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Budget Enforcement Mechanisms

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In the state of Illinois, fiscal conditions are so bad that solutions require a "grand plan" with multiple revenue increases, multiple spending cuts, and multiple years of adjustment. The problem is that a credible plan requires a mechanism for holding to the plan other interests and elected officials in future years. This leads us to examine the literature on the effectiveness of various types of budget enforcement mechanisms.

In recent years, there has been an increasing recognition that many national and local governments are structurally unbalanced in the sense that their revenue systems are inadequate to support current and future spending plans. Remedies usually require a combination of revenue increases and restraint on spending. Because elected officials who give constituents bad fiscal news are sometimes politically disadvantaged, it may be difficult to summon the political will to achieve required fiscal arrangements in the absence of an agreement ahead of time to certain budgetary rules. This article provides an overview of some public budget enforcement mechanisms designed to assist long-term fiscal stability in the U.S and around the world. These examples may provide best-practice options for policymakers to pursue as they deal with Illinois' unprecedented budget crisis and structural deficit.

I. Federal budget enforcement mechanism in U.S.

At the federal government level, the operating budget has been in deficit nearly every year since 1961 except for a few years from 1998 to 2002.[1] There have been many discussions of potential budget enforcement mechanisms that might limit persistent federal deficits and growing federal debt. Some recent mechanisms are discussed below.

1. Budget Control Act of 2011

As a result of negotiations between President Obama and Congress, the Budget Control Act of 2011 was signed into law on August 2, 2011. This legislation caps budget authority, which is the authority Congress gives agencies to spend, from Fiscal Year 2012 to 2021. Caps on discretionary spending are established and a large spending reduction is targeted. Another goal of the act is to build a procedure to raise the debt limit to accommodate realistic deficits in coming years.[2] The legislation also creates a 12-member Joint Select Committee, designed to

[1] See Table 1.1 https://www.whitehouse.gov/omb/budget/Historicals.

[2] For more details, see Congressional Budget Office. (August 1, 2011). Analysis of August 1 Budget Control Act. Available at https://www.cbo.gov/publication/41626?index=12357.

develop a significant deficit reduction plan through Fiscal Year 2021.[3] Another key element of the Budget Control Act is that the House and Senate must vote separately on a proposal to amend the Constitution to require a balanced federal government budget.[4]

2. Pay-As-You-Go

Pay-As-You-Go (PAYGO) is a budget rule that says any new legislation affecting taxes, fees, or mandatory expenditures cannot increase projected budget deficits. Any increases in direct spending must be covered by offsetting increases in revenue or decreases in other mandatory spending.

PAYGO originated as one element of the Budget Enforcement Act of 1990. It worked successfully in the beginning, but started to weaken following an unexpected budget surplus in 1998, and expired officially at the end of 2002. When budget deficits returned in several years after the expiration of PAYGO,[5] it was re-established in 2007. In 2010, the Statutory Pay-As-You-Go Act of 2010 was passed to prevent Congress from making any legislation that would increase budget deficits, aiming to enforce budget neutrality. In order to monitor the net saving and costs of legislation, two PAYGO scorecards were introduced by the Office of Management and Budget.[6]

3. Budget sequestration

Budget sequestration was included as part of the Budget Control Act of 2011.[7] Sequestration would be triggered if Congress and the President enact legislation that causes an increase in net costs. Once sequestration is activated, automatic across-the-board equal percentage spending cuts would be imposed on all nonexempt programs to eliminate the projected deficit increase.[8] If the Congress cannot successfully offset the projected deficit increase, another sequestration is required in the following fiscal year.[9]

The Congressional Budget Office (CBO) is required to issue a report by August 15 every year, providing estimates of the caps on discretionary budget authority through 2021.[10] However, the

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[3] However, the Committee failed to reach agreement on a deficit reduction plan. See Thurber, James A. (2012). *Agony, Angst, and the Failure of the Supercommittee*. Available at https://www.american.edu/spa/ccps/upload/Agony-Angst-and-theFailure-of-the-Supercommittee.pdf.

[4] For more details, see Heniff Jr., Bill, Rybicki, Elizabeth, and Mahan, Shannon M. (August 19, 2011). *The Budget Control Act of 2011*. Available at https://www.fas.org/sgp/crs/misc/R41965.pdf.

[5] For the details about the deficits data, see the White House. *The Budget for Fiscal Year 2008, Historical Tables*. Available at https://www.whitehouse.gov/sites/default/files/omb/budget/fy2008/pdf/hist.pdf.

[6] These two scorecards are a 5-Year Scorecard and a 10-Year Scorecard. For more information, see Institute for e-Health Policy. (August 22, 2012). *Federal Budget and Pay-As-You-Go Rules ("PAYGO")*. Available at http://www.e-healthpolicy.org/docs/HIMSS_PAYGO_FactSheet.pdf.

[7] Budget sequestration was first introduced in Gramm-Rudman-Hollings Deficit Reduction Act of 1985. This act is available at https://www.gpo.gov/fdsys/pkg/STATUTE-99/pdf/STATUTE-99-Pg1037.pdf.

[8] Programs, such as Social Security and the low-income entitlements like Medicaid, are exempt from sequestration. For more exemptions, see https://www.whitehouse.gov/omb/paygo_description.

[9] See Tax Policy Center. *What is PAYGO?* Available at http://www.taxpolicycenter.org/briefing-book/what-paygo.

[10] Congressional Budget Office. *Sequestration Update Report: August 2016*. Available at https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51873-Sequestration.pdf.

Administration's Office of Management and Budget solely determines whether sequestration is needed. According to CBO's estimates, discretionary appropriations do not exceed the caps in Fiscal Year 2014-16.[11]

II. U.S. state and local budget enforcement mechanisms: Tax and expenditure limitations

Despite the fact that almost all U.S. state governments have a legal balanced budget requirement, most analysts believe that many state governments also have a significant structural budget imbalance. One mechanism used to encourage structural budget balance is tax and expenditure limits (TELs). TELs have been widely employed in U.S.

1. Colorado: Taxpayer Bill of Rights

Colorado's Taxpayer Bill of Rights (TABOR), approved in 1992, is the most stringent of TELs in U.S.[12] It applies to all sub-national government sectors including state government, municipalities and school districts in Colorado. TABOR has three primary provisions. First, tax rate increases are not allowed without voter approval. Second, a revenue cap limits the annual increase in government revenue. Taxpayers receive TABOR refunds for the part of revenue in excess of the TABOR limit. Third, spending restrictions can only be changed with voter approval, rather than by the legislature.

In 2000, voters passed a constitutional amendment (Amendment 23) to require that funding for K-12 education increase one percent more than inflation each year through Fiscal Year 2010-11. Over time, TABOR limits began to conflict with this policy, and in 2005 Colorado voters approved Referendum C, which suspended TABOR's revenue limits from 2006 to 2010.[13]

The existing literature on the effect of Colorado's TABOR on budget outcomes is mixed. During the first decade after TABOR was approved, the role of legislators was diminished by restricting their ability to adjust the budget.[14] On the other hand, a recent rigorous empirical study found that TABOR had no impact on Colorado budget outcomes.[15]

2. Michigan: Headlee Amendment

In November 1978, Michigan voters approved the Headlee Amendment to the Michigan Constitution. This amendment added several provisions limiting the taxes and expenditures of state and local government. These provisions became Sections 25 through 33 of Article IX of the

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[11] Congressional Budget Office. *Sequestration*. Available at https://www.cbo.gov/topics/budget/sequestration.
[12] See http://www.bellpolicy.org/basic/colorados-tabor.
[13] See Colorado Department of the Treasury. Available at https://www.colorado.gov/pacific/treasury/constitutional-provisions-0.
[14] See The Bell Policy Center. *Ten Years of TABOR – Full report*. (2012). Available at http://www.bellpolicy.org/sites/default/files/TABOR10.pdf.
[15] Eliason, Paul, and Lutz, Byron. (August, 2016). *Can Fiscal Rules Constrain the Size of Government? An Analysis of the "Crown Jewel" of Tax and Expenditure Limitations.*

state constitution.[16] Section 26 limits revenue to the share of Michigan personal income it was in Fiscal Year 1978-79. If revenue exceeds the limit by 1 percent or more, the excess must be refunded to taxpayers.[17]

Section 31 requires voter approval for any local government tax increase. Section 31 also limits local government revenue from property assessment increases. If the base of an existing tax is broadened, the maximum authorized rate of property tax on the new base must be reduced to yield the same estimated gross revenue as before.

The Headlee Amendment also requires that the proportion of total state expenditure paid to local government must not be reduced below 41.6 percent, the proportion it was in Fiscal Year 1978-79. In Fiscal Year 1994-95, the minimum proportion of state expenditure paid to local government was raised to 60 percent because school finance reform led to increased support for K-12 education. The state is also responsible for fully funding any new or expanded programs it mandates for local governments.

Some argue that the Headlee Amendment limited state and local government spending and protected local governments and citizens from excesses of state power.[18] However, it is also argued that the amendment made it hard for local governments to address fiscal crises because of slowing growth in property tax revenues.[19]

3. Wisconsin: The Taxpayer Protection Amendment

The Taxpayer Protection Amendment was proposed in Wisconsin in 2006. This proposal was designed to limit the annual revenue growth of state and local governments. The annual revenue of each unit of government would be limited based on a formula taking into account population and inflation. Revenue exceeding the cap would have been placed in an emergency reserve fund and would have been returned to taxpayers if the reserve fund exceed 8 percent of the previous year's revenues. The amendment would have required approval by lawmakers in two legislative sessions and by voters in a referendum. However, this 2006 amendment failed to pass both houses of the state legislature, and it was not voted on by the public.[20]

Proponents held the view that the amendment would have lowered the tax burden in Wisconsin and would have helped create jobs and improve the business climate.[21] Some

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[16] For more details about the amendment, see http://www.legislature.mi.gov/(S(amkmdsu1gi0uerkeaovydpk2))/mileg.aspx?page=LoadVirtualDoc&BookmarkID=6536.

[17] The revenue limit, 9.49 percent of personal income, was never exceeded in the first 15 years until Fiscal Year 1994-95. See http://www.michiganinbrief.org/edition06/text/issues/issue-31.htm.

[18] Anderson, Patrick L. (October 17, 2014). *Headlee's signature amendment has worked for all Michigan residents*. Available at http://bridgemi.com/2014/10/headlees-signature-amendment-has-worked-for-all-michigan-residents/#.

[19] Walcott, Eric. (July 25, 2016). *What is the Headlee Amendment and How Does It Affect Local Taxes?* Available at http://msue.anr.msu.edu/news/what_is_the_headlee_amendment_and_how_does_it_affect_local_taxes.

[20] See Kulik, Jeffrey M. (2016). *Tax Expenditure Limitations (TELs) and State Expenditure Structure*. Available at http://opus.govst.edu/cgi/viewcontent.cgi?article=1241&context=capstones.

[21] Gusho, Mark. *Testimony on the Wisconsin Taxpayer Protection Amendment*. Available at http://wispolitics.com/1006/060405Manitowoc_tpa.pdf.

believed that the amendment would have prevented legislators from increasing taxes.[22] On the other hand, an analysis by a University of Wisconsin professor argued that the amendment would have diminished local control and jeopardized the state's future economic development.[23] Furthermore, communities' ability to provide public safety services would have been impaired because of potentially slow and reluctant response to the need for services.[24] This amendment could also have led public universities to raise tuition, implement enrollment caps, and reduce support for university research.[25]

III. Budget enforcement mechanism in other countries

Most countries introduce a variety of limitations on local government budgeting and borrowing. These countries try to maintain fiscal discipline to address inadequate budgetary transparency and injudicious use of discretion.[26]

1. Fiscal responsibility laws

Fiscal responsibility laws (FRLs) are designed to increase budget discipline and to enhance the credibility, predictability and transparency of government budget processes. The key elements of FRLs are setting up fiscal rules and establishing fiscal transparency mechanisms.

Procedural fiscal rules and numerical fiscal rules are the two features of FRLs.[27] Procedural rules establish procedures for the budgetary process. They stipulate the principles and associated practices to enhance transparency, accountability, and fiscal management.[28] They are widely used in Australia, New Zealand, and the United Kingdom. Numerical fiscal rules set quantitative targets for budgetary aggregates.[29] They pose limitations on fiscal policies, and introduce ceilings on certain indicators of fiscal outcomes such as government budget balance,

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[22] Kittle, M.D. (December 6, 2013). *WI taxpayer protection amendment proposed, but would it have loopholes?* Available at http://watchdog.org/119204/taxpayer-republican-constitution/.

[23] Reschovsky, Andrew. (March 4, 2006). *The Taxpayer Protection Amendment: A Preliminary Analysis*. Available at https://www.lafollette.wisc.edu/research-public-service/publications/the-taxpayer-protection-amendment-a-preliminary-analysis.

[24] Wisconsin Professional Police Association. (February 21, 2006).*The Taxpayer Protection Amendment*. Available at http://wppa.com/the-taxpayer-protection-amendment/.

[25] The University of Wisconsin. (March 23, 2006). *Regents: Taxpayer Protection Amendment not in Wisconsin's best interest*. Available at https://www.wisconsin.edu/news/archive/regents-taxpayer-protection-amendment-not-in-wisconsins-best-interest/.

[26] Rattsø, Jørn. (2001). *Fiscal controls in Europe: A summary*. Available at http://www.svt.ntnu.no/iso/jorn.rattso/Papers/dafflonchapter13.pdf.

[27] Corbacho, Ana and Schwartz, Gerd. (2007). Fiscal responsibility laws. *Promoting fiscal discipline, Washington, DC.*

[28] Sharma, Natasha and Strauss, Tove. (May, 2013). Special fiscal institutions for resource-rich developing economies. *Overseas Development Institute*. Available at https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8393.pdf.

[29] Crivelli, Ernesto and Shah, Anwar. (February, 2009). *Promoting Subnational Fiscal Discipline: A Review of Budget Institutions and their Impact on Fiscal Performance*. Available at http://siteresources.worldbank.org/PSGLP/Resources/CrivelliandShahFiscalRules.doc.

debt, expenditure, or revenue developments.[30] Some countries have budgeting frameworks that contain both types of rules, such as Brazil and India.[31]

Procedural rules are useful to identify drawbacks in budgetary procedures and alleviate lack of transparency and accountability to voters. Numerical rules may be useful to reduce fiscal deficits, address time inconsistency and signal changes that result in increase in investor confidence. Unfortunately, research suggests that, up to now, these types of rules have done little to promote high quality fiscal adjustment.[32]

2. Fiscal councils

Fiscal councils are the independent public institutions aimed at improving sustainable public finances.[33] They provide independent public assessments and evaluation of fiscal plans, even though no authority over policy is given to those councils. Their analyses and projections could influence the policymaking process through their contribution to the public debate. Most fiscal councils consist of experts in economics and public policy from academia, whose autonomy is supported by various provisions.[34]

One example of a fiscal council is the High Council of Finance in Belgium, which was established in 1989. The council is responsible for semi-annual reports published in March and June, assessing the implementation of internal stability programs and budgetary policies of local governments respectively. However, the council cannot comment on tax and expenditure polices.[35]

Some research shows that well-designed fiscal councils are able to promote stronger fiscal discipline and also could reduce use of over-optimistic forecasts designed to circumvent fiscal policy rules.[36] Another study finds that fiscal councils are associated with stronger fiscal

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30 The European Commission. (January 19, 2016). *Numerical fiscal rules in the EU Member States*. Available at http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm.

31 For more examples of countries implementing these rules, see Schaechter, Andrea, Kinda, Tidiane, Budina, Nina and Weber, Anke. (July, 2012). Fiscal Rules in Response to the Crisis: Toward the "Next-Generation" Rules: A New Dataset. *IMF Working Paper*. Available at https://www.imf.org/external/pubs/ft/wp/2012/wp12187.pdf. Also see Corbacho, Ana and Schwartz, Gerd. (2007). Fiscal responsibility laws. *Promoting fiscal discipline, Washington, DC*.

32 Corbacho, Ana and Schwartz, Gerd. (2007) provides a case in Brazil, showing that the adoption of the FRL will not only impair the quality of fiscal adjustment, but also raise more budgetary rigidities.

33 International Monetary Fund. (2013). *The Functions and Impact Of Fiscal Councils*. Available at http://www.imf.org/external/np/pp/eng/2013/071613.pdf.

34 Debrun, Xavier, Hauner, David and Kumar, Manmohan S. (2007). The Role for Fiscal Agencies. *Promoting Fiscal Discipline, Washington, DC.*

35 For more details about the High Council of Finance in Belgium, see Debrun, Xavier, Hauner, David and Kumar, Manmohan S. (2007). The Role for Fiscal Agencies. *Promoting Fiscal Discipline, Washington, DC.*

36 Debrun, Xavier, Kinda, Tidiane, Curristine, Teresa, Eyraud, Luc, Harris, Jason and Seiwald, Johann. (July 16, 2013). The Functions and Impact of Fiscal Councils. *IMF Policy Paper*. Available at http://www.imf.org/external/np/pp/eng/2013/071613.pdf.

performance as well as more accurate and less biased forecasts by collecting data among IMF members.[37]

3. Independent fiscal authorities

Independent fiscal authorities are another potential mechanism to facilitate long-term budget stability. Such a fiscal agency exerts control over fiscal policy much as independent central banks exert control over monetary policy. Their tasks would include establishing and enforcing short-term balanced budget targets consistent with debt sustainability. They might be offered some power over tax rates or spending to achieve fiscal balance. However, independent fiscal authorities have not been used in any country up to now[38] probably because policymakers are reluctant to delegate their fiscal mandate. Also, it is always hard to compromise between independent fiscal authorities and governments when conflicts appear.

IV. Other budget enforcement mechanisms

Financial markets and intergovernmental cooperation can play critical roles in ensuring the fiscal discipline. We discuss three types of mechanism that might be used.

1. Bond covenants

Richard Ravitch, the former Lieutenant Governor of New York, proposed a five-year plan in 2010 that authorized about $6 billion in "transitional borrowing" to decrease New York State's projected budget deficit.[39] To achieve structural budget balance, he suggested using new borrowing rules designed to make a fundamental change in the structure of state government in a long run.[40] The idea is that the bonds sold by New York would contain covenants requiring adherence to certain spending. In this way, the bond markets could contribute to imposing financial discipline and enforcing long-term budget balance.

Ravitch's plan required the use of Generally Accepted Accounting Principles (GAAP) to help eliminate budget gimmicks. It also required the creation of a Financial Review Board which would have the power to determine whether the budget was balanced on a quarterly basis. If the budget was not balanced, the board would give the governor and Legislature 15 days to

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[37] Debrun, Xavier and Kinda, Tidiane. (April 08, 2014). Strengthening Post-Crisis Fiscal Credibility: Fiscal Councils on the Rise—A New Dataset. *IMF Working Paper*. Available at https://www.imf.org/external/pubs/ft/wp/2014/wp1458.pdf.

[38] Debrun, Xavier, Hauner, David and Kumar, Manmohan S. (2007). The Role for Fiscal Agencies. *Promoting Fiscal Discipline, Washington, DC.*

[39] McMahon, E.J. (March 10, 2010). *The Ravitch Bailout*. Available at http://www.empirecenter.org/publications/the-ravitch-bailout/.

[40] Benjamin, Gerald. (March 23, 2010). *New York's lieutenant governor has an elegant answer to the state's spending woes.* Available at https://www.nydailynews.com/opinion/new-york-lieutenant-governor-elegant-answer-state-spending-woes-article-1.172449.

address the problem. If they failed, the governor, given extraordinary authority, could decrease expenditures to make the budget balanced.[41]

2. State credit rating and financial rating

State credit ratings can be used to assess states' ability to pay debt. Some private and independent agencies focus on evaluating the performance of states' public finance. One example is Standard & Poor's (S&P) credit ratings.[42] The rating ranges from the highest AAA to the lowest D. For states that get higher ratings, their interest costs on general obligation bonds are lower, indicating a lower cost to borrow money.

The Mercatus Center at George Mason University conducted a study that provided a more methodical alternative to ratings agencies. They used states' audited financial reports to assess their financial health.[43] Their analysis is based on basic financial data such as revenue and expenditures, as well as fiscal obligations data such as debt, unfunded pensions and health care benefits. In their 2016 report, the center reported that, compared to Year 2015, most states' fiscal condition remains relatively constant. Pensions and health care are the key factors affecting states' long-term fiscal performance.[44]

3. Cooperative arrangements across subnational governments

The heterogeneity among subnational governments may make it very difficult for central governments to address state and local budgetary issues. In some countries, e.g. Denmark, voluntary associations of regional governments promote fiscal discipline through cooperative agreements. The central government may enforce such agreements by applying penalties and sanctions. In other places enforcement is delegated to the judiciary. Examples of such cooperative agreements include the National Loan Council in Australia and High Finance Council in Belgium.[45]

V. Summary and conclusion

Our review finds that a large number of budget enforcement mechanisms designed to encourage fiscal discipline and long-term budget sustainability have been used by governments world-wide. Mechanisms include: procedural rules designed to make budget imbalances transparent; numerical triggers designed to make automatic adjustments in spending and revenue should budget gaps appear; and explicit constraints on revenues or spending designed

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[41] Phillips, Ted. (March 17, 2010). *Control by Covenant.* Available at http://www.bondbuyer.com/issues/119_301/new_york_state_budget-1009673-1.html.
[42] For more examples, see The Pew Charitable Trusts. (June 09, 2014). *Infographic: S&P State Credit Ratings, 2001-2014*. Available at http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2014/06/09/sp-ratings-2014.
[43] See Mercatus Center. (June 1, 2016). *Ranking the States by Fiscal Condition 2016 Edition.* Available at https://www.mercatus.org/statefiscalrankings.
[44] It is also reported that Alaska, Nebraska, Wyoming, North Dakota, and South Dakota are the top five states which perform best. The bottom states are Kentucky, Illinois, New Jersey, Massachusetts, and Connecticut. For details, see https://www.mercatus.org/system/files/Norcross-Fiscal-Rankings-2-v3_1.pdf.
[45] For more examples, see Ter-Minassian, Teresa. (2007). Fiscal Rules for Subnational Governments. *OECD Journal on Budgeting*, 6(3), 1-11.

to shrink the size of government. Rigorous investigations of the mechanisms used to date find that such mechanisms often have limited or no impact on long-term budget sustainability. Other mechanisms, such as independent fiscal authorities and strict bond covenants, that would be triggered by budget gaps have been discussed but thus far not implemented. Ultimately, experience suggests that budget enforcement mechanisms are most successful when they have on-going political support.