1979

The Spending Limitation Approach

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Published In
Balancing the Budget: Should the Constitution Be Amended? Washington: Heritage Foundation.
Proposals to balance the government budget or to limit taxes and government spending have appeared since the very earliest days of the republic. Thomas Jefferson's strictures about government debt, and Alexander Hamilton's principles of government finance are, or were, part of the familiar stuff of everyone's first course in U.S. history or civics.

The fact that both Hamilton and Jefferson held compatible views about deficit finance tells us much about dominant opinion of the time. Perhaps because these views were shared widely, the real value of government debt per capita was about the same in 1891 as in 1791. Increases in debt to finance major wars raised real per capita debt temporarily, but budgeted surpluses and rising population lowered real per capita debt in peacetime years. The price level was about the same at the beginning as at the end of the period.

The history of the twentieth century is very different. From 1899 to 1977, prices increased more than sevenfold, and population increased threefold, but the outstanding nominal stock of government and agency debt, as measured in the budget, increased 500 fold. Real debt per capita was 23 times greater in 1977 than at the start of the century. Peaks in real debt per capita occur, as in the 19th century, following wars. But, despite postwar declines in real debt per capita resulting from population growth and high inflation, real per capita debt is now close to the levels reached in the 1950's.
Continued deficits are believed to contribute to our current malaise in three ways. To the extent that deficit finance raises real rates of interest and reduces investment in plant and equipment, we have fewer tools or machines in our old age and leave fewer tools for our children. We consume more today but we are poorer and have fewer goods available tomorrow. To the extent that government spending financed by sales of debt raises prices, private spending is "crowded out." We have more government services but fewer private goods and services. We pay for redistribution that we may not want in ways that, often, are difficult to trace. To the extent that the deficits are financed by printing money, we have inflation. Inflation redistributes wealth and income and, in our system, raises effective tax rates on capital and income.

During the seventies, we have observed all of the symptoms just described. Investment in new plant and equipment has been well below the postwar trend. The capital stock has grown slowly during a period in which the labor force increased rapidly. If capital per worker had grown in the seventies at the average rate of the postwar years, real income would now be as much as 5 or 6% higher; we would have an additional $70 to $80 billion, more than $350 per capita. After-tax returns to investment in real capital and in claims to real capital have been far below the rates of return realized in the previous quarter century. Real, after-tax incomes have grown slowly. Inflation has become the rule, not the exception.

A layman who has read or heard any of the often repeated forecasts of the ominous consequences of repeated budget deficits should not be censured for concluding that most of these consequences have occurred. Economists are
less certain. Many of the undesirable consequences popularly attributed to
deficits would have occurred if government spending and money creation had
followed their historic path of the past twenty years with the budget
balanced. The burden of taxation on current and future generations would
have been quantitatively different. Government debt would be lower, tax
rates higher and inflation about the same. The disincentive effects of taxes
on investment and employment would not have been avoided.

In designing a constitutional amendment to balance the budget, I believe
it is desirable to recognize that the effects of the amendment on the economy
will depend on the level at which the budget is balanced and the frequency
with which balance is achieved. A rule that mandates reductions in spending
or increases in taxes to achieve budget balance in a deep recession imposes
a more stringent standard than the standards of the 19th or early 20th
centuries.

The critics of counter-cyclical fiscal policy correctly conclude that
discretionary fiscal policy has not produced budget balance on average.
They infer, correctly I believe, that there is a bias in favor of deficits
and against surpluses. The problem is to recognize the bias and avoid its
consequences while retaining some of the stabilizing properties of fiscal
policy.

The Proposed Amendment

The amendment I propose is relatively short and concise. The current
version has five sections but only seven sentences, and it is shorter than
the twelfth, fourteenth, twenty-fifth and several other amendments. I have
avoided terms like GNP, inflation or national income that are subject to change or recomputation.

Section 1 limits government spending to the average revenues received in the most recent three years. Section 3 ties the rate of growth of budget revenues to the rate of growth of an index chosen by Congress. Congress not only chooses the index but may change the index by 2/3 vote if more appropriate measures become available in the future. To illustrate the way in which the amendment works, I assume that GNP, as currently measured, is used as the index.

Taken together, sections 1 and 3 produce a budget surplus equal to the average rate of growth of GNP. If on average, real GNP grows at a steady 3% rate and there is no inflation, there would be a surplus equal to 3% of the budget each year. At higher average rates of inflation, the budget surplus increases. This works to slow the rate of inflation. If a new depression were to occur, falling real GNP and falling prices would cause the budget to shift toward a deficit, thereby slowing the rate of decline in output. These properties known as built-in stabilizers are automatic and, therefore, predictable. They are also, I believe, desirable properties of a budget rule.

The proposed amendment could be written to produce a balanced budget instead of a surplus in an economy with real growth and no inflation. The change is easily incorporated. I have provided for a surplus that can be used to pay currently unfunded liabilities as they come due. Unfunded liabilities include payments for social security benefits and for various guarantees on loans and commitments that were made in the past.
Section 2 defines government outlays to include all budget and off-budget expenditure plus the present value of commitments for future outlays. This section prevents Congress and the President from circumventing the amendment by making promises that must be paid from future revenues without recognizing that the promises commit future revenues. For example, when government guarantees loans, private risks of default are unchanged. Current budgets do not recognize the payments that will be made in the future. Many of the problems in the social security program arose in this way.

The proposed definition of spending restricts the growth of future commitments but requires that currently unfunded liabilities be paid from future revenues as they fall due. To spread the cost of funding the liabilities over time, I have written a budget rule that produces a surplus except when GNP falls. Congress could not use the surplus to increase spending but could choose to retire outstanding debt or to fund unfunded liabilities.

The fourth section provides for emergencies. No one can hope to define an emergency now in a manner as applicable in the present as in all future contingencies. I have left to the President and 2/3 of the Congress to decide when the spending limit should be breached. Spending in excess of the limit is temporary. The limit is unaffected and the rate of increase of future spending is not raised. Further, the President and Congress cannot have a permanent emergency; the emergency can be renewed, but a 2/3 vote is required at each renewal.

The last section leaves to the Congress responsibility for enacting legislation to implement the amendment. The Congress should decide who
would have standing to sue, how a budget surplus would be used, how the
transition from current to future procedures would be accomplished and
many other details and procedures. I see few advantages in placing these
details in the Constitution.

The proposed amendment reads as follows:

1. Total government outlays in any fiscal year shall not exceed the spending limit. The spending limit is equal to the average of total budget receipts in the three most recent fiscal years.

2. Total government outlays include all budget and off-budget expenditure plus the present value of commitments for future outlays.

3. The rate of growth of total budget receipts in any fiscal year shall not exceed the average rate of growth of an appropriate index in the most recently completed calendar year. The index shall be chosen by Congress and may be changed by 2/3 vote of each house.

4. In the event that an emergency is declared by the President, the Congress may by 2/3 vote of each house authorize outlays for that fiscal year in excess of the spending limit.

5. Congress shall enact all necessary legislation to implement the amendment.
Some Practical Consequences

The proposed amendment is provisional and subject to revision. The practical consequences of the amendment are of considerable importance for assessing its qualities and the desired type of revisions. I have discussed the implications for the budget surplus in the previous section. This section gives some indication of how the amendment would have worked if it had been in effect during the past twenty-five years.

Estimates of this kind can never be firm. A quarter century of different budget policies and different budget rules would have produced less inflation and more real growth. Anticipations of future inflation would now be lower and tax rates would be lower. I believe the after-tax returns to capital and labor would have been higher. With lower inflation and higher real growth the dollar would not have depreciated to the same extent and perhaps not at all. Would there have been a quadrupling of the price of oil if inflation had not reduced oil prices relative to other prices? We cannot expect to give final answers to questions of this kind and I have not attempted to simulate the effects of the amendment on prices and output. I am content to accept the broad consensus that the budget explosion beginning in fiscal year 1966 marks the start of a period of sustained inflation at rates much higher than in any previous peacetime era. The fact that the inflation could have been prevented, or ended, by less inflationary monetary policies after 1966 is not germane. The facts tell us that inflation increased, and that there was another surge of government spending beginning in fiscal years 1971 and 1972 and continuing throughout the seventies.
The proposed budget amendment would have prevented both outbreaks of spending. The financing of the Vietnam War and the expanded program of income transfers in fiscal years 1966 to 1968 would have required the President to declare, and the Congress by 2/3 vote to approve, an emergency in each of three years. It seems likely, in retrospect, that if a choice between guns and butter had been forced on the President and the Congress, we would have avoided at least some of the consequences of the mistaken fiscal policies of that period. The history of the next decade would surely have been different and almost certainly less inflationary. Perhaps, too, the war would have been shorter.

Comparisons between actual spending and the spending permitted under the amendment are more reliable before 1965 than after 1968. The reason is that tax revenues rise with inflation. Rising tax revenues permit spending to rise with a lag. Since the amendment was not in effect, each new surge of inflation that raised tax collections in the late 1960's and 1970's permitted a new surge of spending a few years later. Actual and permitted budget totals would have been much lower if the inflation had not occurred, and the subsequent changes in permitted spending would have been much smaller.

We can, of course, reduce the spending changes to constant dollars to take out the effect of inflation, but the proper correction of permitted spending requires an estimate of what tax collections would have been in each fiscal year if inflation had been lower. Estimates can be made using one of the many available econometric models, but reliable estimates cannot be made. I have computed, instead, permitted and actual changes in spending in current dollars for the 24 fiscal years 1956 to 1979 and in constant 1972 dollars for 9 fiscal years, 1971 to 1979.

[Insert Chart here]
DIFFERENCE BETWEEN ACTUAL AND PERMITTED ANNUAL CHANGES IN OUTLAYS
(in percent)
In 7 of the 24 years, actual changes in spending were below permitted changes. No reductions would have been required in these years. In most of the remaining 17 years, the differences between the actual and permitted change was less than 6%.

The amendment would not have required massive budget cuts every year. Despite the fact that the rule generates surpluses when GNP rises, the net total of all the required budget reductions in the ten fiscal years 1956 to 1965 is about $1.2 billion per year on average. During the same period, the budget rule would have produced an aggregate surplus of almost $40 billion, nearly $4 billion per year.

During the seventies, the budget rule would have prevented the explosive growth of government outlays from 1975 to 1979. The rule would have permitted spending, in constant 1972 dollars, to increase during the 1969-70 recession and at the start of the 1974 recession. The rule would have required reductions in real spending of less than $1 billion dollars of constant 1972 purchasing power, in only two fiscal years -- 1972 and 1975. Permitted spending in current dollars would have increased every year with the growth of the economy; but the relatively large increases in some of the fiscal years during which there was a presidential elections would have been avoided.

The budget deficits in most of the past twenty-five years would have been replaced by surpluses. For fiscal years 1970 to 1979 the cumulative surplus, in constant 1972 dollars, would have been $73.5, an average of $8 billion per year. But deficits would not have been avoided entirely. During the recession and recovery, in fiscal years 1975 to 1977, the
built-in stabilizing qualities of the budget rule would have shifted the
budget in constant dollars, from a $12 billion surplus to a $7 billion dollar
deficit. In fiscal year, 1978, there is, again, a budget surplus.

These calculations are illustrative only. They tell us much more about
what would have been prevented than about what would have happened. And
they suggest that a budget rule of this kind would not be extraordinarily
difficult to follow.

Long Term Benefits

The budget problems we face are not unique to our time or our country.
Taxes have increased faster than income for the past twenty-five years in
all countries with democratic institutions. In the United States, and in
several other countries, a similar pattern has been observed for a century
or more.

The amendment I have proposed reduces the rate of increase of tax
revenues and government spending to the rate of growth of some broad
measure of economic activity.

The short-term benefits are well-known. We move toward budget balances
and lower inflation and realize higher after-tax returns to capital and
labor. We replace the prospect of high and variable inflation with a low-
average rate of inflation or a price level that remains stable, on average.
These benefits would not be distributed uniformly. Some would gain; others
would lose. Voters as a group would, I believe, currently welcome these
changes.

Any amendment that reduces the growth of government forces the Congress
to make choices about the allocation of a smaller amount of tax receipts.
Congress cannot decide on the amount of funding for each program separately, add up the total and present the bill to the taxpayers. The total would be limited by the rate of growth of GNP, or some other index of economic activity. The parts would be cut to conform to the total.

Public spending can increase as economic growth rises. There is, therefore, some incentive for government to be concerned about efficiency. Critics of budget and spending limitation have pointed out that there are incentives in the opposite direction as well. This is a correct, but incomplete, inference.

A principal reason for relying on a constitutional limitation is to make everyone aware of the rules under which we agree to live. Once there is a limit on spending and taxing, Congressmen can point to the constitution when explaining why a costly proposal desired by a particular group cannot be passed. Voters find that the gains from organizing to press for budget transfers are reduced, so fewer groups organize.

The incentives to organize and to press for increased spending are very different now. It is these incentives that have to be changed. A lasting change cannot be made by defeating one group of legislators and replacing them with another. To achieve a long-term benefit, we must limit the range of choices open to voters and their representatives by common consent.

Limiting the range of choices made by governments is not the only reason for the amendment. Each of us must plan to save over his lifetime to provide for emergencies and for retirement. No one in private or public life can make a rational plan if he does not have any way of knowing how much he will pay in taxes in future years of work and in retirement.
An amendment that fixes the share of income received by government provides information about the future. There is less uncertainty and, therefore, more opportunity to plan for the future and more saving.

Government performs best, I believe, when it provides rules or principles that are as clear and definite as men can make them. This is the high purpose of an amendment that limits the size of government and the growth of taxes and spending, and it is the purpose I have tried to serve with my proposal.