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BALANCED BUDGET AMENDMENT HIGHLY ILL-ADVISED FOR ADDRESSING LONG-TERM FISCAL PROBLEMS

Would Threaten Serious Economic Harm, Raise Host of Problems For Social Security, Other Key Federal Functions

by Robert Greenstein and Richard Kogan

The balanced budget amendment to the U.S. Constitution that the House will consider this week would be a highly ill-advised way to address the nation's long-term fiscal problems. It would threaten significant economic harm while raising a host of problems for the operation of Social Security and other vital federal functions.

The economic problems are the most serious. By requiring a balanced budget every year, no matter the state of the economy, the amendment would raise serious risks of tipping weak economies into recession and making recessions longer and deeper, causing very large job losses. That's because the amendment would force policymakers to cut spending, raise taxes, or both just when the economy is weak or already in recession — the exact opposite of what good economic policy would advise.

When the economy slows, federal revenues decline or grow more slowly and spending on unemployment insurance and other social programs increases, causing deficits to rise. Rather than allowing the "automatic stabilizers" of lower tax collections and higher unemployment and other benefits to cushion a weak economy, the amendment would force policymakers to cut spending, raise taxes, or both. That would launch a vicious spiral of bad economic and fiscal policy: a weak economy would lead to higher deficits, which would force policymakers to cut spending or raise taxes more, which would weaken the economy further.

As Macroeconomic Advisers, a leading private economic forecasting firm, recently stated, "recessions would be deeper and longer" under a constitutional balanced budget amendment, and uncertainty would be cast over the economy that could retard economic growth even in normal economic times (see box, page 2).

The fact that states must balance their budgets every year — no matter how the economy is performing – makes it even more important that the federal government not also face this requirement and thus further impair a faltering economy. And, while the amendment would allow Congress to waive the balanced budget requirement with a three-fifths vote of the House and

Balanced Budget Amendment Would Have "Catastrophic" Impact In Deep Recession, According to Leading Private Economic Forecasting Firm

If a constitutional balanced budget amendment had already been ratified and were now being enforced for fiscal year 2012, "the effect on the economy would be catastrophic," states an October 21 analysis from Macroeconomic Advisers.* One of the nation's preeminent private economic forecasting firms, Macroeconomic Advisers provides nonpartisan analysis to major corporations and government entities such as the President's Council of Economic Advisers (under Presidents of both parties, including Presidents Reagan and George W. Bush) and the Congressional Budget Office.

Below are some excerpts from the Macroeconomic Advisers analysis:

- "Suppose in 2008, when the deficit seemed manageable, a BBA had been sent by Congress to the states, that it was ratified this fall, and enforced for FY 2012. The effect on the economy would be catastrophic."

  If the 2012 budget were balanced through spending cuts, those cuts would total about $1.5 trillion in 2012 alone, the analysis estimates. Those cuts would throw about 15 million more people out of work, double the unemployment rate from 9 percent to approximately 18 percent, and cause the economy to shrink by about 17 percent instead of growing by an expected 2 percent.

- "The pall of uncertainty cast over the economy if it appeared a BBA could be ratified and enforced in the middle of recession or when the deficit was still large would have a chilling effect on near-term economic growth."

- "Suppose the BBA was implemented when the budget already was in balance. There still would be new and powerful uncertainties in play. The economy's 'automatic stabilizers' would be eviscerated [and] discretionary counter-cyclical fiscal policy would be unconstitutional. . . . Recessions would be deeper and longer."

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* "Man Up: AJ(obs)A vs. J(obs)TGA," http://macroadvisers.blogspot.com/2011/10/man-up-ajobsa-vs-jobstga.html.

Senate, that hardly solves the problem. Recent experience shows the difficulty of securing a three-fifths vote in both chambers for almost any major legislation.

Beyond the economy, the balanced budget amendment would raise other problems. That's due to its requirement that federal spending in any year must be offset by revenues collected *in that same year*. Social Security could not draw down its reserves from previous years to pay benefits in a later year but, instead, could be forced to cut benefits even if it had ample balances in its trust funds, as it does today. The same would be true for military retirement and civil service retirement programs. Nor could the Federal Deposit Insurance Corporation or the Pension Benefit Guaranty Corporation respond quickly to bank or pension fund failures by using their assets to pay deposit or pension insurance, unless they could do so without causing the budget to slip out of balance.

The amendment's proponents often argue that, because states and families must balance their budgets each year, the federal government also should do so. But this analogy is a false one. While states must balance their *operating* budgets, they can — and do — borrow for capital projects.

Families often borrow, as well, such as when they take out mortgages to buy a home or loans to send a child to college. The proposed constitutional amendment would bar the federal government from making worthy investments in the same way.

Potential for Serious Economic Harm

The nation faces serious long-term fiscal problems, but a balanced budget amendment to the U.S. Constitution is an ill-advised way to address them. It would require a balanced budget every year regardless of the state of the economy, unless a supermajority of both houses overrode that requirement. This is an unwise stricture that many mainstream economists have long counseled against because it would require the largest budget cuts or tax increases precisely when the economy is weakest. It holds substantial risk of tipping faltering economies into recessions, making recessions longer and deeper, and precipitating very large additional job losses.

When the economy weakens, revenue growth drops and revenues may even contract. And as unemployment rises, expenditures for programs like unemployment insurance (UI) — and to a lesser but significant degree, food stamps and Medicaid — increase. These revenue declines and expenditure increases are temporary; they largely or entirely disappear as the economy recovers. But they are critical for helping struggling economies avoid falling into recessions and for moderating the depth and length of recessions that do occur.

During economic downturns, consumers and businesses spend less, which in turn causes further job loss. The drop in tax collections and increases in UI and other benefits that occur automatically cushion the blow, by keeping purchases of goods and services from falling more. That is why economists use the term "automatic stabilizers" to describe the automatic declines in revenues and automatic increases in UI and other benefits that help to stabilize the economy when it turns down.

A constitutional balanced budget amendment, however, effectively suspends the automatic stabilizers. It requires that federal spending be cut or taxes increased to offset the automatic stabilizers and prevent a deficit from occurring — the opposite course from sound economic policy.

Over the years, leading economists have warned of the adverse effects of a constitutional balanced budget amendment. For example, in congressional testimony in 1992, Robert Reischauer — then director of the Congressional Budget Office and one of the nation's most respected experts on fiscal policy — explained: "[I]f it worked [a constitutional balanced budget amendment] would undermine the stabilizing role of the federal government." Reischauer noted that the automatic stabilizing that occurs when the economy is weak "temporarily lowers revenues and increases spending on unemployment insurance and welfare programs. This automatic stabilizing occurs quickly and is self-limiting — it goes away as the economy revives — but it temporarily increases the deficit. It is an important factor that dampens the amplitude of our economic cycles." Under the constitutional amendment, he explained, these stabilizers would no longer operate automatically.[1]

Similarly, when Congress was considering a constitutional balanced budget amendment in 1997, more than 1,000 economists, including 11 Nobel laureates, issued a joint statement that said, "We

[1] Statement of Robert D. Reischauer before the House Budget Committee, May 6, 1992.

condemn the proposed 'balanced-budget' amendment to the federal Constitution. It is unsound and unnecessary. . . . The proposed amendment mandates perverse actions in the face of recessions. In economic downturns, tax revenues fall and some outlays, such as unemployment benefits, rise. These so-called 'built-in stabilizers' limit declines of after-tax income and purchasing power. To keep the budget balanced every year would aggravate recessions."[2] This summer, five winners of the Nobel Prize for Economics issued a statement opposing a constitutional balanced budget amendment for this reason.[3]

At a Senate Budget Committee hearing in January 2011, CBO director Douglas Elmendorf sounded a similar warning when asked about a constitutional balanced budget amendment:

> Amending the Constitution to require this sort of balance raises risks. . . . The fact that taxes fall when the economy weakens and spending and benefit programs increase when the economy weakens, in an automatic way, under existing law, is an important stabilizing force for the aggregate economy. The fact that state governments need to work … against these effects in their own budgets — need to take action to raise taxes or cut spending in recessions — undoes the automatic stabilizers, essentially, at the state level. Taking those away at the federal level risks making the economy less stable, risks exacerbating the swings in business cycles.[4]

This dynamic is what led Macroeconomic Advisers to conclude that a balanced budget requirement, if adhered to this year, would have doubled the unemployment rate to about 18 percent, as noted in the box on page 2.

The amendment's proponents likely will respond to these admonitions by noting that the proposed amendment would allow a vote of three-fifths of the House and the Senate to waive the balanced budget requirement. However, as the paralysis that often marks the Senate's work indicates, it is difficult to secure three-fifths votes for any major legislation. Moreover, some of the hard data on the economy come with a lag of several months, and it could well take many months after the economy has begun to weaken before sufficient data are available to convince three-fifths of both houses of Congress that economic conditions warrant waiving the balanced budget requirement, if three-fifths were willing to waive the requirement at all. Furthermore, it is all too likely that even after the evidence for a downturn is clear, a minority in the House or Senate would hold a waiver vote hostage to demands for concessions on other matters (such as new, permanent tax cuts). By the time a recession is recognized *and* three-fifths votes are secured in *both* chambers, extensive economic damage could have occurred and hundreds of thousands, or even millions, of additional jobs unnecessarily lost.

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[2] This statement was issued on January, 30, 1997.

[3] See http://www.cbpp.org/files/7-19-11bud-pr-sig.pdf

[4] Federal Service, Transcript of Senate Budget Committee hearing, January 27, 2011.

The Misguided TARP Analogy

Proponents of the constitutional balanced budget amendment have dismissed the notion that the amendment could damage a weak economy. At the sole congressional hearing this year on the constitutional amendment, they blithely asserted that three-fifths of the House and Senate would override the balanced budget requirement whenever that was truly needed. In support of this assertion, they noted that three-fifths of the House and Senate voted for the TARP legislation in the fall of 2008.

These easy assurances are unpersuasive. Congress has *failed* to secure three-fifths margins for critical legislation on many occasions — from House passage, by a single vote, of legislation to extend the term of duty of draftees in 1941 even as Hitler's armies marched across Europe, to the frequent passage of critical legislation, by votes short of three-fifths, to raise the debt limit and avoid government defaults. (Fortunately, in these cases, a majority vote of those present and voting — rather than three-fifths of the entire membership — was sufficient for passage.) Just last November, the House failed to secure three-fifths support for legislation to extend federal unemployment benefits, despite the fact that the unemployment rate was 9.6 percent.

The TARP vote in October 2008 is not a convincing counter-example. The TARP legislation failed when it first came up in the House in September 2008. It passed on a second try only after the Dow-Jones Industrial Average fell by 777 points — and asset values plunged by $1.2 trillion — in a single day, amidst widespread fears of an imminent financial market meltdown. Even then the legislation secured the support of only 60.6 percent of the House.

Moreover, that was the House of 2008. If the circumstances were repeated today, such a measure could well fail to obtain 60 percent support in that chamber.

Finally, when the economy weakens and is at risk of falling into a recession, the weakening usually occurs gradually over a number of months and is not touched off by highly dramatic — and potentially catastrophic – events like credit markets seizing up, the stock market plummeting, and financial markets being on the verge of collapse. And as noted, even in those dire circumstances, TARP barely got 60 percent of the votes of the House. That outcome hardly gives one confidence that Congress would move quickly to suspend the balanced budget requirement when the economy faltered and faced the risk of recession and large job losses.

The fact that states must balance their operating budgets even in recessions — which causes the economy to contract further — makes it even more important that the federal government *not* be subject to the same stricture. As American Enterprise Institute analyst Norman Ornstein wrote earlier this year:

> Few ideas are more seductive on the surface and more destructive in reality than a balanced budget amendment. Here is why: Nearly all our states have balanced budget requirements. That means when the economy slows, states are forced to raise taxes or slash spending at just the wrong time, providing a fiscal drag when what is needed is countercyclical policy to stimulate the economy. In fact, the fiscal drag from the states in 2009-2010 was barely countered by the federal stimulus plan. That meant the federal stimulus provided was nowhere near what was needed but far better than doing nothing. Now imagine that scenario with a federal drag instead.[5]

[5] Norman Ornstein, "Four Really Dumb Ideas That Should Be Avoided," *Roll Call,* January 26, 2011.

The bottom line is this: the automatic stabilizers need to continue to protect U.S. businesses and workers. A balanced budget amendment would preclude them from doing so.

The amendment would also make it even more difficult to raise the debt limit, by requiring a three-fifths vote of both the House and Senate for that as well. It would be foolhardy to make needed increases in the debt limit harder to enact than they already are. *Only three of the last 11* debt limit increases obtained three-fifths vote in both chambers. Two of those instances occurred amidst the financial crisis in 2008 when the debt limit increases were included in larger legislation to respond to the meltdowns already occurring in the housing and financial markets. The third occurred this August, as part of the Budget Control Act, and came only after a lengthy, bitter, highly contentious process that led the nation to the brink of default. A three-fifth requirement would be dangerous, as it would heighten the risk of an unprecedented federal default, which could raise interest rates and damage the U.S. economy for decades to come.

A Host of Other Problems

The constitutional balanced budget amendment also could interfere with Social Security and the military and civil service retirement systems. In addition, it could weaken the stability of banks, thrift institutions, and some private pension systems. These risks are the result of the amendment's rigid requirement that federal spending in any year must be fully offset by revenues collected *in the same year*.

That requirement is far more rigid than any that families or businesses face. Families often use savings accumulated from prior years to pay for some current purchases; for example, they use savings to help pay for children's college education or to buy a car, even though they may "run a deficit" in the sense that they spend more in that year than they earn in the *same* year.[6]

Effects on Social Security and Military and Civil Retirement

Consider how this requirement would affect Social Security. By design, the Social Security trust fund is building up reserves — in the form of Treasury securities backed by the full faith and credit of the United States — which will be drawn down to help pay benefits when the number of retired "baby boomers" peaks in the late 2020s and early 2030s. Currently, Social Security holds $2.6 trillion in Treasury securities, and the Social Security Trustees project that this figure will grow to $3.7 trillion by 2023. But under the balanced budget amendment, it would essentially be unconstitutional for Social Security to draw down these savings to pay promised benefits. Instead, benefits could have to be cut, because all spending would have to be covered by tax revenues collected *during that same year*. More precisely, Social Security would be allowed to use its Treasury securities to help pay benefits *only* if the rest of the federal budget ran an offsetting surplus (or if the House and Senate each mustered three-fifths votes to permit deficit spending).

[6] Most families also borrow — or "run a deficit" — if their savings are not sufficient to cover their current costs, as occurs when they take out mortgages, student loans, or loans to finance an automobile purchase. The balanced budget amendment would prohibit the federal government from either borrowing or using accumulated assets.

The military retirement and civil service retirement systems, which have their own trust funds, would be affected in the same way. Because all expenditures would have to be covered by taxes collected in the same year — and the use of accumulated savings thus would be unconstitutional — these trust funds would not be able to draw down their accumulated balances unless the rest of the budget ran offsetting surpluses.

Effects on the Banking System

The potential effects on the banking system also are cause for concern. The Federal Deposit Insurance Corporation (FDIC) holds substantial reserves, in the form of Treasury securities, to insure the savings of depositors. These reserves are called upon when banks fail. Similarly, the Pension Benefit Guarantee Corporation (PBGC) has assets to draw upon if a corporation's defined-benefit pension plan goes bankrupt.

Here, too, the balanced budget amendment would make it unconstitutional for the FDIC and the PBGC to use their assets to pay deposit or pension insurance since doing so generally would constitute "deficit spending." Such payments could be made only if the rest of the budget ran an offsetting surplus that year (or if Congress achieved the necessary three-fifth supermajorities to override the balanced budget requirement).

In general, a constitutional requirement that all spending during a given year be covered by tax revenues collected in the same year would undercut all U.S. government insurance and loan guarantees. Those range from the "full faith" backing by the U.S. government to pay interest on Treasury securities to deposit insurance, pension insurance, FHA loans, small business loans, flood insurance, and the nuclear power industry's liability insurance under the Price-Anderson Act. Henceforth, the U.S. government would only be able to fulfill its legal commitments if their cost did not cause a deficit, or if both houses of Congress voted by a three-fifths supermajority to waive the balanced budget requirement.

The entire purpose of deposit insurance and other U.S. financial commitments is to *guarantee* financing in case of calamity. How reliable is the "guarantee" if the balanced budget requirement places it at risk or forces it to be withdrawn just when it is needed most?

If banks, thrift institutions, pension funds, small businesses, and mortgagers started to fail during a recession or a financial crisis, the large costs of paying federal insurance and guarantee claims probably could *not* be met within the confines of the balanced budget amendment. And if deposit insurance were no longer effective, panicked depositors could make runs on banks, causing a chain reaction that could turn a recession into a depression. That is what happened from 1929 to 1933. Indeed, federal deposit insurance was enacted in 1933 — after a four-year run by depositors on their banks — to halt that collapse.[7]

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[7] Even when the budget is balanced, the Treasury's ability to borrow can play an important role in protecting the U.S. financial system. For example, when a collapse of the U.S. financial system threatened in the fall of 2008, one important action taken to avert that collapse occurred when the Treasury, on its own initiative, borrowed an additional $300 billion in September of that year and deposited the funds in the Federal Reserve. Although that action did not constitute "spending" and thus would not unbalance a budget otherwise in balance, it did constitute borrowing and hence would breach the debt limit, unless the debt limit happened to be far enough above the actual level of debt. The $300 billion that was deposited in the Federal Reserve in September 2008 enhanced the Fed's ability to promise liquidity to a panicky financial system and to mitigate the meltdown that had begun to occur. The constitutional balanced budget amendment,

Questions Abound About Who Would Enforce the Balanced Budget Requirement — And How They Would Do It

Supporters of the balanced budget amendment tend to sidestep questions about how the constitutional mandate would be enforced. But there are serious questions about this and no clear answers. For example:

- Suppose the budget is out of balance. What happens? Would the President have the unilateral power to impose balance? Suppose, for example, that a reconciliation bill designed to balance the budget is defeated at the end of the congressional session. Can the President unilaterally declare that it is law nonetheless? Can he instead make across-the-board cuts in all spending, including Social Security, Medicare, and defense, without congressional action? Can he *select* which programs to cut unilaterally? Can he impose across-the-board, or selected, increases in tax rates? How about across-the-board or selected reductions in tax expenditures?

- What about the Supreme Court? If the budget is not balanced, can the Court declare a defeated reconciliation bill to be law? Can it override a presidential veto of a reconciliation bill? If it cannot enact a defeated or vetoed law, can it declare that a bill allowing a deficit as having been enacted if it received a majority vote but not a three-fifths vote? Alternatively, can it invalidate appropriation bills, in reverse chronological order? If that seems arbitrary and unworkable, can it order across-the-board cuts in all appropriations, or entitlement programs, or tax expenditures? Can it impose across-the-board surtaxes? Can it hold Congress or the President in contempt and possibly jail them if they ultimately do not act?

- If federal courts award claims or judgments against the United States, as they often do, but the costs would unbalance the budget and require an increase in the debt limit, what action would the courts take?

Mistaken Analogies to States and Families

Proponents of a constitutional amendment sometimes argue that states and families must balance their budgets every year, and the federal government should do so, too. But statements that the constitutional amendment would align federal budgeting practices with those of states and families are not accurate.

While states must balance their *operating* budgets, they can borrow to finance their *capital* budgets — to finance roads, schools, and other projects. Most states do so. States also can build reserves during good times and draw on them in bad times *without* counting the drawdown as new spending that unbalances a budget.

Families follow similar practices. They borrow — they take out mortgages to buy a home or student loans to send a child to college. They also draw down savings when times are tight to cover expenses that exceed their current incomes.

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however, would have made it more difficult for the Treasury to take such action, because the amendment would bar any increases in the Treasury's borrowing limit, except when first authorized by three-fifths votes of the House and the Senate.

But the proposed constitutional amendment would bar such practices at the federal level. The *total* federal budget — including capital investments — would have to be balanced every year; no borrowing to finance infrastructure or other investments to boost future economic growth would be allowed. And if the federal government ran a surplus one year, it could *not* draw it down the next year to help balance the budget.

Conclusion

Policymakers need to begin to change our fiscal trajectory. As various recent commissions have indicated, we need to stabilize the debt as a share of GDP in the coming decade, and to keep it stable after that (allowing for some fluctuation over the business cycle). But establishing a balanced budget amendment in the Constitution would be exceedingly unwise. It would likely exact a heavy toll on the economy and on American businesses and workers in the years ahead. It is not the course the nation should follow.