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THE COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Tied to the Mast: Fiscal Rules and Their Uses

The Peterson-Pew Commission on Budget Reform

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Tied to the Mast: Fiscal Rules and Their Uses

Summary

A growing number of countries have established fiscal rules as a general guide to sound fiscal policy. The U.S. has not. The federal budget process has operated for a long time without the discipline of a fiscal rule—formal or informal.

Surveys of such rules have shown they can help guide policy makers toward prudent budget choices and undergird more specific policies and procedures. By formally adopting such a rule, leaders choose to "tie themselves to the mast" of fiscal responsibility before they are fully exposed to short-term temptations to meet immediate demands and do what is popular.

Before any rule or set of rules can be enacted and sustained in the face of inevitable near-term pressures, public agreement must be obtained. In the U.S., commitment to traditional fiscal rules, such as balancing revenues and spending, has eroded.

One type of fiscal rule is a balanced budget requirement. A balanced budget requirement would not be practical if imposed immediately, given the federal government's current fiscal situation. Moreover, this or any other fiscal rule must be carefully designed to be flexible enough to deal with emergencies and economic cycles and yet not so flexible as to be meaningless as a standard.

For the medium term, the Peterson-Pew Commission on Budget Reform recommends enacting a fiscal rule that would govern publicly held federal debt in conjunction with the adoption of a broader set of budget process reforms such as presented in the Commission's 2010 report. This general fiscal rule would be reinforced by rules governing elements of the budget—caps on certain types of spending and tax expenditures, and a strong version of the Pay-As-You-Go legislation. We also recommend a rule for the long-term that would align spending and revenues closely, taking into account economic cycles.

Adherence to a strong fiscal rule depends on whether it is grounded in public consensus about what constitutes sound fiscal policy. Because the traditional consensus that supported fiscal discipline has evaporated, the first task of U.S. leaders prepared to bind themselves to a fiscal rule is to help restore a national norm of fiscal responsibility. Otherwise, any rule will succumb to the siren call of urgent demands for government to do more than it is prepared to pay for.

Introduction

The United States, like many developed countries, has recently seen a sharp increase in government debt, as efforts to stabilize the financial system and restore economic growth translated private losses into huge public borrowings. In the wake of these efforts and as the world economy begins to recover, many governments are revisiting the sustainability of their public finances and reflecting on the fiscal consequences of their response to the Great Recession. It is now generally recognized that a major fiscal adjustment will be required here and elsewhere.

Can adoption of a general fiscal rule help in these circumstances? The empirical evidence from other countries and the states suggests that adoption of an explicit rule governing public finances may be helpful, but that evidence is somewhat ambiguous and may not apply in present circumstances to the U.S. federal government.

If debt is now dangerously high and the fiscal outlook unsustainable, what kind of rule might be most useful as a guide or standard to judge the soundness of budget choices? Would it make sense to have one kind of rule – such as caps on spending and tax expenditures or targets for budget savings or debt – for the medium term and another for the longer term – such as a balanced budget requirement over an economic cycle once debt is stabilized? In the face of a still struggling economy, when should such a rule be implemented?

In our December 2010 report, ***Getting Back in the Black*** (***GBITB***), the Peterson-Pew Commission recommended adopting a fiscal rule as part of our comprehensive set of proposals to reform the federal government's budget process. As we said then, "experience of some other countries with systems of fiscal rules such as we recommend shows that they can help leaders sustain policy agreements consistent with long-term stability, provided that they take into account the uncertainties inherent in constructing budgets and are therefore not unrealistic or too rigid."

In ***GBITB*** we recommended setting a medium-term target and annual debt targets requiring budget savings sufficient to stabilize the debt, combined with caps on spending and a trigger mechanism to force leaders to adopt policy changes sufficient to meet the targets. The medium-term goal was a debt-to-GDP ratio of 60 percent by 2018.[1] The targets themselves, or spending caps for parts of the budget, could be considered a type of fiscal rule. For the longer term, we recommended adopting a goal of balancing the budget over a business cycle. This too can be considered a fiscal rule. Since the release of the report other organizations covering the spectrum of political ideologies have endorsed or presented similar proposals, albeit with varying targets. The rules recommended in ***GBITB*** are intended to help first force and later enforce budget actions necessary to adhere to the rules and meet the targets.

[1] The 2018 goal would need to be revised at this point to, for example, aim for 60 percent by the end of the decade or later. Under the Committee for a Responsible Federal Budget's realistic baseline, the 2020 debt-to-GDP ratio is estimated to reach 80%.

To determine the potential added value of adopting one or more explicit fiscal rules, this paper explores the logic of fiscal rules and why they may help, reviews international experience with various kinds of fiscal rules to assess their efficacy and applicability to the U.S. federal government, and suggests some criteria that others have offered for selecting a rule or rules. Considering conditions necessary for any rule or rules to be sustained and be effective as a source of fiscal discipline in the U.S. given present circumstances and its unique political system, we then suggest what rules would be most helpful here and when they should apply. As we consider the ways policymakers could tie themselves by rule to the mast of fiscal responsibility, we also consider what other reforms of the federal budget process are needed to sustain adherence to a fiscal rule.

What is a fiscal rule?

The most familiar fiscal rule in the U.S. is the balanced budget. Nearly all state governments must abide by some form of balanced budget requirement.[2] At a national level, although never made explicit, the norm of a balanced budget was implicitly accepted and generally followed for much of our history. Debts were incurred in times of war or other national emergency and paid down swiftly thereafter. As Allen Schick has noted, the federal budget was balanced in two-thirds of the years between 1789 through 1916 (Schick, 2007, page 10) absent an explicit requirement to do so. Ironically, given the attention paid in recent decades to efforts to control deficit spending, balanced budgets have become rare. Adherence to the norm of budget balance has eroded. This has led some to proposals by some for formal adoption of a balanced budget requirement, often in the form of a Constitutional amendment.

In the current Congress, a number of bills have been introduced to require some variation of a federal Constitutional amendment requiring the budget be balanced each year. One of these, H.R. 2560, recently passed the House of Representatives, but was subsequently defeated in the Senate. More recently, the Budget Control Act enacted as part of an August 2011 agreement to raise the debt ceiling requires another vote in each chamber by December 31st, 2011, on the version of such an amendment favored by most Republicans. However, opinion is deeply divided on whether annual budget balance is the proper goal, the details of how to define and implement such a requirement, and whether it should be placed in the Constitution. Adoption of such an amendment is unlikely in the foreseeable future. Even if it were to be adopted, its ratification by the required number of States would take years. It would therefore have little practical value for dealing with the current fiscal situation.

A balanced budget is but one type of fiscal rule. This paper looks at a range of fiscal rule types, many of which are employed in other countries.

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[2] While there are technical reasons why some argue that a handful of states do not require balanced budgets, it is generally accepted that all states save Vermont have some form of formal balanced budget requirement. See National Conference of State Legislatures, 2010.

In 1998 George Kopits and Steven Symansky of the International Monetary Fund (IMF) offered a now commonly cited definition of a fiscal rule: "a permanent constraint on fiscal policy in terms of a summary indicator of fiscal performance" (Kopits and Symansky, 1998). The IMF describes a fiscal rule as "placing a numerical limit on a budget aggregate or on a fiscal performance indicator, such as the deficit, the debt, or one of their components."

A growing number of countries have such rules. A 2009 study prepared on behalf of the IMF and European Commission identified 80 countries that employ fiscal rules to enforce budget discipline (Kumar, et al. 2009).

Among countries with fiscal rules, balanced budget and deficit or debt limit rules are the most common type. Box 1 describes other common types. Debt limit rules generally allow more policy flexibility than those that constrain lawmakers to specific levels of expenditures or revenues. Some countries with such rules also employ a "golden rule," which exempts from the rule's constraints spending on public investment or capital projects that will accrue benefits going forward – presumably in excess of their costs. Golden rules such as these recently have become less common, in large part due to the abuse by lawmakers and governments of what they define as investments. Many point to the United Kingdom's experience as an example of the failure of a golden rule to be of any real use in confining new spending to public investment. Particularly at the close of the past decade under then Prime Minister Gordon Brown, accounting gimmicks and abuse of the golden rule criteria contributed to rapid debt accumulation in the U.K.[3] Other variations include designing rules to allow flexibility in times of natural disaster, severe economic downturns, or other emergencies.

[3] Alongside the golden rule, the U.K. employed the sustainable investment rule, which stated that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. The target debt level was 40% of GDP. But, this level was breached in 2007, and debt exceeded 76% of GDP in 2010, according to the U.K.'s Office of National Statistics (March 2011).

Box 1. Common Types of Fiscal Rules

Balanced Budget rules generally require that spending not exceed revenue over some specified time period. Primary balance rules exclude debt service costs from the equation. Other variants include balance "over the cycle", meaning on average a balanced budget over the business cycle, or a cyclically adjusted balance. A "golden rule" excludes investment spending from the balanced budget calculation.

Debt/deficit rules set a specific target public debt limit, usually as some percentage of the economy. Criticism of this rule includes that when a country is well below its target there may be insufficient fiscal policy guidance, and that it is inherently pro-cyclical.

Expenditure rules set limits on total spending, either across government as a whole or by employing different caps for different sectors. One variation is to exclude interest spending from caps. Another is to include tax expenditures – which are in a very real sense spending mischaracterized as negative revenues – under the expenditure rule. Limits can be in real or nominal terms, as a fixed percentage of GDP, or include flexibility to allow for a certain growth rate over time.

Revenue rules set either a ceiling or floor, or both, on the amount of revenue collected. A revenue rule is used when the goal is to either boost revenue collection, or to keep tax rates low. Similar to the expenditure rule, limits can be in real or nominal terms, as a fixed percentage of GDP, or include flexibility to allow for a certain growth rate over time.

Logic of Fiscal Rules

Why do we need fiscal rules? Thomas Schelling says that "when the values that govern one's preferences are liable to be displaced by values that one deprecates, we need . . . [a] theory of self-command, or self-management."[4] Schelling suggests that, on a personal level, there may be an internal division between a self that is able to plan forward and think strategically and a self that is preoccupied with the moment. On a social level, there may be a similar two-mindedness: mindfulness of the need for fiscal prudence and sustainable commitments in perpetual conflict with the sirens' call to meet immediate demands and do what is popular.

On a personal level, we bargain with ourselves and make vows. On a societal level, we may similarly commit to a rule of fiscal prudence that conflicts with short-term or narrow political interests. Leaders may choose to "tie themselves to the mast" before they are fully exposed to short-term temptations.[5]

[4] See T.C. Schelling, *Choice and Consequence*, Cambridge, MA: Harvard University Press, 1984, page 85.

[5] The reference is, of course, to Homer's Odyssey. It turns out that others before us have used the same analogy applied to fiscal rules. Cf., Debrun, et al. "Tied to the Mast? National Fiscal Rules in the European Union" and in an article on the Swiss debt brake (discussed below) there is this question: "How

Whether we can make such a commitment and then sustain it is another problem. We must consider this when choosing the form of the rule and the means to sustain it in the face of perpetual temptation to violate it for gain in the here and now. Fiscal rules bring the question of fiscal sustainability or prudence more explicitly into the budget process – providing a clear standard for both lawmakers and the public. The vow of fiscal prudence implies a consequence if the vow is broken. Policy makers are exposing themselves to political retribution if they violate their pledge, saying to voters: "if I break this rule, vote against me". If policymakers think that an electoral sanction may not be sufficient to sustain the rule, they may want to reinforce it further by enacting more direct legal penalties, perhaps a statutory budget trigger that imposes automatic budget adjustments as soon as the rule is violated.[6]

As a permanent and binding fixture in a country's fiscal policy framework, a fiscal rule can be an important means of ensuring fiscal discipline. If taken as a credible commitment, it serves as a reassurance to leaders, voters, and creditors of a stable basis for their own decisions. In a closely related context, researchers have noted the contribution that stable, credible "rules of the game" make to economic growth; when property rights are not seen as subject to whim, market activity and investment are stimulated.[7]

Such rules serve as an internal conscience that highlights policymakers' deviation if they do not act to stay within a rule's parameters. The parameters are assumed to translate a public consensus about what constitutes fiscal prudence into specific tests that people can use to readily judge whether budgets achieve an agreed-upon result, such as stabilizing the nation's debt or bringing it down to a safe level over a specified period of time.

A major argument for adopting fiscal rules is that such a permanent constraint can overcome lawmakers' shortsightedness. Historical analysis of lawmakers' budget decisions suggests a "deficit bias," that is, a tendency to authorize spending in excess of current revenues.[8] This may be a partly unintended consequence of the way budgets

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can you keep Odysseus from falling for the sirens of parliament," where politicians want to spend ever more to win elections, said Christoph Schaltegger, an economist at Zurich- based Economiesuisse, which lobbies on behalf of more than 30,000 Swiss companies. "There has to be a mechanism that forces politicians to show restraint." Schelling himself quotes this passage from the Odyssey in discussing the idea of an intrapersonal contract.

6 See the Commission's April 2011 paper, *Peterson-Pew Fiscal Targets: Ten Issues in Designing a Debt Fail Safe,* at http://budgetreform.org/document/peterson-pew-fiscal-targets-ten-issues-designing-new-debt-failsafe, April 28.

7 Cf., North, D. C., and Weingast, B. (1989) "Constitutions and commitment: The evolution of institutions governing public choice in seventeenth century England." *Journal of Economic History*. 49: 803-32. More recently, development economists have stressed the importance of law and regulation in providing certainty about such things as ownership rights, thus serving as a foundation for capital investment and growth; cf. De Soto, Hernando. 2000. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books.

8 Cf., Milesi-Ferreti (2000). Political science research also delves into motivations for deficit bias. For example, some posit that ". . . deficit bias contains a strategic element because incumbent governments

respond to changes in economic conditions; in poor economic times revenues are constrained and automatic stabilizers kick in, often accompanied by deliberate "stimulus" measures to restore economic growth, resulting in large deficits. In good times, the reverse tends to be true, but policymakers tend toward optimism that good times will last and typically therefore fail to prepare for the prospect of hard times and large deficits ahead. And overall, spending and tax cuts are popular while austerity and tax increases are not.

Over time, sizeable deficits accumulate to debt levels that leave little flexibility for fiscal adjustment to unanticipated demands and pose a threat to fiscal and economic stability. Fiscal rules can help prevent a government from reaching the point where it becomes too late to make small or gradual policy adjustments.

Fiscal Rules in the United States

While the balanced budget is the most well-known fiscal rule, others have been employed at various periods in the United States at the federal level. Efforts to employ pay-as-you-go (PAYGO) rules and discretionary spending caps have been used to varying degrees of success, particularly in the 1980s and 1990s. See Box 2 for a summary of examples of such legislation, and one more recently enacted.[9]

have an incentive to 'tie the hands' of forthcoming governments by creating high deficits (Debrun et al., 2008, p. 302)."

[9] A similar contingency policy rule can be found in the 2003 Medicare Modernization Act (the prescription drug bill). As part of that law, Congress imposed a Medicare solvency trigger designed to address long-term Medicare sustainability. The law required that the Medicare Trustees issue a warning if two consecutive Trustee reports project that general revenue will be needed to fund more than 45 percent of Medicare outlays. After the Trustees issued that warning, the law requires the President to submit a legislative proposal to reduce the general fund's contribution to Medicare outlays to 45 percent or less.

Box 2: U.S. Experience with Budget Rules

The Balanced Budget and Emergency Deficit Control Act of 1985

Also known after its authors—Senators Phil Gramm (R-TX), Warren Rudman (R-NH), and Ernest Hollings (D-SC) as the Gramm-Rudman-Hollings Act—this law was designed to ensure actions took place to cut the deficit to specific levels until the budget was balanced. If the deficit exceeded the target for any year, the law required the President to cut spending using a specified mechanism that covered nearly all programs to meet the target. The legislation also made changes to the 1974 Budget Act, including requiring the budget resolution to provide specific allocations to each congressional committee. It established several points of order to enforce budget limits and increased the number of votes required to waive points of order in the Senate from a simple majority to three-fifths. The law established maximum deficit amounts for the fiscal years from1985 to 1990. If the deficit exceeded the limits in those years, the President was required to issue a sequester order that cut nonexempt spending to meet the target. The legislation also made several additional changes to budget law, including reducing the number of budget resolutions from two to one annually.

The deficit in 1986 was $221 billion; in 1989 it was $153 billion. However, there was great debate over whether the constraints implemented by Gramm-Rudman-Hollings were responsible for the decrease. Critics argued that budget gimmicks inflated the deficit decrease and made the law appear to be more effective than it was.

The Budget Enforcement Act of 1990

In 1990 Congress attempted to control spending through discretionary spending caps and by ensuring that revenue was not cut or mandatory spending increased without offsetting changes. The Budget Enforcement Act (BEA) substantially changed the mechanisms to move towards a balanced budget: instead of statutory budget targets, the BEA attempted to produce lower deficits and eventually a balanced budget by controlling spending, including new tax expenditures.

The mechanisms for enforcement included spending caps on discretionary programs (those funded through annual appropriations) and a requirement that mandatory spending increases and/or tax cuts be offset. This became known as the pay-as-you-go (PAYGO) rule. Any violation of the PAYGO rule would to lead to a sequester, (i.e., an automatic reduction) of mandatory spending, although many programs, including Social Security, were exempt from the sequester. In the absence of sufficient PAYGO offsets, a statutorily specified list of mandatory spending programs would face cuts. If the discretionary caps still were exceeded, an across-the-board sequester of appropriated funding was required to eliminate any excess.

The caps and PAYGO requirements of the BEA of 1990 were in effect from fiscal 1991 through fiscal 1995; the terms were extended (with some modifications) twice: first through fiscal 1998 (in 1993) and then through fiscal 2002 (in 1997). Many of its provisions were effectively waived after budget surpluses began to appear in the late 1990s. The law also incorporated a version of what is known as the Byrd Rule, after its author the late Senator Robert C. Byrd (D-WV). The Rule required that provisions of a budget reconciliation bill be germane, i.e., have budget effects.

The Congressional Budget Office estimated at the time that over a five year period, the reconciliation process under the BEA would reduce the deficit by $482 billion.

The Budget Control Act of 2011

This law includes the year caps on discretionary spending enforced by a sequester similar to that imposed by Gramm-Rudman-Hollings and a point of order in the Senate against violation of the caps.

Rather than establishing a rule to guide future budgets or specifying dollar targets for the debt or deficit, the Act relies for its effects on procedural requirements, including establishment of a bipartisan special congressional committee that by majority vote can present legislation calling for $1.2 trillion or more in 10-year budget savings that would be subject to an up or down congressional vote under fast track procedures. If passed and signed by the president, the legislation would authorize a corresponding increase in the debt ceiling. If the committee failed to produce such legislation or the legislation was not enacted, automatic reductions in defense and domestic spending would be imposed beginning in January 2013 to achieve comparable savings. Imposition of such cuts could be avoided by passage of a balanced budget amendment.

Source: Congressional Budget Office.

Kopits and Symansky point to the BEA as a rule that does not fall into the category of a strict fiscal rule, labeling these and similar rules "contingency policy rules" that are triggered only under certain circumstances, and are not a permanent constraint. This is not to say that a contingent rule representing temporary policy agreement cannot be useful for a time in sustaining fiscal discipline; in fact, experience following 1990 with the BEA suggests otherwise. Rather, this history points to the limitations of a rule not grounded in a more durable public and leadership consensus about what fiscal policies adhere to or when they violate a fundamental standard of fiscally prudent policy.

International Experience with Fiscal Rules

Many countries have adopted and use fiscal rules. Their experience shows that not only can setting a rule increase public understanding of a country's fiscal position—by providing a simple to understand benchmark—but also serve as a spur to policy makers to act promptly to address fiscal threats by adhering to the rule, or prevent such actions that are tempting but would lead to a violation of the rule. Fiscal rules can enhance transparency, help provide a measure of accountability, and bolster the credibility of a central government in the eyes of its citizens. Fiscal rules can help policy maker's subordinate shorter-term concerns to longer-term fiscal objectives.

While there are no "one-size-fits-all" fiscal rules, the experience of other countries can help guide U.S. policy makers. Above all, the U.S. political system is unique. In many countries that have successfully implemented a fiscal rule the executive or executive branch equivalent to the U.S. president and administration can implement fiscal policy with little or no input from the equivalent of the U.S. Congress. Other differences that make direct comparisons difficult include the size of a country's economy, monetary and trade policy, and the fact that the U.S. dollar is the world reserve currency. Regardless, international experiences with fiscal rules can be insightful for U.S. lawmakers.

The IMF has conducted detailed surveys on the use of fiscal rules around the world. The Fund's December 2009 comprehensive review of fiscal rules attempted to assess their role in the financial crisis. The report highlighted the growing use of fiscal rules – now used in 80 countries, compared to only seven countries in 1990.[10] Box 3 summarizes the use of fiscal rules in several countries.

Among the IMF's general findings on the use of fiscal rules:

- The use of fiscal rules can be traced to the mid-nineteenth century, largely at the sub-national level. After World War II a number of national governments began to incorporate budget-balance rules. Beginning in the 1970s many more countries, including the United States, looked to fiscal rules to help rein in rapidly accumulating debt.

- The use of fiscal rules really took off in the 1990s as a number of countries' debt and deficits raised alarm.[11]

- Over time countries have gravitated toward using a combination of rules that are often linked to debt sustainability; in recent years, however, the goal of simply restricting the size of government has become a more frequent motive.

- Budget balance and debt rules are the most common, with about 60 percent of the countries studied employing one or the other or both.

- Cyclically-adjusted and structural balance rules remain rare but are becoming more common.

In a 2008 report, Debrun et al. looked more closely at the use of fiscal rules by European Union (EU) countries,[12] and conducted a statistical analysis of the use and strength of rules.[13] The analysis finds an upward trend in both the proportion of a country's government covered by fiscal rules and the rules' strength. Of the 22 countries studied, 18 employed a fiscal rule or rules at the central government level; an expenditure rule was the most commonly applied (by nine countries). Looking at a country's budget balance in 1990 and 2005, the study finds that those countries with a strong performance at the end of the period had increased their reliance on fiscal rules over the period. Similar to other studies, they also observe that it is very difficult to ascertain whether a

[10] In a 2008 report, Debrun et al. noted that there were a total of 13 rules in place in 1990, and 57 in place in 2005. The majority of those rules targeted budget balance and the debt, with revenue rules being rare.

[11] Many European countries adopted common rules as a requirement for participation in a supranational system, e.g. under the Maastricht Treaty and subsequent Stability and Growth Pact, but the widespread failure by most EC members to adhere to those rules demonstrated an absence of true consensus about fiscal policies as well as the lack of disciplining means at that stage of European integration.

[12] The report covers 22 countries. At the time there were 25 EU countries. However, Greece, Cyprus and Malta did not use rules conforming to the Kopits and Symanksy definition of a fiscal rule that the report followed as a basis for inclusion.

[13] Their dataset includes rules employed at all levels of government: local, regional and central government, and social security.

country that increasingly employs rules and sees positive results is inherently more fiscally disciplined and would therefore would act responsibly regardless of using an explicit rule or not.

Box 3. Country Examples of Fiscal Rules

United Kingdom As noted above, the U.K.'s golden and sustainable investment rules have recently been abandoned or ignored. In February 2010, in an attempt to impose new fiscal discipline and to enshrine policy targets into law, the UK implemented the Fiscal Responsibility Act 2010. The act required that public sector net borrowing be halved over four years from its 2009/10 level, borrowing be reduced as a share of GDP in each year, and that public sector net debt fall as a share of GDP from 2015/16. The Fiscal Responsibility Act was almost immediately deemed a failure, and was repealed in March 2011. Almost simultaneously, in May 2010, the UK established the independent Office for Budget Responsibility, describing its mandate thusly, "It is the duty of the Office to examine and report on the sustainability of the public finances." The OBR describes itself as having four primary responsibilities: produce forecasts for the economy and public finances, judge progress towards the Government's fiscal targets, assess the long-term sustainability of the public finances, and scrutinize the Treasury's costing of Budget measures. Under the progress toward fiscal targets, the OBR assesses whether the budget is on track to, first, balance the cyclically-adjusted current budget five years ahead, and, second, to have public sector net debt falling in 2015-16.

The Netherlands In 1993, the Dutch Minister of Finance appointed a study group on the budget that recommended a new budget formulation system focused on the level of expenditures, rather than the level of the deficit, and on cautious economic assumptions. This focus created more stability, as any extra revenue would not automatically translate into extra expenditures, and the cautious economic assumptions would help compensate for uncertainty.

In coalition agreements between different political parties, separate caps on expenditures were established for each of the three sectors of the Dutch budget: the "core" budget sector, the health care sector, and the social security and labor market sector. The coalition agreements also incorporated multi-year expenditure projections of each ministry as the basis for sub-caps for each minister within the "core" budget sector. Caps were established in real terms, which served to prevent the coalition agreements from having to be re-opened during the course of the government's term of office. Transfers are permitted between sectors and between sub-caps established within the "core" budget sector. Surpluses in one area, however, can be used only to fund existing policies that are experiencing higher costs than projected. The consent of the entire cabinet is required to finance new proposals, and budget over-runs must be offset in the area of the over-run. There are strong "firewalls" between revenue and expenditures. If the budgetary situation turns out more favorable than anticipated, then some of the extra revenues may be used to cut taxes, depending on the size of the remaining deficit.

Sweden's Expenditure Caps and Surplus Target In the early 1990s Sweden experienced a recession and a very severe fiscal crisis. As a weak budget process was identified as part of the problem, significant changes in the budget process were initiated in the second half of the 1990s.

The introduction of a nominal expenditure ceiling for the central government in 1997 was an important part of the reformed budget process. The ceilings on expenditure were accompanied by a top-down budget process and a surplus target for the general government sector of 2% (later changed to 1%) of GDP over the business cycle. In 2000, a balanced budget requirement was introduced for local governments. Although the expenditure ceilings were not explicitly derived from the overall surplus target, the surplus target was taken into account when setting the expenditure ceilings. Annual nominal expenditure ceilings were set three years in advance as part of the budget process, and are considered to be binding. The ceilings apply to central government primary expenditures, including transfers and grants to local governments, plus expenditures by the old-age pension system outside the central government budget. Each year, as part of a rolling budget framework, an additional ceiling is applied to expenditures three years out. The ceilings for these years could in principle be altered, but this has not happened. The ceilings were set with a margin over projected expenditures to allow for some policy flexibility and, more importantly, for increases in cyclical spending during an economic downturn. Any attempt by parliament to change a proposed budget has to be presented in the form of a complete package that respects the previously determined expenditure frames and ceilings.

Structural balance rule in Germany In June 2009, the German parliament amended the constitution to include a new rule for both federal and state governments. The rule requires the federal government's structural deficit not to exceed 0.35 percent of GDP. The rule becomes binding in 2016, with a transition period starting in 2011. The states will be bound by a balanced structural budget beginning in 2020. Execution errors are cumulated in a notional account that has to be corrected once errors accumulate above one percent of GDP. However, the adjustment only needs to start after an economic recovery is in place to avoid a procyclical tightening. The provisions allow for an escape clause that can be invoked by parliamentary majority in the event of natural catastrophe or other emergency outside government control. Because the transition towards full implementation of this rule is in its infancy, there is little to say about its impact.

Swiss debt-brake rule This rule took effect in 2003 with the objective of stabilizing government debt, which had increased rapidly during the 1990s. The rule specifies a one-year ahead *ex-ante* ceiling on central government expenditure equal to predicted revenue, adjusted by a factor reflecting the cyclical position of the economy. Effectively, the rule aims at maintaining a structural budget balance every year. It is then possible to run deficits in a recession, but over the medium-term deficits and surpluses are expected to cancel out. Differences between budget targets and outcomes are recorded in a notional account. If the negative balance in the account exceeds six percent of expenditure, the authorities are required by law to take measures sufficient to reduce the balance below this level within three years. An escape clause exists, by which Parliament may allow deviations to the rule in exceptional circumstances.

Augmented growth-based balance rule in Turkey Turkey has recently considered adopting a fiscal rule that promotes countercyclical policy while circumventing the need to estimate the output gap. The draft law submitted to Parliament specifies a general government deficit target of one percent of GDP. In any given year, the actual deficit may deviate from the target to account for cyclical developments. In this case, the deficit may react to changes in the growth rate (relative to the long-run trend of five percent), rather than changes in the output gap. In addition, the rule allows gradual adjustment when the deficit is away from its medium-term target. As a result, the amount of required adjustment in any given year would almost always be feasible, making the rule more politically durable.

Expenditure rule in Finland A system of multi-annual expenditure ceilings was initiated in Finland in 2003 to rein in public expenditure and consolidate public debt. The ceilings are set in real terms for a four-year period at the start of a new government. Every March, ahead of the budget, the government converts real ceilings into nominal ceilings using an updated deflator of the central government price index. Local governments, public enterprises, and about a quarter of the central government budget are excluded from the ceilings. The deficits are not explicitly anchored in debt and deficit limits. Compliance and monitoring is done primarily by the finance minister, and there are no formal sanctions for exceeding the ceilings. But commitment to the ceiling has been high.

European Union's 1992 Maastricht Treaty and 1997 Sustainable Growth Pact (SGP)

Motivation for the creation of rules guiding EU member countries stemmed from a strong belief that a single rule applicable across countries was necessary to establish a credible single currency that would promote (a) long-term fiscal responsibility and sustainability; and (b) short-term macroeconomic stabilization (Anderson and Minarik, 2006). As part of the criteria for membership in the EU, member EU countries should not hold deficit levels in excess of 3% of GDP, or debt levels greater than 60% of GDP. The SGP updated the treaty, adding some modifications. Under the SGP, countries report actual and projected deficit and debt levels to the European Commission (EC), with the expectation that breaching the 3% and 60% bounds would result in some type of punitive response. However, in practice, the targets were routinely exceeded with little or no repercussion.

In a 2010 report, the IMF noted that, "First, the preventive provisions of the SGP—supposed to encourage broadly balanced budgets over the cycle—have largely been ineffective. As a result, insufficient buffers were built in good times. Second, weak governance undermined both preventive surveillance and the enforcement of corrective provisions, reflecting reluctance by the EU bodies to hold member states accountable for their fiscal commitments and obligations. Third, the fiscal framework lacked crisis management and resolution capacities." In the fall of 2010 an EC task force recommended, among other actions, to implement "Excessive Deficit Procedures" that "can be launched regardless of the deficit when debt levels are both excessive (above 60 percent of GDP) and not declining sufficiently rapidly." Critics have been skeptical of the chance for successful fiscal retrenchment even under the task force recommendations.

Sources: International Monetary Fund, Ljungman, Office for Budget Responsibility.

Australia, faced with fiscal imbalance in 1998, chose not to adopt a specific fiscal rule but instead chose to legislate a "charter of budget honesty" prescribing a set of "principles of sound fiscal management (Blondal, et al., 2008)."[14] Although more general than a rule, these have been translated into a requirement for an annual "fiscal strategy statement" that shows how the government's budget conforms to the principles. The argument for a principles-based approach is that it allows for policy flexibility combined with transparency and fiscal accountability. In Australia's case, adherence to the principles appears to have given leaders greater ability to focus on the long-term sustainability of their policies, contributing to the country's currently low ratio of debt to GDP.

[14] The principles are: "to manage financial risks faced by the Commonwealth prudently, having regard to economic circumstances, including by maintaining Commonwealth general government debt at prudent levels; to ensure that its fiscal policy contributes to achieving adequate national savings and to moderating cyclical fluctuations in economic activity. . .", "to pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden", "to maintain the integrity of the tax system," and "to ensure that its policy decisions have regard to their financial effects on future generations."

How Effective are Fiscal Rules?

How effective have fiscal rules been in improving budget outcomes? The 2009 IMF report concluded that countries using fiscal rules experienced improved fiscal performance, on average. However, it also observed that a number of countries either modified or temporarily suspended their national fiscal rules in light of the recent economic crisis.

More recent IMF studies include a narrower look at a select number of countries and their experiences with fiscal rules regarding the economic crisis and efforts for a successful exit from the crisis. A section of one study looking for lessons that the United Kingdom could learn examines successful fiscal consolidations[15] of more than 20 advanced economies (IMF 2010b). The authors note that this section of their report does not test for causation but merely identifies outcomes that appear to be correlated with a country's fiscal adjustment actions. Among its conclusions are: (1) expenditure-driven adjustments have proven to be more successful in reducing the debt, improving growth, and reducing unemployment; (2) adjustments that focused on cuts in transfers, welfare spending, and public wages were part of the most successful adjustments; and (3) front-loaded adjustments appear to deliver better results, but more initial pain does not necessarily result in more gain. But, the report includes a general observation that, ". . . evidence on the usefulness of fiscal rules in supporting fiscal consolidation is generally positive, though rules appear to be neither a necessary nor a sufficient condition for success." To reiterate, however, these findings concern correlations of fiscal rules; the authors did not determine a direct causal relationship. The U.K. report also found that in the midst or face of a crisis, many countries modified, abandoned, or suspended their fiscal rules.

The IMF study, in short, concluded that "the evidence on the usefulness of fiscal rules in supporting fiscal consolidation is positive but not conclusive," noting that this may be the case because countries with fiscal rules also tend to be more fiscally responsible in general. In countries with fiscal rules there are likely to already be in place strong institutions, greater levels of central government transparency, and existing financial management mechanisms to aid in and facilitate successful and more rapid economic recovery. Finally, the report concluded that countries that successfully employed fiscal rules were more likely to have rules-based adjustments that depended primarily on expenditure cuts.

Goldman Sachs analysts have also looked to other countries for direction on how a U.S. recovery might successfully employ fiscal rules as part of its recovery toolbox (Stehn, 2010). Overall, they find that fiscal expansions are more successful when fiscal rules are part of the solution. But they go further in trying to identify the factors behind larger and sustained consolidations. They find that larger[16] and longer consolidations are more likely when fiscal rules are in place —particularly when they are expenditure rules.

[15] A successful consolidation is defined as one that brings about a sustainable reduction in debt and is not accompanied by large output contractions or high unemployment.
[16] Larger than 5 percent.

Based on the results of their analysis they recommend a rule with six components:

1. A target path for debt
2. Multi-year revenue projections
3. Multi-year expenditure ceilings
4. A transition phase, to allow more stimulus if needed
5. A mechanism to avoid "baseline drift"[17]
6. An escape clause

Finally, Goldman recommends that any such rule be made statutory so that in order to be avoided, Congress would have to affirmatively act to cancel or override the rule. IMF and others note, however, that for rules to be directly effective they need strong political support, and should be crafted so that accounting and budget gimmicks are difficult to use as ways around them.

If a fiscal rule is encoded in statute or a written constitution, this obviously helps with monitoring and enforcement. Moreover, formal adoption signals to the public, markets and other countries the importance that a government attaches to the rule. Strong monitoring systems, well-designed enforcement mechanisms, and sanctions in the case of non-compliance are all important adjuncts of an effective rule and can be established or enacted at the same time.

A poorly designed fiscal rule could have a pro-cyclical effect at exactly the time when a country's economy is struggling the most. Escape clauses are most commonly designed to respond to national disasters or wars, or a severe economic downturn or financial crisis. Careful design of escape clauses is important to avoid their abuse as a way to circumvent fiscal rules. The use of emergency spending waivers of normal budget procedures in the United States has been a popular method of exceeding spending limits or other budgetary restraints. However, this practice may illustrate as much as anything the absence of a clearly established fiscal rule that would act to curb such abuses. But the deficit bias and pro-cyclicality of a fiscal rule can be as deleterious to fiscal discipline in good times as in bad times, if the rule is not properly designed. Thus a well-defined escape clause is probably not enough.[18]

The 2008 Debrun analysis of the effectiveness of fiscal rules found that "fiscal rules have a positive and statistically significant impact on budget balances." The analysis also determined that the fiscal indicator targeted by a rule is important in determining whether a rule is effective. For example, while an expenditure rule per se did not prove to materially affect budget balances, expenditure rules that were also tied to budget balance or the public debt had significant impact. An expenditure rule by itself did not conclusively achieve its intended result unless it explicitly included meeting a target.

[17] The GS report recommends that an automatic mechanism be put into place to ensure that fiscal policies continue to keep the budget on track to hit a pre-determined target, to help avoid "drift."
[18] See for example Anderson and Minarik, 2006.

Although such analysis supports our belief that fiscal rules encourage greater fiscal discipline and help with fiscal consolidation, we view it cautiously. First, the experience of most countries with fiscal rules is short-lived and has not been fully tested yet by the Great Recession and its aftermath. Second, the positive examples are almost entirely drawn from countries with a consensual political culture, with an established underlying norm of fiscal prudence, and with political institutions that give the government in power a strong hand in maintaining budget discipline, i.e., parliamentary systems. The U.S. poses a different set of circumstances.

It is important to note that nearly all credible research on the effectiveness of fiscal rules makes two important observations: (1) implementation of and adherence to a fiscal rule requires a good deal of political will; and (2) it is nearly impossible to establish empirically whether countries using fiscal rules are already more likely to be more fiscally responsible than countries without rules, or whether it is the rule itself that results in a more fiscally responsible country. That is, is it simply correlation or is it causation?[19]

Finally, while some lessons can be drawn from past use of fiscal rules, the present circumstances are stressful for all countries, including those with strong fiscal rules. Many continue to struggle with the twin challenges of getting their economies back on track and limiting or reducing a substantial burden of government debt. In "Strategies for Fiscal Consolidation in the Post-Crisis World," the IMF observed there is no precedent for understanding the effects of the debt levels that a number of advanced economies may soon bear, and that if debt were to be stabilized at or near those levels, the ability to react to future economic crises would be constrained. Fiscal rules are hard to establish and harder to sustain in such times, but can nevertheless help.

The best-designed rule is no guarantee of budget discipline. As Federal Reserve Chairman Bernanke put it in a speech at the annual meeting of the Rhode Island Public Expenditure Council: "Clearly, a fiscal rule does not guarantee improved budget outcomes; after all, any rule imposed by a legislature can be revoked or circumvented by the same legislature. However, although not all countries with fiscal rules have achieved lower deficits and debt, the weight of the evidence suggests that well-designed rules can help promote improved fiscal performance (Bernanke, 2010)."

[19] For example, Debrun et al. (2007) state: "A broad policy conclusion emerging from our findings is that rules can provide an important signaling mechanism that can help crystallize underlying preferences for good fiscal behavior, and thereby strengthen the reward for being well-behaved (e.g., through greater re-election changes, but also lower borrowing costs). To put it simply, rules and institutions work best when they are not meant to be binding. However, when they become truly binding, rules may well work effectively only to the extent that there is enough political capital to support their enforcement, or that there are high costs to bypass them, including the action of external enforced or a strong response from capital markets."

Choosing a Fiscal Rule

So what kind of fiscal rule and accompanying regime would be most useful to the U.S.? The answer depends both on general criteria for the design of such a rule and consideration of the specific economic and fiscal circumstances faced by the country today.

General Criteria for Choosing a Fiscal Rule

Chairman Bernanke noted some of his guiding principles for designing effective fiscal rules: they must be transparent, sufficiently ambitious to address the underlying problems, should focus on variables that the legislature can control directly, but cannot substitute for political will – meaning that they must be understood and supported by the public (Bernanke, 2010).

In “Design Choices for Fiscal Policy Rules” Anderson and Minarik (2006) propose a number of criteria for choosing a fiscal rule, noting that “the apparent superiority of any rule on the basis of one criterion is not a sufficient justification for adoption.” A number of questions should be answered when choosing a rule:

- *What is the objective or desired outcome?* Possible answers include: achieving fiscal sustainability over time, reducing annual deficits, or requiring that government spending and/or revenues are maintained at a specified level over time.

- *Is the rule consistent with an established or potential norm of fiscal soundness?* As noted, rules are often a codification of a social and political consensus. When the consensus is weak or absent, as in the U.S., it must be reestablished either prior to or concurrent with the rule’s adoption if it is to survive inevitable short-term pressures.

- *Is the rule practical in light of current and likely future circumstances?* As noted, a rule that would be sustainable starting from a position of rough structural balance and relatively modest projected imbalance would not be practical starting from current and projected large structural imbalance.

- *Is the rule transparent and readily understood?* There is an obvious tension between designing a rule that incorporates adjustments for economic cycles and uses the most sophisticated measures of fiscal position such as the “fiscal gap” and a rule that anyone can readily apply to assess budget outcomes. A less transparent rule also may be more easily gamed or subverted. Given the importance of public opinion in sustaining adherence, some sacrifice of sophistication for transparency seems inevitable.

- *Is the rule flexible enough to be sustained in the face of inevitable shocks and cycles?* Flexibility aids long-term adherence and is therefore a virtue up to a point. It becomes a vice when flexibility undermines its effectiveness. Too flexible a rule is no rule at all.

The same type of fiscal rule is not appropriate for every country due to differences in political institutions and national economies. Miriyagalla et al. (2010) attempted to draw lessons for the U.S. on the use of fiscal rules based on the experiences of Brazil, Chile, Germany, Sweden and Switzerland. Their analysis concluded that the best fiscal rule may in fact be a combination of rules (Miriyagalla, et al., 2010). Using a number of criteria[20] and then scoring the performance of each type of rule as employed by five countries, the Miriyagalla et al. paper evaluates the effectiveness of debt, expenditure, and balanced budget rules. On its own, each of the three rule types exhibits both important strengths and weaknesses. For example, an expenditure rule is very simple to understand and employ; but because it ignores the revenue side, it may be ineffective in controlling debt levels. However, expanding the application of a spending rule to include tax expenditures can broaden its scope and thereby strengthen its effectiveness. Debt rules, of course, can be precisely targeted. But their effects tend to be pro-cyclical. (And as noted previously, if a country is under its debt target such rules provide little guidance for fiscal policy.)

It is important to identify the goal or goals intended to be achieved by a fiscal rule before choosing one over another, or choosing a combination. Following some very basic guiding principles can help achieve the intended result. The rule should be broad in scope, have few escape clauses and minimal accounting discretion, and its enforcement must be credible (Primo, 2010).

Finally, it is necessary to consider the timing and manner of introduction of a fiscal rule, including sequencing of different rules suited to different starting conditions. With many economies still struggling to rebound from the great recession, leaders are looking for ways to both stimulate growth and at the same time put in place permanent measures that will prevent or mitigate another such occurrence. Evidence suggests that certain fiscal rules may in fact help accomplish such a feat.

What is the Best Fiscal Rule for the U.S.?

What kind of fiscal rule makes sense for the U.S.? The United States is unique in many ways that may challenge the design and implementation of rules. On the other hand, some limits for employing fiscal rules elsewhere do not apply as strongly here. For instance, although there is always room for improvement, U.S. fiscal institutions are considered the world leaders in the scope and quality of their budget analysis. They are generally trusted to produce accurate estimates based on the best information available, and the U.S. budget process is considered to be among the most transparent in the world. In general, the institutions and other foundations are in place for implementing an effective fiscal rule in the U.S. But weaknesses are evident also, and based on its recent performance many argue that the budget process has grown increasingly in need of repair.

[20] The criteria: fiscal sustainability, counter-cyclical stabilization, flexibility if responding to shocks, capacity to address deficit bias, clarity of target definitions, vulnerability to creative accounting, simplicity of implementation, accessibility to the public, and government controllability. Each criterion was scored on a four-point scale from 0 (poor) to 3 (high).

Apart from institutional uniqueness, the U.S.'s current fiscal circumstances and outlook may affect the ability to sustain commitment to a fiscal rule. Present circumstances are quite different than those faced in the 1990s. In the U.S. and other countries, immediate imposition of a cyclical balance rule may not be practical because of the size of the adjustment required to quickly achieve structural balance. A rule for the federal budget today may need to be more forward-looking and should be coupled with a fiscal target. A rule suited to the U.S. may be different than one suited to a country that has a higher degree of political consensus or a more unified policy making process.

If the U.S.'s goal is to achieve fiscal sustainability as soon as possible, then a debt rule may be appropriate in the interim. For the medium term, a rule requiring that federal debt be stabilized by a specific year would serve as a fiscal rule meeting many of the design criteria cited above: it includes a clearly defined, readily computable target; is easily described to the public; and is substantively important in the near term as a way to quantify the budget savings required to reach stability. Such a rule seems both realistic and likely to gain broad public support, if not consensus. It should be noted that application of a rule intended to reduce deficits and stabilize the debt will be contractionary. In the medium-term, therefore, a properly designed debt rule should include a mechanism to suspend or waive it in the face of economic weakness, and implementation may need to be delayed or phased in. The chances of suspension are high because the chances of encountering the cycle over the medium term are high. Even so, in the near term a rule setting a target to stabilize the debt is better than no rule and more realistic than a rule that calls for, say, balancing the budget.

A rule to help constrain budget choices during the period of fiscal consolidation may be superseded after debt has been stabilized by a different rule intending to align spending and revenue to reduce debt to a safer level. For the longer term, a rule designed to reduce the debt gradually to a safer level would be realistic and consistent with the traditional view that spending and revenues should, on average, be close to balance. This rule might resemble the cyclically adjusted balance rules adopted elsewhere.

There are questions about how to formulate this long-term rule in a way that is both transparent and sufficiently flexible. The former is necessary, as previously discussed, to ensure public pressure is brought to bear when the rule is violated. The latter is necessary to accommodate inevitable short-term shocks that will require deficits and thereby sustain support for the rule over time. However, experience with cyclically adjusted balanced budget rules is insufficient to judge whether they are sustainable both economically and politically. The more economically sophisticated versions of such a rule, such as the Swiss Debt Brake, are inherently harder to explain to the public and therefore less transparent.

Any fiscal rule, regardless of its design, will be subject to continuing pressure to accommodate immediate demands arising from new circumstances and emergencies. In the case of the U.S., erosion of leaders' and the public's commitment to a norm of balanced budget and the absence of consensus on an alternative norm leave any fiscal rule vulnerable to these pressures. Absent such a consensus, a strong rule seems unlikely to be adopted and, if adopted, likely to be abandoned under pressure or for short-term political gain. Too many exceptions to a rigid rule or adoption of a rule so flexible as to allow its routine subversion will undermine its purpose and effectiveness. The need to reestablish broad consensus on what constitutes fiscally prudent behavior *before* a long-term rule is formally adopted also argues for use of an interim rule focused on stabilizing the debt to allow time for the development of public consensus.

Reinforcing the Rule

The federal budget process has operated for a long time now without the discipline of a fiscal rule—formal or informal. Moreover, it faces extraordinary budget pressures that will make adherence to any binding rule consistent with fiscal prudence hard to achieve and sustain. To reinforce the interim debt stabilization rule, other measures such as those proposed in the Peterson-Pew Commission's 2010 report may be helpful or even necessary. That report made a number of specific recommendations on the design of a fiscal rule that would employ debt targets, automatic triggers, and other means of enforcement to both force and help sustain agreement on policies needed to meet the targets. The Commission's specific recommendations include:

- Establish medium-term and annual debt targets in statute, to stabilize the publicly held debt at a specified level by a specified year.
- Set annual targets to provide a glide path for achieving medium-term target.
- Calculate projected annual savings necessary to achieve debt targets and use the projections in a reformed budget process to guide enactment of a multi-year budget to meet the enacted debt targets.
- Require Congress to craft, and the president to sign, a budget projected to meet each year's target.
- Include opportunities for lawmakers to pass adjustments if re-estimates project missed targets.
- As part of a new statutory framework, include enhanced rescission authority for the president if Congress ultimately fails to pass budge to meet targets.
- If all final legislation fails to meet the yearly target, use a trigger to automatically adjust spending and taxes to close at least part of the remaining gap.

The Commission recommends an escape clause for instances of national emergencies or severe economic downturns, but does not specify the procedure or rule to be followed in reestablishing fiscal discipline afterward. If a fiscal rule is to be sustained or restored after such inevitable periods, then designers will need to define the process and criteria governing those circumstances.

While the optimal rule would include very limited exemptions, there are arguments to be made to exclude some spending components. Exempting spending for those investments expected to return more in the future than they cost (on a net present value basis) could be supported in principle, although posing a danger to fiscal discipline in practice. This is the concept behind the "golden rule," although as discussed earlier, recent experience with such rules casts doubt on whether such rules can be maintained. Even limited exemptions intended to promote long-term economic and fiscal health add to the difficulty of meeting a contemporaneously defined debt target requiring some amount of annual savings.

It is also important, whatever fiscal rule is applied, that the measures of spending, revenues, and the deficit are an accurate current reflection of the nation's fiscal condition. Current application of budget concepts has substantially distorted the government's fiscal position and reduced the transparency and utility of the information used by policy makers. The Commission has recommended a number of changes in the way budgets are estimated and presented that would correct these distortions and aid leaders and the public in determining what is required to adhere to whatever rule is adopted.

Whatever rule is adopted, the immediate fragility of the U.S. and world economy dictates a careful approach to its implementation. One danger, especially if it is to be a rule of the scope envisioned here, is halting or even reversing the nascent recovery. Imposing a rule that imposes structural (or some other type of) budget balance is not politically possible now, and in any case would be fiscally disastrous under current circumstances.

The risk that any strong fiscal rule would be overturned is greater in a country whose recent experience with fiscal rules is limited. Enacting a plan that includes a rule or rules to be phased in over time, and that would begin to take effect very gradually seems therefore the more responsible approach. The timing depends on when leaders and the public arrive at agreement on a durable standard for responsible fiscal policy.

Conclusion and Recommendations

We again recommend enactment of a fiscal rule that would govern publicly held federal debt, in conjunction with the adoption of a broader set of budget process reforms such as presented in the Commission's 2010 report. These would be reinforced by rules governing elements of the budget—caps on certain types of spending and tax expenditures, and a strong version of the Pay-As-You-Go legislation. We also recommend a rule for the long-term that would align spending and revenues closely.

In more detail:

- The medium-term fiscal rule supported by the Commission would specify that the publicly held debt must be stabilized at a specified level by a specified year, probably at the end of a decade.

- A rule for the period afterward would specify that the debt would be reduced to a safer level, possibly 40 percent of GDP, over the two following decades.
- The rule would require that, after 2020 or so, spending and revenues should align, adjusted for economic performance, so that the budget is in deficit only during periods of economic weakness and is in surplus at other times, i.e. roughly in balance over an economic cycle.
- Budget concepts would be adjusted so that outlays record increases in accrued costs for insurance and similar financial guarantees when they arise and not when obligations are satisfied later, and for emergencies based on expected average needs. These changes will provide a truer measure of deficits and indebtedness. If these changes are made, the measure of the debt used as the basis for the fiscal rules would be altered accordingly.
- To reinforce these fiscal rules, means of enforcement such as those recommended by the Commission—including triggers imposing broad-based adjustments to spending and revenues when rules are violated, caps on spending and tax expenditures, and strengthened PAYGO requirements—would be enacted.

Before any rule or set of rules can be specified, enacted, and sustained in the face of inevitable near-term pressures, public agreement must be obtained. Adherence to any strong fiscal rule depends quite simply on whether it is grounded in public consensus about what constitutes sound fiscal policy. The traditional consensus that supported federal fiscal discipline in the past has evaporated. Therefore, the first task of U.S. leaders prepared to bind themselves to a fiscal rule is to help restore a national norm of fiscal responsibility. Otherwise, any rule will succumb to the siren call of urgent demands for government to do more than it is prepared to pay for.

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