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MODERN FISCAL THEORY AND POLICY

BY

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PREFACE

This study deals with fiscal theory before and after Keynesian economics and the influence of modern fiscal theory on fiscal policy.

The object of the work is to integrate and appraise the leading interpretations and inferences of the exponents of Keynesian theory, as it applies to fiscal theory and policy, with a view to setting forth the principles on which marked agreement has been reached.

A section has been devoted to postwar fiscal policy in the United States and Great Britain in order to show the extent of the influence of modern fiscal policy in practice and the difficulties encountered in its application.

I cannot sufficiently express my deep gratitude to Prof. S.B.Himadeh under whose guidance and supervision this work had been prepared. I can only say that any credit that this thesis may deserve goes primarily to his deep and penetrating remarks; while I hold myself solely responsible for all defects appearing therein. I am also indebted to Prof. Albert Badre and to Mr. Issam Ashour for occasional valuable suggestions.

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MODERN FISCAL THEORY AND POLICY

INTRODUCTION:

The term "fiscal policy" has only recently come into common usage. In essence, it is a new concept of the scope and objectives of fiscal operations that has emerged as a result of the trend towards expanding the functions of government; the change in the belief in the unproductiveness of public activity; and the growing recognition of governments as positive forces in the economic world. Like many other economic doctrines, it owes much of its origin to the influence of 'emergency' and 'personality'. Professor D. H. Macgregor, of the University of Oxford, has arrived at the following deep and penetrating conclusion after having reviewed a century's literature of financial debates in the British Parliament. "It is notable", he says, "how the influence of a growing opinion upon the law has depended for its final impact on two factors of human progress, emergency and personality. It is through emergency that the principles of the classical finance came to be established and, ninety years later, overthrown. In each case the advocates of the new outlook disentangled themselves and their case from the emergency itself, and sought to show that the remedies had independent and permanent validity".[1] A parallel but more specific remark had been put forward by E.W.Swanson and E.P.Schmidt when they said: "The decade of the 1930's was unparalleled in two respects. It gave us the worst depression on record and it brought a world of Keynesian ideas".[2] It is possible to say with definite assurance that fiscal

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(1) Macgregor, D.H., Public Aspects of Finance (The Clarendon Press, Oxford, 1939), pp. 11-12.

(2) Swanson & Schmidt, Economic Stagnation or Progress (McGraw-Hill Book Company, Inc., New York, 1946), p. 1.

theory and its offspring fiscal policy owe much of their origin to the severity of the depression of the thirties and to the personality of Lord Keynes. There is no doubt that thinking takes time but, as Polayni said, "it is accelerated if you are pressed for the result; and the crisis of the thirties was bound to speed up the process".(1)

This in no way should lead to the hasty conclusion that fiscal policy had been an overnight invention; nor is it meant to say that a free enterprise capitalistic society had ever existed without important governmental activities supporting, supplementing, or limiting private economic activities. "All through the history of economics and economic policies", writes Gerhard Colm, "we notice the search for that device of policy which could be used as a lever for influencing economic developments as a whole".(2) To the Mercentalists, for example, the accumulation of money in the form of precious metals, was considered to be the important element in economic expansion. Thus, promotion of exports and discouragement of imports "was regarded as the key to a government policy designed to promote economic expansion".(3) When it was recognised, however, that money could be added also by the creation of bank credit, central bank policy then took the lead in the field of economic operations. A policy of implementing the discount rate was devised and, up to the thirties, was believed to be effective in influencing economic activities. The Great Depression of the thirties, however, shattered this confidence in

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(1) Polayni, M., Full Employment and Free Trade (Cambridge University Press, 1948), Introduction.

(2) Colm, G., "Maintaining High Level Production & Employment: Technical Requirements", Amer. Pol. Scien. Review, Vol. 39, No. 6, December, 1945, p. 1126.

(3) Ibid.

the effectiveness of central bank policy which could no longer be regarded as the strategic weapon with which a slack economy could be lifted to a level of full employment. "The conclusion suggested itself that the government must come to grips with a more vital element of the economic mechanism".(1) This has forced economists to pause and reflect on the assumptions of the classical economists.

The latter have taught that low prices for factors of production-- particularly wages and interest rates-- have caused expectations of profit and inducement to expand business activity. More production meant increased payments of money in the form of pay-rolls, and hence additional purchasing power. Expanding business thus created its own market, provided the costs of production were sufficiently low, and credit was available to bridge the gap until the markets had been expanded. During the depression of the thirties, however, notwithstanding the fact that costs of factors of production were low and plentiful credit was available, business did not expand. Hence emerged Keynes' 'expectations'. Business did not dare to expand except when orders came in or when favorable market expectations could be anticipated with a high degree of certainty. If government wanted to influence the volume of business activity without directly telling business what to do, it must increase the amount of effective purchasing power. This it could do, for instance, by additional government expenditures on public works or on develop-

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(1) Colm, G., Amer. Pol. Science Rev., loc.cit., p. 1128.

mental projects which put idle resources to useful work while, at the same time, it augmented wages and purchasing power and created markets for business; or by reducing taxes thus freeing purchasing power and helping to revive markets.

With the recognition of these interrelationships a new weapon was added to the arsenal of democracy: Fiscal Policy. Fiscal policy has been defined as "government expenditures, revenue, borrowing and debt management, considered with a view toward their impact on the flow of purchasing power".[1] In essence, it is an aggregate approach based on recognition that the methods of raising and spending public moneys may have important effects on the economic process as a whole; and that "the whole business of taxing, spending and borrowing by the state should be directed consciously toward controlling the economy, and especially toward combating business depressions and maintaining full employment".[2] It is concerned with the maintenance of gross monetary expenditures or total effective demand at a level appropriate to a satisfactory high volume of economic activity through influencing the stream of money payments by means of the fiscal operations of the state. The emphasis is that the various fields of government activity must be seen in their interrelationship with economic developments such as national income, consumption, business investments, and other transactions of a domestic and international character. Fiscal devices may operate directly on the stream of money payments, or may attempt to influence it

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(1) Colm, G., Amer. Pol. Science Rev., loc.cit., p. 1129.
(2) Bye & Hewett, Applied Economics, 4th. Ed. (Appleton-Century-Crofts Inc., New York, 1947), p. 285.

indirectly through their effect on the expenditures of individuals and business. It is claimed that fiscal policy does affect the general level of business activity and job opportunities without interfering with the basic principles of free enterprise or the freedom of choice in consumption. It is also claimed that it can be used for deflating a boom and for stimulating a slack market. To stout adherents it appears that finally, on the basis of more refined economic theory and the experience of the depression, the long sought lever of economic policy has been found.

One of the most ardent proponents of the new view, Alvin Hansen, states that "it is sound policy to control public expenditure, taxation, and borrowing so as to promote economic stability and continuously high levels of business activity and full employment".[1] He looks to federal budgeting "as the balance wheel in the economy and, in a sense, as a fiscal engine pulling its economic freight up the inclines to ever higher levels of living".[2] A.P.Lerner goes further to say that "the purpose of taxation is never to raise money, but to leave less in the hands of the taxpayer. The government can raise all the money it needs by printing it if the raising of money is the only consideration"; and that "the purpose of borrowing is not to raise money, but to make the public hold more bonds and less money".[3] Here the ultimate in the conception of taxation as a fiscal control device has been expressed with the implication that "those who suppose that

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(1) Hansen, A., State and Local Finance in the National Economy (W.W.Norton & Company, New York, 1944), p. 285.

(2) Buehler, A., Public Finance, 3rd. Ed., (McGraw-Hill Book Company, New York, 1948), p. 131.

(3) Lerner, A.P., The Economics of Control, (Macmillan Company, New York, 1944), pp. 307-308.

taxation exists to provide a meal ticket for government are simply behind the times"[1]. Under this new school of thought also it became no longer necessary for the government to balance its budget. The government should borrow freely when necessary to keep the total volume of expenditures in the economy large enough to provide full employment. As one author put it: "today budgets may be unbalanced on principle"[2]. "The issue is not related to public debt policy. It is a question of the relation of government finance to the whole economy"[3].

These views have developed sharp controversies among economists and authorities on public finance. The older view which maintained that government expenditures should be restricted and that government should be kept as free as possible from debt is still held by many, but a trend toward increasing acceptance of the new philosophy is evident.

It may be pertinent here to state that the fundamental issues with which the topic of this thesis deals may be clarified by a brief comparison between its major assumptions and those principles of 'sound finance' developed during the nineteenth century; and practically universally accepted until the middle thirties of this century. It seems to me that because of differences in unstated premises, adherents of each philosophy often find the views of the opposing school incompatible. Charles O. Hardy summerizes these issues in the following words:

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(1) Groves, H., <u>Trouble Spots in Taxation</u> (Princeton University Press, 1948), p. 47.

(2) Newcomer, M., <u>Taxation and Fiscal Policy</u> (Cambridge University Press, New York, 1940), p. 64.

(3) <u>Ibid.</u>, p. 12.

"The main characteristic which unifies the series of fiscal and monetary practices that are considered sound in the older system is that they all tend to prevent inflation; in the new program the unifying purpose is the avoidance of deflation. The historic code of balanced budgets, gold standard, and high interest rates is a proven bulwark of stability against inflationary pressures. The principal contents of the new orthodoxy-- encouragement of consumption, deficit spending, artificially low interest rates, flexible exchanges-- are effective ways of resisting a tendency of the money flow to shrink in volume, with downward pressure on incomes, production, employment, and prices. There is little dispute about this; the quarrel is really about the relative importance of permanent precautions against upward and against downward disturbances of the value of money.

"In part the change of objective is a reflection of the tendency of mankind to be influenced most by the experience that is most recent. Most wars of modern times were frequent enough to keep the inflation danger fresh in peoples' minds as the standard sequel to unsound fiscal policy. But in the thirties of this century, deflation was so severe that soundness came to mean anti-deflationary, especially in the English-speaking countries where the postwar inflations of the twenties were comparatively mild.

"However, the conflict involves more than a change of financial practice in response to a change in the phase of the business cycle; it involves the underlying economic analysis. The classical

economics of the nineteenth and the first quarter of the twentieth centuries was a realistic description of a society operating as it actually does operate at a peak of prosperity, with full employment of resources and automatic clearance of markets through the operation of the price system. That system never succeeded in fitting depression neatly into its own framework; it treated them as mere episodes, temporary deviations from a normal state of prosperity. Indeed, it came close to proving depressions to be impossible. It rationalized a system in which financial practice was geared to the expectation of continuous growth of capital (financed by thrift) and hence of productivity, income, and living standards. The rival body of theory which has developed since about 1930 (rapidly since about 1936) points as normal a chronic failure of the price system to keep market demand equal to production without a large volume of unemployed resources. It is a rationalization of the behaviour of a society suffering from chronic depression. Prosperity is the temporary deviation from normal that requires a special explanation in each case".(1)

A more striking evidence of the transformation in economic thinking and the influence of emergency on public policy in a single decade is given by George Terborgh. He says: " 'Our situation is fortunate, our momentum is remarkable'. Thus concluded the report of the Committee on Recent Economic Changes of the President's Conference on Unemployment, written in the

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(1) Hardy, Ch.O., A Commentary on: Public Finance and Full Employment, Board of Governors, Fed. Res. System, Washington, 1945, pp. 136-137.

spring of 1929, scarcely six months before the onset of the greatest depression of all time.....They found the economy in an excellent state of 'balance', a 'dynamic equilibrium', the preservation of which was not to be taken simply for granted, to be sure, but was nevertheless to be confidently expected.... The Committee added: 'The conclusion is that economically we have a boundless field before us; that there are new wants which will make way endlessly for newer wants, as fast as they are satisfied.....We seem only to have touched the fringe of our potentialities.

"Ten years later, a nation profoundly shaken by economic catastrophe, dispirited by a halting and broken recovery, was listening to a very different revelation, proclaimed, like the first, under the auspices of the Federal Government. It heard from Administration witnesses before the Temporary National Economic Committee the sad story of the 'mature' economy......

"Rarely if ever have economic thinking and expectation undergone in a single decade so radical and so postentious a transformation....Obviously a product of prosperity, the rosy projections of the Committee on Recent Economic Changes seemed at the time consonant both with history and with sound doctrine. The theories of 'economic maturity' or 'secular stagnation', on the other hand, unknown at the time of the Committee, were developed in the dark valley of the thirties in an effort to rationalise and interpret an unprecedented experience for which earlier economic analysis seemed wholly inadequate".[1]

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(1) Terborgh, G., The Bogey of Economic Maturity (Machinery & Allied Products Institute, Chicago, 1945), pp. 1-2.

Nowadays, after having passed through two decades of depression finance and wartime expansion, with a multitude of debates and authoritative argumentation on the subject, it is possible to say that there has definitely been a growing recognition of fiscal policy as a powerful instrument for maintaining a high and stable level of income. The claim that fiscal policy is an economic panacea, to be applied indiscriminately whenever anything gets wrong in the economy without regard to the nature of the malady, is considered to be an oversimplification of the issue and a simple delusion. A distinction is nowadays drawn between the proper use of fiscal policy, together with policies calculated to minimize the need for it, and its improper use as a panacea. Applied in the latter sense it is considered to be a dangerous device. Although its usefulness is recognized and its existence is considered to be necessary for counter-balancing maladjustments, "it would be the grossest self-deception to think that we have at present either the knowledge, the experience, or the institutional mechanisms to apply this weapon in a closely-controlled and scientific manner.....To conceive of this device as a simple and all-sufficient mechanical solution for our economic ills is simply naive. At best it is only one measure, among many, to be used as a supplement to others, not as a substitute for them".(1)

It is my intention in this thesis to analyse and appraise the basic aspects of modern fiscal theory and policy in the

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(1) Terborgh, G., op.cit., pp. 223-224.

light of current contributions by contemporary economists to this virgin field of social economics and its application in two of the leading capitalistic societies, namely, the United States and Great Britain.

PART ONE - FISCAL THEORY & POLICY

I: FISCAL THEORY AND POLICY BEFORE THE KEYNESIAN REVOLUTION

A. CLASSICAL ECONOMIC THEORY & ORTHODOX FISCAL THEORY

Basic Premises Of General Economic Theory:

Classical economists have always contended that wide-spread unemployment for any very long period was an impossibility. This belief has stemmed from their conviction in the existence of a flexible economy which prevented a general overproduction of goods. "Private enterprise, it was assumed, tended always to employ all available factors of production, provided that wages and prices were sufficiently flexible".[1] At the worst, there could never be more than frictional unemployment or sectional overproduction. It is true that some classicals have visualized instances where too much of any one article may be produced in the short-run, but, they argued, this was a temporary situation, since anything produced could be sold at a price provided of course the price was low enough. When the price of an over-produced commodity falls, additional units of it would be sold and the situation would automatically correct itself. Moreover, owing to the mobility of resources-- another assumed element of flexibility in the economy-- factors of production would move out of unprofitable enterprises into more yielding ones. As a result of this free flowing of factors of production, and the ready adjustment of prices, production would be facilitated and full employment promoted.

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(1) Schumacher, E.F., The Economics of Full Employment (Oxford Institute of Statistics, Basil Blackwell, Oxford, 1944), p. 85.

Furthermore, it was contended that wages and interest, i.e., the prices for labor and capital, were mobile. Anyone who cared to work, they argued, could find employment at some wage rate. Unemployment under certain circumstances, if and when it occurred, was voluntary in nature. The same was considered also true with the rate of interest. To the classicals, oversaving was impossible. When people saved a larger proportion of their income than usual, the rate of interest would fall giving incentive to entrepreneurs to absorb the additional finance capital offered and use it to employ more labor. If the volume of savings were small, interest rates would rise, thus discouraging investment which meant little demand for labor. As a result, wage rates would fall to that level which would allow entrepreneurs to borrow money even at high interest rates. Within this framework of reasoning: when all savings were invested and all laborers, except those who voluntarily abstained, were hired-- it followed that the economic order would tend to maintain itself in equilibrium and at a state of full employment. In other words, according to orthodox view, the economic order was a self-adjusting mechanism.

Derived Fiscal Theory and Method of Analysis:

"Every general theory of economics", says Schumacher, "has as its natural corollary a theory of finance which translates the principles of the former into money terms and into practical financial principles.....Financial theory can never be more than the 'reflected image' of general economic theory"; and that "the

logical corollary of orthodox economics is orthodox finance".[1] When it is assumed, as the classicals did, that all factors of production were normally and inevitably utilised by private business, it followed that "the state can obtain the use of such factors only by preventing private business from using them".[2] Whether the state prints additional new money and competes with private business for the use of available resources-- with consequent pressure of demand and inflation, or it commands part of the income of citizens by way of taxation-- in which case expenditures are balanced by tax revenue-- a definite harm in the first instance, and a mere substitution of public for private expenditures in the second, would follow. "From this it follows that the first principle of sound public finance is that the budget should be balanced".[3] Schumacher also draws the following inferences which he derives from the above line of reasoning:

"First, that the state cannot increase the level of business activity,- a truism when we start from the assumption that private business automatically maintains that level at full employment. Second, that the best budget is the smallest budget,- since taxes always to some extent impinge on private saving; a reduction of private saving being assumed to imply a reduction of private investment, taxes have to be looked upon as an impediment to the accumulation of private capital. Third,.....that the

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(1) Schumacher, E.F., Economics of Full Employment, op.cit., pp.85-86.
(2) Ibid., p. 86.
(3) Ibid.

most undesirable and destructive taxes are those that impinge most heavily on private saving, namely death duties, super tax, business taxes, in fact all taxes on the wealthier classes. Indirect taxes on the other hand, could be taken as impinging primarily on consumption and could thus be considered economically harmless-- albiet socially, perhaps, somewhat objectionable. Fourth, that a budget deficit-- necessitating state borrowing-- leads possibly to inflation and certainly to a reduction in the accumulation of private capital. It leads to inflation if it is financed by the issue of paper money or of short term government debt, because then the rate of interest does not rise sufficiently to produce a fall in private investment which offsets the increase in state expenditure. And if it is financed by the issue of long-term government bonds, such bonds are simply substituted for the bonds or shares which private business would otherwise have been able to place. Fifth....that a budget deficit, even though financed in a way which avoids inflation, must lead to a reduction in the rate of progress (because it derives from the savings of the community which would otherwise all have produced new real capital) unless the government uses borrowed funds exclusively for the creation of capital equipment at least as important as private capital. These principles follow logically from the original proposition of classical economic theory, namely that private business automatically maintains full employment".[1]

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(1) Schumacher, E.F., op.cit., pp. 86-87.

The Natural Corollary: The 'Neutral Budget':

In the light of the above reasoning, it becomes evident that in the field of public finance, the legacy inherited from the 19th. century stipulated that government activities should be held at a minimum; and that individual initiative, regulated by competition, should be allowed a free hand. From reasoning out that governmental activities were mainly unproductive in nature followed the inference that they should be held as low as possible. At best, taxes were considered to be a necessary evil; and that the best tax system was the one that taxed least. It was recognised naturally that the financial operations of the state would have some effects upon such matters as production (the effect of taxes upon the selling prices of commodities for example) and the distribution of wealth and income among citizens; but the line of analysis followed was microscopic in nature. The main objective of a tax levy was to raise revenue; and in the field of public borrowing, it was believed that the government, like the individual, should not go into debt if that were possible.

These traditional conceptions of government policy would presumably have recognized no need to resort to fiscal measures for the purpose of influencing the volume of business activity. As long as there was assumed the automatic tendency in the economy toward equilibrium at full employment, the inference followed that government action in controlling public revenues and expenditures should be determined primarily by narrow considerations. For effects of a general character, principal reliance was placed

in central bank policy. It should be added further that since the task of government had been essentially, in past decades, one of maintaining internal order and external defense, "government revenue and expenditures were not in a range of size where they could significantly affect costs or incomes over the whole economy (federal government expenditures have been only a small proportion of the gross national product: 2% in 1909, 1.9% in 1913, 3.6% in 1926); nor was any stimulus to expenditure in the economy felt to be needed".(1) The plausible conclusion followed that the government budget should be as neutral as possible in its effect on the allocation of resources as determined by private enterprise.

B. INFLUENCE OF ORTHODOX ECONOMIC THEORY ON FISCAL POLICY

Public Expenditures and Policy: The Doctrine of Retrenchment:

The tendency to marshal economic arguments in support of enlarged government outlays is a comparatively recent development. "While certain categories of public expenditure, such as direct relief and work relief programs, have typically risen in periods of crisis or depression, they have rarely, until recently, been thought of as positive aspects of government economi policy".(2) Because of the assumption of full employment, discussions of public expenditures in classical literature have never given adequate thought to the relationship of changing levels of outlay to the general economic situation. The maxims of Adam Smith,

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(1) Morgan, Th., Income & Employment (Prentice-Hall Inc., New York, 1947), p. 211.

(2) Fine, Sh., Public Spending & Postwar Economic Policy (Columbia University Press, New York, 1944), p. 6.

that the role of the state was restricted to the preservation of law and order, of national defense, the establishment of justice, and the erection and maintenance of certain public works remained long unchallenged in theory, although the scope of governmental activity expanded greatly during the nineteenth century. "Not until the business cycle had come to be recognized as a characteristic phenomenon was it pertinent to find an economic justification for enlarged emergency expenditures".[1] P.J.Strayer comments on this by saying that "the typical discussion developed the dogma that the least government was the best (a Jeffersonian maxim) and that the burden of proof for increasing government expenditures should rest on the advocates of expansion. No rules that would permit the translation of these generalizations into definite figures were devised. It was assumed that expenditures would not change radically in the short-run although much comment was devoted to the long-run trend toward higher outlays".[2] The alarm at expanding government expenditures and counter-arguments submitted during the classical era are best illustrated by the following statements quoted by Macgregor[3] from debates in the British Parliament:

"This great, rapid, and menacing expenditure. If those in office do not mend their ways, a financial crisis will take place in this House, which will render it impossible for the public business to be carried on." (Gladstone, 1868)

"There are three principles on which all good finance should be based. The first is, that there should always be a certainty

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(1) Fine, Sh., op.cit., p. 6.
(2) Strayer, P.J., "Public Expenditure and Policy" Amer. Econ. Rev., Vol. 39, No. 2, March, 1949, p. 386.
(3) Macgregor, D.H., op.cit., pp. 22-24.

that, whatever the charge may be, it can be paid. The second is, that in time of peace and prosperity the country should reduce their debt; and the third, is, that they should reduce their expenditure". (Gladstone, 1882).

"The figures make a return to more thrifty and economical expenditure the first and paramount duty of the government". (Asquith, 1906).

On the other side there were such statements similar to the following:

"Mere abstract and declatory opinions in favor of reduction and retrenchment are of no use whatever. I have so often maintained it in this House that I am almost ashamed to repeat, but unfortunately it is not a principle which has yet sufficiently entered into public opinion-- expenditure depends on policy". (Disraeli, 1862).

"We know that it has been said, and extremely well said, that expenditure depends upon policy. I hope that we shall not invert the sentiment and say that our policy ought to be determined by the expenditure which we make". (Northcote, 1879).

The opposition of ideas continued even after World War I. In 1927, Mr. Asquith held that "the only effective way of dealing with economy under existing conditions is that the Chancellor should ration all the Departments. It must be done all round"; and Sir Robert Horne replied that "when we come down to bedrock, the cause which is chiefly responsible is the policy of the government. It is policy upon which expenditure is founded".

The doctrine of retrenchment, however, was the one destined to reign until the early thirties of this century. Now, it should be asked, what is to be said in support of such a policy?

According to Macgregor, retrenchment has had two meanings: one specific and the other more general and lasting. "In the first place, it has been a postwar appeal against the tendency of expenditure to be stepped up after a war and to remain on a high level"[1], with consequent increased debt charge and rising

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(1) D.H. Macgregor, _op.cit._, p. 43.

prices, besides the fact that "war causes the principles of expenditure to become demoralized and to give way for a time to sheer affordability.....A great war both increases the function of government and creates familiarity with larger figures of expenditure".(1) In its more permanent aspect, "retrenchment has been a well-intentioned theory of employment".(2) Its line of reasoning ran as follows: The best way to relieve the burden of laborers was, of course, to give them employment. The latter could only be insured by reducing taxes which pressed more immediately on the productive industry of the country. Retrenchment, heavily dwelling on the elasticity of demand for goods and for labor, argued from lower taxation to more employment, from more employment to more consumption, hence more revenue, and to still lower rates of taxation. "Any surplus was to be at once given away by remissions of future taxation. (In British finance the income tax was brought in to bridge the interval between the fall of prices and revenue and the compensatory increase of consumption and of future revenue".(3)

Such a line of reasoning is perfectly compatible with the principles of orthodox finance. It is symbolic of the extreme individualism which finds little or no good in government; and considers public spending as almost pure waste. This is in sharp contrast with the other extreme of easy optimism that would sanction unlimited public spending, because the latter's

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(1) Macgregor, D.H., _op.cit._, p. 43.
(2) _Ibid._, p. 45.
(3) _Ibid._, p. 46.

idea that public spending may generate the income which enables it to be carried on is opposite pole to the former's idea that public expenditures should be so restricted that existing incomes should be left with a sufficient margin for existing needs.

Public Revenue and Policy: The Theory of Fructification:

To the classics, the principle accepted concerning revenue taxation was that it should produce the maximum revenue with the least disturbance to the economic organisation. "This is a negative principle", writes Buehler, "that taxation should work as little injury as possible".(1) Modern economists, on the other hand, who believe in the effectiveness of regulatory taxation, would employ taxation as a positive force of social progress, reform, and stabilization.

The early writers on public finance have usually frowned upon the exercise of the taxing power for non-revenue purposes because they believed "that the effectiveness of taxation for revenue may be undermined when it is turned to other uses".(2) In the case of a protective tariff, for example, they argued that if protection were to be adequate, no revenue would result; and that the best revenue tariff was one which gave no protection. Taxes should fall mainly upon consumption; and progressive taxation was criticized as impinging upon industry and the formation of capital; besides "leading governments to embark upon the uncertain seas of social reform without redress or compass, thereby endangering the revenue system by weakening the pillars of the capitalistic system".(3) There were instances, of course, where

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(1) A.G.Buehler, op.cit., p. 573.
(2) Ibid., p. 574.
(3) Ibid.

support had been given to taxation on non-revenue grounds, but these were incidental.

During the 17th and 18th centuries, many writers in England argued that taxes have a tendency to stimulate those paying them to greater industry and frugality, and that industrial improvements sprang out of the effort to increase production in an attempt to lower the burden of taxation,(1) but the more cautious writers have observed that such favorable consequences could only follow if taxes were only moderate. A century later (1852), J.R.McCulloch, an English economist, argued that increased taxation in England and France during the late 18th century was accompanied by increases in wealth and industry, but he warned his readers that such benefits were assured only if taxes were increased slowly, otherwise enterprise and savings would be stiffled. In his words: "taxation, according to its magnitude and the mode in which it is imposed, either makes men industrious, enterprising, and wealthy, or indolent, dispirited, and impoverished".(2)

The German economist, Wagner, has urged the use of taxation for social purposes. He advocated progressive taxation as a means of equalizing the distribution of wealth and income. On this latter concept Schumacher remarks: "The concept of taxation as a method of income redistribution is foreign to the theory of public finance that derives from classical economic thought. It is foreign in the sense that it has no economic merit-- although

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(1) Charles J. Bullock, Selected Readings in Public Finance, Second Edition, (Ginn & Company, 1920), p. 223.
(2) *Ibid.*, p. 225.

it may have merits on the grounds of social justice. To use taxation for the purpose of transferring income from the rich to the poor appeared to the classical economist as tantamount to sacrificing progress to current enjoyment. Social reformers were in a dilemma: greater social justice appeared to be obtainable only at the price of retarding the accumulation of capital, and any plea for it could be answered by the question: Is is not better to cease worrying about the distribution of the cake and to concentrate on increasing its size".[1]

The conservative view has been that non-fiscal uses of taxation were objectionable except under special circumstances and for specific purposes; the sole purpose of taxation being the raising of revenue. Sir Josiah Stamp referred to "taxation for revenue only" as the Victorian slogan; maintained that ulterior social purposes are permissible only if they are secondary; and mentioned few instances in which Adam Smith proposed to employ taxation for the regulation of economic activity.[2] The conclusion suggests itself that the history of taxation demonstrates that, while revenue had generally been the purpose of taxation, regulation was frequently an incidental purpose. Even the collection of revenue should not be excessive particularly from progressive taxation such as the income tax whose effect "is to dry up the streams which fertilize the whole field of employment and industry".[3] Money ought to remain in the pockets of the people, there to fructify by use, to stimulate the efforts of their industry, and to add to the resources of the state

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(1) Schumacher, Economics of Full Employment, op.cit., p. 91.
(2) Stamp, J., Fundamental Principles of Taxation, Rev. Ed., (Macmillan Company, 1936), pp. 183 ff.
(3) Lord Asquith, quoted by Macgregor, op.cit., p. 68.

Attitude Toward Public Borrowing:

The earliest writers on public debts have either held excessively optimistic or pessimistic views concerning their effect. The former considered the debts of the state as " a mine of gold", owed by the right hand to the left and, if properly made and employed, enriched the country and did not impoverish it. The latter argued that public borrowing caused undue concentration of population and wealth at the capital, caused injurious increases in taxes, and enabled fundholders to live a "useless and inactive life" at the expense of the industrious taxpayers. The controversy is best illustrated by the views of Karl Dietzel, a German economist, who raised a vigorous protest against the opinions of Adam Smith and his disciples who condemned public borrowing. Dietzel said:

"From Adam Smith's time down to the present (1855) a one-sided view of public loans has prevailed in financial theory, and is encountered in the work of most writers. It is based upon Smith's erroneous conception of capital and income. In brief the substance of this doctrine is as follows:

"Taxes are paid out of income; loans out of capital. If, therefore, the funds needed for extraordinary expenditures are raised by taxation, the people, as a result of their natural dislike of weakening their economic position, will restrict their consumption and endeavor to pay the taxes out of their net income. In this way the capital of the community is not diminished and industry is not disturbed; while the whole effect

of the extraordinary expenditure is to cause a simple retrenchment in consumption. If, however, the extraordinary outlays are met by loans, the funds will come from the capital of the community. By this process the supply of capital will be reduced, and future production of wealth will be decreased. In this way society is permanently injured; for the capital thus expended is lost beyond recovery since it is destroyed in unproductive consumption which the state undertakes through its agency. If this view were correct, the practice of public borrowing would thereby be unconditionally condemned. Fortunately the case is altogether otherwise. In Smith's view we encounter various fundamental errors of prevailing financial theory: a false conception of capital; a one-sided notion of productivity; and the arbitrary assumption of the existence of such a thing as a distinct net income".[1]

After expanding on the above-mentioned criticisms, Dietzel then proceeds to argue the advantages of public loans: that they enable governments to raise large sums of money very quickly; make it unnecessary for governments to increase taxation to an injurious extent; encourage thrift; enable government to place part of the burden of an extraordinary expenditure upon future generations; increase production; and add to the wealth of the country.[2] It may be added that ever since that date, the heat of argument for and against public borrowing among economists and public men has never subsided.

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(1) Quoted from Ch. Bullock, Selected Readings in Public Finance, op.cit., pp. 844-845.
(2) *Ibid.*, pp. 845-851.

When a country, however, whether wisely or unwisely, commits itself into debt, the desirability of redeeming that debt has generally been urged by classicals. Adam Smith, Ricardo, and John Stuart Mill have advocated such a policy. After crossing out as impractical the possibility of a general contribution assessed on property alone to pay off the national debt in one lump sum J.S. Mill suggests the second alternative of paying it gradually by a surplus revenue. He says:

"The desirableness, per se, of maintaining a surplus for this purpose does not, I think, admit of a doubt. We sometimes, indeed, hear it said that the amount should rather be left to 'fructify' in the pockets of the people. This is a good argument, as far as it goes, against levying taxes unnecessarily for purposes of unproductive expenditure, but not against paying off a national debt. For, what is meant by the word 'fructify'? If it means anything, it means productive employment; and as an argument against taxation, we must understand it to assert, that if the amount were left with the people, they would save it, and convert it into capital. It is probable, indeed, that they would save a part, but extremely improbable that they would save the whole: while if taken by taxation, and employed in paying off debt, the whole is saved, and made productive. To the fundholder who receives the payment it is already capital, not revenue, and he will make it 'fructify', that it may continue to afford him an income. The objection, therefore, is not only groundless, but the real argument is on the other side; the amount is much more

certain of fructifying if it is not left in the pockets of the people".(1)

In the light of the above analysis it can be inferred that, as a matter of public policy, the problems of government finance seemed relatively simple. To ration public expenditures and to lower taxes and still be able to pay off debts, if and should they be contracted, was an ideal situation. A useful rule of the thumb developed was that the budget should be balanced annually although this rule was often violated. Theodore Morgan says that "in the 154 years from 1792 through 1945 we (in the U.S.A.) have had 93 years of surplus and 61 years of deficit in the federal budget".(2) But the idea of a balanced budget "remained as a convenient check on the propensity of legislators to vote new expenditures (generally politically popular) without voting new taxes (politically unpopular)".(3) Finally, under the assumptions of the classicals, a national debt did represent a burden-- not necessarily in the sense of a mortgage on posterity, but in the sense of a wasted opportunity. "It did measure the extent to which the state had...prevented the hard-earned savings of the community from augmenting the real capital of the nation. And a reduction of the national debt was-- on these assumptions-- logically tantamount to a making good for the extravagances of the past: an artificial augmentation of current savings and thus of current private investment".(4)

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(1) Charles Bullock, _op.cit._, pp. 854-55.
(2) Morgan, Th., _op.cit._, p. 211.
(3) _Ibid._, p. 212.
(4) Schumacher, E.F., _op.cit._, p. 88.

II: FISCAL THEORY AND POLICY AFTER THE KEYNESIAN REVOLUTION

A. CURRENT ECONOMIC THEORY AND MODERN FISCAL THEORY

Changes in Basic Premises of General Economic Theory:[1]

The preceding discussions have fairly demonstrated that the self-equilibrating philosophy of the orthodox school had been the generally accepted theory until a recent date. During the thirties, however, when popular confidence in the self-adjusting capacity of capitalism was at its lowest, Lord Keynes stepped to challenge most forcibly the classical assumptions and to provide a theoretical framework for popular current economic belief "which left classical theory discredited by the scholarly criticism of one of the most outstanding of the world's economists, as well as by the practical experience of the great depression".[2]

In contrast to the orthodox view, Keynes argued that general overproduction can occur in the sense that there may be a lack of effective demand for all goods produced. People may have the desire for commodities but, unless this desire is coupled with adequate purchasing power to support it, there will be a deficiency of effective demand. Here Keynes developed the concept of aggregate demand, a demand, not for a particular good, as in the analysis of market price, but for goods in general. He also attacked the traditional doctrine that the volume of saving and investment is nicely adjusted by a fluctuating interest rate; and maintained that abstention from consumption meant not an

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(1) The emphasis in this section is placed upon those aspects of contemporary economic theory which are directly related to the field of fiscal theory.

(2) Colm, G., "Fiscal Policy", The New Economics, Seymour Harris, Ed., (Dennis Dobson Limited, London, 1948), p. 452.

automatic accumulation of capital. He substituted for the dictum "what we don't consume, the business man uses for investment" the opposite statement: "unless we consume, the businessman refuses to invest". To him the real cause of unemployment seemed to be a disproportionality between the desire to save and the desire to invest or, to use his own terms, when the propensity to consume and invest runs short of the propensity to save.

While the teachings of Lord Keynes had been challenged vigorously by many writers, it is generally agreed that he has made great contributions to the fields of economic theory and policy. He called attention to ways in which alterations in the volume and value of money are usually associated with other changes in the economic system. He demonstrated, for example, how variations in the quantity and use of money bring about changes in the volume of production and the extent of employment. He pointed out that our economic system was not the flexible, self-adjusting mechanism which orthodox economists described. Rather, there were inherent in it elements of rigidity such as sticky prices, inflexible wage rates, and influential pressure groups, which interfere with the readjustment process in the market for producers' as well as consumers' goods. In view of such impediments to an adjustment in the cost-price mechanism, aggregate demand as well as the size of the national monetary income are matters of great significance.

According to the theory initiated by Keynes, a larger effective demand, leading to a higher level of employment, will

depend, given a certain propensity of the community to consume, on the amount of current investments. In turn, the amount of current investment will depend on the inducement to invest; and the inducement to invest will depend on the relation between the schedule of the marginal efficiency of capital and the complex of interest rates on loans of various maturities and risks.(1) By lowering the interest rate, investment and effective demand _may_ be increased. If, however, the forcing down of interest rates does not bring about sufficient investment, as it probably will not, compensatory government action in the form of deficit spending is recommended. In Keynes' words: "I expect to see the state, which is in a position to calculate the marginal efficiency of capital goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment".(2)

"Autonomous decisions to invest in privately owned capital goods or the government plant are, according to Keynes, the main factors determining the level of income and employment. An autonomous change in investment, when there is unemployment, causes a change in income and employment which is larger than the initial movement; the relationship between cause and effect is determined by a 'multiplier' which in turn is determined by the 'marginal propensity to consume'. Under the institutional arrangments of the capitalistic economy there is no mechanism that induces investments of just that amount necessary to maintain

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(1) Keynes, J.M., _The General Theory of Employment, Interest, and Money_ (The Macmillan Company, 1936), pp. 27-28.
(2) _Ibid._, p. 164.

full employment of all available resources. Investments may be so large as to create an inflationary pressure or so low as to result in chronic unemployment. Classical economics (with few exceptions) regarded full employment as the 'natural' state of affairs and had to look for specific causes for explaining actual under-employment. From Keynes' analysis, it follows that the economy may be in equilibrium in either a high or low level of employment, so that continuing full employment of all resources can be explained only by reference to specific historical circumstances".(1) Furthermore, of the three psychological propensities: the marginal efficiency of capital, liquidity preference, and the propensity to consume, which, together with the quantity of money, determine the level of income and employment, Keynes accords the third factor a special significance. "With the aid of Keynes' consumption function, a theory of economic oscillations containing the acceleration principle as a central feature was readily developed".(2) Unemployment, according to Keynes, may result from action of any of the three propensities: a rise in liquidity preference, a drop in the marginal efficiency of capital, or a decline in the propensity to consume. The level of income and employment can be determined if we possess the knowledge of the marginal propensity to consume, the marginal efficiency of capital, and the rate of interest, that is, liquidity preference plus the quantity of money.

"The answer, following Keynes", writes Sherwood Fine, "for

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(1) Colm, G., The New Economics, op.cit., p. 454.
(2) Ibid., p. 446.

technologically advanced and wealthy countries like England and the United States, is to be found in the disposition of the propensity to consume to decline or, to put it in another form, the propensity to save to rise. With the accumulation of wealth, a decreasing portion of a community's funds are directed into consumption channels. The volume of savings is consequently enlarged"[1]. And in Keynes' words: "....the richer the community, the wider will tend to be the gap between its actual and potential production; and therefore the more obvious and outrageous the defects of the economic system. For a poor community will be prone to consume by far the greater part of its output, so that a very modest measure of investment will be sufficient to provide full employment; whereas a wealthy community will have to discover much ampler opportunities for investment if the saving propensities of its wealthier members are to be compatible with the employment of its poorer members....But worse still. Not only is the marginal propensity to consume weaker in a wealthy community, but, owing to its accumulation of capital being already larger, the opportunities for further investment are less attractive unless the rate of interest falls at a sufficiently rapid rate"[2]. Aggregate demand is, according to him, the ultimate force determining the size of employment opportunities; and "consumption is the end and object of all economic activity"[3]. Aggregate demand can be derived only from present

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(1) Fine, Sh., op.cit., p. 32.
(2) Keynes, J.M., General Theory, op.cit., p. 31.
(3) Ibid., p. 104.

consumption or from present provision for future consumption (that is, the creation of capital goods). Consequently, the greater we provide for consumption demand of the future, the less room there exists for further activity in this direction, and the more dependent we become upon current consumption as a source of demand. Furthermore, the larger our income grows, the greater tends to be the difference between income and consumption outlay, and the greater the disproportionality between productive capacity and effective demand.

The above line of analysis brings us face to face with an important contribution of Keynes' theory of employment to business cycle analysis which is discussed under the oversaving and the under-investment theories of business fluctuations. Prof. John H. Williams summerizes and comments briefly on both theories in the following words:

"Keynes's oversaving theory", he says, "is derived from psychological laws operating in the institutional framework of modern private capitalism. Most important is the propensity to consume, according to which as income rises a part of the increase is saved. Keynes believes an increasing fraction is saved, but this he says is not part of the law. To prevent reduction of income, output, and employment, investment must increase equally with saving, but investment is limited by the marginal efficiency of capital (diminishing productivity as interpreted by expectations); and the cost of investment cannot be reduced sufficiently by lowering the rate of interest because

at some minimum rate we prefer liquid funds to the risk of investment. Net idle saving forces income and employment down to some level at which, through the decline of saving, investment and saving become equal. To get more income and employment we must have deficit spending to offset idle saving or must tax away and spend the idle saving. This fiscal policy should be accompanied by monetary action to reduce interest rates and overcome, so far as possible, the effects of liquidity preference"[1].

Prof. Williams remarks that this theory merely tells us that as we progress to higher income levels, economic progress becomes harder. Although Keynes' statement about the propensity to consume is a plausible hypothesis, its application is limited by the fact that it cannot be applied to producer's saving, at least to corporate savings, which are an important part of the whole; and it fails to account for the opposite tendency in the business cycle, which Keynes had previously described as the excess of investment over saving in the boom period. He adds further that in discussions of fiscal policy, Keynes' hypothesis about saving has been too readily accepted as law or as fact, although no one has yet given us estimates of saving of a kind that really bear upon this argument.

Turning to the under-investment thesis, Prof. Williams says that it "has a better factual foundation than the oversaving theory, and presents a stronger case for the long-run deficit spending. It is based on the view that as the capitalistic

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(1) Williams, John H., Postwar Monetary Plans and Other Essays (Alfred A. Knopf, New York, 1944), pp. 72-73.

economy progresses, it reaches a stage at which the opportunities for investment decline. This mature economy thesis is too familiar to require elaboration.(1) It uses, in general, the same analytical apparatus as the oversaving theory, starting from the same truism that investment plus consumption equal income. It has the same criterion of prosperity: full employment. But the decline of opportunities for investment is not in the other theory, and the tendency toward oversaving is not necessarily a part of this one, though, as I have said, in much of the recent discussion the two have been combined".(2)

Prof. Williams concludes by saying: "The reasons why, as an economy matures, investment opportunities decline, have been presented with great force and much statistical support. Some of them carry considerable conviction, particularly as regards their bearing on employment. This is especially true of the technological changes from capital-using to capital-saving devices. I am less convinced by the reference to declining rate of growth of population, not only because it relates to individuals rather than to families, but because it unduly subordinates, I believe, the possibilities of changes in quality (standard of living). The argument about the passing of the frontier seems

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(1) The so-called stagnant economy thesis is usually associated with the name of Alvin Hansen who argues that declining investment is due to a decreasing rate of population growth, the passing of the frontier, a dearth of great new industries, and the increasing ability of business to finance itself by depreciation reserves and reinvested earnings.

(2) Williams, J.H., op.cit., p. 75.

to me not one of the strongest, largely because I am influenced by my earlier studies of international trade, which showed that trade was greatest not with the frontier countries but between the industrially developed countries having higher living standards and greater purchasing power. But as regards employment there may be no easy substitute for free land".[1]

Nowadays, it is fairly accepted among economists that saving is responsible for a good deal of trouble in the economic system. If everybody were to spend all his income as he received it, the happy state of affairs described by the classics-- that supply creates its own demand-- would prevail; and we should not meet the danger of a falling-off in production through a failure of demand. But we should be wrong if we concluded from this that saving is in itself an evil. If there were no savings we could never increase our capacity to produce by adding to our stock of capital goods; neither could the government ever spend more than it received by taxation, if we exclude the idea of printing money. The real source of trouble is that saving and investment are done by different sets of people from quite different motives. As an antidote to the above conditions, Keynes prescribed: progressive tax measures to decrease the propensity to save; the creation of outlets for new investment through public capital investment, to be financed by borrowing; and the pursuit of a policy of low interest rates. Besides these direct contributions to the field of fiscal policy, Keynes' equally important indirect contribution should be emphasised: he has greatly stimulated thinking along fiscal lines.

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(1) Williams, J.H., op.cit., pp.75-76.

Fiscal Operations Viewed In New Perspective:

The crystallization of the idea of employing fiscal policy as a balancing factor in the economy may be said to date from the publication of Keynes' General Theory of Employment in 1936. Keynes' ideas, there presented, were extended and elaborated in books written by scores of economists as well as in a voluminous body of periodical literature. The distinguishable feature of such discussion has been the growing recognition of the economic effects of government finance. "Government expenditures and revenue, government borrowing and debt repayment are studied, not for their impact on the Treasury, but for their impact on the economy. It is now recognized more than ever before that each aspect of government finance may be used as an instrument of economic policy to influence the size of the nation's income or alter the character of the nation's output. At first, the problems of the depression, and then, the necessities of the war, have converted government finance into fiscal policy".(1)

The preceding discussion has clearly demonstrated that in a private enterprise economy the volume of production, employment, and hence of income, depend upon the existence of the necessary markets. Unless prospective demand is sufficient to pay for the costs of production and leave an adequate margin of profit, production will not be forthcoming, and resources will be unemployed. Similarly, unless aggregate demand remains within the limits of available supply, once a high level of employment

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(1) Somers, Harold, Public Finance and National Income (The Blakiston Company, Philadelphia, 1949), p. 465.

is reached, prices will be driven up and inflation will threaten. The thesis that supply always creates its own demand is now considered foundless since income, once received, may or may not return to the expenditure stream. In addition, in an economic system where millions of people and business firms make free decisions about how much of their incomes they intend to spend or save, there is no guarantee that there will be that exact balance of total spending which is required for full employment. Deliberate policies become, therefore, necessary to keep the rate of spending at that level, and, if that is not possible, to compensate for its deviation from that level.

But although the general requirement is clear cut, its fulfilment, however, is by no means simple. Policy considerations must start with the basic fact that there is no self-adjusting mechanism, in a private enterprise economy, which assures a high and stable level of employment. To set the responsibility for attaining such level on individual consumers or individual businessmen is also absurd, since "each is caught in the upward spiral of inflation or the downward spiral of deflation and....buys and sells too little to affect the sweep of events over the whole economy"(1). The main responsibility for maintaining a high and stable level of activity must lie with the governments, since they alone possess the powers necessary to fulfil this responsibility. The cooperation of business men and trade and labor unions is undoubtedly essential for the success of this policy, but the latter alone cannot determine the general level of employment.

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(1) Morgan, Th., Income & Employment, op.cit., p. 167.

The vital importance of fiscal policy for avoiding a state of deflation or inflation will now become evident.- The government, in order to meet its responsibility, "must see to it that the total expenditures on the national output is neither more nor less than that which is just sufficient to take off the market, at a stable price level, all of the goods and services that can be made available when the population is fully employed".(1) The four components of total monetary outlay being: private consumption, private investment, public investment, and the foreign balance, it is maintained that the second and the fourth, which are subject to autonomous fluctuations, are the main sources of instability in national income and the level of employment. It is also admitted that government is unlikely to be able to succeed completely in preventing fluctuations in private investment and the foreign balance; and that these should be offset by compensatory movements in domestic private consumption expenditure and /or expenditure by public authorities.

It becomes evident, from this line of reasoning, that fiscal policy may and should be used to expand or curtail total effective demand for goods and services, which ever is needed. The government can effect the necessary increase in total demand either by increasing public expenditures, without any concurrent restriction of private expenditures, or by inducing increased private expenditures through remission of taxes or in other ways. Similarly, it can reduce total demand either by reducing public

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(1) Graham, F., Planning & Paying for Full Employment (Princeton University Press, Princeton, 1946), p. 40.

expenditures, without any concurrent change in private expenditures, or by restricting private expenditures through increased taxation or in other ways. "It is thus within the government's power to set the level of total expenditures (private plus public) wherever it will. It follows, as an inevitable consequence, that government can set it at that optimum amount which will provide full employment on a stable price level".(1)

Fiscal Structure and Method of Analysis:

Quantitative Analysis:(2) The individual instruments of fiscal policy are: public expenditures, taxation, public borrowing, and debt repayment. In a purely mechanical sense, the quantitative line of analysis would proceed to look, as a first step, into the flow of purchasing power as related to government operations. Government expenditures bring about an increase in production and employment, it argues, unless there are indirect effects which work toward contracting private consumption or investment outlays. The stimulating effect exists irrespective of whether the expenditures had been directly on output or in the form of a transfer payment. Taxation, on the other hand, withdraws money from the economy and, through contracting the volume of private expenditures, diminishes production and employment. But the government is not confined to spend what it raises by taxes only. It can itself borrow and spend; and government borrowing and spending adds to total effective demand. It can, therefore, use its

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(1) Graham, F., Planning & Paying for Full Employment, op.cit., p. 41.
(2) I am indebted for much of the analysis in this section to Harold Somer's chapter (23) on the fiscal impact on national income in his book Public Finance & National Income, op.cit.

power of borrowing and spending deliberately to add to effective demand and increase employment. If, therefore, government policy goes too far in the direction of heavy taxing and borrowing, and light spending and debt redemption, total expenditures, production and employment will be curtailed; and the opposite would hold true if the mechanism were reversed. It is possible also, as we shall see later,(1) to secure a net stimulating effect through increasing equally both public expenditures and revenue from taxation.

All the individual instruments of fiscal policy have, to a varying degree, been subjected to close examination by economists. An enormous literature dealing with tax incidence, shifting and effects; the multiplier effect of public expenditures; and arguments for and against public debts is now available but, as Somers said, "although the individual instruments of fiscal policy have been studied carefully, the theory of fiscal policy as a whole lacks integration.....As a result, it is difficult to make adequate allowance for the effects of taxation, borrowing, and debt repayment in trying to determine the consequences of any particular volume of government expenditures. Instead of being an integral part of the analysis, these effects usually take the unsatisfactory form of modifications or qualifications".(2)

As a first step, it is proposed here to examine the structure of fiscal policy; and to consider the interrelationships between public expenditures, taxation, public borrowing, debt

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(1) See Section on Balanced Budget Approach, Infra.
(2) Somers, H., Public Finance & National Income, op.cit., p. 486.

repayment, and the national income. Then we can see how fiscal policy may be used to achieve desired ends. This could be done if we study each instrument of fiscal policy according to some comparable basis before constructing a comprehensive picture of the fiscal impact as a whole. Although the aim here is one of integration, each element of government finance will, as a first step, be studied separately in isolation and its broad types of effects considered. Furthermore, since our criterion is to see how fiscal policy influences consumption, investment, and the national income as a whole, "we must consider the extent to which each instrument of fiscal policy involves some impact on the nation's supply of consumption funds and the extent to which it involves some impact on the nation's supply of loanable funds. The impact on consumption funds serves as a starting point for the study of subsequent effects on consumer spending, and the impact on loanable funds serves as a starting point for the study of subsequent effects on investment".[1]

Through the medium of public expenditures, whether for relief, administrative expense, public works, national defense, or the outright purchase of goods and services, government releases both consumption and loanable funds. For the most part, a release of consumption funds is involved; "but there has recently grown up another type of government disbursement of funds whereby the government merely lends its money (nominally at least) and does not give it away or purchase outright any goods or services.

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(1) Somers, H., Public Finance & National Income, op.cit., pp. 486-7.

This has been true of a number of credit corporations set up by the government"[1]. In this latter sense, government expenditures tend to augment the supply of loanable funds, to increase the availability of capital, and to ease the terms of private borrowing. But the exact effects would, of course, depend upon the nature of the inducement to invest prevailing and the availability of credit from other sources, particularly from banks. Thus we may carry over into our later discussion the provisional argument that government disbursement of funds involves the release of both consumption funds and loanable funds.

In the case of revenue by taxation, we have an absorption of funds by the government in one of two ways: when taxes transfer to the Treasury funds which would have been spent on consumption, (as in the case of a sales tax or an income tax on low income groups), or, when they impinge on savings which may have augmented the supply of loanable funds. In the first case, a direct reduction of consumption expenditures and national income is involved; while in the second, unless bank credit is freely available, the availability of private capital would be reduced and the terms of borrowing for private investment would be made less favorable than they would otherwise have been. Taxation, then, involves, prima facie, both an absorption of consumption funds and loanable funds.

When we look to public borrowing, we again encounter an instance of government absorption of funds. Depending upon the

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(1) Somers, H., Public Finance & National Income, op.cit., p. 487.

use to which the funds borrowed would have been put had they not been lent to the government, depends the nature of the funds absorbed. Not all funds lent must necessarily be loanable funds. Some bonds issued and sold during the last war had been of the nature of compulsory savings which would, to some extent, have been spent on consumption goods. Others are likely to have come out of simple hoards. But, in general, it may be said that government borrowing is likely to reduce private consumption and, depending on the state of the banking system, to curtail private investment. As in the case of taxation, we can assume the likelihood that public borrowing involves an absorption of consumption funds and of loanable funds.

Finally we should take into account the release of funds through debt repayment. A debt redemption is likely to release mainly loanable funds which would be put usually on the capital market for the purchase of securities. But the possibility of debt repayment tending to stimulate consumption should not be overlooked. This is particularly true in cases where the purchase of government bonds represents a definite saving program on the part of the individual with retirement marking the end of the program and the spending of the money involved. Debt repayment may then be considered to involve a release of consumption and of loanable funds.

The above tentative analysis suffers, of course, from lack of integration because the several instruments of fiscal policy always operate as a unit. The next step suggested is to sum up

the various consumption and loanable funds elements, and then to analyse the composite effects.

As far as government release of consumption funds is concerned, it should be remarked that not the whole of government expenditures should be regarded as a net addition to consumption funds since there are offsetting effects in the form of taxation. That is why the magnitude of the deficit (financed by borrowing) is sometimes regarded as an appropriate indicator of the government's net contribution to the community's purchasing power. But the latter view, if accepted without reservation, is likely to give a misleading picture of the government's contribution to the community's consumption funds, since part of the borrowed money may represent a reduction in the community's consumption funds; and because some taxes have detrimental effects on consumption. Finally, debt repayment activities of the government should be accounted for. "In short", comments Somers, "we should add together those parts of expenditures and debt repayment which involve a release of consumption funds; and deduct those parts of taxation and borrowing which involve an absorption of consumption funds. In this way we can take account of the consumption effects of each instrument of fiscal policy and obtain a measure of the net government release of consumption funds. This, not the expenditures nor the deficit, is the appropriate measure of the government's direct contribution to the nation's purchasing power and is the appropriate multiplicand of the multiplier principle. It may conceivably

be negative in some circumstances, that is, there may be a net government absorption of consumption funds".(1)

Turning to the effects of instruments of fiscal policy on the absorption of loanable funds, it may be said that government borrowing involves mainly, and taxation almost invariably, an absorption of loanable funds. From the total absorption of loanable funds should be deducted those parts of government expenditures and debt redemption which involve a release of loanable funds, in order to obtain a measure of the net amount of funds the government withdraws from the money and capital markets. "To take only the amount of government borrowing, as is usually done, is incorrect because taxes also involve a withdrawal of loanable funds to some extent; and at the same time the government puts some of these funds back into the capital market through its expenditures and repayment of debts. There may be a net release rather than absorption of loanable funds on the part of the government in some circumstances".(2)

In attempting to figure out the composite effects of government operations on consumption and loanable funds, we may say that because borrowing and taxation absorb both consumption funds and loanable funds while expenditures and debt repayment involve their release, the former tend to have restrictive effects while the latter have expansive ones. "Where there is no change in the government's cash balance and no government printing of money to finance expenditures, the net government absorption of loan-

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(1) Somers, H., Public Finance & National Income, op.cit., p. 490.
(2) Ibid.

able funds is identically equal to the net government release of consumption funds. The fisc is essentially a mechanism which converts loanable funds into consumption funds. In determining the extent of this conversion we must not confine our attention to deficit spending as is so often done. Each instrument of fiscal policy-- expenditures, taxation, borrowing, and debt repayment-- affects the availability of both loanable funds and consumption funds and plays a part in the government's conversion of loanable funds into consumption funds".(1)

Qualitative Analysis: The qualitative aspects of government's fiscal operations, that is, from where and when the government obtains its revenue, and to where and when it spends it, may be more important than the mechanical quantitative aspects arguing in terms of the volume of revenue and expenditure. "The fundamental rule of government finance, to which only minor qualifications exist", writes Theodore Morgan, "is that nothing shall be decided on financial grounds. The basic realities of the economy are resources (labor, management, raw materials, plant, and equipment), and the wants of the people of the economy (for a high standard of living and for useful employment). Money is simply a tool for the effective utilization of these resources toward fulfilling wants. Like other tools, money may get out of order, and can be used skillfully or badly. Government can, through its monetary authority and through its revenue and expenditure policy, exert a considerable influence

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(1) Somers, H., Public Finance & National Income, op.cit., p. 491.

on the flow of money in the economy, and so upon the allocation of resources to one use or another and upon how many of them are used and how many left unemployed".(1)

Sources of Government Revenue:

We have seen that the government can obtain funds in one of two ways: it can tax and it can borrow. Considered from the point of view of their adverse effect upon private expenditures, the most depressing would be taxes on consumption, followed by personal and business income taxes, followed by borrowing from individuals, followed by borrowing from commercial banks which is the least depressing. The taxes levied on consumer goods are depressive because they lead in the main to higher costs of commodities and to lower real wages; and hence they cut the volume of consumption purchases of the poorer groups of the community who spend the bulk of their incomes on consumption, that is, those who possess a high marginal propensity to consume. The personal and business income taxes are depressing to the extent that they absorb funds which would otherwise have been spent on consumption or on investment. The more progressive such taxes are, the less they tend to reduce consumption, but the more they tend to cause well-off people to reduce their savings; and the more progressive taxes are, the more they discourage investment. In the latter case, the potential investor faces the dilemma: if the investment is profitable, the government taxes away much of the profit; and if it is unprofitable,

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(1) Morgan, Th., Income & Employment, op.cit., pp. 212-213.

the investor bears the loss. It is possible, of course, to devise personal income taxes heavy enough on both the low and the high income groups thereby cutting sharply both consumption and investment outlays; but with moderate tax rates, a personal income tax appears to be less depressive than consumption taxes. Some taxes similar to the excess profits tax and the corporate income tax are usually considered to be more depressing than a personal income tax because, it is argued, "they especially discourage the risky investments of small enterprises in new processes and products-- a kind of investment which is very useful toward increased employment and productivity, and toward diminished concentration of production and economic power"[1].

When it comes to borrowing from individuals, there is hardly any depressing effect on private expenditures since people lend to the government out of their savings; and they ordinarily do not lend to the government for the low rate of interest which it offers unless they are unable to make investments elsewhere giving better yield. Here one simple qualification is needed. During the last war, some governments (e.g. the U.S.A. and Britain) have carried on saving-bonds campaigns with the idea of inducing people to cut their consumption expenditures and assist in the war effort. These campaigns may have probably succeeded in persuading some people to cut their consumption; but such a depressing effect on consumption expenditure is very unlikely during peacetime. Finally, borrowing from commercial banks will not

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(1) Morgan, Th., Income & Employment, op.cit., p. 225.

have an adverse effect on private expenditures so long as the central banking authorities, through their open-market operations and other monetary policies, continue to supply the body of commercial banks with sufficient reserves so that they can continue to lend to the government. Under such circumstances, the individual banks will not be faced with the choice between lending to the government or to private business.

Before leaving this topic of government revenue I would like to state that in the foregoing analysis I have been surveying the sources of government funds from one angle only: the extent to which revenue from a given source tends to contract private consumption and investment expenditures. The merits and demerits of a given taxing or borrowing policy are not exhausted, of course, by this kind of analysis; and will be given further treatment at a later section.(1)

Canals of Public Expenditures:

Again, as in the discussion of sources of government revenues, reasoning on pure mechanical monetary level is less significant, when we come to discuss public expenditures, than reasoning about the utilization of real resources in the economy. The principle holds true even though it is less pressing when there is heavy unemployment, because then if the resources used in a doubtful channel by the government were to remain idle, society would be worse-off as a consequence of the failure to spend. If any government expenditure is to be justified, therefore,

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(1) See Sections on Tax and Debt Management below.

the gain accruing to the economy must exceed the loss which results, whether directly or indirectly, from the process of getting the funds. The real gain is of course the increased production and hence employment which results from the expenditure; and the real cost is the loss of possibility of private use of the resources in question plus the burden of the public debt which results if the expenditure is financed by a loan.

From this follow the principles that (a) government expenditures must be justified on the grounds that government can use the resources in question more effectively for the general good than private individuals could, (b) that they should be for socially useful goals and be administered with the utmost efficiency to obtain the maximum of output; and (c) that they should not compete with private enterprise, unless for specific purposes such as the control of a monopoly or some critical social activity as military research for example. Furthermore, government expenditures should, as far as possible, be canalized into channels which will induce more private expenditure. "If this is not true", argues Theodore Morgan, "then stimulus to employment must, instead, be sought through reduced taxation and other measures to stimulate private consumption and investment expenditure"(1). Morgan's view, it seems to me, is rigid; and the case is more realistically stated by Musgrave in the following words: "While the requirements of cycle policy are bound to be reflected in the expenditure pattern, expenditures should be based primarily upon considerations of need and usefulness of the projects as such. Differences

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(1) Morgan, Th., Income & Employment, op.cit., p. 226.

in the leverage effects of various expenditure projects exist, but they should not be over-emphasized. Where relief expenditures are a more effective way to relieve distress in the depression, they should be preferred to public works outlays, even though a somewhat smaller leverage might result. Where public works are needed or are preferred as a matter of public morale, they should be given preference over relief even though they might involve a somewhat higher outlay per unemployed. At the same time, expenditure planning must account for the longer-run as well as the more immediate merits of alternative expenditure projects. Thus developmental programs will not only be useful in an immediate sense but have an important bearing upon the secular level of private investment and the growth of real income"[1]. "The real controversy", argues Newcomer, "has never been over the usefulness of some government expenditure.....The question is, rather, how much government expenditure is desirable, and for what purpose. To form an intelligent opinion on this question, it is necessary to consider first of all the amounts, the aims, and the rate of increase of government expenditures"[2]. A more detailed analysis of these issues will be made at a later stage in this thesis[3].

<u>Burden and Limit of the Public Debt</u>:

In the section on sources of government revenue it was stated that the government can obtain funds either by levying

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(1) Musgrave, R., "Fiscal Policy in Prosperity & Depression", <u>Amer. Econ. Rev.</u>, Vol. 38, No. 2, May, 1948, p. 386.
(2) Newcomer, M., <u>op.cit.</u>, p. 2.
(3) See Section on Public Expenditure Policies below.

taxes or by borrowing. The latter method, it was argued, has direct effects on private expenditures less depressing than the former. The conclusion easily suggests itself that when more expenditures, with a view to enhance production and employment, are needed, the emphasis in government revenue should be placed on borrowing. But such a hasty conclusion fails to consider that borrowing means more public debt; that public debt may be excessive; and that it may have a real or psychological burden under which circumstances the indirect effects of public borrowing on private expenditures may more than offset its stimulating direct effects. A critical appraisal of the latter views will now be attempted.

One of the most ardent supporters of public borrowing among contemporary economists is Alvin Hansen. It is proposed here, as a first step, to put forward a summary of his views, and, later on, to analyse them critically.

"Historically", Hansen points out, "opposition to public debt....gradually broke down by reason of exigencies which appeared more or less uncontrollable. Thus, state borrowing entered as a by-product mainly of the increasingly costly outlays incident to modern warfare. It was not a question of the theoretical principles but of practical hard necessities. The tradition against borrowing was set aside when grave emergencies, such as wars, forced the issue".[1] In his book "Fiscal Policy and Business Cycles", Hansen attacks the traditional theoretical

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(1) Hansen, A., Fiscal Policy and Business Cycles (W.W.Norton & Company, Inc., New York, 1941), p. 135.

arguments and popular prejudices against public debts; and proposes to utilize public borrowing as a means to secure fuller utilization of resources. In his words: "Public debt is an instrument of public policy. It is a means to control the national income and, in conjunction with the tax structure, to regulate the distribution of income"(1). He contends that (a) an internally held public debt need not entail an economic burden; and (b) that we need not be concerned over the imminence of reaching a ceiling on the national debt. With respect to (a), Hansen points out that the answer depends upon the character of the tax structure, and upon the objects and results of public expenditures. If there exists an identity between the taxpayer and the bondholder, no burden may be said to accrue under such circumstances. To the extent that the tax structure is non-progressive, a real burden for the low-income groups, in the form of a reduced standard of living by reason of the interest burden which they are obliged to pay, would of course be involved; but Hansen seeks to minimize this by proposing progressive taxation with which idle savings are drained from the saving stream; and directing the bulk of government expenditures primarily to increasing the consumption stream or the propensity to consume function, and thereby reduce the prevalent inequalities in wealth and income.

The objects of the expenditure, according to Hansen, determine in part the burden entailed by a given magnitude of public

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(1) Hansen, A., <u>Fiscal Policy and Business Cycles</u>, op.cit., p. 185.

debt. Following Ursula Hicks,[1] he distinguishes three types of public debts, namely, (a) dead-weight debt, (b) passive debt, and (c) active debt. The first category refers to debt arising from expenditures which in no way increase the productive power of the community-- yielding neither money revenue nor future flow of utilities-- such as war outlays. Passive debt refers to expenditures incurred on projects such as parks which, while yielding utilities and enjoyments to members of the community, bring in neither money income nor increase productivity in the narrow sense. The last category involves self-liquidating expenditures which directly enhance the productivity of the nation. Hansen's point of emphasis seems to be that deficits arising out of expenditures made for productive purposes do enhance the real wealth of the community and directly or indirectly augment the nation's taxable capacity. This brings us to the third major determinant of the burden entailed by a public debt: the effect of the expenditures so financed upon the level of employment and the standard of living. Hansen emphasizes the need for appraising the primary and secondary repercussions of deficit financing upon the national income. Even in the event of a public debt imposing unfavorable effects upon the consumption stream, he argues, the long-run effects may outweigh the disadvantages. Drawing from British financial history he maintains that the regressive tax structure of Britain during the 19th century served to augment the volume of savings so vital

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(1) Hicks, U.R., The Finance of British Government, 1920-1936 (Oxford University Press, 1938).

in a period characterised by rapid industrial expansion.[1] For present day economics, Hansen's recommendations are that deficit financing be utilized as a means of assuring fuller utilization of resources; with expenditures devoted to productive prospects; and that the tax system be designed in such progressive fashion that the debt burden is minimized.

The considerations with respect to the magnitude of the public debt involve, according to Hansen, an analysis of the concepts of taxable capacity and taxable income on the one hand, and the relation of debt to prices or the threat of inflation on the other. So long as public expenditures, financed by borrowing, permit an increase in the national money income sufficient to permit the transfer payments by taxation, without encroaching upon the monetary income remaining in the hands of the public, we can indefinitely postpone the realisation of an intolerable level of public debt. In his words: "As long as the interest on the public debt is well within the practical taxable capacity of the government, taking the entire business cycle into consideration.....no question can arise with respect to the solvency of the government".[2] In this connection Hansen stresses the flexibility of taxable capacity. The second consideration, the threat of inflation, Hansen summarily dismisses so long as there are unemployed resources available. Even when full employment is reached, all that is needed, he argues, "is that the deficit must no longer be financed by monetary expansion.

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(1) Hansen, A., Fiscal Policy & Business Cycles, op.cit., pp.153-7.
(2) Ibid., p. 159.

If, however, the deficit is financed by diverting a part of the current income stream to the government through borrowing.... a continuing deficit, even at full employment, need not result in price inflation"(1). Hansen concludes that "much of the discussion about the limits of the public debt is wholly unrealistic. There are no rigid and fixed limits. The problem is a manageable one, and can best be taken care of by ensuring that taxation is adequate: (a) to prevent inflation and (b) to provide a reasonably equitable and workable distribution of wealth and income. Within the limits set by these criteria, it is possible to determine, according to varying circumstances, what proportion of public expenditures may advantageously be loan-financed and what proportion should be tax-financed"(2).

The preceding line of approach adopted by Hansen, and stemming out of his adherence to the stagnation thesis, indicates that it would be possible to obtain all the benefits of a public debt program without suffering any appreciable detrimental consequences. The conclusion is that there is no burden to an internal debt; and that we need not be worried about the limits so long as the national income expands sufficiently to cover the costs of servicing the debt. Such an optimistic view, however, although true in an important sense, under-estimates many of the important issues involved. "....the statement that an internally held public debt imposes no economic burden on society is not entirely true. The burden has been enormously exaggerated, but

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(1) Hansen, A., <u>Fiscal Policy & Business Cycles</u>, op.cit., p. 171.
(2) <u>Ibid.</u>, p. 175.

it would be foolish to deny that it does exist. Strains and frictions may develop throughout the system"[1]. This is because the people who pay the taxes are many a time different from those who own government bonds. The larger the absolute volume of taxes needed to service the debt, the more rigid becomes the tax structure; and the larger the volume of the debt, the more it tends toward a rigid inequality of distribution of income. In addition, "the existence of the debt gives incentive to the formation both of rentier pressure groups (whose advantage lies in higher interest rates on the bonds, and stable or falling prices in the economy) and of inflationary pressure groups who will push for a higher price level, and so a lower real volume of debt"[2]. In short, the existence and growth of a large public debt do create a number of issues which would have to be considered in the fields of taxation as well as in the fields of monetary and banking policy. If public borrowing impinges on consumption and adversely affects the inducement to invest, or it reduces the availability of credit for private enterprise; and if public expenditures are undertaken in such manner as to disturb business confidence; and if the tax structure, on account of the debt, becomes excessive and reduces consumption or discourages enterprise, then public borrowing would amount to a real burden with detrimental effects on the formation of capital and income.

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(1) Wright, David, Quarterly Journal of Economics, quoted by Somers, H., Public Finance & National Income, op.cit., p. 391.
(2) Morgan, Th., Income & Employment, op.cit., p. 239.

It remains true, however, following Hansen, that the absolute magnitude of the debt, taken by itself, has little meaning unless we compare its size with a meaningful economic concept such as wealth, population, or income. "What matters is the ratio of the debt to other economic variables, such as taxable income, the resources of the banking system, the volume of private securities outstanding, and so on. Most important in general is the relation between the debt and the economic size, so to speak, of the country.....For purposes of analysis, it is necessary to express this economic size by means of some kind of an index, such as the national income"(1). The ratio of the debt to national income gives a good idea of the magnitude of the whole debt problem since it allows us to compute the ratio of interest charges to the national income, or, in other words, the average tax rate which must be imposed to service the debt. "We thus see that the greater is the rate of growth of income, the lower will be the ratio of debt and of interest charges to income. The essence of the debt problem is a problem of an expanding national income"(2).

Turning to consider the limits, if any, to an internally held public debt, it is possible to say that in a strictly narrow mechanical sense no such limits exist so long as the transfer argument is held. But the greater become the sums involved, the more evident become the strains and frictions

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(1) Domar, E., Public Finance & Full Employment, Postwar Economic Studies No. 3, Board of Governors, Federal Reserve System, Washington, 1945, pp. 55-56.

(2) Ibid., p. 57.

emanating as a result of such transfers. These frictions, however, can be greatly reduced if the Treasury and the monetary authorities provide sufficient liquid resources with which the various transfers can be made. But the contention has generally been that limits do exist, however difficult to estimate, to a public debt which a country can sustain. B.V. Ratchford, for example, states: "When we choose to remove a monetary obstacle to present production or to finance a war by creating a debt, we are able to do so because we have freedom of action. But by that act we give hostages to the future; we restrict our freedom of action to deal with new problems which may arise and at the same time create an obstacle which, according to the best of our knowledge at present, will be a chronic economic problem".[1] The issue is more clearly stated by Seymour Harris in the following words: "Accumulation of debt will not bring ultimate collapse if the economy continues to grow. Capacity increases with the rise of income; and so long as the rise of debt charges is kept well within the limits set by a rising trend of income and capacity to pay taxes, no fears need be felt concerning a rising public debt. But a continued rise of the cost of debt in the face of stable or, even worse, falling incomes will ultimately bring disaster".[2]

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(1) Ratchford, B.V., "The Burden of a Domestic Debt", <u>American Economic Review</u>, September, 1942, p. 467

(2) Harris, Seymour, <u>Postwar Economic Problems</u> (McGraw-Hill Book Company, New York, 1943), pp. 170-171.

B. INFLUENCE OF MODERN FISCAL THEORY ON MODERN FISCAL POLICY

The preceding survey of contemporary economic theory and modern fiscal theory has fairly demonstrated that the basic assumption underlying fiscal policy is that the volume of production and employment depend upon aggregate effective demand for what is produced. If business is unable to sell its produce at prices sufficient to cover its costs of production, that is because of an insufficiency of total effective demand; and, conversely, when sales take place at rising prices, that indicates that there is too large a volume of expenditures. According to the theory, also, an insufficiency or an over-abundance of demand can be compensated by government action whereby, in the former instance, the volume of consumption and investment expenditures would be sufficiently expanded and, in the latter, curtailed. The inference is that, no matter what measures are taken (quantitative or qualitative), the total expenditures of consumers, investment expenditures, and government expenditures must be able to buy the gross output produced at full employment if we are to have that full employment at all.

The use of fiscal policy-- with its three main divisions: receipts, expenditures, and debt management-- as an effective device of economic control has had strong adherents in recent years. The implicit aim is to attain and maintain high employment and productivity at stable prices. "The fact that a considerable degree of latitude is possible in all three phases of

fiscal policy-- with respect, for example, to the magnitude of each, to specific policies within each of the three divisions and to the relation of one division or subdivision to another-- provides the basis for the use of fiscal policy to promote full employment. It signifies that, within the latitude afforded, the choice among different alternatives of action may be governed by the anticipated effect on general business conditions".[1] It is my intention, at this stage, to show how tax policies, public expenditure policies, and debt management combine in shaping government contribution to income and employment. In discussing each part of budget policy I shall assume, for clarity of discussion, that the other two parts are given; and that each phase of the budget is singled out for close examination one at a time.

Tax Policy:

The proposed use of taxation to check expansion and contraction has been popular of late. The argument is that taxation can influence Keynes' propensities in two ways: the amounts absorbed in the form of taxes will affect the ability to spend and to invest; and the distribution of taxes among taxpayers (the upper and lower brackets) will affect all the variable factors: spending, investment, and saving. The term tax policy or tax management is used here to mean changing the form and incidence of taxation with a view to influencing the volume of private expenditures and designed to stimulate production and

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(1) Whittlesey, Ch., Principles & Practices of Money and Banking (The Macmillan Company, New York, 1948), p. 511.

employment. In this light, tax policy raises two main issues: How much of the annual budget expenditures shall be obtained through taxes; and what sources shall be relied on? The two questions are, of course, closely related. Before I proceed to discuss them specifically, a brief word of analysis about the broad effects of taxes seems pertinent at this stage.

Taxation involves a transfer of funds from the taxpayer to the government. This transfer may impinge on hoards; on investment in securities or in actual physical capital; on consumption of goods and services; or on a combination of these. The exact effects of a tax depend on how these economic variables are affected. Again, any tax, no matter how small it may be, has some economic effects which cannot be ignored. A prohibitive tax, for example, interferes with some economic activity or forces it underground; and a revenue producing tax involves a transfer from the public to the government with possible consequent unfavorable effects (excluding the case when hoards are affected). "The reduction in consumption has an unfavorable effect on business activity; the reduction in the purchase of capital goods likewise reduces the volume of business; and the reduction in the savings devoted to the purchase of securities tightens the credit market. The last would have serious effects to the extent that the banking system is not lending with perfect freedom. Thus all taxation, in the merely mechanical aspect of transferring funds from public to government, tends to reduce the volume of national income and business activity"[1].

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(1) Somers, H., Public Finance & National Income, op.cit., p. 309.

With this brief survey of the broad effects of taxes, I now proceed to discuss a rational budget policy whereby the level of tax yield and kinds of taxes used are designed to promote high output and employment. This, of course, involves considerations of equity in income distribution (an important datum for the economist but primarily a matter of social philosophy), and economic effects of alternative taxes, and taxes versus deficits upon income and employment.

The two methods of raising revenue: taxation and public borrowing, differ in their current impact upon the level of private demand. Taxes, for the major part, result in reduced private expenditures. The conclusion suggests itself that the precise nature of the tax structure and tax yield should be different depending upon economic needs. If the level of private expenditures is high and conditions are inflationary, the entire budget revenue or even a surplus should be raised from taxes. If private expenditures are low and the setting deflationary, "there is little difficulty in establishing the rule that the economy will be better off......the less the average tax dollar depresses private expenditures on consumption and investment"(1). Under the circumstances, some deficit may be needed to assure an adequate level of total effective demand. We have seen also, in our discussion of the burden and limit of the public debt,(2) that although the dangers of an increasing public debt are usually exaggerated, its economic

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(1) Musgrave, R., "Fiscal Policy in Prosperity & Depression", loc. cit., p. 388.

(2) Supra, pp. 52-60.

implications are not a matter of indifference; and that public attitude favors policies which involve a minimum of debt increase. The inference follows that, under deflationary conditions, a tax structure with maximum expansionary effects will be needed because it permits the maintenance of full employment with a minimum increase in the public debt. Under conditions of inflation, we need only reverse our deflation rule and argue that taxes should depress provate demand and generate a surplus with which to redeem part of the public debt.

But the choice is not only between taxes and borrowing. It is also among different taxes themselves since some of them curtail private spending more than others. The question is how much can we affect the rate of spending by the distribution of the tax burden? Before proceeding further with the discussion, a brief word about the yield objective of taxes seems pertinent. The attention of the reader is also drawn that I shall assume a deflationary situation, the implication being that if the arguments are reversed, they would hold true for an inflationary state.

It can be safely said that the higher the yield objective sought from taxes relative to national income, the more difficult does it become to rely on revenue sources only. This is because the deflationary pressure of a tax is likely to be great the higher our revenue goal. This leads us to a critical position. "We wish to set a high revenue objective so that the deficit will be small, yet, to have full employment, a high

revenue goal will be permissible only if the deflationary pressure of the average tax dollar remains low. As this condition becomes increasingly difficult to attain the more we collect, the possibilities of reducing the deficit by improving the revenue structure are limited. The solution, in principle, is to devise the best possible revenue structure for a range of yields and then to choose that yield which will leave the economy with an adequate level of total demand. Setting the yield objective thus requires a general appraisal of the economic outlook as well as an estimation of the kind of revenue structure which will be possible".[1] Stated in outline form, our tax policy should minimize tax deterrents to consumption and investment; and should utilize incentive taxation (such as the partial abatement of income taxes on that part of income reinvested in fixed capital and a scheme of carrying losses forward) with the aim of rendering it advantageous for the taxpayer to consume and to invest rather than to retain idle balances.

Tax revenue is usually derived out of funds which would otherwise have been used for consumption expenditures or saved. To the extent that it is paid out of savings, no direct reduction in consumption expenditure would follow. Hence it follows that an effective way of checking tax pressure on consumption is to tax income saved, leaving income spent on consumption relatively tax-free. Again the general rule applies that "a tax

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(1) Musgrave, R., Public Finance & Full Employment, Board of Governors, Fed. Res. Sys., op.cit., p. 25.

system which takes little from low-income groups presents the least obstacle to consumption-- the principal item of the total spending of the nation. These groups constitute the majority of the people and they spend the greatest part of their income on consumption goods very soon after they earn it"(1). The taxpayers with large incomes, on the other hand, tend to save proportionately more than do those in the lower brackets. It follows, therefore, that an estate tax or a progressive income tax paid mainly by the higher income groups is superior in this respect to an excise tax, a pay-roll tax or a personal income tax severe as to affect those in the lower brackets. That progressive taxes fall less heavily on consumption is clear; "but the amount by which taxes may actually be prevented from curtailing consumption is easily over-estimated", argues Musgrave. He says: "If the required yield is large,.....it will be necessary to extend taxation into the middle and middle to lower income groups, where consumption expenditures absorb a large share of income. This is necessary because the largest part of total income goes to families in the lower and middle income groups.....a substantial fraction and, in fact, a larger part of the tax burden will be reflected in reduced consumption outlays"(2). Musgrave arrives at the conclusion that "no reduction in tax pressure-s on consumption can be achieved by pushing the degree of progression within feasible limits once excise, payroll, or other high consumption taxes have been

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(1) Halasi, A., Planning & Paying for Full Employment, op.cit., p. 13.
(2) Musgrave, R., Public Finance & Full Employment, op.cit., p. 26.

eliminated and a reasonable degree of progression in income taxation has been obtained. This, of course, does not render it unimportant to utilise progression for curtailing tax pressures on consumption; nor does it weaken the proposition that progression is desirable on equity grounds. It appears, however, that increased progression cannot be expected materially to alleviate the deflationary effects of taxation should a substantially increased level of consumer expenditures be required".[1]

Our rational tax policy next considers minimizing tax deterrents to investment over and above minimising pressures on consumption. It is in the sphere of investment that great fluctuations occur, and it can therefore be argued that a main tax problem is not to deter would-be investors by too high taxes. There are two main aspects to this problem, argues Musgrave. "Taxation may curtail investment by reducing savings and hence the supply of available funds, or it may reduce the attractiveness of investment and hence the extent to which available funds are channeled into investment outlets".[2] With regard to the first possibility, a distinction must be drawn between the level of saving in general and the supply of particular kinds of savings although the practicability of this possibility is remote since very little is known about the composition of savings by income groups. It is very unlikely also that for sometime, at least, there will be a general shortage

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(1) Musgrave, R., Public Finance & Full Employment, op.cit., p. 28.
(2) Ibid., p. 29.

of savings, assuming that no drastic changes in the community's consumption habits take place. More important become then tax deterrents to the investment of available funds. "If expected investment yields are cut through severe tax rates, investment tends to be discouraged, particularly in risky ventures, while the holding of cash balances tends to be encouraged. As a result, taxation of investment income may depress expenditures for plant and equipment by a multiple of the tax yield".[1] Our concern, it seems to me, should center around three points: the level of tax rates, the degree of progression, and the way in which taxable income is defined. As far as tax rates are concerned, we face the conflict between various objectives. Investment considerations urge lower taxes on the upper income groups while consumption considerations call for moderate rates in the lower income brackets. When the need for yield arises, some compromise must be reached. The case for steep progression at the very upper end of the income range seems to be insignificant from the standpoint of tax yield since the number of taxpayers affected is relatively small; although equity considerations in favor of steep progression may be decisive. With regard to the definition of taxable income, the provision for offsetting losses to determine net income for tax purposes is of vital importance, since without such offsets, risky investments would be prejudiced as they involve the greatest likelihood of losses.

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(1) Musgrave, R., Public Finance & Full Employment, op.cit., p. 30.

We now turn to consider the major aspects of incentive taxation as a part of our rational tax policy. The entire approach is based on the taxpayer's natural desire to avoid paying taxes by offering him the chance to do so if he complies with certain legal requirements. Somers comments on this aspect of tax policy in the following words: "Taxes may be so designed as to stimulate production and employment without regard to considerations of ability to pay, benefit, and earnedness. The idea of incentive taxation falls into this category......the undistributed profits tax was intended partly as a stimulus to consumption by forcing the distribution of profits to shareholders. The taxation of bank deposits is sometimes proposed as a method of stimulating spending. All of these plans are aiming at some high level of employment...... There seems to be a trend in the direction of giving these principles a greater and greater part in framing tax policy. The aim may sometimes be to curtail rather than promote spending. War time policy had this aim in large part".[1] In a deflationary setting, there are two approaches to the use of incentive taxation: first, through the taxation of idle balances and, second, through favorable tax treatment of current income spent on consumption and investment as against income not returned to the expenditure stream. Tax reductions, for example, are proposed for people who employ additional workers, or who hire maids, gardeners, drivers, and other domestics. Although

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(1) Somers, H., Public Finance & National Income, op.cit., pp.135-136.

it is true that both approaches, and particularly the first, offer extreme administrative difficulties in the form of enforcing a declaration of assets held or tax evasion through transfer of assets, etc., yet the whole approach deserves more careful consideration than it has been given to date.

The above framework for a rational tax policy, plausible as it is, seems to me to be difficult to apply. I am inclined to repeat with Charles O. Hardy that "the factual basis of this whole scheme of tax management is highly speculative"; and that "I know of no attempts to carry it through in practice".[1] Tax management, however, is a promising field for further study in the direction of encouraging progress; but it is unlikely to contribute much to the solution of the short-run stabilization problem. There are broad social, political, and equity considerations which impose important limitations on the literal translation of economic arguments in taxation to practice.

Public Expenditure Policies:

Our next aspect of a rational budget policy involves the proper administration of public expenditures. Public expenditures have increased greatly in the last few decades. Expressed as a percentage of the gross national produce, they have risen in the United States, for example, from 7.1% in 1932 to 10.6% in 1939 to roughly 18% in 1947. (The percentage always rises in wartime years: in 1918 it was 20%, and in 1944 and 1945 roughly 50%).[2] The reasons for this had been increased outlays

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(1) Hardy, Ch., "Fiscal Operations as Instruments of Economic Stabilization", Amer. Econ. Rev., Vol.38, No.2, May,1948, p.396.
(2) Morgan, Th., Income & Employment, op.cit., p. 212.

on defense, additional functions assumed by the government, and the servicing of an expanded public debt. These expenditures have of course far reaching effects; and the relationship of the government budget to production and employment forces itself upon our attention.

Public expenditures affect the national income by influencing its two components: the volume of consumption expenditures and the volume of business investments. The two are closely related, since consumption expenditures influence the amount of business investment which, in turn, affects the flow of income and thus of consumer spending. It is suggested, as a first step, to deal in a general way with these interactions and their implications, and then proceed to apply them to practical problems of policy.

Government spending may be assumed to have the initial effect of increasing demand for goods and services. If we assume the existence of unutilized resources in the economy, the primary effect of government spending may be assumed to be an increase in the amount of goods and services produced. Our next step in the analysis deals with the disposition of the income generated by such government spending. Part of it will, in all likelihood, be spent on consumers goods, and the other part saved. The part spent will again generate income of which again part will be spent and part will be saved; and the series of respendings will continue with each successive spending adding, although in decreasing amounts, to the total income created.

This has become known as the Multiplier principle. The crucial point in this analysis is the increase in income, with a relatively small initial expenditure, within a relatively short time. The exact magnitude of the increase will, of course, depend upon how great is the proportion of income spent on consumption at the time of the public expenditure, and the changes which take place in this proportion during the successive stages of spending. Due weight must also be given to the effects, favorable or unfavorable, of the expectations and reactions of businessmen following the announcement of a public expenditure program since they may offset (when, in the opinion of business, government expenditures are considered to be modest and are expected to stop very soon) the favorable effects outlined above, or generate further activity. Out of the latter expectation has emerged the theory of pump-priming.

The portion of income that is saved, during the initial and following stages of spending, is either held idle or is put into investment. Here, in considering the effects of a public expenditure program, we should realize that the demand for capital goods is derived from the demand for the goods which they produce. When there is increased demand for consumption goods, as a result of government expenditure, the profitability of using other capital goods may also increase. When the demand for certain capital goods is increased, the demand for other capital goods may also be stimulated, and in this manner business investment stimulated. This phenomenon has become known as the

Acceleration principle. In actual practice, however, the relative increase in the production of capital goods "will vary with the degree of under-utilization of equipment and the state of expectations, to say nothing of the fact that many outside factors[1] may offset any favorable tendency caused by the increase in consumption taken by itself".[2]

The above discussion has dwelt mainly upon the expansionary effects of government spending. Contemporary economic theory, associated with the names of Keynes and Hansen, concentrates also on a second important function of government spending, namely closing the gap which arises out of disproportionality between intended savings and intended private investment. Where a deflationary gap develops (savings outrun investment), government should step in and convert excessive savings into investment; and in case of an inflationary gap (investments outrunning savings), government function should either curtail investments, or increase savings, thereby in both cases close the gap. But before we proceed further in our discussion, the following important reservation of Somers should be duly noted. He says: "The fullest understanding of economic and business cycle theory must be invoked for any adequate analysis of the influence of government expenditures on the national income...... In considering the effects of government expenditures on the national income the major caution is to avoid considering purely mechanical devices such as the multiplier principle, the

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(1) Such as political unrest, a tight money market, or a deflationary tax structure.
(2) Somers, H., Public Finance & National Income, op.cit., p. 124.

acceleration principle, and the theory of the savings-investment gap as short-cuts which make unnecessary a study of the basic controlling factors in the economy, such as consumer and business expectations".[1] We now turn to a specific study of public expenditures as effective tools of economic control.

There are many economists who propose that planned use of public expenditures should be given top priority in organising the efforts of society to control depressions and economic instability. They argue that manipulations in public spending, financed mainly or entirely by borrowing, are more powerful than tax management when increased funds are to be injected into the income stream. Changes in the rate of public spending can be accomplished more quickly and with more ease than changes in taxation. Spending is a more selective fiscal tool to deal with specific situations in practice than is taxation; and it can generate more new purchasing power than tax reductions since larger amounts are made available through the spending and the borrowing process. The conclusion suggested is that public expenditures furnish more leverage and are more effective than taxation as an instrument of fiscal control. The emphasis is placed upon the multiplier effects of public investment in providing opportunities for the savings of the people. Quoting Hansen's views on public expenditure policy Buehler writes: "A reserve of 50 billion dollars of public works is suggested (for the United States).....in order to be certain of an adequate

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(1) Somers, H., Public Finance & National Income, op.cit., p. 128.

volume and flexibility in public investment. Professor Hansen points out that the annual average of construction in the country, public and private, in the prosperous years of 1925 to 1929, was 10.6 billion dollars, and that it fell to 3.7 billion dollars in the poor years of 1931 to 1935. A government investment program making up a sufficient part of the deficiency would have stabilized construction and would have helped greatly in overcoming the forces of instability, he argues. He particularly endorses public spending for housing and the development of natural resources with more projects of the Tennessee Valley type".[1] It should be noted here that government endeavor to promote economic recovery through public spending need not be confined to public works or to developmental programs only. Consumption may be stimulated also by relief expenditures, bonuses paid, or even the outright purchase of materials and supplies by the government; and since consumption and investment are closely related, the promotion of one is likely to stimulate the other. The initial and ultimate effects of public expenditures may be different, however, depending upon the repercussions of money injections into the economy.

Not all economists, however, are so confident of the possibilities of compensatory and developmental financing. There are some who fear the effects of a growing public debt which may follow from such a policy. Others contend "that much unemployment is not sensitive to changes in the volume of public spend-

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(1) Buehler, A., Public Finance, op.cit., p. 131.

ing, that deficit spending deals with the results of economic instability rather than with the causes, that it may produce only small increases in the national income, and that it is less effective, as a rule, in raising the national income".[1] Theodore Morgan fears that as a result of political pressure by competing sectors in the economy for expenditures, there is "the danger that public expenditures may lead to worsened allocation of resources"[2]; and Albert Halasi confirms Neisser's warning with regard to the use of public investment as a permanent factor in an employment program "that too much reliance on public investment to offset the current flow of savings might carry public enterprise into fields traditionally reserved for private enterprise, and that this might adversely affect the economic climate to the point of making private enterprise reluctant to extend its investments in the same fields".[3] Finally there is Buehler's remark that "as yet, emergency public works programs have provided little more than a limited amount of unemployment relief; and carefully controlled experiments in the long-range planning and execution of public works programs, with the purpose of attaining greater economic stability and a rising national income, are still a dream of the social planners".[4]

It is thus apparent that the controvertial character of compensatory governmental spending is keen. One thing is certain however. Government functions and responsibilities have expanded

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(1) Slichter, S., Public Policies & Postwar Employment, quoted by Buehler, Public Finance, op.cit., p. 131.
(2) Morgan, Th., Income & Employment, op.cit., p. 217.
(3) Halasi, A., Planning & Paying for Full Employment, op.cit., p. 7.
(4) Buehler, A., Public Finance, op.cit., p. 132.

and with them also public outlays. Although public works, developmental projects, and relief payments apparently cannot alone stop wild excesses of prosperity or end a depression, their beneficial effects on employment and business activity should not be under-estimated. While it is true that business cycles are so irregular as to upset forecasts of the future, and public expenditures cannot offset the effects of all contrary forces, much would be gained from carefully laid-out and coordinated long-range plans of public expenditures. The major bulk of public spending should be effected during depression periods when increased employment is highly desirable; and be maintained at a minimum during prosperity. Finally the remark should be made that nothing below full cooperation between the government and the people can bring about the desired results of minimizing economic fluctuations and producing a growing and equitably distributed national income.

Debt Policy for Fiscal Control:

The third weapon in our rational fiscal program is debt management. It is intended in this study to investigate some of the means of employing debt policy as an instrument of economic control. The enormous size of the public debt,[1] and its distribution,[2] has made it possible to exercise a powerful

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(1) It came close to 300 billion dollars in the U.S.A. in 1946. Somers, H., op.cit., p. 330.

(2) Figures for the United States in 1947 and 1948 are: around 27% are held by commercial banks, 9% by the Fed. Res. Banks, 16% by governmental units, 27% by private individuals, and the balance by others, mainly insurance companies.

effect on the size of the national income through changes in the volume and form in which individuals and institutions hold part of their assets. The problem is more difficult and complex than it appears on the surface since the study touches upon virtually every aspect of public life: economic, political, and social; and presents serious problems of analysis. Henry Wallich remarks on this by saying: "that a public debt the service charges on which amount to between 5 and 6 billion dollars constitutes a political problem of the first order goes without saying. The distribution of the debt, and the tax burden which it imposes, may produce important realignments among pressure groups and may lead to a re-weighting of the relative interest which different groups have in various economic and social policies. The handling of the debt will decisively influence the future of the banking system, and the interest rate policies, in particular, into which the debt may drive us, will be of paramount importance for the future of the rentier class and of many educational and other non-profit institutions..... The importance of the debt and the great potentialities which it entails seem to justify viewing its management in the broadest possible terms and regarding it as a major element of national economic policy".[(1)] It is intended in this section to limit discussion to reviewing how debt management could be used as an instrument of economic control; and find out in what sense it can aid, and in what sense it may act as a limiting factor

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(1) Wallich, H., "Debt Management as an Instrument of Economic Policy" Amer. Econ. Rev., Vol.36, No.3, June,1946, pp.292-294.

in our all-fiscal program.

An essential feature of debt management is that its effects are largely qualitative, that is, not easily subject to quantitative determination. Variations in the character and distribution of the debt do make security holders inclined to change their rate of spending, but it can hardly be predicted how much. This is in sharp contrast to revenue and expenditure policies proper which deal primarily in quantitative terms: some moneys are injected into the income stream and others are taxed away. When the acts of government borrowing and spending are fused together, however, the quantitative aspects become more apparent. It is intended here to consider both the quantitative and qualitative aspects of public debts. This, of course, would necessitate considering, besides revenue raised for the purpose of servicing the debt, the effects of the act of borrowing upon the capital and money markets, the effects of the expenditures made by the funds obtained, and the effects of repaying the debt. Because the economic system is very complicated and there are much interrelations among variables in it, I expect, at best, merely to indicate tendencies which are likely to manifest themselves under varying sets of conditions.

To begin with, I should like to state that a view of current debates on the effects of government borrowing gives the induced inference that some conclusions concerning the consequences of public borrowing are faulty, either in whole or in part, while others are logical. The absence or existence of unemployed

resources in the economy seem to be of decisive significance in evaluating public borrowing. This means that the possibilities of expanding production and employment are very crucial when we consider the effects of a public debt program; even though the relation between public debt and economic activity may suffer from definite limitations. As long as there are idle resources, government borrowing-and-spending need not divert savings from industry but, on the contrary, it may add to the total rate of spending and cause an increase in employment and in national income. In support of this argument, we need only refer to the tremendous effects on economic life public borrowing-and-spending has had in the course of the last two great wars. Hansen argues that "it may well be sound policy to finance a large part of a public investment developmental program from borrowing, thus causing a long-run rise in the public debt".[1] The justification is that by promoting investment in housing construction, the development of natural resources, and other public works, private investment opportunities will be opened, employment increased, the national income and the nation's purchasing power expanded. Such a view, however, plausible as it is, does need some qualifications. To be more certain in estimating the probable effects of public loans, we need to know further how and wherefrom are the funds obtained, and how will they be employed.

Internally, governments may borrow from the central bank, from commercial banks, from corporations and firms, or from

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(1) Hansen, A., Federal Debt Policy, Proceedings of the National Tax Association, 1943, p. 263.

individual investors. The funds so obtained must either come from savings out of past or current income or from newly created money. When the funds come from savings, they may have been diverted from other investments, or come out of idle hoards. Except when idle funds are directed into the income stream, no immediate increase in the purchasing power of the community need follow as a result of government borrowing. Borrowing by means of credit expansion, on the other hand, tends to increase, when spent, purchasing power and, to some extent, raise prices. This borrowing-and-spending may be inflationary or non-inflationary depending on the sources of the funds obtained; and whether it involves the creation of new purchasing power or its mere transfer to the government for spending. The mere act of borrowing, without spending, will, in all likelihood, bring about a decrease in purchasing power.

The next point to consider is the purpose of public borrowing. This is very vital. Assuming that public expenditures are to be devoted to projects which would directly or indirectly increase the productive resources and the community's income, spending proposals may be preferred when financed by borrowing than by taxation if additional taxes are estimated to be economically painful and/or politically nonfeasible. It is now almost generally recognized that public borrowing is justified only when the expenditures sustained by borrowing are socially warranted because they will presumably increase the social income by more than the social cost involved; that it should be

employed only when increased taxation is impracticable or that the repercussions of heavier taxation would create greater social costs than borrowing; and that the direct and indirect effects of borrowing as a part of the program of financing expenditures should be estimated carefully in advance by governments.(1)

Another factor still is the interest rate paid on loans and the broader effects on the currency and the banking system. Interest rates not only determine the cost of borrowing, but have significant effects upon the banking system and the level of private investment and business activity in general. The higher is the rate of interest paid on government bonds, the stronger will be the pull on funds devoted to private investments with serious repercussions on marginal enterprises and business activity. If governments also attach tax-exemption to their securities, this may attract investments to them and prejudice private borrowers. Furthermore, should interest rates advance on new borrowings, holders of securities now outstanding would suffer a decline in the value of their investments and this may shake confidence in public credit and have serious consequences. Expansion and contraction of government borrowing is also accompanied by changes in the volume of bank credit and the general price level. Inflation threat would have to follow a large borrowing-and-spending process unless commensurate expansion in output takes place to absorb the excessive purchasing power; or that the retirement of the public

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(1) Buehler, A., Public Finance, op.cit., p. 725.

debt goes very fast to reduce the circulating medium by retiring securities held by the central bank. The present dependence of commercial banks on Treasury policy for their earnings (as the great liquidity created by the debt has removed many enterprises from the need to borrow from banks since they can finance themselves internally), and the banks' heavy government portfolios which made them less amenable to monetary control by the central banking authorities need only be given passing reference.

Finally the general economic conditions prevailing should be properly estimated. Any fall in the general price level will increase the burden of the debt; while the possibility of reducing the debt burden by raising the price level is likely to encounter opposition from certain groups. Government borrowing during boom periods, if it occurs, will necessitate paying high interest rates, and its expenditure may generate inflationary effects; while at the beginning of a recovery it may help to promote business activity. The repayment of loans during depressions and falling prices will be burdensome on account of declining tax resources, the drain on the economy, and the rise in the value of money. Debt redemption during prosperity on the other hand, though discriminating in favor of the government, is likely to be beneficial.

With regard to the specific effects of debt repayment the act may, in addition to reducing the tax burden by eliminating the debt charges (provided, of course, redemption is conducted in such manner as not to burden the economy), actually release

funds that may be employed for new investments or add to consumer spending. The present holdings of liquid assets in the form of public securities are considered to be a valuable asset which may readily be converted into cash if the need for liquid cash arises with a view to stimulating investment and consumption. Debt redemption, on the other hand, is considered to be deflationary to the extent that funds absorbed for debt retirement by the government would have been spent or invested, that those receiving payment fail to restore the money into the income stream, and that deposits with commercial banks are destroyed to pay for taxes as public loans are redeemed. When deposits are destroyed, changes in the velocity of circulation of deposits before and after debt redemption should be accounted for. The conclusion is that while repayment of debts is generally deflationary, it does have some stimulating effects. It is considered to be particularly wholesome in a boom period since it helps to slow down the inflationary trend and bring the economy more under control.

Bearing all these (and other) qualifications and limitations in mind, it should now be asked: what have we to say for and against debt policy as an instrument of economic control?

First, we should notice that there are definite limits on the rate of increase of a public debt irrespective of the magnitude of its absolute height. Government debt should not increase so rapidly as to cause inflation. The borrowing policy of the government forms only a part and not the whole of its

full employment program. Since the government's task is to attain and maintain full employment, it must keep purchasing power in balance with production, preventing the volume of money from falling so low as to result in deflation, or from rising so high as to produce inflation.

Second, we can safely say that public borrowing, if wisely done, will enable a fuller use of resources. It is evident that national development should not depend entirely on taxation, particularly when the country suffers from unemployment or when it is economically under-developed. Besides the quantitative effects of public borrowing-and-spending, debt management can affect the expenditures of investors, and hence national income, by inducing or obliging them to change the form of their assets. What is needed is to induce those adjustments which are in accord with current economic policy and to prevent those adjustments which are not.

Third, because it takes time to effect substantial changes in the types of securities floated and in their distribution among classes of bondholders, an effective debt policy requires a fairly clear formulation of long-run expectations.[1] This should take into consideration the unlikelihood that it would be possible to balance the budget in periods when private investment is low-- indeed a deficit may be required to prevent a slump--; and that when inflation threatens, a budget surplus should be accumulated and a part of the debt retired.

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(1) Wallich, H., "Debt Management as an Instrument of Economic Policy", loc.cit., p. 295.

Finally, it is very necessary that debt policy, if it is not to lose much of its effectiveness or turn to be harmful, must be wisely managed and coordinated with other credit and monetary policies.

Routes To Attain Fiscal Objectives:

1. Adjusting the Revenue and Expenditure Structures:

Assuming that adjustments are needed in the economy in order to attain our fiscal policy objective of a high living standard and full employment, it may be well to consider first the possibility of increasing the flow of private expenditures through improving the existing revenue and expenditure structures. In doing so, the government should aim to encourage private consumption expenditure and private outlays on investment until both are elevated to the desired level. This, the government can do, if existing tax pressure on consumption and deterring effects on investment are reduced; and if government modifies the channels of its public outlays in such manner as to effect a redistribution of income and bring about increased effective demand. It follows that to the extent that the fiscal structure is already sound, only limited results are to be expected from this approach.

The volume of consumption expenditure occupies a vital position, as may be remembered from previous discussions, in the central problem of full employment since it involves the major part of total outlays in the economy.[1] The major bulk of consumption is also done by the lower-income groups. Hence our concern

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(1) Theodore Morgan estimates that it forms two-thirds of gross expenditures. See Income & Employment, op.cit., p. 185.

should be directed toward expanding total consumption by raising the level of consumption of the poor. To do so, there are open before us two possibilities: (a) to get a larger share of the national income go into the hands of the lower-income groups, and (b) to encourage high consumption out of a given pattern of income distribution. The second possibility is beyond the scope of our discussion.

The underlying idea behind the redistribution of income is that when a larger share of the national income is shifted from higher to lower income groups, total consumption will be increased because the latter have a higher propensity to consume than the rich. Pressure on consumption, therefore, may be reduced substantially if our initial situation is one where the larger part of the tax yield is drawn from consumption and other regressive taxes. These taxes are borne mainly by the poor who consume the highest portion of their income; and whose tax payments are manifested in reduced expenditures on consumption. By shifting the tax burden to higher brackets (those who save more than they consume), the pressure of taxes on consumption can therefore be reduced.

Again, the volume of savings are much affected by the distribution of income. "All available evidence goes to show", says Schumacher, "that a more even distribution of income would increase the average propensity to consume and thus reduce the danger of investment outlets being insufficient to absorb all the savings people plan to make at full employment....A government,

therefore,.......must so redistribute the national income that the community will never attempt to save in excess of current investment opportunities".[1] But, the question need be raised: are there no limits to redistributive taxation?

All evidence seems to show also that the very process of releasing consumption expenditure by making the tax system more progressive tends to deter investments by making them less attractive. Surtaxes create the inducement for owners of business to leave their profits undistributed or in the form of reserves; and high income taxes promote tax evasion, both legal and illegal. This is besides their adverse effects upon the incentive to invest since they reduce the reward of risk-taking without reducing the risks themselves. The way out, according to Kalecki, is to have a sufficient part of the income tax put on a modified basis (which eliminates its adverse influence on profitability), or to replace it by a capital tax;[2] and Morgan argues for heavy taxation on inheritance.[3] The point should be emphasized further that if the tax yield objective is high, there is no escape that a substantial part of the revenue should come out of indirect taxes with depressive effects on private spending.

There are similar limitations on the expenditure side of the budget, argues Musgrave. "No great reliance can be placed on raising the level of spending through changes in the composi-

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(1) Schumacher, E., Economics of Full Employment, op.cit., p. 90.
(2) Kalecki, M., Economics of Full Employment, op.cit., p. 54.
(3) Morgan, Th., Income & Employment, op.cit., pp. 198-200.

tion of a given total of public expenditures unless the budget is very large. Different expenditure items, to be sure, will differ substantially in their effects upon private consumption and investment outlays. But within the framework of an established budget pattern, there is relatively little leeway for reshuffling expenditure items from this point of view. After contractual obligations and indispensable expenditures for basic governmental functions are reached, only a relatively narrow range remains in which adjustments can be made".[(1)]

The foregoing analysis should not lead us to conclude that improvements in the revenue and expenditure structures are not essential, or that they are not valuable for our purpose. What is meant is merely to emphasise their limited scope and partial effectiveness, particularly if a well-adjusted system of revenues and expenditures has already been established.

2. The Balanced Budget Approach:

The second possibility open before us is to consider raising both public expenditures and tax revenue by sufficiently equal amounts with a view to increasing the level of productivity and employment. This has come to be known as the balanced budget approach. I wish to point out that I am not considering here whether the budget should or should not be balanced. Rather, my purpose is to find out whether sufficient expansive effects could be secured in the economy through augmenting equally both tax revenue and public expenditures so as to lead to fuller

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(1) Musgrave, R., Public Finance & Full Employment, op.cit., p. 8.

utilisation of resources and higher employment.

The line of reasoning behind this approach is that its stimulating effects come from the fact that some of the funds which are taxed away would otherwise have been saved; and that a dollar or a pound absorbed by taxation may reduce the volume of expenditures in the country by less than a dollar or a pound, whereas its spending by the government adds one full dollar or a pound to total demand in the economy. Naturally the increase in government expenditures required by this route should be very large, since part of the taxes levied would reduce consumption expenditure, rather than savings, and to that extent will offset the stimulating effects of the government expenditures. This is particularly true when taxes fall mainly on people in the lower brackets.

We can start by saying that when public expenditures are increased, and tax revenue is raised by the same amount, available income for private spending will initially remain unchanged. Income added on the expenditure side is absorbed by taxes on the other. But this does not exclude the possibility that as a result of income redistribution private consumption expenditure may be increased. The balanced budget approach dwells heavily on this latter possibility of a net government release of consumption funds-- with favorable multiplier effects and increased national income-- through expansive effects of public expenditures financed by means of certain types of taxes that fall mainly on savings. If, for instance, tax revenue is raised by £100 million

(80% of which representing absorption of consumption funds and 20% absorption of loanable funds), and public expenditures are increased likewise (but that the latter process involves a 95% release of consumption funds and 5% of loanable funds), then we shall have a net release of consumption funds of 15 million pounds with expansive effects and, at the same time, a potential restrictive impact of a similar amount which represents the net absorption of loanable funds. Whether the latter restrictive effects are actually felt will, of course, depend on the state of the banking system and the availability of credit.

Borrowing the same mathematical figures from Morgan,(1) suppose we try and translate the above line of reasoning into practice. We assume as our original situation that the government budget is balanced at 30 billion dollars of tax revenue and expenditure; that gross production is running at about 188 billion dollars, with 8 million people unemployed; and that gross production at full employment should be 206 billion dollars, that, we have a deficiency in aggregate demand of 18 billion dollars. We consider now the possibility of raising both taxes and expenditures to the extent of the deficiency. If the saving-consumption ratio of members of the community is correctly estimated as 1:2, then it follows that when taxes are increased by 18 billion dollars, savings would be six billion dollars less and consumption 12 billion dollars less. When the government spends the 18 billion dollars, the immediate increase in expenditure would be 6 billion

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(1) Morgan, Th., Income & Employment, op.cit., p. 219.

dollars which, with a multiplier of 3 (assumed), would give us the desired rise in total expenditure of 18 billion dollars.

This approach, while intriguing at first sight, seems to be highly unrealistic. It is assumed here that the negative multiplier effects resulting from reduced spending by taxation cancels out against the positive multiplier effects of additional government expenditure, a thing which may not hold true in practice. Contrary to assumptions also, the marginal propensity to consume may change; and different types of expenditures may have different multiplier effects, both necessitating continuous modifications in the volume of revenues and expenditures which is hardly feasible in practice. Again, although it is true that, apart from consumption effects, private investment and the level of total demand may be raised by direct additions to public demand, provided for in the expenditure increase, beyond a certain point of budget expansion, private investment may react unfavorably and fall rather than rise, thus reducing the total leverage effect. Musgrave is led to the logical conclusion that "given a substantial deficiency, the balanced expenditures and tax yield increase, if feasible at all, may well require a budget so large as to be of little practical interest".(1)

3. Compensatory Finance:

The third type of fiscal approach which has been most discussed in recent years, and which has gained ground in face of strong opposition, is compensatory finance. Here the question

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(1) Musgrave, R., Public Finance & Full Employment, op.cit., p. 13.

of a budgetary balance is made subordinate to the more basic decision of establishing the scope of government operations. The implicit aim being to attain and maintain full employment, this approach requires that government should exert expansionary or deflationary pressure as conditions warrant, in order to close any gap left by private enterprise. It is considered to be superior to the first two approaches on account of its more flexibility, stronger efficacy, and better adaptability to deal with changing tendencies in the economy which is rarely in balance.

When discussions of compensatory finance first started during the depression of the thirties, compensatory action was visualized mainly in the form of deficit spending, implying the need for an absolute increase in public expenditures. By now, it is recognized that anti-deflationary measures may also take the form of tax reductions; and that inflation may be met by lowering expenditures and/or by raising tax rates. "Adjusting the size of deficit or surplus is the core of compensatory finance", writes Musgrave. "If there is need for checking inflation, the deficit should be reduced or the surplus should be raised; if there is need for checking deflation, the surplus should be reduced or the deficit be increased....Whether the question is one of moving in the direction of greater surplus or deficit, the required compensatory effect may be accomplished by acting upon the level of public expenditures or the level of tax rates".[1]

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(1) Musgrave, R., "Fiscal Policy in Prosperity and Depression", loc.cit., pp. 383-384.

Proponents of compensatory finance argue that automatic compensatory devices operating through the mechanism of built-in-flexibility(1) will not be sufficient to offset unbalancing tendencies. "Changes in business expectations can come very quickly, and in a free-market economy the cumulative forces can become very powerful within a short period of time. Accordingly, a policy of conscious and controlled compensatory action is absolutely essential".(2) The function of Treasury policy should be to provide a balance wheel, that is, "to serve as a starter at one time and as a brake at another"(3); and fiscal policy should be looked upon as a continuing rather than a temporary expedient. The mechanism of operation suggested depends upon whether deflationary or inflationary tendencies manifest themselves to which discussion we now turn.

Compensatory policy of an expansionary nature involves increased governmental spending through borrowing mainly from the banking system, and reduction in taxation. The choice is to have public expenditures increased sufficiently, with the

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(1) The mechanism of built-in-flexibility is this: "If national income changes, the tax base and hence the yield derived from a given set of rates varies in the same direction. Moreover, there are certain public expenditure items, unemployment insurance in particular, which vary inversely with income. As a result, automatic and compensatory changes in surplus and deficit occur whenever income changes and thereby fluctuations in income are cushioned". (Musgrave, R., "Fiscal Policy in Prosperity & Depression", loc.cit., pp. 385-86).

(2) Hansen, A., Economic Policy & Full Employment (McGraw-Hill Book Company, Inc., New York, 1947), p. 249.

(3) Whittlesey, Ch., op.cit., p. 514.

rates of taxes remaining unchanged, or to keep the level of public expenditures unchanged, with taxes reduced sufficiently. Government spending, as we have seen in previous discussions, tends to raise national income both directly, through the immediate market it provides for idle resources and men, and indirectly, through the multiplier effects. The latter effect will be larger to the extent that people spend more of their increased incomes on consumption; and it will be checked by the circumstance that people have to pay more taxes as a result of their larger incomes. Moreover, financing borrowing for expenditure from commercial banks results in a net addition to the volume of money, and when it is financed from the central bank, it accentuates the possibilities of expanding purchasing power. The reduction of taxes will be stimulating to the extent that it releases funds which would be spent on consumption, and to the extent that it encourages private investment. The reduction in taxes must be large, it should be noted, since some of the funds on which taxes are remitted will go into savings rather than be spent, and so will not expand the volume of expenditures. The relative effectiveness of the two methods may be examined by comparing the increase in demand, and hence in employment, which results if the same amount of deficit is incurred by raising public expenditures or by lowering taxes. To simplify matters, let us assume that funds are obtained by the government from bank credit having negligible effects on private expenditures.

If government undertakes additional expenditures on construction,

for example, there is an initial increase in demand for construction; and if taxes are lowered, the income available to taxpayers will be raised and some initial increase in consumption expenditure will result. In either case, the initial increase in expenditure will be followed by subsequent respendings whose magnitude depends upon the rate of saving of income recipients. But the assumption can be safely made that the total increase in demand will tend to be a multiple of the initial increase; and that the initial increase in demand will be greater if public expenditures are raised than if tax yields are cut by an equal amount since in the first instance the full amount of the public expenditure constitutes a direct addition to the demand for goods and services whereas in the second private expenditure may rise by only a fraction of the tax reduction. The matter becomes less evident, however, if public expenditures do not initially provide a direct addition to demand, as in the case of relief or pension payments, where it merely adds to the purchasing power of private income recipients. Here the final outcome will depend upon how private income made available by both methods is reflected in increased private spending, or, to put it in others words, upon who receives the public payments and who finds his taxes reduced. If additional expenditures go to people in the lower brackets, the initial increase in demand will be greater than if public outlays were to redeem a public debt. Similarly, a reduction in consumption taxes will be more effective than a reduction in an estate tax.

Our analysis must recognize further the resulting changes in private investment. Increased public expenditures on a developmental program, for example, may have investment-inducing effects since they expand and develop rather than interfere with private markets; and a reduction in tax rates may provide for a higher volume of investment, particularly if the initial rates were high and taxable income unsatisfactorily defined. The qualification should be repeated, however, that tax reductions can hardly favor an increase in both private consumption and private investment appreciably at the same time. The following concluding statement of Musgrave seems pertinent. He says: "On balance we may expect that a given increase in public expenditures will usually cause a greater increase in demand than will a similar reduction in tax yield. Hence, the dollar reduction of tax yield required to raise total expenditures in the economy by a given amount will tend to be greater than the required dollar increase in public expenditures; similarly, the resulting deficit will tend to be greater under the first approach. If the budget is to provide for a given increase in total (public and private) expenditures, there is a choice between a somewhat smaller addition to the public debt together with a higher level of public expenditures and a somewhat larger addition to the public debt with a lower level of public expenditures".[1]

The deflationary measures of compensatory finance are, of course, the opposite of those having expansive effects. They

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(1) Musgrave, R., Public Finance & Full Employment, op.cit., p. 12.

involve: reduced government spending; reduction of purchasing power through public borrowing mainly from individuals; the retirement of central bank-held governmental debt; and increased taxation. Detailed analysis of each step is not intended as this would involve mere duplication, in a reversed sense, of the immediately preceding arguments. A word of warning should be emphasized, however, which applies to both expansionary and deflationary measures of compensatory finance. It is the fear of dwelling mainly on quantitative analysis. The amount, the nature, the timing, and the repercussions of the measures undertaken should be accounted for in determining the final outcome; since the problem is qualitative as well as quantitative, and no categorical answer can be given until more is known about the causes of business fluctuations. Other policies carried on by the government, besides the manipulations of taxes and expenditures, may be more important than the mathematical balance struck on the books. Remarking on war experience in the United States Musgrave says that "during the war the solution was found in a moderate level of taxation, combined with direct price and rationing controls. The fiscal mechanism had to give way to other approaches"[(1)].

4. Theory of Functional Finance:

The fourth and last type of fiscal approach suggested, which represents both the latest and the most extreme departure from the traditional government finance, is 'functional finance'.

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(1) Musgrave, R., "Fiscal Policy in Prosperity and Depression", loc.cit., p. 393.

The theory has been advanced by A.P.Lerner, to describe the so-called principle of judging fiscal measures by the way they work or function in the economy; and it embraces the following two rules: (a) that it is the responsibility of the government to keep the total rate of spending in the country on goods and services neither more nor less than that rate which, at the current prices, would buy all the goods that it is possible to produce; and (b) that the government should borrow only if it is desirable that the public should have less money and more government bonds. The case is most clearly stated by Lerner himself in the following words:

"The essential idea of functional finance is very simple. It is that the financial activities of the government should be judged not by any traditional canons of fiscal propriety but by considering the effects of each act and deciding whether these effects are desired or not. The effects that the government should consider are primarily the effects on the public, in whose interest the government is supposed to be acting. The effects on the government are always relatively unimportant.

"The effects can be considered in their most simple and literal sense. For example, two effects of any tax payment are that the taxpayer has less money and that the government has more money. The first of these effects is important, so that the tax should be imposed if there is a good reason for wanting the taxpayer to have less money. The effect on the government, namely that the government will have more money, is not important

because the government can always get more money quite easily without impoverishing any taxpayer. If the government needs more money for any purpose it can simply create some money, either directly by printing it or indirectly by borrowing newly created money from banks.

"From this it follows that taxes should never be imposed simply because the government needs money. Economic transactions, like the purchase or sale of goods, should be taxed only when it is thought desirable to discourage these transactions. Individuals should be taxed only to the extent that it is desired to make the taxpayer poorer. The government should borrow from the public if it wants to replace cash in the hands of the public by government I.O.U.s......For these are the effects of the government action and it is the distinguishing mark of reasonable behaviour that action is governed only by a consideration of its effects. Functional finance is nothing but the systematic application of this principle of rationality to government financial activities".[1]

The mechanism of operation of functional finance is visualised along the following lines. If a serious depression occurs and government's aim is to raise the level of business activity, then government should spend more money. Obtaining the additional funds from taxation or through borrowing will offset the favorable effects of spending to some extent. Under

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(1) Lerner, A.P., Planning & Paying for Full Employment, op.cit., pp. 163-164.

the circumstances, the theory of functional finance would say that government should go directly to its aim of raising the level of economic activity and print the money or borrow it from the central bank, rather than be concerned with any detrimental effects of other methods. That the budget would be hopelessly out of balance is of no concern to the proponents of this theory. Under inflationary conditions, on the other hand, taxes would have to be imposed to whatever degree is necessary to remove the inflationary pressure. Any surplus accumulated would not be used to repay debts for the simple reason that there would be no debts in the real sense. Any borrowing, lending, or debt repayment activity by the government would have for its sole purpose influencing the interest rate. Government should lend freely and at low interest rates when it wishes to stimulate investment, and should go to the open market and borrow at high rates thereby curtailing investment activity. In short, all governmental financial activity is reduced, according to this theory, to six elements which form three pairs of instruments which could be piloted in opposite directions as conditions warrant. These pairs of financial instruments are: government buying and selling; subsidizing and taxing; and lending and borrowing.

The problems involved in the application of this theory-- should it ever be applied-- are both serious and far-reaching inspite of its clear and bold logic. They stem from the assumptions it considers reasonable and the factors it considers

significant. The following few comments are considered sufficient: (a) The author evidently believes that quantitative changes in the supply of money will suffice to determine total purchasing power. He is indifferent to the counter-balancing factor of turnover or velocity of circulation in the rate of private spending which the government cannot control. (b) The theory fails to recognize the implications of changes in the price level, and the variable magnitude in the volume of goods that it would be possible to produce under such an open policy of full employment by the government, with the threat of inflation always imminent. (c) It fails to consider the preventive character of taxes under normal conditions as against the one-sided curative effects of them which are over-emphasized. "It would be false to imagine that in normal conditions taxes are superfluous"[1], Halasi has rightfully remarked. (d) The theory, if carried to its extremes, may imply that government should adopt confiscatory measures and maintain the whole of business activity itself. (e) Finally, it fails to recognize the dangers of the abuse of public credit and the government printing press; and that the whole scheme is not as safe as it appears to be easy.

Fiscal Policy Between Extreme Adherents And Opponents:

The use of the word 'extreme' in the above headline is not without purpose. It is meant to differentiate between one set of economists who believe in the usefulness of fiscal policy but

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(1) Halasi, A., Planning and Paying for Full Employment, op.cit., p. 12.

recognize, at the same time, its limitations; and another set-- composed of two groups standing at opposite poles-- one group denouncing fiscal policy as both dangerous and utterly futile, while the other holds that society has at last found in it the panacea of all its economic ills. To cite specific names, one may undergo the risk of doing injustice to some economists; since economic thought in the field of fiscal policy is still in a fluid stage and is undergoing a process of transformation and refinement. At best, under the circumstances, one could only cite opposite arguments and verify to what extent they are justified.

The main source of controversy centers around the proper role of government in the economic affairs of the nation. One group, guided by the principles of maximum employment and social security, believes that government should broaden the scope of its operations, while the other literally upholds minimum interference with private enterprise. Members of the former group argue that private enterprise can produce, but it cannot insure continuous and sustained demand. Only the government can do this and attain the goal of full employment. When business produces the goods, government can and should create the balance of purchasing power needed to buy them. In a policy of letting business run its natural course without governmental interference, they argue, there is always the danger that a recession may develop into a depression, and a depression into economic paralysis, waste, and unemployment, with risky social,

political, and economic consequences.

The views of the opposition are fairly reflected in the following quotations:

"But I protest against any deliberate misdirection of human efforts, or human relations, for the purpose of filling a gap in the money circle. I am convinced....that the perversity of any such policy would quickly become generally apparent and would be but little less resented than the evil of unemployment for which it would serve as a remedy". (1)

"The point that is relevant for us is that if we are determined not to allow unemployment at any price, and are not willing to use coercion, we shall be driven to all sorts of desperate expedients, none of which can bring any lasting relief and all of which will seriously interfere with the most productive use of our resources. It should be specially noted that monetary policy cannot provide a real cure for this difficulty except by a general and considerable inflation, sufficient to raise all other wages and prices relatively to those which cannot be lowered, and that even this would bring about the desired result only by effecting in a concealed and under-hand fashion that reduction of wages which could not be brought about directly. Yet to raise all other wages and incomes to an extent sufficient to adjust the position of the group in question would involve an inflationary expansion on such a scale that the disturbances, hardships, and injustices caused would be much greater than those to be cured". (2)

"Henry C. Simmons....maintains that public investment proceeding with unlimited funds will raise interest costs to the private sector of the economy, compete for funds and resources with private enterprise, increase the cost of capital assets through government competition, and add its interest burden to tax charges. Professor Simmons further contends that Hansen's proposals create an environment in which private enterprise and government-socialized enterprise confront each other in uninterrupted bitter battle, with the government tending toward absolutism". (3)

"The changed position of government that this new fiscal theory calls for means nothing less than a.....conception of the state as a master. Instead of men being relatively free to take risks, to make mistakes, and to live,.....the people are to be marshalled, regimented, told when to spend, or to lend to the

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(1) Polayni, M., <u>Full Employment & Free Trade</u>, op.cit., p. 29.
(2) Hayek, F., <u>The Road to Serfdom</u> (George Routledge & Sons Ltd., London, 1944), p. 154.
(3) Fine, Sh., <u>Public Spending & Postwar Economic Policy</u>, op.cit., p. 80.

government, or to pay taxes, according to some master plan..... The key to this fantastic doctrine is the public debt....In a free enterprise economy, the market is the regulator that determines, through the price mechanism, the character and quantity of goods to be produced. The new fiscal theory would replace the market by the public debt as the regulator of economic activity".(1)

The rational attitude towards this aspect of the controversy is, to my mind, best stated by Paul Strayer in the following words: "Much of the recent writing on the subject has been negative and has emphasized the dangers of increasing governmental controls without offering any satisfactory solution to the problems that have made the increase inevitable. On the other hand, most advocates of positive government intervention have not established a satisfactory basis for the long-run adjustment of relationships between the private and the public sectors of the economy......much more investigation and groping for solutions will have to be undertaken if guidance and leadership is to be given by moderate economists who would like to see the social and economic issues of the day met without resort to a planned economy. In particular, more attention must be directed to the problem of administration and the political implications of positive government economic programs. The inevitable interrelation and interaction of administrative and political forces with purely economic forces must be given greater emphasis if policy formulation is to be realistic and effective".(2)

The other aspects of the controversy have evolved as a result of weaknesses, both apparent and real, revealed during

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(1) From Harley Lutz, Guide-Posts to a Free Society, quoted by Groves, H., Viewpoints On Public Finance (Henry Holt & Co., New York, 1947), p. 700.

(2) Strayer, P., "Public Expenditure Policy", loc.cit., p. 383.

the process of theoretical reasoning and experimenting with fiscal policy. One of the major attacks made on modern fiscal theory is that in rationalizing about inflationary and deflationary effects of government taxing, borrowing, and spending, it places great reliance on the over-simplified quantitative element in the supply of purchasing power, and neglects the important factor of turnover or velocity of circulation, besides the fact that it makes little provision for the cost-price structure adjustments. The opponents of government expansion also turn on the fear of extravagance and the killing of individual initiative resulting from old-age and unemployment insurance plans. A more important criticism, but which does not apply to all adherents of fiscal policy, relates to the preoccupation with compensatory measures to the exclusion of everything else. Some economists appear to have lost interest in other remedies, or in efforts to correct the specific maladjustments which lie at the root of the trouble and, instead, prefer to override these maladjustments by pouring in or absorbing governmental expenditure. The conservative view on this point is made by Hansen in the following words: "Fiscal policy....does not mean that wage, price, and other policies can be neglected if we expect to achieve a well functioning economy. It does mean, however, that there is a growing agreement that far more emphasis must be placed on fiscal policy than has been the case in the past".[1] The view that the effectiveness of fiscal policy

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(1) Hansen, A., "Three Methods of Expansion Through Fiscal Policy", _Amer. Econ. Rev._, Vol.35, No.3, June,1945, p. 382.

has not been proven from experience, and that it involves some inconsistency has also been advocated by Charles Hardy. He says: "If the slowness of recovery in 1933-39 discredits monetary policy as an instrument of control, the rapidity of recovery in the same years can hardly validate fiscal policy for the same purpose".(1) Later, he remarks: "We depend on the profit motive to call forth a supply of investment, risk-taking, and employment opportunities, but direct our national policy to minimizing the share of profits in the national income. We depend on the minority of large incomes to provide the initiative and bear the risks incident to economic progress, but we strive to eliminate those inequalities".(2) Finally, there is Musgrave's remark that "while it is quite likely that expansionary fiscal policy, if sufficiently vigorous and sustained, can prevent a period of severe and prolonged unemployment, there is less reason to be optimistic about the efficacy of compensatory action to check inflation.....Limitations more specifically applicable to the fiscal approach arise from the dynamics of the inflation process which makes supplementary action along other lines (including credit and wage-profit controls) more urgent than in the deflation case".(3)

Fiscal Policy In Proper Perspective:

The time is now ripe to ask ourselves the question: Where shall we stand? or, to put the question in another form, what is

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(1) Hardy, Ch., "Fiscal Policy & National Income", Amer. Econ. Rev., Vol.32, No.1, March, 1942, p. 104.
(2) Ibid., p. 110.
(3) Musgrave, R., "Fiscal Policy in Prosperity & Depression", loc.cit., pp. 387-388.

the proper place of fiscal policy in the modern structure of the economy?

The principles of fiscal policy are by now well established after fifteen years of debate. The argument, in its bearest outlines, is summerized by Musgrave in the following words: "(1) That high employment and price level stability require aggregate expenditures just sufficient to take the high employment output, valued in current prices, off the market; (2) that this condition is not met automatically in our economy where private demand is subject to violent swings and where severe deflation or inflation may prevail for sustained periods; and (3) that compensatory budget policy offers one device, among others, for holding total expenditures fairly close to the proper level. By providing incentive for private outlays or adding more to the income stream on the expenditure side of the budget than is being withdrawn on the revenue side, deflation may be counter-acted; by deterring private outlays or withdrawing more than is being added, inflation may be curbed. While born and reared in an environment of deflation and unemployment, the principles of fiscal policy apply no less to the boom and war economy. These propositions may be qualified or stated in different terms, but most would accept their essential logic".[1]

From the above statement of the case, and in the light of preceding discussions, it is now possible to draw the following important inferences and to spot some weaknesses in the modern fiscal structure:

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(1) Musgrave, R., "Fiscal Policy in Prosperity & Depression", loc. cit., p. 383.

1. That while economic analysis of the flow of income,-- the dominant role played by consumption, saving, and investment in fluctuations of income, output, and employment-- is almost generally accepted, the practical methods of controlling such fluctuations form the main source of dispute among economists.

2. That a fiscal policy designed to accomplish a high and steady level of income must be supplemented by many other measures. Fiscal policy is no more looked upon as a panacea; and the danger of exaggerating its effectiveness has already been recognized. "Those who look at fiscal policy as a panacea err as much as those who some decades ago thought that one could steer the development of the whole economy by an appropriate central bank policy. Equally wrong, however, are those who fail to recognize that fiscal policy is a most powerful instrument if properly coordinated with all other measures of government policies influencing economic developments".(1) The other policies should include foreign trade policies, wage policies, price policies, and so forth.

3. That the fiscal doctrine has not yet been verified by enough experience or evidence to justify unlimited confidence in it. In the words of William Withers: "Economic doctors prescribe remedies based on hypotheses rather than on scientific knowledge".(2) It does have sufficient plausibility, however, to justify framing a public policy designed to operate in harmony with other social interests.

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(1) Smith, H., Budgeting: An Instrument of Planning & Management, quoted by Groves, H., Viewpoints on Public Finance, op.cit., p.670
(2) Withers, W., Public Finance (1948), quoted in book review by R.C.Blakey, Amer. Econ. Rev., June, 1949, p. 794.

4. It is now recognized that the formulation of policy or the recommendation of a positive program is much more difficult than has been admitted by most writers on fiscal policy in the past. Originally they tended to look at the arithmetic of the situation "as revealed by models constructed on the basis of national income estimates and have neglected the extent and severity of the repercussions of the actual measures that would be necessary to implement their program of government stabilization of effective demand".(1) Nowadays, a host of other complicating factors of political, social and economic nature are usually accounted for in the calculations.

5. Contrary to widely accepted opinion, there seems to exist no automatic or mechanical parallelism between government compensatory policy and the creation of employment. Similarly, the availability of resources in the economy is no guarantee that employment, and not prices, will rise in the wake of government spending.

6. While the growth of government influence in the economy has given government a considerable authority over the free market system, the implications of government interference with private enterprise cannot be appraised without considering the alternatives which may follow in its absence. It is almost universally admitted that the one thing the private economy cannot tolerate is continued depressions and unemployment. "Without vigorous public policies and a clear recognition of public responsibility", Musgrave

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(1) Strayer, P., "Public Expenditure Policy", loc.cit., p. 386.

remarks, "severe cyclical swings will undoubtedly reoccur in the postwar years.....If permitted to reoccur, the chances are that these would lead to violent reactions and most extensive public controls. The true issue, therefore, is not whether we should choose or reject some government participation in economic life, but whether we should select and implement those policies which qualify best to check instability and unemployment while maintaining a free market economy. Fiscal policy rates high in such a program".(1)

C. NEED FOR COORDINATING FISCAL AND MONETARY POLICIES

I believe that it is axiomatic that no government can confidently embark upon a policy of full employment unless it is certain that monetary policy is so managed as to fit in well with its fiscal policy objectives; and that the banking system in general, and the central bank in particular, form a supporting part of its fiscal program. This is because central bank credit policy is very powerful; and should fiscal and monetary policies work in opposite directions at the same time, the results anticipated by fiscal controls may be counter-balanced by opposite effects of central bank policy. The modern trend favors the closest coordination between fiscal and monetary controls; but postwar experience in the United States has emphasized the difficulties of securing such coordination at a satisfactory level, especially when inflationary tendencies manifest themselves;

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(1) Musgrave, R., Public Finance & Full Employment, op.cit., p. 21.

and once heavy deficit spending had proceeded deep enough and a mounting public debt reached.

It became evident from preceding analysis that a compensatory deficit spending program will not increase total spending in the economy unless it is financed in such manner as not to decrease private spending correspondingly. The best way to achieve the desired end is (leaving out the case of printing money), it was shown, to sell securities to the central bank or to the body of banks and provide the latter with the reserves necessary to support the required expansion of credit. The process implies that banks should carry new securities without liquidating other securities or existing loans. Hence it becomes apparent that an expansion of bank credit will ordinarily be necessary to facilitate government operations; and that the success of deficit financing programs depends upon support from the central bank. In a similar manner, a budget surplus policy contemplated by the government will be much influenced by the concurrent policy of the central bank. When government collects an excess of taxes over expenditures and locks it up, or retires with it securities held by the central bank, government's action would be highly deflationary. When it retires with it, however, securities held by the commercial banks, the money drawn out of private deposits to pay for taxes would reflect itself in additional reserves with banks on the basis of which the latter could expand their credit operations and thus defeat the government's purpose in accumulating a budgetary

surplus. Unless the central bank mops up the additional reserves that are set free from being used for expanding loans to business or for the purchase of bonds formerly owned by business, the same funds that were taken away in taxes would be restored to the income stream.

The management of the public debt is also closely related to central bank policy. Debt management, as we have seen, is an indirect method of expanding and contracting purchasing power in the hands of members of the public. If an expansionary move is contemplated, government securities held by individual investors may be redeemed, and securities of an equal amount sold to the body of banks. Here again the success of the operation depends upon the presence of the additional reserves in the banking system. The selling of securities by banks, at a time when government debt is increasing, would have highly deflationary effects, since non-bank investors would have to absorb the new securities issued and the old securities offered by banks, and both imply the destruction of private deposits. The crucial point would be the availability or absence of sufficient reserves; and "the creation and destruction of excess reserves is the keystone of central banking".(1)

The above analysis is meant to serve as a guidepost only. Gathering from war and post-war experience in the United States, immense difficulties for banking and monetary control have grown out of long-run government spending policies. Large amounts of

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(1) Hardy, Ch., "Fiscal Operations As Instruments of Economic Stabilization", loc.cit., p. 399.

liquid assets in the hands of individuals and corporations, and big holdings of government securities by banks and other financial institutions have emerged. John Williams remarks "whether a large and growing public debt which continues to be financed to a large extent by the banking system does not make impossible a general monetary policy and deprive us of the power to vary the interest rate and the money supply as instruments of control of economic fluctuations".[1] The following statistics compiled by Louis Shere from various sources and related to the United States are both pertinent and impressive:

"In the seven-year period beginning January 1,1941, and ending December 31,1947, liquid assets of non-bank investors rose from $93 billion to $322 billion, an increase of $229 billion. The federal deficit was the principal source of growth in these liquid assets, accounting for $206 billion, and commercial bank loans and investments were next in importance, accounting for $21 billion of the increase....The banks absorbed $51 billion of federal securities during this seven-year period, and the federal reserve banks absorbed another $20 billion. On January 1,1941, currency outside banks was $7 billion, demand deposits $35 billion, and time deposits $28 billion. At the close of the seven-year period ending December 31,1947, currency outside the banks amounted to $26 billion, demand deposits $87 billion, and time deposits $56 billion....If, for example, the commercial banks were to sell half of their federal security holdings and the Federal Reserve System

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(1) Williams, J., Postwar Monetary Plans & Other Essays, op.cit., p.96

were to buy them (to provide an ultimate market), the members banks would acquire enough additional reserves to expand credit (at the ratio of 6:1) by about $210 billion. This is nearly double the present money supply consisting of demand deposits and currency"[1].

The above figures of liquid assets, money, and credit available should serve to magnify the complications to any restrictive fiscal policy, if adopted, since individuals and businesses can draw on accumulated liquid assets and credit to supplement their current incomes. They should also emphasize that the powers of credit authorities to resist further credit expansion had been impaired by the wartime increase of the federal debt. Another complicating factor, which resulted from Treasury domination over the Federal Reserve System, has been the maintenance, by the federal reserve banks, of stability of yields on government securities at low levels despite the upward rise in the general price level. The reasons put behind such a move were to minimise the interest burden on the public debt; and to protect private holders of existing securities from suffering capital losses on their investments, thus guarding against panicky selling and loss of confidence. The most obvious effect of such a policy is, of course, to hold down interest charges on the federal debt, and thereby reduce the amount of taxes collected for the purpose; and to protect holders of securities from capital losses in terms of money, though not in terms of purchasing power. "But much more

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(1) Shere, L., "Taxation and Inflation Control", Amer. Econ. Rev., Vol. 38, No. 5, December, 1948, pp. 848-849.

important", remarks Lester Chandler, "are the effects on monetary policy, the behaviour of the money supply, and the cost and availability of funds for private investment and consumption purposes. With the adoption of this policy, the functioning of the Federal Reserve has been radically altered. This is most apparent in the case of open-market operations. Traditionally, this was the one instrument over which the Federal Reserve had complete and accurate control; the System could buy or sell precisely that amount of securities which it considered appropriate in light of existing and prospective economic conditions. But under its present policy of stabilizing government prices according to a selected pattern it has lost almost completely its initiative and its accuracy of control over its holdings of governments. It must as residual buyer purchase all the governments that others are unwilling to hold at the selected pattern of support prices. It must purchase them not only from commercial banks but also from all other types of holders; and purchase them regardless of the purposes for which the seller will use the money....This new policy has made federal reserve discount rates practically ineffective as they are raised above the level of the lowest yields on government securities held by member banks.....Thus, discount rates below the yields on governments may tend to ease credit, but rates above the yields on governments which banks can sell freely to the Federal Reserve are likely to be largely meaningless......Even the efficacy of increasing member bank reserve

requirements is seriously reduced....An increase of reserve requirements can retard the expansion of bank credit for private purposes only to the extent that banks are reluctant to reduce their holdings of governments in order to acquire other assets".[1]

These observations undoubtedly force one to pause and reflect. The present position is obviously incompatible with the discharge of recognized responsibilities of the Federal Reserve System, at least by the traditional means at its disposal. But it is also evident that a most difficult job has been entrusted to central banking authority. It is to prevent the public debt from becoming an obstruction to the accomplishment of the main objectives of central bank policy and, at the same time, to insure continuous easy money and easy terms to the Treasury whenever it needs. This may necessitate a change in the mechanism of central banking credit control; more direct interference with private commercial banks; and a complete transformation in banking theory and practice. It is beyond the scope of this paper to review the conflict over authority between the Treasury and the Central Bank; but assuming that monetary authority and fiscal authority remain separated, the fact remains true more than ever before that the closest of cooperation and coordination between both authorities and their policies is the corner-stone in the success of any full employment program and the maintenance of equilibrium in the economy.

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(1) Chandler, L., "Federal Reserve Policy and Federal Debt", Amer. Econ. Rev., Vol. 39, No. 2, March, 1949, pp.417-20.

PART TWO - MODERN FISCAL POLICY IN PRACTICE

A. THE PROBLEM STATED:

The maintenance of high-level production and employment is widely recognized today as a desirable objective of government policy. The idea of using fiscal policy to provide full employment was first incorporated in a formal sense in the Charter of the United Nations adopted in 1944. In the text of the Charter, the member states have committed themselves to "promote higher standards of living, full employment, and conditions of economic and social progress and development".(1) Between 1944 and 1946, Sweden, Great Britain, Australia, Canada, France, and the United States, among other countries, have adopted comprehensive economic programs ranging from the use of fiscal policy to maintain full employment, to the adoption of a more generalized program for economic stabilization. In all cases, practically, the enacted legislations were influenced by the experiences of the depression and the war with respect to economic and fiscal policies. More specifically, in the case of Great Britain and the United States, which are selected for detailed discussion in this thesis, the emphasis is placed upon a government declaration of policy of full employment, and upon the establishment of a legislative and administrative procedure for formulating a coordinated program of policy designed to attain full employment. In both countries also, government expenditures and tax policies are treated as one instrument of policy to be used in combination with other

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(1) Article 55.

price, wage, and credit policies to provide full employment in a specific period; and that government expenditures and revenue provide a policy device most adaptable to short-run fluctuations in business conditions and particularly useful as a flexible element in the whole program.

As early as 1942, the popular question then raised and discussed was whether full employment could be insured for all those who were willing and able to work. The war, which had generated the querry, provided ample evidence that it was technically possible. The next question raised was whether the objective could possibly be attained at a cheaper price than was borne during the war. This forced economists and public men to pause and reflect. There was one thing that became clear. The masses of people in all countries have come to rate full employment, and the individual security it brings, higher than almost any other political objective. Furthermore, all evidence tended to point out that what was needed was the assurance of a program under which the government would cooperate with business and undertake to create confidence by holding forth a guarantee that there will be no widespread unemployment. It was also apparent that such a program could be developed only by the state, since no other economic group could assume the responsibility. Only the state is in a position to look at the economic scene as a whole, locate the trouble spots, and take effective action to forestall inflation or deflation.

Finally, it has been recognized that fiscal policy programs

should not be determined before knowing what other objectives members of the community favor besides avoiding depressions and inflations. This has necessitated choosing a combination of fiscal operations which match with various social objectives;[1] and which may or may not be necessary concomitants of a full employment program. Within this framework, a compromise became necessary between considerations of compensatory finance and other objectives. Public expenditures, for example, are nowadays generally planned on the basis of their usefulness relative to alternative private outlays; and tax rates then adjusted so as to provide such deficit or surplus as is needed to maintain high employment and prevent inflation. As to the distribution of the tax burden and of transfer expenditures, the attempt is being made to make them abide by the community's preferences regarding the distribution of income. Under present programs, no make-work projects as such would be needed; and, depending upon the availability of flexible projects planned in advance, cyclical adaptations of public expenditures become possible. The fact that actual policy may not comply strictly with the rules of our model is duly recognized;

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(1) The main objectives customarily advocated as guiding principles to shape an integrated full employment fiscal program are: "A high national dividend through improved efficiency and elimination of waste; less inequality in the distribution of income; the consumers free choice to buy the goods they prefer; social security through freedom from want; social opportunity providing educational facilities and economic advancement; and good-neighbor relations with foreign countries. These objectives should be achieved in a free society without loss of the basic political and economic liberties". (Halasi, A., <u>Planning and Paying for Full Employment</u>, op.cit., p. 2.

but government action, it is asserted, should not be postponed until perfection is attained. Due weight is given, however, to the urgent need for exercising the greatest care and guarding against the application of some ready formula on the basis of its mathematical merits without considering the degree of its acceptability in the social and political complex of the moment.

B. FISCAL POLICY IN THE UNITED STATES:

1. Fiscal Policy In Process of Formation: The New Deal Experiment and War Experience: Government finance, it has been shown, had continued to occupy a relatively minor position in the economy until a recent date. When the depression of the thirties started in the United States, the Hoover administration observed strict adherence to fiscal orthodoxy. A balanced budget was visualised as an ultimate objective; and a great alarm was, therefore, revealed following the deficits realized in 1931 and 1932. This is best illustrated by the following quotation from President Hoover's last budget message delivered on December 5, 1932. "Such a situation cannot be continued without disaster to the federal finances", he said. "I cannot too strongly urge that every effort be made to limit expenditures and avoid additional obligations not only in the interest of the already heavily burdened taxpayer, but in the interest of the very integrity of the finances of the Federal Government".[1] As the depression steepened, however, and an easy monetary policy carried to extremes failed to cope with the situation, recognition of government as a major factor in the economy started to emerge. The

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(1) Quoted from Fine, Sh., Public Spending & Postwar Economic Policy, op.cit., p. 87.

Roosevelt administration, assuming office without any generally accepted means for combating the depression, had to resort to various 'unorthodox' measures; and an expansionist public spending program emerged, though reluctantly, as a chief instrument of recovery policy. In the words of Newcomer: "Roosevelt was caught....in a net of economic forces that were too strong for him....Roosevelt did try....but deficits grew, and the Administration was easily pursuaded to make a virtue of necessity, and adopt the theory that deficits were not merely inevitable, but desirable, in times of depression".(1)

But the early New Deal spendings, which were accompanied by an annual promise that the budget would be balanced the following year, indicate that there had not yet developed a consistent theory or program that would permanently give to government a major role in the economic life of the nation. The fact remained, however, that deficits continued to exist and to grow;(2) and a rationalization on the following grounds was offered to members of the public. The decline in business, it was argued, was a result of declining purchasing power which could be elevated by government action in the form of relief and expenditures on public works. Strong emphasis was laid on the multiplied and cumulative effects of public spending; and the line of reasoning followed was that if lowering the interest rate did not, by itself, sufficiently induce investment, then the object could be achieved

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(1) Newcomer, M., Taxation & Fiscal Policy, op.cit., p. 73.
(2) In 1931 the deficit was $462 million. Thereafter it exceeded a billion dollars annually, rose to $5 billion in 1941, and to $56 billion in 1943. (Somers, H., Public Finance & National Income, op.cit., p. 492.)

through the creation of new consumer's income by means of deficits. From this analysis of income-creating expenditures grew the pump-priming theory, with emphasis laid on the power of deficit spendings to stimulate provate investment and recovery to proceed of its own momentum. Later on, when Keynes published his General theory in 1936, emphasis shifted from pump-priming to the need for compensating, by means of public expenditures, chronic tendencies in the economy toward oversaving and under-investment.

According to contemporary economic literature, the publication of Keynes' General Theory is assumed to have marked the beginning of a consistent theory for short-term government intervention at least. On this point, Strayer's remarks appear both pertinent and emphatic. He says: "It was no accident that the rise of the inner circle of 'New Dealers' who advocated the conscious use of fiscal policy, without regard to established tradition, dates from the publication of this book in 1936. The development of the concept and measurement of the national income also aided in the formulation of a short-run theory and has given statistical support to the belief that variation of the government net cash surplus or deficit could offset fluctuations in effective demand in the private economy. The appeal of the fiscal approach was that it did not depend upon an understanding of all the basic reasons for fluctuations in the private economy but could be turned on or off as necessary".(1) But is was not until 1938 that first evidence was revealed that the United States

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(1) Strayer, P., "Public Expenditure Policy", loc.cit., p. 384.

government had adopted the view to regard deficits as a major means to recovery. This came following a set-back in business activity during 1937/38, when a new spending program was hastily improvised in the Spring of 1938 and passed by Congress.(1) Then followed appropriations for the defense program; and with the outbreak of war in 1939, emphasis on public spending as a recovery measure was overshadowed; and war became the dominant factor in the business picture.

Reviewing national economic policy in the United States between 1933 and 1940, a period dominated by the exigencies of the depression, several economists have put forward their views and judgement in a variety of ways; but all seem to agree that the results of fiscal operations during that era were short of expectations. There is Sherwood Fine, for example, who said: "It is not strange that the successive economic measures of this period, born of dire necessity and nurtured by political and economic expediency, were characterized by inconsistency and improvisation....Denied the security and guidance of precedent, the administration was torn between the need for innovation, organized resistance to change, and its own uncertainties over the policies adopted. The outcome, as must be the case under such circumstances, was something less than a consistent, articulate, and aggressive economic program".(2) Later on he remarked: "The experience of the Roosevelt administration with fiscal policy cannot be judged to have been very successful. While

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(1) Williams, J., Postwar Monetary Plans...etc., op.cit., p. 65.
(2) Fine, Sh., Public Spending & Postwar Economic Policy, op.cit., p.86

relief and recovery outlays did absorb some idle resources and contributed, through secondary effects, to a higher level of economic activity, the hoped for results failed to materialize. Throughout the decade we were plagued with enormous unutilized productive facilities. The average unemployment figure for the years 1933-40 was in the neighborhood of ten million.....The spending activities of the administration were conservatively conceived....the Roosevelt administration sought to minimize budgetary deficits....The recovery and relief objectives have never been clarified. Evidences of shifting goals and uncertain policies were manifest throughout the years 1933-40 by the succession of rapidly changing programs. Reversals of position have revealed the uncertainty surrounding the measures adopted. The conflicting philosophies of different governmental departments have repeatedly clashed....The volume of outlays has not been determined by the objective of full employment, but rather by the dictates of social and political necessity".[1] Newcomer, in his book 'Taxation and Fiscal Policy', also remarked that "government expenditures may have been useful in themselves- even necessary; but they did not bring continued business recovery. Why they failed is a matter for conjecture, but various possibilities may be noted. There are some indications that savings have exceeded investments. Business has hesitated to expand, partly because of future uncertainties, partly because of present high costs. The unsettled state of world affairs, with the consequent reper-

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(1) Fine, Sh., Public Spending & Postwar Economic Policy, op.cit., pp. 124-125.

cussions on international trade and finance, has not promoted the necessary confidence"[1]. Finally, there is Sweezy's remark that "if fiscal policy is to be used in the future to maintain full employment and not merely to check a decline when unemployment has already become severe, it will be necessary to find permanent non-relief channels for the government's contribution to income"[2].

Despite all the above criticisms, however, the fact remains that the experience of the great depression not only induced the development of fiscal theory, but it also served as a testing ground for the effectiveness of fiscal policy itself. It seems to me that there is much reason to believe that the failure of business enterprise to revive appreciably has not been due to an inherent defect in fiscal policy, but rather to the adoption of an ill-advised policy which was short of the magnitude required for recovery, poorly timed, and lacking coordination. It remains also true that irrespective of the results achieved, the rapid rise of public expenditures, necessitated by large-scale unemployment, has forcibly raised the issue of the extent to which public outlays constituted a dynamic element in the economic field.

Finally, the war experience afforded another test of the effectiveness and limits of fiscal policy. Commenting on United States war experience, Colm remarks: "Fiscal policy was included

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(1) Newcomer, M., Taxation & Fiscal Policy, op.cit., p. 75.
(2) Sweezy, A., "Fiscal and Monetary Policy", Amer. Econ. Rev., Vol. 36, No. 2, May, 1946, p. 298.

in President Roosevelt's program to combat inflation and insure economic stabilization. If fiscal policy alone had been chosen to do the job, we should have needed much more drastic tax or saving measures than were politically acceptable. Fiscal policy had to be supplemented by a great many other measures, such as price and wage and credit policies....The task of maintaining high-level production and employment is too big to be accomplished by any single device. Fiscal policy can be effective only when reinforced by many other policies....It should be used as a prompt but temporary device, to be applied to those situations in which other measures fail to bring about the desired result. It is therefore not enough to identify deflationary trends and use compensatory fiscal measures. In addition, the underlying causes of such deflationary trends must be analyzed and all policies available in the 'tool chest' of government must be brought to bear on them".(1)

2. The Employment Act of 1946: By 1944, the move was undertaken in the United States to impose upon the government the responsibility for sustaining demand and assuring continuous full employment. The Murray Full Employment Bill was introduced in 1945; but its proposals evoked widespread comment and, as a result, the proposed legislation underwent a number of important changes before it took final form in the Employment Act of 1946.

Under the Employment Act of 1946, the Congress has declared (Sec. 2) that "it is the continuing policy and responsibility of

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(1) Colm, G., "Maintaining High-Level Production and Employment: Technical Requirements", loc.cit., pp. 1130-1131.

the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and state and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power".

Under Section 3 of the Act, the President is called upon to submit to Congress annually an Economic Report "setting forth (1) the levels of employment, production and purchasing power obtaining in the United States and such levels needed to carry out the policy declared in Section 2; (2) current and foreseeable trends in the levels of employment, production, and purchasing power; (3) a review of the economic program of the Federal Government and a review of economic conditions affecting employment in the United States or any considerable portion thereof during the preceding year and of their effect upon employment, production, and purchasing power; and (4) a program for carrying out the policy declared in Section 2, together with such recommendations for legislation as he may deem necessary or desirable".

The machinery set up for preparing and dealing with the Economic Report of the President consists of two parts: in the

Executive Branch, there is the Council of Economic Advisers to the President, consisting of three economists who, with the aid of the necessary staff, are to assist and advise the President in the preparation of the Economic Report; to gather timely and authoritative information concerning economic developments and economic trends, both current and prospective; to analyze and interpret economic developments; to appraise programs and activities of the government in the light of the policy declared in Section 2; and to formulate and recommend national economic policy to promote employment, production, and purchasing power under free competitive enterprise. (Sec. 4). In the Legislative Branch, there has been set up a Joint Committee on the Economic Report, composed of seven members of each House, whose duty it is to evaluate the President's Economic Report and advise Congress on broad economic policy. (Sec. 5).

An analysis of the above Act reveals that it does not embody a specific program for full employment; nor does it commit the government to the practice of compensatory finance. In the declaration of policy, the use of the term 'full employment' is avoided and, instead, maximum production and the purchasing power that makes for high consumption are stressed. The freedom to work is protected by the expression "willing and seeking to work"; and the danger of make-work projects is guarded against by emphasizing "useful employment opportunities". In place of specific emphasis upon fiscal operations as a means to achieve set up objectives, it is provided that government "coordinate and

utilize all its plans, functions, and resources". In addition, strong recognition is given to the promotion of "free competitive enterprise and the general welfare"; the need for "the assistance and cooperation of industry, agriculture, labor, and state and local governments"; and the importance of "other considerations of national policy".

But while great latitude is allowed with respect to the particular measures taken, it is evident that the responsibility of the Federal Government for promoting a high and stable level of business activity is clearly and explicitly affirmed. The Act, essentially a "planning measure", commits the government to "a periodical and continuous assessment of the employment situation"; and "the procedures provided in the Act would focus the eyes of the nation continuously on goals of economic progress and stability, on rising livings standards, and on growth in real national income as rapidly as productivity and high levels of employment permit".[1] Although it is true that the Council of Economic Advisers has no means of ensuring the prompt action which may be desirable to offset the gathering momentum of a downswing or of a speculative boom, yet its mere existence is a long step forward since it makes possible overseeing government policy as a whole, and considering how it interacts with the particular state of the private economy. Furthermore, such a coordinating and recommending agency, not being a political body, tends to lift employment policy above partial views and above special political and economic interests. Finally, the Congress is obliged by the Act for the

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(1) Hansen, A., Economic Policy & Full Employment, op.cit., pp.108-9.

first time to consider federal revenues and expenditures as a unit, rather than piecemeal.

Ever since 1946, the Presidential messages submitted to Congress under the Employment Act have continued to lay before the country a full picture of what has been happening to the American economy during the preceding year; and to recommend comprehensive national policies geared to the maintenance of prosperity. In the Economic Report of the President for 1947, for example, a long-range program designed to strengthen the structure of the American economy was submitted along the following lines: "Efficient utilization of the labor force; maximum utilization of productive resources; encouragement of free competitive enterprise; promoting welfare, health and security; cooperation in international economic relations; and combating economic fluctuations".(1) Among the devices proposed to deal with economic fluctuations were: "a well-integrated program of employment stabilization; improvements in the process by which workers find jobs and employers find workers; improvements in the tax structure; wise management of the public debt; and a flexible credit policy".(2)

The above program gives the underlying philosophy of the Act of 1946. While main reliance is placed on private enterprise, the need for providing adequate demand to take what is produced off the market, as well as the responsibility for absorbing excess purchasing power, is duly recognized in several of the

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(1) Quoted from Seymour Harris, Economic Planning (Alfred A. Knopf, New York, 1949), p. 101.

(2) Ibid., p. 111.

following Presidential addresses. This requires that any government policy, aiming at high and stable employment, must be provided with full knowledge of the factual context in which government will have to pursue its policy. More specifically, it becomes necessary not only to have adequate statistics to measure total expenditures, but also methods of bringing them together with a view to making comparisons with the immediate past, and with current position in other countries. The argument is based on the assumption that policy devices can be used effectively only when the program they are to serve is formulated on the basis of an accurate diagnosis of business conditions.

Under the circumstances, an annual appraisal of the national economy becomes necessary in order to indicate the programs that would be needed for the coming year, or for several years ahead, for reaching or maintaining high employment. This can be accomplished by preparing two kinds of estimates: (a) estimates of employment opportunities needed for full employment, the production of goods and services that would be forthcoming at full employment, and the volume of investment and consumption outlays needed for the purchase of such goods and services; and (b) estimates of the probable number of employment opportunities foreseen, the productivity of labor in terms of the expected price level, and the probable aggregate expenditures of government, business, and consumers during the succeeding year, before taking into account the effect of any employment-creating efforts by the government. In the event that the prospective national income is

estimated to be below the level necessary for full employment, government policy should be designed to lift the national income to full employment level. If projected income is found to be excessive and an inflationary tendency is indicated, the economic program should be designed to curb the inflationary trend.

It should be pointed out, however, that this neat and logical prescription of a basis for policy formulation may suffer in actual practice from both technical and administrative imperfections. While estimates of the labor force may be possible with relatively high degree of certainty, more serious problems arise when a projection of national income and production, and a quantitative appraisal of proposed policies are to be made. These issues are summerized by Gerhard Colm in the following words: "Projections therefore require (a) the most up-to-date actual data of national income and production and their component parts; (b) an appraisal of imminent trends, especially in government expenditures, business investments, and consumer attitudes; (c) a knowledge of the responses of business and consumers to changes in economic conditions on the basis of the record of the past; and (d) most of all, the exercise of good common sense in combining all the pieces of information and expert advice into a consistent pattern".(1)

The President's Report for January, 1948, gives the first detailed reference to fiscal operations in the government's general economic program. In the field of tax policy, it was suggested

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(1) Colm, G., "Maintaining High-Level Production and Employment: Technical Requirements", loc.cit., p. 1135.

that the first feature of long-range tax policy must be the maintenance of tax revenue which, except in years of depression, will balance the federal budget and provide a substantial surplus for debt retirement. "Every consideration of prudence with respect to future problems of the national economy and of the national credit in critical circumstances", the Report asserted, "requires a firm and sustained policy of reducing the public debt". The second requirement suggested was that "the tax rates and the character of the taxes be such as to help sustain prosperity". Lowering particular business taxes may at one time be needed to stimulate business expenditures when they are inclined to lag, while maintaining or raising them may be the thing needed to check over-expansion at another. Similarly, abatement of taxes on consumption may at one time be needed to support purchasing power, whereas their maintenance or increase may be the most effective means of damping an inflationary tendency at another. In the choice between taxes falling mainly on consumption or on investment, the Report observed that "the lessons of wartime and early postwar experience seem to indicate that for the sustaining of an economy of maximum production and a market commensurate with this rate of production, more concern will need to be directed during the years just ahead toward easing the tax burden on the consumer than toward accelerating the rate of capital formation".

In the field of debt management, it was remarked that "the vast increase in the public debt has not created the difficulties that many people feared, partly because our national debt is owned

by our citizens, and partly because of the technical skill with which the debt has been managed jointly by the Treasury Department and the Federal Reserve System". The most important part of the debt-management policy in the United States had been the program to support the market for government securities; and in 1948 it was reaffirmed that "it is the declared purpose to continue active support of government bonds for the purpose of maintaining an orderly and stable market at a low level of long-term interest rates". It was admitted that this policy does not permit the Federal Reserve Bank to make effective use of the traditional methods to limit inflation by requiring banks to borrow in order to obtain additional reserves and by raising the discount rate; but action taken to effect control over the banking system should not involve, it was emphasized, "withdrawing support from the government bond market".

In the field of economic programs to promote stabilization, the Report noted that "while it is most urgent now (1948) that we combat inflationary dangers, we cannot wait until the tide turns before considering affirmative measures that will be needed in the future. Economic conditions may turn rapidly, but the formulation, enactment, and initiation of economic and fiscal programs require a considerable amount of time. Prudence demands that we look ahead and prepare for tomorrow while we act for today". The expansion of social security programs was suggested in 1948, and later reaffirmed in 1949, on the grounds that it would strengthen mass purchasing power and markets in the long-run, while

contributing immediately to the restraint of inflationary pressures. The 1949 Report remarked that "by increasing the coverage and benefits of unemployment and old-age insurance, by introducing disability and health insurance, and by providing more adequate public assistance, we would then contribute towards that reconciliation of immediate and longer-run needs which is so difficult to achieve through the market mechanism". Besides social security programs, the 1949 Report also advocated minimum wage laws adjusted to current price levels; and future tax revisions to strengthen consumer markets but, at the same time, not neglect the need for stimulating investments, especially in areas which offer both great rewards and heavy risks. The Report of 1948 also recommended that steps be taken immediately to plan federal, state and local public works for future years. The idea is that when the inflationary pressures subside, government should speed up the program of resource development, transportation, and urban rehabilitation, and further expand the social security, health, and education programs.

With regard to the last move, there has been a growing recognition, however, of the practical limits of a public works policy as a compensatory device. Drawing from recent experience, Gerhard Colm remarks: "The limits of an effective fiscal policy through manipulations of expenditures were demonstrated in August, 1946, when President Truman wanted to curtail expenditures as one of the measures for combating inflationary pressure. He cut by two billion dollars a federal budget that exceeded forty billion

dollars. The rest of the budget was regarded as largely inflexible because it is determined by legislation or allocated for government purposes that were believed to be non-deferrable. It proved difficult to enforce even this limited curtailment program in view of resistence against the postponement of certain public works. The experience showed not only that flexibility in the federal budget is limited, but also that our legislative and administrative machinery is not yet fully equipped to use even this limited flexibility".[1] There is also Strayer's remark that "except for effects on employment, public works outlay should be greatest in periods of prosperity and least in periods of depression. This follows from the fact that expansion in real income and activity leads to more extensive use of public facilities and demand for entirely new facilities....It does not make sense to tell voters that they should postpone their demands for better facilities until the uncertain day when there will be a depression".[2]

Finally, the President's Report of January, 1949, has put the claim that the American economy stands now in much better position to withstand shocks than during the twenties; and it has put the following reasons in support of such a claim. Business has become better informed and more prudent, particularly in inventory policies. There has been less speculation noticed. The so-called built-in-flexibility in the system-- the social

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(1) Colm, G., "Fiscal Policy", The New Economics, Seymour Harris, Editor, op.cit., p. 464.
(2) Strayer, P., "Public Expenditure Policy", loc.cit., pp. 390-391.

security system, veteran programs, and the farm price-support program-- would all have a cushioning effect in the event of a downswing. On the expenditure side of the budget, large appropriations make an economy more resistant to shock, and on the revenue side, the progressive income tax increases flexibility. The liquid assets created during the war in the hands of business and individuals can act as an immediate shock absorber even though their real value has been reduced by inflation. The Federal Deposit Insurance system would operate against large-scale withdrawals of deposits such as occurred during the thirties; and the Reconstruction Finance Corporation can exert some mitigating influence.

Notwithstanding the above potentialities, however, which are expected to temper only with the effects of fluctuations until more fundamental reforms are instituted for correcting the basic maladjustments, it is argued that the upward adjustment of consumer incomes relatively to prices will be essential in the future to establish sustainable patterns of balanced economic growth. But because these adjustments cannot alone insure an increase in consumption and the maintenance of a high level of activity (since decreases in prices or increases in costs may lead to a recession if they occur at a time when markets are weak and aggregate demand is shrinking), it is considered essential that, during threatening times, adequate support should be given to demand while fundamental adjustments are going on in order to remove the expectation of instability. The Report

concludes by saying that "with adjustments in the price-wage-profit relationship, we shall not be able to place the economy on a basis of continuing stability. Without the simultaneous adoption of policies designed to promote economic growth, we may not safely rely on the adjustments. It is necessary to combine measures that promote growth with those that support stability in an integrated program".

In light of the preceding discussion, it is possible to draw the following inferences and conclusions related to employment policy as applied at present in the United States. The United States has not advanced, up to 1948, far in the direction of a planned economy. Private enterprise remained primarily responsible for operating the economy; with government announcing some public responsibility for purchasing power and employment, and setting up and examining the nation's budget which underlines total demand in relation to supply. From 1948 onwards, however, government programs did reflect a marked advance in the field of planning and government responsibility by providing for influencing the allocation and distribution of resources and of demand by public action, and by suggesting the broad lines of economic development. Nevertheless, it is significant to note that the growth in government influence has not been the result of a program of increased government ownership of the productive resources of the nation, but rather the result of tremendous increases in the extent of transfer expenditures, in war and defense outlays (still in the hands of private producers), and in the level of commitments

to foreign governments. Within the present framework of economic policy, it is hardly possible to judge the effectiveness of fiscal operations undertaken by the state since they are not applied in isolation. All that can be said, to quote Hansen, is that the United States is "moving more and more into a dual economy in which the state plays an important role in the process of income creation-- through its capacity as provider of community services; through public investment in public facilities and the improvement and development of natural resources; through those many monetary and fiscal activities (lending operations, management of the public debt, fiscal operations including taxation and borrowing, control of the rate of interest and of the money supply) that influence indirectly the rate of private expenditures in a market economy; and last but not least, through the maintenance of a well-functioning price system involving wage and price adjustments consistent with the requirements of increasing productivity and technological change"(1).

C. EMPLOYMENT POLICY IN GREAT BRITAIN:

1. Britain's Economic Program: The national economic program, as applied at present in Great Britain, has, in broadest outline, a three fold objective: (a) A stabilization of the domestic economy through selective nationalization of key industries, combined with extensive direction of the flow of private investment and economic development; (b) a rebuilding of the country's export position; and (c) provision for a greatly expanded system of social

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(1) Hansen, A., Economic Policy & Full Employment, op.cit., pp.133-34.

and health benefits in line with the main proposals of the Beveridge Plan.

In the field of British economic planning, three official documents are worthy of note. They are: The White Paper on Employment Policy, which inaugurated officially the endorsement of full employment as a proper end for government policy, and which was adopted by the Coalition Government in May, 1944; the Economic Survey of 1947, which summerized government's findings and achievements during the reconversion period; and the Four-Year Plan (1949-1953) of the Labor Government which was submitted to Parliament in December, 1948. The three documents reveal the transition in attitude toward public policy from one relying primarily on private enterprise, supervised and compensated by public action to (a) a planned use of national resources through controls (such as rationing, allocation of raw materials, control of building and imports through licenses, and control of capital issues) designed to allocate, through government action, scarce and essential resources in the best interests of the nation as a whole (a route necessitated by the assumption of power by the Labor Party and by the difficulties faced during the reconversion period); (b) a more flexible and liberal program compromising national necessities with a high degree of individual liberty. It falls beyond the scope of this thesis to undertake a detailed analysis of all the component parts of the British economic program. Hence, except for a resume, in skeleton form, of the distinguishable features of it, attention will primarily be devoted to

the White Paper of 1944 which, though considerably outmoded up till now, still remains the model plan literally applied (with minor amendments) in several Commonwealth countries; and which embodies the framework of financial planning in Great Britain itself after the present period of transition is over. Reference will also be made to Lord Beveridge's views on employment which have fashioned the application of the White Paper's recommendations.

In the Economic Survey for 1947, and the Four Year Plan, the British government has set its views on economic planning as follows: "The object of economic planning is to use the national resources in the best interest of the nation as a whole. How this is done must depend upon the economic circumstances of the country, its stage of political development, its social structure and its methods of government. The proper system of economic planning for the United Kingdom must start from this fact, and cannot follow some theoretical blue print".(1) Later, in the second document, we read: "Any programme of economic planning must be in the nature of a broad strategical plan sufficiently flexible to meet unpredictable and rapidly changing events"(2); and "Economic planning in the United Kingdom is based upon three fundamental facts: the economic fact that the United Kingdom economy must be heavily dependent upon international trade; the political fact that it is and intends to remain a democratic nation with a high degree of individual liberty; and the adminis-

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(1) Economic Survey for 1947, Economic Planning, Ed., Sey. Harris, op.cit., p. 187.

(2) Quoted from Harris, Economic Planning, op.cit., p. 212.

trative fact that no economic planning body can be aware (or indeed ever could be aware) of more than the very general trends of future economic developments".(1)

Within these limitations, and with a view to achieving the above objectives, the British government has developed a system of economic planning, of which the following are the chief elements: (a) an organisation with enough knowledge and reliable information to assess national resources and to formulate the national needs; (b) a set of economic budgets (the Capital budget, the Financial budget, and the Foreign Balance budget) which relate these to the country's resources, and which enable the government to say what is the best use for the resources in the national interest; and (c) a number of methods, the combined effect of which will enable the government to influence the use of resources in the desired direction without interfering with democratic freedoms. It is evident that the plan is far more comprehensive in scope than a pure full employment fiscal program; although government is presumably prepared under (c) to accept the challenge and wage war on unemployment through a variety of means, among which is fiscal policy.

The initiative and responsibility for the formulation of national economic planning in Great Britain rests in the executive branch of government. Within the Cabinet and the departments, a highly integrated planning machinery has been developed; with growing awareness of the importance of national economic budgets, and the need for close coordination between central planning and

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(1) Harris, S., Economic Planning, op.cit., p. 214.

government budgeting. The role of the Chancellor of the Exchequer has been considerably expanded; and he now guides and directs fiscal operations of the state in the light of findings of the national economic budget.

The basic planning agency in Great Britain is the Economic Planning Board. It is headed by a Chief Planning Officer. The members include: three department heads (the Board of Trade, the Ministry of Labor, and the Ministry of Supply), three members of the planning staff, the Director of the Economic Section of the Cabinet Office, and six interested representatives nominated by industry and labor. The Board has access to all department heads concerned with production; and its principal function is to develop long-term plans for the use of the country's manpower and resources.

The British postwar economy has, so far, been one of scarcities in labor and in resources due to the war which brought about large destruction of capital, serious losses of export markets, of invested capital in foreign countries, and in shipping. Thus far, the government has not been concerned primarily with full employment policy, although it has had a long-range eye on the necessity for a firm national policy to maintain full employment. The nationalisation of key industries pursued is being viewed as an effective means for economic development and for full employment since it widens the area of public investment in which direct control of capital outlays can be exercised. The Labor Government has accepted Lord Beveridge's pleas for controlled

location of industry and the organized mobility of labor as parts of a full employment policy. It has also learned to appreciate the utility of fiscal policy as a counter-cyclical device as is revealed from the following statements on financial policy quoted from the Four-Year Plan: "Government expenditure and revenue ought not to be considered in isolation from their effects upon the general economic prospects of the country...The new task of the Chancellor of the Exchequer is not merely to balance the budget; it is a much wider one-- to match our resources against our needs so that the main features of our economy may be worked out for the benefit of the community as a whole. In order to make the fullest use of the available resources, the fiscal policy of the government must be directed to the maintenance of a high level of employment....We must watch the situation carefully and be ready to detect the moment when the inflationary pressure vanishes and gives place to deflationary tendencies; if such a thing should happen, we must then make a rapid readjustment of our economic and financial policies"(1).

2. The White Paper Employment Policy of 1944: The White Paper of 1944 is considered to have marked the formal entry of Keynesian economics into the realm of practical politics. It began with the following bold statement: "The government accept as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after the war" (Para 1); and later the commitment was reinforced by the promise that "the

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(1) Quoted from Seymour Harris, Economic Planning, op.cit., pp.221-22.

government are prepared to accept in future the responsibility for taking action at the earliest possible stage to prevent a threatened slump" (Art. 41). The document owes much of its origin to Lord Keynes, who has done most to put full employment at the very center of British thinking; and this has led to the pertinent remark that "in view of the influence of British writings on the formulation of the theory of fiscal policy, it is hardly surprising that the most elaborate program for applying such measures is that which has been enacted in Great Britain. The provisions of the British law as outlined in the White Paper of 1944 on Employment Policy constitute a striking example of the way in which economic principles and plans may be carried into practical application".(1)

On the side of diagnosis, the White Paper argues that "a country will not suffer from mass unemployment so long as the total demand for its goods and services is maintained at a high level". It is cognizant of the need for considering external as well as internal demand; hence it affirms that government is seeking to create, through collaboration between the nations, "conditions of international trade which will make it possible for all countries to pursue policies of full employment to their mutual advantage". If the necessary expansion of foreign trade can be assured, the Paper maintains, government believes that widespread unemployment can be prevented by a policy of maintaining total internal expenditure. The Paper envisaged that in the

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(1) Whittlesey, Ch., Principles & Practices of Money & Banking, op.cit., p. 518.

years immediately following the war, the problem would be one of shortages. It therefore suggested that measures be taken for preventing local unemployment by securing a balanced distribution of labor and industry. It proposed to attack this problem in three ways: "(a) by so influencing the location of new enterprises as to diversify the industrial composition of areas which are particularly vulnerable to unemployment. (b) By removing obstacles to the transfer of workers from one area to another, and from one occupation to another. (c) By providing training facilities to fit workers from declining industries for jobs in expanding industries". (Art. 25). When conditions return to normal, there will still remain those long-term problems connected with the maintenance of an adequate and steady volume of employment, for the achievement of which the following three essential conditions must be satisfied: (a) Total expenditure on goods and services must be prevented from falling to a level where general unemployment appears; (b) the level of prices and wages must be kept reasonably stable; and (c) there must be sufficient mobility of workers between occupations and localities. (Art. 39). Finally, while the Paper considered it inevitable that some legislation will be required to confer powers needed for the purpose of executing government policy, it frankly admitted that the success of the policy outlined in the Paper will ultimately depend on the understanding and support of the community as a whole-- and especially on the efforts of employers and workers in industry, on whom stability of wages and of prices mainly depend.

According to the White Paper (Art. 43), the components of monetary outlays are five: private consumption expenditure; public expenditure on current services; private investment expenditure; public investment expenditure; and the foreign balance. The main source of difficulty is diagnosed to lie in the fact that private investment and the foreign balance are susceptible to great variations and are the most difficult to control. (Art. 45). The guiding principles of government policy in maintaining total expenditures are therefore set up (Art. 48) to avoid an unfavorable foreign balance; to do everything possible to limit dangerous swings in expenditure on private investment; to plan public investment, both in timing and in volume, carefully to offset unavoidable fluctuations in private investment; and to be ready to check and reverse the decline in expenditure on consumers' goods which normally follows as a secondary reaction to a falling off in private investment.

For influencing capital expenditures, effective changes in the money supply and in the rate of interest are proposed as one device. (Art. 58-60). A second device proposed is to encourage privately owned enterprises to plan their own capital expenditure in conformity with a general stabilization plan, by appealing to business to invest during periods of depression when costs would be relatively low, rather than in periods of prosperity when they are likely to be high. (Art. 61). In the third place, it is suggested that public investment be planned in such a way as to promote stability in the flow of monetary expenditures. The

procedure prescribed (Art. 63) is that local government units and departments should submit each year their plans for capital expenditures concerning the following five years. After coordinating the plans and studying them in the light of anticipated private outlays, recommendations are to be made to adjust the programs, upward or downward, so as to assure a steady flow of total monetary outlay. As a necessary prerequisite for successful adjustments in public investment, both speed and flexibility in execution are fully noted. (Art. 64).

In the field of regulating consumption expenditures, the importance of acting quickly is also emphasized. Provision is made for varying the weekly contributions to social insurance by employers and employees (Art. 68), whereby contributions would be reduced at the outbreak of a recession to help maintain consumption expenditure by wage-earners and to defer discharge of employees by employers. Variations of rates of taxation; and the incorporation of some system of deferred credits, with similar considerations in mind, are also recommended. (Art. 72).

The use of public debts as a means of maintaining full employment is described in skeleton form only. While an effective reduction of the public debt is endorsed (Art. 76), government should not fail to undergo additional indebtedness necessitated by increased capital expenditures for reasons of employment policy (Art. 75), although no support is given to the idea of permitting an indefinite expansion in the size of the national debt. On this Whittlesey remarks: "In this as in other respects, the British

program for full employment impresses one by its tone of practical conservatism combined with firm reliance upon what a few years ago would have been regarded as an undue exercise of fiscal discretion".(1)

The machinery envisaged by the White Paper toward implementing the promise to maintain demand at full employment level includes the establishment, on a permanent basis, ?a small central staff qualified to measure and analyze economic trends and submit appreciations of them to the Ministers concerned (Art. 81); expanding the work of the Central Statistical Office so that new and up-to-date statistics of great value will be collected. (These include quarterly or monthly statements of present and prospective employment in the main industries and areas in the country, based on returns from employers; regular information relating to savings, projected capital expenditures, and, as far as possible, those by private industry; an annual census of production including particulars of value of output, stocks, and work in progress; monthly figures of production, consumption, stocks, and, if possible, figures of orders on hand; and annual and quarterly estimates of foreign capital movements and the balance of foreign payments). (Art. 83). Finally it is provided that the Chancellor should present to Parliament not one budget, but a set of three interrelated budgets: a Revenue budget, showing how much the government wishes to raise and spend; a Foreign Payments budget; and, most important, a Capital budget of the nation's wealth. (Art. 84).

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(1) Whittlesey, Ch., op.cit., p. 522.

The Capital budget is supposed to be a statement of estimates showing the total value of national income at market price, given full employment, on one side, and expected public and private expenditures, and the foreign balance on current account, on the other. If the expenditure side were to be the larger, this would be a warning of impending inflation; and if the income side were to be the larger, it would be a warning of shortage of demand and depression. Either way, it should be the first duty of the Chancellor to balance this Capital budget by altering the financial plans of the government to fit in well with it. This can take the form of manipulating the monetary supply and the rate of interest, as well as adjusting the levels of taxation, public expenditures, and the public debt as conditions warrant.

Analysis of the White Paper reveals that, on the side of diagnosis, it is an excellent document. It gives a very clear picture of total demand and its composition; and it domonstrates the significance of public spending as a vital factor influencing the level of consumption and investment expenditures. It also admits the harm which has resulted in the past from decreasing public spending during periods of depression. When it comes to the remedies side, however, it becomes evident that the Paper does not follow up, in its prescription, the full implications of the diagnosis. The medicine prescribed, to quote Seymour Harris, is "a mild form of Keynesianism: monetary policy, some reliance on government spending, some adjustments in taxes to variations in demand, and, in part, direct measures to deal with structural

adjustments".[1]

The Government of 1944, concerned over the size of the public debt, has given greater weight to the practical difficulty of exerting direction over private investment and the foreign balance and, as such, has assumed the continuation of business cycles, at least in a flattened form. The White Paper merely called for anti-cyclical action involving various forms of compensatory action; although it affirmed government responsibility "for taking action at the earliest possible stage to arrest a threatened slump". Furthermore, the Paper expressed the pious hope that, through appeal to labor and industry, workers would be reasonable and employers would cooperate in stabilizing capital investment. The chances that such hopes would materialize are very remote, of course, before government actually demonstrates its ability to control cyclical fluctuations. Meanwhile, it remains wishful thinking to suppose that business, which expects a depression, will be pursuaded to embark on large-scale capital investment at the beginning of it.

The conservative tone of the White Paper has evoked sharp criticisms from Lord Beveridge, who regarded the government's declaration of war on unemployment in the document as "a war with reservations". In his Report "Full Employment in a Free Society", Beveridge dismisses the Paper's fears about a mounting public deficit; and rejects the timing of public works to fit into the slack phases only of private investment. He suggests, instead,

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(1) Harris, S., Economic Planning, op.cit., p. 159.

the maintenance of public investment at an even high level; and urges increased public expenditures and government intervention to overcome the "evils of want, disease, ignorance, and squalor". He argues that government would do better to carry its responsibility a step further to prevent the slump instead of remedying it. This difference in attitude toward the business cycle is obviously a reflection of a difference in attitude toward business itself. Those who hope to abolish the business cycle seem to demand a larger measure of public control than those who accept cyclical fluctuations as inevitable, and, as such, ask that they be compensated for by public action.

The drafters of the White Paper of 1944 seem to belong to the group of mild interventionists; and they have worked on the assumption that the control of business fluctuations calls for two things: first, setting up a basic common objective, and, second, a concert of efforts-- both public and private, to achieve it. Viewed in this light, their pioneering document in the field of economic planning remains worthy of careful study and appraise. "This is true", Hansen remarks, "not only because of the policies that it advocates will inevitably become a part of the arsenal that any government must employ in its war upon unemployment, but also because no government can afford to discount or overlook the difficulties and obstacles in the path toward full employment which are disclosed in that document".(1)

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(1) Hansen, A., Economic Policy & Full Employment, op.cit., p. 58.

SUMMARY AND CONCLUSION

"Fiscal policy" is a term that has gained prominence only in recent years. It owes much of its origin and development to the severity of the depression of the thirties, to the personality and ideas of Lord Keynes, and to the ideas of many thinkers and writers in the field of social economics.

Underlying fiscal policy is the basic assumption that all the government's financial activities should be integrated and used to influence the national economy. It is emphasized that the objective of public revenue and expenditure policies should go far beyond their traditional service and redistribution function, to include their use as positive instruments of economic control. More specifically, the aim of the whole business of taxing, spending, and borrowing by the state should, it is maintained, be directed consciously toward controlling the economy, and especially toward combating business depressions and the maintenance of a high level of productivity and employment.

The term "fiscal policy" has been defined as "government expenditures, revenue, borrowing and debt management, considered with a view toward their impact on the flow of purchasing power". In essence, it is an aggregate approach concerned with the maintenance of gross monetary outlays, or total effective demand, at a level appropriate to a satisfactory high volume of business activity, through influencing the stream of money payments by means of the fiscal operations of the state. The fiscal devices may operate directly on the stream of money payments, or they may

attempt to influence it indirectly through their effect on the expenditures of individuals and businesses. They can be used to guard against deflation, as well as to provide a necessary safe-guard against inflation.

The income-expenditure approach in the field of economic theory constitutes the theoretical background behind modern fiscal operations. The analysis of the said approach, based on the investment-saving thesis, represents the latest interpretation in economic thought of how the economic system tends to operate. According to it, the volume of production, employment, and hence, of income depend, in a private enterprise economy, upon the existence of the necessary markets. Unless prospective demand is sufficient to pay for the costs of production and to leave an adequate margin of profit, production will not be forthcoming, and resources will be unemployed. Similarly, unless aggregate demand remains within the limits of available supply, prices will be driven up and inflation will threaten. With the thesis that supply always creates its own demand discarded, since income, once received, may or may not return to the income stream, and no guarantee exists that there will be that exact balance of total spending which is required for full employment, deliberate policies become, therefore, inevitable to keep the rate of spending at that level and to compensate for deviation from it.

The problem of fiscal policy has arisen chiefly out of the likelihood that markets will prove incapable of absorbing the output that could be produced at full employment. To make sure

that demand for goods and services will be as large as is needed for full employment, it is necessary, in part, to make certain public expenditures, planned on the basis of their social usefulness, which would help solve the unemployment problem; in part, it is a matter of tax reform; and finally, it is a matter of setting up a balancing mechanism- a relief and social insurance principle- to assure the volume of demand needed without waiting for basic expenditure and tax policies to strike an ideal position.

It is evident that the main responsibility for maintaining a high and stable level of activity must lie with the government, since government alone possesses the powers to fulfil this responsibility. Through the individual instruments of fiscal policy (public expenditures, taxation, public borrowing, and debt retirement), government can expand or curtail total effective demand for goods and services as conditions necessitate. In doing so, however, the government should weigh carefully the implications of its fiscal decisions upon the economy. The fact that there is considerable degree of latitude possible in all phases of fiscal operations -with respect to the magnitude of each, and to the specific policies followed within each division- signifies that, within the latitude afforded, the choice among different alternatives of action must be governed by the anticipated effects on general business conditions; and by the attainment of other social objectives considered desirable by members of the community. More specifically, the government's program should be outlined with a view to promoting maximum initiative and enterprise in private

business, and to providing for extended programs in fields that would contribute to general welfare and opportunity, such as health, education, and housing.

In order to attain the objective of high level productivity and employment, the current trend is to consider manipulations in public spending, to be financed mainly by borrowing when funds are to be injected into the income stream, more powerful than manipulations in taxation. Changes in the rate of public spending, it is argued, can be accomplished more easily and quickly than changes in taxation, particularly when the economic situation calls for higher taxes. Spending is also a more selective fiscal device than taxation since it may be adjusted to meet the requirements of specific situations. Because of the time lag and deferred effects that are correlated with tax adjustments, public spending is believed to furnish more leverage and to be more effective than taxation as a fiscal control device. The modern view also accepts the existence of budget deficits in times of unemployment, but foresees public debt retirement in periods of over-expansion of private business activity.

In the field of practical application of policy, it has been revealed that two things at least are necessary for insuring that a full employment policy would be workable. First, a government declaration of policy undertaking that a high and stable level of employment would be maintained, and, second, a body of government policy as a whole which must be such that government action would be in harmony with accepted social and economic values. From the

second stipulation two main corollaries also follow: (a) that reliance upon compensatory fiscal action must be a temporary device pending more basic adjustments to be effected in the economy, and (b) that reliance on extra public works and services to provide employment must be kept within reasonable limits. The formulation of a many-sided recovery plan should mitigate the dominance of the general expedient of public spending and assign to it the residual task of providing employment for resources not otherwise occupied. At the same time, it is necessary to distinguish between compensatory measures as such, and basic measures of permanent value to the economy such as taxation that is progressive but not discouraging to risk-taking, expanded public welfare expenditures, and developmental schemes undertaken by the state.

The above conclusions have been the source of much controversy and debate among economists, particularly with regard to the proper role of government in the economy. While there is a growing agreement that far more emphasis should be placed on fiscal policy than has been the case in the past, it is also recognised that only as experience accumulates would it be possible to ascertain more fully its results. Thus far, the following observations seem to have received sufficient recognition:

1.- While economic analysis of the flow of income,- the dominant role played by consumption, saving, and investment in fluctuations of output and employment- is almost generally accepted, the practical methods of controlling such fluctuations form the main

source of dispute among economists.

2.- A fiscal policy designed to accomplish a high and steady level of income and employment must be supplemented by, and coordinated with, many other measures of government policy designed to influence economic development. Fiscal policy is no more looked upon as a panacea; and the danger of exaggerating its effectiveness has already been recognized.

3.- While the fiscal doctrine has not yet been verified by enough experience and evidence to justify unlimited confidence in it, it does have sufficient plausibility to justify framing a public policy designed to operate in harmony with other social objectives.

4.- The formulation of policy, and the recommendation of a positive fiscal program, have proved much more difficult in practice than was thought by most writers on fiscal policy. Difficulties arose in connection with the proper timing of fiscal action, adjustment of fiscal structure, and technical requirements for setting up the proper machinery to administer efficiently the fiscal operations of the state. It is nowadays recognized that a host of other complicating factors of political, social, and economic nature should be accounted for in the calculations.

5.- Finally, the masses of people in all countries practically have come to rate full employment, and the individual security it brings, higher than almost any other political objective.

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