Fiscal Discipline In The Federal System: National Reform And The Experience Of The States

Advisory Commission on Intergovernmental Relations
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Preface

The fiscal behavior of the federal government has been a long-standing concern of the Advisory Commission on Intergovernmental Relations (ACIR). In previous decades, when the federal government appeared to be flush with funds while state and local governments faced fiscal demands that seemed to exceed their capacities, the Commission focused considerable attention on the federal grant-in-aid system. Generally, the Commission supported that system of intergovernmental fiscal sharing, though not necessarily the proliferation of programs within the system.

Yet lurking behind the growth in federal expenditures, of which aid to state and local governments was only one part—a small part—was the specter of regular deficit spending. No longer regarded as an occasional policy-making expedient to combat economic downturns, deficit spending became an institutionalized feature of federal budgeting. Neither economic growth nor deliberate public policy was able to prevent the total debt of the federal government from growing to an enormous size, one that poses serious problems for the nation's economy, state and local finances, and intergovernmental fiscal sharing. Since 1982, annual net interest payments on the national debt alone have exceeded federal aid payments to state and local governments. Consequently, federal deficits, rather than the intrinsic merits of particular intergovernmental arrangements, have come to occupy a greater prominence in discussions of fiscal federalism. Efforts to reform federalism and restore balance in the federal system are mired in deficit controversies.

In June 1985, ACIR directed its staff to conduct a study of "fiscal discipline" in the federal system. In particular, the Commission instructed the staff to examine a potentially relevant and important body of evidence which has been largely neglected in discussions of federal deficit spending, namely, the record of the states and the possible relevance of that record for the federal government. Some states have had constitutional and/or statutory mechanisms of fiscal discipline for more than a century. The experience of the states provides one basis for evaluating the effectiveness of such devices as constitutional requirements for a balanced budget, executive line-item veto authority, spending and taxing limits, and capital budgeting, and for assessing the possible consequences of including such devices in the "fiscal constitution" of the federal government.

Chapter I of this report provides historical and general information about federal deficit spending, along with different perspectives on the nature and consequences of deficit spending. *Chapter II* examines the leading current reform actions and proposals regarding deficit spending by the federal government. *Chapter III* presents an empirical analysis of the effects of several fiscal-discipline mechanisms on taxes and spending in the nation's 50 states. The conclusion of the analysis is that, by-and-large, the presence of fiscal discipline mechanisms in the states is associated with lower spending, and with lower deficits or higher surpluses. Other factors are important too, but constitutional and statutory provisions governing fiscal behavior on the part of state governments do appear to be one important factor in promoting fiscal discipline.

Although the Commission does not believe that these state mechanisms can, in every instance, be simply replicated by the federal government, the Commission does believe that they deserve serious consideration by the Congress and the President. With appropriate adjustments for the special circumstances that confront the national government, these mechanisms should encourage the Congress and the President to achieve and maintain balanced budgets.

Robert B. Hawkins, Jr.
Chairman

Acknowledgments

This report was prepared primarily by Gary M. Anderson. Significant assistance was provided by John Kincaid and Ronald J. Oakerson. Special thanks go to Lawrence A. Hunter for helpful suggestions and criticisms. In addition, the Commission gratefully acknowledges the valuable ideas and commentary provided during the research process by Carolyn D. Lynch, Mark D. Menchik, and Max B. Sawicky of the ACIR staff, as well as James Bennett, James M. Buchanan, Randy H. Hamilton, Dolores T. Martin, William Niskanen, Joseph Pechman, Robert D. Reischauer, Allen Schick, William Craig Stubblebine, and Aaron Wildavsky. Full responsibility for the content and accuracy of this report rests, of course, with the Commission and its staff.

John Shannon
Executive Director

Contents

Recommendations 1

Recommendation 1 **Statutory and Constitutional Approaches to Deficit Reduction** 1

Recommendation 2 **Procedural Approaches to Deficit Reduction** 1

Recommendation 3 **Presidential Line-item Veto** 2

Summary of Principal Findings 3

1. Deficit Spending, While Reaching Major Economic Peacetime Proportions Only in Recent Years, Has Been a Regular Feature of Federal Fiscal Policy for the Past 56 Years. For this Reason, Limits on Deficit Spending May Not Be Easy to Institute Without Determined Reform. 3
2. State Experiences with Fiscal Restraint Mechanisms Indicate that Constitutional Restraint Can Be an Effective Instrument of Fiscal Discipline. 3
3. The National Government Can Draw upon the Aggregate Experience of The States as It Considers the Potential for Redrawing the Boundaries of Its Own Fiscal Behavior. 3
4. The National Debt Is Not a Problem that Affects the Federal Government Alone. It Is a Problem that also Affects the American Federal System, One that the Federal System Is Constitutionally Equipped to Address. 4

Introduction 5

Chapter I **Fiscal Discipline In The Federal Government** 9

A. The Current Controversy 9

B. Historical Background 11

C. Are Deficits Systemic or Aberrational? 14

D. Current Perspectives on the Nature of Deficit Spending 16

E. Other Possible Factors in the Emergence of Large Deficits 19
F. The Current Political Context of the Deficit Dilemma 20

Chapter II **Reform Actions And Proposals** 23
A. Gramm-Rudman-Hollings and Balanced Budgets 23
B. Spending and/or Revenue Limitations Proposed in Congress 25
C. Line-Item Veto Authority for the President 25
D. Capital Budgeting and Reform of the Federal Budgetary Process 26
E. Other Possible Kinds of Budgetary Reform 29
F. Proposals for Constitutional Reform 31

Chapter III **Research Findings: Fiscal Discipline Mechanisms In The States** 37
A. The Range of State Fiscal Discipline Mechanisms 37
B. Do Fiscal Discipline Mechanisms Work? 39
C. Summary of Empirical Research Findings 45
D. Is the Record of the States Relevant to the National Debate? 46

Technical Appendix 49
1. A General Note on the Empirical Results 49
2. The Effect of Balanced Budget Requirements on State Deficits 51
3. The Effect of Balanced Budget Requirements on State Spending 52
4. The Effect of Constitutional Restrictions on State Debt 53
5. The Effect of Balanced Budget Requirements on State Tax Revenue 55
6. Conclusion 56

Figures and Tables

Figure 1 **Federal Government Totals as Percentages of GNP** 10
Figure 2 **Net Federal Debt** 12
Figure 3 **Percentage Composition of Federal Government Outlays** 13
Figure 4 **Federal Government Outlays as Percentages of GNP** 15

Table 1 **The Federal Debt, 1890-85** 14
Table 2 **State Fiscal Discipline Management Tools Presently Under Study** 38
Table 3 **Balanced Budget Requirements, 1984** 40
Table 4 **The Effect Of Balanced Budget Requirements On State Deficits** 42
Table 5 **The Effect Of Balanced Budget Requirements On State Spending** 42
Table 6 **The Effect Of Constitutional Restrictions On State Debt** 43
Table 7 **The Effect Of Constitutional Restrictions On State Debt By Type** 44
Table 8 **The Effect Of Balanced Budget Requirements On State Taxing** 44
Table 4A **The Effect Of Balanced Budget Requirements On State Deficits** 52
Table 5A **The Effect Of Balanced Requirements On State Spending** 53
Table 6A **The Effect Of Constitutional Restrictions On State Debt** 54
Table 7A **The Effect Of Constitutional Restrictions On State Debt By Type** 55
Table 8A **The Effect Of Balanced Budget Requirements On State Taxing** 56

Recommendations

Recommendation 1:

Statutory and Constitutional Approaches to Deficit Reduction

The Commission finds that a fundamental imbalance exists in the federal budget process. For more than half a century, forces that favor spending have ordinarily prevailed over forces that favor fiscal restraint. The Commission also finds, however, that the states have long had a good record of fiscal discipline, in large part because of constitutionally and statutorily imposed limits on legislative and executive behavior, such as balanced budget requirements, constitutional debt limitations, and tax-and-expenditure limitations. States that use such instruments tend to have lower deficits or larger surpluses, and also tend to have lower levels of state government spending. The Commission believes that the experience of the states is relevant to the fiscal problems of the federal government.

The Commission recommends,* therefore, that the Congress and the President continue to develop and refine statutory controls over deficit spending for the purposes of eliminating such spending, except in cases of clear national emergency, and of reducing the nation's total debt to a level consistent with sound principles of political economy and responsibility. The Commission also endorses the principle of a constitutional limitation on fiscal behavior, and thus urges the Congress to consider proposing a balanced budget amendment to the United States Constitution so as to ensure a level of fiscal discipline comparable to that found in the states.

Recommendation 2

Procedural Approaches to Deficit Reduction

Capital Budget, Unified Budget, Biennial Budget, Rules or Germaneness, and Combined Balanced Budget Requirements and Tax and Spending Limits

The Commission finds that the states have had degrees of success in promoting fiscal discipline by employing such mechanisms as biennial budgets, capital budgets,

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*Mayor William H. Hudnut, III, dissents from *Recommendation 1.*

rules of germaneness with regard to all bills, and taxing and spending limits. The concept of a unified budget also appears to hold promise as a potential reform for both the states and the federal government.

The Commission recommends, therefore, that the Congress and the President consider the above mechanisms as potential means for achieving greater budgetary efficiency and greater fiscal discipline in the federal government.

Recommendation 3

Presidential Line-item Veto

The Commission finds that the President lacks a crucial power commonly exercised by state governors—the power to veto legislative appropriations line-by-line. The experience of the states suggests that this executive authority is an important element of fiscal discipline. The Commission believes, moreover, that the introduction of comprehensive budgeting procedures in the Congress makes line-item veto authority on the part of the President necessary in order to maintain an effective executive check on legislative power in accord with the basic constitutional design of the national government.

The Commission recommends, therefore, that the President be provided with the power to exercise a line-item veto of appropriations voted by the Congress, subject to an appropriate override for the Congress.

These recommendations were adopted by the Commission at its regular meeting of June 5, 1987, in San Francisco, CA.

Summary Of Principal Findings

1. Deficit Spending, While Reaching Major Economic Peacetime Proportions Only in Recent Years, Has Been a Regular Feature of Federal Fiscal Policy for the Past 56 Years. For this Reason, Limits on Deficit Spending May Not Be Easy to Institute Without Determined Reform.

From 1789 to 1930, the federal government ran a deficit in only 46 years (or 32 percent of the total 142 years). Since 1931, however, the federal government has run a deficit in 50 of the past 56 years (or 89 percent of those years). Generally, the total federal debt has also grown steadily over the past 56 years, although until recently, the growth of the debt was ordinarily out-paced by economic growth. Since 1981, however, the federal debt has grown steadily as a percentage of GNP (33.6 percent in 1981 to 53.7 percent in 1987). Substantial economic consequences of this growth in debt may lie still further in the future.

This long-term practice of regular deficit spending suggests that there may be underlying patterns of government behavior that militate against fiscal restraint. These developments warrant the concern of both national and state officials who jointly bear responsibility for maintaining the American Constitutional system.

2. State Experiences with Fiscal Restraint Mechanisms Indicate that Constitutional Restraint Can Be an Effective Instrument of Fiscal Discipline.

The ACIR study of fiscal discipline among the 50 states provides significant evidence that constitutional rules, including those requiring that expenditures and revenues be in balance, can be effective instruments for influencing fiscal behavior. States that use such instruments tend to have lower deficits or larger surpluses, and also tend to have lower levels of state government spending.

3. The National Government Can Draw upon the Aggregate Experience of The States as It Considers the Potential for Redrawing the Boundaries of Its Own Fiscal Behavior.

Similarities between the states and the national government argue for the general relevance of state experiences to the national deficit problem. Important differences between the states and the national government, especially differences in responsibility, argue more for modifications in the design of national fiscal

discipline mechanisms, than for their irrelevance. Proposals currently before the Congress accommodate these differences in responsibility by providing for various emergency provisions in the event of war or serious national recession. At the same time, however, the experience of the states is sufficiently varied that a range of possible fiscal restrictions—of varying stringency—are available for possible consideration in the course of national reform.

4. The National Debt Is Not a Problem that Affects the Federal Government Alone. It Is a Problem that also Affects the American Federal System, One that the Federal System Is Constitutionally Equipped to Address.

State efforts to petition the Congress to call a constitutional convention reflect a high level of concern about the national debt and deficit spending. The concern of the states, as representatives of the American people charged with Constitutional responsibilities, is both legitimate and predictable. Consequently, the spirit of federal partnership, of sharing in responsibilities and hard decisions, may be jeopardized if the Congress and the President do not address these problems in a determined manner, as the states have done repeatedly for more than a century.

Introduction

This study (1) provides background information on federal deficit spending, (2) measures the effects of state constitutional, statutory and other procedural mechanisms designed to "discipline" the taxing and spending behavior of state governments, and (3) seeks to determine whether the findings of this research can be applied to the question of fiscal discipline in the federal government. The study is motivated in part by the fact that 32 state legislatures have petitioned the Congress to call a constitutional convention to consider a balanced budget amendment to the U.S. Constitution.

The apparent need to exercise greater discipline is dramatically illustrated by the following developments:

- in 27 of the past 28 years, federal policy makers have spent more than they collected in revenues.
- in the past six years, annual deficits have exceeded $100 billion for the first time in American history, and the national government's debt has more than doubled, and now is approaching $2 *trillion*.
- in 1964, the interest paid annually by the federal government on the national debt was $57 per capita, in constant (1972) dollars. In 1987 this amount had risen to $198, in constant dollars—an increase of about *250 percent*.

The question of fiscal discipline is complex, however, and there appear to be no simple answers. The goal here is to shed light on the context of the problem and provide some limited evidence concerning possible reforms that could be adopted by the federal government based on state experiences with various mechanisms designed to maintain a balance between revenues and expenditures and to limit debt. Although empirical research suggests that state fiscal discipline mechanisms are effective, it should be noted that the appropriateness of fiscal discipline mechanisms for the federal government does not depend entirely on the question of the effectiveness of state mechanisms. A more pertinent point is that the very existence of such mechanisms in the states reflects a widespread public desire for "responsible" fiscal behavior and for constitutional and/or statutory mechanisms that can promote such behavior.

Fiscal discipline on the part of the national government is important to the well-being of the federal system in several respects. For one, all of the states have various formal mechanisms, constitutional and/or statutory, which are designed to restrain public expenditures, manage public debt, and keep current revenues and expenditures roughly in line with each other. The U.S. government is the only government in the American system that lacks equivalent discipline mechanisms.

It is particularly significant that balanced budget requirements are written into the constitutions of 44 states. Since state constitutions and constitutional amendments ordinarily require voter approval, the prevalence of these balanced budget mandates suggests that there is wide voter support for such discipline in government, and that voters in many states regard such discipline as being important enough to enshrine in their state constitution. In most cases, these requirements were added to state constitutions when voters came to believe that public officials would not discipline their own taxing and spending behavior. The absence of equivalent federal mechanisms, therefore, seems to contradict public preferences for such

devices where officials do not discipline themselves. Normal congressional and Presidential electoral processes may not give voters an opportunity to express their preferences on this matter. Congressional approval of a constitutional amendment would give voters, through their state legislatures, a clear opportunity to decide whether they wish to constitutionalize fiscal discipline in the federal government.

The absence of equivalent federal mechanisms has certain advantages and disadvantages for state and local governments. Deficit spending allows the national government to influence the U.S. economy in ways that presumably benefit most state and local economies. Deficit spending also allows the national government to provide states and localities with numerous grants-in-aid, entitlement payments, defense contracts, services, and the like.

In effect, though, federal deficit spending has also been a kind of fiscal escape valve for the states, a way for state officials to circumvent their fiscal restraint mechanisms by shifting certain costs to the national government. If it is the case that voters would prefer more fiscal discipline, then federal deficit spending is a way for federal, state, and local officials to circumvent voter preferences. Limits on federal spending, or on levels of federal deficit spending, would close this escape valve and place greater fiscal pressure not only on federal officials but also on state and local officials. Wherever the federal government reduced expenditures, state and local governments would have to decide whether to increase expenditures, debt limits, and/or taxes to compensate for the reductions. Alternatively, wherever the federal government elected to raise taxes in order to stay within debt limits, state and local governments would have to decide whether to raise or lower taxes and alter expenditures and debt limits in response to increased competition for tax dollars.

One could argue that the federal system needs a fiscal plug in order to promote greater fiscal responsibility and accountability on the part of federal officials as well as state and local officials. The absence of such a plug—whether it be a balanced budget amendment to the U.S. Constitution or various statutory restraints—is a temptation for state and local officials to shift costs and responsibilities to the federal government, and a temptation for federal officials to transfer costs to future generations. However, a strong plug could create a kind of pressure cooker decision-making environment for federal, state, and local officials. For federal officials, such pressure would be especially great during periods of national crisis. While a plug might compel public officials to establish priorities and define public interests more carefully, the temptation to raise taxes in order to stay within debt limits could place tremendous pressure on the nation's tax base, thereby intensifying conflict, both intergovernmental and intragovernmental. Conflict might take the form of healthy competition between jurisdictions that could lead to improved public services at lower costs to taxpayers, or to simple turf battles that could reduce coordination among governments and produce waste. Reduced debt, however, would free up tax revenues now dedicated to interest payments and lower the level of competition faced by state and local governments as well as the private sector in investment markets.

A fiscal plug in the federal system could compel state and local governments to (1) assume more fiscal responsibility for public policies, (2) reduce or eliminate certain programs, and/or (3) find more cost effective ways of implementing policies. In the process, there might be a need to change the way we often understand and evaluate public policy. The tendency to measure policy commitments in terms of dollar inputs would have to be counterbalanced by an improved ability to measure policy commitments by better outcome criteria. In other words, how can we get more bang for the buck? Some programs generate large, but diffuse benefits over time; other programs lead to large, but diffuse costs. In both cases, prediction and measurement of the long-term effects can be complex and problematic. Evaluation of the true costs and benefits to society, over the long run, of working within fiscal restraints may, therefore, require more complex measures of actual policy outcomes than is ordinarily employed in policy analysis.

In the meantime, the absence of a satisfactory resolution of the issue of federal deficit spending has already created problems for the federal system, particularly state and local governments. The specter of huge deficits has virtually driven fiscal federalism in recent years, often diverting attention away from the substantive merits of intergovernmental programs and policies. State and local governments seeking cooperation from the federal government find themselves operating in an environment of fiscal uncertainty and conflict over the rules of the fiscal game.

Another consequence for states and local governments is the pressure of increasing federal debt on interest rates. Even if we assume that the net impact of federal borrowing on market interest rates is relatively small, so long as the federal deficit is measured in the hundreds of billions of dollars, state and local taxpayers will almost certainly find that many additional billions of their tax dollars will go to pay for the cost of public borrowing than would otherwise be the case. Naturally, every dollar spent on higher interest rates

by state and local governments is a dollar unavailable for other kinds of public spending or for taxpayer relief.

In short, greater fiscal discipline in the national government would have reverberating effects throughout the federal system. Some of the resulting changes would be welcomed and others unwelcomed by state and local officials. Most observers would agree that the policy and practice of the national government with respect to deficits and the national debt affects the fiscal environment facing the states and local governments in important ways. Therefore, improving fiscal discipline in the federal budget is a "federalism" issue, because of the many potentially significant ramifications for the different governmental elements of the American federal system.

Chapter I

Fiscal Discipline In The Federal Government

"Fiscal discipline" refers in general to "responsible" taxing and spending behavior by government—that which expresses the true preferences of voters. For the purposes this study, we define "fiscal discipline" to mean institutional controls that establish limits on political decisions pertaining to budgetary matters. Such limits are intended to protect voters from governmental fiscal behavior they would regard as irresponsible and to increase levels of citizen participation (however indirectly) in fiscal decision making.

In recent years, there has been increasing interest in and debate about one kind of "fiscal discipline": institutional restraint on the use of deficit finance. There are three basic reasons why such restraint might be advocated: (1) the belief that budget deficits are inherently bad (either because of the economic costs to present and future generations or simply on the moral grounds that governments should operate in a fiscally "responsible" manner), (2) the belief that while moderate levels of deficit spending are acceptable, consistently high levels of deficit spending, such as those experienced in recent years, are unacceptable, and (3) the belief that deficit spending is a vehicle for excessive growth in government spending and, as a result, excessive growth in the size of government, particularly the federal government.

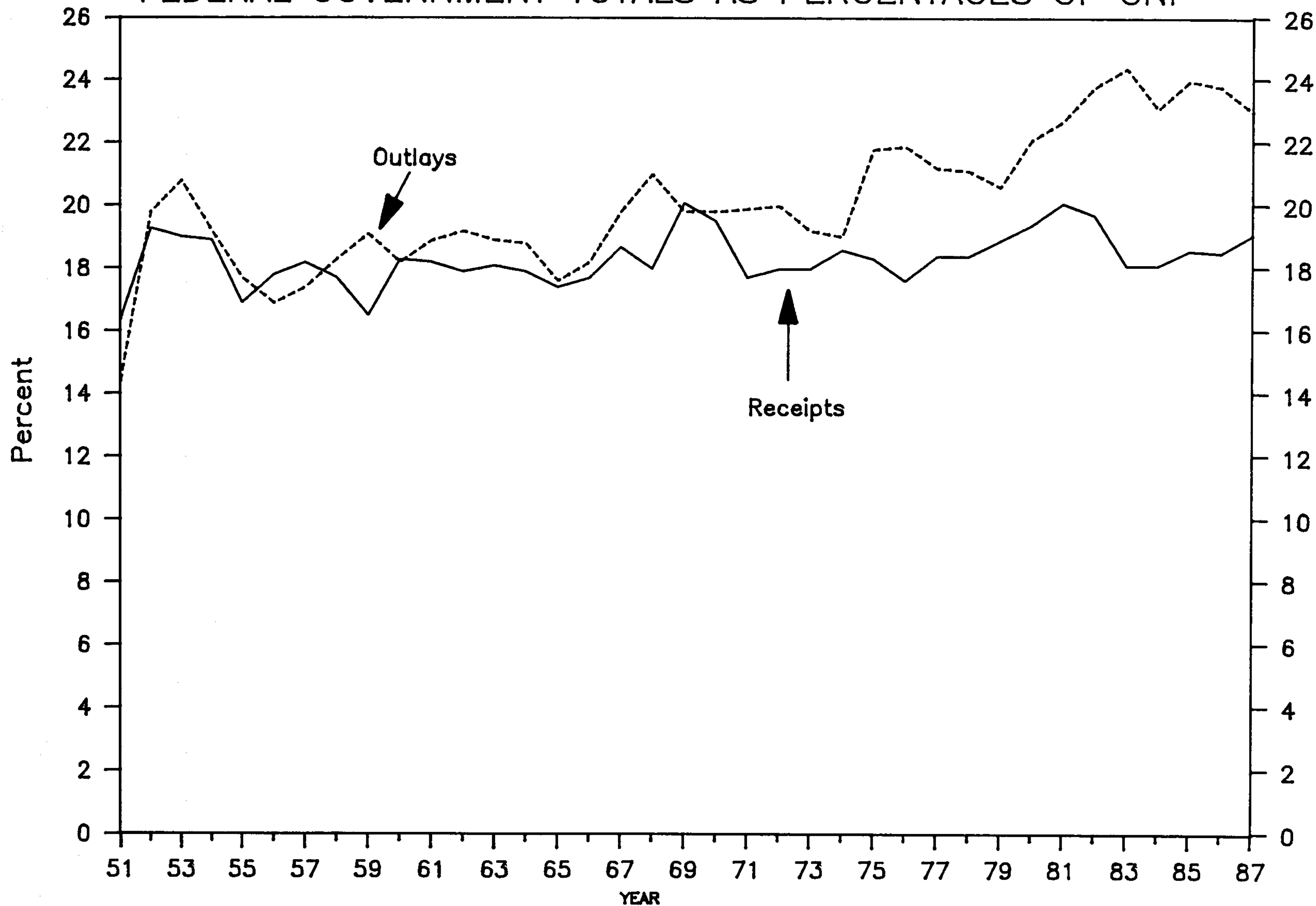
A. The Current Controversy

The rise of the peacetime federal deficit to $1 trillion in 1980 and then to nearly $2 trillion in 1985 has sparked considerable controversy about the levels and nature of federal spending and about the ways in which the Congress and the executive branch handle the raising and spending of public funds. Some critics argue that the Congress has lost control of the budgetary process and allowed domestic programs to grow much faster than they should, putting a large portion of the budget on virtual automatic-pilot, thereby generating ever larger deficits. Others maintain that the current Presidential Administration has brought on the rapid growth in budget deficits by its pursuit of increased defense spending without adequately increasing revenues to cover the costs sufficiently or reducing spending for nondefense programs. This controversy promises to continue, especially since President Ronald Reagan has projected a budget deficit of $164 billion for FY 1987 and the Congressional Budget Office has projected an even higher deficit of $174 billion. Whichever estimate is more nearly correct, the deficit will be big. Meanwhile, still other critics argue that large budget deficits signify a basic flaw in the way the federal budgetary process is organized, and that fundamental reform is necessary (e.g., a constitutional amendment). Others counter that large deficits are the result of irresponsibility on the part of either the present Administration, the Congress, or both, and that minor reforms in the budgetary process combined with growing voter antipathy to fiscal mismanagement will eventually resolve the issue.

There is some disagreement among economists as to how a "balanced federal budget" should be defined, and even whether a balanced budget *per se* is a

Figure 1

FEDERAL GOVERNMENT TOTALS AS PERCENTAGES OF GNP



SOURCE: Office of Management and Budget, Historical Table: Budget of the United States Government, FY 1988 (Washington, D.C.: Government Printing Office, 1987). [Post–1987 estimate based on OMB projections.]

worthwhile goal. For example, Robert Eisner has argued that when the federal budget is analyzed in a manner similar to a corporate budget, with assets and liabilities explicitly taken into account, the budget deficit can be said to be significantly lower than the figure reported by the OMB.[1] If the federal government had a separate capital budget, which distinguished spending on investment-type projects from other spending, the apparent size of the deficit would be reduced. Some economists (especially those describing themselves as "Keynesians" or "neo-Keynesians") argue that macroeconomic stabilization policy may require relatively small deficits (calculated on an annual basis) under certain conditions. While taking these differences into account, it is fair to say that most economists favor approximate budgetary balance over the course of the business cycle (which might imply the occasional intentional employment of relatively small annual deficits by the federal government during recessions).[2] There is some disagreement among economists over the relative importance to the nation's economy of large, unplanned deficits by comparison with other factors influencing the economy, but there is nearly unanimous agreement that huge deficits are a cause for serious concern.

B. Historical Background

Much of the discussion about fiscal discipline in the federal government has taken place in a kind of historical vacuum. Proponents of institutional reform sometimes seem to imply that national policy makers have nearly always produced bloated deficits. Opponents of major institutional reform have, on occasion, argued that large deficits are only a temporary aberration and will surely be reversed after the next congressional or Presidential election.

1. 1789-1980. In fact, the history of the deficit is more complex. For the federal government, fiscal discipline was not an object of much public discussion until the mid-1970s. Historically, deficits tended to be relatively small during peacetime. Deficits typically grew in wartime but, as a rule, they were steadily reduced in peacetime as a matter of deliberate policy. Hence, from 1789 until the Great Depression, deficits occurred mostly as the result of wartime spending. Peacetime deficits sometimes occurred, but they were unusual events and were typically the result of temporary economic downturns. Balanced budgets—or even budget surpluses—have been the rule for much of American history.

With the Great Depression, however, federal debt began to trend steadily upward. By 1934 (in the trough of the Depression), gross debt reached an historic peacetime high of $27 billion in nominal terms, equivalent to 17.8 percent of the GNP. Federal debt then increased steadily over the course of the Depression and World War II until 1946, when it reached an incredible 134.2 percent of the GNP, or $270 billion. Thereafter (except for a brief period following the war, when it fell slightly), both the nominal and the real (adjusted for inflation) debt continued to grow at a relatively slow, but fairly steady, rate—an upward trend that continues today.

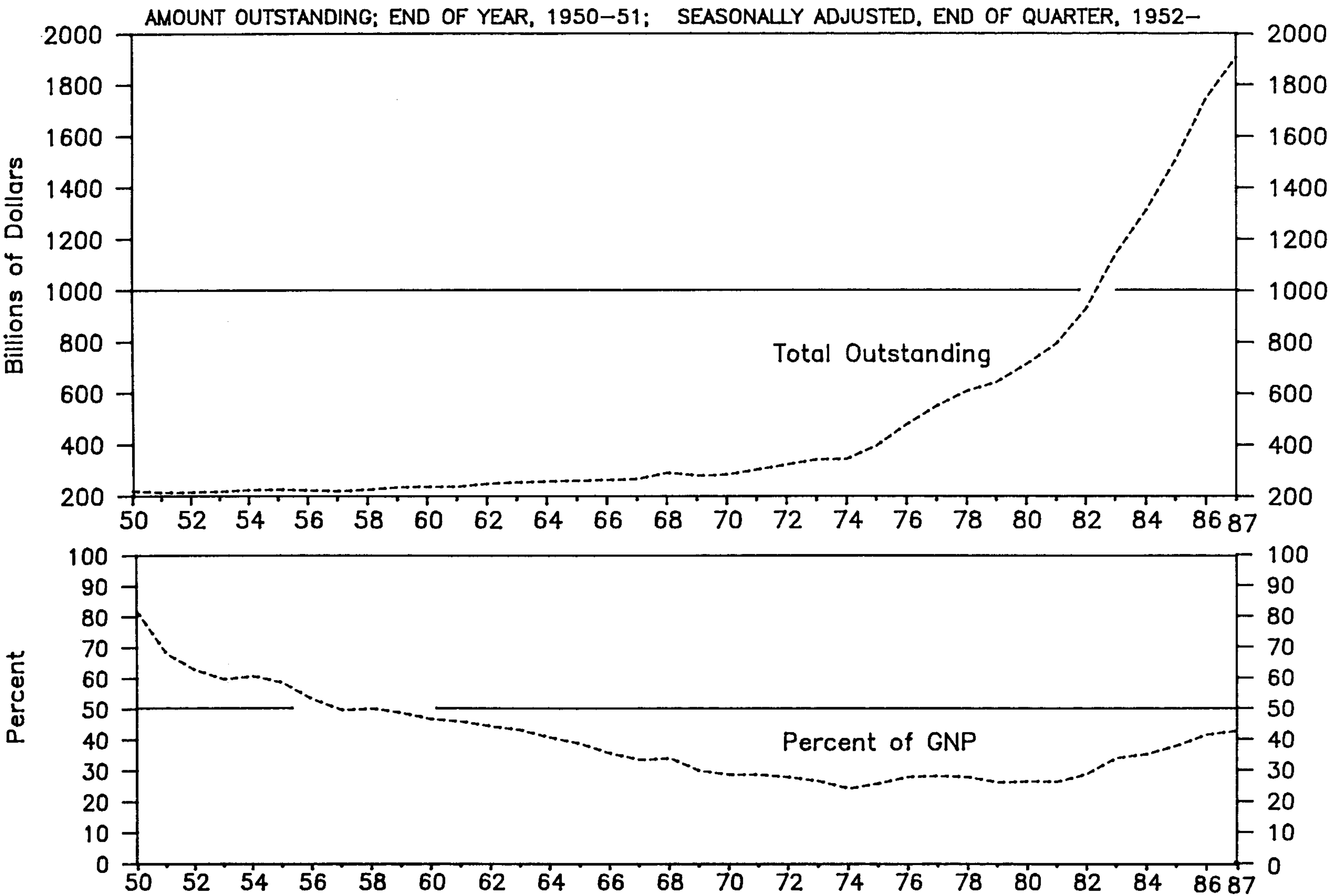
However, in order to gauge the burden of the debt on the overall economy, it is useful to examine the size of the national debt as a percentage of GNP. The debt as a proportion of GNP proceeded, for the most part, to drop from 1950 to 1980—from 97 percent of GNP in 1950 to 58.4 percent in 1960, 39.5 percent in 1970, and 35.5 percent in 1980. At the same time, the gross federal debt consistently rose in nominal terms. For example, in 1952, at the peak of the Korean War, the gross federal debt was $214 billion; by 1980 it had reached $914 billion. Nevertheless, despite the huge, cumulative, nominal increase, this 1980 figure reflected a fall of 40.9 percent in relation to GNP (see *Table 1*).

It is helpful to view these developments graphically. *Figure 1* shows the history of the federal budget deficit since 1951. *Figure 2* shows net federal debt outstanding since 1950. *Figure 3* shows net interest as a percentage of total federal outlays since 1951.

Political decision makers normally make debt-related decisions based on the size of the nominal debt (or, as an alternative, the debt adjusted for inflation), not on the debt as a percentage of GNP. Obviously, if the government makes no effort to retire the debt but ceases to add to it, even minimal levels of economic growth will at least slow the apparent size of the debt relative to GNP, or actually show a reduction in this percentage. Thus, a decline in the debt as a percentage of GNP does not necessarily imply any deliberate effort by political leaders to reduce the size of the debt. However, it is clear that up to 1980, although the debt continued to grow, the economy grew faster; consequently, the economic burden of the debt generally declined during the 1950-80 period.

Figure 2

NET FEDERAL DEBT

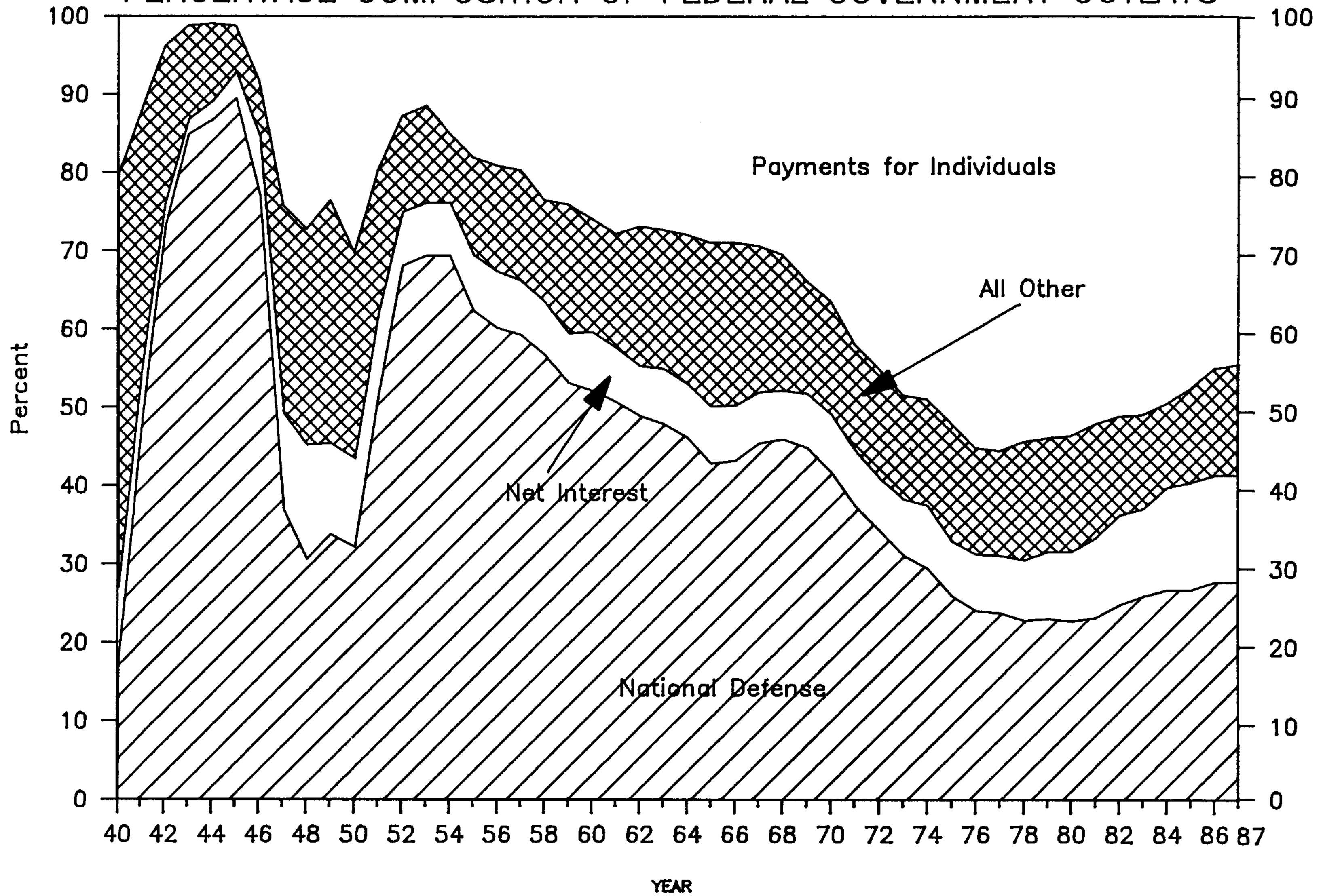


SOURCE: Board of Governors of the Federal Reserve System, 1986 Historical Chart Book (Washington, D.C.: 1986).

NOTE: 1987 estmated.

Figure 3

PERCENTAGE COMPOSITION OF FEDERAL GOVERNMENT OUTLAYS



SOURCE: Office of Management and Budget, Historical Table: Budget of the United States Government, FY 1988 (Washington, D.C.: Government Printing Office, 1987). [Post-1987 estimate based on OMB projections.]

Table 1

THE FEDERAL DEBT, 1890-85

(selected years)

Year	Total Gross Federal Debt (billions)	Gross Federal Debt as Percent of GNP
1890	$1.1	8.5
1900	1.2	6.7
1910	1.1	3.2
1915	1.1	2.9
1920	24.2	26.5
1929	16.9	16.4
1930	16.1	17.8
1940	50.6	53.4
1945	260.1	119.9
1950	256.8	97.9
1955	274.3	72.1
1960	290.8	58.4
1965	323.1	49.0
1970	382.6	39.5
1975	544.1	36.8
1976	631.8	38.5
1977	709.1	38.1
1978	780.4	37.3
1979	833.7	35.4
1980	914.3	35.5
1981	1003.9	34.8
1982	1146.9	37.7
1983	1381.8	42.9
1984	1576.7	44.0
1985	1910.5	46.3

SOURCE: Bureau of the Census, U.S. Department of Commerce, *Historical Statistics of the United States, Colonial Times to 1970* (Washington, DC: Government Printing Office, 1975): p. 224; and Office of Management and Budget, Executive Office of the President, *Historical Tables: Budget of the United States Government, Fiscal Year 1988* (Washington, DC: Government Printing Office, 1987): Table 1-1.

2. 1980-87. From 1952 to 1980, then, the national debt generally grew in nominal terms even while it ordinarily fell as a percentage of GNP. Since 1980 (coincidentally, the same year in which the debt passed the $1 trillion mark), the debt has grown steadily both in nominal terms and as a percentage of GNP. In 1986, the national debt reached $2.1 trillion, or 44.3 percent of GNP.

This reversal in the trend toward long-term debt reduction relative to GNP replicates, in a limited way, the many previous experiences of the U.S. involving the accumulation of debt during wartime. While the U.S. has not been at war since the mid-1970s, by 1981 the Congress and two successive administrations had decided that a period of sustained net growth in defense spending in peacetime was an urgent requirement; consequently, the debt has grown for basically the same reason it grew during past wars—defense spending increased at the same time that other forms of spending continued to grow, or at least not fall (in net terms). It must be noted, however, that this recent shift is mostly in terms of rates of change; the 1985 debt was still less than half of the debt at the peak of the Korean War (1952) as a percentage of GNP.

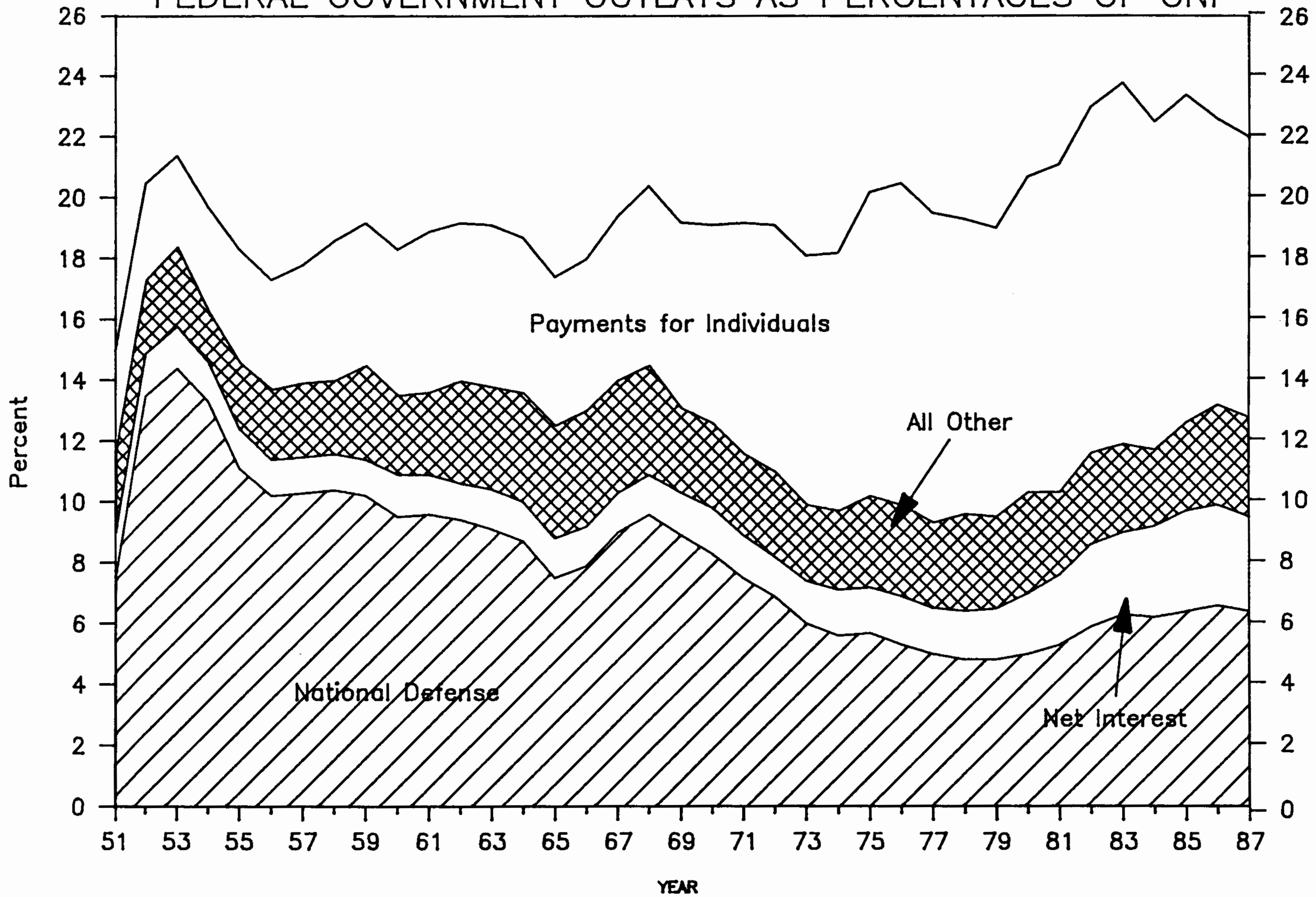
In short, for most of American history, debt incurred by the federal government was either gradually retired, or at least (following World War II) grew only slowly relative to the level of economic growth. During most of the post-World War II period, the growth in the federal debt was significantly outpaced over time by the rate of growth in the general economy. Only in the last six years has the debt caught up with the rate of growth of GNP and exceeded it consistently. This recent expansion of the debt is unique because, unlike past expansions, it did not occur during wartime.

C. Are Deficits Systemic or Aberrational?

Views on the nature of the deficit phenomenon can be divided into two major camps: (1) the view that regular deficit spending since 1969 is the result of major flaws in the decision-making structures of the federal government, and is a *systemic* problem, and (2) the view that truly problematic deficit spending is of recent vintage, has not resulted from any structural problems in the system of government, and represents, therefore, a kind of *aberration* in American fiscal history. Proponents of the latter view tend to argue that the deficit problem will be resolved as voters replace present elected officials. Proponents of the former view tend to argue that the system itself needs to be reformed before significant deficit reductions can be expected.

Both sides can appeal to the fiscal history of the United States for at least some support for their positions. Proponents of the "aberration" view can point to the long periods—until 1930, and then again after World War II until the early 1970s—when deficits during peacetime were unusual events, typically relatively small, and commonly supplanted by budget surpluses. Proponents of the "systemic" view claim that deficits have moved steadily upward since 1930 (although many fluctuations occurred), and that this trend has seemingly accelerated since about 1970, although the growth has not been continuous (i.e., the FY 1976 deficit was 19.3 percent of federal outlays in that year, and deficits in every successive year until FY 1983 were actually substantially lower than this.)

Figure 4



SOURCE: Office of Management and Budget, Historical Table: Budget of the United States Government, FY 1988 (Washington, D.C.: Government Printing Office, 1987). [Post-1987 estimate based on OMB projections.]

We should note that the pattern of federal government activity was also changing substantially in the period following World War II. At the same time that federal budget deficits in peacetime were occurring with increasing frequency, transfer payments to individuals began a period of substantial growth. In 1951, transfer payments constituted only 22.6 percent of the total budget, and 3.3 percent of GNP. By 1980, the statistics were 47 percent and 10.8 percent, respectively.[3] *Figure 4* outlines these developments.

There is also an important difference between the history of the debt following World War II and the periods following earlier major wars in American history. Since 1946, elimination of the national debt has not, for the most part, been a major, intentional fiscal policy.[4] True, the debt as a percentage of GNP declined steadily during the 35 years following the end of the war, but this was due basically to the rapid growth of the overall economy in the post-war period (while net *additions* to the total debt were generally small.)

Our conclusion, then, is that while advocates of the "aberration" view of the deficit have a valid point—really large deficits are a quite recent phenomenon—advocates of the "systemic" view also have a point insofar as deficits began to become *common* occurrences more than 50 years ago, and then began to occur every year after 1970. Most important, perhaps, for the "systemic" view is that the earlier American tradition of steady, intentional debt retirement has not been a major priority of executive-congressional decision making since World War II.

Debate over federal deficits, however, is further confused by threshold considerations. Some critics regard virtually any deficit as bad, as symptomatic of the underlying irresponsibility of fiscal decision making.[5] In light of consistent patterns of deficit spending since 1930, such critics tend to view federal deficits as a major systemic problem. Although no one seems to favor a deficit approaching one-quarter of the size of the total federal budget (as it did by FY 1985), many participants in the debate do hold that some level of deficit spending, whether regular or occasional, is necessary and often good.[6] For them, the key question seems to be: what frequency and/or level of deficit spending is acceptable? Those who set the peacetime thresholds low may also regard the post-World War II levels of deficit spending as being a systemic problem. Those who set the peacetime thresholds comparatively high, though, are likely to regard the deficits over the past decade, and especially since 1980, as being only an aberration in an otherwise well functioning system.

There are other problems in clarifying the debate. For one, the current deficit phenomenon might really be systemic even though the onset was comparatively recent. That is, the cumulative and perhaps unintended effects of structural changes in the political system may, by the 1980s, have allowed the deficit to break through previously accepted peacetime thresholds. On the other hand, from a long-term view of history, post-World War II deficits could be regarded as an aberration of several decades duration. Consequently, it is not always easy to distinguish between the systemic and aberrational views. Is a phenomenon of relatively brief duration an aberration, even though it may have resulted from structural changes in the political system? Does a series of aberrations reflect some underlying structural flaw in the system?

In assessing possible fiscal discipline reforms, the difficulty of establishing a firm dichotomy between the systemic and aberrational views may not be all that important in every instance. If deficit spending is judged to be a systemic problem, structural reforms are obviously necessary. If instead it is judged to be only an aberration, which nevertheless tends to recur, this still implies that structural reform is worth considering insofar as one can identify the structural factors that permit these aberrations to occur regularly. Hence, some of those who disagree over the precise cause of high deficits could, in principle, agree on a practical solution. Still, those who see the post-1980 deficits as only an aberration are likely to look to future congressional and Presidential elections and/or to reduced spending and other measures to bring down the federal deficit.

D. Current Perspectives on the Nature of Deficit Spending

Public officials, policy analysts, and scholars in both economics and political science have advanced very different interpretations of the dimensions of the deficit issue and the nature of desirable reforms. In fact, there is even a minority view, which holds that there is no "deficit problem" and, further, that (correctly interpreted) there really is no federal deficit. While we cannot present each view in all of its relevant detail, our intention is to provide a brief overview of each so as to allow the views to be compared and contrasted with one another in terms of their major elements.

Perspective 1: **The Deficit Is an Illusion.** Perhaps the most surprising and provocative view is that there

really is no deficit when budgetary aggregates are interpreted properly. This position is the most counterintuitive, but has been developed by a small group of economists who have devised a thorough analysis of the federal debt and budget deficits.[7] Basically, these theorists argue that conventional measures of the federal *debt* and the *deficit* tend to be seriously misleading because they do not distinguish between *current* and *capital* expenditures.[8] This practice is at variance with prevailing accounting practices for private business (as well as those used by most state and local governments). A number of economists have therefore argued that the application of conventional private accounting methods to interpretation of the federal budget would generally move government accounts toward surplus. One recent application of this analysis purports to demonstrate that after adjusting for interest rate effects and inflation, a nominal deficit of $61.2 billion for 1980 becomes a $7.3 billion surplus.

Robert Eisner has recently qualified this view by arguing that a "real" deficit exists as well, which has grown rapidly in the last few years.[9] Nevertheless, this "real" deficit is far smaller than the deficit reported in the budget of the United States government.

Perspective 2: **The Deficit "Problem" Is an Illusion.** A view that is identified with "supply-side" economics concentrates not on challenging the quantitative estimates of the actual budget deficit (or on the national income accounting conventions used in calculating those estimates), but more basically on challenging the idea that the deficit is a "problem."[10] In its most extreme form, this view holds that the deficit is economically irrelevant, regardless of size. Large deficits do not affect interest rates significantly, and are unrelated to inflation unless the Federal Reserve Board pursues a policy of "monetizing the debt" (i.e., repudiating part of the debt by increasing the money supply). Such a policy, however, would, in this view, represent an abuse of the Federal Reserve's discretionary authority.

To the extent that "crowding out" of funds for private investment occurs in capital markets (i.e., the displacement of private investment by government borrowing), this is not a result of deficit spending specifically, but of government spending more generally; it represents the expropriation of real resources by government (by both taxing and borrowing), which reduces the stock of resources available to the private sector. Stated differently, the economically relevant "crowding out" effect is the displacement of private resource allocation by government resource allocation.

However, another type of "crowding out" effect can occur in a federal system. This is the adverse impact of federal government borrowing on the capital market conditions faced by states and local governments. Large-scale federal government borrowing—necessary in order to finance a budget deficit—reduces the supply of loanable funds available to state and local governments and tends to drive up the interest rates which those governments must pay to borrow money. In this way, larger federal deficits imply a greater debt burden on state and local governments for the same levels of borrowing.

Other proponents of the "illusion" view make the more limited argument that the detrimental consequences of budget deficits are grossly exaggerated in public discussion. Their concern is that if effective tax rates are raised to reduce the deficit, the economic costs of the cure are likely to be worse than the disease.[11] Some observers have also argued that the deficit "problem" is being used as a stalking-horse by certain liberals who favor increases in effective tax rates and by certain conservatives who seek to reduce domestic spending and alter the foundations of fiscal policy (e.g., through a balanced budget amendment to the U.S. Constitution.)

Perspective 3: **Deficits Are Only a Temporary Problem, and the Existing System Will Correct Them.** The third general perspective accepts the idea that consistently large deficits represent a significant economic problem, but argues that present deficits cannot be regarded as evidence of any serious structural defect in the political system. Rather, large budget deficits are only a recent phenomenon and are the result of a specific concatenation of political events, which can be expected to be temporary and which the present political system can be expected to eliminate in the near future.[12] Adherents of this position either insist that, given a change in administrations and/or the political composition of the Congress, the deficit problem will be overcome rapidly, or that present politicians will be forced by increasing constituency concerns to reduce the deficits.

Some proponents of this view argue that the federal deficit problem is merely the result of policies pursued by the Reagan administration, specifically, of increasing defense spending, holding other spending approximately constant, and reducing taxes all at the same time. This seems to be a fair description of the context of recently growing deficits, although the Congress shares responsibility for having supported these policies. Administration supporters argue that the rearming of America was necessary for national security and that tax reductions were necessary for national

economic recovery. The deficits that resulted from these fiscal priorities are regrettable, but represent an acceptable cost (at least in the near term) for achieving these important ends. Administration critics counter that the President has intentionally pursued policies designed to increase budget deficits for the purpose of forcing the Congress to cut domestic spending in the short run, and of building support for a balanced budget amendment to the U.S. Constitution in the long run.

Perspective 4: **Deficits Are a Problem, and the Solution Requires Some Limited Reforms.** The fourth general position argues that consistently large deficits are the result of problems in the structure of political decision making, but that these problems are not necessarily evidence of any basic flaws in the democratic process. Proponents of this view focus on changes in operational procedures in the Congress since the mid-1960s, changes which have allegedly disrupted the fiscal discipline of the Congress as a whole.[13] Various reforms (e.g., the rapid growth of the subcommittee system) have simultaneously improved the ability of individual members of the Congress to serve the interests of their constituents while reducing the responsibility of the behavior of the Congress as a body.[14]

Hence, proponents of this view generally advocate changes in the rules of congressional decision making. Changes in the rules are assumed to be necessarily an internal matter (i.e., the Congress is expected to reform itself by reframing some of its procedural rules). Although "pork barrel politics" is thought to play a key role in explaining the recent emergence of large budget deficits, another important factor has been misguided congressional reforms in the past, which eliminated or reduced in effectiveness certain constraints on the propensity of members of the Congress to sacrifice the national interest for the interests of their constituents.[15]

Perspective 5: **Deficits Are a Result of Major Structural Defects, and Radical Reform Is Necessary.** The fifth general perspective holds that consistently large budget deficits are the result of basic flaws associated with the way in which contemporary democratic government conducts policy and makes decisions. Proponents of this view argue that deficits are the inevitable consequence of a political process of budget making in which politicians have a strong tendency to favor increased spending while holding tax rates constant, and in which the majority will of the voters (who may overwhelmingly favor fiscal discipline) is not expressed coherently and consistently at the ballot box.[16] Thus, it is argued that large, unplanned budget deficits are the result of a fundamental and predictable malfunctioning of a poorly constrained democratic political process, rather than the accidental byproduct of recent reforms clearly intended to address unrelated problems.

Under the existing system, politicians do not have a sufficiently strong incentive to take effective anti-deficit action voluntarily. A number of scholars attribute to elected officials the tendency to make decisions that are shortsighted—not seeing beyond the next election. Hard choices required for deficit reduction—either tax increases, or spending reductions, or a combination of both—tend to lead to dissatisfaction among the voters who must bear these costs, and therefore to reduced political support for the proponents of such policies. Although these same voters may strongly oppose deficit spending, they ordinarily prefer that someone else's programs be cut, or that someone else's taxes be raised. Even when political leaders have the best of intentions concerning fiscal discipline, achieving it may be difficult.

Some observers have argued that this tendency was reinforced by the political acceptance of Keynesian economics. A growing body of scholarly opinion holds that, regardless of its economic merits, Keynesian economics has had a profound political effect. As Dwight Lee has argued:

> The success of Keynesian economics . . . was primarily political and had less to do with its theoretical soundness than with its tendency to cater to the shortsighted proclivities of the political process.[17]

This view likens a commitment to Keynesian economic theory and its contemporary progeny to a political "hair trigger" accelerator on the engine of government without a concomitant braking mechanism.[18] If this line of reasoning is correct, a major side-effect of the acceptance of Keynesian economics has been to encourage lax fiscal discipline on the grounds that deficit spending can be an effective tool for achieving full employment under certain circumstances, and that limitations on public debt are pointless because "we merely owe it to ourselves."

Proponents of this view maintain that in the past, fiscal responsibility depended critically upon widespread moral commitments on the part of voters and politicians—moral commitments that have been steadily eroded during the past 50 years due to a variety of causes.[19] In other words, one of the effects of the Keynesian Revolution (whether intended or not) was to convince most political decision makers that previously held notions of what constituted fiscal responsibility were obsolete. This shift in the attitude of politicians has been described as "one eyed Keynesianism," namely, the tendency to incur sub-

stantial budget deficits, even in circumstances where Keynesian theory, strictly interpreted, would imply that a balanced budget (or even a surplus) would be more appropriate.[20] As evidence to support this view, proponents point to the tendency of the federal government since World War II to run deficits regardless of economic circumstances (with surpluses rare and invariably tiny).

Therefore, the solution lies in the direction of improving restraints affecting political decision making to enforce deficit reduction. Such reforms are necessarily external (e.g., by constitutional amendment) because any internal reform (e.g., via majority agreement within the Congress) will itself be inherently unstable and therefore ineffective. The results of the *Congressional Budget Act of 1974* would appear to provide some support for this view. One of the major goals of this measure was to reduce the growth of federal spending. Many supporters argued that the act would lead to balanced federal budgets.[21] Given that deficits have grown since 1974, proponents of the structural view argue that the record of legislative reform points to a strong need for basic constitutional reform.

E. Other Possible Factors in the Emergence of Large Deficits

A variety of factors have no doubt come into play to create the current situation. In addition to the arguments listed above, some observers maintain that large deficits are a side effect of the rapid growth in federal spending, a side effect exacerbated by slow economic growth during the 1970s, which did not allow deficits to fall significantly in relation to GNP.[22] Regardless of whether large deficits have induced rapid spending growth, or vice versa, high rates of federal spending since the Great Depression have at least been associated with the emergence of peacetime deficits. Logically, spending could grow at a very high rate without revenues necessarily falling below expenditures. Further, large deficits and rapid spending growth might be associated by coincidence.

In any event, additional factors affecting spending and deficit growth appear, according to various observers, to include the following:

1. Ratification of the 16th Amendment in 1913 permitted the federal government to replace low-elasticity revenue sources, such as customs revenue, with high-elasticity income taxes. Reliance on customs duties as the single major source of federal revenue tended to support an economically inefficient system of protective duties. However, the absence of a more "efficient" source of revenue with greater growth potential also acted as a check on government spending.

2. Expansion of the electorate since 1920 has brought new claimants into the political arena seeking a share of government benefits. This has led to a steady upward pressure on the level of total government spending.

3. Since the 1930s, state and local governments and various interest groups have pressured the federal government to provide financial aid to states and localities and to assume full or partial fiscal responsibility for many domestic functions.

4. Since 1940 the United States has borne unprecedented responsibilities in world affairs requiring, among other things, levels of defense spending unprecedented in American peacetime history. In turn, since the mid-1960s, federal budget making has been locked in a "guns and butter" conflict, with strong advocates of increased defense spending and strong advocates of increased domestic spending each seeking to hold the budgetary high ground.

5. There has been a steady increase in the public's desire for more and better public services, stimulated in part by rising wealth and economic growth.

6. Once in place, it becomes increasingly difficult to dismantle or reduce federal program spending, whether it be defense or domestic spending. Important programs have powerful and well organized defenders who monitor them closely and mount determined opposition to any proposed reduction.

7. In recent decades, policy makers and interest groups have tended to measure policy commitments and program quality in dollar terms. Reductions in spending tend to be viewed as reductions in government's commitment to public programs, and as reductions in the quality of public policies.

8. Interest group politics has become more intense since the 1950s, with growing numbers of interests being well represented in Washington, DC, and with single-interest groups and coalitions of groups being better able to protect their interests and to load costs onto the more diffuse majority.

9. Reforms in electoral processes and congressional procedures have weakened the ties of both Presidential and congressional candidates to their party organizations, thereby strengthening candidate

ties to specific interests and rendering the executive-congressional political processes more individualistic and less disciplined.

10. The Washington, DC, environment has become increasingly pluralistic and competitive. Neither the Congress nor the President can effectively orchestrate the situation. Party leaders have difficulty coordinating members of the Congress, and the President has difficulty controlling his subordinates.

F. The Current Political Context of the Deficit Dilemma

Regardless of which explanation or interpretation is correct, the current deficit situation appears to be associated with an impasse between the Congress and the Administration. President Reagan has strongly favored increases in defense spending, while the Congress, particularly the Democratic House of Representatives, has strongly opposed decreases in domestic spending.[23] It might be noted, for example, that the deficit could have been reduced substantially by trimming social security COLA adjustments and making social security payments fully taxable. However, neither political party wanted to risk antagonizing senior citizens—a powerful and growing sector of the electorate.

The failure to achieve a consensus for cuts on the expenditure side of the budget could have been bypassed by a major increase in federal taxes. President Reagan has strongly opposed a tax hike, and Democrats in the Congress have been reluctant to promote a tax increase in the absence of Presidential initiative on this politically explosive issue.

Since the enactment of the *Gramm-Rudman-Hollings* bill for reducing deficits, there has been a sharp decline in the rate of growth of defense spending, a "freezing" of most domestic expenditure levels, and a greater use of "one-shot" budgetary strategies to attempt to bring the budget deficit down to the range set forth by *Gramm-Rudman-Hollings* for fiscal 1987.[24]

While there appears to be widespread agreement that large and growing budget deficits represent a serious political and/or economic problem for the American economy, there remains widespread disagreement about exactly why (or whether) deficits are a problem (or the magnitude of that problem) and about the appropriate remedy or remedies for the situation. At the same time, much of the debate has focused on whether an amendment to the U.S. Constitution mandating a balanced budget for the federal government might be an effective and appropriate institutional reform. Other reforms (most notably, Presidential line-item veto authority) have been proposed, and have generated their own share of controversy.

ENDNOTES

[1]See Robert J. Eisner, *The Real Federal Deficit* (New York: Basic Books, 1986).

[2]A 1979 survey of economists found that 83 percent of those polled agreed (or agreed with reservations) with the statement: "The federal budget should be balanced over the business cycle rather than yearly." It is unclear what proportion of the 17 percent who disagreed with the statement nevertheless favored annual an budgetary balance, and what percentage thought deficits were not important problems. See J.R. Kearl, C.L. Pope, G.C. Whiting, and L.T. Wimmer, "A Confusion of Economists?," *American Economic Review*, 69 (May 1979), 30.

[3]It has sometimes been asserted that the federal budget has been changing its composition in very fundamental ways, most importantly in terms of a purported shift from capital investment to current consumption, particularly in the form of transfer payments. This appears to have been the case. At the same time that transfer payments to individuals were increasing from 17.5 percent to 47 percent of total spending, federal spending for physical capital investment was falling with equal rapidity as a proportion of total spending and GNP. In 1940, outlays for major physical capital investment constituted 34.8 percent of federal spending. By 1984 this had fallen to only 12 percent. Capital investment as a share of GNP also fell, from 3.5 percent in 1940 to 2.8 percent in 1984; such investment has fallen gradually but quite consistently from a post-World War II high of 6.4 percent in 1953.

Another change in federal spending behavior since 1940 has been the rapid increase in what some have termed "uncontrollable" spending. Such spending can be divided into three categories: interest on the federal debt, payments due for contracts and obligations entered upon in the past but payable in the present, and entitlement programs. In 1967, 57 percent of the federal budget was relatively uncontrollable. By 1984 this had risen to 73.3 percent, or an in-

crease of 28.59 percent. Most of this growth occurred in the realm of payments for individuals in open-ended programs (e.g., social security, SSI, AFDC, etc.); this component grew from 25.5 percent of total outlays in 1967 to 42 percent in 1984, an increase of 64.7 percent. Payments for individuals in open-ended programs in 1984 exceeded $357 billion. In any event, the growth in federal spending between 1960 and 1980 was due largely to the rapid rise in transfer spending.

[4]In other words, by comparison with previous postwar periods, retirement of the World War II debt was a relatively low political priority. See Carolyn Webber and Aaron Wildavsky, *A History of Taxation and Expenditure in the Western World* (New York: Simon and Schuster, 1986), esp. Chapters 8 and 9.

[5]For example, James M. Buchanan and Richard Wagner maintain that deficit spending per se is a violation of the "moral constitution" that guided American fiscal policy for most of U.S. history. In their view, even relatively small levels of deficit spending are evidence that political decision makers have budgeted irresponsibly. See their *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977).

[6]This position has recently been defended by Robert Eisner and Paul J. Pieper, who argue that the deficit should be evaluated from the perspective of its effect on the overall economy. Employing calculations of a cyclically adjusted "high employment budget," they conclude that in every year from 1975 to 1981, the federal deficit was actually equivalent to a "high-employment" *surplus*—implying that the federal budget deficit was *too low* in each year to generate full employment, and stimulated the economy less than it might have. However, they also conclude that since 1981 the federal deficit has been too large, even by their alternative measure. See their "How to Make Sense of the Deficit," *The Public Interest*, No. 78 (Winter 1985), 101-18.

[7]See Eisner and Pieper, *ibid.*

[8]The federal debt is the accumulated liabilities resulting from past borrowing of funds to finance government spending. The deficit is the amount by which expenditures exceed revenues in a given year. Current expenditures are those with short-run purposes (e.g., transfer payments to individuals, or paying the salaries of police), while capital expenditures are those designed as long-term investments by government (e.g., building schools). Economists generally agree that, depending on the exact assumptions employed, specific kinds of government spending might sometimes be usefully classified as "current," and other times as "capital," expenditure.

[9]See Robert J. Eisner, *How Real Is the Federal Deficit?* (New York: Free Press, 1986).

[10]For a good summary of the "supply-side" arguments, see Paul Craig Roberts, *The Supply-Side Revolution* (Cambridge, MA: Harvard University Press, 1984).

[11]See Paul Craig Roberts, "Discussion" in *The Fourth Donald S. MacNaughton Symposium Proceedings: What Should Be Done About the Federal Deficit?* (Syracuse, NY: Syracuse University, 1984), pp. 25-27.

[12]For a cogent presentation of this view, see Norman J. Ornstein, "The Politics of the Deficit," in Phillip Cagan (ed.), *The Economy in Deficit* (Washington, DC: American Enterprise Institute, 1985), pp. 311-33.

[13]See Kenneth A. Shepsle and Barry R. Weingast, "Policy Consequences of Government by Congressional Subcommittees," in C. Lowell Harris (ed.), *Control of Federal Spending* (Montpelier, VT: Capital City Press, 1985).

[14]These critics maintain that by means of a series of "reforms" instituted in the 1960s and 1970s, Congress relaxed its internal restraints on budgetary decision making. Rules changes in the House and Senate effectively ended the traditional separation of appropriations from legislative authorization; the rapid expansion of the number and authority of subcommittees led to reduced concern among individual members of the Congress for the interests of nonconstituents; reform of the seniority system and other rules contributed to a significant reduction in party discipline (which had traditionally acted as a restraining factor on the decision making of individual members of Congress); and there occurred a wide-scale shift from temporary to permanent agency appropriations, thereby eliminating a brake on program growth. These and other structural modifications in congressional decision making are offered as proximate explanations for the twin problems of the rapid growth of "uncontrollable" spending and the emergence of the deficit as a major fiscal problem over the course of the 1970s and 1980s. For a detailed review of these arguments, see Allen Schick, "The Distributive Congress," in Allen Schick (ed.), *Making Economic Policy in Congress* (Washington, DC: American Enterprise Institute, 1983).

[15]In the case of this view, one can separate the historical analysis of the deficit problem from the question of reform per se. It is possible to concur with the

analysis of the emergence of the deficit problem as resulting from altered structural restraints on decision making within the Congress and yet disagree that internal reform is feasible. The process may not be self-reversing; once begun, it may represent a sort of fiscal trap in which individual members of the Congress have strong incentives to maintain the status quo and hence be extremely unlikely to restore past constraints, even if most might agree that Congress as a whole would be a more effective institution as a result. Consequently, effective reform might be more likely if it takes an external form (i.e., outside Congress), perhaps in the form of a Presidential line-item veto or a balanced budget constitutional amendment.

[16]See Aaron Wildavsky, *How to Limit Government Spending* (Berkeley, CA: University of California Press, 1980).

[17]Dwight R. Lee, "Constitutional Reform: A Prerequisite for Supply-side Economics," *Cato Journal*, 3 (Winter 1983/84), 795.

[18]Advisory Commission on Intergovernmental Relations, *The Condition of Contemporary Federalism: Conflicting Theories and Collapsing Constraints* (Washington, DC: August 1981; Commission Report A-78).

[19]This argument is presented in fuller form in Buchanan and Wagner, *Democracy in Deficit*, *op. cit.*

[20]See Richard Rose and Guy Peters, *Can Government Go Bankrupt?* (New York: Basic Books, 1978), p. 133.

[21]See John W. Ellwood, "Budget Control in a Redistributive Environment," in Allen Schick (ed.), *Making Economic Policy in Congress* (Washington, DC: American Enterprise Institute, 1983), pp. 69-99.

[22]*Ibid.*, p. 85.

[23]There is every reason to expect that the Senate in the 100th Congress, now controlled by a Democratic majority, will pursue policies more in line with those of the House than was the case in the six years following the 1980 elections, during which time the Republicans held a majority in the Senate.

[24]Many observers argue that extensive divestiture by the federal government of assets it has acquired over the years (i.e., privatization) is desirable on efficiency grounds as distinct from budgetary considerations. Indeed, there is some evidence that certain of these assets could possibly be better and more efficiently managed by private owners. However, the asset sales currently proposed by OMB in the *Fiscal 1988 Budget of the United States Government* are ostensibly intended to help meet the *Gramm-Rudman-Hollings* deficit reduction target.

Chapter II

Reform Actions And Proposals

Given that the problems associated with evaluating the economic costs of deficits are complex, there is considerable disagreement regarding the desirability of restraining deficit spending by means of particular mechanisms (e.g., a balanced budget amendment to the U.S. Constitution). If we assume, however, that there is need for reform of the existing structure of fiscal policy making, what options are available?

Institutional reform can be regarded as a way of improving controls on political decision makers by taxpayer-voters. In this respect, reforms can be viewed as mechanisms for enhancing the effectiveness of the democratic process. Because such reforms have important implications for federalism, they can also be viewed as mechanisms for maintaining or restoring a balance of power between the states and the national government.

Fiscal reform could be constitutional and/or statutory. There are various costs and benefits associated with constitutional reform relative to statutory reform. Reform via the U.S. Constitution can be a complex and ponderous undertaking, but one that represents a potentially strong and abiding restraint on the behavior of government. Statutory reforms may be instituted more easily; however, such reforms can also be modified more easily or removed entirely. In general, then, statutory measures can be expected to represent less effective restraints on government behavior. In this sense, one needs to consider a trade-off between the loss (gain) of fiscal flexibility and the gain (loss) of restraining power when contemplating the substitution of constitutional amendments for statutory restrictions (and vice versa.)

A. Gramm-Rudman-Hollings and Balanced Budgets

The status quo should first be considered briefly. In December 1985 both houses of the Congress passed the *Balanced Budget and Emergency Deficit Control Act*, an amendment to the debt ceiling limit bill (PL 99-177), named after its sponsors, Senators Phil Gramm, Warren Rudman, and Ernest Hollings (*Gramm-Rudman-Hollings*). The act is intended to produce a balanced federal budget by FY 1991. It establishes deficit reduction targets for each fiscal year until then. The stipulated maximum budget deficit in fiscal 1987 is $144 billion (the targets for succeeding years are: 1988, $108; 1989, $72; and 1990, $36 billion).

The most controversial feature of *Gramm-Rudman-Hollings* is its requirement for automatic, across-the-board spending reductions in the event that Congress fails to provide for either spending reductions or revenue increases sufficient to meet the deficit target. Representatives Dale Kildee (D-MI) and Ted Weiss (D-NY) have introduced a bill (HR 275) to repeal *Gramm-Rudman-Hollings* on the grounds that these automatic spending reductions are unfair. Representative Weiss has argued that *Gramm-Rudman-Hollings* has failed to achieve its goals and that deep budget reductions would, in any event, plunge the nation into a recession. Programmatically, the net effect of

Gramm-Rudman-Hollings has been to reduce spending on domestic programs, especially those that serve poor and middle-class Americans, while at the same time protecting excessive defense spending from needed cuts. *Gramm-Rudman-Hollings* ignores the fact that the budget crisis has been caused by "two fundamental policy changes enacted by the Reagan Administration—huge increases in defense spending and extravagant tax giveaways to the wealthy." What is needed, then, are tax increases as well as reduced defense spending.[1]

There have also been technical controversies over the act. The Comptroller General was assigned the task of performing these reductions. Although a special three-judge panel threw out this procedure as unconstitutional in February 1986 on the grounds that it violated the separation of powers (because the Comptroller General, as head of the General Accounting Office, works for the Congress and not the executive branch)—a decision upheld by the United States Supreme Court in July—the Congress has made some efforts to abide by the act's requirements. In the first seven months of fiscal 1986, $11.7 billion in automatic spending reductions were made in order to achieve the *Gramm-Rudman-Hollings* target. Despite the recent Supreme Court ruling concerning the constitutionality of the automatic cutting mechanism, the Congress appears to be in general agreement that the *Gramm-Rudman-Hollings* target for fiscal 1988 should remain the goal—although the actual deficit is likely to exceed that level slightly.

The Administration's proposed budget for fiscal 1988 remains within the *Gramm-Rudman-Hollings* deficit target range. However, the Administration's estimate is, in part, predicated on the assumption that the federal government can expect a sizable windfall in revenues in the coming year due to the recent tax reform bill. Initial estimates of the effect of tax reform on revenue flows indicate that an $11 billion windfall can be expected in 1987. The Congress could, therefore, decide that this additional revenue will be sufficient to keep the deficit below the ceiling without further spending reductions. Both the Administration and the Congress are likely to agree on additional "revenue enhancements" to reach this goal, but the bulk of these will be essentially one shot (e.g., selling off federal assets).

However, there are strong reasons to doubt the effectiveness of *Gramm-Rudman-Hollings* beyond 1987. In the current *Gramm-Rudman-Hollings* legislation, there is no effective provision for enforcing automatic cuts (following the recent Supreme Court decision); Congress is therefore not bound to follow these procedures in the event that the *Gramm-Rudman-Hollings* targets are not met. A "Gramm-Rudman-Hollings II" bill has been introduced in the Senate to restore the enforceable automatic cutting mechanism in a constitutionally acceptable form, but the bill has not been enacted into law. Fiscal 1988 may, therefore, require very large spending reductions in order to meet the *Gramm-Rudman-Hollings* target.

The Administration's budget proposals for FY 1988 include provisions for spending cuts of $19 billion. The President's budget also predicts an increase in receipts of $6.1 billion in FY 1988. If these figures prove to be accurate, the federal deficit will be reduced significantly. However, most of the easy spending cuts have already been made, and further reductions are likely to be more difficult politically. The prospect for further asset sales after 1987 is also uncertain. Furthermore, if the economy is weak next year (a possibility according to some economists, despite the recent strong performance of the stock market), the deficit is likely to grow, thereby exacerbating the problem facing both the Congress and the President. The President's FY 1988 budget proposal projects a deficit of $92.8 billion in FY 1989—over $20 billion above the *Gramm-Rudman-Hollings* target of $72 billion.[2]

Finally, the future stability of *Gramm-Rudman-Hollings* is open to doubt because of features built into it by the Congress. In writing *Gramm-Rudman-Hollings*, the Congress protected essentially all important programs that pay benefits to individuals, either entirely, or by allowing only their cost of living increases (COLAS) to be cut (as in the case of federal retirement programs). As a result, the bulk of any automatic cuts will come equally from nonexempt domestic and defense programs, which together account for only about 27 percent of the federal budget. Assuming low rates of inflation, the COLA cuts will likely be relatively small. Even a relatively small dollar amount of automatic cuts would likely result in huge percentage decreases in these nonprotected programs; by contrast, automatic cuts totaling $10 billion in a more than $1 trillion budget would probably result in only relatively minuscule reductions in many different programs. The latter type of automatic reduction, though, would probably be much more politically tolerable than the former.

In this context, the question of the desirability of a constitutional amendment mandating a balanced federal budget—as well as the other proposed statutory mechanisms that would seek to accomplish the same end—remains relevant. Admittedly, *Gramm-Rudman-Hollings* in its current form could work. But then again, it might not.[3]

B. Spending and/or Revenue Limitations Proposed in Congress

Because of uncertainty about the effectiveness of *Gramm-Rudman-Hollings* as well as wariness about amending the U.S. Constitution, members of the Congress have proposed a number of budgetary resolutions. These resolutions propose to achieve fiscal restraint in one of two ways: either by imposing explicit spending and/or revenue growth limitations (similar to the limits in effect in several states), or by revising congressional budgetary procedures.

There is somewhat greater diversity among these resolutions than among those calling for a balanced budget amendment. The plans run the gamut from extremely stringent requirements for balanced budgets combined with tight spending lids to reorganization of the entire congressional budget process without any specific rule for eliminating deficits. In principle, a combination of spending and/or revenue lids with budgetary procedural reform is possible, and might be more effective than either one or the other reform alone.

C. Line-Item Veto Authority for the President

Another possible tool of fiscal discipline is line-item veto authority for the President. Many states grant their governor some form of line-item veto authority. This authority need not simply be a fiscal discipline mechanism, although such authority could in principle be limited to appropriations bills. Proponents argue that the line-item veto would prevent, or at least moderate, the excessive growth of government spending that can result from congressional log-rolling and "pork-barrel" politics by permitting the President to strike particular items from the budget and thereby prevent individual items (which the legislature as a whole would not regard as serving the public interest) from being bundled with other, larger spending proposals that do command a consensus. In other words, a line-item veto could tend to function as a fiscal discipline device.

In the context of single continuing budget resolutions of over half a trillion dollars, the case for line-item veto authority for the President becomes more plausible than ever.[4] No President is likely to veto an entire appropriations bill of this magnitude in order to save the taxpayers "only" a few billion dollars by eliminating spending he deems unnecessary and/or excessive. Furthermore, a number of proposed reforms of the congressional budgetary process call for only one budget resolution per annum (and some per biennium). Line-item veto authority is arguably a necessary balancing mechanism in the event of such reforms.

There are basically two different ways of providing the President with line-item veto authority. The one which has received the most attention is one that could be provided by a constitutional amendment. Proponents argue that such an amendment would insulate Presidential veto power from the whims of the Congress, and that such insulation would be necessary to ensure that the President could wield his authority effectively. Governors with line-item veto power hold it by virtue of their state constitution.

However, it is also possible to provide for such authority via legislation. Currently before the Congress are two bills that would grant the President line-item veto authority. Many scholars have argued that the Congress confronts what economists term a "free-rider problem" with respect to fiscal discipline, particularly on the spending side; that is, even though all members of the Congress might agree that spending in general should be trimmed, each member refuses to trim programs that benefit his or her constituents. By providing the President with line-item veto power, the Congress could overcome this problem. If so, then legislation providing line-item veto power to the President would be safe from political pressures to revoke it in response to veto activity the Congress may find displeasing. If this is the case, line-item veto authority via legislation would certainly be easier to implement than that via a constitutional amendment.

On the other hand, some observers are skeptical that improved fiscal discipline would be the actual result of granting the President such a power. Some critics, including some former governors, argue that members of Congress will only pad the budget, knowing that the President will veto the items, or even wanting him to veto them. More substantively, critics of the line-item veto argue that such authority involves an unjustified transfer of power from the Congress to the President. They argue that such a shift of power is unlikely to lead to improved budgetary responsibility, but instead to changes in the composition of the federal budget in ways the President happens to favor. The line-item veto could be wielded by a President not merely to eliminate waste and "pork barrel" from appropriations bills, but also to facilitate the President's

policy or political agenda. For example, the President could threaten to veto a spending project important to the constituents of a particular member of Congress if the legislator refused to vote the way the Administration would prefer. Opponents insist that advocates of the line-item veto typically portray the President as a "white knight" battling a Congress beholden to special interests, while in reality, both the President and members of Congress are normally practical politicians who sometimes make good, and sometimes make bad, decisions. Also, the President already has a powerful veto authority, which most recent holders of that office have utilized far less than they might have.

D. Capital Budgeting and Reform of the Federal Budgetary Process

As the federal budget is now constituted, operating outlays and investment outlays are treated alike. Some observers have argued that investment-like outlays should be presented in a separate capital budget and financed primarily by borrowing. Current operating expenses would then be funded from current revenues.

Proponents of a separate capital budget emphasize the disadvantages of the present unified budget. For example, some cite what they view as the rapid deterioration of public infrastructure as evidence that capital expenditures are not dealt with in an appropriate manner in the existing budgetary process. In 1984 the National Infrastructure Advisory Committee to the Joint Economic Committee reported that capital outlays for basic infrastructure as a percentage of GNP have declined significantly in real terms since the early 1960s. The committee projected a revenue shortfall for basic infrastructure needs of $450 billion for the period 1983-2000.

In its recommendations, the committee called for a separate federal capital budget that would distinguish capital outlays from current operation outlays as the key to redressing this perceived imbalance. The committee concluded that a separate capital budget would redefine the federal commitment to supporting infrastructure investment and would put to rest the "considerable uncertainty" about the federal government's future infrastructure role.[5] The committee argued that the apparent neglect of public infrastructure maintenance is a consequence of such investment being lumped together in the existing federal budget with all of the various forms of current expenditures, despite the fact that unlike many of these other programs, infrastructure maintenance investment generates a stream of future benefits of great magnitude.

Proponents also argue that a separate capital budget is now routinely used by state and local governments, as well as by many private business firms. They see the adoption of a separate capital budget as bringing the national government in line with modern accounting practice. Using standard accounting procedures, capital outlays would not add to the budget deficit in the year when the spending occurs but would be deferred to future years and would be balanced against accrued benefits from the investment. Such an approach would allow a clear overview of the nation's infrastructure needs and would permit long-range planning to meet those needs.[6]

Critics point out that state and local governments, as well as the federal government, have reduced infrastructure investment, despite the fact that many states and local governments have separate capital budgets.[7] To be sure, the federal government currently bears a large proportion of the fiscal responsibility for infrastructure expenditure (e.g., the interstate highway system), but it is still the case that the state and local experience with separate capital budgets may not be directly applicable to the federal government.

Opponents of capital budgeting also argue that removing investment-like outlays from the unified budget would make it impossible to establish priorities among programs. Given a finite amount of funding, the Congress must make choices as to which programs will receive funds. Direct tradeoffs among competing interests are difficult enough within the unified budget. Opponents of a separate capital budget also argue that such a budget would encourage the Congress and the President to shift spending from current to capital accounts in order to make it easier to finance some activities by borrowing, even in cases where the arguments justifying such a transfer are weak.[8]

There are, however, certain conceptual problems with a federal capital budget. Private firms operate on the basis of profit and loss, and they market the goods they produce directly to consumers. Capital can be distinguished from current operating expenses, and capital can be seen to earn a measurable rate of return. But in the case of governments, which operate in a very different decision-making environment and can be said to "market" the public goods they produce only indirectly to their citizens (who are required by law to pay for them in the form of taxes), the concept

of "capital" is ambiguous. While a school, highway, aircraft carrier, or some other public good requiring long-term investment may be expected to generate future benefits, such long-term investments cannot be bought and sold across markets and, hence, have no genuine capital value; further, future benefits are difficult to measure in any precise way. Taxpayers and voters have no way to calculate the "true" rate of return on long-term investments in the case of most public goods. This is different from the case of private firms, where a single rate of return on capital will be unambiguous.

There is also controversy regarding the types of expenditures that should be included in a capital budget. In addition to spending for infrastructure, expenditures for human capital investment, for military weapons systems, and for research and development have also been considered for inclusion in a capital budget.

Long-term investments of many types are important in the provision of many kinds of public goods by government. But given the ambiguity involved in assigning dollar values to the future benefits associated with such spending, and consequently the lack of a genuine, business-like capital value attached to such investment by government, a separate capital budget may tend to give a spurious precision to the value of public sector investment, and reinforce the notion that long-term investment is somehow "better" per se than short-term spending. This is not to deny that information detailing the proportion of government spending devoted to investment as opposed to current outlays is not likely to be useful to both voters and legislators, but such information may be relatively less meaningful or useful in the case of government than it is in the case of a private firm. While common business practices can help to improve government organization in some ways, government is not a business; it necessarily operates according to different standards.[9]

Proponents of a separate capital budget counter that these kinds of obstacles are only technical and can be overcome once the government has made a commitment to separate accounting for investment activities. According to them, policy considerations must take precedence over problems of accounting consistency and format.

However, the recent history of off-budget spending is relevant here. Until the fiscal 1986 budget, certain forms of federal spending (e.g., the Federal Financing Bank) were not listed in the budget of the United States (typically, such activities as loan guarantees of various sorts). Many critics argued that this off-budget activity was simply disguised government spending, and that closing this loophole was vital for preventing end-runs by the federal government around fiscal limitations. The issue was finally resolved for all intents and purposes when outgoing Director of the Office of Management and Budget David Stockman ordered that the 1986 Budget document contain estimates of on-budget plus off-budget outlays together, along with the official budget figures. Without any formal change in budgetary rules by the Congress, off-budget expenditures were brought on-budget de facto.

The moral would seem to be that most of the planning advantages of a separate capital budget can be achieved simply by presenting estimates of capital expenditure as distinguished from current outlays, without any formal changes in budgetary rules. (See *endnote 33* for further discussion of this possibility.) By the same token, most of the disadvantages of a separate capital budget cited by critics are contingent on the assumption that such an accounting device (along with a separate current outlays budget) would replace the present budgetary system rather than supplement it. Obviously, gamesmanship at the level of defining certain forms of spending as "capital investment" for purposes of protecting them from critical scrutiny would be basically pointless as long as capital outlays were presented separately for informational purposes—and especially so if different estimates, based on different definitional assumptions, were presented—alongside the figures for total outlays. It is hard to see what the disadvantages could be to providing such additional information to voters and legislators.

Regardless of the merits of presenting a separate capital budget, such a budget would likely be a fiscal discipline device only in the limited sense that it could improve budgetary efficiency. A capital budget per se is not a limit on fiscal behavior. Although it is sometimes mentioned alongside various fiscal limitations (e.g., a balanced budget amendment), its customary function is not so much to restrict the growth of spending, taxing, or deficits, but to improve the organization of the budgetary process. Some opponents of a separate capital budget argue that it would be little more than a kind of window-dressing behind which the true size of a budget deficit could be hidden from voters.[10] But as long as information concerning the total budget—capital and current accounts—is freely available, it seems doubtful that voters could be systematically hoodwinked. If estimates of a hypothetical capital budget were published alongside total budget figures, voters would have the opportunity to evaluate the deficit from both perspectives. Again, it is hard to see how increasing the available information would not benefit all participants.

State Capital Budgeting. While capital budgeting by the federal government has been discussed for many years but never implemented, both local governments and the states have had extensive experience with capital budgeting. Forty-two states have some form of capital budget. However, there is wide variation among the states' capital budgets. According to a recent article by Jonathan Rauch:

> In some states, such as California, the capital budget is simply a separate listing, within each agency's budget, of capital spending. In others, it is a separate document. In some, the legislative capital budget is an appropriations bill, or a bunch of appropriations bills, which may or may not be passed annually . . . . Eight states generally finance their capital spending out of tax revenues rather than by borrowing. Thirty-three states leave some of their capital spending—sometimes the bulk of it—out of their capital budget.[11]

A cursory survey of state capital budgeting practices reveals the following diversity.[12] Of the 42 states that maintain capital budgets, 37 generally finance capital expenditure through borrowing (whether through general obligation bonds, revenue bonds, or both). The other five states do not ordinarily finance capital expenditure through borrowing. The fact that a state maintains a separate capital budget does not necessarily imply that capital appropriations are dealt with separately in the legislature. While 34 states present capital appropriations in a separate capital bill, the other eight capital budget states integrate capital and noncapital appropriations in single bills. To illustrate: the "capital outlay budget" of Michigan and the "capital expenses" of Virginia are listed separately from the remainder of the budget. In New York, capital spending is listed within each agency's budget. Illinois finances most capital projects by the sale of bonds, while Virginia finances many out of tax revenues. New York has a "capital projects fund," but not all capital projects are contained in it.

The problems of defining "capital" and of preventing the classification of items from becoming a political football in the case of a federal capital budget has caused some critics concern. These matters do not appear to be much of a problem for the states. The definition of "capital" does not vary much from state to state. Almost all states include in their capital budget the purchase of land, construction, buildings, and the initial purchase of major equipment necessary in connection with construction. Twenty states also include other major equipment. Major maintenance is generally included in the capital budget by 36 states, although in some of those states, such maintenance sometimes appears in the operating budget instead. Additionally, three states generally classify certain kinds of motor vehicles as capital investments.

There appears to be little controversy about the appropriateness of applying the term "capital" to the above forms of spending. However, some proponents of a federal capital budget argue that such a budget should include "human capital" investments. At present, no state capital budget includes investment in human capital (e.g., expenditures for education and training), even though such investment might be thought of as yielding long-term gains for the state. It is in the case of intangible forms of investment like this that the most controversy is likely to arise over specific cases. Such diverse forms of expenditure as child care programs, postage allowances for legislators, and state inspection of barbershops might plausibly be argued to represent forms of long-term investment. In each of these cases (as well as most other forms of spending that may produce future returns which may be hard to measure) such classification could be very controversial. The states appear to have avoided such problems altogether by opting for relatively conservative definitions of capital investment. By so restricting capital budget assignments to activities like prison and school construction, maintenance and replacement of buildings and other capital stock, and other forms of spending that seem to be unambiguously related to investment, the states seem to have been able to avoid undue political manipulation by legislators seeking to protect programs they favor, regardless of the current or capital nature of the projects.

It must also be noted that, even in states with separate capital budgets, some capital spending normally does not appear in those budget documents. Twenty-five states have autonomous authorities of various sorts, and the spending they conduct is entirely outside the state budget. These authorities are most commonly charged with constructing toll roads, bridges, ports, and university systems. In only nine states are all major state capital spending projects reported in the capital budget. Most commonly excluded of the major forms of expenditure is transportation capital.

One of the major goals of the advocates of a federal capital budget is an explicit allowance for depreciation over time of the public capital stock. Certainly in private financial accounting systems, depreciation is an important element. However, no state budget includes depreciation.

In terms of the questions of whether a federal capital budget would serve as a major restraint on spending or only do little more than hide real deficits, it should be noted that the capital budgets of states are

usually relatively small. For example, in FY 1986 the "capital improvements" budget of North Carolina was equal to about .6 percent of the current general fund operating budget; in New Jersey, capital construction appropriations amounted to about 2 percent of current general fund appropriations; and in Michigan, the "capital outlay budget" was about 5.9 percent of current general fund expenditures.[13]

State capital budgets also do not explicitly weigh assets against liabilities—a major goal of most advocates of a federal capital budget. This is the form of capital budget used by corporations, and is subject to the problems noted previously—namely, government is not a corporation, and long-term public investments are not "capital" in a strict or easily definable sense. To reiterate, such problems are not insurmountable; it is certainly possible to make accurate estimates of government capital expenditures based on reasonable definitions and assumptions, even if it is also unlikely that one single estimate would be universally regarded as correct. The state experience in this connection does not provide much guidance for the design of a "corporate-like" federal capital budget.

In sum, increasing the availability of information regarding the nature of federal spending—especially in terms of the mix between current outlays and capital investments likely to generate benefits in the future—has considerable merit. It seems less clear whether a separate, explicit, single capital budget is necessary to accomplish this goal. Furthermore, because of the definitional problems associated with calculating a "corporation-like" government capital budget, it is unlikely that one set of estimates could command consensus support.[14] There might, therefore, be advantages to presenting several different estimates of federal capital spending in the budget documents, each based on a different set of reasonable assumptions.

E. Other Possible Kinds of Budgetary Reform

Several other kinds of fiscal restraints are important in the states, and potentially relevant to the federal government. Although these mechanisms are ordinarily of lesser significance for state fiscal decision making than some other devices (which are extensively analyzed in *Chapter III*), each deserves to be considered briefly.

Tax and Expenditure Limits in an Environment of Budgetary Balance. The most restrictive fiscal environment is in these states in which there are both stringent balanced budget requirements and limits on the growth of spending and/or taxes. When a state is required to balance its budget each fiscal year and, at the same time, maintain a lid on spending, both deficits and spending growth (beyond a certain defined percentage) can be eliminated. California lawmakers are confronted with this situation. There is a limit on the growth of appropriable tax revenues (the "Gann Limit," passed as a constitutional amendment by way of an initiative in 1979)[15] and a state constitutional requirement for a balanced budget. Yearly growth in appropriations may not exceed the percentage increase in population and inflation. Also, surplus revenues must be returned to taxpayers by revision of tax rates or fee schedules within two fiscal years. The California limit is unusual in that it is defined in terms of state population increase and inflation. It is not defined as a maximum allowable percentage rate of growth in state government appropriations (as in Colorado), the average rate of growth of state appropriations over a previous period (as in Hawaii), or as a percentage of state personal income (as in Arizona). Alaska is the only other state that has a limit defined in terms similar to that of California.

In the first few years after enactment of the Gann Limit, the limit was not an important factor in the state budget-making process. State spending still had room for growth before it approached the limit. In the early 1980s, high rates of inflation and slow growth in tax revenues associated with the recession were enough to prevent state spending from reaching the established ceiling. However, state spending has been steadily approaching the limit during the past five years, and spending adjustments may be necessary in order for the state to remain within the limit in the 1987-88 fiscal year, which begins on July 1. There are indications that major cutbacks may be required in the following fiscal year.[16]

The limit does not expressly restrict deficits in California; the state constitution already does that. What it does, which the balanced budget requirement does not do, is explicitly limit spending. Although many advocates of balanced budgets argue that deficits tend to drive excessive government growth, it is possible in principle to have both balanced budgets and rapid growth in government spending. California's "Gann Limit" eliminates this possibility.

This situation is not unique to California. Eight other states face generally similar sets of fiscal restraints (i.e., stringent balanced budget requirements combined with either limits on the permissible level of

tax revenues as a percentage of state personal income, or similar limits on appropriations).

Some advocates of balanced budget amendments to the U.S. Constitution have long argued that such tax and expenditure limits would be desirable because of their potential for reducing the rate of growth of federal spending. A number of proposed, and some introduced, amendments make explicit provisions for either revenue limits, or spending growth limits in addition to balanced budget requirements. To the extent that deficit reduction measures are deemed desirable due to a belief that budgetary imbalance leads to excessive growth in federal spending, it makes sense to combine such devices with express limits on the ability of political decision makers to balance budgets by simply raising revenues. This would prevent the intentional use of deficits by the Congress (or the President, or both acting together) as a means for achieving growth in government spending.

On the other hand, combining tax and/or expenditure limits with balanced budget requirements reduces the flexibility of the legislature in responding to changing economic conditions, especially in situations where a deficit occurs as the result of an unforeseen revenue shortfall during a recession. There may be situations where most voters would actually prefer a greater reliance on tax increases than on spending reductions, at least within a certain range. Proponents of this position might argue that such reduced flexibility would frustrate the desires of voters as expressed through their elected officials.

Annual versus Biennial Budget Cycles. Twenty-one states have biennial budget cycles. Some critics of the federal budgetary process have suggested that moving from an annual budget to a biennial budget would be a worthwhile reform for the federal government. In fact, several bills have been introduced in Congress to make this change.[17]

Advocates of a biennial budget make several distinct, but related arguments in its favor. They suggest that it would reduce the sometimes lengthy delays in the congressional budget process because the federal budget has grown too complex for the time now allotted—basically, January through September.[18] Proponents argue that a biennial cycle would simplify the budget process for federal agencies and for state and local governments because they would know the level of appropriations in advance (making planning easier), and also that such a two-year cycle would eliminate one year of time-consuming appropriations procedure and preparation, allowing both the legislature and the executive to devote more time to other matters. Most important, a biennial budget cycle might lead to more careful consideration of appropriations, allowing the Congress to spend more time on careful program planning and design. This could imply that a biennial budget cycle would lead to lower deficits and lower spending.

However, critics charge that a biennial cycle would require so many mid-cycle corrections and adjustments that the biennial process would be as time consuming as the present system.[19] Some critics have argued that a biennial budget would make planning even more difficult for agencies and legislators because of the increased number of supplemental appropriations. Finally, a two-year cycle might actually allow for less control over programs, by favoring established programs over new ones and helping to entrench spending interests.[20]

The record of the states on this point is somewhat unclear. Although 33 states have annual budgets, or in practice undertake annual review, this number has not changed since 1972. In the early 1940s only four states had an annual budget. State switches from biennial to annual budgets grew most rapidly during the 1960s; in 1962, only 18 states had annual budgets. The predominant reason for the shift to annual budgets—a move advocated by many "good government" reformers—was the belief that financial and budgetary policies must be reviewed more often than every two years.[21] Also, seven states which have a biennial budget cycle also have biennial legislative sessions; no states have annual budgets and biennial sessions.

A shift to a biennial budget for the federal government may or may not be a useful way to improve efficiency in the budget-making process. However, such a device is problematic in terms of its expected effect on either deficits or spending; it could increase, decrease, or simply have no effect on spending and/or deficits. For this reason, a biennial budget—however potentially important as a means for making the budget-making process more efficient—is probably not properly considered a "fiscal discipline" mechanism, strictly speaking.

Unified Budget. A unified budget refers to a system that merges appropriations, authorization, and revenue decisions. Proponents of this kind of system argue that a unified budget would force legislators to face up to hard choices between increasing spending and increasing taxes, rather than deferring such decisions to some later date.[22] New spending would have to be matched with sources of new revenue, or else "exchanged" in the legislative process for some reduction in existing spending programs. This kind of arrangement would have the added advantage of making deficits impossible. Arguably, a unified budget is another way of accomplishing the same goal as a balanced budget requirement.

At least one state has established such a system in a limited way. Maryland requires that appropriations bills other than the budget bill can be introduced only if they provide for funding sources. However, no states require that appropriations and funding decisions be combined in a comprehensive fashion in budget bills.

Rule of Germaneness. One way of accomplishing the same thing would be to institute a "rule of germaneness" in the legislature. All state legislatures have such a rule in some form. What this means is that the leadership in either or both houses of the legislature has the power to define limits on what is germane, or relevant, to any given bill. Any riders or other encumbrances which legislators attempt to introduce can be ruled out of order. For example, a paragraph appropriating money for hospitals would probably be ruled not germane to a bill designed to provide money for trash disposal. Such a rule can, in principle, prevent a situation like that which sometimes occurs in the United States Congress, where whole separate pieces of legislation have been inserted into appropriations bills, or cases in which completely unrelated spending provisions have been "tacked on."[23]

F. Proposals for Constitutional Reform

The legislatures of 32 states have enacted resolutions petitioning the Congress to summon a constitutional convention for the purpose of considering a balanced budget amendment to the U.S. Constitution. This effort (which began in 1976, prior to the "tax revolt" of the late 1970s) is only two states short of the number needed to compel the Congress to act. The majority of the states have, therefore, placed this issue on the constitutional agenda of the Union and made fiscal discipline a priority for the federal government.[24]

The most prominent versions of the amendments would require the federal government to balance its budget under ordinary circumstances. All of these proposed measures would require the federal government to balance the budget each fiscal year. Many economists, however, argue that it would be better to balance the budget over the course of the business cycle—though economists also differ on precisely how to define and predict the length of business cycles. There are, moreover, various problems associated with the design of an effective balanced budget amendment—for example, defining the precise dimensions of the budget to be balanced, preserving adequate flexibility so that the federal government could still respond effectively to fiscal crises while retaining sufficient strength so that the amendment could not be evaded easily, and enforcing constitutional requirements (including the design of sanctions for failure to abide by an amendment's restriction). These problems have been addressed in different ways in the assorted proposals for designs of balanced budget amendments which have been introduced in the Congress.

Fourteen resolutions proposing a constitutional amendment requiring a balanced federal budget were introduced in the 99th Congress prior to the passage of *Gramm-Rudman-Hollings*. For such an amendment to be added to the U.S. Constitution, it would first have to be passed by a two-thirds majority vote in both Houses, and then ratified by three-fourths of the states.

All of the proposed amendments would require total outlays not to exceed total receipts. They differ in the exact definition of "receipts," the special circumstances (if any) under which outlays could temporarily exceed receipts following a special vote by the Congress, and the majority that would be required for such a vote to be effective. The proposals also differ on other matters, such as the kinds of restrictions included (e.g., limits on the annual rate of growth in certain specific budget categories).

The wisdom of a constitutional amendment, of course, has been subject to considerable controversy. Some opponents of a constitutional amendment argue that an amendment would be an unnecessary and undemocratic restriction, or even rejection, of the will of the majority. A number of proponents argue that an amendment would enhance the democratic process.

Some supporters of an amendment argue that opponents are basing their objections on an idealized model of "perfect political democracy." The substance of this model is the idea that democratic government will only act on the will (expressed at the ballot box) of the majority of citizens. This model can be a helpful analytical tool in studying political institutions, but for understanding how real institutions function, it would appear to be deficient in three important ways. First, unrestrained democracy does not protect minority rights in every instance (e.g., civil rights). Second, the model of perfect democracy neglects fundamental logical inconsistencies of the majority-rule political process (discussed below), which can produce considerable instability in voted outcomes. Third, the model assumes that there are no costs to mobilizing and acting politically (costs which are sometimes referred to by economists as "information and transactions costs").

The model of perfect political democracy assumes that politically significant activities—such as becoming informed about the workings of government on a day-to-day basis, communicating preferences to legislators, and voting itself—all cost the citizen little or nothing in time or money. Furthermore, while the model of perfect democracy assumes that the "majority will" is well defined and stable, political decisions in real electoral and legislative settings overcome the instability problems associated with majority rule outcomes only when they closely approximate unanimous agreement among voters. If these assumptions were realistic, voter sovereignty expressed through ballots would seem to be a close analogue to consumer sovereignty expressed through dollar "votes." Perfect political "markets" (across which "political goods" are exchanged for votes) would share the characteristics associated with perfect markets for ordinary goods that satisfy consumer preferences efficiently. In short, the real world is more complex than the model.

The model of perfect private markets is unrealistic because there are significant costs to exchange, and for certain goods, property rights may be ill-defined and true demand unrevealed. This fact tends to lead to inefficient levels of provision of many different kinds of goods and services—levels that are different from the levels the public would prefer. Such market failure has long been recognized and plays an important role in justifying a wide array of government regulations and activities designed to correct these problems. In turn, government failure also persists in democratic systems. Just as perfect markets are usually unachievable in practice, so is the model of perfect political democracy, because it is unrealistic to ignore the inherent instability of majority rule decision making and to assume that there are no informational and transactional costs in the political process.

A large body of literature has grown up in recent years that analyzes the causes and consequences of problems with majority rule decision making.[25] This research also seeks to explain the behavior of politicians as rational individuals who ordinarily respond in predictable ways to different incentive structures. These writers attempt to study the decision making of democratically elected officials in a realistic setting.

In order to understand the question of constitutional limitations on government, it is first necessary to explore the role and function of government in a free democratic society. In a market society, the private sector is based solely on voluntary exchanges of goods and services. Government, however, establishes the necessary prerequisites for peaceful market exchange by providing the basic services of law, protection of the public peace, and national defense. Many would argue that there are other proper roles for government action (such as providing income assistance for the poor.) But without these basic services, an orderly market economy could not function. These services are examples of public goods. Once produced, these goods benefit all residents regardless of whether they have contributed to defray the cost of their production.

The provision of public goods creates a simple problem: if individuals know that they will benefit from a public good regardless of what they contribute to the cost of providing it, they may make the rational decision to free-ride on the investment of others (by paying nothing, or by paying less than the share they themselves would otherwise regard as fair, other things being equal). Hence, a purely voluntary provision of public goods is likely to provide a smaller quantity of the good in question than the public would actually prefer to purchase; in some cases, none of the public good might be provided, however urgently desired by the public. Government can resolve this problem (in principle) by cutting the knot of free ridership by replacing the voluntary provision of public goods with the coercive collection of revenues via taxation. In a federal system, moreover, the provision of public goods can be shifted from one jurisdiction to another. In this sense, it is not contradictory for individuals to prefer to be coerced, so long as that coercion is consented to (in principle by citizens) before the fact and represents the low-cost method of providing public goods.

By coercing all members of a community to pay a share of the costs of a public good, which all agree is fair, the free-rider problem is overcome. The public good can be provided in the quantity the community agrees is adequate. In theory, tax finance of public goods may provide the same level of funding contributions that individuals would have agreed freely to offer in exchange for the good had the free-rider problem not intervened.[26]

However, in the absence of express restraints, government is unlikely to limit its coercive taxing power merely to resolving the public goods/free-rider problem. The power of coercion allows government to extract wealth from individuals over and above what they would freely exchange for public goods. In a representative democracy, legislatures come under intense pressure from organized coalitions of voters sharing particular interests of the majority. Those groups less well organized to influence the decisions of legislatures in the use of the coercive power of government are likely to suffer. This is particularly true of a tax where the coercive power of government is partially masked, as with automatic withholding of in-

come taxes and automatic increases in tax levels due to economic growth and inflation (so-called "bracket creep"). It is in order to protect the democratic process and the general interest from abuse by special interest influence that restraints on the power of government to engage in coercive transfers of wealth have been viewed as vital by many past and present students of democracy.

The term "constitutional restraints" can be said to refer to all mechanisms for establishing limits to political decision making in the broad sense, and is thus basically synonymous with the "rules of the game" of political behavior in a democratic setting. Hence, the concept of a fiscal constitution aimed expressly at establishing limits on government's taxing, borrowing and spending power includes those portions of the U.S. Constitution relevant to public finance (and there are many, starting with the honoring of contracts). However, the concept is more extensive because it includes all other statutory and nonstatutory, formal and informal, restraints on political decision makers with respect to fiscal activities. Most citizens appreciate the importance of constitutional guarantees of freedom of speech and other rights; however, there is sometimes a tendency to overlook the constitutional protections afforded citizens against arbitrary expropriation and other violations of economic rights. The debate over different possible constitutional mechanisms of fiscal discipline is, in part, a debate over the degree of appropriate protection of the economic rights and interests of citizens against the potential irresponsibility of government's fiscal decision making.

Restraints on political decision making in the form of a fiscal constitution could play a significant role in preventing slippage between the preferences of voter-taxpayers and the actual behavior of politicians controlling public finances. Some scholars of public finance have concluded that political decision makers tend to prefer debt to tax finance.[27] Under realistic assumptions concerning the incentives facing voter-taxpayers and politicians, respectively, decision makers may be expected to choose a mix of debt and tax finance for government activities, a mix that a majority of voters would not regard as suitable (i.e., give rise to a "deficit problem"). There may, for example, be a tendency for the political process to generate higher levels of debt—and a consequent shift of tax burdens to future generations—than citizens would consider optimal.

As to the other side of the debate, some policy makers object to the possibility of enacting a balanced budget amendment, even though they generally favor budget balancing (and in some cases even specific restrictions on the growth in outlays and/or revenues). Some critics have expressed concern that adoption of a balanced budget amendment would tend to lead to the routine adoption of amendments and tend to trivialize the Constitution.[28] Others have argued that the constitutional amendment process is too unwieldy and time-consuming, and that legislative reforms designed to achieve the same goals would be more effective. Legislative reforms would also have the advantage of being easier to adjust in terms of technical presentation (e.g., the precise definition of receipts, or the exact limits on the growth of budgetary categories). Constitutional amendments could be interpreted broadly or narrowly, but could not be "fine tuned" in quite the same way as legislative enactments.

Proponents of amendments counter that flexibility is a two-edged sword. Technical adjustments to an amendment would tend to be relatively difficult, but so would attempts to "water down" the restrictions in politically expedient ways. This would imply that a constitutional amendment might be a more binding restraint on political decision making because it would be less flexible. However, some opponents of a balanced budget amendment have expressed concern that such a measure would be too inflexible to permit appropriate fiscal management by the federal government.[29] To the extent that a statutory balanced budget requirement would be easier to adjust, it would be less vulnerable to this line of criticism. The possibility of amending the Constitution also raises the question of what role the U.S. Supreme Court would play in interpreting a balanced budget amendment. Would such an amendment entangle the Court in the budgetary process? Would the Court interpret such an amendment much like it has interpreted the Tenth Amendment, namely, as a truism and therefore essentially meaningless as a restraint on the exercise of congressional power? If the Congress and the President failed to balance the budget, would the Court nullify appropriations or somehow become involved in managing (or "micro-managing") the federal budget?

On the other hand, there is a ready example of a statutory balanced budget requirement that has not worked. In 1978, PL 95-435 (the *Bretton Woods Agreement Act*) was enacted by Congress and contained the following clause in Section 7:

> Beginning with fiscal year 1981, the total budget outlays of the federal government shall not exceed its receipts.

While the lack of effect of this particular statute probably cannot be taken to imply that all statutory requirements pertaining to deficit reduction would be equally ineffective, it does suggest the difficulty of matching legislative intent with actual practice.[30]

In sum, there are a variety of proposed reforms intended to change the fiscal decision-making environment of the federal government. All of these measures would alter the fiscal constitution of the federal government—the set of rules and restraints that guide the fiscal decisions of public officials. In principle, the fiscal constitution can be modified without any changes being made in the U.S. Constitution. While potential amendments to the U.S. Constitution have probably received the most attention, many of the proposed reforms would require only statutory enactment. Assuming that a well-operating system of fiscal decision making requires rules limiting the discretion of public officials, there are a number of options available for potential implementation in the area of fiscal discipline.

ENDNOTES

[1]See Representative Ted Weiss, "Repeal the Balanced Budget Law," New *York Times*, March 3, 1987, p. 27.

[2]Figures from Executive Office of the President, Office of Management and Budget, *Budget of the United States Government: FY 1988* (Washington, DC: Government Printing Office, January 5, 1987), pp. 2-2, M-4.

[3]Commenting on *Gramm-Rudman-Hollings* following the July Supreme Court decision, Jonathan Rauch ("Is It Really Working?" *National Journal*, 19 (January 31, 1987), pp. 244-48) writes:

> What the Supreme Court's decision perhaps did was to change the nature of the beast. The act was conceived as a way to suspend the conventional rules of politics; stripped of its most radical feature, it has instead worked as a handmaiden to those rules. The difference between punishing budgetary failures with political embarrassment and with a government-wide train wreck is the difference between working within the system and upending it (p. 248).

[4]Louis Fisher has recently challenged this idea, arguing that omnibus appropriations bills have been the rule since the first Congress. Certainly, however, the size of the bills has greatly expanded. He also argues that, unlike the appropriations process in the states, the federal appropriations process does not generate bills with line-item sums listed; if the line-item veto authority for the President were to work, the structure of appropriations bills might have to be modified in such a way as to make line-item veto feasible. See "The Item Veto—A Misconception," *The Washington Post*, February 23, 1987, p. A-11.

[5]See The Committee for Economic Development, *Strengthening the Federal Budget Process: A Requirement for Effective Fiscal Control* (New York: CEO, June 1983), p. 3.

[6]The existence of a separate capital budget might also help to mitigate the problem of excessive shortsightedness which some observers attribute to the democratic political process. If voters could easily distinguish between government expenditures made for purposes of investment as opposed to those allocated to consumption, politicians might make greater efforts to orient spending in ways which were designed to increase the capital stock of society. This might tend to cause political decision makers to show greater concern for long-term investment activity of government and less preoccupation with short-run political gains from noninvestment forms of spending.

[7]However, recent research by James M. Poterba implicitly challenges this view. In a paper entitled "Capital Budgets, Borrowing Rules, and State Capital Spending," presented at a National Bureau of Economic Research (NBER) conference held in Cambridge, MA, December 12-13, 1986, Poterba concludes, following an econometric analysis using state data, that states that borrow to finance capital outlays, and those that maintain separate capital and operating budgets, do tend to spend more on public capital.

[8]The Committee on Economic Development (*op cit.*, p. 45) notes:

> The possibilities for arbitrary decisions on what belongs in a separate capital budget (and consequent game playing with budget numbers) are especially numerous because of the formidable conceptual difficulties involved in making decisions on such issues as the classification of various forms of military spending and the basis of measuring depreciation.

[9]The President's budget now includes information on investment-type spending in *Special Analysis D: Federal Investment and Operating Outlays*. The analysis in the FY 1986 budget documents stressed that the figures it contained were used in the process of capital planning and were not to be viewed as a capital budget *per se*. The chief obstacles to a separate capital budget (mentioned in *Special Analysis D* of that document) are the lack of adequate depreciation guidelines, difficulties in classifying non-

defense physical capital investment in the form of grants to state and local governments, and uncertainties in distinguishing between operating outlays and capital investment. Probably the least difficult method of supplying the informational benefits of a capital budget would be to take these estimates already routinely made and present them more prominently alongside the President's budget in the main body of the budget document.

[10]See for example Aaron Wildavsky, *Budgeting: A Comparative Theory of Budgetary Processes* (Boston: Little, Brown, and Co., 1975), pp. 152-53.

[11]Jonathan Rauch, "A Capital Idea for a Budget," *National Journal*, 18 (December 6, 1986), p. 2948.

[12]This discussion draws heavily on a draft paper by Lawrence W. Hush and Kathleen Peroff of the Office of Management and Budget staff, entitled "Tabulation of State Responses to a Survey on State Capital Budgets" (July 1986), based on a detailed survey of responses to questionnaires by relevant state officials.

[13]This account is based on ACIR staff research.

[14]"As a practical matter," OMB Director James Miller recently asked, "how do you amortize nuclear submarines or historic buildings such as the Capitol and the White House?" *National Journal*, 18 (December 6, 1986), p. 43.

[15]At a special election held in November 1979, 74 percent of those voting voted for having the limit, known as Proposition 4, included as an amendment to the state's constitution.

[16]For a recent discussion of these matters, see Robert Schmidt, "Is the Gann Limit Unbearable?" *California Journal*, XVIII (March 1987), pp. 154-57.

[17]These include the "Biennial Budgeting Act of 1985" (HR 382), sponsored by Representatives Leon E. Panetta (D-CA) and Ralph Regula (R-OH); a bill with the same title, HR 748, introduced by Representative Earl Hutto (D-FL); and the "Federal Budget Reform Act" (S 20), introduced by Senator William V. Roth, Jr. (R-DE).

[18]See Alice Rivlin, statement of the Director of the Congressional Budget Office to the Senate Committee on Governmental Affairs, in U.S. Congress, *Hearings on the Budget Reform Act of 1982*, 97th Congress, 2d Session, August 19, 1982; p. 3.

[19]See American Enterprise Institute, *Budget Reform Proposals* (Washington, DC: AEI, August 1985), p. 45.

[20]See Arnold J. Meltsner, "Budget Control through Political Action," in Aaron Wildavsky and Michael J. Boskin, (eds.), *The Federal Budget: Economics and Politics* (San Francisco: Institute for Contemporary Studies, 1982), pp. 320-341.

[21]See Council of State Governments, *Annual or Biennial Budgets?* (Lexington, KY: CSG, August 1982).

[22]See Allen Schick, *Crisis in the Budget Process: Exercising Political Choice* (Washington, DC: American Enterprise Institute, 1986), p. 50.

[23]See Allen Schick, "The Evolution of Congressional Budgeting," in Allen Schick (ed.), *Crisis in the Budget Process: Exercising Political Choice* (Washington, DC: American Enterprise Institute, 1986), p. 47.

[24]The public at large has long favored the idea of a constitutional amendment requiring the federal government to balance its budget, but at the same time regards the likely efficacy of such a device with some skepticism. Although an April 15, 1986 NBC/Wall Street Journal poll found that 74 percent of respondents favored a constitutional amendment requiring the federal government to balance its budget, only 34 percent of respondents thought that such an amendment would actually produce balanced budgets. Most citizens therefore appear to agree that such an amendment might help reduce the federal deficit, but also believe that it would not represent a panacea. Public opinion polls for the past 12 years have consistently found a large majority of respondents favoring a constitutional balanced budget amendment.

[25]For two recent surveys of the literature, combined with a detailed technical discussion of the issues involved, see William H. Riker, "Implications from the Disequilibrium of Majority Rule for the Study of Institutions," *American Political Science Review*, 74 (June 1980), pp. 201-35; and Charles K. Rowley, "The Relevance of the Median Voter Theorem," *Journal of Institutional and Theoretical Economics*, 140 (March 1984), pp. 135-48.

[26]For a general introduction to the theory of public goods, see James M. Buchanan and Marilyn R. Flowers, *The Public Finances* (Homewood, IL: Richard D. Irwin, 1975).

[27]Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (New York: Cambridge University Press, 1980).

[28]For example, see Gary L. McDowell, "On Meddling with the Constitution," *Journal of Contemporary Studies*, 5 (Fall 1982), pp. 3-18.

[29]See for example Paul A. Samuelson, *AEI Economist*, 10 (April 1979), p. 5.

[30]This clause was brought to our attention by Dean Randy H. Hamilton of the Graduate School of Public Administration, Golden Gate University, San Francisco, CA.

Chapter III

Research Findings: Fiscal Discipline Mechanisms In The States

Most of the debate on fiscal discipline has been focused on the federal government—its debt, budget deficit, and overall growth. This is ironic, given that the 50 states exercise a great deal of fiscal independence and face similar problems with respect to fiscal discipline. As a group, the 50 states carried a total debt of $212 billion at the end of FY 1985. This represented a 74 percent increase over FY 1980 and a 194 percent increase over FY 1975.[1] Obviously, then, a comprehensive discussion of fiscal discipline must include the fiscal practices of the states.

The states have had extensive experience with a variety of institutional restraints on budgeting behavior since the early 19th century. These include constitutional amendments and statutes limiting state and local debt; constitutional amendments and statutes requiring balanced budgets; state and local tax and expenditure limitations; and other mechanisms relevant to budgetary decision making, such as the veto authority (both line-item and entire bill) of governors and various constitutional and statutory restrictions affecting spending, such as capital budgeting.

This section presents a brief overview of these state fiscal discipline mechanisms and considers the relevance of the state experience for the federal government.

A. The Range of State Fiscal Discipline Mechanisms

The states employ a variety of fiscal discipline management tools. *Table 2* lists ten categories of what can be regarded as direct fiscal discipline devices. As the table shows, all states have enacted or adopted some sort of fiscal discipline tool, and many states have several different tools in place. There is considerable variation across states in the chosen mix of devices to which the state government is subject. To date, ACIR has analyzed three specific instruments of fiscal discipline in some depth: balanced budget requirements, gubernatorial vetoes, and constitutional debt limitations. These mechanisms are relevant to the fiscal discipline debate in the federal government and are most likely, according to our preliminary investigation, to have significant effects on measurable aspects of state government fiscal behavior.

The most widely used fiscal discipline tool (which all states but Vermont employ in one form or another) is the requirement of a balanced budget. *Table 3* lists state balanced budget requirements in detail. In seven states, the requirement is solely statutory; in 29, solely constitutional; and in 13 states, the requirement is both constitutional and statutory. In three states, the requirement stipulates only that the governor must submit a balanced budget, but in 25 states, it mandates that the state may not carry over a deficit into

Table 2

STATE FISCAL DISCIPLINE MANAGEMENT TOOLS PRESENTLY UNDER STUDY

	Balanced Budget Requirement	Gubernatorial Line Item Veto	Constitutional Debt Restrict.	Tax and Expenditure Limits	Require Super-Majority Vote to Pass Tax	Index Income Tax	Fiscal Note Review Procedure	Program Evaluation & Sunset	"Rainy Day" Funds
TOTAL	49	43	30	18	7	10	41	29	24
New England									
Connecticut	X	X					X	X	X
Maine	X		X			X		X	
Massachusetts	X	X					X		
New Hampshire	X						X	X	
Rhode Island	X		X	X			X	X	X
Vermont								X	
Mideast									
Delaware	X	X			X			X	X
Maryland	X	X					X	X	
New Jersey	X	X	X				X		
New York	X	X							X
Pennsylvania	X	X					X	X	
Great Lakes									
Illinois	X	X					X	X	
Indiana	X		X				X	X	X
Michigan	X	X		X			X		X
Ohio	X	X	X				X		X
Wisconsin	X	X	X			X	X		
Plains									
Iowa	X	X	X			X	X		X
Kansas	X	X	X				X	X	
Minnesota	X	X	X			X			X
Missouri	X	X	X	X			X		
Nebraska	X	X	X				X		X
North Dakota	X	X	X						
South Dakota	X	X	X		X		X		
Southeast									
Alabama	X	X	X				X	X	
Arkansas	X	X			X		X		
Florida	X	X			X		X		X
Georgia	X	X	X				X	X	X
Kentucky	X	X	X				X		X
Louisiana	X	X		X	X		X	X	
Mississippi	X	X	X		X		X		X
North Carolina	X						X		
South Carolina	X	X	X	X		X	X	X	X
Tennessee	X	X		X			X	X	X
Virginia	X	X	X				X		X
West Virginia	X	X	X				X	X	
Southwest									
Arizona	X	X	X	X		X	X	X	
New Mexico	X	X	X				X	X	X
Oklahoma	X	X						X	
Texas	X	X	X	X			X	X	
Rocky Mountain									
Colorado	X	X	X	X		X	X	X	X
Idaho	X	X	X	X			X		X
Montana	X	X		X		X	X	X	
Utah	X	X	X	X			X	X	
Wyoming	X	X	X				X	X	X
Far West									
California	X	X	X	X	X	X	X		X
Nevada	X			X			X		
Oregon	X	X	X	X		X	X	X	
Washington	X	X	X	X			X	X	X
Alaska	X	X	X	X				X	X
Hawaii	X	X		X				X	

SOURCES:1984 ACIR Survey of Executive and Legislative Fiscal Officers.

the next fiscal year. There is a wide range of variation in the stringency of these requirements across states. In the statistical work reported below, a simple index of the degree of stringency of balanced budget requirements was developed and employed in order to test for the effects of such variable requirements.

B. Do Fiscal Discipline Mechanisms Work?

The statistical techniques employed in this investigation are cross-sectional linear regressions with single equation models. There are well known limitations to these techniques (discussed in detail following the outline of results below); however, they are extremely useful for evaluating which potential influences are statistically related to particular effects. The procedure is designed to show whether particular institutional or fiscal influences are associated with certain state fiscal behaviors and whether this association is statistically reliable, even when other influences are taken into account. Our interest here is twofold: (1) is the presence of fiscal limitations significantly associated with relatively more "disciplined" fiscal behavior, and (2) to the extent that this apparent association exists, does it continue to hold up when other important factors are taken into account?

The results concerning the effects of fiscal restraints are divided into four sections: (1) effects on deficits/surpluses in state budgets; (2) effects on levels of state government spending; (3) effects on levels of state government long-term debt; and (4) effects on levels of tax revenues collected.

1. Effects of Balanced Budget Requirements on State Deficits or Surpluses. The empirical results reported here derive from an effort to determine the effect of varying degrees of stringency of balanced budget requirements on the size of state budget surpluses/deficits as distinct from other factors of likely importance.

This study has found that more stringent balanced budget requirements are significantly associated with a reduction in budget deficits and with an increase in the size of surpluses. A number of different econometric models were employed to take into account several factors of likely importance in explaining differences in fiscal behavior across states—including the stringency of balanced budget requirements. Consistently, in many different regression models employing fiscal 1983 and 1984 data, the role of balanced budget requirements was statistically significant, or at least near statistical significance. Also, results from regression models of the determinants of the five-year annual average state deficits (employing data from the period 1980-84) suggest that the presence and stringency of balanced budget requirements significantly reduce the size of deficits in this longer time frame as well, although this degree of significance varies across different models, in some being relatively low. Still, these results bolster the findings for annual deficits, given that explaining the fluctuations of deficits over longer periods is likely to involve more complex factors and therefore be inherently more difficult.

However, it should also be noted that the relative stringency of state balanced budget requirements was not the only apparent factor in explaining differences in fiscal behavior, nor was it the most important. Generally, the level of state wealth (as measured by state per capita income) was a more important determinant of differences in fiscal behavior. Nevertheless, balanced budget requirements were found to have a substantial contributing effect. In other words, balanced budget requirements are only one of the significant factors affecting the fiscal choices of the American states.

Table 4 summarizes two similar regression models. Model 1 was especially designed to explain variations in state deficits per annum. Model 2 is a standard model of the determinants of fiscal behavior which we have used throughout as a control (note that the standard model includes variables reflecting whether or not a state has a tax or expenditure limit in place, and whether or not the governor has the authority to employ the line-item veto). Each different model is a regression that seeks to explain variation in the year-end balance of the general fund, which is part of the operating budget. In other words, the dependent variable "explained" by this regression is the 1984 year-end balance as a percentage of all general expenditures. As shown by the asterisks, the stringency of balanced budget requirements exerts a statistically significant influence on the level of the surplus or deficit. The plus sign shown for this explanatory variable indicates a positive relationship: holding other important factors constant, more stringent balanced budget requirements are associated with higher surpluses or smaller deficits in year-end operating balances.

The additional rows in *Table 4* show other potential influences (explanatory variables) that may affect the level of surpluses or deficits. Not all these potential influences are statistically significant. For example, the percentage of the population that is elderly is not

Table 3

BALANCED BUDGET REQUIREMENTS, 1984

(explanation of table at end of next page)

States and Region	Category I: Statutory or Constitutional? () = number of points		Category II: Nature of Requirement () = number of points					Degree of Stringency Scale (high=10; low=1)
	(1) Statutory	(2) Constitutional	(1) Governor Only has to *Submit* a Balanced Budget	(2) Legislature Only has to *Pass* a Balanced Budget	(4) May Carry Over a Deficit but Must be Corrected in Next Fiscal Year	(6) State Cannot Carry Over a Deficit Into Next Biennium	(8) State Cannot Carry Over a Deficit Into Next Fiscal Year	
New England								
Connecticut	X		S	S	S			5
Maine	X						S	9
Massachusetts		X	C					3
New Hampshire	X		S					2
Rhode Island		X					C	10
Vermont				No Requirement				0
Mideast								
Delaware		X					C	10
Maryland		X	C	C	C			6
New Jersey		X					C	10
New York		X	C					3
Pennsylvania	X	X	S,C	S	S,C			6
Great Lakes								
Illinois		X	C	C				4
Indiana		X					C	10
Michigan		X			C			6
Ohio	X	X					S,C	10
Wisconsin		X			C*			6
Plains								
Iowa		X					C	10
Kansas		X					C	10
Minnesota	X	X				S,C		8
Missouri		X					C	10
Nebraska		X					C	10
North Dakota		X				C		8
South Dakota	X	X					S,C	10
Southeast								
Alabama		X					C	10
Arkansas	X						S	9
Florida	X	X					S,C	10
Georgia		X					C	10
Kentucky	X	X				C	S	10
Louisiana		X		C				4
Mississippi	X						S	9
North Carolina	X	X					S,C	10
South Carolina	X	X			S,C		C	10
Tennessee		X			C		C	10
Virginia	X	X				S,C		8
West Virginia		X					C	10
Southwest								
Arizona		X					C	10
New Mexico		X					C	10
Oklahoma		X					C	10
Texas		X		C		C		8
Rocky Mountain								
Colorado		X					C	10
Idaho		X					C	10
Montana		X		C		C	C	10
Utah	X	X					S,C	10
Wyoming		X				C		8
Far West								
California		X	C		C			6
Nevada	X	X	S	C				4
Oregon	X	X	S			C		8
Washington	X	X				S,C		8
Alaska	X	X	S		C			6
Hawaii	X	X	S,C			C	C	10

Source: ACIR staff compilation based on 1984 surveys of executive and legislative fiscal directors, and *Limitations on State Deficits*, Council of State Governments, Lexington, KY, May 1976.

Continued on next page.

Table 3 (cont.)

BALANCED BUDGET REQUIREMENTS, 1984

NOTE: The following states have a balanced budget relating to constitutional debt limitations (debt limit in parenthesis): Alaska ($350,000), Arizona ($350,000), Colorado ($100,000), Iowa ($250,000), Kansas ($1,000,000), Kentucky ($500,000), Missouri ($100,000), Nebraska ($100,000), New Jersey (1% of appropriations), New Mexico ($200,000), Ohio ($150,000), Oklahoma ($500,000), Rhode Island ($50,000), South Dakota ($100,000), Texas ($200,000), and Utah (1.5% of taxable property value).

CALIFORNIA: Article XVI, Sec. 1, requires that the legislature shall not, in any manner, create a debt in excess of $300,000 without a vote of the people. This section has been interpreted to allow a carry-over deficit, as long as the deficit is repaid within "a short period of time."

CONNECTICUT: If revenues are deficient by 5% due to lower than projected revenue collections after the budget has been passed, the General Assembly must approve expenditure cuts. (Statute 4-85; Subsection C)

DELAWARE: "No appropriation, supplemental appropriation or budget act shall cause the aggregate State General Fund appropriations enacted for any given fiscal year to exceed 98 percent of the estimated State General Fund revenue for such fiscal year from all sources, including estimated unencumbered funds remaining at the end of the previous fiscal year . . . ." (Const. Art. VIII, Sec. 6) The state provides for this 2 Percent Fund and a 5 percent Budget Reserve Account to be used for an unanticipated deficit. There are no provisions in the constitution that call for specific action if a projected deficit exceeds 7 percent of general fund revenues.

INDIANA: "No law shall authorize any debt to be contracted, on behalf of the state, except in the following cases: To meet casual deficits in the revenue . . . ." (Const. Art. 10, Sec. 5)

KENTUCKY: Agencies must set aside 2.5% of their budget each year in the event of a revenue shortfall (KRS 48.120).

VERMONT: Governor is statutorily required to submit recommendation to alleviate deficits from previous years in his or her budget request. There is no requirement that the governor must submit a balanced budget.

WEST VIRGINIA: "No debt shall be contracted by this state except to meet casual deficits in the revenue . . . ." (Const. Art. X, Sec.4)

WISCONSIN: Section S20.004 of Wisconsin statutes requires that no bill may be passed if the bill will cause the General Fund balances at the end of the biennium to be less than one percent of total General Fund appropriation.

Explanation of Table: The degree of stringency index is based on the number of points each state can receive for its requirement, as noted above each of the "Nature of the Requirement" columns. In cases where a state had more than three features incorporated in its requirement, only the highest for each category is counted. For example, in a case where a state had a requirement that the Governor has to submit a balanced budget, and a requirement that the legislature has to pass a balanced budget, it would only receive 2 points for the latter, not 2 points in addition for the former [see Category II]. If that state's requirement was both statutory (1 point) and constitutional (2 points), it would only receive the 2 points for the latter [see Category I]. Such a (hypothetical) state would receive a total of 4 points. The weights assigned to different features are based on the subjective judgment of the ACIR staff.

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significant in either column of *Table 4*. The presence of mineral resources is, however, a strong determinant of surpluses. (The bottom row of the table indicates how well the regression model fits the data. A 1.00 is a perfect fit; zero means no association at all.) Note that the significance level found for balanced budget requirements in model 1 is the same as that found in model 2, although amount of variation explained by the latter is slightly lower.

The investigation reported here also suggests that the relationship between fiscal behavior and the stringency of balanced budget provisions tends to be stronger during periods of high unemployment. When a state economy is strong, other factors seem to be more important determinants of the level of state budget surpluses. Balanced budget requirements appear to play a greater role during economic downturns. Nevertheless, stringent balanced budget re-

Table 4

THE EFFECT OF BALANCED BUDGET REQUIREMENTS ON STATE DEFICITS*

[Each model designed to explain GENERAL FUND DEFICIT]

Explanatory Variables	Model 1	Model 2
Balance Requirement	(+)[1]	(+)[3]
Tax-Expenditure Limitation		(+)
Line-Item Veto		(-)
Per Capita Income		(+)[3]
Per Capita Value of Mineral Output		(+)[3]
Federal Grants Per Capita	(+)[3]	(+)[3]
Agricultural Output Per Capita	(+)[2]	
Size of Legislature	(-)	(-)
Year of Statehood		(+)
Is State in the South? [1=Yes, 0=No]	(+)[2]	(+)
Elderly as Percentage of Population	(-)	(-)
Per Cent of Variation Explained by Model:	.46	.66

*Because surpluses are entered as positive, and deficits as negative, (+) implies reduction in the size of deficits.

[1]Significance at 10% level.
[2]Significance at 5% level.
[3]Significance at 1% level.

quirements tend to be associated with surpluses, both in periods of relatively high or low unemployment.

2. **Effects of Balanced Budget Requirements on State Government Spending.** In addition to the hypothesized constraining effect on deficits, many proponents of fiscal restraints argue that they represent a potentially effective way to reduce the rate of growth in government spending, which the majority may deem excessive to levels most desired by voters.

This study has found that more restrictive fiscal discipline mechanisms (in the form of more stringent balanced budget requirements) are consistently significant factors in explaining the variability in levels of state government spending, when other relevant factors are also taken into consideration. This is shown in *Table 5*, indicating the influences on total state expenditures, minus federal aid, in 1984. The plus sign for balanced budget requirements indicates that more stringent laws are associated with lower spending, other potential influences being held constant. Again, two models are reported, one designed to explain spending variations in particular, and the standard model described previously. The results from both models are generally similar, although those from the first model are more statistically significant than those from the second.

Naturally, other factors are also important in determining differences across states in government spending. One of the other potential influences on spending, which has in fact been found to be significant, is the personal income of state residents, which naturally has a positive relation to state expenditures. States in the South tend to spend less than others. This could be due, in part, to the tendency of many voters in these states to be both politically and fiscally conservative. The size of the legislature (a variable which just fails to achieve significance in this model, but is significant in others) is negatively associated with spending. This is consistent with other research suggesting that large legislatures find it more difficult to reach a consensus on appropriations bills.

Table 5

THE EFFECT OF BALANCED BUDGET REQUIREMENTS ON STATE SPENDING

***[Both models are designed to explain* OWN SOURCE (i.e., total spending minus federal aid) SPENDING PER CAPITA]**

Explanatory Variables	Model 1	Model 2
Balance Requirement	(-)[3]	(-)[2]
Tax-Expenditure Limit		(-)
Line-item Veto		(-)
Per Capita Income	(-)	(+)
Per Capita Value of Mineral Output		(+)[1]
Agricultural Output Per Capita	(-)	
Size of Legislature	(-)[3]	(-)[1]
Is State in the South? [1=Yes, 0=No]	(-)[2]	(-)
Year of Statehood		(+)
Elderly as Percentage of Population	(-)[1]	(-)[2]
Per Cent of Variation in the Data Explained by the Regression:	.49	.57

[1]Significance at 10% level.
[2]Significance at 5% level.
[3]Significance at 1% level.

One question is beyond the scope of regression analysis: that is, whether fiscal restraints operate to bring fiscal behavior more or less in line with the preferences of voters. More stringent mechanisms have been found to be associated with reduced spending. Of course, a number of additional factors influence variations in the demand for public services. Along with these other factors, however, fiscal discipline mechanisms appear to play a significant role in restraining the expansion of public expenditure.

3. **Effects of Gubernatorial Vetoes on State Government Spending.** A series of models were also developed to test for the effects of gubernatorial vetoes on levels of state spending. Data limitations prevent a direct analysis of the effects of line-item veto activity as distinct from veto activity in general for years prior to 1984. During the legislative session for which we have detailed line-item veto information (1983-84), this form of veto was rarely used; hence, we have been unable to determine any direct effects resulting from its employment. This may only indicate that the line-item veto acts mostly as a deterrent against legislative attempts to increase spending. In an effort to capture any such effect, a variable has been employed that reflects not the number of line-item vetoes, but whether a state grants the governor line-item veto authority. Models were developed expressly for the purpose of testing for any effect of the presence of line-item veto authority; in addition, as noted previously, the standard models included in each table reporting the determinants of various categories of fiscal behavior included a variable controlling for the effect of the presence of such authority.

Analysis of the consequences of gubernatorial vetoes produced mixed results. In some statistical specifications, the number of vetoes was found to be significantly and negatively related to state government own-source expenditures: as veto activity went up, spending tended to go down. However, this apparent relationship was not found to hold in plausible alternative statistical specifications, or for different years (i.e., the negative and significant results for 1984 could not be replicated using data from earlier years). This does not necessarily imply that the level of veto activity is not a significant factor in determining levels of aggregate state government spending, or growth in spending over time, but only that we have been unable to demonstrate any consistently statistically significant relationship. It is possible that the level of gubernatorial veto activity is a more important factor in affecting the composition rather than the size of state government budgets. Hopefully, this important question will be resolved in some future research.

Table 6

THE EFFECT OF CONSTITUTIONAL RESTRICTIONS ON STATE DEBT

[Each model designed to explain STATE DEBT PER CAPITA]

Explanatory Variables	Model 1	Model 2
Constitutional Debt Limit	(–)[2]	(–)[2]
Tax-Expenditure Limitation		(–)
Line-Item Veto		(+)
Per Capita Income	(+)	(+)
Per Capita Value of Mineral Output		(–)
Federal Grants Per Capita		(+)
Agricultural Output Per Capita	(–)[1]	
Size of Legislature		(–)
Year of Statehood		(–)
Is State in the South? [1=Yes, 0=No]	(–)	(–)
Elderly as Percentage of Population	(–)	(–)
Per Cent of Variation Explained by Model:	.40	.41

[1]Significance at 10% level.
[2]Significance at 1% level.

However, we did find another relationship with the level of veto activity in which we have greater confidence. In models designed to explain variations in the level of state expenditures on economic regulation, the amount of gubernatorial veto activity was consistently both significant and negatively correlated. In other words, states where the governor uses his or her veto authority more aggressively appear to regulate somewhat less. Those who argue that state governments tend to over-regulate their economies may see the gubernatorial veto as a useful tool in reducing such regulation. However, the relationship between veto authority and economic regulation remains a potential topic for future research, whether or not a reduction in state economic regulatory activity has any relationship (positive or negative) to state economic performance.

4. **Effects of Constitutional Debt Limits on State Long-Term Debt.** Constitutional limits on state debt are the oldest explicit fiscal restraints, many dating from the early 19th century. Owing in part to the

Table 7

THE EFFECT OF CONSTITUTIONAL RESTRICTIONS ON STATE DEBT BY TYPE

[Each model designed to explain one type of STATE DEBT PER CAPITA]

Explanatory Variables	Model 1	Model 2	Model 3	Model 4
	Full-Faith and Credit Debt Per Capita		Nonguaranteed Debt Per Capita	
Constitutional Debt Limit	(–)[3]	(–)[3]	(–)	(–)[1]
Tax-Expenditure Limitation		(–)		(–)
Line-Item Veto		(+)		(+)
Per Capita Income	(+)	(+)	(+)	(+)
Per Capita Value of Mineral Output		(–)[2]		(–)
Federal Grants Per Capita		(+)		(+)
Agricultural Output Per Capita	(–)		(–)	
Size of Legislature		(+)		(–)
Year of Statehood		(+)		(–)[2]
Is State in the South? [1=Yes, 0=No]	(–)	(–)	(–)	(–)
Elderly as Percentage of Population	(–)[1]	(–)[2]	(–)	(–)
Per Cent of Variation Explained by Model:	.36	.40	.22	.29

[1]Significance at 10% level. [2]Significance at 5% level . [3]Significance at 1% level.

length of time these limits have been in place, and also to the fact that, typically, they restrict only a certain kind of state debt ("full faith and credit" debt), many observers have maintained that these limits are likely to be dead letters (i.e., they have no effect on state decision making). A number of scholarly studies have essentially agreed.

Our findings need to be interpreted cautiously. Nevertheless, the results (reported in *Table 6*) suggest that such limits are significantly associated with reduced levels of long-term debt when one compares fiscal behavior across states. Results were consistent from both the specially adjusted model of the determinants of state net debt and the standard model. States with constitutional debt limits tend to have significantly lower levels of per capita net long-term debt (net of long-term debt offsets, i.e., cash and security holdings) than states without such limits.

It is often argued that state governments are not really restrained by constitutional debt limits because such limits do not restrict nonguaranteed debt (e.g., "moral obligation" debt or industrial revenue bonds). States with restrictive limits on guaranteed, "full faith and credit" debt will, according to this reasoning, simply issue nonguaranteed debt. In order to test for such a substitution, models were constructed to distinguish between the two kinds of debt. Two different regression models (a specifically designed version for this problem and the standard model) were employed. The results of these models are reported in *Table 7*. The tentative conclusion is that there does not appear

Table 8

THE EFFECT OF BALANCED BUDGET REQUIREMENTS ON STATE TAXING

[Both models are designed to explain PER CAPITA TAX REVENUES]

Explanatory Variables	Model 1	Model 2
Balance Requirement	(–)[2]	(–)[2]
Tax-Expenditure Limit		(–)
Line-item Veto		(+)
Per Capita Income	(+)[1]	(+)
Per Capita Value of Mineral Output	(–)	(–)
Federal Grants Per Capita	(+)[2]	(+)[2]
Agricultural Output Per Capita	(–)	
Size of Legislature	(–)[2]	(–)[2]
Is State in the South? [1=Yes, 0=No]		(–)
Year of Statehood		(+)
Elderly as Percentage of Population		(–)
Percentage of Variation Explained by the Model:	.55	.57

[1]Significance at 5% level.
[2]Significance at 1% level.

to be a systematic substitution of nonguaranteed for guaranteed debt in states subject to constitutional debt restrictions. Both models indicate that the presence of a constitutional debt limit is significantly associated with reduced levels of both kinds of debt. This could reflect the fact that the two sorts of debt are not good substitutes, given that the purposes for which nonguaranteed debt may be issued tend to be relatively more limited—that is, more precisely defined and specifically restricted—than is the case with guaranteed debt. Alternatively, it might reflect different preferences across states with respect to the appropriate mix of tax financing versus debt financing. In other words, states with constitutional debt limits may be states in which the voters tend to be uncomfortable with high levels of debt issue, irrespective of the precise nature of the public debt.

5. Effect of Fiscal Discipline on Tax Revenues. Some proponents of fiscal discipline instruments have claimed that they will reduce taxes in the long run, even if such instruments do not explicitly limit taxing authority. Critics have charged that balanced budget requirements tend to increase tax rates significantly. In order to test for a possible relationship between the stringency of balanced budget requirements and tax revenues, a model was developed to explain variations in total tax revenue, per capita, across states. In addition, our standardized model of fiscal behavior was also employed to explain these variations. These results are reported in *Table 8*.

The analysis showed that more stringent balanced budget mechanisms were associated in a statistically significant manner with lower per capita state tax revenues. The results from the standardized model and those found in the specialized model were both significant at normally accepted levels. This finding is consistent with the arguments of the fiscal discipline proponents mentioned above, and also consistent with the findings in relation to spending. However, this part of the analysis is admittedly quite limited, in part because no attempt has been made to look at the effect of balanced budget requirements on the relative proportions of revenue contributions from different kinds of tax revenue, or the mix of tax and nontax revenues.

C. Summary of Empirical Research Findings

What effects might important mechanisms of fiscal discipline have on state fiscal behavior? The results seem to be consistent: The major state mechanisms of fiscal discipline are associated with the effects their proponents claim for them, and such findings are, for the most part, statistically significant.[2] In a cross-state comparison for 1984, more restrictive fiscal discipline measures were associated statistically with lower levels of per capita state government spending, a greater avoidance of deficits, and a tendency toward lower levels of per capita tax levies. Additionally, there is some evidence consistent with the notion that higher levels of fiscal discipline may be associated with lower levels of state economic regulation.

An important limitation of this particular regression analysis (which also applies to regression analysis more generally) should be noted here. At best, regression analysis can only demonstrate statistically significant correlations between possible explanatory factors and fiscal behavior; such correlations may, but need not necessarily, imply a cause-and-effect relationship (e.g., it cannot prove that the presence of a balanced budget requirement causes a state government to have lower deficits). In certain circumstances, it is possible that there is some other, underlying cause of both. For example, it is possible that more fiscally conservative states tend to have more stringent fiscal discipline mechanisms because voters in those states are more concerned about problems associated with government fiscal behavior. (In such a case, low deficits and stringent fiscal discipline requirements could have the same cause: the fiscal conservatism of voters. We have attempted to adjust for possible relationships of this kind, but such adjustments are necessarily imperfect. Results therefore must be interpreted cautiously.)

However, as long as this limitation is kept in mind, the analysis presented here is useful in estimating the possible effects of state fiscal discipline devices. These econometric techniques allow us to consider the relationships between such devices and fiscal behavior in the states, while at the same time taking into account other factors, which may also be important—an advantage other, nonstatistical investigative techniques would not allow.

In other words, these results do not prove that enactment of a fiscal limit will actually change a government's taxing, spending, borrowing, or regulating behavior, nor do the results demonstrate any causal connection between such limits and economic performance. The results do suggest that, contrary to the assertions of some critics of fiscal restraints, such devices may play a significant role both in reducing the size of state budget deficits and in holding down the rate of growth in state spending. This effect may be directly "caused" by the fiscal limitations, or it may be an indirect result of the establishment of a political

consensus—reflected in the implementation of fiscal limits by a state—favoring disciplined fiscal behavior. The precise mechanism behind the statistical association we have found here would be a useful topic for future research.

D. Is the Record of the States Relevant to the National Debate?

During the same time that the federal government has consistently run large deficits, the operating budgets of most states have shown at least small surpluses. (Deficits have usually been small and eliminated quickly.) Some observers argue that this record provides clear evidence for the efficacy of state balanced budget requirements in avoiding deficit spending. Others argue that drawing any fiscal analogies between the states and the national government is fraught with pitfalls. Although this is a complex question, its main aspects can be broken down into a few key elements.

In the past, the debate over proposed fiscal discipline reforms for the federal government has largely neglected the record of the states with regard to the design, implementation, effectiveness and consequences of mechanisms of fiscal restraint. This is unfortunate because the results of fiscal experimentation conducted by practical politicians in 50 state legislative "laboratories" should have some bearing on questions involving proposed national reforms. What lessons can be learned from the successes and failures of state fiscal reforms that can improve our understanding of the issues surrounding reform of the federal government's fiscal constitution?

We need to face squarely the relevant differences between the states and the federal government. Extrapolation from the state experience to usable recommendations for the federal government is fraught with hazards. Indeed, some observers insist that these differences are so extreme as to make any meaningful comparison impossible. However, a complete rejection of the state and local experience would seem to be a mistake, despite the fact that significant differences do exist.

It is important to take note of some major similarities between the states and the national government, which are of relevance to the determination of fiscal behavior. Like the nation as a whole, all states are representative democracies under constitutions, and are organized along similar lines in most important respects (e.g., separation of powers among the three branches, bicameral legislatures [except for Nebraska], terms of elected officials limited to broadly similar lengths, and so on). In principle, these similarities permit a large degree of accurate extrapolation from state to state and from the states to the national government. The problems, constraints, and opportunities confronting political decision makers in the states and national government in general are quite similar.

Nevertheless, individual states are not microcosms of the entire nation. State governments face fiscal environments that, in some ways, differ substantially from the fiscal environment confronting the federal government.

It is often argued, for example, that the most significant difference between state and national fiscal problems is that the national government has the responsibility for macroeconomic policy making. Deficit spending is often claimed to be a useful and effective tool for stimulating the economy during an economic downturn. Thus there are likely to be occasions when it will be desirable for the federal government to engage in deficit spending as a deliberate counter-cyclical economic strategy.

There are other major differences. Unlike the federal government, state governments cannot print money to cover their debt. Moreover, the states do not face the fiscal stress associated with war and other national emergencies (although, of course, state governments must sometimes confront both natural and economic disasters of various kinds).

Additionally, there are some less tangible differences. For example, the "constitutional environments" confronting the two governments are different. The process of change in the U.S. Constitution is complex and difficult, and partly in consequence, constitutional amendments are a rare occurrence. Although this is also true in the case of many state constitutions, there is a great deal of variation in the difficulty and frequency of state constitutional change. As a result, state constitutional provisions (e.g., balanced budget requirements) are somewhat imperfect analogues for similar amendments to the U.S. Constitution.

On another front, the states and their local governments face a form of fiscal discipline which is not formally imposed but nonetheless inescapable: inter-jurisdictional competition from other states and localities for investment and jobs. Fiscally irresponsible state and local officials are likely to face a gradual erosion of their tax base as businesses and residents "vote

with their feet" by moving to other jurisdictions judged to be more fiscally responsible. At the same time, however, nations also compete with one another for citizens and, especially, investment capital. While interstate competition is typically regarded as an important issue for state fiscal behavior, international economic competition appears to be becoming an increasingly important issue for the federal government's fiscal behavior too, as the U.S. economy increasingly takes on the character of being a "regional" economy in the world system.

Basically, then, while it must be recognized that state governments are not simply miniatures of the national government, the record of the states does offer the potential for real-world testing of the efficacy and consequences of a large variety of fiscal discipline tools of potential relevance to the national government.

The most important conclusion, which can be drawn from this discussion of the analogy between the state and national governments, would seem to be this: the similarities between the two governments are great enough to warrant extrapolation from one government's experience with fiscal limitations to probable outcomes for the other government in broad outline, but probably not in detail. The fact that fiscal limitations do (or do not) seem to work for the states provides useful and relevant information regarding the likelihood that some kind of fiscal limitation devices would produce similar results for the national government, but probably not much in the way of guidance about what kind of fiscal limitation devices work best there (e.g., whether constitutional amendments would work more or less effectively than statutory limits, or exactly what form a national reform should take).

Thus, it would probably be a mistake to regard the results of this study as providing a workable road-map to the details of fiscal discipline reform in the national government. Nevertheless, these results do seem to suggest that the establishment of institutional restraints on the national government would provide a good prospect for affecting the fiscal behavior of the federal government.

ENDNOTES

[1]See. Allen D. Manvel, "How Should Budget Balance Be Measured?" *Tax Notes*, January 12, 1987, pp. 175-77.

[2]We are confident that the models employed here are well constructed and take into account the most important factors economic theory predicts will affect fiscal behavior. However, there are alternative modeling procedures, which we have not employed, which nevertheless have merit, and which could in principle produce different statistical results. There is no single "right" way to model state fiscal behavior. Rather, a number of different models could be employed which would all show impressive explanatory power when applied to the analysis of these problems. The models outlined below have been chosen because they seem best suited to investigate the problems we are interested in here. The analysis presented here in no way pretends to be the last word on the subject.

Technical Appendix

We provide here a technical summary of the empirical research reported in this report. The statistical results presented here analyze the effect of various fiscal discipline devices on the fiscal behavior of states.

The statistical models developed here to explain variations across states in government fiscal behavior are structurally similar to those reported in recent papers by Dennis C. Mueller and Peter Murrell, and by Barton A. Abrams and William R. Dougan.[1] Indeed, the basic approach chosen has been partly adapted from their work. Mueller and Murrell are concerned with testing for the effects of interest group pressure on the fiscal behavior of European central governments, and do not test the effects of fiscal discipline mechanisms *per se*. Abrams and Dougan attempt to test for fiscal effects of fiscal discipline devices, but do not employ the same level of detail about fiscal limitation devices that we have used here. The present work also draws heavily on models of government behavior at the state level which have been developed in recent years.[2]

There are a number of limitations to the statistical techniques employed here, and the exercise itself is limited to a narrow range of possible consequences of fiscal discipline mechanisms. The intention is to eliminate, or at least to minimize, both of these problems in the course of further research. To date, the study has not emphasized in-depth analysis of the fiscal behavior of particular states. The staff intends to pursue such detailed analysis in the coming months but concluded that the logical place to start the empirical study was at the broadest possible level—all 50 states.

The statistical techniques utilized here are cross-sectional linear regressions with single equation models. While the results are useful, there are well known limitations to these particular techniques. Most importantly, such techniques can only establish the presence or absence of statistically significant relationships between different variable factors, and do not allow us to necessarily conclude that a cause-and-effect relationship therefore exists between them. For example, if it were established that a statistically significant relationship exists between state government spending and spending by consumers on automobiles, this would not imply that the latter was the "cause" of the former [or vice versa]; in this case, it is most likely that both would have been the result of some other factor, such as state citizens having relatively high incomes. However, this form of statistical approach is commonly accepted among social scientists, and is often utilized in the exploration of the relationships between different factors in the fields of economics, political science, and other disciplines.

1. A General Note on the Empirical Results

Our statistical investigation has been restricted to the use of a variety of single equation ordinary least squares (OLS) regressions. The relationships between different fiscal discipline mechanisms and various dimensions of state government fiscal behavior have been examined utilizing a variety of models, each designed to reflect the role of different factors that economic theory predicts should be relevant. However, an effort has been made to maintain as much uniformity as feasible across the various models in order to maximize the intercomparability of different results.

As a result, most of the models have some important independent variables in common.

Additionally, a single "standard" model developed by ACIR staff, designed to control for major factors likely to influence state fiscal policy, has also been included in each particular set of regressions. This model was expressly designed to explain variations in state spending levels, but should also be effective in modeling the determinants of other kinds of fiscal behavior as well. The model is:

Fiscal Behavior = F (Balance1, Balance2, Tel, Item, Y/Pop, Mineral, Elders, South, State, Size)

where

Fiscal Behavior = either size of state budget surplus or deficit, level of state spending from own sources, level of state tax revenue, or level of net state debt, 1984;

Balance1 = dummy variable, 1 if state prohibited from allowing a deficit to carry over into next fiscal year; 0 otherwise;

Balance2 = index of the relative stringency of state balanced budget requirement, from 1 (least stringent) to 10 (most stringent);

Tel = dummy variable, 1 if state has a tax and/or expenditure limit, 0 otherwise;

Item = dummy variable, 1 if governor has line-item veto authority;

Y/Pop = state per capita income, 1983;

Mineral = value of mineral output per capita, 1980;

Elders = percentage population aged 65 and over, 1984 [expressed as percent of 1];

South = dummy variable, 1 if state in that region, 0 otherwise;

State = year statehood was granted;

Size = total size of state legislature, 1984.

Two different variables are included to reflect variations in the restrictions of balanced budget requirements. **Balance1** basically distinguishes between states with a very strict type of balanced budget requirement and others (all states except Vermont have some kind of balanced budget requirement). The disadvantage with this particular variable is that it fails to take into account gradations in the restrictiveness of such devices. Accordingly, **Balance2** is included as an alternative. This index has been calculated by ACIR, and assigns points for stringency to different possible features of balanced budget requirements. While this variable has the merit of incorporating more information content than **Balance1**, it is based on a subjective weighting system of the relative importance of various different features of state balanced budget requirements. We believe that the judgments made in constructing this index were reasonable, and fairly portray the relative stringency of various state's requirements. However, we have employed the less subjective **Balance1** variable in most regressions reported here.

We note that replacing one **Balance** variable with the other consistently produced very similar results. If more stringent requirements reduce the growth of state government spending, these variables will have a negative sign.

Tel is designed to identify any effects of spending of the presence of the various different state tax-and-expenditure limits. Most of these devices explicitly limit appropriations to some fixed level, either as a percentage of state personal income or in some other manner. But in some cases, these ceilings were set sufficiently high as to have little apparent effect on state decision making since their passage. For example, although the appropriations limit in California was passed in 1979, until fiscal year 1987-88 it appears to have had little effect on state budget policy. In any event, if these critics are incorrect, **Tel** should have a negative sign.

Item controls for the presence of gubernatorial line-item veto, a mechanism which has sometimes been described as a kind of fiscal limit. Again, if these devices limit spending we expect a negative sign.

Y/Pop is a standard control for income effects. States with wealthier citizens should generally demand more government services, just as they demand more private goods. We expect a positive sign.

Grants is included because such revenues normally flow into state general revenues. The larger the amount of revenue available from the federal taxpayers, rather than state taxpayers, the lower the costs of deficit reduction to state politicians. To the extent that politicians can replace politically costly deficit spending with spending out of federal aid, deficits will tend to be lower. Hence, **Grants** will probably have a negative effect on the size of general fund deficits; in our model, this implies a positive sign, because surpluses are entered as positive numbers and deficits as negative numbers.

Mineral is a control for a major source of revenues, the burden from which tends to be highly exportable to residents of other states. It functions as a proxy for the state's severance tax base. This variable will probably have a positive sign as well.

Finally, several institutional variables are also included. As the elderly are generally relatively low demanders of public goods and services (at the state level), **Elders** should have a negative sign. **South** controls for a region often considered to be "fiscally con-

servative," this sign should also be negative. **State** is a control for the degree to which pressure groups in a state have become entrenched over time, and has been previously employed in the economics literature.[3] Simply stated, interest groups in older states have had more time to establish effective control over political institutions, and introduce various barriers to the entry of competing interests. Therefore, the established interest groups in older states may be better situated to extract rents for their members through the state government, leading to higher levels of spending, *ceteris paribus*. This would imply that **State** would have a negative sign. **Size** has been found in the literature on the economics of legislatures to have a negative effect on legislative output, on effect usually explained by the increased transactions costs associated with legislative operations as size increases. If such an effect influences the budgetary process as well, a negative sign can be expected here as well.

Alaska's experience over the last ten years, as a direct consequence of the enormous Prudhoe Bay oil discoveries, has been highly unique. A relatively conservative state, Alaska went from a level of per capita spending in 1970 near the mean for the 50 states to a level in 1984 about seven times the mean. This has been a direct result of the severance tax windfall the Alaska state government has collected over the past few years, most of the burden of which is borne by out-of-state companies and consumers. As a result, Alaska has been able to expand greatly the services provided to residents for "free," i.e., without increasing in-state tax bills. Given that most of the regressions reported here utilize fiscal 1984 data, it is necessary to control for this extreme outlier. We employed two methods to accomplish this. In one set of equations, a Alaska was included as a separate variable. This variable was invariably positive and highly significant. The other method employed was to delete Alaska as an observation in our regressions. This resulted in almost identical results for the regressions as a whole compared to those with 50 observations but including Alaska as a separate variable, the major exception being that the R2 and F statistic in each case was lower. In the following, we report only the results of the latter set of regressions.

Regressions are reported by the category of fiscal behavior they are designed to explain. When alternative models were employed (in addition to the standard model) these are listed in functional form, and when variables not included in the standard model are introduced, these new variables are defined.[4]

In interpreting the following results, a cautionary note is in order concerning the estimated magnitudes of the effects of different variables on fiscal behavior. The coefficients of the various independent variables must be interpreted with the exact nature of the particular variable under consideration in mind. A number of the independent variables—most importantly, the fiscal limitation variables—are dichotomous in nature, and are designed to reflect only the presence or absence of the specific limitation in a given state. It is to be expected that the coefficients of such variables will tend to be relatively large. On the other hand, independent variables which are continuous in nature—for example, per capita income—will tend to have relatively small coefficients. The estimated coefficient in the former case will reflect the effect of the presence or absence of some particular factor, while the coefficient in the latter case will indicate the apparent effect of a single unit change in that factor on the dependent variable. For instance, in a regression where **Balance** has an estimated coefficient of 155, this implies that the presence of a balanced budget restriction changes the dependent variable by $155; whereas a coefficient of .04 on **Y/Pop** implies that for every dollar of change in per capita income, the dependent variable changes by 4 cents. [In cases where the independent variable is expressed in percentage terms, we also expect the estimated coefficients to be very large. However, in the case of **Elders**, which is expressed as a percentage of 1, it is necessary to shift the decimal point two places to the left when interpreting the estimated coefficient (e.g., 3509.10 should be interpreted as 35.0910)]

2. The Effect of Balanced Budget Requirements on State Deficits

One of the principal lessons of economic history is that merely passing a law, no matter how draconian in language, will not necessarily have any important effect on behavior. Some critics of balanced budget restrictions have argued that such devices tend to be "dead letters," sounding strict and restrictive but in reality having little or no effect. It is certainly the case that, unlike (say) traffic laws, balanced budget restrictions and other fiscal limits on government seldom impose any penalty for violation. This fact has led some to suggest that fiscal limits in general should normally be ineffective.

Our purpose in the present section is to statistically examine the evidence for the effectiveness (or

lack thereof) of balanced budget restrictions on state deficits or surpluses. If these laws are "dead letters," we can expect to find no significant relationship between the size of a state's budget deficit (or surplus) and the presence of these limits, taking other relevant factors into account. On the contrary, a significant relationship between more stringent balanced budget restrictions and smaller deficits (and larger surpluses) would be consistent with the hypothesis that such devices indeed had a significant effect. [Such a finding would not, however, prove that fiscal limits caused smaller deficits.]

In order to estimate the effects of balanced budget requirements on state government deficits, we employed both the standard model and the following model:

Deficits = F (Balance, Grants, Agriculture, Size, South, Elders)

where the previously undefined variables are:

Deficits = the fiscal year 1984 state government deficit or surplus [deficits expressed as negative numbers] on the general fund, per capita;

Agriculture = value of agricultural output in 1980, per capita.

Agriculture is included as a control for the sometimes alleged fiscal conservatism of the farm population.

Table 4A shows the results obtained from these two regressions. In model 1, **Balance** is significant at above the 10 percent level. In model 2, **Balance** is significant at the 1 percent level. For every increase in one in the stringency of a state's balanced budget restrictions (on a scale from 0 to 10), that state's budget surplus will tend to be between .79 and 1 percentage points higher than it would otherwise be. Therefore, we can conclude that states with more stringent balanced budget requirements appear to have significantly smaller deficits, and larger surpluses, than do other states.

Table 4A

THE EFFECT OF BALANCED BUDGET REQUIREMENTS ON STATE DEFICITS

[Each model designed to explain GENERAL FUND DEFICIT]

Explanatory Variables	Model 1	Model 2
Constant	-9.7032	-71.3735
Balance Requirement	.7933 (1.71)[1]	1.0120 (2.44)[2]
Tax-Expenditure Limitation		.2294 (.09)
Line-Item Veto		-3.4421 (-1.30)
Per Capita Income		.0018 (2.67)[2]
Per Capita Value of Mineral Output		.0041 (3.74)[2]
Federal Grants Per Capita	.0530 (4.86)[2]	.0346 (3.16)[2]
Agricultural Output Per Capita	.5999 (.42)	
Size of Legislature	-.0111 (-.56)	-.0059 (-.33)
Year of Statehood		.0214 (.84)
Is State in the South? [1=Yes, 0=No]	.6522 (.25)	3.522 (1.29)
Elderly as Percentage of Population	-79.9682 (-1.27)	-26.41 (-.51)
R Squared:	.46	.66
F Statistic:	6.15	7.48

[1]Significance at 10% level.
[2]Significance at 1% level.

3. The Effect of Balanced Budget Requirements on State Spending

Balanced budgets per se are not the sole aim of many supporters of fiscal discipline reform. Supporters of budgetary balance frequently argue that deficit spending allows spending to grow at an excessive rate. This would imply that greater restrictions on deficit spending might result in lower levels of government spending.

In the statistical tests reported here, state own-source spending is used as the dependent variable. Own-source spending is defined as spending minus federal grants. There seems to be no direct connection between the level of federal grants and state deficits—revenues from federal grants automatically equal expenditure from this source—and research on the de-

Table 5A

THE EFFECT OF BALANCED REQUIREMENTS ON STATE SPENDING

[Both models are designed to explain OWN SOURCE SPENDING (i.e., total spending minus federal aid) PER CAPITA]

Explanatory Variables	Model 1	Model 2
Constant	1698.1997	444.5839
Balance Requirement	-192.2243 (-2.54)[3]	-155.9286 (-2.11)[2]
Tax-Expenditure Limitation		-124.9286 (-1.49)
Line-Item Veto		-1.7141 (-.01)
Per Capita Income	-.0234 (.91)	.0403 (1.59)
Per Capita Value of Mineral Output		.0634 (1.89)[1]
Agricultural Output Per Capita	-16.0636 (-.37)	
Size of Legislature	-1.5061 (-2.63)[3]	-1.0778 (-1.81)[1]
Is State in the South? [1=Yes, 0=No]	-196.4010 (-2.24)[2]	-147.9174 (-1.59)
Year of Statehood		.529 (.60)
Elderly as Percentage of Population	-3586.3372 (-1.85)[1]	-3867.0140 (-2.16)[2]
R Squared:	.49	.57
F Statistic:	6.74	5.95

[1]Significance at 10% level. [2]Significance at 5% level. [3]Significance at 1% level.

termination of variations in levels of federal grants suggests that the relative degree of influence of a state's Congressional delegation, and not state-level political factors, are important factors.[5] Therefore, for purposes of estimating the effects of state fiscal restrictions spending from own-sources is preferable to total spending as dependent variable.[6] In addition to the standard model, the following model was employed to test for the effects of balanced budget restrictions on spending. This was:

Spending = F (Balance, Y/Pop, Agriculture, Size, South, Elderly)

in which the previously undefined variables are:

Spending = state own-source spending in 1984, per capita; and

Agriculture is included to control for the possible effect of a large farm sector in the state on demand for public services. We expect the sign to be negative.

The standard model, explained in *Section 2* (above), was used with **Spending** the fiscal behavior dependent variable.

The results obtained from these two models is reported in *Table 5A*. **Balance** was negative and significant in both, at the 1 percent level in Model 1, and at the 5 percent level in Model 2. This result appears to imply that states with relatively more stringent controls on deficit spending do indeed have lower levels of state spending than other states, after controlling for other important influences on the size of state budgets.

4. The Effect of Constitutional Restrictions on State Debt

Thirty states have some form of constitutional limitation on debt issuance by state government. Many of these limits are very old, dating from the early 19th century. They vary from a cap of $100,000 of debt issuable per year in Colorado, Missouri, Nebraska and South Dakota, to 1.5% of taxable property value in Utah. Given that many modern state budgets are measured in the billions of dollars, these limitations are in general very strict—at least on paper. However, a number of authorities have argued for some time that these limits are of little effectiveness as constraints on governmental debt issue for the simple reason that they apply to state guaranteed ("full-faith-and-credit") debt, and do not restrict nonguaranteed debt-revenue or so-called "moral obligation" bonds.[7] In recent years, nonguaranteed debt issue has grown dramatically, while guaranteed debt has remained fairly constant (although guaranteed and nonguaranteed

debt are not perfectly substitutable). Nonguaranteed debt requires the state to pay higher interest rates and is generally linked to specific purposes (usually capital projects) and consequently implies less fiscal flexibility than "full-faith-and-credit" debt. Nevertheless, a number of writers have taken the existence of this "loophole" in the state debt restrictions to imply that such limitations are necessarily ineffective in limiting state debt levels.

This is a complex issue, and deserves an intensive analysis in its own right. We limited our research to addressing a relatively simple question: Do debt limits have any effect on levels of debt across states? To explore this question, two models were employed. The first model was:

Net Debt = (Debt Limit, Y/Pop, Agriculture, South, Elders)

where previously undefined variables are:

Net Debt = per capita net long-term state debt in 1984

Debt Limit = a dummy variable, 1 if a state has a constitutional debt limit, 0 otherwise;

Elders = the percentage of the population aged 65 and over.

Elders is a variable reflecting an important demand-side influence on public debt issue. Long-term debt is issued for many purposes, but in most states a large percentage is issued for education, highways, and other kinds of public goods for which the elderly are likely to be low demanders. Therefore, as the percentage of the population over 65 increases, **Net Debt** should decrease, other things held equal. By this reasoning, the sign of **Elders** should be negative.

The second regression was the standard fiscal behavior model, utilizing **Net Debt** as the dependent variable, and in which **Debt Limit** replaced **Balance** as explanatory variable.

The results of these two regressions are reported in *Table 6A*. **Debt Limit** is negative and highly significant at the 1 percent level in both.

These preliminary results suggest that constitutional debt restrictions are significantly associated with lower levels of long-term debt even controlling for off-budget debt issue. It has sometimes been argued that constitutional debt limits are likely to have no significant effect owing to the fact that they apply only to "full-faith-and-credit" debt issue, and that the other commonly used type of debt issue—nonguaranteed, or "moral obligation," debt—is exempt from the restrictions. Therefore, it is argued, constitutional debt limits mostly have had the effect of causing a shift from guaranteed to nonguaranteed debt at the state level.[8] Although the results reported above clearly bear on this issue—**Net Debt** includes both—this problem has been addressed more directly by use of separate regressions for the two major kinds of state debt. The question of greatest interest is: Do states with constitutional debt restrictions issue more nonguaranteed debt?

Table 6A

THE EFFECT OF CONSTITUTIONAL RESTRICTIONS ON STATE DEBT

[Each model designed to explain STATE DEBT PER CAPITA]

Explanatory Variables	Model 1	Model 2
Constant	574.3560	4050.9497
Constitutional Debt Limit	−312.2138 (−2.70)[2]	−347.9789 (−2.78)[2]
Tax-Expenditure Limitation		−5.3576 (−.03)
Line-item Veto		59.9949 (.34)
Per Capita Income	.0586 (1.40)	.0555 (1.18)
Per Capita Value of Mineral Output		−.0838 (−1.14)
Federal Grants Per Capita		.5959 (.84)
Agricultural Output Per Capita	−132.9983 (−1.86)[1]	
Size of Legislature		−.6808 (−.61)
Year of Statehood		−1.8456 (−1.10)
Is State in the South? [1=Yes, 0=No]	−144.2496 (−.96)	−160.2916 (−.86)
Elderly as Percentage of Population	−4402.0745 (−1.44)	−6709.9205 (1.18)
R Squared:	.40	.41
F Statistic:	5.91	2.69

[1]Significance at 10% level.
[2]Significance at 1% level.

For this purpose, two refined versions of the basic model described above were estimated. In one instance, the dependent variable **Net Debt** was replaced with total net long-term full-faith-and-credit debt outstanding per capita in fiscal 1984. In the second version, **Net Debt** was replaced with total net long-term

Table 7A

THE EFFECT OF CONSTITUTIONAL RESTRICTIONS ON STATE DEBT BY TYPE

[Both models designed to explain one type of STATE DEBT PER CAPITA]

Explanatory Variables	Model 1	Model 2	Model 3	Model 4
	Full-Faith and Credit Debt Per Capita		Nonguaranteed Debt Per Capita	
Constant	.5068	-.6750	.0674	4.7260
Constitutional Debt Limit	-.2082	-.2217	-.1039	-.1262
	(-2.65)[3]	(-2.68)[3]	(-1.45)	(-1.70)[1]
Tax-Expenditure Limitation		-.0140		-.0087
		(-.13)		(-.09)
Line-Item Veto		.0385		.0214
		(.33)		(.20)
Per Capita Income	2.916D-05	3.584D-05	2.945D-05	1.967D-05
	(1.02)	(1.15)	(1.13)	(.70)
Per Capita Value of Mineral Output		-9.691D-05		1.306D-05
		(-1.99)[2]		(.30)
Federal Grants Per Capita		.0006		6.195D-05
		(1.40)		(.14)
Agricultural Output Per Capita	-.0637		-.0692	
	(-1.31)		(-1.57)	
Size of Legislature		2.205D-05		-.0007
		(.03)		(-1.06)
Year of Statehood		.0005		-.0023
		(.49)		(-2.41)[2]
Is State in the South? [1=Yes, 0=No]	-.0854	-.0076	-.0587	-.1525
	(-.84)	(-.06)	(-.63)	(-1.38)
Elderly as Percentage of Population	-3.9552	-5.4572	-.4467	-1.2526
	(-1.90)[1]	(-2.43)[2]	(-.23)	(-.62)
R Squared:	.36	.40	.22	.29
F Statistic:	4.87	2.55	2.46	1.56

[1]Significance at 10% level. [2]Significance at 5% level. [3]Significance at 1% level.

nonguaranteed debt outstanding per capita in fiscal 1984.

Table 7A reports four regressions, each of the models explained above employed to explain the level of full-faith-and-credit, or guaranteed, state debt, and non-guaranteed debt, respectively. In both the non-standard and standard models, **Debt Limit** is negative and significant at the 1 percent level in explaining variations in full-faith-and-credit debt. In the case of nonguaranteed debt, **Debt Limit** is negative in both, but significant (at the 10 percent level) only in the standard model.

5. The Effect of Balanced Budget Requirements on State Tax Revenue

The results reported above suggest that balanced budget requirements have a significant effect in limiting state spending levels. However, we also found that balanced budget requirements were associated with lower deficits and higher surpluses. Do states with stringent balanced budget requirements achieve budget balance by increasing taxes relative to other states? In order to address this question, two different models were employed. The first was:

Taxes = F (Balance, Y/Pop, Mineral, Grants, Size)

where the previously undefined variable is:

Table 8A

THE EFFECT OF BALANCED BUDGET REQUIREMENTS ON STATE TAXING

[Both models are designed to explain PER CAPITA TAX REVENUES]

Explanatory Variables	Model 1	Model 2
Constant	61.0231	77.7923
Balance Requirement	−168.9216 (−2.63)[2]	−171.6202 (−2.52)[2]
Tax-Expenditure Limitation		−53.3157 (−.71)
Line-Item Veto		69.8654 (.87)
Per Capita Income	.0424 (2.22)[1]	.0357 (1.58)
Per Capita Value of Mineral Output	−.0015 (−.05)	−.0115 (−.33)
Federal Grants Per Capita	.8739 (2.82)[2]	.8530 (2.51)[2]
Agricultural Output Per Capita	−.4181 −(.40)	
Size of Legislature	−1.4936 (−3.49)[2]	−1.3100 (−2.46)[2]
Is State in the South? [1=Yes, 0=No]		−29.6249 (−.35)
Year of Statehood		.2276 (.29)
Elderly as Percentage of Population		−684.4761 (−.43)
R Squared:	.55	.57
F Statistic:	10.72	5.05

[1]Significance at 5% level. [2]Significance at 1% level.

Taxes = state tax revenue for 1984, per capita.

The second regression employed the standard fiscal behavior model, in which **Taxes** was used as dependent variable.

The results of this investigation are reported in *Table 8A*. In both regressions, **Balance** is negative and significant at the 1 percent level.

All other variables have signs and significance levels consistent with prior expectations. Although these results need to interpreted cautiously, they do appear to suggest that any effect balanced budget requirements may have in reducing the size of state deficits is not accomplished by increasing the relative size of the per capita tax burden on state taxpayers.

6. Conclusion

Many different factors appear to have a statistically significant effect on state fiscal behavior. These things include the average level of wealth of the state population, the percentage of the state's population who are elderly, the magnitude of federal grants, and the value of state mineral resource output, to name some of the most important. At the same time, the presence of relatively stringent balanced budget requirements seems to be consistently and significantly associated with lower levels of deficits, lower levels of spending, debt, and taxes. While it is difficult to directly compare the relative magnitude of different factors in terms of their effect on fiscal behavior, it seems safe to conclude on the basis of the findings reported here that balanced budget requirements generally have substantial effects. It is not the case that these devices are only associated with tiny or trivial differences in state fiscal outcomes.

On the other hand, we have found only weak direct evidence that constitutional tax-and-expenditure limits and gubernatorial line-item veto are associated with fiscal behavior. The measures of the variation across states with respect to these mechanisms which we chose for our tests consistently indicate that their presence is related to lower deficits, spending, debt, and taxes, but that the relationship is not statistically significant. It remains for further research to determine whether in fact there is no important effect on fiscal behavior of such devices, or instead that more sophisticated measures of variation are required.

Finally, we reiterate the cautionary note which has been made previously. Even in those cases where we have demonstrated statistically significant relationships, the regressions results reported here have not shown cause-and-effect. These techniques are not designed to show that some factor X "causes" variation in some other factor Y, but only whether the two factors are statistically related. Therefore, our results should be taken to indicate only that more stringent balanced budget requirements may help cause fiscal

"restraint," not that they necessarily cause such behavior. Moreover, the further question of whether fiscal restraint is even desirable cannot be answered by these (or any other) statistical results.

ENDNOTES

[1]See Dennis C. Mueller, and Peter Murrell, "Interest Groups and the Political Economy of Government Size," in Francesco Forte, and Alan Peacock (eds.), *Public Expenditure and Government Growth* (New York: Basil Blackwell, 1985): pp. 21-37; and Burton A. Abrams and William R. Dougan, "The Effects of Constitutional Restraints on Governmental Spending," *Public Choice*, 49 (1986): pp. 101-16.

[2]For a summary of this literature, see Robert E. McCormick and Robert D. Tollison, *Politicians, Legislation, and the Economy* (Boston: Martinus Nijhoff, 1981).

[3]For example, see Lowell Gallaway and Richard K. Vedder, "Rent-Seeking, Distributional Coalitions, Taxes, Relative Prices, and Economic Growth," *Public Choice*, 18 (1986); and Mancur Olsun, *The Rise and Decline of Nations* (New Haven, Connecticut: Yale University Press,. 1982).

[4]The data used in the regressions reported below is from the following sources: U.S. Department of Commerce, Bureau of the Census, *State Government Finances in 1984* (Washington, DC: Government Printing Office, 1983); U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States* (Washington, DC: Government Printing Office, various years); Council of State Governments, *The Book of the States* (Lexington, KY: CSG, various years); and U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1984 (Washington, DC: ACIR, 1985).

[5]See Randall G. Holcombe, and A. Zardkoohi, "The Determinants of Distribution of Federal Grants," *Southern Economic Journal*, 48 (October 1981): pp. 393-399; and David Laband, "The Private Interest in Public Redistribution: A Public Choice View of the Geographic Distribution of Federal Funds," *Public Choice*, 49 (1986): pp. 117-25.

[6]In their aforementioned study, Abrams and Dougan (*ibid.*) appear to have employed total spending as their dependent variable.

[7]See James A. Heims, *Constitutional Restrictions Against State Debt* (Madison, WI: University of Wisconsin Press, 1963).

[8]See James T. Bennett and Thomas J. DiLorenzo, *Underground Government: The Off-Budget Public Sector* (Washington, DC: The Cato Institute, 1983): pp. 15-18.

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