THE EVOLUTION OF FEDERAL BUDGET RULES AND THE EFFECTS ON FISCAL POLICY
How Informal Norms Have Trumped Formal Constraints

Most discussion of federal government deficits and debt focuses on recent decades and formal budget rules, such as the debt ceiling, sequestration, and balanced budget amendments. However, the underlying deficit problem goes back much further and is driven in part by changes to *informal* rules.

A new study published by the Mercatus Center at George Mason University argues that, beginning late in the 19th century, the informal rules that govern fiscal policy began to reward policymakers for increasing spending—even for increasing it beyond the capacity of federal revenues, and therefore at the cost of chronic deficits. Despite numerous legislative attempts to constrain spending over the past 40 years, these informal rules have trumped formal constraints, and the deficit problem has marched steadily on.

With this evolution of federal budget rules in mind, today's reform discussions must address the deeper problem of informal rules driving systematic deficits and unsustainable debt. Otherwise, formal restraints will not work.

Below is a summary of this analysis. To read the entire study and learn more about its authors, Peter T. Calcagno and Edward J. López, please see "The Evolution of Federal Budget Rules and the Effects on Fiscal Policy: How Informal Norms Have Trumped Formal Constraints."

TODAY'S FISCAL CHALLENGES

The federal government is suffering from an unsustainable fiscal condition. Under conservative assumptions, the Congressional Budget Office projects that, after temporary, near-term declines, federal budget deficits will increase to 150 percent of their current magnitude by 2023. Federal debt held by the public will exceed $18 trillion within that same decade, according to the Congressional Budget Office's estimates, and the outlook is even worse if assumed budget disciplines are relaxed.

For more information, contact
Camille Walsh, 703-993-4895, cwalsh@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

- Overspending is driving the long-term fiscal problem more than inadequate taxation. Federal revenues and spending both averaged about 3 percent of GDP from 1792 to 1929. But from 1930 to 2013, average expenditures jumped to 18.5 percent while average revenues increased only to 16 percent. More recent decades show a worsening of the imbalance. Since 1952, for example, federal spending has settled into an average of about 19 percent of GDP, while tax revenue has stayed at 16 percent. The obvious result of this imbalance is chronic deficits.

- At the same time, fiscal policymaking has become more complex and fragmented and less predictable. As deficits spiked in the first few years after 2000, for example, fiscal policymakers increasingly relied on emergency and supplemental spending bills that evaded spending limits and the formal budget process, while also enacting temporary tax provisions that raised uncertainty in markets and compromised economic growth.

- The growth of mandatory spending on entitlement programs—which run automatically without annual review or appropriation—has exerted even more deficit pressure, as has the burden of debt service. From 1962 to 2014, mandatory spending has increased from 25 percent to 65 percent of the budget, while discretionary spending has correspondingly dropped from 68 to 34 percent. This trend is projected to continue, with mandatory spending expected to exceed three-fourths of the budget by 2020, according to Office of Management and Budget projections.

THE EVOLUTION OF FISCAL POLICY RULES: KEY SHIFTS IN NORMS

Beginning late in the 19th century, the federal government's fiscal policy has been driven by two gradual changes to informal rules: a shift away from the balanced-budget norm and the emergence of the career politician.

- By the early decades of the 20th century, fiscal policy was drawing away from the balanced-budget norm that had prevailed since America's founding, and toward using the budget to underwrite a stronger safety net for economic security and to manage macroeconomic performance. As the decades passed, these two sets of expectations exerted pressure for increased federal spending, not only during times of national emergencies, but also under ordinary conditions. This led to the acceptance of increased federal spending even at the cost of deficits, rather than balanced budgets, as the new policy norm.

- During this time, norms in the government were shifting as well. The elected class mutated from a high-turnover group of temporary officeholders into a body of career politicians. In addition, the organization of Congress, political parties, and the executive branch led to a diffusion of budget access and authority within government.

The shift from the old balanced-budget norm to the modern deficit-as-policy norm, coupled with the professionalization of elected office, began to exert enormous pressure on policymakers to increase federal spending. They responded by codifying these new norms into formal law, laying the groundwork for chronic deficits and unsustainable debt.

FROM CODIFYING DEFICITS TO CONSTRAINING OVERSPENDING: EVOLUTION OF THE FORMAL RULES

Following these two shifts of informal fiscal norms, numerous changes to the formal rules of fiscal policy emerged. The salient theme in the evolution of formal rules has been the struggle to balance the need for fiscal discipline against the demands of a professionalized government expected to use its budget to promote economic security and macroeconomic management.

- At the household level, the single most profound change came with the 1935 Social Security Act. Over time, the act centralized responsibility for public assistance and social insurance programs, and started a permanent demand for increased spending on a comprehensive range of social insurance and public assistance programs.
- Other policy initiatives expanded the government's role in trying to boost economic performance. The Federal Reserve Act of 1913 centralized responsibility for financial stability and the supply of liquidity during financial crises. The 1946 Employment Act set the objectives of stabilizing unemployment, output, and inflation. The Full Employment and Balanced Growth Act of 1978 (commonly known as the Humphrey-Hawkins Act) extended the Federal Reserve's macroeconomic goals.
- In addition, the economics profession began to support the use of budget deficits as a policy tool for achieving macroeconomic stability and avoiding a repeat of the Great Depression. By the mid-20th century, the mainstream positions in academia, the media, and the intelligentsia had accepted the case for countercyclical policy articulated in the 1930s by John Maynard Keynes.
- In the early 1970s, following a standoff between Congress and President Nixon, lawmakers tried to coordinate their budget activities with the Congressional Budget and Impoundment Control Act of 1974, which put the final touches on the modern budget process. The Budget Act built on the existing committee structures in the House and Senate, but created the Budget Committees to supervise and coordinate the budget process, and a Congressional Budget Office to provide Congress with its own independent fiscal analysis.
- Because the Congressional Budget Act repeatedly failed to control fiscal outcomes, Congress made numerous other attempts to constrain spending. These included the Omnibus Budget Reconciliation Act of 1981—with its explicit goal of reducing spending—the Balanced Budget and Emergency Deficit Control Act of 1985, the Budget Enforcement Act of 1990, and the Omnibus Budget Reconciliation Act of 1993. These attempts to constrain spending added layers of complexity to the fiscal policy process.

- Yet despite these efforts, every annual budget since 1974 has experienced a deficit, with the exception of 1998–2001. In sum, by the time Congress was beginning to take serious steps to rein in the budget, the systematic tendencies toward deficit-financed overspending had already been cemented into place.

WHY THE DEFICIT-AS-POLICY NORM TRUMPS FORMAL SPENDING CONSTRAINTS

The diffusion of spending authority among numerous committees of Congress has led to higher transfers, deficits, and debt. This, coupled with other forces, has ingrained the deficit-as-policy norm in federal budgeting.

- Each committee allocates funds for its segment of the budget—e.g., agriculture, defense, commerce—but when the several appropriations are aggregated, the sum is greater than anyone intended and more than available revenues can offset. Thus, the federal government generates deficits as a matter of routine, regardless of whether emergency conditions are at hand.

- Meanwhile, safety net programs for the elderly, children, and the unemployed have evolved into permanent entitlements that now absorb two-thirds of federal spending. Relief of economic hardship has motivated historic expansions of unemployment benefits, food assistance, and other safety-net programs.

- Economic experts argue that increased deficit spending is needed to promote economic growth and that more spending carries only minor tradeoffs because Treasury yields and debt service levels remain low. This deficit-as-policy norm also has effectively granted any group with a good cause access to the federal budget.

- On the financing side, there is intense pressure to avoid the burden of financing additional expenditures. The lack of future taxpayers' representation in current policy choices creates a bias in favor of financing current spending through future, rather than current, taxes—that is, a bias toward debt-finance. In the era of professional politics, politicians have a career interest in taking credit for the benefits of additional budget outlays. This incentive creates a systematic tendency toward increased spending, both in good times and in bad.

LESSONS FOR REFORM

The deficit-as-policy norm and the professionalization of politics have become ingrained in American politics and will be difficult to reverse. Serious reform discussions must focus on the fundamental, underlying institutional rules of the fiscal game, including and especially the relevant informal rules. Only then will the people with a seat at the table have the incentive to act systematically to promote fiscal discipline.

Formal constraints on spending—such as a balanced budget rule or fixed spending limits—may be helpful, but will not work unless the public begins to change its view that programs such as Social

Security and health care are entitlements. This is a huge challenge that requires gradual changes in attitudes, but the reality is that meaningful fiscal reform does not stand a chance without some further evolution of norms beyond deficit-as-policy.

Reform discussions must start by recognizing that current fiscal challenges are rooted in these deep institutional changes. Effective reforms must focus on institutional rules, both formal legislation and informal norms. Most importantly, changes in public attitudes are needed to move the American political culture more toward a balanced-budget norm—recognizing that the abilities of the federal government are limited, as should be its spending authority.