

ECONOMICS U\$A

PROGRAM #18

FISCAL POLICY: CAN WE CONTROL THE ECONOMY?

AUDIO PROGRAM TRANSCRIPT

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(MUSIC PLAYS)

ANNOUNCER: Funding for this program was provided by Annenberg Learner.

FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when the series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

(MUSIC PLAYS)

FRANK 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 Behravesh, a vice president for Wharton Econometrics. I'm Frank Stasio.

FRANK 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 1929, 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.

FRANKLIN D. 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."

FRANK 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.

ROBERT NATHAN: "It was quite clear by...by, uh, '32, '33, 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, Works Projects Administration, public works, and the like, to turn the economy around. And...and Keynesian principles that, in times of recession, uh, government deficits could be erased, and then, any factors certainly proved to be true."

FRANK STASIO: In 1935, 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.

FRANK 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.

ROERT 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."

FRANK STASIO: But it wasn't until World War II 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 Behravesh is a vice president for Wharton Econometrics.

NARIMAN BEHRAVESH: "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."

FRANK 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?

NARIMAN BEHRAVESH: "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."

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

NARIMAN BEHRAVESH: "Yes. Eventually it really was a spending in...on World War II that got us finally out of the Depression."

FRANK 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?

NARIMAN BEHRAVESH: "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 people's pockets, who then turn around and spend part of the money that they get from the government."

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

NARIMAN BEHRAVESH: "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."

FRANK 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?

NARIMAN BEHRAVESH: "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."

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

Behravesh: That's exactly right.

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

NARIMAN BEHRAVESH: "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."

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

NARIMAN BEHRAVESH: "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."

FRANK STASIO: Do policymakers take that into account, or is that a fairly negligible difference?

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

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

NARIMAN BEHRAVESH: "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."

FRANK 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...."

FRANK 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.

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

FRANK STASIO: When John Kennedy took office in 1961, unemployment was very high. Even though a recovery from the recession of 1960 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:

WALTER 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.”

FRANK 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?

WALTER 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 '62 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."

FRANK 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:

DAVID STOCKMAN: "In 1962, 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 1970, they cost five percent of GNP. And in 1986, they will require eight point eight of GNP living...leaving a diminishing amount of room for everything else."

FRANK STASIO: In this 1985 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 1930s. 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:

ROBERT 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 the 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 in proportion, 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 to moderate the...the, uh, increases.”

FRANK 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 1984, when government spending threatened to over-stimulate the economy, policymakers and economists called for drastic cutbacks. Former budget director, David Stockman:

DAVID STOCKMAN: “We must either undertake a thoroughgoing 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, sophistical arguments about why Amtrak, or UDAG, or 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 tim...tinkering projects that were marginally affordable in an earlier, happier fiscal era.”

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

NARIMAN BEHRAVESH: “I think that the record, over the ‘60s, ‘70s, and early ‘80s, 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 ‘coarse-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, this lag between the idea and the implementation is a real problem in fiscal policy."

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

NARIMAN BEHRAVESH: "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 affect which Congressman's district, and so forth. So, fiscal policy is very closely tied up with the political process."

FRANK 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?

NARIMAN BEHRAVESH: "Again, I think the issue here is that we can coarse-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."

FRANK 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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FRANK STASIO: You've been listening to Economics U\$A, one of a series of programs on micro- and macroeconomic principles. Our guests have been Robert Nathan, New Deal economist and President of Robert Nathan and Associates, and Nariman Behravesh, a vice president for Wharton Econometrics. Economics U\$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

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(MUSIC PLAYS)

Announcer: Funding for this program was provided by Annenberg Learner.