



A BALANCED BUDGET AMENDMENT: WHAT CAN WE LEARN FROM STATE EXPERIENCE?

Testimony Prepared for

"A Balanced Budget Amendment to the Constitution"

United States House of Representatives, Committee on the Judiciary

October 4, 2011

Matthew Mitchell, PhD

Research Fellow

Mercatus Center at George Mason University

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INTRODUCTION

On its current course, United States fiscal policy threatens to hobble the nation's prospects for economic growth. Economic theory suggests that an important source of the problem is the government's ability to purchase services for current voters with taxes levied on future generations. A balanced budget requirement, by "internalizing" both the costs and benefits of government services, would therefore seem to be a natural solution.

In this testimony, I summarize the scope of the fiscal problem and then review state-level evidence to consider the ways that a federal balanced budget amendment might impact the nation's fiscal and economic future.

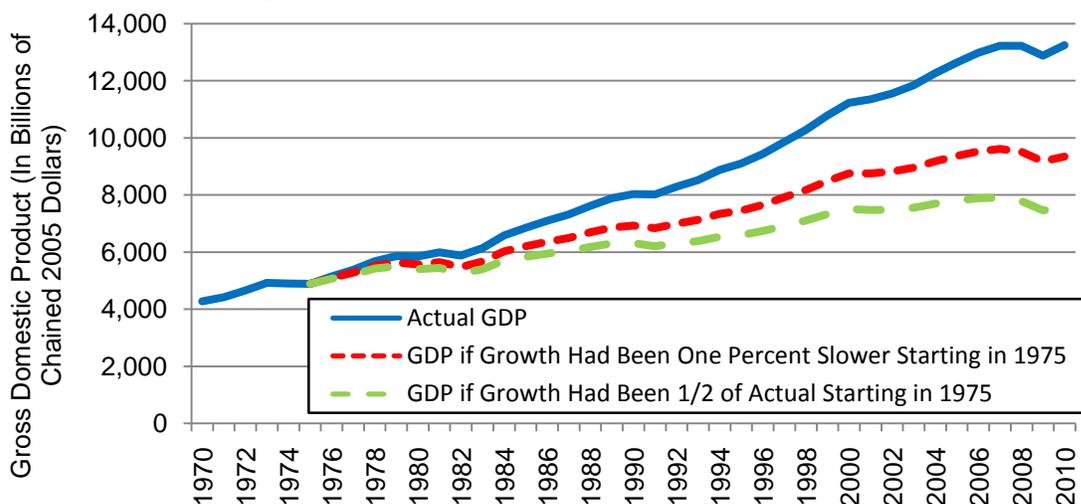
THE SCOPE OF THE PROBLEM

The Congressional Budget Office (CBO) projects that, absent policy change, the nation's public debt will exceed 90 percent of Gross Domestic Product (GDP) within seven years.¹ The ninety percent figure is important. At that point, according to economists Carmen Reinhart and Kenneth Rogoff, debt begins to hamper economic growth. Using data from forty-four countries spanning 200 years, they find that when a nation's debt level exceeds 90 percent of GDP, its growth rate slows. In the median case, real growth slows by about 1 percentage point; in the mean case, growth is cut in half.²

¹ Congressional Budget Office, *2011 Long-Term Budget Outlook*, Alternative Fiscal Scenario, June 2011. The "Baseline Scenario" assumes no change in *law*, while the "Alternative Fiscal Scenario" assumes no change in *policy*. Current law calls for a number of policy changes that are unlikely to materialize. For example, under current law, physician reimbursements will be cut by about 30 percent. Since Congress has repeatedly intervened to ensure that such reductions do not take place, most experts believe the "Alternative Fiscal Scenario" is a more realistic projection of future policy.

² Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt," *NBER Working Paper*, No. 15639, 2010, <http://www.nber.org/papers/w15639>. See Table 1. These figures are from advanced economies.

Figure 1: Actual and Alternative Growth Paths



Sources: Bureau of Economic Analysis, author's calculations.

To put these numbers in perspective, consider Figure 1. The top line shows the actual growth of United States GDP over the last four decades. Below that are two hypothetical paths: GDP if the country had grown 1 percentage point slower and GDP if it had grown at half its actual pace. Note that the most calamitous economic contraction in decades—the Great Recession that began in 2008—is just a blip compared with the lost income associated with persistently anemic economic growth.

As the operator of the world’s reserve currency, the United States enjoys what has been called an “exorbitant privilege.”³ Because the world’s central banks and international traders conduct their business in the dollar, the United States may be able to accumulate debt levels in excess of 90 percent before experiencing the type of slowdown that other nations have experienced. That said, CBO expects debt to reach 100 percent of GDP within 10 years, and nearly 200 percent within 25 years. Not even a reserve currency nation can withstand these debt levels without experiencing a significant slowing of economic growth. Moreover, the economic pain will be more pronounced if our debt levels threaten the dollar’s status as the world currency or if they trigger a precipitous flight of capital.

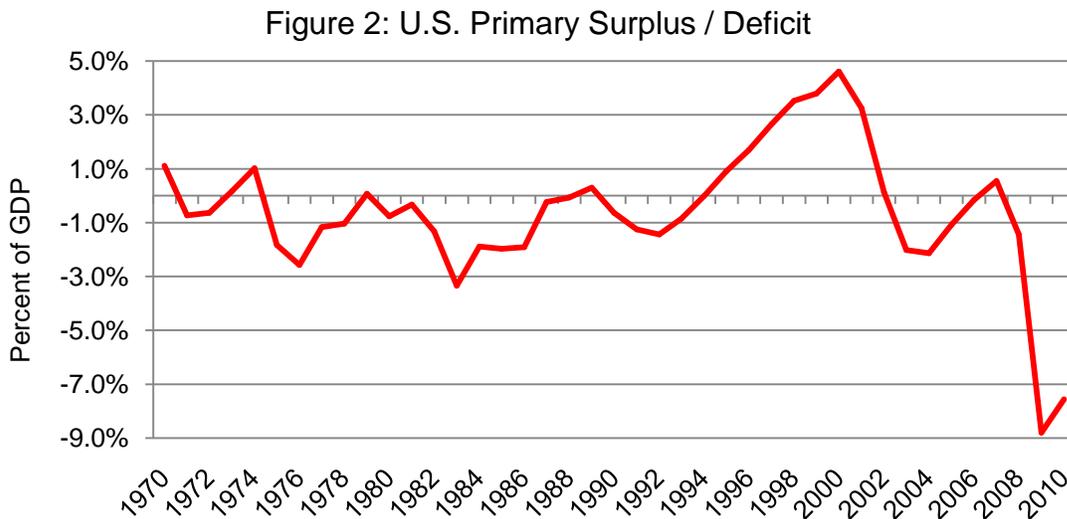
These crippling debt projections are the result of two distinct problems.

The first problem is a long-running, systematic bias toward deficit spending. This is evident when one looks at the historical record. The most conservative measure of the deficit does not count interest payments as expenses and is called the “primary deficit.” Figure 2 shows the United States’ federal primary deficit from 1970 through 2010. Positive values indicate a surplus while negative values indicate a deficit. For most of this period—83 percent of the time—the United States economy was expanding.⁴ Therefore one would

³ The term is often attributed to Charles De Gaulle, though it appears that it was actually coined by his lieutenant, Valéry Giscard d’Estaing. Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*. (New York: Oxford University Press, 2011).

⁴ US Business Cycle Expansions and Contractions, National Bureau of Economic Research, <http://nber.org/cycles/cyclesmain.html>.

expect that the federal government would have run a primary surplus for most of these years.⁵ Instead, the federal government ran a primary deficit 66 percent of the time. When one uses a less-conservative measure of the deficit and counts interest payments as expenses, the government ran a deficit 90 percent of the time.⁶ The bias toward deficit spending is systematic in that it is evident in both good and bad economic times and in both Republican and Democratic administrations.



Sources: White House Office of Management and Budget, Historical Tables, 2.1 and 3.1; Bureau of Economic Analysis, National Income and Product Accounts; author's calculations.

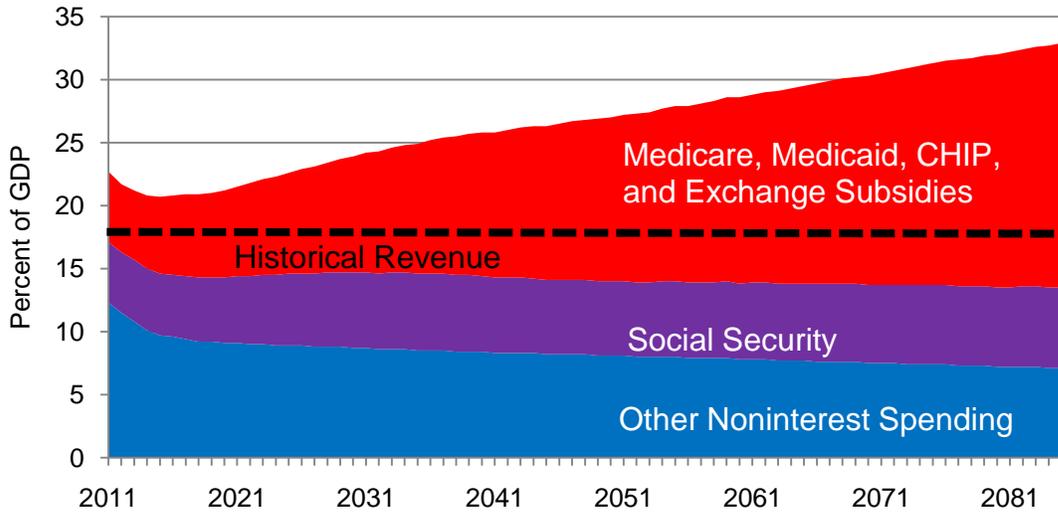
The second problem threatening to push the debt to dangerous heights is an explosion in entitlement spending. As indicated in Figure 3, CBO projects that, absent policy change, noninterest spending on entitlement programs, particularly Medicare, will consume an ever-larger share of national output. As these programs consume more of the nation's resources, they will also consume more of the federal government's resources, crowding out spending on national defense, domestic security, education, energy and all other discretionary programs.⁷

⁵ If the government were to attempt to run a sustainable Keynesian counter-cyclical fiscal policy, it would need to run deficits when the economy was in recession and surpluses when it was expanding. The surpluses are needed to pay off the debt accumulated during the recessions. See Paul Krugman, "Hard Keynesianism," *The Conscience of a Liberal* (May 2, 2011), <http://krugman.blogs.nytimes.com/2011/05/02/hard-keynesianism/>.

⁶ Office of Management and Budget, Historical Tables, Table 1.2.

⁷ Within three years, the federal government will spend more on entitlement programs than on all other discretionary programs combined.

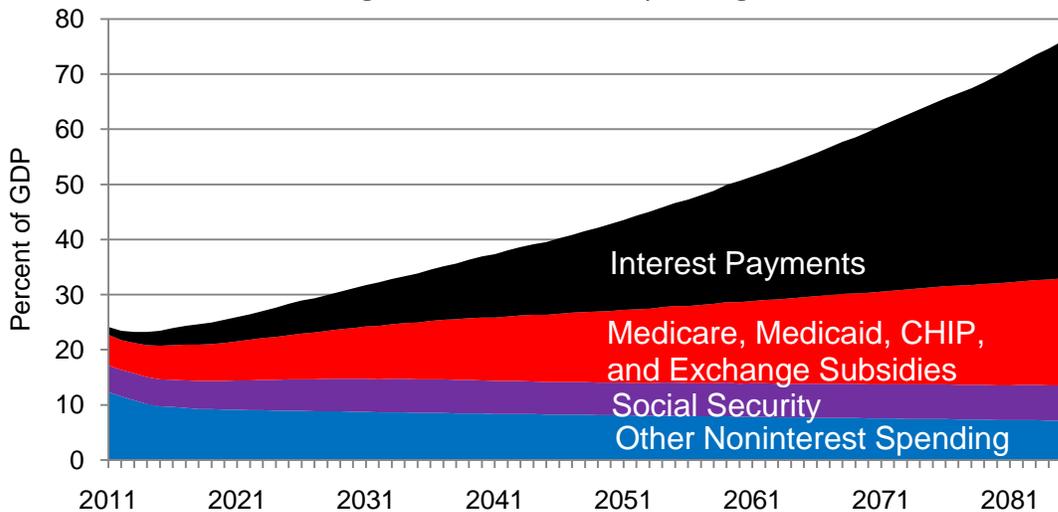
Figure 3: Federal Non-Interest Spending and Revenue Projections



Source: Congressional Budget Office, Long Term Budget Outlook, Alternative Fiscal Scenario, June 2011.

Because noninterest spending is projected to exceed revenue, the difference must be financed by ever-larger deficits. As borrowing increases, the debt grows. And as the debt grows, payments on the debt grow. These payments on the debt then become part of the problem, adding to the government's spending. As shown in Figure 4, total federal spending as a share of GDP will be twice its historical average within just a few decades. Note, also, that interest on the debt will soon become the single largest line item in the budget, dominating all other programs. In other words, the debt and payments on the debt make it ever more difficult for government to perform its core functions.

Figure 4: Total Federal Spending



Source: Congressional Budget Office, Long Term Budget Outlook, Alternative Fiscal Scenario, June 2011.

Ultimately, the problem is one of incentives. The federal government's bias toward deficit spending has been evident for decades. And the long-run fiscal problems with the entitlement programs have been known for just as long. But politicians of neither party have an incentive to fix these problems. This is because the costs of the status quo are mostly borne by those who are too young to vote (or not yet born), while the costs of reform would be borne by today's median voter.

The problem is akin to the simple externality problem familiar to environmental economists. If, in the process of producing goods for consumers, a factory owner is allowed to bilge smoke into the sky without accounting for the costs it imposes on others, he will inefficiently produce too much of his product. Similarly, if in the process of providing services to current voters, government is allowed to push off the cost onto future generations, it will produce an inefficiently large quantity of services. This problem was identified by Nobel-Prize-Winning economist James Buchanan and his fellow economist, Richard Wagner, over thirty years ago:

This bias toward deficits produces, in turn, a bias toward growth in the provision of services and transfers through government. Deficit financing creates signals for taxpayers that public services have become relatively cheaper. Because of these signals, voters will demand a shift in the composition of real output toward publicly provided services (including transfers).⁸

The solution to both problems is to “internalize the externality” by making those who benefit from the good or service pay for all the costs involved in producing it. At the federal level, a balanced budget requirement would internalize the fiscal externality imposed on future generations. Buchanan and Wagner argue that a cultural balanced budget requirement existed for most of the history of the American republic and that that cultural requirement was weakened by the advent of Keynesian theory.⁹ In its place, policy makers have contemplated a legal balanced budget requirement for the better part of a century.¹⁰ How might such a requirement work and what would be its effect?

LESSONS FROM THE STATES¹¹

Fortunately, federal policy makers are not flying blind. Nearly every state in the Union has a balanced budget requirement, and there is much to be learned from their experience.

Justice Brandeis famously referred to the federal system as a “laboratory” in which each state was free to implement novel social and economic experiments.¹² For the social scientist interested in understanding how a balanced budget amendment might affect policy outcomes, the metaphor is apt. While every state but Vermont has a balanced budget requirement, the stringency of these requirements varies widely, allowing researchers to exploit the variation to understand the impact of more or less-stringent requirements. At the same time, many other factors that might influence fiscal outcomes are invariant across the states. In other words, cross-state studies effectively control for factors such as macroeconomic conditions, culture, and the

⁸ James Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (Indianapolis: Liberty Fund, [1977] 1999), Chapter 7.

⁹ In their words, “Keynesian economics has turned the politicians loose; it has destroyed the effective constraint on politicians’ ordinary appetites. Armed with the Keynesian message, politicians can spend and spend without the apparent necessity to tax.” Ibid, Chapter 1.

¹⁰ The first such proposal appears to have been made by Harold Knutson (R-MN), in May of 1936.

¹¹ Parts of this section are drawn from Matthew Mitchell, “Institutions and State Spending: An Overview” (working paper, Mercatus Center at George Mason University, Arlington, VA, 2011).

¹² *New State Ice Co. v. Liebmann*, 285 U.S. 262 (1932), <http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=285&invol=262>.

broad legal/constitutional setting in which each state operates. Furthermore, researchers are able to employ various econometric techniques to control for the influence of those factors that *are* different across states, such as climate or demography. In sum, the setting provides a rich laboratory in which to test the effect of different balanced budget rules on budgetary outcomes.

How do balanced budget requirements vary across the states? In some states, the “requirement” of balance only applies to the governor’s proposed budget. In other words, the governor must submit a balanced budget, but the legislature need not pass one. In other states, *estimates* of the enacted budget need to show balance, but there are no consequences if these estimates prove wrong at the end of the fiscal year and the actual budget is out of balance. In some states, the legislature may carry-over a deficit from one year to the next, while in others they may not. Lastly, in some states an independently elected Supreme Court is the ultimate enforcer of the requirement, while in others the legislature appoints the members of the Supreme Court.

A number of studies have found that states with stricter balanced budget requirements tend to tax and spend less than other states. Henning Bohn of U.C. Santa Barbara and Robert Inman of the University of Pennsylvania, for example, find that per-capita spending is about \$189 less in states with strict balanced budget requirements relative to those with weak requirements.¹³ David Primo of the University of Rochester arrives at a remarkably similar result, finding that strict balanced budget requirements reduce spending by about \$184 per capita.¹⁴ If this is the impact of moving from a weak to a strict balanced budget requirement at the state level, it is possible that if the federal government were to adopt a balanced budget requirement where none now exists, the impact would be even greater.

Strict balanced budget requirements have other beneficial effects. Bohn and Inman find that states with strict requirements tend to have larger rainy day funds and larger surpluses. They also find that states with these requirements tend to balance their books through spending reductions rather than revenue increases. This is helpful given the fact that most recent evidence suggests that tax increases are a more economically damaging way to close deficits than spending reductions.¹⁵

Shanna Rose of New York University finds that states without strict balanced budget requirements are more likely to suffer from a “political business cycle” whereby policy makers increase spending just prior to an election, only to cut back following the election.¹⁶

But there may be some unintended consequences of a strict balanced budget requirement. Economists Noel Johnson, Steven Yamarik, and I recently examined the impact of rules that make it difficult to carry a deficit over from one year to the next. On the one hand, we found that these rules limit the likelihood of

¹³ This estimate, and all others in this paper, has been converted into 2008 dollars for ease of comparison. When authors report a range of estimates, I take the average and then convert that average into 2008 dollars. Henning Bohn and Robert Inman, “Balanced Budget Rules and Public Deficits: Evidence from the U.S. States,” (working paper No. 5533, National Bureau of Economic Research, 1996).

¹⁴ David Primo, *Rules and Restraint: Government Spending and The Design of Institutions* (Chicago: University of Chicago Press, 2003). Mark Crain has also corroborated this result. See Mark Crain, *Volatile States: Institutions, Policy and the Performance of American State Economies* (Ann Arbor: University of Michigan Press, 2003).

¹⁵ See, for example, Alberto Alesina and Silvia Ardagna, “Large Changes in Fiscal Policy: Taxes Versus Spending,” *Tax Policy and the Economy*, Vol. 24 (2010): 35-68. See, also, Daniel Leigh, Pete Devries, Charles Freedman, Jaime Guajardo, Douglas Laxton, and Andrea Pescatori, “Will It Hurt? Macroeconomic Effects of Fiscal Consolidation,” in *World Economic Outlook: Recovery, Risk, and Rebalancing* (Washington, D.C.: International Monetary Fund, 2010).

¹⁶ Shanna Rose, “Do Fiscal Rules Dampen the Political Business Cycle?” *Public Choice* 128, no. ¾ (September 2006): 407–431.

partisan fiscal outcomes. On the other, they may increase the likelihood of partisan regulatory outcomes. When Democratic-controlled states were unable to carry a deficit forward to the next fiscal cycle, they were more likely to raise the minimum wage, less likely to adopt a right-to-work statute, and more likely to regulate personal freedoms (as measured by an index of personal freedom).¹⁷

WAYS TO IMPROVE ON A BALANCED BUDGET REQUIREMENT

Rainy Day Fund

Some commentators worry that a balanced budget requirement exacerbates the ups and downs of the business cycle. Since budgets tend to be the tightest at the bottom of an economic downturn, this argument goes, strict balanced budget requirements force governments to cut back on spending at the worst time.¹⁸ I think this is a fair critique. One institutional answer to it is a “budget stabilization fund,” better known as a rainy day fund. States contribute to these funds during good years and then draw on them when the budget is strained due to a downturn or some other event such as a natural disaster. Forty-seven states currently maintain such funds, but like many institutions, their design varies on a state-by-state basis.¹⁹

Studies of rainy day funds suggest that they can smooth out the spending-cycle, but the details matter. Gary Wagner of Duquesne University and Erick Elder of the University of Arkansas conducted the most-comprehensive recent study of rainy day funds. They find that states whose rainy day funds have strict rules governing deposits and withdrawals tend to experience a \$14 per-capita reduction in spending volatility (as measured by the cyclical variability of per capita spending over time).²⁰

Balance Over the Business Cycle

Alternatively, the pro-cyclicality of a balanced budget requirement may be avoided with a stipulation that the budget be balanced over some period longer than a year. This would allow the government to run a deficit during contractions, but would force a surplus during the next expansion. As Alex Tabarrok, an economist at George Mason University, has recently reported, Sweden has had such a rule for over a decade now and it has met with success.²¹ Economists Glenn Hubbard and Tim Kane recently made a similar point.²²

¹⁷ Noel Johnson, Matthew Mitchell, and Steven Yamarik, “Pick Your Poison: Do Politicians Regulate When They Can’t Spend?” (working paper, Mercatus Center at George Mason University, Arlington, VA, 2011),

http://mercatus.org/sites/default/files/publication/Partisan_Policies_Johnson_Mitchell_Yamarik_WP1128_0.pdf.

¹⁸ Norman Ornstein, “Why a Balanced-Budget Amendment Is Too Risky,” *Washington Post*, July 29, 2011,

<http://www.aei.org/article/103883>.

¹⁹ Kim Rueben and Carol Rosenberg, “State and Local Tax Policy: What Are Rainy Day Funds and How Do They Work?” in *The Tax Policy Briefing Book*, Tax Policy Center, August 12, 2009, <http://www.taxpolicycenter.org/briefing-book/state-local/fiscal/rainy-day.cfm>.

²⁰ Gary Wagner and Erick Elder, “The Role of Budget Stabilization Funds in Smoothing Government Expenditures over the Business Cycle,” *Public Finance Review*, Vol. 33, No. 4 (July 2005): 439–465.

²¹ Alex Tabarrok, “The Virtues of an Unbalanced-Budget Amendment,” *Time*,

http://www.time.com/time/specials/packages/article/0,28804,2086781_2086783_2086788,00.html. For a review of international experiences with budget rules see Manmohan Kumar, et al., “Fiscal Rules: Anchoring Expectations for Sustainable Public Finances,” *International Monetary Fund*, December 2009, <http://www.imf.org/external/np/pp/eng/2009/121609.pdf>.

²² Glenn Hubbard and Tim Kane, “In pursuit of a balanced budget,” *Politico*, July 28, 2011, <http://dyn.politico.com/printstory.cfm?uuid=61211C7E-4B46-45EB-B4AE-FE6EF30DEADD>

A Transition Period

Another concern with a balanced budget amendment has to do with the transition. Given that the nation currently borrows 45 cents for every dollar spent, a requirement to immediately achieve balance would require either draconian spending cuts or dramatic tax increases.²³ This can easily be remedied, however, with a smooth glide-path to achieve balance.

CONCLUSION

On almost every conceivable measure, the U.S. states are more fiscally fit than the federal government. On a per-capita basis, states spend about one half of what the federal government spends. Their debt loads are about one seventh that of the federal government.²⁴ And state unfunded liabilities are about one third as large as federal unfunded liabilities (taking the most conservative estimate of the latter).²⁵ Furthermore, states manage to balance their operating expenses (some gimmickry aside) on an annual or biennial basis while the federal government is out-of-balance more years than not. When states do borrow, it is typically for long-term capital projects, so that future generations end up paying for roads and bridges that they themselves will use. In contrast, much of the federal bill that my daughter's generation will inherit is to pay for my generation's consumption.

This is all the more surprising given the fact that, constitutionally, states essentially have a blank check whereas the federal government does not. As Madison put it in Federalist No. 45:

The powers delegated by the proposed Constitution to the federal government, are few and defined. Those which are to remain in the State governments are numerous and indefinite.²⁶

In my view, the relative probity of the state governments owes much to the simple fact that each generation of state taxpayers must bear both the costs and the benefits of government services. As long as the federal government is allowed to vote benefits for the current generation while passing the costs onto future generations, I believe the national debt will continue to grow.

Thank you for your time. It has been an honor to speak with you today, and I welcome any questions.

²³ Office of Management and Budget, Historical Tables, Table 1.1.

²⁴ Author's calculation, based on data from U.S. Census Bureau, State Government Finances Page, <http://www.census.gov/govs/state/>; and Office of Management and Budget, op. cit.

²⁵ For state unfunded liabilities, see *State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs*, Government Accountability Office, No. 10-899 (July 2010), <http://www.gao.gov/new.items/d10899.pdf>. For Social Security's unfunded liabilities, see *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, (Washington, D.C.: U.S. Government Printing Office, May 13, 2011), <http://www.ssa.gov/oact/tr/2011/tr2011.pdf>. For Medicare unfunded liabilities, see *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, (Washington, D.C.: U.S. Government Printing Office, May 13, 2011), <https://www.cms.gov/ReportsTrustFunds/downloads/tr2011.pdf>.

²⁶ James Madison, "No. 45," in *The Federalist*, by Alexander Hamilton, James Madison, and John Jay, ed. Clinton Rossiter (New York: Signet Classics, [1787] 1961).