CLOSING THE BLACK FISCAL HOLE: ALTERNATIVES TO THE "SPEND IT OR LOSE IT" POLICY FOR AGENCY DISCRETIONARY SPENDING

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Introduction

In 2015, the budget for the United States federal government was $3.759 trillion, with federal agency discretionary funding representing $1.027 trillion of the total budget.[1] Under the "spend it or lose it" policy, federal agencies have an incentive to (collectively) burn through every last cent of the $1.027 trillion discretionary funding during the year because the agencies lose control over their budget at the end of each year; as its name suggests, under this policy if agencies don't spend their budget, they lose control over any remaining funds. This paper proposes revising this budget policy to disincentivize wasteful federal spending by allowing federal agencies to save for the next fiscal year. More specifically, I propose extending the obligation period and "taxing" surplus funds to finance other programs.

The federal government, along with most state and local legislatures, sets budget appropriations to expire at the end of the fiscal year, without allowing agencies to roll over its unobligated funds—the funds that are not committed or used by the end of the fiscal year. Because unobligated funds become worthless to agencies, agencies have an incentive to use all available funds before they expire at the end of the fiscal year. This results in wasteful spending by agencies, as they purchase low-quality goods and services. Innovative organizations and scholars have offered several alternatives to this "spend it or lose it" policy. This paper will explore these alternatives and propose another solution that could help reduce wasteful spending caused by the "spend it or lose it" policy.

There is a surprisingly limited amount of scholarship available on year-end agency spending. Jeffrey Liebman and Neale Mahoney's pa-

1. Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2016, at 91, 100 (2015).

per—*Do Expiring Budgets Lead to Wasteful Year-End Spending? Evidence from Federal Procurement*—is the first economic analysis of the "spend it or lose it" policy, and Jason Fichtner and Robert Greene's paper—*Curbing the Surge in Year-End Federal Government Spending: Reforming 'Use It or Lose It' Rules*—is the only other reputable modern economic analysis of year-end agency spending to date.[2] I primarily rely on the Government Accountability Office's (GAO) official reports, and Michael McPherson's work—*An Analysis of Year-End Spending and the Feasibility of a Carryover Incentive for Federal Agencies*[3]—because both sources provide comprehensive overviews of the "spend it or lose it policy," notwithstanding the limited scholarship presently available.

Although this paper mainly analyzes the "spend it or lose it" policy at the federal level, the analysis is applicable to state and local governments. State and local budget appropriations typically mirror the structure and process of federal budget appropriation to their respective agencies, including the "spend it or lose it" policy.[4] Furthermore, state and local governments have similar structures as that of the federal government, which makes the principal-agent relationship at those levels similar to those of Congress and its federal agencies. Therefore, federal, state and local governments largely share the same problems and can benefit from the same solutions with respect to the "spend it or lose it" policy.

In Part I, I will explore the history and background of the "spend it or lose it" policy. Part II will examine the detrimental effects of the policy; there, I will explain and argue that the "spend it or lose it" policy encourages unnecessary spending during the fiscal year, as demonstrated by a spending surge that occurs towards the end of the fiscal year. Part III will discuss alternatives to the "spend it or lose it" policy used by some organizations or proposed by scholars. Finally, in Part IV, I will suggest an approach that will mitigate the negative effects of the "spend it or lose it" policy.

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2. Jeffrey B. Liebman & Neale Mahoney, *Do Expiring Budgets Lead to Wasteful Year-End Spending? Evidence from Federal Procurement* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 19481, 2013); Jason J. Fichtner & Robert Greene, *Curbing the Surge in Year-End Federal Government Spending: Reforming "Use It or Lose It" Rules* 7–8 (Mercatus Ctr. at George Mason Univ., Working Paper, Sept. 2014).

3. Michael F. McPherson, An Analysis of Year-End Spending and the Feasibility of a Carryover Incentive for Federal Agencies 1 (Dec. 2007) (unpublished M.B.A. thesis, Naval Postgraduate School) (on file with Dudley Knox Library, Naval Postgraduate School), http://calhoun.nps.edu/handle/10945/10215.

4. *See* Liebman & Mahoney, *supra* note 2.

I.
Background and History of the "Spend It or Lose It" Policy

The "spend it or lose it" policy is largely a consequence of the historical statutory timing requirements and the bona-fide-need rule. It is also reinforced through the apportionment requirement and incremental budgeting. Article 1, Section 8 of the Constitution gives Congress the authority to fund seventeen different categories of expenditure through taxation.[5] The Constitution places no time limit on any category except the power "[t]o raise and support armies[,]" which is limited to two years.[6]

Section 105 of the Appropriations Act provides that federal agencies are only allowed to obligate appropriations during the fiscal year, which starts on October 1 and ends on September 30 of the following year.[7] Starting midnight on September 30, any unobligated funds "may not be used except in special circumstances."[8] This paper will refer to this as the "one-year rule." After expiration, the unobligated funds "remain available . . . to adjust and make payments to liquidate liabilities arising from obligations made within the fiscal year for which the funds were appropriated."[9]

The bona-fide-need rule, 31 U.S.C. § 1502a, provides that "[a] fiscal year appropriation may be obligated only to meet a legitimate, or bona fide, need arising in, or in some cases arising prior to but continuing to exist in, the fiscal year for which the appropriation was made."[10] A corollary to this rule is that federal agencies may use funds only towards needs—which is determined by its congressionally-directed objectives[11]—for the current year and not for the succeeding year.[12] The original bona-fide-need rule originating from the first general-appropriations act in 1789 did not include the timing requirement that is included in the latter part of 31 U.S.C. § 1502a.[13] In 1789, the

5. U.S. Const. art. I, § 8.

6. U.S. Const. art. I, § 8, cl. 12; *see* Liebman & Mahoney, *supra* note 2, at 25.

7. U.S. Gov't Accountability Office, GAO-04-261SP, 1 Principles of Federal Appropriations Law 5-4 (3d ed. 2004); 1 U.S.C. § 105 (2016).

8. McPherson, *supra* note 3.

9. 31 U.S.C. § 1553(a) (2016); U.S. Gov't Accountability Office, *supra* note 7, at 5-6.

10. U.S. Gov't Accountability Office, *supra* note 7, at 5-11.

11. Thus, for large capital expenditures that require multi-year spending, the "need" is proportionate based on the year.

12. McPherson, *supra* note 3, at 11.

13. Act for 1789 Federal Government Appropriations, ch. 23, 1 Stat. 95 (1789) (providing for federal government appropriations); *see* McPherson, *supra* note 3, at 5.

one-year rule became part of the bona-fide-need statute "due to confusion over the timing of the requirements[.]"[14]

Whether an appropriation made at the end of the year is a bona-fide need depends on the reason for the year-end spending.[15] A contract is a bona fide need when "the contracted service is either a recurring seasonal requirement, or addresses a need that was present during the closing of the fiscal year."[16] However, an appropriation that is made "merely in order to use up such an appropriation" is not a bona fide need.[17] For example, purchasing a large amount of pencils when it is clear that there are enough pencils for several years violates the bona-fide-need rule.[18] Similarly, obligating funds for goods and services that a federal agency does not receive until the next fiscal year arguably violates the bona-fide-need rule because the funds are being obligated to fulfill needs of the succeeding year.[19] However, existing regulations "allow for [year-end] purchases [of goods] that will be shipped in the next fiscal year."[20]

Another statute that affects the "spend it or lose it" policy is the Anti-Deficiency Act,[21] which requires apportionment for federal agencies. The Anti-Deficiency Act, 31 U.S.C. § 1341, prevents federal agencies from spending in excess of their appropriations during the fiscal year.[22] The Act resolves the historical problem of federal agencies spending their authorized funds early in the year, running out of funds before the year is over, and then requiring Congress to bailout the fund-less agencies.[23]

In the early 20th century, Congress amended the Anti-Deficiency Act to create § 1512—Appointments and Reserves—under U.S.C. Ti-

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14. Section 1502 provides that "appropriation . . . *is available only for payment of expenses properly incurred during the period of availability* or to complete contracts properly made within that period." 31 U.S.C. § 1502 (2016) (emphasis added). By contrast, the 1789 act provided that "*there be appropriated for the service of the present year*, to be paid out of the monies which arise." Act for 1789 Federal Government Appropriations, ch. 23, 1 Stat. at 95 (emphasis added); *see* McPherson, *supra* note 3, at 5.

15. U.S. Gov't Accountability Office, *supra* note 7, at 5-11.

16. McPherson, *supra* note 3, at 11.

17. U.S. Gov't Accountability Office, *supra* note 7, at 5-11 (internal citation omitted).

18. *Id.* at 5-13.

19. McPherson, *supra* note 3, at 11.

20. *Id*.

21. U.S. Gov't Accountability Office, *supra* note 7, at 1-12.

22. McPherson, *supra* note 3, at 5.

23. *See id.* at 7.

tle 31.[24] Section 1512 requires apportionment of federal funds "to prevent obligation or expenditure at a rate that would indicate a necessity for a deficiency or supplemental appropriation for the period."[25] This requirement apportions federal funds in monthly or quarterly amounts in order to prevent agencies from overspending.[26] Although the Anti-Deficiency Act cures the problem of overspending, and thus, ending up with a deficit early in the year, it "limit[s] [the] agencies' ability to obligate funds in a timely fashion" and "diminish[es] discretion [for agencies] to execute budgets."[27] Naturally, the diminished discretion from restricting earlier use of the funds would contribute to the year-end buildup of the funds because apportionment in effect forces agencies to save during the year for use of funds for the remainder of the year. Without the Anti-Deficiency Act, agencies would have the discretion and freedom to make disproportionately large purchases earlier during the year, which would mitigate the problem of surplus funds towards the end of the fiscal year.

Federal agency officials have the authority to delegate and control the apportionment process of subordinate agencies. The Office of Management and Budget (OMB) distributes apportioned authority to federal agencies on a monthly and quarterly basis.[28] The federal agency officials in charge of the administrative control of the apportionment are required to promulgate regulations that restrict obligations or expenditures for subordinate agencies.[29]

The federal government currently uses incremental budgeting, which increases or decreases the agency's current-year budget based on the previous year.[30] As an agency requires more funds relative to the previous year, the agency receives an incrementally greater budget relative to the previous year. Although incremental budgeting minimizes the resource costs for the budgeting process, it does not carefully analyze the baseline funding, and rarely results in the termination of programs.[31] When the agency fails to use all its baseline funds, "it is logical to [presume] that the entirety is not needed and can be re-

24. *See* U.S. Gov't Accountability Office, *supra* note 7, at 1-32 n.61; McPherson, *supra* note 3, at 7.

25. 31 U.S.C. § 1512 (2016).

26. Generally, the higher-level agency would set this appropriation in quarters or months to subordinate agencies.

27. 31 U.S.C. § 1514 (2016); *see* McPherson, *supra* note 3, at 8, 11.

28. *See* McPherson, *supra* note 3, at 7–8.

29. 31 U.S.C. § 1514 (2016).

30. *See* David N. Hyman, Public Finance: A Contemporary Application of Theory to Policy 210 (11th ed. 2014).

31. *Id.* at 210–11.

duced."[32] Therefore, when a federal agency fails to spend the entirety of its budget, there is a presumption that the agency can manage with less funds during the next fiscal year.

To date, Congress has recognized the potential for "granting greater flexibility over unobligated funds, and has tested the concept in the Department of Justice"—this will be explored further in Part III.A, which discusses alternatives to the "spend it or lose it" policy.[33] The Senate's Homeland Security and Governmental Affairs Subcommittee has been exploring the possibility of giving other departments the same authority.[34]

II.
Examining the Detriments of the "Spend It or Lose It" Policy

The two detrimental effects of the "spend it or lose it" policy are the reduction of value of the funds at the end of the fiscal year and the risk of future budget cuts due to incremental budgeting. The "value" of the funds depends on the utility of the funds for the agency. For example, an agency with an exigent need of $1 million would value the funds more than an agency that does not have immediate need for $1 million. Because of these consequences, the "spend it or lose it" policy encourages federal agencies to rush spending at the end of the year. Throughout this paper, I will refer to this problem as the "year-end spending surge." I will also explain in this section how the year-end spending surge has the third detrimental effect of encouraging agencies to purchase low-value goods and services. When examining these detriments of the "spend it or lose it" policy in Part II.A, I will use the economic analyses by Liebman and Mahoney, and Fichtner and Greene, to support the conclusion that the year-end spending surge exists. Part II.B will analyze the incremental budgeting policy and discuss how it contributes to the year-end spending surge. Then, in Part II.C, I will use principal-agent theory to discuss the problem of agencies hiding information from the legislature, and explore possible solutions. Finally, Part II.D will conclude by providing an illustration of the year-ending spending surge.

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32. McPherson, *supra* note 3, at 5–6.

33. As discussed above, the Department of Justice maintains a unique authority to transfer expired unobligated authority to the subsequent year. *Id.* at 46.

34. *Id.*

A. *Economic Analyses of Agency-Spending Data Suggest that the Year-End Spending Surge Exists*

When there is uncertainty for future budget appropriations, "[agencies] have an incentive to hold back on marginal spending early in the budget cycle and then burn through this buffer-stock at the end of the year."[35] Data also on spending patterns suggests that federal agencies have this incentive to save funds towards the beginning of the budget cycle.[36] Towards the end of the budget cycle in a fiscal year, the agencies often have a surplus of funds because of these budget savings from the beginning of the year. If there is a lack of need for these savings, the agencies then "must rush to spend these resources on low quality projects at the end of the year."[37] Setting expirations for budgets creates a perverse incentive for federal agencies to spend on low-value goods and services because "the opportunity cost to [the agencies] of spending about-to-expire funds is effectively zero."[38]

Recent studies contradict the GAO's position that "year-end spending is not inherently more or less wasteful spending [than] at any other time of the year," and the position that seasonal spending or delayed spending causes the year-end spending surge.[39] In maintaining its position, the GAO cites a study conducted in 1980 that analyzed the spending patterns within the federal government, but the GAO has also concluded that this study's data was "questionable" and that more studies were required.[40] Although the 1980 study comprehensively shows that a year-end spending surge does exist, it contains little economic analysis regarding the causal relationship between the year-end spending surge and spending behavior—unlike Liebman and Mahoney's paper. The study concludes that the year-end spending surge is caused by ineffective monitoring policies and places substantial weight on interviews with agency officials,[41] in part because of the unreliability of the data itself.

Liebman and Mahoney's analysis is preferable because it is more objective, modern, and applicable to analyzing the year-end spending surge. Because of technological advances, it is fair to assume that the

35. *See* Liebman & Mahoney, *supra* note 2, at 1.
36. *See id.*
37. *Id*.
38. *Id*.
39. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 7, at 5–18.
40. U.S. GOV'T ACCOUNTABILITY OFFICE, PAD-81-18, FEDERAL YEAR-END SPENDING: SYMPTOM OF A LARGER PROBLEM 1 (1980).
41. *Id.* at 1–9.

availability of accurate data has drastically increased since the 1970s, and that Liebman and Mahoney would encounter less questionable data than that which the GAO encountered in its 1980 study. There has also been much advancement in the field of economics, including game theory and econometrics; these advancements had not yet been realized when the GAO completed its report and so are absent. Furthermore, the year-end spending surge was a problem in 1980, and remains a problem. If ineffective monitoring was indeed the cause of the year-end spending surge in 1980, and has not been corrected more than thirty years later, then we should consider a new approach and hold ineffective monitoring as a static variable. Liebman and Mahoney analyzed the large compilation of federal procurement spending data for policies both with and without a budgetary rollover plan.[42] Their study then supports the conclusion that monitoring is not the only explanation for the year-end spending surge.

In order to examine the year-end spending surge, Liebman and Mahoney focused on the federal procurement spending data because procurement spending has the highest potential of the main categories of government spending for a year-end spending surge.[43] This potential is as compared to other U.S. federal spending categories such as the sixty-five percent of spending on mandatory programs and interest on debt that is not subject to timing limitations, or the thirteen percent of spending on compensation for federal employees, which is unlikely to exhibit an end-of-year spending surge.[44] The year-end spending surge is generally limited to private goods and services, which totaled $538 billion in 2013, or 15.3% of federal spending in 2009.[45] The GAO study above not only has "questionable" data, but also does not examine federal procurement data alone.[46] The scope of the GAO study is larger because it also examines patterns of spending for non-discretionary expenditures. GAO's failure to analyze the discretionary spending alone caused it to draw the cursory conclusion that the year-end spending surge is attributed to cyclical reasons rather than agency incentives to spend due to the "spend it or lose it" policy.

Another reason Liebman and Mahoney chose to use federal procurement data was because federal procurement makes up a sizeable amount—fifteen percent—of federal government expenditure,[47] and

42. *See* Liebman & Mahoney, *supra* note 2, at 13, 41.
43. *Id*. at 8.
44. *Id.*
45. *Id.*
46. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 1.
47. *See* Liebman & Mahoney, *supra* note 2, at 2.

when issuing federal procurement, "agencies have the most discretion over the timing of spending."[48] Analyzing a category where agencies have the most discretion would best reflect agency action on spending. If instead, agency discretion did not exist because an agency was required to spend by statute, then there would be a weaker causal relationship between expenditures and low-value spending. Liebman and Mahoney primarily rely on data from 2004 through 2009 because—although the Federal Procurement Data, available on USAspending.gov, has tracked federal contracts since 1978—agency reporting was incomplete until after 2000.[49]

After analyzing the data, Liebman and Mahoney found that the year-end surge in spending "occur[ed] in nearly all of the major government agencies."[50] The procurement data showed "that spending in the last week of the year [was] 4.9 times higher than the rest-of-the-year weekly average."[51] In contrast, if agencies spent their budget at a constant rate, the weekly rate of expenditure would average only 1.9% across the fiscal year.[52]

Furthermore, it is clear that the year-end spending surge correlated negatively with the quality of the spending because the quality of spending drastically dropped towards the end of the year as the federal agencies spent more of their budget on "buildings, furnishings and office equipment, and [Information Technology] services and equipment."[53] In order to determine the quality levels, Liebman and Mahoney examined the federal Information Technology (I.T.) procurement data available at the federal I.T. Dashboard, which measures the performance for major I.T. projects.[54] Using this quality index, Liebman and Mahoney found that the odds were 2.2 to 5.6 more likely for year-end projects to have a lower quality score.[55]

Liebman and Mahoney did not conduct a similar analysis for buildings, furnishings, and office equipment, probably because of a lack of data. However, spending large amounts in these categories at

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48. *Id.*

49. The Federal Procurement Data has up to 176 data points, including dollar value, component of agency, fixed price, and type of contract. Of the 14.6 million contracts rewarded examined, 95% of contracts were below $100,000 while 78% of contract spending was accounted for contracts more than $1 million. The Department of Defense accounted for 70% of the procurement spending. *See id.* at 9–10.

50. *Id.* at 2.

51. *Id.*

52. *Id.*

53. *Id.* at 3.

54. Liebman and Mahoney scored the level of quality by taking the average of three of the most prominent indices: "cost, schedule, and performance." See *id.* at 14–16.

55. *See id.* at 3.

the end of the year could suggest the purchases were on low-value goods and services because the categories focus on goods and services that do not add much value for the agency. For example, agencies may wish to renovate their buildings or replace their furniture because of the gains from aesthetic value and morale even if the shelf life is much longer. The fact that the spending occurs at the end of the year suggests that the spending was not urgent enough to have been required during the year, which makes it less likely that the purchase was necessary that year and more probable that the purchase was possible in light of the "surplus" funds at the end of the year.

As explained previously, the bona-fide-need requirement means agencies can only use federal appropriations for the bona-fide needs of the fiscal year for which they are appropriated.[56] In other words, federal agencies may not prepay for the next year's expenses.[57] Construction-related goods and services, furnishings and office equipment, and I.T. services and equipment are areas with flexibility of timing and that could easily meet the bona-fide-need requirement.[58] In contrast, spending for professional, administrative, and management support services, research and development, and utilities and housekeeping services tended to have year-end spending rates that were near the yearly average because it was difficult to meet the bona-fide-need requirement for increased spending in these categories at the end of the year.[59]

Fichtner and Greene later conducted an independent study that supports Liebman and Mahoney's study using federal contract spending trends found on USASpending.gov from the years 2000 to 2013 using a similar methodology.[60] While much of the study simply confirms Liebman and Mahoney's work, the data also examined the disparity among the different agencies to find that the severity of the year-end spending surges depended on the agency.[61] On the high end of the spectrum, "the Department of Health spent 28.7 percent" and "the Department of State spent 38.8 percent of its contracting expenditures" in the last month of FY2013.[62] In contrast, a uniform monthly

56. *See* U.S. Gov't Accountability Office, *supra* note 7, at 5-11; McPherson, *supra* note 3, at 11; Liebman & Mahoney, *supra* note 2, at 8.

57. U.S. Gov't Accountability Office, *supra* note 7, at 5-11.

58. Liebman & Mahoney, *supra* note 2, at 11.

59. *Id.* at 9.

60. *See* Fichtner & Greene, *supra* note 2, at 7–8.

61. *See id.* at 8.

62. *See id.*

spending rate throughout the year is roughly 8.33%.[63] News reports support these findings. According to one article, as the federal government's fiscal year was drawing to a close in September 2013, the Department of State awarded a $1,000,000 contract for a piece of granite artwork.[64] Another article reported that a $5,000,000 order for more than 12,000 pieces of custom crystal glasses and bar accessories—in twenty different styles—was placed by the State Department on the day before the 2013 government shutdown.[65]

An alternative explanation for the year-end spending surge and the drop-off in quality is procrastination.[66] A large number of contracting officers may procrastinate by obligating funds at the end of the year, which would then lead to a surge of low-quality spending.[67] If procrastination causes the year-end spending surge phenomenon, then allowing agencies to roll over funds may not improve the outcome.[68] However, Liebman and Mahoney refuted this alternative explanation by "compar[ing] the relative performance of projects procured by the same acquisition professionals at different points in time" using data from contracting offices.[69] Acquisition professionals theoretically should procrastinate less with more experience because more familiarity with the acquisition process and necessary expenditures should allow them to be more proficient at timing the contracts. The data showed that the drop-off in quality was similar for both the experienced and inexperienced acquisition professionals, which suggests that procrastination is not the cause of the drop-off in quality.[70]

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63. The analysis does not adequately explain explanations of the disparity between the different agencies, and more studies would be needed to explain why the disparity is greater in some agencies than others. *Id.*

64. Jeryl Bier, *State Department Buys Million Dollar Granite Sculpture from Irish-Born Artist*, WKLY. STANDARD (Dec. 3, 2013), http://www.weeklystandard.com/blogs/state-department-buys-million-dollar-granite-sculpture-irish-artist_769513.html; Fichtner & Greene, *supra* note 2, at 13.

65. Meghan Keneally, *State Department Finalized a $5 Million Order for Custom Crystal Wine Glasses for American Embassies Just Hours before the Government Shutdown*, DAILY MAIL (Oct. 7, 2013), http://www.dailymail.co.uk/news/article-2449171/Government-filed-5m-order-crystal-glasses-shutdown.html; Fichtner & Greene, *supra* note 2, at 13.

66. Liebman & Mahoney, *supra* note 2, at 22–23.

67. The paper also notes that single-bid contracts increase towards the end of the fiscal year, probably because of the time crunch. *Id.* at 24.

68. *Id.* at 22.

69. *Id.* at 22–23.

70. *See id.*

B. The Incremental Budgeting Policy Contributes to the Year-End Spending Surge

The other detrimental effect of the "spend it or lose it" policy is that it runs the risk of future budget cuts in subsequent years because of incremental budgeting. Incremental budgeting places structural pressure on federal agencies to spend the entirety of their funds before the end of the fiscal year. In addition to relinquishing authority to use the unobligated funds at the end of the year, agencies that surrender unobligated funds also risk getting their budgets cut in subsequent years.[71] Unobligated funds signal to Congress that there is a reduced "need" for funds.[72] This incremental budgeting system has two major repercussions. First, federal agencies receive funding where there is no real "need" because of the presumption that the year's baseline is justified merely because the budget was justified the previous year. Second, Congress punishes honest federal agencies, which may actually "need" the funds, merely because of the surplus.

An agency's "need" is not objectively accurate because incremental budgeting presumes that the baseline need from the previous year is justified merely from the fact that the baseline was part of the budget from the previous year. Federal agencies may create "slack resources" by spending on goods and services that help cushion the baseline for future years.[73] Slack resources both inflate the agency's budget and grow the agency beyond what Congress intended.[74]

To illustrate, if an agency conserves its use of paper, or overspends on paper the previous year, the agency will save money because it does not need to purchase as much paper in the present year. The paper is then a slack resource. Congress could view this slack resource as a reduced baseline need and punish the honest agency that surrenders the surplus funds from not purchasing paper by taking away its funding *for future years* merely because the agency generated a surplus. Ironically, Congress would instead reward the wasteful agency that expends the surplus funding by providing more funding to the wasteful agency and mistakenly believing it needs more funds.

In contrast to incremental budgeting, zero-based budgeting requires an annual reassessment of the agency's expenditures to avoid budget cuts.[75] Under zero-based budgeting, Congress reviews the costs and needs for expenditures every year, which provides a more

71. McPherson, *supra* note 3, at 1.
72. Liebman & Mahoney, *supra* note 2, at 6.
73. McPherson, *supra* note 3, at 22.
74. *See id.* at 22.
75. *See* HYMAN, *supra* note 30, at 210.

objective assessment because policymakers reevaluate needless items.[76] However, the United States government abandoned zero-based budgeting because the costs to generate information outweighed the savings from zero-based budgeting.[77] The incremental budgeting approach, while seemingly more cost-effective overall, lacks accuracy when determining the real baseline need.

C. Principal-Agent Theory, Information Hiding, and Theoretical Solutions

The principal-agent theory can explain agency behavior, as well as its underlying problems, when analyzing the relationship between Congress and its agencies. Congress, the principal, may delegate powers and resources to the federal agencies, the agents.[78] Congress benefits from this delegation because it may further "the congressional agenda and the substance of legislative outputs."[79] However, delegating powers is also risky for the principal because "[the] agents may use the powers granted [to] them to pursue interests not those of their principal."[80] Furthermore, the principal would then suffer additional loss in welfare because of the cost of correcting the improperly-behaving agency's actions.[81]

Under the principal-agent theory, the year-end spending dilemma exists because of competing objectives of Congress and the federal agencies based on information asymmetry. An agent often has information that is unavailable to the principal.[82] Agents use information "to advance their own self-interest or to maximize their own utilities,"[83] and may therefore reveal only information that is advantageous to them.[84] The year-end spending requirement "forces agencies to obligate funds to protect the organization and its leadership, in effect, hiding the information that there are monies left over."[85] By obligating more funds, agencies protect their budgets from "inexpedient

76. *See* McPherson, *supra* note 3, at 13.

77. *See* Hyman, *supra* note 30, at 210.

78. William T. Bianco, Congress on Display, Congress at Work 140 (2000).

79. *Id.*

80. *Id.*

81. *See* McPherson, *supra* note 3, at 15.

82. D. Roderick Kiewiet & Mathew D. McCubbins, *Delegation and Agency Problems*, *in* The Logic of Delegation 23–37 (1991); McPherson, *supra* note 3 at 15.

83. Aman Khan & W. Bartley Hildreth, Budget Theory in the Public Sector 124 (2002).

84. *See id.*

85. McPherson, *supra* note 3, at 21.

cuts, potential future cuts, and perceived failure."[86] Thus, agencies are acting rationally when they rush to spend funds because it protects them against possible punishment from Congress, the principal.[87]

With such asymmetric information, "there is every reason to expect that the consequent budgetary solution will be suboptimal and wrought with unexpected results."[88] Because of information hiding, the agent's benefits "cannot be tracked accurately without [the agency's] assistance."[89] The agent has then effectively "turned the autonomy granted to him against the principal."[90]

A federal agency may hide information regarding its budget needs both when Congress determines the agency's budget and when the agency expends its remaining dollars at the end of the year. An agency would have an incentive to exaggerate its needs to Congress in order to avoid a shortage of funds for the following year. For example, if there is a seventy percent chance that an agency needs $100,000 dollars some time during the year to replace critical equipment, the agency could request the additional $100,000 dollars as discretionary funding. After the appropriation, suppose the agency's technicians find the equipment to be in surprisingly good condition because of proper maintenance and thus conclude that there is no need to replace the equipment during the year. The agency now has an "excess" of $100,000. When the agency finds no need to spend the now-excess funds within the year, the agency could then spend the excess funds on low-quality projects, such as construction or office equipment, before the funds expire.

The agents' incentives and the nature of information-hiding activities change throughout the fiscal year. During the year, the agency has an incentive to save and act "conscientiously" towards spending because cost-efficient spending is more likely to enhance its performance than inefficient spending.[91] Here, the agent has little reason to hide information about its savings because it is the spending, rather than the saving, that principals generally scrutinize. Thus, much of the information-hiding problems at year-end, with respect to agency needs, are not as significant during the year when agencies seek to save "rainy day" funds in order to meet their objectives. At the end of

86. *Id.*

87. *Id.*

88. KHAN & HILDRETH, *supra* note 83, at 124.

89. *See* McPherson, *supra* note 3, at 15.

90. McPherson, *supra* note 3, at 15; *see* Kiewiet & McCubbins, *supra* note 82, at 26.

91. *See* McPherson, *supra* note 3, at 15.

the fiscal year, however, the department heads maximize their performance by spending as much as they can to avoid a complete loss and ultimately, providing more resources for their agency to complete its objectives. Thus, the department head has incentives to hide information that reflects actual funding needs in order to make use of the funds.

The principal may respond to information-hiding by providing incentives for the agencies through contracts, increasing the monitoring of the agencies, or restructuring the agency.[92] Congress could provide incentives for federal agencies through "removal of stress, honoring of good behavior, and promotion or advancement."[93]

Stress removal would be achievable by "lightening the workload [ ][or] allocating more resources to a task . . . ."[94] However, designing effective contracts is difficult in the government because legal restrictions prevent personal rewards or punishment.[95] In the private sector, the principal would be able to compensate the agent by offering a portion of the output.[96] This would often not be possible in the government for several reasons. First, it is difficult to translate much of the output generated by the government into monetary terms.[97] Second, civilian employees sometimes receive monetary rewards, but "their impact is often diminished because rewards are not given promptly and much of the behavior that earned the reward is forgotten."[98] Finally, Congress has difficulty affecting behaviors within the agencies because agencies are structured so that the higher-level officials within agencies design the reward systems for subordinate officials.[99]

The principal may alternatively monitor its agents by requiring its agents to share information with it.[100] However, both the principal and agent suffer costs from having to transfer information from the agent to the principal.[101] Furthermore, "if the agent has an incentive and means to hide information, the principal may never know unless it conducts an investigation."[102] An in-depth investigation costs consid-

92. *See id.* at 15.
93. *See id.* at 16–17.
94. *Id.*
95. *See id.* at 16.
96. *See id.*
97. *See id.*
98. *Id.* at 16–17.
99. *Id.*
100. *Id.* at 17.
101. *Id.*
102. Kiewiet & McCubbins, *supra* note 82, at 23–37; *see* McPherson, *supra* note 3, at 15–17.

erable amounts of resources for the principal, and sometimes the cost for the principal to investigate could become greater than any possible benefit it might gain.[103]

Another manner in which a principal may better protect its interests is by restructuring the federal agencies.[104] Currently, the federal agencies are structured so that the department head manages the comptroller, who is responsible for the budget.[105] This arrangement provides little incentive for either the department head or the comptroller to save funds.[106] Greater funding generally makes achieving objectives easier for the agency.[107] Losing funds could lead to failure of agency objectives or cancellation of certain projects.[108] The department head "is punished for saving because it represents lost opportunity to secure mission resources."[109] Furthermore, "exhaustive spending may be regarded not only as the hallmark of a successful year, but a key criterion by which executives and financial managers are judged effective."[110] Because the comptroller works under the department head, he vicariously faces pressure to use more allocated funds.[111] Furthermore, saving resources could undermine the comptroller's agency entirely, which likely jeopardizes the comptroller's best interests.[112] Therefore, both the department head and the comptroller have an incentive to spend for the survival of the agency.[113]

An alternative way to set up the federal agencies would be to make the comptroller independent from the department head's managerial control. Congress, the principal, could directly reward the comptroller for saving money and the department head for productivity.[114] As long as the department head does not evaluate the comptroller, the comptroller would work to optimize savings.[115] However, this approach would also require additional mechanisms in place to ensure sufficient communication between the department head and the comptroller in order to ensure that the comptroller has adequate information

103. Kiewiet & McCubbins, *supra* note 82, at 23–37; McPherson, *supra* note 3, at 15–17.
104. McPherson, *supra* note 3, at 17–18.
105. *See id*.
106. *Id.*
107. *See id.* at 6.
108. *Id.*
109. *Id.* at 18.
110. *Id.* at 6.
111. *Id.* at 18.
112. *See id.* at 17–18.
113. *See id.* at 6, 18.
114. *See id.* at 18.
115. *Id*.

regarding the agency needs. For example, statutes allowing the comptroller to have access to all reports accessible by the department head or allowing the comptroller to sit in on all meetings by the department head could ensure adequate information. Another plausible alternative is to emphasize savings when evaluating the department head's performance, in which case the principal would strike a balance between productivity and savings to reach an optimal outcome based on how the principal weighs productivity against savings.

As a brief caveat, I should note that I am presuming that the department head within the agency aims to optimize cost-efficiency throughout the year. Under public choice theory, the department head should act to optimize his or her private incentives. These incentives include not only personal agendas that may be against congressional interest but also the incentive to maintain his or her seat of power or enhance future appointments. Given that a principal evaluates an agent based on the agent's ability to advance the principal's aims, the department head should seek to maximize his or her agency's performance—as perceived by Congress—as long as it does not conflict with other personal agendas.

D. *Illustration with a Theoretical Example*

In concluding Part II, I will use a theoretical example to illustrate how the "spend it or lose it" policy undermines efficient use. Suppose two federal agencies, the Department of Homeland Security (DHS) and the Department of Defense (DOD), receive the same funding for years one and two, adjusted for inflation. Both agencies have no additional duties between years one, two, and three. In year two, DHS takes the initiative and invests in efficiency-enhancing measures, such as training and technology. As a result, DHS now requires fewer personnel and equipment relative to year one, and thus needs fewer funds, to accomplish the same duties without increasing security risk. The honest DHS decides to return the surplus funds back to the Treasury. DOD, on the other hand, takes no measures to enhance its efficiency and suffers unexpected, but preventable, losses of equipment in year two because of fewer training and technology investments relative to DHS. Also, suppose that DOD, because of ineffective procurement procedures, finds itself with a large amount of funds in September, which DOD quickly expends on marginally beneficial projects and slack resources.

Under the current "spend it or lose it" policy, Congress will effectively punish DHS for its efficiency both by taking away its unobligated funds and cutting its funding in subsequent years. Congress will reason that the enhanced efficiency reduces DHS' need for additional funds. Some members of Congress may even frown at the DHS for not being "effective" and expending all of its funds. On the other hand, Congress will reward DOD for its inefficiency. DOD will benefit from both the marginally beneficial projects from last minute spending and slack resources used by year-end spending in year two. Furthermore, Congress may increase DOD's budget in year three because DOD may "need" the funds in order to repurchase the lost equipment the subsequent year. Even if DOD does not have real "need" for extra funding because the equipment lost was unnecessary, DOD could characterize the lost equipment as necessary. Through information-hiding, DOD could describe the equipment as "mission critical" and "vital" to national security. Even if Congress has doubts about DOD's characterization, Congress may not discover the truth because DOD officials, from years of experience, have become experts at hiding information from the relatively "newer" members of Congress. Although DOD's actual need in year three is less than year two because the slack resources, DOD will maintain, or even increase, its funds by expending all of its funds, unlike the hapless DHS. Thus, the "spend it or lose it" policy ultimately rewards agencies that are inefficient and wasteful, while punishing agencies that are efficient and honest about its expenditures.

III. ALTERNATIVES TO THE "SPEND IT OR LOSE IT" POLICY

Policymakers and scholars have proposed several methods that could avert the year-end spending surge. Part of the proposed solutions is to allow budgetary rollovers, which various governmental bodies have successfully adopted. For example, Canada allows agencies to roll over up to five percent of their budget.[116] Within the federal government, the Department of Justice (DOJ) has special authority to roll over its budget for certain expenditures.[117] Oklahoma and Washington also "allow their agencies to roll over their budget authority to some extent."[118]

In Part III.A, I will discuss the benefits of a simple budgetary rollover that allows an agency to roll over unobligated funds to the subsequent year using the DOJ as an example. Part III.B will explain McPherson's Carryover Incentive Plan, which allows limited use of

116. *See* Liebman & Mahoney, *supra* note 2, at 25–26.
117. *See id.*
118. *See id.*

unobligated funds in the subsequent year for one-time use and emergencies. Part III.C will explore the Oklahoma Plan, which uses a budgetary rollover with a longer period than proposed in Part III.A and legislative authority to discontinue use of rollover funds. Finally, Part III.D will discuss the successful plan in use by the Washington State government that allows budgetary rollovers for indefinite periods and uses the surplus funds to finance education.

A. The DOJ's Rollover of Unobligated Funds to the Subsequent Year

The simplest way to resolve the year-end spending surge is to allow agencies to roll over their budgets to the next fiscal year. The one-year limitation can undermine the federal agencies' objectives because one year is often too short for planning purposes.[119] Extending the one-year limitation would allow agencies flexibility and reduce the incentives for agencies to spend heavily before budget authority expiration.[120] Furthermore, budgetary rollovers could encourage entrepreneurialism, efficiency, and long-term savings.[121] As illustrated in Part II.C, budgetary rollovers increase the value of year-end funds to agencies. This would encourage agencies to decrease expenditures by creating incentives to reduce costs and enhance efficiency. Depending on the limitations on the use of funds, the agencies may act like entrepreneurs and save in order to purchase goods and services that benefit the agency.

Liebman and Mahoney also recommend policies that allow agencies to roll over unused portions of the budget to the next fiscal year in order to avoid wasteful year-end spending, and used the DOJ's budgetary rollover plan to illustrate the effectiveness of a budgetary rollover.[122] Liebman and Mahoney analyzed the spending patterns for I.T. projects at the DOJ and the government-wide average.[123] DOJ is unique because it has the authority to roll over its I.T. budget. DOJ had "substantially lower end-of-year I.T. spending [ ] relative to non-I.T. spending and I.T. spending at other agencies without this flexibility."[124] At DOJ, only 3.4%[125] of I.T. spending occurred in the last week of the year in contrast to the 12.1% government-wide aver-

119. McPherson, *supra* note 3, at 1.
120. *See id.*
121. *Id.* at 1–2.
122. *See* Liebman & Mahoney, *supra* note 2, at 3.
123. *See id.* at 29.
124. *Id.* at 3.
125. 1.9% is the weekly average with a constant rate of expenditures throughout the year.

age.[126] Liebman and Mahoney found that DOJ's I.T. projects did not have a drop off in quality.[127]

There are substantial benefits even with a policy that has limited budget rollovers. In order to calculate the agency benefits, Liebman and Mahoney used indirect inference[128] to compare the year-end spikes and drop-off in quality in a status quo model without a budgetary rollover and a model with a budgetary rollover.[129] They then used value function iteration to project a pattern with a rollover, with the difference between the two models being the welfare gains from rollover.[130]

With a budgetary rollover, Liebman and Mahoney estimate that agencies could maintain the value of current spending with only eighty-seven percent of their current funds.[131] Liebman and Mahoney found that even in cases where "Congress can commit [to a rollover] with a limited probability . . . for only a short grace period[,]" there were large welfare gains.[132] "A 50 percent commitment probability or a 3-month rollover period generates welfare gains almost three-quarters of the full rollover value."[133] This is because a policy allowing even limited rollovers increases the value of the year-end funds relative to expired funds.[134] To make these determinations, Liebman and Mahoney framed and calibrated an economical model representing spending with the data from the I.T. Dashboard Data and the Federal Procurement Data.[135] To represent welfare with a rollover, Liebman and Mahoney calculate welfare with a full rollover with value function iteration.[136] Although this approach is commonly used among economists, the major weakness is that the value function is premised on the I.T. Dashboard Data's representation of quality, which could be different outside of I.T. categories. The qualitative value of I.T. could be subjective and speculative, perhaps more than other industries. Although this might result in bias on the value func-

126. *See id.* at 29.
127. *Id.* at 3.
128. Indirect inference is a methodology that matches regression coefficients in actual and simulated data. *Id.* at 58.
129. *Id.*
130. Please refer to Liebman & Mahoney's paper for a complete discussion on their methodology. *See id.*
131. *Id.* at 3–4.
132. *Id.* at 4.
133. *Id.*
134. *See id.* at 4.
135. For an in-depth discussion, *see id.* at 58–60.
136. *Id.*

tion, without better means of determining the subjective value of quality, Liebman and Mahoney are left with few alternatives.

A current hurdle to the "spend it or lose it" status quo is that "Congress favors one-year obligation[s] because it gives members control over agencies and flexibility for Congress to review and change funding and policy . . . ."[137] Granting agencies the authority to use funds beyond a year would require Congress to relinquish some control with respect to reviewing and changing funding and policy. The concern is that agencies could use the saved funds from the previous years to offset the current budget, allowing agencies to pursue agendas that are outside of the congressional aim.

Congress members should not fear loss of control from adopting an extended obligation period, however, because most of the budget process remains intact, in contrast to multi-year forms of budgeting. For example, biennial budgeting is a budgeting framework in which Congress proposes a two-year budget instead of a one-year budget.[138] Biennial budgeting is not the same as a two-year obligation period because "it does not affect the annual budget process, only the time allowed for execution."[139] State and municipal governments have successfully extended the obligation period without problems for the state and municipal lawmakers.[140] Extending the obligation would still allow Congress to control fiscal use of the funds while increasing the value of the funds appropriated to the federal agencies.[141]

B. Carryover Incentive Plan: Credits for Onetime or Emergency Use

Alternatively, McPherson proposes the "carryover incentive," where agencies retain "previous-year authority for onetime or emergency use for the next twelve months."[142] In contrast to the previously discussed budgetary rollover, the "carryover incentive" is limited to onetime use or emergency situations in the form of credits.[143] Furthermore, the Carryover Incentive Plan would still require federal agencies to close their budget at the end of the year.[144]

137. McPherson, *supra* note 3, at 28.
138. Roy T. Meyers, *Biennial Budgeting* 1 (Cong. Budget Office Staff Working Paper, 1987), https://www.cbo.gov/sites/default/files/100th-congress-1987-1988/reports/87-cbo-002_0.pdf.
139. McPherson, *supra* note 3, at 28.
140. *See id.*
141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.*

This plan would make the actual agency baseline more visible and enhance accurate planning for agencies. A current dilemma in the federal government is that "exigencies constantly throw budgets off, making a real baseline nearly impossible to determine."[145] The carryover initiatives would establish "a separate pool of authority to pay for one-time and emergency funding [that] would clarify the agency baseline."[146] Furthermore, while merely extending the obligation period "would mask the actual baseline needs of the agency[,]" the carryover incentive resolves this problem because it only authorizes funding under one-time and emergency funding, which should be easy to track.[147] The separate pool "would stabilize agency budgets and allow managers to plan more accurately."[148] In other words, the funds carried over to the next year would offset certain needs for the next year, which creates administrative difficulties in distinguishing the actual baseline need. This could apply even if the carryover were limited to certain categories of goods and services because of the grey areas. For example, an agency may use I.T. funds for construction funds because the expense is for infrastructural I.T. goods. Another advantage is that the carryover initiative would not shock the budgetary decisions the subsequent year because "[t]he actual amount carried over would represent a very small portion of the actual budget, and limits could be placed on how much could be carried over."[149]

Nevertheless, McPherson notes that the carryover incentive has drawbacks.[150] Firstly, the carryover incentive may limit other agencies that have greater use for the funds from accessing the funds.[151] The current system provides higher-level agencies the authority to channel the funds to other subordinate agencies.[152] Another drawback is that the carryover incentive may reward agencies that generate surplus funds from poor planning.[153]

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145. *Id.*
146. *Id.*
147. *See id.*
148. *See id.*
149. *See id.*
150. *See id.*
151. *See id.* at 31–32.
152. *See id.* at 31.
153. *See id.* at 32.

C. The Oklahoma Plan: Legislation Can Discontinue the 16.5-Month Rollover, Which Is Limited to Non-Recurring Purchases

In 1997, Oklahoma adopted a carryover program in response to the year-end spending surge.[154] Believing that the requirement for the Oklahoma agencies to return unobligated funds back to the state treasury caused the year-end spending surge, the Oklahoma government created a new plan that "allowed agencies to retain unspent appropriations for up to 16.5 months beyond the end of the fiscal year, effectively opening an appropriation window of 28.5 months to obligate annual appropriations."[155] The Oklahoma legislature "specifically used the term 'surplus funds,' which gave it the flexibility to discontinue granting carryover appropriations if the agencies generated more carryover money than they really needed or took part in unacceptable spending practices."[156] The carryover funds were limited to non-recurring purchases in order to ensure that funding would not go to regular operating expenses.[157] In effect, the Oklahoma agencies are given "a buffer to pay for one-time expenses they would have previously used current-year appropriations for. This buffer has stabilized budget execution and made it more predictable."[158] Under Liebman and Mahoney's analysis, Oklahoma agencies would have a greater incentive to save the previous year by avoiding year-end surge spending because they can instead save and spend the following year on one-time purchases on areas the legislation may not have been able to afford.

D. Washington State's SIP: Indefinite Taxed Rollover that Funds Education and is Limited to Customer Service

Washington State's Savings Initiative Program (SIP) is another successful carryover plan.[159] Under SIP, Washington agencies had the authority "to keep a portion of their unobligated balance from each fiscal year . . . ."[160] The agencies keep half of the non-earmarked funds while all of the earmarked funds go to education construction.[161] The state treasurer then moves the unobligated funds to a savings account, which accrues short-term interest so that the funds do

154. James W. Douglas & Aimee L. Franklin, *Putting the Brakes on the Rush to Spend Down End-of-Year Balances: Carryover Money in Oklahoma State Agencies*, 26 PUB. BUDGETING & FIN. 46, 54 (2006).
155. *See id.*
156. *See id. at* 46.
157. McPherson, *supra* note 3, at 32–33.
158. *Id.* at 33.
159. *Id.* at 34.
160. *See id.*
161. *Id.* at 35.

not lose value from inflation.[162] The saved funds do not expire and accrue indefinitely, which allows the agencies to save funds for goods or services they were previously unable to afford.[163] The agencies have considerable discretion in use of credits and are encouraged to strategically plan the use of credits "even if it means waiting up to ten years or more, as it is the case for a quarter of the agencies."[164] The state legislature retains the authority to remove or transfer the funds.[165]

The Washington legislature placed limitations on the use of the funds credited to the agency.[166] Specifically, funds may only be used for "improving service to customers[,]" with the "justification expectations [to be][ ] fairly loose" for one-time expenses.[167] Examples include employee training, improving technology, or enhancing efficiency.[168] Agencies may not use the credits for ongoing programs.[169]

Because the Washington State agencies keep half of the non-earmarked funds, the agencies have an incentive to save their unobligated funds, rather than spend it on purchases that add little value.[170] Between 1997 and 2006, the educational savings account received over $311 million, while the agencies received a credit of $44.7 million, with the agencies only using 22.6% of the credits.[171] There is discrepancy on the year-end savings, with some agencies having significant amounts of savings, while other agencies do not have enough yearly savings to be affected by the program.[172] Of the fifty-one agencies surveyed as part of a state-mandated survey, "[n]one of the 51 agencies reported a negative impact[,] . . . [o]ne third of the agencies (17 of 51) stated that it had a positive impact," and the remaining agencies reported little or no impact because the agencies "have always used their money prudently" or "needed every penny and had none left unobligated."[173]

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162. *Id.*
163. *Id.*
164. *Id.* at 36.
165. *Id.* at 35.
166. *See id.* at 36.
167. *Id.*
168. *See id.*
169. *Id.*
170. *Id.* at 35.
171. *Id.* at 35.
172. *Id.*
173. *Id.*

The SIP not only saves on year-end spending, but also reduces the incentive to spend throughout the year.[174] Furthermore, the Washington State legislation has not reduced the agencies' budget as a reaction to the surplus to encourage agencies to continue to participate in the Savings Initiative Program.[175] Both the Washington State executive and legislative branches seek to preserve the incentive to participate in the Savings Initiative Program because of the substantial education benefits from this program.[176]

IV.
Alternative Approach that Could Mitigate the Detrimental Effects of the "Spend It or Lose It" Policy

Combining the effective parts of the various budgetary rollover plans employed by the organizations discussed in Part III, I will propose an alternative budgetary rollover plan ("the Indefinite Rollover Plan") that could further mitigate the negative effects of the "spend it or lose it" policy. I propose replacing the "spend it or lose it" policy with a system with an indefinite rollover period for unobligated funds that is limited to emergencies and one-time spending. Furthermore, Congress should tax the saved funds and channel the taxed funds to other programs that have greater utility.

Part IV.A will discuss the optimal length of the period that the Indefinite Rollover Plan should extend for agencies to obligate their funds. Part IV.B will address any limitations on the use of funds. In Part IV.C, I will address the idea of taxing the saved funds and discuss where Congress can use the saved funds. In Part IV.D, I will address the constitutional limitations of congressional authority over the Indefinite Rollover Plan. Part IV.E will introduce two mechanisms that can allow Congress to cut the agency budgets without undermining agency incentives to save. Finally, Part IV.F will summarize my proposed plan.

A. *Indefinite Obligation Period as the Optimal Length*

Given proper limitations, discussed in the next section, the most social-welfare optimizing approach is to have an indefinite rollover period. Not only does an indefinite rollover period maximize the value of agency funding and reduce monitoring costs, but it also encourages strategic saving and shows the true budget baseline. Although Con-

174. *See id.* at 36–37.
175. *See id.* at 37.
176. *See id.*

gress should not take drastic action to cut funds immediately after the true baseline becomes apparent, as I later discuss, it should give Congress some guidance on the actual needs of an agency and redirect its budget appropriations accordingly.

Liebman and Mahoney's study suggests that the optimal period of extension for fund obligation ("extended obligation period") is four months or slightly longer. Liebman and Mahoney predicts that "[a] one-month grace period achieves 41 percent of the welfare gains from full rollover; a two-month grace period achieves 66 percent; [a 3-month rollover period could achieve almost 75 percent;] and a four-month grace period 90 percent."[177] The marginal welfare gain after four months decreases steadily until it caps at around twelve months.[178]

In addition to the welfare gains under Liebman and Mahoney's model, four extra months allow agencies to better plan their budget because of the enhanced predictability of their subsequent-year budget. Generally, Congress does not pass the annual appropriations bills on time.[179] Every year, the budget may increase, remain the same, or decrease. With an additional four months, agencies will have the incentive to retain the funds and redirect the funds with better certainty. The overlap between the appropriation periods between two fiscal years would give room to readjust and direct funds as necessary in order to enhance efficiency.

Another benefit of an additional four-month period is that it may reduce principal-agent costs from supervision and monitoring. The federal agencies will value their funds more, which will encourage spending on higher-value goods and services at the end of the fiscal year. Therefore, less policing is required against frivolous expenditures.

Alternatively, Congress could set a longer extended obligation period, for instance, one year as proposed by Liebman and Mahoney, or 16.5 months under the Oklahoma Plan, so that it overlaps with the next fiscal year. In addition to the benefits under a four-month extension, a twelve-month extended obligation period should effectively eliminate, or make negligible, the value reduction caused by the "spend it or lose it" policy because the agencies are able to use the rollover funds for the entire duration of the subsequent year.[180] The prior-year surplus would offset the subsequent year's budget, which

177. *See* Liebman & Mahoney, *supra* note 2, at 4, 34.
178. *See id.* at 44.
179. *See id.* at 12.
180. *Id.* at 44.

should effectively make the value of the prior-year surplus the same as the current-year funds.

As for the upper-level cap, Washington State's SIP program, as previously discussed, shows that rollover plans with an indefinite extended obligation period are also possible. Although the welfare gains from the value of the funds may cap at twelve months, the advantage of an indefinite extended obligation period is the potential for the federal agencies to make use of the savings entrepreneurially.[181] If federal agencies can save funds strategically to purchase goods and services that it previously was unable to purchase, it should further encourage the agencies to take initiative to maximize savings. Federal agencies, in theory, would spend less on goods and services with less value in order to purchase future goods and services with higher value. This should ultimately lead to higher welfare as the agencies seek to optimize the value of their purchases over subsequent years.

Another advantage to an indefinite extended obligation period is that agencies are more likely to show their true baseline, as demonstrated by the Oklahoma Plan. With a one-year extended obligation period, the prior-year funds can only displace current-year funds. Thus, the agencies would save only to the extent that is required for the next year. If agencies can save indefinitely, then the agencies should seek to maximize savings each year, which would make the actual baseline more transparent.

Under the principal-agent framework, one issue with information hiding is continuity. Voters constantly reelect members of Congress, while federal employees generally remain in position.[182] Because of this arrangement, "agencies [have] develop[ed] fine maneuvering skills within Congress's system of controls," of which members of Congress may not be aware.[183] By enabling federal agencies to save, Congress alleviates this information-asymmetry dilemma by shifting the information needs to the agencies. The federal agencies would then use, rather than hide, this information to reduce expenditures.

For the reasons above, an indefinite period is the optimal choice with respect to efficient spending. However, the obvious problem with an indefinite extended obligation period is Congress's loss of control over budget expenditures as the federal agencies use the saved funds to grow beyond the scope of what Congress intended. If a federal agency can save indefinitely, then it may have the potential to build

181. *See* McPherson, *supra* note 3, at 35–36.
182. *Id.* at 22.
183. *See id.*

savings to the point where it can overcome significant budget cuts against Congress's will.[184] The solution to this problem is to limit the use of funds, as Washington State and Oklahoma have, so that the federal agencies do not grow beyond what the legislature intended.

B. Limiting Use of Saved Funds to Emergencies and One-Time Expenses

At least some degree of limitation is required for the use of the saved funds in order to prevent unwanted expansion of the federal agencies. If federal agencies had no limitations on the use of saved funds, the federal agencies could use the funds on operating expenses, which may fund projects or activities beyond what Congress intends. As discussed above, the Oklahoma and the Washington State plans both establish limitations by restricting use of funds for recurring expenses.[185] Under the Oklahoma Plan, the agencies are limited to using saved funds for one-time expenses.[186] The Washington State Plan, on the other hand, limits the use of saved funds to improving service to its customers with a lax justification requirement for one-time expenses.[187] Given that states have successfully adopted extended obligation periods with one-time expenses,[188] it seems unlikely that an agency could capitalize on a one-time consumption and drastically increase the scope of its operations.

The benefits of the one-time consumption should decrease shortly after the agency's consumption. Capital expenses, on the other hand, could significantly enhance the efficiency of the agency so that the agency can reallocate its work force to other areas. However, Congress could restrict agencies from this expansion in two ways. Congress could disallow agencies from shifting the work force caused by enhanced efficiency from the one-time expenses. Alternatively, Congress could reevaluate the agency's use of workforce as it determines the next year's budget. Thus, restricting the use of saved funds to one-time expenses should resolve the concern of unwanted agency expansion.

Congress should also allow the use of saved funds for emergency use. McPherson's Carryover Incentive Plan, in addition to one-time

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184. One-year savings alone would not be a large portion of the actual budget. The savings should only become substantial as the savings build. *See id.* at 28.
185. *Id.* at 32–33, 36.
186. *Id.* at 32–33.
187. *Id.* at 36.
188. *E.g.*, Washington State and Oklahoma. *See supra* notes 185–87.

use, proposes to allow the saved funds for emergency use.[189] The advantage of using saved funds for emergencies is that it helps stabilize and enhance the predictability of the agencies' budget as the actual baseline need becomes more apparent.[190] Under the current system, emergencies often arise throughout the year, which makes the estimated baseline inaccurate.[191]

Therefore, limiting the use of savings to one-time expenses and emergencies is a risk-averse course of action that mitigates unwanted agency expansion. Because the Oklahoma Plan and the Washington SIP have both tested this extended obligation with success on one-time expenses, Congress should opt for this approach. Further, there is also no reason to exempt emergencies, unless the "emergency" is recurring and labelled as such to expand federal agency reach.

C. Taxing the Saved Funds

Congress does not need to allow the federal agencies to retain all of the saved funds. Instead, Congress could "tax" the saved funds and funnel the taxed funds to another program or allow the taxed funds to expire. As previously discussed, the Washington State's SIP funnels expired earmarked funds to education construction and allows agencies to keep half of the non-earmarked funds.[192] Because the Washington State agencies kept only half of the non-earmarked funds and relinquished all of the earmarked funds, the state agencies under the SIP ended up with less than fifteen percent of the total amount saved.[193] Nonetheless, Washington State agencies still maintain a strong incentive to save funds.[194]

Congress could vary the "tax rate" for saved funds depending on the congressional priorities. A tax would decrease the agency's valuation of the excess funds at the end of the fiscal year. An agency with a fifty percent tax on September 30 would value its excess funds at roughly half of the value of an agency without a tax on September 30. However, Congress could use the taxed funds on other projects. Therefore, if Congress wishes for agencies to maximize savings, it should keep a low budgetary tax rate, whereas if Congress wishes to maximize funding, it would need to strike a carefully balanced tax rate that maximizes the return on saved funds.

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189. McPherson, *supra* note 3, at 28.
190. *See id.*
191. *See id.*
192. *Id.* at 34.
193. *See id.* at 35.
194. *See id.* at 37.

Congress could use the taxed funds in several ways. For example, Congress could allow the taxed funds to expire, such that it would then follow the normal budgetary processes in place today. Another option is to retransfer the funds among the federal agencies so that marginal need for each dollar is the same among the various agencies. This approach would be the most "fair" as the redistribution would best match the agency's real "needs." However, the critical weakness to this approach is that providing additional funds to an agency for not generating savings would deter agencies from saving.

Alternatively, Congress could use the taxed funds on underfunded areas, such as Washington State's use of saved funds on education programs. There are three advantages to this approach. First, this approach will increase the likelihood of a rollover bill passing in Congress so long as the drafters allocate the gains from saved funds so that it benefits most of the Congress members. For example, redistributing the taxed funds to the states should enhance the likelihood of the bill passing. If most members of Congress place high priority on healthcare, redistributing the saved funds to healthcare programs would support the bill. A second advantage is that this approach will increase social welfare as the taxed funds are redistributed to areas where funding is needed the most. Finally, this approach would not undermine agency incentives to save, and may even increase the agency's incentive to save. For example, if Congress uses the taxed funds to fight cancer, we would hope that the public servants at federal agencies would value these taxed funds at a rate greater than zero.

D. Limitations on Congressional Authority over the Indefinite Rollover Plan

One way to ensure legislative control over the budget is for the legislature to have the authority to seize the saved funds. Although this idea may serve as an effective safety net at the state level, Congress runs into a constitutional separation of powers issue under *I.N.S. v. Chadha*, a case in which the Supreme Court of the United States declared legislative vetoes unconstitutional.[195] A legislative veto "is a procedural device that permits Congress to control executive or agency actions outside the ordinary legislative process."[196] Thus, if Congress authorizes the executive federal agencies to use prior-year

195. I.N.S. v. Chadha, 462 U.S. 919, 959 (1983).
196. David A. Martin, *The Legislative Veto and the Responsible Exercise of Congressional Power*, 68 VA. L. REV. 253, 256 (1982).

funds, being able to raid or deny the federal agencies that power subsequently may violate *Chadha* because the raid or denial could amount to a legislative veto.

Congress may avoid the *Chadha* issue in two ways. First, Congress could raid or deny the federal agencies the saved funds through the ordinary legislative process. However, this process could become time consuming. Alternatively, Congress may still protect its authority by reserving the right to reduce the subsequent-year's budget by the amount saved from the prior year. This approach should avoid the *Chadha* issue because Congress does not deny the federal agencies the power to use its saved funds. It merely denies funding that the federal agencies are not yet entitled to. Furthermore, because yearly budget authorization is already the status quo, Congress would not have to deal with the saved funds separately—it would become merged with the current budget appropriation process. However, Congress must exercise care when cutting budgets the subsequent year because this would rob the agencies of the incentive to save.

E. Cutting Agency Budgets Without Destroying Incentives

Policymakers must place mechanisms that prevent budgetary surplus as grounds to reduce funding the subsequent year. Suppose Congress uses the budgetary surplus as a signal that the baseline need of the federal agency with the surplus is actually lower, and then reduces the agency's funding the subsequent year. This action will effectively remove the agency's incentive to save because the federal agencies will receive less long-run future funding for each subsequent year. Thus, its long-term loss is far greater when saving under this approach.

On the other hand, a budgetary surplus does in fact highly suggest that the baseline need is indeed lower than initially estimated. If an agency truly requires all of its allocated funds, then it will not generate surplus funds. Allowing agencies with a high budgetary surplus to sustain this surplus is wasteful. Two theoretical mechanisms could both reduce the surplus budget without drastically reducing the agency's incentive to save. One theoretical mechanism is to disallow consideration of the budgetary surplus when deciding future budgets until the department head leaves office. Under this approach, the department heads do not suffer the direct consequences of a budget cut because of their savings, which should allow the department heads to save without suffering the repercussions of the subsequent budget cut.

Another theoretical approach is to reduce the budget incrementally and proportionately to the savings over a length of time.

Under the theory of economic exponential discounting and hyperbolic discounting,[197] individuals prefer near-term returns over long-term returns.[198] The decision-making officials in federal agencies and Congress are ultimately individuals, and thus are subject to the psychological phenomenon of discounting. Therefore, the agencies would value the immediate budgetary savings more than a long-term decrease in savings even when adjusted for inflation.

Let us assume there is no inflation and an agency saves $100 million in year zero, and therefore Congress assumes the baseline need is $100 million less than the current amount. All other factors equal, Congress should keep the year one budget the same until the end of the year to avoid offsetting the savings from year zero,[199] which would decrease the agency's incentive to save. However, starting at the end of year one, Congress could reduce the budget by a certain amount so that the agency's incentives to save remain greater in year one than incentives not to save. Congress should announce the program at or before the start of year zero to avoid undermining the credibility of the program.

One way of reducing the budget is to decrease the budget by the discount factor.[200] Assume that the discount factors,[201] which decrease the value of future budgets, are fifty percent in year one, thirty percent in year two, twenty-five percent in year three, and ten percent in year four. Congress could reduce the budget by $50 million at the end of year one, further reduce this so that year two's valuation is thirty percent of the original amount, or $30 million, at the end of year two, and so on. The following are two tables with savings and without savings.

197. Economists commonly use discounting to evaluate intertemporal preferences of rational individuals.

198. *See* Maureen Cropper & David Laibson, *The Implications of Hyperbolic Discounting for Project Evaluation* 3 (The World Bank Dev. Research Grp. Env't & Infrastructure, Working Paper No. 1943, 1998), https://www.econ.umd.edu/sites/www.econ.umd.edu/files/pubs/jc41.pdf.

199. Because the savings would occur at the *end* of year zero, Congress should hold off on any action until the next year.

200. Although I use the discount factor to adjust the nominal budget, this usage is arbitrary. Any adjustment is acceptable as long as the aggregate present value is greater than the aggregate budget without the savings.

201. Discount rates measure the rate of decrease; discount factors measure the amount multiplied to get the present value.

TABLE 1: EXAMPLE BUDGET WITHOUT SAVINGS
(IN MILLIONS OF DOLLARS)

	Year 0	Year 1	Year 2	Year 3	Year 4	Total
Nominal Budget	100	100	100	100	100	500
Discount Factor	1	.5	.3	.25	.1	
Real Budget	100	50	30	25	10	215

TABLE 2: EXAMPLE BUDGET WITH SAVINGS
(IN MILLIONS OF DOLLARS)

	Year 0	Year 1	Year 2	Year 3	Year 4	Total
Nominal Budget	200 (additional 100 from savings)	50	30	25	10	315
Discount Factor	1	.5	.3	.25	.1	
Real Budget	200	25	9	6.25	1	241

In this example, although Congress spends $185 million less over the aggregate five years, the agency values the extra $100 million in year zero from savings more than the value decreased. Saving at the end of year zero offsets the reduced budget in the following years. However, an important caveat is that while this approach may work in the short term, it may not work for longer periods. Eventually, the nominal budget needs to return to ordinary levels as the reduced budget offsets the benefits from the extra income in year zero. Therefore, this mechanism is most useful for short-term budget reduction.

Congress could use any one of these two mechanisms, or both, to produce an effective solution for budget reduction without severely undermining agency incentives. For example, if Congress's main priority is to cut budgets, then Congress could enact legislation that adjusts the above-baseline-need amount by the discount factor each year until the department head leaves office, and then completely remove the above-baseline-need amount. On the other hand, if Congress wishes to grant agencies the discretion to exercise entrepreneurialism, Congress could simply use a more lax discount factor when reducing agency budgets.

F. Summary of the Proposed Plan

If the primary goal of Congress for federal agencies is to encourage saving and enhance the quality of spending, then the obvious choice is to eliminate the "spend it or lose it" policy. However, under the principal-agent analysis, Congress is not a unified body sharing the same objective.[202] Each senator and representative of Congress is a principal, who serves his or her own best interests.[203] The interests of certain members of Congress may not coincide with the goal of budget saving. For example, some Congress members benefit from the current system "because it enables devices such as earmarks and other tools for Congressional representatives to fund project[s] that are advantageous to their constituents."[204] Congress should want its agents to avoid using funds without a bona fide need and instead allow the funds to expire.[205] However, "many congressmen resist this argument because the authority would remain unavailable for five years," and "many [congressmen] will be out of office and the savings will not [be] useful to them."[206] Because Congress is composed of numerous individuals with self-serving agendas,[207] which generally involve winning the approval of their constituents, overcoming the congressional hurdle may be difficult. My alternative approach, however, overcomes this congressional hurdle by using the taxed savings to win votes by funneling the agency-saved funds to various programs that the Congress members can support.

However, mechanisms must remain in place to continue agency incentives to save. First, the tax rate must not be so high that the agencies are discouraged to save. Although further studies are needed before determining the optimal rate, Washington SIP could serve as a benchmark for the appropriate amount, which is half of non-earmarked funds. Ultimately, the agencies retained only fifteen percent of the total savings, but retained a strong incentive to save. Second, Congress must not use the saved funds as grounds for a budget cut. Instead, Congress could avoid cutting funds for the duration of the department head's term or incrementally reduce the budget over time, carefully weighing the discount rate for the agencies.

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202. McPherson, *supra* note 3, at 21.
203. *Id.*
204. *Id.*
205. *Id.* at 22.
206. *Id.*
207. As implied under the principal-agent theory. It is possible some congress members are altruistic and not self-serving.

In order to optimize social efficiency, Congress should opt for an indefinite obligation period with limitations. With appropriate limitations, Congress can prevent agencies from expanding beyond what Congress desires, while ensuring agencies seek to optimize use of funds. This approach would have overwhelming advantages over the current "spend it or lose it" policy. Social welfare will improve because federal agencies will use their funds on higher-quality goods and services. Transparency would increase as the agencies spend fewer resources on frivolous expenses. With enhanced transparency, Congress could then readjust the current baseline need closer to the actual baseline need. Finally, federal agencies would require less supervision and monitoring on frivolous expenditures, which would reduce costs for both Congress and the agencies.

When federal agencies are able to save for rainy days, they face less risk because the banked funds help cushion them from the necessary expenses arising from unexpected exigencies, and Congress will need to provide fewer future emergency funds. Thus, the overall government expenditures should decrease as the federal agencies use less discretionary spending this year, and Congress uses less emergency spending next year.

The alternative system I propose could provide tremendous benefits. For every one percent the federal agencies collectively save on discretionary spending, over $20 billion are available for use between the federal agencies and Congress. Congress could "tax" these funds and use the proceeds for underfunded projects. As a result, the funds that the federal agencies would otherwise use for frivolous goods and services convert to funds that directly enhance social welfare. By maintaining the status quo of the "spend it or lose it" policy, Congress squanders billions of dollars with little benefit. Under my proposed approach, Congress would both reduce current and future expenditures by federal agencies and gain funds for other socially beneficial projects.