

ECONOMICS USA  
PROGRAM # 6:

FISCAL POLICY:  
CAN WE CONTROL THE ECONOMY?

BY FRANK M. NESBITT

AIRSCRIPT  
MAY 14, 1985

## 6. FISCAL POLICY: THE GROWING ROLE OF THE GOVERNMENT

### PURPOSE:

To show that a key element of Keynes' contribution is that, at least in theory, the government can fine-tune tax and spending policies to reduce the severity of business cycle fluctuations.

### THE VIEW WILL UNDERSTAND:

1. Government spending on goods and services is an injection into the circular flow of the economy. As government purchases rise the demand for GNP rises and, assuming that the economy is below full capacity, GNP produced will rise. The rise in GNP is larger than the rise in government spending. In fact, it is equal to the rise in government spending times the multiplier.
2. Taxes have a similar but opposite effect on GNP. Moreover, the impact of taxes is indirect. A tax cut results in an increase in disposable or after-tax income. This additional income can either be saved or spent. Only that portion of the tax cut which is spent is considered an injection into the circular flow. Consequently, a tax cut of the same magnitude as a spending increase will usually have a smaller impact on GNP than the spending increase. Rises in transfer payments such as social security and welfare payments have the same impact on GNP as a tax cut.
3. Generally speaking, the larger the government deficit (taxes less spending) the larger will be the net injections into the circular flow and the larger will be the volume of the flow (GNP). The opposite is true for surpluses. Thus by changing the spending and tax policies the government can, in the abstract, stimulate growth in the economy or slow the economy down.
4. The U.S. economy also has a number of built-in stabilizers which raise the deficit (lower the surplus) in recessions and lower the deficit (raise the surplus) in recoveries. These include unemployment benefits and welfare payments which rise when GNP is falling and vice versa. The progressive structure of the U.S. tax structure also serves as a stabilizer. In a recession tax receipts are lower because of higher unemployment. This means that the deficit is larger. The reverse is true in periods of high growth.

### KEY ECONOMIC CONCEPTS:

aggregate demand management  
budget surplus and deficit  
lump-sum tax  
proportional tax  
progressive tax

recessionary and inflationary gaps  
automatic stabilizers  
balanced budget multiplier  
government purchases  
government transfers

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ANNENBERG/CPB PROJECT (Logo & Music)

TEASER

FDR: “ I believe that private enterprise can give full employment to our people.”

DAVID SCHOUMACHER: 1944. Franklin Roosevelt declares that every American has a right to a job...Can the government guarantee that we’ll never have another “Great Depression”? 1952. Dwight Eisenhower prepares to take office as the first Republican president since Herbert Hoover...How will he handle his first economic crisis?

KENNEDY: “The torch has been passed to a new generation of Americans...”

DAVID SCHOUMACHER: 1961. John Kennedy has promised to get the country moving again...How will he keep his promise? Three presidents, three policies, but one common resolve...The government must never again permit another “Great Depression”. Fiscal policy...can we control our economy? That’s the story we’ll investigate, with the help of economic analyst Richard Gill, on this edition of Economics USA. I’m David Schoumacher.

(MUSIC PLAYS-OPENING TITLES)

(FISCAL POLICY: CAN WE CONTROL THE ECONOMY?)

PART I

DAVID SCHOUMACHER: The twenty years after World War II brought a growing self-confidence to American political economics. The lessons of depression and war convinced economists and politicians alike that the government could prevent hardship

and promote prosperity by manipulating taxes and spending. These continuing adjustments are called “fiscal policy”, and for the two decades after World War II, each new administration asked itself the same question...How can we use “fiscal policy” to control the economy? Our story begins in 1944....Americans still had vivid memories of the “Great Depression”...They remembered a quarter of the work force without jobs, factories closed, families hungry, and they remembered an inspirational leader who showed them that the government cared. Ultimately, however, it was the war and not the “New Deal” that put an end to the Depression. By 1944, twelve million men and women were in uniform...66 million more had jobs supporting the mightiest war machine the world has ever known. And in the midst of the fury of a world in conflict, Senator Harry Truman said, “War is hell, but peace might be worse.” Working with Truman, in the Senate, was a young Staff Aide named Bertram Gross...

BERTRAM GROSS: “The big upturn during World War II was all based on government spending for more production, and so when those contracts were withdrawn, we said things could all topple to pieces...Everyone felt that way and it could have...It could have toppled.”

DAVID SCHOUMACHER: Throughout the country people feared a return of hard times...And the man who lead the nation out of the Depression made a bold promise to the American people.

FDR: “A second Bill of Rights under which a new basis of security and prosperity can be established for all regardless of station, or race, or creed...Among these are the right to a useful and remunerative job in the industries, or shops, or farms, or mines throughout the nation.”

BERTRAM GROSS: “Roosevelt captured the high ground in his State-of-the-Union message...in January ’44, with the economic Bill of Rights...and the Republicans were forced to say, “Me, too, me too...jobs for all.” And the air was full of it...we had to have jobs for all. However, after working in the campaign, I began to feel...This is nice rhetoric...do they all mean it? Will they do things...or will they just talk that way? And so, out of that thinking, came the original Full Employment Bill based upon the idea that

both parties committed themselves to jobs for all...let's have them write it down in legislation.”

DAVID SCHOUMACHER: Bertram Gross drafted a full employment bill that was introduced in the Senate in January, 1945. The bill instructed the President to use the wide range of approaches, including spending programs, to promote full employment. Much of the theory came from John Maynard Keynes...During the 1930's Keynes argued that an industrial economy could get stuck at high levels of unemployment...and the Depression proved this. He predicted that strong government intervention in the form of tax-cuts and spending programs would restore prosperity. This seemed to be happening during World War II...By 1945 many people were ready to accept Keynesian theories, but were reluctant to see them turned into law. To bridge this gap between economics and politics a Council of Economic Advisors was suggested...The question remained, Where to put this “new body.”

BERTRAM GROSS: “We put it in the conference committee and put it in the Executive Office of the President, which tied it up to Presidential power and fit it into the basic idea that the President in the modern world is the manager of economic affairs on a broad number of sets.”

DAVID SCHOUMACHER: While Conservatives and Liberals debated in Congress, a weary President died. The nation mourned Franklin Roosevelt and wondered about its new leader, the relatively unknown and uncharismatic Harry Truman. But for all his supposed shortcomings the new President had some common sense ideas on unemployment. Leon Keyserling, an original member of the Council of Economic Advisors recalls...

LEON KEYSERLING: “Well, Truman was asked: “When is unemployment too high?”...and he said: “It depends on whether or not you're unemployed.” Now this was not a wise-crack...This showed that he had a more fundamental understanding of what the game is about than a lot of later people...Because he realized that if you were going to talk you had to talk about people and what was happening to them...and where the hardships were and where the losses were.”

DAVID SCHOUMACHER: As a Senator, Harry Truman had worked hard to push the idea of a “full-employment” bill...As President, he signed the Employment Act of 1946...a law that changed greatly in a year of Congressional debate. It no longer referred to “full-employment”...instructing the government instead to promote “maximum employment”, production and purchasing power. What was lost from the original idea?

BERTRAM GROSS: “Well what was really lost was the right...the right to a job...the right to work...the right to an opportunity for paid employment at good wages...that was what was lost.”

DAVID SCHOUMACHER: And what was gained?

LEON KEYSERLING: “Well, the government had had what might be called policies and programs but it had never had a policy or a program. The Secretary of the Treasury proposed one thing and the Secretary of Agriculture another...the Director of the Budget other things and so forth up and down the line...these were policies and programs...most of them were needed...most of them did some good...but it was a confused and disorganized army. The Employment Act of 1946 made it necessary that all of these programs be evaluated and that each of these programs be evaluated in terms of the whole.”

DAVID SCHOUMACHER: By the time the Employment Act became law, the war was over. The economy erupted into prosperity. Dire predictions of hard times vanished in the explosion of pent up consumer demand...And the law that was supposed to prevent a return of the “Great Depression” became, instead, the continuing justification for “fiscal policy” in the years ahead. The end of the war signaled the beginning of the long and by previous standards uninterrupted period of continuing prosperity. And passage of the Employment Act of 1946 marked the commitment of the government to use its considerable power to insure that that prosperity continued. We asked economic analyst, Richard Gill the rationale for using “fiscal policy” to maintain economic stability...

(MUSIC PLAYS – COMMENT & ANALYSIS I)

(ECONOMICS USA LOGO – appears on screen)

RICHARD GILL: The rationale was very much influenced by the ideas of John Maynard Keynes whose major work had been published in 1936, a decade before the Employment Act. Keynes' basic idea was that total private spending...on consumer goods and business investment...might be insufficient to sustain national income at the full employment level. The solution...increase government spending to fill the gap. We can illustrate this idea with a simple diagram. Let's measure total spending...by consumers, businessmen and the government on this vertical axis, and national income... GNP...along this horizontal axis. Now, in 1946, full employment national income... GNP when everybody who wanted jobs was able to find them...was probably around here, at \$300 billion in terms of 1946 dollars. Let's now draw a vertical line here that is also equal to \$300 billion. What this line will tell us is how much spending we need to sustain full employment national income. Now the first thing that Keynes said is that private spending on consumer goods (C) and business investment (I) might not be large enough to keep GNP at this \$300 billion level. He thought that this private spending would increase as income increased...you see, we've drawn the curve sloping up as GNP increases...but that it might end up here, with this gap of \$50 billion between total private spending and full employment national income. And the second thing he said was that we could fill this gap with public or government spending (G) the government steps in \$50 billion of its spending...defense, public works projects, whatever...and we can simply add this "G" on to the total of private spending. And look at what happens. The gap has disappeared. Total spending...private plus public spending...is now sufficient to maintain full employment GNP at \$300 billion. Now even the most rabid Keynesians in those days would have admitted that there could be a few snags in this simple analysis. Nevertheless, the basic idea seemed quite convincing: namely, that the government not only should, but could, keep the economy up at the full employment level, or pretty near it. And it was this idea that many economists had in mind when they supported the Employment Act of 1946 so vigorously!

## PART II

DAVID SCHOUMACHER: I like Ike. Millions of voices echoed the cry...and it swept Dwight Eisenhower to victory in 1952...The first Republican president since Herbert Hoover. Like Hoover, Eisenhower inherited a prosperous economy...And like Hoover, Eisenhower was forced to watch as that economy slid into a recession. Now Hoover responded with a huge tax increase that deepened the depression...What would Ike do? Would he repudiate 20 years of modern economics? When Eisenhower took office in 1953, he inherited a prosperity that had been “bubbling” along since the post-war boom. American factories worked to capacity to fill the demand...then worked over-time to build the bombs, planes and tanks needed to fight the Korean War. Ike promised to end the war...and in July, 1953, he did. But there was little time for rejoicing...By August the economy had stalled...War orders came to a halt and this time there was no explosion of consumer demand to fill the gap. Ike was worried. Where would he turn for advice? Arthur Burns was Chairman of the Council of Economic Advisors. George Humphrey was Secretary of the Treasury...The two did not always agree...

HERBERT STEIN: “He used to say when Arthur Burns came into the cabinet room... ‘well here comes Arthur with his little kit of tools’...By which he meant his kit of tools for dealing with the recession and at various times he kind of got out-of-line. This is Humphrey who got out of Eisenhower’s line by saying, ‘oh no, the idea of increasing expenditures in a recession, that’s really a terrible thing.’ He was more in the Hoover image, but he quickly got back into line.”

DAVID SCHOUMACHER: Ike’s forecast showed unemployment climbing past 6% during the winter of 1954...The highest level since the Depression...Millions of workers were idle and angry. President Eisenhower went to the American people to urge confidence. He predicted that the economy would soon improve and he promised a series of spending programs if it did not. He was ready to take action, but he didn’t have to.

HERBERT STEIN: “If you just keep the tax rate stable for example, then the revenue will automatically fall when the economy falls because people will have less income...The revenue will rise when the economy rises because people will have more

income...and that exercises a certain stabilizing effect on the economy...Also some expenditures will rise in a recession...unemployment compensation expenditures, for example. So, we at the Committee for Economic Development, where I worked, coined that term, “a stabilizing budget policy” and meant it to describe one in which, except in extraordinary circumstances, you rely on these automatic stabilizers.”

DAVID SCHOUMACHER: During the 1954 recession, these automatic stabilizers left an additional \$10 billion in the pockets of American consumers...dollars that would have gone to the Treasury as tax revenue in a healthy economy. \$10 billion helped to fuel the engine of American prosperity and, by the summer of 1954, the first Republican recession since the Crash of '29 had come and gone...leaving a prosperous economy to continue growing. In the economic history of 20th century America, the recession of 1954 is nothing more than a wrinkle in the long upward climb of post-war prosperity, but it is significant...because it shows us that by the 1950's most economists agreed that the government not only could, but should use fiscal policy to minimize recessions. To the Eisenhower Administration, that meant taking advantage of the automatic stabilizers in our economy. We asked economic analyst, Richard Gill how those stabilizers worked...

(MUSIC PLAYS - COMMENT & ANALYSIS II)

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RICHARD GILL: In 1954, when real GNP began to fall, federal tax revenues also began to fall. Not because of any plan but simply because there was less taxable income. This meant relatively more money in the hands of consumers, which, in turn, meant that private spending did not have to fall as much as one might have expected. In terms of our diagram, what this means is that this private spending curve, instead of going down like this, was flatter...like this. Instead of the economy spiraling down into a Great Depression, private spending was maintained at a relatively high level and the fall in national income was cushioned. One may well ask, if these stabilizers are so wonderful and worked so nicely in 1954, why didn't they stop the Great Depression of the 1930's?

The basic answer is that government was already playing a much larger role quantitatively in the economy in the 1950s than it had been twenty years earlier. This was very much what Keynesians of the time were advocating.

### PART III

Audio clip: Kennedy Inauguration.

DAVID SCHOUMACHER: The bright promise of that day blinded many to the fact that John Kennedy had managed only a “razor-thin” margin of victory...And he was taking over as leader of a country that was stalled in a recession and beset by problems of poverty...pollution...and urban decay. The new President had promised to get the country moving again, but he had no definite program. What would he do to keep his promise? Over the years, John Kenneth Galbraith had provided John Kennedy with answers to economic questions...

JOHN KENNETH GALBRAITH: “I’ve often said that I went through several stages in my friendship with Kennedy...One was where he would call up and ask me what I thought he should do...this was when he was a Senator...Later, as he grew older in the Senate, he would call up and say, “What’s the reasoning behind all this argument?,” this having to do with economics...Then there was the third stage when he acted on his own and didn’t bother to call at all.”

DAVID SCHOUMACHER: Many predicted that Galbraith would come to Washington with the new administration...Instead, he went to New Delhi as Ambassador to India. Walter Heller was appointed Chairman of the Council of Economic Advisors...He found the new president a receptive pupil.

WALTER HELLER: “He was interested in economics and interestingly enough, somebody who’d know him for a long time, Ken Galbraith, came in to see me before he went to India as Ambassador, and said: “One of the things you should understand about the President is that he has the capacity to read and to understand.”...and he said, “Don’t be afraid to write him”...this is very unlike Lyndon Johnson who wanted little short

memos...he said, “don’t be afraid to write him fairly lengthy memos...he’ll be interested.” He said, “ just put a little humor in it.”

DAVID SCHOUMACHER: John Kennedy took office as the country was already beginning its recovery from the Recession of 1960, but unemployment remained distressingly high...And Kennedy’s advisors began to realize that the recovery contained the seeds of its own early demise. The government would soon be taking in more money than it was spending...That surplus would stop economic growth well short of full employment.

JOHN KENNETH GALBRAITH: “That could be corrected in two ways: by tax cuts or by increased expenditure. I had the feeling that our social programs at that time, particularly the programs on behalf of the poor, were very much in need of more support...that we had a commitment to the people who were in need...and that was how the money should be used.

DAVID SCHOUMACHER: But Kennedy’s new economic advisor had a different idea...

WALTER HELLER: “Well, there wasn’t as much disagreement as is often made out to be...I wanted a tax-cut surely, but I wanted it as a package...including substantial spending increases. But remember...Kennedy went up to the Hill and 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.”

DAVID SCHOUMACHER: Throughout 1961, the economy continued to grow...but slowly. Unemployment was a problem, but not a crisis. Economist Heller saw room for improvement, but politician Kennedy held back. Then in 1962, Walter Heller saw his chance...

WALTER HELLER: “The economy sputtered in ’62 and I pushed hard for a tax-cut starting in about March, April. The Treasury resisted a big tax-cut. I wanted to have a down payment on it in ’62 to make sure we didn’t fall into a recession again, and then go

ahead in '63. Well, he didn't buy that...but he did buy, by mid-year in '62...he bought the idea of an across-the-board tax-cut. I remember so well..."

KENNEDY: "Every dollar released from taxation that is spent or invested will help create a new job...and a new salary. And these new jobs and new salaries can create other jobs and other salaries. And more customers and more growth for an expanding American economy."

DAVID SCHOUMACHER: Although the President had agreed with him, Heller still had Galbraith to contend with...

WALTER HELLER: "Every now and then his long shadow would fall across the White House when he'd come home for a report from India, and I always knew it because the President would say, "Well, Galbraith's been in here lobbying me again, against your tax-cut."

JOHN KENNETH GALBRAITH: "I had access to the President and expressed myself with some vigor...expressed the concern that if we went for tax-cuts they would become too popular with Conservatives...and that they would be taken up by Conservatives at the cost to the expenditures that were needed on behalf of needy people."

DAVID SCHOUMACHER: Despite Ambassador Galbraith's arguments the President remained committed to his tax-cut. The only remaining questions were: when and how much?

WALTER HELLER: "The Treasury, being sort-of-a keeper of the fiscal keys, was very dubious about a big tax-cut. I wanted a \$12 billion tax-cut...and they wanted about 3 or 4 billion, as they said, "to lubricate tax reform"...was the term they used. And right after Kennedy gave that speech in August of '62, saying, "yes, we're going to have a big tax-cut and I'm going to present it next January"...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 \$12 billion instead of Doug's four"...Well, eventually, and this is a, you know, a slightly simplified

version of history, but eventually we compromised on \$ 12 billion...and that's the kind of compromise I like.”

DAVID SCHOUMACHER: If the economy wasn't prosperous, it wasn't depressed either. Throughout 1963, President Kennedy tried to sell the \$12 billion tax-cut to a reluctant Congress. Then, in November, tragedy struck.

LYNDON JOHNSON: “We meet in grief...John Kennedy's death commands what his life conveyed...that America must move forward...”

DAVID SCHOUMACHER: Congress passed the Kennedy tax program and President Lyndon Johnson signed it into law. On March 15, 1964, a monument to a martyred President. The economy immediately took off in a burst of prosperity...Within 18 months GNP was growing at a feverish 5%...Unemployment had dropped to its lowest level in 7 years...It seemed that in President Kennedy's phrase, “A rising tide really had lifted all boats” and on December 31, 1965, the cover of TIME magazine featured John Maynard Keynes...19 years dead, but once again a household word. For economists, accustomed to laboring in obscurity, it was a welcome change to bask in the “limelight”. Just about everyone...journalists, economists, the general public, agreed that the tax-cut was an unqualified success. By 1965, it appeared we had finally learned how to use fiscal policy to control the economy. We asked economic analyst, Richard Gill, why the tax-cut of 1964 had seemed like such a rousing success...

(MUSIC PLAYS -- COMMENT & ANALYSIS III)

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RICHARD GILL: Well, it did seem to work, that is, get the country moving again. And it also seemed a proof of the Keynesian theory which was pretty dominant among economists by the 1960's. In terms of our diagram, what the tax-cut did was simply give more disposable income to consumers. It shifted this whole curve of private spending up like this. The gap between spending and full employment income was eradicated. Of

course, it could also have been done as, for example, Professor Galbraith urged, by increasing public spending...leaving private spending where it was and increasing “G”, like this. In any case, the apparent success of the tax-cut of 1964 was hailed by many as a total vindication of Keynesian ideas. This was, in fact, the heyday of Keynesian economics. But problems change and so do theories. Within a few years...perhaps even because of the basic success of Keynesian-style policies...we entered a quite different economic world. The wisdom of using fiscal policy to maintain the stability of the economy...in fact, the wisdom of the whole trend towards increasing government participation in the economy, was to come under sharp scrutiny. It’s an issue that divides economists to this day!

DAVID SCHOUMACHER: It’s no wonder the economics profession was feeling pleased with itself by 1965...For two decades the country had prospered...Severities of the business cycle had been sharply reduced...And if recession had not been completely eliminated, at least we thought that fiscal policy held the key to ever-increasing growth and prosperity. It might well have been an economist and not a poet who wrote... “Pride goes before a fall.” The “fall” was certainly coming...and with it would come a new look at the limits of fiscal policy, but that’s a subject for another edition of Economics USA. This is David Schoumacher.

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