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Government Spending in a Growing Economy

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In the postwar period fiscal policy in the United States has gone through two broad phases: fiscal expansiveness and fiscal restraint. During the long expansion of the 1960s, policy took a deliberately Keynesian approach to macroeconomic management. In the early 1960s President Kennedy's Council of Economic Advisers argued that the economy was being slowed by a large structural budget surplus; the surplus, resulting from excessively high tax revenues, was slowing aggregate demand before the economy reached full employment. A tax cut proposed in 1962 and enacted in 1964 led to a lowering of the budget surplus. President Johnson's War on Poverty and the war in Vietnam boosted government spending and contributed to further lowering of the surplus.

The large and growing budget deficits of the 1970s along with stagflation called into question the Keynesian demand management policies of the previous decade. The abandonment of these policies coincided with the implementation of "supply-side" policies during the Reagan years. Ironically, the combination of large tax cuts, reduced domestic spending, and massive defense spending produced huge budget deficits during the relatively long expansion of the 1980s. Thus, unwittingly, Reagan's policies resembled the Keynesian policies of an earlier generation.

The passage of the Omnibus Budget Reconciliation Act of 1993 and later the Balanced Budget Act of 1997 marked the entry of fiscal policy into the second phase. These acts represent an important policy shift toward greater fiscal restraint, a shift that led in 1998 to the first budget surplus since 1969. In both the United States and overseas the pursuit of balanced budgets or fixed deficit targets has come to be seen as one of the principal ways to increase long-run growth, and restrictive fiscal policies are a common element in policy discussions in Washington and the European Union and in the International Monetary Fund's structural adjustment policies. In contrast to the Keynesian policies of the 1960s and the policies of the 1970s and 1980s, with their Keynesian-like effects, fiscal austerity has become the conventional wisdom of the 1990s.

That conventional wisdom is based on the neoclassical theory of output and employment, which has two variants. The extreme version assumes the economy to be continuously at the level of output corresponding to full employment. An increase in government spending financed by borrowing leads to a rise in interest rates; higher interest rates lower private investment, thereby lowering output growth.

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The moderate version of the neoclassical theory (for example, Blinder and Solow 1973) allows that unemployment may exist in the short run so that fiscal policy, specifically budget deficits, may have a positive impact on output. An increase in government expenditure, or a decrease in the tax rate, stimulates spending, output, and employment. However, once full employment has been achieved, the stimulative effect of the government deficit becomes inflationary.

The CGC Model: An Alternative Theoretical Framework

From a policy standpoint, both variants of neoclassical theory imply that higher investment, output, and employment and lower interest rates and prices over the long run can be obtained only by lowering the budget deficit. The mantra of fiscal austerity as the principal means to increase long-run economic growth, which can be heard from authorities of diverse political persuasions, is rooted in this fundamental theoretical perspective. Yet, empirical reality has not substantiated the neoclassical perspective. Numerous studies by the World Institute for Development Economics Research, for example, have shown that the effect of budget deficits on growth is ambiguous: deficits can lower or raise output growth (Taylor 1985, 1988). The analysis presented here is based on an alternative theoretical framework, one that is consistent with empirical reality and demonstrates that the impact of budget deficits is far more complex than is generally predicted.

The alternative is called the classical growth cycles (CGC) model. The CGC model starts with the assumption that growth in output and employment is a persistent feature of the economy, in the short run and the long run. It assumes that investment decisions, rooted in profitability considerations and carried out in an uncertain world, are responsible for growth. This view contrasts with the standard view that growth is a long-run phenomenon resulting from exogenous changes in population and technology. Further, in a fundamentally uncertain world, there is no inherent reason why planned investment spending should match available savings and the mismatch is reflected in the demand for bank credit. Hence, the money supply is not under the total control of the central bank. If banks' profit expectations are the same as those of firms, banks will automatically extend to firms the credit they need, and the money supply will expand endogenously. The model also assumes that unemployment and excess capacity are recurrent features of the economy over the course of business cycles; however, structural unemployment (reflected in the relatively low employment rates of certain strata of the population) persists over the long run when productive capacity is utilized at the normal level. Finally, the model is embedded in a social accounting matrix with fully articulated stocks and flows.*

*The model discussed here is not the Levy macroeconomic model, which was developed by Wynne Godley. The discussion of fiscal policy in the CGC model distinguishes between policy's effects over two time horizons. The first one, usually referred to as the "short run," has been the traditional focus of macroeconomic policy and has the duration of a single business cycle. The second one, usually referred to as the "long run," spans several business cycles. The impacts of fiscal policy on growth are transmitted via its effects on business profitability and the business saving rate. (Unlike the neoclassical approach, household saving in the CGC model is of secondary importance as far as business investment is concerned.) We will analyze the scope of fiscal policy by examining how budget deficits affect these two crucial variables over the two time horizons.

Impact of Government Spending on Growth in the Short and Long Run

Over the course of a business cycle, a rise in the budget deficit (that is, the ratio of budget deficits to output) increases the growth rate of output and employment. By increasing effective demand, the rise in the budget deficit raises potential business profits, thereby stimulating investment spending by firms. If planned investment is greater than firms' available savings, firms borrow from banks. However, the injection of bank credit also leads to the accumulation of financial charges that eventually slow down the expansion. The positive effect of the budget deficit can be augmented by expansionary monetary policies that maintain low interest rates, which would have the dual effect of providing greater monetary stimulus from the deficit and keeping

financial charges on business debt low. These results accord well with the proposition that monetary policy should be designed to stimulate growth and employment (Papadimitriou and Wray 1994) rather than targeting inflation.

How does government policy affect growth over several business cycles? Standard models assume that the economy experiences full employment and full utilization of capacity over the long run, implying that fiscal policy has no positive role to play in the long run. Therefore, according to conventional wisdom, policy should focus on minimizing the undesirable short-run social and economic consequences of business cycle fluctuations, while leaving almost everything else to market forces.

In the CGC model the market economy, left to itself, is not capable of eliminating structural unemployment even in the long run. Moreover, even if productive capacity is fully utilized in the long run, government spending may still have a positive role to play. Specifically, increased government spending, even deficit spending, may not lead to lower growth; indeed, the long-run growth rate under certain plausible policy regimes may even rise. This can occur if government spending raises either the long-run rate of profit or the social saving rate (the combined government, business, and household saving rate). One means of raising the social saving rate is to increase business retained earnings. This might be accomplished by policies such as investment tax credits, lower corporate tax rates, and accelerated deductions for capital depreciation (Fazzari 1993). Combined with appropriate taxes on capital gains and "luxury" consumption, these policies could produce enough of a rise in the total social saving rate to allow a fixed or modestly rising budget deficit. The consequence would be an increase in the long-run growth rate.

Government spending can be divided into two types: consumption spending (expenditures on goods and services) and public investment spending (expenditures on infrastructure, education, public health, research and development, and other expenditures that are conducive to raising business productivity). A number of empirical studies have found that a rise in public investment significantly reduces business costs and improves business profitability, thereby raising the long-run growth rate. In the CGC model a rise in the growth rate is also obtained by raising the share of investment spending relative to consumption spending while keeping the budget deficit constant.

Implications for Fiscal Policy

Three major implications for the scope and effects of macroeconomic policy can be derived from analysis based on the CGC model. First, a fixation on arbitrarily restrictive fiscal targets will not necessarily yield any long-run benefits and, in fact, can lead to a collapse of demand over the course of the business cycle.

Second, government spending in excess of government revenues can play a positive role in the long run even if productive capacity is fully utilized. Structural unemployment persists even in boom times, as indicated by the substantial number of people in the United States today who are underemployed or out of the work force (Pigeon and Wray 1998). Therefore, a significant portion of the present and predicted budget surpluses should be spent on large-scale public investment projects rather than "saved," that is, rather than retiring government debt (see Wray 1999a, 1999b). Such projects could contribute to creating new jobs, reducing income disparities, and raising the productivity of the private sector. In the current period of global economic crisis characterized by overcapacity (Levy and Levy 1999; Godley and Martin 1999), expansionary fiscal and monetary policies are required to maintain aggregate demand growth. In the event of an economic slowdown in the short to medium run, spending limits will have deleterious economic and social consequences. At a time when demand would need to be injected into the economy, such limits would retard cyclical growth. Further, cutbacks in the social safety net would dramatically increase social costs once unemployment rises in an economic downturn.

Third, the various beneficial supply-side effects of government policy can improve industrial competitiveness. Thus, as Arestis and Sawyer (1998) argue, an effective way to increase investment, growth, and employment is to integrate macroeconomic policy with an appropriate industrial strategy. As they point out, the path to high employment needs to take into account both demand-side and supply-side factors. Provided that a lower unemployment rate does not result in wage growth that exceeds productivity growth, there is clearly scope for both industrial policies and labor market policies. To conclude, the blind pursuit of indiscriminate deficit cutting and tight monetary policies is not to be recommended. In the event of a decline in growth rate, such policies will do more harm than good in the short run without remedying the long-run structural causes of the downturn. They will deepen the recession (Minsky 1986) by slashing demand, and cuts in public investment may reduce future private investment and thereby lower long-run growth. A narrow policy of balanced budgets will be totally off the mark if the system is in the midst of a long-run slump characterized by a decline in profitability. Cutting the budget deficit will not lead to a rise in the long-run profit rate, which is the regulator of the long-run growth rate.

The blind pursuit of indiscriminate deficit cutting and tight monetary policies is not to be recommended. In the event of a decline in growth rate, such policies will do more harm than good in the short run without remedying the long-run structural causes of the downturn.

In other words, indiscriminate budget deficit cutting may exacerbate poverty and inequality in both the short and the long run. Fiscal policy options and their possible outcomes are dependent on the rate of growth; fixed fiscal targets make no sense in such a context. These issues are of particular significance for the current world crisis with its growing mass unemployment and the draconian austerity measures that are now at the core of mainstream macroeconomic policies.

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Jamee K. Moudud is a resident scholar at the Levy Institute. His research focuses on three areas. One aspect of his work is a collaboration with Distinguished Scholar Wynne Godley on the development and application of U.S. and world models that are based on consistent accounting systems. His research on nonlinear dynamics involves an investigation of fiscal policy and foreign trade in the context of a growth cycles model that is based on a social accounting matrix. Finally, he is studying welfare policy and reform and variations of the social wage in the postwar U.S. economy. Moudud received a B.S. and an M.Eng. in electrical engineering and electronics from Cornell University and a Ph.D. in economics from New School University.

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