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# A Theoretical Analysis of the Case for a Balanced Budget Amendment

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## ABSTRACT

A balanced federal budget is not a best outcome for all situations, and a constitutional amendment to require annually balanced budgets is not well defended on grounds that it is. However, the case for a balanced budget amendment may have some merit on other, subtler grounds. This article outlines a set of such grounds.

Specifically, if it can be shown that the political process systematically undervalues a desirable relationship between revenues and expenditures, a balanced budget requirement might be defensible. The grounds would be that annually balanced budgets are a second best solution, given an argument that the unconstrained political process produces even less desirable outcomes. However, existing knowledge does not make an adequate case that such a rule is needed.

## Introduction

The proposed amendment to the U.S. Constitution to require a balanced federal budget raises several theoretical issues that are independent of and logically prior to problems of practicality and enforcement, which are prominent among the arguments of opponents to the amendment. Questions about the desirability of the principle of annually balanced budgets are sometimes begged, and some important questions about the desirability of putting such provisions into the Constitution are often not raised. (For important exceptions see Ackley, 1982; Aranson, 1983; Noll, 1983; and Shepsle, 1983). This essay identifies and discusses a series of such issues.

Specifically, many opponents observe that the amendment could not be effectively

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enforced, for example because expenditures could be shifted to "off budget enterprises," because certain other government goals could be met by regulations instead of direct expenditure, or because the relevant numbers could be manipulated (see Shepsle, 1982). These arguments are telling, but they sometimes beg the question of whether or not the amendment is desirable in principle. Of course, if the proposal were sure to be rejected on grounds of practicality and enforceability, the questions of desirability would be moot. But since there is a risk that the arguments about enforceability may not prevail, and that the amendment may not be rejected, the theoretical case is important. If the theoretical case is unsound, then the practicality arguments are moot. This essay concentrates on questions of desirability in principle.

## I. The Perspectives of Self-Command and the Authentic Self

To put a policy goal such as a balanced budget requirement into the Constitution implies that the government cannot be depended on to achieve this goal without a rule. Imposing such a rule is similar to what Thomas Schelling (1984a, b) calls "self-command," an effort to "overrule one's own preferences." Schelling develops this concept in the context of theories of rational choice on the individual level, such as consumer behavior. He suggests, for example, that the alternation between the desire to smoke and the desire to quit smoking is a problem of choice between two selves, an issue of interpersonal comparison of utilities, with all of the well-known intellectual difficulties that go with that problem.

Indeed, some of the proponents of a balanced budget amendment explicitly use the analogy that the government is like an alcoholic, drunk on deficits and unable to achieve the sobriety of balanced budgets without a rule such as that proposed (Buchanan and Wagner, 1977, p. 159). What should we infer from this analogy? As Jon Elster (1985) observes, Schelling suggests that there are sometimes genuine dilemmas in identifying the "authentic self." If so, the elements of the political system which seek to balance the budget may not be superior to or more "authentic" then the elements which produce large and repeated deficits. There is no doubt about the hierarchy of authority between the civil society, which amends the Constitution, and the government, which defines the balance between revenues and expenditures. Yet there is reason to doubt that the representatives of the people who may act to pass a balanced budget amendment to the Constitution act on behalf of a more authentic self than the other representatives of the same people, who produce deficits.

Elster suggests that "the authentic self is the one who is capaple of acting strategically towards the other self or selves" (1985, p. 92). If some of the critics are correct, this definition implies that the "authentic" governmental self may be the one that would defeat the purpose of a balanced budget amendment with techniques such as off budget enterprises, since these may be strategically chosen ways of avoiding the scrutiny of the budget process.

Of course there is a collective action problem in the present case, i.e., a problem of preference aggregation. Is an expression of collective wishes through constitutional amendment more authentic than an expression through the budget process? The former demands extraordinary majorities regarding a simple sounding proposition. The latter involves only simple majorities in a process which allows a much more elaborate expression of specific interests [1].

The proposed amendment would involve the representatives of the people acting as amenders of the Constitution, limiting the discretion of other representatives of the people acting as policymakers. The proposed amendment amounts to the argument that the normal political process is insufficient to achieve objectively desired ends, so that the process must be constrained by rules.

Before incorporating the desire for balanced federal budgets into constitutional superiority over a political process that produces deficits, we should know more about why balanced budgets are to be considered superior to deficits, and, if so, why the government cannot be relied on to make this judgment without a rule. We consider first the nature of the case for balanced budgets, and then the possibility that government decisions need to be constrained by rules.

## II. The Case for Balanced Budgets and Its Relation to Other Goals

In my reading of the literature, I find no sustained argument that balanced budgets are first principles or ends in their own right [2]. Budget deficits are opposed for instrumental reasons. Deficits are said to be related inversely to other implicitly higher goals such as price stability, capital formation, and, by extension, long term growth.

Clearly there are circumstances in which this is true. As Martin Feldstein demonstrates (1980, p. 647):

> a permanent increase in the government's real deficit in a fully employed economy... must raise the rate of inflation or lower the capital intensity of production or both.

But as he also points out, "deficits may have no adverse affect in an economy with sufficient unemployed resources" (p. 637). Deficits are not necessarily undesirable in all circumstances, at least with respect to the goals of price stability and capital formation.

The balanced budget amendment most commonly discussed (Senate Joint Resolution 58. See Rabushka, 1983) does not explicitly distinguish these situations. War is the only condition which the proposed amendment recognizes as grounds for waiving the balanced budget requirement. Presumably this is because the consequences of losing a war may be even worse than the consequences of deficits. Surely this is so, and since the effort to win wars typically involves deficits, this is a reasonable exception.

The fact that other exceptions are conceivable is recognized in the provision that "Whenever three fifths of the whole number of both Houses shall deem it necessary, Congress may provide for a specific excess of outlays over receipts by a vote directed solely to that subject." One wonders what the exceptions would be that might generate a three fifths vote. I imagine at least two kinds.

One kind of exception would be cases in which deficits would not have the adverse consequences for price stability or capital formation that make them otherwise undesirable, i.e., cases in which the basic rationale for balanced budgets does not apply. The Great Depression is the classic example. Another is presented in a recent *Economic Report of the President* (1984, pp. 38–40), where current deficits are defended as contributing to economic recovery, while persistent deficits are acknowledged to have potentially adverse effects for price stability and capital formation.

The balanced budget amendment is of course proposed because its advocates seem to believe that the President and Congress cannot tell the difference between cases in which a balanced budget is warranted and those in which it is not (when the advocates recognize such a distinction at all). An amendment with a requirement of a three fifths vote for unbalanced budgets merely makes the presumption of a balanced budget explicit and raises a high hurdle for exceptions. In other words, the amendment says that an extraordinary majority must acknowledge exactly what there are doing when they vote for an excess of outlays over receipts. It does not say that they may never do so.

A second kind of exceptional situation would be analogous to war, namely cases in which other goals besides economic management competed with the rationale for a balanced budget. War as a threat to survival of the society clearly deserves to be on the same plane with or higher than a balanced budget. But if winning a war is so high a priority, how much lower is the avoidance of war, or national defense in a nuclear age? A former director of OMB opposes the amendment on grounds that the budget would be balanced at the expense of adequate national defense (*Wall Street Journal*, 25 July 1984, p. 1).

And if defense of the society is allowed to interfere with budget balance, why could not other allocation goals do the same? Peter Aranson, an erstwhile defender of the balanced budget amendment, suggests that "the public sector deficit, like its private sector counterpart, must be justified by the nature of the activities it supports," and he identifies several conditions which "welfare theory" suggests could be grounds for deficit spending (1983, pp. 161–163).

Furthermore, the nominal size of budget deficits, which receives so much attention, may be a misleading measure of the meaningful magnitude of deficits. Robert Eisner and Paul Pieper (1984) identify a series of ways in which the excess of government expenditures over receipts may misstate the nature and size of government deficits or surpluses. They take into account differences between par and market value of government obligations, between capital and current accounts, and between high employment and nominal deficits. The clear implication is that nominal deficits are not a good indicator of economic health. Indeed, in a study of seventeen OECD countries between 1949 and 1981, Guess and Koford (1984) find that "there is *no support* for a *consistent* causal relationship from deficits to inflation, reduced GNP, or reduced investment" (1984, p. 399, emphasis in original).

The above discussion implies that the balanced budget should not be placed at the top of a hierarchy of goals, i.e., of a lexicographical ordering. If it were, and the political process regularly subordinated budget balance to goals that ranked below it, this fact could be grounds for an "external and superior rule" such as the proposed amendment. But since even the proposed amendment itself recognizes circumstances in which other goals may legitimately compete with a balanced budget, the rationale must be more subtle.

Even though a balanced budget may not always be objectively desirable, some deficits may be too large, as Benjamin Friedman (1983) points out. If the political process consistently generates deficits which are too large even after taking other considerations into account, a balanced budget requirement may be a second best solution. Annually balanced budgets are surely not optimal regardless of other conditions, but they may be better than the deficits produced by an unconstrained political process. If the case for a balanced budget actually rests on these second best grounds, it will have to be made more carefully than it has been as yet.

## III. Rules, Discretion and the Theory of Economic Policy

At present, elected officials have the "discretion" to weigh the considerations mentioned above as they see fit. Under the proposed amendment their discretion would be constrained by the "rule" mandating budget balance. If things worked as intended, the budget would normally be balanced, with the consequences for other objectives being subordinated to this concern, for better or worse.

The case for "rules" rather than "discretion" is an old one in economics, going back at least to Henry Simons (1936) [3]. It is usually associated with monetary policy and Milton Friedman is its leading contemporary exponent. Yet the case for rules in monetary policy, however sound, is not equivalent to a case for rules in fiscal policy, such as an annually balanced budget. Moreover, the case for a rule is not equivalent to the case for a constitutional amendment.

The rule Friedman advocates is a fixed growth rate for the money stock regardless of cyclical fluctuations. His rationale is that discretion does not give clear enough guides to policy and criteria for performance evaluation. Imperfect knowledge and the unpredictability of the lags in the relation between money and prices make it likely that discretionary stabilization policy may actually *destabilize* the economy. That is, monetary measures designed to be countercyclical may actually turn out to be procyclical because economic conditions may have changed by the time they take effect (Friedman, 1959, pp. 86–90).

On one level the case for rules rather than discretion is approximately as strong for fiscal as for monetary policy. The difficulty of accurately forecasting the economy is the same. And the risk exists in fiscal policy too that policy responses may actually destabilize because of unpredictable lags. However, on another level the case for a balanced budget rule is much weaker. A rule of a constant growth rate in the money supply would avoid the risk that stabilization policy would destabilize by accident. But although a fixed monetary growth rule is not actively destabilizing, a rigidly balanced budget may be. If the economy goes into a recession due to an autonomous reduction in aggregate demand, tax receipts will fall and government transfer payments will rise. Each contributes to a deficit, and an effort to balance the budget would be procyclical rather than countercyclical. Balancing the budget under such circumstances would further reduce aggregate demand and make the recession worse. Unlike a fixed monetary growth rate, the balanced budget amendment is a rule it may be actively destabilizing to follow.

There is theory of economic policymaking which would provide a rationale for full discretion. A balanced budget role would almost certainly obstruct the effectiveness of economic policymaking under such theory, because it would take away a policy instrument. In one formulation, a series of economic goals, such as inflation and unemployment, could be combined in an "objective function" that identifies target values and marginal rates of substitution between them. This objective function can be "optimized" subject to real world limitations by suitable manipulation of policy instruments. For example, Chappell and Keech (1983) show how a president might minimize a weighted combination of inflation and unemployment (the objective function) by suitable choice of government spending (the control variable) subject to the constraint (a multi-equation model of the U.S. economy). It is possible in principle for stabilization policy to achieve a series of specific goals or targets, so long as the number of policy instruments is at least equal to the number of targets.

A balanced budget amendment would in general add to the difficulty of the problem in the theory of economic policy, since it would require that government spending not exceed tax revenues. Taxes and government expenditures are commonly viewed as separate policy instruments for purposes of achieving economic targets. To ask that one be limited to the value of the other at best adds a target or removes an instrument, thus making it more difficult to achieve a full set of goals. A rule such as a balanced budget amendment does not make much sense in a world described by such theory of economic policy so long as balanced budgets are seen as instrumental and not as a goal in their own right (see Benavie and Froyen, 1984, pp. 9–17).

The case for discretionary macroeconomic policy has been undermined and the case for rules has been revitalized by the rational expectations hypothesis, which has had a deep impact on macroeconomic theory in the last decade. The rational expectations hypothesis is based on the assumptions that economic agents use all information readily available to them and that they do not make systematic errors (see Begg, 1982; Fischer, 1980). In the context of macroeconomic policy, this has been shown to lead to the conclusion that systematic stabilization policy cannot work. The rational expectations hypothesis implies that

> systematic, and therefore anticipatable monetary policy would have no real effects even in the short run; systematic fiscal policy would not affect current real output or employment, and would affect these variables only to the extent that, by manipulating the composition of the given output level, it could affect investment and therefore future aggregate supply (Begg, 1982, pp. 132–133).

There is serious question that the policy ineffectiveness proposition holds in its strongest form, for example in labor markets which do not clear (Begg, 1982, pp. 150–153), and even in its strongest form it permits policy to have an effect through surprises. Still, the rational expectations hypothesis has undermined confidence in the theory that shows how policymakers can use their discretion to achieve macroeconomic targets.

In addition, rational expectations brings us full circle back to the advocacy of rules rather than discretion in macroeconomic policy. Sargent and Wallace (1975) and Kydland and Prescott (1977) argue that rational expectations assumptions imply that predictable rules lead to more desirable policy than does the use of discretion. Ironically, Friedman's rationale for rules was that we don't know enough to use discretion in fine tuning the economy, whereas rational expectations produces the same recommendation for rules from assumptions that expectations are not systematically in error (see Gapinski, 1982, chapter 8).

But the rejuvenated case for rules is not equivalent to the case for a balanced budget. The case is made in terms of monetary rather than fiscal rules (Sargent and Wallace, 1975). Benavie and Froyen show that even under rational expectations a balanced budget rule would be suboptimal. Automatic stabilizers reduce the variance in real output, and constraining taxes to match expenditures would make prices or output more unstable (1984, pp. 21–24). In general, the case for rules over discretion collapses as we move from monetary to fiscal policy.

The main advantage for the balanced budget as a policy rule derives from its simplicity and its widespread support, but not from the argument that it is a good rule in its own right. Kydland and Prescott suggest that in a democratic society, "it is probably preferable that the rules be simple and easily understood, so it is obvious when a policymaker deviates from the policy" (1977, p. 487). Henry Simons argued that the rules should be "definite, simple (at least in principle) and expressive of strong, abiding and pervasive popular sentiments" (1936, p. 29). There is no rule that is more intuitive to the public than the rule that budgets shall be balanced. While this may not be the best rule for public officials to follow, it is hard to imagine subtler rules, such as fixed monetary growth or constant full employment surpluses, having the public impact or public support of the balanced budget [4]. If we are to have a rule which reflects "abiding and pervasive popular sentiments," the balanced budget rule is by far the most likely candidate, even if it is not a good rule. Whether it is better than no rule depends in part on our understanding of the political process.

## IV. Three Views of the Nature of the Political Process

The balanced budget amendment was proposed by advocates who felt that the normal political process produces outcomes which are objectively undesirable. The above review rejected the view that a balanced budget is more desirable than an unbalanced budget regardless of other conditions, and it considered some rationales for rules over discretion. The next question becomes how adquate the political process is to make appropriate decisions about budget size without being constrained by rules. I consider three basic possibilities.

*A. The possibility that a theory exists which would show when and how the political process can be relied on to produce desirable outcomes*

The basic fact is that there is no widely accepted theory that relates political preferences and institutions to the desirability of policy outcomes. We have an idea of what such theory would look like in microeconomic general equilibrium theory, which relates preferences and procedures to outcomes with explicit standards of evaluation. And John Rawls gives us an intuitive idea of what such a theory might do in his concept of "perfect procedural justice," with the metaphor of the rule that provides an incentive for equal division of a cake (Rawls, p. 85). But efforts to achieve comparable success regarding political activity have achieved negative results [5].

As Rawls (1971, p. 360) puts it:

> There seems to be no way to characterize a feasible procedure guaranteed to lead to just legislation. ... So far at least there does not exist a theory of just constitutions as procedures leading to just legislation which corresponds to the theory of competitive markets as procedures resulting in efficiency.

Although our concern here is with desirable outcomes in general, rather than with "just legislation," the point stands nonetheless.

The problem is twofold. On the one hand we do not have the theory to identify what the most desirable outcomes are. On the other, we do not have the theory that would tell us how political institutions might aggregate preferences or guide behavior towards optimal outcomes.

In Herbert Stein's words (1984, p. 352) regarding the first point, the decision as to the optimal size of government surplus or deficit is a decision about rates of economic growth, and

> There is no objective way to determine how much the nation should forego current government services and private consumption in order to make future national income greater.

On the second point, the greatest recent progress in theories about how institutions guide preferences into collective outcomes has had to do less with optimizing than political pathologies, or putatively undesirable consequences of political processes.

*B. The possibility of political pathologies*

One of the major developments in political science and economics in recent years has been theory that suggests conditions under which the political process might lead to outcomes that are objectively undesirable, or at least not within a certain range of desirability. If this is the case, a rule such as the balanced budget amendment might be worth a second look as a possible means of keeping outcomes within such a range.

The first of these developments starts from the context implied by the theory of macroeconomic policy, in which this theory would guide the choices of a welfare maximizing planner. The theory of the political business cycle shows how, under certain definitions of economic constraints, a politician/planner who maximized votes instead of welfare could create politically induced business cycles which would lead to suboptimal outcomes (see Nordhaus, 1975; Keech and Simon, 1985; Chappell and Keech, 1983).

Considerable research has been done to investigate whether or not there is substantial evidence of such cycles on electoral periods and empirical support is uneven at best (see Keech, 1985, for a review). While some politicians may from time to time try to manipulate the economy in the fashion suggested by this theory, such manipulation appears to be neither systematic nor regular. Furthermore, rational expectations assumptions discussed above deny that it would be possible for politicians to behave this way on a regular basis. And while most empirical studies of how the public evaluates economic policy suggest that voters would reward such manipulation if it existed, there is more recent evidence that questions whether voters would do so (Chappell and Keech, 1985). Even if there were full empirical support for political business cycles, the case is not yet made that a balanced budget amendment would be an effective antidote.

Another model of political pathologies for which the balanced budget amendment is seen to be relevant is what might be called theory of distributive politics (Fiorina, 1981; Shepsle and Weingast, 1981). This is theory which shows how there are incentives for the organized to seek publicly-provided private benefits, the costs of which are distributed across the population. The benefits may not be justifiable in terms of the normal grounds that justify public expenditures, yet the organization of representative government on a geographic basis provides incentives for public officials to respond positively to these demands.

Because these programs increase the size of the public sector and increase government expenditures without necessarily being accompanied by corresponding revenue increases, a balanced budget amendment is sometimes seen as relevant to their control. Indeed, the proposed amendment includes a provision that would limit the growth of public expenditures. But preferences for a large or even "too large" public sector do not imply a preference for deficits until it is demonstrated that there is a systematic unwillingness to raise enough revenues to pay for these expenditures (Noll, 1983).

Buchanan and Wagner (1977, ch. 7, 8) argue that there is such an unwillingness. They contend that without a balanced budget rule, there is a bias in democratic politics in favor of deficits and against surpluses. If people can avoid direct payment for public expenditures with deficits, they will support more expenditures than they otherwise would because the tax price is lower. The undesirable consequences of deficits, such as inflation or reduced capital formation, are not clearly perceived, especially by persons who anticipate a short term gain, according to Buchanan and Wagner, but no systematic evidence is presented by the authors.

Crain and Ekelund (1978), argue that deficits are likely to be a systematic product of political rivalry in democratic governments, especially when public debt is financed by taxes on human capital, i.e., income taxes. Taxes on physical capital are immediately reflected in reduced value of that capital, Crain and Ekelund contend, whereas the burden of taxes on human capital can be shifted to future generations. They present some modest evidence that deficits are positively associated with dependence for revenues on taxes on human capital.

Roger Noll (1983) addresses the possibility that the theory of distributive politics might lead politicians to pay less attention to the overall level of revenues than to the distribution of tax breaks, but he does not find compelling reason to believe that this is a systematic cause of excessive deficits. If it were, he suggests, we would have to explain why deficits have been so small. As it stands, Noll argues that deficits are well explained by wars and the state of the economy, and without variables reflecting political pathologies [6].

*C. The liberal interpretation of democracy*

In the absence of convincing theories of political optimization or of political pathologies, we are left in a rather large middle ground. William Riker provides one interpretation of the resulting situation. He argues that "the outcomes of voting are not necessarily fair and true amalgamations of voters' values" (Riker, 1982, p. 233), and suggests that the outcomes of political decision procedures may be arbitrary and without moral content. Democratic institutions are best defended on grounds that there is always another election and another opportunity to reject current policies, including, presumably, excessive deficits. While he argues that voters can always reject incumbents of whom they do not approve, his work undermines the prospect that the electoral process can assure any pattern of outcomes, whether desirable or not. He does not address the possibility of "objective" standards for evaluating outcomes, or of rules designed to assure adherence to such outcomes. Yet he clearly undermines contentions that the electoral process is predictably either optimizing or pathological [7].

## V. Conclusion: Policy and Procedures in the Constitution

A balanced budget amendment would be an effort to incorporate a policy goal into the Constitution. While the clearest precedent is probably the Prohibition Amendment, a balanced budget amendment seeks to constrain not individual but governmental behavior. It is an exercise in self-command on the part of the political community. Just as it is the case with individuals, the government can command itself to be more disciplined about some activity such as matching revenues with expenditures. It can do so without establishing a rigid rule. A constitutional amendment is an extreme solution that might conceivably be justified under certain conditions.

If balanced budgets were unconditionally superior to deficits, or if the political process were shown systematically to produce objectively inferior results, a balanced budget amendment would make more sense than it can now be shown to make. The case for rules rather than discretion in policymaking has been given new vitality by rational expectations theory, but this case has not been extended to balanced budgets as well as monetary growth rates. Even if it had been, the case for such rules is not equivalent to the case for a constitutional amendment. Rules can be followed without being incorporated into a constitution. And to incorporate a rule into the U.S. Constitution without any more intellectual justification than this one has would be hasty and premature.

## Notes

1 Conceivably the regularity with which the budget process produces deficits is similar to the strength of the shortsighted selfishness position in the prisoners' dilemma game.
2 Perhaps the closest approximation is Adam Smith's observation that "What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom" quoted in Wagner, Tolleson, et al., 1982, p. 7.
3 Simons argued for "a stable framework of definite rules" designed to assure "a minimum of uncertainty for enterprisers and investors" (1936, p. 29).
4 See Blinder and Holtz-Eakin, 1984, for a discussion of sources of public support for a balanced budget amendment.
5 The landmark is of course Arrow, 1963.
6 For a more systematic effort to explain deficits, which is consistent with this view, see Barro, 1984.
7 John Rawls' concept of pure procedural justice is potentially relevant to a situation in which there is neither a theory of optimization nor of pathology (1971, pp. 85–6).

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