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Before the Committee on the Judiciary

U.S. House of Representatives

October 4, 2011

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Chairman Smith, Ranking Member Conyers, and members of the Committee, thank you for inviting me to share my views on amending the constitution to require annually-balanced federal budgets. The views I express result from 20 years of both participating in—and studying—the budget process.

I must make clear that I do not differ with those who say that the federal debt is at unsustainable levels and needs to be reduced. If the Joint Select Committee on Deficit Reduction decided to go much further than the $1.5 trillion required by the Budget Control Act of 2011, I would join the rejoicing chorus.

Further, I am sympathetic to the frustration that leads people to believe that amending the constitution to require a balanced federal budget will be the silver bullet that leads the Congress and the President to engage in fiscally responsible budgeting. I strongly disagree, however, with the contention that amending the constitution will have any effect on either current or future deficits. I think it is more likely to be an empty promise that will be evaded in the same way budgetary control mechanisms in the past have been evaded. Even if a balanced budget amendment defied convention and did work, it would become a fiscal straightjacket that would rob the federal government of its important economic stabilization role.

I will cover five points in my testimony:

- The federal debt is too large, and growing, meaning that serious action to reduce that debt is essential to the future economic well-being of the country.
- There is little reason to believe that amending the constitution to require a balanced federal budget will actually reduce the debt, or prevent it from growing in the future. Evidence accumulated over decades indicates that budget process rules are effective for enforcing already-passed policy; they are not effective in forcing future policymakers to make choices that they do not want to make.
- A balanced budget amendment would not be self-enforcing. Many technical details would need to be worked out in legislation, spending cuts and tax increases would need to be enacted, and enforcement mechanisms would need to be developed. These important decisions face national political leadership, with or without a constitutional

amendment. There is nothing to stop the Congress and the President from solving the debt problem now, other than political will.

- Analogies between the federal budget and budgets of families, corporations, and state and local governments are misguided. To the extent that arguments in favor of a balanced budget amendment rely on these analogies, they are in error. In particular, such arguments fail to recognize the unique and extensive economic role of national governments.
- Versions of the balanced budget amendment that attempt to limit federal spending as a percentage of the economy will have unintended consequences resulting from the inevitable efforts to get around those limitations.

The Need to Reduce Federal Debt

The fiscal problems that currently face the United States are well-documented. Debt held by the public almost tripled from $3.3 trillion (34 percent of GDP) to $9 trillion (62 percent of GDP) between 2001 and 2010. Current projections by CBO indicate that, assuming that certain current policies (such as the Bush tax cuts and the Medicare payment rates for physicians' services) are continued, federal debt at a percentage of GDP will reach 82 percent by 2021. This is nothing compared to the long-term challenge. Using that same "current policy" baseline, CBO projects that debt could reach 190 percent of GDP by 2035. Much of this additional increase is driven by the growth in spending for the major entitlement programs, particularly Medicare and Medicaid.

Deficit and debt projections are not predictions, and the path that they assume is not inevitable. They are simply attempts to communicate the potential effect of failing to act. I endorse the view expressed by the President's deficit commission, the Rivlin-Domenici Commission, and the Peterson-Pew Commission on Budget Reform: serious action needs to be taken, and soon. The sooner policy actions are taken, the less draconian those actions will need to be, and the less damage rising debt will create. The question is not, in my view, whether something needs to be done about the debt. I concur with those who say that the mounting debt is a problem that needs to be taken seriously sooner rather than later. Further, the magnitude of the problem is so great that I think that no policy solution can be excluded. So far, domestic discretionary spending has taken the brunt of the cuts, but other spending, including defense and mandatory spending, will need to be reduced as well. Notably, this is not only a spending problem, and the solution is not only a spending solution. Based on my read of the numbers, I would agree with the conclusions of all of the major debt reduction commissions that it is inevitable that increases in revenue will be necessary in order to reduce the debt to sustainable levels.

Experience with Fiscal Rules Suggests that a Balanced Budget Amendment Won't Work

While few need convincing that the debt is a problem, as one absorbed by study and observation of the federal budget process, I am concerned about the apparent rush to conclude that the fiscal rule under consideration is a credible response. I am skeptical that a constitutional balanced budget requirement would have prevented the country from getting into this fiscal fix. I am relatively certain that it will neither resolve the present challenge nor prove effective in preventing future fiscal crises. Congress has experience with fiscal rules that can inform judgment on this point. Since at least the mid-1980s, Congress has experimented with different kinds of fiscal rules—as attempts to come to grips with large deficits that began emerging in the 1980s.

The Congressional Budget and Impoundment Control Act of 1974, which created the Budget Committees, the budget resolution, and CBO, was intended to force the Congress to deal comprehensively with the budget. This was all well and good, except that there was nothing about the budget process created in 1974 that necessarily forced political leadership to confront the large deficits that began to surface by the mid-1980s. The Balanced Budget and Emergency Deficit Control Act of 1985 (later revised in 1987), also known as Gramm-Rudman-Hollings (GRH), attempted to put the budget on a glide path to balance by setting fixed deficit targets, over multiple years.

The Gramm-Rudman-Hollings legislation was a watershed event, because it explicitly focused the budget process, for the first time, on attempting to get a handle on out of control budget deficits. It did not, however, achieve its goals. In fact, the fiscal year 1993 budget, which was to be balanced under the revised 1987 targets, had a deficit of $255 billion. The failure of GRH stemmed primarily from its focus on estimated, rather than actual, deficits. Policymakers tended to meet the projected deficit targets through systematically optimistic forecasts, particularly of economic growth. These optimistic forecasts were embraced by both the President and Congress, and by both Republicans and Democrats.

The failure of GRH to reduce deficits to manageable levels contributed to the search for a different approach, which ultimately culminated in the Omnibus Budget Reconciliation Act of 1990. This act combined spending cuts and tax increases to reduce 1991-1995 deficits by an estimated $500 billion. It also included a new procedure, called the Budget Enforcement Act (BEA), which combined statutory caps on discretionary programs with a new pay-as-you-go (PAYGO) system designed to prevent future policy actions from undermining deficit-reducing decisions enacted in 1990. Under PAYGO, if mandatory spending was increased or taxes decreased, compensatory action to reduce mandatory spending or increase taxes was required in order to make the overall effect "deficit neutral". Both the caps and PAYGO were enforced on a multi-year basis.

The BEA approach survived the 1990s. New five-year reconciliation bills were passed in 1993, and again in 1997. The BEA process itself was extended until 2002, but the onset of budget surpluses in fiscal year 1998 ultimately led to its downfall. Congress and the President resorted to loopholes starting in the late 1990s, such as declaring funding for the conduct of the 2000 census to be an emergency. (This seemed to many to stretch the emergency designation more than a little, since the requirement for the decennial census is in the U.S. constitution.)

Between 1997 and this year (when the discretionary spending caps in the Budget Control Act were enacted) the budget process was not used to enact any multi-year deficit reduction agreements. While there were uses of reconciliation during the 2000s, all of them (including the 2001 and 2003 Bush tax cuts) had the effect of adding to deficits rather than reducing them. While a statutory PAYGO law was enacted in 2010, it includes a number of sequestration exemptions that limit its usefulness.

I suggest that this history reveals a clear lesson about fiscal rules. Very simply, it demonstrates that the budget process is not good at forcing the Congress and the President to do things that that they do not believe is in their political interest, regardless of what the rules may require.

There has never been a budget rule that the Congress could not figure out a way around if it wanted to. The targets in Gramm-Rudman were clear. Members of Congress, and Presidents, evaded those targets by making unrealistic assumptions about future economic growth and by resorting to gimmicks. I think the main take-away from GRH is that meeting projected targets is not that hard, as long as the Congress and President are willing to cook the numbers in a way that allows them to appear to meet the goals, rather than actually meeting them. More conclusively, it's clear that setting targets without simultaneously reaching consensus on policy actions to achieve those targets is an empty promise. The major failing of GRH was that it did not require anything of political leadership, other than a promise to do something later.

The BEA approach worked, at least during the 1990s, because it was not an attempt to get policymakers to do something later, but rather it created an enforcement regime that required compliance with already-agreed policy actions. The PAYGO process, and the discretionary caps, did not CAUSE fiscal responsibility. They were a consequence or manifestation of fiscal responsibility. When the consensus around the overall budget goals fell apart, so did the effectiveness of the rules.

The bottom line is simply that <u>the budget process is better at enforcing compliance with actions already taken than generating policy agreements.</u> The balanced budget amendment is just Gramm-Rudman in different clothes. The BBA migrates the goal of a fixed target for the deficit (here annual balance) from statute and enshrines it in the constitution. However, rules cannot substitute for political will and political leadership. All successful deficit reduction efforts in the last three decades have one basic thing in common. The President and the Congress agreed on a future path for the budget, on a related set of policy actions, and then the budget process was used to enforce compliance with those actions. Promising balanced budgets later, because the constitution is going to make them happen, is a feel-good action that will likely have little consequence.

A Balanced Budget Amendment Would Require Implementing Legislation

Imagining a balanced budget amendment was passed by the necessary two-thirds vote in both houses of Congress and sent to the states for ratification, it is useful to consider what next steps would be required in order for such an amendment to deliver on its promise. Presumably, given the magnitude of the fiscal problem facing the country, the Congress would not want to wait until the states take action to begin considering the necessary legislative changes to bring the budget into balance by fiscal year 2016 (the amendment's effective date). In fact, both H.J. Res 1 and H.J. Res. 2 include a section providing explicitly for implementing and enforcement legislation. Let's pause for a moment to consider issues implementing legislation would need to address.

1. The Congress would need to resolve many definitional and other technical details that it is neither possible nor appropriate to put into the constitution. For example, most versions of the amendment (including H.J. Res. 1 and H.J. Res. 2) define balance in terms of "total outlays" and "total receipts". These, and many other, concepts in the proposed amendments are subject to interpretation. What is the "debt of the United States held by the public"? When does a bill become a "bill to increase revenue"? How does "revenue" differ from "receipts"? The implementing legislation is to rely on "estimates of outlays and receipts". Whose estimates? H.J. Res. 1 includes a spending limit of 18 percent of "economic output of the United States". How is that defined? All of these, and other, concepts would need to be spelled out in legislation. More importantly they could be redefined later in a way that made them more, or less, constraining.
2. Further, to state the obvious, the balanced budget amendment only sets out a goal. After the goal was established, it would be necessary to enact the spending cuts and revenue increases that would enable achievement of the goal. The amendment would not make these changes. The hard choices would still be necessary. Consensus on the specifics of these policy actions has eluded the Congress and the President thus far. The Joint Select Committee meets as we speak only because political leadership has failed to arrive at and act on consensus.

3. How would a balanced budget requirement, and associated subsequent policy actions, be enforced? If the balanced budget requirement relies on estimates, as the text of the amendment states, what would happen if a budget estimated to be balanced actually ran a deficit in fact? Would a future year's budget be cut to compensate? How would policy actions that might be enacted to achieve a balanced budget be enforced? What would be the role of the President and the courts in enforcing the goals of the amendment?

In raising these questions, my point is not to identify all issues that need to be resolved. I mean to suggest something more simple. It is these kinds of decisions, concerning how budget concepts are defined, what actions need to be taken, and how they will be enforced, that are at the heart of solving our current debt problem, and in preventing future fiscal crises. The balanced budget Constitutional amendment merely establishes a goal that future political leadership would have to reach. It does not tell us how to get there, and it does not establish penalties for failing to do so. The inability to agree on these policy changes, and sanctions, is the problem we already have TODAY. There is nothing about the balanced budget amendment that helps us solve that problem. In fact, it is a distraction from solving that problem.

<u>The Balanced Budget Amendment Relies on Erroneous Analogies to Families and State and Local Governments</u>

Of no less concern, the amendments on the table rely on a faulty premise. Senator Orrin Hatch, the main sponsor of the amendment in the Senate, argued that the federal government should balance its budget because "(h)ard-working families across the country have tightened their belts, balanced their budgets, and lived within their means." He also pointed out, as have many other BBA supporters, that states are required to balance their budgets.

This might be a compelling argument, if only it were true. Families have mortgages; they have car payments; they have student loans; they have large balances on their credit cards. Equally, businesses carry debt in order to invest in the plant and equipment that will support future growth. State and local governments balance their operating budgets, but they borrow to build highways, or dormitories, or prisons. Borrowing is a fundamental part of the financial model for families, corporations, and governments. Used correctly it can be very productive and result in measurable gains. The problem is not that the U.S. government has debt: it is rather that the fiscal imbalance is too large, and is too heavily weighted towards debt that does not make us better off in the long-run. That is the problem that should be addressed.

The analogies to state and local budgeting are particularly misleading, in my view. Proponents of a federal balanced budget requirement often point out that 49 of the 50 states have such requirements. States and local governments, however, only balance their operating budgets. They have separate capital budgets, and borrow large amounts of money by issuing debt, which for the most part is borrowed in the bond markets. In fact, a recent estimate put total state and local borrowing at $2.4 trillion. The federal government does not have a separate capital budget. Moreover, the broad consensus among experts who study state and local budgeting practices is that state and local governments do not balance their operating budgets primarily because their constitutions force them to. Fiscal responsibility at the state and local level is much more heavily influenced by the effect that irresponsible decisions would have on bond ratings, and future borrowing costs. Even the political fallout associated with lowered bond ratings, I would argue, is much greater than the negative consequences of unbalanced budgets.

Finally, as many others have noted, an annual balanced budget requirement for the federal government fails to recognize the particular economic stabilization role played by national governments. The failure to account for this reality is particularly ironic at this time, since actions taken by the federal government demonstrably lessened the impact of the recent recession on both state and local governments, and ordinary citizens. When the deficit rises because of the deterioration of the economy, it is important that this not require spending cuts and tax increases, at precisely the time that they would be most difficult, and economically and politically harmful, to enact. This is not only about discretionary fiscal policies, such as the stimulus. This is primarily about the effect of the so-called “automatic stabilizers” which reduce revenue collections and increase spending on programs such as unemployment insurance, food stamps, and Medicaid. If it had been imperative that the government balance its budget during the recent recession, tax increases and spending cuts would have been required at the very time that such measures would have made state and local governments and individual citizens much more vulnerable to the effects of the economic downturn.

Versions of the Balanced Budget Amendment with Spending Limits Will Have Unintended Consequences

Some versions of the balanced budget amendment, including H.J. Res. 1, attempt not only to require a balanced budget, but limit federal spending as a percentage of the economy. H.J. Res. 1 includes a particularly strict spending limitation that would limit spending to 18 percent of the "economic output of the United States" (which presumably means GDP, but could be defined in a different way).

Aside from the problems (already noted) associated with attempting to limit spending during recessions there are two main problems with such a limitation, in my view. First, a limitation of 18 percent of GDP is substantially below the 40 year historical average spending level. Federal outlays, between fiscal year 1971 and 2010 averaged 20.8 percent of GDP. Taking out fiscal years 2009 and 2010, during which spending spiked due to the effects of the recession, only reduces that average slightly, to 20.6 percent of GDP. Moreover, future demands for spending are projected to rise because of factors related to the growth of the major entitlement programs, which are heavily influenced by demographics (in the case of Social Security and Medicare) and health care inflation (in the case of Medicare and Medicaid). Thus, even keeping to the historical average would require substantial spending reductions from the current policy level. Cutting spending to 18 percent of GDP would require major reductions, especially in these three large entitlement programs.

Second, attempts to live within that 18 percent limitation would invite, in my view, a number of strategies or gimmicks to get around the limitation. These would include, but not be limited to: moving costs from one fiscal year to another; redefining outlays to exclude particular programs; enacting more user fees that count as offsets to spending; passing on costs to state or local governments, or the private sector, through unfunded mandates; and expanding the use of the tax code to confer benefits. This latter case is perhaps particularly likely. So-called "tax expenditures", which normally permit taxpayers to exclude certain income from taxation, have proliferated in recent years. The deficit, however, is affected as much by a reduction of $1000 in taxes paid as a $1000 increase in spending. If there is a ceiling for spending, but not a floor for taxes, this will increase the incentives to provide benefits through the tax code, even in cases where these tax benefits are a less efficient way to achieve particular policy objectives.

Conclusion

A constitutional amendment, in my view, is a distraction from the challenging task of forging policy consensus that national political leadership currently faces, and will neither address the current debt problem, nor keep the problem from returning. Amending the Constitution is not necessary in order to balance the budget—and won't actually move us any distance towards a balanced budget in the short run. In the longer run, it will only be as good as the political consensus around achieving its goals. Further, there is a real risk that this short-run feel-good action will undermine market confidence in Congress' ability to do its job, while justifying public cynicism about Washington—thus making it harder for future legislators to work the country out of the fiscal corner it's in.

The only way to address the current problem is to take timely action to reduce the debt. But not by imposing an arbitrary rule that says that revenues should match spending in every year. There are much more direct ways for elected legislators to show commitment to deficit reduction. In 1992 testimony before the House Budget Committee, then Congressional Budget Office director Robert Reischauer argued that it was a "cruel hoax to suggest to the American public that one more procedural promise in the form of a constitutional amendment is going to get the job done." He went on to state what should be (but apparently is not) obvious, which is that "(t)he deficit cannot be brought down without making painful decisions to cut specific programs and raise particular taxes." In the 1990s, two presidents (George H.W. Bush and Bill Clinton) worked with the Congress to do just that, and this helped to move the country from deficit to surplus by the end of the decade. Only a similar willingness to make hard choices will lead the country out of the current crisis, and promote greater fiscal responsibility.

If the goal is reducing the current level of debt in the medium-term and enacting budgets that maintain budget discipline in the longer term, it is my view that the Congress already has the major tools that it needs. The budget resolution itself is designed to set targets for multiple years, and those targets can (and should) reflect the desire to reduce deficits to a manageable level of GDP. Moreover, the budget resolution's reconciliation process has been most successful in the past in assisting the country to deal with deficits. Particularly during the decade of the 1990s (with separate reconciliation bills passed in 1990, 1993, and 1997) reconciliation was used to enact policies that reduced the deficit over multiple years. This would seem to be an appropriate model for the Congress and the President to follow now.

The budget process is appropriately a vehicle to enact policies, but it cannot force a particular set of policies to be enacted, or a particular economic or fiscal path to be followed. In the 1980s, it was manipulated to make promises that were not kept. In the 1990s, it was used to promote fiscally responsible policies, because there was a political consensus around that fiscal direction. In the 2000s, there was a consensus around lower taxes and more spending, and the process was used to promote these outcomes. We are living with the results. If the Joint Select Committee is successful in coming up with policies to reduce future deficits, then accompanying that with BEA-like enforcement mechanisms to dissuade future Presidents and Congresses from undoing those policy actions will be essential. Even there, however, history demonstrates that if a future national political leadership wants to get around those rules, they will find a way to do so. The same is true, sadly, for constitutionally-imposed balanced budget requirements.