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A critical analysis of functional finance

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A CRITICAL ANALYSIS OF FUNCTIONAL FINANCE

SUBMITTED TO THE FACULTY OF ATLANTA UNIVERSITY
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
MASTER OF BUSINESS ADMINISTRATION

BY

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PREFACE

For many centuries the prevailing economic theory has been that a person becomes well-to-do or wealthy by working at something productive and saving a part of the money he earns. This also applied to groups of people and nations. People believed that a nation became prosperous and continued to be prosperous by following a policy similar to that followed by individuals.

The period since the First World War, however, has been one in which strange and confusing changes have occurred in economic and political philosophies. The economic system of free enterprise passed for a time into eclipse amid freely expressed doubts as to whether it deserved further trial. In the atmosphere of pessimism and uncertainty that prevailed, the prophets of a new era gathered many followers who were ready to believe that government could and should support them.

Today two opposing philosophies with respect to public finance exist in high government circles. The traditional view has been that sound fiscal policy requires holding a nation’s indebtedness to as low a level as possible. Men experienced in finance believed that a continuously unbalanced budget and a rapidly increasing debt imperil the financial stability of a nation. The new conception is that a huge public debt is a national asset rather than liability and that continuous deficit spending is essential to the economic prosperity of the nation. The more the nation spends on nonproductive activities and the larger the deficits, the more prosperous it becomes. The old ideal of a balanced budget, it argues, belongs in the category of obsolete economic dogma.
The traditional view is held by the United States Treasury, by the Board of Governors of Federal Reserve System, by the President, by numerous congressional leaders both in House and in the Senate, and by many individuals occupying important positions. The new conception is advanced by the National Resources Planning Board, by numerous individuals who were high in the councils of the government, and by various groups not connected with the administration.

Since both theories can not be correct, and undoubtedly each theory has its good points and has proved to be effective at times, it is the intent of this writer to point out the weakness and strength of the two theories and to present them in light of their workable and nonworkable application.

It is noteworthy to realize that emphasis shall be placed largely upon the functional aspect of the theories. Then, it is not so much the question of how well they stand up under given periods as it is to how well do they function at any period of time and what purpose do they serve.

The first chapter of this study is devoted to the material that led to the formation of the Functional Finance concept. This brief analysis begins with the pre-1930's concern about the public debt and advances to the changing views. The second chapter involves the nature of the Functional Finance concept together with its practical application. The third section deals with the supporting views of the new conception on the public debt. The fourth section concerns itself with the traditional view of the public debt as opposed by the new conception. Finally, the fifth chapter gives an overall summary of the study, conclusion, together with particular emphasis upon the middle ground of the theories.

At this point, the writer wishes to express his sincere thanks to all
who have contributed to the successful completion of the research. Without doubt, the greatest obligation is to Dr. Samuel Z. Westerfield, Jr., advisor, for his sincere interest, counsel, inspiration, and encouragement during the period of the research report.
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CHAPTER I

EVOLUTION

Prior to the depression of the 1930's and the book by the late John Maynard Keynes, most economists, statesmen, and business leaders accepted without much question the conclusions of the economic writings of the great classical economists (David Ricardo, 1772-1823; John Stuart Mill, 1806-1873; and Alfred Marshall, 1842-1924) that labor would be fully employed continuously, and that the techniques and natural resources of the nation would be used most efficiently, if government kept entirely out of business.¹

In addition, since only 10 to 15 per cent of the national income flowed through the public economy,² scarcely anyone questioned the proposition that the government's budget should be balanced every year. Thus a balanced budget seems appropriate when we are satisfied with the existing level of total expenditures - roughly, in periods of full employment without inflation.³

The depression of the 1930's, however, showed that the adjustment (prescribed by the great classical economists) did not automatically take place. The experiences of the same period showed that the controls assigned to the central banking systems, largely related to interest rate determination, of the leading nations were not adequate to bring about


³Ibid., p. 316.
this most efficient adjustment.\(^1\)

It was also made crystal-clear that our economic structure, built on nineteenth-century laissez-faire principles, was hopelessly out of date, according to Hansen.\(^2\) The nineteenth-century society leaped forward with terrific strides but with violent fluctuations. These fluctuations became cumulative in themselves.\(^3\)

Almost speaking in defense of the fluctuations, Broadus Mitchell said that the most significant feature of this depression period was the unexampled intervention of the Federal government in the economic life of the country. Measures of relief and reform increased in variety and scope. Moreover, remarked Mitchell, the depression was proof that the self-sufficiency of the economy had broken down. Few economic forces continued independent of government assistance or correction. Autonomous economic developments were in a peculiar degree suspended.\(^4\)

As the depression deepened in the 1930's, the annually balanced budget program became a serious problem, too. Although desperate efforts were made by bewildered men to reduce Federal expenditures and increase Federal taxes,\(^5\) the government just could not balance the budget. Deficit spending was incurred because it could not be avoided.\(^6\) Both political parties

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\(^3\)Ibid.


\(^5\)Lindholm, *op. cit.*

\(^6\)Bach, *op. cit.*, p. 305.
regarded Treasury deficits as unfortunate; and the new Democratic administra-
tion was especially insistent on the maintenance of sound finance.\(^1\) In
counter both the administration and Congress were unwilling to cut govern-
ment expenditures; and Congress was unwilling to impose additional taxes
upon individuals who were unemployed and upon business firms that were on
the verge of bankruptcy.\(^2\)

But when income and employment begin to drop, and a recession appears,
Bach tells us that a deficit will automatically be created unless corrective
steps are taken. To correct the deficit, the government must raise tax
rates to get money, or reduce expenditures to match its reduced tax re-
ceipts. If we believe that the government ought to be trying to "expand"
total spending in order to check the recession, the balanced-budget policy
is clearly wrong. "Reduced" tax rates and increased "spending" would con-
tribute most to raising the level of total spending, but the balanced-budget
policy leads to exactly the opposite action.

On the other hand, what if there is inflation resulting from increased
private spending when there is already full employment? Increased national
income will increase government revenues, providing a surplus. A balanced-
budget policy would tell the government therefore to reduce tax rates or to
increase government spending to match the higher government receipts. But
in order to check the increase in total spending, reduced government spend-
ing and higher taxes are needed. Henceforth, if we want the government to
play a positive role in stabilizing the economy, a balanced-budget fiscal

\(^1\) Harold G. Moulton, The New Philosophy of the Public Debt (Washington,

policy at all times is unlikely to be satisfactory.¹

In turn, the experience of the 1930's led to a justifiable skepticism about the effectiveness of low interest rates, excess reserves, and favorable investment terms. Business investment did not respond and unemployment continued.

It was under these conditions that the Keynesian position began to develop such appeal and the influence of Hansen became important in this country. Hansen's stagnation thesis, suggesting that investment demand would not recover and that public investment would have to fill the gap, seemed to fit the facts of the 1930's.² Hence the political tradition against government intervention had been greatly weakened. The government inevitably had to intervene to rescue distressed debtors and to preserve the "liquidity of credit institutions."³

At the same time that new thinking about monetary and credit policy was evolving, the continued deficits of the 1930's led to the gradual acceptance of a new budget policy and a new attitude toward the growing public debt.⁴

Moreover, an increasing number of people, led by the now famous economist John Maynard Keynes, began to argue that the government's excess spending was actually a good thing in depression. The arguments went something like this:

¹Bach, op. cit., p. 316.
³Twentieth Century Fund Committee on Debt Adjustment, Debts and Recovery (New York, 1938), p. 12.
⁴Strayer, op. cit.
Pump Priming. Instead of balancing the budget or having government receipts just equal expenditures yearly, would not the sensible thing be to balance the budget roughly over the length of the business cycle — running a deficit in depression when government net spending would help increase total spending, and then paying off the accumulated debt in prosperity when government spending would help hold down the boom? The government deficit spending in depression would prime the pump.

Compensatory Government Spending. As the long black years of the 1930's dragged on, faith in both monetary policy and government pump-priming waned. Talk of the stagnant economy and a chronic deficiency in private investment expanded. Emphasis shifted to continuing "compensatory" government spending, aimed to fill the deficiency of private investment. It was argued that government deficit spending should be continued as long and as heavily as necessary to attain and maintain full employment.

Basic Case for Fiscal Policy. Many economists and laymen thought it should be the government's responsibility to help provide economic stability for the nation. Since no private business or agency has the vast powers to assume the task, the government fiscal policy should be used as a potential stabilizer for our economy.

Fiscal Powers Against Depression. The fiscal policy was regarded as a powerful tool against economic instability. Discussion was directed toward the fiscal powers the government can bring against depression and inflation. Fiscal powers against depression were considered first, since the economy was in a phase of recession.

In depression, the required action is to raise the level of total spending. (1). The government can contribute directly to the increased
income stream by spending more than it currently collects in taxes, hoping for a big multiplier effect. It can redistribute income by taxing the rich and spending on the poor, hoping for an expansion in total spending.\(^1\)

However, not until the end of 1936, when it passed the tax on undistributed profits, did the administration give any sign of being guided by "the new economics." One of the more potent arguments for the measure was that, by holding on to their profits, the corporations kept money out of the stream of purchasing power. If they paid out what they earned, those who received the dividends would probably spend it.

In brief, "purchasing power" was what John Maynard Keynes had been talking about.\(^2\)

Fiscal Powers to Check Inflation. With respect to fiscal powers to check inflation, they are essentially the reverse of its powers to check deflation. The most direct attack on inflation was regarded as the withdrawal of funds from the income stream through taxes and to hold or destroy the money. Whether the budget surplus would be obtained by raising taxes, reducing government expenditures or both, was of secondary importance. The crucial thing was a drain on the income stream that was not replaced through government spending.\(^3\)

The full flowering of the new trend was delayed until the war paved the way for an unlimited expansion of public credit. The vast increase in public expenditures mopped up unemployment and gave us a great increase

\(^{1}\)Bach, op. cit., pp. 305-306.


\(^{3}\)Bach, op. cit.
in national production. It was pointed out by the advocates of the new
trend that we had found a way to full employment. Moreover, "We discover-
ed, as have other nations, that increased production pays the real costs
involved."¹

Granting the change in attitude and the new commitments of government
to act to prevent or to offset the effects of economic fluctuations, there
remains the question of the power to achieve its objective. Hence it is
noteworthy to analyze the capacity of the Federal government to take pre-
ventive action in order to assure the maintenance of stable conditions at
all times.² This is in essence the maintenance of full employment which
Functional Finance proposes.

¹Moulton, op. cit., p. 19.
²Strayer, op. cit., p. 154.
CHAPTER II

FUNCTIONAL FINANCE

Functional Finance is directly concerned with no policy other than full employment.\(^1\) It has nothing to say directly about the equality of income and wealth, but the application of Functional Finance would indirectly reduce inequalities through the effect of full employment.\(^2\) It is necessary to build up the explanation of the determination of the volume of employment, however, before advancing to what influences the level of employment and thus how full employment is maintained.

The amount of money in existence together with the liquidity preference gives us the rate of interest, namely, that rate of interest at which the public wants to hold the amount of money in existence. The rate of interest, together with the opportunity to invest (as shown by the investment curve), gives us the volume of investment, namely, that rate of investment which brings the marginal efficiency of investment into equality with the rate of interest. The volume of investment, together with the propensity to consume, gives us the level of income (and of consumption), namely, that level at which the public wants to save just as much as is being invested. Total income, which consists of total investment plus total consumption, is the same thing as total spending, and this gives us the level of employment, namely, that level which is necessary for the production of all the goods and services that the money outlay will buy.

With this understanding of the mechanism through which the level of

\(^{1}\) Abba P. Lerner, Economics of Employment (New York, 1951), p. 306.

\(^{2}\) Ibid., p. 305.
employment is determined, the next step is to see what can be done to influence the level of employment. If there is too little employment because of too little spending in the economy, the thing to do is to get an increase in total spending. This may take the form of increasing any one or more of the five elements which make up total spending by working on their determinants. An increase in the propensity to consume (which is the same thing as a decrease in the propensity to save) would serve the purpose. So would an increase in the opportunity to invest. With the same opportunity to invest there would be more investment if the rate of interest were reduced, and this could be brought about by either reducing the public's liquidity preference or increasing the available stock of money.

If there is too much spending so that there is inflation, exactly the opposite changes are desirable. It would then be necessary to decrease one or more of the five elements in total spending. It would help if there could be arranged a decrease in the propensity to consume (which is the same thing as an increase in the propensity to save) or a decrease in the opportunity to invest. With the same opportunity to invest there could still be a decrease in investment by having a higher rate of interest, which could be brought about by a higher liquidity preference or by a decrease in the amount of money available for the public to hold in their cash balances.

Inadequate total spending is called "deflation" and its cure lies in increasing one or more of the elements in total spending. The opposite - excessive total spending - is called "inflation," and its cure lies in diminishing one or more of the elements in total spending. Inflation is fairly easy to recognize. It is seen in rising prices. Deflation is not quite so obvious, except if there are falling prices. But if prices are
stationary there still may be quite a considerable deficiency in total spending. It may be possible to increase employment and national income and output without coming up against inflation for quite a while. In such cases too, an increase in spending in such a case should be increased until the beginnings of inflation are reached in the form of rising prices. The process must then be called to a halt.¹ This is because the issue is the prevention of both deflation and inflation.²

In the prevention and cure of inflation and deflation economic understanding by individuals is of little use in itself, because the individual reacts perversely.³ This is because it is not always in the interest of individuals to do that which is good for a community as a whole. In learning that there is going to be too much spending which will lead to inflation, each individual will want to buy more now before the price rises. If he were sure that the inflation depended only on his own action, he might be deterred, but he does not think that his own spending amounts to much in the total effect. His own refraining from buying will not prevent the inflation from taking place. Most people would therefore increase their spending if they understood that an inflation was threatening, and this increase in spending would increase the inflationary pressure.

In the same way, if there is insufficient spending with heavy unemployment and falling prices, even a universal knowledge and understanding that this could be corrected by everybody's increasing his spending will not help. Most individuals will succumb to the temptation to postpone

¹Ibid., p. 124.
²Ibid., p. 123.
³Ibid., p. 136.
expenditures in order to benefit from the expected lower prices in the future.\textsuperscript{1} Social action is therefore necessary to prevent inflation and deflation and must be undertaken by the government.\textsuperscript{2}

The government has three pairs of fiscal instruments for dealing with inflation and deflation. They are as follows:

(1) Buying and selling.

(2) Giving and taking (money to or from citizens).

(3) Lending and borrowing.

All three first items are inflationary and so are appropriate to correct a deflationary situation while all three second items are deflationary and therefore appropriate to correct an inflationary situation.

Each of the six fiscal instruments that constitute the three pairs has many other repercussions on the economy, which means they are exhaustive. They include everything that the government can do to influence or offset the level of total spending. Every possible action by the government to affect total spending either is simply the use of one of these instruments or consists of a combination of two or more of them.

A habit of considering fiscal instruments in combination is confusing, however. Thus one often hears the argument that total spending is not reduced by taxation (i.e., by the government's taking money from people) because the government spends the money it takes away. It has been said that taxation increases total spending because the taxpayers reduce their spending by only a part of the taxes while the government increases its spending by the whole amount of the tax revenues.

\textsuperscript{1}Ibid., p. 125.

\textsuperscript{2}Ibid., p. 136.
Such arguments rest on the supposition that when one says taxing one means not simply taxing but taxing-and-spending. The argument is then correct, but it is very confusing and makes it difficult to consider what would be the effect of, say, increasing taxes without increase spending. This can be clarified by saying "taxing" when one means simply taxing and not when one means "taxing and spending."

The same kind of difficulty is also found in reverse, when it is said that government spending does not increase total spending because the taxes the government has to impose to get the money for its spending makes other people reduce their spending. But it is possible for the government to increase its spending without imposing any extra taxes—it can spend money which it happened to have in stock, or it can cause money to be created, or it may borrow money, or it may buy on credit, and so forth.

Therefore, when the effects of any of the governmental instruments are spoken of, it is meant simply the effects of applying that instrument alone. When the effects of government borrowing are mentioned, for example, it is not meant, as is frequently supposed, the combined effects of government borrowing-and-spending, but merely the effects of borrowing when there is no change in government spending or in any of the other instruments or other conditions of the situation.

Closely related to the implicit association of different instruments is the idea that taxing is undertaken only in order to make available for the government the money which for some reason or other it wishes to spend. But if it is recognized as the prime responsibility of the government to prevent inflation and deflation and there is seen in the six fiscal instruments the means by which it can achieve this objective, there is no room
left for the traditional idea that the government must collect in taxes all the money that it spends or that it must keep its spending within the range of its tax revenues. For if the government undertakes to exercise its economic powers for the prevention of inflation and deflation, that determines its spending, its taxing, and the other economic actions which it undertakes. If this happens to result in government's spending being equal to its tax revenues, then the budget is balanced anyway and there is no need for any principle of balancing the budget. On the other hand, if the application of the six fiscal instruments for the prevention of inflation and deflation results in an unbalancing of the budget, if it results in government spending being either greater or smaller than tax revenues, one would have to choose between the two different policies. One could leave the budget unbalanced and continue to prevent inflation and deflation, or one could give up the task of preventing inflation and deflation in order to be able to balance the budget.

The principle of disregarding all traditional conceptions of what is "sound" in finance and judging fiscal measures only by their effects or the way the function in society may be called Functional Finance.

The objective of Functional Finance (as previously stated) is the prevention of inflation and deflation. In the absence of the two, however, Functional Finance does not come into existence. Nevertheless in accepting the objective of preventing inflation and deflation through the use of

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1 Ibid., pp. 126-131.
3 Lerner, op. cit., p. 131.
4 Ibid., p. 134.
the six fiscal instruments as the proper responsibility of the government, we are abandoning "sound finance," which makes the balancing of the budget the main criterion of fiscal policy, in favor of "Functional Finance," which says (again) that each instrument in the hands of the government should be judged not by any traditional rule, such as the budget should be balanced, but by the way it functions in the general interest and in the first place in contributing to the prevention of inflation and deflation.¹

Functional Finance rejects both the dogma of the left that 100 per cent collectivism is necessarily in the social interest and the dogma of the right that the government of a country must keep to the fiscal principles appropriate to a grocery store. As soon as it is recognized as the duty of the government to ensure the maintenance of full employment, and that any so-called principal of "sound finance" that might interfere with this task can have no possible justification, the instruments by which full employment can be maintained stand out clear and unmistakable.² This approach is called "Functional Finance" because it views the problem of government finance purely functionally, as a means towards the goal of economic stability.³

The balancing of the budget is not the only idol that falls when the rational or functional approach is applied to fiscal policy. One such implication is that taxes should never be imposed for the sake of tax revenues. It is true that taxation makes money available to the government, ¹Ibid., pp. 131-132. ²Abba P. Lerner, The Economics of Control (New York, 1959), p. 302. ³Bach, op. cit., p. 317.
but this is not an effect of any importance because money can be made available to the government so much more easily by having some created by the Treasury or by the banking system. The important effect of taxation is the effect on the public in influencing their economic behavior - in making them spend less because, for one thing, they have less money to spend. It is these effects which should be considered seriously and not the availability of money for the government. If these effects are not desired, if, for instance, there is insufficient total spending which a tax increase would make worse, it would not be wise to suffer this deflation just because the government needs some money which could be provided by an appropriate printing job.

Another result of the functional approach is that government borrowing is seen to be not inflationary but deflationary. It has the effect of raising the rate of interest and discouraging investment and thus reducing total spending. The notion that government borrowing is inflationary derives from a coupling of government borrowing with government spending. But the effect of borrowing, taken as borrowing and not as borrowing-and-spending, is deflationary.

It is important to note that the creation of money does not figure at all in the six instruments. The creation of money is completely subsidiary to the six fiscal instruments. The use of the instrument should never be hampered just because there may not be enough money stock in the treasury at the moment. To sacrifice the prevention of deflation because of shortage of money which could be printed is no more sensible than to refrain from carrying out any other important government action because the necessary paper forms or stationery would have to be printed.

The size of the national debt is also subsidiary to Functional Finance.
If the program of preventing inflation and deflation calls for borrowing, it of course entails an increase in the national debt. And if the program calls for lending money and there happens to be no money around, then more money will have to be printed. The size of the stock of money as well as the size of the national debt are results of the actions that will have to be undertaken to prevent inflation and deflation and are never considerations that should prevent the government buying and selling, giving and taking, and borrowing and lending that are indicated by the objective of functional finance - the prevention of inflation and of deflation.

Functional Finance does not interfere with other governmental objectives either. It might be thought that Functional Finance, by governing all the buying and selling, giving and taking, and borrowing and lending by the government, would prevent it from taking care of other matters. But Functional Finance is in one sense the last thing for the government to think about. The government must first of all decide on all the other reasons for buying various things or for taxing certain activities or for applying any other instruments of fiscal policy. Only when it has applied itself to all other problems and tasks does Functional Finance come in. When these other decisions have all been made there results a total of spending by the government as well as by the individuals and by businesses, on consumption as well as on investment. All of these are influenced in different degrees by the actions undertaken by the government for reasons not directly connected with the prevention of inflation and deflation. Then it is considered whether the total spending resulting from all these forces is deficient or excessive, whether it would result in deflation or in inflation, or whether perhaps it turns out to be just the right amount of total spending that will give us neither inflation nor deflation.
If this last is the case Functional Finance remains static. But if the resulting total spending is not exactly at the level which avoids inflation on the one hand and deflation on the other so as to give us full employment, the government has to apply Functional Finance to raise or lower total spending to the requisite level. Functional Finance, then, is merely the balancing item.

This means that Functional Finance is not a policy. It is only a framework within which all sorts of different policies may be applied. It is merely the conscious adoption by the government of responsibility for the prevention of inflation and of deflation. It is not the only interest of government, but neither is it the least important of governmental responsibilities. It is considered neither first nor last, but together with all the other objectives in arriving at a general policy.¹

Functional Finance is often called deficit financing and deficit financing is normally interpreted as regularly borrowing to meet current expenses and so incurring national debt. Although the function of government borrowing is to check excessive investment, there are circumstances in which Functional Finance would lead to government borrowing and an increase in the national debt.

Functional Finance would lead to government borrowing if the government wanted to run a deficit, but did not want to cover the difference by the issue of new money.² "Money issue" often stands for an excess of government spending over tax collection combined with the issue of new money, and "borrowing" often stands for an excess of government spending over tax

¹Lerner, op. cit., pp. 130-137.
²Ibid., pp. 270-271.
collection combined with borrowing from the public to equal this difference. If the different elements of these complexes could be separated, Functional Finance would prescribe a government deficit whenever there would otherwise be insufficient spending for full employment. Or, the deficit would be necessary only if in its absence total spending would have been too little. The borrowing would be necessary only if covering the deficit by issuing new money would lead to too much liquidity, too low a rate of interest, and excessive investment. Investment is excessive if it entails the elimination of some other and socially more desirable expenditure where permitting both would mean too much spending and inflation. Government borrowing then raises the rate of interest and cuts out some of the investment. It is then possible, without making total spending excessive, for the government either to spend more itself or to lower taxes and thereby enable others to spend more on the socially more desirable alternative. The resources that would otherwise be absorbed by the eliminated investment now go to produce the alternative goods consumed by the government or by the relieved taxpayer.

By far the most important alternative that is given priority over investment is expenditure for war purposes, and this is of course the main source of our national debt.  

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1 Ibid., p. 287.
2 Ibid., pp. 286-287.
CHAPTER III

PROONENTS OF FUNCTIONAL FINANCE

The most pressing opposition to Functional Finance is the growing concern over the size of the national debt. As the forerunner of the concept, Abba P. Lerner began by saying that the size of the national debt (when held by citizens of the country) is a matter of almost no significance beside the importance of maintaining full employment. Furthermore, a natural limit (which is reached when the ownership of national debt makes people so rich that they spend enough to provide full employment) to the debt makes an arbitrary limit unnecessary. To impose an arbitrary limit to the national debt is to rule that at some point it is more important to prevent the national debt from growing than to maintain full employment without inflation. To sacrifice Functional Finance for the sake of preventing the national debt from growing is therefore to embrace the definite economic harm of depression or inflation.

With respect to transfer burden of a growing debt, Professor Buchanan stated that the process of government borrowing transfers current purchasing power from the hands of individuals or institutions to the government. The utilization of this purchasing power by the government employs resources in the same general time period as that in which the borrowing operation takes place. Insofar as these resources are drawn from private employments, the full opportunity (real) cost of the public expenditure is

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1 Lerner, op. cit., p. 302.
2 Ibid., p. 274.
3 Ibid., p. 287.
4 Ibid.
held to be borne by those individuals living in the initial or "current" time period. In this particular respect, the financing of a public expenditure by borrowing is little different from financing by taxation. In either case, the "real burden" is borne currently. Any shifting of the primary real burden of public expenditure over time by changing the method of financing is impossible.¹

U. S. News informed us that the burden of the debt has been growing lighter, even while the actual size of the debt in dollars has expanded. This has happened because the country has been growing rapidly, in income and population, while the size of the debt has changed very little.

At the end of 1952, the debt of 267.5 billion dollars amounted to $1,690 for each person in the country. That compared with a debt figure of $1,832 per capita in 1946.

At the start of 1957, on January 1, the total debt stood at 277 billion dollars - up 9.5 billion in four years. Yet the amount per person had dropped to $1,631, as the number of people helping to carry the debt expanded sharply.

Part of that improvement is due to inflation and part is due to the result of the rise in real income in our country. Hence the actual size of the debt has been shrinking for the preceding two years, as small surpluses have been used to liquidate part of the debt.²

Secondly, Lerner contends that the interest on the internally owned national debt is not a burden on the nation, since the interest payments are


not lost. They are merely transferred to the recipients from taxpayers or from new lenders, and if it should be difficult or undesirable to raise taxes the interest payment can be met, without imposing any burden on the nation as a whole, by borrowing the money or printing it.\(^1\)

Stuart Chase becomes informative on the point that the government does not decrease the nation's purchasing power with the payment of interest. Even though the government can not spend this money, those who receive the interest have that freedom. When this right is exercised, the dollar circuit is unaffected. Also, it is theoretically conceivable that the recipients of interest remunerate taxes to an equivalent amount. In such a case, the interest "burden" is a pure bookkeeping charge.\(^2\)

The part to consider is whether the national income (on which taxes are levied) is increasing as rapidly as interest payments due on the debt are increasing, commented Morgan. In considering policy for the future, it should be remembered that well-advised government expenditures can cause an annual rise in the national income much exceeding the annual rise in interest payments due on the debt that is financing these expenditures. If this be true, the real burden of interest payments is insignificant upon the economy.\(^3\)

Domar mentioned that a growing national debt is indicated by the maintenance of two propositions. First, the total volume of monetary expenditures, public and private, must grow at the same rate. Secondly, of the total volume of these expenditures, a sufficient amount should be directed

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\(^{1}\) Lerner, op. cit., p. 305.


toward increasing the efficiency of production, in order to allow the required volume of monetary expenditures to occur without a rise in prices. ¹

Again U. S. News informed us that the interest charges have become easier for the country's taxpayers to meet, even while those charges were rising in dollar amount.

In 1946, interest on the public debt amounted to $2.80 in each $100 of national income. By 1952, that cost was down to $2.10 for each $100 of income. And there has been no rise in this figure even during these recent years of "tightening" money and rapidly rising interest rates.

What has happened is that income out of which interest on the debt is paid has been rising right along with the interest charges themselves. The following table will give the relation of the interest charges to national income for the period 1919 to 1957.

TABLE 1

COST OF NATIONAL DEBT - HOW IT COMPARES WITH INCOME

<table>
<thead>
<tr>
<th>Years</th>
<th>Interest Charges as Per Cent of National Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1919</td>
<td>1.4%</td>
</tr>
<tr>
<td>1930</td>
<td>.9</td>
</tr>
<tr>
<td>1939</td>
<td>1.4</td>
</tr>
<tr>
<td>1946</td>
<td>2.8</td>
</tr>
<tr>
<td>1952</td>
<td>2.1</td>
</tr>
<tr>
<td>1956</td>
<td>2.1</td>
</tr>
<tr>
<td>1957</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: Through 1956, Treasury Department; 1957 estimate by USN & WR Economic Unit. ²


Thirdly, Lerner stated that the nation can not be made "bankrupt" by internally held debt.¹ Unlike a business concern, ordinary trader or individual, the government has the power to create the money necessary to liquidate its obligations. Hence the nation can not be thrown into a debtor's prison or debarred by a bankruptcy order from continuing its business.² For the economy as a whole, the trouble comes only when the nation falters in the course of its economic expansion³ or depletes its men or material.⁴

To strengthen the above argument, Chase quoted the Finance Minister of Canada on this point:⁵

How can we use such a term as bankrupting the nation to describe a process under which this country (Canada) has doubled its national income in three years, has wiped out unemployment, has multiplied its production of many times, and learned many types of new skills, has expanded and diversified its equipment, has multiplied its government revenue by more than four times, has enabled millions of its citizens to acquire a nest egg for the future, has mobilized its full strength as producing machine?...no country goes bankrupt in that way.⁶

Fourth, Lerner inferred that the other misconception lies in looking at only one side of the debt-credit relationship. Every debt has a corresponding credit because there must be someone to whom the debt is owed.⁷ If we look at the whole nation as a going concern, remarked Morgan, we see that

¹Lerner, op. cit., p. 304.
²Ibid.
³Morgan, op. cit., p. 320.
⁴Chase, op. cit., p. 102.
⁵Ibid., p. 103.
⁶Ibid.
⁷Lerner, op. cit.
its internal debts, business and governmental, are merely aspects of its assets. Debt in the broad sense is the adverse of investment.¹

The final proposition is that there is a sharp and important distinction between an internal and external public debt.² With the former the government has within its accounting limits both the debtors and the creditors. The debt in such circumstances is a mere financial transaction.³ Only an external debt⁴ has the earmarks of the private debt of an individual. A public debt (internally held) is an instrument of public policy. It is a means to control the magnitude of the national income and, in conjunction with the tax structure, to offset income distribution.⁵

Closely allied with the preceding statement is the consideration for expanding (government) control. In this respect, Lerner stated that there is no reason, however, for supposing that this law of distribution (which says an increase in the scope for both private property and income would accentuate the inequality of economic wealth and power) will hold if the authorities of a controlled economy prefer another more equalitarian distribution of income and of private property.⁶

Regarding expanding control over private economic affairs, Lindholm implied that if the economy fluctuates between boom and depression, however, aggressive fiscal policy need not involve any long-run growth in

¹Morgan, op. cit., p. 320.
²Buchanan, op. cit., p. 10.
³Ibid.
⁴Lerner, op. cit., p. 305.
⁶Lerner, op. cit., p. 307.
government control over economic affairs. Moreover, the biggest expansions in government spending and control have come with war and preparations for war, not with attempts to avoid depression. Even the New Deal of the 1930's channeled only a small fraction of the national income through the government in this worst of all depressions, compared to war period spending.¹

According to Hansen, in a free market economy no single unit is sufficiently powerful to exert any appreciable control over the price mechanism. In a controlled economy the government, the corporation, and organized groups all exercise direct influence over the market mechanism. Moreover, modern democracy does not mean individualism. It means a system in which private, voluntary organization functions under general, and mostly indirect, government control.²

It has also been stated that the essence of an expanding debt lies in the "oversavings" thesis, "mature economy" doctrine, and the independence of industries in freeing themselves largely from the outside methods of financing. (At least this was stated in the 1930's).

With respect to the "oversavings" thesis, Gordon Hayes' contention was that there tended to be a chronic shortage of buying power in our markets, because of the amount of money that was withheld from activity. Since our savings were not employed in investment, and that this was practically inevitable periodically, "oversavings" became the crux of our difficulty in distributing our product and maintaining employment.³

¹ Lindholm, op. cit., p. 328.
With particular respect to (the late) John Maynard Keynes, he developed the point that if the people of a nation have a given "propensity to consume," which means also a given "propensity to save," the volume of investment will determine the degree of employment that is provided. He accordingly recommended policies to encourage investment, and, failing that, the spending of government funds to put the unemployed to work. Therefore, the Keynesian analysis runs in terms of constant additions to investments being the remedy for unemployment.¹

Professor Hansen developed the thesis that, as an economy reaches a high state of development and thus "matures," a point is eventually reached at which full employment can not be maintained, in the absence of (continuous) government action, because at the full employment level of national income the volume of investment is inadequate to absorb the amounts of savings which are made at this income level. As a consequence, aggregate demand falls below the volume of output at current prices, and national income declines to the level at which savings and investment are equal, and thus below the full employment figure. Thus, Hansen has emphasized the importance of investments equalling savings if full employment is to be maintained.²

Concerning the independence of industries, it was recorded that from 1930 to 1939, fifty-eight big companies, representing roughly one-fifth of the manufacturing and mining industries, financed 83 per cent of their total capital expenditures from their own sources. Thus the older industries can no longer be counted on as outlets for other people's savings.³

¹Ibid., p. 15.
²Lindholm, op. cit., p. 543.
In discussing the role of the United States Government, Hansen stated that the Federal Government should be prepared to play a balancing role, checking any temporary tendency toward an excessive boom, and, on the other hand, prepared to go forward with large Federal expenditures on public improvement projects to compensate for any strong tendency toward deflation and depression.  

As a proposal, Hansen discussed the shift toward a high consumption economy. For example, he disclosed that from the long-run standpoint, a persistently pursued policy to maintain full employment raises interesting questions with respect to the effect of such a policy on (1) the distribution of income, and (2) the proportion of full employment income which, it may be expected, would be expended on consumption. In brief, it is reasonable to suppose that the ratio of consumption to income in a full employment economy would automatically tend to be higher than the ratio of consumption to income at the peak of a boom in a violently fluctuating economy. A full employment economy would tend automatically toward a distribution of income favorable to high consumption. This affords ground for optimism with respect to the feasibility of a positive program designed to maintain full employment. Such a policy, if successfully pursued, tends to develop repercussions upon the distribution of income which reinforce the program to maintain full employment.

That this is true can best be seen if we analyze the problem of corporate profits in a society continually operating at a full employment level. Peak prosperity profits have never in the past been realized for any considerable period of time. In a highly fluctuating society such as we have

known, normal profits are some sort of average of good times and bad times. Thus, for example, in the period 1925-1940, the net income of corporations fluctuated very violently in relation to the total national income. In periods of high prosperity, the ratio of net income of corporations to the total national income was high, while in periods of depression, despite a fall in the national income, the ratio of the net corporate income to the total national income was low. Over the entire 16-year period from 1925-40, inclusive, the corporate net income averaged only 4.6 per cent of the national income, although the national income was relatively low. In other words, corporate profits constituted only a low percentage of a small national income — small in comparison with the income potentially realizable.

In a highly fluctuating society, corporate profits are high in good times and extremely low in bad times, but the average must be adequate to motivate a profit economy and insure its workability. If, however, it were possible to maintain continuously a full-employment national income, it is obvious that corporate profits, representing the same percentage of national income as that averaged over the cycle in the past, would yield an absolute profit figure far above the experience of 1925-40. Yet such a percentage continuously maintained would be much lower than the high ratio of profits to national income reached in a fluctuating society in the peak boom years.¹

A positive governmental program looking toward full employment would greatly vitalize and invigorate private enterprise. An expansionist program would permit private enterprise to operate at high output levels.

The notion that we can not finance our own production is quite without foundation. Every cent expended, private and public, becomes income for

¹ Hansen, op. cit., pp. 15-16.
members of our own society. Costs and income are just opposite sides of the same shield. The public expenditures required to provide needed social services, and to maintain full employment can be provided for out of the enormous income which the full utilization of our rich productive resources (material and human) makes possible. The costs of producing this income are merely payments to ourselves for the work done. There is not - there cannot not be - any financing problem which is not manageable under a full employment income. From a $100 billion income we can raise large tax revenues - large enough to service any level of debt likely to be reached and to cover all other Government outlays - and still retain for private expenditures more than we had left in former years under a $70 billion income with lower taxes. And, taxes are merely one way of paying for social services and public-improvement projects which we need. Financial responsibility requires a fiscal policy (including governmental expenditures, loans, and taxes) designed to promote economic stability.¹

In discussing the role of the Federal Government, Strayer referred to the Employment Act of 1946. He stated that this act requires the Federal Government to use all practicable means to assure both the maintenance of full employment and a growing economy. As a result, the government can not ignore a depression and must use all possible means of preventing another collapse of the magnitude of the Great Depression of 1930’s. It is now generally conceded that another depression of such dimensions would have repercussions which would threaten both the economic and the political framework of our society.

Secondly, he mentioned that the inadequacy of state and local governments deserves much consideration. For example, there have been no new

¹Ibid., pp. 4-5.
state income taxes since 1947; but indirect levies have multiplied as a mean of raising more revenue in the least painless way. Such developments raise the question of the capacity of the states and local governments to continue to expand their basic services without federal assistance.

Thirdly, he revealed that another development of great interest is the growth in dependence of certain industries upon government orders. Public construction is about as large as total private construction. Aircraft and missiles are almost completely dependent upon government orders for the bulk of their business. Unfortunately these industries tend to be concentrated in certain parts of the United States so that a decline in government spending may have a much greater impact in certain areas than in others.\(^1\)

Public expenditures, commented Somers, tend to cause an upward movement in national income through the operation of the multiplier principle. This movement would usually also tend to be stimulated by private investment induced by the increased purchasing power made available by the government. Moreover, as national income rises, savings will also rise, and, according to the "psychological law" of Keynes, will form an increasing proportion of the increased income. In other words, although both consumption and savings will increase, the volume of savings will rise relative to that of consumption.

The effect of the formation of capital will tend to be favorable up to a point. This increased purchasing power will increase the profitability of the heavy industries. The acceleration principle postulates that any increase in the rate of increase in consumption will, after a high level of employment of resources has been reached, tend to promote a relatively large

\(^1\) Strayer, op. cit., pp. 6-7.
percentage increase in the production of investment goods.¹

Keynes viewed the fiscal policy (government spending, taxing, and borrowing) as the most important weapon against unemployment.²

"If a democratic society," says Hansen, "does not take bold action to achieve full employment, including use of fiscal policy to the extent necessary, our system of free enterprise is doomed."³

³Chase, op. cit., p. 108.
CHAPTER IV
OPPONENTS OF FUNCTIONAL FINANCE

In contrast with the preceding chapter, the opponents of Functional Finance challenge the impact of a large national debt, the difficulties associated with interest payments, the desirability of a growing debt, and government intervention; and in lieu of them, they form a case for economy.

Hugh Dalton's case against a large debt is that, as a rule, it worsens distribution and discourages production.¹ He presents his case as follows:

...roughly speaking, there will be a direct burden if the proportion of taxation paid by the rich towards the cost of the debt service is smaller than the proportion of public securities held by them...taxation, even if progressive, is seldom likely to be so sharply progressive as to counterbalance, among the wealthier classes, the income derived from public securities. In most cases, therefore, an internal debt is likely to involve transfers from the poorer to the richer, and hence a direct burden...and there is also a general presumption, on the grounds of production, against the enrichment of the passive at the expense of the active, whereby work and productive risk-bearing are penalized for the benefit of accumulated wealth.

...as a general rule, an internal debt is likely to involve an additional and indirect burden on a community...one reason for this is that the taxation required for the services of the debt may check production, if it reduces taxpayers' ability and desire to work and save. Another reason is that short sighted 'economies' in desirable social expenditure are likely to be made, when heavy taxation is required to meet debt charges...where the debt involves a direct real burden...it is also probable that taxation will reduce personal efficiency more than the receipt of debt payments will increase it. There would thus be a net loss to work, while ability to save would be unaffected by the transfer of income....

The preceding argument points to the conclusion that deadweight public debts should not be lightly created.²

According to Professor Ratchford, the net effect of a large debt,

²Ibid., pp. 181-184.
therefore, is to reduce consumer buying and to increase savings. As he states it, 1

A large national debt not only transfers funds from one group to another but at the same time it also causes a change in the use to which the funds are put. Although our federal tax system is progressive, small income receivers still pay a substantial amount of federal taxes either indirectly as excise taxes or directly as income taxes. It is a fairly safe assumption that a large majority of these funds would be spent for consumer goods if they were not paid as taxes. The part of those funds which is paid out as interest on the debt goes, on the average, to financial institutions or to individuals who are higher in the income scale. Those bondholders who receive the interest will spend some part of it for consumer goods, but the proportion so spent will be smaller than if the funds had remained in the hands of the taxpayers. More of those funds will be saved, directly or indirectly, and hence the total amount of savings will be increased by the transfer. 2

One of the worst economic consequences of internal debt, remarked Stamp, is the fact that it is expressed in money, and if the money changes in value, the transaction of wealth from one class of owners to another varies greatly. He stated that only be the national "heap" being made substantially larger as the money value of individual items diminishes can the actual proportion of it in physical objects which are transferred to these recipients, be prevented from increasing. 3

On the other hand, Professor Hatchford surpassed Dalton on the debt burden and took the extreme view. He said that an internally-held debt is an economic burden even when taxes are paid to service the debt in the same ratio as the bonds are held. This is true because of the friction of levying

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2 Ibid.
and collecting the taxes and because of the difference in the subjective effects of applying taxes and receiving interest.¹

Variations of the above views are the difficulties associated with the interest payments. In short, from the standpoint of its demand upon the tax system, an advance in interest charges presents much the same problem of new revenues or reductions in other expenditures as any other new outlays by the government. An increase in debt charges is therefore often a threat to the continuance or expansion of federal outlays for various desirable social services and other governmental activities. And, because interest charges constitute an inflexible item in the budget, they become especially burdensome in bad times when the national income and tax receipts decline.² Even though the debt may have been contracted during a period when the national income was increasing rapidly, such a debt is a long-term obligation and there is no certainty that the national income may not shrink (and perhaps rise again) in the meantime. If the national income should decline, the community still has to meet the interest charges on the debt in addition to the other expenditures of the Federal Government. Therefore, the burden would be felt more strongly if the debt were large in proportion to the national income. Moreover, a mounting federal debt means higher taxes to cover interest charges and to provide funds for amortizing the debt. If the debts have been incurred in time of war, as is largely true of our present federal debt, the tax and amortization burden will continue far into the postwar era where production is no longer geared for victory. Unless national income continues high, many will maintain the

Government should increase its expenditures in order to increase national income which will, in turn, lessen the tax burden necessary to service the public debt. Such expenditures would further increase the debt burden in the long run - a burden to be borne by future generation.¹ In that way we hope to escape all the painful consequences of loss and error. Theoretically such a process can go on forever. Practically it can not. For in its logic are figured two factors of abundance which are not always present: the abundance of confidence and the abundance of peace. In 1929 we lost our abundance of confidence. But the real trouble will arrive if we should ever lose the abundance of peace.²

Even if the preceding statement does not materialize, an article in Business Week tells us that the lack of financing our mammoth $280-billion debt always involves risk. Though the Treasury has set up an elaborate and detailed system to prevent failures, there is nothing safe or automatic about its marketing operations.

The very fact that the public debt is two-fifths of all debt means that the Treasury's borrowing policies have a major effect on over-all economic activity. In every financing, it has to consider how aggressively it should compete for the available supply of funds, and whether its action will be inflationary or deflationary.³

The rise in sales of government securities to banks accounted for the expansion of money, income, and savings in the war period.

The inflation problem originates in no small part in the vast growth

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of liquid assets - cash, deposits, and government securities - associated with the financing of the war, and in particular, the rise in public debt. Should a large inflation develop, with an increased general awareness of future declines in the value of money, the flight to goods may be precipitated.  

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Closely allied with the element of risk is the case of uncertainty. When the Treasury started to talk to the Federal Open Market President about the proposed refunding, continued Business Week, the President had suffered a heart attack and the economic outlook was far from clear. There was a good deal of confusion about future credit policy.

The government bond market, for instance, was acting as if the Federal Open Market would ease up. But what Burgess (then Undersecretary of Treasury) learned from the Federal Open Market President convinced him there would be no easing. Instead it looked as if the credit screws would be tightened still further. 2

In June, 1969, the Eisenhower administration revealed a new threat to the President's precariously balanced fiscal 1960 budget. It said interest on the national debt would climb to an all-time high of $8,600,000,000. That would push the cost of running the government a half billion dollars higher than the 77 billion estimated by Eisenhower in his budget message to Congress last January.

The House Ways and Means Committee made public on June 23rd a staff analysis of the new data which indicated a strong possibility that the government would wind up in the red despite administration hopes - and even

1 Seymour E. Harris, National Debt and the New Economics (New York, 1947), pp. 12-13
2 "Managing the Public Debt," op. cit., p. 75.
if no big new spending programs are approved.

 Treasury Secretary Anderson and Budget Director Stans made clear the hoped-for balance still was depending on Congress enacting the increased postal rates and federal gasoline tax sought by Eisenhower. However, the committee staff noted there is little likelihood Congress will go along, resulting in a "small deficit" in the next fiscal period. ¹

Aside from the burden and interest payments on a growing national debt, there is strong objection to an expanding debt as being the essence of prosperity.

If the stagnation thesis were valid, commented Due, the government would be confronted with a continuing task of combating unemployment rather than a temporary one of stimulating recovery from depression. The basic problem would be that of eliminating the gap between investment and savings at full employment levels, either by raising the level of investment or by reducing the volume of saving. ²

The optimists say that whether any investment possibility is available as a profitable outlet for current savings depends on the anticipated relationship between costs and revenues involved. The "availability" of investment outlet, therefore, hinges on the anticipated profitability of the tremendous range of possible investments, not on any absolute existence or nonexistence of investment projects. The failure of private investment and consumption to maintain full-employment levels during periods like the 1930's thus points toward the factors that destroy profitable cost-price relationships and inhibit private investment - not toward a "mature"


economy in which government investment must play an increasingly dominate role.\textsuperscript{1} It can not be demonstrated that the rate of investment actually slows down permanently as an economy becomes highly developed.\textsuperscript{2} The long depression of the thirties reflected a disastrous combination of financial collapse, other deflationary cyclical developments, and unwise governmental policies, say the non-stagnationists.\textsuperscript{3} Moreover, some critics have attempted to argue that stagnation is impossible, because interest rates would adjust in such a way as to insure equality of investment with savings at full employment levels. Nevertheless stagnation must be recognized as a possibility, but there is no conclusive evidence that it will actually be encountered.\textsuperscript{4}

The Committee on Public Debt Policy claimed there is every indication now (1948) that a large volume of private investment will be required in the next several years to fill the backlog of consumer and producer demand built up during the war, to satisfy housing, and to exploit the accumulation of new inventions.

Beyond that time, there seems good grounds for confidence that private investment outlets will readily absorb our savings. Further development of our country intensively, and rising living standards for the people, can provide the basis for huge capital requirements, without reliance upon a heavy public spending program. In case of temporary set backs, they may perhaps be kept at a minimum in number and severity if government policies

\begin{flushleft}
\textsuperscript{1} Bach, \textit{op. cit.}, p. 240.
\textsuperscript{2} Due, \textit{op. cit.}, p. 545.
\textsuperscript{3} Bach, \textit{op. cit.}
\textsuperscript{4} Due, \textit{op. cit.}
\end{flushleft}
are such as to foster a continuing economic environment in which pioneering Americans are encouraged to go ahead with new business ventures.¹

Simons' conviction is that investment opportunities are and have been nearly limitless (with respect to marginal efficiency under free market conditions). He believes that the productivity curve for new capital is extremely flat; that investment, proceeding at the maximum rate consistent with high thrift, would have little effect for the significant future, even failing large accretions of innovations, on yields in this sense. What we need to know is not actual yields or prospective yield at prospective prices and wage rates, but what yields would be in a monetarily stable economy if costs of capital assets were purged of monopoly and racketeering elements and if assets, once constructed, were reasonably assured of the productivity (annual rent yield) which they would have in a free market for complementary factors. We need to know, in other words, what the marginal efficiency of investment would be, at different rates of investment, on the basis of free-market values (or productivities at full employment).²

Simons admits that the foregoing is a large order of statistical inquiry; but unless substantial confirmation is forthcoming from such inquiry, he points out, the novel doctrines which explain our difficulties (without mentionable facts) should be weighed carefully.³

Briefly, Simons attributed the plight of investment as being largely an incident of wholesale restraint of internal trade - of racketeering or

³Ibid., p. 193.
The budget-balancing school insisted that new industries could be established if the spirit of enterprise existed. The slowing up of population increase may reduce the primary need for necessities; but the very reduction in size of families should increase the demand for better housing and luxury goods.

If the theory of government spending were sound, maintained the budget-balancing school, it should be applicable to all countries. Yet Britain, even before the adoption of the rearmament program achieved a more satisfactory recovery than the United States, while maintaining a practically balanced budget.

In its attack against the "oversavings" thesis, the Committee on Public Debt Policy pointed out that consumer spending habits may be changed by the huge accumulation of liquid assets and the availability of consumer credit. If, for example, people have large backlogs of savings they may, in defiance of the "oversavings" theory, spend their current incomes more freely and also borrow on installment, thus creating an actual excess of spending and inflation. Secondly, the fact is that many other influences enter into demand for capital funds (not just the rate of consumer expenditures), notably the rate at which important new inventions are being developed.

An opposite view is held by Harold G. Moulton. He maintained that the argument that we are confronted with a permanent excess of money savings is based upon a fallacious comparison — that of consumption with

1Ibid., p. 194.


3Committee on Public Debt Policy, op. cit., p. 5.
national income - which takes no account of increasing taxes and their ef-
fect upon savings.¹

Pointed to the need for savings, Professor Slichter stated that today
(1947) the United States is grievously short of plant and equipment. More-
over, for many years the private plant and equipment of the country have
been from one and one-half to two times as large as the annual output of
industry. At the present time plant and equipment are just about the size
of the annual output of industry. The prewar ratio between plant and equip-
ment on one hand and the output of industry on the other may never be re-
stored, but it is safe to estimate that the country is short at least $40
billion of capital and probably much more. The country needs to encourage
the formation of capital, and savings are needed in order to make this pos-
sible.²

The belief that business corporations have in recent years largely
freed themselves from dependence on the capital market grows out of a fail-
ure to differentiate between the replacement of old and the creation of new
plant and equipment.³

The objectionists argued that increased government participation of
private enterprise is not required, that the system of private enterprise
is sufficiently resilient and automatic so that, given the proper political
milieu, the goods produced will find a market at profitable prices.⁴

Despite the basic justification for depression borrowing, it has cer-
tain repercussions which may serve to check the effectiveness of the

¹ Moulton, op. cit., p. 42.
² Committee on Public Debt Policy, op. cit., p. 6.
³ Moulton, op. cit., p. 43.
⁴ Harris, op. cit., p. 7.
recovery program. The greatest danger is purely psychological if the
growth of debt lessens the confidence of the business community in the fu-
ture stability of the government and the economy, private investment will
be discouraged. If private investment is to be forthcoming on an ever-
larger annual scale, argued the optimists, institutional and political
conditions conducive to profitable investment must be maintained. In war
periods, when confidence is good little attention is paid to the growth of
the debt. But in depression, when pessimism is strong anyway, the reaction
to borrowing may be very serious. Businessmen can not be expected to ven-
ture capital on large-scale projects if they feel the political and econ-
omic cards are staked against them. This consideration played a major
role in checking the effectiveness of recovery programs during the thir-
ties. Hence smoothing the institutional channels for the flow of in-
dividual money savings would remove one possible impediment to the effec-
tive operation of the private enterprise, private-investment process.
(This view is also held by Lewis W. Douglas.)

Another possible limitation is the effect of borrowing upon the in-
terest rates; if these rise, some deterring effect would be placed upon

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1 Due, op. cit., p. 537.
3 Due, op. cit.
5 Due, op. cit.
6 Bach, op. cit.
private investment.¹

Furthermore, the advocates who propose Government as a cure for the depression tell us that their method increases individual consumer power, which they claim, in turn creates additional employment. But the greater part of our unemployment unfortunately exists in (heavy goods) industries which the consumer does not buy.²

The second argument of the advocates of government spending is that the government's programme of public works assists the capital-goods industries in which reemployment is most needed. To a certain extent, this is true. But the amount that can be contributed to such industries by any programme of the government is so small that it offers no solution to the problem of unemployment in those industries.³

Referring to the public works of the 1930's, William Hard emphasized the point that these expenditures were not aimed with directness or marksmanship at citizens in distress. They were aimed at citizens in general and at large. In nine years we had approximately $7,000,000,000 in public works - and recovery was still behind the clouds.⁴

Slichter discussed the effect of a program of public works upon the price structure. He stated that it was impossible to spend large sums upon public work construction without affecting certain prices. Consequently, whether public works are intended to peg prices or not, they are a form of indirect price pegging. The fact that the effect on prices is largely

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¹Douglas, op. cit.
²Douglas, op. cit.
³Ibid., p. 411.
unintended and unplanned is itself a source of danger. This is because he regards depressions as reactions to maladjustments between supply and demand which involve maladjustments in price relationships. Consequently, whether or not a program of public construction aggravates or alleviates a depression depends upon whether it reduces or magnifies the original maladjustments in price structure.

Registering a general view, Hard stated that from 1934 to 1939 the Democrats spent over $30,000,000 in respond to the spending-for-recovery "theorists." But more were unemployed in 1939 than in the previous four years.

Another argument advanced in defense of government spending, continued Douglas, is that the deficits incurred by the government build up bank credit which must eventually be used to finance private enterprise. Government deficits, met by the issuance of enormous amounts of Government bonds, do, of course, result in an increase in commercial bank deposits. But this is not the sort of credit that the commercial banking system can properly grant in substantial volume.

It has also been stated that a dollar of expenditure by the government is likely to result initially in a smaller amount of production than will result from a dollar of private expenditure. In private enterprise there

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2 Ibid., p. 38.
3 Ibid., pp. 45-46.
4 Hard, op. cit., p. 4.
5 Douglas, op. cit., p. 537.
is ordinarily a close connection between those who are spending and the
source of the money. This creates a certain amount of caution and care in
the spending of money which is not likely to exist in government spending.¹

A rapid increase in the public debt may produce fear of ultimate in-
flation.² The danger of excessive spending, as regarded by the inflation-
ists, is even greater in that Government will spend too much and finance
unwisely what it does spend, which in turn may impede private investment.
In fact, say the inflationists, we may well end up again having both infla-
tion and unemployment. Hence large government spending should not be used
or counted on to bail the economy out of any widespread tendency toward un-
employment.³

One of the greatest hazards of depression fiscal policy is the danger
that the economy will slip backward again, once the stimulus of fiscal
action is removed, remarked Due. In short, if the recovery by this time
has not become sufficiently self-generating, the withdrawal of the stimulus
will cause a reverse action of the multiplier and the acceleration prin-
ciple.⁴ When the government reduced spending in 1937 and invited private
business to take over, for example, the economic collapse was spectacular.
Government intervention in the crisis weakened the claims of the system of
private enterprise. What began as succor to private business now threaten-
ed to supplant it.⁵

¹National Association of Manufacturers, op. cit., p. 149.
²Slichter, op. cit., p. 44.
⁴Due, op. cit., p. 540.
Recognition of the limitations to investment and recovery suggests consideration of the possibility of attempting to develop depression fiscal policy with a balanced budget, commented Due. Such a program involves equivalent increases in both government expenditures and taxation and relies for its effectiveness upon the validity of the principle that a balanced budget exercises a net expansionary effect upon the economy.¹

Professor Lutz prescribed taxation for a depression remedy. He stated that the doctrine of compensatory spending would no doubt keep the national income from falling in a depression by inflation of purchasing power (due to rise in prices rather than physical volume). But if there is a depression, it means a decline of production. If it becomes necessary to share a smaller total product during a depression, that sharing can be accomplished quite as well by appropriate methods of taxation as by an inflation of purchasing power, for the effects of inflation produce effects similar to those of taxation. The great advantage of using a sales tax, for example, to spread the available purchasing power and thus to enable all to obtain a share of the diminished product in a depression, as against deficit created purchasing power for this purpose, is that there is no aftermath of public debt to impede the subsequent recovery. The depression comes to an end when the incentives to produce are restored, and these incentives become operative when there is a prospect of realizing gain. The public subsidies delay or prevent the adjustment of costs which is essential to the prospect of profitable operation. It is for this reason that pump-priming, once begun, can never be halted without producing a tailspin. The inflation may produce a huge money income, but the standard of living will not advance,

¹Due, op. cit., p. 438.
for only the vital incentives to produce will be drugged by the opiates of government support.\(^1\)

Lutz's emphasis is upon production, sustained when necessary by taxation.

Moreover, the amount of employment that occurs in a depression is largely caused by wage and other rigidities. The attempt to sustain total income by resisting wage revision defeats its own purpose by promoting greater unemployment.\(^2\) Stabilized or rigid wage rates would automatically throw all persons whose services were not worth the fixed wage into unemployment and eventually onto relief.\(^3\) If wages could be promptly revised downward, and if business concerns operated on equity rather than on debt capital, thereby eliminating the rigid cost of interest payments, employment and production could be reasonably well sustained in the face of price changes. When wages and prices go down together, real income is not seriously affected.\(^4\)

On the other hand, if full employment means work for all at such wages as may be determined by equating the supply of labor and the demand for it, we need not be seriously concerned about a depression. The deficits of the 1930's were incurred principally to subsidize wage levels that were unreal and artificial at the time.\(^5\) If we were to create governmental deficits every time unemployment rose above the normal (say, 4) per cent, we would

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\(^1\) Lutz, _op. cit._, pp. 5-6.
\(^2\) Ibid., p. 9.
\(^3\) Ibid., p. 12.
\(^4\) Ibid., p. 11.
\(^5\) Ibid., p. 117.
be operating under a deficit nearly all the time. Moreover, it would be
dangerous constantly to increase the public debt in time of peace when the
prospect of war still hangs over us, because during the time of war further
everous increases always occur. Unless we provide a margin of safety in
peacetime for the war which may occur, we are likely to be in great trouble
if and when such a war breaks out.¹

Furthermore, to use deficit financing in order to drive unemployment
down below 6 per cent is therefore very dangerous. It will tend to do far
more harm through inflation than the good it will do by absorbing some of
those who are unemployed from seasonal and transitional causes. Since
there is no real idle supply of labor below that level, extra money pumped
into the economy by budgetary deficit can not appreciable increase produc-
tion. Probably we should not run a governmental deficit unless employment
exceeds 8 per cent, possibly slightly more than that.²

Simons maintained that a strong argument can be made for continuous
and ultimately drastic reduction, whether to diminish inequality, to stabi-
ize prices and employment, or even to modify the consumption function, not
to mention the specter of increasing federal centralization and the author-
itarian state. Few of our recent social welfare expenditures are suffici-
ently meritorious to justify expansion (save to provide some medical serv-
ices for everyone) or even continuance at recent levels where the alter-
native is reduction of our worst taxes. Their marginal cost, measured in
terms of federal and state excise taxation, is excessively high, since
these levies pump their revenues predominantly from mass consumption from

¹Paul H. Douglas, Economy in the National Government (Chicago, 1952),
pp. 253-254.

²Ibid.
the bottom of the income scale. For the future, we should fashion our 
optional spending in such manner as to avoid and escape large recourse to 
deeply regressive levies. 

He concluded that investment, of course, is the way out; but at some 
level the choice between governmental and private investment is the choice 
between ways of life, individualist and authoritarian. Most of Hansen's 
proposals for public works and public consumption are conservative and com-

mendable; but such proposals can be carried out within a budget balanced 
by taxes and issues, without debt increases, and as rapidly as their best 
execution would permit. Hence we must somewhere allow some savings and 
resources to be wasteful, facing that wastage as a problem of restoring 
free markets and free occupational migration, not glossing it over by more 
spending. 

According to The Atlanta Constitution of July 2, 1959, President 
Eisenhower demanded of Congress (July 1st) not only a budget balance in 
the new fiscal year but a surplus permitting some reduction in the record 
national debt. This action is designed as a guard against "irresponsible 
spending" and "inflation." 

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1Simons, op. cit., p. 212. 
2Ibid., p. 195. 
3"The Calls for Budget Surplus to Reduce Record U. S. Debt," The 
4Ibid.
CHAPTER V

SUMMARY AND CONCLUSIONS

In presenting a critical analysis of Functional Finance, this study resulted in a discussion of two diametrically opposed philosophies with respect to public finance in the Federal Government. On one side were the proponents of Functional Finance advocating a continuously rising debt and a growing national income as a program toward full employment without inflation. On the other side, the opponents adhered to the staunch principle of a constantly balanced budget and the absence of government intervention, particularly on a large scale, except in areas where it would be more advantageous for the government to undertake the responsibility than private enterprise. The former ascribed to increased income, sustained when necessary by deficit financing; the latter emphasized increased production, substantiated by taxation whenever applicable. Under the former there was no danger of a large national debt imperiling the financial stability of the nation as long as the national income was climbing in proportion to the rising interest charges. It was more or less the failure of the two to remain in equilibrium, with the interest charges taking extra strides, that the opponents feared most. Consequently, a major conflict exists in high government with respect to public finance.

The new view is an outgrowth of the disordered economic conditions of the thirties; but it developed to its present form by gradual stages.

Prior to the time and the book by the late John Maynard Keynes, it was generally conceded that labor would be fully employed continuously, and that the techniques of natural resources of the nation would be used most
efficiently, if government kept entirely out of business. And, since only 10 to 15 per cent of the national income flowed through the public economy, scarcely anyone questioned the proposition that the budget should be balanced every year.

The depression of the 1930's, however, showed that the proper adjustment did not take place. The experiences of the same period showed that low interest rates were not effective in securing the most efficient adjustment. Unemployment rose to an all time record (around 13 million); and this necessitated the intervention of the government in the economic life of the country.

The annually balanced budget concept became a gruesome problem, too. The budget could not be balanced; deficits steadily mounted. As a result, talk began to wane around pump priming and compensatory spending. Discussion was soon geared toward a new case for the fiscal policy: what the government can actually and should do for the economy at all times. The fiscal powers both against depression and to check inflation were exploited. But not until the war did full employment occur.

Accordingly, Functional Finance has become the prime doctrine of full employment. Its objective is twofold: the prevention of deflation and of inflation. It ascribes to the employment of the six fiscal powers as a means for bringing about the right adjustment between savings and investment so as to maintain total spending in a manner to avoid both inflation and deflation.

Under Functional Finance the budget should balance itself in the long run, because a natural limit is reached. However, a growing national debt, a balanced budget and the like are considered to be secondary to Functional Finance. This is because Functional Finance views the problem purely
functionally, as a means towards economic stability.

According to Lerner, to sacrifice Functional Finance for the sake of preventing the national debt from growing is to embrace definite economic harm of depression or inflation. Moreover, Professor Buchanan stated that the cost of public expenditures is held to be borne by those individuals living in the initial or "current" time period. Any shifting of the primary real burden of public expenditure over time (even by changing the method of financing) is impossible.

On the other hand, it was reported that the burden of the debt has been growing lighter, even while the actual size of the debt in dollars has expanded. This was attributed to a growing national income and a rising population, while the debt has changed very little. For example, the amount per person of the debt has dropped from $1,832 in 1946 to $1,631 in 1957.

Secondly, Lerner contends that the interest on an internally national debt is not a burden on the nation, since the interest payments are not lost. Chase pointed out that the government does not decrease the nation's purchasing power with the payment of interest, since those who receive the interest could spend the money. Besides, Morgan mentioned that well-advised government expenditures can cause an annual rise in the national income much exceeding the annual rise in interest payments due on the debt that is financing these expenditures, which will make the real burden insignificant. The interest on the public debt amounted to $2.80 in each $100 of national income in 1946 as compared with $2.10 in 1952.

Thirdly, Lerner stated that the nation can not be made "bankrupt" by an internally held debt. This is because the government has the power to create the money necessary to liquidate its obligations. The trouble comes only when the nation falters in the course of its economic expansion or
depletes its men or material.

Since every debt has a corresponding credit, debt in the broad sense is the adverse of investment, according to Lerner and Morgan. Furthermore, Hansen implied that an internal debt has none of the earmarks of an external debt.

With respect to expanding government control, Lerner discussed the law of distribution of income and private property and said that a more equalitarian distribution of income and private property could be applied. Lindholm's statement was that an aggressive fiscal policy need not involve any long-run government control over economic affairs. For Hansen, a modern democracy means a system in which private, voluntary organization functions under general, and mostly indirect, government control. Besides, in a free market economy no single unit is sufficiently powerful to exert any appreciable control over the price mechanism.

It was believed that the essence of an expanding debt existed in Hayes' "oversavings" thesis, Hansen's "mature economy" doctrine, and the independence of industries in freeing themselves largely from the outside methods of financing. These three points were reinforced by Keynes' establishment of a low "propensity to consume" and hence a low volume of investment for private enterprise.

In discussing the role of the United States Government, Hansen stated that the Federal Government should be prepared to play a balancing role, checking any temporary tendency toward an excessive boom and going forward on public improvement projects to compensate for any strong tendency toward deflation. As a proposal, he discussed the shift toward a high consumption economy.

Similarly, Strayer referred to the Employment Act of 1945 for support.
He then questioned the capacity of the states and local governments to continue to expand their basic services without federal assistance, since no new state income taxes have been passed since 1947. Another development of greater interest was the growth of dependence of certain industries upon government orders.

Somers contended that public expenditures tended to cause an upward movement in the national income through the operation of the multiplier principle.

And Keynes viewed the fiscal policy (government spending, taxing, and borrowing) as the most important weapon against unemployment.

In contrast with the proponents, the opponents of Functional Finance challenge the impact of a large national debt, the difficulties associated with interest payments, the desirability of a growing debt, and government intervention; and in lieu of them, they form a case for economy.

Hugh Dalton's case against a large debt is that, as a rule, it worsens distribution and discourages production. For Professor Ratchford, the net effect of a large debt is to reduce consumer buying and to increase savings. Stamp remarked that one of the worst economic consequences of an internal debt is the fact that it is expressed in money, and if the money changes in value, the transaction of wealth from one class of owners to another varies greatly.

On the other hand, Professor Ratchford ruled that an internally-held debt is an economic burden even when taxes are paid to service the debt in the same ratio as the bonds are held, because of the friction of levying and collecting the taxes and because of the difference in the subjective effects of applying taxes and receiving interest.

Variations of the above views were the difficulties associated with the
interest payments. The National Association of Manufacturers expanded on
the point that an advance in interest charges presented much the same prob-
lem of new revenues or reductions in other expenditures as any other new
outlays by the government. An increase in debt charges was therefore often
a threat to the continuance or expansion of federal outlays for various
desirable social services and other governmental activities. Helton dis-
cussed the absence of abundance of confidence and of abundance of peace.
News Week referred to the elements of risk and uncertainty. And Harris ex-
pressed the inflationary effects.

Aside from the burden and interest payments on a growing national
debt, there was strong objection to an expanding debt as being the essence
of prosperity, especially for the period of the thirties.

Due contended that if the stagnation thesis were valid, the government
would be confronted with a task of combating unemployment rather than a
temporary one of stimulating recovery from depression.

The optimists said that whether any investment possibility was avail-
able as a possible outlet for current savings depended on the anticipated
relationship between costs and revenues involved. The Committee on Public
Debt Policy advanced the case of a backlog for consumer and producer demand
which incurred during the war as a means for a large volume of private in-
vestment. Simons' conviction was that investment opportunities have been
nearly limitless (with respect to marginal efficiency under free market con-
ditions). He in turn attributed the plight of investment as being largely
an incident of wholesale restraint on internal trade. As in agreement, the
budget-balancing school insisted that new industries could be established
if the spirit of enterprise existed.

The Committee on Public Debt Policy, Moulton and Slichter attacked the
"oversavings" thesis. The committee pointed out that consumer spending habits may be changed by the huge accumulation of liquid assets and the availability of consumer credit. To Moulton, the argument that we are confronted with a permanent excess of money savings is based upon a fallacious comparison - that of consumption with national income - which takes no account of increasing taxes and their effect upon savings. For Hansen, the United States (in 1947) was grievously short of plant and equipment, at least $40 billion of capital and probably more.

It has been stated that the belief that business corporations have in recent years largely freed themselves from dependence on the capital markets grew out of a failure to differentiate between the replacement of old and the creation of new plant and equipment.

Despite the basic justification for depression borrowing, the opponents inferred that it has certain repercussions which may serve to check the effectiveness of the recovery program. The greatest danger is purely psychological. Another possible limitation is the effect of borrowing upon the interest rate. Still another is that the greater part of our unemployment unfortunately exists in (heavy goods) industries which the consumer does not buy. Fourth, Slichter discussed the effect of a program of public works upon the price structure. And fifth, Hard stated that the bank credit that the government builds up is not the sort of credit that the commercial banking system can properly grant in substantial volume.

Due mentioned that one of the greatest hazards of depression fiscal policy is the danger that the economy will slip backward again, once the stimulus of fiscal action is removed.

Due further stated that the recognition of the limitations to investment and recovery suggested consideration of the possibility of attempting
to develop depression fiscal policy with a balanced budget. Such a program involved equivalent increases in both government expenditures and taxation and relied for its effectiveness upon the validity of the principle that a balanced budget exercised a net expansionary effect upon the economy.

Professor Lutz prescribed taxation for a depression remedy. He stated that the great advantage of using a sales tax, for example, to spread the available purchasing power and thus to enable all to obtain a share of the diminished product in a depression, as against deficit created purchasing power for this purpose, is that there is no aftermath of public debt to impede the subsequent recovery.

On the other hand, Lutz and (Paul) Douglas feel that if full employment means work for all at such wages as may be determined by equating the supply of labor and the demand for it, we need not be seriously concerned about a depression nor unemployment falling below, say, 6 per cent.

Simons maintained that a strong argument can be made for continuous and ultimately drastic reduction, whether to diminish inequality, to stabilise prices and employment, or even to modify the consumption function, not to mention the specter of increasing federal centralisation and the authoritative state. In this respect, he favored a balanced budget by taxes and issues, without debt increases. He therefore stated that we must allow some savings and resources to be wasteful, facing that wastage as a problem of restoring free markets and free occupational migration, not glossing it over by more spending.

To guard against "irresponsible spending" and "inflation," President Eisenhower demanded of Congress (July 1, 1959) not only a balanced budget in the new fiscal year but a surplus permitting some reduction in the record national debt (of $280 billion).
In conclusion, there seems little doubt that the government can affect the level of national income and employment and the general price level, by adjusting its revenues and expenditure policies. Fiscal policy offers the most positive weapon the government has to bring about greater economic stability, with a minimum amount of direct interference in the basic operation of the private enterprise system. On the whole, governments should find it possible to control any peacetime inflationary trends by fiscal policy. However, inflation during an all-out war can not be controlled entirely by fiscal policies, but appropriate tax and borrowing programs can greatly weaken the inflationary pressures and increase the effectiveness of direct control measures.

On the other hand, fiscal programs should aid in bringing about recovery from depression, but they must be planned and managed with great care to avoid offsetting reactions which might prevent attainment of the goals. The greatest problems center around financing and possible adverse effects of government deficits upon the confidence of the business community. Tax reductions have substantial merit as depression fiscal policies, especially because they avoid confidence-destroying and increases in the size of the governmental sphere of the economy. But they provide no assistance to the unemployed and may prove inadequate in a severe depression, and thus must be supplemented by public works and direct relief programs. Substantial aid to economic stability can be provided by adjustment of regular public construction activities in terms of employment conditions and by coordination of state and local construction with federal fiscal programs.

Nevertheless, while fiscal policies offer a greater chance of success than other potential stabilization policies, they can not be expected to produce complete economic stability, regardless of the effectiveness with
which they are executed. Problems of timing and forecasting, unforeseen reactions to the various programs which interfere with their success, and political obstacles are certain to prevent complete attainment of the goals. Fiscal policy must not be regarded as a flexible plan to insure complete stability, but as an instrument which can be used to lessen the severity of economic instability, checking severe price inflation, on the one hand, and aiding the elimination of mass unemployment, on the other. If these objectives alone can be attained, a major step will have been made toward realization of optimum economic welfare.
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