

ECONOMICS U\$A LESSON #6

(MUSIC PLAYS)

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Stasio: Economics U\$A. One of a series of programs designed to explore Twentieth Century micro and macroeconomic principles. The subject of this edition is Fiscal Policy. Our guests are Robert Nathan, New Deal Economist and President of Robert Nathan and Associates and Nariman Behraves, a vice president for Wharton Econometrics. I'm Frank Stasio.

Stasio: The Roaring Twenties. Business was better than ever and America was convinced that the sparkling tonic of free enterprise could cure all economic ills. Except for prohibition, the impact of the federal government on the lives of most Americans was negligible. In Nineteen Twenty-nine the federal budget was less than three percent of national income. American business was private enterprise relying on its own resources and determination to make profits and keep the economy moving. Few economists or policymakers saw a direct role for the federal government in managing the economy. Even at the depth of the Great Depression, President Herbert Hoover clung to the old principles that had guided the country for a century and a half. Progress is born of cooperation he said. The government should assist and encourage these movements of

collective self-help by cooperating with them. But the old ideas weren't working and the country turned to a new leader for answers.

Roosevelt: Let me assert my firm belief that the only thing we have to fear is fear itself. Nameless unreasoning unjustified terror which paralyzes needed efforts to convert retreat into advance.

Stasio: Franklin Delano Roosevelt would eventually begin an ambitious program of direct and indirect government intervention to help bail out the economy. But he did not start right away. Roosevelt was not an economist and knew little of the revolutionary teachings of John Maynard Keynes. Keynes was a British economist who advocated government deficit spending as a way out of the Depression. Robert Nathan was an economist in the Roosevelt Administration. He recalls that Roosevelt's conversion to Keynesian economics came almost out of desperation.

Nathan: It was quite clear by...by, uh, Thirty-two, Thirty-three that something had to be done. And this was, I think, the genius of the New Deal that for the first time in history there was a decision that government had to take a part and move in not to take over industry, not to own and operate, not to socialize the economy, but take fiscal measures and monetary measures and even work measures, uh, work projects administration, public works and the like to turn the economy around. And...and the Keynesian principles that in times of recession, uh, government deficits could be erased and then any factors certainly proved to be true.

Stasio: In Nineteen Thirty-five Congress approved the largest public works program in the nation's history. The WPA or Works Progress Administration made work for

millions of jobless Americans in almost every area of the economy from road building to song writing.

Stasio: The WPA would cost five billion dollars – half of the government’s total spending that year and ten times what had been spent on public works earlier. Did the economy improve? Yes, a little but enough to give national leaders confidence in the power of federal government to change the course of the economy. Programs like the WPA were make work projects, contrived by the government to give idle workers something to do and inject money into the economy. The federal government created jobs that the private economy could not or would not support.

Nathan: Now I know that a lot of the business community and the conservatives talked about leaf raking, and some of them did rake leaves that’s true. And, uh, we did take artists who were very talented and couldn’t sell their art at all and were practically some of them at starvation levels and doing street cleaning practically for a living or selling apples and we had art projects. We paid them minimum levels to live, uh, had music projects, they had a whole range of things but people were put to work. And a lot of good productive projects came out of that WPA.

Stasio: But it wasn’t until World War Two that the country was able to fully recover from the Great Depression. New Deal jobs programs may have started the recovery but it took the production demands of the war effort to fully revive the economy. Sixty-six million people returned to the civilian workforce. Another twelve million were enlisted in the armed services. Any doubt about the effectiveness of government spending in a

recession had all but vanished. Nariman Behravesch is a vice president for Wharton Econometrics.

Behravesch: Let's take the example of the government spending its money on tanks or even on paper clips. What happens is the money it spends initially ends up in peoples' pockets. So that means that income goes up and of course production goes up to...to provide those goods for the government. So that's in the first round you're getting both increases in GNP and in income. But that doesn't stop there. What happens is that income is then spent by the people who have it; part of it is also saved a little bit. So you then get a second round effect of an increase in consumption going on. So that boosts GNP and income even further. Then you have it coming back around again in the way of increased incomes which are spent again. And so finally after a number of rounds you get an increase in GNP and in income that's a multiple of that initial spending by the government. So that helps to boost the economy.

Stasio: Well, look you—we had the WPA. There were other programs that all required the government to spend money. Why didn't those programs end the Depression?

Behravesch: Well I think the WPA and the other programs did work the way they were supposed to work. They indeed did increase, uh, income and GNP during the Depression. The problem was that they weren't large enough to get the economy out of the Depression.

Stasio: And so it took spending on the, uh, um, on the war effort to bring that about?

Behraves: Yes. Eventually it really was a spending in...on World War Two that got us finally out of the Depression.

Stasio: Does it make a difference if the goods that the government spends money on are things that are not consumer goods? If they're...if they're war material?

Behraves: No it really doesn't. Um, it...it's just a question of the...of the fact that the government is spending the money, it ends up in peoples' pockets who then turn around and spend part of the money that they get from the government.

Stasio: When the government spends money, isn't it just putting back into circulation money that it's already removed from the economy?

Behraves: Well I think the key here is that if the government actually spends more than it takes in, in other words if government spending is more than the taxes that come in, then that stimulates the economy. If vice versa, the taxes it takes in are larger than its spending then actually it can have a depressing effect on the economy. So it's the balance of these two or the deficit or surplus that really makes a difference.

Stasio: So if government spending, deficit spending, is a good thing when, uh, when times are bad, then it must be a great thing when times are good?

Behraves: Well actually the opposite is true because when the economy's very strong and near full employment, the last thing you want to be doing is to be spending more because the net result of that would be inflation. So it's, uh, what's good in a depressionary period is...is a bad idea in a...in...in an inflationary period.

Stasio: Some's good. If...if some's good, more's better doesn't work in the economy?

Behravesch: That's exactly right.

Stasio: Now what about taxes? Uh, if policymakers saw the need to pump more money into the economy, couldn't they just cut taxes?

Behravesch: Yes. That's the other way that fiscal policy can boost the economy. Uh, by cutting taxes you can actually pump up either consumer spending or spending by businesses on investment. Uh, and in fact a lot of economists feel that this is the preferred way to go because they prefer to see a...an increase in private spending rather than in government spending. This was the dilemma that was facing the Kennedy Administration, uh, as they tried to decide how to improve the economic conditions in the Early Sixties. And finally they came down on the side of cutting taxes.

Stasio: Nariman, is a dollar returned in a tax cut the same as a dollar spent by the government?

Behravesch: Actually a tax cut of the same magnitude as an increase in government spending will result in a slightly smaller increase in GNP. The reason is that when you give people money in the way of a tax cut, they can either spend it or save it. And typically the American consumer saves about one-tenth of that tax cut and spends nine-tenths of it. So the net result is a slightly smaller fiscal stimulus from a tax cut than from a correspondingly similar spending increase.

Stasio: Do policymakers take that into account or is that a fairly negligible difference?

Behraves: I think policymakers do take that into account. Uh, certainly people like Walter Heller in...in, uh, the Kennedy Counsel knew that when...when he made the recommendations that he did.

Stasio: What about tax increases? Is it reasonable to assume that the effective tax increase would be the reverse of a tax cut?

Behraves: It will indeed. Uh, you have the opposite effect going with a tax increase. As you take money away from people, you'd expect both consumer spending to drop and you'd also expect to see a slight decrease in consumer saving as well.

Stasio: So, during a recession the government can help to improve the economy's performance by increasing its own spending, cutting taxes, or providing tax incentives to encourage business to invest more money. If the economy becomes overheated and supply cannot keep up with demand, the government can cut spending or increase taxes or both to control inflation. But who controls fiscal policy?

Male Voice: Subcommittee will come to order.

Male Voice 2: Well as I said I'm very pleased to appear before this committee and to have the chance to answer your question about the likely effect of deficit reductions of the sort that the Administration has now been talking about...

Stasio: Well in Congress, there are budget committees in the House and Senate that decide how much money will be spent and on what priorities. The Congressional Budget Office conducts research to help members of Congress decide budget issues. The Finance Committee in the Senate and the Ways and Means Committee in the House

consider tax policy. And a joint economic committee made up of members of both chambers was established in Nineteen Forty-six to review economic issues. Generally speaking though it is the President who has the greatest influence on fiscal policy. He is assisted by the Treasury Department on tax matters and the Office of Management and Budget on spending. The President also may rely on the Council of Economic Advisors. There is a complex relationship between and among these policymaking bodies.

Kennedy: The torch has been passed to a new generation of Americans ...in this century, tempered by war disciplined by a hard and bitter peace, proud of our ancient heritage and unwilling to witness or permit...

Stasio: When John Kennedy took office in Nineteen Sixty-one, unemployment was very high. Even though a recovery from the recession of Nineteen Sixty had begun, it appeared as though economic expansion might not reach full employment. As Nariman Behravesh pointed out earlier, Kennedy had two options. He could cut taxes or increase spending. An argument raged for a year within his Administration over the best course. John Kenneth Galbraith who had been an economic advisor to Kennedy while Kennedy served in the Senate urged the President to spend more on social programs to improve services for the poor. Meanwhile, Walter Heller who chaired Kennedy's Council of Economic Advisors pushed for a tax cut. Walter Heller:

Heller: Well there wasn't as much disagreement as it's often, uh, made out to be. I wanted a tax cut, surely, but I wanted it as a package, uh, including substantial spending increases. But remember Kennedy went up to the Hill and, uh, got knocked down again and again on the programs. And I simply concluded that as a practical matter if we

wanted to stimulate the economy, if we wanted to get it moving again, we had to have it primarily on the tax side.

Stasio: Eventually Heller won out and Kennedy decided on tax cuts. But that led to another disagreement within the Administration. How big should the tax cut be?

Heller: The Treasury, being sort of the keeper of the...of the fiscal keys, was very dubious about a big tax cut. I wanted a twelve billion dollar tax cut. And they wanted about three or four billion as they said to lubricate tax reform was the term they used. And right after, uh, Kennedy gave that speech in August of Sixty-two saying yes we're gonna have a...a big tax cut and I'm going to present it next January, uh, Kennedy asked me, he said what do we do now? And I said well we set up the cabinet committee on economic growth. And he said well what's that for? Well I said that's for me to get my twelve billion dollars instead of Doug's four. Well eventually, and this is a, you know, slightly, uh, simplified version of history, but eventually we compromised on twelve billion dollars. And that's the kind of compromise I like.

Stasio: But one should not conclude that the Council of Economic Advisors has the upper hand in every Administration. The amount of influence enjoyed by an advisor or policy group changes with each new President. President Ronald Reagan, for instance, feuded openly with the chairman of his Council of Economic Advisors, Martin Feldstein. Feldstein regularly warned against the dangers of huge budget deficits run up by the Reagan Administration and recommended a tax increase. President Reagan would have no part of it. And toward the end of Feldstein's tenure, the White House was publicly ridiculing the Council chairman. The Reagan White House relied most heavily on the

Office of Management and Budget for guidance on economic policy. Former director of OMB, David Stockman:

Stockman: In Nineteen Sixty-two the social contract which is social security, Medicare and unemployment and the means tested safety net together cost three point four percent of GNP. By Nineteen Seventy they cost five percent of GNP. And in Nineteen Eighty-six they will require eight point eight of GNP living...leaving a diminishing amount of room for everything else.

Stasio: In this Nineteen Eighty-five speech, David Stockman refers to a safety net. What does he mean? He is talking about the various social programs that provide aid and services to families in need of assistance. Most of these programs, food stamps, aid to families with dependent children, unemployment insurance, were enacted after the Great Depression. By providing families with some income in the worst of times, government not only eases their suffering but also keeps the economy from grinding to the near total standstill experienced in the Nineteen Thirties. These government programs are called automatic stabilizers because they absorb some of the impact of a recession without the need for special legislative or executive action. The tax structure also acts as an automatic stabilizer. Robert Nathan explains:

Nathan: When tax revenues drop in a recession because profits are down, people are unemployed, there's less income on which to pay income taxes, so the government revenues go down and often their expenditures go up because of unemployment compensation, because of relief and because in some states and cities need the federal government increase its...its, uh, project expenditures so what you do is you...you go

from a balanced budget which is logical or a surplus in boom times where you don't very often get there. But historically the, you get into bigger deficits in recessions, and that's good because a deficit means Uncle Sam is pouring money out into the hands of the private sector, consumers and producers, more than it takes in. And that stimulates economic activity so that in a recession the deficits tend to cushion the decline and give sort of a spring to that economy so that it tends to move up. And in boom times when profits are very high and incomes are high, uh, your revenues tend to come in more...more fully and you have, uh, expenditures not rising proportionate so you tend to cut those deficits and that takes, uh, some of that steam out of the economy. And so it has an automatic tendency to moderate the decline and the moderate the...the, uh, increases.

Stasio: There are other automatic stabilizers. Corporate dividends are often maintained even when production is off. And dividends rarely rise at the same rate as output. Also, people tend not to change their spending habits immediately even if their income level suddenly rises or falls. But automatic stabilizers alone cannot eliminate the cycles of inflation and unemployment. Sound fiscal policy must include deliberate acts by the government to control the economy. Depending on the current economic conditions, the government can adjust taxes or spending to cope with either an overheated or a sluggish economy. In Nineteen Eighty-four when government spending threatened to over stimulate the economy, policymakers and economists called for drastic cutbacks. Former budget director, David Stockman:

Stockman: We must either undertake a thorough going housecleaning of the accumulated baggage in the government's discretionary sector or run the risk posed by massive

structural budget deficits. That work is uncongenial to the Congress because the programs that must be excised were conceived and nurtured down in the obscure and incestuous subcommittee labyrinth where most of the real business of government takes place. In that environment you can hear a thousand technical, sophisticated arguments about why Amtrak or UDAG or the Small Business Administration or mass transit subsidies should be spared. But I would suggest today that these arguments are now irrelevant. All of these programs are societal amenities not essentials. They reflect not profound national needs of an enduring character but the parochial claims and the episodic tinkering projects that were marginally affordable in an earlier happier fiscal era.

Stasio: There is still a healthy debate about how effective fiscal policy can be in controlling unemployment and inflation. Nariman Behravesesh points out the difficulty economic planners have in making fiscal policy work.

Behravesesh: I think that the record over the Sixties, Seventies, and Early Eighties suggests that policy, and in this case, fiscal policy does have an impact on the economy. Uh, you can stimulate the economy by increasing government spending or cutting taxes. You can pull down the economy by raising taxes or cutting government spending. I think one of the problems with fiscal policy and policy in general is that it's very difficult to fine tune. You can course tune but it's...it's...it's very difficult to fine tune. This is especially true for fiscal policy because there's a very long process involved in implementing fiscal policy. Uh, let's take the case of the tax cuts. It took almost two years between the time President Kennedy, uh, wanted to cut taxes and the time that they were actually enacted.

Uh, you know first the President proposes it, it's debated, then Congress begins the

process and that's often a very lengthy one. And as happened in the case of the Kennedy Johnson tax cuts, by the time the tax cut was actually put through, the economy was just doing fine. So it did give a boost to the economy but at a time when the economy, in fact, had recovered quite nicely. So there's lag between the idea and the implementation is a real problem in fiscal policy.

Stasio: There are also political considerations to...to take into account. Uh, economic decisions aren't made in a vacuum?

Behravesch: Absolutely. Any decision on fiscal policy does involve, uh, political ramifications having to do with, uh, national elections, having to do with you know how a tax cut goes into effect, which spending programs is going to effect which Congressman's district and so forth. So fiscal policy is very closely tied up with the political process.

Stasio: Suppose we could formulate fiscal policy in a vacuum. Are we sophisticated enough to come up with a policy that could keep the economy on an even keel?

Behravesch: Again, I think the issue here is that we can course tune but I think the uncertainties about the economy and our knowledge of fiscal policy are such that it's very difficult to fine tune.

Stasio: Let's look back at some of the ways government can help to control the economy. During a recession the government tries to put more money in the hands of consumers and investors. This can be done either by increasing spending or cutting taxes. In times of inflation, the government may decide to take money out of circulation

by cutting spending or increasing taxes. Some government programs act automatically to balance the economy. These are called automatic stabilizers. Automatic stabilizers include the progressive tax structure, unemployment compensation and welfare payments. These programs soften the impact of a recession on individuals in the economy. In addition to automatic stabilizers, the government may raise discretionary spending such as public works projects and changes in welfare payments to stabilize the economy. It may also change tax rates. Fiscal policy at the federal level is decided through a complex web of legislative and executive bodies. Budget committees in the House and Senate decide funding levels for federal programs. The Finance Committee in the Senate and the Ways and Means Committee in the House consider tax policy. A joint economic committee made up of members of both houses reviews broad economic issues. Congress is aided in its research on fiscal matters by the Congressional Budget Office. The President, because of his authority as chief executive, has the most influence on fiscal policy. The President is guided by the Treasury Department on tax matters, the Office of Management and Budget on spending, and he also receives expert opinion from the Council of Economic Advisors. Fiscal policy has never been a complete success in stabilizing the economy partly because political pressure can compromise economic planning and partly because fiscal programs take time to work. Often that lag time can reduce the effectiveness of a program. Finally, public acceptance of active government involvement in the economy is relatively new. In the last sixty years federal spending has grown from three to more than twenty percent of national output. It was the limited success of emergency public works projects in the Great Depression that first showed economists and policymakers the value of government involvement. From that time

forward the issue was not whether but when and how much should the government intervene.

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