/debt brake is complemented by other fiscal rules. An emergency fund provides for stabilization over the business cycle, and for other emergencies such as natural disasters and military conflict. A capital investment fund is introduced to prioritize infrastructure investments essential for long term economic growth. Our deficit/debt brake is designed for the unique institutions in the U.S. economy. In this chapter the proposed fiscal rules are simulated for the U.S. over the forecast period 2018-2038, based on parameters unique to the U.S. economy over this time period.

It is important to contrast the proposed MP fiscal rules, with other fiscal rules proposed for the U.S. We propose a combination of interrelated fiscal rules designed to achieve multiple targets, including a deficit/GDP ratio, and a debt/GDP ratio. After some debt reduction occurs, the proposed rules approximate a cyclically balanced budget, with surpluses in periods of economic expansion offsetting deficits in periods of economic contraction.

The long term goal should be a sustainable fiscal policy. The flaw in U.S. fiscal policy is the failure to set long term goals and to incorporate those goals in the budget process. Some have argued that it is unrealistic to set long term goals and impose fiscal rules to achieve those goals. They argue that Congress already struggles with short term budgets, and that Congress is not able to hold to long term goals. But this is an argument for continuing a budget process relying on discretionary fiscal policies that created the debt crisis. Continuing to muddle along with current discretionary fiscal policies is no longer a viable option in the long run.

Critics will argue that such a complex set of rules will be difficult to enact and to implement. In this chapter we simulate the proposed fiscal rules to show how they can be implemented to
achieve the multiple targets. In the final chapter we provide a roadmap for enacting the proposed fiscal rules as constitutional and statutory measures. We maintain that this combination of fiscal rules is a prerequisite to fiscal stabilization in the U.S. over the long term.

Setting the Targets for Fiscal Policy

The key to a sustainable fiscal policy is to stabilize and reduce debt as a share of national income. The U.S. with a large and growing level of debt as a share of GDP is on an unsustainable fiscal path.

Ben Bernanke provided this analogy in a speech on fiscal policy at a conference in 2018. Fiscal Stimulus “is going to hit the economy in a big way this year and next, and then in 2020, Wile E. Coyote is going over the cliff.” Bernanke was referring to the return of trillion-dollar deficits on top of the 21 trillion dollars in debt that the federal government had already accumulated. What Bernanke and most economists are saying is that even the most prudent monetary policies are now undermined by deficit spending. As debt continues to accumulate, we are watching the federal government go over a fiscal cliff without a safety net (Merrifield and Poulson 2018B).

We can stop Wile E. Coyote from going over the cliff. Other countries have shown that well-crafted fiscal rules can produce balanced budgets and reduce debt to sustainable levels. There is controversy regarding the level of debt that will trigger retardation and stagnation in economic growth, but there is little doubt that the U.S. debt is now within that range.

The long-term goal of members of the European Union is to reduce debt levels below 60% of GDP. The heavily indebted countries in the European Union with debt levels above this range are currently experiencing retardation and stagnation in economic growth, and are struggling to achieve that target.

Debt levels in the U.S. are comparable to that of the heavily indebted European countries. One could argue that the U.S. is less vulnerable to financial crises than these European countries because a large share of the debt held by European countries is held abroad. However, a large and growing share of U.S. debt is now held by foreign governments, as well as foreign citizens. The U.S. is increasingly vulnerable to financial market instability if foreign governments choose not to hold U.S. debt.

The precedent in countries that have successfully addressed their debt crisis, such as Switzerland, is that a transition period is required to reach a sustainable debt level. But a transition period does not mean deferring the enactment of effective fiscal rules. We propose a two-decade period during which our proposed fiscal rules are implemented in several stages.

In the current fiscal environment, the immediate objective is to reduce and eliminate deficits in the budget. With effective fiscal rules in place the budget could be balanced and the debt/GDP ratio stabilized over the next decade. However, stabilizing the debt-to-GDP ratio at current levels is not a sufficient condition for a sustainable fiscal policy.

Prudent policies would impose constraints on fiscal policy well before a country reaches debt levels that could trigger financial crises. The fiscal rules we propose set a tolerance level for debt
at 80% of the target set in the European countries (80% x .60 = 48%). When the debt/GDP ratio hits 48%, more stringent limits are imposed on spending growth.

In the long term, this rules-based approach to fiscal policy would reduce the debt-to-GDP ratio to historic levels. At these lower levels of debt, the country can restore long run rates of economic growth, and also provide fiscal space to pursue countercyclical economic policy. When debt has been reduced to this sustainable level, the fiscal rules can allow for a cyclically balanced budget, with surplus revenue in periods of economic expansion offsetting deficits in periods of recession. Fiscal rules can restore this ‘old time religion’ of balanced budgets.

Critics who have grown used to the unconstrained growth in debt over the past half century will view this as a radical proposal. Some critics even suggest that we can continue to muddle along with current fiscal policies and defer addressing the debt crisis until sometime in the future. But, as Bernanke and others argue, the time for kicking this can down the road is over. We must return to the balanced budget principles that achieved a sustainable fiscal policy for two centuries. Indeed, it is not unreasonable to set aspirational goals as Thomas Jefferson did to eliminate debt entirely in the long run.

An Expenditure Limit

Spending limits can be linked to different measures of aggregate economic activity. The most commonly used spending limit is one tied to the rate of growth in national income. However, our analysis of this type of spending limit at both the national and subnational level reveals that it is too volatile. In periods of rapid growth this limit allows spending to grow too rapidly, resulting in fiscal stress in in periods of recession and revenue shortfall. In some cases, this type of spending limit has proven to have little impact in constraining spending.

For highly indebted countries, such as the United States, more stringent spending limits must be imposed to reach the desired target levels of debt. The spending limit that has proven to be most effective is one linked to the sum of inflation and population growth. Our analysis suggests that this more stringent spending limit can achieve the targets we have set for debt within our time frame. When combined with the other fiscal rules that we propose this spending limit can also provide for fiscal stabilization over the business cycle.

In the long run the spending limit should be adjusted to reflect the growth in the demand for government services. In the MP rules an expenditure limit multiplier is set at 1.2 to capture the impact of long-term factors impacting the demand for government services.

A controversial issue is the spending base against which the spending limit is applied. The broader the base the more effective the limit will be in controlling spending. In Switzerland, for example, the spending limit is applied to all non-interest spending, with the exception of Social Security payments.

Some would argue that a spending limit should apply to all federal expenditures in the U.S. This would eliminate the distinction in current law between discretionary and mandatory expenditures. This approach would be the most effective in constraining federal spending. However, this would prove to be difficult because it would force fundamental changes in the
rules for entitlement programs, or huge discretionary spending cuts, both of which would be very difficult politically. Both Social Security and Medicare are funded from Trust funds with unique rules regarding the contributions to and benefits paid from the funds. Spending for these entitlement programs is projected to grow more rapidly than other federal expenditures. Applying spending rules that significantly directly reduce these entitlement expenditures would undermine public support for a rules-based approach to fiscal policy.

The MP rules follow the precedent set in applying the Swiss debt brake. The spending limit we propose would apply to all non-interest spending with the exception of Social Security and Medicare Part A, i.e. that part of mandatory spending financed from trust funds. All other mandatory expenditures would be constrained by the expenditure limit.

A Deficit/Debt Brake

A deficit/debt brake provides the guardrails in the MP rules to make sure that fiscal policy does not go off track. The deficit/Debt brake is a refinement of the Swiss debt brake. A tolerance level is set for both deficits and debt. The tolerance level for deficits is set at 80% of the deficit target (80% x .03 = .024). When deficits as a share of GDP exceed .024 the deficit brake reduces the expenditures limit.

The tolerance level for debt is set at 80% of the debt target (80% x .60 = .48). When debt as a share of GDP increases above .48 the debt brake reduces the expenditure limit.

Both the deficit and debt brake can be imposed more stringently. Multipliers are applied to each to achieve more stringent braking.

The MP rules take a unique approach in applying the deficit/debt brake to the expenditure limit. The expenditure limit is applied to all non-interest spending with the exception of Social Security and Medicare Part A. Given the political resistance to imposing spending limits on entitlement programs, this is the most feasible way to apply the spending limit. However, the MP rules have a unique design component that indirectly pressures Congress to enact reforms in these entitlement programs.

The measures of deficits and debt used in applying the deficit/debt brake are based on total expenditures and total revenues. Total expenditures include Social Security and Medicare Part A. For this reason, the deficit/Debt brake will result in more frequent and harder braking of discretionary spending. As expenditures for Social Security and Medicare crowd out discretionary spending, this will indirectly pressure Congress to enact reforms in these entitlement programs.

With effective rules constraining discretionary spending, it is much easier to make the case for entitlement reform. The long-range forecast by the Congressional Budget Office is that under current law, the growth in entitlement spending will significantly crowd out other expenditures in the federal budget (Congressional Budget Office, 2018). With the MP rule in place to constrain discretionary spending, the share of the budget allocated to these programs will decrease even more rapidly than under current law. It is inconceivable that Congress would accept the sharp cutback, and in some cases elimination, of other programs as entitlement spending absorbs larger shares of the budget. Our expectation is that just as in Switzerland, enacting the MP rule would set the stage for entitlement reform.
To illustrate how the MP rule impacts spending growth, we show how the rule would have applied in 1993. The underlying philosophy of the braking formulas is that when the national debt is close to or above the 60% of GDP tolerance threshold, some belt-tightening is in order. The fiscal circumstances are troublesome. How close is close enough to be in fiscal trouble? We chose 80% of the debt tolerance threshold as the threshold for proportionate fiscal braking to begin (0.8 \times 60\% = 48\%). The spending cap is equal to the sum of inflation plus population growth times a multiplier \((\text{Pop}+\text{Infl} ) \times \text{MULT}\). The spending cap is reduced by the debt brake proportionate to the distance from the 60% of GDP tolerance threshold. And depending upon the authorities’ preference for the time frame for getting out of fiscal trouble, they could choose a multiple \((\text{DEBTBRATE})\) of the basic braking rate described in this equation:

\[
((\text{Debt}/\text{GDP})/0.6) \times ((\text{Debt}/\text{GDP}) – 0.48)
\]

Behavior that will eventually yield fiscal trouble (large deficits), even if the national debt is still far from troublesome, also triggers belt-tightening. With the preferred deficit tolerance rate at 3% of GDP, and an 80% standard for close to fiscal trouble, deficits of 2.4% (80% of 3%) will trigger braking, as follows, again with the potential for the authorities to choose a multiple \((\text{DEFBRATE})\) of the basic braking rate described in this equation:

\[
((\text{Deficit}/\text{GDP})/0.03) \times ((\text{Deficit}/\text{GDP}) – 0.024)
\]

Total braking is the sum of debt- and deficit-based braking. So, for example, in 1993, the national debt stood at 65% of GDP, and the national debt rose by 5% of GDP. So, the debt was troublesome, and the federal government was spending itself into deeper trouble. For 1994 spending, with \(\text{DEBTBRATE}\) at its default value of 1.0, the debt-based braking rate (\(\text{DBBR}\)) is:

\[
\text{DBBR} = 1.0 \times ((0.65/0.6) \times (0.65 – 0.6)) = 0.0542
\]

And with \(\text{DEFBRATE}\) at its default value of 3.0, the deficit-based braking rate (\(\text{DefBBR}\)) would be:

\[
\text{DefBBR} = 3.0 \times ((0.05/0.03) \times (0.05 – 0.03)) = 0.1
\]

Total Breaking (\(\text{TB}\)) is:

\[
\text{TB} = \text{DBBR} + \text{DefBBR} = 0.1542
\]

The spending growth rate cap is:

\[
\text{SPCAP} = ((\text{Pop}+\text{Infl}) \times \text{MULT}) \times (1 – \text{TB}) \text{ or } 0, \text{ whichever is greater.}
\]

For 1994: \(\text{SPCAP} = (0.042 \times 1.25) \times (1 – 0.1542) = 0.044\) (a 4.4% spending growth cap)

**An Emergency Fund and Escape Clause**

The MP rules contain a new approach to emergency spending pressures (Merrifield and Poulson 2017). Define the basis for emergency spending, assume there will be some, and plan for it. For example, the basis would include approved spending categories and approval would entail a mix of congressional super-majority and executive order. The MP rules include annual deposits into an emergency fund until the account fills. The deposit amounts don’t count against the discretionary spending cap. An annual deposit rate of twenty percent of discretionary general fund spending, with an account balance limit of forty percent was enough to finance the military
emergencies, natural disasters, and financial crisis responses of 1994-2015. Such an emergency fund allows the government to meet those needs while maintaining stable growth in funding for ongoing programs. Extraordinary emergencies, such as declarations of war, and especially large natural disasters, are wholly exempt from the emergency fund limits or allow borrowing against future deposits.

The MP rules also allow for deficits in the emergency fund in periods of financial crisis and recession. However, like the Swiss debt brake, these deficits in the emergency fund must be offset by surpluses in the primary budget in the near term. Given the average duration of business cycles in the post-World War Two period, a three-year time limit should be adequate to restore positive balances in the emergency fund. A simulated recession over the forecast period provides evidence that these provisions for an emergency fund could stabilize expenditures during a mild recession, without undermining the effectiveness of the MP rules in achieving the debt targets in the long term (Merrifield and Poulson 2017).

The emergency fund rules could also allow for deficit spending (IMF 2017, 2018a). However, the budget must be balanced in the near term, with deficits offset by surplus revenue from the general fund. As in the Swiss case, deficits in the emergency fund must be balanced by surpluses within a fixed time frame, e.g. three years. The emergency fund is similar to the notional account used in Switzerland to achieve budget balance in the near term.

The rules constraining the emergency fund could be suspended in the case of a war (Blanchard et al 2010; Delong and Summers 2012). Upon declaration of war, and a supermajority vote of the legislature, the federal government could borrow and spend funds in excess of the emergency fund cap. But this escape clause could not apply in the absence of a declared war. The expenditures that are now labeled as emergency funds, including military expenditures, would become part of the discretionary spending subject to the constraints imposed by fiscal rules.

A Capital Investment Fund

We propose a version of the golden rule that would retain the integrity of the fiscal rule. Investment spending spurs economic growth, so some countries exempt it from spending caps, and also allow debt financing. But even with a clear formal definition of investment, an exemption creates a loophole we want to avoid. So, the MP rule creates regular saving to fund investment beyond what the ex-ante fiscal limits allow.

The capital investment fund proposed in Merrifield and Poulson (2017) is patterned after the Swiss model. The capital investment fund is designed to fund infrastructure investments. In periods when economic growth is above the long-term average rate of economic growth a portion of revenue is set aside in the capital investment fund. In periods of slower economic growth, money is transferred from the capital fund to help finance infrastructure investments. This method of allocating the capital funds based on the rate of economic growth assures a steady growth in infrastructure investment in the long run.

A deposit equal to one percent of spending occurs when the most recent one-year GDP growth is above the most recent ten-year average. That one percent is on top of the discretionary spending allowed by the spending growth cap at a multiple of population growth plus inflation. There is an investment fund account balance cap equal to five percent of annual discretionary spending.
Withdrawals occur when the most recent GDP growth is less than the ten-year average. How much less dictates the withdrawal amount.

The MP capital investment fund would only finance infrastructure. The benefits of countercyclical use of the investment fund arises from a more stable construction industry, and the counter-cyclical nature of investment bargains. Construction quality is down and price is up in the rapid growth phase of the business cycle. Uncertain Keynesian macroeconomic benefits of counter-cyclical infrastructure spending (Cogan et al. 2013A, 2013B) would be on top of that. Reduced private to public sector transfer of resources typically yields accelerated economic growth even without tax rate cuts. The MP rules address countercyclical government services demand growth with a higher spending cap equal to half the amount of revenue declines.

The money in the capital investment fund is allocated to major infrastructure projects, including the construction of highways, bridges, tunnels, air terminals, seaports, dams, etc. The rationale is that construction of these infrastructure projects is risky, and beyond the financial resources of individual states. Because major infrastructure projects have benefit spillovers to all citizens, individual states are unlikely to undertake these risky projects. Benefit cost analysis would be used to prioritize infrastructure projects; and approval of these infrastructure investments would be part of the budget process in which expenditure limits constrain spending.

The proposed capital investment fund would result in a more efficient allocation of infrastructure investment. Currently much of the federal expenditures for infrastructure investment is allocated through matching grants to the states, e.g. the Highway Trust Fund. Because the state match is a small fraction of the total investment, the states have an incentive to invest the money inefficiently in order to capture more federal dollars. The selection of infrastructure projects is biased by special interests at both the state and federal level. This mixture of state and federal funding means that there is less transparency and accountability for individual projects. The political business cycle literature also suggests that infrastructure investments are currently targeted to influence elections.

The capital investment fund could not incur a deficit. This approach to funding infrastructure investments would satisfy the pay as you go principle. The proposed capital investment fund would replace the Highway Trust fund and all the other special funds created to finance and subsidize infrastructure investments in the U.S. Since the capital investment fund could not incur a deficit, this reform would automatically eliminate major sources of deficit spending.

A Fiscal Responsibility Council

At present there is no agency empowered with enforcement of fiscal rules in the U.S. comparable to the fiscal responsibility councils in OECD countries. To be effective, a rules based budget process would require new institutions comparable to the fiscal responsibility councils (Merrifield and Poulson 2017).

The current controversy regarding long term forecasts by the OMB and the CBO underscores the need for new institutional arrangements to enforce fiscal rules. Neither agency is charged with
monitoring and reporting on fiscal rules. The CBO has provided analysis of the potential impact of proposed fiscal rules, such as the Ryan Roadmap; but that analysis is circumscribed by the assumptions dictated by legislators. It would be difficult, if not impossible, for the CBO to credibly provide transparency and accountability for the proposed new fiscal rules.

The reason why fiscal responsibility councils have been successful in other countries is their independent status in the budget process. Economist are appointed by the Executive for a fixed term in office, and are routinely approved by the Parliament.

Following this precedent an independent fiscal responsibility council could be created in the U.S. The analogy in the U.S. is the appointment of members of the Federal Reserve Board. The Federal Reserve Board is an autonomous agency, whereas the fiscal responsibility council would be an integral art of the budget process. Nonetheless, there is no reason why a fiscal responsibility council could not be created to provide transparency and accountability for a rules-based budget process in the U.S.

Closing the Fiscal Gap

The CBO in long term forecasts estimates the fiscal gap (Congressional Budget Office 2016a). The fiscal gap is the magnitude of expenditures reductions and/or revenue increases, required to stabilize the debt/GDP ratio to current levels (Auerbach 1997; Auerbach and Gale 2014). An alternative way to think about the fiscal gap is as the magnitude of savings the federal government must generate to achieve the desired debt/GDP ratio. In our research we use a dynamic simulation model to estimate the fiscal gap with the proposed fiscal rules in place. In 2018 we estimate the fiscal gap at about $800 billion per year. That is the amount of savings the federal government must generate each year for the next two decades to stabilize the debt/GDP ratio at current levels (Merrifield and Poulson 2018).

As a result of the recent tax reforms, and the 2019 budget resolution, closing the fiscal gap got a lot harder. The CBO revised long term forecasts to reflect the impact of this legislation. We estimated the fiscal gap to incorporate data from that long-term forecast. There is no question that closing the fiscal gap will be a much greater challenge in coming decades. In addition to imposing stringent expenditures limits, the federal government must enact reforms that can generate the requisite savings each year. This will require fundamental reforms to the major government programs driving deficits and debt, i.e. entitlement programs. It will also require heterodox fiscal policies, including federal asset sales and leasing, privatization, and devolution of programs from the federal government to state and local governments.

Entitlement Reform

Analysis of the fiscal gap and the magnitude of savings required to achieve debt/GDP targets makes it clear why entitlement reform must become part of the budget process. Only these mandatory spending programs have the potential to generate the requisite savings. The CBO estimates the potential for savings from reforms to Social Security and Health Care programs (Congressional Budget Office 2018; Meyerson 2014; Winfree, 2016).
The fiscal rules that we propose would require that all mandatory spending programs with the exception of those funded by the Social Security and Medicare Trust Funds, be subject to expenditures caps. Because Social Security and Medicare are funded from trust funds, they are subject to unique fiscal rules and must be treated separately. But this does not mean that these programs should be exempt from fiscal rules, or independent from the budget process.

The precedent for reforming social security as part of the budget process was set in Switzerland and other European countries. The Swiss rules require that any time the Social Security trust Fund falls below an actuarially sound level, the federal government must increase contributions to the Fund to meet that requirement. During the Transition period, fiscal rules in the U.S. could mandate similar contributions by the federal government to the Social Security and Medicare Trust Funds. The goal would be an actuarially sound level of funding in the Trust Funds within a two-decade transition period. That would give elected officials time to enact reforms to constrain the cost of these entitlement programs, while holding them accountable for the benefits promised to citizens.

As federal funding for Social Security and Medicare increase this will decrease funding available for other federal programs. As less funding is available for highways, education, military spending etc., elected officials will have an incentive to enact reforms to hold down the cost of the entitlement programs.

Elected officials would have an incentive to enact reforms increasing contribution rates and modifying benefits to the entitlement programs to keep them actuarially sound. Citizens paying the higher contribution rates would perceive the real cost of these programs, and would support reforms to hold down the cost of these programs.

Federal Asset Sales and Leasing, Privatization

In the current fiscal environment, generating the level of savings required for a sustainable fiscal policy may seem unattainable. However, if we expand the budget process to incorporate some heterodox fiscal policies the goals are attainable.

We propose the sale, leasing, and privatization of a broader range of federal asset that are now underutilized in the public sector. These assets include federal land, real estate, and mineral rights. To determine the potential for federal asset sales to reduce the national debt requires an inventory of federal assets, and several studies provide such estimates. The Federal Real Property Council estimated in 2006 the value of all federal land, buildings, and infrastructure at $1.3 trillion. One class of property not included in that estimate is the value of oil, natural gas, and coal on federal property. Shughart and Close (2017) estimate the value of these mineral deposits at $55.6 trillion.

Congress could pass a new Homestead Act, thereby selling federal land, real estate, and mineral rights (Merrifield and Poulson 2017; Anderson et al 1999). This Homestead Act could improve the nation’s finances in several ways. The revenue generated from the asset sales could be
earmarked for debt reduction. As assets are transferred into the private sector, profit-maximizing owners and entrepreneurs would bid for the resources, ensuring they will be allocated toward their most productive uses. The more efficient allocation of these resources would generate higher levels of income and tax revenues. While the proposed new Homestead Act could achieve multiple objectives, the primary objective would be debt reduction.

Clearly, federal asset sales could play an important role in reducing debt. However, selling federal assets in a discontinuous way could disrupt resource markets. But our proposed new Homestead Law would link such asset sales to debt reduction in the long term. Because federal assets could be sold over many decades, they could be sold at a rate that would not significantly distort resources markets.

The sale, leasing, and privatization of federal asset would strengthen finances at the state and local level. With land, energy resources, and other federal assets shifted to the private sector, the tax base for state and local governments would expand significantly. That would generate the tax revenues to at least partially offset the financial burdens on state and local governments resulting from these policies.

Privatization of public lands and mineral resources could be combined with devolution of programs from the federal government to state and local governments. The Public Land Initiative in Utah could serve as a model for preserving our public land heritage. Transferring land in our national parks, national monuments, and wildlife areas to the states is the best way to implement this model. With state management of these lands, state legislators are more likely to respond to the different interest groups impacted by these policies. The different stakeholders are more likely to participate in the process when they can hold their state legislators accountable.

An indirect effect of a new Homestead Act would be a restoration of the balance between the federal government, the states and the people envisioned in the 10th amendment to the constitution. Our state and local governments have learned to live with a balanced budget for several centuries; the proposed fiscal rules would force the federal government to learn to live with a balanced budget as well.

Chapter 4. Dynamic Simulation Analysis of the MP Rules

Introduction

Continuing to incur deficits and accumulate debt with current fiscal policies is not an option in the long run. As the CBO forecasts, these fiscal policies will eventually be accompanied by

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5 The analysis of the MP rules in this ‘Blueprint’ is based on the dynamic simulation model constructed in 2018. Some refinements were made to this model in 2019, so the results for simulating the current model differ somewhat from the results presented in this ‘Blueprint’. 
retardation and stagnation in economic growth. At some point a debt crisis would be inevitable, accompanied by a collapse in international financial markets.

In this study we explore how the Merrifield/Poulson rules can be used to solve the debt crisis. The design of the fiscal rules follows the precedent set in Switzerland and other OECD countries that are successfully using new fiscal rules to achieve a sustainable fiscal policy. Those countries have several decades of experience in reducing debt to sustainable levels.

When Switzerland enacted their fiscal rules, their debt levels were well below that in the U.S. today. For several decades the U.S. has incurred deficits and accumulated debt well above a sustainable level. It should not be surprising that the task of addressing the debt crisis in the U.S. is now more formidable than that facing the Swiss at the time they enacted their fiscal rules. The U.S. must enact more stringent fiscal rules than those enacted in Switzerland. Policy makers may be surprised at the magnitude of the task; like other heavily indebted countries, the U.S. faces constraints and has few options, requiring difficult choices.

At this point the U.S. is severely constrained in responding to external shocks and business cycles. It would be difficult for the country to pursue a countercyclical fiscal policy without triggering an explosive increase in debt similar to that during the recent financial crisis. Using debt to finance higher levels of spending, even when the funds are used to finance infrastructure investment would be counterproductive because of the negative impact of debt on private investment. Increasing taxes to offset higher levels of spending is also counterproductive because of the negative impact on economic growth.

**Toward a Sustainable Fiscal Policy**

**Deficits and Debt**

Much of the literature on the debt crisis in the U.S. focuses on closing the fiscal gap. Each year the CBO estimates the magnitude of savings required to stabilize the debt/GDP ratio at current levels. The rationale for this approach is clear, if we are to solve the debt crisis we must begin to reduce and eliminate deficits.

Graph 4.A Simulating Debt and Deficits with New Fiscal Rules
In the above graph we compare the debt and deficit levels in the CBO long term forecast, with the debt deficit levels projected with the new fiscal rules in place. The CBO forecasts that with current fiscal rules, over the next two decades debt will increase to $74 trillion, more than 150% of GDP.

The MP rule is designed to close the fiscal gap and stabilize the debt/GDP ratio. With the MP rule in place over this period, debt is projected to increase to $48 trillion, roughly equal to GDP. With the MP rule the government can close the fiscal gap. But this would be a pyrrhic victory, because it would leave the country with an unsustainable level of debt.
As the CBO has forecast, under current law deficits are projected to grow continuously over the forecast period, to $4.2 trillion, 9% of GDP by 2040. It is inconceivable that deficits would reach this level on a long-term basis. During the recent financial crisis deficits exceeded 10% of GDP. But, as the CBO concludes, incurring deficits of this magnitude in the long term would result in economic stagnation and financial crisis.

What is perhaps even more surprising, is the long-term forecast with the MP rule in place. The simulation analysis reveals that with the MP rule deficits would continue to be incurred over the forecast period, but at a much lower rate than under current law. By the end of the period the nation incurs deficits equal to about $500 billion, 1% of GDP. This outcome would surely disappoint many folks; after two decades imposing stringent fiscal rules the nation still could not balance the budget.

In this study we estimate the magnitude of savings required for a sustainable fiscal policy. To reduce debt below 60% of GDP the government must generate additional savings. We will explore the potential sources for such savings, but it is important to understand why the additional savings is required for a sustainable fiscal policy.

In the following graph we project the MP rules over the next two decades including the additional savings required to reduce the debt/GDP ratio below 60%. We refer to this as the MP rules on steroids. The U.S. must save about $800 billion per year for the next two decades to reach that goal. With the MP rules on steroids, by the end of the forecast period debt is projected to increase to $25 trillion, equal to about 50% of GDP.

Reducing and eliminating deficits is the first important step toward a sustainable fiscal policy. The simulation analysis reveals just how difficult that will be. The simulation analysis reveals that with the MP rules on steroids the nation could balance the budget. As the graph shows, in the final years of the forecast period the budget is balanced, and by the end of the period the nation generates a surplus of roughly $400 billion.

With the MP rules on steroids, deficits are eliminated and the budget is balanced over the next two decades. By the end of the period surplus revenue is generated to help pay down the debt, and nominal debt is falling. By reducing the debt burden in this way the U.S. not only closes the fiscal gap, but also achieves a sustainable fiscal policy.

Switzerland and other countries have demonstrated the benefits of using fiscal rules to achieve a sustainable debt level. The Swiss now have a cyclically balanced budget, with deficit spending in periods of recession offset by surplus revenue in periods of rapid growth. With a cyclically balanced budget the Swiss were able to pursue a countercyclical fiscal policy during the recent financial crisis without triggering an increase in debt in the long run.

Once debt levels are reduced to a sustainable level, the U.S. could also pursue a cyclically balanced budget. With the MP rules on steroids the U.S. would have the fiscal space to respond to external shocks and business cycles. The government could pursue fiscal policies to stabilize the economy over the business cycle without triggering unsustainable deficits and debt. The country could also have the fiscal space to invest in infrastructure to promote economic growth.
With the MP rules on steroids the U.S. could meet the demand for government services in the long run. Reforming entitlement programs will be essential in generating the savings required for a sustainable fiscal policy. Even with entitlement reform, however, the nation will be challenged to meet the demand for pension and health benefits demanded by an aging population.

Just as it has taken many years to create the debt crisis, it will take many years of fundamental fiscal reform to solve the crisis. Simply closing the fiscal gap is not enough. The nation must now combine stringent fiscal rules with significant savings each year for the next two decades, to balance the budget and achieve a sustainable fiscal policy.

**Outlays**

The measures of spending in this simulation analysis are based on CBO long term forecast data. The CBO forecasts general fund spending less interest. That measure of spending is used in Congressional budget negotiations. It is important in the present analysis because that is the base against which the spending limit is applied.

The measure of spending that is most relevant in determining deficit and debt levels is total outlays. Total outlays include general fund spending, plus Social Security, Medicare, and interest. When total outlays increase deficits and debt in excess of tolerance levels, the deficit/debt brake is triggered. At that point more stringent limits are imposed on general fund spending less interest.

As shown in the following graph, the CBO projects that under current law, general fund spending less interest will grow to $5.1 trillion, about 11% of GDP by the end of the forecast period. With the MP rule in place, general fund spending would be frozen at $2.2 trillion. By the end of the period with the MP rule general fund spending as a share of GDP is 5%.

The CBO projects that total outlays will increase to $12.9 trillion, 27% of GDP by the end of the period. With the MP rule in place total outlays are projected to reach $10.0 trillion, 21% of GDP, by the end of the period. It is important to note that Social Security and Medicare spending are not constrained by the spending limit.

**Graph 4.B Simulating Federal Spending with New Fiscal Rules**
With the MP rule on steroids in place general fund spending less interest is projected to increase to $3.0 trillion, 6% of GDP by the end of the period. Total outlays are projected to increase to $10.2 trillion. With the MP rule on steroids the government generates about $800 billion in savings per year.

Revenues
The measure of revenue used in this analysis is general fund tax revenue. As shown in the following graph, the CBO projects that general fund tax revenue will increase to $6.4 trillion, 13% of GDP over the period. With the MP rule in place, general fund tax revenue is projected to increase to $6.5 trillion.
With the MP rule on steroids general fund tax revenue is projected to increase to $6.8 trillion. The higher rate of growth of general fund tax revenue with these fiscal rules in place reflects the higher rate of GDP growth.

Social Security and Medicare.
The CBO long term forecast shows social security and Medicare expenditures growing more rapidly than other federal spending over the forecast period. The following graph shows the CBO forecast that under current rules expenditures for social security and Medicare will increase to $5.6 trillion, almost 12% of GDP by the end of the period. Under current law Social security and Medicare revenues are projected to grow from $1.1 trillion to $2.9 trillion. It is this growing gap between Social Security and Medicare expenditures and revenues that is the major source of deficits and debt.
With the MP rule in place, Social Security and Medicare revenues are projected to increase to $2.9 trillion, 6% of GDP by the end of the period. With the MP rule on steroids, Social Security and Medicare revenues are projected to increase to $3.0 trillion. The more rapid increase in Social Security and Medicare revenues with the fiscal rules in place reflects the more rapid growth in GDP. Note that even with the fiscal rules in place there is a wide and growing gap between Social Security and Medicare revenues and expenditures. The imperative to enact reforms to lower the cost of Social Security and Medicare and close this gap is clear in this analysis.

Output and Employment

With the proposed fiscal rules in place output and employment grow at a faster pace than under current law. The fiscal rules constrain the growth of the public sector, and the shift of resources from the public to the private sector boosts output and employment.
The CBO long term forecast projects slower growth in output over the next two decades, compared to the long run historical rate of growth. Real GDP is projected to grow about 3% per year through 2019, and then fall to 1.9 percent over the forecast period. That is a substantial drop from the historical average growth rate of approximately 3 percent per year.

Graph 4.E Simulating Gross Domestic Product with New Fiscal Rules

As shown in the above graph The CBO projects that by the end of the period nominal GDP will grow to $47.6 trillion. With the MP rules in place nominal GDP is projected to grow to $48.2 trillion by the end of the period. With the MP rule on steroids nominal GDP is projected to grow to $49.3 trillion.

The higher growth rates with fiscal rules in place would be accompanied by a significant increase in employment. By the end of the period total employment is boosted 3.4 million jobs with the MP rule. and 9.4 million jobs with the MP on steroids rule.
The simulation analysis reveals how difficult it will be for the U.S. to achieve a sustainable fiscal policy at this point in time. After incurring deficits and accumulating debt for half a century, this should not be surprising. While other countries have imposed effective fiscal rules to reduce and eliminate deficit spending, the U.S. continues to pursue an unsustainable fiscal policy. Just as it has taken a long time to create the debt crisis, it will take a long time to reduce deficits and debt to sustainable levels.

It will not be enough to close the fiscal gap at current debt levels. To achieve a sustainable level of debt the U.S. must impose stringent fiscal rules and also generate surplus revenue to pay down debt over the next two decades. As the simulation analysis reveals, the U.S. has few options and faces difficult choices.

The MP rules impose a stringent limit on general fund spending. When total outlays result in deficits and/or debt in excess of tolerance levels, this triggers an even more stringent limit on general fund spending. With the MP rule on steroids, there is more flexibility in growing general fund spending. However, even with the MP rule on steroids, general fund spending at the end of two decades would be about half that projected in the CBO long term forecast.

The MP rule that we propose is more stringent than the fiscal rules imposed in other OECD countries. With this rule in place the U.S. could close the fiscal gap and stabilize the debt/GDP ratio. But, closing the fiscal gap at current debt levels is not sufficient to achieve a sustainable debt level. The U.S. must, in addition, generate significant savings to pay down debt over the next two decades. The simulation analysis reveals how the combination of stringent fiscal rules and additional savings, MP rule on steroids, could accomplish this goal.

With the MP rule on steroids, the government must generate $800 billion in savings each year to pay down the debt. One of the most difficult choices the U.S. must make will be reform of the entitlement programs, Social Security and Medicare. We have followed the precedent set in Switzerland in not imposing spending caps on Social Security and Medicare. The rationale is that separate fiscal rules must be imposed on these entitlement programs because of the unique rules governing the trust funds used to finance these programs. The simulation result with these assumptions are similar to the CBO long term forecast. Under current law larger shares of the federal budget would be allocated to Social Security, Medicare, and interest on the debt, while funding for virtually every other federal program would have to be reduced or eliminated. It is inconceivable that citizens would allow these entitlement programs to continue to grow at a rapid pace, while virtually all other federal programs are reduced in size or eliminated. The imperative to reform entitlement programs is clear today, and will become more urgent over the next two decades.

Critics of this rules base approach to fiscal policy will argue that this is an impossible task. Given the failure to enact reforms in Social Security and Medicare for several decades, critics will argue that it is unreasonable to expect the government to enact fundamental reforms in entitlement program proposed in this study. But Switzerland and other countries have
demonstrated that with effective fiscal rules in place to constrain other spending, it is easier to make the case and convince citizens of the need for entitlement reform.

To generate the savings now required for a sustainable fiscal policy the federal government must enact other heterodox fiscal policies. A major source of that savings could be the privatization and sale of assets in the public domain, with revenue earmarked for debt reduction. For example, the value of mineral resources now in the public domain is estimated at fifty-five trillion dollars. We should expect that the privatization of fifty-five trillion dollars of in energy resources would be accompanied by a revolution of innovation and technological change in the energy industries. Higher rates of economic growth will be essential in bringing the debt-to-GDP ratio down to tolerable levels.

We propose a new Homestead Act, transferring land and other resources from the public domain to the private sector. Shifting resources from the public sector to the private sector would result in a more efficient allocation of resources.

The new Homestead Act would also transfer land in the public domain to the states, and devolve federal programs to the state and local level. This would strengthen finances at the state and local level. With land and energy resources shifted to the private sector, the tax base for state and local governments would expand significantly. That would generate the tax revenues to at least partially offset the financial burden resulting from devolution of federal programs to state and local governments.

We should expect this expanded role for state and local governments to result in greater efficiency in the provision of government services. The precedent for this productivity advance was the modest devolution of federal programs during the Reagan Administration. With block grants replacing direct federal funding, state and local governments responded with reforms to deliver government services at lower cost.

Those opposed to this rules-based approach to fiscal policy offer no viable alternatives to achieve a sustainable fiscal policy. Higher growth rates alone cannot reduce debt to a sustainable level. Offsetting deficit with higher taxes would trigger retardation and stagnation in economic growth. We cannot escape the difficult choices explored in this analysis, including heterodox fiscal reforms.

**Conclusion**

In a recent op-ed Martin Feldstein posed the question ‘is another recession looming’. Feldstein’s conclusion was not only that a recession is inevitable, but that there is nothing that the U.S. can do to prevent it, referring to the ineffectiveness of monetary policy.

In a recent speech, Ben Bernanke predicted that Wile E. Coyote would go off the cliff in 2020. He was referring to the return of trillion-dollar deficits that will undermine monetary policies. Whether we expect a debt crisis in 2020 or some future year, the outcome would be a disaster for other countries as well as the U.S. The debt crisis in Greece and Argentina suggests how a debt crisis unfolds in a highly indebted country.
Such gloomy forecasts are now ubiquitous, lending credence to the view that economics is the dismal science. To test this hypothesis, we simulated a mild recession over the forecast period. We found that with our proposed fiscal rules in place the government is able to pursue a countercyclical fiscal policy. The fiscal rules provide for disbursement of emergency funds to offset revenue shortfalls. These funds can be used to finance the increased spending required for automatic stabilizers such as unemployment insurance and other transfer payments. Funds are also disbursed from the capital fund when GDP growth is below long-term average growth. With the fiscal rules in place discretionary spending is stabilized and countercyclical expenditures sustain the level of spending in a mild recession.

A mild recession makes it more difficult to reach the long-term goal of a sustainable fiscal policy. This would increase the magnitude of savings required each year to reach that goal. But simulation analysis underscores the importance of linking countercyclical fiscal policy to fiscal rules. With the proposed fiscal rules in place the U.S. would have the fiscal room to pursue countercyclical fiscal policy.

The precedent for this combination of countercyclical fiscal policy and fiscal rules was set by Switzerland. Switzerland pursued a countercyclical fiscal policy during the recent financial crisis without increasing the debt/GDP ratio. For decades Switzerland has pursued a cyclically balanced budget, with deficits in periods of recession offset by surplus revenue in periods of growth. Economists often argue that fiscal rules tie the hands of elected officials and preclude them from responding to business cycles. Switzerland’s experience refutes that argument. Effective fiscal rules enabled Switzerland to pursue a countercyclical fiscal policy.

Because the U.S. is now a major debtor country it has less room to pursue a countercyclical fiscal policy. But the proposed fiscal rules would allow the U.S. to pursue countercyclical policies in response to a mild recession. The rules would not allow the U.S. to pursue discretionary fiscal policies as it did prior to and during the recent financial crisis. Incurring deficits and debt of that magnitude would result in a financial crisis accompanied by retardation and stagnation in economic growth, as the CBO predicts in their long-term forecast under current law.

The simulation of our proposed fiscal rules allows us to turn the Feldstein and Bernanke argument on its head. The U.S. will likely experience a recession and financial crisis if elected officials don’t act. If they fail to enact effective fiscal rules required for a sustainable fiscal policy, their gloomy predictions are inevitable. It is not that we don’t have effective fiscal rules available, it is that elected officials refuse to make the difficult choices that would be required by the rules.

We should not allow Wile E. Coyote to go off the cliff. We do not have to wait for credit markets to signal an unfolding debt crisis in the U.S. By enacting new fiscal rules, such as the Merrifield/Poulson rules we propose, we can prevent a financial crisis, and put the country on the path toward a sustainable fiscal policy.
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