THE ECONOMICS OF THE BALANCED BUDGET AMENDMENT: WHY IT IS BAD FOR AMERICA

A revised version of this paper was published as "The Sorry Politics of the Balanced Budget Amendment," Challenge, v. 40, May/June 1997, 5 - 13.

Thomas I. Palley
Assistant Director of Public Policy and Economic Research
AFL-CIO
815 Sixteenth Street, NW
Washington DC, 20006

EXECUTIVE SUMMARY

The balanced budget ammendment risks seriously harming the long term health of the U.S. economy. Initial *implementation* effects will lower aggregate demand, and risk sending the economy into recession. *Destabilization* effects, arising from greater volatility of government spending and taxation, will amplify the swings of the business cycle. They will also generate more volatile interest rates as the Fed tries to offset the volatility of fiscal policy. Negative *growth* effects, arising from a forced reduction in public investment spending, risk lowering the economy's growth rate. Lastly, the ammendment creates *financial instability* effects. By cutting off the supply of government bonds, the ammendment will likely inject more risk into the portfolios of banks and financial institutions, thereby resuscitating the possibility of old style financial crises.

Keywords: Balanced budget ammendment, implementation effects, destabilization effects, growth effects, financial instability effects.

INTRODUCTION

The 105th Congress has just begun its deliberations. One item that is its agenda is the balanced budget amendment (BBA). After years of gradually accumulating support, the BBA may now have sufficient votes to pass in both the Senate and the House of Representatives. However, President Clinton and Treasury Secretary Rubin both remain staunchly opposed to it, and there are indications that the Federal Reserve is also opposed to it. For opponents, the amendment threatens to reduce policy flexibility, and potentially destabilize the economy by turning mild economic downturns into deep recessions. They argue that the real challenge is to actually balance the budget, and the BBA is a circus that obscures the difficult choices involved in achieving such an outcome.

SNATCHING DEFEAT FROM THE JAWS OF VICTORY

Ironically, after years of running extensive deficits, measured as a percentage of national income, the federal government is shifting back toward budget balance. The push for the BBA therefore represents an instance of snatching defeat out of the jaws of victory.

During the 1980s, the federal deficit averaged 3.6% of gross domestic product (GDP): since the current economic recovery began in earnest at the beginning of 1992, the federal deficit has steadily declined as a share of GDP, and was only 1.4% of GDP last year. Such a percentage represents dynamic balance in the sense that the deficit is sufficiently small that the national debt is actually falling as a percentage of GDP.

Though less widely known, state governments have run budget surpluses during this period of federal deficits. During the 1980s, total state budget surpluses averaged 1.1% of GDP: during the 1990s these surpluses have averaged 0.4% of GDP%, which is where they currently stand. The division of fiscal responsibilities between state and federal government is a political artifact. When the two are considered as a single entity, as is the case in other countries, two important features emerge. First, state budget surpluses have helped offset federal budget deficits. Second, both state and federal budgets have been moving into balance, so that the BBA is redundant.

One cause for concern is the issue of projected future federal deficits. The Congressional Budget Office projects that the federal budget deficit will start increasing in the latter part of this decade, reaching $244 billion by the year 2000. There are two important qualifiers to this observation. First, the economy will continue to grow: if it grows at 4.8% per annum (2% growth plus 2.8% inflation), such a deficit will represent only 2.7% of GDP. A $244 billion deficit is disastrous for an economy with a GDP of $500 billion: it is of much less consequence for an economy with a GDP of $9.2 trillion.

The second important feature is that 125% of the projected increase in the deficit is attributable to increased medicaid and medicare expenditures. In the absence of these expenditures, the deficit would actually fall. These increased outlays are not the result of demographic developments associated with an increased aged and infirm population: rather, they are the result of projected continued excessive medical cost inflation. The deficit problem is therefore really one of medical cost containment. This is the issue America needs to address: however, the BBA obscures this by pretending to solve the problem with a unilateral declaration of victory. If passed, the problem will remain to be solved, albeit now under the additional constraint of the BBA.

THE BUDGET AS A MISLEADING ACCOUNTING MEASURE

Not only does the balanced budget crusade obscure the true source of the nation's budgetary difficulties, the budget itself provides a misleading indicator of federal fiscal integrity. In effect, the BBA seeks to balance a deeply flawed accounting measure.

First, the federal budget fails to distinguish between "operating" and "capital" expenditures. Operating expenditures are those incurred in running government and funding the services it provides; capital expenditures relate to purchases of long lived buildings and equipment, and include expenditures on infrastructure. The failure to distinguish these types of expenditures is at odds with accepted accounting practice, and is at odds with the accounting practices adopted by corporate America. It amounts to claiming that expenditures on roads and buildings are equivalent to consumption, and that these assets are fully used up in the year they are purchased. The result is to overstate spending, and give government an air of profligacy. If capital expenditures were appropriately capitalized, both government expenditures and the deficit would be lower.

A second failing of the federal budget is its incorrect accounting of the effects of inflation. The government is the country's largest financial debtor. Just as inflation lowers the burden of mortgages for households, so too it lowers the burden of the national debt. Financial markets recognize that inflation erodes the value of loans, and interest rates rise in inflationary periods to compensate for this. In effect, higher rates compensate lenders for loan principal erosion, and are tantamount to early repayment of loans. From an accounting standpoint, this means that the portion of interest rates attributable to inflation should be treated as loan repayment rather than an expenditure. With inflation at 3% per annum, and the publicly held portion of the national debt currently at $3.6 trillion, such treatment would have reduced the deficit in 1996 by $108 billion. The federal budget would therefore already be in balance.

THE ECONOMIC CONSEQUENCES OF THE BBA

Implementation effects: risking a recession

Passage of the BBA is likely to have a range of deleterious effects. In the first instance, there will be negative "implementation" effects. The federal budget is in deficit, so that conforming to the ammendment will require significant spending cuts. Aside from the political problem of getting agreement on what spending will be cut, there is a danger of such cuts causing a recession. Depending on when one dates the begining of the current economic recovery, it is either five or six years old. This means that it is getting to be fairly mature, and with maturity comes fragility. A negative demand shock, caused by a reduction in government spending, could be sufficient to tip the economy into recession.

Destabilization effects: aggravating the business cycle

In addition to negative implementation effects, the BBA will likely have "destabilization" effects. These risk turning mild recessions into severe economic downturns, and possibly worse. The reason is that when the economy is down, tax revenues decrease and the budget deficit increases. The BBA will force government either to cut spending or raise taxes in recessions, which will in turn lower demand: this will make recessions worse. An analogous logic applies to the case of booms, during which tax revenues increase and the budget moves into surplus. In this event, the government will have to increase spending and lower taxes, thereby adding to demand and inflationary pressures.

To offset these destabilizing effects, the Federal Reserve will be obliged to move interest rates up and down like a yo-yo. To offset the BBA's negative effect on demand in recessions, the Fed will have to lower interest rates additionally: to offset the positive effect on demand in booms, it will have to raise interest rates additionally. Such interest rate volatility will make business planning more difficult, and likely lower investment spending. Worse than that, financial markets will come to expect interest rates to rise significantly after recessions. To avoid incurring losses, financial investors will not bid down rates on longer term bonds in recessions, and this means that the economy could get stuck in recessions with high long term rates. The impact on housing and investment spending would be disastrous. In effect, the economy could get locked into a self-fulfilling high interest rate trap in which expectations of future high interest rates keep current interest rates high.

Keynesian economists emphasize the destabilizing "demand" effects of the BBA. Supply-siders emphasize the destabilizing effect of volatile tax rates. Paradoxically, both agree that the BBA is destabilizing. Under a BBA, the government would lower tax rates in booms and increase them in recessions so as to maintain budget balance. This would make tax rates more volatile, thereby making business planning more difficult. For supply-siders, optimal tax policy calls for constant tax rates: the BBA produces the opposite result.

Growth effects: public investment and America's third deficit

The BBA will also have adverse "growth" effects that will lower the economy's long run growth rate. Over the time, the economy is steadily growing owing to the effects of technological innovation, investment, education, and population growth. This growth manifests itself in a higher national income. If the BBA is passed, government will be obliged to run a zero deficit, and as a result the national debt will cease growing. The publicly held share of the national debt currently amounts to 50% of GDP. Overtime, with national income growing and the debt constant, this percentage would steadily fall.

The fact that the debt/GDP ratio would fall, has significant implications for the meaning of a balanced budget. In an economy with no growth, budget balance requires a zero deficit, this being the only way to stop the debt/GDP ratio exploding. In an economy with growth, the debt must also grow to stop the debt/GDP ratio going to zero. This implies that a balanced growing economy should run deficits. The meaning of budget balance is different for a static no growth economy versus a dynamic growing economy: this is a subtle point that has been lost in the BBA hysteria.

If government is unable to borrow, this will have a severe negative impact on public investment, which will in turn hurt growth. In the private sector, when a business wants to expand, it does so by borrowing from a bank or having an initial public offering on Wall Street. Such actions provide business with the finance to buy the plant and machinery necessary for growth. Thus, business is not forced to rely exclusively on its existing profits: if it were, start-up companies which have no profits could never get going. Instead, both new and existing business borrows to finance expansion, and then uses the resulting profits to redeem the debt. This is an unending process in a growing economy, and it means that the total amount of business debt is always increasing.

Exactly the same logic applies to the government, which is in the business of being U.S.A. Inc.. Government helps grow the economy by expanding the road and highway network which facilitates commerce, building schools and universities which educate our children and generate technical advances and higher productivity, and by providing the urban infrastructure that supports business operations. These expenditures grow the economy, which in turn generates the tax revenue to pay back the initial borrowing. In effect, U.S.A. Inc. is just like private business: if the economy is to grow at its maximum rate, U.S.A. Inc. must also be able to increase its borrowing.

The BBA prevents government from borrowing to finance public investment. Instead, such projects will either have to be financed out of current revenues or through tax increases. Whatever they are, politicians are not stupid. They know that taxes are unpopular, and hurt the voters who pay them today: they also know that the benefits from capital spending accrue to the future, and the future does not vote today. The logic is clear and forceful. The BBA establishes an unambiguous incentive to cut back on public investment spending, with adverse consequences for economic growth and the quality of life.

America's low rate of public investment spending has already been termed "America's third deficit" (i.e in addition to the budget and trade deficits). Public investment has a high rate of return, both in terms of improved quality of life, and in terms of its positive effect on business productivity. The existing low rates of public investment spending are already blamed for much of the slowdown in economic growth that has occurred since 1973. By further lowering such spending, the BBA will compound this problem.

A reduction in public investment spending is also deeply at odds with the problems posed by the greying of America and the need to fund social security. The putative problem is that twenty years hence the demographics of the baby boom will produce a surge in retirement. At that time, the nation will have to devote much of its resources to supporting this elderly population. Far sighted policy should anticipate this scenario, and ensure that the needed resources are in place. Unfortunately, it is hard to build the needed factories today since they will be outmoded by then. However, public infrastructure is extremely long lived, and offers the best means of anticipating these needs. The nation is still benefitting from the interstate highway system and airports that were built in the 1950s. Though many of our schools are deteriorating and require improvement, it is also the case that they were built sixty to seventy years ago. Thus, they have been long lasting, and new schools can be equally so. One of the best ways to prepare for the aging of America is to increase public infrastructure investment, yet this is exactly what the BBA will inhibit.

Financial instability effects: restoring old style financial crises

Another serious implication of the BBA concerns its impact on financial markets. Government bonds occupy an important place in the portfolios of households and financial intermediaries. They are safe reliable assets that carry a reasonable rate of return, and the markets in which they are traded are healthy. The BBA would put an end to new supplies of government bonds. For financial institutions, particularly banks, this would have serious consequences. Banks park their excess liquidity in government bonds since they are both safe and earn a return: when they have excess liquidity, they buy bonds; when they are short of liquidity, they sell bonds. In this fashion, government bonds help the financial system buffer the demands of business for credit.

In the event that the supply of government bonds were to dry up, banks and other financial institutions would look for other financial assets in which to park their liquidity. They would likely start to increase their holdings of corporate bonds. However, such bonds are risky, and their prices can fall in economic downturns owing to increased bankruptcy risk. Consequently, such a portfolio shift would inject significantly more risk into the financial system. In the 1980s, the S&L crisis cost the American taxpayer $500 billion: the banking system also nearly went belly up, and the Federal Deposit Insurance Corporation was close to insolvent. The system just managed to weather that storm: there is a risk that future storms may be unmanageable if government bonds, which are the bedrock of the financial system, are replaced by corporate bonds in private portfolios.

SUMMARY

In sum, the BBA risks seriously harming the long term health of the economy. Its implementation will lower aggregate demand, and risks sending the economy into recession. Destabilization effects, arising from volatile government spending and tax patterns, risk amplifying the swings of the business cycle. This will also result in volatile interest rates that could place the economy in a high interest rate trap. Negative growth effects risk lowering the economy's growth rate owing to a forced reduction in public investment spending. Moreover, this is exactly the wrong strategy for dealing with the coming "greying" of America. Lastly, by cutting off the supply of new government bonds, the BBA will likely inject more risk into the financial sector, restoring the possibility of old style financial crises.

Economic theory, both Keynesian and supply-side, provides no support for the BBA. Over three hundred economists, including seven Nobel Prize winners, have signed a statement declaring it to be bad for America. In his commencement address at Yale University on June 11, 1962, President Kennedy spoke about fiscal policy and the national debt:

"The great enemy of the truth is very often not the lie -- deliberate, contrived and dishonest -- but the myth -- persistent, persuasive, and unrealistic. To often we hold fast to the cliches of our forebears. We subject all facts to a prefabricated set of interpretations. We enjoy the comfort of opinion without the discomfort of thought...

There are myths also about our public debt. It is widely supposed that this debt is growing at a dangerously rapid rate. In fact, both the debt per person and the debt as a proportion of gross national product have declined sharply since the Second World War..... debts, public and private, are neither good nor bad, in and of themselves. Borrowing can lead to over-extension and collapse -- but it can also lead to expansion and strength. There is no single, simple slogan in this field that we can trust."

His instructive message still endures.