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Proposed Balanced Budget Amendment Is Extreme by International Standards

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Some proponents of a constitutional balanced budget amendment have argued that other developed countries' constitutions require balanced budgets, suggesting that such a requirement for the federal government would therefore be appropriate.[2] In reality, however, *no* European country — not even Germany or Switzerland, which are considered fiscally responsible compared to others — has adopted or is seriously considering a fiscal rule requiring a balanced budget in every year like the balanced budget amendments that Congress has debated in the past and that congressional Republicans continue to propose.

The "Fiscal Compact" that euro area countries[3] signed in March 2012 limits the budget deficit these countries can run over an *entire economic cycle,* not every year.[4] Governments can still run higher deficits during recessions in order to reduce the severity of economic downturns or in response to "exceptional circumstances." In contrast, constitutional balanced budget amendment proposals, including one recently introduced by Senator John Cornyn (R-TX), would require a balanced federal budget every year, regardless of the state of the economy, unless a supermajority of both houses overrode that requirement.[5]

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[1] Hannah Shaw co-authored the original version of this paper. Shea Conaway provided valuable research assistance.

[2] For example, see Steven G. Calabresi, "The Answer Is a Balanced Budget Amendment," *The American Spectator*, October 2011, http://spectator.org/archives/2011/10/28/the-answer-is-a-balanced-budge, and David A. Patten, "Tea Party Applauds Europe's Call for Balanced Budgets," *Newsmax*, August 16, 2011, http://www.newsmax.com/Newsfront/tea-party-europe-balanced/2011/08/16/id/407595.

[3] The euro area, also known as the "eurozone," consists of European Union member states that have adopted the euro as their currency. They are: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

[4] Treaty on Stability, Coordination, and Governance, 2012, http://european-council.europa.eu/eurozone-governance/treaty-on-stability. Eurozone countries are subject to all provisions of the Fiscal Compact; non-eurozone member states (excluding the Czech Republic and United Kingdom) are only accountable for Articles III and IV, which state, respectively, that countries' budgetary positions should accord with their medium-term objectives (to be outlined in their constitutions) and that general government debt should fall to 60 percent of GDP.

[5] Various balanced budget amendment bills have been introduced over the years; while they vary in specific details, they all share this fundamental feature of requiring a balanced budget in every year (except in times of war). Most recently, Senator John Cornyn (R-TX) introduced a balanced budget amendment, S.J. Res. 7, February 13, 2013. Congress debated and rejected a similar amendment in 2011.

A 2012 International Monetary Fund survey of 81 countries worldwide — including all member countries of the Organisation for Economic Co-operation and Development (OECD) — found that in 2011, *not one* had a constitutional balanced budget requirement that would require balance of the entire budget in every year, with no adjustment for economic cycles or capital investment.[6]

A constitutional requirement to balance the U.S. budget in every year would substantially threaten the U.S. economy. The highly regarded private forecasting firm Macroeconomic Advisers has warned that if a balanced budget amendment had been put in place during the recent recession, "the effect on the economy would be catastrophic." It also warned that a balanced budget amendment would make recessions "deeper and longer" and likely retard economic growth in both good times and bad by eviscerating the "automatic stabilizers" (automatic spending increases for social programs and declines in tax revenues during an economic slowdown) that moderate economic fluctuations, creating permanent uncertainty about fiscal policy. The amendment would also raise numerous problems for Social Security and other vital federal functions.[7]

Media Reports May Create Mistaken Impression of Fiscal Compact

In claiming that European countries have set an example for a U.S. constitutional balanced budget amendment, proponents have pointed to media reports of the negotiations leading to the Fiscal Compact describing it as requiring "euro zone governments to enact legislation that would constitutionally bind their governments to balancing their budgets."[8] After leaders signed the treaty in March, media reports continued to portray the requirements of the Fiscal Compact as strict, stating that "the agreement is designed to force governments to adopt balanced budgets through a 'golden rule' or face fines."[9] Another report related that, "Some European countries — Switzerland, Germany, Italy, Spain — have adopted balanced-budget amendments . . . so this is an idea that is spreading somewhat in some Western industrialized nations."[10]

Such reports could create the mistaken impression that the Fiscal Compact commits eurozone countries to a very restrictive balanced budget requirement of the sort that have been included in U.S. balanced budget amendment proposals.

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[6] Andrea Schaechter, Tidiane Kinda, Nina Budina, and Anke Weber, "Fiscal Rules in Response to the Crisis — Toward the "Next-Generation" Rules: A New Dataset," International Monetary Fund Working Paper, Fiscal Affairs Department, July 2012, http://www.imf.org/external/pubs/ft/wp/2012/wp12187.pdf.

[7] Robert Greenstein and Richard Kogan, "Balanced Budget Amendment Highly Ill-Advised for Addressing Long-Term Fiscal Problems," November 14, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3616; Macroeconomic Advisers, "Man Up: AJ(obs)A vs. J(obs)TGA," October 21, 2011, http://macroadvisers.blogspot.com/2011/10/man-up-ajobsa-vs-jobstga.html.

[8] Nicola Clark, "Sarkozy and Merkel Vow Fiscal Unity for Euro Nations," *New York Times,* August 16, 2011, http://www.nytimes.com/2011/08/17/business/global/merkel-arrives-in-paris-to-begin-economic-talks-with-sarkozy.html.

[9] Reuters Ireland, "EU Leaders Sign New Budget Rules Deal," March 2, 2012, http://www.rte.ie/news/2012/0302/euro-business.html.

[10] Ben Philpott, "Perry Likely to Push for Balanced Budget Amendment," *Texas Tribune,* October 25, 2011, http://www.texastribune.org/texas-people/rick-perry/flat-tax-speech-perry-push-balanced-budget/.

Fiscal Compact Does Not Require a Balanced Budget Every Year

U.S. balanced budget amendment proposals would require the entire federal budget to be balanced every year, regardless of economic conditions. By contrast, the EU Fiscal Compact and the fiscal rules that some European countries have already adopted reflect a principle known as the "golden rule," which allows countries to run deficits during recessions and surpluses during booms.[11] The golden rule requires only that the "structural" budget — the level of revenues and expenditures that would occur if the economy were at full employment and growing at normal rates — be balanced. The golden rule therefore requires a government to consider what parts of its spending and revenues are due to the economic cycle (as noted, tax revenues typically dip during recessions while safety net spending rises) and, setting aside those cyclical elements, balance the level of public spending and revenue that would occur if the economy were running at capacity.

This focus on balancing *structural* budgets acknowledges that countercyclical fiscal policy plays an important role in moderating recessions and dampening booms. Governments can run deficits during a recession, whether through automatic stabilizers or by enacting budget increases and/or tax cuts to boost a weak economy. Moreover, the Fiscal Compact's version of the golden rule provides even more flexibility by permitting governments to run structural deficits during expansions as well as recessions, as explained below.

By contrast, requiring a balanced budget every year — as the balanced budget amendment that Congress has considered would do — would make "discretionary counter-cyclical policy unconstitutional" and mean that "recessions would be deeper and longer," according to Macroeconomic Advisers.[12]

Proponents of a U.S. balanced budget amendment often assert that the federal government should balance its entire budget every year just like families do. But families typically borrow to finance investments, such as when they take out a mortgage to buy a home or loans to send a child to college.[13] Thus, families do *not* budget like the proposed constitutional amendment would require the U.S. government to do. Nor do businesses and corporations, for which borrowing to finance new investments is standard practice. The balanced budget amendment that Congress debated, in contrast, would prohibit the federal government from borrowing to make worthy capital investments. Even U.S. states, which are required to balance their operating budgets, are generally allowed to borrow to finance capital investments.

Fiscal Compact's "Golden Rule" Focuses on Medium Term and Provides Flexibility

The Fiscal Compact follows the 1997 EU Stability and Growth Pact, which established that all European countries should aim to achieve a balanced structural budget with decreasing general

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[11] Organisation for Economic Co-operation and Development (OECD), "Public financial management and fiscal goals," Working Paper No.1 on Macroeconomic and Structural Policy Analysis, 1998.

[12] Macroeconomic Advisers, "Man Up: AJ(obs)A vs. J(obs)TGA," October 21, 2011, http://macroadvisers.blogspot.com/2011/10/man-up-ajobsa-vs-jobstga.html.

[13] See also Robert Greenstein, "The False 'Family Analogy' Argument for a Balanced Budget Amendment," *Off the Charts* blog, November 16, 2011, http://www.offthechartsblog.org/the-false-family-analogy-argument-for-a-balanced-budget-amendment.

government debt.[14] The Fiscal Compact, which elaborates and strengthens adherence to those principles, requires each eurozone country to set a "medium term objective" for its structural deficit. This objective cannot exceed 0.5 percent of GDP and countries must "progress towards" that target. This provision:

- **Sets a medium-term objective, not a hard numerical limit.** The European Commission evaluates countries on their "progress towards and respect of" the objective and proposes each country's time frame for convergence. The Commission's recommendations, however, are suggestive and not legally binding. A country might therefore have a structural deficit greater than 0.5 percent of GDP but still comply with its requirement if it makes progress toward the objective. Moreover, a country's structural-deficit-to-GDP ratio is only one factor in the assessment of its progress.

- **Allows for countercyclical fiscal policy and even structural deficits.** The medium-term objective targets only structural deficits "net of one-off and temporary measures." This means that countries can run countercyclical deficits during recessions, whether caused by automatic stabilizers or temporary, discretionary countercyclical policies (such as temporary stimulus spending or tax cuts).

  Furthermore, the Fiscal Compact permits countries to set a medium-term objective that allows *structural* deficits of up to 0.5 percent of GDP. That is, in addition to any temporary deficit caused by recession, countries may set an objective that allows them to run a deficit of an additional 0.5 percent of GDP that would persist even if the economy were at full capacity. Separately, the 1997 Stability and Growth Pact set a target for *total* deficits for each eurozone country of 3 percent of GDP. [15]

  Both of the Fiscal Compact requirements are much more flexible than U.S. balanced budget amendments, which would make any deficit — structural or otherwise — unconstitutional in each and every year.

- **Gives countries extra flexibility in "exceptional circumstances," including "severe economic downturns."** The Fiscal Compact allows eurozone countries to deviate from progress toward their structural deficit objective in the case of "exceptional circumstances," which it defines as "unusual events outside the control of a Contracting Party" or "severe economic downturns."[16] The Stability and Growth Pact's definition of a "severe economic

[14] Resolution of the European Council on the Stability and Growth Pact, Amsterdam, June 17, 1997, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML.

[15] Resolution of the European Council on the Stability and Growth Pact, Amsterdam, June 17, 1997, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML. European Council regulations stipulate that countries with general government debt exceeding 60 percent of GDP should reduce their debt by 0.05 percent of the difference between the country's current debt ratio and 60 percent of GDP. The Stability and Growth Pact permits deficits up to 3 percent of GDP. The Fiscal Compact clarifies this provision and permits deficits up to 0.5 percent of cyclically-adjusted GDP (1 percent for countries with government debt of less than 60 percent of GDP). Sanctions, which may occur only after the Commission determines the country is in breach of the excessive deficit criterion, cannot exceed 0.1 percent of GDP (Treaty on Stability, Coordination, and Governance, 2012, Article VII and VIII).

[16] Treaty on Stability, Coordination, and Governance, 2012, Article III, Par. 3(b).

downturn" as a large deficit due to a negative growth rate or "the accumulated loss of output during a protracted period of very low growth relative to potential growth"[17] appears to give countries significant leeway to run structural deficits above 0.5 percent of GDP (and total deficits above 3 percent of GDP) during a contraction or prolonged slump.[18] Eurozone countries have interpreted "unusual events" to include bank bailouts and national disasters.[19]

By contrast, U.S. balanced budget amendment proposals would require a supermajority vote of both the House and Senate to waive the balanced budget requirement.[20] Recent experience shows that securing a supermajority in both chambers for almost any major legislation is extremely difficult.

- **Loosens the objective if the country achieves a fiscal position that is otherwise low-risk.** If a country's debt-to-GDP ratio is significantly below 60 percent and "risks in the long-term sustainability of public finances are low," the Fiscal Compact allows countries to run structural deficits of up to 1.0 percent of GDP.[21]

- **Does not require that budgets in violation of the objective be struck down.** Each country must adopt an automatic correction mechanism that will trigger upon "significant observed deviations from the medium-term objective or the adjustment path towards it."[22] The European Commission will propose common principles that countries should follow when adopting the correction mechanism (e.g., what is a "significant deviation" and what type of action should be triggered). By contrast, under proposed U.S. balanced budget amendments, any deficit not approved by a supermajority of both houses of Congress would be unconstitutional and thus sure to entangle the U.S. budget in legal battles.

In short, the Fiscal Compact's emphases on medium-term objectives, structural deficits, and flexibility differ sharply from the proposed U.S. constitutional amendment.

Eurozone Implementation of Golden Rule Highlights Contrast with U.S. Proposal

A number of European countries have adopted policies or constitutional rules that incorporate key characteristics of the golden rule, some in response to the Fiscal Compact. These golden rules were all far less damaging than the proposed U.S. balanced budget amendment.

- The **United Kingdom** (UK) in 1997 adopted a golden rule stating that, "over the economic

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17 Council Regulation (EC) No 1056/2005 of 27 June 2005 Amending Regulation (EC) No 1467/97 Article I, Par 1.

18 See European Council, "European Council concludes discussion on the new fiscal compact," December 09, 2011, http://www.european-council.europa.eu/home-page/highlights/european-council-concludes-discussion-on-the-new-fiscal-compact.

19 IMF report, 2012, pp. 20, 42.

20 Recent Republican versions of the balanced budget amendent, such as the one Congress rejected in 2011 and that Senator Cornyn introduced this year, would require a two-thirds majority vote to waive the requirements. Previous versions of the amendment typically required a three-fifths majority for waivers.

21 Treaty on Stability, Coordination, and Governance, 2012, Article III, Par 1(d).

22 Treaty on Stability, Coordination, and Governance, 2012, Article III, Par 1(e).

cycle, the government will only borrow to invest and not to fund current expenditure."[23] The Institute for Fiscal Studies, an independent UK think tank, explained that the UK preferred the golden rule to the kind of balanced budget requirement Congress considered because:

> The danger of a strict balanced budget rule is that it could inappropriately prevent spending on beneficial investment projects that are prohibitively expensive for current taxpayers alone to finance, because it would not permit future generations to bear part of the cost. It seems unreasonable not to allow governments to borrow when individuals often do so to fund long-term purchases such as houses. . . . [T]he golden rule would allow investment projects to go ahead because it distinguishes capital from current spending.[24]

In the UK, the executive branch adopted the golden rule as policy; the rule was *not* enacted in law or enshrined in a written constitution, and non-compliance had no legal consequences. The current UK government has adopted a "new golden rule," also referred to as the "fiscal mandate," which sets deficit targets based on the golden rule principle but with some operational differences from the original version.[25]

Germany, Switzerland, and Spain are the only European countries with constitutional versions of golden rule currently in operation.[26]

- **Germany's** constitution, as revised in 2009, allows the central government to run a structural deficit of up to 0.35 percent of GDP — or somewhat larger when recessions occur.[27] During a natural disaster or emergency, a simple majority of the parliament can override the rule. There are no binding sanctions for violating the rule, but a new independent "Stability Council" will evaluate compliance.

- **Switzerland's** constitution requires that the structural budget be balanced based on revenue

[23] Her Majesty's (HM) Treasury (United Kingdom), "Financial Statement and Budget Report 1997," July 1997, http://archive.treasury.gov.uk/budget/1997/report/fsbr.htm, Section 1.19. The UK Treasury considered the golden rule to be met if the annual average budget surplus as a share of GDP over the economic cycle is in balance or surplus: HM Treasury (United Kingdom), Pre-Budget Report, December 2004, http://news.bbc.co.uk/nol/shared/bsp/hi/pdfs/02_12_04_pbr04_maindoc1.76.pdf, p. 193.

[24] Institute for Fiscal Studies, "The Government's Fiscal Rules," November 2006, http://www.ifs.org.uk/bns/bn16.pdf, p. 10.

[25] Institute for Fiscal Studies, "The IFS Green Budget Chapter 2, The New Fiscal Framework: An Assessment," http://www.ifs.org.uk/publications/5460. Under the current version, the "current budget must be forecast to be in balance or in surplus by the end of a rolling, five-year forecast horizon."

[26] As eurozone countries ratify the Fiscal Compact, more countries will establish such national rules. Most newly approved rules (as of October 2012) will become effective between 2013 and 2020. See IMF (2012) and European Parliament, Directorate General for the Presidency, "Table on the Ratification Process of Amendment of Art. 136 TFEU, ESM Treaty and Fiscal Compact," updated October 2 2012, http://www.europarl.europa.eu/webnp/webdav/site/myjahiasite/users/fboschi/public/art.%20136%20ESM%20fiscal%20compact%20ratprocess.pdf.

[27] If the golden rule is excessively violated, then to offset the violation the German government is required to run smaller deficits or larger surpluses than otherwise allowed once the economy is in recovery. The rule is being phased in and will take full effect in 2016. IMF 2012 report, pp. 21-22.

forecasts of the coming year and adjusted for the business cycle. If the deficit exceeds 0.6 percent of GDP, parliament must reduce the debt within three years.[28] A supermajority of both houses of the parliament can override the rule in "exceptional circumstances." Parliament may also enact higher expenditures than normally allowed through supplemental budgets, as long as future plans offset these expenditures.[29]

- **Spain's** legislature enacted in 2011 what has been called a golden rule constitutional amendment.[30] In addition to affirming European Union deficit and debt limits,[31] it sets additional limits on structural deficits for each level of government.[32] By targeting structural rather than total deficits, the measure allows for cyclical deficits and surpluses. It also permits the government to exceed the deficit and debt limits with majority approval of the lower house of parliament in cases of "natural disasters, economic recession or extraordinary emergency situations that are either beyond the control of the State or significantly impair the financial situation or the economic or social sustainability of the State."[33]

European countries are not unique in shunning the version of the balanced budget amendment before Congress. As noted, the IMF's 2012 survey of fiscal rules in force in 81 countries worldwide — including all member countries of the Organisation for Economic Co-operation and Development (OECD) — found that in 2008, *not one* had a constitutional balanced budget requirement that would require balance of the entire budget in every year, with no adjustment for economic cycles or capital investment.[34]

Even Fiscal Rules Less Extreme than U.S. Proposal Are Not Necessarily a Sound Idea

Fiscal rules that allow for countercyclical fiscal policy, such as the golden rule principle in the Fiscal Compact and those adopted by the UK and Germany in the past, are much less extreme and damaging than the proposed U.S. balanced budget amendment. This does not mean, however, that they are necessarily sound ways to stabilize the public debt at a sustainable level.

Particular difficulties with the golden rule include:

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28 IMF "Fiscal Rules—Anchoring Expectations for Sustainable Public Finance," December 16, 2009, p. 39, http://www.imf.org/external/np/pp/eng/2009/121609.pdf.

29 Frank Bodmer, "The Swiss Debt Brake: How it Works and What Can Go Wrong," *Schweizerische Zeitschrift für Volkswirtschaft und Statistik* (2006) Vol. 142 (3), pp. 307-330; IMF 2012 report, pp.20-21.

30 Agence France-Presse, "Spain passes 'golden rule' reform to fend off debt crisis," July 9, 2011, http://www.france24.com/en/20110907-spain-passes-golden-rule-reform-fend-off-eurozone-sovereign-debt-crisis-parliament.

31 Those limits are 3 percent of GDP for deficits and 60 percent of GDP for debt. *Official Journal of the European Union,* "10. Protocol on the excessive deficit procedure," December 16, 2004, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2004:310:0337:0338:EN:PDF.

32 IMF 2012 report, p. 26.

33 Centre for European Policy Studies, "Spanish Constitutional Reform," September 2011, http://www.ceps.eu/book/spain's-constitutional-reform-what-seen-and-not-seen, p. 2.

34 IMF 2012 report.

- **Debt reductions larger than required to meet debt targets.** Countries have adopted golden rules with a view toward stabilizing their debt-to-GDP ratios at some acceptable level. However, golden rules can lead to continuing large reductions in debt relative to the size of the economy *beyond* what is needed to meet a reasonable debt-to-GDP target. For example, the IMF has noted concerns that the Swiss fiscal rule "may be too tight, implying a sharp reduction of the public debt-to-GDP ratio over the long run."[35] These extreme reductions may also reduce worthwhile public investments so that countries achieve their deficit target.

- **Errors projecting the state of the economy and government accounts.** To attempt to balance the operating budget over an economic cycle, a government must project: the rate at which the economy can sustainably grow, the difference between what the economy will produce and what it is capable of producing, and levels of government spending and revenues. Considerable uncertainty is present in all of these calculations.[36]

- **Difficulty defining capital spending.** Some versions of the golden rule require only that the *operating* budget be balanced over the economic cycle. That is, governments can run structural deficits in order to finance net new capital investment, though not to fund current operating spending. This is similar to the way that state balanced budget requirements generally work in the United States (although states must balance their operating budgets every year, not just over the economic cycle),[37] but it requires strong public accounting standards to determine what is "capital" and what is "operating" spending.[38] Even where those accounting standards exist, they may not be ideal.

  In the UK, the definitions of operating and capital spending were determined by accounting convention rather than by economic criteria.[39] For example, teachers' salaries and early childhood health intervention expenditures are considered operating spending by accounting standards, even though they may benefit future generations in terms of both public well-being and future fiscal costs saved and thus might be regarded as capital spending. Therefore, even the UK golden rule does not fully permit "borrowing to finance current spending projects of value to future generations," as the Institute for Fiscal Studies has noted.[40]

- **Deliberate gaming.** The technical difficulty of determining key elements of the golden rule — such as the state of the economic cycle and what counts as operating spending — can permit real or perceived gaming of the rule. For example, in 2005 the UK Treasury revised its national account data, which shifted the start of the previous business cycle from 1999 to 1997. Though the National Audit Office found that the re-dating was reasonable, an IMF analysis noted that it

[35] IMF 2009 report, p. 39.

[36] IFS, p. 11-12.

[37] While states must balance their operating budgets they can — and do — borrow significant amounts for capital projects. (A number of states' balanced budget requirements also allow the state to run operating deficits during an economic downturn or to meet some emergency, as long as the state has accumulated sufficient "rainy day funds" by running operating surpluses in prior years.)

[38] Organisation for Economic Co-operation and Development, "Public financial management and fiscal goals," Working Paper No.1 on Macroeconomic and Structural Policy Analysis, 1998.

[39] IFS, p. 2.

[40] IFS, p. 20.

"raised questions about the possible manipulation of the rules as the new dates pulled a sizable current surplus in 1998 into the present cycle, effectively providing room to delay [fiscal] adjustment without imperiling observance of the golden rule."[41]

Conclusion

The United States would be an outlier if it were to adopt the type of constitutional balanced budget amendment that Congress has considered in the past and that congressional Republicans are currently promoting. No other country has or is considering a rule that would prohibit countercyclical fiscal policy, and for a very good reason: such a rule would worsen recessions, potentially causing "catastrophic" economic damage in the words of Macroeconomic Advisers. Countries such as Germany, as well as the European Union, have adopted or considered rules that have been called "balanced budget amendments," but those rules differ markedly from U.S. balanced budget amendments.

[41] Keiko Honjo, "The Golden Rule and the Economic Cycles," International Monetary Fund Working Paper WP/07/199, http://www.imf.org/external/pubs/ft/wp/2007/wp07199.pdf, p. 5.