Unbalanced Amendment

By Alan Reynolds

"...UM... DR. DOLE?...UM, SIR, I THINK BUSINESS WOULD PICK UP IF WE JUST STUCK TO REGULAR SURGERY..."

HENRY PAYNE

Balanced Budget Amendment, R.I.P.

AT THE END OF 1931, President Herbert Hoover asked for a temporary tax increase, jacking income tax rates back up to levels not seen since the previous depression of 1920–21 (when there was also an emergency tariff increase, as in 1930). "Nothing is more important than balancing the budget," reasoned President Hoover. It was, he said, "indispensable to the restoration of confidence and to the very start of economic recovery....We cannot maintain public confidence nor stability of the Federal Government without undertaking some temporary tax increases."

In June 1932, Congress increased the top tax rate to 63 percent at an income of $1 million, up from the previous maximum of 25 percent at $100,000. The bottom tax rate rose to 4 percent from 1.1 percent. The Treasury Department promised that the revenue gained from hiking tax rates would result in a balanced budget. And that, Hoover guaranteed, would restore confidence in financial markets and thus ensure economic recovery.

The relevance of the 1932 experience to today's ongoing debate over the Balanced Budget Amendment goes beyond the obvious point that it is foolish to raise tax rates during a depression. The important lesson is that, then as now, Congress and the president swore by "static" revenue estimates. If the proposed amendment ever comes to pass, it will inevitably promote higher tax rates, not less spending. The amendment's focus on short-term budget estimates tilts the odds away from big spending cuts—which rarely can be done quickly—in favor of an endless series of seemingly small tax increases. Indeed, the Balanced Budget Amendment could scarcely be better designed to encourage an extremely myopic focus on a "quick fix" for next year's budget. That means delegating enormous authority to bookkeeping bureaucrats in charge of revenue estimates.

Consider this: If the Balanced Budget Amendment had been in place in 1932, the tax increase enacted at that time would have been in perfect conformity with law. But there is nothing in the amendment that requires that the budget *ever* has to be balanced. All it requires is that next year's *estimated* revenue equal next year's *estimated* spending. The 1932 tax increase met that criterion completely. Yet tripling tax rates did not result in a balanced budget.

TO THE CONTRARY, REVENUE FROM THE individual income tax dropped from $1.1 billion in 1930 to $834 million in 1931, $427 million in 1932, and $353 million in 1933. The drop in revenue could, of course, be blamed on the collapse of the economy. But that begs the question of the extent to which the Depression was at least aggravated by higher tax rates and tariffs.

At the end of 1933, President Hoover complained that "the increases in revenues enacted at the last session had not had the results hoped for," so he asked Congress to enact a national sales tax. "The time has come when, if the Government is to have an adequate basis of revenue to assure a balanced budget,...excise taxes should be extended to cover practically all manufacturers at a uniform rate, except necessary food and possibly some grades of clothing," said Hoover.

"Some assured me that no man could propose increased taxes in the United States to balance the budget in the midst of a depression and survive an election," Hoover remarked in an October 1932 campaign speech. He was genuinely surprised later, when the voters did not appreciate his manly display of "fiscal responsibility."

Suppose, for the sake of argument, that Hoover had managed to balance the budget, or that the current Congress reduces the deficit to zero in, say, the year 2002 (the target year mentioned in the proposed legislation). What happens next? Sweden had a balanced budget from 1987 to 1991. So did Britain from 1988 to 1990, and Mexico from 1990 to 1994. Even with balanced budgets, however, inflation and interest rates in those countries were not nearly as low as in the United States. Sweden and Mexico have since experienced major currency crises, and budget deficits in all three countries soon blew up again.

Minimizing government borrowing is not a unwise goal, but it is not sufficient to ensure economic success. And without economic success, a balanced budget in 2002 would soon prove as ephemeral in the United States as it has been in Sweden, Britain, and Mexico.

The economic arguments for a permanent prohibition on federal borrowing are far too dubious to justify enshrining conservative Keynesianism in the Constitution. Devotees of a balanced federal budget claim, for example, that the federal government should have to live within its annual income, "just like American families and businesses do." That's a good soundbite, but a shaky analogy. Families, businesses, and state and city governments borrow about half a trillion dollars a year. If there were no borrowers, there could be no lenders (i.e., savers).

AMENDMENT BACKERS ALSO SAY THAT failure to balance the budget will impose a heavy burden on our children and grandchildren. Actually, the debt-service burden will neither increase nor decrease very much unless the government actually *retires* debt (for instance, by auctioning off the Presidio of San Francisco and other federal property). The Congressional Budget Office estimates that if Congress did nothing at all to reduce "current services" deficits, the cost of paying interest on the national debt would rise from 3.3 percent in 1995 to 3.4 percent of GDP by 2002. That is a lot of money, almost as much as projected Medicare spending.

But future taxpayers will also acquire some federal assets to go with the liabilities, including military equipment that makes it easier to cut future defense spending, and a lot of federal property that could be sold. Major federal outlays and grants for physical capital, such as highways and prisons, were $119.2 billion in 1994, $65.6 billion of which was for Defense Department buildings and equipment. Classifying research, education, and training as investments lifts the total to $223.2 billion. There is plenty of pork in these figures, of course, as well as equipment for enterprises such as the TVA that should be privatized. But federal assets nonetheless have some value.

Moreover, there are many ways of putting burdens on future generations that would not show up in the budget right away, such as unfunded promises to pay pensions, or federal insurance and guaranteed loan schemes. In any case, adding new or higher taxes to balance the budget is doing no favor to the young or unborn. Higher tax rates would burden future generations too—and do so in a more immutable way than borrowing. Hoover's temporary tax rates of 1932 were not significantly reduced until 1965 (and then only for a few years).

Another rationale for the deficit fetish is the familiar "confidence" game of

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Herbert Hoover, which has been subsequently updated by such people as Reagan-era Budget Director David Stockman and current Fed Chairman Alan Greenspan. A balanced budget, goes this line of thought, would restore confidence in financial markets and thus lower interest rates (yields) on long-term bonds. Yet interest rates are set on world markets, varying mainly with expected exchange rates.

There is no connection between deficits and interest rates in U.S. experience, or across countries. For instance, bond yields rose dramatically from 1955 to 1981 (when deficits were small), fell from 1983 to 1992 (when deficits were large), then rose again in 1994 (as the deficit came down). Total government borrowing in the United States today is no larger than it is in Japan (1.8 percent of GDP), and lower than in Germany (2.4 percent). Interest rates have been lower in Japan and Germany than in the United States because their currencies have been more trustworthy.

The Clinton administration argues that higher tax rates on "the rich" would raise overall national saving by reducing the deficit. That assumes that 1) higher tax rates would result in more revenue, and 2) private savings would not be reduced. Both assumptions have proved false. Since the United States increased marginal tax rates in 1990 and 1993, revenue from the individual income tax fell from 8.6 percent of GDP in 1989 to 8.2 percent in 1994 (despite a one-time windfall in April 1994 from retroactive taxes). Meanwhile, personal savings fell by nearly $44 billion from 1992 to 1994—the first significant drop since 1987, when Individual Retirement Accounts were curbed and the capital gains tax increased.

IT IS UNFASHIONABLE TO SAY SO, BUT IT makes sense for governments to finance capital investments with debt, because infrastructure yields benefits over decades. It also makes sense to borrow during recessions, because raising tax rates in slumps and lowering them in booms only makes the economy more unstable. Households and firms, after all, tend to defer income-producing activities when the economy is weak and tax rates are high.

When people say they want the government to live within its means, they really mean within *their* budgets as taxpayers—don't spend more than we can afford. "Deficit spending" is a metaphor for excess spending, for a government that costs too much, delivers too little to those who pay the bills, and sends too many checks to people who neither work, save, support their own children, nor plant crops.

Unfortunately, the Balanced Budget

Amendment says nothing about how much the government can take from Jones and give to Smith. It does not constrain federal spending in any respect. Instead, it focuses entirely on *how* the spending is financed—by borrowing or taxing—and is silent on whether cutting spending or increasing taxes is the better policy.

But higher tax rates have quite different effects on the economy than does lower spending. Cutting federal purchases can free up scarce labor and capital that the private sector needs to keep expanding. Cutting transfer payments can improve incentives to work, save, support your own children, or plant crops.

Far from being equivalent to such spending restraint, higher tax rates would have, and are having, the exact opposite impact. For instance, growth in the number of job seekers has been very slow since the tax hikes of 1990–93, and personal savings have fallen. Reasonably decent economic growth may not be a sufficient condition to minimize deficits, but it is a necessary one.

Remember, the Balanced Budget Amendment does not ever require that the actual budget be balanced. It only requires that next year's budget *estimates* be balanced—that *estimated* revenue equal *estimated* spending. Because that requirement makes no distinction between restraining federal spending and raising tax rates, it encourages the *illusion* that higher tax rates are the politically easy way out of any future budget squeeze.

On paper, it is always easy to balance next year's budget the way that Herbert Hoover did in 1932: Keep raising tax rates and assume this has no bad effects at all on the economy or on tax avoidance. This is, in fact, the way revenue estimates are prepared. And estimates are all that are required to comply with the amendment.

Because the amendment covers only the immediate future—next year—it virtually mandates a short-term approach that continually neglects festering long-term problems, such as the looming scarcity of younger workers to finance Social Security and Medicare for retiring baby boomers. Faced with a major crisis in next year's budget, it would be literally impossible to turn big spending programs around quickly enough to meet the deadline. That means suicidal, Hoover-esque tax increases would often be the only apparent solution available.

BIG SPENDING PROGRAMS ALSO HAVE huge, well-organized interest groups to fight cuts. Tax increases, by contrast, can target different small groups each year—picking us off one by one. Look at the way the 1993 tax hikes were defended on the grounds that not many votes were involved, just a small percentage of "rich" families, or small businesses, or Social Security recipients.

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Indeed, even if the requirement of a supermajority to enact higher tax rates had not been scrapped, effective tax rates could still ratchet up, year after year. How? Through such devious devices as raising the amount of income subject to payroll taxes, lowering the amount of income at which Social Security benefits are taxed, lowering income caps for tax deductions or credits, and stopping the indexing of tax thresholds and letting inflation push more and more families into the new 36–40 percent tax brackets. Every one of these tricks was employed in 1993, but there is ample room for more of such mischief.

If the Balanced Budget Amendment were in force, it is easy to envision a long series of budget crises in which 1932-style "emergency" tax increases will be repeatedly enacted, always with the promise of balancing next year's budget. Yet the deficits nonetheless will get worse, not better, as the increasingly onerous tax burden causes chronic economic stagnation and wholesale tax evasion.

This is exactly what happened in Canada. A surtax on higher incomes in 1990 and a new 7-percent national sales tax in 1991 left tax revenues lower at the end of 1994 than they had been in early 1990—even in shrunken Canadian dollars.

The United States has seen similar fallout on the state level. In New Jersey, former Gov. Jim Florio thought he had raised taxes by $2.8 billion a year in 1990, taking the pressure off for spending cuts, but revenue actually fell. Gov. Pete Wilson of California likewise attempted to "raise taxes" $7–8 billion in 1991, but revenue is lower now than it was then. All that happened after New Jersey's and California's tax hikes is that two of the strongest economies in the nation became two of the weakest. A panicky pursuit of balance at the federal level, relying on phony estimates of revenue from higher tax rates, would prove equally counterproductive.

Under the amendment, with its shortsighted focus on next year's *estimated* deficit, Congress would be hostage to the typically deceptive *estimates* of lavish revenues from boosting tax rates and exaggerated losses from tax cuts. Far from promoting smaller government, the amendment would be most useful to pols who hope to block constructive tax reforms, to play Robin Hood with the tax code, and to thwart any serious efforts to curb the growth of federal spending. Let the Balanced Budget Amendment, and Herbert Hoover, rest in peace.

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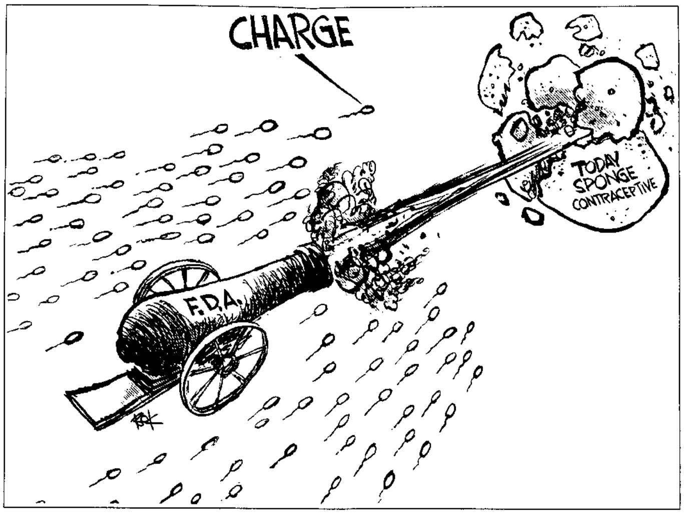
Sponge Bath

By Michael Fumento

How the FDA squeezes women's choices



CHIP BOK

THREE YEARS AGO, WOMen saw the Food and Drug Administration remove their choice in types of breast implants. Now David Kessler's agency has reduced their options in yet another area. In fairness to the FDA, the agency did not *demand* the removal of the Today Sponge contraceptive from the market. It just made it inevitable. Although a remaining few may be on store shelves, the manufacturer officially stopped producing the sponge on January 10, 1995.

Manufactured by Whitehall-Robins Healthcare, the Today Sponge was unique because it could be inserted up to 24 hours before sex and could be used for more than one act of intercourse. It was available without a prescription and, unlike male or female condoms, it didn't interfere with sensation.

The Today Sponge was popular—since its introduction in 1983, about 400,000 women have used the sponge—and was often used as an interim method while beginning use of the birth control pill. It also provided some protection against the spread of sexually transmitted diseases.

To be sure, as a contraceptive, Today's failure rate was relatively high, but the FDA considered the sponge both safe and effective. It was certainly a lot more effective than using nothing, which may often be the alternative now that it's gone.

Today's fate was sealed when FDA inspectors found that water in the sole plant that produced the sponge contained bacteria. There's no evidence that the bacteria ever contaminated the sponge, admits FDA spokesman Don McLearn. That's why the agency never *ordered* the product off the market. In fact, the FDA eschews responsibility for pulling the product off drugstore shelves. "They [Whitehall-Robins] have made the corporate decision to close this plant down," McLearn emphasizes.

Ah, but the FDA *had* let Whitehall-Robins know that the bacteria situation was intolerable—and the agency doesn't just make suggestions. Explains Whitehall-Robins spokesperson Ann Brice, "We tried diligently to improve [the situation] and did. [But] if we would have changed our manufacturing processes further, it would have required additional approval by the FDA."

Indeed, the only way to meet the standards would have been to set up the process at a new plant. But again, FDA regulations stood in the way. As FDA spokesman McLearn points out, if you make "a product at a new site, it's a totally new product." It simply doesn't matter if the product made at the new site is identical to the one made at the old site (as would have been the case with Today). To the FDA, "new site" equals "new product." And *that* means the dreaded "NDA," or new drug application, the tortuous approval process for which the agency has become infamous.

The "new place, new product" rule is "an anachronism," says Henry Miller, former director of the FDA's Office of Biotechnology and a visiting fellow at the Hoover Institution in Palo Alto, California. "You can now introduce stringent release specifications and look at whether products meet those specifications, as you do for a drug."

No matter: For the FDA, rules are rules. Faced with a reenactment of such a costly and lengthy procedure, Whitehall-Robins chose to throw in the sponge.

NOT SURPRISINGLY, THE PRESSURES THAT led to that decision outraged people involved in the effort to prevent unplanned pregnancies. Dr. Robert Hatcher, Emory University professor of gynecology and obstetrics and editor of *Contraceptive Technology,* has nothing but scornful words for the FDA's handling of contraceptives. "The delays and costs on companies are unconscionable," he told the *Atlanta Journal and Constitution.* "As far as I'm concerned, the Food and Drug Administration is Disneyland. It's a mess."

"The point is that women need different methods of birth control throughout their reproductive lifetime," says Susan Tew of the Alan Guttmacher Institute, a Manhattan-based nonprofit organization engaged in research and education on contraception and abortion. "Women spend three-quarters of their reproductive lifetime trying to avoid unplanned pregnancy. Any method found safe and effective should be available to U.S. women."

Although it may look as though we're in the midst of a "second contraceptive