

FEDERAL EXPENDITURE AND ECONOMIC STABILITY: THE FALLACY OF THE BALANCED BUDGET

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There is a prevailing opinion in both lay and expert circles that a balanced budget is substantially neutral in its effects on the economy. This opinion is fallacious.

There are a great many things to be said in favor of a balanced budget. In particular, if we are fearful of a growing debt, a balanced budget, by definition, means a stable debt. This financial consequence of a balanced budget does not, however, mean that the balanced budget leaves the economy substantially unaffected. A balanced budget may be highly expansive in its impact on the economy and may cause inflation. A balanced budget may also be highly restrictive in its impact on the economy and may cause depression. Likewise a budget that shows a surplus—generally regarded as being restrictive in its effects on the economy—may in fact be inflationary. A budget that shows a deficit (hence requiring borrowing—usually regarded as being expansive in its effects on the economy—may, in fact, be restrictive. It is necessary to examine the nature of the expenditures and the taxes (and the borrowing) before any conclusion can be drawn as to the impact of any budget on the economy, whether it is a balanced budget or shows a surplus or a deficit.¹

FEDERAL EXPENDITURE IN THE BUDGETARY CONTEXT

It is undoubtedly possible to discuss the relation between Federal expenditure and economic stability by treating the Federal expenditure in isolation. We would then ignore other aspects of the Government's fiscal operations, such as tax revenues and borrowing. As a practical matter, however, it is budgetary policy as a whole that is the concern of policymakers. If we set as our aim the achievement of economic stability we cannot evaluate the effects of any particular amount or type of Federal expenditure unless we know many things about the economy. One of the most important of these is the revenue side of the Federal budget. For instance, a large Federal expenditure may have a small expansive effect if there exist certain taxes which drain off the expenditure as quickly as it reaches the economy. Budgetary policymakers should, in fact, consider both expenditure policy and tax policy more or less simultaneously because of the fact that the impact of the one is determined in part by the nature and extent of the other.

For these reasons our discussion of Federal expenditure and economic stability is set up in the context of the Federal budget as a

¹ Harold M. Somers, *Public Finance and National Income*, Blakiston, Philadelphia, 1949, pp. 485-527.

whole. We shall indicate the various consequences of a given amount and type of Federal expenditure under a variety of different assumptions as to the prevailing tax structure. Since our primary interest in this paper is with Federal expenditure, the references that are made to tax policy are in the nature of assumptions as to prevailing institutional conditions. Among other important institutional conditions are the nature of the banking system and the state of the money market as a whole.

THE STRUCTURE OF BUDGETARY POLICY

Most of the individual instruments of budgetary policy—expenditures, taxation, borrowing, and debt repayment—have been subjected to meticulous examination by economists. The multiplier theorist has explored the effects of expenditures, and the tax theorist has built up an enormous literature dealing with every nook and cranny of tax incidence and effects. Borrowing and debt repayment have not been studied quite so thoroughly but there is a substantial literature even on these subjects. Although the individual instruments of budgetary policy have been studied carefully, the theory of budgetary policy as a whole lacks integration. The terminology and interests of the tax theorist have not been the same as those of the multiplier theorist while the borrowing and debt repayment expert has busied himself with matters monetary and capital to which the others have, in the main, paid only passing attention. As a result, it is difficult to make adequate allowance for the effects of taxation, borrowing, and debt repayment in trying to determine the consequences of any particular volume of government expenditures. Instead of being an integral part of the analysis, these effects usually take the unsatisfactory form of “modifications” or “qualifications.”

The immediate task is to study each instrument of budgetary policy on some comparable basis and then construct a comprehensive picture of the budgetary impact as a whole. In every case the same broad types of effects are considered. Printing of new money has economic effects only insofar as the money is spent, hence printing of new money is not considered separately. Credit creation for government expenditures forms part of borrowing, in this case from the banking system. Since we wish to see how budgetary policy influences consumption, investment, and national income as a whole, we must consider the extent to which each instrument of budgetary policy involves some impact on the Nation's supply of income and capital funds. The impact on income funds serves as a starting point for the study of subsequent effects on consumer spending and the impact on capital funds serves as a starting point for the study of subsequent effects on investment.

Expansive effects of Federal expenditure

An elementary approach to the problem of measuring government spending for the purpose of determining the effects on economic stability would be simply to look at the amount of spending. Government expenditures of \$20 billion would be expected to have an expansive impact twice as great as government expenditures of \$10 billion.

Brief reflection will show that this approach is inadequate. There is no doubt that it is necessary to break down the amount of government spending in order to get an accurate measure of the effects

on economic activity. It is important to know who receives the money paid out by the Government. If the money is received by persons who will spend it immediately the impact is much more expansive than if it is received by people who will save most of it. Any amount that is saved may be assumed to be available for use on the capital market if suitable terms are available. Some items listed as Federal expenditures are in fact entirely capital items making available funds for loans, e. g. an appropriation to a Federal lending agency. In some cases the Government merely pays money to itself, leaving the economy unaffected.

Another distinction that should be made is that between government transfer payments and government income-producing payments. The former represents merely a transfer of funds from the government to individuals and does not in and of itself involve any employment or income creation. Government income-producing payments represent the purchase of goods or services by the Government and therefore in and of themselves result in employment and income. In the case of transfer payments we must wait for the spending of the money before there is any impact on the economy.

What is done with funds received from the Government is not fixed and invariable. It depends on the psychological climate, the state of expectations, which will in turn be affected by what the Government does and how it does it.

Through the medium of expenditures the Government induces both consumer spending and capital lending. For the most part, income-creation is involved, as in the case of administrative expenses, relief, public works, and most national defense items. By purchasing goods or services the Government directly transfers income funds to the firms and individuals concerned. As pointed out above, there has also grown up another type of government disbursement of funds whereby the Government merely lends its money (nominally, at least) and does not give it away or purchase outright any goods or services. The extension of credit tends to have the same sort of ultimate effects on national income as the outright purchase of goods and services by the Government, but the path taken by these effects is different. Government expenditures associated with lending activities augment the supply of capital funds and thus tend to ease the terms of private borrowing. The effects of this depend on the nature of the inducement to invest and on the possibility of obtaining funds from other sources, for instance, the banks. On the other hand, the direct purchase of goods and services by the Government means, in and of itself, means that the community's supply of income funds in hand is augmented. Government expenditures that directly result in the production of income we shall call "release of income funds"; expenditures that result merely in making loanable funds available (although if invested they too will create income) we shall call "release of capital funds." Thus we carry over into our later discussion the two categories of government disbursement of funds—those which involve a release of income funds and those which involve a release of capital funds.

Restrictive effects of taxation

In the case of tax revenues we have an absorption of funds by the Government; and here again we may consider the funds involved to

be of two types. To some extent, the process of taxation transfers to the Treasury funds which would have been spent on consumers' goods. This is true in some degree of sales taxes and of income taxes on low-income groups. But some taxes impinge on savings, which may have augmented the supply of capital funds. These two parts of taxation have different effects on the national income. The first part directly reduces consumers' expenditures and national income while the second has only an indirect effect operating through the availability of capital supplied by individual income recipients. As a result of this type of taxation the terms of borrowing for private investment may be less favorable than they would otherwise have been. Where bank credit is freely available the restrictive effects arising from the absorption of capital funds through taxation may be negligible. Taxation, then, involves both an absorption of income funds and an absorption of capital funds.

Restrictive effects of borrowing

When we turn to borrowing we again find an instance of government absorption of funds. It might seem that since the money is borrowed the funds involved must necessarily be capital funds. But if we are concerned with the use to which the funds would have been put if they had not been lent to the Government, then we can see, paradoxically perhaps, that not all funds lent to the Government need be capital funds. In the case of some bonds issued during the war and more clearly in the case of compulsory savings, the money lent to the Government would, to some extent at least, have been spent on consumption goods. If the borrowed money comes from a restriction of consumption as a result of public pressure accompanying the borrowing campaign, the effects are different from those which result when the borrowed money comes from credit expansion or from savings which would have taken place anyway. The ordinary multiplier analysis usually takes it for granted that the borrowing of the money in itself is completely innocent of any effects as far as expansion and contraction are concerned. But Government borrowing might reduce private consumption and, depending on the state of the banking system, might discourage private investment. Hence, in the case of borrowing as in the case of taxation we should consider separately the absorption of income funds and the absorption of capital funds.

Expansive effects of debt repayment

We should not leave out of account the release of funds through debt repayment which goes on even when a net increase in the debt is taking place. The repayment of the debt (interest payments being considered part of expenditures) might seem to involve solely a release of capital funds. For the most part, this is true, since the funds paid out by the Government in retiring debt will probably be put on the capital market for the purchase of securities. But in some cases, the Government bonds represent a definite savings program on the part of the individual, with the retirement of the bonds marking the culmination of the program and the spending of the money involved. The repayment of bonds sold in wartime through the use of public pressure or compulsion will also have the effect of stimulating con-

sumer spending. Debt repayment may then be considered to involve a release of income funds as well as a release of capital funds.

OPERATION OF THE BUDGETARY MECHANISM

The several instruments of budgetary policy operate as a unit. Their respective releases and absorptions of income and capital funds combine to achieve the total budgetary impact on the national income. It is useful to consider the various income and capital funds elements separately and then analyze the relation between the two.

Net government release of income funds

Having completed the isolated examination of each instrument of budgetary policy we can obtain an estimate of the extent to which the Government adds directly to the community's income funds. It is generally considered a mistake to regard the whole of Government expenditures as a net addition to income funds because there are offsetting effects in the form of taxation. Hence the magnitude of the deficit, sometimes modified to take account of capital items within expenditures and taxation, is generally regarded as the appropriate indicator of the Government's net contribution to the community's purchasing power. The deficit (or some variant of the deficit) has been generally used as the appropriate multiplicand of the multiplier principle. But if the foregoing dissection of budgetary policy has any validity, the deficit (that is, the extent to which expenditures are financed out of borrowing) gives a misleading picture of the Government's contribution to the community's income funds. Nor should we regard the whole of taxation as being an item to offset expenditures; some taxes are completely innocent of any detrimental effects operating directly on consumption. Finally, we should take account of the debt repayment activities of the Government.

In short, we should add together those parts of expenditures and debt repayment which involve a release of income funds; and deduct those parts of taxation and borrowing which involve an absorption of income funds. In this way we can take account of the income effects of each instrument of fiscal policy and obtain a measure of the net Government release of income funds. This, not the expenditures nor the deficit, is the appropriate measure of the Government's direct contribution to the Nation's purchasing power and is the appropriate multiplicand of the multiplier principle. It may conceivably be negative in some circumstances, that is; there may be a net Government absorption of income funds.

Net Government absorption of capital funds

The other effects of each instrument of budgetary policy must not be ignored. Government borrowing involves mainly (and, in ordinary times, entirely) an absorption of capital funds. Likewise, taxation almost invariably absorbs some capital funds. These elements which involve an absorption of capital funds should be added together, and from them should be deducted those parts of expenditures and debt retirement which constitute a release of capital funds. In this way we obtain a measure of the net Government absorption of capital funds. In other words, we obtain a measure of the net amount of funds the Government withdraws from the money and capital

markets. To take only the amount of Government borrowing, as is usually done, is incorrect, because taxes also involve a withdrawal of capital funds to some extent, and, at the same time, the Government puts some of these funds back into the capital market through its expenditures and repayment of debt. There may be a net release rather than absorption of capital funds on the part of the Government in some circumstances.

In deriving the overall measure representing the net absorption or release of capital funds, we should not lose sight of the individual segments making up this overall measure. The overall measure must be treated with the care required wherever we deal with broad concepts and ignore qualitative considerations. In the case of capital funds, in particular, quality is a vital consideration; a plenitude of funds in the call-money market is of no use to a family desiring to build a house; nor need a scarcity of funds in the long-term capital market have a detrimental effect on a business seeking to renew a 30-day note.

Conversion of capital funds into income funds

Each instrument of budgetary policy may, then, be considered to have a consumption-funds element and a capital-funds element. Borrowing and taxation absorbs both income funds and capital funds, while expenditures and debt repayment release both income funds and capital funds. We may say that expenditures and debt repayment have expansive effects, while borrowing and taxation have restrictive effects. We have broken up each of the expansive and restrictive effects into two parts: the effect on income funds and the effect on capital funds. There is usually a net absorption of capital funds and a net release of income funds. Where there is no change in the government's cash balance and no government printing of money to finance expenditures, the net government absorption of capital funds is identically equal to the net government release of income funds.

The fisc is essentially a mechanism which converts capital funds into income funds. In determining the extent of this conversion, we must not confine our attention to deficit spending, as is so often done. Each instrument of budgetary policy—expenditures, taxation, borrowing, and debt repayment—affects the availability of both capital funds and income funds and plays a part in the Government's conversion of capital funds into income funds.

EFFECTS OF BALANCED AND UNBALANCED BUDGETS

It has been suggested above that the net government release of income funds rather than the deficit is the appropriate overall indicator of the direct expansive impact of budgetary policy. This emphasis on the net government release of income funds directs attention to the expansive effects of expenditures financed through certain types of taxes. Since it is possible to have a net government release of income funds when the budget is balanced, it is possible to have an expansive effect on consumption, and thus national income, when the budget is balanced. For instance, if expenditures are \$70 billion, made up of \$65 billion release of income funds and \$5 billion release of capital funds, and if tax revenues are also \$70 billion (thus

balancing the budget), made up of \$50 billion absorption of income funds and \$20 billion absorption of capital funds, the net government release of income funds is \$15 billion (\$65 billion release through expenditures minus \$50 billion absorption through taxation). At the same time, the indirect restrictive impact is potentially \$15 billion in the form of a net absorption of capital funds (\$20 billion absorption through taxation minus \$5 billion release through expenditures). Whether this indirect restrictive influence is actually felt depends on the state of the banking system and the general availability of capital. In any case, there is a direct expansive impact of \$15 billion, even though the budget is balanced.

The direct expansive impact of budgetary policy may be greater than that indicated by the size of the deficit. For instance, if tax revenues were only \$50 billion in the above example, and borrowing were \$20 billion, both involving solely an absorption of capital funds, the net government release of income funds would be \$65 billion (\$65 billion release through expenditures with no absorption through taxes and borrowing). Thus, there would be a direct expansive impact of \$65 billion with a deficit of \$20 billion. There may also be an offsetting restrictive impact of \$65 billion absorption (50 plus 20 minus 5) of capital funds in a tight-money market.

There may be a direct expansive effect even with a budget surplus. For instance, if expenditures are only \$50 billion, constituting solely a release of income funds, and tax revenues are \$70 billion (making a budget surplus of \$20 billion), constituting \$30 billion absorption of capital funds and \$40 billion absorption of income funds, the net government release of income funds is \$10 billion (\$50 billion release through expenditures minus \$40 billion absorption through taxation). In this case, there is a direct expansive effect of \$10 billion, even though there is a budget surplus of \$20 billion.

On the other hand, the direct expansive effect may be less than that indicated by the size of the deficit, and there may even be a direct restrictive effect when there is a balanced budget or when there is a deficit. If expenditures are \$70 billion, releasing \$50 billion income funds and \$20 billion investment funds; if tax revenues are \$60 billion, absorbing \$45 billion income funds and \$15 billion capital funds; and if borrowing is \$10 billion, absorbing capital funds of the same amount, the net government release of income funds is only \$5 billion (\$50 billion release through expenditures minus \$45 billion absorption through taxation). Thus, we have a direct expansive impact of only \$5 billion when there is a deficit of \$10 billion.

If expenditures are the same as above and tax revenues are also \$70 billion, absorbing \$60 billion income funds and \$10 billion capital funds, there is a net absorption of \$10 billion income funds (\$60 billion absorption through taxation minus \$50 billion release through expenditures). Thus, there is a direct restrictive effect of \$10 billion, even though there is a balanced budget.

If expenditures are again the same but tax revenues are \$60 billion, absorbing \$55 billion income funds and \$5 billion capital funds, and borrowing is \$10 billion, absorbing only capital funds, then the net absorption of income funds is \$5 billion (\$55 billion absorption through taxation minus \$50 billion release through expenditures). Thus, we have a direct restrictive effect of \$5 billion, even though there is a deficit of \$10 billion.

In all cases, there is a net absorption (or release) of capital funds equal to the net release (or absorption) of income funds. If investment capital is plentiful, however, a release or absorption of capital funds by the Government will have little overall impact on the amount of investment that actually goes on. In a tight-money market, on the other hand, any release or absorption of capital funds will have a corresponding effect in stimulating or restricting actual investment.

SIGNIFICANCE OF FEDERAL RESERVE POLICY

It was indicated above that a balanced budget of \$70 billion may involve a net release of consumption funds of \$15 billion and a net absorption of loanable funds of \$15 billion. Although these figures are hypothetical it is reasonable to assume that a balanced budget of large magnitude involves a net release of income funds and a net absorption of capital funds. The release of income funds is undoubtedly expansive. Whether or not the absorption of capital funds is restrictive depends on the state of the money market. In a sufficiently tight-money market the absorption of capital funds may be highly restrictive, offsetting completely the expansive effects of the release of income funds. In an easy-money market, however, the absorption of capital funds may have little effect. Then the balanced budget as a whole would be expansive and under conditions of full employment inflationary.

Federal Reserve policy can determine the state of the capital market, hence the effect of the balanced budget. The balanced budget will be substantially neutral if and only if the Federal Reserve System tightens the capital market so as to make fully felt the effects of the Government's absorption of capital funds and thus offset completely the effects of the Government's release of income funds. In an easy-money market or even a moderately tight-money market the balanced budget is expansive, hence inflationary under conditions of full employment.

CONCLUSION

Federal expenditure in itself is expansive, hence inflationary under conditions of full employment. Federal expenditure matched fully by Federal revenue—i. e., a balanced budget—also tends to be expansive unless capital funds are scarce. A balanced budget is thus generally not neutral. The balanced budget becomes neutral only if it is accompanied by a Federal Reserve policy of tight money.