



EPI BRIEFING PAPER

ECONOMIC POLICY INSTITUTE • JUNE 22, 2011 • BRIEFING PAPER #315

WHY SPENDING CAPS ARE POOR POLICY

Understanding the costs and constraints of capping spending as a share of the economy

BY REBECCA THIESS, ANDREW FIELDHOUSE, AND ETHAN POLLACK

Congress is currently considering legislative proposals for both a federal spending cap and a balanced budget amendment (BBA). This paper examines possible implications of both the Commitment to American Prosperity (CAP) Act proposed by Sens. Bob Corker (R-Tenn.) and Claire McCaskill (D-Mo.), as well as the balanced budget amendment proposed by Sen. Orrin Hatch (R-Utah) in the Senate (and endorsed by Senate Republican leadership) and Rep. Bob Goodlatte (R-Va.) in the House.

Our analysis is based on the construction of a realistic current policy baseline, which is used to examine the full magnitude of the cuts required to meet the proposed limits.

This paper finds that the Corker-McCaskill spending cap would do the following:

- Cap annual federal outlays at 20.8% of gross domestic product by 2021, 3.5 percentage-points below the level projected under current policy.¹
- Force a cut of \$3.5 trillion to primary outlays (excluding interest) over 2013–2021, relative to our current policy baseline.
- Cut Social Security and Medicare—the largest programs by expenditure—by \$882 billion and \$692 billion, respectively, over 2013–2021, if the above cuts were made in a proportional manner.
- Reduce domestic discretionary spending by \$710 billion through 2021 (which includes a \$128-billion reduction in 2021 alone, a 26.2% cut relative to the baseline), if the scenario were such that Social Security and Medicare were exempt from cuts.

TABLE OF CONTENTS

The overall spending cap in the CAP Act	2
Exploring the fallout had this cap been in place during the Great Recession	8
A balanced budget amendment would pose a similar threat to meeting nation’s needs	9
Conclusion	10

www.epi.org

This paper also examines the effects of such a spending cap had it been in place prior to the Great Recession. Unless a supermajority in both chambers had overruled the cap, the automatic and enacted policy responses that increased spending to stabilize both aggregate demand as well as the financial sector would not have occurred, impacting the recession and financial crisis in the following ways:

- Relative to actual spending, the cap for 2009 would have required a \$424 billion spending cut.
- This federal spending reduction, at the deepest point in the recession, would have reduced economic output by 4.2%, resulted in 5 million more jobs lost, and pushed the unemployment rate up 1.6 percentage points, to 10.1%.
- By 2010, further spending cuts prompted by the downturn under the formula for the spending cap would have obstructed economic recovery and forced more unnecessary job losses.

Besides analyzing the Corker-McCaskill spending caps, this paper also briefly examines the consequences of enacting a balanced budget amendment, and finds that the cap included in the Senate Consensus Balanced Budget Amendment would:

- Cap federal spending at 18% of prior-year economic activity, effectively limiting spending to an average of 16.6% of current GDP over 2016–20; and reducing spending as a percent of GDP to 60-year lows.
- Force spending cuts of \$7 trillion over 2016–2020, the first five years the law would be in effect.

The overall spending cap in the CAP Act

The Commitment to American Prosperity Act introduced by Sens. Bob Corker and Claire McCaskill would create a hard cap on government spending. The bill would gradually reduce what the federal government is allowed to spend from an effective cap of 22.25% of GDP in 2013 to 20.8% in 2021 and 20.6% of GDP by 2022. In the event the cap was breached, the act would impose across-the-board cuts (proportionate to the share of each

spending category's increase), which could be waived only by a two-thirds supermajority vote in both the House and the Senate.

Sequestration, the technical term for the process of imposing these automatic spending cuts, would produce cuts in direct spending, security discretionary spending, and non-security discretionary spending based on the projected spending growth levels in those categories.

While these cuts would have significant negative impacts in the short run, the impacts would grow deeper over time, due to the phase-in design of the cap. The cap would require significant cuts relative to federal spending under the policies currently in place. Furthermore, the spending levels proposed under the cap are also much lower than spending under President Reagan, which averaged 22.3% of GDP across his two terms (OMB 2011a).

Capping spending at 20.6% ignores changes in federal priorities since the 1970s

Under the CAP Act, federal spending in 2022 would be the same percentage of GDP that it was, on average, from 1970–2008. Capping future spending at a historical level does not adequately capture current and future needs. For example, the U.S. population is aging, with the number of people age 65 and older (retirement age) expected to grow significantly. The ratio of retirement-age Americans to the working-age population (those ages 20–64) is currently 21.4%. By 2035, this percentage will grow to almost 36% (CBO 2010b, Figure 3-2).

Additionally, national health care expenditures are considerably higher today than over 1970–2008, and health care costs are expected to keep growing faster than the economy. Along with rising economy-wide health care costs will come rising costs for Medicare, Medicaid, the Childrens' Health Insurance Program (CHIP), and the health care exchange subsidies to be established in 2014 under the Affordable Care Act. The Congressional Budget Office projects that federal spending on health care will rise from 5.6% today to 7.7% by 2022 (when the cap proposed in the CAP Act would be fully phased in), and rise further to almost 11% by 2035 (CBO 2010b).² Finally, capping spending at average historical levels ignores the realistic costs of legislation passed over the last decade; specifically, the prescription drug benefit (Medicare Part D) enacted under President

Bush, increased spending on domestic security activities, spending on overseas contingency operations, and interest costs from a slew of tax cuts.

Federal spending in 2011 is currently projected at 24.1% of GDP (CBO 2011b). Outlays have been at around this level since 2009 largely because of automatic stabilizers and deliberate stimulus spending by the government to help boost the economy during—and in the aftermath of—the Great Recession. Outlays are projected to fall as the economy strengthens, but pulling back this economic support too rapidly could threaten the nascent recovery and even drag the country back into an economic downturn.

Spending under the levels set by the CAP Act would not be possible without large cuts to Medicare, Medicaid, Social Security, and other programs. (For an analysis of the impact of CAP Act cuts on Social Security, see “Unbalanced Budgeting: Federal Spending Cap May Endanger Social Security.”) Because Medicare and Medicaid are expected to grow significantly faster than GDP, these programs would likely need major restructuring—which could be detrimental—in order to achieve the savings required under the act.

Cuts under the CAP Act would be steep and far-reaching

The formula for the cap is based on a rolling average of GDP in previous years—the so-called “lookback GDP.”³ The legislation sets a nominal cap that is applied to the

average GDP of the first three of the preceding four fiscal years, meaning that a cap for 2013 would be determined by GDP levels from 2009–11. Applying the nominal cap to “lookback GDP” generates an effective cap for permissible spending for a given year. If the cap were enacted this year, the nominal spending cap for 2013 would be set at 25% of “lookback GDP,” which would create an effective cap of 22.25% when applied to projected GDP levels in 2013. The nominal cap would decrease to 23.63% of “lookback GDP” by 2021 and 23.46% by 2022, at which point the effective cap is expected to be 20.6% of GDP in that year.⁴ By 2021, the end of the current 10-year budget window, the effective cap would hit 20.8% of GDP, 3.5 percentage points lower than projected spending under adjusted baseline levels.

The reasons Corker and McCaskill give for pursuing this “lookback” formula are: a) to allow for cyclical changes in the economic environment to be smoothed out over any given time period; b) to account for data limitations and revisions that arise because GDP numbers are not final until three full months after the year has concluded, and; c) to allow for a permissible spending estimate to be available a year before the start date of the fiscal year at hand, which would give policymakers enough time and information to deliberate on their spending decisions (Office of Senator Bob Corker 2011).

We have analyzed cuts under the cap relative to our adjusted baseline, a plausible extension of current policy for spending and revenues (Table 1). Starting from CBO’s

TABLE 1

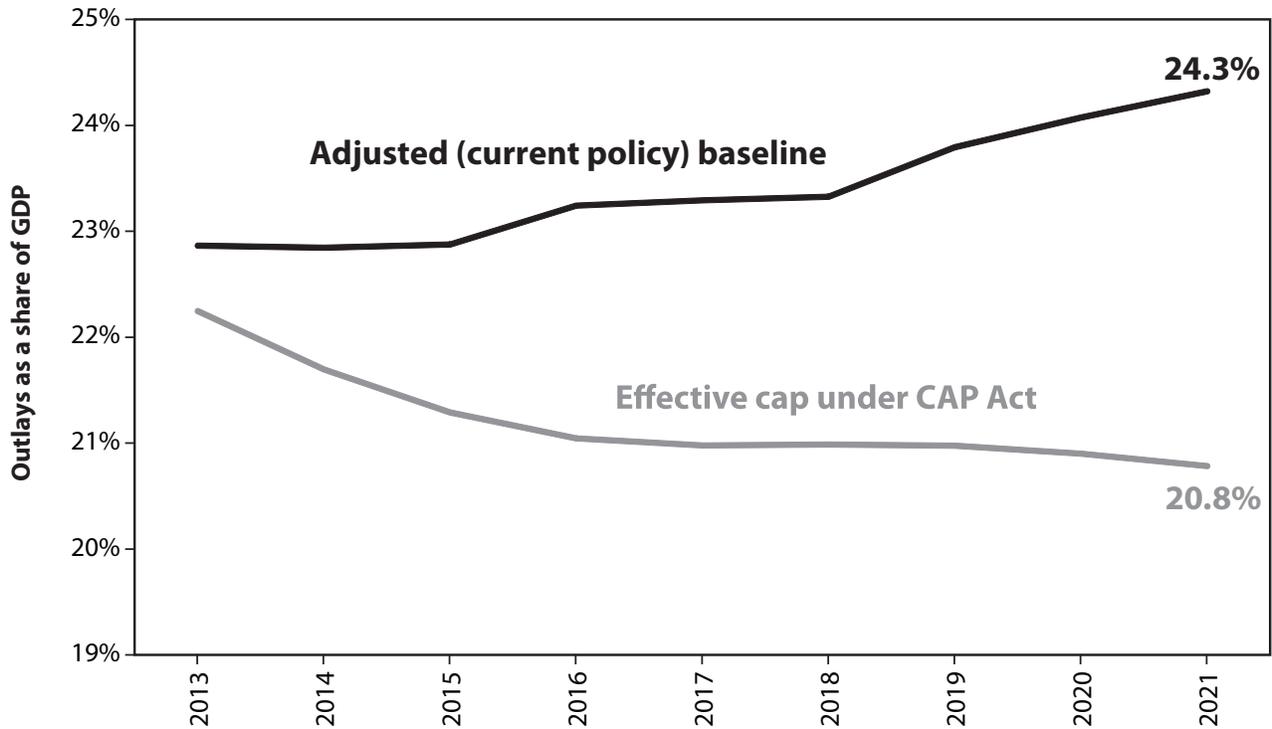
Federal spending under adjusted (current policy) baseline, in \$billions, 2011–2021

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
<i>CBO March 2011 baseline revenues</i>	\$2,230	\$2,558	\$3,087	\$3,440	\$3,642	\$3,826	\$4,071	\$4,271	\$4,483	\$4,703	\$4,951
Adjusted baseline revenues	2,230	2,534	2,788	3,021	3,194	3,366	3,594	3,775	3,962	4,154	4,370
<i>CBO March 2011 baseline outlays</i>	3,629	3,639	3,779	3,954	4,180	4,460	4,661	4,856	5,148	5,412	5,680
Adjusted baseline outlays	3,629	3,630	3,750	3,942	4,162	4,449	4,666	4,883	5,200	5,493	5,791
<i>Net interest outlays</i>	213	257	325	406	488	576	660	739	813	891	962
Primary spending	3,417	3,373	3,425	3,536	3,674	3,873	4,006	4,144	4,387	4,602	4,828

SOURCE: Author’s analysis of data from the Congressional Budget Office (CBO 2011b).

FIGURE A

Federal outlays under current policy vs. CAP Act, as a share of the economy, 2013–2021



SOURCES: Office of Senator Bob Corker 2011 (for effective cap) and author’s analysis of Congressional Budget Office data (CBO 2011b) (for adjusted baseline).

March 2011 baseline budget projections (CBO 2011b), we adjust outlays by adopting the CBO budget option drawing down the Overseas Contingency Operation (OCO) path and extending Medicare payment rates for physicians at 2011 levels rather than allow a cut to reimbursement rates scheduled under the Sustainable Growth Rate (SGR) formula (i.e., the baseline includes continuing the “doc fix”). We adjust net interest costs accordingly, adding additional interest costs resulting from permanently indexing the 2011 parameters of the Alternative Minimum Tax (AMT) for inflation, from extending all the Bush tax cuts (this extension of current tax policy increases net interest costs by nearly \$800 billion through 2021), and from extending all expiring tax provisions. We also assume that an extension of the Bush tax cuts will increase outlays through the changes in the refundable credits.

As **Figure A** shows, the cap would cut outlays dramatically by 2021, compared with baseline outlay levels (a detailed discussion of our adjusted baseline follows above). Much of the projected rise in spending under the baseline outlay scenario results from increased debt service costs, so primary spending (excluding net interest) under the cap would see increasing cuts over time. Given projected growth in health care costs and related federal spending on health care, these cuts would grow significantly deeper beyond 2021.

Table 2 shows in more detail the cuts from adjusted outlays if the cap were in place. In 2017, five years after going into effect, the cap would cut primary outlays by 10.1%, or 2.0% of GDP. By 2021, the cap would cut primary spending by \$656 billion, a 13.6% cut to primary outlays relative to baseline levels of spending, or 2.8%

TABLE 2

Cuts from adjusted outlays if cap were in place, in \$billions and as a % of GDP, 2013–2021

	Cuts in \$billions									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	
<i>Adjusted-baseline outlays</i>	\$3,749.8	\$3,942.5	\$4,162.0	\$4,448.8	\$4,666.5	\$4,883.2	\$5,200.4	\$5,493.0	\$5,790.8	
<i>Outlays permitted under cap</i>	3,648.7	3,744.2	3,873.5	4,028.1	4,202.8	4,393.8	4,584.4	4,769.2	4,948.8	
<i>Cut in total outlays under cap</i>	101.1	198.3	288.5	420.7	463.7	489.4	615.9	723.9	842.1	
<i>Cut in primary spending under cap</i>	98.5	189.2	268.5	382.9	404.7	406.9	504.3	577.5	656.5	
<i>Net interest savings under cap</i>	2.6	9.1	20.1	37.7	59.0	82.6	111.6	146.4	185.6	
<i>Percent cut to total outlays under cap</i>	2.7%	5.0%	6.9%	9.5%	9.9%	10.0%	11.8%	13.2%	14.5%	
<i>Percent cut to primary spending under cap</i>	2.9	5.3	7.3	9.9	10.1	9.8	11.5	12.5	13.6	

	Cuts as % of GDP									
	2013	2014	2015	2016	2017	2018	2019	2020	2021	
<i>Adjusted-baseline outlays</i>	22.9%	22.8%	22.9%	23.2%	23.3%	23.3%	23.8%	24.1%	24.3%	
<i>Outlays permitted under cap</i>	22.2	21.7	21.3	21.0	21.0	21.0	21.0	20.9	20.8	
<i>Cut in total outlays under cap</i>	0.6	1.1	1.6	2.2	2.3	2.3	2.8	3.2	3.5	
<i>Cut in primary spending under cap</i>	0.6	1.1	1.5	2.0	2.0	1.9	2.3	2.5	2.8	

NOTE: Figures in columns may not add perfectly due to rounding.

SOURCE: Authors' analysis of data from the Congressional Budget Office (CBO 2011b) and Office of Senator Bob Corker, 2011.

of GDP. The cut to primary spending would total \$3.5 trillion by 2021.

How would these cuts impact specific programs? A small portion of the total cut would be absorbed by net interest savings, but the vast majority of the forced cuts would come from primary spending. The legislation only specifies how cuts would be made if the permissible spending level were breached, triggering automatic cuts, but Congress could take many routes to avoid such a formulaic approach to budgeting. To analyze a range of potential impacts, we modeled several plausible scenarios of how Congress could seek compliance with the law.

The first scenario assumes that each of the three major non-interest spending categories—non-security discretionary, security discretionary, and mandatory—are cut proportionately to their share of total primary spending. The second and third scenarios make the same assumption, except that the second scenario assumes no cuts to Social Security and Medicare, and the third scenario

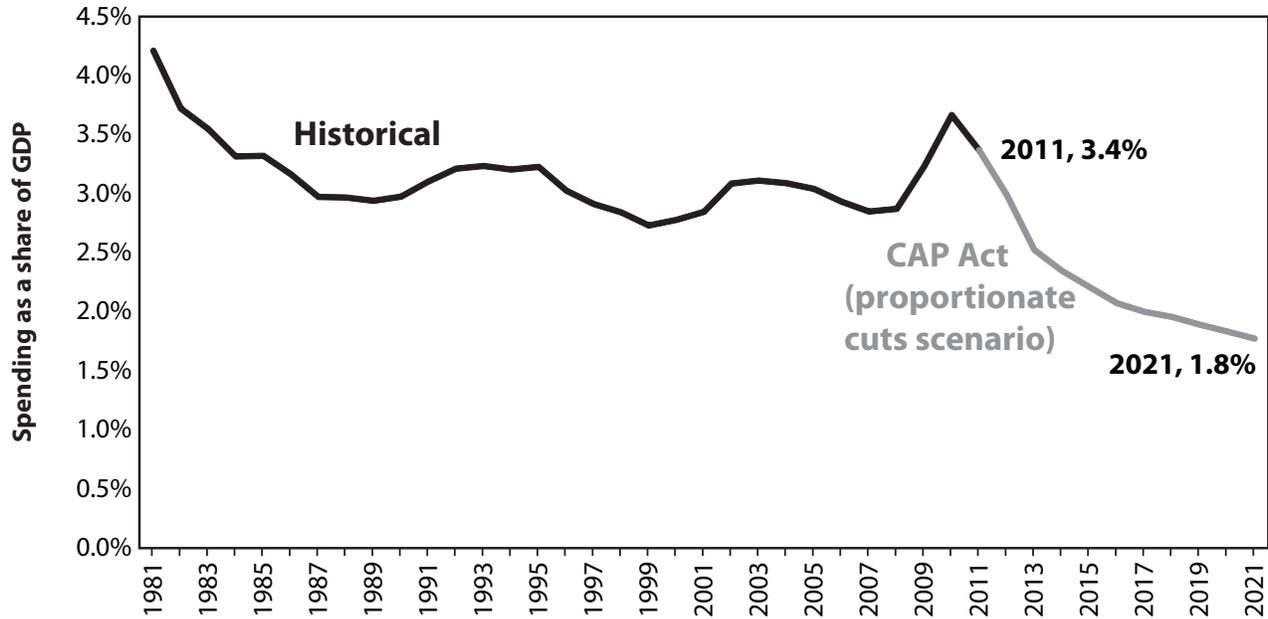
leaves discretionary security spending intact. Finally, the fourth scenario models the sequestration mechanism, which makes automatic cuts if Congress fails to reduce spending below the cap.

Scenario 1: Proportionate Cuts

Assuming proportionate cuts to the three major non-interest spending categories, the results would be huge cuts to the social safety net for seniors, children, and the disabled, as well as to public investments such as education and infrastructure. This across-the-board cut would reduce non-security discretionary spending to 1.8% of GDP in 2021, far lower than it has ever been in the last 50 years and 46% below its current share of the economy (Figure B). For a little context, this portion of the budget currently represents 3.4% of GDP, which is the same level it was during the Reagan administration. Over the last 50 years, the non-security portion of the budget averaged 3.3% of GDP.

FIGURE B

Non-security discretionary spending after CAP Act across-the-board cuts, as a share of the economy, 1981–2021



SOURCES: Authors' analysis of data from the Congressional Budget Office (CBO 2011b), Office of Management and Budget (OMB 2011b), and the Office of Senator Bob Corker (2011).

Security spending, which includes spending on defense, homeland security, veterans, nuclear weapons, and foreign affairs, would fall to 3.5% of GDP, lower than 46 of the last 50 years, and more than a third below its current, 5.7% share of the economy (**Figure C**).

The largest dollar-value cut, however, would be to the mandatory budget. This portion of the budget consists mainly of Medicare, Social Security, and Medicaid. Between 2013 and 2021, mandatory programs would be cut by \$2.3 trillion, with spending falling 13.6% below adjusted baseline levels projected for 2021. Social Security and Medicare—the largest programs within that category—would get cut by \$882 billion and \$692 billion, respectively, over that same time period. Both programs would fall as a share of the economy, even as the elderly population dependent on these programs increases by nearly 25% (SSA 2010).

For comparison, the House Republican Budget, which would start phasing in cuts immediately, would cut \$2.9

trillion from Medicare, Medicaid, and other mandatory programs through 2021. Thus cuts of a similar magnitude would be implicitly required by the Corker-McCaskill spending caps.

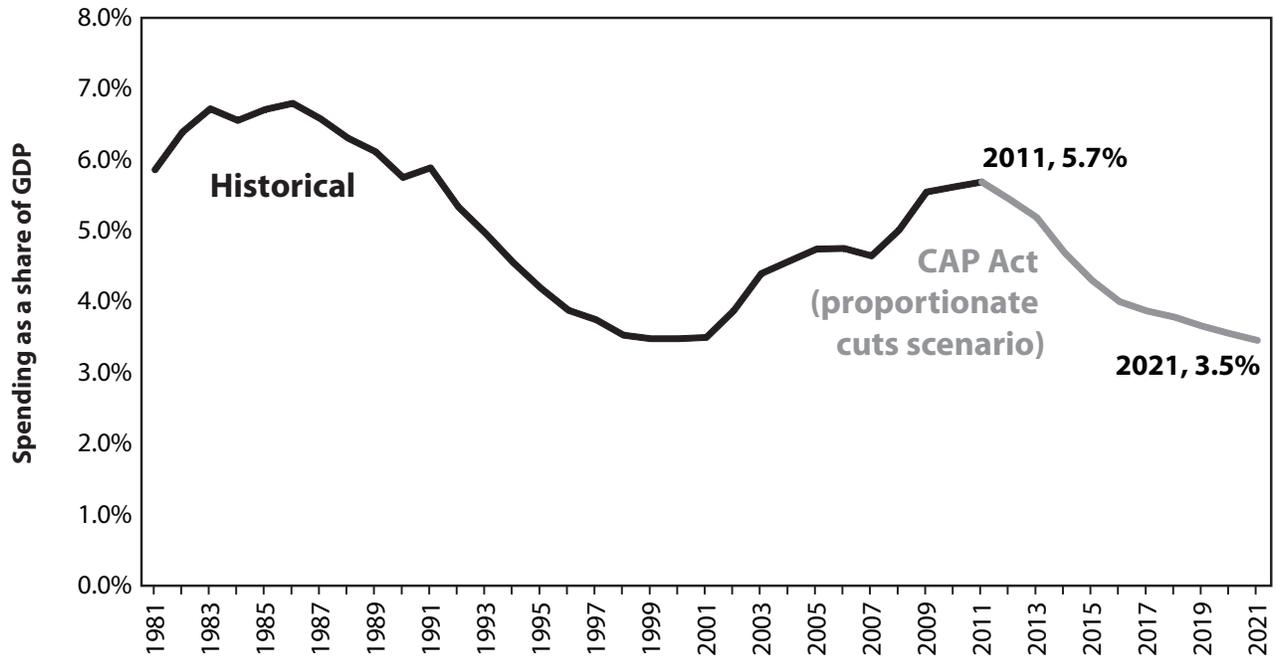
Scenario 2: Social Security and Medicare exempt

Sparing Social Security and Medicare from budget cuts would force greater cuts elsewhere in the budget.

Under this scenario, the cumulative cuts to other programs increase by 87%. Domestic discretionary spending would be cut by \$128 billion in 2021 alone, a 26.2% cut relative to the baseline. Total cuts through 2021 would be around \$710 billion. This would bring domestic discretionary down to 1.5% of GDP, more than halving spending as a share of the economy over the next decade. Security spending would be brought down to 3% of GDP, its lowest level in 50 years. And other mandatory spending—which mainly for health coverage, food assistance, and

FIGURE C

Security discretionary spending after CAP Act across-the-board cuts, as a share of the economy, 1981–2021



SOURCES: Authors' analysis of data from the Congressional Budget Office data (CBO 2011b), Office of Management and Budget Data (OMB 2011b), and the Office of Senator Bob Corker (2011).

income security for vulnerable populations; veterans benefits and services; and federal employee retirement and disability—would be cut by around \$1.4 trillion over 2013–2021. Cuts of this magnitude would likely require cutbacks that would harm vulnerable populations or other obligations to citizens, particularly veterans and civilian employees.

Scenario 3: Social Security, Medicare, and security spending exempt

In addition to protecting Social Security and Medicare from cuts, Congress could also spare security spending, which primarily consists of spending by the Department of Defense, but also includes spending on areas like border enforcement and the Veterans Administration.

Under this scenario, the domestic discretionary and other mandatory budgets would see more than a 40% cut in 2021 relative to the baseline. Domestic discretionary

spending would fall to 1.2% of GDP, around a third of its level under the Reagan administration. This cut would roughly equal the entire federal education, transportation, law enforcement, and energy budgets. Other mandatory spending would be cut by more than \$2.3 trillion over 2013–21.

Scenario 4: CAP Act automatic cuts

If Congress failed to meet the permissible spending cap, the Corker-McCaskill legislation would trigger an automatic spending reduction, which could be waived only by a two-thirds supermajority of both chambers of Congress. This sequestration mechanism would make cuts to domestic discretionary, security discretionary, and mandatory spending in proportion to their share of the total primary spending increase in that year. For example, if spending were projected to exceed the cap by \$100 billion in a given year, and if the mandatory

portion of the budget accounted for 85% of all *growth* in primary spending for that year, then this mechanism would automatically cut mandatory spending by \$85 billion to bring outlays down to within the cap.

Consequently, the areas of the budget with the fastest growth—such as health care spending—would be cut the most. The above example is approximately accurate: Mandatory spending would receive by far the most cuts, around \$3 trillion over 2013–2021. In fact, this is very close to the \$2.9 trillion mandatory spending cut in the House Republican 2012 budget resolution, relative to current law (Ryan 2011),⁵ and would require the same approach of shifting costs onto seniors, children, and the disabled.

Exploring the fallout had this cap been in place during the Great Recession

While a spending cap is problematic for a number of reasons, including the cuts mentioned above, it would be extremely detrimental under certain circumstances, notably during a time of economic downturn. Given that the U.S. economy is emerging from the worst downturn since the Great Depression, this is an especially pertinent concern. To illustrate these risks to the economy, we modeled the trajectory of the Great Recession had it come after full implementation of the Corker-McCaskill cap.

Our model assumed an identically designed bill was enacted in 1995 (the year a balanced budget amendment fell a single vote short of passing in the Senate after clearing the House of Representatives). With implementation begun in 1995, the global spending cap would have been fully in effect in 2007—the beginning of the recession as marked by the National Bureau of Economic Research.

Our model also assumed an identical initial nominal spending cap for 2007 as for the first year (2013) under the actual CAP Act today—25% of “lookback GDP,” to decrease to 23.46% of “lookback GDP” by the end of the 10-year window. In modeling this case study for a fully implemented cap, we held government spending to a “permissible spending limit” of 23.46% of lookback GDP in each fiscal year. If projected spending were to exceed the permissible spending limit for a given fiscal year, the CAP Act would require sequestration to bring projected spending

within the spending limit. Congress could override the cap and exceed the permissible spending limit only if a two-thirds supermajority in each chamber consented.

Given the voting record on recession-related legislation such as the American Recovery and Reinvestment Act, this high legislative hurdle certainly would have impeded the ability to exceed the spending cap. Neither the Emergency Economic Stabilization Act of 2008 (which authorized the Troubled Asset Relief Program) nor the American Recovery and Reinvestment Act of 2009 met this hurdle. The EESA was first rejected by the House, and then later passed 263-171, just shy of a supermajority. It passed the Senate 74-25. The 2009 Recovery Act fell short of a supermajority in each chamber, passing the House 246-183 and the Senate 60-38. Subsequently, the lower *de facto* 60-vote threshold in the Senate (resulting from ubiquitous use of the filibuster) prevented an appropriate continuation of textbook stimulus (witness the effort to block extensions of the emergency unemployment compensation program and success in clawing back the federal additional compensation program and COBRA benefits). Using these votes as a proxy, it is highly likely that the spending caps would have proven binding. For the purposes of this case study, we assume that Congress would have allowed pro-cyclical spending cuts as opposed to choosing the option of overriding sequestration orders.

So how would these spending cuts have played out and impacted the Great Recession? In 2008, the first year of the recession, the CAP Act would have required a \$61 billion cut relative to actual spending levels (OMB 2011a). Using Moody’s Analytics’ estimate that \$1 in government spending translates to \$1.40 in GDP impact (Zandi 2011), we estimate an \$86 billion (0.6%) drop in GDP, relative to actual levels. Standard macroeconomic modeling suggests that the economy would have thus consequently lost an additional 715,000 jobs in 2008.⁶ Similarly, the GDP gap (difference between potential GDP and actual GDP) would increase by 0.6 percentage points, pushing the unemployment rate up 0.2 percentage points to 5.5% in the early stages of the recession.⁷ This pro-cyclical cut would thus have clearly exacerbated the downturn.

The impact of the Great Recession on the federal budget grew exponentially between 2008 and 2009 as job losses accelerated, both in terms of deliberate policy

responses and automatic stabilizers that kicked in. The first of the Recovery Act outlays, estimated at \$114 billion, were made in 2009 (CBO 2011c). In total, CBO estimates that automatic stabilizer spending jumped from \$34 billion in 2008 to \$315 billion in 2009 (CBO 2011d). Consequently, had the CAP Act been in place, it would have required a much larger \$424 billion sequester for 2009, shrinking GDP by \$593 billion, or 4.2%. Using the same methodology, we estimate that this huge hit to aggregate demand would have resulted in an additional 5 million jobs lost. The GDP gap would have surged four percentage points to 10.1%, pushing the unemployment rate up 1.6 percentage points, to 10.1%. At this point, the economy would have been operating more than \$1.5 trillion below potential.

By 2010, the “lookback GDP” formula used by the CAP Act would start to pick up the downturn GDP, further exacerbating the pro-cyclical cuts required by the CAP Act. Calculating “lookback GDP” adjusted for the 2008 sequester, the CAP Act would have required a \$217 billion sequester in 2010, knocking off \$303 billion from GDP, or 2.1%, and decreasing employment by 2.5 million jobs. The GDP gap would have jumped 2.0 percentage points to 7.7%, and the unemployment rate would have increased 0.8 percentage points, to 10.5%.

By the current fiscal year, the “lookback GDP” formula also would have picked up the much larger economic hit in 2009, forcing a much larger cut in spending than experienced in 2010. Relative to projected spending for 2011, a sequester of \$368 billion would decrease economic activity by \$515 billion, or 3.4%, and employment would fall by 4.1 million relative to actual levels. The economy would be running 6.7% below potential (compared with a current GDP gap of 5.1%) and the unemployment rate would be pushed up to 10.9%—almost a percentage point above the actual peak of the recession in October 2009. The U.S. economy would stand roughly 3.4% below this year’s projected level of output.

The forecast for 2012 would continue to show additional cuts. The Office of Management and Budget would have to issue sequester orders for \$353 billion in the upcoming fiscal year (again relative to CBO baseline projections) and consequently unemployment would be projected closer to 9.9%.

Relative to the automatic stabilization spending and policy responses enacted over 2008–2011, spending would have been cut by nearly \$1.1 trillion. The CAP Act sequesters would have ruled out the possibility of the Recovery Act and continuations of both unemployment insurance and state fiscal relief, unless significant cuts were made elsewhere—effectively counteracting the stimulative effect of those measures. Unemployment would have averaged 1.0 percentage point higher over these years, and unemployment would be projected to remain much higher than baseline forecasts. The economy would be operating on average 2.4 percentage points further below potential output, and economic output would be projected well below current baseline forecasts.⁸ The scarring effects of a deeper recession would last generations (Irons 2009), and lower output would decimate revenue. In short, budget deficits are inevitable and desirable during recessions.

A balanced budget amendment would pose a similar threat to meeting nation’s needs

Besides the CAP Act, a number of politicians have recently voiced support for a balanced budget amendment (BBA). A BBA is not a new idea—policymakers have proposed them numerous times over the last few decades, arguing that such an amendment is necessary to force fiscal responsibility upon our government. A BBA, in principal, is a constitutional rule requiring that spending levels not exceed revenue levels.

While a BBA would force budget balance, it would have negative economic effects in both the short and the long run. Indeed, as with concerns about a global spending cap, one of the most troubling aspects of a BBA is the constraint imposed on countercyclical fiscal policy at times of economic downturn. During economic downturns, revenues fall while public expenditures automatically rise. A BBA would require the federal government to reduce its spending to match reduced revenues, or impose tax hikes in the midst of a recession, forcing a fiscal policy that would exacerbate the recession. Indeed, premature fiscal retrenchment was tried in 1937, causing a double dip in the Great Depression.

If previously in effect or if implemented today, a BBA would depress our nascent recovery. This policy would deprive government of the ability to step in and

act during a recession, that is, at a time of exceedingly low consumer and business demand. The policy would in fact force the opposite—a pullback in federal demand for goods and services. With 14 million people still unemployed, a return to prerecession unemployment rates by 2016 is unlikely absent policies that work to fill the gap in private-sector demand for goods and services. The most promising policy lever to fill this gap in the near term is expansionary fiscal policy (Bivens 2011). A BBA would restrict the government's capacity to pursue expansionary fiscal policies in times of economic crisis, and derail any recovery: For example, closing the current trillion dollar budget deficit projected for next year through any combination of spending cuts or tax increases would devastate the economic recovery.⁹

Furthermore, the BBA proposed by Senate Republican leadership this spring goes beyond requiring spending in line with revenues. The Consensus Balanced Budget Amendment, authored by Senator Orin Hatch (R-Utah), would also cap spending at 18% of GDP; require a supermajority vote to pass any tax increases; and require a supermajority vote to raise the debt limit (Consensus Balanced Budget Amendment 2011). The Consensus BBA would lower parliamentary hurdles set for times of war and military conflict, *but not recessions*.

The 18% spending cap would take effect in the fifth fiscal year after ratification, meaning that if it were ratified immediately, it would go into effect in FY 2016. Though the nominal spending cap for a given year would be 18% of GDP under the BBA, the effective cap would actually be around 16.6%, because although GDP rises over time, the cap in a given year is applied to GDP from prior years (for a full explanation, see Fieldhouse 2011a and Bartlett 2011). Outlays have not been as low as 16.6% since the 1950s, before the implementation of the modern social safety net as we know it. Relative to the adjusted current policy baseline, this cap would force spending cuts of \$1.25 trillion in 2016 alone. Over the five years from 2016 to 2020, the cap could force spending cuts of \$7 trillion relative to the adjusted baseline.

Along with the Senate BBA, the House has introduced a version that is quite similar (Fieldhouse 2011b). Sponsored by Rep. Bob Goodlatte (R-Va.), H.J. Res. 1

would limit federal spending to 18% of GDP and require a two-thirds supermajority vote in Congress to waive this limit. Because this legislation caps spending (excluding interest payments) at 18% of GDP for the *current* fiscal year, budgets would be drafted based on projected GDP. This would politicize the CBO's economic projections and also force deep cuts if those projections were too high, for instance at the onset of a recession. This design would also leave open the door for costly tax cuts, which would further harm economic health and shrink revenue levels. Politicians who support such amendments support levels of spending that would require the dismantling of the safety net as we know it.

Conclusion

The debt ceiling must be lifted by August 2 to avoid an unprecedented default by the U.S. government, according to Treasury Secretary Timothy Geithner. Until then, the fight over the debt ceiling will heat up, with demands from many members of Congress to attach to the debt ceiling increase a spending cap, a balanced budget amendment, a debt or deficit trigger, or similar legislation.

Creating arbitrary caps on spending levels fails to take into account the cuts those levels would force, and the unintended consequences of those cuts on Americans. While policymakers who want to push through such bills claim to care about making hard choices, these bills do anything but. Both the global spending cap and the proposed balanced budget amendments would force spending cuts and leave revenue solutions completely off the table: by offering a ceiling on outlays as opposed to a floor on revenues (in the case of the spending cap) and by requiring a supermajority vote to pass any tax increases (in the case of the BBAs). Those who are seriously concerned with long-term deficit reduction know that revenues must be considered, as well as spending reductions.

A responsible budget picture can be achieved without an amendment and without an overall spending cap—both tools which obscure the truly difficult choices we face ahead. These measures ignore the changing needs of our economy, and threaten our ability to respond when the economic circumstances call for action.

Endnotes

1. The adjusted current policy baseline adjusts the CBO's March 2011 current law baseline to prevent a scheduled reduction in Medicare physician payments under the Sustainable Growth Rate (SGR) formula (i.e., maintaining the "doc fix"), index the 2011 parameters of the alternative minimum tax (AMT) for inflation, extend all of the individual income and estate and gift tax cuts scheduled to expire on December 31, 2012, and adopt overseas continuing operations (OCO) funding levels assumed in the president's 2012 budget request.
2. This assumes The Alternative Fiscal Scenario, in CBO's Long-Term Budget Outlook.
3. The one-pager on the CAP Act (Office of Bob Corker 2011) includes the following explanation: "The amount of spending allowed in any given year is a function of two things: a "lookback GDP" and a "nominal spending cap" expressed as a percentage of GDP. The lookback GDP is the average GDP of the first three of the preceding four years – i.e., the lookback GDP for 2013 would be the average GDP of 2009, 2010, and 2011 as determined by OMB (Office of Management and Budget). To determine the amount of permissible spending, the lookback GDP is multiplied by the nominal spending cap. In 2013, the CAP Act permits spending amounting to a nominal spending cap of 25% of lookback GDP. It is important to note that the nominal spending cap percentage will be higher than the actual percentage of GDP spent (the 'effective cap') because GDP in the current year will be higher than the lookback GDP barring an economic catastrophe. For example, 25% of the lookback GDP for 2009/10/11 results in an effective spending cap of 22.25% of GDP in 2013."
4. Analysis in this paper was conducted over a nine-year time period of 2013–2021 because sufficient CBO budget data to accurately portray the effect of the CAP Act in 2022 was unavailable.
5. The House Republican 2012 budget resolution would require a much larger \$4.3 trillion mandatory spending cut relative to the president's budget request (perhaps a better reflection of current policy than the CBO baseline), largely because the president's budget maintains the "doc fix," increases mandatory outlays by expanding refundable tax credits, and shifts transportation spending (slated for cuts under the Republican budget) to the mandatory side (Ryan 2011).
6. Specifically, we assume a 1% reduction in gross domestic product corresponds with 1.2 million full-time nonfarm payroll job losses. This is consistent with CBO estimates of the impact of the 2009 Recovery Act and private sector forecasts.
7. The change in the unemployment rate is modeled using Okun's rule of thumb. Specifically, the projected increase reflects the difference between the actual GDP gap and projected GDP gap with Corker-McCaskill divided by 2.5. This is meant as a conservative estimate, assuming the labor market is relatively unresponsive to growth.
8. These are static estimates in the sense that decreased economic activity is not assumed to have reduced revenue (and thus increase debt service) and policymakers are not assumed to have enacted additional tax cuts to cushion the fall in demand. Policymakers would likely have resorted to a second-best approach of using massive tax cuts as stimulus, but a wide range of private forecasters and the CBO agree that tax stimulus yields a much lower bang-per-buck than government spending (Zandi 2011, CBO 2010a). Less efficient policy responses and a substantially weaker

economy (possibly still in recession) would also exacerbate the state of public finances. The federal budget would have run smaller deficits over 2008–11, decreasing aggregate demand, but much of the deficit reduction associated with spending cuts would have been offset by decreased revenue from the additional lost economic activity. Every dollar increase in actual GDP relative to potential GDP is associated with roughly a \$0.37 improvement in the budget deficit (Bivens and Edwards 2010). Furthermore, should the Troubled Asset Relief Program not have been enacted because of global spending caps, the financial crisis likely would have played out differently, with higher interest-rate spreads, lower asset-price valuations, more bank failures, and a different (hopefully more aggressive) policy role played by the Federal Reserve. These counterfactuals are well beyond the scope of this paper. Blinder and Zandi (2010), however, estimate that without the combination of fiscal, monetary, and direct financial sector support, the economy would have experienced outright deflation in 2010 and the unemployment rate would have breached 11.5%.

9. The budget deficit for FY2012 is projected at \$1.081 trillion (6.9% GDP) under the CBO baseline and \$1.164 trillion (7.4% of GDP) under the president's budget request (CBO 2011b).

References

- Bartlett, Bruce. 2011. "Dopiest Constitutional Amendment of All Time?" *Capital Gains and Games* (blog), March 31; <http://capitalgainsandgames.com/blog/bruce-bartlett/2194/dopiest-constitutional-amendment-all-time>
- Bivens, Josh. 2011. "Abandoning What Works (and most other things, too)." Washington, D.C.: Economic Policy Institute, Briefing Paper #304, April 6. http://epi.3cdn.net/ec12c2ff3297c3785e_rkm6bh919.pdf
- Bivens, Josh and Kathryn Edwards. 2010. "Cheaper Than You Think—Why Smart Efforts to Spur Jobs Cost Less Than Advertised." Washington, D.C.: Economic Policy Institute, Policy memorandum #165, May 18. <http://www.epi.org/publications/entry/pm165/>
- Blinder, Alan and Mark Zandi 2010. "How the Great Recession Was Brought to an End." July 27. <http://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf>
- Congressional Budget Office (CBO). 2011a. "Long-Term Analysis of a Budget Proposal by Chairman Ryan," Washington, D.C.: CBO, April 5. http://www.cbo.gov/ftpdocs/121xx/doc12128/04-05-Ryan_Letter.pdf
- Congressional Budget Office (CBO). 2011b. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2012." Washington, D.C.: CBO, April 15. <http://www.cbo.gov/ftpdocs/121xx/doc12130/04-15-AnalysisPresidentsBudget.pdf>
- Congressional Budget Office (CBO). 2011c. "Budget and Economic Outlook: Fiscal Years 2011 through 2021." Washington, D.C.: CBO, January 26. <http://www.cbo.gov/doc.cfm?index=12039>

Congressional Budget Office (CBO). 2011d. "The Effects of Automatic Stabilizers on the Federal Budget." Washington, D.C.: CBO. April 21. http://www.cbo.gov/ftpdocs/121xx/doc12129/04_21_AutomaticStabilizers.pdf

Congressional Budget Office (CBO). 2010a. "Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output From July 2010 Through September 2010." Washington, D.C.: CBO. November. <http://www.cbo.gov/ftpdocs/119xx/doc11975/11-24-ARRA.pdf>

Congressional Budget Office (CBO). 2010b. "Long-Term Budget Outlook," Washington, D.C.: CBO. June.

"Consensus Balanced Budget Amendment," 2011. Senate Budget Committee Minority website, <http://budget.senate.gov/republican/analysis/2011/2011-04-01BalancedBudget.pdf>

Committee on the Budget, Chairman Paul Ryan of Wisconsin (Ryan). 2011. "The Path to Prosperity: Fiscal Year 2012 Budget Resolution." Washington, D.C.: United States House of Representatives: <http://budget.house.gov/UploadedFiles/PathToProsperityFY2012.pdf>

Department of the Treasury, 2011. "Debt Limit: Myth v. Fact." Washington, D.C., <http://www.treasury.gov/initiatives/Documents/Debt%20Limit%20Myth%20v%20Fact%20FINAL.pdf>

Fieldhouse, Andrew. 2011a. "An 18% spending cap is not just bad policy, it's simply not feasible." Economic Policy Institute commentary. Washington, D.C.: EPI, March 31; http://www.epi.org/analysis_and_opinion/entry/an_18_spending_cap_is_not_just_bad_policy_its_simply_not_feasible/

Fieldhouse, Andrew. 2011b. "House 18% spending cap is as bad and infeasible a policy as the Senate's." Economic Policy Institute commentary, Washington, D.C.: EPI, June 3; http://www.epi.org/analysis_and_opinion/entry/house_18_spending_cap_is_as_bad_and_infeasible_a_policy_as_the_senates/

Irons, John. 2009. "Economic scarring: The long-term impacts of the recession." Washington, D.C.: Economic Policy Institute, Briefing paper #243, September 30. <http://www.epi.org/publications/entry/bp243/>

Office of Management and Budget (OMB). 2011a. "Table 1.1—Summary of Receipts, Outlays, and Surpluses or Deficits (-): 1789–2016." Historical Tables. Washington, D.C.: Office of Management and Budget. <http://www.whitehouse.gov/omb/budget/Historicals/>

Office of Management and Budget (OMB). 2011b. Fiscal Year 2012 Budget, Supplemental Materials. Public Budget Database, Outlays. <http://www.whitehouse.gov/omb/budget/Supplemental/>

Office of Senator Bob Corker. 2011. "Commitment to American Prosperity (CAP) Act." Washington, D.C.: United States Senate, February 2. http://corker.senate.gov/public/?a=Files.Serve&File_id=af2cc42b-7f97-4ce0-9e42-e036263123e7

Ryan, Paul. 2011. "The Path to Prosperity," Washington, D.C.: United States House of Representatives, April. <http://budget.house.gov/UploadedFiles/PathToProsperityFY2012.pdf>

Social Security Administration (SSA). 2010. "The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds" (2010 OASDI Trustees Report), Table IV.B2. "Covered Workers and Beneficiaries, Calendar Years 1945-2085"; <http://www.ssa.gov/oact/TR/2010/lr4b2.html>

Zandi, Mark. 2011. "At Last, the U.S. Begins a Serious Fiscal Debate." West Chester, Penn.: Moody's Analytics, April 14. http://www.economy.com/dismal/article_free.asp?cid=198972&tid=F0851CC1-F571-48DE-A136-B2F-622EF6FA4