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ECONOMIC FORECASTING FIRM HARSHLY CRITICIZES PROPOSED CONSTITUTIONAL BALANCED BUDGET AMENDMENT

Amendment Would "Retard Economic Growth" in Good Times And Be "Catastrophic" During Deep Recession

by Richard Kogan

If a constitutional balanced budget amendment (BBA) had already been ratified and were now being enforced for fiscal year 2012, "the effect on the economy would be catastrophic," according to a scathing analysis of a BBA by Macroeconomic Advisers, one of the nation's preeminent private economic forecasting firms.

This conclusion is one of several striking findings about a BBA that was included in an October 21 blog post from Macroeconomic Advisers. (See the Appendix for the relevant portion of the analysis.) Macroeconomic Advisers, which provides nonpartisan analysis to major corporations and government entities such as the President's Council of Economic Advisers (under Presidents of both parties) and the Congressional Budget Office, also concludes that under a balanced budget amendment, "recessions would be deeper and longer," and uncertainty would be cast over the economy that could retard economic growth even in normal economic times.

Specifically:

- Macroeconomic Advisers writes that if a constitutional balanced budget requirement had been ratified in 2008 and took effect in fiscal year 2012, "The effect on the economy would be catastrophic." If the 2012 budget were balanced through spending cuts, those cuts would have to total about $1.5 trillion in 2012 alone, which the report estimates 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.[1] These results, the report explains, would occur in part because "[t]he Fed would be near powerless to offset this huge fiscal drag" and "[n]o model could capture the ensuing chaos and uncertainty, which would make matters far worse."

- Macroeconomic Advisers also notes that a balanced budget amendment would create great

[1] Macroeconomic Advisers derived these figures in two steps. First, it estimated how much the economy would shrink and unemployment would rise because of budget cuts to eliminate the observed deficit. Second, since the slowing economy and increased unemployment would drive down revenues — requiring yet another round of budget cuts — Macroeconomic Advisers estimated how much *more* the economy would slow and unemployment would rise as a result of those cuts. The figures above combine the two steps.

Macroeconomic Advisers Is Nonpartisan, Mainstream, and Highly Regarded

Macroeconomic Advisers (MA) was founded in 1982 by Laurence Meyer, Joel Prakken, and Chris Varvares. In 1996, the Senate confirmed Meyer as a member of the Board of Governors of the Federal Reserve; he returned to MA in 2002 when his term expired. Prakken was elected president of the National Association for Business Economics in 1999. Varvares worked for the Council of Economic Advisers in the Reagan Administration.

Both the Reagan and G.W. Bush Administrations contracted with MA for economic analysis. In 1986, 1993, and 1995, MA won awards for making the most accurate economic forecasts of all major forecasters. MA's analysis of the economic effects of the 2003 tax cuts proposed by President Bush was cited by the Heritage Foundation.

uncertainty because it would be unclear whether the balanced budget requirement would be enforced or suspended during a recession. "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."

- Macroeconomic Advisers concludes that "the only way to implement a BBA without some fiscal drag is to ratify it when the budget is in balance or surplus. Of course, then we wouldn't have needed the BBA to achieve balance in the first place." Moreover, even if a BBA went into effect when the budget happened to be in balance, it would be economically undesirable.

  The report observes that, even under this best possible circumstance, placing a BBA in the Constitution would create "new and powerful uncertainties," in part because "[t]he economy's 'automatic stabilizers' would be eviscerated" and "discretionary counter-cyclical fiscal policy would be unconstitutional." "We believe," Macroeconomics Advisers writes, that "this would change cyclical dynamics. Recessions would be deeper and longer," and the uncertainty by itself could "retard economic growth" even during normal times.

The Macroeconomic Advisers analysis indicates that any version of the balanced budget amendment would do significant harm to the American economy, a view that mainstream economists broadly share.

APPENDIX

The following is the portion of an October 21 blog post[2] *from "Macroadvisers," the blog of Macroeconomic Advisers, that discusses a balanced budget amendment.*

The Republican call for a Balanced Budget Amendment is maddeningly vague in the operational details that could well doom it. Which definition of the budget? Is it the current deficit, the projected deficit, or even the structural deficit that is to be eliminated? Is balance in the budget required year by year or on average over the business cycle? What's the enforcement mechanism? Would enforcement require spending cuts, tax increases, or some combination of both? Are there any contingencies (war, natural disasters, recessions, etc) for which the commitment is temporarily set aside? Even if we knew when a BBA might go into effect — and we have no idea, other than never — without these details we could not possibly simulate its impact.

We can, however, say this: the initial impact of a "hard" BBA on jobs would depend on the size of the deficit at the time when the amendment was first enforced. 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. Our current forecast shows a Unified Budget deficit of about $1 trillion for FY 2012. Suppose this fall the federal government enacted a budget for FY 2012 showing discretionary spending $1 trillion below our forecast, resulting in a "static" projection of a balanced budget for next year. $1 trillion is roughly two-thirds of all discretionary spending, and about 7% of GDP. Our short-run multiplier for discretionary spending is about 2, and let's assume a simple textbook version of Okun's law in which the unemployment gap varies inversely with, but by half as much as, the percentage output gap. Then, instead of forecasting real GDP growth of 2% or so for FY 2012, we'd mark that projection down to perhaps -12% and raise our forecast of the unemployment rate from 9% to 16%, or roughly 11 million fewer jobs. With interest rates already close to zero, the Fed would be near powerless to offset this huge fiscal drag.

And that would not be the end of it. Soon it would become obvious that revenues were falling far short of earlier static projections as both taxable income and average tax rates declined cyclically and mandatory spending increased cyclically as well. The induced rise in the deficit could come to $500 billion, requiring an additional $500 billion cut in discretionary outlays that would zero them out. (That's right, zero them out!) This would cause another 5% decline in GDP and another other 4 million jobs lost, etc.

No model could capture the ensuing chaos and uncertainty, which would make matters far worse. We assume no policymaker faced with this economic reality would advocate implementing such policy. 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. Indeed, the only way to implement a BBA without some fiscal drag is to ratify it when the budget is in balance or surplus. Of course, then we wouldn't have needed the BBA to achieve balance in the first place.

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

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, discretionary counter-cyclical fiscal policy would be unconstitutional, and the sole responsibility for macroeconomic stabilization policy would rest with the Fed — perhaps at a time, like today, when the ability of the FOMC to offset fiscal drag is sharply curtailed by the proximity of interest rates to the zero bound. We believe this would change cyclical dynamics. Recessions would be deeper and longer. Furthermore, in our model, critical markers for financial conditions, like private credit spreads and the VIX, have important cyclical components, the magnification of which would further aggravate the business cycle. In all likelihood the effort to legislate fiscal morality with a simple rule would be overturned or suspended with the first big recession following ratification, creating new uncertainty about fiscal policy and the governance that produced the amendment in the first place.

The ultimate goal of a balanced budget amendment is to reduce the federal deficit. As we have written elsewhere, we believe strongly that deficit reduction is necessary both to avoid the slow crowding out of private investment and to avert the eventual sovereign debt crisis implied by current policies. A BBA would not necessarily achieve these goals before being abandoned or circumvented. Furthermore, an interesting and growing literature suggests that uncertainty surrounding fiscal policy retards economic growth.[3] The attempt to enforce a BBA could well end up heightening fiscal uncertainty while magnifying cyclical risks to the economy. It would be far better to achieve a sustainable fiscal policy through considered discretionary actions than under the yoke of a mechanical rule.

[3] For example, see Jesús Fernández-Villaverde, Pablo Guerrón-Quintana, Keith Kuester, and Juan Rubio-Ramírez, "Fiscal Volatility Shocks and Economic Activity," (Federal Reserve Bank of Philadelphia, Working Paper 11-32; August 9, 2011).