CHAPTER I

PUBLIC EXPENDITURES: ADMINISTRATION AND FINANCE

We have examined in preceding chapters the devices by which the monetary authorities may remove or counteract certain causes such as price changes, or credit expansion and contraction, which tend to promote undesirable fluctuations in business activity. These devices might be regarded as methods for inducing business to stabilize its expenditures, which, being the greatest source of the income of society, make regularization of first importance for a stable economic System. But we have seen also that the monetary measures at the disposal of the authorities cannot be completely successful. Even in booms their efficacy is limited, and in depressions they may be quite unable to stop the process of deflation. Even the cheapest money may not be a stimulant to business, and the flow of purchasing power that business can set in motion, particularly in its expenditures for plant and machinery, may, despite all efforts, be undesirably reduced.

In these circunstances, the government may have to resort to other means of control. These means consist in the purposeful manipulation of public expenditares and taxes and are commonly referred to as "fiscal policy" Through these manipulations, government is in a position to modify the aggregate demand for the goods and services of society, upon which the

levels of output and employment depend.

FISCAL POLICY

The total outlay for the product of society as represented by the gross national product or expenditure is divided at any given time into three components: (1) private consumption expenditures, (2) private outlays on capital goods, including residential buildings,and commonly called "private capital formation", and (3) governmental expenditures for goods and services.

For the year 1954 we have the following data: *

Gross national product	$ 357.2 billons of dollars
Government expenditures	77.5
Private gross capital formation .	45.7
Consumers' expendirures	234.0

* Source: Economic Reports of the President.

In so far as government can modify its own expenditures or bring about modification of private expenditures it can increase or decrease the total of aggregate demand in any given period. Thus the fiscal policy of the government, determining as it does its rates of expenditures, the level and distribution of taxes, and the rate of payments on the public -

debt, offers an important tool for affecting in the interests of public welfare the level and stability of the total economic effort of the community. Fiscal policy is a particularly suitable device in a free enterprise society, since it can influence promptly the flow of purchasing power without any regimentation of private business. Furthermore the instruments of fiscal policy are not strange or novel. They are the -- accepted machinery of governments. We are familiar enough - with taxes and government expenditures. We are even familiar with their use to modify the income structure of society as through progressive taxes or subsidies or relief payments. It needs no great jump of the imagination, no notable change in attitudes of the people, to extend their use in the service of stabilization.

Whereas banking and monetary policy would be regarded as the appropriate instrument of stabilization by those who, like - Hawtrey or Hayek, hold business cycles to be the consequence of monetary instability, fiscal policy has developed under - the influence of Lord Keynes with his emphasis on the importance of maintaining effective demand. Because of this relationship, the emphasis of fiscal policy has been on attacking deflation where the emphasis of banking policy has been on - attacking inflation. Monetary theorists, especially those - who regard depressions as the result of booms, aim to moderate booms. Those who follow Keynes, regarding depressions as avoidable interruptions to periods of high employment, tend to look upon fiscal policy as primarily designed to attack - depression.

The functions of fiscal policy can best be understood if we recall the pattern of analysis developed by Keynes. This pattern may be briefly summarized as follows:

1. Any given level of employment and income can be maintained provided that investment - expenditures on capital goods - such as buildings, factories, machinery, and so on - is adequate and no more than adequate what people save at this level of income; that is, what they do not spend on consumption.

2. Contrary to classical views, there is no certainty that - private investment outlets are effectively adapted to - offset any given volume of savings. This is the more probable considering that habits of consumption and saving - are relatively stable while investment, depending as it - does on the varying prospects of profits, is uncertain, volatile, and capricious.

3. As a result we face the possibility that planned investment may exceed or fall short of savings. If it exceeds savings, aggregate effective demand will rise, and if we have started from a level of high employment, inflation - will set in. If planned investment falls short of saving, aggregate effective demand will fall and we face a period of deflation.

4. A society therefore that wants a high and stable level of employment, and is not prepared to leave the attainment - thereof to luck, must adopt deliberate fiscal measures de-

signed to maintain or restrain effective demand, whenever it falls below or rises above the level necessary to support the desired volume of employment.

The instruments of fiscal policy

The fiscal devices at the disposal of the government fall into two general classes:

1. Variations in the aggregate of such governmental expenditures as can be varied, deliberately or by some automatic arrangement, with stabilizing effects. Such stabilizing expenditures lie in two major areas: (a) expenditures on public works, or communal goods such as roads, schools, post offices, hospitals, parks, and the like; (b) transfer payments, not representing any current equivalent in goods or services, such as interest on the public debt, payments to veterans, farm benefits or other subsidies, relief payments, unemployment insurance, and social security benefits.
2. Variation in tax yields or tax rates or the tax structure in such wise as to encourage or restrain private expenditures on consumption or investment. These variations may consist in reducing or increasing taxes in general, or by so modifying the structure of taxes as to increase or decrease the share of income after taxes falling to the classes with a high propensity to consume.

The essential purpose of these fiscal devices is to prevent

total outlay from falling below or rising above the volume required to maintain a desirable level of output and employment. If private expenditures bring outlay below these levels (which would usher in a period of deflation as in 1929-1932) public expenditures should be expanded, taxes, especially on consumption or on the classes with a high propensity to consume, should be reduced and the government should incur a deficit. If private expenditures bring outlay above these levels (which would usher in a period of inflation as in 1946-1948), public expenditures should be restrained, public works postponed, and taxes should be maintained or raised, especially on consumption. Thus the government should accumulate a surplus, which could be used to reduce deficits previously contracted. Thus by alternating deficits and surplus, the government might be able to hold total expenditures to more stabilized levels.

AUTOMATIC STABILIZERS

To some extent, the stabilizing effects of expenditures and taxes may be brought about automatically from the natural operation of the expenditures or revenues involved as the economy expands or contracts. This characteristic is sometimes referred to as "built-in", or "automatic", stability, and the expenditures and revenues in question as built-in, or automatic, stabilizers. They constitute a quasi servomechanism which operates to moderate the variations of the economy.

An effective automatic stabilizer would cause government ex-

penditures, which puts money in peoples' hands, to increase - in contraction and fall in expansion; and would cause government revenues, which take money away from people, to rise in expansion and fall in contraction. The effect of these fiscal changes would be to reduce the peoples' disposable income in boom and increase it in slump. Unless the government insisted on balancing the budget yearly, these automatic stabilizers would cause a budget surplus in boom and a deficit in - slump. Only in this-way, indeed, can they be effective.

Automatic, or built-in, stability is found in the income tax, both personal and corporate, the unemployment insurance system, to some extent in social security payments, and in price supports to agriculture.

The personal income tax is a progressive tax with present exemptions of $ 600 per person for a man, his wife, and dependent children. In a period of expansion, as income rises, more incomes rise above the exemption level, and more and more persons move into higher tax brackets. As a result, the average tax rate and therefore the total tax yield rises more than proportionally to income. In a slump, on the other hand, incomes fall into lower brackets,the number of exemptions increase, and the average tax rate - together with the total - tax yield - falls more than proportionally to income. As a result, both expansion and contraction are moderated.

As for corporate income tax, though this is not progressive

for most corporate income, corporate profits rise and fall - disproportionately to the national income, again causing corporation taxes to serve as an automatic brake and easement in boom and slump, respectively.

Unemployment insurance collections increase as payrolls rise (up to maximum levels) and are paid out as benefits as employment falls. They are, therefore, a good example of built-in stabilizers - taking money away in boom, paying it out in - slump.

Social security payments are stabilizing to some degree. They tend to be lessened in boom to the degree that recipients, - who otherwise might be idle, are employed for wages, thus - cutting down benefits. And in slump they tend to reach their maximum levels as recipients find jobs not so available, if available at all. Also, social security taxes vary with the payroll, rising in boom, falling in slump.

Public relief,although to some degree continuing in good - - years and bad, rises sharply in depression, as do subsidies to agriculture when agricultural prices fall below parity or some proportion thereof.

All these built-in stabilizers tend to reduce the amplitude of the fluctuations of disposable income by creating a deficit in depression when revenues fall relative to expenditures and a surplus in expansion when revenues rise relative to ex

penditures. In depression, government takes away less than - it puts back, while in expansion it takes away more than it - puts back. This plan eases the strain of depression and moderates the inflationary dangers inherent in a boom.

A.G. Hart estimates that, if we take all the automatic stabilizers together, the effect would be to increase the budget deficit or surplus by "well over a third" of the fall or rise of the national income. That is, a fall in national income - of $ 10 billion would automatically increase the government - deficit by $ 3 or $ 4 billion. Or, to put it another way, - the depressing effects of a $ 10 billion fall in national income would be alleviated to the extent of $ 3 to $ 4 billion increase in government expenditures over government revenues. These deficit expenditures would serve to offset an equivalent fall in private investment and, by being financed through the banking system, would tend to offset any decline in the total money supply.

While these automatic stabilizers thus serve a very useful - purpose, they do not cover the whole ground nor are they likely to be powerful enough to justify too exclusive reliance upon them. They should not be regarded as more than a first line of defense. Other measures of a deliberate sort, such as expenditures on public works or changes in the general - schedule of taxes made by the decision of the appropriate governmental body, must be taken to prevent more serious economic fluctuation.

The problems arising in these further areas are problems of public policy, involving specific decisions which may have - substantial influence on the economy. To these we now turn our attention.

Public works espenditures are well adapted to purposes of stabilization, and the problems they raise and their solution - throw so much light on the complications of fiscal policy as it relates to any public expenditures that they will be taken as a generalized example capable of standing for all other - stabilizing expenditures. Much of what will be said of public works will apply without much modification to transfer payments and to some extent to increases or decreases in the general levels of taxes. More specific analysis of certain types of transfer payments, such as unemplyment insurance benefits, and the general problem of tax variation are taken up in Chapter 25.

PUBLIC WORKS

Public works are defined by Clark as "durable goods, primarily fixed structures, produced by the government" They commonly include all public buildings, roads, airports, canals, sewage systems, projects for conservation and development of - natural resources such as water power and forests, flood and erosion control, river and harbor development, and similar - projects. What they include, of course, depends on the sco-