The Heritage Foundation Backgrounder

No. 1104

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The Thomas A. Roe Institute for Economic Policy Studies

February 19, 1997

WHY A TAX LIMITATION/BALANCED BUDGET AMENDMENT IS NEEDED TO CONTROL SPENDING

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INTRODUCTION

After nearly 30 consecutive years of deficit spending, Congress soon will vote on whether to add a balanced budget amendment to the Constitution. Should an amendment be approved by Congress and ratified by the states, the fiscal policy changes could be enormous. The objective of imposing such discipline is to balance the budget by reducing the size of government. A strong provision to limit taxes—such as a two-thirds supermajority requirement to raise taxes—would help ensure that politicians could not evade the amendment's intent by simply replacing debt-financed spending with tax-financed spending.

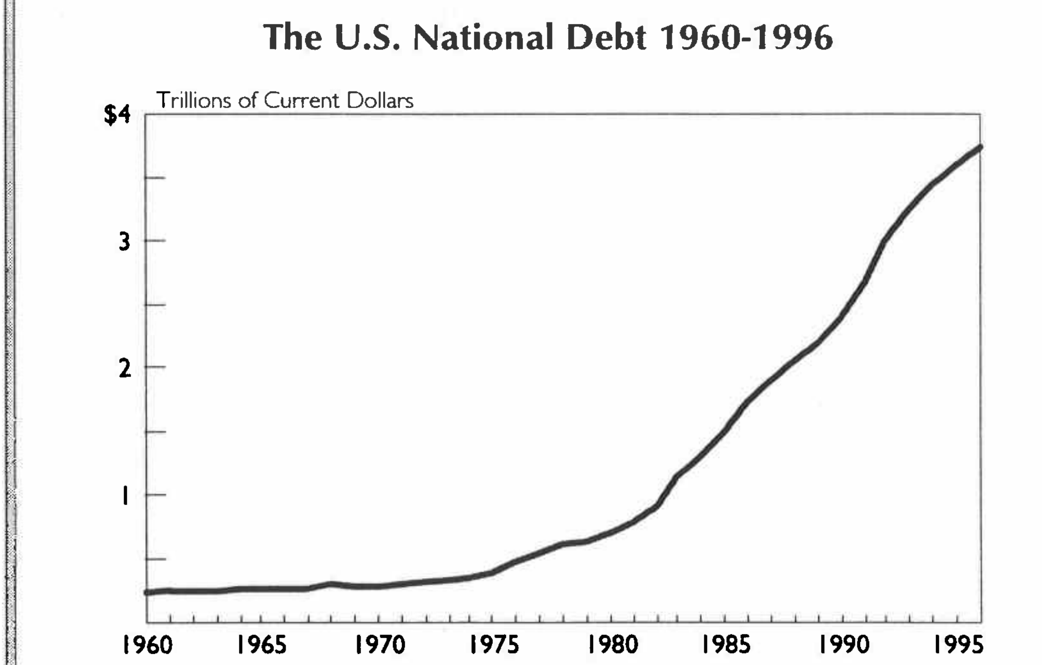
For much of America's history, government debt was kept under control. On those rare occasions on which budget deficits did occur, almost invariably because of war or economic downturn, lawmakers would approve budget surpluses in subsequent years. Unfortunately, beginning in the 1930s and culminating in the 1970s, this strong sense of fiscal responsibility was replaced by the view that deficit spending was good for the economy.

Armed with the rationale that more government would help the economy, politicians therefore were free to indulge in special-interest spending on an unprecedented scale. The fiscal policy consequences, not surprisingly, have been unpleasant. In particular:

- The annual budget today is nearly 18 times larger than it was in 1960.
- In inflation-adjusted dollars, government spending has tripled.

- Government is now spending nearly $6,100 for every man, woman, and child in America, up from $510 in 1960.
- Since 1960, the budget has been balanced only once, and deficit spending has increased the national debt from less than $237 billion to nearly $3.9 trillion.[1]

Chart 1

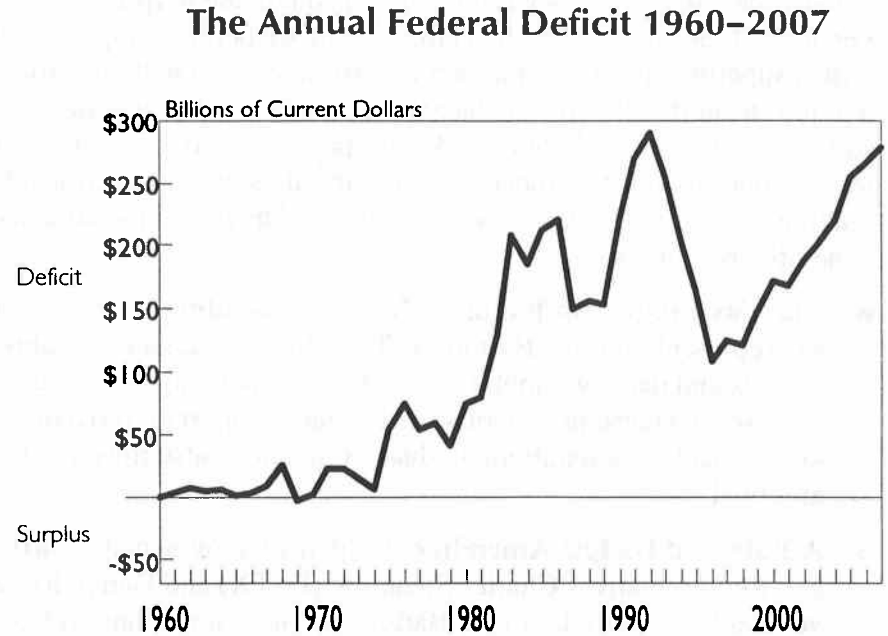


Note: Figures include federal debt held by the public and by the Federal Reserve System.
Source: Table 7.1, pp. 102-103, Historical Tables, *Budget of the United States Government, Fiscal Year 1998.*

- Each person's share of that $3.9 trillion debt is more than $14,450, up from $1,311 in 1960.
- Interest payments on the debt now consume about $240 billion annually—more than the combined budgets of the Departments of Commerce, Agriculture, Education, Energy, Justice, Interior, Housing and Urban Development, Labor, State, and Transportation.
- The real news is even worse: The government's official debt calculation does not include $10 trillion to $20 trillion in unfunded liabilities for Social Security, Medicare, government employee retirement programs, and other programs.

1 The "gross" federal debt is about $5.3 trillion, but this includes $1.5 trillion the Department of the Treasury owes to other parts of the federal government (such as the Social Security Trust Fund). Thus, this $5.3 trillion figure, like the Trust Funds themselves, is meaningless. The only debt that has any real economic meaning is the amount "held by the public" (in other words, the amount the government has borrowed from private credit markets).

Chart 2



Source: Table 1.3, pp. 23-24, Historical Tables, *Budget of the United States Government, Fiscal Year 1998.* Figures from 1997 onward are taken from Congressional Budget Office, Summary Table 2, "CBO Baseline Deficit Projections," *The Economic and Budget Outlook: Fiscal Years 1998-2007*, p. xviii, and assume that government expenditures continue at levels mandated by current law.

This rampant use of deficit spending not only endangers the well-being of millions of Americans, but also has mortgaged the future of America's children. The United States needs a balanced budget now. Even more important, however, is how the budget is balanced. If policymakers want a balanced budget amendment to promote faster economic growth, they need to make sure that their efforts result in less government spending. And the only way to do that is by adding to the amendment a meaningful tax limitation provision.

WHAT CAN A TAX LIMITATION/BALANCED BUDGET AMENDMENT ACCOMPLISH?

The obvious purpose of a tax limitation/balanced budget amendment is to prohibit politicians from engaging in deficit spending except in unusual circumstances, such as war. Government spending hinders the economy's performance by transferring resources from the productive sector to the government. This is true whether government spending is financed by taxes or by borrowing. A balanced budget amendment, by making it more difficult to use borrowing as a way to raise revenue, should slow the growth of government.

In order to maximize the possible economic benefits of a balanced budget amendment, however, politicians will need to include a strong tax limitation provision such as a supermajority requirement. By making it as difficult for politicians to raise revenue by increasing taxes as it will be to raise revenue by issuing debt, the tax limitation/balanced budget amendment will help ensure that the end result is smaller government and more freedom for Americans.

WHAT SHOULD THE BALANCED BUDGET AMENDMENT SAY?

How the amendment is written will depend on the purpose desired. Two competing versions of the balanced budget amendment are before Congress at the present time, one with a supermajority tax limitation provision and one without. Both amendments include a requirement that lawmakers balance the budget unless a deficit has been approved by a supermajority vote of Congress. A third proposal also has been offered, but it is not a true "balanced budget" amendment because it exempts a significant portion of the federal budget before the calculations are made. The three amendments can be described generally as follows:

- **The Tax Limitation/Balanced Budget Amendment.** Sponsored in the House by Representative Joe Barton (R–TX), this amendment contains a prohibition on deficits and debts without a two-thirds vote of Congress. It also includes a special escape clause in case of war. The most important provision of the Barton amendment is its requirement that tax increases also must obtain two-thirds approval.
- **A Balanced Budget Amendment.** Sponsored by Senator Larry Craig (R–ID) and Representatives Charles Stenholm (D–TX) and Dan Schaefer (R–CO), this version is very similar to the Barton tax limitation/balanced budget amendment. It does not include, however, a meaningful provision that prevents efforts to balance the budget by raising taxes. There is a requirement that tax increases be approved by a "constitutional majority" (51 in the Senate and 218 in the House) during a roll call vote, but this is only a small improvement over current law. In addition, only a three-fifths vote would be required to approve deficits or debt. Both this version of the amendment and that of Representative Barton enjoyed significant support in the 104th Congress.
- **The "Exempt Social Security" Amendment.** Led by Senator Byron Dorgan (D–ND), some Members of Congress are proposing an amendment that supposedly would require a balanced budget while allowing politicians to pretend that Social Security did not exist. The most noteworthy feature of this version is its political relevance. Many Members of Congress do not want a balanced budget requirement, but they realize that voting "no" would antagonize voters. Presenting a phony alternative allows these members to vote against a legitimate version of the amendment and, at the same time, tell their constituents that they voted for a balanced budget amendment.

HOW WOULD THE AMENDMENT WORK?

Several critics have charged that a balanced budget amendment is unenforceable. What, for example, would happen if the budget approved by lawmakers used overly optimistic economic assumptions but the actual numbers threatened to dip into the red? Would Congress be forced to revisit the budget halfway through the fiscal year? If the fiscal year ended and there was just a minimal deficit—even less than one dollar—would a constitutional battle follow?

These concerns can be precluded if the amendment is drafted properly. The key is to include a clause requiring a supermajority vote to issue new debt. Such a provision would make the balanced budget amendment self-enforcing. Take the example outlined above. Lawmakers could use every budget gimmick, pull every smoke-and-mirrors trick out of the hat, and make the most ridiculous economic assumptions, and it would do no good; once the fiscal year began and spending threatened to outpace revenue, they would be unable to issue new debt without a three-fifths or two-thirds vote.

Thus, failure to include the supermajority requirement to issue debt would be a serious mistake. It either would make a mockery of the amendment (lawmakers might try to use outlandish economic assumptions to evade the intended fiscal discipline) or would result in legal challenges that could give the federal judiciary unwarranted control over fiscal policy. Indeed, not only is the three-fifths vote requirement on new debt critical to the amendment's success, but it actually makes the main provision—barring outlays that exceed receipts—superfluous.

HOW WOULD THE AMENDMENT AFFECT SOCIAL SECURITY?

Senior citizens worry that a balanced budget requirement would pressure Congress to reduce Social Security benefits. This is a legitimate concern, but the amendment is not the problem. Social Security has an unfunded liability of between $7 trillion and $11 trillion. Whether the amendment is approved or not, lawmakers will be forced to address this issue, especially once the system begins to run a deficit shortly after the turn of the century.

The privatization of Social Security is the best way for senior citizens to protect their retirement benefits. When Chile privatized its retirement system, participants were given bonds equal to the value of their promised benefits. These bonds became the participants' private property, which meant that benefits no longer were subject to the whims of politicians. This privatization should occur in the U.S. system as well, regardless of whether the Constitution is changed to require a balanced budget. It is the only way senior citizens and those nearing retirement can ensure their retirement income.

Some opponents of the balanced budget amendment have argued that Social Security funds should be excluded because the surplus "masks the true size of the deficit." But Social Security is a government program; the money spent on retirement benefits is government spending, and payroll taxes are government revenues. The only proper and reasonable definition of the deficit is the amount of money the government has to borrow from private credit markets when total spending exceeds total revenue.

To exclude Social Security from the balanced budget requirement would be to create a gaping loophole that lawmakers could use to promote new spending at the expense of the economy and future generations. It does not take a vivid imagination, for instance, to foresee future lawmakers creating new programs and making them part of the Social Security system in order to avoid having to pay for them.[2] Critics of the amendment will

2 For those who doubt this could happen because politicians would be reluctant to add programs to Social Security that are not related to old-age retirement, the food stamps program is instructive. Even though welfare programs usually are administered by the Department of Health and Human Services, the food stamp program was given to the Department of Agriculture. Supporters put forward the weak rationale that the food people eat usually comes from farms, which is rather like arguing that housing programs should fall under the Department of the Interior because so much lumber comes from national forests. The real reason, however, was to create an alliance for more spending:

deny this is their goal, and will argue that their real intent is simply to protect Social Security from future cuts. If that were the case, however, they would support privatization.

Rather than use Social Security as a way to add loopholes, policymakers should see the balanced budget amendment as absolutely essential to dealing with the looming Social Security crisis. In less than 15 years, Social Security will begin to run deficits—shortfalls that will grow rapidly to alarming levels. Defenders of the status quo say there is nothing to worry about until the Trust Fund runs out around 2030, but this ignores the fact that the Trust Fund is nothing more than the "IOUs" that the government has issued to itself.

As a result of this recurrent practice, the moment Social Security goes in the red shortly after the turn of the century, lawmakers will come under enormous pressure to deal with the system's unfunded liabilities. Needless to say, this may require significant benefit reductions or crippling payroll taxes.[3] To the extent that the government still is running large deficits when the Social Security crisis hits, the steps that must be implemented will have become even more severe.

HOW SOON WOULD A BALANCED BUDGET AMENDMENT TAKE EFFECT?

Before a balanced budget amendment can take effect, it must clear two major hurdles. First and foremost, it must obtain two-thirds support from both Houses of Congress. Should this occur, the amendment would be sent to the states for ratification. To become part of the Constitution, it would need to be approved by both chambers of three-fourths, or 38, of the state legislatures.[4] If an amendment is approved by Congress and ratified by the necessary number of state legislatures, there probably would be a grace period of two years between ratification and actual implementation. Many supporters would like to time the amendment to take effect in 2002 because that is the target date for balancing the budget, but the actual timing will depend on overcoming the obstacles that exist.

WOULD THE AMENDMENT SOLVE AMERICA'S ECONOMIC PROBLEMS?

A balanced budget amendment does not guarantee sound economic policy. All it does is make it difficult for politicians to finance their spending by borrowing money. Supporters of the amendment believe that restricting debt will result in smaller government, and scholarly evidence demonstrates that the economy will grow faster if the size of government is reduced.[5] It is also possible, however, that a simple balanced budget requirement

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Supporters of agriculture subsidies wanted votes from Members of Congress representing urban areas, and supporters of more welfare wanted votes from Members of Congress representing rural areas. Lumping these two programs together created precisely that dynamic.

3 The ideal way to avoid the Social Security crisis would be through privatization, as Chile, Australia, and Great Britain already have done. For more detail, see Daniel J. Mitchell's forthcoming Heritage Foundation paper on Social Security.

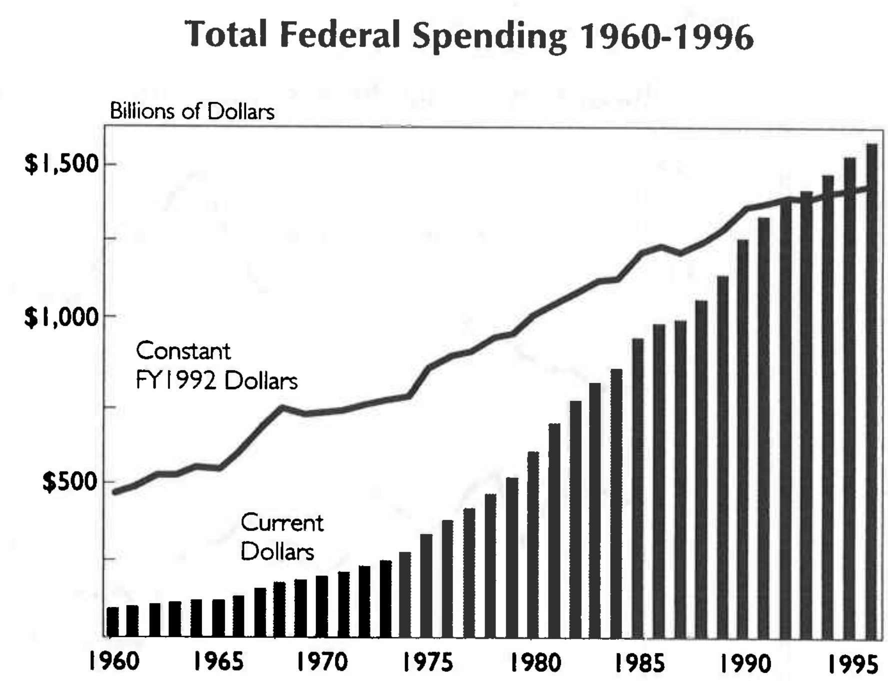
4 Nebraska has a unicameral legislature.

could lead politicians to finance their spending through higher taxes. Such financing policies almost certainly would dampen the economy's performance. Moreover, because of lower incomes, lost jobs, and reduced profits, tax increases have never generated the amount of new revenues that politicians expected;[6] thus, a balanced budget amendment could trigger a dismal cycle of more taxes, followed by more debt, followed by more taxes, followed by more debt, and so on.

For this reason, requiring a supermajority in order to raise taxes to balance the budget is critical. More specifically, a supermajority means there would be no bias in favor of tax-financed spending, and the likelihood of a continuing spiral of taxes and debt would be greatly diminished.

To be fair, the constitutional majority requirement in the amendment proposed by Senator Craig and Representatives Stenholm and Schaefer could require a supermajority of those voting if some members are absent. For example, 51 votes would be required in the Senate even if only 90 Senators were available to cast their votes. In this case, for instance, a tax increase would need the approval of 57 percent of Senators present. This also would be true in the House, where passage would require 218 votes. The problem with a "constitutional" majority to pass tax increases, however, should be clear: If all

Chart 3



Source: Table 1.3, pp. 23-24, Historical Tables, *Budget of the United States Government, Fiscal Year 1998.*

5 See Kevin Grier and Gordon Tullock, "An Empirical Analysis of Cross-National Economic Growth, 1951–80," *Journal of Monetary Economics,* Vol. 24 (1989), pp. 259–276; see also Robert Barro and Xavier Sala-I-Martin, *Economic Growth* (New York, N.Y.: McGraw–Hill, Inc., 1995), p. 494.

6 For more detail on flaws in the current revenue-estimating process, see Daniel J. Mitchell, "How to Measure the Revenue Impact of Changes in Tax Rates," Heritage Foundation *Backgrounder* No. 1090, August 9, 1996.

Members of Congress were available for a vote, a tax hike could pass with a simple majority.

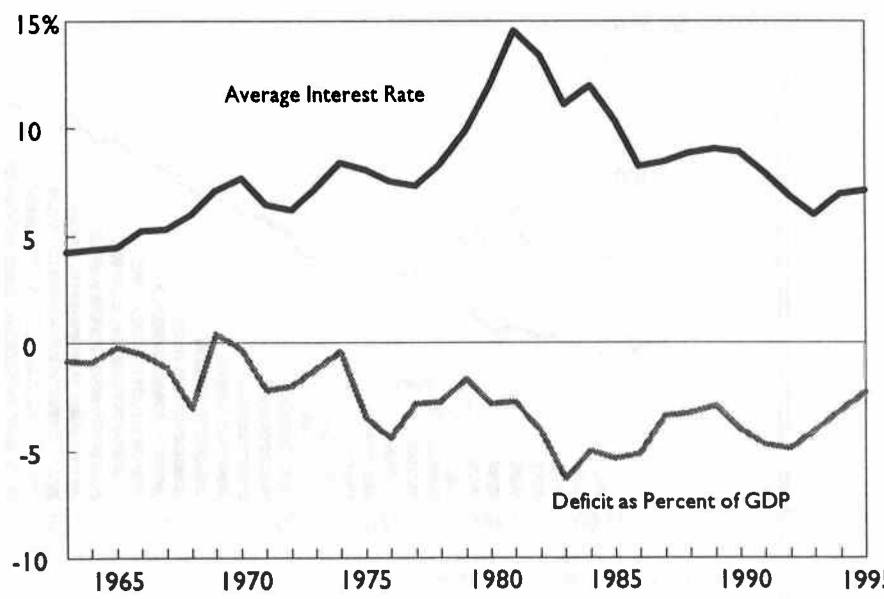
WILL A BALANCED BUDGET LEAD TO LOWER INTEREST RATES?

Some proponents of a balanced budget amendment argue that eliminating the deficit would lead to dramatic reductions in interest rates. The scholarly research,[7] however, indicates that these claims are, at best, greatly exaggerated. Although it is almost certainly true that reductions in government borrowing will put downward pressure on interest rates, it appears that the impact is too small to measure. Simply stated, in world capital markets in which trillions of dollars exchange hands every day, changes of $30 billion, $40 billion, or $50 billion in the U.S. budget deficit are not large enough to make a measurable difference.

This can be seen by comparing interest rates and budget deficits over the past 20 years. During this period, budget deficits have experienced significant shifts up and down with changing fiscal and economic circumstances. As Chart 4 illustrates, however, interest rates do not respond as the theory predicts. Indeed, instead of rising when deficits increase and falling when deficits decline, the opposite seems to be the case. This does not mean that higher budget deficits lead to lower interest rates; it means simply that other

Chart 4

Budget Deficit and Interest Rates: No Clear Relationship



Note: Interest rate figures are a composite of short, medium and long-term interest rates.
Source: *Economic Report of the President*, Council of Economic Advisers, February 1996.

7 Charles I. Plosser, *Further Evidence on the Relation Between Fiscal Policy and the Term Structure* (Rochester, N.Y.: University of Rochester, 1986).

factors, such as monetary policy, tax policy, and overall demand for credit, are much more important than shifts in the U.S. budget deficit.[8]

ARE DEFICITS AND DEBT INHERENTLY BAD?

Contrary to rhetoric, borrowing is not evil. There have been times in which government borrowing has been in the national interest. Winning World War II, for instance, probably would have been impossible if the government had not been able to tap private credit markets. Similarly, the limited extent to which President Ronald Reagan's restoration of the U.S. military added to the national debt was a small price to pay for the collapse of communism.

There are analogies from the private sector as well. Almost all households and businesses go into debt at some point. Consumers borrow to buy cars, families borrow to build homes and send their children to college, and businesses borrow to expand productive capacity. There is nothing wrong, either morally or financially, with these decisions.

Although deficits and debt are not necessarily bad, politicians certainly have abused the privilege. Like profligate consumers who use credit cards to live beyond their means, many politicians see government borrowing as a way to increase federal spending for programs that are not in the nation's best interests. The difference between the irresponsible consumer and the irresponsible politician is that bad behavior on the part of the consumer leads to a bad credit rating and a sharply reduced ability to borrow money. Politicians escape a similar fate because they can pass the costs of a bill on to the next generation. By requiring a supermajority vote to issue new debt, however, the balanced budget amendment will impose a similar restriction on such fiscally reckless politicians.

DO DEFICITS REALLY STIMULATE THE ECONOMY?

Opponents of a balanced budget requirement, particularly those in the Clinton Administration, argue that deficit spending is a useful tool to jump-start a sluggish economy. By limiting deficits, Treasury Secretary Robert Rubin and others claim, the balanced budget amendment somehow will make economic downturns more likely. This argument is based on the economic theory known as Keynesianism. According to this theory, which first influenced policymakers in the 1930s and remained popular into the 1970s, politicians can stimulate economic growth by borrowing money and increasing government spending.[9] Critics from the beginning noted that this theory did not make sense, but politicians liked Keynesian economics because it gave them a quasi-respectable rationale for increased spending.

Ultimately, reality proved to be the undoing of Keynesian economic theory. The economic stagnation of the 1970s showed that deficit spending—especially when combined with rising taxes and inflation—was not a recipe for growth. Moreover, the success of President Reagan's supply-side tax cuts further undermined the case for Keynesian

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8 For more detail on the lack of a relationship between interest rates and the deficit, see Daniel J. Mitchell, "Taxes, Deficits, and Economic Growth," Heritage Foundation *Lecture* No. 565, May 14, 1996.

9 Keynesian theory also favors using monetary policy to fine-tune the economy; but just as the Keynesian view on deficits has fallen into disfavor, so has this notion of manipulating monetary policy.

policies by showing that improved incentives were the key to growth. Nonetheless, there are some who still cling to Keynesian theory.

Despite the accumulated evidence, both from the United States and from around the world, the Administration may believe that deficit spending truly is good for the economy. Even though all versions of the balanced budget amendment contain provisions that allow for supermajority approval of deficits and debt, the White House has launched an extensive lobbying campaign against the amendment.

WOULD THE AMENDMENT MAKE IT MORE DIFFICULT TO CUT TAXES?

Because of existing budget rules and antiquated revenue-estimating techniques, it already is extremely difficult to cut taxes. It is hard to imagine how enactment of a balanced budget amendment could make tax cuts even less likely. Under current law, legislation that is estimated to increase the deficit faces procedural hurdles, including a three-fifths supermajority requirement in the Senate. In other words, tax cuts need to be accompanied by offsetting savings from the spending side of the budget.

If a balanced budget amendment is ratified by the states, the obstacles to tax cuts should remain unchanged. If anything, existing budget rules probably would be strengthened to ensure compliance with the amendment. It is almost certain that supporters of tax cuts would continue to be obliged to "pay for" their proposals with spending savings.

CONCLUSION

Excessive government spending is shackling the U.S. economy. A balanced budget amendment, however, should help limit the future growth of government by making it more difficult for politicians to finance additional spending with government borrowing. It is important to recognize that all the benefits of a balanced budget amendment depend on reducing the size of government. If, as many fear, politicians simply replace debt-financed spending with tax-financed spending, faster economic growth will not materialize. A strong tax limitation provision is the key to achieving a pro-growth balanced budget amendment.