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Would the 1995 Balanced Budget Amendment be an Effective Mechanism for Stabilizing Public Debt?

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ABSTRACT. The 1995 Balanced Budget Amendment for is often brought up as a way to stabilize the public debt. But how would it operate, what implications would it have for U.S. public finance or macroeconomic conditions, and would it be effective at controlling whatever threat the federal debt poses? After the bill failed in 1995, two economists published opposing views on the effectiveness of the failed amendment. Examining their arguments and history, it remains unclear whether the 1995 amendment could effectively control the federal debt.

I. Introduction

For 2011, the U.S. Statistical Abstract (2012, 469, 472, 474) estimated that the four largest federal expenditure programs cost $2.3230 trillion, while total federal revenues only amounted to $2.1737 trillion. These four expenditure programs (Defense, Social Security, Medicare, and Medicaid) alone outpaced all revenues but only account for 59.9% of all expenditures in the United States' unified budget. Including the other ~40% of expenditures, the total federal deficit amounted to an estimated $1.6451 trillion. The same year, Congress passed a Budget Control Act to cap *discretionary* defense spending and non-defense spending in attempt to reduce future deficits and the growing federal debt (Govtrack 2013).

The U.S. federal debt is as old as the country itself. Born during the Revolutionary War, the first federal debt was guaranteed by Article 1, Section 8, Clause 2 of the Consitution. In the U.S., fear of debt is perhaps just as old as debt itself. Thomas Jefferson had anxiety over the misuse of federal debt. In 1835, President Andrew Jackson and his contemporaries achieved the first and only period when the federal debt was zero. This was largely made possible by the use of restrictive tariffs and government sale of massive lands seized from natives. Sadly, this anti-debt strategy ended with a five-year recession due to the bank panic of 1837. Public debt in the pre-Keynesian era was largely a product of wars, such as the civil war, which produced a clause in the 14th

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amendment that invalidated Confederate debt (Rosen and Gayer 2010, 461-473). After World War II the federal government had a 91-94% marginal tax rate for the top bracket until 1964 to deal with the massive wartime debt (OMB 2013, 2.1). In 2011 a constitutional amendment to permanently balance discretionary and *mandatory* spending with taxes failed.

The idea of a balanced budget amendment for the federal government is not new. Forty-nine out of fifty states have some form of constitutionally forced balanced budget, but the states' budgets are different from the federal budget. Only the operating budgets have to be balanced for states, while their capital budgets allow debt for pensions and investments. The federal government uses a unified budget that lumps both areas together but does not include some "off budget items." Balancing a unified budget is not the same as balancing an operating budget, so comparisons between the federal budget and states' budgets are not equitable (Rosen and Gayer 2010, 132).

The amendment to balance the federal budget has petitions from thirty two state legislatures and needs thirty four to start the constitutional process from the state side (Glaeser 2011). On the federal side, the amendment came closest to approval in March 1995, when it passed the House of Representatives with a super majority but was one vote short in the Senate. Afterwards, Charles Schultze, an economist and former director of the Office of Management and Budget, published a journal article against the amendment while James Buchanan, an economist and Nobel laureate, published a journal article in favor of the amendment. Both economists made predictions and arguments for or against the need and efficacy of a balanced budget back in 1990s. Roughly fifteen years passed between then and the amendment's failure to pass in 2011. So is the 1995 styled balanced budget amendment an effective mechanism to stabilize government debt? This is a complicated, speculative question due to the difficulty of forecasting, unpredictable politics, and both authors' economic ideologies.

II. Core of the Issue

The purpose of a balanced federal budget amendment is to permanently confine deficit spending so as to control the federal debt (Buchanan 1997, 118). Federal debt is the total amount accumulated from all past, outstanding deficits to be paid with tax revenues or refinanced with more

debt sometime in the future. The term "federal debt" is often vague and can be misleading because there are different types of federal debt. The most pertinent form is the federal public debt, a portion of which is held by the Federal Reserve for open market operations and the rest is held by the general public. It is part of some mutual funds, foreign investments, and grandpa-purchased savings bonds for a grandchild's college fund. The gross federal debt consists of public debt plus money owed to government agencies such as Social Security which controls the Old-Age and Survivors Insurance and Disability Insurance trust funds. Some reports define federal debt as a combination of federal gross debt and state and local debt (Rosen and Gayer, 2010: 466). Others include unfunded liabilities like Medicare, Medicaid, and Social Security that are not presently covered by issued debt. These unfunded liabilities are debt not yet incurred, based on projected trends of entitlement program growth and projected revenue shortfalls creating deficits unless the programs are changed. Federal debt could also include contingent liabilities which are debts not accrued but could be due to government guarantees should their owners run into trouble; examples include Fannie Mae and Freddie Mac (Chinn and Freiden 2011, 87-119). This distinction among the types of debt is important as the balanced budget amendment would only directly interfere with the growth of public debt.

Public debt is most crucial of all forms of debt because it is traded publicly and requires faith in the federal government's ability to pay back the debt that it owes with interest. Government demand for savings has to compete with other forms of investment and, theoretically, as federal debt increases it will crowd out private investment and raise interest rates if there is no proportionate increase in the supply of savings. Interest rates can also rise if investors see the government as more risky because of perceptions that the government will not pay its debts. If the risk is too high investors may not lend at all (Rosen and Gayer 2010, 461-473).

The risk of running out of lenders is exclusive to public debt, because trust funds are essentially the government owing the government. Trust funds, however, represent a form of future public debt, should their outlays exceed their revenues and the difference is paid with public debt instead of other revenues. Unfunded liabilities also include other non trust-fund programs as do contingent liabilities and function the same way, so actual public debt could be much larger in the future than what is presently reported, which leads to fears about growing public debt. Interest payments could consume larger portions of the federal budget due

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to the increased size of the debt, especially if interest rates rise. We would then have to borrow more for the same spending if there were no changes in revenues. A graver scenario is that lenders will no longer finance and refinance public debt leaving the government with three main options. It could tax the nation to pay back the debt it owes, it could default on the debt by not paying, or it could attempt to monetize the debt (Rosen and Gayer 2010, 461-473).

Full tax repayment would be strenuous, but if all of the public debt were internal, the result would just be redistributive. This is to say income or wealth would be transferred from citizens to repay the debt held by other citizens. The problem is that 54% of the 2010 public debt is external so the taxed income and wealth would leave the country. In addition, there would be transaction costs for redistribution and potential inefficient allocations even if the debt were 100% internal. There is also the issue of income redistribution between generations.

Simply defaulting on the debt would erode almost any chance of future government borrowing for emergencies, cause upheaval in global financial markets, and destroy the benefits the U.S. receives from having a reserve currency. It would also be unconstitutional (Rosen and Gayer 2010, 461- 473). Forcing, circumventing, controlling, or abolishing the Federal Reserve to print currency to buy the outstanding debt (monetizing the debt) would cause similar chaos with the addition of destructive hyperinflation (Miskin 2010, 628).

The goal of a balanced budget is to prevent an unsustainable debt spiral, produced by reckless deficit spending, which results in macroeconomic chaos (Buchanan 1997, 135). Yet the amendment only addresses current-year public debts, so when is public debt unsustainable? There is no definite answer, but the measurement is usually based on the ratio of public debt to gross domestic product (GDP) where a lower percentage is preferred to a higher one and we might not know where the line is until after it has been crossed (Abel, Bernanke, and Croushore 2008, 341-343).

The justification for some deficits is to promote GDP stability, and thus debt stability. This is where Schultze and Buchanan strongly disagree. Schulze claims that goals of full employment and low inflation are better maintained by monetary policy, but fiscal policy with deficits may be required occasionally in times of recession. He is not against running federal surpluses for unfunded liabilities like Medicaid, Medicare, and Social Security, which he believes should be reformed to

avoid major future deficits (Schultze 1995, 317). Buchanan views government responsibly using deficit financing is a pipe dream, because politicians are only concerned with the next election, which is easier to win with fewer taxes and more spending. He puts little faith in practical Keynesian economics from politicians who lack the incentives from their constituents as well as the knowledge and ability for effective fiscal policy. He doesn't touch on preventing future increases in public debt, but pushes the amendment as a way to control pressures for public debt as they occur (Buchanan 1997, 120)

## III. Lagged Implementation and Political Irresponsibility

To maintain a federal balanced budget, the budget must first be balanced. Instead of immediately shocking the deficit-financed system, the balanced budget amendment of 1995 required the deficit to gradually fall until it was near zero in 2002. This is known as lagging, an issue that Buchanan favors as it shapes expectations by setting a date in stone. Schultze claims this will only lead to a longer implementation date. (Buchanan 1997, 124; Schultze 1995, 321).

Schultze suggests that citizens suffer from cognitive dissidence; they want to maintain their favorite programs, despise increases in taxes, and are in favor of a balanced budget. As a result, the budget is in the red and politicians receive mixed signals for trying to balance the budget (Schultze 1995, 321). This is essentially the previously stated argument that Buchanan gives for why governments, set free by the excuse of Keynesian philosophy, run continuous budget deficits (Buchanan1997, 120). Schultze, however, points out that a large portion of federal spending is nondiscretionary and will occur even if politicians do nothing (Schultze 1995, 322). Congress must actually change these programs by somehow reducing their payments if revenues are held constant. Nondiscretionary spending includes Social Security, Medicare, Medicaid, farming subsidies, and veterans' benefits. These programs made up ~60% of the federal budget in both 1995 and in 2011 (Austin and Levitt 2012, 10). Schultze claims that as citizens feel the effects of phased-in tax hikes or spending cuts, there will be less support for balancing the budget, and a desire to push back implementation by threats to politician's careers; that is the major incentive for them to run continuous deficit (Schultze 1995, 322). Buchanan, on the other hand, asserts that the size of the lag cannot increase because constitutional deadlines do not provide extensions (Buchanan 1997, 125).

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Schultze provides an interesting finding on the difficulties of a balanced budget amendment. During the "Clinton surpluses" from 1998 through 2001, total debt actually rose every year despite the on-budget surplus for those years. This occurred because trust funds for Social Security, which are financed by the payroll tax, are spent according to payments owed to beneficiaries. When collected taxes are greater than benefits paid, there is a surplus that the trust fund invests solely in federal debt, is used for federal spending, and is not counted as public debt (Rosen and Gayer 2010, 239-240). Since the on-budget surplus was not greater than the surplus of the trust funds, the total debt rose. Separating the revenues and expenditures from trust fund systems, Schultze provided two graphs to try to dampen the arguments for a balanced budget. These graphs are updated from 1996 to 2011 (OMB 2012).

General Operating Receipts and Outlays as a Percentage of GDP
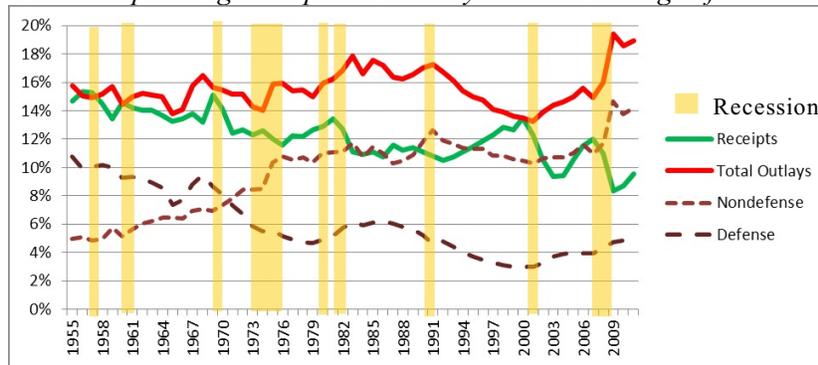
Source: Derived from OMB 2012: 1.4, 2.1, 3.1

Trust Fund Receipts and Outlays as a Percent of GDP
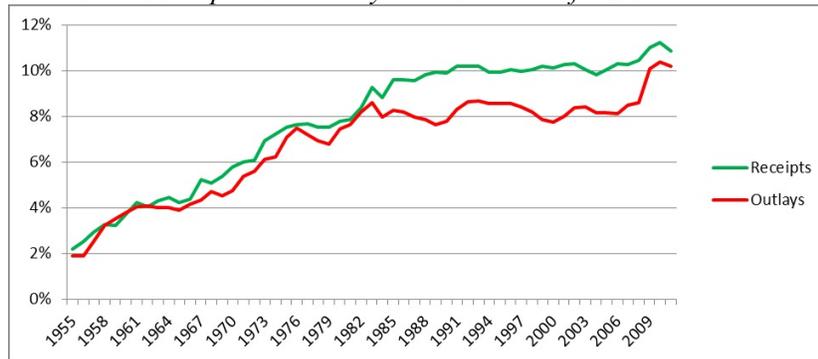
Source: Derived from OMB 2013: 1.4

Schultz first attempts to debunk the idea that government spending is out of control as the general operating expenditures remained fairly constant as a percentage of GDP with a downward trend from his 1995 reference point, which would have been more pronounced if interest on the debt was removed from the equation. This argument might shed light on some discretionary spending constraints but does not consider the growth in trust fund government spending as a portion of GDP even though it was running a surplus. His second attack is on the notion that current taxpayers and politicians are short sighted and discount the future costs of current deficits. His main argument is that when politicians were confronted with possible deficits for Social Security in the 1980's, they raised the payroll tax and increased future full-retirement ages. This is supposed to be taken as political responsibility, but the argument seems to disprove his point. Current retired citizen are more likely to vote and have a vested interest in Social Security while citizens too young to vote incurred most of the cost for higher taxes and later retirement dates. The old received the benefits and the young paid the costs. This argument also doesn't justify the majority of years where there was an on-budget deficit without a recession. He does provide Keynesian responses for some deficit years but that only begs the question of political irresponsibility and whether there should be a balanced budget (OMB 2013, 1.4; Schultze 1995, 322-325).

So is lagging of the balanced budget amendment an issue for delayed implementation? If the amendment would have passed and been lagged till 2002, Schultze's argument seems invalid because the operating budget was almost balanced and the on-budget was running a surplus in 2001 by that time without countervailing political force. However, the lag did occur during an unusual expansionary period for GDP and would have been cut short by a recession and September 11th occurring less than a month before fiscal year 2002. Had there been no major adjustments in fiscal policy from President George W. Bush, the lag would have worked and the amendment would have been thoroughly tested.

IV. The Amendment and Rules of the Game

A balanced budget amendment does not necessarily mean that government projected revenues and expenditures will balance for every fiscal year. In fact the amendment in 1995 had three main rules: a three-fifths vote by both houses of Congress was required to *not* balance

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expenditures with revenues; the same voting system was required to *raise* the debt ceiling or to *raise* taxes. So the budget can be unbalanced if Congress votes to run a deficit. That might require a second vote to raise the debt ceiling. Cutting expenditures is relatively easier than raising revenues to bring the budget back into balance. The budget can hypothetically be unbalanced in favor of a surplus or deficit even if Congress takes no action because projected revenues and expenditures can differ from actual values due to forecasting errors and changes in the economy (Schultze 1995, 317).

Buchanan has a classification system as to whether a rule is procedural or substantive. The default balanced budget and static debt ceiling are procedural because the outcome for near zero deficits is provided, but Congress is free on how to achieve it and can vote to run a deficit. The rule to constrain raising taxes is substantive because it prescribes how to achieve the outcome: cutting expenditures, unless Congress votes otherwise. Buchanan favors procedural rules to achieve the outcome of constraining deficit spending and debt growth but has less to say about the way the goal is achieved (Buchanan, 1997; 125). Schulze on the other hand is much more concerned about substantive rules of balancing the federal budget and that politicians will maneuver around the rules (Schultze, 1995: 317).

Buchanan argues that *constitutional policies* provide choices *among* rules while *ordinary policies* provide choice *within* rules. The amendment constrains the legislative branch to have a balanced budget but it is free to pursue how to balance the budget. He goes further in stating that ordinary policies will not balance the budget because politicians have incentives to choose to not tax for what they spend (Buchanan 1997, 125). Schulze argues that even if these rules force the federal on-budget items to be balanced, that the balance could come from changes in other ordinary policies such as regulation, shifting accounts off-budget, and forcing states to finance federal programs (Schultze 1995, 326-327).

Both arguments are speculative because the constitutional amendment has never been enacted, but in 1995 two studies performed regressions to determine the effectiveness of different states' constitutional procedures to balance their general operating budgets. The first study found that states with rules that only force the governor to submit a balanced budget and states that are allowed to carry over their unexpected deficits are much less likely to run a surplus. States that are not allowed to carry over

unexpected deficits are more likely to run surpluses and the effect is increased if the budget is biannual. States with a "no carry" rule are also more likely to run a surplus if the governor has line-item veto power to cut specific areas in expenditures and if the state Supreme Court justices are elected and not appointed (Ahmed 1996, 79-84). Using Buchanan's game theory of federal choice and the states' finding, simply submitting a forecasted balance budget may not be entirely effective for reducing federal deficits but the inability to raise the debt limit could force a built-in surplus as a buffer. The option of an executive line item veto is not provided in the 1995 constitutional amendment and was interpreted by the Supreme Court as unconstitutional when President Clinton tried to enact one (Biskupic and Dewar1998).

V. Effectiveness of a Debt Limit

Buchanan has a case for the importance of rules, but the most important rule from the states, explicitly stating that the federal government cannot carry an unexpected deficit, is only implicitly and contingently provided by the debt ceiling rule (Buchanan 1997, 129). The second study of state budgets examined why states were more likely to have a "no carry" rule and found that states with high levels of federal grant aid as a percentage of state revenues or states with larger expenditures were more likely to have such a rule and states with higher per capita income were less likely to have a such a rule (Ahmed 1996, 84-85). States with a "no carry" rule have a hard debt limit of zero for their operating budgets whereas the federal government could still raise its soft debt limit. The states also have a separate capital budget, so the state to federal comparison is once again not equitable but interesting, should more than two-fifths of one federal house refuse to raise the debt ceiling.

The federal government already has a self-imposed statutory debt limit that requires Congress to allow the Executive branch to finance the shortfall of revenues. The House of Representatives is the only institution constitutionally able to tax. Either the Senate or the House can start expenditures legislation but both legislative bills have to be agreed on by both houses. The president can submit a budget to Congress but has no real power to enforce it aside from a budget veto that can be overridden. The Executive branch must raise the appropriated revenues and distribute the expenditures with the Treasury Department covering the difference should the two not match. Essentially Congress has to allow the Treasury

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to push debt over the statutory limit, and if Congress hesitates, the Treasury must take "extraordinary measures" to cut other funding for the federal government to pay its outstanding obligations. If the Treasury can make no more cuts to items like the civil servants' pensions, then the federal government will be forced to default on its outstanding obligations (OMB 2013, 7.3).

The history of the debt ceiling is a gradual transfer from specific congressionally approved debt instruments to present day Treasury-controlled debt instruments with Congress enforcing the upper limit of debt the federal government is allowed to have. There is no knowing what the debt would have been had there been no debt limit and the rule of raising the debt limit would *technically* be harder under a constitutional amendment as it requires a three-fifths majority in both houses of Congress. That said, the Senate has the option of a filibuster, which requires a three-fifths vote to approve a statutory law that normally requires a simple majority. This is a strange and complicated ritual but it might provide insight into how a balanced budget would work in practice.

The graph below, denominated in millions, shows the relationship of the debt ceiling to gross debt and public debt since 1940 (OMB 2013).
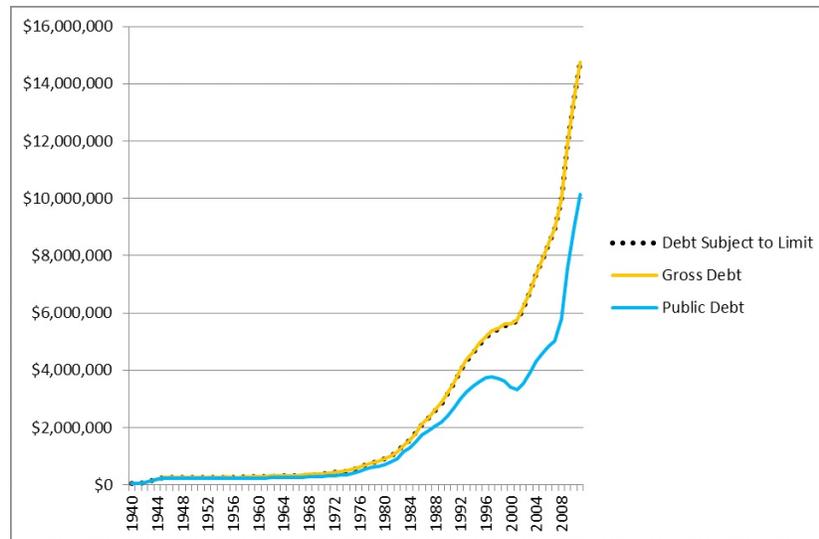
Source: Derived from OMB 2013: 7.1,7.2

Perhaps a stricter debt limit with a required near balance of revenues and expenditures would be effective for slowing or reversing the statutory growth of gross debt, like a strict no carry rule for states (Amed 1996, 79). There are some complications as the on-budget could be balanced by a surplus in the trust funds, which would cause gross debt to increase more than a reduction in public debt, which would require the limit to rise if gross debt was at the limit. Yet the biggest problem with the limit is similar to the events leading to the fiscal cliff, where politicians threatened not to raise the debt limit as a partisan strategy. This could have meant that outlays, like interest payments, would not have been paid with debt because there was a built-in deficit in the budget, which would lead to a default. Standard and Poor's downgraded the U.S.'s debt from AAA to AA+ in part due to this fiasco which implies that the debt has more risk and should incur higher interest rates, though that is not what happened (Pylas 2013). This problem begs the question of what would happen if Congress submitted a balanced budget instead.

VI. Efficacy with Uncertainty and Automatic Stabilizers

Having a balanced budget amendment and having a perfectly balanced budget are two different concepts with the latter being extremely hard to achieve. The rules of the amendment state that *projected* outlays and receipts must match, not that the two will actually match in a fiscal year (Schultze 1995, 325). This is a twofold problem because forecasting revenues for a year with 100% accuracy is impossible and some expenditures increase or decrease without immediate control of the government for the same year. There is an unintended budget surplus if actual revenues for the year are higher than actual expenditures for the year. However an unintended deficit may occur if the opposite occurs and this will cause a problem if the deficit will push the government debt over the limit.

The federal government receives about 91% of its revenue from three forms of taxes that depend on income: Individual income tax, payroll tax, and corporate tax. Without going into the extreme intricacies and loopholes of what type of income is taxed, there are major problems in trying to predict how much income there will be in a given year. The Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) both try to forecast the two-year change in wage and salary disbursements plus corporate book profits as a share of GDP. An

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obvious problem for both agencies is trying to predict changes in nominal GDP. Between 1976 and 2004 both agencies always either over or under predicted the two-year growth rate of nominal GDP by an average of 1.5 percentage points. If forecasted GDP growth is 3%, the actual rate could be between 1.5% and 4.5 % on average.   Projected revenues as a portion of GDP are more difficult to calculate when the whole of GDP is not certain. Similarly, both agencies miscalculated changes in the percentage of GDP that is taxable by an average of 1.1 percentage points. The CBO says that forecasting taxable income is even more difficult due to statistical discrepancies in national income and product accounts, changes in non-taxable fringe benefits, and changes in the tax codes such as increasing the amount of capital depreciation so corporations can show lower profits to tax.   This is not to say these agencies forecasts are worthless or that the overestimated revenue deficits they would create would be larger than the status quo, but the main point is that revenues for a year are uncertain (CBO 2006, 8, 12).

There is also a forecasting problem on the expenditure side, mostly dealing with mandatory expenditures. The federal government approves discretionary spending with a budget but changes to mandatory spending require an alteration to the program.   Forecasts can attempt to make a guess as to how much will be spent, but precisely determining when every American will retire, lose their job, fall under the poverty line, become ill, etc, is not feasible. This is a problem. Should there be an unexpected recession in the fiscal year, welfare and unemployment benefits will rise and incomes will fall so tax revenues will decrease. These are known as automatic stabilizers and are intended to stimulate aggregate demand and reduce the depth and length of a recession without any political action (CBO 2010, 1-3). Schultze states that "in the 50 years since the second World War, the American economy has been far more stable than it was in the era between the Civil War and the Second World War… which many economics credit to automatic stabilizers in the federal budget" (Schultze 1995, 325). Buchanan is skeptical of Keynesian economics and favors a stable money supply but views the legislative reality of such stabilizers as a matter of interpretation. He argues that the deficit can be corrected in the next budget with some pragmatism (Buchanan 1997, 129). In either case, if the federal budget were forecast to be balanced without the knowledge of a recession, the actual budget would be in deficit, as tax revenues would decrease while automatic expenditures would increase.

*Deficits and Surpluses as a Percent of GDP due to Automatic Stabilizers*
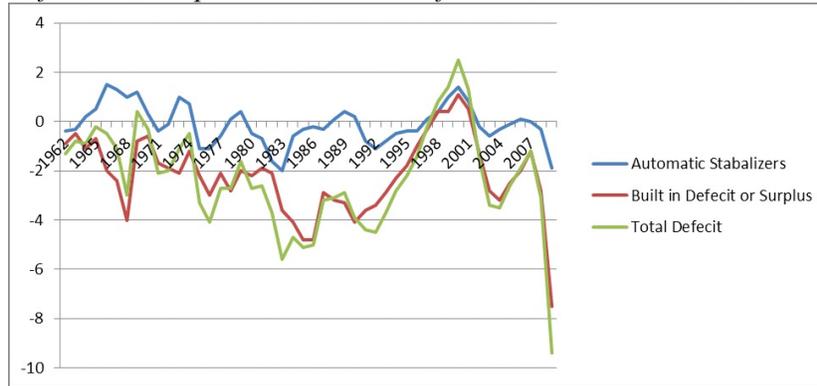
Source: Derived from CBO 2010:5-6

Schultz asserts the federal government should balance a high employment budget and if the there is a recession, the stabilizers would serve their Keynesian function, and the deficit would be capped at no more than 2% of gross national product to be paid back in three years (Schultze 1996, 325-326). Alternatively, politicians could use more conservative forecasts of expenditures and revenues as if the economy were in a recession given current tax rates; revenues would be underestimated and expenditures would be overestimated, providing margins for error. If the economy is in expansion, then there is a built-in surplus, and if there is a recession there may be a decreased surplus or a deficit depending on the level of precaution. Theoretically, the surpluses would counteract the deficits so the public debt could potentially be absolutely reduced or at least grow slower. That dependson the level of precaution and changes in the growth rate of GDP and non-budget government intervention. While Schultze does give a forecasting plan based on full employment he quickly rejects the idea because politicians can manipulate full employment and other projections to build in deficits. Buchanan counters this notion by suggesting that non-partial parties should provide the forecasts (Schultz 1995, 326; Buchanan 1995, 129).

Assuming that the federal government does attempt a projected balanced budget, what would happen if an unforeseen deficit did occur? The state of Iowa has a balanced budget amendment and forecasts revenues with a Bayesian range instead of predicted growth rates. Unfortunately, the forecasted revenues for the center of the bell curve are

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seldom achieved and tend to be overestimated: some years the actual shortfall of revenue had a predicted ~0% probability of happening. When the Iowa state government discovers there will be a deficit, it cuts spending during the year to eliminate the deficit (Lewis and Whitemen 2008, 9). Instead of having a built-in surplus to correct for shortfalls, the federal government could just cut spending to make up the difference and try to avoid going over the debt limit. Correction of an unexpected deficit could also occur by raising taxes, but raising taxes is far less publicly favorable, slower to respond, and more difficult due to the rule requiring a three-fifths majority in both houses of Congress (Schultz 1995, 318).

The federal government often adds on additional spending after the unified budget is voted on, which is known as supplemental appropriations (Kliesen and Thornton 2012). These additional non-budgeted expenditures can be used to cover disasters such as hurricanes, additional financing for wars, or approved stimulus packages. This is another problem for the rule of forecasted revenues matching forecasted benefits. The federal Supreme Court would have to decide whether it is constitutionally legal for Congress does to allow forecasted revenues to not equal forecasted expenditures. The federal government could try to budget for these contingencies, but that is not explicitly stated in the three main rules of the amendment (Schultze 1995, 327).
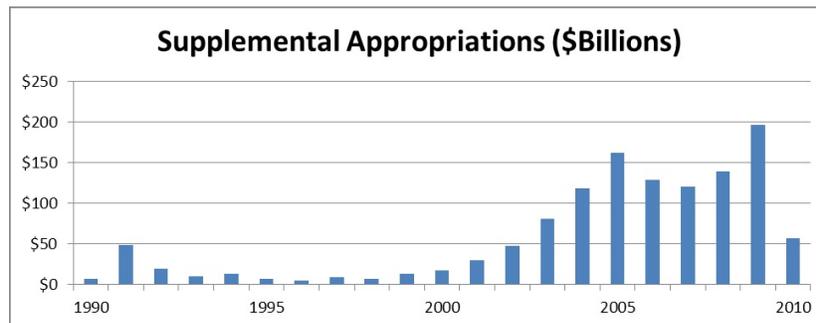

Source: Derived from Kliesen and Thornton 2012: 31

If the federal government does follow its rules it could still continue deficit financing, though the process would require more votes. In January of 2001 the Congressional Budget Office forecasted that budget surpluses would continue till 2011 for cumulative surpluses of $5.6 trillion. In reality, the accumulated deficits for the ten-year period were

$6.1 trillion (CBO 2012, 1). Had the balanced budget passed and been implemented in 2002 how would Congress have reacted to the events between 2001 and 2011? Would the lag have prevented the tax cut of 2001 in response to a recession? Would the amendment have stopped wars in Afghanistan or Iraq, the additional tax cuts in 2003 and 2005, or the stimulus spending of 2008? As long as three-fifths of both houses of Congress agreed to raise the debt limit and let expenditures outpace revenues, the answer is no.

Jumping through these additional hoops might have deterred more senators and representatives from passing additional legislation and perhaps more offsets in cutting certain expenditures would have occurred. Below are voting majorities from some of the major legislation that the CBO cites for creating the $11.7 trillion negative turnaround from debt reduction to debt increase over the 2001 to 2011 period. These votes are not a great proxy for speculating whether Congress would have also voted in favor of not balancing the budget but are informative because some bills did not have a three-fifths majority in both houses, so maybe these bills would not have passed knowing the deficits they would create (CBO 2012, 1).
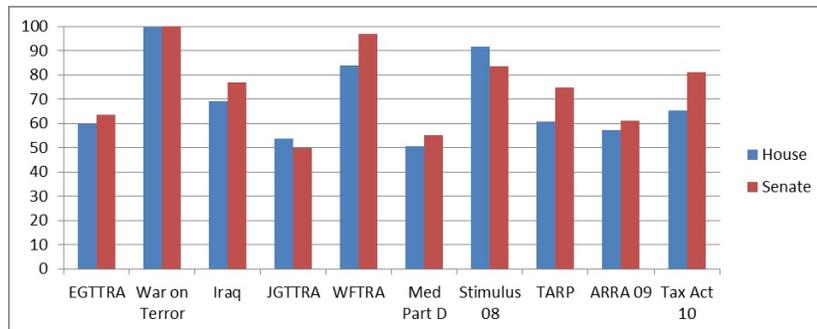

Source: Derived from votes according to govtrack.com

VII. Efficiency in Stabilizing the Public Debt to GDP Ratio

As previously mentioned, the federal government has allowed both nominal gross and public debt to rise due to unbalanced budgets and a loose limit on nominal debt growth. However, the more important debt measurement, the public debt-to-GDP ratio, was higher in the late 1940's than 2011 and fell mainly because of the end of war deficits and GDP

rising faster than nominal public debt (Schultz 1995, 321). What makes the 2010's different than the 1940's is the projected increase of debt due to unfunded liabilities. Estimates vary in size, but are in the trillions; two separate forecasts predic that unfunded liabilities will be $79 trillion or $211 trillion (Hummel 2012, 24). This future increase in spending is attributed to the aging of America and rising healthcare costs, so there will be more expenditures with a simultaneous withdrawal from the revenue base.
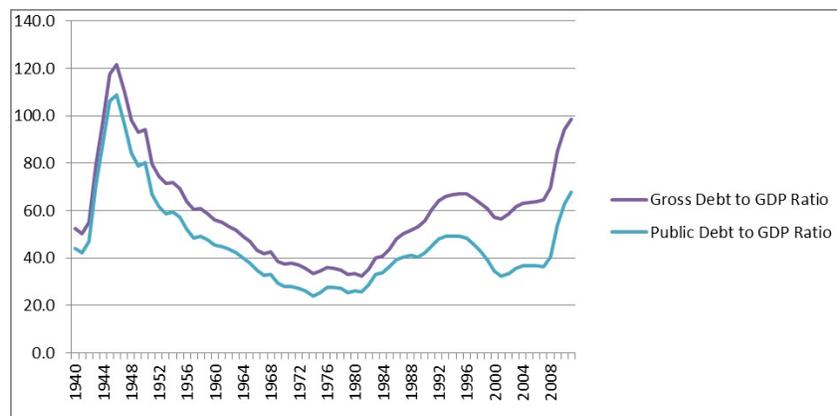
Source: Derived from Office of Management Historic Tables

The gross debt will likely change composition as trust fund debts are repaid because their programs are running deficits. The federal government will have to raise revenues, cut expenditures, or finance the deficit with public debt. The federal government could reform these programs now, but no rule of the balanced budget amendment forces the Congress to make proactive policy changes. The federal budget could use accrual accounting to estimate and realize future unbalanced budgets and correct mandatory spending or tax revenues for future balance. Yet this is not set by the rules and would be extremely hard to estimate and revise. Schultze's main case for the threat of debt is the future realization of unfunded liabilities that would be better to fix in the present with pragmatic legislation then wait and make unpopular, reactive spending cuts or tax increases when debts cannot be accumulated (Schultz 1995, 320). That is not to say Congress cannot do this on its own; it reformed Social Security in 1983, reformed AFDC to create TANF in 1995, and passed the Affordable Healthcare Act that may or may not reduce future

costs to the federal government by reducing the largest unfunded liabilities: Medicaid and Medicare (Rosen and Gayer 2010, 180-275).

There is also the issue of contingent liabilities. These are also not addressed by the amendment and would have the same unpopular effects as unfunded liabilities should these unknown debts have to be paid. Some contingent liabilities like wars or disasters have already been mentioned with supplemental appropriations, with the remedy that they could be budgeted for since world peace is unlikely. The other portion of contingent liabilities is much more debatable, with regards to financial bailouts, deposits insurance, and loan guarantees. The argument about automatic stabilizers between such economic titans as Hayak and Keynes illustrates what, if anything, should fiscal policy do to influence the business cycle, and the same issue divides Buchanan and Schultze (Wapshott 2012). Taking Buchanan's side means there is no reason for fiscal policy to stimulate the economy. Taking this approach and assuming monetary policy cannot push interest rates below zero, a major recession or depression would not only mean reduced GDP but possibly deflation until the downturn corrected itself. Both factors would increase the public debt-to-GDP ratio since debt is in past nominal terms. On the other hand with Schultz, fiscal stimulus from the tax cuts of 2001 and resulting the resulting deficits created changes in capital flows that could have been a factor in the boom based recession of 2008 (Chinn 2012, 175-200). Perhaps there is danger in attempting to fiscally fine tuning an economy and producing mal investment but the federal debt already exists and huge drops in GDP and increases in deflation would increase the danger from federal debt.

VIII. Changes in Substantive Budget Choice

The tax rule is aimed at forcing a substantive political choice for influencing GDP. Taxes pose a burden on markets and most taxes have an excess burden. They usually result in higher prices with less output. According to the Laffer curve, taxes rates that are set too high will result in less tax revenue as incomes fall due to increased tax rates. Both of these ideas make the tax rule appealing because GDP growth would be less suppressed. There is also an implicit cap on the size government from difficulty in raising taxes to increase expenditures. Assuming that some government spending is wasteful and there is potential for government failures then GDP growth is less hindered. By this reasoning the tax rule

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address the denominator of the federal debt's stability, but is that the whole story? Schultze protests this rule because of other substantive political choices that could be more inefficient, given increased austerity (Schultze 1995, 320).

There was an estimated $1 trillion loss of tax revenues in 2008 due to tax expenditures. Tax expenditures are items not taxed or taxed less than the normal rate. These items include capital gains, employer paid health insurance and pensions, mortgage interest payments, and "giveaways" to certain industries. Regardless of their intent, tax expenditures create a market distortion. Eliminating all of these tax expenditures would bring the federal budget closer to balance. This would also forgo whatever the intent was of the reduced tax that could have been socially efficient due to a positive externality. The same could negative externalities where certain taxes that decrease output increase social efficiency, so writing all taxes off as pure inefficiencies seems rash (Rosen and Gayer 2010, 397). The issue decreased efficiency from excess burden could come from changes of what should actually be taxed at an optimal rate: income, consumption, and excise (Turnovsky 1996, 21).

By the same reasoning, government expenditures, the reason we have taxes, should go towards improving macroeconomic efficiency. Social Security has a negative correlation with national savings, unemployment insurance correlates with longer periods of unemployment, and Medicaid correlates with overconsumption of medical goods. However, these social insurance programs reduce the risk of adverse selection, creating some external benefits, complicating their reform (Feldstein 1974; Rosen and Gayer 2010, 190, 290). The purest public good, national defense, is perhaps the most sacred of expenditure cows but determining an optimal level is much more complicated than a vertical summation individual demand curves; specialized military personal with benefits, thousands of variations of capital investment, strategic nuclear reserves, all play into the incomprehensible equation for efficiency. Wars are a sad byproduct of the human condition and the net present value for the U.S. invasion of Iraq from 2003 to 2006 was estimated at conservative -$1 trillion to a moderate -$2 trillion (Bilmes and Stigliz 2006, 30).

Speculating on a basket of programs with the highest net present value and an optimal tax policy would be an extremely costly endeavor and subject to forecasting errors, not to mention conclusions that could be contrary to many ethical values of citizens. That said, any actions of

the government have costs and benefits on top of the income redistribution from government revenues to government expenditures. How the federal government presently makes these decisions affects the macro economy. Yet the logic of the tax rule is a half truth because the government could keep inefficient programs and cut efficient ones. Political, not economic, pressures from a balanced budget could distort these substantive choices even without deficit financing.

If politicians are myopic, would it make sense to vote for policies and programs that do not have immediate or clear returns to voters, regardless of how big those returns might be in terms of GDP growth, over policies that have clear and immediate returns? Using the basics of the Solow growth model, there are three main areas that the government could influence to promote GDP growth: labor, capital, and technology (Abel, Bernanke, and Croushore 2008, 223-240). Immigration reform could be used to increase overall GDP, even if per capita income would not change. Capital public goods could be better funded, stimulus spending or not, to raise the U.S.'s D+ grade for infrastructure from the American Society of Civil. Higher federal funding for basic research could lead to higher levels of development research from business, probably increasing technological change, and increasing future GDP as a result (The Economist 2013, 5-14). The problem with these funds is that they would compete with more politically focused spending for fewer revenues and probably be reduced because of their long term, obscure returns. Research and infrastructure are investments with possible returns for future generations. Assuming the future generations will benefit from the investment, they could also pay for it under the benefits received principle. This means that these items should be funded with debt via a capital budget, which would make them more competitive with other expenditures.

Buchanan offers the counter case of capital budgeting in a balanced budget amendment. He argues that current taxpayers should pay for current benefits of government investments like infrastructure because it is constantly being rebuilt (Buchanan 1997, 132). His argument does not address underfunding, but this could be remedied by individual state's capital budgets. There is the potential for unfunded mandates so that states have to make certain investments that may not be efficient for a state's needs or place an inefficient burden on a state with external benefits to other states from its investment.

If continuous deficit spending is always a problem as Buchanan

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argues, then politicians may move to off-budget government policies to achieve their goals. Schultze takes this one step further, claiming that most of the burden of policies to personal and business budgets could shift to regulations, since the amendment makes tax increases difficult to match expenditures for policies. He goes so far as to say that in one generation the U.S. could go from being one of the least regulated economies in the world to one of the most regulated (Schultze 1995, 327). Once again this is a speculative argument and the U.S. already has regulations, but would the tradeoff between reducing the debt be offset by counterproductive regulations that would reduce GDP growth?

A major problem with democracies or republics stems from the rationality of people. Americans may behave rationally in many instances for private matters but tend to hold irrational beliefs in political matters. To be more specific, Americans tend to favor counterproductive economic policies against free markets, international trade, technological progress, labor conservation, and are pessimistic about economic growth. If the U.S. were a direct democracy, economic growth would probably be significantly reduced. The U.S. is a republic, at least at the federal level, and representatives have the ability to circumvent the irrational demands of the people (Caplan 2007, 23-49). Granted, there is a minimum wage, some trade restrictions, federally guaranteed loans for college and housing, a war on drugs, restrictions on medication, etc, and these policies are inefficient in many cases, but require deeper analysis for each case. Not all regulations have implicit costs higher than their implicit benefits, but a speculative estimate put total costs to small businesses at $1 trillion a year for federal regulation (Crane 2005). Politicians already regulate for better and worse. It would be a complete shot in the dark to predict if Congress would substitute more inefficient regulation that would offset the net benefits of deficit reduction. Controlling Congress is reason for the amendment. Yet the control Congress retains is the source of opposition for the amendment. So to reiterate what has been said before, the degree of effectiveness from the amendment is largely in the hands of politicians and the electorate.

IX. Conclusion

The federal balanced budget amendment has a real possibility of being proposed as a constitutional amendment by either the state legislators or Congress in the future, though ratification would be a little harder. Given

enough time and the help of an economic expansion, the lag process could be painless for implementing the amendment. Yet the three rules provided by the 1995 amendment do not give a clear answer as to how effective a balanced budget amendment would be as a mechanism to stabilize government debt.

Buchanan's argument in favor of the balanced forecasted revenues and expenditures rule as well as the debt limit rule would probably have reduced or made it harder to run the deficits of 2002 to the present. There is political wiggle room to sneak in deficits or use three-fifths votes to avoid Buchanan's two favored rules and continue to run deficits. However, this would have to be repeated every fiscal year and every time the debt reached its limit. With these continuous hurdles, it's possible that debt growth would have at least slowed. An unexpected surplus would reduce the need to raise the debt limit. The 1995 amendment doesn't guarantee that the threat of federal debt would be controlled but decreasing debt growth could be conducive to higher growth of GDP.

Schultze's arguments are less concentrated on deficit reduction and more on the amendment's unintended consequences. The tax freeze rule alludes to the other component of controlling the threat of federal debt: growth of GDP. Arguments about politicians' inefficient decisions in response to the amendment are highly speculative. Changes in regulation, spending composition, investment, tax policy, program formats, and macroeconomic phenomena are hard to measure and predict. As far as some economic ideological divides go, the change in congressional behavior could have been a boon or a bane to the economy. This implies more uncertainty as to whether the threat of debt could be controlled.

The main point is that the 1995 balanced budget amendment was not air tight on preventing deficits and that the true threat of debt is uncertain. Future constitutional balanced budget amendments could be altered to leave less room for political maneuverability in creating current and future deficits but forecast errors will always be a problem. Nor will future amendments be able to remove all possible criticism so long as there is a divide in politics, public finance, and macroeconomics.

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