

# Balanced Budget Rules and Expenditure Limits: Lessons from the US and Australia and Implications for the EU

By Mark Humphery-Jenner\*

## A. Introduction

Governments periodically receive accusations of over-spending. These accusations are sometimes warranted. Some commentators propose that strict tax and expenditure limits (TEs) and/or balanced budget requirements (BBRs) may resolve excessive expenditure.<sup>1</sup> Governments can implement TEs and BBRs through constitutional amendments, statutory schemes, or non-binding aspirational goals. They have been proposed as a remedy to allegations of over-spending in some European countries.<sup>2</sup> However, it is not entirely clear if TEs or BBRs are effective or will resolve excess expenditure. I analyze TEs and BBRs as implemented in the United States and Australia. I argue that the Australian model of aspirational TEs and BBRs is beneficial if there is a political will to enforce them. However, if there is no such political will, then statutory (as opposed to constitutional) TEs and BBRs best strike a balance of flexibility and constraint.

Government expenditure has become an important issue. It has become important in the United States, where S&P downgraded the United States' credit rating from AAA to AA+.<sup>3</sup> It is important in Australia, where the federal government is considering the need to restore a budget surplus, after the budget was reduced in order to respond to a financial

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<sup>1</sup> See, e.g., Yilin Hou & Daniel L. Smith, *Do State Balanced Budget Requirements Matter? Testing Two Explanatory Frameworks*, 145 PUB. CHOICE 57, 57 (2010). They show that while balanced budget requirements (BBRs) can influence public expenditure, the precise impact depends upon the nature of each BBR.

<sup>2</sup> For example, France and Germany have pushed for balanced budget requirements in the E.U. See Mark Latham & Sumi Somaskanda, *France, Germany Push for Balanced Budgets*, USA TODAY, Dec. 9, 2011, available at <http://www.usatoday.com/news/world/story/2011-12-08/sarkozy-merkel-debt-europe/51730480/1> (last visited Apr. 29, 2012).

<sup>3</sup> For further information, see STANDARD & POORS, UNITED STATES OF AMERICA LONG-TERM RATING LOWERED TO "AA+" DUE TO POLITICAL RISKS, RISING DEBT BURDEN; OUTLOOK NEGATIVE, Aug. 05, 2011, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563> (last visited Apr. 29, 2012).

crisis and to natural disasters.<sup>4</sup> It is important in the EU, where Greece,<sup>5</sup> Spain,<sup>6</sup> and Italy<sup>7</sup> have faced criticism for excessive spending financed by excessive debt.

These expenditure issues are especially important in a federal system, which contain member states. These states can bind together to form a country, as in the US and Australia. Alternatively, they can form a union such as the EU, which has a single currency and aims to enforce fiscal prudence. Here, the fiscal and monetary policy of each member state is important. Strong states may have to bail out weak states if weak states incur too much debt or engage in excessive spending. If they do not bail out the weak state, or resolve the spending and debt issues, then the system risks instability and may fracture. This suggests that there should be some policy to deter member states from imprudent policies.

Some federal systems have policies to deter excessive spending. The systems can function at a federal level or at a local level. A federal policy comes from the overall governing body, such as the US congress, or the EU. A local rule comes from the member states, *i.e.*, a state based law in the US or a national law in the EU. The mechanisms to deter excess spending tend to function at a local level and come in two forms: TELs, which limit a state's revenues and expenses, and BBRs, which compel governments to balance

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<sup>4</sup> On the impact of the crisis in Australia and Australia's plans to achieve a budget surplus, see Press-Release, 2012-13 Pre-Budget Submissions, The Hon Wayne Swan MP: Deputy Prime Minister and Treasurer (Dec. 19, 2011), <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/157.htm&pageID=003&min=wms&Year=&DocType> (last visited May 14, 2012).

<sup>5</sup> See *Greece's Budget Deficit Shrinks More Than Expected*, USA TODAY (Mar. 21, 2012), <http://www.usatoday.com/money/world/story/2012-03-21/greece-deficit-targets/53684370/1> (last visited Apr. 29, 2012); Stelios Bouras, *Greece Budget Deficit Widens 15%*, WALL ST. J. (Oct. 12, 2011), <http://online.wsj.com/article/SB10001424052970204002304576626430653206132.html> (last visited April 29, 2012); Rachel Donadio, *Greek Statistician Under Scrutiny for Budget Estimates Before Euro Crisis*, N.Y. TIMES (Apr. 06, 2012), <http://www.nytimes.com/2012/04/07/world/europe/greek-official-under-scrutiny-for-pre-crash-budget-figures.html?pagewanted=all> (last visited Apr. 29, 2012); *Greece Budget Deficit Worse Than Thought*, BBC WORLD NEWS (Apr. 26, 2011), <http://www.bbc.co.uk/news/business-13194344> (last visited Apr. 29, 2012).

<sup>6</sup> See David Goodman, *Spanish Bonds to Fall as MEAG Sees 10-Year Yields Near 7%*, BLOOMBERG BUSINESSWEEK (Apr. 18, 2012), <http://www.businessweek.com/news/2012-04-18/spanish-bonds-to-fall-as-meag-sees-10-year-yields-near-7-percent> (last visited Apr. 29, 2012); Juan Montes, *Update: Spain's Rajoy Says Country Can Avoid Bailout*, WALL ST. J. (Apr. 17, 2012), <http://online.wsj.com/article/BT-CO-20120417-713554.html> (last visited Apr. 29, 2012).

<sup>7</sup> See Giada Zampano, *Italy Narrows Budget Deficit*, WALL ST. J. (Apr. 4, 2012), <http://online.wsj.com/article/SB10001424052702303299604577323020883719812.html> (last visited Apr. 29, 2012); Rachel Donadio & Gaia Pianigiani, *Italy Pushes Back Balanced Budget by 2 Years*, N.Y. TIMES (Apr. 18, 2012), <http://www.nytimes.com/2012/04/19/business/global/19iht-italybudget19.html> (last visited Apr. 29, 2012).

expenditure and receipts. Such systems exist in Australia and the United States (as described in the remainder of this paper). The form and nature of the TELs and BBRs varies from state to state. Some TELs restrict expenditure only, some restrict revenues only; however, most TELs restrict both expenditures and revenues.<sup>8</sup> The TELs that restrict expenditure and revenue are similar to BBRs. A BBR requires the state to maintain a balanced budget.<sup>9</sup> Intuitively, this means a budget in which revenues exceed expenses, possibly subject to some exceptions.<sup>10</sup> The precise definitions of revenues, expenses, and allowable increases thereof vary between states. The most fundamental difference between the different TELs and BBRs is whether they are in the constitution, whether they are a statutory scheme, or whether they are purely aspirational. The systems have not been wholly successful, but they can indicate the situations in which certain TELs and BBRs may be beneficial.

Australia presents one type of TEL and BBR. Australia is comprised of six states. These states have aspirational or non-binding TELs and BBRs, as detailed in Part D. The experience in Australia has been largely positive, albeit with some areas for improvement. As described in Part D, the policies in Australia have several general trends. First, they are non-binding. Second, there is a political consensus from the two main parties that the policy should be supported. Third, there is general acknowledgement that some deviation from strict limits can create value. This has allowed the aspirational targets to implicitly deter value-reducing investments and promote value-creating investments.<sup>11</sup>

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<sup>8</sup> For a full summary of the tax and expenditure limits, see the tables in the Appendix.

<sup>9</sup> See James M. Poterba, *Balanced Budget Rules and Fiscal Policy: Evidence from the States*, 48 NAT'L TAX J. 329, 330 (1995). For theoretical modeling of BBRs see generally Stephanie Schmitt-Grohe & Martin Uribe, *Balanced-Budget Rules, Distortionary Taxes, and Aggregate Instability*, 105 J. OF POL. ECON. 976 (1997).

<sup>10</sup> Exceptions can include natural disasters. Article V of North Carolina's Constitution contains some exceptions that could arguably allow it to respond to natural disasters. See Robert Ward Shaw, *The States, Balanced Budgets, and Fundamental Shifts in Federalism*, 82 N.C. L. REV. 1195, 1200 (2004). Alternatively, they can include super-majority provisions that would allow the government to borrow. For example, Article 8, § 8 of Montana's Constitution states that "[n]o state debt shall be created unless authorized by a two-thirds vote of the members of each house of the legislature or a majority of the electors voting thereon." MONT. CONST. art. 8, § 8.

<sup>11</sup> There are some exceptions to the trend of value-creation. However, the main party responsible for violating prudent spending limits saw its support base fall from 55% of the electorate to 23% of the electorate. See Imre Salusinszky, *Kristina Keneally Leading the Most Unpopular Labor Government in History*, AUSTRALIAN (Oct. 29, 2010), <http://www.theaustralian.com.au/news/kristina-keneally-leading-the-most-unpopular-labor-government-in-australia/story-e6f6g6o6-1225944944807> (last visited Apr. 29, 2012).

The states in the US mostly have statutory and/or constitutional TELs and BBRs imposed at a state, as opposed to national, level.<sup>12</sup> Some have been unsuccessful. Some have had mixed success, albeit with negative side effects, such as deflationary side-effects, barriers to value-creating expenditure, and restrictions on making long-term investments.<sup>13</sup> The analysis suggests that overall the Australian experience has been more positive than the United States' experience with constitutional TELs and BBRs, and that the presence of statutory TELs and BBRs can be beneficial.

The EU is a region where local state-based TELs and BBRs may be beneficial. The EU contains member states that loosely collaborate in a federal-type union.<sup>14</sup> The member-states have different political and legal processes, have different laws, and have different national identities. The EU has some restraints on excessive deficits in member-states.<sup>15</sup> Under the Stability and Growth Pact, member-states cannot have deficits that exceed three percent of GDP<sup>16</sup> and cannot have public debt above sixty-percent of GDP.<sup>17</sup> These are not the same as TELs and BBRs. First, they impose no clear restriction on spending.

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<sup>12</sup> On the lack of BBR at the federal level see Giancarlo Corsetti & Nouriel Roubini, *European Versus American Perspectives on Balanced-Budget Rules*, 86 AM. ECON. REV. 408, 412 (1996); Jonathan Rodden & Erik Wibbels, *Fiscal Decentralization and the Business Cycle: An Empirical Study of Seven Federations*, 22 ECON. & POL. 37, 42 (2010); Lisa Desjardins, *Why the U.S. May Never Have a Balanced Budget Again*, CNN.COM (Mar. 29, 2012), <http://edition.cnn.com/2012/03/29/politics/balanced-budget/index.html> (last visited Apr. 29, 2012).

<sup>13</sup> For a full discussion, see *infra* Part B.

<sup>14</sup> See Mark L. Humphery-Jenner, *The Impact of the EU Takeover Directive on Takeover Performance and Empire Building*, 18 J. OF CORP. FIN. 254 (2012); Anne Meuwese et al., *Towards a European Administrative Procedure Act*, 2 REV. EUR. ADMIN. L. 3, 4 (2009); Wim Voermans & Ymre Schuurmans, *Better Regulation by Appeal*, 17 EUR. PUB. L. 507 (2011); Rey Koslowski, *A Constructivist Approach to Understanding the European Union as a Federal Polity*, 6 J. EUR. PUB. POL'Y 561 (1999); Eddy Wymeersch, *Europe's New Financial Regulatory Bodies*, 11 J. CORP. L. STUD. 443, 444 (2011); Elis Ferran, *Crisis-Driven EU Financial Regulatory Reform*, in *THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS* 1, 3 (Elis Ferran et al. eds., 2012).

<sup>15</sup> See Jurgen von Hagen & Barry Eichengreen, *Federalism, Fiscal Restraints, and European Monetary Union*, 86 AM. ECON. REV. 134, 134 (1996); Barry Eichengreen & Tamim Bayoumi, *The Political Economy of Fiscal Restrictions: Implications for Europe from the United States*, 38 EUR. ECON. REV. 783 (1994).

<sup>16</sup> This comes from the Stability and Growth Pact. See Resolution of the European Council on the Stability and Growth Pact, 1997 O.J. (C236) [hereinafter Stability and Growth Pact]. For a discussion see Martin Feldstein, *The Euro and the Stability Pact*, 27 J. POL'Y MODELING 421, 25 (2005). The EU also provides a discussion on its website. See Council Regulation 1467/97, *The Corrective Arm: The Excessive Deficit Procedure*, 1997 O.J. (L 209) 6, 8 (EC).

<sup>17</sup> See S. Tolga Tiryaki, *Has the Stability and Growth Pact Changed the Likelihood of Excessive Deficits in the European Union?*, CENT. BANK REPUB. TURKEY REV. 65, 66 (2008); Ludger Schuknecht et al., *The Stability and Growth Pact: Crisis and Reform* 5 (European Central Bank, Occasional Paper Series No. 129, Sept. 2011). For a useful summary see *Financial Glossary: Stability and Growth Pact*, REUTERS, Sep. 21, 2011, available at [http://glossary.reuters.com/index.php/Stability\\_and\\_Growth\\_Pact](http://glossary.reuters.com/index.php/Stability_and_Growth_Pact) (last visited Apr. 29, 2012); Feldstein, *supra* note 16.

Thus, if the country has a relatively large GDP, then it can accrue a relatively large deficit.<sup>18</sup> Second, unlike with the US or Australian system, where local (*i.e.*, state) governments impose TELs/BBRs (see below), in the EU, budgetary restrictions are imposed by the central EU authority.<sup>19</sup> That is, in Australia and the US, local people elected local officials who imposed local TELs and BBRs that (attempted) to account for local circumstances (as discussed in Parts B, C, and D). In the EU, fiscal restrictions come from an international body. Here, the connection between the local people and the members of the international body is indirect.<sup>20</sup> This is important because a law that has more local support is more likely to create informal normative support, and, thus, a popular will to support compliance.<sup>21</sup> Further, even if such international rules receive popular support, they are simply difficult to enforce due to the myriad of legal and administrative regimes in the different member states.<sup>22</sup> This suggests that EU lacks TELs and BBRs in the traditional sense, and may benefit from considering the state-based models in the US and Australia.

The analysis of the situation in the United States and Australia leads to several main findings. First, constitutional TELs and BBRs can be excessively restrictive and can prevent governments from responding to fiscal downturns. Second, statutory TELs and BBRs can be beneficial. They create a normative social constraint on political activity while still allowing some flexibility. Third, aspirational TELs and BBRs can be effective. However,

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<sup>18</sup> This is a mathematical implication: If the country can have a deficit of 60% of GDP, then the country with the larger GDP can accrue a larger deficit.

<sup>19</sup> Examples of this include the Maastricht Treaty, Feb. 7, 1992, 31 I.L.M. 247, and the Stability and Growth Pact, *supra* note 16.

<sup>20</sup> The voting for the E.U. parliament is relatively less direct than the voting for the national parliament. Under the Lisbon treaty, there will be 751 members spread across the twenty-seven member-states. Each state has at least six members of the European parliament (MEPs) and at most ninety-six MEPs. Where the state has six MEPs, the citizens of that state will typically vote for fewer MEPs than they will national parliamentarians. For example, Luxembourg is entitled to six MEPs, but has a parliament that comprises sixty members in the Chamber of Deputies. See ELECTIONS IN EUROPE: A DATA HANDBOOK 2051 (Dieter Nohlen & Phillip Stover eds., 2010).

<sup>21</sup> Yilin Hou & Daniel L. Smith, *Informal Norms as a Bridge Between Formal Rules and Outcomes of Government Financial Operations: Evidence from State Balanced Budget Requirements*, 20 J. PUB. ADMIN. RES. & THEORY 655, 656 (2010). The lack of direct democratic accountability is one of the criticisms of the WTO and is an argument for why it lacks broad-based normative (legal) support. See Tamas Pasztor, *Redressing the Legitimacy Deficit Within the World Trade Organization: The Aspect of External Transparency*, 38 LEGAL ISSUES ECON. INTEGRATION 163 (2011). Further, Lavrijssen and Hancher suggest that the lack of transparency of some supranational E.U. administrators may induce an accountability and legitimacy gap. See Leigh Hancher & Saskia Lavrijssen, *Networks on Track: From European Regulatory Networks to European Regulatory Network Agencies*, 26 LEGAL ISSUES ECON. INTEGRATION 23 (2009).

<sup>22</sup> This follows the analysis in Asen Lefterov, *How Feasible Is the Proposal for Establishing a New European System of Financial Supervisors?*, 38 LEGAL ISSUES ECON. INTEGRATION 33 (2011).

they are effective only if all political parties support the TEL and BBR. Otherwise, the TEL and BBR risks being politically undermined. Fourth, in all cases, the rules appear to have more legitimacy because they are imposed at the local level; and thus, have greater direct democratic support. This increases their normative force and enhances the likelihood of compliance.

These results have implications for states in a federal system, governments, and the member-states of the EU. If there is a political consensus over the need for prudent financial management, then aspirational BBRs and TELs are optimal. If there is no such political consensus, then a statutory limit is optimal. The statutory limit can enable a prudent party to hold to account an imprudent party for violating a statute. However, it can also allow a prudent party to overrule a policy that impedes value-creating investments.

The remainder of this paper proceeds as follows. First, I examine constitutional TELs and BBRs in the United States. It is impractical and unhelpful to examine all states. Thus, I focus only on Colorado—sometimes regarded as one of the more successful models—California, and Florida. Second, I examine statutory TELs and BBRs to show that they can deter imprudent spending by creating political repercussions if a party violates them. I also show that they can be sufficiently flexible to allow a government to respond to crises or to make long-term investments. Third, I analyze aspirational TELs and BBRs, as they exist in Australia. I highlight that they are largely successful in promoting government flexibility. However, they are likely to be unsuccessful if there is no political consensus over the need to maintain them. I then conclude that statutory TELs and BBRs are the most likely to be successful, by balancing flexibility and constraint.

## B. Constitutional Restrictions

Constitutional TELs and BBRs have the most stringent requirements. Here, the constitution imposes some restriction on the rate of revenue growth and/or the amount of expenditure.<sup>23</sup> These can apply to segments of the economy, such as property tax, or to the whole economy.<sup>24</sup> I focus on TELs and BBRs that apply to the whole economy. Further,

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<sup>23</sup> In addition to the examples discussed in Part B, North Carolina also has a constitution that restricts expenditures and borrowings. See Robert C Lowry, *A Visible Hand? Bond Markets, Political Parties, Balanced Budget Laws, and State Government Debt*, 13 *ECON. & POL.* 49, 53 (2001); Shaw, *supra* note 10; Donald B. Tobin, *The Balanced Budget Amendment: Will Judges Become Accountants—A Look at State Experiences*, 12 *J.L. & POL.* 153, 158 (1996).

<sup>24</sup> An example of this is Colorado, which started with a property tax limit and then imposed a TEL that covered the whole economy. See Tom Brown, *Constitutional Tax and Expenditure Limitation in Colorado: The Impact on Municipal Governments*, 20 *PUB. BUDGETING & FIN.* 29, 30 (2000).

not all TELs and BBRs are the same, with revenues growth variously being linked to (inter alia) population and inflation.<sup>25</sup> Table 1 and Table 2 indicate several states that have constitutional balance requirements and tax and expenditure limits (of some kind). I present case studies from California and Colorado. I use these as case studies to highlight that while constitutional TELs and BBRs may reduce expenditure, they can be inflexible, inhibit long-term growth, and prevent governments from responding to fiscal downturns.

### *I. California*

California has featured successive relaxations in its constitutional expenditure limits.<sup>26</sup> In 1979, California passed the "Gann Limit."<sup>27</sup> This restricted the growth in state expenditure to the level of population growth plus inflation. If revenue exceeded expenses, then the government had to return the revenue to tax payers.<sup>28</sup> This has induced several problems over time. Key problems stem from subsequent amendments to the limit.<sup>29</sup>

First, amendments have weakened the expenditure limits. For example Proposition 98 and Proposition 111 increased funding for schooling at least partially derived from excess revenues that would otherwise be tax refunds.<sup>30</sup> However, the possibility of amendments leads to additional complications. The funds for these amendments tend to come from excess revenues, *i.e.*, cash windfalls.<sup>31</sup> However, as these excess revenues persist during boom times, governments start to budget for windfalls, with the possibility of a structural deficit.<sup>32</sup>

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<sup>25</sup> On the myriad of possible TEL permutations, see Thad Kousser et al., *For Whom the TEL Tolls: Can State Tax and Expenditure Limits Effectively Reduce Spending?*, 8 ST. POL. & POL'Y Q. 331, 358 (2008); Daniel R. Mullins & Bruce A. Wallin, *Tax and Expenditure Limitations: Introduction and Overview*, 24 PUB. BUDGETING & FIN. 2, 3 (2004).

<sup>26</sup> I describe these relaxations in this section.

<sup>27</sup> See James D. Savage, *California's Structural Deficit Crisis*, 12 PUB. BUDGETING & FIN. 82 (1992).

<sup>28</sup> See David R. Doerr, *The California Legislature's Response to Proposition 13*, 53 S. CAL. L. REV. 77, 78 (1979); Juliet Musso et al., *State Budgetary Processes and Reforms: The California Story*, 26 PUB. BUDGETING & FIN. 1 (2006).

<sup>29</sup> I do not argue that a "pure" limit without amendments would be superior; it is not possible to test this counterfactual. I merely argue that the amendments have created sub-optimal outcomes in some respects.

<sup>30</sup> See John J. Kirlin, *Impact of Fiscal Limits on Governance*, 25 HASTINGS CONST. L.Q. 197, 201 (1998); Savage, *supra* note 27.

<sup>31</sup> See the "ratcheting up" effect documented in Kirlin, *supra* note 30; Musso et al., *supra* note 28; Juliet Musso & John Quigley, *Fiscal Federalism and Health Care Provision in California*, in GOVERNMENT FOR THE FUTURE 103 (Ake E. Andersson ed., 1997).

<sup>32</sup> See Kirlin, *supra* note 30; Musso et al., *supra* note 28; Musso & Quigley, *supra* note 31.

Second, over time, amendments have created myriad guaranteed claims over government revenues, and the presence of myriad competing claims can make it difficult to determine which party takes priority, and reduce lawmakers' discretion in determining the appropriate expenditures in each budget.<sup>33</sup>

Third, the creation of myriad claims can both facilitate and conceal government discretion.<sup>34</sup> For example, say that (a) there is a BBR, (b) there are two projects competing for a claim on excess government revenue, and (c) the government prefers one of those two projects. The government can simply deny one of those projects by shifting the favored one into the main budget. This move means that the favored project is funded in the "main budget" rather than out of excess revenue. This effectively gives priority to the government's favored project while denying funding to the less favored project. These adaptations can lead to budgetary decisions that are less transparent and that allow greater government discretion.<sup>35</sup>

This suggests that the preponderance of restrictions, coupled with amendments has induced: (1) confusion over precisely to whom to allocate funds;<sup>36</sup> (2) restrictions on government discretion in allocating funds as needs require;<sup>37</sup> and (3) potentially arbitrary discretion as governments chose which newly entitled group to prioritize.<sup>38</sup> This appears to render the constitutional expenditure limits counter-productive.

## II. Colorado

Colorado has relatively stringent tax and expenditure limits under the Taxpayer Bill of Rights (TABOR).<sup>39</sup> In 1992, Colorado inserted Section 20, Article X into the State

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<sup>33</sup> See Musso et al., *supra* note 28, at 20.

<sup>34</sup> For a discussion of how BBRs can produce unexpected results, including additional pork barreling, see Matthew J. Gabel & Gregory L. Hager, *How to Succeed at Increasing Spending Without Really Trying: The Balanced Budget Amendment and the Item Veto*, 102 PUB. CHOICE 19, 21 (2000).

<sup>35</sup> See Kirlin, *supra* note 30, at 207–08.

<sup>36</sup> See Musso et al., *supra* note 28.

<sup>37</sup> *Id.*

<sup>38</sup> See Kirlin, *supra* note 30.

<sup>39</sup> TABOR is in the Colorado Constitution. COLO. CONST. art. X, § 20.



Constitution.<sup>40</sup> TABOR limits expenditure increases to the rate of inflation plus population growth.<sup>41</sup> It applies to most sources of revenue and to most types of expenditure, and applies to both the state government and to local governments.<sup>42</sup> The government must return excess revenues to tax payers.<sup>43</sup> There have been some amendments, for example, allowing the government to retain and spend some of the surplus revenue.<sup>44</sup>

The general effect of TABOR is to reduce expenditures during a time of high growth. This is simply because TABOR requires the government to return excess revenues to the population, thereby imposing a 'hard limit' on expenditure. Thus, studies suggest that expenditures grew at a lower rate post-TABOR than pre-TABOR.<sup>45</sup> However, there are several issues with TABOR.

First, TABOR arguably emphasized short-term tax rebates over long-term investment. For example, the emphasis on refunding excess revenues, rather than spending them, arguably resulted in a diminution in the standing of Colorado's school system.<sup>46</sup> This appears to be a consequence of a political approach that focuses on short-term electoral outcomes coupled with a TEL that focuses on meeting the current year's expenses, rather than on meeting the expenses that might be required in future years, or on providing adequate infrastructure.<sup>47</sup>

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<sup>40</sup> See Richard B. Collins, *The Colorado Constitution in the New Century*, 78 U. COLO. L. REV. 1265, 1334 (2007).

<sup>41</sup> See COLO. CONST. art. X, § 20(7).

<sup>42</sup> See Brown, *supra* note 24.

<sup>43</sup> See COLO. CONST. art. X, § 20(7)(d).

<sup>44</sup> This came through Referendum C in 2005. Referendum C allows the state to spend excess revenue on services such as health care, public education, and transportation. The Colorado government reports the revenue here at [http://www.colorado.gov/cs/Satellite/Treasury\\_v2/CBON/1251592160342](http://www.colorado.gov/cs/Satellite/Treasury_v2/CBON/1251592160342). For a discussion, see Collins, *supra* note 41; Christine R. Martell & Paul Teske, *Fiscal Management Implications of the TABOR Bind*, 67 PUB. ADMIN. REV. 673–75 (2007).

<sup>45</sup> See Brown, *supra* note 24; Kousser et al., *supra* note 25.

<sup>46</sup> See Kathleen J. Gebhardt, *Challenges to Funding School Facilities in Colorado*, 83 NEB. L. REV. 856, 863 (2005); STAFF OF COLORADO LEGISLATIVE COUNCIL, ISSUE BRIEF 03–06: HOW COLORADO COMPARES IN K-12 FUNDING (1999).

<sup>47</sup> See William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQ. L. REV. 19, 19 (2004).

Second, there is limited evidence that TABOR stimulated growth. Colorado was growing strongly prior to TABOR, and continued growing during TABOR.<sup>48</sup> Instead, the growth in Colorado during the 1990's appears to have been an artifact of the high ambient growth at the time, and the carry-over from prior spending on education.<sup>49</sup>

Third, the strictness of the expenditure limits can prevent the government from responding to economic downturns. One way to respond to reductions in economic growth is to increase government expenditure on value-creating initiatives in an attempt to stimulate employment and production. However, in a recession or market downturn, revenues fall. Thus, if expenditures must be below revenues, then expenditures must fall. This prevents the government undertaking responsible counter-deflationary spending. This was an issue after 2001. After 2001, the states, including Colorado, suffered a downturn. However, the evidence suggests that Colorado was unable to increase expenditures in order to combat the downturn, or even to maintain some services. This worsened and prolonged the downturn.<sup>50</sup> This is especially the case where, as in Colorado, the government is unable to increase taxes without voter approval to amend TABOR, thereby creating an inadequate revenue stream.<sup>51</sup>

Overall, the following picture of TABOR emerges. It appears to have been successful in limiting government expenditure. This may not have been beneficial. It has arguably caused short-termism and an inability to respond to a financial downturn without producing a commensurate increase in growth. This suggests that strict financial binds may not be beneficial.

### *III. Overall*

The case studies illustrate several traits about constitutional TELs and BBRs. First, they can effectively constrain spending and revenue. Second, constraining spending and revenue is not always beneficial: It can prevent governments from responding to downturns, lead to short-term policies and a failure to focus on long-term planning, and has no clear positive impact on economic growth. These factors all appear to derive from the inflexibility of the

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<sup>48</sup> See Therese J. McGuire & Kim S. Rueben, *The Colorado Revenue Limit: The Economic Effects of TABOR* (Economic Policy Institute, Briefing Paper No. 172, Mar. 23, 2006).

<sup>49</sup> *Id.*

<sup>50</sup> For an analysis of the impact of the downturn in the 2000s on Colorado, see Martell & Teske, *supra* note 45; Franklin James & Allan Wallis, *Tax and Spending Limits in Colorado*, 24 PUB. BUDGETING & FIN. 16, 25 (2004).

<sup>51</sup> See Fox, *supra* note 47.

constitutional TELs and BBRs. Specifically, their failure to adapt to changing economic and social circumstances can have negative consequences.

### C. Statutory Restrictions

Some states have only statutory TELs or BBRs. The distinguishing feature is that they are ordinarily easier to remove because they do not require a constitutional amendment. Table 1 and Table 2 suggest that statutory TELs and BBRs are relatively common. I jettison case studies and focus on the unique aspects of statutes that might make them a more appropriate tool than constitutional TELs and BBRs. First, I highlight how statutory provisions can be more flexible than constitutional provisions. Second, I emphasize that the human desire to comply with institutionalized social norms means that statutory provisions can still constrain government actions. Third, I conclude that statutory restrictions can be beneficial.

#### *1. How Do Statutory Provisions Promote Comparative Flexibility?*

##### *1. Ease of Removal*

Statutory restrictions are easier to remove than constitutional restrictions. The general rule is that an earlier legislature cannot bind a later legislature; that is, entrenchment provisions that purport to constrain future legislative activity are ineffective.<sup>52</sup> Examples of entrenching provisions include “this statute can amended only if there is a 2/3 legislative majority.”<sup>53</sup> It is beyond the scope of this article to analyze the arguments for or against the anti-entrenchment rule. However, there are at least two main arguments—that might also apply in the states—against the validity of entrenching provisions. First, there is a “traditional understanding of the limits on legislative power,”<sup>54</sup> which the constitution incorporates. This supposition does not generally derive from the text of the constitution,<sup>55</sup> and thus, it is difficult to support. Support would require a highly liberal and

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<sup>52</sup> See *United States v. Winstar Corp.*, 518 U.S. 839, 872 (1996).

<sup>53</sup> For a discussion of the nature of such entrenching provisions, see John O. McGinnis & Michael B. Rappaport, *The Constitutionality of Legislative Supermajority Requirements: A Defense*, 105 YALE L.J. 483, 486 (1995); Eric A. Posner & Adrian Vermeule, *Legislative Entrenchment: A Reappraisal*, 111 YALE L.J. 1665 (2002); Michael J. Klarman, *The Majoritarian Judicial Review*, 85 GEO. L.J. 491, 509 (1997); John C. Roberts & Erwin Chemerinsky, *Entrenchment of Ordinary Legislation: A Reply to Professors Posner and Vermeule*, 91 CALIF. L. REV. 1773, 1784 (2003).

<sup>54</sup> See McGinnis & Rappaport, *supra* note 53, at 504–05.

<sup>55</sup> *Id.*

dynamic reading of the constitution, which has received only moderate support.<sup>56</sup> Second, arguably, any entrenching position alters the way in which congress (or the legislature) can make laws, and thus, it is akin to a constitutional amendment.<sup>57</sup> Of course, this argument is disputable on grounds that entrenching provisions do not alter the text or structure of the state constitution, and thus, are not equivalent to constitutional amendments.<sup>58</sup>

Overall, this suggests that a statutory TEL or BBR is easier to remove than a constitutional one. Even if entrenching provisions are allowed, they are unlikely to impose amendment mechanisms that are more onerous than are those to amend constitutional provisions.

## 2. Principles of Interpretation

It is easier to interpret away undesirable provisions in statutes than it is in constitutions. A purposive interpretation is one in which the court aims to implement the purpose of the statute.<sup>59</sup> This can facilitate a dynamic interpretation, in which the court can update the meaning of words over time as circumstances change.<sup>60</sup> A notionally contrary interpretation is a textualist or originalist interpretation in which the court aims to implement the original meaning of the text and does not allow the meaning of words to change over time.<sup>61</sup>

A dynamic interpretation would allow the court to update a TEL or BBR to the present circumstances.<sup>62</sup> For example, say a TEL came into force in 1850 that said: “[E]xpenses

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<sup>56</sup> This type of “dynamic” constitutional interpretation has not received universal support. See generally Richard H. Fallon, *A Constructivist Coherence Theory of Constitutional Interpretation*, 100 HARV. L. REV. 1189, 1205 (1987); John G. Wofford, *The Blinding Light: The Uses of History in Constitutional Interpretation*, 31 U. CHI. L. REV. 502, 503–04 (1964); David L. Faigman, “Normative Constitutional Fact-Finding”: *Exploring the Empirical Component of Constitutional Interpretation*, 139 U. PA. L. REV. 541, 607 (1991).

<sup>57</sup> See McGinnis & Rappaport, *supra* note 53.

<sup>58</sup> See Posner & Vermeule, *supra* note 53, at 1680–81.

<sup>59</sup> See Philip P. Frickey, *Structuring Purposive Statutory Interpretation: An American Perspective*, 80 AUSTRALIAN LJ. 849, 849 (2006).

<sup>60</sup> See Mark L. Humphery-Jenner, *Should Common Law Doctrines Dynamically Guide the Interpretation of Statutes?*, 3 LEGISPRUDENCE 171, 172 (2009).

<sup>61</sup> I note that these are reconcilable; however, the notion that the original framers wrote the strict text with the intention that it receives a dynamic interpretation has received tentative, but not uniform, support. See Jack M. Balkin, *Framework Originalism and the Living Constitution*, 103 NW. U. L. REV. 549, 558 (2009).

<sup>62</sup> For a full summary of the operation of dynamic interpretation, and the arguments for and against it, see Mark L. Humphery-Jenner, *Securities Fraud Compensation: A Legislative Scheme Drawing on China, the US and the UK*,

must not exceed revenues, unless required to respond to a disaster.” Now, imagine that, in 2011, complex financial derivatives threaten the stability of the state’s banking sector. A textualist interpretation would consider the meaning of “disaster” at the time the legislature passed the statute. This would be limited to the meaning of “disaster” in 1850. This would probably exclude disasters due to the failure of complex financial derivatives. A dynamic interpretation, on the other hand, would update the meaning of “disaster” over time so that it would take its contemporary meaning. This could, at least arguably, include a financial disaster that could threaten the state’s economic stability.

Dynamic interpretations appear to be more acceptable for statutes than for constitutions. Dynamic statutory interpretations have become common, or at least widely accepted, in most countries.<sup>63</sup> Dynamic interpretations of constitutions are more controversial<sup>64</sup> and have only recently received support.<sup>65</sup> This suggests that a statutory TEL or BBR may be more able to adjust to contemporary budgetary requirements than would a constitutional TEL or BBR.

### 3. Limiting Definitions

Statutes are easier to avoid through definition provisions than are constitutions. The legislature cannot pass legislation that purports to define words in the constitution.<sup>66</sup> This is because such legislation would limit or expand the operation of the constitution; and

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38 LEGAL ISSUES ECON. INTEGRATION 143 (2011); Randal Graham, *A Unified Theory of Statutory Interpretation*, 23 STAT. L. REV. 91 (2002); William N. Eskridge, *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479 (1987).

<sup>63</sup> For example, Australia implicitly permits dynamic statutory interpretations in the *Acts Interpretation Act 1901* (Cth) s 15AA (Austl.). This has also received some broad support in common law jurisdictions generally and in the United States. See Graham, *supra* note 62; Humphery-Jenner, *supra* note 60; Eskridge, *supra* note 62; William N. Eskridge, *Public Values in Statutory Interpretation*, 137 U. PA. L. REV. 1007, 1018 (1989); William N. Eskridge & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321, 345 (1990); Frickey, *supra* note 59; Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 493 (1989).

<sup>64</sup> See the objections in William H. Rehnquist, *Notion of a Living Constitution*, 54 TEX. L. REV. 693, 695 (1976); Arthur Selwyn Miller, *Notes on the Concept of the Living Constitution*, 31 GEO. WASH. L. REV. 881 (1963).

<sup>65</sup> See Arlin M. Adams, *Justice Brennan and the Religion Clauses: The Concept of a “Living Constitution”*, 139 U. PA. L. REV. 1319, 30 (1991); Balkin, *supra* note 61.

<sup>66</sup> For example, in Australia, the parliament has the power to make laws with respect to defense. See AUSTRALIAN CONSTITUTION s 51(vii). Courts have held that the government cannot simply define a law as being with respect to defense, *i.e.*, what constitutes “defense.” See *Australian Communist Party v Commonwealth (Communist Party Case)* (1951) 83 CLR 1, 262 (Austl.).

thus, be equivalent to an amendment.<sup>67</sup> By contrast, legislation often contains definition sections,<sup>68</sup> and legislatures can narrow or expand prior acts through subsequent acts.<sup>69</sup> This could enable the government to change the impact of a TEL.

An example can illustrate the impact of legislative definitions. Suppose that the TEL contained a revenue limit with the clause “the government may not raise property taxes.” Further suppose that the state suffers an economic downturn and must increase income. One way to circumvent this is to pass subsequent legislation that states “for the purpose of the TEL, property means chattels.” This would re-allow the legislature to tax real property, while still exempting personal property. This enables the legislature to circumvent limitations that may be counterproductive in some circumstances.

## II. Can They Still Constrain Governments?

The advantages of a statutory model include the ease with which a government can avoid it. The issue is then if the statutory model can effectively constrain government activity. The answer is that it can create implicit or political deterrents. This is for at least two reasons. First, Hou and Smith suggest that the informal norms built into the administrative infrastructure are at least as important as formal rules.<sup>70</sup> That is, the administrative apparatus is as important as the law itself.

Second, legislators incur a reputational penalty if they cynically undermine TELs and BBRs.<sup>71</sup> This penalty could come from a tarnished political legacy or simply looking bad in polling.<sup>72</sup> Ellickson argues that diminished status and tarnished reputation are key disincentives.<sup>73</sup> Posner hypothesizes—and finds supporting evidence—that after the government creates a norm, such as maintaining a prudent budget, there is a social penalty

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<sup>67</sup> See *Fisher v Fisher* (1986) 161 CLR 376, 455–56 (Austl.); Posner & Vermeule, *supra* note 54, at 1680–81; IAN IRELAND, THE HIGH COURT AND THE MEANING OF “MARRIAGE” IN SECTION 51(XXI) OF THE CONSTITUTION (Parliament of Australia: Law and Bills Digest Group, Research Note 17 2001-02, Feb. 17, 2002).

<sup>68</sup> See D.C. PEARCE & R.S. GEDDES, STATUTORY INTERPRETATION IN AUSTRALIA (7th ed. 2011).

<sup>69</sup> *Id.* at 335–36.

<sup>70</sup> See Hou & Smith, *supra* note 21.

<sup>71</sup> See Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537 (1998).

<sup>72</sup> The public choice literature suggests that the threat of poor polling can be a significant disincentive. See RICHARD POSNER, ECONOMIC ANALYSIS OF LAW (2nd ed. 1977).

<sup>73</sup> See Ellickson, *supra* note 71, at 540–41.

for violating the norm and this social penalty deters violations.<sup>74</sup> Eisenberg indicates that the impact of such social norms can influence corporatized behavior.<sup>75</sup> In the present context, this would discourage lawmakers from undermining TELs and BBRs. Hou and Smith find some support for this, suggesting that informal norms aid in the maintenance of BBRs.<sup>76</sup>

### *III. Overall*

The overall picture of statutory TELs and BBRs is positive. They appear to provide the opportunity to constrain government spending while enabling a government to flexibly alter constraints as political exigencies emerge. The constraint comes from the social norm that would promote compliance with an institutionalized principle of prudent expenditure. The flexibility comes from the amendability of statutory provisions, compared with constitutional rules. This suggests that statutory provisions might be a better mechanism through which to implement TELs and BBRs.

### **D. Aspirational-to-No Restriction**

States may operate without a formal balanced budget requirement. Some states may operate with no balanced budget requirement at all. However, states often create an aspirational balanced budget requirement. Axiomatically, these usually have limited or no legislative force. I use the Australian system as a case study of a purely aspirational system. I will first describe the system and, second, analyze it.

#### *I. The Australian System*

The situation in Australia best reflects the aspirational system. Australia has six states.<sup>77</sup> The states have legislated to create aspirations of a balanced budget. These statutes are not binding and non-compliance does not have repercussions. This contrasts with the situation in the US, where the BBRs are binding. New South Wales, an Australian state,

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<sup>74</sup> See Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1796 (2000).

<sup>75</sup> See Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1255 (1999).

<sup>76</sup> See Hou & Smith, *supra* note 21.

<sup>77</sup> I do not consider the Northern Territory and the Australian Capital Territory as they do not have full state status. The federal government may intervene in the affairs of territories and overrule their legislation; however, it cannot do so for states.

aims to reach a budgetary surplus and to reduce government debt.<sup>78</sup> These aspirations are not binding.

Victoria operated without legislatively enshrined goals until 2000.<sup>79</sup> Thereafter, Victorian legislation required the government to set budgets having regard to “[p]rinciples of sound financial management,” none of which compel the government to maintain a balanced budget.<sup>80</sup>

Queensland requires the government to tender “from time to time” a “Charter of Fiscal Responsibility.”<sup>81</sup> The legislation does not make the charter binding and does not specify the contents of the charter. An example was the (then) Bligh government’s charter, which does include the aim to achieve a budget surplus by 2015–2016.<sup>82</sup> This aim is non-binding, and the government needs only to “report regularly” to the parliament on progress towards achieving the charter’s objectives.<sup>83</sup>

Tasmania requires the government to prepare a fiscal strategy statement in accordance with enumerated principles of sound financial management.<sup>84</sup> The principles of sound fiscal management do not include maintaining a balanced budget.<sup>85</sup> The legislation states that it does not create “rights or duties that are enforceable in judicial or other proceedings.”<sup>86</sup>

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<sup>78</sup> This is in the *Fiscal Responsibility Act 2005* No. 41 (NSW) (Austl.), which follows the *General Government Debt Elimination Act 1995* No. 83 (NSW) (Austl.).

<sup>79</sup> On the prior position see D.J. Thomas, *Insolvency and the State of Victoria*, 12 *ECON. PAPERS* 63 (1993).

<sup>80</sup> In 2000, the *Financial Management (Financial Responsibility) Act 2000* (VIC) (Austl.) inserted Sections 23C and 23D into the *Financial Management Act 1994* No. 18 (VIC) (Austl.), which require the government to operate following the enumerated principles of sound financial management.

<sup>81</sup> See *Financial Accountability Act 2009* (QLD) s 11 (Austl.).

<sup>82</sup> See CHARTER OF FISCAL RESPONSIBILITY (Jul. 28, 2010), available at <http://www.treasury.qld.gov.au/office/knowledge/docs/charter-of-fiscal-responsibility/index.shtml> (last visited Apr. 29, 2012).

<sup>83</sup> See *Financial Accountability Act 2009* (QLD) s 11(3) (Austl.).

<sup>84</sup> See *Charter of Budget Responsibility Act 2007* (TAS) sch 1, pt 1, s 1 (Austl.).

<sup>85</sup> See *Charter of Budget Responsibility Act 2007* (TAS) sch 1, pt 3, s 3 (Austl.).

<sup>86</sup> See *Charter of Budget Responsibility Act 2007* (TAS) s 3(2) (Austl.).



Western Australia states that government financial planning must accord with enumerated “financial management principles.”<sup>87</sup> However, these do not include maintaining a balanced budget,<sup>88</sup> and the legislation does not create legally enforceable rights or duties.<sup>89</sup>

South Australia lacks legislation on financial planning goals.<sup>90</sup> However, the government has established the Sustainable Budget Commission, which is responsible for analyzing the state’s budgets and suggesting improvements. The commission recommended achieving an “operating surplus as soon as possible” as the “the Government’s top priority.”<sup>91</sup> However, the recommendations are not binding.<sup>92</sup>

## II. Analysis

The Australian system is flexible, which has its benefits and disadvantages. In analyzing the benefits and disadvantages it is naïve to merely focus on whether particular states achieve a surplus or deficit, since a deficit may reflect the government’s response to emergencies or the government engaging in pork barreling or waste.<sup>93</sup> Instead, I analyze the experience that Australia has had with flexible state budgets.

Excess flexibility may exasperate agency conflicts and may facilitate government expenditure on value-reducing investments. A danger is that aspirational goals impose only limited fiscal discipline on politicians.<sup>94</sup> Because there are no legally binding constraints on expenditure, this effectively gives politicians additional cash and cash flow

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<sup>87</sup> See *Government Financial Responsibility Act 2000* (WA) s 10(1) (Austl.).

<sup>88</sup> The principles are in *Government Financial Responsibility Act 2000* (WA) s 6 (Austl.).

<sup>89</sup> See *Government Financial Responsibility Act 2000* (WA) s 3(2) (Austl.).

<sup>90</sup> See Julie Novak, *Next Generation State Budgets: Stronger Fiscal Rules for Better Budgetary Outcomes and More Prosperous States* 2011 INST. PUB. AFF. 1, 24. Further, the Sustainable Budget Commission notes that the extent and nature of budget savings is a matter for government discretion. See SUSTAINABLE BUDGET COMMISSION, 2 BUDGET IMPROVEMENT MEASURES: RESTORING SUSTAINABLE STATE FINANCES (2010).

<sup>91</sup> SUSTAINABLE BUDGET COMMISSION, *supra* note 90, at s. I.

<sup>92</sup> See *id.* at intro.

<sup>93</sup> See Andres Velasco, *Debts and Deficits with Fragmented Fiscal Policymaking*, 76 J. PUB. ECON. 105, 106 (2000). However, “pork barreling” has arguably become a less dominant determinant of budget deficits. See Alison F. Del Rossi, *The Politics and Economics of Pork Barrel Spending: The Case of Federal Financing of Water Resources Development*, 85 PUB. CHOICE 285 (1995).

<sup>94</sup> For a criticism of “aspirational targets” in the European context, see CHRISTIAN EGENHOFER, CTR. EUR. POL’Y STUD., LOOKING FOR THE CURE-ALL? TARGETS AND THE EU’S NEW ENERGY STRATEGY 118 (CEPS Policy Briefs, 2007).

with which to invest in projects. This is a problem because it loosens capital constraints, which might otherwise discipline politicians and deter them from investing in value-reducing projects.<sup>95</sup> Thus, politicians are freer to invest in pet-projects, pork barrel, or simply exert less scrutiny over projects in which they may otherwise invest.<sup>96</sup>

There is some heuristic evidence of waste in state budgets. There is no quantitative measure of waste for state government expenditure. This is because there is no market value with which to conduct an ordinary market-based assessment of value-creation.<sup>97</sup> There are some examples of waste. For example, the New South Wales state government incurred a cost of at least AUD 300m in cancelling on 20 February 2010 a light rail project,<sup>98</sup> and raised the possibility of sovereign risk by undermining a promise to tendering companies that the project would proceed.<sup>99</sup> However, such large-scale failings appear to be uncommon. A possibly less flagrant example of waste is the use of project valuation principles that are arguably arbitrary and inappropriate.<sup>100</sup> Such inaccuracies seem mundane; however, for projects worth billions of dollars, they can have significant financial implications, and, furthermore, the presence of multiple small inaccuracies can amass to

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<sup>95</sup> This follows from the finance literature, which documents how the absence of constraints on expenditure can lead to value-reducing investments. See, e.g., Jarrad Harford, *Corporate Cash Reserves and Acquisitions*, 54 J. FIN. 1969, 1996 (1999).

<sup>96</sup> This is consistent with the well-documented relation between agency conflicts and cash in a corporate context. *Id.*; Jarrad Harford et al., *Corporate Governance and Firm Cash Holdings in the US*, 87 J. FIN. ECON. 535, 537 (2008); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

<sup>97</sup> Compare Ronald W. Masulis et al., *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851 (2007), with Ronald W. Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009).

<sup>98</sup> See Ben Sandilands, *The Killing of Sydney*, DRUM OPINION (June 2, 2010), <http://www.abc.net.au/unleashed/34734.html> (last visited May 5, 2012); Louise Hall, *Metro Damages Bill: \$330m, 350 Jobs*, SYDNEY MORNING HERALD, Jun. 2, 2010.

<sup>99</sup> See Bridget Carter, *Leighton Holdings CEO Wal King Warns NSW Premier Keneally over Metro*, AUSTRALIAN Feb. 12, 2010.

<sup>100</sup> For the approach to “discount rates” used in valuation of public-private-partnerships in New South Wales, see NEW SOUTH WALES TREASURY, DETERMINATION OF APPROPRIATE DISCOUNT RATES FOR THE EVALUATION OF PRIVATE FINANCING PROPOSALS (Technical Paper, February 2007), available at [http://www.wwg.nsw.gov.au/\\_data/assets/pdf\\_file/0011/3107/discount.pdf](http://www.wwg.nsw.gov.au/_data/assets/pdf_file/0011/3107/discount.pdf). The approach has several problems including: Failure to adjust for changes in project-risk and capital structure over time; the possibility of arbitrary adjustments to key inputs into discount rates; the reliance on market-based models to value an asset that will not be listed; and the use of inputs such as “beta,” which are difficult to determine due to the lack of publicly available companies on which to base a “beta” estimate (as would be standard practice for a “pure play” beta). These could issues induce inaccurate valuations. See TIM KOLLER ET AL., VALUATION (4th ed. 2005); JAMES R. HITCHNER, FINANCIAL VALUATION (2006).

large financial costs. A possible explanation is that the lack of hard budgetary constraints reduces the discipline imposed upon governments (and administrators), thereby allowing them to persist with sub-par valuation procedures. While there may not direct evidence of a link between valuation inaccuracies and a lack of financial discipline, there is a logical and documented link between corporate value destruction and a relaxation of financial constraints.<sup>101</sup>

Flexibility can enable governments to respond to unusual situations, such as natural disasters. Natural disasters are costly and may induce government deficits. Thus, budget flexibility has enabled the Queensland government to respond to floods and hurricanes.<sup>102</sup> However, Queensland had already forecast operating deficits,<sup>103</sup> so the flood only increased the deficit. Further, while the Queensland government had self-insured against disaster, the provisioned funding was less than the cost of the floods.<sup>104</sup> This suggests that while the absence of balanced budget requirements can create flexibility, it may also reduce the incentive to create a “rainy day” fund.

The lack of budget constraints may enable governments to adequately respond to financial downturns by giving governments flexibility. A way to partially address an economic downturn is to spend money on value-creating investments.<sup>105</sup> This underlies the United States and Australian responses to the financial crisis.<sup>106</sup> Restrictions on expenditure can prevent governments from appropriately increasing spending. This was the situation in the

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<sup>101</sup> As documented in Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5 (2005); Jensen, *supra* note 96; Harford, *supra* note 95; Harford et al., *supra* note 96; Edward Lee & Ronan Powell, *Excess Cash Holdings and Shareholder Value*, 51 ACCT. & FIN. 549 (2011); Steven V. Mann & Neil W. Shicherman, *The Agency Costs of Free Cash Flow: Acquisition Activity and Equity Issues*, 64 J. BUS. 213 (1991).

<sup>102</sup> See QUEENSLAND TREASURY, MID YEAR FISCAL AND ECONOMIC REVIEW (2011), available at <http://www.treasury.qld.gov.au/office/knowledge/docs/mid-year-review/mid-year-review-2010-11.pdf>.

<sup>103</sup> See Daniel Hurst, *State Budget 2010: Big Spend, Big Deficit*, BRISBANE TIMES, Jun. 8, 2010; Tony Moore & Daniel Hurst, *Queensland State Budget Deficit to Last Eight Years*, BRISBANE TIMES Jun. 16, 2009; QUEENSLAND TREASURY, STATE BUDGET 2009-2010: CAPITAL STATEMENT (2009), available at <http://www.budget.qld.gov.au/previous-budgets/2009-10/budget-papers/bp3.shtml>.

<sup>104</sup> This concern, *inter alia*, encouraged the Federal Government to undertake the National Disaster Insurance Review, details of which are available from at <http://www.ndir.gov.au/content/Content.aspx?doc=tor.htm>

<sup>105</sup> See Eric M. Leeper et al., *Government Investment and Fiscal Stimulus*, 57 J. MONETARY ECON. 1000 (2010); W. Max Corden, *The Theory of the Fiscal Stimulus: How Will a Debt-financed Stimulus Affect the Future?*, 26 O. REV. ECON. POL'Y 38 (2010).

<sup>106</sup> This was a publicly-stated rationale for the stimulus spending. See Phillip Coorey, *Saving the Nation*, SYDNEY MORNING HERALD, Feb. 4, 2009; Wayne Swan, Treasurer of the Commonwealth of Australia, Budget Speech 2009-2010 (May 12, 2009).

United States under the national banking system between 1846 and 1914, in which the fiscal policy prevented states from having the capital necessary to respond to fluctuations and contributed to the crisis of 1907.<sup>107</sup>

Overall, the main benefit of a lack of fixed TELs and BBRs is that the government can respond to downturns with inflationary spending. The biggest disadvantage is that there is little incentive to ensure that spending in general is prudent or sustainable. This can manifest itself in the form of large expenditures. However, it is more likely to be evident in smaller details such as mispricing of government expenditures. This suggests that by reducing financial constraints, flexibility also reduces fiscal discipline.

### E. Conclusion

This paper examined the desirability of forms of tax and expenditure limits (TELs) and balanced budget requirements (BBRs). The focus was on the form of the TEL and BBR. That is, whether the TEL or BBR is constitutional, statutory, or purely aspirational. I showed that a statutory TEL or BBR best balances the need for a legally and normatively binding constraint on government action with the need for budgetary flexibility.

This paper has clear implications for federal and national systems. TELs and BBRs have received the most attention in the context of their application to states within a federal system, as evidenced by their adoption in Canada, the United States, and Australia. However, given the importance of fiscal prudence in the EU, they may be appropriate for the member states of the EU. Subsequently, they have been proposed as one way to deter excessive spending in some EU member-states and to ensure fiscal stability.<sup>108</sup>

I analyzed the form of these TELs and BBRs to examine whether they could be an appropriate remedy for excessive government spending. I reached the following relevant conclusions.

First, constitutional TELs and BBRs constrain spending but curtail government flexibility. They typically prevent governments from spending too much more than revenues. However, they can constrain growth, deter long-term spending, and prevent governments from responding to economic downturns.

Second, statutory TELs and BBRs should be beneficial. The presence of a statutory constraint creates a normative obligation on the government to be prudent. However, a

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<sup>107</sup> See FED. RESERVE BANK OF N.Y., U.S. MONETARY POLICY AND FINANCIAL MARKETS 20 (1998).

<sup>108</sup> See Corsetti & Roubini, *supra* note 12.

statutory TEL and BBR provides flexibility because (1) they provide greater interpretative freedom, (2) they are easier to amend, and (3) governments can define their operation. They remain effective due to the normative force of an institutionalized constraint on behavior.

Third, aspirational TELs and BBRs are effective only if there is a bipartisan will to enforce them. They can allow flexibility and can deter excess spending. However, governments lack a normative or legal obligation to adhere to them. Thus, governments can spend imprudently or can fail to implement effective cost reduction controls.

Overall, this suggests that a statutory TEL or BBR imposed at the local level, rather than at federal level, may be the most effective mechanism to curtail excess government spending. The institutionalization of a local statutory constraint that has normative force should encourage a reduction in expenditure. Long-term, such schemes may help to alleviate budgetary concerns in member states of regions such as the EU.

## F. Appendix: Tables

**Table 1: State Tax and Expenditure Limits in the US**

This Table summarizes the United States tax and expenditure limits. The information is from the National Conference of State Legislatures (2007) and is available at <http://www.ncsl.org/default.aspx?tabid=12633>.

State	Year Adopted	Constitution or Statute	Type of Limit	Main Features of the Limit
Alaska	1982	Constitution	Spending	A cap on appropriations grows yearly by the increase in population and inflation.
Arizona	1978	Constitution	Spending	Appropriations cannot be more than 7.41% of total state personal income.
California	1979	Constitution	Spending	Annual appropriations growth linked to population growth and per capita personal income growth.
Colorado	1991	Statute	Spending	General fund appropriations limited to the lesser of either (a) 5% of total state personal income or (b) 6% over the previous year's appropriation.
	1992	Constitution	Revenue & Spending	Most revenues limited to population growth plus inflation. Changes to spending limits or tax increases must receive voter approval.
	2005	Referendum	Revenue & Spending	Revenue limit suspended by voters until 2011 when a new base will be established.
Connecticut	1991	Statute	Spending	Spending limited to average of growth in personal income for previous five years or previous year's increase in inflation, whichever is greater.

State	Year Adopted	Constitution or Statute	Type of Limit	Main Features of the Limit
Connecticut (continued)	1992	Constitution	Spending	Voters approved a limit similar to the statutory one in 1992, but it has not received the three-fifths vote in the legislature needed to take full effect.
Delaware	1978	Constitution	Appropriations to Revenue Estimate	Appropriations limited to 98% of revenue estimate.
Florida	1994	Constitution	Revenue	Revenue limited to the average growth rate in state personal income for previous five years.
Hawaii	1978	Constitution	Spending	General fund spending must be less than the average growth in personal income in previous three years.
Idaho	1980	Statute	Spending	General fund appropriations cannot exceed 5.33% of total state personal income, as estimated by the State Tax Commission. One-time expenditures are exempt.
Indiana	2002	Statute	Spending	State spending cap per fiscal year with growth set according to formula for each biennial period.
Iowa	1992	Statute	Appropriations	Appropriations limited to 99% of the adjusted revenue estimate.
Louisiana	1993	Constitution	Spending	Expenditures limited to 1992 appropriations plus annual growth in state per capita personal income.

State	Year Adopted	Constitution or Statute	Type of Limit	Main Features of the Limit
Maine	2005	Statute	Spending	Expenditure growth limited to a 10-year average of personal income growth, or a maximum of 2.75%. Formulas are based on state's tax burden ranking.
Massachusetts	1986	Statute	Revenue	Revenue cannot exceed the three-year average growth in state wages and salaries. The limit was amended in 2002 adding definitions for a limit that would be tied to inflation in government purchasing plus 2%.
Michigan	1978	Constitution	Revenue	Revenue limited to 1% over 9.49% of the previous year's state personal income.
Mississippi	1982	Statute	Appropriations	Appropriations limited to 98% of projected revenue. The statutory limit can be amended by majority vote of legislature.
Missouri	1980	Constitution	Revenue	Revenue limited to 5.64% of previous year's total state personal income.
	1996	Constitution	Revenue	Voter approval required for tax hikes over approximately \$77 million, or 1% of state revenues, whichever is less.
Montana	1981	Statute	Spending	Before 2005, spending was limited to a growth index based on state personal income. In 2005 the Attorney General invalidated the statute, and it is not in force at this time.



State	Year Adopted	Constitution or Statute	Type of Limit	Main Features of the Limit
Nevada	1979	Statute	Spending	Proposed expenditures are limited to the biennial percentage growth in state population and inflation.
New Jersey	1990	Statute	Spending	Expenditures are limited to the growth in state personal income.
North Carolina	1991	Statute	Spending	Spending is limited to 7% or less of total state personal income.
Ohio	2006	Statute	Spending	Appropriations limited to greater of either 3.5% or population plus inflation growth. To override, either a two-thirds supermajority or a gubernatorial emergency declaration is required.
Oklahoma	1985	Constitution	Spending	Expenditures are limited to 12% annual growth adjusted for inflation.
	1985	Constitution	Appropriations	Appropriations are limited to 95% of certified revenue.
Oregon	2000	Constitution	Revenue	Any general fund revenue in excess of 2% of the revenue estimate must be refunded to taxpayers.
	2001	Statute	Spending	Appropriations growth limited to 8% of projected personal income for biennium.
Rhode Island	1992	Constitution	Appropriations	Appropriations limited to 98% of projected revenue, which becomes 97% on 1 July 2012.

<b>State</b>	<b>Year Adopted</b>	<b>Constitution or Statute</b>	<b>Type of Limit</b>	<b>Main Features of the Limit</b>
South Carolina	1980 1984	Constitution	Spending	Spending growth is limited by either the average growth in personal income or 9.5% of total state personal income for the previous year, whichever is greater. The number of state employees is limited to a ratio of state population.
Tennessee	1978	Constitution	Spending	Appropriations limited to the growth in state personal income.
Texas	1978	Constitution	Spending	Biennial appropriations limited to the growth in state personal income.
Utah	1989	Statute	Spending	Spending growth is limited by formula that includes growth in population, and inflation.
Washington	1993	Statute	Spending	Spending limited to average of inflation for previous three years plus population growth.
Wisconsin	2001	Statute	Spending	Spending limit on qualified appropriations (with some exclusions) limited to personal income growth rate.

**Table 2: State Balanced Budget Requirements in the US**

This table summarizes the balanced budget requirements in the United States. The data is from the 2010 Fiscal Brief of the National Conference of State Legislatures.<sup>109</sup> A full description of the operation of these BBRs is available at <http://www.ncsl.org/default.aspx?tabid=12612>.

Key: C=constitution; S=statute.

State	Governor Must Submit Balanced Budget	Legislature Must Pass Balanced Budget	Governor Must Sign Balanced Budget	Constitutional Provision	Statutory Provision
Alabama	C,S	S		Amendment No. 26 of the Constitution of 1901, § 213	41-19-9, 41-4-83, 41-4-90, 41-19-4
Alaska	S	S	S	Art. IX, §§ 8, 10	§§ 37.07.020; § 37.07.030
Arizona	C,S	C,S	C,S	Art. 9, §§ 3, 5	35-115
Arkansas	S		S	Amendment 20	19-1-212; 19-4-201
California	C	C	C	Art. 4, § 12(a); Art. 16, § 1	Government Code § 13337.5
Colorado	C	C	C	Art. 10, §§ 2, 16; Art. XI, § 3	24-37-301
Connecticut	S	C,S	C	Art. XXVIII	4-72
Delaware	C,S	C,S	C,S	Art. VIII, § 6	Tit. 29, §§ 6337; 6339; 6533
Florida	C,S	C,S	C,S	Art. 7, § 1(d)	§ 216.221(1)
Georgia	C	C	C	Art. 3, § 9, para. IV(b)	45-12-75
Hawaii	C,S		C,S	Art. VII, § 5	Tit. 5, § 37-74(c)

<sup>109</sup> NAT'L CONFERENCE OF STATE LEGISLATURES, NCSL FISCAL BRIEF: STATE BALANCED BUDGET PROVISIONS (Nat'l Conference of State Legislatures, NCSL Fiscal Brief, October 2010), *available at* <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>.

State	Governor Must Submit Balanced Budget	Legislature Must Pass Balanced Budget	Governor Must Sign Balanced Budget	Constitutional Provision	Statutory Provision
Idaho		C		Art. 7, § 1; Art. 8, § 1	
Illinois	C	C	S	Art. VIII, § 2	
Indiana				Art. 10, § 5:	Tit. 4, Article 4- 9.1-1-8
Iowa	C,S	S	S	Art. VII, § 2	8.22, pt. 1(2)(f)
Kansas	S	C,S		Art. 11, §§ 4, 6, 7	75-3722
Kentucky	S	C	C,S	§§ 49, 50, 171	
Louisiana	C,S	C,S	C,S	Art. VII, § 10(E)– (G)	
Maine	C,S	C	C,S	Art. 9, § 14	Tit. 5, ch. 149, § 1664
Maryland	C	C	C	Art. III, § 52(5a)	
Massachu- setts	C,S	C,S	C,S	Art. 63, § 2	Ch. 29B, § 2
Michigan	C,S	C	C,S	Art. 4, § 31; Art. 5, §§ 14, 15, 18, 20	
Minnesota	C,S	C,S	C,S		§§ 16A.11(2), 16A.15(1)
Mississippi	S	S			§ 27-103-125
Missouri	C,S		C	Art. 3, § 37; Art. 4, §§ 24, 27	
Montana	S	C		Art. 8, § 9	
Nebraska	C	S		Art. 13, § 1	
Nevada	S	C		Art. 9, § 2	353.205(1); 353.235(2)
New Hampshire	S				Chs. 9:3(e), 9:9, 9:16-b: I
New Jersey	C	C	C	Art. 8, § 2, para. 2; Art. 8, § 2 para. 3	Tit. 52, § 27B- 21, 27B-22

State	Governor Must Submit Balanced Budget	Legislature Must Pass Balanced Budget	Governor Must Sign Balanced Budget	Constitutional Provision	Statutory Provision
New Mexico	C	C	C	Art. 9, §§ 7, 8	
New York	C	S	C,S	Art. 7, § 2	Legislative Law, § 54
North Carolina	C,S	S		Art. III, § 5(3)	§ 143-25
North Dakota	C	C	C	Art. X, § 13	
Ohio	C	C	C	Art. 8, §§ 1, 2; Art. 12, § 4	Tit. 1, § 126.05
Oklahoma	S	C	C	Art. 10, § 23	
Oregon	C	C	C	Art. IX, §§ 2, 6	291.216(2)
Pennsylvania	C,S		C,S	Art. 8, §§ 12; 13(a)	71, § 233
Rhode Island	C	C	S	Art. 6, § 16	35, §§ 3-13, 3-16
South Carolina	C	C	C	Art. 10, § 7(a)	
South Dakota	C	C	C	Art. 13, § 2	Tit. 4, ch. 7-10; 8-23
Tennessee	C	C	C	Art. 2, § 24	
Texas		C,S	C	Art. 3, § 49; 8, § 22(c)	
Utah	C	C,S		Art. 13, §§ 1, 9; 14	63-38-10(3)
Vermont					
Virginia			C	Art. 10 § 7	
Washington	S				43.88.050; 43.88.110(5)
West Virginia		C	C	Art. VI, § 51(B)(7); Art. X, § 4	
Wisconsin	C	C	C,S	Art. 8, §§ 5, 6	20.003(4)
Wyoming	C	C	C	Art. 16, §§ 1,2	

**Table 3: Australian Balanced Budget Aspirations**

This table details the balanced budget aspirations in the Australian states. All are aspirational and are non-binding.

<b>State</b>	<b>Year Adopted</b>	<b>Main features</b>
New South Wales	2005	The Fiscal Responsibility Act 2005 contains aims to reach a surplus and reduce debt.
Queensland	2009	The Financial Accountability Act 2009 compels the state treasurer to tender a “charter of fiscal responsibility.” It does not specify the contents of the charter. The current charter contains an aim to reach a surplus by 2015–2016.
South Australia	N/A	The Government has established the Sustainable Budget Commission and aims to maintain a balanced budget. The Commission has marked this as a top priority.
Tasmania	2007	The Charter of Budget Responsibility Act 2007 requires the government to prepare a fiscal strategy statement in accordance with enumerated principles of sound financial management, which do not include maintaining a balanced budget, per se.
Victoria	2000	Under the Financial Management (Financial Responsibility) Act 2000, which amends the Financial Management Act 1994, the government is required to set budgets having regard to “principles of sound financial management.”
Western Australia	2000	The Government Financial Responsibility Act 2000 holds that government financial planning must accord with enumerated “financial management principles,” which do not include maintaining a balanced budget, per se.