FEDERAL SPENDING AND ECONOMIC STABILITY

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These hearings are to be welcomed as providing an opportunity for looking at the problems of government spending in long perspective. We are concerned not with devising specific measures for meeting immediate problems, but with developing a basic understanding which can serve as a guide in the indefinite future.

As a contribution to such understanding, I offer two basic principles:

1. Federal spending policies can and do have very important effects on the stability of the economy.
2. The deliberate and persistent reliance on Federal spending as an instrument for preserving economic stability will tend to have the contrary effect and promote instability.

Taken together, these two principles seem to form a paradox. If it is granted that Federal spending can have an important impact on stability, it might seem to follow that we can, and ought to, make use of that impact as a means of keeping our economy in balance.

But paradoxes are often the beginning of wisdom. The remainder of this paper will be devoted to a discussion of why the two principles stated above are not mutually contradictory. It will be necessary to begin with some discussion of the nature of economic stability, and the possible dangers of instability we will face in the future.

Economic Stability as an Objective

A stable economy would certainly not be defined as an economy in which no change occurred, or if it were it would be dismissed immediately as an aim of policy. Our previous history has been one of growth and change, and we surely do not want the type of "stability" which would prevent that process from continuing.

But economic growth does not mean a uniform rate of increase for all areas of economic activity. Our past growth has resulted in striking qualitative changes in character—from a predominantly agricultural economy to one in which agriculture plays a relatively minor role, for example. Although we cannot foresee them in detail, the only safe assumption is that similar qualitative changes will occur in the future. There is no worse illusion than to assume that economic growth will produce an economy which is identical with the present one, except on a larger scale. It is of the very essence of economic growth that its effects on different types of activity will be uneven. Uneven growth should not be confused with economic instability.

This basic point is worth dwelling on. We had better face the fact that all of us, as individuals, will have to make personal adjustments as the economy grows and changes, and for some of us the adjustments

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will be quite drastic. If, in the name of "economic stability" we try to prevent such adjustments from taking place we shall sacrifice the chief benefits of economic change. For example, the improvement in our agricultural productivity would not have been much help to us if we had insisted on retaining as large a percentage of our work force on the farms as we had a century ago.

Our free enterprise economy has within itself resources for guiding and facilitating such adjustments. But there is real cause for concern that, by confusing change with instability, we may devise policies which will retard or misdirect the process of adjustment.

All this makes the problem of maintaining stability—and there is a problem—much more difficult. It cannot be dealt with by efforts to freeze the status quo, or to insure that all sectors of the economy will grow at an equal rate. At least it cannot be so dealt with unless we are willing to surrender our hopes for economic growth.

The Real Problem

In the past, we have had not only economic growth and the accompanying economic changes. We have also had episodes of economic development which cannot be defended as either desirable or inevitable. Certainly neither periods of prolonged large-scale unemployment nor periods of persistent inflation can be defended on these grounds.

In what follows, the problems of instability will be taken up under two headings: The danger of recession and the danger of inflation. This is the customary procedure, although it is adopted here with some reluctance. Recession and inflation are in no sense opposites of each other, and they may not even be mutually exclusive. One of the gravest dangers of the future is that we might have both at the same time.

A recession, or depression, is a period in which a substantial part of our manpower and other productive resources is not being utilized. For an explanation of why such periods occur, we must turn first of all to a consideration of profitability.

Despite the inroads of government in recent years, this is still a profit-oriented economy. Things happen because someone believes it will be profitable to take the steps which cause them to happen. Other things fail to happen because no one finds it profitable to take the steps which might bring it about.

(There are some who say that it should not be so and that the guiding criterion should be "human welfare" rather than profitability. It is assumed, however, that this point need not be argued here.)

A period of unemployment, then, is a period in which there are insufficient opportunities for making a profit through the employment of people to produce goods. Since profit is an excess of selling price over cost, we must conclude that in such a period there is something wrong with the relationship between the price which may be obtained for finished goods and the cost of producing them.

This type of imbalance is by no means a hypothetical danger. At present wage costs, the largest element of total cost, are set not by market action, but by arbitrary fiat, in a wide and critical sector of our economy. As a result, the profitability of employment-creating

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activities has been seriously reduced. Just how close we are to the margin where it will be impossible to maintain our recent high levels of employment is not precisely determinable, but we have been moving nearer to it.

It is not our purpose to discuss this danger in all its ramifications, but only as it relates to government spending. It is clear that government spending cannot penetrate to the heart of this problem and correct the condition which have brought it about. The most that government spending might do, conceivably, is to offset the evil effects of such job-destroying situations.

The Federal Government can create new opportunities for earning a profit through employing people and producing goods. It can do this by bidding for additional goods on a cost plus basis. It can also create new jobs by spending its money so as to employ people directly.

Whether or not such new opportunities would be a net addition to the number of opportunities for making a profit through employing people to produce goods is another question, and a difficult one. It would depend on the way the money was spent and on the way it was raised.

Spending money raised by taxation is a very doubtful way of stimulating business activity. The question of how those who bear the tax burden would otherwise have spent this money must be raised. Beyond this, it must be remembered that private business activity can be stimulated only by creating new opportunities for profit and most forms of taxation have an adverse effect on profitability.

The spending of borrowed money is also doubtful in its effect. If the Government offers to pay a competitive interest rate it may simply attract away loanable funds that might have been used for expending existing enterprises.

If the Government borrows money through persuading the monetary authorities to create new liquid funds for its accommodation another question must be asked. If the problem of the economy is the need for increased liquidity, why should the Government spend money and divert productive resources from their natural uses simply to bring about this result? The responsibility for providing sufficient liquidity, together with other responsibilities of course, belongs to the Federal Reserve System and there is no necessity for the intervention of government spending with its many side effects.

But suppose, for argument, that a technique could be found whereby it could be assured that government spending would provide a new addition to the opportunities for profitable production and employment. Would not this be the perfect and painless answer to all our fears of recession?

In the first place, it is not a painless solution. It involves surrendering to the Government some part of the productive potential which could otherwise be used to produce goods for us to enjoy as individuals. It is one thing if government spends money for performing its necessary functions. It is another thing if the Government purchases goods for the purpose of providing a market for them.

Second, it is not a perfect solution since it does not deal with the root causes of the difficulty—costs that are too high in relation to

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market conditions. At best, it can only offset the depressing effects of that imbalance.

Many will brush this argument aside as irrelevant. What difference does it make, if it works? If government spending can put people back to work, why should we care whether it corrects the condition which originally put them out of jobs?

The answer is that government spending of this character would counteract the economic forces which would otherwise tend to bring the economy back into balance. With the corrective forces eliminated, the malady could be expected to become progressively worse. What might have been a temporary maladjustment is preserved indefinitely.

Picture our condition if we decide, as a fixed policy, to offset the effects of cost-price maladjustments through government spending. Everyone who makes major economic decisions is assured then that, however economically absurd his actions may be, the Government will spend money to offset their harmful effects in curtailing output and employment. There would be no incentive for the entrepreneur to resist any of the claims which would result in higher costs, since he is assured that government will provide the market.

With a fixed policy of government spending for this purpose, the total of such expenditures could be expected to rise periodically as each new cost-price crisis arose and was offset rather than cured. There is no theoretical limit short of the Government purchasing 100 percent of the national product, although it is probable that the absurdity of the policy would become apparent well before that point and it would be abandoned.

The only safe policy is for government to limit its expenditures to those necessary for the performance of governmental functions. Expenditures specifically motivated by the intention of promoting "economic stability" must in the long run intensify instability.

Spending Policy as an Anti-Inflation Weapon

One of the gravest dangers in the future is the possibility of a gradual, but cumulative, erosion of the purchasing power of our money. This does not exclude the possibility of simultaneous recession and unemployment. In fact both might result from the same cause—cost levels that are arbitrarily and unrealistically set too high. But continuous inflation cannot result from the cost side alone, unless rising costs are accompanied by efforts to validate the higher costs by monetary expansion.

In a situation like this it is difficult to see how Federal spending policies can be of much help. If monetary powers were being used to validate the arbitrary cost levels, then a reduction in government spending would simply necessitate an even greater injection of new money.

If and when an inflationary danger arises from the demand side (rather than the cost side) a reduction in government expenditures might be of some help. But this device is available only if the expenditures were too high in the first place. Certainly we would not want to reduce expenditures below the level necessary to provide essential services.

It might be argued that we ought to maintain a high level of expenditures in normal times, so that we might reduce them when in-

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flation threatened. This would be a little like arguing that personal extravagance is a good habit since it leaves plenty of margin for cutting expenses when the need arises.

The So-called Compensatory Budget

In recent years, the "compensatory budget" view of Federal fiscal policy has attained a certain currency. In this view, Federal budgets of the general type we have had since World War II should be regarded with satisfaction since they exercise an automatic stabilizing effect on the economy.

This alleged stabilizing effect is the product of three features of our recent budgets:

1. The emphasis in our tax system on income taxes, and especially on progressive taxes. This means that tax collections are extremely sensitive to business fluctuations.
2. The growing importance of welfare-type expenditures, which increase automatically as times get bad and decrease as conditions improve.
3. The magnitude of the budget, which means that the effect of 1 and 2 will be substantial in the economy generally.

From these considerations, it is argued that the budget will exert a strong influence in counteracting cyclical fluctuations. When purchasing power is declining in the private economy, federal fiscal policy will automatically increase it, and vice versa.

There is a curious, perverse, sort of logic in this thinking. It can be said that by saddling ourselves with a high budget and high progressive tax rates we tend to stabilize the economy. But it is equally true in about the same sense that a man who is tied hand and foot may be said to be stabilized in his activities.

In its application as an antirecession weapon, the compensatory view seems to depend on the fact that by collecting excessive amounts in taxes during good times, we have an opportunity to improve conditions in bad times by reducing the amount of tax collections. This is like arguing that it is a good policy to hit one self on the head with a hammer every day, since it leaves one with the opportunity to improve his well-being by ceasing to do so.

There are signs that enthusiasm is waning for the compensatory budget views. One of the services this panel might perform is to announce its final demise. It is bad enough to have to meet arguments that high spending and high taxes are unavoidable necessities. It is far worse to have to meet the contention that they are to be regarded as causes for self-congratulation.

Conclusion: The Problem of Stabilization

Economic stability is generally accepted as a desirable objective, although no one has succeeded in defining it precisely. There are extreme situations which everyone would agree represent undesirable instances of instability. There is also a vast borderland of cases where there might be a dispute as to whether they are to be considered evidence of instability or merely the normal accompaniment of growth and change.

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Our market system generates forces which guide the economy and tend to keep production, employment, etc., in rough adjustment. It is true that these forces sometimes act with distressing sluggishness. It is also true that these forces may be rendered inoperative by deliberate interference with market operations—e. g., by monopolistic setting of wage costs. But the impersonal market forces must always be our major reliance if we are to preserve an economic system which is recognizable as free enterprise.

Government spending cannot directly influence these equilibrating forces. The most it can do is to substitute itself for them, when they do not seem to be operating satisfactorly.

Government spending policies would have to be designed with almost superhuman wisdom, if they were to have this effect, even in the short run. But let us concede that it can be done, and government spending can offset the maladjustments which occur from time to time.

The trouble is the government spending, by offsetting the unpleasant effects of the maladjustment, also offsets the corrective forces which would eliminate it. Thus a consistent policy of using government spending to promote stability must result in a constant accumulation of unstabilizing influences.

Moralists preach that it is good for us to suffer for our sins since we are then fortified in our resolve to sin no more. Perhaps somewhat the same principle applies in economics, and government spending which protects us against the unpleasant consequences of our own wrongheadedness is the road to perdition.

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