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The Balanced Budget Amendment*

Having been passed by the Senate, the Balanced Budget Amendment now awaits House action. The amendment is criticized by opponents for being both too restrictive and not restrictive enough. That some of the more vehement opponents have been leading lights of high spending, big Government suggests that the amendment may indeed have some restraining effect, which is what we conclude from our analysis of it. Although the amendment would not ensure against continuing increases in the size of Government or against budget irresponsibility, it would put these issues more into the public eye. That should better enable the public to choose the level of Government it wants.

On August 4th, after nearly 2 weeks of heated debate, the U.S. Senate passed by a vote of 69 to 31 (two votes more than the required two-thirds) a proposed Balanced Budget Constitutional Amendment. The version passed was exactly the one the Senate Judiciary Committee supported last year except for the addition of a provision requiring a three-fifths vote of both Houses in order to increase the statutory debt limit from its current "permanent" level of $400 billion. (See the box on page 130 for the provisions of the proposed amendment.) The U.S. House of Representatives is now considering the original version of the Balanced Budget Amendment, with the measure receiving more highly charged attention than ever before as the possibility of its becoming the 27th amendment increases.

Much of the controversy surrounding the Senate's passage is purely political. Opponents of the proposed amendment charge that many Senators who voted for it do not in fact want the amendment adopted. Fully expecting the House to reject it, those Senators, say the opponents, voted in favor in order to improve their public images as fighters for fiscal responsibility, even as they presently vote for more spending and bigger deficits in the 1983 budget. The charge may well be accurate, as may be the expectation that the House will reject the amendment. We do not consider ourselves qualified to judge people's motives or the probable disposition of the issue by the House.

But other criticisms of the proposed amendment can be analyzed more usefully. Two criticisms we have seen are contradictory. One is that the amendment is too restrictive, that budgets should not be forced into a balance if the imbalance is attributable largely to a drop in revenues arising from a drop in economic output and income. This is the budget attitude associated with Keynesian theory: deficits are favorable for the economy during recessions because they will help keep total spending up and prevent an economic contraction from spiraling downward into a major depression. The counter phase to the deficit period, according to this view, is budget surpluses during economic expansions.

This notion dominated budget making since the mid-1930's, and practice has shown that the time never seems right for budget surpluses. We have been left with the legacy of chronic deficits and their now-recognized disastrous inflationary consequences. Indeed, the Balanced Budget Amendment has been offered and is getting a serious hearing only because the need for balance over some span has been ignored in practice. When account is taken of how loose budgeting has been in practice, the contention that the amendment would be too restrictive has a mighty hollow ring – especially when the sources of such wailing are some of the biggest Big Spenders in Congress. Besides, as we describe below, the amendment would not force Congress to balance the budget. It would simply require a larger majority than the present simple majority for adoption of a budget with a planned deficit.

This is the object of the contradictory criticism; namely, that the amendment is not restrictive enough. According to this view, the amendment is so loose that Congress could readily circumvent the ostensible restrictions if Congress were intent on doing so; thus, if the amendment would bring balanced budgets only if Congress willingly went along, the amendment would be superfluous because Congress could do the same without the amendment. In the contrary event that Congress would disregard the amendment, critics declare such would tend to undermine respect for the Constitution, and the role of law in general, as did the Prohibition amendment.

This criticism, too, has a hollow ring when it is made by those who have been in the forefront of seeking redress for many social ills in more Government spending and wealth transfer programs. In our opinion, respect for law and the Constitution did not suffer nearly so much from the fiasco of Prohibition as it has from the fiasco of an activist interpretation of the Constitution by the judicial and legislative branches of Government. Public support for many of the costly activist programs probably would not have been garnered if elected representatives had to tap taxpayers' pocketbooks dollar-for-dollar to finance these programs, that is, if deficit financing were not such an easy avenue to take. It seems somewhat perverse for proponents of activist Government now to claim that the Balanced Budget Amendment, which would impede access to the easy avenue of spend-spend-spend that fostered an ever-more-interfering Government, is defective because its circumvention might weaken the Constitution.

Limited Restriction

True, the restrictiveness of the proposed amendment is limited, but that is not a defect. The amendment attempts to create a budget process that offsets, or bal-

* Some of the comments printed here were published earlier in our April 1982 *Economic Education Bulletin* having this title. If readers would like more discussion of some points mentioned here, they may find it in our April *Bulletin*.

ances, what now is a bias of Congress toward excessive spending. The string of deficits by themselves suggests there is such a bias, and an impressive explanation can be given for the bias.

Most spending programs benefit a comparatively small group of persons (small in relation to the number of U.S. taxpayers) having a common interest. The dollar benefit per member of the special interest group from any spending program thus is high in relation to the cost per taxpayer or per victim of inflating; therefore, the special interest members are willing to expend considerable funds and effort to get their program enacted. There is no effective countervailing political force. Taxpayers and victims of inflating are not well organized. Furthermore, when it comes to specific programs, their financial interest *per person* is not as great as that of the potential beneficiaries, so they do not oppose the program as vigorously as the proponents support it.

In having to vote on any specific spending proposed, Members of Congress usually find it policitically advantageous to vote in favor of bills supported by the organized, well-financed special interest rather than to have that group as a potential enemy at the next election.

BALANCED BUDGET – TAX LIMITATION CONSTITUTIONAL AMENDMENT

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled (two-thirds of each House concurring therein), That the following article is proposed as an amendment to the Constitution of the United States, which shall be valid to all intents and purposes as part of the Constitution if ratified by the legislatures of three-fourths of the several States within seven years after its submission to the States for ratification:

Article

Section 1. Prior to each fiscal year, the Congress shall adopt a statement of receipts and outlays for that year in which total outlays are no greater than total receipts. The Congress may amend such statement provided revised outlays are no greater than revised receipts. Whenever three-fifths of the whole number of both Houses shall deem it necessary, Congress in such statement may provide for a specific excess of outlays over receipts by a vote directed solely to that subject. The Congress and the President shall ensure that actual outlays do not exceed the outlays set forth in such statement.

Section 2. Total receipts for any fiscal year set forth in the statement adopted pursuant to this article shall not increase by a rate greater than the rate of increase in national income in the last calendar year ending before such fiscal year, unless a majority of the whole number of both Houses of Congress shall have passed a bill directed solely to approving specific additional receipts and such bill has become law.

Section 3. The Congress may waive the provisions of this article for any fiscal year in which a declaration of war is in effect.

Section 4. The Congress may not require that the States engage in additional activities without compensation equal to the additional costs.

Section 5. Total receipts shall include all receipts of the United States except those derived from borrowing and total outlays shall include all outlays of the United States except those for repayment of debt principal.

Section 6. This article shall take effect for the second fiscal year beginning after its ratification.

Note: This version is the one being debated in the U.S. House of Representatives. The version passed by the U.S. Senate has an additional provision that would require a three-fifths vote of both Houses of Congress to raise the National debt ceiling above its "permanent" statutory limit of $400 billion. As of June 30, public debt subject to the limit totaled $1,080 billion and was fast approaching the current "temporary" limit of $1,143 billion.

But what about the adverse economic consequences of budget deficits year after year? Those effects cannot be readily quantified. Moreover, as the Judiciary Committee put it, "... the availability of unlimited deficit spending allows the political costs of spending measures to be deferred in time, while enabling the political benefits to be enjoyed immediately. While the benefits of the measure usually will be understood immediately by its beneficiaries, the cost – in the form of higher future taxes, higher future inflation, and higher future interest rates – usually will be evident only at some distant time. Indeed, there may be no political costs whatsoever unless those who suffer from these economic ills are sophisticated enough to understand the cause-effect relationship between the earlier spending and the present symptoms." And how many Americans are so well informed?

By forcing Members to go on record in highly visible votes in support of either deficits or increased taxes when their spending would exceed a designated revenue level, the amendment may counter somewhat the spending bias of Congress.

Section 1 does *not* prohibit the adoption of a budget with a planned deficit; it only requires that a three-fifths majority of the whole number (not just those present) of both Houses vote in favor of a planned deficit in a bill directed solely to that issue. If the amendment were adopted, Members of Congress who support a deficit budget would have to "stand up and be counted" in favor of it, with their votes recorded for any challengers to their seats to use to best advantage.

For any given level of spending, the alternative to the three-fifths vote for a deficit is contained in Section 2, which provides for a simple majority vote (again of the whole number of both Houses) in favor of a bill directed solely to raising taxes. This highly visible vote would have to take place *before* appropriation bills could be passed, forcing Members of Congress to make a clear statement of their position on fiscal responsibility.

With any budget projection (statement), the estimated level of revenues is crucial to determining the amount of a projected deficit arising from any specific level of spending. If Congress were allowed to adopt wholly unrealistic projected levels of receipts, the balanced budget requirement or the alternative requirement of raising taxes could be subverted, and the related check on spending nullified. Section 2 may appear to restrict this possibility, but its effectiveness is doubtful.

The source of the doubt is the absence of a mandated linkage between statement (budgeted estimates of) re-

ceipts and actual receipts for any year. Instead, the proposed amendment limits the rate of *increase* in *estimated* receipts for the year being budgeted from the *yet-estimated* receipts of the fiscal year still in progress to the rate of increase in national income in the prior calendar year's national income. The *estimated* receipts for the year still in progress thus are equally determinant of the contemplated fiscal year's receipts as the rate of increase in national income during the prior calendar year. The latter, however, can be calculated from actual experience, once a measure of "national income" is determined. The estimated budget receipts for the year still in progress, however, is a creation of Congress, and thus is subject to the whim of Congress.

The Judiciary Committee's report on the Balanced Budget Amendment acknowledged the ultimate dependence of the amendment's receipts "restriction" on Congress, itself: "Because the amendment statement looks to the future, a future necessarily shrouded in some measure of uncertainty, reasonable men may disagree as to the proper amounts of receipts and outlays to be expected. As a practical matter, a Congressional majority will be the final arbiter among the estimates."

Once the base year statement receipts were set, however, growth of budgeted receipts in succeeding years would be limited to the growth of national income by Section 2. The amendment thus would "freeze" the level of Government expenditures in relation to the national economy, *unless Congress would act* to raise taxes or approve a deficit. Today's inflationary times combined with progressive income tax rates give Congress an increasing portion of the national income to spend without elected representatives having to record their support for the bigger take. Section 2 would put a stop to that.

Sections 3 and 4 are self-explanatory. Section 3 provides that a simple majority of Congress can waive the process during time of war. Surely if war were declared, getting a majority to waive this provision should be no problem. Yet, if a President were waging an unpopular, undeclared war, such a waiver may not be forthcoming, and that could rightly nip in the bud another Vietnam. Either the people would have to be informed and in support of such an action, or Congress would have to think twice about financing it.

Section 4 ensures that Congress cannot simply transfer costly programs to the states, without providing funds to cover those programs.

Section 5 blocks a potential route by which Congress might escape the restriction: shifting expenditures programs now on-budget to the off-budget category. Under Section 5, expenditures would not be divided into on- and off-budget outlays; rather, outlays would include all Government outlays with the exception of repayment of debt principal.

Informed and Vigilant Public Still Essential

Clearly, the Balanced Budget Amendment would not prevent Congress from taking any fiscal action it chooses. Indeed, the trends toward a larger role for Government, more spending, and bigger deficits after ratification of this amendment could be the same as before it. The only difference would be that Members of Congress would be forced to go on public record in a highly visible vote in support of these trends. This would not ensure good (or bad) budgets; it simply would increase Congress's accountability to the public.

Whether Government spending and deficits are too large has been and is argued continually. Few economists would argue, however, with the proposition that prices of things that do not take account of all the costs tend to induce too high a demand for the product. In the case of the "product" of Government, its apparent costs (total taxes) understate its actual costs (taxes plus the multifold adverse economic consequences of chronic deficits, accumulating debt, and the possibly related inflating). This probably induced the public to "demand" an excess of Government. For the public to decide the "proper" level of Government, it must have accurate information about the benefits and costs of Government.

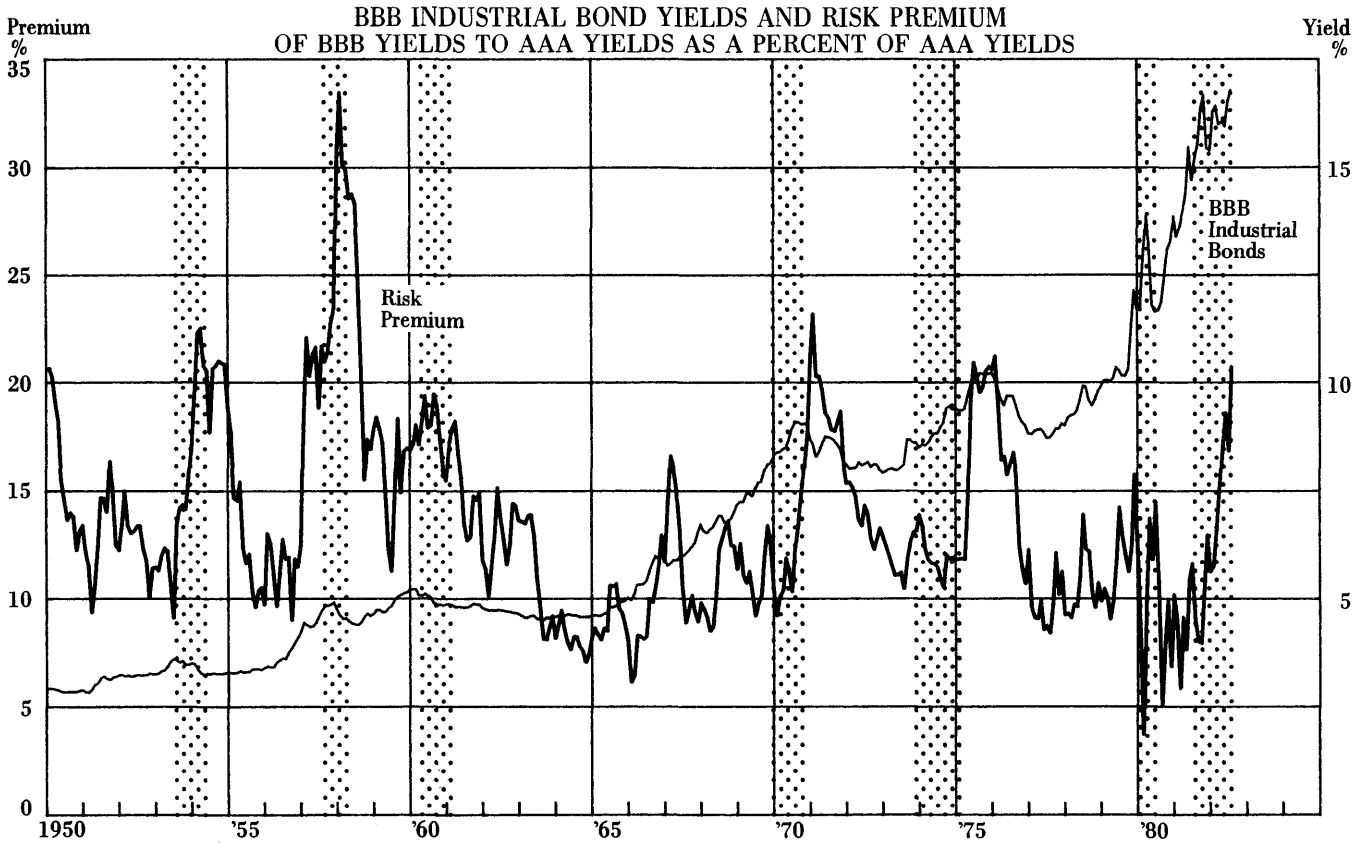
The proposed amendment has the potential for improving somewhat the information flow to the public about the fiscal actions of its elected representatives to Congress, but this alone would not ensure fiscal responsibility. The public also must be aware of the adverse consequences of bigger Government and larger deficits, many of which do not become evident for some time. The proposed amendment would not improve the public's understanding of these matters, which now seems dangerously woeful. In the end, only an informed, concerned, and vigilant electorate can keep Congress on the fiscal "straight and narrow." Therefore, the Balanced Budget Amendment should not be viewed as a guarantee against Government fiscal imprudence, but it may help prevent it.

THE RUSH TO QUALITY: DOES IT SIGNAL COLLAPSE?

Alarm about the quality of debtors has risen sharply recently, with reported large increases in bankruptcies and the failure of a medium-size bank. This greater desire for quality has been reflected in the yields on bonds, with high-quality bond yields falling substantially, but low-quality yields falling little. The risk premium thus has risen considerably. But its recent trend and level are not out of line with historical patterns. There is no support in these data for the warning that the Big Collapse is imminent.

The "herd instinct," the tendency of a group of animals to behave in a certain way because the others are, seems to be evident in the market activities of human beings from time to time. This herd instinct becomes more apparent in some forms when cyclical ups and downs of the economy in general and of specific activities in particular have been underway for some time. One form in which it now seems to be gaining momentum is in the developing fear of a financial collapse brought on by a rush of investors and creditors away from lower-quality issues and debtors into higher-quality ones, leaving all but the best-rated firms with no source of external funds and fostering spiraling bankruptcies. The fear becomes self-fulfilling to some degree in that as the trend begins and is reflected in the widening price differentials of various issues, it encourages similar switches, no one wanting to find himself stuck if later he, too, wants to get out of lower-quality issues.

Readers who have followed our work for some time will readily realize we are not asserting that concern about the possibility of financial chaos is without foundation. Indeed, we have stressed time and again that decades of inflating have created enormous economic distortions in the United States and throughout the world, one of them being such an excessive use of debt that many debtors almost surely would be unable to repay them in a noninflationary environment. We also have emphasized repeatedly, however, that in a world of centrally managed, fiat currencies, the monetary environment is highly



Latest data plotted, July 1982.

inflationary, even if inflationary policies and price increases have cyclically moderated somewhat.*

That word "cyclically" takes us back to the fear of major financial defaults. Some events, indeed, can be a genuine source of such fear. Bankruptcies have leaped, and the collapse of Penn Square Bank of Oklahoma City left a considerable number of depositors with the prospect of losing roughly a reported 20 cents on each dollar of uninsured deposits. The increased concern about the survivability of less-able debtors has been reflected in changes in yields of high-quality bonds compared with those of lower-quality bonds. For example, according to Federal Reserve Bank of St. Louis data, the yield on long-term Treasury securities (having virtually no financial risk) has declined from 14.03 percent during the week ending June 25th to 13.04 percent for the week ending August 6th, a 99 basis point drop. (A basis point is 0.01 percentage points.) The yield on the highest rated corporate bonds (AAA rated) decreased from 15.10 to 14.22 over the same period, an 88 basis point decrease. For BBB-rated (medium-quality) corporate bonds, however, the decrease over this period was only 34 basis points, from a yield of 17.03 percent to 16.66 percent. This has alarmed many analysts, leading some to conclude that it signals an imminent collapse of confidence and the financial markets.

Such alarm seems exaggerated – at least at this time. As the accompanying chart reveals, investors' preference for higher quality usually has risen sharply after a recession has been underway for some time. (The preference is represented by an increase in the risk premium, or the higher yield investors demand on BBB industrial bonds to that on AAA industrials, expressed as a percentage of the AAA yield.) Indeed, the peak preference for quality more often than not has signaled the end of "hard times" (a recession) and the beginning of cyclically improving financial conditions. (This is shown by the peak in the risk premium occurring near the ends of the shaded areas, which depict recessions.)

As for the current situation, we cannot be sure that the July 1982 risk-premium high thus far in this cycle will prove to be the high when later data become available. Thus, one cannot say with confidence that the worst is over. However, in view of the fact that the most recent risk premium is not out of line with the highs associated with other cycles, there is no basis here for concluding that *this time* the financial world surely is at an end. The financial sky often has been darkest just before the dawn of a new cyclical expansion.

* Whenever the potential of major bankruptcies has threatened the financial structure, as has the plight of savings institutions in the United States the past 2 years, Government officials have been quick to promise whatever aid would be required to prevent it. For example, the U.S. House of Representatives passed a bill that authorizes government deposit-insuring agencies to guarantee the net worth of "qualified" thrift institutions, with the guarantees backed by a special Treasury account. And where would the Treasury get the funds? Plainly through monetization of debt if necessary.

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