EXPENDITURE POLICY FOR ECONOMIC GROWTH AND STABILITY IN A FEDERAL SETTING

Werner Hochwald, Chairman, Department of Economics, Washington University

This paper will present a brief summary of considerations which may influence the impact of government expenditures on economic growth and stability in a Federal setting. For this purpose the paper will (1) categorize the general impact of government expenditures, (2) indicate the extent to which impacts may depend on the level of government at which public functions are performed, and (3) the influence of grants-in-aid on these impacts.

Impact of Government Expenditures

Government expenditures will increase national income as government employees are paid and government contracts are let. The impact of these expenditures on aggregate economic growth and stability will depend on (1) the expenditure patterns of government income recipients (multiplier effects), (2) the expenditures private individuals and groups forgo because of government activities (substitution effects), (3) the total resources available to the community and their relations to the aggregate expenditures made by all sectors of the economy (price effects).

Multiplier effects

Government employees and contractors will spend at least part of their income for their own consumption and investment needs. These expenditures in turn will stimulate another round of consumption and investment on the part of new income recipients, leading to an endless chain of income creating new income through the spending cycle. These multiplier effects of government expenditures, as they influence aggregate employment and economic growth, have been discussed frequently in the literature of the last generation and form the basis of government efforts to influence overall economic activity through fiscal policy.

Multiplier effects of government expenditures may also contribute to economic stability as they are timed to counterbalance shifts in the expenditures of private groups. Such timing is difficult, however, and may present serious limitations to the effectiveness of fiscal policy.

Substitution effects

Only rarely will government expenditures be a net addition to all expenditures made by private groups. It is more likely that some private spending will be replaced by public expenditures as services provided by government take the place of private consumption or investment. Illustrations are readily provided by public education and free highways, by public power projects and municipal airports.

Private expenditures may also be adversely affected whenever erratic public spending undermines confidence in the future stability of the economy or raises doubts about the future place of the private business sector in the economy. Any such substitution effects will counteract the multiplier effects discussed above.

Beyond the mere size of private and public expenditures, however, there is a more subtle issue involved here. Where economic growth is measured in real rather than monetary terms, interest is focused on the efficiency of resource allocation, whether the spending is done by private or public bodies. As long as government expenditures merely add to private spending, the issue of relative efficiency does not arise, as it can be argued that any employment of otherwise idle resources is more efficient than unemployment. As government takes the place of private enterprise, however, it becomes necessary to evaluate these substitution effects, in regard to their aggregate size as well as to their impact on the efficiency of resource use.

Price effects

Multiplier and substitution effects thus far have been discussed with the implicit assumption that no changes have taken place in the total money supply: Government expenditures have been financed through taxes or borrowing of existing funds. Where these taxes have been raised from taxpayers who would have spent the funds if they would have not been taxed, substitution of public for private spending is obvious. Where the taxes are paid from funds which otherwise would have been saved, some net addition to total spending is possible.

Governments are not limited to the spending of tax revenue. They may borrow, either from existing funds or newly created bank credit. Where the total money supply is expanded by government debt, government expenditures may still proceed without overall price effects as long as spending is matched by the more efficient employment of resources. Where spending outruns real resource availability and use, however, the impact of government expenditures will be partly on prices rather than employment. Their impact on economic stability and growth will then be impaired by the forces of inflation. Though government expenditures will still increase money income, a growing part of this increase will now be accounted for by purely monetary gains without a corresponding growth in the output of real goods and services.

Level of Government at Which Public Functions Are Performed

The above discussion applies to all levels of government. The political process of decision making, the fiscal capacity of government units, the legal authority of debt creation, the skill of tax and debt administration, all differ on various levels of government, however. It will be instructive, therefore, to review the impact of government expenditures with specific reference to the level at which public functions are performed. This survey will again proceed in the order followed above, reviewing in turn (1) multiplier effects, (2) substitution effects, and (3) price effects.

Multiplier effects

Government employees and contractors are likely to spend their income regardless of the specific government unit from which they receive their funds. Consumption multiplier effects are therefore the same whether teachers are paid by Federal, State, or local governments. Neither would it appear to matter whether old-age beneficiaries receive their checks from Federal or local authorities. Investment multipliers are more readily affected by shifts in the government spending unit as actual or potential government contractors may be expected to "buy at home" and therefore be influenced by the geographic jurisdiction of the public agencies with which they deal.

The stability of government expenditures and their multiplier effects also may be subject to increasing limitations as the level of government descends. The smaller the government unit, the more it becomes the follower rather than the leader of its economic environment, subject to the general fortunes of the economic base on which its fiscal capacity and its spending power depend.

Substitution effects

Many substitution effects are again likely to occur regardless of the specific level of government at which the public function is performed. There are some reasons, however, why substitution effects may be larger at the lower level. To the extent that the fiscal capacity of smaller government units is limited, expenditures may absorb a larger share of local purchasing power, thus increasing the substitution of public for private spending. Also, taxpayers may find it easier to evade the local tax burden by shifting to other areas; it is this consideration of competitive disadvantages for local business and the resultant substitution effects of higher taxes which often limits the willingness of local governments to spend.

Difficult as it is to assess the aggregate size of substitution effects, it is even more hazardous to estimate the relative efficiency of government at different levels. As local government is closer to the people it is designed to serve, efficiency of resource use and responsiveness to shifting needs may be better safeguarded. On the other hand, the inefficiencies of local patronage have been notorious at times. Few general observations appear possible, therefore, on the more subtle aspects of resource use efficiency on different levels of government.

Price effects

Only the Federal Government has the power to create new money. The price effects of government expenditures are greatly influenced, therefore, by the level of government which finances these expenditures. Local and State governments can borrow, yet their access to the money market is subject to the same restraints which characterize the borrowing activities of private groups. The inflationary potential of government expenditures is, therefore, much more limited at levels below the Central Government which combines the fiscal and monetary powers of sovereignty.

It is this very limitation which has been the strength and weakness of lower level government expenditures. The need for local government to compete in the money market with private claimants for funds may assure more careful appraisal of government projects and thus lead to a more efficient resource allocation among private and public uses. On the other hand, local government units are much less equipped to "lean against the wind" and thus may accentuate rather than balance fluctuations in aggregate employment and income.

Influence of Grants-in-Aid

Grants-in-aid are a device of intergovernmental relations designed to combine the fiscal advantages of each government level. The greater fiscal capacity of the National Government is called upon to finance expenditures of lower authorities whose more limited jurisdiction is thought to assure greater efficiency and responsiveness to local needs. The following observations will briefly indicate how such a complex Federal setting of intergovernmental fiscal relations may change the impact of government expenditures on economic stability and growth. Here, again, it will be convenient to retain the distinction among (1) multiplier effects, (2) substitution effects, and (3) price effects.

Multiplier effects

As stated before, government income recipients are not likely to be influenced by the source from which they receive the funds. There are several ways, however, through which grants-in-aid could change these multiplier effects. First, matching grants may induce the receiving government unit to spend more on its own in order to maximize the fiscal benefits received from the grant; such a reshuffling of State and city budgets is often the very purpose of matching grants and thus leads to intergovernmental multipliers. Second, grants-in-aid may be designed to redistribute income among geographic regions and areas; to the extent that such redistribution of income from well-to-do to poor areas is accomplished, the consumption multiplier will be increased.

It thus would appear that the multiplier effects of grants-in-aid depend on the way the grant is administered. Matching grants offer an incentive toward intergovernment multipliers yet limit the regional redistribution of income; grants defined by local performance standards rather than financial participation emphasize the regional redistribution of income throughout the jurisdiction of the grantor government.

Substitution effects

Grants-in-aid minimize the substitution effects of tax inequalities as they tend to equalize income as well as the tax burden among all units participating in the grants. This again holds particularly for grants requiring no financial participation of the grantee government though to a minor extent it also holds for matching grants. While grants-in-aid thus limit the competitive impact of Government expenditures among geographic areas, they may increase substitution among resources as the larger expenditures of local governments for goods and services bid resources away from private employment. This latter impact is minimized if grants-in-aid are used for transfer payments to final consumers, such as old-age assistance or educational benefits.

The appraisal of grants-in-aid and their impact on the efficiency of resource allocation presents again the difficulties encountered in any appraisal of government efficiency. Grants-in-aid wish to combine the fiscal efficiency of big government with the citizen participation that local government on the grassroots level appears to preserve. Yet fiscal efficiency presents some dangers. The pain of additional State-local taxes may serve as a helpful yardstick to sharpen the critical appraisal of services demanded by local constituents, an appraisal dulled by easy access to financial support from governments of higher jurisdiction. In fields with a strong and clearly identified national interest, local governments can best serve their citizens by drawing on the superior fiscal powers of the Central Government. Yet such reliance on outside support should not impair the discipline associated with the discomfort of higher taxes.

Price effects

To the extent that grants-in-aid rely on the fiscal and monetary authority of the National Government, they are likely to have the same price effects direct Federal expenditures would have. The greater reserves available to the Federal Government for raising funds increase their potential contribution to economic growth as well as to price inflation. This apparent ease of Federal financial support—based on broader geographic jurisdiction, more efficient tax and debt administration, freedom from the fear of industrial migration and tax evasion, ready access to the money market—offers almost irresistible temptation of increased reliance on grants-in-aid as a convenient way out of the financial wilderness of State-local finance.

Yet the easy way may not always be the safest way to economic growth and stability. In the twin national emergencies of the great depression and the World War, there was no choice but to turn to the National Government for increasing support on all levels. As the rapid growth and relative stability of the postwar decade have greatly strengthened the national economy, State and local governments have been endowed with increased fiscal capacity to exercise more freedom of choice in deciding how to finance the costly public services their electorates are demanding. Full participation on all levels of government, not only in spending funds, but also in raising the revenue needed for these expenditures, appears the best assurance for a national resource allocation to further economic stability and growth.