

FISCAL CONTRACTION AND ECONOMIC EXPANSION: THE 2013 SEQUESTER AND POST–WORLD WAR II SPENDING CUTS

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Proposals for government spending cuts are almost always accompanied by doomsday predictions from Keynesian-influenced economists. For example, Richard K. Vedder documents that when the Second World War ended in 1945, Keynesians loudly declared that if government spending declined, the economy would return to the Depression-era conditions of the 1930s (Vedder and Gallaway 1991, 1998; Taylor and Vedder 2010). In fact, the government’s role in the U.S. economy declined dramatically as government spending went from 41.8 percent of GDP in 1945 to only 17.9 percent in 1946. Furthermore, over 9 million military personnel returned to civilian economic life and millions of civilian jobs related to the war effort disappeared. In anticipation of these cuts, the consensus forecast was that the unemployment rate would return to the double-digit numbers of the 1930s. Yet, despite the large government contraction, unemployment was less than 2.3 million, or a rate of 3.9 percent, in 1946, and 2.6 million, or a rate of 4.4 percent, in 1947—achieving “full employment,” as defined by economists. As Taylor and Vedder (2010: 6) note, “The ‘Depression of 1946’ may be one of the most widely predicted events that never happened in American history.”

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A similar episode occurred in 2012 and 2013 when government spending cuts associated with the Budget Control Act (BCA) of 2011 and the sequester were implemented. It was widely predicted that if the sequester's across-the-board cuts in federal spending were executed, the economy would be thrown back into those conditions seen in the Great Recession of 2007–09, or worse. Yet, as was the case in 1946, significant cuts occurred despite these dire warnings. Nominal government spending fell in both 2012 and 2013—the first time that government spending had fallen two years in a row since the 1950s. Once again the dire predictions did not come to pass. Monthly employment numbers grew at a faster rate after the spending cuts than they had prior to them, and GDP grew at around the same pace pre- and postcuts. The “sequester-induced contraction of 2013,” which was a major part of the ominous sounding “fiscal cliff” over which the country was supposedly going to topple, was—like the post-WWII government contraction—another of the most widely predicted events in U.S. history to never happen. This paper compares these two episodes and looks for policy lessons.

World War II Spending Cuts: Fear of the Depression's Return

By the outbreak of war in Europe in late 1939, President Franklin Roosevelt's New Deal economic programs had been in place for nearly seven years with only limited success at ending the Great Depression. While unemployment was lower than it was in 1933, many contemporaries viewed this reduction as being the product of government relief jobs rather than a bona fide, permanent recovery. Government employment via Depression-era agencies like the Works Progress Administration, it appeared to some, would have to remain part of the economic landscape indefinitely. In fact, Bateman and Taylor (2003) show that this fear caused long-term economic goals to continue to be a large part of the objectives of New Deal “alphabet agencies” even after the nation entered the Second World War.

Between 1942 and mid-1945, the United States was essentially a command economy and unemployment practically disappeared.¹

¹For a thorough discussion of the U.S. mobilization for WWII, see Koistinen (2004) and Vatter (1985).

FISCAL CONTRACTION AND ECONOMIC EXPANSION

The Controlled Materials Plan, introduced in November 1942, was created and operated inside the War Production Board to harness the production capacity of the nation for military purposes. The Office of Price Administration rationed or restricted consumer durables like automobiles and office chairs with metal frames. Labor was also commandeered or otherwise directed by the federal government into military purposes. The Selective Service registered and drafted citizens into the military, while the Employment Service and the War Manpower Commission used incentives to mobilize and employ labor into jobs of highest military priority. At its peak, the war effort supported 45 percent of the nation's civilian labor supply, while another 12 million citizens, representing around 18 percent of the total (military plus civilian) labor force, were employed directly by the military (U.S. Bureau of the Budget 1946). The unemployment rate fell below 2 percent as the United States went from a dramatic labor surplus in the 1930s to a labor shortage during the war.

In light of all this, it is easy to understand why policymakers so feared that a rapid transition from the command-oriented economy described above to a market-oriented one following the war would bring back high unemployment. If the war ended the Depression, what would the end of the war bring? As the war ended after the Japanese surrender in mid-August 1945, the National Resource Planning Board predicted that over the next year, unemployment would rise to between eight and nine million, representing 12 to 14 percent of the labor force. John Snyder, director of the Office of War Mobilization and Reconversion, submitted a report in which he forecast that eight million people would be unemployed by the spring of 1946 (U.S. Office of War Mobilization and Reconversion 1945: 5). The press followed suit as the September 1, 1945, issue of *Business Week* predicted that unemployment would peak "closer to 9,000,000 than 8,000,000."² These predictions were relatively optimistic compared to some others. Leo Cherne of the Research Institute of America and Boris Shishkin, an economist for the American Federation of Labor, predicted 19 and 20 million unemployed, respectively, which would have translated to an unemployment rate around 35 percent (Ballard 1983: 17–18).

²Quoted in Vedder and Gallaway (1993: 162).

Even in the face of these dire warnings, within six weeks of the Japanese surrender, the Controlled Materials Plan was, with a few exceptions, ended so that resource allocation was once again left to the private sector. Furthermore, Ballard (1983: 135) notes that by the end of 1945, 80 percent of all war contracts had been settled. Despite the massive decrease in government production and the discharge of over 10 million men and women, who had been employed directly by the military either as soldiers or civilian workers, into the private sector, the postwar unemployment problem did not materialize. Table 1, which provides key labor force and employment data for 1939 to 1950, shows that as the government withdrew, the private sector grew. Vedder and Gallaway (1993: 171) refer to this as a “classic case of ‘reverse crowding out.’” The smooth transition of labor resources from government-directed to market-directed production was viewed as a miraculous event. Vedder and Gallaway (1993: 158) write, “We know of no other episode in American economic history that more clearly illustrates several neoclassical and Austrian economic insights than” the postwar transition.

TABLE 1
CIVILIAN LABOR FORCE, EMPLOYMENT, AND
UNEMPLOYMENT (IN THOUSANDS),
1939–1950

Year	Civilian Labor Force	Employed	Unemployed	Unemployment Percentage
1939	55,218	48,993	6,225	11.3%
1940	55,640	50,350	5,290	9.5%
1941	55,910	52,559	3,351	6.0%
1942	56,410	54,664	1,746	3.1%
1943	55,540	54,555	985	1.8%
1944	54,630	53,960	670	1.2%
1945	53,860	52,820	1,040	1.9%
1946	57,520	55,250	2,270	3.9%
1947	59,682	57,053	2,629	4.4%
1948	60,621	58,358	2,263	3.7%
1949	61,315	57,683	3,632	5.9%
1950	62,079	58,892	3,187	5.1%

SOURCE: Carter (2006).

The Post–Great Recession Era and the Government Spending Sequester

In 2008, the federal government began to take extraordinary steps in an effort to combat the “Great Recession.” President George W. Bush signed the Keynesian-oriented, \$152 billion Economic Stimulus Act of 2008, which sent checks to U.S. households in hopes that the country could spend its way out of the downturn. In 2009, President Barack Obama outdid the Bush stimulus by more than a factor of five with the American Recovery and Reinvestment Act—an \$831 billion stimulus consisting of tax rebate checks, infrastructure spending, and smaller amounts of spending on health, education, and renewable energy, among other categories. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 brought another \$916.8 billion in stimulus by prolonging the Bush tax cuts, cutting payroll taxes, and extending unemployment coverage. The Middle Class Tax Relief and Job Creation Act of 2012 extended the payroll tax cut provisions, which was said to create another \$167.6 billion in stimulus. Of course, it could be argued that extending tax reductions already in place is not true stimulus so much as an avoidance of contractionary policy. All told, however, the major and minor stimulus legislation from 2008 to 2012 amounted to over \$2 trillion in new federal spending and tax rates below what they would otherwise have been (Firey 2012).

In light of these actions, the federal budget deficit averaged nearly \$1.3 trillion between 2009 and 2012, adding over \$5 trillion to the national debt in just four years (U.S. Office of Management and Budget 2014a). Given this quick buildup, the government had to raise its authorized debt ceiling or face default. As it happens, the government actually hit this ceiling in May 2011, but the Treasury was able to employ some extraordinary measures to avoid an immediate crunch. The stated deadline at which the United States would default on its debt payments unless Congress raised the debt ceiling was August 2, 2011.

Republicans, who had won control of the House of Representatives in 2010, insisted that any increase in the debt ceiling be accompanied by spending cuts. Representative William Shuster declared, “We are in a spending-driven debt crisis. Washington is spending money it doesn’t have, and it’s leaving the American

people, our children and our grandchildren, with the tab.”³ After a long standoff, on August 2, the Budget Control Act of 2011 was passed. The BCA granted an immediate increase of the debt ceiling by \$400 billion, and another \$500 billion would be added to the debt ceiling in September unless it was explicitly disapproved by Congress. The president could further request the debt ceiling be raised another \$1.2–\$1.5 trillion in 2012. In exchange for the \$900 billion increase in the debt ceiling, federal spending had to be cut by \$917 billion over the next decade, and the first installment of these cuts had to begin in the 2012 fiscal year. Furthermore, a new committee, the Joint Select Committee on Deficit Reduction, better known as the “supercommittee,” would be created with the task of identifying and proposing \$1.5 trillion in deficit reduction measures by November 23, 2011. The committee’s recommendation would go to Congress, without any amendments, for an up-or-down vote no later than December 23, 2011.

Importantly, Congress was strongly incentivized to vote in favor of the committee’s proposed deficit reduction measures because a “trigger” mechanism was included in the BCA, which stated that if the \$1.5 trillion in deficit reduction was not passed by December 23, 2011, \$1.2 trillion in automatic, largely across-the-board spending cuts would go into effect, in exchange for an additional \$1.2 trillion increase in the debt ceiling. This so-called “sequestration” would apply to any nonexempt account of the federal government and would be split evenly between defense and nondefense discretionary spending. The legislation went on to list the various caps in new spending that would be allowed for different government accounts. If caps were exceeded, sequestration would occur to bring spending down to the cap. The trigger was not set to go off until January 2013—conveniently after the fall 2012 elections—at which point \$110 billion of automatic spending cuts would be implemented.

The supercommittee, which consisted of six Democrats and six Republicans and was co-chaired by Republican Jeb Hensarling and Democrat Patty Murray, announced on November 21, 2011, that “After months of hard work and intense deliberations, we have come to the conclusion today that it will not be possible to make any bipartisan agreement available to the public before the committee’s

³Rep. William Shuster (R-Pa.), *Congressional Record* 157 (110), July 21, 2011.

deadline” (Joint Select Committee on Deficit Reduction 2011). With no recommendation for Congress to vote upon, the automatic cuts of the sequester would be enacted starting January 2, 2013.

The sequester’s start date happened to coincide with several other “contractionary” fiscal policy measures. Among them was the scheduled expiration of the marginal tax rate cuts put in place in 2001 and 2003 under Bush. While these were initially to expire in 2010, they were temporarily extended by Obama’s aforementioned 2010 stimulus. Additionally, a 2 percent reduction in the payroll (Social Security) tax was set to expire on January 1, 2013, as were extended unemployment benefits. The Alternative Minimum Tax (AMT) was also scheduled to revert back to its 2000 tax year levels. The simultaneous timing of all these tax increases and spending cuts became known as the “fiscal cliff”—this ominous name coming from Ben Bernanke, then chairman of the Federal Reserve (Kurtz 2012).

In early June 2012, Representative Gerry Connolly, a Democrat, shamed the Republicans for not working with his party, saying that failure to act would bring “economic calamity [and] will send America back into a recession.”⁴ The lack of a plan to tackle the spending cuts gained prominence as the 2012 presidential election neared. In response to President Obama’s declaration that he would veto any measures that would avoid sequestration and the fiscal cliff that were not to his liking, Republican presidential nominee Mitt Romney said Obama’s “approach would let our economy sink into recession for the sake of pursuing job-killing tax increases” (Politi 2012).

Obama won re-election in November 2012, at which point less than two months remained before the nation was due to plunge over the fiscal cliff. Bernanke urged Congress to make progress in solving the looming crises, saying, “It will be critical that fiscal policy makers come together soon to achieve longer-term fiscal sustainability, without adopting policies that could derail the ongoing recovery” (Bernanke 2012). The parameters of the debate were simple. Republicans wanted deficit reduction through spending cuts while Obama and the Democrats wanted to achieve deficit reduction by raising taxes on the wealthiest 2 percent of taxpayers. When Obama delivered his opening offer to the Republicans in the negotiations over avoiding the fiscal cliff—an offer that included \$1.6 trillion of tax increases on the rich and very little in the way of

⁴Rep. Gerry Connolly (D-Va.), *Congressional Record* 158 (86), June 8, 2012.

spending cuts—Republican Speaker of the House John Boehner said, “Listen, this is not a game. Jobs are on the line. The American economy is on the line” (Burlij and Polantz 2012). Republican Congressman Joe Wilson insisted that Democrats and Republicans had to negotiate a settlement to avoid the sequester: “This important issue must be addressed [before it] devastates national security and destroys 700,000 jobs.”⁵ Democratic Senator Bill Nelson of Florida insisted that all that needed to be done was to “recognize that the President won [the election], produce revenue with the upper 2 percent paying a little more, and eliminate sequestration.”⁶

The Senate and the House passed the American Taxpayer Relief Act (ATRA) of 2012 on January 1, 2013, and President Obama signed the bill into law the next day, thus averting at least some of the fiscal cliff. The two primary issues addressed in the legislation were the expiration of the Bush tax cuts and the coming sequestration. The ATRA made the marginal income tax cuts of 2001 and 2003 permanent for all but the top 2 percent of taxpayers, who saw their marginal rate rise from 35 to 39.6 percent. Second, ATRA delayed the implementation of the sequester until March 1, 2013, in hopes that an agreement might be reached that could replace the blunt, across-the-board approach of the sequester with a program of more targeted cuts. Congressional Budget Office (CBO) Director Rudolph Penner noted that ATRA had “reduced the probability of recession quite a bit,” but that Congress and the White House “gave us a New Year’s Eve present of another cliff in two months” (Sahadi 2013).

Predictions of Doom if Sequester Deal Not Reached

In the first few weeks of 2013, estimates of the impact of the sequester varied, though most of them were highly negative in outlook. Third Way published projections that claimed that by the end of 2014, “the U.S. economy will provide 1.9 million fewer jobs . . . the pain will reach all states and all sectors, most deeply affecting public investments” (Brown 2013). CBO said that assuming the sequester occurs, “economic activity will expand slowly this year [2013], with real GDP growing by just 1.4 percent.” The fourth quarter unemployment rate in 2013 was predicted by the CBO to rise to 8 percent, from its level of 7.5 percent at the time (Congressional Budget Office

⁵Rep. Joe Wilson (R-S.C.), *Congressional Record* 158 (164), December 19, 2012.

⁶Sen. Bill Nelson (D-Fla.), *Congressional Record* 158 (160), December 12, 2012.

2013). On February 13, 2013, the day the CBO report was released, Director Douglas Elmendorf testified before Congress that real GDP growth “would increase 1.5 percentage points faster were it not for fiscal tightening” (Elmendorf 2013). Janet Yellen, then vice-chairwoman of the Federal Reserve, also expressed displeasure with the fiscal tightening: “Discretionary fiscal policy hasn’t been much of a tailwind during this recovery [but instead] has actually acted to restrain the recovery. . . . I expect that discretionary fiscal policy will continue to be a headwind for the recovery for some time” (Yellen 2013). Paul Krugman highlighted studies predicting that the economy would lose 700,000 jobs in 2013 due to the sequester, prompting him to argue that “we should be spending more, not less, until we’re close to full employment; the sequester is exactly what the doctor didn’t order” (Krugman 2013).

Still, not all commentary on the coming sequester was grave. *Reason* magazine editor-in-chief Matt Welch wrote that “taxpayers shouldn’t be fearing the forced spending cuts, they should be fearing that the cuts don’t go nearly far enough” (Welch 2013). The *Wall Street Journal* (2013) published an opinion piece claiming: “The sequester will help the economy by leaving more capital for private investment. . . . From 1992–2000 Democrat Bill Clinton and (after 1994) a Republican Congress oversaw budgets that cut federal outlays to 18.2 percent from 22.1 percent of GDP. These were years of rapid growth in production and incomes.”

In the political sphere, the rhetoric surrounding the sequester drowned out almost every other issue of the day. President Obama characterized the cuts as being particularly harmful to the middle class, and in one of his weekly YouTube addresses said, “It’s important to understand that, while not everyone will feel the pain of these cuts right away, the pain will be real. . . . Economists estimate they could eventually cost us more than 750,000 jobs and slow our economy by over one-half of one percent” (White House 2013). Those dire claims were echoed by Congress as well. Representative Dan Kildee lambasted Republicans, saying that they were “willing to pink-slip 750,000 American workers just to protect billions of dollars in handouts for . . . five big oil companies.”⁷ One week later, Democratic Senator Barbara Boxer wondered how we arrived at “a place where we are having

⁷Rep. Dan Kildee (D-Mich.), *Congressional Record* 159 (27), February 26, 2013.

mindless, across-the-board cuts in spending with absolutely no thought.”⁸ Many Republicans also expressed disgust with the nontargeted nature of the sequester. Speaker John Boehner called the sequester “an ugly and dangerous way” to achieve the necessary spending cuts (Boehner 2013).

This time there was no 11th hour agreement. On March 1, 2013, \$85 billion of federal spending was sequestered. The Office of Management and Budget (OMB) estimated that sequestration would require a 7.8 percent cut in nonexempt defense spending; a 5 percent cut in nonexempt, nondefense funding; and a 2 percent cut in Medicare. Furthermore, because these cuts had to be achieved in just seven months (prior to the close of the fiscal year on September 30), the effective reduction was approximately 13 percent for defense and 9 percent for nondefense programs. In his cover letter to the speaker of the house announcing sequestration, OMB Deputy Director Jeffrey Zients chastised Republicans for creating such a doomsday device and not having the foresight to avoid its activation, writing that “sequestration is a blunt and indiscriminant instrument. It was never intended to be implemented and does not represent a responsible way for our Nation to achieve deficit reduction” (U.S. Office of Management and Budget 2014b).

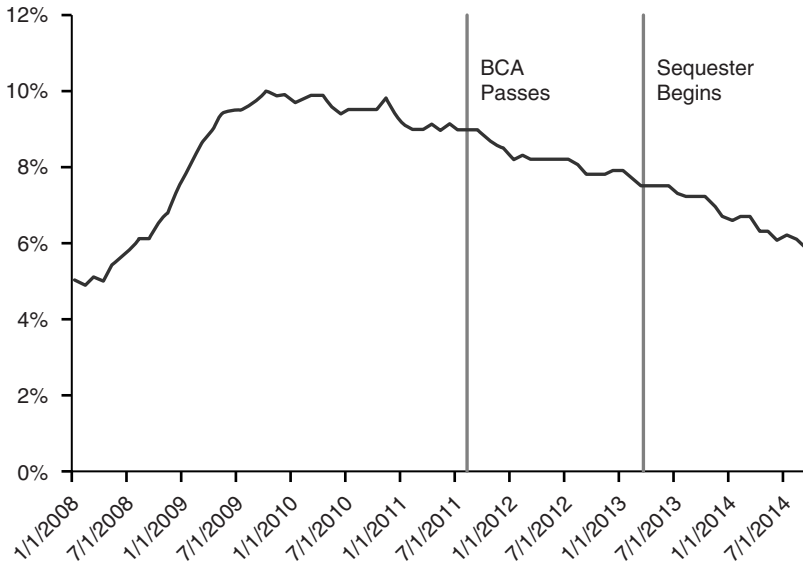
Postsequester Data

Were the dire predictions of economic Armageddon correct? As noted earlier, federal spending fell in nominal terms in both 2012 and 2013—the first time since the end of the Korean War that spending fell two years in a row. Spending did rise a bit in fiscal year 2014. For the purposes of this study, we will focus on the movement of key economic variables in the 18 months either side of the sequester’s implementation.

In October 2014, the unemployment rate was 5.9 percent compared to a level of 7.5 percent in April 2013 when the sequester was implemented. The decline of 1.6 percentage points in 18 months is actually larger than the decline during the prior 18 months—November 2011 to April 2013—when it fell from 8.6 to 7.5 percent. In comparison with the CBO’s projections of a rate of 8 percent at the end of 2013, unemployment actually ended 2013 at 6.7 percent.

⁸Sen. Barbara Boxer (D-Calif.), *Congressional Record* 159 (30), March 4, 2013.

FIGURE 1
UNEMPLOYMENT RATE: BCA AND SEQUESTER



NOTE: BCA = Budget Control Act.
SOURCE: Research.stlouisfed.org.

Figure 1 shows the unemployment rate between 2008 and 2014, highlighting the dates of the passage of the Budget Control Act and the implementation of the sequester.

Examinations of quarterly GDP growth also show no signs of a sequester-induced slowdown. The economy grew at only 0.1 percent in the fourth quarter of 2012—the final quarter before the sequester took effect. Growth was 1.1 percent in the first quarter of 2013—the sequester took effect two-thirds of the way through this quarter. Growth then accelerated in the immediate postsequester quarters to 2.5, 4.1, and 2.6 percent—and real GDP growth for 2013 was 1.9 percent, about half a percentage point higher than what the CBO had predicted it would be in light of the sequester.

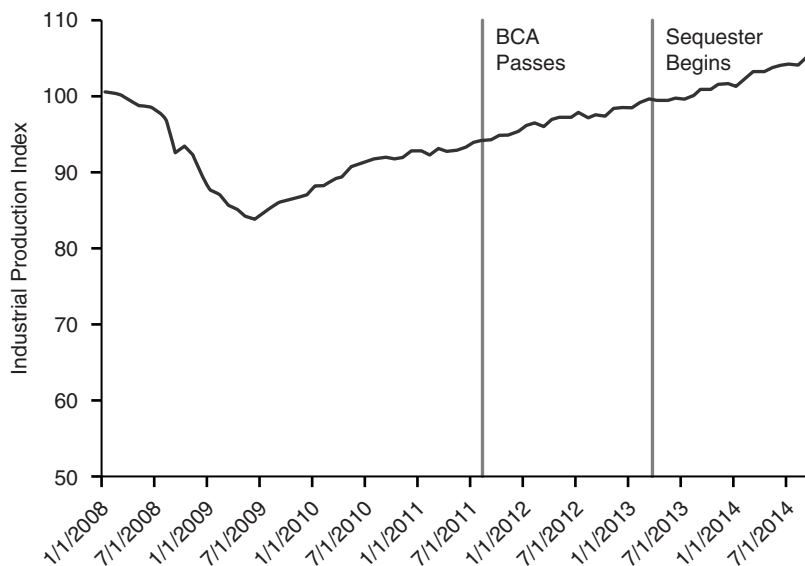
GDP tumbled 2.1 percent in the first quarter of 2014, despite the fact that labor force participation was up from the previous quarter, while the average monthly unemployment rate was lower. Clearly the decline was not caused by fiscal contraction, as federal spending actually rose 0.6 percent during the quarter after falling by an average of

6.1 percent during the prior four quarters. Many have blamed that low GDP growth number on a very harsh winter. The drop could also have been caused in part by the Federal Reserve announcement in December 2013 that it was going to reduce the size of its asset purchases, and the subsequent 1,000 point drop in the Dow Jones Industrial Average over the following month. Still, the second and third quarters of 2014 experienced impressive growth rates of 4.6 and 3.5 percent, respectively, so that the notion that the first quarter contraction was caused by the sequester does not seem viable.

Industrial production, shown in Figure 2, also continued to climb unabated by the sequester. In the 18 months prior to the sequester, from September 2011 until March 2013, the industrial production index grew by 5.5 percent; in the following 18 months, from the sequester until September 2014, it grew by 5.6 percent.

In the months leading up to the implementation of the sequester, it was suggested that hundreds of thousands, or even millions of

FIGURE 2
INDUSTRIAL PRODUCTION INDEX, INDEX 2007=100,
MONTHLY, SEASONALLY ADJUSTED



NOTE: BCA = Budget Control Act.

SOURCE: Research.stlouisfed.org.

government workers would lose their livelihood. In fact, according to the Government Accountability Office, only one government employee, who was employed by the Department of Justice, lost his job as a result of the sequester (U.S. Government Accountability Office 2014). There were, of course, furloughs of around 770,000 employees from various government agencies. But while many predicted that these could go on for weeks, none of the furloughs actually lasted more than six days.

By mid-2013, the media began to report how wrong politicians' predictions just a few months earlier had been. *Washington Post* reporters Fahrenthold and Rein (2013) listed 48 dire predictions about the sequester's impact, such as long waits in airport security and border crossings and 600,000 low-income Americans being denied federal food aid. Less than a quarter of these predictions came to pass. In most cases, agencies found ways to make things work with less by moving resources around. For example, the authors note that the U.S. Geological Survey said that the sequester would require them to shut off 350 gauges used to predict impending floods. In fact, only 90 were shut off as the agency cut other budget items like conference expenses; it sent only 350 of its scientists to conferences in 2013 as opposed to the 469 it had sent the year prior. Similarly, Fahrenthold and Rein note that the U.S. Park Police said all of its officers would have to be furloughed for 12 days should the sequester occur. In fact, the National Park Service found \$4 million in savings in its budget, so that only three furlough days were required. Fahrenthold and Rein's article can be summed up by a quote from their interview with Robert Bixby of the Concord Coalition: "The dog barked. But it didn't bite."

President Obama's 2014 budget contained enough cuts that federal spending would fall under the caps on both defense and non-defense discretionary spending. Thus the Office of Management and Budget determined that sequestration was not needed for the 2014 fiscal year (Clark 2014). Furthermore, projections regarding the nation's economy and budget in coming years are generally positive. In a June 2014 press conference, Federal Reserve Chairwoman Janet Yellen displayed projections showing 2015 real GDP growth above 3 percent, and unemployment falling below 6 percent by the end of 2015—despite budget cuts (Yellen 2014). In fact, unemployment fell below 6 percent in October 2014, and stood at 5.1 percent, right around the natural rate of unemployment, as this issue went to press.

Likewise, the CBO's January 2015 projections for GDP growth were generally optimistic, suggesting that the economy would grow at a "solid pace in 2015 and for the next few years," while the gap between actual and potential output would be closed by 2017 (Congressional Budget Office 2015).

Federal Spending and the Economy

This article has documented two cases in which it was widely predicted that a contraction of government spending would bring economic ruin. In neither case did this prediction come to pass. It has been argued that one of the reasons a major downturn was avoided in the post-WWII era was because of pent-up demand—after several years of rationing of private sector goods during the war, people were ready, and had the means, to spend. To the extent that this is true, the postsequester period offers a more difficult test of the market's ability to flourish in an era of government contraction. On the other hand, it could be argued that the Federal Reserve's aggressive monetary policy in the years after the Great Recession created tailwinds that helped the economy avoid a sequester-induced downturn. But the world rarely provides policy experiments in a perfect vacuum. In any case, numerous econometric studies, which attempt to hold other factors constant, have found that fiscal policy shocks have little or no effect on output and employment, and sometimes even have a perverse effect (see Landau 1983, Conte and Darrat 1988, Grier and Tullock 1989, Rao 1989, Barro 1991, Christopoulos and Tsionas 2002, Afonso and Furceri 2010, and Wang and Abrams 2011).

One straightforward explanation of why steep declines in government spending in both 1946 and 2013 did not result in economic disaster is that that excessive government spending—as may be said to have occurred in the lead-ups to both these episodes—does not stimulate the economy, but rather crowds out private sector spending. Between 1942 and 1945, government deficits were around 25 percent of GDP and total federal outlays were around 42 percent of GDP. Between 2009 and 2012, deficits were around 10 percent of GDP and total federal outlays were over 24 percent of GDP—both of these measures were at their highest levels since WWII.

Some government spending is certainly necessary in order for the economy to reach its full potential, and during times of war, one would expect government to play a larger role in the economy.

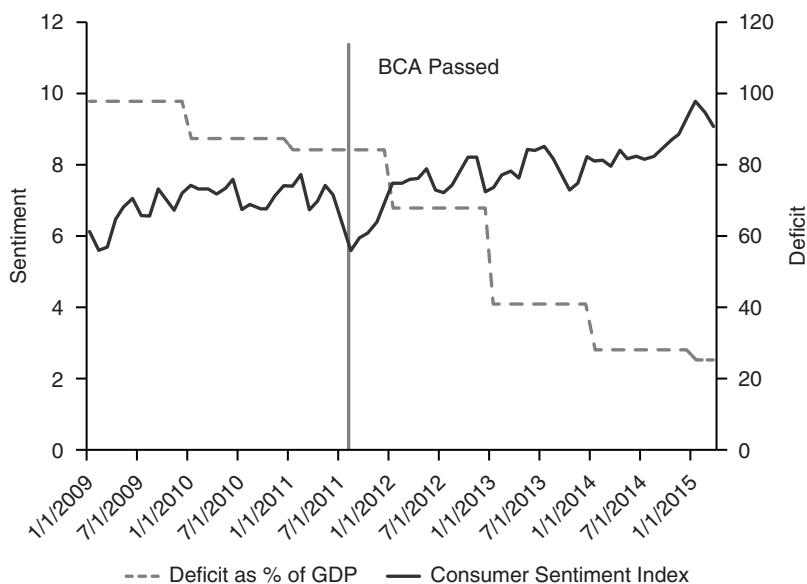
Vedder and Gallaway (1998: 2) note that “In a world without government, there is no rule of law, and no protection of property rights. . . . There is little incentive to save or invest because the threat of expropriation is real and constant.” But they claim that government is subject to diminishing, and at some point, negative returns. Vedder and Gallaway’s (1998) empirical analysis estimates that the optimal level of federal spending in the United States—in terms of its impact on aggregate output—is around 17.5 percent of GDP. The nation approached this value in the years around the turn of the 21st century, when federal spending was just above 18 percent of GDP. When spending as a percentage of GDP exceeds this level—as was the case around 1945 and again in 2012—cuts in spending do not hurt, but rather help the economy.

A second, and related, potential explanation for the economy’s resilience in the face of dramatic cuts in government spending after both WWII and the sequester of 2013 comes from the theory of “Expansionary Fiscal Contraction.” Giavazzi and Pagano (1990) were among the first to formally argue that, under certain conditions, government spending cuts could stimulate the economy. Sometimes called the “German View,” this theory relies heavily on expectations and the effects that deficits can have on them. In particular, if agents become concerned that large government deficits could lead to higher interest rates or national default, they may cut back on current period consumption and domestic investment. If cuts in government spending boost confidence in economic actors, this could act as a stimulus. Alesina and Ardagna (1998) and Ardagna (2004) provide empirical case study evidence that fiscal contraction can indeed be expansionary.

Figure 3 shows movements in the University of Michigan’s Index of Consumer Sentiment in the months around the sequester.⁹ At the passage of the Budget Control Act of 2011, consumer sentiment was at the lowest it had been since November 2008—this was very likely related to a fear of government default, which politicians kept highlighting. Consumer sentiment rose quickly after passage of the BCA and it has continued a slow, albeit uneven, rise since then. While sentiment has risen, the budget

⁹The deficit is calculated as a percentage of GDP using annual deficit data and quarterly GDP data.

FIGURE 3
SENTIMENT (LEFT AXIS) vs. DEFICIT (RIGHT AXIS)



NOTE: BCA = Budget Control Act.
SOURCES: Congressional Budget Office (2015) and Research.stlouisfed.org.

deficit as a percentage of GDP has declined sharply. Clearly, many other factors affect sentiment besides the deficit, but Figure 3 offers some evidence consistent with the theory of expansionary fiscal contraction.

Conclusion

In several different writings, Richard Vedder and his various coauthors have highlighted the full employment post–World War II transition as strong evidence that markets can respond well to fiscal contraction—“No other episode more clearly supports the notion that the best economic stimulus is for government to get out of the way” (Taylor and Vedder 2010: 6). Still, when those government cuts were taking place, Keynesians predicted an economic bloodbath. While most mainstream predictions were for unemployment to jump to 14 percent in 1946 should the government dramatically cut spending and hand over resources to the private sector, some pundits had this measure rising to around

30 percent. In fact, despite government spending falling from around 42 percent of GDP in 1945 to under 25 percent in 1946 and under 15 percent in 1947, unemployment remained below 5 percent throughout the period.

This article has explored parallels between the post–World War II fiscal contraction and the fiscal contraction brought about by the Budget Control Act of 2011 and one of its creations, the sequester, which was implemented in March 2013. Like 1945, predictions by politicians, government forecasters, and the media were for a dramatically negative economic effect. The sequester was to cause GDP to grow 1.5 percent slower than would otherwise be the case, unemployment would rise to over 8 percent, and employment would fall by 1.9 million. Despite these warnings, nominal federal spending fell in 2012 and 2013—the first time the United States has seen two consecutive years of declining government spending in nearly six decades. And yet it turned out that GDP grew faster and the unemployment rate fell more quickly in the 18 months after the sequester went into effect than it did in the 18 months that preceded it. Once again, Keynesian predictions of Armageddon when government spending falls back toward its optimal level were shown to be wrong. The sequester episode provides further support for Vedder’s view that cuts in government spending toward their optimal level—around 17.5 percent of GDP—do not harm, but actually help, the economy.

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