

Economic Review

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Compact for America: An Economic Explanation

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In recent years many proposals for a balanced budget constitutional amendment have seen the light of day. The lively debate over the topic is welcome, primarily because it sheds more light on one of the most pressing economic issues of our time: the rapid growth in federal debt.

Yet amending the constitution to turn the tide on our nation's debt is complex and risky. The complexity has to do with passing an amendment; the risk is associated with the design of the amendment itself. Given the significant weight that a constitutional amendment has in guiding day-to-day policy, a wrongly designed debt amendment could do significant harm to the nation's economy.

Rightly designed, however, a constitutional amendment could do a lot of good. Short term it could help Congress

and the President steer our nation away from the disastrous consequences of runaway debt. Long term it could help us avoid returning to the edge of the debt abyss and instead stay on the path of prosperity, economic freedom and full employment.

Since the design of the amendment is ultimately a matter of fiscal and monetary policy, it is the duty of the economics profession to suggest what a good amendment looks like. With this paper we explain why we believe that the Compact for America proposal is the best amendment proposal out there.

The Compact for America proposal

Compact for America's (CFA) proposed amendment to the United States Constitution can fairly be described as a "debt control amendment." It is through the control of debt that the proposed amendment would, in turn, often (but not always) require the federal budget to balance. By requiring a simple majority of state legislatures to approve increases in the federal debt beyond a certain limit, the federal Congress will be forced to balance the federal budget over the long-term, except in extraordinary times, such as war or other long-term emergencies, when it can convince state legislators to acquiesce to more debt. Since state legislators are required to balance budgets, they are unlikely to be easily convinced to increase the federal debt in times when the nation is not experiencing duress.

Perhaps the biggest concern brought up about the CFA

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amendment, however, is its possible economic effects. Some share concerns that balancing the federal budget could upset the current economic order, with deleterious effects. Related concerns involve the CFA amendment's impact on the money supply. In fact, the amendment will bring about greater overall policy and economic stability, not less. This stability will be a boon to the economy since markets flee uncertainty and are destabilized by it. The CFA amendment will bring about wiser government policy, incentivizing the federal government to take on a stabilizing role in the economy rather than to pursue ad hoc policies that create uncertainty and destabilize the economy as is current practice.

Risk-Based Policies

John Allison, former CEO of BB&T makes a convincing case that the federal government played a significant role in first creating the financial bubble in housing and then following policies that have deepened and lengthened the Great Recession. One of the biggest contributors to the creation of the housing bubble was the policy of using Fannie Mae and Freddie Mac, both government-created "private" enterprises, to encourage home ownership through the purchase of mortgages. Since Fannie Mae and Freddie Mac are both backed by a government guarantee against losses, this risk should have been explicitly recognized by the federal government. Instead, it was ignored.

The CFA amendment would have forced Congress to recognize the financial risk of its policies vis-à-vis the mortgage and banking industry by forcing Congress to consider the likelihood of having to request from state legislatures the ability to take on more debt. This is because there is no guarantee that state legislatures, looking over Congress' shoulder, so to speak, would automatically grant such permission.

Congress has failed to consider risk in many of its policies. Medicare, Social Security, Medicaid, unemployment insurance, welfare, pensions, the FDIC, student loan guarantees, flood insurance, and now Obamacare, are all risk-based programs. That is, they carry a great deal of risk for federal finances (and taxpayers) due to inherent economic risk and uncertainty as well as the risk and uncertainty associated with nature.

National defense, too, presents obvious financial risk for

the nation. All of this risk should be rationally considered and plans made to either organize finances to deal with it in an orderly manner or to take steps to reduce the risk.

The CFA amendment would likely require Congress to minimally plan more carefully for the risk to which its policies have exposed taxpayers and the overall economy of the United States. In some cases, with a realistic risk assessment, which the CFA amendment would encourage, Congress would look at potential risks and decide against a risk-based policy. For example, had the CFA amendment been in place prior to the debate on Obamacare, there is some probability that Obamacare would not have been adopted, or that Congress would have recognized that Obamacare's risk would have to be offset with policy changes in other areas. This does not mean Congress could not have made policy changes to positively impact the health care industry in the United States for both patients and providers. It just means Congress would have had to consider different policies that distributed the risk in a different way, and may well have resulted in less overall risk than the current policy. Without delving deeply into health care, this could have included adjusting the tax code to reduce price pressures brought on by encouraging the use of health insurance and to favor the widespread use of health savings accounts. These policies would have seen risk borne by individuals and providers whose decisions have the greatest impact on the risk in the first place.

Other examples include the bailouts of Chrysler and GM in addition to various financial institutions. These actions have created more risk for the federal treasury (and taxpayers) by causing business leaders to make less careful and rational decisions since they will think it more likely that such bailouts will be an accepted policy in the future. Large companies considered too big to fail have engaged in risky behavior and these kinds of policies obviously encourage even more risky behavior and more bailouts in the future. Without easily available additional borrowing capacity, made available by the dispensation of state legislatures, Congress would be less likely to take on such risk.

The CFA amendment, by restricting and forcing the control of Congress' propensity for taking on risk by forcing it to make provision for controlling that risk, means the federal government is less likely to contribute to large economic expansions and investment bubbles. On the other hand, when market corrections do take place, they are less likely

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to be so traumatic and government would stand to have the resources to have an effective countercyclical impact in the face of corrections that are not so deep as the Great Recession.

Prioritizing the Budget and the Economy

The CFA amendment also forces prioritization on the part of federal spending habits. In 2011, the National Endowment for the Arts (NEA) enjoyed a \$125 million appropriation. Because deficit spending was on the order of \$1 trillion that year, nearly one-quarter of federal spending was done with borrowed money. There was little if any talk of whether the \$125 million appropriation to the NEA could be better spent or prioritized elsewhere. The arts projects the NEA funded were effectively considered as important as repaired or rebuilt bridges, research into strategic missile defense, research into cancer cures or any number of other federally funded projects that should take priority in funding even if arts funding is reduced or zeroed as a result.

With seemingly unfettered access to debt, everything is a priority and nothing is unaffordable. With unfettered access to debt, Congress does not have to justify its spending to current taxpayers and future taxpayers have no voice anyway. With unfettered access to debt, the trivial becomes all-important and resources get used in ways that do not renew capital and fail to even increase the potential for standards of living to increase.

By forcing policy makers, especially Congress, to recognize the reality of scarcity, the CFA amendment will force real prioritization. Confronted with a debt limit, Congress will have to limit spending, which means it will have to prioritize in one of two ways. Either Congress will have to decide that NEA funding and a bridge to nowhere are more important than leaving money in the pockets of taxpayers and raising taxes, or Congress will have to decide these luxuries are more important than repaired infrastructure and reorder spending. Or, perhaps more wisely, Congress will have to make real decisions about what is important and focus government on its core functions, which are not likely to include funding for arts.

While Congress is not a particularly good arbiter of cost/benefit analyses, at the current time even considering the calculation appears absent from its decision making. Prioritization would force Congress to at least think about

what is more important to fund and in most cases, this means the relative costs and benefits of various programs would have to be considered. Clearly, from an economic point of view, those programs that present the greatest benefits compared to costs should be prioritized over others. This kind of budgeting calculation results in a government that serves as a true economic and societal contributor, less likely to engage in activities that present a net cost to our society.

Rational Federal Reserve

The CFA amendment also makes it impossible for the Federal Reserve to be used simply to print money on behalf of the finances of the United States government. This is because doing so would increase the debt obligations of the U.S. government, which is explicitly prohibited by the amendment. The Federal Reserve could print money to purchase private assets, much as it has done recently, arguably in violation of its original charter. However, the Federal Reserve is a quasi-private entity that must remain financially solvent. It could not print money and simply dump it on the economy.

Prior to the Great Recession, the Federal Reserve's balance sheet basically consisted of federal government treasuries in the asset column and Federal Reserve notes in the liabilities column. By incurring debt (selling treasuries) and having the Federal Reserve purchase it with printed money, the federal government profited from inflation. This is because

the federal government is effectively the first purchaser. That is, the debt that becomes monetized is incurred before the new money put into circulation by the Federal Reserve has its full inflationary effect on the economy. This is why knowledgeable economists call inflation an insidious hidden tax. The general public does not benefit from being the first to consume as a result of issuing treasuries. Instead, money held by the general public loses its value, thus inflation "taxes" away purchasing power.

The CFA amendment will put the federal government on an equal footing with the general public. Since the federal government will not be able to easily print and issue new treasuries to have them monetized by the Federal Reserve,

it will no longer be the first consumer, and so it will no longer easily profit from inflation. Thus, Congress is likely to become an inflation hawk, resistant to the Federal Reserve's tendency to print copiously during the smallest hiccup of the economy. This is a good thing because there is plenty

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of debt outstanding that the Federal Reserve can potentially monetize.

Some might be concerned that without the federal government issuing new treasuries the Federal Reserve will not be able to increase the money supply sufficiently and the economy could suffer from deflation for want of sufficient currency. First, there is little likelihood that the world will run out of U.S. treasuries sufficient to fuel money supply growth from Federal Reserve purchases for a very long time. Second, if that day of "reckoning" ever does occur, it is just the sort of issue over which the Congress can go to the states to ask permission to issue more debt. Third, deflation is not in and of itself a bad thing anyway. The U.S. experienced a period of sustained deflation during the latter part of the 19th century which was also a period of unprecedented national economic growth, not just for the United States, but for any nation of the world.

Implications for the Economy Overall

Some might be concerned that without additional debt capacity on the part of Congress and the federal government, the economy is put at risk. This concern is natural given all the recent talk about the United States government not being able to fulfill its obligations if the debt limit were not increased. It can be accurately stated, unequivocally and without hesitation, however, that the CFA amendment will NOT destabilize the U.S. or world economy for fear that the United States cannot meet its obligations.

The CFA amendment does not prevent Congress from raising taxes. If current government spending is so important in its entirety that every dime currently spent must continue to be spent, surely the American people can be persuaded to accept higher taxes. In the event that the American people cannot be persuaded to accept higher taxes, the Congress has only one other choice under the CFA amendment if it cannot persuade a majority of state legislatures to agree to the federal government undertaking more debt. Congress will have to reduce spending. This does not mean the economy will shrivel proportionally to how much federal spending is reduced. It simply means that funds previously made available to government will be made available to private enterprise to invest in productive activity.

One thing Congress has not done well for some decades

"One thing Congress has not done well for some decades now is plan."

now is plan. The CFA amendment will certainly force Congress to plan and budget more responsibly. During periods of economic plenty when demand for programs such as Medicaid and unemployment insurance is low, Congress will have an incentive to pay down the federal debt in order to leave itself some debt capacity for tougher economic times. Additionally, Congress will have to open debt capacity in order to have room to meet short-term emergencies such as natural disasters and short-term military necessities.

When the inevitable macroeconomic corrections occur, the CFA amendment does not prevent Congress from going into more debt. It just means Congress has to have planned ahead and built debt capacity within the debt limit it is authorized by the states to incur. In other words, Congress will have to discipline federal spending to play exactly the role many economists believe it should play. During times of plenty, government spending will have to be reduced, mitigating the top of the business cycle. During times of recession, government will have the debt capacity to increase spending and, at least according to Keynesian theory, mitigate the bottom of the business cycle. Thus, the CFA amendment will be a stabilizing influence, not a destabilizing one.

The Most Recent Recession

Had the CFA amendment been in place well prior to the last recession, Congress likely would have restrained spending during the good economic times, building borrowing capacity by paying down bonds. Raising taxes has not been successful in the United States in recent times due to Hauser's Law, the notion, based on historical evidence, that the United States tax system cannot collect more than 20 percent of GDP regardless of tax rates. Very simply, Hauser's Law is the result of the freedom Americans have to choose not to invest, not to earn income, and to shelter income in various legal ways. Americans also step up their illegal tax evasion schemes in times of

high marginal tax rates. The institutional structures that allow for these strategies, both legal and illegal, are not likely to be repealed or otherwise significantly changed. In essence, Americans are tolerant of only a limited level of taxation. Congress would have had no choice but to bring down total debt.

The implications for inflating the financial/housing bubbles

are easy to see. The risk surrounding Fannie Mae and Freddie Mac would have been evaluated more objectively. In so doing, the bubbles these institutions helped create would not have been so highly inflated. Even if, in this climate, the bubbles had managed to form, once they burst, there would have been borrowing capacity such that the Federal Reserve would likely not have felt compelled to intervene so heavily. The Federal Reserve's policies have been destabilizing by creating uncertainty. Interest rates are so low that potential investors are looking for riskier opportunities just to increase rates of return. At the same time, bank reserves are so high that business decision makers are concerned about the potential for future inflation. Uncertainty is the rule of the day and it has effectively frozen our economy. Many, if not most, of these problems would have been avoided with the CFA amendment in place.

The financial uncertainty has been made all the greater by the passage of the Patient Protection and Affordable Care Act (Obamacare). This law added profoundly to the risk facing the federal financial picture in addition to adding considerably to the risk of doing business and growing a business in the United States. The CFA amendment would have forced very different thinking surrounding Obamacare on the part of Congress and its financial advising arms, especially in the midst of the deepest recession in recent history.

This does not mean the federal government would not have taken positive steps in the area of health care. They just would have been different steps. None of this discussion means the federal government has no role to play in helping to stabilize the economy. It just would have taken on a different role. One example includes unemployment insurance. The benefit period for this social benefit was extended to nearly two years (99 weeks) during the recession. Economist Robert Barro estimated in 2010 that had this benefit not been extended, the unemployment rate would have been considerably lower since the policy essentially subsidized unemployment. The CFA amendment would have forced a fundamentally different financial calculation on Congress and there is a high likelihood that the benefits would not have been extended, not just due to the short-term effects on federal finances, but also because of the long-term financial

implications that the unemployment benefit extension's precedent created.

Fighting Recessions & Deficits: A Combined Strategy

In addition to steering Congress away from risk-based policy endeavors, the CFA would encourage our federal legislators to become considerably more proactive in their management of fiscal policy. They would have to respond in a more concerted fashion to changes in the business cycle.

One of the ingenious consequences of the CFA is that it would give Congress the opportunity to combine a short-term fiscal policy strategy to avoid a recession with long-term structural reforms that lead to a smaller, fiscally sustainable government with a smaller exposure to the risks explained earlier.

A simple business-cycle analysis explains how the short- and long-term strategies can be combined into one.

As is well known, the business cycle consists of three phases: the growth period when the economy is doing well; the recession when growth is slow (or negative) and unemployment is high; and the decline or recovery phase in between.

No two business cycles look exactly the same, but they do have some important basic properties in common. One of those is that when a change is on the horizon, whether a decline or a recovery, there are early indicators in the economy to tell us what is about to

happen. These indicators are always important in both fiscal and monetary policy, telling lawmakers when it is appropriate to act – or not to act – to affect the economy with policy instruments.

The academic economics literature is full of analytical arguments in favor of, but also against, the notion that government can or should try to affect the business cycle. While theory is fairly simple and upfront on this, history shows that this can be difficult in practice.

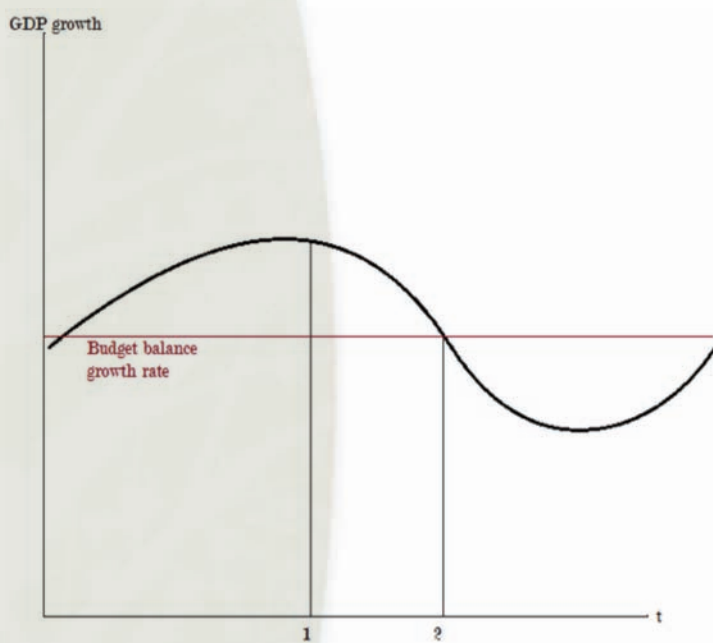
However, this does not mean that it is impossible. Failure or success in fiscal policy has more to do with the choice of instruments than the ability per se to affect the economy at

“...there are early indicators in the economy to tell us what is about to happen. These indicators are always important in both fiscal and monetary policy, telling lawmakers when it is appropriate to act – or not to act – to affect the economy with policy instruments.”

the right point in time. We know, e.g., that a well-designed tax cut can have profound effects on the economy if timed well. This is important, because under a balanced budget amendment Congress will need to pay attention to where the economy is in the business cycle. Recessions cause deficits, prompting Congress to take preemptive action.

Figure 1 illustrates two Congressional reaction points in the business cycle. Point 1 is the so called Reform Point while Point 2 is the Panic Point:

Figure 1



The reform point is where the economy is showing its first substantial signs of a downturn. Employment has stopped growing, gross private non-residential investment is flattening and residential investment is showing signs of contraction.

Knowing that the looming recession will come with a budget deficit, Congress is well advised to react at this point.

The panic point is where the budget deficit is beginning to accelerate as a result of the weakening economy. Historically, Congress has not taken any action at this point to close the budget gap; under a balanced budget amendment, however, they would be constitutionally mandated to address the deficit at this very point.

A major problem with waiting to address the deficit until it is already accelerating is that Congress will have very little time to achieve results. This is why Point 2 is called the “panic point”: there is a significant risk that Congress will

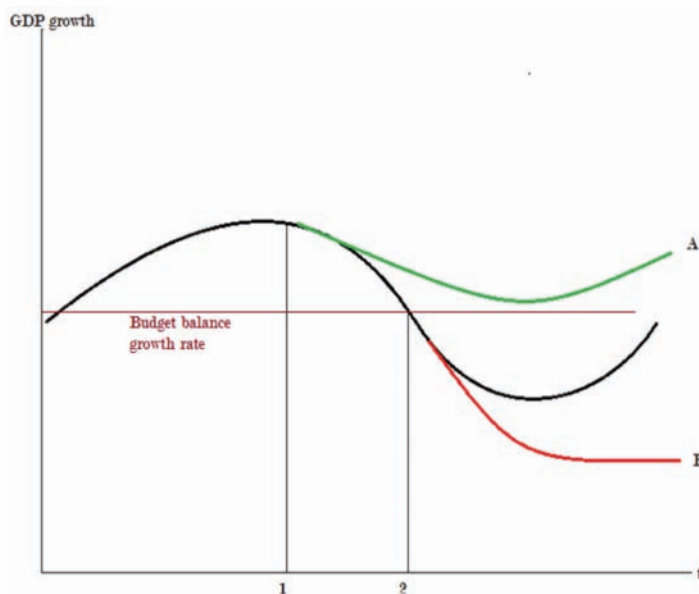
take actions that will have short-term but temporary effects on the budget balance, but destructive long-term effects on the economy itself.

Known as “austerity”, panic-driven fiscal policy measures have proven ineffective on budget deficits in many European countries. The result has instead been a perpetuation and even aggravation of the deficit.

By failing to respond at the Reform Point, Congress will create a situation for itself where it may be in a long, multi-year violation of the Balanced Budget Amendment. If, on the other hand, the knowledge of this risk motivates Congress to react at the Reform Point, the results for the American economy can be substantially better.

Figure 2 illustrates the stylized effects of Congressional response at, respectively, the Reform Point and the Panic Point:

Figure 2



Path A is the prosperity path. Suppose Congress responds at the Reform Point with a combination of tax cuts and appropriate, structurally oriented spending cuts. A structurally oriented spending cut requires removing a government promise. The tax cuts allow the private sector to keep more of its money, and the structural spending cuts remove wasteful government programs and open new sectors of the economy for private investment and entrepreneurship.

As a result of the reform package, the downturn in the economy bottoms out earlier and more shallowly than otherwise. Expanding private-sector activity then leads to an

early recovery and the economy pulls out of the economy with a smaller government, a thriving private sector and a balanced government budget.

Path B is the poverty path. This is what we can look forward to if Congress waits with responding to an economic downturn until the Panic Point. Across-the-board spending cuts combined with tax increases will drain the private sector for resources, erode the tax base, perpetuate the deficit and thus produce a result that is the exact opposite of what was intended.

Two More Reasons to Avoid the Panic Point

Recent research by economists at the International Monetary Fund establishes that panic-driven spending cuts have an even stronger negative effect on the economy than economist previously believed. The multiplier of changes to government spending is larger for spending cuts than for spending increases, an asymmetry that puzzles economists but is a warning signal for policy makers.

A probable explanation is that short-term oriented spending cuts have more immediate, depressing effects on private consumption and investments than long-term, structurally executed spending cuts. When hit by sudden changes to entitlements and government contracts-based spending, consumers and businesses experience a surge in uncertainty about the future. As a result, they cut their spending more rapidly than they otherwise would have.

This new research compels legislators to take preemptive action and seek structural reform over destructive austerity.

Another reason to avoid the Panic Point is that austerity measures almost always include tax increases. Short of a situation where conservative Republicans control both the executive and legislative branches of the federal government, it is fair to assume that any policy initiatives at the panic point would consist of some combination of spending cuts and tax increases.

It is well known that high taxes depress private-sector economic activity. What is less known is that high taxes are closely linked to government inefficiency.

According to a classic research paper by three economists at the European Central Bank, there is a significant difference in government efficiency between industrialized countries. Measured as input efficiency, or the efficiency with which

government uses a given amount of tax revenues, the ECB study finds that governments in Japan, Luxembourg and the United States are least wasteful.

By contrast, government input efficiency is lowest in three Nordic countries characterized by large welfare states, with Sweden exhibiting an efficiency rate of only 57 percent of the top three:

Table 1

		Input	12	Canada	0.75
1	Japan	1.00	13	Greece	0.73
2	Luxembourg	1.00	14	Norway	0.73
3	United States	1.00	15	Germany	0.72
4	Australia	0.99	16	Netherlands	0.72
5	Ireland	0.96	17	Austria	0.67
6	Switzerland	0.95	18	Belgium	0.66
7	Iceland	0.87	19	Italy	0.66
8	U.K.	0.84	20	France	0.64
9	New Zealand	0.83	21	Denmark	0.62
10	Spain	0.80	22	Finland	0.61
11	Portugal	0.79	23	Sweden	0.57

The numbers in Table 1 do not suggest that American and Japanese taxpayers get \$1.00 back from government for every \$1.00 they spend in taxes. Government always comes with an efficiency loss. The correct way to interpret Table 1 is instead as follows:

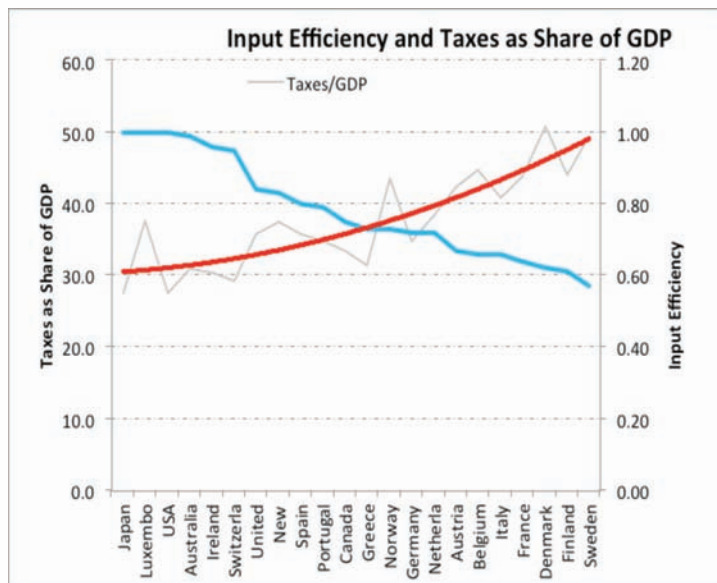
For the same amount of taxes, the Swedish public sector delivers only 57 cents worth of services and entitlements for every \$1.00 that the American public sector delivers.

“...panic-driven spending cuts have an even stronger negative effect on the economy...”

There is an important policy implication in this. The three countries at the top of the list have lower taxes than the three countries at the bottom. Does this mean that the rate of taxation on an economy has anything to do with the efficiency of how those taxes are used?

To answer this question, let us add the tax-to-GDP ratios for the countries in Table 1. These ratios are reported in Figure 3. The blue line represents the input efficiency numbers from Table 1, while the red trend line represents the trend in the tax-to-GDP ratio for the same countries. The results are striking:

Figure 3



As taxes rise, more and more of what taxpayers surrender to government is lost to inefficiencies.

Implications for Compact for America

A solution to a budget deficit that includes tax increases will inevitably have negative effects on the economy. With rising input inefficiency in government comes lower economic

activity. Money taken from the private sector, where it would have been used to the highest attainable efficiency under the pressure from the free market, produces less economic output when processed through government.

If Congress fails to respond at the Reform Point in Figure 1, and instead waits until it reaches the Panic Point, chances are that it will use tax increases in one form or another to close its budget gap. That will exacerbate government inefficiency and send the United States further to the right in Figure 3.

As this happens, increased inefficiency in government is combined with depressed growth from higher taxes. The inevitable result is an erosion of the tax base that government relied on in order to comply with the balanced budget requirement.

When the tax base erodes, government fails to achieve its revenue target for a balanced budget. Instead of eliminating the deficit, government perpetuates it by means of its own policies.

The numbers presented in Figure 3 constitute a stark warning to Congress: under the CFA proposal, our federal legislators must take proactive action as soon as they become aware of the first indicators of a looming recession. ■

Endnotes

¹ John A. Allison, *The Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope* (New York: McGraw-Hill Books, 2013).

² A recent example of the risk involved in the Obamacare reform is the decision by the U.S. Department of Health and Human Services to cap the high-risk pool program. The federal government simply cannot afford to deliver on all its promises to those with pre-existing conditions. See Washington Post, February 15, 2013: http://www.washingtonpost.com/national/health-science/2013/02/15/cb9d56ac-779c-11e2-8f84-3e4b513b1a13_print.html

³ <http://www.nea.gov/about/11Annual/2011-NEA-Annual-Report.pdf>

⁴ <http://www.heritage.org/research/reports/2005/10/the-bridge-to-nowhere-a-national-embarrassment>

⁵ <http://online.wsj.com/article/SB10001424052748704608104575217870728420184.html>

⁶ <http://online.wsj.com/article/SB10001424052748703959704575454431457720188.html>

⁷ http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2048739

⁸ <http://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf>

⁹ <http://www.ecb.int/pub/pdf/scpwps/ecbwp242.pdf>

¹⁰ Eurostat national accounts data. These numbers are from 2005 while the efficiency numbers are from 2003. In theory this creates a discrepancy for a cross-section study; in practice, the two-year difference is of negligible importance. The input efficiency numbers reflect the structure of government and of the economy, which is characterized by significant reform inertia. It is therefore a safe bet to assume that the input efficiency values for 2003 would be almost identical in 2005.