Tax Foundation's

Tax Review

Toward better government
Founded 1937

APRIL 1977
Vol. XXXVIII, No. 4

Full Employment Budget: How Good a Guide to Public Policy?

By Alan Reynolds

Before the Great Depression there was a reasonably effective presumption in favor of balancing the Federal budget annually. In the 135 years from 1796 through 1930, the Federal budget was in deficit only 39 times, and nearly half of those deficits occurred during war years.

This traditional discipline of a balanced budget rule then suffered a massive intellectual assault during the pump-priming fad of 1933 through 1937. Why should a budget be balanced in so arbitrary a period as one year? Why not instead run budget deficits during recessions to be offset by surpluses during booms? That seemed reasonable enough in theory, though bearing little relationship to the deficit-prone asymmetry with which the idea was later applied.

After the economic setback in 1937, and continuing through the onset of the postwar boom, this theory was replaced by the notion of secular stagnation. The problem was said to be chronic excess savings, with few profitable investment outlets available at any positive interest rate. So the government would have to run chronic deficits to mop up these savings and put them to work. History has not been kind to this particular rationalization for chronic deficits, so others were quickly devised.

Budget deficits were held to be both the consequence of high unemployment and the cure for high unemployment—an ambiguous position that makes it rather hard to test the efficacy of deficits. This ambiguity gave birth to the idea of budgeting as though the economy were at "full employment," in order to separate deliberate deficits from those arising from recessions that might occur despite the enlightened application of fiscal nostrums. Somehow, a dollar of deliberate deficit was considered more powerful than the accidental kind.

This idea of separating discretionary from automatic deficits is at least questionable. If a certain volume of deficit spending is expansionary, it is expansionary—even if it would be a surplus at some other level of employment, and even if it results from automatic rather than discretionary changes in taxes and spending. It is hard to believe that the impact of the actual budget is less significant than the impact of an imaginary budget.

In any case, the first major statement on behalf of full employment budgeting was a pamphlet, *Taxes and the Budget,* issued by the Committee for Economic Development in 1947. Some of the arguments originally made for full employment budgeting seem rather Utopian, if not amusing, in view of the subsequent perversion of the concept. In particular, the CED plan was supposed to "prevent the initiation of unnecessary expenditure programs," and the CED economists were

This Issue in Brief

Can chronic deficits cure secular stagnation? Basic to the notion of full employment budgeting is the assumption that fiscal policy can be used to reduce unemployment, says Economist Reynolds.

But fiscal policy, the author points out, can only promote inflationary monetary policy or reduce investment and growth.

"confident that. . . .levels of employment can be maintained that will reduce the debt under this program." The hope that the new principle would impose a discipline on fiscal policy, comparable to annual budget balancing, has not materialized.

The most conspicuous problem with the notion of full employment budgeting is the definition of full employment. The original CED pamphlet picked 4 percent because unemployment "probably cannot be much below this figure without serious inflationary pressure." But they also advocated that "the price level should be consistent with the maintenance of stable high employment." This sort of circular reasoning persists in most econometric models—in which inflation depends on wages, wages depend on unemployment, and unemployment depends on inflation. Since this theory cannot explain periods in which unemployment and inflation are both high, some people have concluded that the theory is right but reality has gone wrong.

Many economists have noted that because of the increased number of women and teenagers in the labor force, a 4 percent unemployment rate a generation ago is comparable to at least a 5.5 percent rate today. But that still does not tell us that even a 5.5 percent unemployment rate is a durable buffer against the inflationary consequence of any conceivable amount of fiscal or monetary "stimulus."

To say that a deficit is desirable when unemployment is high is not enough. It does not tell us how much fiscal stimulus is too much, or not enough, or when it should be turned off and on. There are several reasons for doubting that the unemployment rate is an adequate guide to the appropriate timing of stabilization measures, much less to the magnitude of such measures. Employers are slow to lay off employees in the downturn and slow to rehire in recoveries, so the unemployment rate typically peaks a few months after a recovery begins. And discouraged workers drop out of the labor force during downturns and reenter during recoveries, understating unemployment in recessions and overstating unemployment in recoveries. Moreover, unemployment has often turned up when measures of manufacturing capacity utilization became tighter and vice-versa.

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The latest CED clarification of this issue, in *Fighting Inflation and Promoting Growth,* is not particularly helpful:

"Although the full-employment concept is traditionally defined in terms of a hypothetical 4.0 percent unemployment rate, any other rate would serve essentially the same analytic purpose, provided it remained fixed from year to year."

But the specific definition of full employment is critical to the public relations value of explaining why deficits are really surpluses. If we had instead defined full employment as, say, 10 percent, deficits would look worse instead of better, and politicians would never have adopted the scheme. The hard truth is that the only time we have achieved a 4 percent unemployment rate in the postwar period is when we drafted teenagers and sent them into battle.

If the budget is to balance only if and when we reach a level of unemployment that in fact is almost never attained, that proposal implies literally unlimited expansion of the national debt and of the taxes needed to pay interest on that debt.

Moreover, it is difficult to estimate even actual budgets, much less hypothetical ones.

Another acknowledged problem is that the measure of the full employment budget includes increases in receipts due to inflation.

Does It Reduce Unemployment?

But the problem with full employment budgeting is more basic than these details about how it is to be calculated. The fundamental assumption of full employment budgeting is that fiscal policy can be used to reduce unemployment. So the real question is whether or not conventional fiscal policy works as advertised—whether fiscal stimulus stimulates and automatic stabilizers stabilize.

If fiscal policy works, and its impact is properly measured by the size of the full employment deficit, then it should be possible to find some correlation between either the level or direction of the full employment budget and some measure of current or subsequent economic activity. George Terborgh tried to find some such link back in 1968, in *The New Economics,* but found only a weak correlation that turned out to be perverse. That is, larger full employment surpluses were associated with faster economic growth. More rigorous tests by economists at the

St. Louis Fed, and again at Citibank, had no more luck in uncovering the magical properties of the full employment budget. A sharp shift toward larger full employment deficits did not prevent the recession of 1953-54, for example, nor the mini-recession of 1967. In 1946, a $60 billion reduction of Federal spending (equivalent to $400 billion today) was followed by a vigorous boom, and a combination of tax cuts and higher spending in 1948 (the equivalent of $75 billion today) was followed by a sharp recession.

The theory of fiscal policy is almost as messy as the evidence. If deficit spending is financed by borrowing from the private sector, there is no obvious stimulus—even to that undifferentiated thing called "demand." Whoever buys the government securities surrenders exactly as much purchasing power as is received by the beneficiaries of Federal largess. There would be a net fiscal stimulus only if there were no private demand for the funds needed to cover the added Treasury borrowing. Otherwise, lendable funds are just diverted from market-determined uses to politically determined uses.

There *may* be a stimulus in some circumstances if the deficit is financed by a more rapid increase in the money supply, but this is really a monetary stimulus, not a purely fiscal effect. The Fed could achieve the same effect by buying existing government securities.

Some economists argue that selling more Treasury securities adds to wealth—that they are an asset without any corresponding liability. That is rather implausible (aside from a trivial effect due to Uncle Sam's relatively low borrowing costs). It may be true that taxpayers always underestimate their implicit future tax liabilities required to service a larger debt— that they suffer from "bond illusion"—but there is no obvious reason why they should not learn from experience.

In the long run, resources allocated through the government must displace those allocated through markets, and growth of government spending must be at the expense of the private sector. The government has only three sources of revenue—taxes, borrowing, and printing money—and increasing any one of those must reduce the private sector's command over real resources. Although deficit spending may at times be a short-run stimulus to nominal demand, it is also a long-run drag on real supply—siphoning resources from uses that would otherwise augment the economy's productive capacity, and instead diverting those resources into hand-to-mouth consumption through government salaries, subsidies, and transfer payments.

The ultimate inevitability of public borrowing "crowding out" private borrowing is obscured by Catholic accounting—in which all past sins are forgiven at the end of each fiscal year. It is often said, for example, that we squeaked through the past year without any crowding out whatsoever—which presumably means that interest rates were no higher than they would have been in the absence of all that Treasury borrowing, or that private borrowing is wholly insensitive to interest rates. If that were not incredible enough, it is implied that the Treasury securities issued last year, which must be rolled over and serviced this year, will have no impact this year.

The economy's long-run real growth depends mainly on the quantity and quality of labor and capital, which in turn depends on the after-tax real rewards to productive activity. Deficits have almost nothing to do with it—or at least nothing positive.

So, the theory and evidence suggests that fiscal policy is essentially impotent, or at least unpredictable, except as a device to promote inflationary monetary policy and/or to reduce investment and growth. Moreover, budgeting as though deficits were really surpluses—through full employment budgeting—yields a continually growing debt over time, and an onerous tax burden to service that debt.

The Stabilizers Are Destabilizing

What about the so-called "automatic stabilizers": transfer payments that rise and taxes that fall in recessions? Stagflation plays havoc with this idea, since effective tax rates can rise sharply during inflationary recessions, thus accentuating the recession, and the real value of un-indexed transfers may fall. But even in the best of circumstances, the stabilizers are destabilizing.

Consider the usual timing of a business cycle. In periods of high unemployment, the deficit rises sharply as a result of the automatic stabilizers. As the resulting Treasury borrowing combines with business recovery to push interest rates up, the Federal Reserve invariably accelerates the growth of the money supply in a futile effort to keep interest rates down. That fuels an accelerating inflation which eventually lowers the deficit, and the Fed then turns restrictive to combat an inflation born in the previous recession. The end result is that the initial recession-induced deficit sows the seeds of a later boom-bust cycle. Far from being a stabilizer, the deficit is the prime source of instability.

This destabilizing effect of automatic stabilizers is aggravated by their effect on incentives—by what Professor Arthur Laffer calls the "wedge" between the value of what people produce and the value of their rewards. Transfer payments are a transfer of real resources from producers and workers to people based on criteria unconnected with their output performance; in fact, transfers are usually given only on condition that recipients do not work. Since servicing government debt involves a future tax burden, and inflation is a tax on money, any method of subsidizing non-work must impose a tax burden on work. When you tax work and investment, you get less of them, and when you subsidize non-work and consumption, you get more of them. Since transfer payments rise sharply in recessions, and rarely return to pre-recession levels, they increasingly discourage productive activity, particularly during recessions—making it less and less profitable for workers to work, for employers to employ, or for investors to invest.

Despite the fact that I view chronic deficits as an unmitigated evil—fostering inflationary money growth, and diverting savings into unproductive uses—I would not favor balancing the budget by raising taxes. My primary concern is the relative size and power of the government sector compared with the voluntary sector, regardless of how the government is financed. Republicans often seem too anxious to do the fiscally responsible thing, and vote taxes to pay for spending programs they oppose. Democrats spend, Republicans tax, and those of us who are not too impressed by the results of either the taxes or the spending are left without effective representation.

There are two schools of thought on this. One group figures that gargantuan deficits are still a source of political embarrassment, but will be as big as the politicians and their advisers can rationalize through such gadgets as the full employment budget. If so, we should go for tax reductions whenever we can get them, figuring that the resulting deficits will generate pressure to trim spending.

The other school likes to maintain a clear link between taxes and spending, believing that the public considers deficit spending a free lunch, so they favor full and immediate tax financing of spending programs. This position has merit, though the sneaky practice of raising effective tax rates implicitly, through inflation, makes it difficult to hold specific politicians responsible for such hidden tax increases.

As a compromise, I favor an old-fashioned Keynesian remedy—massive cuts in taxes during recessions and equivalent cuts in Federal spending during booms. This would probably do nothing for the ups and downs of the economy, but it would put Leviathan on a diet—getting both sides of the budget down to the point where the private sector would have some room to breathe. It is Utopian, but theoretically orthodox.

At a more serious level, I am concerned that any additional taxes are likely to be imposed on the most productive elements of society—through stiffer taxes on income from investments and high marginal tax rates on additional earnings. The result would be less investment and less effort, and the *relative* strength of government would rise dramatically by sapping the strength of the private economy. The economic impact of government depends on how the government taxes and spends, and not just on how much.

In 1960, Professor James Tobin argued that "increased taxation is the price of growth." The idea was to generate a budget surplus which would provide the savings to finance more investment. The Brookings Institution study of the capital scarcity issue promises the same sort of strange combination of ever- increasing tax rates, high investment, and rapid growth—except that the tax rate increases are due to inflation. Either way, a budget surplus achieved through taxing the sources of private savings is not likely to generate a net increase in total savings. Instead, it just transfers savings from the private to the public sector. If you raised corporate income taxes, for example, in order to generate a surplus, that would just make it easier for corporations to borrow in order to pay their taxes.

Budget balance is important, and a surplus would be even more constructive, but it must be obtained by slashing Federal spending—not by taxing the private sector into oblivion.

The balanced budget rule was an imperfect rule, but it was better than no rule at all. The attempt to substitute a fiscal rule based on an arbitrary unemployment rate failed immediately, because there was no particular reason to suppose that balance or a slight surplus would always be the appropriate goal at full employment if fiscal policy really had the great potential for good that was implied in the concept.

In *The New Economics One Decade Older*, Professor Tobin states:

"There are times when the full employment budget should be in deficit, 1972 for example. . . .In 1972, the Administration proudly pointed to a fiscal deficit, even in the full employment budget, as its principal weapon to promote recovery and reduce unemployment. The New Economics lives after all."

In view of the subsequent inflation, that piece of policy advice might serve as a fitting obituary for the new economics. Herb Stein, one of the creators of the full employment budget, probably had the last word on the subject:

"People may invoke a full employment budget when it serves their purposes, but they will forget or reject it when it limits them."