

---

# EPI Issue Brief

---

Issue Brief #103

Economic Policy Institute

January 24, 1995

## Balanced Budget Amendment Imperils Long-Term Health of U.S. Economy

*by Dean Baker*

Twelve years of staggering federal deficits during the Reagan and Bush administrations have helped create a public perception that federal spending is helplessly out of control. Today, that public sentiment is fueling the perennial drive for a balanced budget amendment, despite the fact that, except for the threat imposed by rising health care costs, the deficit is now back under control.

Unfortunately, the drive in Congress to pass a balanced budget amendment is based more on political posturing than on sound economic principles about federal spending or the financial health of the U.S. government. Rushing into such a policy without regard to the consequences will cost the country dearly in the years ahead.

### **Deficit spending is often essential to increasing demand and keeping the economy out of recession.**

When the government runs a deficit, either by increasing spending or cutting taxes (or both), it creates demand in the economy and gives people jobs. Since World War II, the government has deliberately increased its deficit during economic downturns, thereby keeping them from becoming more serious. In large part because of this policy, the slumps since World War II have been much milder than the Great Depression of the 1930s.

If the government is required to run a balanced budget, it will be prevented from playing this essential role in supporting the economy. Furthermore, since tax collections automatically fall any time the economy goes into a downturn, a balanced budget amendment will require the government to *raise* taxes or cut spending anytime the economy slows down. Such a move will virtually guarantee that recessions are far more severe in the future.

Although the proposed balanced budget amendments may allow a super majority (60%) of Congress to vote to run a deficit when economic conditions warrant, recent history provides little reason to believe that Congress will be able to operate this efficiently. Congress has often been unable to put together a simple majority—much less a super majority—when legislation was needed quickly to help the economy.

## **The federal government is in absolutely no danger of going bankrupt.**

The federal government is considered by financial markets to be one of the most secure borrowers in the world. As a result, it pays a lower rate of interest on its debt than almost any other borrower. The debt is enormous, but the economy is even larger. As long as the economy is growing relative to the size of the debt, the government can continue to borrow without any concern about harming its credit-worthiness, and the interest burden will be no greater for future generations than it is at present.

In this way, the federal government is exactly like a private corporation. Corporations borrow regularly through banks and bond sales, and most corporations will have more debt in 10 years than they do now. For most of them, this debt is acquired to finance expansion and to increase profits. Preventing them from borrowing would cripple their ability to function.

## **Deficit spending does not directly reduce private investment.**

The link between the budget deficit and private investment is weak and indirect. A deficit can reduce private investment only by raising interest rates, yet economists have not found the link between higher deficits and higher interest rates to be very strong: often when the deficit falls interest rates rise and vice-versa. Furthermore, investment does not rise much even when interest rates fall. (Demand for housing and consumer durable goods, such as cars, is far more responsive to interest rates than is demand for investment.)

However, one factor that has been shown to boost private investment is public spending on infrastructure such as airports and roads. Therefore, if spending on needed infrastructure is reduced in the drive to balance the budget, we may actually reduce private investment.

## **The vast majority of government spending goes to programs that are considered essential and enjoy overwhelming public support.**

The largest items in the budget are Social Security, Medicare, defense, and interest on the debt. By 2004 spending on health care, Social Security, defense, and interest will total approximately 75% of the budget. The remaining quarter will cover everything else the government does, such as building infrastructure, financing education, and supporting the federal court system. The programs often held up as examples of “waste” account for a tiny portion of the budget. For example, *all* spending on foreign aid comes to about 1% of the budget. Spending on AFDC (Aid to Families with Dependent Children, popu-

larly referred to as welfare) is approximately the same. Programs should always be scrutinized for waste, but a balanced budget amendment will not make our political leaders any more adept at finding waste than they are at present. Furthermore, there is not enough “waste” that could be eliminated in any case to balance the budget. This goal can be accomplished only by raising taxes, or by making substantial cuts in the programs that people consider essential.

---

***For further information on the federal budget deficit, fiscal policy, and the impact of a balanced budget amendment, see:***

Baker, Dean and Todd Schafer. 1995. *The Case for Public Investment*. Washington, D.C.: Economic Policy Institute.

“Economists Oppose Balanced Budget Amendment to the U.S. Constitution” (signed economists’ statement). Washington, D.C.: Economic Policy Institute.

Eisner, Robert. 1994. *The Misunderstood Economy: What Counts and How to Count It*. Cambridge, Mass. Harvard University Press.

Faux, Jeff, **Jared** Bernstein, and Todd Schafer. 1995. *The Bottom Line on the Balanced Budget Amendment: The Cost to States, Congressional Districts, and Individuals*. Briefing Paper. Washington, D.C.: Economic Policy Institute.

Fazzari, Steven M. 1993. *Investment and U.S. Fiscal Policy in the 1990s*. Briefing Paper. Washington, D.C.: Economic Policy Institute.

Sawicky, Max B. 1994. *Up From Deficit Reduction*. Washington, D.C.: Economic Policy Institute.