The Heritage Foundation Backgrounder

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BALANCED BUDGETS, SPENDING LIMITATIONS, AND THE ECONOMY

INTRODUCTION

The proposal to amend the Constitution with a balanced budget requirement is no longer a notion appealing only to a philosophical minority. The economic trends and political temper of recent times have made it an issue with tremendous popular appeal. The pressure from the public, the states, and some of its own members will force Congress to confront this issue.

As the momentum for a balanced budget amendment has increased, both proponents and the opposition have become more impassioned. The balanced budget is for some a panacea, solving all of the economic ills of today. To others it is a prescription for economic disaster and social chaos. This study will examine some of the economic implications and also look at some congressional proposals.

MACROECONOMIC ISSUES

Certainly one of the major points of debate is the effect of a balanced budget upon economic performance. The argument encompasses not only such purely economic issues as inflation and growth but also philosophical or social questions such as the amendment's effect on the poor.

Excessive Spending

A major factor in the move for a balanced budget has been the public's perception of government spending as excessive and politically motivated. The chronic deficits are often cited as evidence of the government's inability to restrain itself. For instance, since 1961, the federal budget has been in deficit 19 times and

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produced a surplus only once. During the past four years (1976-79), Congress has defied conventional economic theory and accumulated $193.4 billion in deficits during a remarkably robust recovery.

The public often complains that since households must balance their budgets, it is only fair that the government also do so. Critics dismiss this idea as both naive and erroneous. They observe that households engage in deficit spending when purchasing a home or car. Furthermore, consumer debt has, since 1950, grown at a rate faster than federal debt.

These criticisms miss the point. Households must balance their budgets over a segment of time. The federal government does not operate on the same principle. Unlike households, the government can pass its debt on to future generations. Its debt horizon is seemingly infinite, while its budgeting horizon rarely extends beyond the next year.

The knowledge that future Congresses must absorb the cost of this year's deficit makes the professionally myopic legislator less restrained in spending choices. Programs initiated in the present will be paid for in the future. The FY 1980 legacy of past Congresses is the $57 billion in interest payments on the national debt. This sum is nearly double the projected budget deficit and is more money than will be spent on education, training, employment, social services, transportation, and energy combined.

The ability to incur a deficit presents Congress with a strong political temptation to do so. Theoretically, Congress should spend until the benefits of each additional expenditure are equal to the cost of financing that expenditure. Under a balanced budget amendment, the public's reluctance to be taxed would act as a natural brake on government spending. If, for example, the government attempted to extend spending beyond the point where benefits equalled costs, the public's dissatisfaction with the additional taxes would exceed the benefits of the expenditures. Expenditures beyond the benefit-cost equilibrium, when financed through a deficit, appear costless. No additional taxes are levied and thus the restraining influence is lost. Congress is permitted to enjoy the benefits of deficit spending while ignoring the costs, inflation and slow economic growth.

Inflation

To Congress, the budget deficit appears costless. In reality this is not the case. Over thirty years ago, in the heyday of the Keynesian Revolution, Colin Clark theorized that when the public refused to support additional expenditures through taxes, governments would finance additional spending through inflation.[1] Although there is no statistical correlation between deficits and

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1. Colin Clark, "Public Finance and Changes in the Value of Money," The Economic Journal, 1945.

inflation, there does exist a strong relationship between inflation and the money supply. The Federal Reserve accommodates federal deficits by expanding the money supply and thus creating inflation. Clark also hypothesized the deficit-inspired inflation would become chronic. Recent shifts in consumer behavior suggest that the public now perceives inflation as a permanent state. In previous inflationary episodes households reduced consumption, increased savings, and waited out the inflation. Currently households are increasing consumption, reducing savings, and undertaking unprecedented levels of debt.

Economic Growth

Another significant cost imposed by the deficits is slower economic growth. In addition to inflationary increases in the money supply, deficits may be financed through borrowing from the public. The persistent deficits and the borrowing needs of the government "crowd out" the private sector in the financial market. Funds which would have been used to finance capital investment are diverted in support of the deficit. The result has been a range of economic ills, including an absence of private investment and a subsequent decline in productivity. The inflation-induced reductions in personal savings portend even greater difficulty for the private sector in obtaining funds.

The federal deficit also contributes to the decline of the foreign exchange value of the dollar. Over twenty percent of the national debt is in foreign hands. The interest payment on this debt adds to the U.S. balance of payment deficit and ultimately leads to pressure against the dollar.

Fiscal Policy

A balanced budget requirement would effectively eliminate the government's ability to undertake discretionary countercyclical policy. In that event, critics foresee an economy careening recklessly out of control, with a decided inclination toward recession. This scenario is unrealistic for a variety of, occasionally exclusive, reasons. First, it is based on benign assumptions about both the intent and effectiveness of fiscal policy. Secondly, it ignores the capacity of monetary policy to perform in a countercyclical manner. Finally, there is evidence which suggests that the private sector is inherently stable and that efforts to "fine tune" are, in practice, destabilizing.

Fiscal policy is based on the belief that the government can smooth out the business cycle. In times of faltering private demand, the government promotes expansion by spending in excess of receipts. Conversely, when demand threatens to burst into inflation, the government reduces demand by cutting expenditures and raising taxes, and thereby producing a budget surplus.

The recent unsymmetrical application of fiscal policy indicates that elected officials find its political uses more compelling than its economic application. Fiscal policy serves not only as a guise for excessive spending, but also as a tool in electoral politics. William D. Nordhaus of Yale University has found that U.S. macro-economic policy, under both political parties, has been manipulated on a cycle corresponding to the four-year presidential term.[2]

The efficacy of fiscal policy, even when pursued with the purest of motives, has become increasingly suspect. There has developed in recent years a prominent school of economic thought known as "rational expectations." Adherents believe that stabilization policies fail because they are based on the proposition that the public can be repeatedly fooled. For example, policymakers attempt to stimulate the economy through a tax cut. The public, believing income has increased, will spend more. However, if government spending is not reduced in concert with the tax cut, the perceived rise in income will be illusory. The large deficits, interest costs, inflation, and future tax rises will eliminate the benefits of the tax cut. The "rational expectations" school believes that after a number of such tax cuts, the public will anticipate the longer term effects and not respond in the expected manner. The intended effect of the tax cut will then be lost. Expansionary monetary policy and federal spending increases will meet the same fate.

The growing acceptance of the rational expectations school is indicative of a quiet revolution within the economics profession. Fortune, in a random sample of economics professors in the southeast, mid-west, and southwest, uncovered some startling changes within the profession. Over 80 percent of the respondents expressed "less confidence in the ability of the government to fine tune the economy." Nearly all, in the past five years, have changed their approach in teaching economics. Perhaps the most telling point is the comment of Otto Eckstein of Harvard University and Data Resources Inc. "Economists no longer believe that some blissful state can be achieved by demand management. Unfortunately that hasn't penetrated to the Brookings Institution or the White House -- they're both ten years behind academic thought in fiscal policy."[3]

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2. William D. Nordhaus, "The Political Business Cycle," Review of Economic Studies, Vol. 42, (April) 1975.

3. Fortune, December 31, 1978, p. 77.

THE FORTUNE POLL[4]

	Yes
* Is there a sense of lost moorings in economics?	66%
* Increasing doubt about the accuracy of macroeconomic models?.	75%
* Less confidence in the ability of the government to fine-tune the economy?	82%
* Less confidence in government programs as solutions to economic problems?	87%
* Are you teaching economics differently than you did five years ago?	98%

Despite the loss of fiscal policy, a balanced budget would not preclude the use of countercyclical economic policy. Still remaining would be the government's ability to manipulate the nation's money supply, known as monetary policy. In a landmark study, Leonall C. Andersen and Jerry L. Jordan, both at that time with the Federal Reserve Bank of St. Louis, found that monetary policy was superior to fiscal policy in terms of strength, speed, and predictability.[5] Examination of the 1960s policy record offers confirmation. Only twice did the government engage in contradictory monetary and fiscal policies. In 1965 and again in 1968, the effects of monetary policy overwhelmed fiscal effects, much to the surprise and anguish of the policymakers.

Both fiscal and monetary policy are based on the depression-inspired belief that the private sector is unstable. Proponents of stabilization policies have argued that the government must continually intervene to avert erratic and harmful economic cycles.

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4. Ibid., p. 77.

5. Leonall C. Andersen and Jerry L. Jordan, "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization," Federal Reserve Bank of St. Louis Review, November 1968.

The reawakening of the economics profession to the importance of money has brought with it a recognition of the inherent stability of the private sector.[6] Private demand, which is dependent upon the money supply, is relatively stable. Fluctuations are caused by changes in the money supply, under the control of the Federal Reserve, and erratic fiscal policy.

BALANCED BUDGETS AND THE POOR

An implicit purpose of the balanced budget amendment is to reduce the growth in government spending. A belief shared by both proponents and opponents is that Congress will slow the growth in government spending to match tax receipts, rather than increasing taxes to match the growth in spending. Opponents of the amendment charge that any restriction on government outlays would be felt primarily by the poor and underprivileged. This view claims that a balanced budget requirement would represent an abdication of the social responsibility of the government and a reversal of Western tradition.

Ironically, both pro and con forces share a common outlook concerning congressional responsibility. Proponents of the amendment believe it necessary to curtail Congress' fiscal irresponsibility. Opponents believe that because of Congress' irresponsibility the interests of the poor will be subservient to more politically remunerative projects.

It is important to realize that nearly all balanced budget and spending limitation measures would not require a cut in existing services, but merely impose a limit on the growth of expenditures. The current services budget, a projection of revenues and outlays at existing levels, including those tied to inflation, will be in balance in 1982. The possibility that any constitutional amendment could take effect before then is small. It would, however, behoove Congress to prepare.

An implicit but essential element of the claim that the poor will suffer under a balanced budget is the proposition that welfare and income security are low priority items. That proposition bears little resemblance to reality. Federal expenditures for income security, which includes programs such as social security, unemployment insurance, food stamps, and child nutrition, has risen from 21.9 percent of total budget outlays in 1970 to 33.7 percent in 1980. Health outlays have risen from 6.6 percent in 1970 to 10 percent in 1980. Both the size and growth of these functions present a strong case that welfare is a high priority expenditure. It is difficult to accept the proposition that high priority expenditures will suffer under a balanced budget.

The charge that national security will absorb the brunt of the fiscal restraint appears more plausible. Defense outlays have decreased from 40 percent of total outlays in 1970 to 23.7 percent in 1980.

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6. Thomas Mayer, The Structure of Monetarism (New York: W. W. Norton & Company, 1978), p. 14.

BALANCED BUDGET AMENDMENTS

Balanced budget amendments possess a great popular appeal. The concept is simple and easily understood. Yet it is this simplicity which creates many practical difficulties. A proposed amendment might be judged on how well it confronts the following obstacles.

Reversibility: A constitutional amendment mandating a balanced budget could, in the event of war or economic catastrophe, render the government helpless. It is essential that any such amendment contain an escape clause.

Definition: Perhaps the most insistent criticism of the balanced budget concept is that it is undefinable. It is charged that the Congress will evade the intent of the amendment by removing spending programs from the budget. Many state governments, bound by law to a balanced budget can in practice run a deficit through the separation of current and capital expenditures. If a balanced budget is instituted, some claim, Congress will follow the states' lead.

The problem of definition, while real, can be overestimated. Although most of the balanced budget amendments do not define what is meant by the terms "outlays" or "expenditures," informal definitions of these terms do exist. Furthermore, actions such as taking on-budget items off budget would be identifiable as attempts to evade the constitution. Skeptics must make a case for not only congressional defiance of the Constitution but also for judicial approval, a more difficult proposition.

Economic Forecasts: Congress presents its budget on May 15, four and one-half months before the fiscal year begins. Projections of both revenues and expenditures are reliant upon economic forecasts, and thus are somewhat tentative. It is quite possible that a budget balanced in May, or even September, when the second resolution is adopted, will become unbalanced during the course of the fiscal year.

Enforcement: The final consideration is enforcement. Projecting revenues and outlays is an inexact science. Just as economic forecast accepted in good faith, can be in error, it is possible that revenue projections will be incorrect. If the budget is not in balance, should it be brought into balance? How, and by whom?

Lugar Amendment

Senator Richard G. Lugar (R-Ind.) has proposed a constitutional amendment (S.J. Res. 4) requiring that any concurrent resolution in which "total budget outlays" exceeds the "recommended level of federal revenues" must be approved by two-thirds vote in each House.

By definition this "supermajority" approach offers Congress sufficient flexibility to deal with any emergency. Total budget outlays, although not defined in the amendment, is a term commonly used in the budget document.

The Lugar amendment, because it applies to the concurrent resolution, is dependent upon economic forecast. This difficulty is mitigated by the need for two-thirds approval in each House. The vote will center about not only the budget but also economic assumptions. However, it is conceivable that members will vote for a balanced budget with unrealistically favorable assumptions.

Perhaps the most attractive point about the Lugar amendment is that is does not require adjustment after the fiscal year. The proposal is not intended to produce a strictly balanced budget but to make it more difficult for Congress to produce a deficit. The focus of attention is not on the final line, but rather on how that number is arrived at.

Stennis Amendment

Senator John C. Stennis (D-Miss.) has offered a constitutional amendment (S.J. Res. 6) which would require the president to determine and Congress to enact a tax surcharge to make up any deficit. The amendment permits the surplus to be suspended through a three-quarters vote of each House.

The Stennis amendment avoids the pitfalls of economic forecasts. It balances the budget after the fact. There are, however, flaws. It is quite possible that the timing of the surcharge might retard economic growth. If for instance a deficit was incurred during the low point of a business cycle, as is most likely, the tax surcharge assessed in the next calendar year might very well reduce aggregate demand and thus threaten the economy. Another consideration is that a series of small deficits which are quite possible even with the best of intentions might cause a more costly surcharge. The uncertainty regarding taxes might impede the private sector.

Proxmire Bill

Senator William Proxmire (D-Wis.) has introduced S. 331, a bill requiring the president to submit a budget balanced on the assumption of a 3 percent real growth rate. Should the actual rate of real growth exceed 3 percent, there would be a surplus. If the economy grew at a rate of less than 3 percent, the budget would be in deficit.

The advantage of such a proposal is that the budget is balanced over the business cycle. This concept has much greater economic validity than the yearly balance. Proxmire chose 3 percent because it is close to the nation's long-term average growth rate. The budget would become an automatic stabilizing device, in deficit when

growth is slow and in surplus when growth is rapid. Proxmire claims that if applied to the last 17 years, there would have been surpluses in 12 years, not just one.

The bill also avoids one of the major deficiencies of balanced budget proposals, the problem of economic forecasts. The forecast of real economic growth is irrelevant. However, an important variable is the rate of inflation. A budget balanced at the assumptions of 3 percent real growth and 4 percent inflation will differ from a budget based on assumptions of 3 percent real growth and 10 percent inflation.

The Proxmire bill has much to recommend it. A serious drawback is that it promises more than it can deliver. The bill requires only that the president submit such a budget. It offers no assurance that Congress will adopt it.

Heinz-Stone Amendment

Undoubtedly, the most explicit and comprehensive amendment was developed by the National Tax Limitation Committee and offered by Senators John H. Heinz III (R-Pa.) and Richard Stone (D-Fla.). The proposal is to link the growth rate of government expenditures with the growth rate in the nominal Gross National Product (G.N.P.) of the previous calendar year. Should the inflation rate be at or below 3 percent, government spending may grow at the same rate as had G.N.P.[7] If inflation exceeds 3 percent, the growth rate of government spending will be reduced by one-quarter of the difference between 3 percent and the actual rate of inflation. For example, nominal G.N.P. has increased by 10 percent with an inflation rate of 7 percent. Federal spending might then increase by 9 percent: 10 percent minus the 1 percent inflation penalty.

The amendment requires that any surplus be used to reduce the public debt. It also contains a clause permitting the outlays limit to be changed by a three-quarters vote of each House.

Finally, the amendment protects state and local governments by specifying that for the first six years after ratification federal grants must be continued at the same proportion as existed three years before ratification. Any reductions in grants after six years will lower federal spending limits. This would remove any incentive the federal government might have to gain at the expense of the states. The federal government is also prevented from mandating any additional state spending without providing the necessary funds.

The amendment very adeptly avoids the major pitfall of the balanced budget. Since outlays are based on the calendar year prior to the beginning of the fiscal year, the spending growth is based on

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7. For an interesting discussion of spending limitations, see Jeffrey T. Bergener, "Federal Spending Limitations: An Idea Whose Time Has Come?" Policy Review, Spring 1979.

actual data and not economic forecasts. The twenty-one month difference between the fiscal year and the calendar year on which it is based incorporates an automatic countercyclical element in federal spending. If, for instance, the economy peaks in 1979 outlay growth will be large in 1981 when the economy most likely will be slowing down. Conversely, slow G.N.P. growth will slow federal spending twenty-one months later when the economy is in a boom and growth in government demand may invite inflation.

The amendment also presents the federal government with a strong incentive to reduce inflation. A rate of inflation beyond three percent cuts into government spending. To maximize its spending, the government would attempt to minimize inflation. The link between real economic growth and government spending would also promote greater federal interest in promoting economic growth.

The spending limitation is superior to a balanced budget concept in all regards save one. The balanced budget is more flexible, a crucial difference. Under a spending limitation, federal expenditures are either a stable or declining proportion of G.N.P. The deficiency is that there is no reason to believe that the public-private sector mix, as desired by the taxpayers, will always be declining or stable. If, for example, the Soviet Union increased its military spending, the public might be very willing to surrender its resources to the public sector to bolster U.S. security. This could be easily achieved under a balanced budget by raising taxes. With a spending limitation, it would require an act of war or a declaration of a national emergency. Limitations on the declaration of an emergency and the time duration of an emergency might thwart a widely desired response. Military spending is merely one example of a possible change in the taxpayer's private-public preference.

CONCLUSION

The balanced budget concept possesses both political and economic virtues. The public's resistance to taxes will act as a counterweight to the political impulse to spend. The restrictions against deficits will prevent the casual commitment of the future's resources. Although a balanced budget does not guarantee an inflation-free society, the elimination of deficit spending would remove a major incentive for inflationary monetary policies. Finally, a balanced budget would free resources vitally needed by the private sector for investment. This latter point, which is usually the least emphasized, is perhaps the most important. It is the private sector which produces long-term economic growth and raises the nation's standard of living.

A balanced budget, while restricting spending, does not remove the pressures to spend. It might be anticipated that the government will attempt to satisfy these demands through other means. Guaranteed

loans or mandating that state government or the private sector make the outlays are two such avenues. They are, however, by no means inevitable. The same public pressure which produced a balanced budget amendment, can be brought against these instruments.

The balanced budget offers tremendous benefits at little risk. Despite the doomsayers, there is only one way to find out if it works: try it. Perhaps the most compelling argument in favor of the balanced budget is the alternative: to continue our present policy.

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