Fiscal Policy in the Shadow of the Great Depression

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Abstract

Before the Great Depression the U.S. government borrowed in time of war, and almost invariably ran peacetime surpluses to pay off accumulated war debt. The possibility of using the government deficit as a tool of macroeconomic management was never considered.

The Great Depression itself broke this pattern: both the Hoover and the first Roosevelt Administrations wished to maintain the pattern of peacetime surpluses, but both found the austerity required to achieve surplus in the midst of the Great Depression to be politically impossible. In the end—backed by Keynesian and Keynesian-like economic theories—the political nation made a virtue of necessity by concluding that large deficits in time of recession helped moderate the business cycle.

In the generation after World War II, economists and politicians moved toward a consensus position on deficits set out by the CED [Committee on Economic Development]: set tax rates and expenditure plans so that the budget would be in surplus or in balance at high employment, but do not take any steps to neutralize the "automatic stabilizers" set in motion as the budget swings into deficit when recession threatens (and perhaps take discretionary action to further stimulate the economy in recession should the "automatic stabilizers" be seen as too small to be fully effective).

Unfortunately, the American political system seems unable to hold more than one idea at a time. The idea that "cyclical" deficits in recession could be good appears to have weakened attachment to the idea that persistent "structural" deficits that lowered the national savings rate were a bad idea. The Reagan administration called for large tax cuts—and Congress never refuses a presidential call for a tax cut—that created substantial and damaging structural deficits in the 1980s. Confusion between "cyclical" and "structural" deficits appears to have played an important role in the creation of the structural deficits of the 1980s. And revulsion in the 1990s against the persistent "structural" deficits has led to proposals for balanced-budget amendments to the Constitution that would eliminate the government's ability to run beneficial "cyclical" deficits to moderate recessions.

I. Introduction

Before the Great Depression it is hard to speak of the U.S. government having a "fiscal policy." The government did at times borrow—almost exclusively in wartime—and sometimes borrowed on a significant scale: a typical war would end with the federal debt perhaps three-tenths of annual national product. But after the wars were over the debt was invariably repaid: the debt-to-national-product ratio was effectively zero on the eve of World War I, and in the generation before the Civil War.

To the extent that the U.S. had a fiscal policy before the Great Depression, it was that the peacetime budget should always be in surplus, so that the federal government should (save in time of war) strive to have as little debt outstanding as possible.

All this changed with the Great Depression. First involuntarily (with the inability of Hoover and of first-term Roosevelt to find acceptable policies that would balance the budget), and then voluntarily (making a virtue of necessity by trumpeting the macroeconomic benefits of unbalanced budgets), the U.S. abandoned the principal that peacetime federal budgets should always be in surplus.

The post-World War II generations have seen a number of alternative principles competing for politicians' and economists' allegiance: "deficits are desirable as long as they do not permanently destabilize the debt-to-GDP ratio"; "deficits are desirable in recession, but the nominal budget should be in balance over the business cycle"; "deficits are desirable in recession, but the nominal budget should be in balance at full (or high) employment"; "the government should use the federal budget to bring average national saving over the course of the business cycle into line with desired targets"; "the government should seek popularity among the voters by running large deficits, and blaming the deficits and any negative consequences that ensue on the Federal Reserve."

For the first post-World War II generation it appeared that economists' and politicians' opinions were moving toward a consensus position set out by the Committee on Economic Development [CED]: set tax rates and expenditure plans so that the budget would be in surplus or in balance at high employment, but do not take any steps to neutralize the "automatic stabilizers" set in motion as the budget swings into deficit when recession threatens. Many went further in urging that the government should take discretionary action to further stimulate the economy whenever there was a gap between actual and potential output because the fiscal "automatic stabilizers" would be too small to be fully effective.

But no principle has become the basis of an enduring consensus. And no logic can be seen in the pattern of U.S. fiscal policy across decades—especially with the emergence of the "structural" Reagan deficits in the 1980s.

This paper traces, first, the breakdown of the old-fashioned pre-Depression consensus on fiscal rectitude under the pressure of the Great Depression. It then attempts to account for the failure of public and policy-making opinion to form a new consensus around any of the possible principles put forward after World War II as economists, bureaucrats, and politicians struggled to make sure that they had learned the *right* lessons from the Great Depression.

It concludes on a note of pessimism: pressures on the U.S. fiscal balance are strong, political understanding of the benefits of alternative fiscal policies are weak, and so U.S. fiscal policy in the future is likely to display the same lack of logic and the same lack of positive influence on the U.S. economy that it has in the post-World War II past.

II. Fiscal Policy in the Great Depression

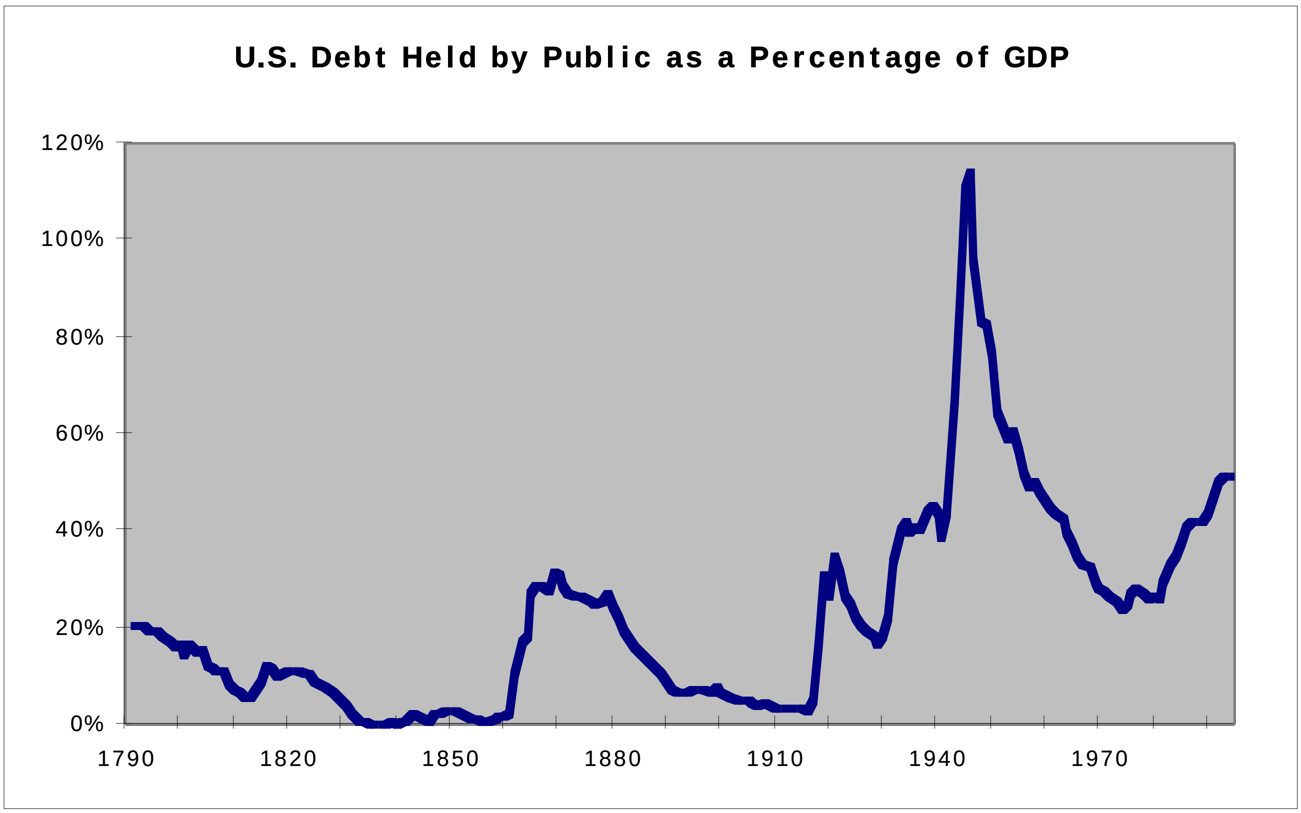
Fiscal Policy Before the Great Depression

Before the Great Depression, the idea that the government should tune its fiscal policy to help control and moderate the business cycle was far from the center of political and economic discourse.

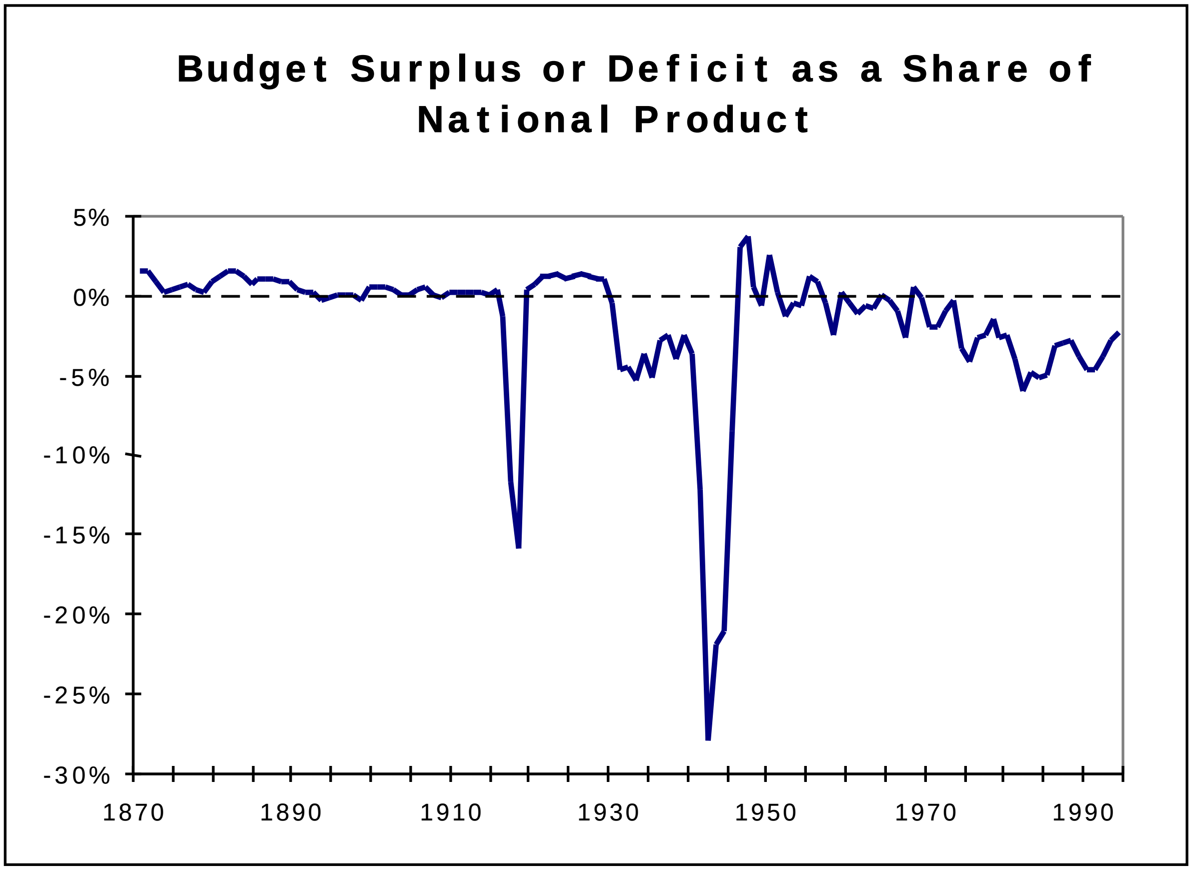
The government did at times borrow, but its net borrowings were almost exclusively confined to wartime. Wartime borrowings were large relative to the size of the economy: wars are very expensive. The Revolutionary War debt assumed by Treasury Secretary Alexander Hamilton amounted to perhaps a fifth of the then-United States's annual national product. The Civil War debt accumulated under Treasury Secretary Salmon Chase, and the World War I debt borrowed under Treasury Secretary William G. McAdoo each amounted to roughly three-tenths of annual national product.

But after the wars were over the debt was invariably repaid. President Andrew Jackson paid off the entire national debt. The small debt run up during the Mexican war was largely retired in the 1850s. The federal debt-to-national product ratio was less than three percent on the eve of World War I. And the decade of the 1920s saw a near-halving of the federal debt as a share of national product.

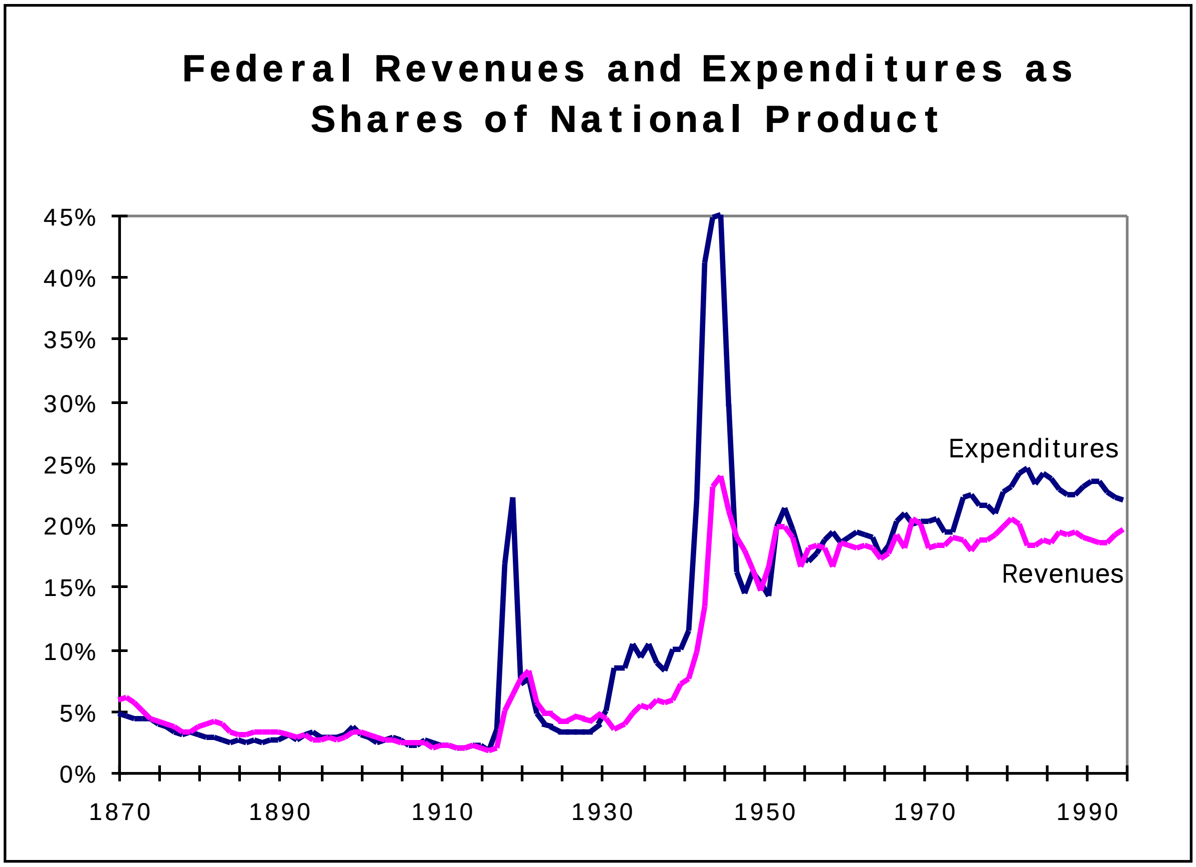
To the extent that the U.S. had a fiscal policy before the Great Depression, it was that the peacetime budget should always be in surplus, so that the federal government should (save in time of war) strive to have as little debt outstanding as possible.



This policy was almost invariably followed in the years leading up to the Great Depression. Before 1930, the years in which the nominal federal budget was in significant deficit were war years. There were peacetime decades—the 1920s, the 1880s, and the 1820s—in which the nominal federal budget was in *surplus* to the extent of two percent of national product or so. And there were peacetime decades in which the nominal federal budget was in rough balance, and in which the growth of the real economy (and the process of inflation, if any) steadily reduced the debt measured as a share of national product.



Indeed, it is not clear how the pre-Depression federal government could have used the budget as a tool of business cycle management if it had wanted to. Before World War I federal receipts and expenditures were roughly three percent of national product. To obtain the same magnitude of fiscal "automatic stabilizers" that we have today—when a $70 billion fall in annual national product is associated with a $26 billion dollar increase in the federal deficit—would in pre-World War I circumstances require that the government respond to a recession carrying with it a four percentage-point increase in the rate of unemployment by either doubling federal spending or eliminating taxation entirely.



Striving for Budget Balance in the Depression

When the Great Depression began, the government's first instinct was to do nothing. As President Hoover wrote, "No President before had ever believed that there was a governmental responsibility in such cases" as the October-November 1929 stock market crash and the associated recession. Hoover stressed that he did assume a governmental responsibility to fight the Depression--in sharp contrast to the:

> "leave it alone liquidationists" headed by Secretary of the Treasury Andrew Mellon, who felt that government must keep its hands off and let the slump liquidate itself. Mr. Mellon had only one formula: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.' He insisted that, when the

> people get an inflation brainstorm, the only way to get it out of their blood is to let it collapse... even a panic was not altogether a bad thing..."[1]

Bust Hoover's idea of an activist government policy to fight the Great Depression was for the government to make sure that its federal budget remained in surplus. Hoover wrote that as the economy slid into the Depression:

> ... our major sources of revenues, income taxes and corporation profits, were going out from under us with appalling speed. In the fiscal year ending June 30, 1932, revenues dropped over $2,000,000,000, or more than 50 percent of our total [federal tax revenue].
>
> National stability required that we balance the budget. To do this, we had to increase taxes on the one hand and, on the other, to reduce drastically government expenditures.... At once the Battle of the Budget with the Democratic-controlled Congress was on...

As Hoover saw it, "the country as a whole supported the administration, but the Democratic leaders were set in their determination to delay [economic] recovery."[2]

Hoover justified attempting to balance the budget—and thus to raise taxes in the middle of the Depression—in his December 1931 State of the Union message:

> Our first step toward recovery is to reestablish confidence and thus restore the flow of credit which is the very basis of our economic life.
>
> The first requirement of confidence and of economic recovery is financial stability of the United States government.
>
> Even with increased taxation, the Government will reach the utmost safe limit of its borrowing capacity by the expenditures for which we are already obligated.... To go further than these limits... will destroy confidence, denude commerce and industry of their resources, jeopardize the financial system, and actually extend unemployment and demoralize agriculture rather than relieve it.

From our perspective these fears appear distinctly odd. The federal debt had stood at more than 35 percent of national product at the end of World War I; it was down to little more than 20 percent of

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[1] Four paragraphs later, Hoover insists that "Secretary Mellon was not hard-hearted. In fact he was generous and sympathetic with all suffering."

[2] Hoover seems to have always assumed the worst about the motives and aims of his political adversaries--both politicians in Washington and grass-roots demonstrators and advocates, whether Democrats "set in their determination to delay recovery" or "old-guard Republican leaders in the Senate and the House... defeated in their Presidential ambition in 1928... [who] certainly did not exert themselves energentically in their traditional duty to counterattack and expose [Democratic political] misrepresentations." His account of the 1932 veterans' "Bonus March" on Washington is--literally--incredible: I did not believe it when it was first summarized for me, and I still can barely believe it.

national product by the end of the 1920s. There was no sign in 1919 that the government had reached the "ultimate safe limit" of its borrowing capacity. And indeed in the late 1940s the federal debt was to reach a total of 115 percent of a year's national product.[3]

If Hoover did not believe that an expansionary fiscal policy was the way to fight the Depression, what policies did he advocate? In Herbert Stein's words, the major thrust of Hoover's policy was to "try to manage the economy by talking to its vital forces on the telephone." Walter Lippmann marvelled at Hoover's "utmost confidence and boldness" that he could, through discussion and exhortation, "guide and oversee the industrial life of the country, initiating major policies as to wages [paid by firms in the Great Depression], purchases of raw materials, capital investment, and what not" (quoted in Stein (1968)). "Corporatism" is the word often used to describe Herbert Hoover's vision of the federal government's role in the economy: encouraging business-government cooperation.

The Depression-Era Case Against Expansionary Policies

Herbert Hoover and his fellow politicians were not alone in possessing a positive fear of stimulative policies in recession. The gap between our calm acceptance today of fiscal automatic stabilizers—and thus the emergence of "cyclical" government budget deficits when unemployment rises—and the general pre-World War II attitudes of bankers and economists is very, very large. Republicans were not alone in seeking budget balance: recall that Franklin Roosevelt made Hoover's inability to balance the federal budget in the Depression a campaign issue in 1932.

Or consider Joseph Schumpeter, writing from Harvard in the middle of the Great Depression that there was a:

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[3] Herbert Stein, in his classic *The Fiscal Revolution in America*, sees two causes of Hoover's campaign to raise taxes and balance the budget in 1932. The first is that "Hoover and his close advisers had prejudices in favor of balancing the budget." The second is the "gold outflow of 1931 [following Britain's abandonment of the gold standard]... rising interets rfalling bond prices, increasing bank suspensions," all of which led some solidity to the fear that, as Stein quotes Keynes, "with the confused psychology that often prevails... [fiscal stimulus] may, through its effects on [business and investor] 'confidence', increase liquidity-preference or diminish the [anticipated] marginal efficiency of capital which, againmay retard other investments..."

> presumption *against* remedial [stimulative policy] measures… [because] policies of this class are particularly apt to…produce additional trouble for the future.... [For depressions are] not simply evils, which we might attempt to suppress, but…forms of something which has to be done, namely, adjustment to…change... [and] most of what would be effective in remedying a depression would be equally effective in preventing this adjustment. (See Brown, 1934).

In what Haberler (1937) classified as "monetary over-investment" theories of the business cycle, depressions were born either because of excessively easy monetary policy or because of *ex post* overoptimistic expectations of economic growth. When monetary policy ceased to be easy, or when investors and businesses recognized that their forecasts of future growth had been overoptimistic, the economy was left with a large inventory of investment projects that were unprofitable.

True and sustainable economic recovery was not possible until the economy's overinvestment overhang had been "liquidated"—and the painful depression was this process of liquidation. Monetary and fiscal policies to moderate the depression would, in this conceptual framework, keep workers and firms producing in unsustainable lines of business and levels of capital intensity. Such attempts to alleviate the depression would make the depression less deep only at the price of making it longer, and would add to the total sum of human misery (Hayek (1935)).

Indeed, economists Lionel Robbins (1934) went as far as to blame the tiny steps toward moderating the decline in the money stock and boosting fiscal demand that governments undertook over 1929-1933 for the persistence of the Great Depression into the mid-1930s.

This doctrine—that in the long run the Great Depression would turn out to have been "good medicine" for the economy, and that proponents of stimulative monetary and fiscal policies in the 1930s were shortsighted enemies of the public welfare—did draw some anguished cries of dissent. Keynes (1931) tried to ridicule this view, which Salant (1989) terms the "crime and punishment" view of business cycles.[4] Ralph Hawtrey (1938), an advisor to the British Treasury and the Bank of

[4] From Keynes (1931): "Some austere and puritanical souls regard [the Great Depression] both as an inevitable and a desirable nemesis on so much [late 1920s] overexpansion, as they call it; a nemesis on man's speculative spirit. It would, they feel, be a victory for the mammon of unrighteousness if so much prosperity was not subsequently balanced by universal bankruptcy. We need, they say, what they politely call a 'prolonged liquidation' to put us right. The liquidation, they tell us, is not yet complete. But in time it will be. And when sufficient time has elapsed for the completion of the liquidation, all will be well with us again....

England, called it the equivalent of "crying, 'Fire! Fire!' in Noah's flood" (Temin (1989)). Much later, Milton Friedman would recall that at the Chicago where he went to graduate school such ideas were not taught, but that perhaps the presence of such doctrines at other universities like Harvard would induce bright economists to rebel and become Keynesians (see Gordon (1972)).

But it drew broader support. And Hoover bought the claim that the Great Depression was due to the Federal Reserve's supposed "credit inflation" of the late-1920s hook, line, and sinker. The evidence that the Federal Reserve overinflated the economy in the 1920's? The size of the Depression of the 1930s, for in Schumpeter's, Hayek's, and Robbins' view you cannot have a recession without previous overspeculation and inflation. Never mind that Friedman and Schwartz find no sign of too-loose monetary policy in the 1920s, as both monetary aggregates and prices followed their normal long-run growth path. Never mind that economic historians like Jeffrey Miron (1992) have argued that the Federal Reserve in the 1920s was too contractionary—and set the Great Depression in motion as a result of their attempts to cool off the economy out of the fear that the stock market boom of the 1920s reflected "overspeculation."

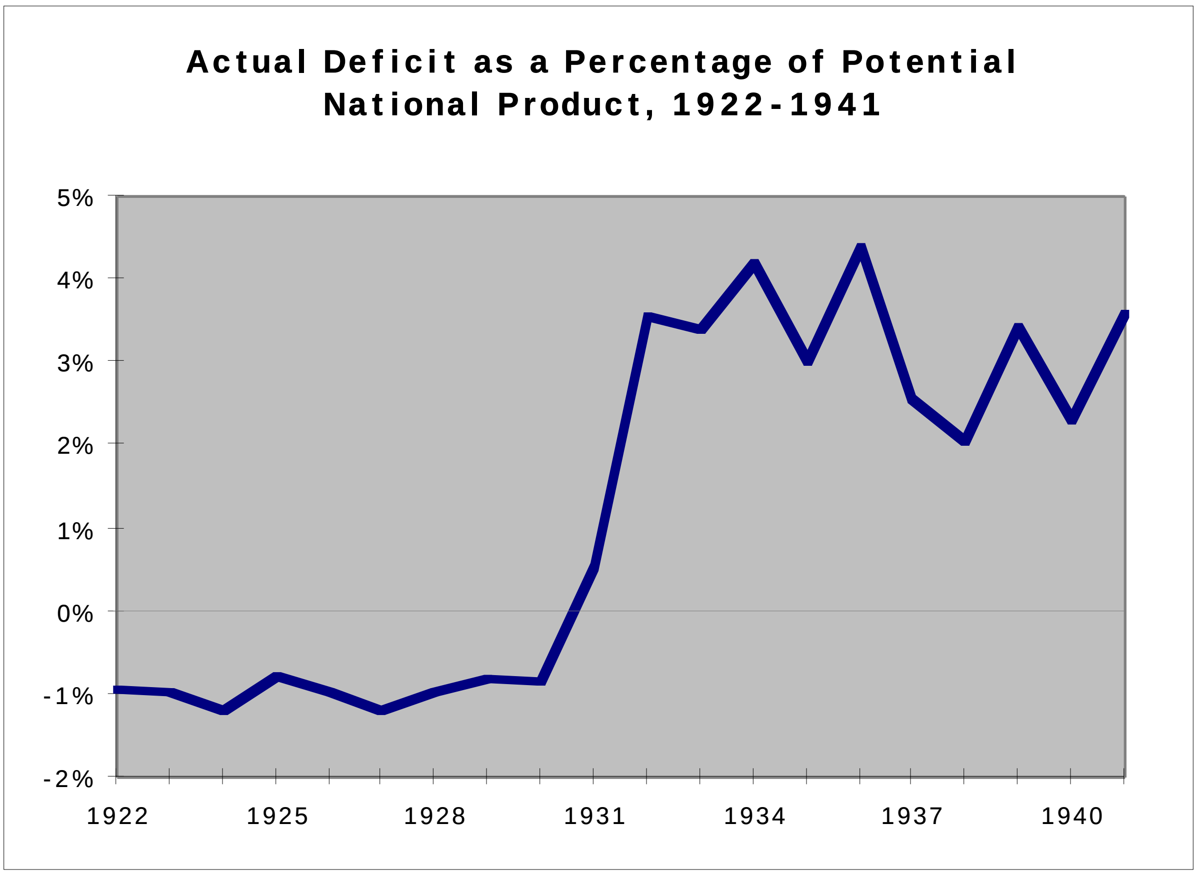
Hoover had no doubt that a Federal Reserve governed by "political appointee[s]... utterly devoid of global economic or banking sense... mediocrities... mental annex[es] to Europe" had set the Great Depression in motion by not causing absolute deflation in the 1920s. And he came close to demanding the execution by firing squad of the entire Federal Reserve Board, ending the section in his *Memoirs* dealing with 1920s Federal Reserve policy with the sentence: "There are crimes far worse than murder for which men should be reviled and punished."

III. Assessing Depression-Era Fiscal Policies

"I do not take this view. I find the explanation of the current business losses, of the reduction in output, and of the unemployment which necessarily ensues not in the high level of investment which was proceeding up to the spring of 1929, but in the subsequent cessation of this investment. I see no hope of a recovery except in a revival of the high level of investment. And I do not understand how universal bankruptcy can do any good or bring us nearer to prosperity…"

The Full-Employment Surplus

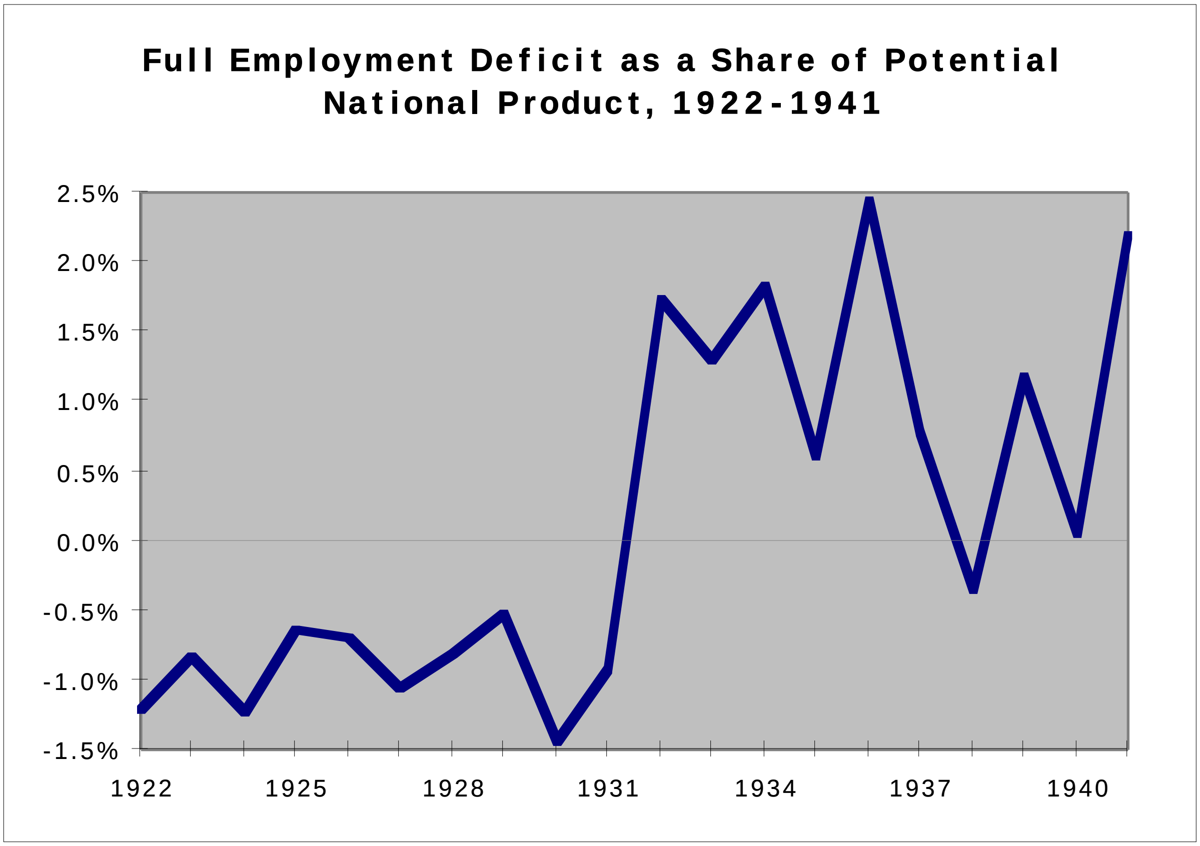
If Herbert Hoover regarded his presidency as a success or failure depending on whether he managed to keep the budget balanced, his presidency was a failure. The federal budget swung from substantial surplus at the start of Hoover's presidency into a deficit of three percent of GDP or more, partly as a result of Congressional override of Hoover's veto of the Veterans' Bonus, partly as a result of "extraordinary" relief expenditures, and mostly as a result of the collapse in the collections of a relatively progressive tax system as real national income and the price level fell in the slide into the Great Depression.



Calculations of the full-employment deficit—the net impact of fiscal policy on the economy after removing the effects of the fiscal "automatic stabilizers" are extremely hazardous in the Great

Depression. Subject to error. Extrapolation of behavioral responses. E. Cary Brown's (1956) estimates.

Nevertheless...



Full-Employment Balance Much Better than the Alternative

There have been powerful (and I believe correct) arguments that the federal government has neither the knowledge of economic structure nor the institutional capacity to do any more than allow fiscal automatic stabilizers to function (see Friedman (1953); Eisner (1969); Stein (1969, 1980, 1984)). But arguments in recession that the current federal deficit—whatever it may be—is "cyclical," and that steps to reduce it immediately would aggravate the recession, have been effective trump cards in public policy debates. And since World War II, at least, they have kept policy makers for taking significant steps to reduce cyclical deficits.

Depression-Era Deficits and National Saving: In the Long Run We Are All...

IV. The Keynesian Golden Age

The 1946 Employment Act

The 1946 Employment Act

- established Congress's Joint Economic Committee
- established the Council of Economic Advisers
- called on the President to estimate and forecast the current and future level of economic activity in the U.S., and
- announced that it was the "continuing policy and responsibility" of the federal government to "coordinate and utilize all its plans, functions, and resources... to foster and promote free competitive enterprise and the general welfare; conditions under which there will be afforded useful employment for those able, willing, and seeking to work; and to promote maximum employment, production, and purchasing power" (see Heller (1966), Bailey (1950)).

It thus committed the federal government to the business of macroeconomic management. Or did it? Consider the 1978 the Humphrey-Hawkins Act required the Chairman of the Federal Reserve to testify before the Congress twice a year on the state of the macroeconomy. It committed the federal government to reducing the unemployment rate to four percent by 1983 *and to maintaining it thereafter*. It also committed the federal government to reducing the inflation rate to zero by 1988. The Humphrey-Hawkins Act has had no effects.

However, laws that merely establish goals can and do serve as markers of changes in opinions, perceptions, and aims. People then speak of the effects of the law, but in many cases they are using the law as a shorthand marker of the changes in the hearts and the minds of the people. A law like Humphrey-Hawkins—in large part passed for short-term political advantage because it was expected to be a dead letter—that signals no shift in hearts and minds has no effects.

The Employment Act of 1946 certainly signalled the commitment of the federal government to the macroeconomic management business. As originally introduced, the *Full* Employment Act required the president to submit a "National Production and Employment Budget" [NPEB] that would set out a spending and legislative program for the current legislative session that would "assure a full employment volume of production" *in the following fiscal year*—a fiscal year that would begin approximately six months after the submission of the NPEB.

Since no extra funds were to be appropriated for the preparation of the NPEB, the work involved in the preparation of such a program would have been carried out by the then-Bureau of the Budget, the subgroup within the Executive Office of the President that is now the Office of Management and Budget. Such an institutional setup would have solidly entrenched a strong bias toward active countercyclical fiscal policy in the core of the American Executive Branch.

As finally enacted, the Employment Act called for an annual *Economic Report* "setting forth... current and foreseeable trends in the levels of employment, production, and purchasing power... and a program for carrying out the policy" of the federal government to promote "conditions under which there will be afforded useful employment for those able, willing, and seeking to work." The enacted bill is a weaker signal of the federal government's commitment to macroeconomic management than was the initial proposal. The enacted bill avoids the explicit institutionalization of short-run Keynesian fiscal policy within the government. It avoids every hint of an enforceable "right to a job." But it is still an important commitment, and a powerful signal.[5]

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[5] The Employment Act of 1946 also created the Council of Economic Advisers. But its creation of the Council of Economic Advisers as we know it today—one chair, two deputies, and a senior staff of fifteen, almost invariably drawn from and planning to return to the professoriate—is best described as an *accident*. The original proposal was for an expansion of the Budget Bureau, or perhaps for an "Office of Director of the National Budget."

Other institutional arrangements were proposed. House Republicans sought a Federal Trade Commission or Federal Reserve Board-like structure for the Council of Economic Advisers, with members confirmed by the Senate serving not at the pleasure of the President but for five-year overlapping terms. Treasury Secretary Vinson sought a cabinet-level economic policy coordination committee chaired by—no surprise—the Treasury Secretary. The staff of such an economic policy coordination committee would have been composed *not* of economists on one- or two-year rotations from the professoriate, but of the mix of civil servants and ex-campaign workers that make up the operating levels of the White House staff.

Such a cabinet-level economic policy coordinating committee has often existed (and, when it has existed, has often been chaired by the Secretary of the Treasury). The head of such a committee (when not the Secretary of the Treasury) and the staff of such a committee have, however, typically been very different from the members and staff of the Council of Economic Advisers. Compare Roger Porter or John Ehrlichman to Michael Boskin or Herbert Stein; at the staff level, compare James Pinkerton to Susan Collins or Matthew Shapiro.

My reading of the legislative history is that the Truman Administration dropped the ball on issues of Executive Office of the President organization on which it ought to have had strong views, and that Congress—I believe incorrectly—saw use of the Senate's advice-and-consent power and the existence of an economic policy appropriation line

Automatic Stabilizers

Automatic stabilizers may not have significantly reduced post-World War II business-cycle variability below pre-Depression levels (Romer (1986). And any belief that automatic stabilizers have a significant effect on business cycle variability does depend on liquidity constraints being pervasive in the economy (see De Long and Summers (1986)). Nevertheless, the shift in the cyclical behavior of the federal budget, considered as a sea-anchor for the economy's level of total spending, is impressive.

A good deal of this increase in the magnitude of automatic stabilizers comes from the increase in the size of the government as a share of national product. The post-World War II federal government taxes and spends one-sixth or more of national product in *peacetime*. The Depression-era federal government taxed five to seven percent and spent eight to ten percent of national product. The pre-Depression federal government taxed and spent five percent of national product in peak peacetime periods. In other periods—the first peacetime presidency of Woodrow Wilson, for example—federal revenues and federal expenditures were little more than one-fiftieth of national product.

With a large federal government automatic stabilizers can easily be large: a 2.5 percentage-point increase in the unemployment rate associated with a five-percent fall in output relative to previous forecasts would "automatically" produce a deficit of one percent of national product if revenues and spending are one-fifth of national product, even if revenues have a unit elasticity with respect to shocks to production and even if expenditures do not rise in response to unexpected increases in unemployment. When revenues are only six percent of national product the smaller size of the government alone makes automatic stabilizers only one-third as large. And when, as before the Great Depression, both spending and revenues are five percent of national product or less, it is hard to see how "automatic stabilizers" could have any macroeconomic significance.

The table below presents simple regressions of the level of the government's fiscal balance as a share of national product on the unemployment rate (using annual data, for fiscal years, applying

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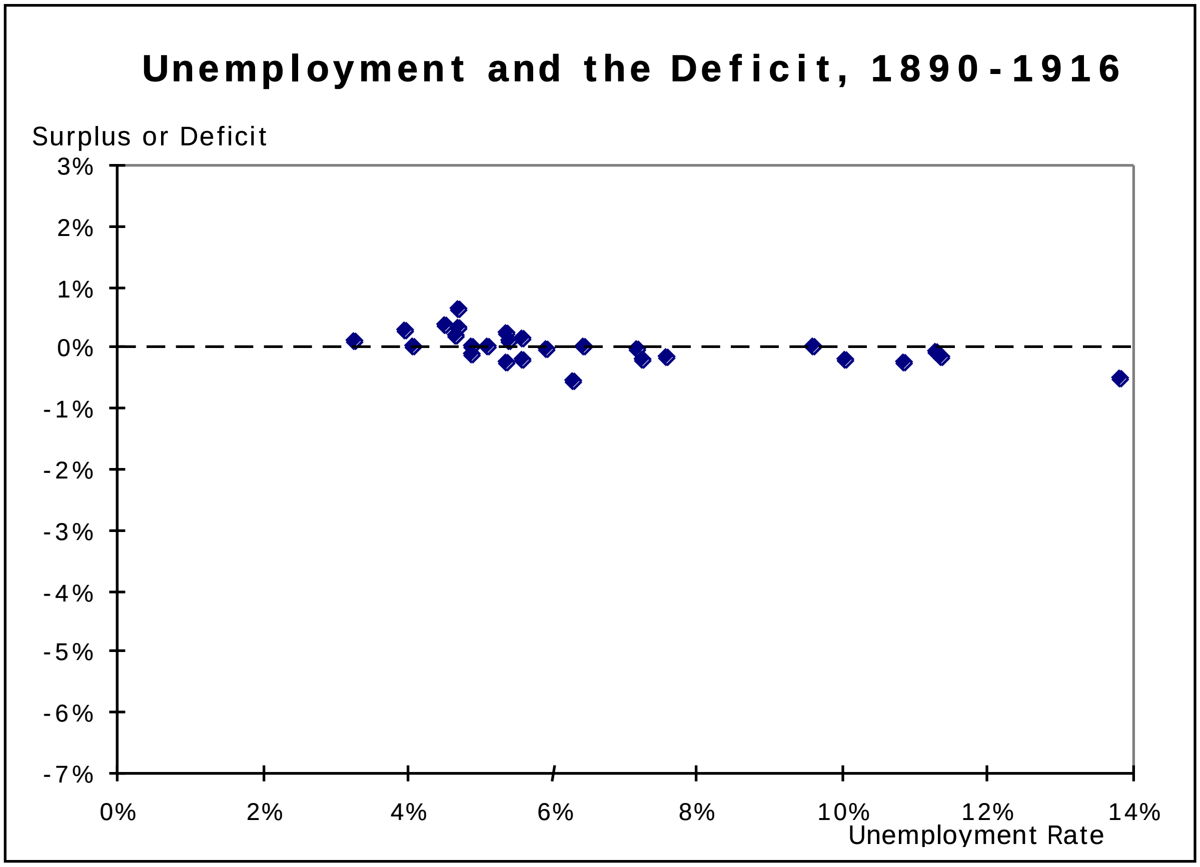
item as tools it could use to influence the macroeconomic policy planning in the Executive Office of the President. Only because of the institution-building of Arthur Burns and Walter Heller did the CEA acquire the recruitment and staffing patterns that it has today.

Romer’s (1986) suggested correction to pre-Depression estimates of unemployment rates, and reporting robust standard errors) as a way of summarizing the degree to which fiscal policy stabilized the economy, either through automatic stabilizers that they were allowed to operate (and not offset by attempts to move toward budget balance in recession), or through discretionary fiscal policy.

Responsiveness of Federal Budget to Unemployment: Pre-World War I, Interwar, and Post-World War II

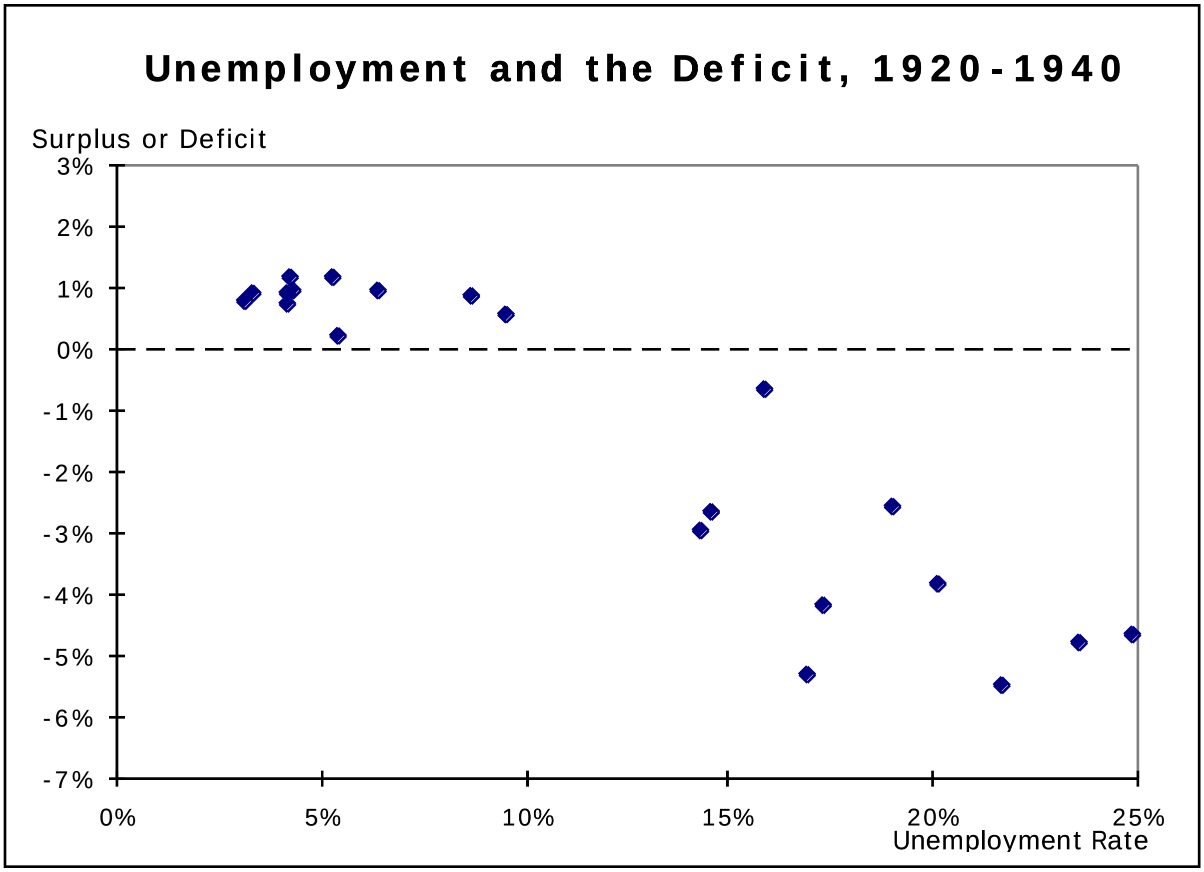
Period	Unemployment Rate	Post-1982 Period	R^2	SEE
1890-1916	-0.056 (0.023)		0.307	0.002
1920-1940	-0.317 (0.045)		0.847	0.010
1950-1995	-0.894 (0.188)		0.526	0.013
1950-1995*	-0.680 (0.127)	-0.021 (0.004)	0.746	0.010

Not surprisingly, the pre-World War I period shows no signs of automatic stabilizers: the federal budget balance is correlated with unemployment, but the small size of the federal government means that a five percentage-point rise in the unemployment rate would be associated with only an 0.28 percentage-point rise in the federal deficit as a share of national product.

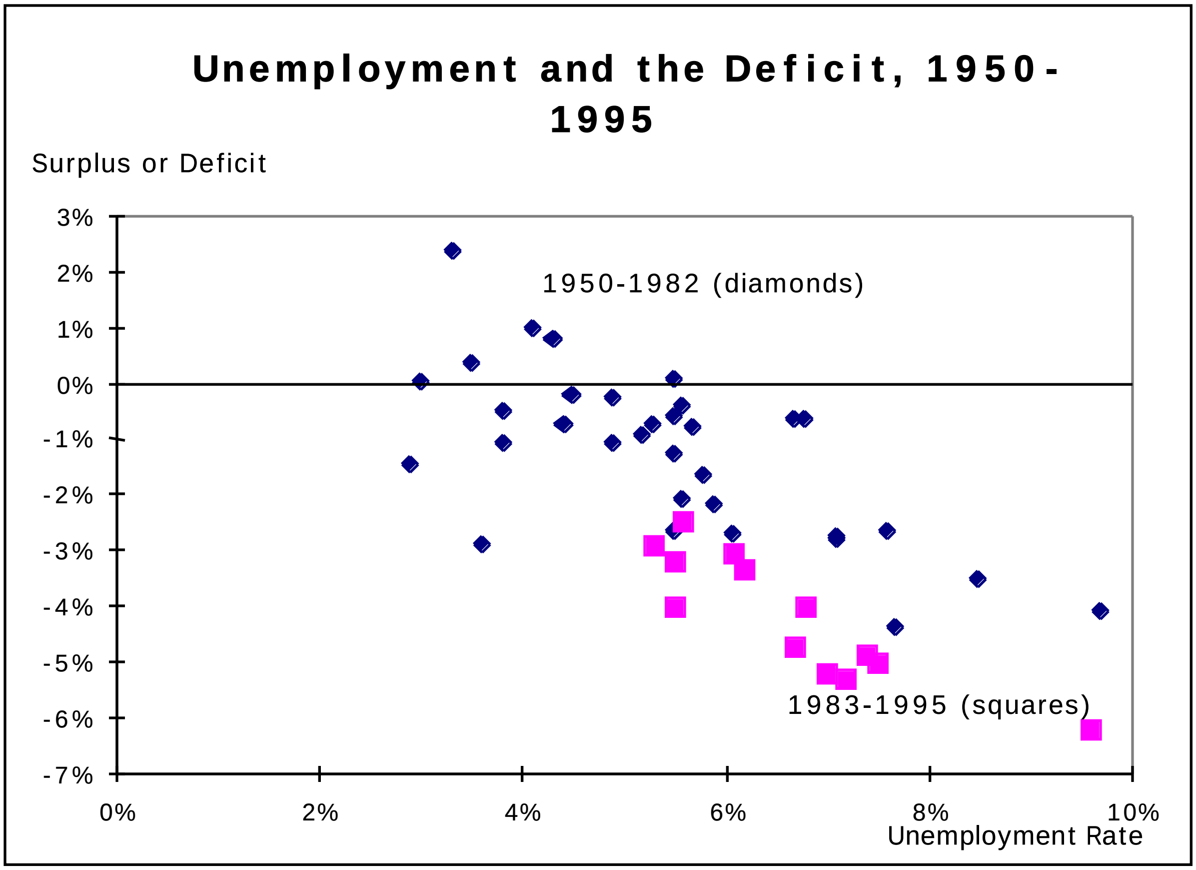


The interwar period—the overwhelming share of identifying variance comes from the Great Depression—shows a degree of stabilization: a five percentage-point increase in the unemployment rate is associated with a 1.6 percentage-point increase in the deficit as a share of national product. The bulk of this stabilization comes on the discretionary expenditure rather than on the tax side: between 1929 and 1933 revenues remained roughly constant as a share of national product as nominal national product fell by more than forty-five percent. By contrast, nominal federal expenditures rose by fifty percent.

The post-World War II period shows the greatest cyclical responsiveness of fiscal balance to unemployment. A five percentage-point increase in the unemployment rate is associated with a 4.5 percentage-point increase in the federal deficit as a share of national product over the post-World War II period as a whole.



If one allows for a shift in the intercept in the early 1980s as a result of the change in America's budget politics brought about by the shift of a large chunk of the Republican party from a commitment to budget balance as the highest priority to a commitment to tax cuts as the highest priority, the stabilization exercized on the economy by the government's fiscal balance appears somewhat smaller: a five percentage-point increase in the unemployment rate is associated not with a 4.5 but with a 3.5 percentage-point increase in the federal deficit as a share of national product.



<u>*The Single Success of Discretionary Fiscal Policy*</u>

Looking back at the budget since World War II, it is difficult to argue that on balance "discretionary" fiscal policy has played any stabilizing role at all (see Gordon (1980); De Long and Summers (1986)). Walter Heller could find one case of successful discretionary stabilization stabilization policy—the Kennedy-Johnson tax cut (Heller (1966)). But even those who believe early-1960s fiscal policy was a great success find no other examples, and no successful repetitions in which a discretionary fiscal policy intended to shift output relative to potential had the desired effects (see Eisner (1969).

The basic difficulty is that recessions are not expected, are not forecasted, and develop quickly. Economic policy makers are working with shaky data from one quarter or so in the past. The legislative process takes at least two or three quarters. Appropriated funds require at least two more quarters before they can be spent on any substantial scale. And by that time the "need" for economic stimulus has passed. The U.S. government simply lacks the knowledge to design and the institutional capacity to exercise discretionary fiscal policy in response to any macroeconomic cycle of shorter duration than the Great Depression itself.

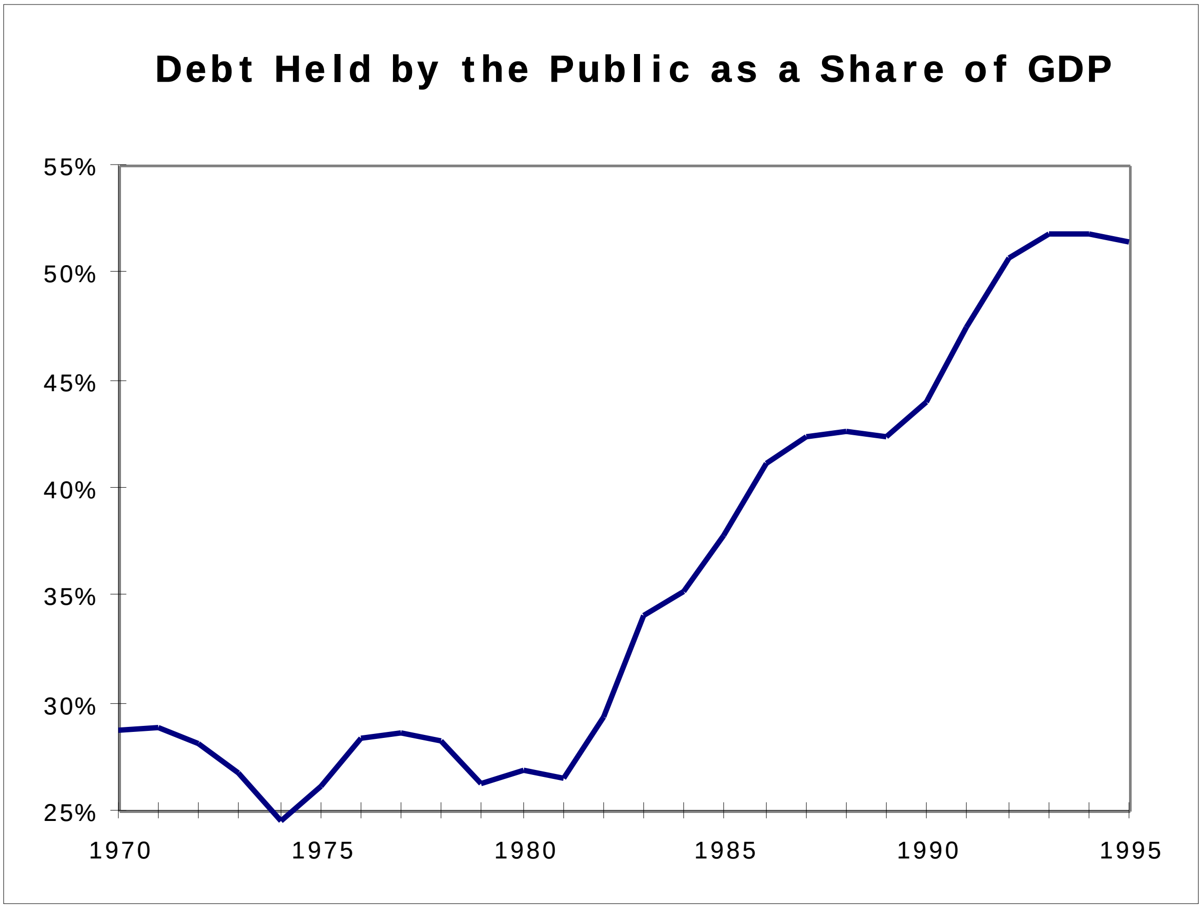
By contrast, automatic stabilizers swing into action within the current quarter. A fall in incomes leads to a shortfall in revenues—and an increase in the deficit—as soon as witholdings reach the Federal Reserve. It is difficult to imagine how alternative policy instruments could deliver such a within-the-quarter response to shifts in spending and employment.

V. Long-Run Effects of Short-Run Policies

The Point of Equipoise: Robert Solow

The Transformation of Cylical into Structural Deficits: Martin Feldstein and James Buchanan

There is an important argument that the belief in fiscal policy as a tool of economic stabilization has had harmful consequences for the economy as a whole. Buchanan and Wagner (1977) argue that deficits are very dangerous because voters are myopic: when spending is raised and taxes are raised to finance the extra government spending, voters feel both the pain of reduced after-tax incomes and the benefits of spending programs, and can judge whether the one is worth the other; when spending is raised and financed by borrowing, voters feel the benefits from spending but do not sense the true resource cost imposed by the higher future taxes (or the hyperinflation) required by the added indebtedness. The consequence? A government that is “too large,” in that in engages in spending programs that do not provide social benefits equal to their resource costs, and a heavier and heavier tax burden on future generations.



Democratic politics applied to government spending, Buchanan and Wagner (1977) argue, functions well only as long as deficits are effectively prohibited—regarded as extremely costly and as a dire moral evil. Arguments that deficit spending could be useful as a tool of stabilization policy managed, in Buchanan and Wagner's view, to undermine the polity's immune system that prevented the emergence of borrow-and-spend as a standard operating procedure of political parties. And the adoption of borrow-and-spend as a policy threatens to have evil consequences for economic growth: here in the United States we are still waiting for even the first sign of an endogenous rise in private savings to offset the fall in national wealth accumulation generated by the U.S.'s "structural" deficits.

It is hard to look back at the politics of America's federal deficit since 1980 without concluding that there is a good deal of truth in Buchanan and Wagner's argument. "Cyclical deficit—good. Structural deficit—bad" appears to be a message that is just a little bit too hard for official Washington to hold on to. And it is hard to believe that the alternative explanations for the emergence of structural deficits in the 1980s—primarily the necessity of slowing the preplanned growth of federal spending as a result of the slower growth of the real revenue base after the beginning of the post-1973 productivity slowdown (see Auerbach (1994))—are the entire story.

It is, however, a very malign fate that made the American political party usually seen as most sympathetic to Buchanan's general philosophy the carrier of the policies that he feared were the natural consequences of the use of fiscal policy for macroeconomic stabilization.

Overconfidence

VI. Conclusion

The Shadow of the Great Depression

A second answer is that there could have been no 1946 Employment Act only if the shifts in sentiment and opinion of which the 1946 Employment Act was a signal had not occurred, and if attitudes toward *laissez-faire* as a principle, toward government responsibility for the economy, and toward the likely effectiveness of government macroeconomic intervention in 1946 had been much more like attitudes in 1929.

A world in which opinion leaders and policy makers had not learned the lessons taught by the Great Depression and World War II would have been a very different world—presumably a world in which post-World War II macroeconomists called themselves Hayekians rather than Keynesians, discoursed on how deep recessions were a necessary price for the dynamic growth efficiencies of market-led economic development, and one in which governments responded depressions by cutting spending and raising tax rates to keep the budget in balance and so prevent investors from losing confidence and making the depression worse.

In such a world an outbreak of inflation like that seen in the 1970s would have been very unlikely. In such a world a repeat of the Great Depression would have been somewhat more likely.

I do not think that, on balance, many of us would think that it would have been a better world than the one in which we have lived for the past fifty years. But my opinion depends on a belief that the social and economic costs of the outbreak of inflation in the 1970s were low relative to the probability and cost of another episdoe like the Great Depression.

What Are the Shadows Being Cast Today?

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Appendix

Herbert Hoover's view of the 1932 Veterans' Bonus March (from Herbert Hoover, *The Memoirs of Herbert Hoover: The Great Depression, 1929-1941* (New York: Macmillan, 1952)):

"Probably the greatest [Democratic propaganda] coup of all was the distortion of the story of the Bonus March on Washington in July, 1932. About 11,000 supposed veterans congregated in Washington to urge action by Congress to pay a deferred war bonus in cash instead of over a period of years.

"...the Democratic organization seized upon the incident with great avidity. Many Democratic speakers in the campaign of 1932 implied that I had murdered veterans in the streets of Washington.

"The story was kept alive for twenty years. I, therefore, deal with it at greater length than would otherwise be warranted. As abundantly proved later on, the march was in considerable part organized and promoted by the Communists and included a large number of hoodlums and ex-convicts determined to raise a public disturbance. They were frequently addressed by Democratic Congressmen seeking to inflame them against me for my opposition to the bonus legislation. They were given financial support by some of the publishers of the sensationalist press. It was of interest to learn in after years that they also had put on a special battery of speakers to help roosevelt in his campaign, by the use of the incident.

"When it was evident that no legislation on the bonus would be passed by the Congress, I asked the chairmen of the Congressional committees to appropriate funds to buy tickets home for the legitimate veterans. This was done and some 6,000 availed themselves of its aid, leaving behind about 5,000 mixed hoodlums, ex-convicts, Communists, and a minority of veterans in Washington. Through government agencies we obtained the names of upwards of 2,000 of those remaining and found that fewer than a third of them had ever served in the armies, and that over 900 on the basis of this sampling were ex-convicts and Communists.

"Some old buildings on Pennsylvania Avenue had been occupied by about 50 marchers. These buildings stood in the way of construction work going on as an aid to employment in Washington. On July 28th the Treasury officials, thorugh the police, requested these marchers to move to other quarters. Whereupon more than 1,000 of the disturbers marched from camps outside of the city armed with clubs and made an organized attack upon the police. In the melee Police Commissioner Glassford failed to organize his men. Several were surrounded by the mob and beaten up; two policemen, beaten to the ground, fired to protect their lives and killed two marchers. Many policemen were injured.

"In the midst of this riot the District Commissioners, upon Glassford's urging, appealed to me. They declared that they could not preserve order in the Capital, that the police were greatly outnumbered, and were being overwhelmed. With the same right of call on me as municipalities have on the governor of any state, they asked military assistance to restore order. At my direction to Secretary of War Hurley, General Douglas MacArthur was directed to take charge. General Eisenhower (then Colonel) was second in command. Without firing a shot or injuring a single person, they cleaned up the situation. Certain of my directives to the Secretary of War, hoever, were not casrried out. Those directions limited action to seeing to it that the disturbing factions returned to their camps outside the business district. I did not wish them driven from their camps, as I proposed that the next day we would surround the camps and determine more accurately the number of Communists and ex-convicts among the marchers. Our military officers, however, having them on the move, pushed them outside the District of Columbia."

Four comments seem appropriate:

- First—if this is how Herbert Hoover perceived the Bonus March at the time, and not just in retrospect—America came closer to “European”-style Depression-era politics than I would have believed.
- Second, that Herbert Hoover’s *Memoirs* are far from being a trustworthy account of Depression-era events.
- Third, it is clear that Hoover does more damage to his reputation with his retrospective justification of actions during the Bonus March than all of Roosevelt’s surrogate speakers could possibly have done during the 1932 campaign.
- Fourth, “Congress shall make no law... abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.”