FEDERAL EXPENDITURES AND ECONOMIC GROWTH

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At the start of this study of the interconnections between Federal spending and economic growth, it seems a fair presumption that each will have an effect on the other. Thus, there are two separate questions to be considered, which may be phrased as follows:

1. *How are the level and nature of Federal expenditures likely to affect our prospects for economic growth in the coming decades?* Under this heading we will want to decide whether it can be said that one size or kind of Federal budget will promote growth and another size and kind will impede it.

2. *Assuming an environment of economic growth, how should this affect our decisions as to the proper amounts and objects of Federal spending?* In other words, we will want to see how economic growth will affect our need for, and our ability to afford, the various types of Federal spending.

Question 1 will be taken up first.

Federal Spending as a Determinant of Growth

The entire history of the United States has been one of economic growth. True, there have been cyclical swings above and below the prevailing upward trend, but it would be mere confusion of language to label these periods as alterations of the underlying growth trend. The present panel is concerned with long-term growth trends, rather than with cyclical fluctuations above and below them, and, in this context, the first thing to recognize is that the upward trend has been persistent.

With this in mind, the analyst looking for a connection between Federal spending and economic growth must very quickly develop a feeling of frustration. Growth has occurred under so wide a variety of spending levels that one must wonder whether there is any connection whatever between the two.

During the first 140 years of our existence as an independent nation—surely, a period of economic growth—Federal expenditures (except during brief war periods) were at levels which must be considered purely nominal compared with the levels we have become accustomed to in recent decades. Yet the past two decades apparently have also been a period of growth.

The fact that there has been an increase in spending levels since pre-World War I days is too well known to require statistical corroboration. Yet the astounding magnitude of the change is worth reporting:

Annual Federal expenditures in 3 periods of economic growth

	Billions of dollars	Per capita	Percent of gross national product
Average, 1871–1910	$0.4	$6	2.8
Average, 1921–30	3.4	29	3.8
Average, 1947–56	53.4	342	16.5

This contrast between recent and historical levels of Federal spending suggests that economic growth may be affected very little by the level of government spending. The same conclusion is indicated by a more detailed examination of the recent years.

Compared with historical precedents, Federal expenditures have remained high since 1941. Yet there has been considerable variation in spending levels within that period. These variations do not seem to be closely related to economic growth, which proceeded throughout the period with only short and minor interruptions.

During World War II, Federal spending amounted to almost 50 percent of our gross national product. After the war spending was reduced to about 13 percent of gross national product. Contrary to some predictions, this reduction caused no cessation of economic growth. During the Korean war, expenditures rose again, reaching 21 percent of gross product in 1953. Since that year there has been some decline and the figure for 1956 was 17 percent.

This factual record gives no support to glib assertions that there is a determinable minimum level of Federal expenditures necessary for the support of economic growth. Equally, the record does not encourage the assumption that there is a clearly definable upper limit such that when expenditures rise above it they become destructive of prospects for growth. One is tempted to conclude that government spending has very little to do with the process of growth, either positively or negatively.

Yet commonsense forbids us to dismiss the subject with this negative conclusion. There must be limits—both minimal and maximal—to the levels of Federal spending which can make economic growth possible, whether or not we can define those limits precisely. The subject is worth pursuing further, provided we recognize the futility of attempting to set up precise operating rules on this basis.

Although the present discussion is oriented toward the spending side of the budget, we should not forget that the effects of spending in discouraging or encouraging growth depend to an important degree on the methods used in obtaining the necessary funds. A badly designed tax system might be destructive of growth potentials even if the total revenue it provided was moderate in amount. A well-designed tax system might protect growth possibilities to a point much higher in the spending scale, but certainly there are limits to this protection.

Government as a Market for Goods and Services

A thought which underlies some discussion of the proper level of Federal expenditures, is that the Government is an important customer for our national output of goods and services. Approximately

11 percent of our total output was sold to the Federal Government in 1956.

Every businessman recognizes the customer as a most essential element in the conduct of his business. He cannot grow—in the sense of expanding his output and his employment—unless he can find new customers or persuade existing customers to take more of his output.

These are indisputable facts of business life. From like considerations many people conclude that the Federal Government, by increasing its expenditures (i. e., by becoming a better customer), can provide an essential support for economic growth. They further conclude that as our productive capacity expands it will be more and more necessary for the Government to take a substantial part of the product off the market, in order that men and machines may not be left idle through lack of sufficient demand for their expanding output.

The train of reasoning described above is not customarily expressed explicity. The view seems to be going out of fashion that we can predict statistically the gap between demand and potential output and adjust Federal spending to fill it.

But emphasis on the importance of the Government as a customer is still implicit in much of the argument over Federal spending. For example, we hear fears that a reduction of defense spending might have a depressing effect on our economy. With economic growth and expanded productivity there might seem to be even greater difficulty in finding sufficient nongovernmental demand to keep us going.

The customary answer to this argument, and the one which will be given here, is that there is no limit to the growth of private demand, since human wants are insatiable.

This thesis has a stale, trite sound—more like a copybook maxim than a realistic basis for economic confidence. Yet in our lifetime we have seen it vindicated to an extent which should astonish even those who have been most sure of it. In 1929 we thought we were prosperous enough, but since that time per capita expenditures on consumption, in real terms, have increased by more than 50 percent. The average person consumes half again as much, in the way of goods and services, as he did a generation ago, and with no visible signs of satiety. Surely the burden of proof is on those who would claim that this process has come to an end, and that we shall henceforth be unable to generate sufficient demand to keep an expanded economy growing.

That is not to say that there is no conceivable danger of depressed markets in the future. Goods are produced not simply because people want them but because they can be sold at a price which will repay their costs and yield some profit. Unworkable relationships between cost levels and the state of demand might make it impossible to keep our resources at a high level of employment.

But these are problems which ought to be dealt with on their own terms. They should be solved by preserving the flexibility of our economy in adjusting cost and price levels to changing conditions. Merely to offset such difficulties by increasing government spending is to risk converting the temporary maladjustment into a chronic one.

Of course it can be argued that we will not have to worry about these difficult problems if we simply resolve to keep government demand at a high enough level to keep everyone employed, no matter what maladjustments occur. But this is the fallacy of regarding production, rather than the enjoyment of the product, as the ultimate aim of economic activity. Government spending which is motivated solely by the desire to increase total demand is not a support to economic growth but a dissipation of the benefits of growth.

All this is not to say that there is no minimum below which Federal expenditures may not fall without injury to economic growth. The Government has functions to perform which are essential to the well-being of the Nation generally, and therefore to economic growth. These functions cost money and unless the budget provides adequately for them, economic growth might be seriously impeded. But the basic function of the Government is to govern, and not to provide a market for the Nation's output. This still leaves a broad area of controversy as to the proper level of government expenditures, but it is helpful at least in clarifying the objective.

One other point which it may be well to clarify is that there is nothing wrong in principle with a government timing its purchases with some regard for the possibility of getting lower prices by waiting. Every prudent buyer will seek to time his purchases, whenever possible, so as to make them in the most favorable markets. But no prudent buyer ever buys something he does not need or want, simply because the market for that product is depressed.

Federal Expenditures as an Impediment to Growth

The discussion thus far of the impact of expenditures on growth has dealt with the question of the minimum expenditures necessary for growth. The conclusion has been that the minimum is set by the need for performance of essential Government functions, rather than by any need for contributing to market demand.

It remains to discuss the negative impact of Federal spending on growth. In a sense all Government spending has a negative impact since it is a withdrawal of manpower and other productive resources which might otherwise be used in expanding the economy. The most that can ever be said of any form of Federal spending is that we might be even worse off if the expenditure were not made. (For example, we certainly will not have economic growth if we lay ourselves open to external aggression through failure to provide an adequate national defense.)

It would probably be futile to attempt to specify the precise point at which Government spending would become totally destructive of economic growth—although some such limit must certainly exist. For a period during World War II the Federal Government took almost 50 percent of our national output. But this was under special circumstances and it seems unlikely that any such level of spending could long continue and leave anything over in the way of resources for expanding our economy.

The record of the post-World War II era is ambiguous. On the surface it appears to have been a period of economic growth and of expansion in our capital equipment. Yet it was also a period of rapid consumption of our existing stock of capital. (The rate of capital consumption is grossly understated in accounting records.) Only a relatively small percentage of our capital outlays represents a genuine net expansion of our productive facilities. Until we have more perspective it will be hard to judge the impact on economic growth of postwar Federal spending, which in recent years has hovered between 16 and 21 percent of the national product.

The important point is that all Federal spending, to some degree at least, reduces the potential for economic growth. We come back again to the previous conclusion. Federal expenditures should be limited to the levels necessary to support the activities which only the Government can perform or which the Government can perform better than anyone else. Expenditures above this level: (1) are not needed to support demand; and (2) would deprive us of resources otherwise available for growth.

Spending Objectives in a Growing Economy

We have examined the impact of spending on growth, and the next question is the impact of growth on spending—question 2, as posed at the beginning of this paper. This may be approached either from the point of view of needs for Government services or from the point of view of ability to afford Government services.

First, what will be the effect of economic expansion on our need for Federal services? At first blush it might seem that our needs in this respect might be expected to expand roughly in proportion to the expansion of the economy. However an examination of the specific objects of current Government spending indicates a quite contrary conclusion:

Federal expenditures, calendar 1956

[Billions of dollars]

Purchases of goods and services:	
National defense	40.4
Other national security	2.0
Other	5.2
Transfer payments	13.5
Grants-in-aid to State and local governments	3.2
Net interest paid	5.2
Subsidies less current surplus of Government enterprises	2.8
Total	72.3

Source: U. S. Department of Commerce.

National defense is the largest item. What our future needs for this purpose will be is unpredictable but there is no reason to suppose that these needs will grow pari passu with the growth of the economy. Economic growth will neither increase nor decrease our need for defense, which depends on other factors.

The same is true of Federal interest payments, which are determined by the size of the debt and the average rate of interest on it—factors which are only indirectly (if at all) related to economic growth.

The $5.2 billion of outlays for goods and services, other than national defense or national securitly, may contain some items which would have to grow along with economic growth. These, however, must be an extremely small part of total expenditures.

The $13.5 billion of transfer payments consists mainly of payments from social insurance funds (which are outside the regular budget) and veterans benefits. The social insurance benefits will probably increase, but this will be the result of maturing of contractual obligations rather than of economic growth per se. Unfortunately the increase will occur whether or not the economic growth is realized.

Government expenditures of the type which are intended to relieve individual distress might be expected to decline with economic growth. As general economic well-being improves there is less need for such Federal aid. Although this principle may be of little help with respect to future benefits already contracted for, it might be kept in mind when questions arise of expanding such obligations or assuming new ones.

Similarly, there is reason to hope that grants-in-aid can be reduced as economic growth progresses. With improving economic conditions the States and localities should become better able to take care of their own needs, and the need for Federal assistance will decline.

Welfare expenditures generally are a process of taking money from one group of citizens and paying it to, or spending it for the benefit of another group. Whatever humanitarian reasons may be advanced to justify such a process, the need for it must become less cogent as economic growth makes us more prosperous.

Thus the Federal budget is a mixture of various kinds of expenditure. In some cases (covering the larger part of the budget) the needs which the expenditure is intended to satisfy will be unaffected by economic growth. In other cases the need will decline as the economy grows. A comparatively small part of total expenditures are for needs which will increase along with growth.

(This is by contrast with the expenditures of States and localities. These are mostly for the provision of essential community services and they do increase along with the increase in population and the growth of the economy.)

What Can We Afford?

This whole problem can be approached from a totally different direction. Instead of asking: "What will we need?" one might ask "What will we be able to afford?" in a growing economy. If one cares to argue from the latter viewpoint he can claim that as our economy grows we will be able to afford more in the way of Federal expenditures and, therefore, we should have them.

This attitude is often met in practice When the tax system begins to yield more than is needed to meet current expenditure levels, there are those who will view this as an opportunity for undertaking new expenditures, rather than for reducing tax rates. Now we can afford to do what we have always wanted to do, they will say.

However reasonable such an attitude may seem in particular cases, as a long-range proposition it is a way of getting nowhere. Its consistent application would mean that we are stuck forever with the existing tax levels. It would mean that any rise in taxes for meeting a temporary need would be built into the tax system permanently as new uses were found for the revenue thus yielded.

The rise since World War II in Federal expenditures to levels which would have been inconceivable in our previous peacetime history is, in part, at least, to be explained by just such a process. We have become inured to tax rates which we would have resisted vigorously a generation ago and the Government has found ways of spending our larger contribution.

Concluding Remarks

The propriety, or impropriety, of any proposed item of Federal expenditures is only partly a subject for economic analysis. In an ultimate sense it is simply a question of what people want from their government and what they are willing to pay for. When they have made their choice it is not for the economist to say that what they want is wrong.

Yet, in practice, the desires of the people are usually oriented toward general objectives and are seldom formulated into specific measures. The task of the economist is to advise as to whether the specific spending proposals will in fact contribute to the general objectives, which he must take as given.

Since last January, the people have indicated rather clearly that they do not want a rising level of government expenditures. The preceding economic discussion can only add that a rising level of expenditures is not essential to economic growth and is in fact an impediment to it.

The conclusion of the analysis is that government expenditures should be limited to those necessary for performing essential government services. This rule does not, of course, answer all questions but it does answer some important ones.

There will be many problems as to what constitutes an "essential government service." Neither this panel, nor any other group, can produce a simple rule of thumb for deciding these questions. Legislators must be aware of what people want from their government and what they want to pay for it, and they must offer leadership in determining practical ways of attaining these goals.