



# *Liberty Brief*

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## **The Balanced Budget: An Economic Analysis** *by Sven R. Larson, Ph.D.*

### **EXECUTIVE SUMMARY**

Policy proposals to end the growth in the federal debt often gravitate toward legal budget-balancing measures, such as an amendment to the constitution. Proponents of such an amendment often fail to account for the economic policy consequences of their proposals. A constitutional amendment to mandate a balanced budget re-directs policy focus from the cause of the deficit to the budget balance. This paper explains that efforts to balance the budget can cause significant fiscal harm to the economy. This harm is especially serious if the enforcement of a legal balanced-budget mandate takes place on an annual basis.

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## INTRODUCTION

Efforts to contain the federal debt are almost as old as the debt itself. Lawmakers, constitutional experts and policy analysts have suggested various forms of legislative action, including amending the U.S. constitution, with the explicit intent to bring debt accumulation to an end.

As is evident from the steady increase in the federal debt, there is no mandatory balanced-budget mechanism in federal law. This gives rise to new proposals for balanced budget amendments to the constitution. This paper analyzes two examples:

- The National Debt Relief Amendment, originally proposed by RestoringFreedom.org<sup>1</sup> and endorsed by the Goldwater Institute,<sup>2</sup> which gives state legislatures a say in the federal budget process; and
- The Shelby-Udall proposal, sponsored by Senators Richard Shelby (R-AL) and Mark Udall (D-CO),<sup>3</sup> which strictly limits federal spending to 20 percent of the Gross National Product (GNP) or to federal tax revenues, whichever is lower.

While legal analysis of a balanced budget amendment is plentiful, macroeconomic analysis is lagging behind. Such analysis is essential: if added to the constitution, a balanced budget amendment would dictate how government interacts with the economy. In effect, the amendment would determine fiscal policy – meaning

taxation and government spending – in the largest economy in the world. The potential consequences of a balanced budget are so considerable, in fact, that the ultimate decision whether to introduce one or not should be made based on macroeconomic analysis, rather than constitutional law.

This paper is a contribution toward that analysis. The first section provides elementary macroeconomic tools for the analysis and defines the balanced budget idea from a macroeconomic perspective. The second section discusses the consequences of legislative mandates of balanced the budget.

## I. BASIC TOOLS FOR MACROECONOMIC ANALYSIS

Proponents of a balanced-budget constitutional amendment contend that the issue has nothing to do with economic policy. A case in point is Andrew Moylan, president of the National Taxpayers Union:

Opponents contend that we have never enshrined any specific economic policy in the Constitution and should not do so now. But the BBA is not an economic policy and it is not a federal budget; it is a set of guidelines within which Congress can create economic policy and a federal budget.<sup>4</sup>

Unfortunately, this is a misunderstanding of both the nature of the economy and of economic policy. This misunderstanding reveals a theoretical disconnect between the constitutional efforts

to amend the Constitution and the economic reality in which the balanced-budget amendment would go to work.

### a. The Government Budget

This section outlines the structure of the economy with reference to the three types of economic policy instruments available to government: fiscal policy – also known as government spending and taxation – and monetary policy. Before we get to the economy itself, let us briefly define these three instruments.

- Spending is government outlays and comes in two forms. The first kind pays for work: paychecks to government employees, and payments to government contractors for work or supplies. The second kind pays people entitlement checks for no other reason than that a person is determined to be eligible for it. An example is Social Security.
- Taxation is also of two kinds. The first kind is the general taxation for general purposes of government spending. Taxes on income and consumption (e.g., sales tax) are good examples. The second kind is designated taxes, or taxes that feed a specific spending program. Social Security taxes belong to this kind.
- Monetary policy is the only economic policy instrument that is not formally within the jurisdiction of a legislature. The tool used for monetary policy is the

money supply, which is controlled by the Federal Reserve. The money supply consists of more tools than just printing “cash,” some of which interface with fiscal policy tools and give Congress indirect control over monetary policy.

An approximate definition of the role of monetary policy in America is that it is reactive to fiscal policy. Therefore, here it will be ignored for the most part.

Fiscal policy, consisting of spending and taxation, exhibits itself in the government budget. Spending, symbolized by the letter  $G$  in formal presentations, is one side of the budget equation, with taxation,  $T$ , being the other side.

A very simple way to express the budget equation is:

$$(1) \quad G = T$$

By definition, this equation expresses a balanced budget. This does not in any way imply that a budget ought to be balanced. It is simply a logical starting point for our analysis.

There are two kinds of spending and two kinds of taxation, which are not distinguished in equation (1). We therefore have to qualify the equation somewhat.

We distinguish between government spending for general purposes – spending that pays for work – and government spending on entitlement programs, which by definition are financial transactions.  $G_\theta$  represents the former kind of spending

and  $G_E$  the latter kind.

Correspondingly,  $T_\theta$  represents taxation that pays for general government spending and  $T_E$  symbolizes taxation for entitlement purposes:

$$(2) \quad G_\theta + G_E = T_\theta + T_E$$

The normal state of affairs is that each type of taxation pays for the corresponding type of spending, so that  $G_\theta = T_\theta$  and  $G_E = T_E$ . However, any time the federal government borrows money from the Social Security system it does, in effect, make  $T_E$  pay for general government expenditures. When government repays the loan,  $T_E$  is reduced by the amount the government pays back.

Keeping the two types of government spending separate is important for reasons elaborated on later. However, it is even more important that we understand the role of the equality sign in the equation. This is where the balanced-budget advocates come into the picture.

Equation (2) is written with an equality sign solely for definitional purposes. A government budget is never automatically balanced. Equality between revenues (right hand side) and spending (left hand side) is always a matter of policy. If and only if the two depended directly on one another, or one side was causally tied to the other, would the budget always be in balance.

General government spending,  $G_\theta$ , is not caused by  $T_\theta$ . Legislative practice sepa-

rates spending bills from tax bills. Spending is determined by legislation that establishes government programs, e.g., law enforcement, military and highway maintenance and construction. The levels of spending in these programs are determined by preferences, which in turn originate either in the legislature or in appropriations requests from government agencies.

Taxation to pay for spending is more or less an afterthought. The legislative practice is to separate appropriations, or spending, from revenues, or taxation.

Entitlement spending and entitlement taxation are somewhat tied together. The outlays of the Social Security system are supposed to be paid for by the revenues of the specifically designated Social Security tax. The fact that Congress raised the Social Security tax 20 times in 40 years, from 1950 to 1990, is indicative of a lack of close ties between spending and taxation for that particular entitlement program.<sup>5</sup> However, so long as Congress handles an imbalance between Social Security expenditures,  $G_E$ , and Social Security taxes,  $T_E$ , by raising the Social Security tax instead of  $T_\theta$ , they maintain a balance in the part of the federal budget that consists of Social Security.

Ultimately, all taxes are sourced from the income earned by private-sector employees and businesses. Government revenues are determined by tax rates and private sector income. The income earned by the private sector is, in turn, independent of any variable that defines general government spending. As a result, gov-

ernment spending and tax revenues fluctuate independently of one another.

Over a business cycle, defined as a growth period with full employment followed by a recession with unemployment,<sup>6</sup> there are significant changes to the balance between government spending and tax revenues. Macroeconomic theory stipulates that the government budget is in a surplus during a growth period because some spending programs are in less demand than during a recession, and because more people work and more people earn higher tax-paying incomes. Correspondingly, in a recession tax revenues fall short of government spending, leading to a budget deficit.

Given the existence of the business cycle and given the causes of government spending and tax revenues, it is fair to say that a balanced-budget requirement will face with a considerable challenge.

### **b. Fluctuations in Government Spending and Tax Revenues**

To understand what causes a budget deficit we need a more detailed analysis of government in the economy. A good venue for that is  $G_E$ , entitlement spending.

Households are the recipients of entitlement checks. To keep this simple, let us for now assume that  $G_E$  is welfare or poverty relief and nothing else. Government pays for a minimum of expenses for every person who falls below the poverty line; let us use the symbol  $\bar{C}$  to represent the consumption that the poor can afford

based on transfers,  $G_E$ . On top of that consumption, households spend a certain percent of their net-tax income. Let us symbolize this spending with  $\beta \cdot Y_d$ , which is the consumer's propensity to spend out of his disposable income, multiplied by his disposable income.

We now have a sum total of household outlays, or private consumption:

$$(3) \quad C = \bar{C} + \beta \cdot Y_d$$

To emphasize that government always pays for  $\bar{C}$ , i.e., that  $\bar{C} \equiv G_E$ , let us substitute so that:

$$(3) \quad C = G_E + \beta \cdot Y_d$$

Suppose a recession hits. More people will be out of work and poor. The share of private consumption that is driven by disposable income will fall, while subsistence consumption, or  $G_E$ , will increase.

Back now to equation 2. The recession-driven increase in entitlement spending does not come with an increase in tax revenues. Therefore:

$$(2) \quad (G_\theta + G_E) > (T_\theta + T_E)$$

This is by definition a budget deficit. To further illustrate why this deficit is virtually a certainty, let us define in more detail where tax revenues come from. Since there is no federal property tax, let us simplify the federal tax code so that:

$$(4) \quad Y_d = Y - tY$$

Our disposable income,  $Y_d$ , is what is left after government has taken a percentage,  $t$ , from our pre-tax earnings,  $Y$ . The flip-side of this tax coin is that:

$$(5) \quad tY \equiv T_\theta + T_E$$

Let us now make one more substitution in equation 2:

$$(2) \quad (G_\theta + \bar{C}) > tY$$

(We are assuming that is  $G_\theta$  is constant.)

Once the economy climbs out of the recession and into a growth period, private income will rise, replacing government-paid subsistence spending with privately earned income. In other words,  $\bar{c}$  falls and  $tY$  rises. In theory, this continues to a point where the deficit eventually turns into a surplus.

Conventional macroeconomics implies (but does not explicitly state) that budget deficits and surpluses cancel each other out over a business cycle. There is, however, no credible evidence to prove this implication true. The net result over the business cycle can be a surplus, a balance or a deficit, depending on how three variables interact:

- The actual sum total of entitlement spending;
- The actual tax collections; and
- The duration of the recession vs. the growth period.

In effect, it is a coincidence whether or not the budget will be balanced over a business cycle.

### c. The Permanent Deficit

The U.S. government has run a budget deficit almost uninterruptedly for the last half century. Expenditures have exceeded revenues even when the economy has grown strongly and employment has been virtually at full. This type of deficit is sometimes referred to as a “structural” deficit. However, the term “structural” has a more comprehensive meaning in the context of economics; it is more appropriate to refer to this type of deficit as “permanent.”

Technically, a permanent deficit is caused by a lasting mismatch between government spending and taxation. A more detailed economic analysis will reveal whether or not the mismatch is caused by too much spending or insufficient taxation. Proponents of economic redistribution – a.k.a., liberals – tend to blame insufficient taxation, while proponents of economic freedom – libertarians and to some degree conservatives – point to over-spending as the cause of the permanent deficit. Regardless of which position one takes, it is an indisputable fact that a permanent deficit is created by the creation of spending programs without corresponding funding plans. When government hands out entitlements and increases  $G_E$  for ideological purposes – income redistribution or compassionate conservatism – the usual legislative approach is to leave the funding to separate legislation.

General government spending can also



drive permanent deficits. Public education is an example. When the federal government decides to create a program such as No Child Left Behind, it does not attach to it a taxation bill specifying what tax shall pay for the program. It is presumed that funding will come out of the stream of general tax revenues.

It is fair to say that the United States suffers from a permanent deficit. The recession that started in 2008 added a business-cycle driven deficit on top of the permanent deficit. Spending programs implemented by Congress during the recession have added to the deficit, but it remains to be seen whether, e.g., the expenditures created in the ARRA "Stimulus Bill" are temporary (as intended) or will become permanent. If they do become permanent they will obviously increase the permanent deficit, all other things given.

## II. MANDATING A BALANCED BUDGET

There are, in general, two types of legislative balanced budget efforts. Both have the economic purpose of eliminating budget deficits:

- A hard deficit cap: government spending and tax revenues must match every single fiscal year;
- A soft deficit cap: raising the debt takes significant legislative efforts.

### a. A Hard Cap

The hard-cap approach is well represented by the Shelby-Udall proposal. It states that:

- Federal spending cannot exceed federal revenue each fiscal year;
- A 3/5 majority in both Congressional houses can override this restriction for one fiscal year;
- The only automatic suspension of the requirement is in times of a war declared by Congress.

A technically unrelated feature of the proposal is that federal spending cannot exceed 20 percent of the Gross National Product (GNP).<sup>7</sup> However, as part of the package it effectively caps federal taxation at 20 percent of GNP.

The consequence of the hard cap is that Congress must prevent a budget deficit every year. Strictly speaking, since tax revenues can exceed federal spending, Congress does not have to *balance* the budget. For practical purposes, though, we refer to the measure as a hard balanced-budget requirement.

As we saw in the previous section, government spending is determined by variables that are independent of the variables that determine tax revenues. In fact, lower tax revenues actually correlate with higher government spending: when the economy enters a recession and people make less money, tax revenues fall; at the same time, when personal incomes fall more people are going to be eligible for entitlements from government.

The result is a budget deficit.

Under the hard balanced-budget requirement forces Congress to either raise taxes



or cut spending. If federal spending is at 20 percent of GNP when the recession opens, the only option is obviously to cut spending. The question for lawmakers is: will the cuts come within general government spending or within the entitlement spending that increased as a result of the recession?

Furthermore, whenever Congress cuts spending without a corresponding tax cut, it makes a net withdrawal of spending from the economy. Regardless of the wastefulness of government spending programs, a net reduction of spending does have negative consequences on economic activity as a whole. This adds to the depression of economic activity and thus aggravates the recession. The actual effect depends on where in the federal budget Congress chooses to make its cuts.

If federal spending is below 20 percent of GNP at the outset of the recession, Congress has the option to raise taxes to pay for the recession-driven expenditures. The depressing effect on economic activity tends to be more immediate from tax increases than from spending cuts, though the immediacy ultimately depends on exactly what taxes Congress chooses to raise.

Regardless of whether Congress cuts spending or raises taxes, its policy measures will aggravate the recession. It is fair to assume that this is an unintended consequence of the Shelby-Udall proposal, which makes it all the more important to consider it. It is possible that the choice between the Devil (tax increases) and the Deep Blue Sea (spending cuts) will be so unpalatable that there will be a

three-fifths majority in both the House and the Senate to suspend the balanced-budget requirement.

### **b. A Soft Cap**

Unlike the Shelby-Udall proposal, the suggested National Debt Relief Amendment from RestoringFreedom.org does not *force* Congress to avoid budget deficits. It reads as follows:

An increase in the federal debt requires approval from a majority of the legislatures of the separate States.<sup>8</sup>

The practical meaning of this is that before sending a budget with a deficit to the President for signature, Congress would have to send the budget out to the states for approval. This begs the question: how will states vote?

At the heart of any answer to that question lies the fact that states receive considerable amounts of money from the federal government each year. These funds, which come under the label Federal Aid to States, were responsible for an estimated 35 percent of all state spending in 2010. Referred to as “federal funds” in state budgets, this program amounted to an estimated \$564 billion, which is almost as much as what states spent through their general funds (\$618 billion).

In two years alone, from 2008 to 2010, Federal Aid to States increased by 45 percent. Most of this increase is likely attributable to the American Recovery and Reinvestment Act (ARRA) “Stimulus Bill” and supposedly temporary. It remains to

be seen how much of the state-bound ARRA funds will indeed turn out to be temporary, but regardless of how much of those funds will remain after the expiration of the ARRA spending program, there is a distinct possibility that states will want to approve an increase in the federal debt to preserve the Federal Aid to States program.

State dependency on the federal government represents a considerable problem for the advocates of the National Debt Relief Amendment. Even as all Americans are acutely aware of the massive federal budget deficit, many states show little or no interest in reducing their dependency on that same budget. In October 2010, then-Governor Parkinson of Kansas flew out to Washington, DC to ask for more money so he could close his state's deficit.<sup>9</sup> In March 2011 his successor, Sam Brownback, was faced with demands from the federal government that his state increase education spending, or lose federal funds.<sup>10</sup> Governor Brownback made clear he did not want to lose any federal money, a sentiment apparently shared by Republicans in the state legislature.

Republicans, supposedly most prone to avoid deficit spending, have shown significant interest in federal funds during this recession. In November 2010 newly elected Governor Kasich in Ohio accepted more federal funds for schools, a message that was well received by Ohio's Republican lawmakers.<sup>11</sup>

Many states have unabashedly increased their dependency on the federal government over the past few years. A striking example is South Dakota, where in 2010

federal funds constituted 46 cents of every dollar spent by the state, up from 41 cents in 2005. There are no traces of concern among state legislators in The Mount Rushmore State over this dependency.

A similar attitude of indifference characterizes the way fiscally conservative Republicans in Missouri think about federal funds:

A committee vote yesterday [February 28, 2011] to spend \$189 million in federal education funds showed the split among Republicans on how important it is to send Washington a message about growing federal deficits. By a 7-2 vote, the Senate Appropriations Committee approved a supplemental budget bill to spend money the Democrat-controlled Congress approved in August. Both "no" votes were from Republicans, Sen. Jim Lembke of St. Louis and Sen. Will Kraus of Lee's Summit. . . . Committee Chairman Kurt Schaefer, R-Columbia, said he wants to use the money because the state needs it and sending it back [to the federal government] means it will be given to other states. "My solution is that if people don't like what is coming out of Washington, then the message should be sent through the people we send to Washington," Schaefer said. "I share the concerns, but everything weighs in favor of passing it."<sup>12</sup>

Indeed, states' continuously increasing dependency on federal funds led the National Governors Association to make a plea in February 2011:

Their states on the brink of financial catastrophe, governors pleaded Sat-

urday for the divided federal government to avoid doing anything that would hamper the tenuous economic recovery back home. Their message to Washington: prevent a government shutdown, abstain from spending cuts that dramatically will affect states and end even preliminary discussions about allowing states to declare bankruptcy.<sup>13</sup>

If state legislators and governors have to choose between a balanced federal budget with cuts in Federal Aid to States, and a budget deficit with no cuts in Federal Aid to States, there is a considerable risk that they will choose deficit over cuts. For this reason the National Debt Relief Amendment may in fact achieve quite the opposite of what its sponsors intend: by allowing states to have a formal say in the federal budget process, the amendment effectively provides the alcoholic with keys to the liquor store.

In other words, both proposals for a constitutional amendment would serve as fiscal policy dictators. They would mandate increased taxes or reduced spending – or both – and at the same time make it unconstitutional for Congress to make a net tax cut in a recession. Both the Reagan and Bush tax cuts would have been unconstitutional under the National Debt Relief Amendment as well as the Shelby-Udall amendment.

### **c. The Balanced-Budget Amendment Alternative**

The U.S. government has run a deficit virtually without interruption for the last

half-century.<sup>14</sup> There is no doubt that Congress has acquired an addiction to deficit spending, an addiction that coincides with the expansion of a number of welfare state programs. Among the driving forces of federal spending the past 3-4 decades has been the Federal Aid to States program. Over the last ten years alone spending through this program has grown by 7.5 percent per year, far more than the U.S. economy.

As we saw in Section 1 above, government tax revenues ultimately depend on earnings in the private sector. If government spending grows faster than earnings in the private sector, then for strict arithmetic reasons government will have to choose between running a deficit and raising taxes. Congress has chosen the former, ostensibly because there is a widespread awareness that higher taxes stifle economic activity.

The Federal Aid to States program is an example of how the federal government has created its deficit. Not only does the actual spending grow faster than the tax base from which government must pay for it, but the content of the spending is also cost-driving in itself. Federal funds for states pay for a large variety of welfare state programs, from direct poverty relief (TANF, WIC, Food Stamps/SNAP) to redistributive health insurance programs (Medicaid, SCHIP) to public education (NCLB/Race to the Top). Other programs are not related to the welfare state (such as coast guard funds for Wyoming and Oklahoma) but the redistributive programs in the welfare state dominate.

The amounts that the federal government sends to states are determined not by available tax revenues, but by the entitlements that Congress has instituted through these programs. Deficit-driving spending is thus caused by ideological preferences embedded in entitlement programs. There is no logical reason why these ideological preferences must cause deficit spending, but there is also no logical reason why they will not. If Congress wants to give a select segment of the American people some entitlements, they will not attach any funding restrictions on those entitlements. It is a mere coincidence if tax revenues match spending.

A legal measure that would maximize the chances for a balanced federal budget would be one that restricts spending to the essential functions of government. These functions are limited to the protection of life, liberty and property. While strictly speaking not mandating a balanced budget, a constitutional amendment that specified the spending authority of the federal government to these functions would effectively bring the risk of deficits down to a minimum.

## ENDNOTES

<sup>1</sup> See National Debt Relief Amendment, *available at* [http://www.restoringfreedom.org/wp-content/uploads/RF\\_modelResolution.pdf](http://www.restoringfreedom.org/wp-content/uploads/RF_modelResolution.pdf).

<sup>2</sup> See Nick Dranias, *Need National Debt Relief?*, GOLDWATER INST. (Nov. 16, 2010), <http://goldwaterinstitute.org>.

<sup>3</sup> *Udall Co-Sponsors Balanced Budget Amendment*, MARK UDALL (Feb. 1, 2011), [http://markudall.senate.gov/?p=press\\_release&id=893](http://markudall.senate.gov/?p=press_release&id=893).

<sup>4</sup> Douglass Kellogg, *Nation's Oldest Taxpayer Group Tells House Committee: America Needs Balanced Budget Amendment*, NAT'L TAXPAYERS UNION (May 13, 2011), <http://www.ntu.org/news-and-issues/budget-spending/bba-tla/nations-oldest-taxpayer.html>.

<sup>5</sup> See Sven R. Larson, *Dynamic Private Accounts: A Model for Sustainable Termination of Social Security* (Wyo. Liberty Grp. working paper), *available at* [http://libertyworkingpapers.com/social\\_security](http://libertyworkingpapers.com/social_security).

<sup>6</sup> This is a simple definition of the business cycle. A more complex definition would include GDP growth and, at least according to older economics literature, price and wage trends.

<sup>7</sup> The difference between Gross Domestic Product and Gross National Product has to do with the treatment of income made by foreigners in the United States and income made by Americans abroad. For the purpose of this paper it is not important to outline the consequences of using one definition over the other.

<sup>8</sup> See *supra* note 1.

<sup>9</sup> Sven R. Larson, *Spending Delusion: Cash-Strapped Kansas Gov. Like a General with No Army*, LARSON 4 LIBERTY (Oct. 22, 2010), <http://www.larson4liberty.com/2010/10/spending-delusion-cash-strapped-kansas.html>.


<sup>10</sup> Sven R. Larson, *Fiscal Noose: Kansas Gov Ensnared by Fed Funds Addiction*, LARSON 4 LIBERTY (Mar. 10, 2011), <http://www.larson4liberty.com/2011/03/fiscal-noose-kansas-guv-ensnared-by-fed.html>.

<sup>11</sup> Sven R. Larson, *Drinking the Federal Kool Aid: Ohio Gov-Elect Takes Obama School Cash*, LARSON 4 LIBERTY (Nov. 23, 2010), <http://www.larson4liberty.com/2010/11/drinking-federal-kool-aid-ohio-gov.html>.

<sup>12</sup> Sven R. Larson, *Spendoholic in Denial: Missouri Legislator Spends Fed Funds, Blames D.C.*, LARSON 4 LIBERTY (Mar. 3, 2010), <http://www.larson4liberty.com/2011/03/spendoholic-in-denial-missouri.html>.

<sup>13</sup> Sven R. Larson, *Governors: Please Don't Cut Our Allowance!*, LARSON 4 LIBERTY (Feb. 28, 2010), <http://www.larson4liberty.com/2011/02/governors-please-dont-cut-our-allowance.html>.

<sup>14</sup> See OFFC. MGMT. & BUDGET, FISCAL YEAR 2010 HISTORICAL TABLES, <http://www.gpo.gov/fdsys/pkg/BUDGET-2012-TAB/pdf/BUDGET-2012-TAB.pdf>.



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