IRET Congressional Advisory

June 4, 1992 No. 7

FOR REAL BALANCE, A BALANCED BUDGET CONSTITUTIONAL AMENDMENT SHOULD ALSO MAKE IT HARDER TO RAISE TAXES

This may be the year that Congress finally passes a balanced budget amendment. The House almost approved one in 1990, and support has increased since then. This month, the House and Senate will vote on several proposed amendments.

Grass-roots and Congressional sentiment for an amendment are largely born out of frustration. Although elected officials frequently condemn budget deficits, they have not managed to balance the federal budget even once in nearly a quarter century. These seemingly perpetual deficits have occurred despite official assurances in most years that deficits were on a downward path and would soon disappear. Moreover, past attempts to reform the Congressional budget process have either been ineffectual or made matters worse. For instance, although Congress and the Bush Administration promised that the 1990 budget agreement would staunch the red ink, the 1992 deficit has ballooned to almost $400 billion, largely because generous spending increases were built into the 1990 budget deal and because the deal's large tax hikes have deepened the economic slowdown.

Although people have lost patience with the budget deficit and are extremely concerned about its effects, there is enormous confusion about exactly how the deficit harms the economy. The widely held fear that Americans are living beyond their means when the government runs a budget deficit is largely unfounded. So, too, is the position expounded at length by Democrats in the 1980s that budget deficits elevate real interest rates and choke off investment. Instead, the greatest danger of deficits may be that they conceal the true costs of government spending programs. Because government programs financed by borrowing appear to be less expensive than they really are, people demand and members of Congress vote for too many government services. No wonder government programs have expanded so rapidly over the last generation — with deficit financing, government services look like terrific bargains because much of their true cost is screened from view.

Most of the balanced budget proposals before Congress would end Washington's casual acceptance of never ending deficits by prohibiting federal spending from exceeding federal revenues unless three-fifths of the total members of each House of Congress vote to suspend the restriction that year. (The plan unveiled by the House Democratic leadership is a conspicuous exception to this supermajority requirement.)

Unfortunately, requiring a balanced budget affords no guarantee that public policy makers' decisions about how much to spend on what kinds of government activities will be effectively disciplined. Also needed is some effective constraint on tax increases, without which a balanced budget requirement might well be met by sharp increases in both spending and taxes. Particularly in view of policy makers' penchant for raising taxes that are largely hidden from the majority of the public, it is imperative that a balanced budget requirement be paired with new restrictions on Washington's ability to raise taxes. If that is not done, government spending will surely remain too high and the full burden of taxation too great.

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Most of the balanced budget proposals do contain some provisions regarding tax increases. On examination, however, these tax-limitation sections are generally not significant changes from current law. Regrettably, they are primarily gimmicks: long on appearance but short on substance. The proposal of Senator Robert Kasten (R-Wis) is an exception. Kasten's plan would bar Congress from increasing taxes at a faster rate than national income unless three-fifths of the total members of each House of Congress vote for the increase. A simpler but less flexible provision might be to require a three-fifths supermajority for tax increases, period.

What The Budget Deficit Is

The federal budget deficit is defined in terms of the relationship between federal expenditures and federal revenues. The deficit is a residual: it is the amount by which expenditures exceed revenues. For instance, if government outlays are $1,500 billion and taxes (and other revenue sources) are $1,100 billion, the budget deficit is the $400 billion difference. Another way to view the budget in this example is that the government is financing $1,100 billion of its spending with taxes and the remaining $400 billion with borrowed or newly printed money.

The Costs Of Government Spending

Regardless of how the government finances its spending, it must acquire $1,500 billion of resources, in the example. Because the government does not produce its own income and wealth, those resources must come from the private sector. That means $1,500 billion less of resources are available through the private sector and $1,500 billion more is under the command of government. This $1,500 billion of resources taken away from private control is the primary cost of government operations. This primary cost does not depend on how the government finances its operations. Moreover, because the government requires the resources now, it is a cost incurred in the present, not in the future.

An additional cost of government services — indirect but typically very large — is that in obtaining resources the government usually distorts market signals, and that causes people to make some very inefficient decisions. These indirect costs are very sensitive to the exact means by which the government finances its spending. Taxes differ widely in how severely they bias market incentives and, hence, how badly they injure the economy. For instance, if the government collects some of the $1,500 billion in the example through heavy taxes on saving and investment, people will save and invest too little, and that will reduce the rates at which incomes, productivity, and employment will grow in the future.

Deficit financing, likewise, may have secondary costs that are in addition to the resources being extracted. Many countries whose debts are large relative to their capital markets resort to the printing press. The inflation that almost invariably results can have seriously adverse economic effects. The enormous size of the U.S. capital market and the fact that the U.S. effectively coped with a national debt that was relatively much larger following World War II suggests that this is not a critical problem here. In a country like newly independent Russia, however, it is. Deficits may also distort economic activity because in order to service government debts, taxes may be raised in the future. Those higher taxes will distort market signals when they occur and worsen economic inefficiencies then. Moreover, there is a deadweight loss incurred in transferring income from taxpayers to the government-debt holders to whom interest on the debt must be paid.

To anticipate a later point, the financing method will also affect costs if it lulls people into spending too much on government services. For instance, suppose that most people believe it is only other people who pay for government services. As a result, they demand that government spending be raised from, say, $1,500 billion to $1,600 billion.

With that spending increase, the direct cost of government (i.e., the resources used) rises by $100 billion. In addition, because the government must extract an extra $100 billion of resources, the indirect costs attributable to distorted market incentives also increase.

Changes in government spending, not changes in the deficit, are the proper indicator of changes in the cost of government. For instance, suppose that spending rises by $100 billion while taxes do not change. Then the basic cost of government will have gone up by $100 billion and so will the deficit. On the other hand, suppose that both spending and taxes rise by $100 billion. Then the deficit stays constant but the cost of government has still risen by $100 billion. As another case, suppose that spending remains constant while taxes are cut by $100 billion. Then the basic cost of government will be unchanged but the deficit will be $100 billion larger. Whether the indirect costs rise or fall depends on whether the taxes that were cut were more or less distortionary than the larger deficit. As a final illustration, suppose that spending and taxes are both reduced by $100 billion. Then the deficit has not changed but the basic cost of government (i.e., the resources claimed and redirected by the government) has decreased by $100 billion.

Some Fallacies Regarding The Budget Deficit

It is often claimed that deficit financing allows the current generation to escape paying for government services by shifting the cost to future generations. As explained earlier, though, the primary cost of government outlays is the resources it diverts from private control. This taking of resources occurs at the time of the outlays. Thus, the primary cost of government outlays is necessarily borne in the present.

Another concern is that a government running a deficit is analogous to an individual who habitually spends more than he makes. Slightly modifying the example, suppose that an individual spends $1,500 each month, earns $1,100, and borrows the remaining $400. If the individual keeps this up and does not increase his income, he will quickly go broke. Why isn't it just as dangerous when the government runs a deficit? The flaw in the analogy is that while the individual, to service the debt he incurs, must sooner or later cut his spending, increase his income, or do both, the government need do neither. Absent some constitutional or statutory provision, the government can borrow continuously to service its existing debt, as well as to increase its other outlays. Indeed, that is exactly what the federal government has been doing for many years.

Another worry is that the federal budget deficit drives up interest rates. Many studies have found, however, that historically there has been no statistically significant relationship between interest rates and the government budget deficit. Just in the last couple of years, market and inflation-adjusted interest rates have plummeted even as the budget deficit has soared.

Deficit Financing Hides Much Of The Cost Of Government Spending

The greatest danger of a budget deficit may be that it conceals the costs of government spending. That is, when the government pays for a spending program with borrowed funds, most people cannot point to any specific sacrifice they have made and tend to assume, falsely, that they are not paying for that government program. In other words, a budget deficit results in an understatement to the public of the price of government activities. In reality, of course, the government is taking resources away from people and, on top of that, the extraction process is generating added distortions of its own. If deficit spending causes people to underestimate the true costs of government services and to assume incorrectly that they, personally, are not bearing any of the costs, it will make government programs look like better buys than they are and lead to an overdemand for government services.

By making it more difficult for Congress to engage in deficit spending, a balanced budget amendment has the virtue that it would greatly

diminish this type of hidden financing. If people can perceive more fully the true costs of government services, they will make better informed choices about the proper level of government spending.

There has been much gnashing of teeth that a balanced budget requirement would necessitate horribly painful budget decisions. What should be remembered, however, is that government spending is the main determinant of the cost of government. Because a balanced budget requirement would not increase government spending — outlays would probably go down — it would not increase the basic cost of government — only render it more visible. The requirement would indeed compel public policy makers to make some hard choices that they should have been making all along. To be sure, the indirect costs due to distorted market signals could rise if the deficit were mostly closed through tax increases and if the tax increases selected were highly distortionary ones. Recognizing this stresses the importance of placing effective constraints on tax increases and of relying on highly visible taxes imposed on the majority of the public.

Further, if it is desired to ease the transition to a balanced budget, that could be readily accomplished by deferring the date on which the budget must come into balance until a set number of years after its ratification. For example, if the amendment were to become fully effective five years after ratification, Congress and the Administration could achieve most of the deficit reduction by slowing the growth rate of federal spending programs, without raising taxes.

Taxes Also Hide Costs

Although a restriction on budget deficits would close off one means of camouflaging the true costs of government services, it would leave another avenue unobstructed. While taxes tend to be more visible than a budget deficit, many of them are largely concealed from view.

The employer-share of the social security tax is a prime example. Most workers probably assume they do not pay this tax; it is not listed on their wage statements and they are not the ones with legal liability to pay it. Nevertheless, workers do pay it, albeit indirectly. Because the tax is an expense of employing labor, it eats up part of the total compensation that workers can command based on the value of their services. As a result, both the number of jobs and the rate of employee compensation are lower than they would be otherwise.

Another telling example is the corporate income tax. Corporations are merely legal means of organizing business activities. It is people who ultimately receive the fruits of corporate activities, whether as owners, employees, or customers. And it is people who must necessarily pay the corporate income tax, as owners (in lower returns), employees (in fewer jobs and lower wages), or customers (in higher prices for corporate products). These effects are so indirect, though, that they are not perceptible in our daily economic lives.

When government spending is financed with taxes that people do not realize they are paying, the programs naturally seem cheaper than they are — just as is the case with deficit financing. As with deficit financing, the illusion regarding program costs leads to an excessive demand for government services. For example, if a person thinks he is paying $80 for a service that actually costs him $100, he will demand too much of the service, certainly more than he would if he saw the full cost. This hidden-cost problem is especially serious because, to minimize political damage, elected officials gravitate towards concealed taxes as opposed to highly visible ones.

Even when taxes are highly visible, they generate secondary costs that are difficult to spot but often very large. For instance, most taxes discourage work effort, and many taxes, notably income taxes, reduce saving and investment. The

consequences are a less productive economy with fewer jobs, lower real wages, and diminished prospects for growth. Yet, because these losses can only be appreciated if one compares actual economic conditions with the economy's potential prosperity, they tend to be either underestimated or overlooked entirely.

The "It's-A-Budget-Crisis" Excuse For Raising Taxes

Restraints on tax hikes become more urgent than ever if deficit spending is curtailed. A balanced-budget requirement could become a powerful political tool for forcing through tax increases. Spending and taxes at the state level provide many graphic illustrations of this. Almost all states have balanced budget amendments; yet, many of them also have serious fiscal problems. During the long and vigorous expansion of the 1980s, state spending and revenues grew rapidly. When the economy began faltering in the late 1980s, growth in state tax revenues slowed but state spending continued to increase swiftly. Numerous states predictably faced large deficits. In general, the response to projected deficits has been a combination of spending cuts (many of which prove imaginary) and tax increases (which almost never prove to be so). In states ranging from Connecticut to California to Maryland, governors and legislators pointed to projected deficits in ramming through mammoth tax increases.

The combination of reduced spending and higher taxes assumes implicitly that the threatened deficits are attributable to a mixture of excessive government spending and under-taxation of the populace. When the real culprit is the rapid growth of spending, however, the approach leads to a ratcheting up over time of government outlays and an increase in people's already heavy tax burdens. That explains why the citizens of many states, almost always starting at the grass-roots level and confronting vehement opposition from entrenched interests, have found it necessary to demand that tax limitation measures be added to state constitutions that already contained balanced budget provisions.

Deficits at the federal level also stem mostly from the rapid growth of federal outlays, not from low taxes. Although it is often asserted that taxes were slashed during the Reagan Administration, most of the 1981 tax cut was needed merely to roll back the unlegislated tax increases that had been produced by inflationary bracket creep. In almost every year since then, Congress has passed a tax increase. That explains why federal revenues have risen by about one-fifth in inflation-adjusted dollars since 1980 and are still about as large relative to the size of the economy as they were in the 1970s.

The explanation for the federal budget deficit is that expenditures have climbed even more rapidly than revenues. Federal spending set peacetime records as a share of the economy in the 1980s. (Although the Reagan Administration supposedly cut social spending, the "cuts" were measured relative to the projected increases in spending; social spending actually rose.) Although slowed by Gramm-Rudman-Hollings, outlays have again surged during the Bush Administration. Because the federal budget deficit is simply the difference between federal spending and federal revenues, deficits naturally result when elected officials consistently vote for the government's spending more than it collects in taxes.

One study found that with every dollar of added revenues, Congress raised spending by almost $1.60. (Richard Vedder, Lowell Galloway, and Christopher Frenze, "Federal Tax Increases And The Budget Deficit, 1947-1986: Some Empirical Evidence," Report To The Republican Members Of The Joint Economic Committee Of Congress, 1987.) This carries several messages. One point is that raising taxes to cut the deficit will not work, given current budget procedures. Instead, the net results would be greater economic distortions dues to the higher taxes, larger direct government costs due to the expansion of government outlays, and, perversely, a bigger deficit. Higher taxes might work to reduce the deficit, of course, if Congress is forced to operate under a balanced budget constraint. Another point is that since high spending is the primary culprit behind the budget deficit, the adjustment to

a balanced budget should occur on the spending side. That is an additional reason to include a limitation on tax increases in a balanced budget amendment, apart from the fact that taxes are partially hidden from view.

How An Amendment Should Protect Against Tax Increases

To provide balanced restraint, tax increases should also require a supermajority. If a budget deficit is prohibited unless three-fifths of the total members in each House of Congress vote to suspend the restriction, Congress should operate under the same discipline when it comes to hiking taxes.

This supermajority requirement is especially reasonable because the tax system already has large automatic increases built into it that do not require further Congressional action. A big factor is inflation. Because the tax system is not fully adjusted for inflation, real taxes rise as prices increase. Taxes will also rise due to real economic growth. A larger economy over time means more taxable activities and, thus, greater tax collections. Therefore, even if Congress were never to pass another tax hike (which is much more restrictive than a supermajority requirement), the government would not be starved for funds. On the contrary, it would have growing real revenues.

Ironically, Congress already operates under a supermajority constraint with regard to tax decreases. A net tax reduction will be ruled out of order in the Senate unless three-fifths of the total members agree to the cut. To give American taxpayers an even break, it is long past time that the approval process for tax increases be held to at least as rigorous a standard. (Senator McCain has argued that the 1990 Budget Deal got things exactly backwards in terms of controlling Congressional profligacy when it endorsed a supermajority for tax reductions but a simple majority for tax hikes.)

Supermajority requirements are an accepted Constitutional and legislative device to prevent important decisions from being taken too lightly. For example, two-thirds of each House of Congress is needed to override a Presidential veto, two-thirds of the Senate is required to approve a treaty, two-thirds of each House of Congress and three-fourths of the states are needed to ratify a Constitutional Amendment, and 60 votes are needed in the Senate to shut off a filibuster. The main criticism of a three-fifths supermajority requirement, compared to those already in the Constitution, might well be that it is relatively weak. Why not strengthen the requirement for incurring budget deficits or raising taxes from three-fifths to two-thirds, which is what the Founding Fathers thought appropriate for veto overrides and treaty ratifications?

What The Proposed Amendments Would Do With Respect To Tax Increases

The tax-restraint sections in most of the balanced budget proposals are merely window dressing. A typical example is the plan of Representative Charles Stenholm (D-Tex), which is a leading contender in the House. Although this amendment has a special section dealing with tax increases, it differs only slightly from current law. Instead of requiring that a tax increase receive a simple majority of the members voting in each House of Congress in order to be approved (the present rule), it would require that a revenue raiser gain a simple majority of the total members of each House of Congress. The proposed change is minor because most members normally vote, and almost all members routinely cast votes on major legislation if the outcome is uncertain.

It does not take much imagination to see where this would lead. Unsuccessful reform attempts like the 1974 budget-process bill and the 1990 budget deal have demonstrated with their perverse results that technical details can subvert stated objectives. Under the Stenholm proposal deficit-financed spending would require a three-fifths supermajority, but higher spending that is tax financed would need only a simple majority. That provides a road map to continued high spending. First, have a simple majority of the total members push through a tax increase, and, second, have a simple majority of the

members who vote approve a spending hike. At no point is a supermajority needed.

The Kasten proposal, unlike most others, does contain a tough and meaningful limit on revenue increases. It would bar revenues from increasing faster than national income two fiscal years earlier unless three-fifths of the total members of each House vote for "specific additional receipts". This would permit taxes to grow as fast as the overall economy without any special restrictions, but it would set a higher standard for increases beyond that. It combines flexibility, revenue adequacy, and taxpayer protection. Senator Kasten emphasizes the high, hidden price we pay for taxes in terms of diminished economic growth. He believes a tighter leash on tax increases would pay big dividends through greater productivity, more jobs, and higher incomes. Some of that growth dividend could be directed into government services, without enlarging the government's relative burden on the rest of the economy.

Another interesting approach is that of Representative Jon Kyl (R-Arz). As discussed earlier, the real imbalance in the federal budget is that spending is too high and accelerating too rapidly. Deficits, and to a lesser extent, taxes contribute to this problem because they do not fully reveal the true costs of government services. The Kyl proposal would tackle rising government spending head on. In addition to prohibiting deficit financing unless voted for by three-fifths of the total members of each House of Congress, his amendment would limit federal outlays to 19 percent of the previous year's gross national product, again, unless a three-fifths supermajority votes to approve spending beyond that. Representative Kyl notes that 19 percent is about what federal revenues have averaged over the past quarter century. The limitation would rein in federal spending but not hold it constant; spending could still grow along with the economy. For added fiscal discipline, another section of the proposal would arm the President with a line-item veto.

Nothing Is Perfect

Even the best written balanced budget amendment cannot guard against all methods of budgetary mischief. For instance, state budgets are a reminder of the struggles that ensue when lower-than-projected revenues or higher-than-projected outlays upset budgets that had seemed to be balanced according to prior (often unduly optimistic) estimates. It is also obvious from experiences at the state level that creative changes in the definitions of outlays and revenues would be attempted in order to squeeze in favored spending programs.

One of the most worrisome dangers is that an amendment successfully curbing on-budget spending would probably worsen Congress's habit of concealing expensive social programs in mandates. Mandates are legally binding requirements placed on private businesses and on state and local governments that oblige them to undertake certain activities on behalf of the federal government — but with no federal compensation. Mandates possess the unfortunate characteristics that they are expensive and inefficient but look attractive because most of the costs are hidden. (For example, who could oppose a requirement that employers give all their workers generous medical benefits — until it is realized that the requirement would cost many workers their jobs and lower the other components of workers' compensation packages.)

Conclusion

Americans have been disillusioned by supposed budget reforms that were either ineffectual or actually interfered with fiscal discipline. They will be profoundly disappointed with a balanced budget amendment if it does not restrict both budget deficits and tax increases. The real fiscal problem is the growing size of government spending relative to people's resources. That cannot be adequately controlled solely by limiting the budget deficit. The Kasten proposal offers a truly balanced approach in that it would also make it more difficult to increase

taxes beyond certain limits. The Kyl proposal is also very positive. It hones in on rising government spending as the basic problem and would make it harder for Congress to raise spending above certain limits. Regrettably, most of the proposals only deal with deficit financing. They need to be fortified by the requirement that no tax increase be enacted unless a supermajority of each House of Congress votes to do so. An alternative would be for them to adopt either the tax restriction in the Kasten proposal or the spending restraint in the Kyl plan. If Congress passes a balanced budget amendment without a curb on taxes or spending, the next grass-roots call will be for a tax-limitation constitutional amendment.

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