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The title of this note is drawn from Milton Friedman's 1948 article, "A Monetary and Fiscal Framework for Economic Stability", which I've always liked. (Friedman 1948) In that piece, he put forward what he thought was a new proposal according to which the government would run a balanced budget only at full employment, with deficits in recession and surpluses in economic booms. Nothing surprising there-that was incorporated in just about all post-war orthodox thought, until the Democrats decided to become fiscally responsible and advocate permanent budget surpluses come what may.

But what was unusual was Friedman's "proposal" to finance budget deficits through money creation. Surpluses would destroy money. He thus proposed to combine monetary policy and fiscal policy, using the budget to control monetary emission in a countercyclical manner. He also would have eliminated private money creation by banks through a 100% reserve requirement, something that he had picked up from Fisher and Simons, hence, there would be no "net" money creation by private banks-they would only expand the supply of bank money as they accumulated reserves of government-issued money.

This proposal results in strong counter-cyclical forces to help stabilize the economy. He could still be a good Friedmanite, because he could argue that it would be fluctuation of money--not government spending--that stabilized the economy. Further, his plan for countercyclical stimulus is rules-based, not based on discretionary policy.

In principle, there is nothing wrong with his article, except that at bottom it is not a proposal-it is just a description of what really happens (so long as we drop the 100% reserves idea). Abba Lerner called it the "functional finance" and "money as a creature of the state" approach. (Lerner 1943, 1947) When I first studied money and banking, it was still there, at least in an appendix. When government spends, it does so by creating "high powered money" (HPM)-that is, by crediting bank reserves. When it taxes, it destroys HPM, debiting bank reserves. A deficit necessarily leads to a net injection of reserves, that is, to what Friedman called money creation. Stephanie Bell and I have been trying to explain this in a series of articles, but have been making little progress because no one can follow balance sheets any more. (Bell 2000; Wray 1998) They all have come to believe that government finances its spending through taxes, and that deficits force the government to borrow back its own money so that it can spend.

Note that Friedman would have had government deficits and, thus, money emission so long as the economy operated below full employment. Again, that is Abba Lerner's functional finance view, and I suppose it was adopted by just about everyone after WWII. But almost no respectable economist or Democratic politician will today go along with that on the belief it would be inflationary and/or would bust the budget. Such is the sorry state of economics education in the US.

In Friedman's proposal, the size of government would be determined by what the population wanted government to provide. Tax rates would then be set in such a way so as to balance the budget only at full employment. To build in sufficient countercyclical swings to move the economy back to full employment requires two conditions. First, government spending and tax revenues must be strongly cyclical-spending needs to be countercyclical, and taxes pro-cyclical. This implies a strong social safety net so that transfer spending increases sharply in a downturn. Alternatively, or additionally, tax revenues also need to be tied to economic performance-progressive income or sales taxes could do the job.

Second, government needs to be big. Hyman Minsky used to say it needs to be about the same size as overall investment spending-or at least, swings of the budget imbalance have got to be as big as investment swings. According to Minsky, government was far too small in the 1930s to stabilize the economy--even during the height of the New Deal, the federal government was only 10% of GDP. Today, all major OECD nations probably have a government that is big enough. I'll say more about state and local government in a minute because that complicates things. Based on current realities, it looks like the national government can range from the US low of less than 20% of GDP to a high of 50% in France. The countries at the low end of the range need more fluctuation built into the budget.

Looking to the decade of the 1960s in the US, one sees that it was more-or-less Friedmanian. I know those are always called the Keynesian years, but actually they were more consistent with Friedman's proposal than with Keynes's policy prescriptions. Federal government spending ran right around 18-20% of GDP, and deficits ran $4 or $5 billion a year, except for 1968 when they temporarily increased to $25 billion-but for the decade, deficits ran well under 1% of GDP on average. Yes, we could quibble about whether the US was at full employment in the 1960s; I would argue we weren't very close, but I'm in a small minority. On Friedman's 1968 ("natural rate" or "nonaccelerating inflation rate of unemployment") definition, we must have been close. And, yes, one could object that it took a war on two fronts (Viet Nam and Poverty) to get spending up to 20% of GDP, so that might sound a bit more like military Keynesianism than rules-based Friedmanianism. However, the US almost always has at least one war going, so one could counter that the 1960s were not a major deviation from the rule-Americans must like wars, or at least those Americans who formulate policy must like wars because we tend to carve off a fairly large part of GDP to support them.

In fact, military spending was much higher during the 1950s-peaking at 14% of GDP during the Korean War, and it was still at 10% in 1959. Over the 1960s, total defense spending remained a constant 8-9% of GDP, even with the Viet Nam war escalation,

and that fell by half over the 1970s. At the end of the Reagan presidency we got it back up to 6%, but it fell by half again, to 3% by the end of Clinton's term. So compared with the Military Friedmanian 1960s, we lost up to 6% of GDP by cutting military spending and that is not likely to come back, even with the war against terrorism. However, while defense spending fell from 1970, total federal government spending remained fairly constant at close to 20% of GDP, with some cyclical fluctuation, until the late 1990s-so cuts of defense spending were matched by rising social spending.

We encountered three major problems over the course of the post-1970 period. Let me deal with each in turn.

The first is that the budget was not sufficiently countercyclical, and I suspect changes made over the 1970s and 1980s, and even into the 1990s made matters worse. While government spending did swing, typically by about 2% of GDP over the cycle, that was not enough to result in much of a stabilizing influence. As government became increasingly mean-spirited about the safety net, the problem was compounded. Looking at Bush senior's expansion and recession, the total swing of spending as a percent of GDP was only 1%. By contrast, the swing during the recession of 1974-5 had been 1.5%. Over the period, federal tax revenue was never very cyclical, and became less pro-cyclical as we reduced progressivity. During the Reagan recession, federal receipts fell by about 1.5% of GDP; during the Bush recession, receipts fell very slowly, and by a total of only 0.8% of GDP. Still, it is true that deficits grew in the right direction, and remained fairly large as unemployment remained high. Just what Friedman wanted, although not of sufficient size.

What Friedman had not counted on was the growing and persistent trade deficit, reducing the impact of the government's deficit on unemployment. (No particular line of causation is implied, although it seems likely that the foreign desire to accumulate dollar-denominated assets is the underlying cause of our trade deficit.) Recall that Friedman had wanted a balanced budget at full employment, which is fine so long as a nation has balanced trade (and no desire to net save domestically-as we'll see). With a trade deficit, the budget has got to offset it to avoid a domestic private sector deficit. If full employment coincides with a trade deficit of 5% of GDP, then the appropriate budget stance is a deficit of 5% at full employment (ignoring the private sector's desire to run surpluses). Otherwise, full employment is unsustainable-for both flow and stock reasons. At the aggregate level, the private sector balance must equal the public sector balance plus the foreign sector balance. Let me leave state and local government to the side for a second. If the federal government has a balanced budget, and the trade deficit is 5% of GDP, then the private sector must have a deficit of 5% and the outstanding stock of private sector debt will also grow.

Without getting into more details, we can't say for sure whether the private sector's deficit will have to grow faster than its income, or whether the debt-to-income ratio will grow, both of which would make it obvious that this is not sustainable for long. But it is simpler than that. It just isn't conceivable that in the real world, as opposed to a modeled world in which just about anything can happen, that the private sector

will spend more than its income year after year. Even if it is willing to deficit spend for some time, it will eventually want to reverse that so that it can accumulate savings and net wealth. (All the tax advantages bestowed upon savings, as well as loss of faith in Social Security and unbridled optimism about stock returns together enhance the inducement to save.) As the private sector tries to adjust its spending in line with income, the economy drops below full employment and a budget deficit results (and maybe the trade deficit falls). This means that a federal budget that is set to balance at full employment in an economy that runs trade deficits at full employment guarantees that full employment can only be rarely achieved, and only when the private sector runs sustained deficits.

If that isn't convincing enough, we can just look to the historical record. As Wynne Godley has shown and as I've argued elsewhere, the US private sector ran increasingly large deficits during the last half of the 1990's-the first time private savings had ever gone negative. By the end of last year, the private sector deficit actually reached over 6% of GDP (Godley 2002; Wray 2000). By no coincidence, the private sector's debt-to-income ratio also reached an all-time record. These results were guaranteed because of the tendency to run trade deficits whenever the economy grew, as well as by the government budget surplus that grew over the expansion. Things were made worse because the Clinton budget was actually biased to run surpluses at full employment.

Note that even if trade is balanced, we cannot have a private sector surplus unless the government has a deficit. Hence, Friedman's original specification requires no net or "outside" saving or net wealth accumulation by the private sector. All this means that our expectation would be that at full employment, the federal budget ought to be in deficit, and equal to the sum of the private sector's desired net saving (or surplus) plus the trade deficit. Since the mid-1980s that has averaged something like 3-4% of GDP, with an upward trend because of the rising trade deficit (and with strong countercyclical swings, rising sharply in recession and falling in expansion).

Finally, since 1960, state and local governments have grown relative to GDP and relative to the federal government. In 1960, state and local government spending totaled about 40% of federal spending; that is now well over 60%. State and local governments taken as a whole almost always run surpluses. Only in the recession years of 1982, 1991, and 1992 did they run deficits, which isn't surprising, as most states are prohibited from running deficits by both their constitutions and by financial markets that downgrade their debt when they run current account deficits. As a result, during a slowdown, they must raise taxes and/or slash discretionary spending. In fact, they have mostly raised taxes because there isn't much spending that is discretionary.

For example, over the Bush, senior, recession years, from 1990-92 federal receipts rose by 6%, while state and local government receipts rose by 15%. While state and local government spending rose slightly more than 15%, they were able to keep total deficits to less than $10 billion per year. In contrast the federal budget deficit rose from $173 billion to almost $300 billion annually. Because they raise taxes as much as they increase spending in recession, and because state and local governments have regressive tax systems, they do not help to maintain demand in a

countercyclical manner. In fact, they do the opposite. In expansion, they run up surpluses--$50 billion a year by 1999-which makes it even harder to achieve and maintain full employment because private sector deficits have to be that much greater. In other words, because of the different financing situation faced by state and local government, to prevent large deficits from rising, they must raise taxes and/or cut spending precisely when fiscal stimulus is required. Prior to Clinton's welfare reform, they relied mainly on tax hikes so that they could cover needed social spending. This time around, they seem to be mostly cutting spending to avoid deficits.

A lot has changed since Clinton took office-mostly for the worst, so far as Friedman's proposal goes. First, Democrats became fiscally responsible and gave the Republicans what they thought they wanted-a budget that would run huge surpluses at anything approaching full employment. Under Clinton, federal government receipts rose above 20% for the first time since WWII, indeed, receipts nearly reached the 1944 wartime peak. At the same time, federal government spending fell to about 17% of GDP-the lowest since the start of the Viet Nam build-up. Of course, those surpluses were supposed to run as far as the eye could see, enabling the government to retire all debt and then to accumulate trillions of dollars of claims on the private sector. This gave candidate Gore his single campaign issue: a proposal to lock away innocent little ones and zeros from the Fed's computer tapes, to be consumed later by retiring babyboomers. Ironically, this freed Republicans, who quickly disowned fiscal responsibility when they realized it amounted to a peaceful socialist revolution that would result in the government owning everything. So with Greenspan's blessing, they advocated tax relief for the rich as a counter-revolutionary measure to restore budget deficits and rightful ownership to the wealthy.

What can we do to halt the recession and to put the budget on sound, Friedmanian, footing?

First, we need tax relief. The Republicans were mostly right, but didn't carry tax relief far enough-the rich got just about the right amount of tax relief, but the Republican tax cut should have been supplemented with a permanent reduction of the payroll tax by at least a third, and up to a half. (Wray and Tcherneva 2001) I'd also increase the Earned Income Tax Credit, and I support James Galbraith's proposal to increase Grants-in-Aid to states on the condition that they reduce regressive taxes on a dollar-for-dollar basis. The total tax reduction should be in the $200-300 billion per year range.

Let us turn to spending.

When Clinton ended welfare "as we know it", and substituted lifetime limits in TANF, he virtually guaranteed that Federal spending cannot provide a big enough response to a recession. "Lifetime limits" is bad economics and bad social policy. It will shift more of the burden to state and local budgets for the simple reason that communities are not going to stand by and watch families kicked off the TANF roles. In addition to federally subsidized tax relief, I'd provide additional federal aid to encourage state spending. I would make this a permanent program-maybe along

the lines of an infrastructure bill I've been working on that would provide nearly $400 billion of interest free loans for state and local infrastructure projects. (Wray 2001) The bill would build up to that figure, adding $80 billion over each of the next 5 years. The timing of the spending could be made somewhat counter-cyclical. If local unemployment rates are below 1 or 2%, spending would be postponed.

To make the overall budget more countercyclical, and to ensure that jobs will be available when they are needed most, we need an employer of last resort (ELR) program-or, what has been variously called a public service employment program, or a job guarantee. (Forstater 2001; Wray 1998) Enough has been written enough about this that there is no need to go into the details now, but if we look at typical swings of unemployment over the business cycle, we can get some idea of the countercyclical forces of an ELR program. The number of officially unemployed workers swung by about 4 million during the Reagan recession, and by about 3 million during the Bush recession. If we presume that additional federal spending on employing a worker in ELR above average spending on an unemployed worker is about $20,000 each (direct wage costs, benefits, and program costs, less unemployment compensation paid to the small percent of the unemployed that qualify for benefits), we come up with budget swings of $60 to 80 billion in recession.

The actual swing will probably be larger because we know that most people who lose their jobs go out of the labor force. If one looks at the Bush, senior, recession, and takes into account trend growth of the labor force, we were probably short at least 5 million jobs strictly due to the cycle, so ELR countercyclical spending might be as much as $100 billion a year. That is slightly larger than the size of cyclical fluctuations of private fixed investment, so by Minsky's measure, ELR might provide enough of an automatic stabilizer to offset investment fluctuations.

I think we need to build more into the budget because what we used to call autonomous consumption (not geared to income and hence more subject to fluctuation) has become more important. A strengthened social safety net, with some of that taking the form of grants to States, would help. I'd like to see a more progessive tax structure, but the reduction of payroll taxes that I mentioned earlier might be enough.

Friedman was on the right track in 1948. Government deficits do inject HPM into the economy, some of which is drained through Treasury sales of interest-earning government bonds. This allows the private sector to run surpluses-or, net save. Because there are all sorts of reasons to expect the private sector to normally run surpluses, the long term budget stance of government should be biased to run deficits at full employment. If we add to Friedman's insight the recognition that the US will run trade deficits at anything approaching full employment, the case for a "permanent" budget deficit is strengthened. By the same token, the notion that the federal government ought to aim for persistent surpluses is exposed as a huge backward step in thinking. ◆

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