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2 Fiscal Policy in the Shadow of the Great Depression

J. Bradford De Long

Before the Great Depression the U.S. government did not have a fiscal policy, at least not in the sense that economists have meant for the past two generations. The government did not attempt to tune its deficit or surplus to achieve the goal of full employment or low inflation. This is not to say that the federal budget was typically in balance. The federal government did borrow, and borrow on a very large scale in wartime: a typical pre-World War II war would end with total federal debt equal to some three-tenths of a year's national product.

But after a typical war was over the debt would rapidly be redeemed: the War of 1812 debt had been paid off by the 1830s. The Mexican War debt had been extinguished by the early 1850s. The enormous Civil War debt and the less enormous Spanish-American War debt had been extinguished by the eve of World War I. Thus U.S. "fiscal policy" before the Great Depression was simple: the federal government borrowed what it could during wartime. It strove thereafter to run peacetime surpluses to reduce the ratio of debt to national product. All this changed with the Great Depression.

The first depression-era federal deficits were involuntary: both Herbert Hoover and (in his first term at least) Franklin Roosevelt tried to achieve balanced budgets. But they each failed to find politically feasible policies that could pass the Congress and would balance the budget. Later depression-era federal deficits were more voluntary: the government came to make a virtue out of necessity and to trumpet the potential macroeconomic benefits of a depression

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deficit. Thus the U.S. government abandoned the principle that the only good peacetime budget was a balanced budget. And the depression-era deficits were continued and vastly expanded during World War II.

The shadow cast by the Great Depression prevented a return to the predepression principle of budget balance after World War II: the political economic folk wisdom, not completely wrong, was that addiction to budget balance had deepened the depression. But what was to replace the predepression commitment to peacetime balance as an operational goal?

For the first generation or so after World War II, economists' and politicians' views appeared to be converging on a possible consensus, a position that had been set out by the Committee on Economic Development (CED) under the intellectual leadership of future Nixon-era Council of Economic Advisers (CEA) chair Herbert Stein.¹

The CED position was to set tax rates and expenditure programs so that the budget would be in surplus or in balance at high employment (whichever was desired) but to leave unhindered the operation of the "automatic stabilizers" set in motion as recession causes revenues to fall, spending to rise, and the budget to swing into deficit. These automatic stabilizers take effect within a single calendar quarter, as claims for unemployment insurance and food stamps are filed and as tax withholdings are received (or not received) by the Federal Reserve system. They reduce the sensitivity of aggregate demand to shifts in autonomous spending or monetary velocity, thus diminishing the magnitude of cyclical fluctuations. And they operate much more quickly than discretionary fiscal policies or shifts in monetary policy can—thus they are an irreplaceable tool of macroeconomic management.

But neither Herbert Stein's nor any other principle managed to become the basis of an enduring consensus. And no logic can be seen in the pattern of U.S. fiscal policy across decades: whatever logic might have been seen vanished with the emergence of long-term "structural" deficits during the 1980s under Ronald Reagan's presidency, and with the appearance of very long term projections of large deficits as a social insurance system designed before 1973 collided with slower real revenue after the 1973 beginning of the productivity slowdown (see Auerbach 1994).

This paper traces, first, the breakdown of the predepression consensus on fiscal rectitude under the pressure of the depression. It then considers the shadow cast by the memory of the depression on post-World War II fiscal policy, as economists, bureaucrats, and politicians struggled to learn the *right* lessons from the depression.

It concludes on a note of pessimism: pressures on the U.S. fiscal balance are strong, political understanding of the benefits of alternative policies are weak, and the attention span of the political system is short. Even though the consen-

1. Stein's *The Fiscal Revolution in America: Policy in Pursuit of Reality* was and remains a classic.

sus of economists has provided and will continue to provide good advice, fiscal policy in the future is likely to display a similar lack of logic and have similar damaging effects on the economy as in the recent past.

2.1 Predepression Fiscal Policy

2.1.1 Peacetime Surpluses

Before the Great Depression, the idea that the government should tune its fiscal policy to control and moderate the business cycle was far from the center of political and economic discourse. The government did borrow, but its borrowings were 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 one-fifth of the then-United States' 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 (see fig. 2.1).

But after the wars were over, the debt invariably shrank as a share of national product. Some of the debt was retired by budget surpluses. The remaining debt, constant in nominal terms, shrank relative to GDP because of real per capita income growth, population growth, and inflation.

The Revolutionary War debt (both that issued under the Articles of Confederation and that assumed from the states on Hamilton's initiative) had been reduced from roughly 20 to perhaps 5 percent of national product by the eve of the War of 1812. The War of 1812 debt was steadily reduced throughout the

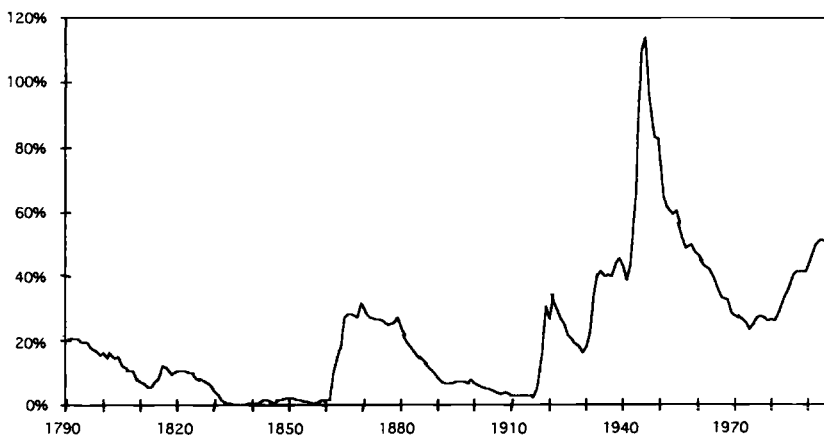


Fig. 2.1 Federal debt as a share of national product

Sources: U.S. Bureau of the Census (1975) and CEA (1996).

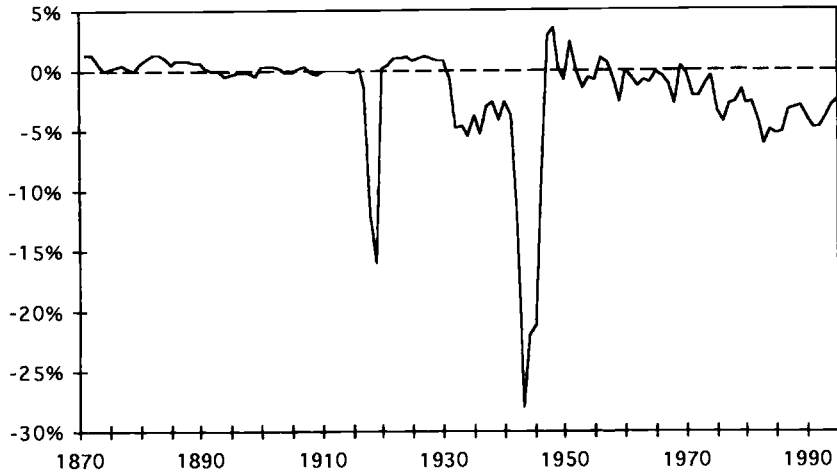


Fig. 2.2 Budget surplus (or deficit) as a share of national product

Sources: U.S. Bureau of the Census (1975) and CEA (1996).

1820s, and President Andrew Jackson paid off virtually the entire national debt in the 1830s. The small debt run up during the Mexican War was similarly erased by the end of the 1850s.

The large Civil War debt and the small (relative to national product) Spanish-American War debt were similarly paid off over the decades: the ratio of federal debt to national product was less than 3 percent on the eve of World War I. The pattern was the same after World War I. The decade of the 1920s saw a near halving of the federal debt as a share of national product.

Before the Great Depression there were peacetime decades—the 1920s, the 1880s, and the 1820s—in which the nominal federal budget was in *surplus* to the extent of 2 percent of national product or so. There were peacetime decades in which the nominal federal budget was in rough balance, and in which the growth of per capita income, the growth of population, and (usually) the slow progress of inflation reduced the relative size of the debt measured as a share of national product. There were no peacetime decades in which the federal budget was in more than trivial deficit (see fig. 2.2).

2.1.2 Ideologies and Doctrines

The rationale for the predepression consensus against countercyclical fiscal policy had at least five facets. First came a fear of the impact of large federal debts on the *economic* health of the country. A large debt meant large interest payments to service the debt. Relatively large interest payments to service the debt required high taxes—and, perhaps, a significant excess burden, especially given the limited record-keeping capacities of pre-twentieth-century governments and thus the limited range of taxes that they could effectively administer.

Adam Smith, for example, surveyed the rising trend in war-induced debts, writing that rising debt as a share of national product “has gradually enfeebled every state which has adopted it. . . . Spain seems to have learned the practice from the Italian republics, and (its taxes being probably less judicious than theirs) it has, in proportion to its natural strength, been still more enfeebled. . . . [The same is true of] France . . . [and] the United Provinces [of the Netherlands]” ([1776] 1937, 880–81).

Smith believed that the conclusion of this “progress of the enormous debts” was “probably ruin.” He showed little patience with those who argued that the eighteenth-century British Empire need not fear the economic consequences of the accumulation of debt:² “Another war . . . may . . . render the British system of taxation as oppressive as that of Holland, or even as that of Spain. . . . Let us not . . . rashly conclude that [the British economy] is capable of supporting any burden; nor even be too confident that she could support without great distress a burden a little greater” ([1776] 1937, 881).

Second came a fear of the *political* consequences of a high national debt. The government becomes more concerned with keeping its debt holders happy when the ratio of debt to national-product is high. It fears the consequences of capital flight: the government becomes, in a sense, the *property* of its debt holders when this ratio rises. Perhaps followers of Alexander Hamilton were not unhappy with the idea of a government whose every step was taken with a worried backward glance to see whether it pleased the bondholders. But followers of Thomas Jefferson or Andrew Jackson were very unhappy.

Third—and perhaps most important—was that few believed that deficits in recession would be successful stabilization policy. Running a peacetime deficit to try to alleviate a recession would increase the tax burden, depress production and wealth in the long run, and reinforce dangerous tendencies in politics, *and* it would fail to boost employment and production in the short run.

One important reason to doubt that deficits would be effective at fighting recessions was the operation of the pre-World War I gold standard. Under the prevailing international monetary system—the gold standard—capital flowed freely across national borders. To a first approximation, the domestic interest rate was set in world markets: equal to the world interest rate plus whatever risk premium international investors demanded for placing their wealth in the home country. Thus, there seemed to be little reason to think that deficits would be a powerful stimulative policy. First, deficits reduce the net supply of loanable funds to the private market: money borrowed by the government is not available to be loaned to business. Second, deficits might well increase—perhaps sharply increase—the risk premium investors would demand for lending their capital on the domestic market.

The net effect? *If* private domestic demand for loanable funds is inelastic,

2. On the British political military state, see Brewer (1990). Also relevant is De Long and Shleifer (1993).

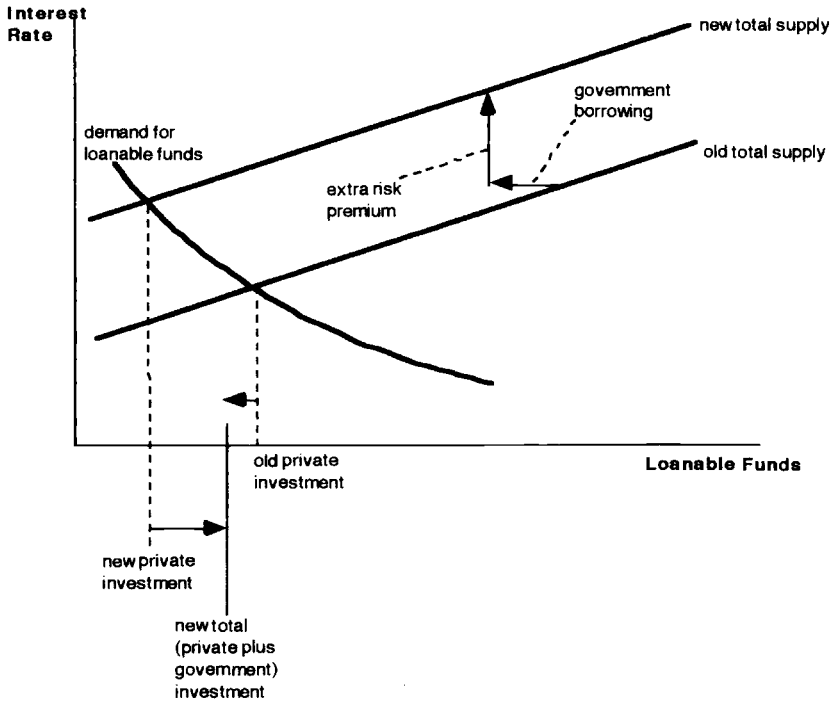


Fig. 2.3 Effect of deficit spending on demand and supply of investment funds under the gold standard

and *if* the shift in the risk premium charged by overseas investors is small, then it *might* be that the sum of private investment and public spending if the deficit-spending program were undertaken would be larger than otherwise. But it might not. And there was no theoretical presumption that it would (see fig. 2.3).

Indeed, these fears made coherent sense in an impeccably Keynesian framework: that of Keynes's (1936) *General Theory*. Stein quotes Keynes that deficit spending "may have the effect of increasing the rate of interest, and so retarding investment . . . whilst . . . the increased cost of capital goods will reduce their marginal efficiency. . . . With the confused psychology that often prevails, the Government programme may through its effects on 'confidence' increase liquidity-preference or diminish the marginal efficiency of capital" (quoted in Stein 1969, 36–37). And economists working in the Keynesian tradition have at times argued that deficit spending is not expansionary. Consider Alan Blinder's claim that the 1993 fiscal policy contraction in the United States boosted production and employment: "The remarkable decline in long-term interest rates from the fall of 1992 to the fall of 1993 is what kick-started a previously lackluster economic recovery into sustained growth. Remember . . .

that the bond market rallied with no change in monetary policy. Does anyone seriously doubt that the Clinton administration's large, credible, deficit-reduction plan of 1993 was the driving force behind the lower long-term interest rates?"³ The predepression fears that fiscal policy multipliers could be zero or negative were real fears.

Overinvestment Theories

A fourth argument against countercyclical fiscal policy was not that it would not work but that it would—and that depressions were good for you. Many economists explained the business cycle in general and the Great Depression in particular as consequences of “overinvestment.” For example, Joseph Schumpeter, writing from Harvard in the middle of the Great Depression, claimed that there was a “presumption *against* remedial [stimulative policy] measures [because] policies of this class produce additional trouble for the future. . . . [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” (quoted in Brown et al. 1934, 138).

In what Haberler (1937) classified as “monetary overinvestment” 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 like 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 1929–33 for the persistence of the Great Depression into the mid-1930s.

Limits to Predepression Action

Fifth came yet another reason to be skeptical about predepression countercyclical fiscal policy: the problem of implementation. How might the government

3. See <http://www.slate.com/CoC/96-09-09/Monday.asp>.

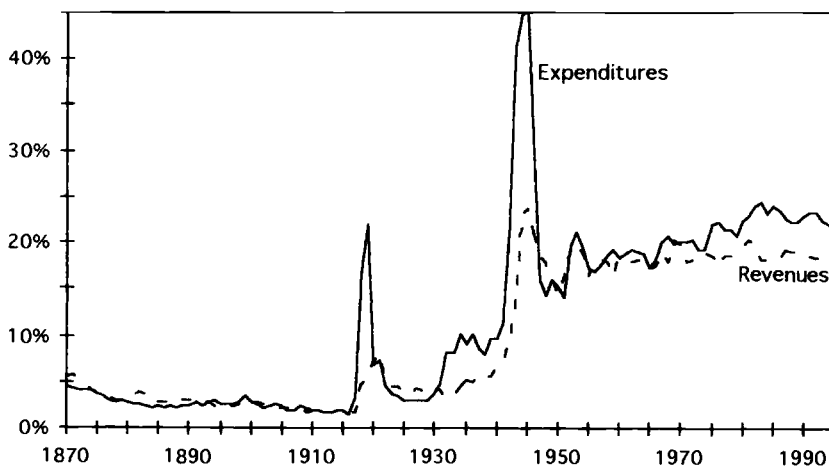


Fig. 2.4 Federal revenues and expenditures as shares of national product

Sources: U.S. Bureau of the Census (1975) and CEA (1996).

manage to spend money in a timely fashion on a large enough scale to do any significant good? It is not clear how the predepression federal government could have used the budget as a tool of business cycle management, even if it had very strongly wanted to (see fig. 2.4).

Before World War I, federal receipts and expenditures were roughly 3 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 4 percentage point increase in the rate of unemployment by either doubling federal spending or eliminating taxation entirely. Fiscal policy can be stabilizing only if government spending is large enough to act as a plausible sea anchor for aggregate demand.

2.2 Fiscal Policy during the Depression

2.2.1 Striving for Budget Balance

Before the Great Depression, the government’s first instinct when the economy turned down was to do nothing. President Hoover sought to break this pattern. He stressed that he *did* assume a governmental responsibility to fight the depression—in sharp contrast to many others in his own party. He reserved special scorn for his own economic policy team, whom he termed 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" (1952, 3: 30).⁴

But Hoover's idea of how activist government policy should fight the Great Depression was for the government to make sure that its budget remained in surplus. Hoover sought tax increases because "our major sources of revenues, income taxes and corporation profits, were going out from under us with appalling speed. . . . 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" (1952, 3: 132).⁵

Thus Hoover's December 1931 State of the Union message called for stringent action to balance the budget:

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. (Hoover 1952, 3: 132–33)

From our perspective, Hoover's fears appear wrongheaded. The federal debt at the end of World War I had been nearly twice as large as a share of GDP as at the end of the 1920s. There was no sign in higher interest rates that the government had reached the "ultimate safe limit" of its borrowing capacity.⁶ Moreover, reasons that led monetary economists to fear deficit spending quickly vanished during the depression. What could do more to discourage

4. Four paragraphs later, Hoover insists that "Secretary Mellon was not hard-hearted."

5. Hoover seems to have assumed the worst about the motives and aims of his political adversaries—both politicians in Washington and grassroots demonstrators and advocates: whether Democrats "set in their determination to delay recovery"; "old-guard Republican leaders in the Senate and the House . . . defeated in their Presidential ambition in 1928 . . . [who] certainly did not exert themselves energetically in their traditional duty to counterattack and expose [Democratic political] misrepresentations"; or bonus marchers seeking early payment of the World War I veterans' bonus, "organized and promoted by the Communists [who] included a large number of hoodlums and ex-convicts . . . frequently addressed by Democratic Congressmen seeking to inflame them against me . . . given financial support by some of the publishers of the sensationalist press. . . . 5,000 mixed hoodlums, ex-convicts, Communists, and a minority of veterans" (1952, 3: 225–26).

6. Herbert Stein 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 combination of the "gold outflow of 1931 [following Britain's abandonment of the gold standard.] . . . rising interest rates, falling bond prices, increasing bank suspensions," all of which led some solidity to Hoover's fears.

private investment than the 8 percent per year deflation seen over 1929–33? To where could capital flee when other countries were likely to devalue further than the United States?

Republicans were not alone in seeking budget balance: recall that Franklin Roosevelt made Hoover's inability to balance the federal budget during the depression a campaign issue in 1932. And the overinvestment 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—drew relatively broad support.

There were proponents of government action to expand demand in the Great Depression. Keynes tried to ridicule the “overinvestment” view, which Salant (1989) terms the “crime and punishment” view of business cycles.⁷ Ralph Hawtrey, an advisor to the British Treasury and the Bank of England, called it the equivalent of “crying, ‘Fire! Fire!’ in Noah’s flood” (1938, 145; see also Temin 1989). Much later, Milton Friedman would recall that at Chicago, where he went to graduate school, such dangerous nonsense was not taught—but he would speculate that perhaps the presence of such doctrines at other universities like Harvard was what induced otherwise bright economists to rebel and become Keynesians (see Gordon 1972).

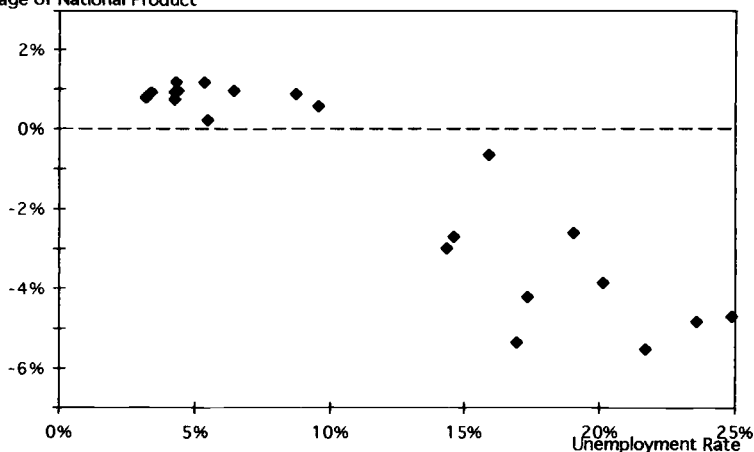
But President Hoover, at least, swallowed the claim that the Great Depression was due to overinvestment brought about by the Federal Reserve's supposed “credit inflation” of the late 1920s hook, line, and sinker. Never mind that Friedman and Schwartz (1963) find no sign of too-loose monetary policy in the 1920s, as both monetary aggregates and prices followed their normal long-run growth path. Never mind that economic historians like Jeffrey Miron have argued that the Federal Reserve in the 1920s was too contractionary and set the Great Depression in motion by its 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. He came close to calling for the

7. From Keynes:

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. . . . 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. ([1931] 1973, 349)

Budget Surplus or Deficit, as a Percentage of National Product

**Fig. 2.5 Unemployment and the budget, 1920–40**

Sources: U.S. Bureau of the Census (1975) and CEA (1996).

execution of his entire Federal Reserve Board, ending the section in his *Memiors* dealing with 1920s Federal Reserve policy with the accusatory: “There are crimes far worse than murder, for which men should be reviled and punished” (1952, 3: 9, 14).

2.2.2 Depression-Era Deficits

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 3 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 nominal collections of a relatively progressive tax system, as real national income and the price level fell in the slide into the Great Depression.

Figure 2.5 shows the pattern of deficits and official unemployment rates during the interwar period. The 1920s see relatively low official unemployment, in the 3–8 percent range, with government surpluses established to reduce the World War I debt in the range of approximately 1 percent of national product. By contrast, the 1930s see unemployment in the 15–25 percent range. And the federal deficit varies from near 1 up to 6 percent of national product.

Swings in the deficit associated with swings in the unemployment rate in the interwar period are substantial. On average, a 5 percentage point increase in the unemployment rate is associated with a 1.6 percentage point increase in the deficit, measured as a share of *actual* national product.

During the Hoover and the first Roosevelt administrations, these deficits

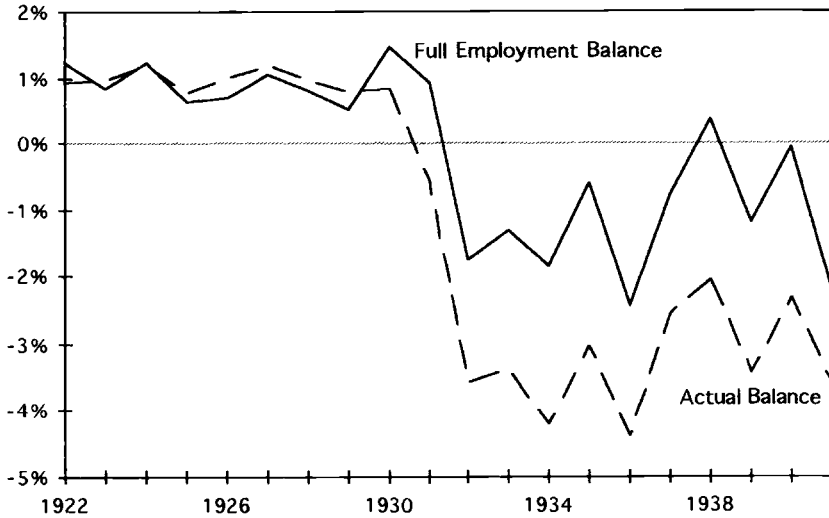


Fig. 2.6 Full employment and actual budget balance as a share of national product, 1922–41

Sources: U.S. Bureau of the Census (1975), CEA (1996), and author's estimates.

were by and large involuntary. The collapse of nominal revenues outran the ability of the executive branch to propose, and the Congress to enact, cuts in expenditures. The deficit rose in spite of discretionary fiscal policy action, due to the operation of the automatic stabilizers built into the government's budget.

By automatic stabilizers economists mean the natural tendency of revenues to fall—and for entitlement social welfare spending to rise—in a recession. As businesses lay off workers and lose profits, tax collections fall. As more people apply for relief programs of various kinds, expenditures rise. This “automatic” swing in the federal budget generates a shift toward a deficit that “stabilizes” the economy. It cushions the fall in disposable income that accompanies a recession, helps keep consumption from falling, and reduces the Keynesian multiplier.

It has become conventional to conceptually divide fiscal policy into two parts: first, the operation of the automatic stabilizers that swing into action without any legislated changes in spending programs or tax schedules; second, changes in legislated policy that affect what the government surplus or deficit would be if economic activity were unchanged relative to potential output. This second component is usually measured by the full-employment deficit—what the federal deficit would be if the economy was near “full employment” (see fig. 2.6).

Such estimates of the full-employment deficit are hazardous for the period of the depression. They require extrapolating tax collections and spending programs down to levels far outside previous experience. Brown's (1956) esti-

mates were the first to show that fiscal stimulus on a full-employment basis, as opposed to automatic stabilizers, was rare during the Great Depression. Compared to a Great Depression that at its nadir involved a 40 percent reduction in output relative to potential, the 1 or 2 percent of GDP full-employment deficits of the mid-1930s delivered very little discretionary fiscal stimulus.

By the second Roosevelt administration the government had begun to make a virtue of necessity, and to trumpet the potential fiscal advantages of unbalanced budgets. As Stein (1969) points out, the widespread belief in this politically palatable doctrine came well before the spread of the Keynesian tools of analysis that were to provide it with a respectable theory. Note that the title of Stein's book is not the *Keynesian Revolution* but the *Fiscal Revolution in America*; for the fiscal revolution, the acceptance of deficit spending as an appropriate depression-fighting tool, was largely accomplished in America before the arrival of Keynesian doctrines.

2.3 The Keynesian Age

2.3.1 The Employment Act of 1946

The Employment Act of 1946

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 United States 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).

Did it commit the government to the business of managing the macroeconomy? Perhaps. But recall that the 1978 Humphrey-Hawkins Act committed the federal government to reducing the unemployment rate to 4 percent by 1983 *and to maintaining it thereafter*, committed the federal government to reducing the inflation rate to zero by 1988, and required the chairman of the Federal Reserve to testify before Congress twice a year on the state of the macroeconomy. The Humphrey-Hawkins Act has had no effects—save to trigger the semiannual Humphrey-Hawkins testimony of the Federal Reserve chair.

On the other hand, sometimes we refer to laws as boundary stones: short-hand markers of deeper changes in attitudes and predispositions. In this sense the Employment Act of 1946 certainly marked the commitment of the federal

government to the macroeconomic management business. As introduced, the *Full Employment Act* required the president to submit a National Production and Employment Budget (NPEB) that “assure[ed] 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. Congress does not move that fast; as written, the Full Employment Act could not have been implemented.

As 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 not a cause but a signal of the federal government’s commitment to macroeconomic management. However, it is a powerful signal.⁸

2.3.2 Post–World War II Automatic Stabilizers

Belief that automatic stabilizers have a significant effect on business cycle variability depends on the arguable proposition that liquidity constraints are pervasive in the economy (see De Long and Summers 1986). The procyclicality of taxes and transfers can work to reduce the size of recessions only if a significant fraction of consumers depend at the margin on their disposable income to finance their spending. Granting that movements in disposable income have significant effects on consumption, the shift over the past 70 years 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-fifth or more of national product in *peacetime*. The depression-era federal government taxed 5–7 percent and spent 8–10 percent of national product. The predepression federal government taxed and spent 5 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 (see fig. 2.7).

8. The Employment Act of 1946 also created the Council of Economic Advisers. But its creation of the CEA as we know it today—one chair, two deputies, and a senior staff of 15, 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 the Director of the National Budget.” 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 advise-and-consent power (along with the existence of an economic policy appropriation line item) as tools it could use to influence macroeconomic policy. The institution building of primarily Arthur Burns and secondarily Walter Heller gave the CEA the recruitment and staffing patterns that it has today.

Budget Surplus or Deficit,
Percent of National Product

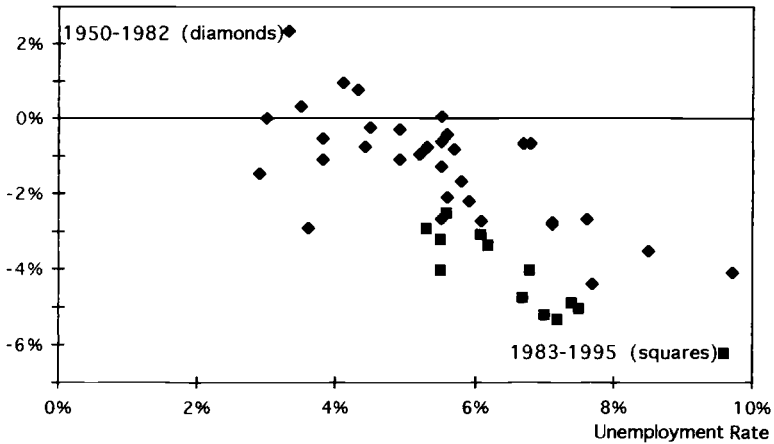


Fig. 2.7 Unemployment and the deficit, 1950–95

Sources: U.S. Bureau of the Census (1975), CEA (1996), and author's estimates.

With a large federal government, automatic stabilizers can easily be large: a 2.5 percentage point increase in the unemployment rate associated with a 5 percent fall in output relative to previous forecasts would “automatically” produce a deficit of 1 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 6 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 5 percent of national product or less, it is hard to see how automatic stabilizers could have any macroeconomic significance.

Table 2.1 presents simple regressions of the level of the government’s fiscal balance as a share of national product on the unemployment rate (for 1890–1916, the *nonfarm* unemployment rate). Think of these regressions as summary statistics for how fiscal policy stabilized the economy, either through automatic stabilizers that were allowed to operate (and not offset by moves toward budget balance in recession) or by legislated changes in fiscal policy.

The pre–World War I period shows little sign of automatic stabilizers: the small size of federal spending prohibits the deficit from acting as a sea anchor to stabilize the economy. Thus, post–World War II fiscal policy has been very different from what it would have been in the absence of the Great Depression. The growth in domestic federal spending can be traced to the expectations of the proper role of government and the social insurance state set in motion by the Great Depression. And it is hard to imagine that automatic stabilizers of

Table 2.1 Regressions of Federal Budget Balance as a Share of GDP on the Unemployment Rate

Period	Unemployment Rate	Post-1982 Period	R ²	SEE
1890–1916 ^a	–0.083 (0.043)		0.257	0.002
1920–40	–0.317 (0.045)		0.847	0.010
1950–95	–0.894 (0.188)		0.526	0.013
1950–95	–0.680 (0.127)	–0.021 (0.004)	0.746	0.010

^aUsing nonfarm unemployment only.

the magnitude engendered by this growth in government would have been allowed to function, were it not for the shadow of the Great Depression.

2.3.3 Discretionary Fiscal Policy

It is difficult to argue that “discretionary” fiscal policy has played any stabilizing role at all in the post–World War II period (see Gordon 1980; De Long and Summers 1986). Even Walter Heller could find only one case of successful discretionary stabilization policy—the Kennedy-Johnson tax cut (Heller 1966). Recessions of the size seen in the post–World War II era are not anticipated, are not forecasted, and develop quickly. Economic policymakers 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 withholdings 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.

Thus, a sensible rule of thumb to adopt for fiscal policy would be the recommendation of the CED: let the economy’s automatic stabilizers work unhindered and set the cyclically adjusted full-employment or high-employment deficit at whatever level is felt to be consistent with views on the desirable long-run level of national savings. Indeed, for the first generation or so after World War II economists’ and politicians’ views did appear to be converging on this position. But the second post–World War II generation saw the disappearance of all possible consensus. The 1980s saw the unbalancing of fiscal policy, as slowed bracket creep from the fall in inflation, rising defense spend-

ing, and broad-based tax cuts together produced large deficits not just in recessions but in expansions as well. The 1980s saw the reversal of the peacetime rule that the debt-to-GDP ratio fell: the debt-to-GDP ratio rose from near 25 percent at the end of the 1970s to 50 percent by the early 1990s.

2.4 Long-Run Effects of Short-Run Policies

There is an argument that use of fiscal policy as a stabilization tool has had harmful side effects. Buchanan and Wagner (1977) argue that deficits are dangerous because voters are highly 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; but when spending is raised and financed by borrowing, voters feel the benefits from spending but do not sense the true resource cost of added indebtedness.

The consequence, Buchanan and Wagner argue, is a government that engages in spending programs that at the margin do not provide social benefits equal to their resource costs. Democratic politics applied to government spending functions well only as long as deficits are effectively prohibited. Arguments that deficit spending could be used for stabilization managed, in Buchanan and Wagner's view, to undermine the polity's immune system, which had 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: in the United States, at least, there is no sign that any increase in the government's deficit sets in motion an endogenous rise in private savings to offset the fall in national wealth accumulation.

It is hard to look back at America's federal deficit since 1980 (see Auerbach 1994) 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 the political nation to grasp.

2.5 Conclusion

Before the Great Depression the U.S. government borrowed in time of war and ran peacetime surpluses to pay off war debt. The use of the government deficit as a tool of macroeconomic management was rarely considered, and—if considered—was rejected as inconsistent with international exchange rate arrangements.

The depression broke this pattern: both Hoover and Roosevelt wished to maintain surpluses, but both recoiled at the austerity required in the midst of the depression. In the end, the political nation made a virtue of necessity: it concluded that deficits in time of recession helped alleviate the downturn. Later on, a theoretical rationale—John Maynard Keynes's *General Theory*—was advanced to provide underpinnings for this shift in policy. But in Herbert

Stein's formulation, the fiscal revolution in America was broader based than and was completed before the Keynesian revolution.

In the generation after World War II, economists and politicians moved toward a consensus view of fiscal policy: set tax rates and expenditure plans so that the high-employment budget would be in surplus, but do not take any steps to neutralize automatic stabilizers set in motion by recession. Set the high-employment budget surplus or deficit to conform to views about the desired impact of the federal budget on national saving over the business cycle. Do not attempt to aggressively use discretionary fiscal policy because the lags make it impossible to do so in an effective manner.

But the American political system could not hold more than one idea in its mind at a time. The idea that cyclical deficits in recession could be good has weakened the belief that structural deficits that permanently reduce the national savings rate are bad. Some share of the deficits that began under Ronald Reagan's presidency is attributable to the shadow of the Great Depression. And it may turn out that fear of continued structural deficits has undermined support for allowing fiscal automatic stabilizers to work smoothly: few who advocate balanced budget amendment proposals think about the implications of such proposals for stabilization policy. Thus, the shadow cast over fiscal policy by the Great Depression may be fading.

A world in which the Great Depression had not cast its shadow over post-World War II fiscal policy would be a different world. It might be a world in which many post-World War II macroeconomists called themselves Hayekians rather than Keynesians, discoursed on "monetary overinvestment," and argued that deep recessions were a necessary price for the dynamic growth efficiencies of market-led economic development. It might be a world in which many governments responded to 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 highly unlikely. In such a world a repeat of the Great Depression would have been somewhat more likely. To the extent that the social and economic costs of the outbreak of inflation in the 1970s were low relative to the probability and cost of another episode like the Great Depression, we are indeed fortunate that post-World War II fiscal policy has been made in the shadow of the Great Depression.

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