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Balanced Budget Amendment Proposal Is Extreme by International Standards

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Congressional Republicans are promoting a constitutional amendment requiring a balanced federal budget every year — regardless of the state of the economy — unless supermajorities of both houses override that requirement.[2] The proposal risks causing severe economic damage, because, as explained below, the inability to run deficits during downturns would make recessions more severe. Proponents argue that other countries have benefited from adopting "fiscal rules" that guide and limit their fiscal policies.[3] But no other country has — or is seriously considering — a constitutional rule requiring a balanced budget in every year. A 2015 International Monetary Fund (IMF) survey of 89 countries worldwide, including all members of the Organisation for Economic Co-operation and Development (OECD) and the Eurozone, found:[4]

- *Not one* of the 89 countries had a constitutional balanced budget requirement that would require balancing the entire budget every year, with no adjustment for economic cycles or capital investment.
- Most fiscal rules are not constitutional. Instead they are in statutes, policy, or even agreements between political parties and can be overridden through normal legislative processes.

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[2] This paper's discussion of a U.S. balanced budget amendment focuses on H. J. Res. 2, introduced by House Judiciary Committee Chairman Bob Goodlatte, which would require that the entire federal budget be balanced or in surplus in every year and would bar any increase in the debt limit. These requirements would be waivable only by a three-fifths vote of both the House and Senate, by declaration of war, or by enactment of a joint resolution declaring a "military conflict which causes an imminent and serious threat to national security." Congressional Republicans have also proposed constitutional amendments even more restrictive than H. J. Res 2. See Richard Kogan and Cecile Murray, "Senate Proposal for Balanced Budget Amendment Would Require Extreme Budget Cuts," Center on Budget and Policy Priorities, May 3, 2016, http://www.cbpp.org/research/senate-proposal-for-balanced-budget-amendment-would-require-extreme-budget-cuts.

[3] For example, Douglas Holtz-Eakin, testimony before the Senate Judiciary Committee, March 16, 2016, http://1.usa.gov/1VV2mi0.

[4] IMF, "Fiscal Rules at a Glance," April 2015, http://bit.ly/1pCYynJ.

Only nine countries have constitutional rules about budget balances or deficits — and again, none of those requires balancing the budget during recessions.

Further, international and U.S. experience does not indicate that adopting any type of fiscal rule — and certainly not one as draconian as the proposed balanced budget amendment — would by itself produce sound fiscal policy. Such rules cannot replace or force difficult political decisions about fiscal and economic priorities. And even fiscal rules that are far more moderate than the proposed balanced budget amendment can have serious downsides.

The highly regarded private forecasting firm Macroeconomic Advisers has warned that if a balanced budget amendment had been in place during the last recession, "the effect on the economy would be catastrophic." It warned that a balanced budget amendment would likely impede economic growth by eviscerating the "automatic stabilizers" (automatic spending increases for social programs and declines in tax revenues during an economic slowdown) that moderate recessions and booms, so that "recessions would be deeper and longer."[5] The amendment would also likely harm Social Security and other vital federal functions.[6]

Other Countries' Fiscal Rules Accommodate Recession-Fighting Deficits

Countercyclical fiscal policy is an important tool for moderating recessions and dampening booms. To boost a weak economy during recessions, governments run deficits, whether through automatic stabilizers or by enacting budget increases and/or tax cuts. The resulting increase in public and private spending can help shore up demand for goods, services, and workers.

A balanced budget amendment that prevents the use of deficits to ameliorate recessions could cause severe economic damage. It would force policymakers to cut spending, raise taxes, or both just when the economy is weak or already in recession — the *opposite* of what good economic policy would advise. That would launch a vicious spiral: a weak economy would raise deficits, which would force policymakers to cut spending or raise taxes more, which would weaken the economy further.

In light of these facts, *no* country's fiscal rules — even those referred to as "budget balance rules" — require total budget deficits to be zero in every year, the IMF analysis finds.[7] Instead, they allow the country to run deficits during recessions and surpluses during booms by:

- **Setting targets for the "structural" or "cyclically adjusted" budget.** The structural budget is the level of revenues and spending that would occur if the economy were at full employment and growing at normal rates. This type of 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*

[5] "Man Up: AJ(obs)A vs. J(obs)TGA," October 21, 2011, http://bit.ly/26soR1G.

[6] Richard Kogan, "Constitutional Balanced Budget Amendment Poses Serious Risks," Center on Budget and Policy Priorities, July 16, 2014, http://bit.ly/1SqBvYP.

[7] The April 2015 IMF report updates IMF Working Paper 12/127 "Fiscal Rules in Response to the Crisis — Toward the 'Next-Generation' Rules. A New Dataset," by Andrea Schaechter *et al.,* July 2012. That paper defined as a "budget balance" rule any fiscal rule that constrains "the variable that primarily influences the debt ratio" and targets deficits, even though the rule itself may allow governments to run deficits and not require actual budget balance.

those cyclical elements, meet a budget target based on the spending and revenue that would occur *if* the economy were running at capacity.

- **Targeting budget balance over the course of an economic cycle** or some other period so the budget is balanced for the period as a whole or in an average year during that period. This type of rule allows deficits in recessions or when the economy is recovering but still not at full employment, as long as the budget reaches a particular target over a specified multi-year period.
- **Targeting balance only in the "operating budget,"** thus permitting deficits to finance spending considered long-term investment.[8]

For example, countries of the European Union (EU) agreed in 2012 to a "Fiscal Compact" requiring each of them to adopt a deficit target; in response, some countries have enacted legislation or constitutional changes. Because the target applies to the structural deficit, it allows countercyclical deficits during recessions and surpluses during booms. Furthermore, the Fiscal Compact permits a government to run structural deficits during both expansions and recessions as long as it sets a "medium term objective" to make progress towards a structural deficit of no more than 0.5 percent of GDP. That is, in addition to any temporary deficits caused by recession, a country may set an objective that allows it to run a deficit of 0.5 percent of GDP *even when* its economy operates at full capacity.[9]

The IMF study identifies only nine countries with constitutional rules about budget balance or deficits, and none requires a balanced budget during recessions. The rules in Denmark, Germany, Italy, Latvia, Lithuania, Malta, and Switzerland target structural budget deficits rather than total deficits. Singapore's rule targets balance over a multi-year period (the current term of the government), and Georgia's rule allows for deficits up to 3 percent of gross domestic product (GDP).

By contrast, the proposed U.S. balanced budget amendment would require supermajority votes in both the House and Senate to waive the balanced budget requirement, even in a recession. Recent experience shows that securing a supermajority in both chambers for almost any major legislation is extremely difficult, so the amendment would likely prevent countercyclical deficits in many or all situations. Other countries' fiscal rules not only allow for countercyclical policy but also have much more flexible means of enforcement, as explained below.

Many Countries "Fiscal Rules" Are Statutory or Political Agreement

Under the proposed U.S. balanced budget amendment, any deficit not approved by congressional supermajorities would be unconstitutional and thus likely spark complex legal battles, perhaps shifting significant budget-making authority to the President or the courts if Congress failed to enact the tax increases or programs cuts needed to balance the budget. By contrast, many fiscal rules in

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[8] For example, the IMF analysis describes the rules of Brazil, Costa Rica, Japan, and Malaysia as targeting operating balances.

[9] Separately, the 1997 Stability and Growth Pact set a target for *total* deficits for each Eurozone country of 3 percent of GDP. Resolution of the European Council on the Stability and Growth Pact, Amsterdam, June 17, 1997, http://bit.ly/24irfG4. For more on the Fiscal Compact, see the prior version of this paper at http://bit.ly/1NxRAf2.

other countries can be overridden by a simple majority vote (or whatever other process is normally required to pass ordinary laws) or have no clear enforcement mechanisms other than political attention and pressure.

For example, Swedish governments have explicitly noted that Sweden's fiscal rules are not intended to constrain or replace political decision-making about budget priorities:

> [T]he purpose of the fiscal policy framework is not to deprive democratically elected representatives of the right to decide fiscal policy. To be legitimate, fiscal policy shall represent values. There is no alternative to political representatives when it comes to gathering up and channelling values. . . . In general, therefore, fiscal policy will vary depending on the parliamentary situation on which the government of the day is based. Consequently it is neither possible nor desirable to replace the political decision-making process with mechanical rules and still preserve the decisions' legitimacy.[10]

Instead of constraining political processes, the fiscal framework aims to draw attention to the country's long-term fiscal sustainability and make fiscal policy more transparent.[11] Sweden's fiscal framework is flexible and accommodates countercyclical deficits (see box).

Fiscal Rules Do Not Cause Good Fiscal Policy

Even a fiscal rule that was better designed than the proposed U.S balanced budget amendment could not substitute for making hard budgetary and economic choices or for generating the political consensus necessary to do so. Indeed, "merely adopting a fiscal rule is not likely to improve budgetary outcomes," noted the Congressional Budget Office (CBO), citing an IMF review of fiscal rules internationally.[12] CBO explained:

> [E]xperience in the United States and elsewhere suggests that fiscal rules are not a substitute for making difficult choices about the budget. Rather, fiscal rules appear to be useful for enforcing budgetary goals when there is a consensus about those goals and about the policy changes needed to meet them. Rules can make it harder for policymakers to succumb to pressure to stray from agreed-upon policy decisions. But when consensus about budgetary goals erodes, rules will not necessarily stand in the way of policymakers who want to spend more or tax less than the rules allow.[13]

The Balanced Budget and Emergency Deficit Control Act of 1985 illustrates that fiscal rules can't force budget changes. Also known as Gramm-Rudman-Hollings (GRH), it was intended to force policymakers to achieve major deficit reduction at a time when they could not agree on such policies. The law set fixed annual deficit targets and triggered automatic, across-the-board spending cuts if they were not met. But, as CBO explained, GRH "clearly did not lower the deficit to

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[10] Swedish Fiscal Policy Council, "The Swedish Fiscal Policy Framework," March 2011, pp. 14-15, http://www.finanspolitiskaradet.se/download/18.49955727139d0ce5f5d43af/1377195302645/The+Swedish+fiscal+policy+framework.pdf.

[11] *Ibid.,* p. 5.

[12] Congressional Budget Office (CBO), "Choices for Deficit Reduction," November 2012, p. 28

[13] *Ibid.,* pp. 28-29.

anywhere near close to the targeted level."[14] Instead of reaching agreement on "real, permanent" deficit reduction to avoid the across-the-board cuts, policymakers met the targets "by using overly optimistic economic assumptions and outright budget gimmickry such as shifting military pay dates between years and moving costly spending off-budget." CBO concluded that "Any budget procedure that establishes fixed deficit targets represents an attempt to force future agreements and is subject to this problem," and that a constitutional balanced budget amendment would be no exception.

The Budget Enforcement Act of 1990 was more credible and successful because it aimed at preventing erosion in the deficit reduction that Congress and the President had *already agreed to* earlier that year, rather than trying to force such an agreement.[15] The law established statutory limits on discretionary spending at the levels specified in the budget agreement and required any future spending increases or tax cuts to be offset by other policy changes (the so-called pay-as-you-go rule).

Similarly, fiscal rules in the Netherlands do not attempt to force agreement on deficit targets and how to achieve them. Instead, they codify and help enforce an agreement that the parties forming the government have already reached (see box).

Even Less Draconian Fiscal Rules Can Have Serious Drawbacks

A fiscal rule that allows for countercyclical fiscal policy and does not require a congressional supermajority to override would be much less extreme and damaging than the proposed U.S. balanced budget amendment. This does not mean, however, that such rules are necessarily sound ways to stabilize the public debt at a sustainable level, because they still have significant drawbacks.

- **Excessive debt reduction.** Rules that target the structural deficit and thus accommodate automatic stabilizers and countercyclical policy when the economy is weak can lead to continuing, large reductions in debt relative to the economy, *beyond* what is needed to stabilize debt at a reasonable share of the economy. For example, the IMF has noted concerns that even though the Swiss fiscal rule targets structural balances, it "may be too tight, implying a sharp reduction of the public debt-to-GDP ratio over the long run."[16] These extreme reductions may reduce worthwhile public goods and services.
- **Errors projecting the state of the economy and government accounts.** To attempt to eliminate a structural deficit (or balance the 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.[17]
- **Problems with capital budgeting.** Some fiscal rules require only that a government's *operating* budget be balanced over the economic cycle. That is, governments can run structural

[14] CBO, "The Economic and Budget Outlook: Fiscal Years 1994-1998," January 26, 1993, p. 87.

[15] See CBO, "Economic and Budget Outlook," pp. 84-89.

[16] IMF, "Fiscal Rules — Anchoring Expectations for Sustainable Public Finance," December 16, 2009, p. 39, http://bit.ly/1XVFAEE.

[17] Institute for Fiscal Studies (IFS), "The Government's Fiscal Rules," November 2006, pp. 11-12, http://www.ifs.org.uk/bns/bn16.pdf

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),[18] but it requires strong public accounting standards to determine what is "capital" and what is "operating" spending.[19] Even where those accounting standards exist, they may not be well matched to policy goals. If the policy goal is to allow borrowing to finance current spending that can benefit future generations, then limiting borrowing to spending on physical capital owned by the government, as a capital budget does, draws the line too narrowly.[20]

For example, until 2008, the United Kingdom had a fiscal rule that allowed borrowing for capital investment but did not fully permit "borrowing to finance current spending projects of value to future generations," according to the Institute for Fiscal Studies.[21] This occurred because the definitions of operating and capital spending were determined by accounting convention rather than by economic criteria.[22] As a result, under the rule, borrowing was not allowed for spending on early childhood health and education, which is considered operating spending by accounting standards, even though it may benefit future generations in terms of both public well-being and future fiscal costs saved.

Careful design may avoid some problems with fiscal rules, but other problems, such as forecasting error, are harder to overcome. Furthermore, mechanical rules are inherently ill-suited to forcing agreement on deficit reduction: rigid rules can neither take into account the full range of priorities and values that policymakers must balance, nor foresee and accommodate all future economic and social conditions.

Conclusion

The United States would be an outlier if it were to adopt the type of constitutional balanced budget amendment that has been proposed. 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.

While well-designed fiscal rules can help enforce deficit reduction agreements that policymakers have already reached, they cannot substitute for or force hard political choices about the specific spending and revenue measures to take to reduce deficits.

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[18] While states must balance their operating budgets they can — and do — borrow significant amounts for capital projects. State debt currently amounts to $3.0 trillion, according to the Federal Reserve. A number of states' balanced budget requirements also allow 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.

[19] OECD, "Public financial management and fiscal goals," Working Paper No.1 on Macroeconomic and Structural Policy Analysis, 1998.

[20] For an assessment of capital budgeting, see *Report of the President's Commission to Study Capital Budgeting*, February 1999, http://1.usa.gov/1qRpYY3.

[21] IFS, p. 10.

[22] IFS, p. 2.

Other Countries' Fiscal Rules Far Different from Draconian U.S. Proposal

U.S. proponents of a balanced budget amendment have pointed to other developed countries' fiscal rules as demonstrating why the US should adopt such a proposal, but other countries' fiscal rules allow for countercyclical fiscal policy to lessen the impact of recessions. Further, most are not constitutional or can be overridden without special procedures. For example:

Sweden

Sweden's fiscal rules, described as a "framework" rather than strict rules, are statutory and political rather than constitutional. The Budget Act 2011 requires the government to set a target for government deficits or surpluses, report on adherence to the targets, and, if it deviates from them, explain how it intends to reach them. Governments have accommodated countercyclical deficits by setting a goal for achieving a net surplus *on average* over an economic cycle. Underscoring the flexibility of the framework, the current government has announced that it will adopt a target of simple balance on average over the course of an economic cycle.[a] The framework provides no automatic fiscal or legal consequences for failure to reach the targets; it is up to the government to assess whether and how to correct deviations, taking into account fiscal stability, redistribution, and other policy objectives.[b]

Netherlands

The formation of a government in the Netherlands requires a coalition between members of two or more political parties that have been elected to the parliament. The coalition agreement outlines the government's key policy objectives, including a detailed set of budgetary policies as well as budgetary rules. Those rules are designed to ensure adherence to the budgetary policies in the coalition agreement — not to force an agreement. Legislation enacted in December 2013 codified the basic principles underlying the previous rules but "did not really change the material budgetary landscape."[c] The rules are not constitutional, and "It is rather unlikely than an individual or group could judicially enforce a violation of the budgetary norms."[d] They do not require a balanced budget but instead accommodate countercyclical policy. The budget has been in deficit since 2009.

[a] Charles Duxbury, "Sweden Seeks to Drop Budget Surplus Target," *Wall Street Journal*, March 3, 2015, http://www.wsj.com/articles/sweden-seeks-to-drop-budget-surplus-target-1425379037.

[b] Swedish Fiscal Policy Council, p. 6.

[c] Dutch Report for the 19th International Congress of Comparative Law in Vienna, July 2014, p. 28, http://bit.ly/1QzbmBl.

[d] *Ibid.,* p. 29.