The Pursuit of an Effective Balanced Budget Amendment

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Abstract

This article provides an alternative to the standard simplistic form of a balanced budget amendment to the U.S. Constitution. Instead of simply prohibiting government outlays from exceeding government revenues, which could lead to higher government spending and to higher taxation levels, this proposal provides potential flexibility in the federal budget and deficit conditions (when necessary) while protecting against tax increases and excessive growth in government outlays. The proposal prohibits government spending from exceeding revenues; however, under some conditions, with the approval of a two-thirds majority of both the House and Senate along with approval of the president, a temporary budget deficit of up to 2.5 percent of GDP could be authorized. The requirements that must be met for such a limited budget deficit include the following: the ratio of government spending to GDP may not exceed 20 Percent (its approximate average historical level), and the unemployment rate must exceed 8 percent (to reflect genuine recessionary conditions). Those conditions could be modified; for example, a 7.5 percent unemployment rate could be adopted.

Introduction

During the latter years of the Clinton administration and through the early years of the George W. Bush administration – that is, fiscal years 1998 to 2001 – the federal government had four consecutive years of budget surpluses. However, beginning with fiscal 2002, the federal budget has been in a deficit. As shown in the table, during the Bush years after fiscal 2001, the federal budget deficit ranged from a low of $158 billion to a high of $459 billion. Expressed as a percent of GDP, the federal budget deficit ranged from a low of 1.2 percent (fiscal 2007) to a high of 3.5 percent (fiscal 2004). Beginning with fiscal 2009, the federal budget deficit surged to $1.41 trillion (10 percent of GDP), followed by a deficit of $1.65 trillion (10.9 percent of GDP) for fiscal 2010. The projected federal budget deficit for fiscal 2011 is slightly in excess of $1.1 trillion (7 percent of GDP); although with increased unemployment rates it is likely to be higher.
## Federal Budget Deficits, Fiscal Years 2002-2011

<table>
<thead>
<tr>
<th>Year</th>
<th>Expressed in Current Dollars</th>
<th>Expressed as a Percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$158 billion</td>
<td>1.5%</td>
</tr>
<tr>
<td>2003</td>
<td>$378 billion</td>
<td>3.4%</td>
</tr>
<tr>
<td>2004</td>
<td>$413 billion</td>
<td>3.5%</td>
</tr>
<tr>
<td>2005</td>
<td>$318 billion</td>
<td>2.6%</td>
</tr>
<tr>
<td>2006</td>
<td>$248 billion</td>
<td>1.9%</td>
</tr>
<tr>
<td>2007</td>
<td>$161 billion</td>
<td>1.2%</td>
</tr>
<tr>
<td>2008</td>
<td>$458 billion</td>
<td>3.2%</td>
</tr>
<tr>
<td>2009</td>
<td>$1.41 trillion</td>
<td>10%</td>
</tr>
<tr>
<td>2010</td>
<td>$1.65 trillion</td>
<td>10.9%</td>
</tr>
<tr>
<td>2011</td>
<td>$1.01 trillion (est.)</td>
<td>7% (est.)</td>
</tr>
</tbody>
</table>

*Source: Council of Economic Advisors, “Economic report of the President, 2011, tables B-75, B-76 (2011).*

The magnitude of those federal budget deficits is of concern both in the short and long run. For example, the well-known Harvard economist Martin Feldstein has warned that the economy is worse than we think and that we can expect more bad economic news until a plan is enacted to bring deficits under control.

Within that context, this article addresses a balanced budget amendment to the U.S. Constitution. The annual federal budget deficit is more than 10 times what it was in 1997, when the Senate last came close to approving a balanced budget amendment. Given that such an amendment, if carefully and wisely crafted, could do much to improve the short- and long-term problems of the U.S. economy, this article has two fundamental objectives: (1) to outline the goals of a useful and practical balanced budget amendment to limit the size of the federal budget deficit and the growth of the national debt; and (2) to propose a balanced budget amendment that can achieve those goals while not interfering excessively with the use of the federal government’s taxing and spending policies to combat a severe or persistent recession.

I begin with a brief description of the current economic and political environment. Next, the basic goals of a useful and practical balanced budget amendment are provided. Given that list of goals, I then summarize the conventional form of a balanced budget amendment, including serious, basic flaws. Then, a balanced budget amendment consistent with those goals and not burdened with those flaws is proposed. The conclusion provides a summary and overview.

### Current Economic and Political Environment

The proposed 2012 Obama administration budget resembles that for 2011 in several respects. Total projected outlays are proposed in the range of $3.7 trillion to $3.8 trillion (roughly 27 percent of the GDP, as in the 2011 proposed budget), with a projected federal budget deficit in excess of $1.1 trillion. Moreover, in view of the December 2010 passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Jobs Act,
P.L. 111-312) and the expressly temporary extension of the Bush tax cuts included therein, the 2012 budget speaks repeatedly (as did the 2011 budget proposal) of future federal income tax increase (as well as reduced tax deductions), especially for the “rich”. In other words, despite passage of the Jobs Act (and perhaps because of its passage), it remains noteworthy that embedded in the administration’s 2012 budget and anticipated future budgets are (a) increased federal government spending levels, (b) significantly increased federal taxation (through higher federal tax rates, more federal taxes, and reduced tax deductions), and (c) continued high budget deficits.

In addition, the healthcare bill passed in 2010, the Patient Protection and Affordable Care Act (P.L. 111-148), is projected to elevate federal taxes sufficiently to raise an additional $409.2 billion for the treasury by 2019. Indeed, according to Kiplinger, there are 13 federal tax changes in the healthcare reform legislation, 10 of which constitute tax increases.

Several consequences of the pattern of huge federal budget deficits in the context of proposed higher taxes can be readily observed. One of great concern is that as the federal budget deficits and the national debt have surged in recent years. Standard & Poor’s in April lowered its outlook on U.S. debt; in addition, Moody’s Investors Service warned in June that it also may soon downgrade the credit rating based on its debt. Indeed, on August 4, Standard & Poor’s actually downgraded long-term Treasury debt from AAA to AA+ with a negative outlook. Over time, that could lead to a further downgrading of the U.S.’s credit rating, with would undoubtedly lead to a rise in the interest rates that would have to be paid on new budget deficits and all maturing national debt issues. The latter interest rate increase would ironically add to the level of government spending and raise the budget deficits and national debt even further since the additional interest outlays would themselves have to be borrowed by the treasury. Further, as interest rates on federal debt rise, so too will interest rates in the private sector. The latter would act to reduce private-sector investment and economic growth.

Another consequence involves the administration’s three-part response to the public’s increased concern over large federal deficits, namely: (1) plans to continue many of the Bush tax cuts but not for those earning more than $200,000 ($250,000 if married filing jointly) once the Jobs Act has expired; (2) plans to limit income tax deductions, and not merely for the rich; and (3) plans to eliminate $2 trillion in federal spending over the next 10 years, which would only marginally cut the size of federal budget deficits and the growth rate of the national debt. Interestingly, the first two of those policies would assuredly reduce fiscal freedom and thereby lead to diminished long-term growth, whereas the third would largely consist of Medicare cuts. In any case, they would constitute only $200 billion per year at most in reduced deficits, leaving the bulk of the oversized budget deficit problem still intact.

Another consequence of the pattern of huge federal budget deficits and rising national debt has been the resurrection of debate over a balanced budget amendment to the Constitution. That amendment, in its simplest and most commonly known form, would require that aggregate federal tax collections equal or exceed federal government outlays over the course of each fiscal year.

Against that background, my analysis addresses the two basic objectives of this article. First, I identify the fundamental goals of a real-world balanced budget amendment and how a balanced budget amendment like that briefly described above is deeply flawed, including how it
could lead to increased federal taxation. Then, I outline what a practical and useful balanced budget amendment must include to achieve its fundamental objectives.

Efficient Balanced Budget Amendment Search

Ostensibly, the basic goals of a balanced budget amendment include:

1. eliminating federal budget deficits to prevent higher interest rates and diminished credit availability, factors that reduce private-sector investment in new plant and equipment, new housing, and the like;
2. limiting the extent of federal taxation, so that the private sector can maximize the degree to which it reaps the rewards of its labor, creativity, and risk taking; thus, it would promote fiscal freedom for the private sector on the revenue side;
3. limiting the uncertainty about future tax increases and thereby reducing the perceived riskiness of investment in new plant and equipment and purchases by households of new durable consumer goods;
4. limiting the size of government to maximize the availability of society's resources for the use and benefit of the nation's citizens – that is, the private sector; thus, it would promote freedom from excessive government size on the expenditure side; and
5. limit “crowding out” in financial markets, a situation in which sales of treasure securities compete with the private sector and not only raise the cost of borrowing for the private sector (households and firms) but also reduce the extent of private-sector borrowing.

The simplest, best known and most easily understood balanced budget amendment would require that total federal government spending in each fiscal year equal the sum of all federal government income tax collections plus other federal government revenue. Total federal government outlays are to include all on- and off-budget expenditures. If government spending is less than federal government revenues (that is, if a budget surplus occurs), that surplus presumably would be used either to pay off at least some of the existing national debt or be returned directly to the tax payers in the form of a tax rebate or credit in the following fiscal year. This version of the balanced budget amendment can be labeled the rudimentary balanced budget amendment (RBBA). The usual form of an RBBA has a clause that permits a budget deficit in any given fiscal year is a supermajority of two thirds of both the House and Senate vote in its favor and it receives the president’s written approval. That clause is taken to mean that it is not easy to violate a budget deficit amendment to the Constitution.

The process by which the RBBA would operate seems simple enough, but it is deeply flawed. For example, if Congress and the president wished to increase government spending, they would be able to circumvent the intentions of the RBBA by merely raising federal tax collections to match the planned increase in government outlays. That would have the effect of violating the second, third, and fourth objectives of a balanced budget amendment. In this scenario, the RBBA would in effect act as a vehicle by which the federal government could grow – possibly quite substantially.
Another flaw of the RBBA is that it could hamstring “discretionary fiscal policy” — that is, restrict or limit the use of federal tax decreases and/or federal government spending increases that result in federal budget deficits — to combat a recession. That is especially problematic if the recession is a severe one, like those experienced in 1981-1982 and 2007-2009. Unless a congressional supermajority — along with presidential approval — were achieved, the recession could not be alleviated through either federal tax cuts (which could stimulate private-sector spending by raising household disposable income) or government spending increases (which if properly directed to the purchase of new goods and services, as opposed simply to increased government transfer payments, could directly increase private-sector employment). The job of alleviating the recession would then fall on the Federal Reserve, whose tools to fight recession are limited and much better suited to combating inflation.

A Useful, Flexible Balanced Budget Amendment

Rather than the popular but simplistic and flawed version of a balanced budget amendment (the RBBA), this section proposes a flexible balanced budget amendment (FBBA). The fundamental provisions of an FBBA would:

1. require that total federal government spending in each fiscal year must be equal to or less than the sum of all federal government income tax collections, plus other federal government revenues. That can be achieved by a simple majority voting rule;
2. require that total federal government outlays include all on- and off-budget expenditures, including all forms of transfer payments;
3. require that any surplus be used to pay off at least some of the existing national debt or returned directly to the taxpayers as either a tax rebate or credit in the following fiscal year; and
4. allow total federal government spending in any fiscal year to exceed the sum of all federal government income tax collections, plus other federal government revenues, provided that all the following conditions are met during that fiscal year: (a) the deficit resulting must not exceed 2.5 percent of the GDP; (b) the unemployment rate exceeds 8%; (c) total federal government outlays (as defined in provision 2 above) must not exceed 20 percent; and (d) the budget for that fiscal year is approved by at least a two-thirds majority of both the House and Senate and receives presidential approval.

The FBBA would eliminate or sharply control the ability of the federal government to incur new budget deficits and grow the national debt. It would limit federal taxation of the private sector and reduce, if not eliminate, uncertainty regarding significant future tax increases. Additionally, it would limit the size of government in the economy so as to maximize the availability of society’s resources for the use and benefit of the nation’s citizens. Further, the suggested FBBA would limit, if not eliminate, crowding out in financial markets, in which sale of treasury securities compete with the private-sector and not only raise the cost of
borrowing for the private sector but also absorb credit and thereby reduce private capital formation and economic growth.

**Summary and Overview**

In sum, the FBBA recommended above, or a reasonable facsimile, would at the least limit the size and frequency of federal budget deficits, limit federal taxation and thereby promote fiscal freedom for the private sector, limit the size of the federal government and thereby promote freedom from excessive government size, and limit crowding out of the private sector by budget deficits sold in the financial markets. Moreover, the FBBA would still allow for a variety of expansionary fiscal actions in the event of a severe or persistent recession, thus making it even more preferable than an RBBA. Finally, an FBBA would likely require a restructuring of a host of federal entitlement programs, including Social Security, Medicare, and federal employee retirement benefits. That could create incentives for Americans to save more, which could result in long-term economic growth benefits in terms of growing an environment that stimulates private enterprise and investment while simultaneously protecting those invested in outstanding national debt.
References


