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ALVIN H. HANSEN'S CONTRIBUTIONS TO BUSINESS CYCLE ANALYSIS

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Abstract

Alvin H. Hansen (1886-1895) approached business cycle analysis broadly from the theoretical, statistical, structural, and historic views. From an orthodox position that gave primary emphasis to investment fluctuations he became the leading protagonist of the Keynesian analysis in the United States, extending and stimulating its application to business cycle analysis and stabilization policy. The development of compensatory fiscal policy as a complement to monetary policy received was given great impetus by his work.

ALVIN H. HANSEN'S CONTRIBUTIONS

TO BUSINESS CYCLE ANALSYSIS

Alvin H. Hansen was a student of business cycles throughout his professional life, building his broad view of them on theoretical, statistical, structural and historical studies. He applied his findings to policy with such effect that "no American economist was more important for the historic redirection of United States macroeconomic policy from 1935 to 1965." [Tobin (1976) 32] Trained at the University of Wisconsin, he spent the bulk of his professional life at the Universities of Minnesota and Harvard, where he achieved his greatest fame.

1. His first major monograph, *Business-Cycle Theory: Its Development and Present Status* (1927), concluded that the primary disturbances initiating cycles were such external forces as technological developments, territorial and population changes, and alterations in the accessibility of natural resources, factors which raised profit expectations relative to interest costs and induced real investment. This view placed Hansen with such cycle theorists as Schumpeter, Cassell, Wicksell, Spiethoff, and Robertson who viewed investment fluctuations as the primary determinant of business cycles.

These external initiating factors gave rise to a cumulative process of induced spending (enhanced for capital goods by the accelerator) and expanded income that increased by Say's law without limit until constrained by such external factors as diminishing returns, factor-supply limitations, and shortages of credit (financial crises, such as in 1907, often terminated booms up to that time), which would generate a downturn in the demand for capital goods. A cumulative downward process would then be set in motion until revived by some external factor, and the game would start over again. [Hansen (1927) Chap. 8]

Hansen was not persuaded that the cycle was self perpetuating, believing that it required external shocks to continue the attenuating fluctuations. Moreover, he suspected that the major disturbing forces of the previous 150 years--exploitation of new resources, revolutionary technical changes, agricultural fluctuations, uncontrolled credit, and wars--were moderating. He viewed these developments with hope as curbing the business cycle's violence. These ideas were soothing in 1927; but, when they formed a part of his Keynes-like stagnation thesis in the late 1930s, they agitated some, who saw it as an implicit criticism of the economic system.

2. Hansen's rather orthodox views on the business cycle were severely shaken in the mid-1930s by Keynes' *General Theory of Employment, Income, and Money* (1936) and by the limited business recovery of 1937. Initially his review of Keynes' work was unenthusiastic: he concluded that it failed to provide "a foundation for a 'new economics'." [Hansen (1936) 686] But by early 1938 his papers moved towards Keynes, and by mid-year his introduction to *Full Recovery or Stagnation?* (1938) stated: "Few books in the whole history of economic literature have created such a stir among professional economists." [8] Hansen's embrace of the Keynesian system seemed complete in his presidential address in December to the American Economic Association. [Hansen (1939); Stein (1969) 164] This remarkable feat for a man over 50 soon made him the leading American advocate and expositor of Keynes' theory of income determination. He had clearly found his greatest professional challenge and reward. He and the brilliant group of Harvard students around him, most notably Paul A. Samuelson, were active in clarifying and working out the implications of the Keynesian system and applying them to business-cycle analysis, such as the multiplier-accelerator interaction and the balanced-budget theorem. [Samuelson (1959, 1975); Hansen (1944) 245]

Hansen was stimulator and synthesizer; teacher and student. His mature views on the business cycle, as found in *Business Cycles and National Income* (1951), were based on "three stepping stones": (1) the inducement to invest (the relationship between the marginal efficiency of capital and the rate of interest); (2) the investment multiplier; and (3) the acceleration principle. In this formulation endogenous factors could bring an expansionary process to an end without the previous reliance on exogenous limitations. [Hansen (1951) Chapter 24] Add timing response to this structure and the basis for much of the model building of the next two decades is provided.

3. Hansen's interest in cycles was not limited solely to short-run phenomena; he was also a student of longer cycles which gave his short-run analysis great richness. In his view the long-run movements in the factors affecting investment opportunities or other structural aspects of the economy could not only generate short-term cyclical swings, but their long-run upswings and downswings could strengthen or weaken the shorter-term business cycle. For instance, he used the building-construction cycle of 17 to 18 years to help explain the amplitude of cyclical swings.

Hansen was profoundly disturbed when the recovery of the 1930s failed in 1937 to reach the previous cyclical peak in either real output per capita (present data would also add total output) or in employment, then tumbled into one of the shortest and sharpest recessions in our business-cycle history. This failure, by itself, was not shocking to Hansen whose historical studies had found many such incomplete recoveries. His search for why it happened, however, led him to the conclusion that secular stagnation was a possibility for the United States economy, a thesis that was his most widely known as well as his most controversial.

Hansen characterized the 1934-37 recovery as a "consumption" recovery fed by consumer installment credit and by federal expenditures on recovery and relief and on the veterans' bonus of 1936. The recovery ceased when these stimuli played out. Even worse, they were reinforced by sharp increases in wages and prices and by the start-up of a new Social Security system which began collecting revenues before paying benefits.

New investment, geared very closely to the short-run requirements of current consumption, was inadequate to offset these deflationary factors. In contrast, past investment booms developed on the basis of the long-term expectations of entrepreneurs and this new development seemed to confirm his earlier view that 19th century booms might be a thing of the past.

The problem was further exacerbated by the halving of population growth in the 1930s with prospects for still lower growth rates. The potential impact on capital formation of such a development could be staggering. Hansen's rough estimates indicated that population growth in the last half of the 19th century might have been responsible for as much as 60 percent of the total capital formation of the United States. [Hansen (1941) 359] A loss of investment outlets of this magnitude would make far more difficult the achievement of full employment: greater reliance would have to be placed on the stimulus of new technologies to fill the gap, and they appeared to Hansen to have weakened. Secular stagnation--an equilibrium at less than full employment--loomed ahead with weakened capital formation perhaps inadequate to absorb full-employment savings. To avoid such an outcome, useful government expenditures needed to be raised to offset this secular deficiency of demand.

A storm of controversy was aroused by this thesis, but the preoccupations of World War II deferred it. By then the low population increase of the 1930s was supplanted by decades of high growth that encompassed the baby boom of the 1950s; inflation seemed to be the major problem. Ironically, the strength of capital formation over this period, attributable in part to the the baby boom, may actually have vindicated Hansen's concerns about a falling rate of population growth. On the other hand, we would now also take into account the added propensity to consume of an aging population, and its partial offset to the weakening of capital formation. [Samuelson, (1988)]

4. Hansen was unquestionably the creator and--along with such disciples as Richard A. Musgrave and Walter Salant--a major developer of compensatory fiscal policy as a stabilizing complement to monetary policy, completing a structure that may have been inherent, although certainly not worked out, in Keynes' *General Theory*. Like Keynes and others, Hansen initially overemphasized reliance on government expenditure policies, especially when concerned with the prospect of secular stagnation. But his analysis broadened rapidly into the detailed and comprehensive classic, *Fiscal Policy and Business Cycles* (1941). He not only examined many fiscal instruments, new and old, but he also flatly rejected his earlier, orthodox view that compensatory action should be postponed until the depression's beneficial liquidation had taken place. [Hansen (1932) 189; Hansen (1941) 91-95]

The discussions of compensatory fiscal policy that followed in the 1940s and 1950s clarified its theory, instruments, and strategies. (1) Much greater emphasis was given to the role of taxation (and transfer payments) as more flexible and responsive instruments than government purchases, as potentially more neutral distributionally, and as providing a broader base on which to perform stabilizing actions, in contrast to the burdensome destabilization of a single industry, like construction, through public works manipulation. (2) There was a growing awareness of the responsiveness of the budget to economic fluctuations, and attention was focused on the degree to which reliance could or should be placed on this automatic response, on how it could be strengthened, and on the conditions under which it could and should be supplemented by discretionary shifts in taxes or expenditures. (3) The flexibility of discretionary policy was found to depend on the ability to forecast or to know the state of the economy, and on the response and promptness with which the government could act. Methods of improving this performance were given much analysis. [Stein, Chaps. 8-9]

Though not directly involved, Hansen was the major intellectual force behind the Employment Act of 1946, viewed by many as the magna carta of government stabilization responsibility. An activist in pressing for full use of resources with stable prices, he was ever in search of proposals that would improve fiscal instruments and governmental decision-making processes. Hansen's tireless and many-faceted attack on the business cycle, his prodigious productivity, his energy, enthusiasm, openness, and encouragement, so infectious to students and colleagues, made him a dominant figure in the mid-century taming of drastic business fluctuations.

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