SOME PROBLEMS IN OPTIMIZING THE LEVEL OF PUBLIC EXPENDITURES

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Summary

In this paper I should like to discuss a few of the problems that are met with in the determination of the optimum level of Federal expenditures, with particular reference to stable economic growth. It may be useful to preface the more extended remarks with a brief summary of the major points that will be covered in the text.

It seems to me that there is a tendency on the part of many commentators on the problem of Federal finance to be unduly pessimistic on the effectiveness of the budgetary process in holding Federal expenditures to the level that makes a maximum contribution to aggregate social welfare. In an age in which economic resources are still scarce, public information media can be counted upon to call attention to any really serious misallocation of resources between the public and the private sectors of the economy, or within the public sector. It has to be conceded, of course, that the complexities of the budgetary process, and the obstacles to making close calculations with respect to the relative social desirability of public and private spending programs, provide room for much difference of opinion on the effectiveness with which our economic institutions allocate resources. What should not be conceded is the contention that these difficulties make intelligent budgeting of resources for maximum social welfare an unattainable objective.

In accordance with the relatively optimistic attitude adopted here toward the possibility of intelligent budgeting, two commonly held and widely divergent opinions are rejected. One is the view that the secular rise in gross national product entitles the Federal Government to proceed with additional social-welfare programs on some kind of automatic basis, and the other is the frequently expressed view that Federal expenditures are "too high," or that they have risen too rapidly. Both of these opinions beg the question by making tacit assumptions on which there is room for disagreement. It is merely an assumption that government is entitled to share in any definite way in the annual increments to national product; but on the other hand it is to be expected that as an economy grows, the absolute economic importance of government will grow with it. The job that has to be done is to determine how far and in what directions government functions should evolve when population, national output, and productivity are growing.

By restricting the discussion of Federal spending to problems of economic growth, we exclude two types of programs. Day-to-day housekeeping expenditures, though both affecting and affected by economic growth, are not a primary consideration. Moreover, Fed-

eral programs which may be definitely classed as social consumption are not directly relevant. A problem is posed in practice, however, in differentiating between programs which increase the capacity of the economy to produce goods and services (or to make progress in some broader sense), and those which merely contribute to current social consumption. The difficulty is, of course, that many programs have aspects of both. Examples which readily come to mind comprise most of the major Federal nonmilitary programs: Federal aid to schools, hospitals, residential construction, depressed areas, slum clearance, highways, aid to small business, social security, and the like. In passing judgment on the admissibility of particular programs we should be careful to distinguish between their social consumption aspects and their capacity for contributing to growth. Both are equally relevant to social welfare; but it is necessary to face up to the implications of selecting a given ratio between the two objectives, and this involves taking a long look at every proposed program with this distinction in mind. This is an aspect of Federal budgeting which has not received sufficient attention in the past.

A possible defect in our capacity for properly evaluating the net welfare contribution of Federal expenditures for economic development stems from the fact that there is less resistance to spending programs that can be financed out of an automatic rise in tax receipts as national income rises than there is for programs that require a rise in tax rates. The reason is that public opinion seems to be fairly united on the view that tax rates, and especially income-tax progression, have reached (or surpassed) permissible peacetime limits. Implicitly this means that the public believes that Federal spending has already gone somewhat beyond the point at which its net marginal contribution to national welfare is negative. The effect is that adequate consideration may not always be given to the relative impetus to economic growth (and thus to an ultimate rise in the tax base and tax yields) of development programs that initially, at least, require a rise in tax rates. This disability is not a prohibition, however, and it therefore is of interest to consider 1 or 2 points that bear on the effects on economic stability of a rise in Federal spending that is financed by a rise in tax rates.

One point is the possibility that destabilizing effects may arise out of an increasing divergence between the nominal and the actual income-tax rate structure when already high nominal rates are increased. The higher rate schedule stimulates individuals and firms to seek a multiplication of exemptions, and the distortions caused by the varying success of different groups may adversely affect investment. Another destabilizing effect of increased tax rates appears if increased excise tax rates, or increased rates of other taxes entering into cost of production, result in a rise in the Consumer Price Index. The consequences of increased tax rates are thus complex, and the particular mixture of inflationary and deflationary effects that is experienced depends on circumstances.

A discussion of the growth functions of Federal expenditure programs leads into the question of efficiency of Government operations. In this context efficiency is not closely related to the narrow concept of minimization of waste in Government offices, but is concerned with the question of the scope of Government functions, and the coordination of the objectives of the various Government agencies. In other words, concern is with the efficiency of resource utilization by the Government within the context of efficiency of resource utilization for the economy as a whole. It is this broader concept of efficiency, rather than the narrow "office-manager" concept, that ought to be used in determining the limits and judging the effectiveness of Government functions.

Finally, this paper calls attention to an aspect of the impact of a high Federal spending floor on economic stability. To a significant extent the knowledge that Federal spending is high, and will remain high, is a substitute for a large volume of liquid assets in providing a stimulus to private investment. So long as the monetary authority refrains from taking strong steps to discourage private borrowing, firms and individuals can borrow from banks (and thus create purchasing power) with the certainty of a massive basic demand for products on the part of the Government. Thus an important contribution is made to investment for growth in the private sector; but in these circumstances the assurance of price stabiltiy appears to call for a more determined Federal Reserve policy than would be needed in the absence of the Government spending floor. In other words, there may be a bias toward optimism which might on occasion have to be counteracted in the interest of inflation control. It can be argued that interest rate policy may therefore have to be supplemented with other types of control, particularly controls over investment through internal financing.

THE PRECONDITION OF EFFECTIVE BUDGETING

The public finance theorist tells us that the cost of producing an additional unit of public goods is the sacrifice of real private consumption or investment that is necessary to release the resources needed to give effect to the increase in public spending. In order to maximize social welfare, therefore, public expenditures should be pushed to the point at which the social satisfaction obtainable from an additional (or marginal) dollar spent on publicly produced goods no longer exceeds that of a dollar spent on privately produced goods.[1] (Publicly produced goods are defined here in a broad sense, including not only government services, but also the net satisfactions derived from government transfer expenditures.)

This concept is basic, and underlies the budgetary procedures in any political system. The principle is being applied whenever an intelligent decision is made, but it is qualified under rule by pressure groups if the wishes of the strong are accorded a heavier weight than those of the weak (for example, producers versus consumers). It is true that we have an exceedingly difficult hurdle to surmount when we attempt to translate this marginal principle into practical action.

[1] At first blush one hesitates to state a proposition that would appear to be, in theory at least, so obvious. That there is nothing obvious about its practical political application is apparent from the manner in which (1) protagonists of increased provision of governmental welfare services simply assume that the more of these services the economy produces, the greater the net contribution to social welfare, and (2) exponents of Federal tax reduction assert that "expenditures have risen too rapidly and have reached too high a level." In seeking the optimum level of public services in a mainly free enterprise economy, this is, of course, precisely the issue that must be debated. The implications of the problem can be clearly seen if one consults Governor Stevenson's campaign statement entitled "A Program for the True Economy: Where Is the Money Coming From?" and the comments thereon by selected economists, Review of Economics and Statistics, May 1957, pp. 134 ff., and the Committee for Economic Development, Tax Reduction and Tax Reform—When and How, May 1957, pp. 10 ff.

Developed by economic theorists for use in thinking about the optimization of public expenditures, it is subjected to severe criticism (possibly too severe criticism) by those who are experienced in the budgetary process and are impressed by the complexities of political decision making.[2] (1) It assumes substantial knowledge on the part of the public of the available alternatives; (2) it supposes that substitutions between public and private spending can be made in small enough units so that some attention is paid to the sacrifice in the consumption of private goods that must be made when government spending is increased; (3) it assumes that the welfare contributions of alternative public expenditure programs are comparable; (4) it takes it for granted that the general public and its legislative representatives make a reasonably successful attempt to reconcile future social welfare with present social welfare; (5) it assumes that account is taken of the fact that a particular objective, like growth or a welfare program, produces incidental adverse, social effects, and that some government-produced goods hurt one group of individuals while benefiting others, or while benefiting society as a whole (for example, an airport in a residential area); and (6) it assumes that it is not a fatal defect of decision-making that many individuals and groups favor or oppose on purely dogmatic or sentimental grounds increases in the relative importance of Federal expenditures within the framework of aggregate spending. If we consider these points in order, the practical difficulties come into focus at once, and not the least of them is the irreconcilability of opposed value judgments, upon which the economist has no special competence whatever to give an opinion.

Thus, (1) no one has ever suggested a completely satisfactory means of providing the knowledge of alternatives that is needed to permit full weight to be given in our fiscal thinking to the public and private goods and services that must be forgone when a decision is taken to tax and to spend for a particular purpose; (2) even if such a tool were perfected, the fact that no price is too great to pay for adequate self-defense, for example, is an indication of the impossibility of making close, marginal calculations in Federal spending; (3) our ideas with respect to comparability of the satisfactions from alternative forms of public expenditure are fuzzy; (4) little success can be expected from an attempt to reconcile future with present social welfare so long as economists and others divide themselves neatly between those who believe we should encourage present consumption at the expense of present investment and future consumption and those who believe that we should do the reverse;[3] (5) surprisingly little attention

[2] See, for example, Jesse Burkhead, Government Budgeting (Wiley, 1956), pp. 42, 44, who states that "Marginal social benefit and marginal social cost are attractive phrases, but they are devoid of explicit content;" and with respect to the allocation of public expenditures, "At the time when decisions are in process, marginal theory provides no guidelines for the allocation of public expenditures." This statement appears to be rather extreme, since budget making and budget cutting are by no means always across-the-board.

[3] See the opposed testimony of several prominent economists at the hearings before the Joint Economic Committee in June of this year: Fiscal Policy Implications of the Economic Outlook and Budget Developments. Federal Reserve Board Chairman Martin has stated (Senate Finance Committee hearing, August 19 of this year) that present inflationary pressures arise out of overspending and undersaving (and that the Federal Government may be the "chief offender"). The counterargument would be that a high ratio of consumption to income makes an invaluable contribution to full employment, which is itself indispensable to rapid capital formation. But, again, it has been argued that the rate of capital formation in the fifties has been somewhat less than that of the twenties, with the implication that the saving-consumption ratio might well be increased. When the question is raised whether the level of saving in the twenties may have been too high to sustain full employment, the elusiveness of this whole issue becomes apparent.

is ever paid to the long-term adverse welfare effects of public spending programs; and (6) to the extent that individuals and groups have preconceptions and particularistic points of view, the conditions are lacking for an objective, socially oriented approach to welfare economics.

All these obstacles to applying the marginal principle in order to ascertain the correct level and distribution of Federal expenditures are serious ones, and they stand out ominously in the dark shadows of the budgetary process. They have to be borne in mind when we are considering the net contribution that can be made by Federal spending and taxing to the maintenance of the maximum rate of growth (assuming that we want to maximize growth) that is consistent with the minimum acceptable degree of economic stability. Yet they are not insurmountable so long as the issues are debated in the full glare of publicity. Indeed, to take any other view would be to admit that public spending decisions are completely haphazard, and, despite all the shortcomings of the budgetary process, this is patently untrue.

The Role of the Federal Government in Economic Growth

In consonance with the terms of reference of these hearings, I shall limit myself to a discussion of Federal expenditures for growth and stability. At the same time, an adequate level of current maintenance expenditures and spending for protection is an indispensable prerequisite to growth, if not to stability, and both these types of expenditures are themselves dependent on the rate of growth. Consequently, they are likely to rise over the long run, and thus they are necessarily always under consideration, implicitly if not explicity.

At the outset it may be noted that a public spending policy aimed at encouraging growth exerts complex effects on economic stability. Federal expenditures on production factors place a floor under aggregate demand, and, to that extent, reduce the danger of both cyclical downturns and secular stagnation. On the other hand, a concomitant of growth is a rise in the flow of goods and services, which, taken by itself, is a deflationary factor. The net effect cannot be easily foreseen very far in advance. Moreover, unless great care is taken in the choice and magnitude of governmental projects, the private sector may react adversely to increased competition for limited supplies of savings and scarce resources. In contrast to the possible deflationary effects of government spending for growth are the inflationary implications. The acceleration of rates of growth may provide the background for creeping inflation, and to avoid this a careful balance needs to be kept between public and private investment programs. Moreover, there is always some danger that the public may ultimately react to a lengthy period of creeping inflation by shifting into assets that are believed to be inflation proof. If this occurs, there is no guaranty that the pace of inflation will not be greatly accelerated.

It is easy to approve, in general terms, any rise in aggregate spending that is expected to contribute to stable growth. The trick is to determine, of the expenditures that can be made for this purpose, what proportion should be undertaken by the Federal Government. This problem has roots that are deep in the Nation's history. It will be recalled that Alexander Hamilton held to the view that growth would be stimulated if the National Government would take the lead in economic life, whereas his opponents divided themselves between two positions; (1) that the private sector could do the job best unaided by government except in essentials like protection of life and property, and (2) that the States, rather than the National Government, should assume responsibility for certain risky and expensive developmental investment projects. In seeking to maximize growth, we must accept one important human characteristic. It is a rare individual who concerns himself much that growth should be stable, provided only that it is rapid. Feelings run strong, however, on the ratio in which the public and private sectors should share responsibility for spending for growth; and purely economic judgments are modified, and may at times even be submerged, by political philosophies.

The feeling is widespread that we are helpless in stemming the tide of Federal spending. But what is meant by this? Net budget expenditures, which were 15.3 percent of gross national product in fiscal 1949, after rising to 20.4 percent in fiscal 1953, had declined again to 16.1 percent by 1956. Gross national product has been rising steadily, while Federal spending has been subject to considerable fluctuations, primarily in response to the military situation. Private spending has likewise been rising, however, and there is no a priori reason why a long-term rise in gross national product should not consist, in part, of publicly produced goods and services. Indeed, it might be a contribution to clarity of thought if we ceased making regretful references to our inability to prevent a secular rise in Federal spending. Economic growth implies an expansion in the output of both public and private goods.

It is not impossible, moreover, that balanced growth may call for an increase in the ratio of public to private goods during certain phases of economic and political development. The latter statement receives support from the relatively sharp rise in State and local expenditures in recent years, much of which has been in direct response to a public demand for new types of State and local services. Many of them, like hospitals, highways, and standards of police protection, are at once cause and effect of economic growth. A similar point applies to some Federal expenditure programs. It might be found, for example, that a rising proportion of Federal spending to gross national product would be justified by the need to react to the effects of growing international pressures which themselves are a corollary of growth of populations and of the expansion of economic aspirations of all nations. To the extent that this were true, a rising trend of Federal expenditures would be as much a result of growth as a cause of it. We may have to reckon with the possibility, as the expensiveness of national defense rises, that the ratio of Federal spending to national income will rise.

Rising Gross National Product as a Justification for Expanded Federal Programs

A line of argument has often been set forth, and recently discussed by a symposium of economists, the acceptance of which would, indeed, greatly complicate the task of making an objective assessment of the relative satisfactions to be derived from public and private spending. This is the view (mentioned in footnote 1) that, even with present tax rates, prospective economic growth can be counted upon to finance automatically such desirable public services as medical and unemployment insurance, a really adequate system of public education, slum clearance, the development of natural resources, and an expanded concept of old-age security. If this argument is taken to mean only that the automatic annual increase in Federal tax revenues can be counted upon to finance some rate of secular rise in Federal expenditures, then it is not very interesting as a basis for establishing future spending policy. But if it is meant that we have some slack to play with in the budget, and that surely we can earmark a portion of the annual increment in national product for welfare purposes, or, indeed, for any particular objective, we are perilously close to being in the position of short circuiting the budgetary process. The essence of budgeting is to reexamine constantly the relative merits of the performance of functions by the public or private sector, as well as the merits of performance versus nonperformance of the function.

Budgetary experience in this country runs strangely counter to the view that there is no problem to be faced in financing a planned secular increase in Federal welfare and other programs simply because at constant tax rates the total rise in Federal tax receipts over some period of years will be several times the total cost of the programs. It is a matter of record that revenues have not been, and are not now, adequate at present tax rates to finance all the programs that are urged upon (and by) the American people each year. Where, then, would we be if we went ahead and earmarked funds for an expansion of Federal programs?

The immediate answer would appear to be that either tax rates would have to be raised, or other spending programs would have to be curtailed. In fairness, however, this answer needs to be qualified. Of the Federal programs mentioned above, some contribute to economic growth and some do not (or do so to a very minor extent). Those which do not (namely, all those which come under the rubric "the better life") would be a deadweight charge on future budgets. But those which do facilitate growth also serve to enhance taxable capacity, and in some instances they may do so relatively to alternative programs undertaken in the private sector.

It seems imperative that the public should always be informed in advance of the cost to the Nation, in terms of foregone possibilities of growth, of an option in favor of a diversion of resources toward the better life. The voting appeal of liberalized social-security benefits, for example, is very great. Therefore we need estimates of the cost to the private sector, in terms of taxes, that must be paid over the long term, taking account of increased revenue needs due to population growth and to changes in the age distribution of the population. Moreover, account must be taken of the forms which demands for further elaboration of the good-life concept are likely to take, merely in consequence of the acceptance of initial and successive phases of the program. For in accepting a program of this sort we are not only committing ourselves to the cost of foreseeable welfare and other government services. In addition, we are assuming responsibility for the automatic increases in the cost of these programs that result from rapid population growth; and we are advancing one step along the road toward the acceptance of at present unthought-of spending programs, since the achievement of one goal opens way for the struggle for another.

It is important to note that nothing in this discussion should be construed as representing basic opposition to an expansion of Federal spending programs intended to contribute to growth and long-term social welfare. We need a healthy competition between the public and private sectors for the privilege of implementing the investment decisions that will optimize the utilization of resources at the disposal of the economy. Given the criteria of optimization, the test is relative efficiency, and there is no reason to advocate reduced expenditures merely because this permits a reduction in tax rates. But the good life ought not to be confused with economic development. We should be quite clear on the distinction between those Federal expenditures that can reasonably be considered to contribute to growth and those which are synonymous with consumption. This distinction is often obscure in the realm of public spending.

Let us reject, therefore, the view that our dearest objective is always to strive to reduce Federal spending, however desirable judiciously spaced intermittent economy drives may be. On the contrary, we should be prepared to consider acceptance of an expansion of Federal programs when it can be established that they will make a greater contribution to desired growth, per dollar of expenditure, than would private investment programs. No purely general discussion can enter into the manifold details that have to be sifted in giving effect to this judgment. One may simply state the belief that this is an area in which the planning principle, because of its obvious usefulness, should be acceptable to everyone. At what point, for example, does investment in educational resources cease to contribute to growth and become a form of consumption? Remembering the serious political consequences of "overeducation" in certain European countries during the interwar period, we may ask whether we do not need a detailed forecast of the economy's future needs for trained personnel in order that intelligent decisions can be taken with respect to what the desirable contribution of the Federal Government to education should be. (Similar exhaustive investigations ought to be made, and kept current, with respect to all long-range Federal programs.) It is quite clear that productivity will be raised by improved standards of education only up to the point at which the working force is optimally distributed among job opportunities. Beyond that point educational expenditures become a form of luxury. This may be all to the good socially; but it will not necessarily contribute to growth.

High Tax Rates as an Obstacle to Expanded Federal Spending

It is quite a step from the argument that a portion of the annual increment to real national income should always be earmarked for Federal spending to the view that at some point positive steps may have to be taken to curtail the expansion of Federal programs. If we look at economic growth alone as a criterion for Federal expenditure policy, we do not discover at the present moment any compelling argument in favor of the curtailment of Government spending. Notwithstanding some recent slowing down in productivity increments, there appears to be no serious dissatisfaction with the current rate of growth in real national product, nor with the part played by the Federal Government in providing the basis for it.[4] On the other hand, we must reckon with the eventuality that, taking into account the possibility of the need for a rise in military expenditures, the level of desirable Federal spending programs may rise sufficiently to call for higher tax rates. If this were to occur it would be necessary to subtract from any contribution made by increased Federal expenditures to economic growth the adverse effect that was produced on private investment and initiative by higher tax rates, and hence on the rate of growth in the private sector.

At the risk of repetition, it should be emphasized that this problem is nonexistent to the extent that the rising tax base associated with rising gross national product provides each year an automatic increase in tax revenues. Under current tax rates, and with current annual increments to GNP, about $3 billion of additional revenues come automatically into the Treasury each year. Only a portion of this, however, is available for programs designed to stimulate growth. Not only does this figure have to be deflated for a rising price level, but also account has to be taken of automatic increases in Federal spending under a wide variety of programs which are themselves a function of growth in population, for example, grants to States and localities, highway programs, collection and analysis of statistics, services to agriculture and industry, and so on. Even when this is done, however, a modest residual is left which might be employed to finance new governmental programs without the aid of new taxes. But no one can predict for many years the cost of maintaining international political and military equilibrium, and it is therefore conceivable that in the light of urgent national defense projects desirable civil spending programs could not be financed solely out of automatic annual increments of tax revenues.

Destabilizing Effects of Increased Tax Rates

It is rather unlikely that at present high income-tax rates public opinion would be favorable to tax increases even in order to finance growth programs that might ultimately contribute more to national income (and to the tax base) than would the private investment programs that would have to be sacrificed unless taxes on consumption were increased.[5]

Nevertheless it is of some interest to glance at a possible consequence of any significant further rise in personal income tax rates. There is good reason to believe that pressure for exemptions and favorable tax rates under the income tax are some kind of a function of the severity of the nominal rate structure. If this is so, then a further rise in income-tax rates would tend to shift the income-tax burden still further in the direction of those individuals and proprietorships which are not in a position to benefit from such conces-

[4] Moreover, despite the large space devoted to the inflation problem in the press, there is so far little evidence that the public feels great concern over a gradually rising price level (though this situation could change drastically). On the contrary, many policymakers show signs of being more fearful of temporary periods of declining prices than of a long-term upward trend in prices.

[5] It is hardly to be expected that if tax-rate increases were found to be necessary, the income tax would be exempt.

sions as percentage depletion, accelerated amortization, conversion of ordinary income into capital gains, and so on. Consequently, those who were unable to escape the effects of the higher nominal rates would invest less (because of higher marginal tax rates), and would, moreover, have smaller after-tax incomes. But those who did manage to avoid being subject to the higher rates would have no incentive or capacity to increase investment (ignoring the income effects of the additional Federal spending). Consequently there would be a net adverse effect on that part of economic growth that is accounted for by investment in the private sector.[6]

One argument in favor of holding any rise in Federal peacetime expenditures within the limits of the automatic increment of tax receipts determined by current rates of growth in gross nationl product is the difficulty of finding new revenue sources that are not destabilizing. As stated above, further rises in personal income-tax rates would probably have disincentive effects on those who are unable to escape the nominal rates. With respect to death taxes, there is scope for increased rates and lower exemptions, but this scope is limited. The other major alternatives, sales, and excise taxes, have a potentially serious defect if they are exploited during a period of creeping inflation, or when there is a delicate balance in the economy between inflationary and deflationary forces. The Consumer Price Index of the Bureau of Labor Statistics, which is the index used in most wage-escalator agreements, includes "sales taxes, retail excise taxes, customs duties, and all manufacturers' and processors' taxes passed on to the consumer." Thus any increase in the rates or coverage of these taxes causes an automatic rise in the Consumer Price Index, and therefore in all wage rates either formally covered in escalator agreements or in practice tied to the cost of living in wage bargaining. The number of workers directly or indirectly covered under formal escalator agreements (nearly 4 million at the present time) is of special significance, for there is no room for doubt that their hourly wages will increase in accordance with specified rises in the Consumer Price Index. At the same time it is precisely during a period of rising prices that we find the maximum number of workers covered under escalator agreements.[7]

In view of the fact that the two effects mentioned above tend to offset each other (higher income-tax rates are here viewed as deflationary, and higher excise-tax rates as inflationary) it may be reasonable to infer that some combination of rises in the rates of each tax could be found which would be reasonably neutral to inflation. An important difficulty, however, is the distortion caused by the mixture of unemployment and rising prices. Higher income-tax rates would tend to discourage output, while higher sales-tax rates would stimulate

[6] A possible exception to this statement may be of interest. If we start with a sufficiently progressive rate structure in the higher brackets, the pressure for exemptions and special treatment may be very great if income tax rates are raised still further. If this is so, an increase in the nominal rate structure could actually result in a lessening of the tax burden on the higher-income groups. (This is what would actually occur if a very high rate structure were to lead to the exemption of realized capital gains from the income tax.) Conceivably the consequence might be a net increase in investment by them, since in the extreme case assumed here their after-tax incomes would be higher under the higher nominal tax rate structure. The practical application of this case is probably unimportant, but it serves to call attention to the nature of the economic effects of a high nominal income tax rate structure, which are usually ignored in favor of discussions of equity effects.

[7] Moreover, the recent growing popularity of the longer term labor contract had already led to wider adoption of the clause even in advance of the price rise of 1956.

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price and wage rises. The situation would be one of a mixture of rising prices and soft spots. The very evident confusion of economists in trying to explain economic trends in the circumstances of the past year or two, when a somewhat similar situation has developed for other reasons, is testimony to the obstacles which would face an attempt to prevent the appearance of destabilizing effects if substantial additional tax revenue should come to be needed.

There is, to be sure, an alternative tax which does not suffer from the "cost-inflationary" defect of sales taxes. This is a spending tax of the type proposed by the Treasury in 1942. This tax, levied at progressive rates on an individual's spending, provides no mechanism whereby the tax shows up in the Consumer Price Index, and therefore contains no element of cost-push inflation.[8] At fixed rates, and with relatively low personal exemptions, this tax could be used to finance an increased amount of Federal investment expenditures without disincentive effects on either private investment or personal consumption. A Federal spending and tax policy could thus be evolved which would be consistent with both growth and price stability, though at a political cost. The cost would be a substantial increase in the role of government in the overall planning of resource use. But this eventuality is really implied anyhow in a fiscal program aimed simultaneously at growth and economic stability.

A Criterion of Efficiency of Government Spending Programs

It is difficult to conceive of a discussion of government spending functions that omits reference to the question of economy and efficiency in Federal expenditures. The greater the efficiency with which government performs its services, the easier it becomes to gain public acceptance of the diversion of a given quantity of resources from private to public use. Unfortunately, as everyone knows, it is far from simple to compare efficiency in the private and public sectors. The efficiency of private enterprise is tested in terms of bankruptcies and declines in capital values that are often associated with bargain purchase by a more aggressive management group. No such objective market test is at hand for government services, and this fact not only complicates the problem of ascertaining the efficiency with which government agencies operate, but makes the public sector vulnerable to frivolous, along with the justified, charges of inefficiency. It is often forgotten, moreover, that it is no easy matter to measure the efficiency of private enterprise. Furthermore, government action itself contributes to the degree of efficiency that is achieved by the private sector. Again, subsidies, favorable tax treatment, tariff protection, and the like may find legitimate support on one ground or another; yet they obviously widen the range within which inefficiency on the part of private management can conceal itself. I would contend that relative efficiency, in any narrow sense, does not provide much of a basis for helping us decide the proper scope of governmental functions. In any event, each government agency ought to be glad to

[8] It might be worthwhile for Congress to reexamine the good and bad points of this tax in the light of the growing importance of wage cost-of-living clauses, and of the possibility that valorization clauses may sometime become increasingly popular in many types of contracts besides wage agreements (for example, index bonds, variable annuities, escalated social security payments, etc.). For a recent searching analysis of this tax see Nicholas Kaldor, An Expenditure Tax, George Allen and Unwin, Ltd., London, 1955.

subject itself to a periodic checkup on efficiency, and to report its progress in reducing cost per unit of output.

In a broader sense, the question of efficiency borders on that of the determination of the limits of government functions. Here efficiency is conceived of, not in the technical sense of output per worker, but with respect to the form that the long-term objectives of government programs ought to take in the light of forecasts of the future needs of the Nation. In other words, efficiency is conceived of in terms of output per unit of resources. In this area Congress might sponsor technical studies, perhaps undertaken by the staffs of appropriate joint committees, of the alternative short- and long-term objectives of major national welfare and other spending programs. This would give much-needed assistance to administrative agencies in making their self-evaluations, and would at the same time help to keep decisions on the scope of government functions from being made on opportunistic grounds. Certainly these decisions are ultimately political ones; but holders of public office would clearly benefit from analyses made by technical experts, and important public spending issues would receive the benefit of timely clarification. One is struck with the need for maximum agility on the part of both government and private enterprise in making their decisions to devote resources to promising developmental projects, and in determining upon a method for sharing responsibility for them. Any equilibrium between public and private spending plans must be tentative and subject to change. There is no room for dogma in allocating functions between government and private enterprise. We are engaged in a constant process of trial and error, and we can maximize the rate at which we learn, only if programs are constantly reassessed.[9]

The Impact of a High Federal Spending Floor on Economic Stability

Up to this point we have been primarily concerned with the question of the impact of Federal spending programs on growth. It is necessary also to take account of the ways in which the floor of Federal spending, as well as probable changes in Federal spending levels in response to fluctuations in income and employment, react upon spending in the private sector. The importance of doing this lies in the fact that the level of private investment spending (and through the multiplier, consumption spending) is partly, indeed significantly, determined by the fact that Federal spending is high, will remain high, and is likely to rise on the advent of any serious unemployment. The world situation assures a minimum Federal budget in the vicinity of $70 billion. Moreover, the great expansion of economic activity in recent years has necessitated a substantial rise in State and local programs; and since these promise to continue to increase, private long-term investment decisions are made in the light of knowledge that public demand for resources will rise secularly. It is true that cutbacks in Federal spending in the interest of economy add their weight to the soft spots caused by specific overproduction, inventory reductions, and lagging consumer demand. But even those who stress these

[9] A case in point is the difficulty of coordinating the objectives of different Federal agencies. For example, the Department of Agriculture is continually concerned with the problem of excess capacity in agriculture, while the Bureau of Reclamation's irrigation program obviously adds to it.

phenomena, and who believe that maintenance of expansion rates rather than the danger of inflation is the major economic problem facing this country today, would probably grant that these adverse signs are primarily structural and temporary in nature.

A high floor under government spending has a direct effect on economic development. It also has an indirect effect by way of its encouragement or discouragement to private investment spending. Provided that aggregate spending is not so high that interest rates are driven up to the point of discouraging private investment, a high level of government spending is a favorable sign for full employment and for the contribution of the private sector to rapid economic growth. Viewed in the broadest possible terms, one of the tasks of the Federal budgetary process is to take a position on the rate of private capital formation that is the optimum precondition of the desired rate of expansion of Federal (and State and local) developmental programs. Economic progress is maximized when the correct balance is struck between public and private spending programs.

Permanent full employment (with no more than relatively minor recessions) in a free-enterprise economy is an achievable objective provided two hurdles can be surmounted. First, the private sector must be permanently convinced that the demand for resources for public use will rise indefinitely in response to growing demand for the kinds of programs that are best undertaken by government. In the public sector there is no important question of a lack of purchasing power; what has to be established is the reasonable certainty of a public desire for the expansion of governmental programs. Second, some kind of procedure has to be worked out whereby competition between government and private enterprise for limited resources is not allowed to lead to an inflationary situation that is serious enough to be a prelude to crisis and possible collapse in the private sector. The problem is complicated by the fact that within the private sector itself specific overproduction and miscalculations are integral to the investment decision-making process, and serious deflationary consequences can ensue if rapidly rising interest rates happen to coincide with inventory reductions and cutbacks resulting from temporary overproduction.

Any defects attributable to monetary and fiscal policy as instruments of inflation control are magnified under circumstances of high level Federal spending and taxing, and particularly so under a philosophy of assuring government its share in the secular rise in national product and in responsibility for rising national economic potential. The problem arises out of the fact that while monetary and fiscal policy are suitable instruments for discouraging private spending, they are quite irrelevant to the control of Federal (though not, of course, State and local) spending.[10] Sharp criticism has been directed

[10] This is a worldwide phenomenon. Considerable complaint has been voiced in a number of European countries that fear of inflation leads governments to impose controls on private investment and consumption, while no similarly effective instruments are at hand to curb ambitious public spending programs. One difficulty is that whereas controls over the private sector can be made to operate more or less continuously, national governments often tend to delay moderating action with respect to their own spending programs until a serious international monetary crisis has arisen. Some method needs to be evolved that will encourage national governments to submit to a more continuous regulation of spending programs in the light of what the governments themselves expect the private sector to accomplish for economic growth and stability. In a word, the instruments of economic control at the disposal of free enterprise were developed prior to the appearance of national governments as massive users of economic resources, and are inadequate to cope with present-day problems.

in recent months against a monetary policy that is credited with being effective in stiffening the terms of borrowing to potential homeowners, small and new business, and farmers. The Treasury's difficulties with debt financing are indeed well publicized; but while borrowing problems discourage private investment and consumption spending, they do not enter into legislative spending decisions. This phenomenon has been complained of in many countries, centrally controlled and decentralized alike, in the postwar decade, and it appears to be part of the price that has to be paid for full employment.

Recent discussion has called attention to a further complicating element in inflation control.[11] Monetary policy is alleged to suffer from the serious defect that its major influence is exerted in restricting investment in the competitive sections of the market; big business and oligopoly can utilize price policy and reinvested earnings as a defense against monetary control. In my judgment it is not necessary or desirable to carry too far the basically valid point that monetary policy can never be as important an instrument of control as it was thought to be in an era when the commercial banking system occupied a highly strategic position in the aggregate credit flow. Institutions have changed; they have not been swept away. The correct course would appear to be to forge supplementary political institutional weapons that will assist in the control of investment by large enterprise and by the Federal Government. The dice are loaded in their favor in the struggle for scarce resources. Moreover, there is always the threat that any sign of weakening on the part of the relatively competitive segment of the private sector of the economy will be taken as an invitation to government or big business to step in and fill the gap. There may be cogent reasons why further concentration of economic power in the hands of the Federal Government and big business is desirable. But it would seem imperative at the earliest possible moment to establish ground rules which, if there is found to be an imbalance of power at the expense of the private sector, and specifically at the expense of new and small enterprise, make it possible and likely that steps will be quickly taken to redress it.

[11] Cf., for example, J. K. Galbraith, Market Structure and Stabilization Policy, Review of Economics and Statistics, May 1957, pt. V.