Tax Policy Center

Urban Institute and Brookings Institution

CONSTITUTIONAL SOLUTIONS TO OUR ESCALATING NATIONAL DEBT: EXAMINING BALANCED BUDGET AMENDMENTS

TESTIMONY OF HENRY J. AARON[1] TO THE HOUSE JUDICIARY COMMITTEE

Henry J. Aaron
Urban-Brookings Tax Policy Center
July 24, 2013

ABSTRACT

Henry J. Aaron testifies before the House Judiciary Committee, arguing that despite the relatively high levels of current government debt and the budget challenges that the nation faces in the future, instituting a federal balanced budget amendment would negatively impact the economy and threaten the nation's financial stability. Aaron notes five main reasons a balanced budget amendment should not be passed or implemented.

[1] *Bruce and Virginia MacLaury Senior Fellow, the Brookings Institution. The views expressed here are my own and do not necessarily reflect those of the trustees, officers, or other staff of the Brookings Institution.*

TESTIMONY OF HENRY J. AARON TO THE HOUSE JUDICIARY COMMITTEE

Mr. Chairman, Mr. Ranking Member, Committee Members:

Balanced budget amendments have been around a long time. They appeal to the universally recognized virtue of fiscal responsibility. Still, Congress has never sent one on to the states for ratification. Congress should not do so now, despite the relatively high levels of current government debt and the budget challenges that the nation faces in the future. There are at least five reasons.

First, budget deficits are sometimes beneficial. These times include not only declared wars but also economic slowdowns. Had either H.J. Res 1 or 2 been in effect during the recent financial crisis, each would have required either tax increases or spending cuts that would have greatly intensified unemployment and the fall of GDP. The constitutional amendments proposed in these resolutions would have become *automatic destabilizers* threatening perverse tax and expenditure policy that would raise unemployment and destabilize financial markets unless avoided by super-majority votes. To require super-majority votes to avoid catastrophic policy is folly.

Second, requiring a super-majority to raise the debt ceiling or to run a deficit is a veritable summons to political extortion by an intransigent minority. The consequences of a failure to raise the debt ceiling would be intrinsically catastrophic and could trigger a constitutional crisis. A mere two-fifths of either House could demand as ransom for its votes enactment of legislation on which it insists. This threat has no political allegiance. It could be wielded in the service of small government or large government, lower taxes or higher taxes, lower spending or higher spending.

Third, the deficit and debt ceiling provisions of H.J. Res. 1 and 2 would prevent access to the Social Security trust fund to sustain benefits unless the rest of the government was not just balanced but running a surplus...unless, that is, three-fifths of the whole membership of both Houses of Congress agreed to sustain pensions for the elderly and disabled. A similar problem could stymie important government activities vital to combat financial panic just when they are most needed.

Fourth, a Congress, constrained by the limits in H.J.Res.1 and 2 but anxious to accomplish some agreed objective would inevitably resort to all manner of devices that would circumvent those limits in ways that led to inefficient government. Spending could become tax credits (seeming to lower both spending and revenues) or unfunded mandates on state governments. No one interested in good and honest government should increase incentives for elected officials to find devious ways to accomplish objectives dear to them.

Finally, Mr. Goodlatte, I must note that just three years ago, the version of H.J. Res. 1 reported out of committee, which you sponsored, proposed to limit government spending to 18 percent of economic output. Now you propose a limit of 20 percent of economic output. Just three years ago you endorsed a bill that would have made such spending a violation of the Constitution. Is it not possible that at some future date you might conclude, in light of new and better information, that a different percentage is desirable? Does not this change in what would be a cap written into the Constitution raise questions about the wisdom of locking into the Constitution an economic variable you are willing to change based on facts and circumstances?

I

Balanced budget amendments are harmful because deficits are sometimes beneficial. In a democratic republic, it should not take a super-majority to do the right thing.

Successive Congresses and presidents of both parties have crafted public policies that automatically generate deficits when the economy weakens. These automatic stabilizers include all taxes, which drop when incomes fall or sales decline; Social Security, claims for which increase as labor markets soften; and unemployment insurance and nutrition assistance. They kick in as soon as the economy weakens, often long before official statistics record the slowdown and even longer before political officials react to them. The delay between the onset of an economic slowdown and the marshaling of three-fifths of the full membership of both Houses to authorize budget deficits that now occur as soon as the economy weakens would mean increased unemployment, lost output, and human suffering.

I am not saying that the automatic stabilizers are perfectly designed. To the extent that they are not, they should be revised. But they should not be turned into automatic ***destabilizers***, which is just what a balanced budget amendment would do.

A requirement that the budget must be balanced at all times would prohibit deficits. Of course, one might avoid deficits during recessions by raising tax rates as the economy weakens or by cutting spending as the need for it increases. Had such measures been taken during the recent financial crisis that began in 2007, a painful slowdown would have been transmuted into a disastrous depression rivaling that of the 1930s. In 2011 Macroeconomic Advisors, a leading economic forecasting company, estimated that a constitutional amendment requiring that the 2012 budget be balanced would have required that all government spending be cut by 60 percent (assuming that Social Security and interest payments were protected). The cuts would have had to apply to national defense, veterans benefits, nutrition assistance, Medicare—everything other than Social Security and interest payments. These cuts or equivalent tax increases, it is estimated, would have put 15 million ***more*** people out of work, doubled unemployment from 9 percent to 18 percent, and cut GDP by 17 percent.

Make no mistake: if you endorse a balanced budget amendment, you are endorsing such spending cuts during a similar future recession. If you endorse a balanced budget amendment, you are endorsing *automatic destabilizers* that will intensify future recessions and increase unemployment. You would be endorsing devastating cuts in national defense regardless of threats to the nation. You would be favoring cuts in assistance to the unemployed just when job opportunities were drying up. You would be endorsing such untoward effects, unless....

II

....unless, of course, three-fifths super majorities of all members (not just of those present and voting) of ***both*** Houses of Congress agreed to sensible policies.

One hopes, of course, that they would do so. Even if they were willing to waive the amendment's constraints, it would take time for Congress to act—time during which unemployment would climb, the slowdown would deepen, and hardship would increase. But the waiver might not be granted at all or not until the majority bought off a stubborn minority by granting its demands for policies a majority opposes.

Put simply, a two-fifths minority of ***either*** House could hold Congress and the nation ransom. It could insist that its pet idea be included in such waiver of the balanced budget requirements. Today, support of balanced-budget proposals comes almost entirely from conservatives and is opposed mostly by progressives. But a minority of any political persuasion can withhold its support for waiving the limits imposed by balanced budget limits unless its demands are satisfied. Today the ransom might take the form of repealing the Affordable Care Act. Tomorrow it might take the form of requiring the introduction of a value-added tax after the recession ends or passage of Medicare-for-all. The automatic economic destabilization inherent in a balanced budget amendment is a political doomsday weapon that any determined minority can threaten to detonate.

III

If there is one subject on which members of both parties agree, it is that Social Security benefits for those now on the rolls and soon to retire should be protected. Republicans and Democrats have different and competing visions about how the pension system for the elderly and disabled should evolve over time. But everyone agrees that significant structural changes, if any, should be phased in gradually and that those who are now on the rolls (or soon will be) should be protected from large benefit cuts. Much the same applies to Medicare. Whatever the form of one's preferred Medicare system, members of both parties agree that health benefits for people now on the rolls should be largely protected.

The balanced budget amendments under discussion today are inconsistent with that bi-partisan commitment. Here is why. Both Medicare Hospital Insurance and Social Security are financed through trust funds. The assets in these trust funds are invested in Treasury securities. Those securities are part of the national debt subject to the debt ceiling, but these reserves are not what CBO, other analysts, and H.J. Res. 1 and 2 refer to as "debt in the hands of the public."[2] The Hospital Insurance (HI) Trust Fund is now selling off its holdings of Treasury securities in order to pay for current benefits. The Disability Insurance (DI) trust fund is now selling off its holdings in order to pay current benefits. The Old-Age and Survivors Insurance Trust Fund is still buying Treasury securities, but the 2013 Trustees Report projected that the OASI Trust Fund will start to sell assets in 2022.

[2]In April, 2014, the total federal government debt subject to the debt ceiling was $17.6 trillion. Of this total, $5 trillion was held by various government agencies, the largest single part of which is held in the Old-Age, Survivors, and Disability Insurance Trust Funds. The remaining $12.6 billion is 'debt in the hands of the public' to which H.J.Res. 1 and 2 refer. Of the debt held by the public, nearly $6 trillion was held by foreign governments, people and organizations and $6.6 trillion was held by U.S. based individuals, insurance companies, banks, and other organizations.

When the OASI, DI, and HI trust funds sell securities, they do so by presenting them to the Treasury Department, which credits cash to the trust funds. To raise that cash, the Treasury must sell securities to the public–that is, it must borrow money from the public. Under the terms of the balanced budget amendments, such sales to the public would be barred if the total debt in the hands of the public were at the maximum set by Congress. The sales would be barred even if the budget for the rest of government operations was in balance. The sales would be barred even if the debt were below the statutory limit, because the spending would push the total budget into deficit.

Put simply, when Social Security and Medicare Hospital Insurance finance spending from accumulated reserves, they are still engaging in deficit spending which still requires Treasury borrowing to cover it. In these cases, the reserves accumulated for Social Security and Medicare Hospital Insurance would be unavailable to pay benefits.

The same principles apply to reserves accumulated to pay benefits to civil service and military retirees and to reserves accumulated in any fund that holds securities not counted as being held by the public. The bulk of these reserves were accumulated by charging workers extra taxes or contributions beyond those necessary to pay for current benefits. Those extra charges were justified on the grounds that they would be available to cover future benefits. A balanced-budget amendment would betray that promise unless the rest of government operations ran surpluses sufficient to fully offset the draw-down of these reserves.

The balanced budget amendments would also threaten financial stability. As noted in a report of the Center on Budget and Policy Priorities, the Federal Deposit Insurance Corporation (FDIC) and the Pension Benefit Guarantee Corporation (PBGC) hold a total of $57 billion in reserve to insure deposits and protect defined-benefit pensions.[3]

"Here, too, the balanced budget amendment would make it unconstitutional for the FDIC and the PBGC to use their assets to pay deposit or pension insurance, since doing so would generally constitute 'deficit spending.' Such payments could be made only if the rest of the budget ran an offsetting surplus that year (or if Congress achieved the necessary ... supermajorities to override the balanced budget requirement).

"In general, a constitutional requirement that all spending during a given year be covered by tax revenues collected in the same year would undercut ... deposit insurance, pension insurance, FHA loans, small business loans, flood insurance, and the nuclear power industry's liability insurance under the Price-Anderson Act.

...

"If banks, thrift institutions, pension funds, small businesses, and mortgagers started to fail during a recession or a financial crisis, ... panicked depositors could make runs on banks, causing a chain reaction that could turn a recession into a depression."

[3]Richard Kogan, "Constitutional Balanced Budget Amendment Poses Serious Risks: Would Likely Make Recessions Longer and Deeper, Could Harm Social Security and Military and Civil Service Retirement," 16 July 2014.

It is important to understand that these problems do not arise because these funds hold Treasury securities. They would arise even if they held assets other than Treasury securities. The simple fact is that spending that exceeds current revenues would be barred regardless of the size of accumulated reserves. The only way that Social Security or the FHA or the PBGC could spend more than current revenues would be if the rest of the budget ran a current, cash-flow surplus.

IV

Some people embrace balanced budget amendment proposals because they hope that the amendments will curb what they regard as harmful tendency of legislators to fiscal irresponsibility. I believe that the fiscal record of this nation does not support this fear, but supporters of balanced budget amendments clearly believe otherwise. I have argued so far that efforts to curb this alleged tendency are likely to produce seriously adverse economic effects. I have also argued that they would give minorities a dangerous and unpredictable power during crises to force majorities to accept policies that most people oppose. But balanced budget amendments suffer from a different and equally serious problem: they can be gamed and circumvented in ways that would render them ineffective in achieving their stated objective and would simultaneously degrade governmental efficiency, which is not something that any of us would wish.

The problem is that one can achieve a given impact on the private economy in any number of different ways that are recorded quite differently in budget accounts. Suppose a Congressional majority wishes to expand support for people with low earnings.

1) It can provide a direct wage subsidy financed by new taxes.

2) It can provide an earned income tax credit equal to a portion of earnings (as it has actually done). This credit can be counted as a reduction in revenues, as an expenditure, or as part one and part the other, with the decision entirely contingent on a Congressional rule, which is what Congress has done.

3) It could mandate that state governments provide such subsidies, with or without incentives that relieve states of some or all of the cost of the mandate.

4) It could mandate that employers supplement earnings, according to a stated formula backed by tax incentives to defray some or all of the added costs.

One can achieve pretty much the same results by any of these devices. Yet the impact on the budget is quite different. Method 1) raises both spending and taxes. It could run afoul of the limit in H.J.Res 1 on the share of ‘economic output’ that the government could spend, but methods 2), 3), and 4) would not do so. Method 2) could run afoul of the balanced budget requirement in H.J. Res. 1 or 2, as could method 1) if the new taxes were not as large as the wage subsidy, but methods 3) and 4) would go unnoticed by a balanced budget rule. The four methods I have listed above are far short of the menu that a clever advocate of wage subsidies could design to circumvent a balanced budget requirement. That menu would include loan guarantees and all manner of regulations, some of which would work through indirection.

The key point is that if members of Congress want to do something, they or their staffs are smart enough to find a way to do it. A balanced budget amendment forecloses some ways of achieving given objectives but it does not foreclose others. Confronted with a super majority requirement that sixty percent of the full membership of both Houses vote to raise taxes to pay for increased spending, the clever legislator can propose a tax credit that lowers taxes and, under H.J.Res 1 and 2, requires only a simple majority of those present and voting to achieve the same end. A tax credit may work adequately as a means of boosting net wages, but it is not so effective a way to pay for stealth bombers. Those who are reluctant to use federal power to muscle state legislatures into implementing Congressional will may change their minds when a balanced budget amendment makes direct federal action too difficult.

In plain English, members of Congress intent on achieving a pet goal will work hard to circumvent a balanced budget amendment. Those who have marveled at the capacity of private citizens to manipulate tax laws and of Congress to find room for pet initiatives within pay-go budget rules should not expect less imagination when they turn their minds to circumventing a balanced budget amendment.

V

Three years ago the chairman of this committee was the lead sponsor of a bill to cap the share of ‘economic output' that the federal government can spend at 18 percent. H.J. Res. 1 proposes a limit of 20 percent, presumably because the sponsors now believe that 18 percent was too strict. If so, it is worth noting that a 2 percentage point increase—about $345 billion in 2014, rising to $536 billion in just ten years—is not chump change. It is also worth asking whether 20 percent is a number that should be enshrined in the Constitution. I believe that legislation, not a constitutional amendment, should be used to set policies about which people hold views that change over time.

In thinking about this matter, looking at history is helpful. President Reagan enjoyed a well-merited reputation as a politically conservative president. But spending exceeded 20 percent of GDP during all eight years of the Reagan presidency. And spending during the Reagan presidency did not include one cent of Social Security retirement benefits for the baby-boom generation, as the oldest baby-boomer was more than a decade away from becoming eligible for Social Security retirement benefits. In addition, health care spending as a share of GDP was more than one-third lower than it is today. Social Security spending will rise a total of 1.2 percent of GDP until the baby-boom generation is fully retired. Added spending on health care through Medicare, Medicaid, and other federal health programs will add more and will also lower revenues because of the exclusion from income and payroll taxation of the portion of compensation employers spend on health insurance for their workers.

History also reveals that spending can fall below 18 percent of GDP. It did so during the last three years of the presidency of Bill Clinton. The robust economy during the Clinton years is a partial explanation. The other part of the story is that during the 1990s two presidents, one Republican and one Democratic, George Herbert Walker Bush and Bill Clinton, working with

Congresses that were controlled at various times by each party, produced three deficit reduction laws. All reflected bipartisan compromise.

This experience should teach two important lessons. The first is that when members of both parties work together, they can limit spending, drastically reduce deficits, and even achieve balanced budgets. The second is that if sound fiscal policy is what one wants, one doesn’t need a balanced budget amendment to get it.