A Constitutional Amendment for a Balanced Budget

Testimony to the
Senate Judiciary Committee
Subcommittee on the Constitution, Civil Rights and Human Rights

Douglas Holtz-Eakin, President
American Action Forum*

November 30, 2011

* The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I am grateful to Gordon Gray and Cameron Smith for assistance.

Introduction

Chairman Durbin, Ranking Member Graham and members of the Committee, I am pleased to have the opportunity to appear today. In this testimony, I wish to make four basic points:

- The U.S. faces a dramatic threat from the current and projected levels of federal debt,
- The adoption of a "fiscal rule" would be a valuable step toward budgetary practice that would address this threat and preclude its recurrence,
- A balanced budget amendment to the U.S. Constitution is one such fiscal rule; one whose very nature would render it an effective fiscal constraint immune from the forces that have generated a history of Congresses reneging on budgetary targets, and
- Recent incarnations of a balanced budget amendment contain provisions that address some traditional concerns regarding balanced budget requirements.

I will pursue each in additional detail.

The Threat from Federal Debt

The federal government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's (CBO's) *Long-Term Budget Outlook*[1]. In broad terms, over the next 30 years, the inexorable dynamics of current law will raise federal outlays from an historic norm of about 20 percent of Gross Domestic Product (GDP) to anywhere from 30 to 40 percent of GDP. Any attempt to keep taxes at their post-war norm of 18 percent of GDP will generate an unmanageable federal debt spiral.

This depiction of the federal budgetary future and its diagnosis and prescription has all remained unchanged for at least a decade. Despite this, action (in the right direction) has yet to be seen.

Those were the good old days. In the past several years, the outlook has worsened significantly.

[1] Congressional Budget Office. 2011. *The Long-Term Budget Outlook.* Pub. No. 4277. http://www.cbo.gov/ftpdocs/122xx/doc12212/06-21-Long-Term_Budget_Outlook.pdf

Over the next ten years, according to the Congressional Budget Office's (CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2012[2], the deficit will never fall below $750 billion. Ten years from now, in 2021, the deficit will be 4.9 percent of GDP, roughly $1.2 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing. As a result of the spending binge, in 2021 debt in the hands of the public will have more than doubled from its 2008 level to 90 (87.4) percent of GDP and will continue its upward trajectory.

Clearly, the passage of the Budget Control Act of 2011, its embodied caps on discretionary spending, and the formation of the Joint Select Committee on Deficit Reduction reflected a commitment to move the nation's finances in a better direction. With the Super Committee having failed to report recommendations to reduce future deficits, the fallback sequester is scheduled to go into effect for FY 2013. Even if the sequester is allowed to be fully imposed, the long-term budget challenge will remain. Nothing could be more important than addressing this challenge.

The "Bad News" Future under Massive Debt Accumulation. A United States fiscal crisis is now a threatening reality. It wasn't always so, even though – as noted above – the Congressional Budget Office has long published a pessimistic *Long-Term Budget Outlook*. Despite these gloomy forecasts, nobody seemed to care. Bond markets were quiescent. Voters were indifferent. And politicians were positively in denial that the "spend now, worry later" era would ever end.

Those days have passed. Europe is embroiled in a debt crisis that may fundamentally alter the EU. Despite the wherewithal of some European nations, Moody's is questioning the ratings of <u>all</u> European sovereign debt. And the U.S. is by no means immune – as witnessed by the decision of S&P to downgrade the federal credit rating. The federal government ran a fiscal 2010 deficit of $1.3 trillion – nearly 9 percent of GDP, as spending reached nearly 24 percent of GDP and receipts fell below 15 percent of GDP.

What happened? First, the U.S. frittered away its lead time. It was widely recognized that the crunch would only arrive when the baby boomers began to retire. Guess what? The very first official baby boomer already chose to retire early at age 62, and the number of retirees will rise as the years progress. Crunch time has arrived and nothing was done in the interim to solve the basic spending problem – indeed the passage of the Medicare prescription drug bill in 2003 made it worse.

[2] Congressional Budget Office. 2011. *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012.* Pub. No. 4258. http://www.cbo.gov/ftpdocs/121xx/doc12130/04-15-AnalysisPresidentsBudget.pdf

Second, the events of the financial crisis and recession used up the federal government's cushion. In 2008, debt outstanding was only 40 percent of GDP. Already it is over 60 percent and rising rapidly.

Third, active steps continue to make the problem worse. The Affordable Care Act "reform" adds two new entitlement programs for insurance subsidies and long-term care insurance without fixing the existing problems in Social Security, Medicare, and Medicaid.

Financial markets no longer can comfort themselves with the fact that the United States has time and flexibility to get its fiscal act together. Time passed, wiggle room vanished, and the only actions taken thus far have made matters worse.

As noted above, in 2021 debt in the hands of the public will have more than doubled from its 2008 level to 90 (87.4) percent of GDP and will continue its upward trajectory. Traditionally, a debt-to-GDP ratio of 90 percent or more is associated with the risk of a sovereign debt crisis.

Indeed, there are warning signs even before the debt rises to those levels. As outlined in a report[3], the credit rating agency Moody's looks at the fraction of federal revenues dedicated to paying interest as a key metric for retaining a triple-A rating. Specifically, the large, creditworthy sovereign borrowers are expected to devote less than 10 percent of their revenues to paying interest. Moody's grants the U.S. extra wiggle room based on its judgment that the U.S. has a strong ability to repair its condition after a bad shock. The upshot: no downgrade until interest equals 14 percent of revenues.

This is small comfort as the 2012 Obama Administration budget targets 2015 as the year when the federal government crosses the threshold and reaches 14.2 percent. Moreover, the plan is not merely to flirt with a modest deterioration in credit-worthiness. In 2021, the ratio reaches 20.3 percent.

Perhaps even more troubling, much of this borrowing comes from international lending sources, including sovereign lenders like China that do not share our core values.

For Main Street America, the "bad news" version of the fiscal crisis occurs when international lenders revolt over the outlook for debt and cut off U.S. access to international credit. In an eerie reprise of the recent financial crisis, the credit freeze would drag down business activity and household spending. The resulting deep recession would be exacerbated by the inability of the federal government's

[3] Moody's determines debt reversibility from a ratio of interest payments to revenue on a base of 10 percent. Wider margins are awarded to various governments to indicate the additional "benefit of the doubt" Moody's awards. The US finds itself on the upper end at 14 percent. The ratios are "illustrative and are not hard triggers for rating decisions." See: *Aaa Sovereign Monitor Quarterly Monitor No. 3*. Moody's Investor Service. March 2010.

automatic stabilizers – unemployment insurance, lower taxes, etc. – to operate freely.

Worse, the crisis would arrive without the U.S. having fixed the fundamental problems. Getting spending under control in a crisis will be much more painful than a thoughtful, pro-active approach. In a crisis, there will be a greater pressure to resort to damaging tax increases. The upshot will be a threat to the ability of the United States to bequeath to future generations a standard of living greater than experienced at the present.

Future generations will find their freedoms diminished as well. The ability of the United States to project its values around the globe is fundamentally dependent upon its large, robust economy. Its diminished state will have security repercussions, as will the need to negotiate with less-than-friendly international lenders.

The "Good News" Future under Massive Debt Accumulation. Some will argue that it is unrealistic to anticipate a cataclysmic financial market upheaval for the United States. Perhaps so. But an alternative future that simply skirts the major crisis would likely entail piecemeal revenue increases and spending cuts – just enough to keep an explosion from occurring. Under this "good news" version, the debt would continue to edge northward – perhaps at times slowed by modest and ineffectual "reforms" – and borrowing costs in the United States would remain elevated.

Profitable innovation and investment will flow elsewhere in the global economy. As U.S. productivity growth suffers, wage growth stagnates, and standards of living stall. With little economic advancement prior to tax, and a very large tax burden from the debt, the next generation will inherit a standard of living inferior to that bequeathed to this one.

The Value of Fiscal Rules

At present, the federal government does not have a fiscal "policy." Instead, it has fiscal "outcomes". The House and Senate do not reliably agree on a budget resolution. Annual appropriations reflect the contemporaneous politics of conference committee compromise, and White House negotiation. Often, the annual appropriations process is in whole or part replaced with a continuing resolution. Annual discretionary spending is not coordinated in any way with the outlays from mandatory spending programs operating on autopilot. And nothing annually constrains overall spending to have *any* relationship to the fees and tax receipts flowing into the U.S. Treasury. The fiscal outcome is whatever it turns out to be – usually bad – and certainly not a policy choice.

I believe that it would be tremendously valuable for the federal government to adopt a fiscal rule. Such a rule could take the form of an overall cap on federal spending (perhaps as a share of gross domestic product (GDP)), a limit on the ratio of federal debt in the hands of the public relative to GDP, a balanced budget requirement, or many others. Committing to a fiscal rule would force the current, disjointed appropriations, mandatory spending, and tax decisions to fit coherently within the adopted fiscal rule. Accordingly, it would force lawmakers to make tough tradeoffs, especially across categories of spending.

Most importantly, it would give Congress a way to say "no." Spending proposals would not simply have to be good ideas. They would have to be *good enough* to merit cutting other spending programs or using taxes to dragoon resources from the private sector. Congress would more easily be able to say, "not good enough, sorry."

What should one look for in picking a fiscal rule? First, it should work; that is, it should help solve the problem of a threatening debt. A fiscal rule like PAYGO at best stops further deterioration of the fiscal outlook and does not help to solve the problem.

Second, it is important that there be a direct link between policymaker actions and the fiscal rule outcome.

Finally, the fiscal rule should be transparent so that the public and policymakers alike have a clear understanding of how it works. This is a strike against a rule like the ratio of debt-to-GDP. The public has only the weakest grip on the concept of federal debt in the hands of the public, certainly does not understand how GDP is produced and measured, and (God help us) may not be able to divide. Without transparency and understanding, public support for the fiscal rule will be too weak for it to survive.

As documented by the Pew-Peterson Commission on Budget Reform[4] other countries have benefitted from adopting fiscal rules. The Dutch government established separate caps on expenditures for health care, social security and the labor market. There are also subcaps within the core sectors.

Sweden reacted to a recession and fiscal crisis by adopting an expenditure ceiling and a target for the overall government surplus (averaged over the business cycle). Later (in 2000) a balanced budget requirement was introduced for local governments. Finally, in 2003 the public supported a constitutional amendment to limit annual federal government spending to avoid perennial deficits.

A lesson is that, no matter which rule is adopted, it will rise or fall based on political will to use it and the public's support for its consequences.

A Balanced Budget Amendment

[4] http://budgetreform.org/

In this consequence, how should one think of proposals to amend the Constitution of the United States to require a balanced federal budget? It would clearly be quite significant. Despite the good intentions of the Budget Control Act of 2011, there is little indication that the resultant savings will do anything but delay the fiscal threats outlined above. Absent significant fiscal reform, these challenges will continue to evolve from pressing to irreversible. The distinguishing characteristics of a Constitutional amendment to address these challenges make it a far more robust tool in this endeavor.

First, fiscal constraints, in the form of spending caps, triggers, and other like devices are laudable, but fall short of Constitutional amendment in their efficacy as a fiscal rule similar to those pursued by nations such as the Netherlands and Sweden. A Constitutional amendment, by design, is (effectively) permanent, and therefore persistent, even if bypassed in certain exigent circumstances, in its effect on U.S. fiscal policy. Fiscal rules should allow policy figures to say "no." A Constitutional amendment will not only allow that, but given the gravity inherent in a Constitutional amendment, hopefully dissuade contemplation of legislative end-arounds that other rule might invite.

Second, there is a clear link between Congressional actions – cutting spending, raising taxes – and the adherence to a balanced budget amendment. Of course, Congressional action is not *all* that determines annual expenditures and receipts.

Military conflicts and other such contingencies can incur costs without advance Congressional action, while economic conditions can effect spending, such as with unemployment insurance and other assistance programs, and tax revenues. However, these fluctuations are ultimately not the driving force between the U.S. fiscal imbalance. Indeed, in a world with stable tax revenue and without frequent military contingencies, the U.S. would still be headed towards fiscal crisis. Rather, enacted spending and tax policy largely set forth the U.S. fiscal path that must be altered to avert a fiscal crisis. A meaningful constraint on these factors would confront policymakers with the necessity to alter those polices, and as discussed above, to make the choices and tradeoffs needed to shore up the nation's finances. Tying those choices to an immutable standard, in the form of a Constitutional amendment would facilitate that process.

A third facet of a Constitutional amendment that augurs well for its efficacy is the ratification process itself. This is a process that takes years. While the two-century long ratification of the 27^{th} amendment may be an extreme example, suffice it to say successful ratification of a Constitutional amendment requires acceptance at many levels of public engagement. For the purpose of constraining federal finances, this is beneficial, as it necessarily requires public "buy-in." Without question, the changes needed to address federal spending policy will be difficult. Any process that engages the public, and by necessity, requires public complicity to be successful will ease the process of enacting otherwise difficult fiscal changes.

Lastly, the very nature of a Constitutional amendment shields it from the annual, or perhaps more frequent, vicissitudes of federal policymaking. It cannot be revised, modified, or otherwise ignored in the fashion of the many checks on fiscal policy enacted or attributable to the Congressional Budget Act of 1974 or its successors. Congress cannot renege on its obligations with such an amendment in place. While unquestionably a constraint on Congress, as a parameter of federal policymaking it would be one by which all must abide.

Auxiliary Features of a Balanced Budget Proposal

As noted above, a balanced budget amendment to the Constitution has several unique characteristics that distinguish it as an effective fiscal rule. However, not all balanced budget amendments are created equal. Balanced budget amendments can differ significantly, with considerable variation in the consequence of their design.

While largely the result of choices by policymakers, the U.S. fiscal situation is, and will be in the future, shaped in some way by forces outside of the legislative process, such as war, calamity, of economic distress. Critical to an effective balanced budget amendment is the acknowledgment of this reality with a mechanism for adjusting to these forces without undermining the goal of the amendment to constrain fiscal policy. The abuse of emergency designations in legislation to get around budget enforcement is an example of what can happen when the goal of constraining fiscal policy is subordinated to flexibility in the face of some crisis, real or otherwise. Stringent accountability, such as the requirement of supermajority, affirmative votes can mitigate this problem.

Past iterations of balanced budget amendments have legitimately raised questions as to their capacity to limit the scale of the federal government. There is nothing inherent in a balanced budget amendment to limit federal spending beyond the belief that at some point, the tax burden necessary to balance the expenditure of a large federal government ultimately reaches an intolerable level. But there is nothing about a balanced budget amendment alone that precludes reaching tax and spending levels just approaching that tipping point, which is far from desirable policy. Accordingly, recent examples of balanced budget amendments seek to staunch the accumulation of debt, which is ensured by balance, while also limiting the spending to the historical norm. Likewise, recent examples of balanced budget amendments limit the Congress's ability to raise taxes. In each case these limitations can be waived by supermajority votes. These are sound approaches that address concerns that a requirement to be in balance will add tax policy to the share of fiscal policy already on autopilot.

The last issue of concern, but with a less obvious remedy relates to enforcement. It is not obvious in any of the extent amendments what would occur if the requirements of the amendment were violated. The enforcement mechanism for these requirements arguably may not exist, and may not exist until tested after the ratification of a balanced budget amendment. The various waivers provide

Congressional allowances for specific overages as a means of establishing compliance should U.S. finances fail to balance or exceed certain limits assuming one of the proposed amendments is successfully ratified. The provision in the prevailing Senate balanced budget amendment prohibiting courts from raising revenues in the event of a "breach" entertains the possibility that the U.S. may indeed find itself in an *ex post* violation of a balanced budget amendment. That suggests that irrespective of the waiver provisions, there is nothing within the amendment itself that addresses enforcement, whether by sequestration or some other means. While many ciriticisms of past approaches to balanced budget amendments have been meaningfully addressed in recent efforts, the question of enforcement remains a challenge that should be thoughtfully considered.

Thank you for the opportunity to appear today. I look forward to answering any questions the Committee may have.