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Federal Spending as an Economic Stabilizer

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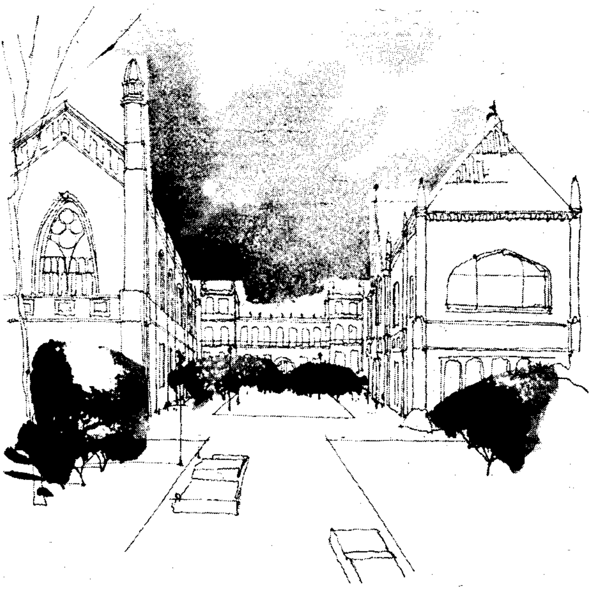

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IN THIS PAPER, I propose to re-examine an old yet perennially new question: To what extent can and should federal expenditures be manipulated for the purpose of achieving more stable economic conditions? Put another way: Has federal spending policy been an effective short-run economic stimulant in periods of economic slack and a depressant in periods of inflationary pressure? Could it serve more effectively in the future than in the past?

These are controversial questions about which many people have strong opinions. Even professional economists are divided because these questions do not have simple technical answers and because economists, like other humans, differ in their values and their vested interests-intellectual and political,

Only a few years ago, many people believed that economic stability could be achieved quite simply by compensatory government finance. In recessions, it was argued, the government should increase its expenditures to fill the deflationary gap caused by deficient private demand; conversely, during periods of inflationary exuberance, the government should curb its spending to bring excess total demand down to a noninflationary, full-employment level.

Some people still argue that way.

But the simple spigot theory has lost its charm. Technical difficulties, problems of implementation, and popular notions about fiscal proprieties were too much for it. The debate has moved on to a more sophisticated plane. Since government spending is only one of several policy variables, and not the easiest to manipulate, the debate now centers on the "appropriate fiscal-monetary mix." How should spending policies be fitted into the total scheme of things-Federal Reserve monetary policies, tax policy, debt management, and international financial transactions? To what extent are various stabilizing devices substitutes for one another? To what extent are they complements? Which policy parameters should remain sensibly fixed while the others are adjusted to them and to changing economic circumstances? How do operational constraints affect the choice of means to be used for stabilizing ends? These are the critical and current questions.

Debate Grows Complicated

Whereas the public debate over fiscal stabilizers was once conducted on too simple a level, it has now, perhaps, become too complicated-at least for policy-makers. There is even a danger that we will become lost in a maze of our own construction. For this reason I should like to: (1) review some of the technical and operational problems involved in using spending policy as a stabilizing device; (2) look briefly at the postwar record for lessons that may help us in the future; and (3) state my own views, based on analysis and observation, as to the proper role of fiscal policy in our quest for economic stability.

At the outset let us clear up a few matters which seem to me to be beyond dispute.

First, federal expenditures very definitely do affect the level of income, output, employment, prices, and other key measures of aggregate economic activity. This simple truth is readily acknowledged even by people who are opposed to deliberate fiscal manipulation for stability purposes; and almost every forecaster explicitly takes government demand into account when he tries to chart future economic developments. The issue is not whether expenditure policy will influence economic events but whether that influence will be bad or good. It is basically inconsistent for people to vie for government contracts or clamor for local support from the federal government and then to dismiss fiscal policy as ineffectual "pump-priming." The fiscal issue that concerns us here is whether government expenditures should be jockeyed about in response to changing economic circumstances or whether they should serve simply as a reasonably firm part of the economic framework within which other policies operate. This latter issue is the real issue, and much of what follows deals directly or indirectly with it.

Second, far too much of the debate over fiscal policy revolves around deficits and the federal debt. Deficits per se are neither good nor bad; they may be inflationary or deflationary. They may be automatic (i.e., determined by general economic conditions) or discretionary (i.e., determined by deliberate action or inaction on the part of the government). Theoretically and practically, a budget deficit or surplus by itself is no guide to action, no measure of fiscal impact, and no indicator of fiscal responsibility.

No one except a small minority really believes that it is possible or desirable for the federal government to balance its budget each and every year. The premises are palpably absurd: They assert that the government should cut its spending simply because private demand is declining, or should raise tax rates in a recession to maintain a constant flow of tax dollars from falling levels of national income. Even the Chicago *Tribune* hauls up at the brink of this abyss. But this does not mean that the balanced-budget notion is nonsense; nor does it mean, as we shall see, that *discretionary*, ad hoc fiscal policies have very much technical or operational merit as economic stabilizers.

A Rule of Cost

The annually balanced-budget dictum is essentially a simple and important rule of cost -that, when resources are transferred from private to public use, they should be paid for honestly, openly, and fully. Considering mankind's long experience with fiscal chicanery, it is not a bad idea-only an unworkable one.

In a recession, deficits are ***inevitable*** because of our flexible tax structure and the automatic increases which occur in various welfare payments; and they are ***beneficial*** because disposable income, consumer spending, and employment are maintained at higher levels than would otherwise be the case. Furthermore, it is an incontrovertible fact that debt-financed government expenditures are no more inflationary, in a purely monetary sense, than are tax-financed expenditures-as long as the funds are borrowed in the open market at unpegged rates of interest. Both methods of finance take money from the public and take bank reserves out of the financial system. It is also a historical fact, however, that past deficits (at home and abroad) often ***have*** been financed by inflationary methods, or have led to inflationary policies at a subsequent date, because of political reluctance to pay market rates of interest on accumulated defits, i.e., on the national debt. Hence, the balanced-budget idea contains a second grain of empirical truth imbedded in its unworkable formula.

With this clearing of the decks, let us now review the principal policy issues. The difficulties of trying to use discretionary ad hoc shifts in government expenditures as an economic balance wheel are well known yet often ignored.

Three Time Lags

The biggest problem is one of time and time lags. According to a popular schema adopted from a now classic article by Lloyd

Metzler on inventories,[1] there are three time lags which will always plague the policy-maker.

First is the information lag. We never know where the economy is at the moment-only where it was last month or last quarter. Because our statistical indicators are unavoidably late at best and because of the difficulties of short-term forecasting, considerable time elapses before the need for policy action is clearly perceived.

Second is the decision lag. After the need for action is recognized, decisions take time. What kinds of expenditures should be increased, by whom, and by how much? The Bureau of the Budget simply cannot "push the funds out." Other policy questions also must be considered. For example, should certain kinds of military procurement proceed apace when the Department of Defense is yet uncertain as to whether a particular weapons system is really what is wanted in the long run? According to one of several "Stigler's Laws," the government cannot do anything quickly.[2] From observation I can tell you how this law operates in connection with fiscal policy. What usually happens is that internal pressures to accelerate the flow of obligations and expenditures build up gradually within policy councils. Then the various agencies must be consulted, and they generate a veritable snowstorm of paper. This process takes considerable time and, no doubt, yields considerable job satisfaction to government employees. There is much activity but little action. By the time significant fiscal shift takes place, the need has often passed, and the effects are often perverse. Where congressional

1 "The Nature and Stability of Inventory Cycles," *Review of Economic* Statistics, XXIII (1941), 113-20.

2 George J. Stigler and Paul A. Samuelson, *The Proper* Economic *Role of the* State ("Selected Papers," No. 7 [Graduate School of Business, University of Chicago, 1963]).

action is needed, as in the case of a tax cut, the decision lag can be interminable. More than two years of debate and harangue preceded the 1964 tax cut, and all during that time the Administration stoutly maintained that immediate action was desperately needed for short-run economic stimulus. By the time the tax bill passed, fears were growing that it might “overheat” the economy in the short run.

The third lag is the time required for the economic adjustments to take place. The effects of any policy-a significant shift in federal expenditures, for example-spread gradually through the economy. Public works and major procurement items have a long lead time. Even allowing for some immediate stimulus to private activity when contracts are let and before expenditures actually are made, the process of adjustment is slow. In military procurement, expenditures tend to rise about nine months after new obligations are made. The secondary multiplier effects of a rise or fall in government spending build up twelve to eighteen months after the shift in policy is made.

Limiting Effects

In practical terms, these three lags severely limit the scope for stabilizing expenditure policies. Indeed, there is an ever present danger that fiscal manipulations will operate in a procyclical manner to accentuate the swings of the business cycle, rather than moderate them.

To speed things up and reduce these inevitable time lags, a variety of proposals has been made over the years, ranging from a reserve shelf of public works to more flexible administrative procedures in the Bureau of the Budget. The late President Kennedy, for example, requested from Congress executive authority to cut tax rates within a range and to undertake discretionary public works projects as economic stimulants when he deemed these actions to be desirable. As might have been expected, Congress did not rush to divest itself of its traditional prerogatives. For the present, at least, the forecasting, timing, and time-lag problems still loom as very large, if not insurmountable, obstacles to any full-blown stabilizing expenditure policy.

There are further difficulties. Stabilizing expenditure policy is clumsy. It calls for whipsawing governmental expenditures back and forth, expanding them in recession and cutting them back in a boom. In the process it seems highly likely that spending decisions will be even less rationally made than they are now. Governmental services are either wanted and worth what they cost or they are not, and spending decisions should be made on the basis of strict cost-benefit principles-as difficult as they are to apply in governmental budget-making. As a practical matter it is impossible to manipulate government spending in order to stimulate or depress aggregate demand without creating economic inefficiencies. For this reason tax policy and monetary policy, which leave expenditures more or less fixed or to be decided upon the basis of independent criteria, have important advantages as stabilizing instruments.

Resources, Productivity

In strict theory, of course, optimum combinations of several policies can be devised. For maximum output, resources employed in any particular manner should be as productive as in all possible alternative uses. This means that resources invested publicly should have the same marginal productivity as resources invested privately. Presumably, prospective government investments can be ranked in descending order of productivity, with fewer projects having higher rates of return (interest), and many more projects having lower anticipated yields.

Assume for the moment that the economy is in proper balance at high employment with both the private and the public sectors having equal marginal productivities. Now, private investment demand shifts sharply downward. To stimulate private investment sufficiently to restore total demand to previous levels, monetary policy would have to be sharply expansionary and interest rates would have to fall far enough to induce the necessary private spending. However, at these lower interest rates there would be underinvestment in the public sector, and our efficiency rule would be violated. Ideally, there should be some combination of money creation and increased government investment which would simultaneously restore full-employment demand and maximize over-all production. Similarly, the efficiency rule requires a cutback of government spending and monetary restraint when private demands are shifting upward beyond the full employment level at current interest rates.

All this is well and good-and technical. In reality, no precise schedules are available to policy-makers, nor are policy decisions made on the basis of a neat economic calculus. Budgets are, at best, crude economic instruments. During a recession, they become the vehicle upon which politicians load all their pet spending schemes. For this reason, many well-intentioned people distrust the use of expenditures as a stabilization device. They fear that government expenditures will be expanded willy-nilly in a recession (ostensibly to promote recovery) and expanded again in boom times (when tax receipts are permissibly high). In short, they fear that "stabilizing" expenditure policy will be used as a one-way street to permanent enlargement of the size and scope of government and that no sensible economic calculations will be used to control the traffic. Who would say that such fears are completely irrational or unfounded?

The last set of operational problems I want to mention deals with prediction, control, and substitutability. Much discussion of both expenditure and tax policy takes place within a vacuum. The effects of a change in expenditures or in tax-rate schedules will depend critically upon the direction of the accompanying monetary policy. Only to a limited extent are fiscal policies a substitute for monetary policies. In the main, they are complements, and the hoped-for stimulative or depressing effects of fiscal policy will not come to pass without cooperating monetary measures.

Consider the multiplier effects on total spending induced by an increase in government spending or by a cut in taxes. How is one to predict their magnitude? Will the Board of Governors of the Federal Reserve System be willing to increase the stock of money in sufficient amounts to finance additional transactions? If not, interest rates will rise and private spending will decline by an unpredictable amount, to offset, at least partially, the hoped-for build-up of secondary or induced spending.

This is a simple case. The difficulties are more fundamental and complicated. Besides capital market offsets, there may be adverse price effects (bottlenecks), foreign-trade effects, inventory effects, and a host of other induced ripples, positive and negative, which will affect the outcome in any given situation.

Moreover, the size of the expected multiplier depends critically on the stability of the relation between private consumption expenditure and national income. If stability conditions do not hold, the value of the multiplier cannot be predicted with confidence. When one allows for other dynamic economic changes, the difficulties are compounded.

The President's Council of Economic Advisers speaks blithely of "plugging in the best multiplier that economic science can produce."[3] Unfortunately, the best is not very good. Economic science simply cannot produce a very good number which will accurately predict multiplier effects in advance. This honest admission of uncertainty is, in itself, no bar to the use of fiscal policy, but it should cause economists to adopt a proper attitude of humility in making their recommendations.

Prediction, Control Crucial

Prediction and control are crucial for economic policy. The best policy instruments are those which are properly subject to governmental control and which produce predictable results. In the final analysis, stabilizing expenditure policy must be judged in terms of these criteria. In a highly significant study for the Commission on Money and Credit,[4] Milton Friedman and David Meiselman tested the predictability of the effects of changes in autonomous expenditures (net private investment and government) upon consumption and income as compared with the predictability of changes in the stock of money upon consumption and income. As the authors say, "the results are strikingly one-sided." It turns out that money matters very much. Monetary changes are much more highly correlated with subsequent income and consumption than are autonomous changes in expenditures.

3 **Chairman Walter Heller at the Conference on Monetary and Fiscal Policy of the President's Advisory Committee on Labor-Management Policy, Washington, D.C., November 14-15, 1962.**

4 *The Relative Stability* **of** *Monetary Velocity and the Investment Multiplier* **in** *the United States, 1897-1958,* **to be published as part of the Commission's five-foot bookshelf.**

The authors do not claim their findings to be decisive; there are statistical difficulties in fitting data into appropriate theoretical categories. But the study is highly suggestive and has created some stir. If money, which is subject to control, is a better predicter than autonomous expenditures, which are under only partial control and hard to manipulate, then is there really a stabilizing task left for expenditures policy? Friedman and Meiselman have to be taken seriously because they ask the right questions. By trying to resolve what is basically a question of empirical fact, they have helped to lift stabilization policy out of the realm of theology.

The Postwar Fiscal Record

Part of my assignment is to review the postwar fiscal record. This I shall do with desperate brevity. I can be brief because those who are interested have access to two recent studies which cover the ground rather thoroughly, though with somewhat different objectives in view. One is the Wilfred Lewis study, ***Federal Fiscal Policy in Postwar Recessions*** (Brookings Institution, 1962), and the other is Michael E. Levy's ***Fiscal Policy Cycles and Growth*** ("Studies in Business Economics," No. 8 1 [National Industrial Conference Board, 19631).

Without doubt, the automatic fiscal stabilizers have worked well-on both the tax side and the expenditures side of the fiscal equation. In recession, automatic deficits appear because tax receipts fall, and at a faster rate than income; and various federal and state welfare (notably unemployment compensation) expenditures rise. In periods of economic expansion, tax receipts rise faster than income, and welfare payments fall. The ebb and flow of these prompt, automatic fiscal operations have been highly beneficial. They have reduced the amplitude of business fluctuations and have helped to keep postwar recessions mild. Because no information and decision lags are involved, there is no problem of timing or danger that these fiscal operations will get perversely out of phase.

Currently, there is much debate over whether the automatic stabilizers, especially the tax structure, are efficient on the upswing of the economy. The present Council of Economic Advisers shares the widely held view that the present tax system is too repressive, that it generates too much revenue (i.e., withdraws too much income from the spending stream) before the economy reaches adequately high levels of recovery. This doctrine of "fiscal stagnation" was used as a key argument for the tax-reduction bill passed by the Congress in early 1964.

I do not plan here to examine the fiscal stagnation thesis. Obviously, the drag of the tax system must be analyzed in the context of other relevant economic variables, including government expenditures. Since expenditures tend to rise to match income, the over-all repressive effect of the tax system is not at once obvious-though particular features of it certainly are repressive. Just as there are a number of good reasons for seeking tax reform, "there are plenty of explanations around other than the weight of the federal tax load" to account for the sluggishness of economic recoveries since the 1957-58 recession.[6]

When we turn to the postwar discretionary ad hoc fiscal policy, the record is less clear and far from reassuring. In some periods, fiscal policy was contracyclical and in other periods procyclical. According to Wilfred Lewis' findings, over-all fiscal policy was mildly expansionary in the downswing of

5 See George Terborgh's statement to the Joint Economic Committee in the Hearings on February 13, 1963, reprinted in the *Capital Goods Review, No. 53,* Machinery and Allied Products Institute, March, 1963.

1948-49, sharply contractionary in the downswing of 1953-54, and approximately neutral in the recession phases of the other two postwar recessions. In the upswing, performance has been erratic, with fiscal stimulus coming typically after recovery is under way. In 1954 there was an administrative speed-up of expenditures, and then an administrative slowdown in 1957 when the economy was already faltering. In 1958 the congressional bandwagon got rolling and piled up a large deficit in fiscal year 1959. The reaction was to depress expenditures in fiscal year 1960, again at a time when the economy was faltering-this time under the anesthesia of a pervasive deflationary monetary policy. In 1961 there were some expansions of federal expenditures but largely for reasons other than economic stability.

All in all, discretionary stabilizing fiscal policy has not been a resounding success. While federal officials have generally tried to make the federal budget behave in a sensible way, with genuine concern for its impact on the economy, other political considerations and the enormous difficulties mentioned earlier-difficulties which inevitably beset ad hoc stabilizers-have been too much for them.

Where Do We Go from Here?

Does all this mean we should abandon economic stability as a goal of budget policy? I think not. To do so would constitute another form of "fiscal irresponsibility." Despite the existence of serious technical and operational constraints on the effective use of discretionary expenditure policy, the economic effects of the budget simply cannot be ignored. At minimum, the budget pressures should work in the right direction. There is no excuse for tolerating the perverse fiscal acts which have sometimes occurred in the past. Moreover, there does exist some modest scope for improving the administrative procedures in order to adapt spending policy somewhat more effectively to changing economic conditions.

My own position-with which neither the strong opponents nor the proponents of vigorous use of government finances for stability purposes will agree-is generally as follows. To keep business fluctutions within reasonable bounds, we should rely primarily on the automatic stabilizers-taxes and expenditures -and upon monetary policy. There are some ways in which the automatic stabilizers could be strengthened, and there is vast room for improvement in our monetary management. (Incidentally, I do not accept the popular notion that monetary policy has been rendered feckless by our balance-of-payments deficits and that fiscal policy now must serve as its deputy. This notion presupposes that fiscal and monetary measures have a very high degree of substitutability. I do not believe this is true, and, if it is, I have yet to see a convincing empirical demonstration of the case.)

Beyond the automatic stabilizers and appropriate monetary measures, I suggest that spending policy could operate more effectively as a reinforcement in our defenses against instability. At any point in time, a large volume of current and past appropriations remains unobligated. With improved administrative procedures, it seems to me, the flow of funds from government to the public could be better scheduled with stability purposes in mind. As I pointed out earlier, the obstacles are large, but this is no reason not to improve our fiscal operations to the extent that improvement is possible.

I also suggest that, when and if the rate of expenditures is to be accelerated (decelerated) for stability reasons, the following strict criteria should be applied:

1. The programs should be ones which already have been decided upon on their own merits and for which funds already have been appropriated.
2. The programs should be ones where prompt action and effects are possible.
3. There should not be undue increases in cost of the programs as a result of a speedup or slowdown.

Unless these criteria are firmly adhered to, the economic damage will be far greater than the gains; there will be economic waste and the government will cause greater instability.

There are many unsettled questions in the field of stabilization policy. Most of them are not theoretical issues but questions of empirical fact. In other words, they are questions that eventually may be answered by painstaking research. One of the serious deterrents to progress on this front lies in the fact that too many people, including many economists, have a vested interest in or strong commitment to a particular intellectual apparatus or policy position. Such policy positions are often unrelated to economic realities. They change slowly.