



# *Policy Note*

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## FISCAL STIMULUS, JOB CREATION, AND THE ECONOMY: WHAT ARE THE LESSONS OF THE NEW DEAL?

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### **The Need for a New Look at the New Deal**

As the nation watches the impact of the recent stimulus bill on job creation and economic growth, a group of academics continues to dispute the notion that the fiscal and job creation programs of the New Deal helped end the Depression. The work of these revisionist scholars has led to a public debate that has obvious implications for the controversy surrounding fiscal stimulus bills. Since we support a new stimulus package, one that emphasizes jobs for the 9.8 percent of the workforce that is currently unemployed, we have been concerned about this debate. We will use this policy note to outline our disagreements with recent unfavorable assessments of President Roosevelt's deficits, public works projects, and relief programs, having dealt with critiques of some other New Deal programs in a recent public policy brief (Papadimitriou and Hannsgen 2009). Because we are not economic historians and have tried our best to keep this note short, we cannot do justice to the academic literature on this subject, though we provide some references to this work. Rather, our purpose is to respond to arguments that have appeared frequently in magazines, newspapers, and other popular forums (e.g., Barro 2009; Ohanian 2009; Reynolds 2009).

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## The Great Depression and Roosevelt's Macroeconomic Response

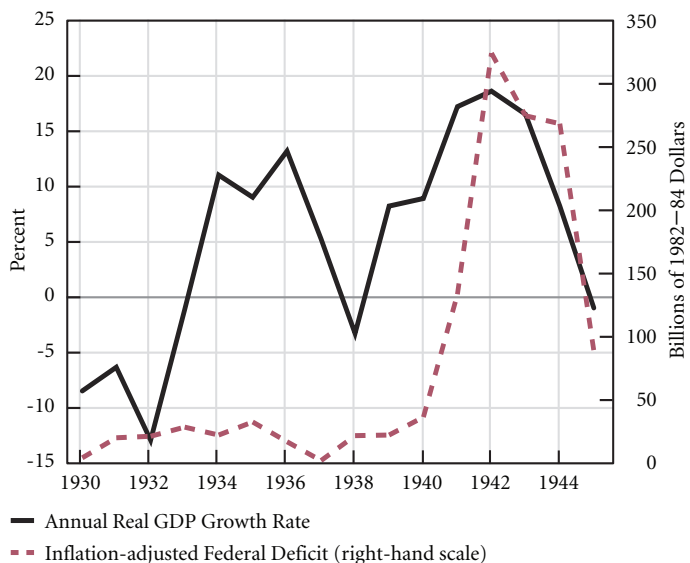
When Roosevelt took office, the unemployment rate had reached 25 percent and the country's economic outlook was dismal. Modern economist Nancy E. Rose describes the dire conditions of the 1930s:

The unemployed are selling apples on street corners to make a few pennies or standing in line at soup kitchens, while food is rotting in the fields because the farmers cannot sell it for enough to make it worth harvesting. Houses are boarded up and farms foreclosed as the owners fail to meet their mortgage payments, and apartments are vacant since people have no money for rent. The growing numbers of homeless are building ramshackle temporary housing out of cardboard and wood on the outskirts of cities across the country. Panicked depositors are withdrawing their money from banks, which are failing one after the other, while barter is replacing cash transactions. Rising unemployment and falling incomes are leading to declining tax revenues, and in many towns teachers are out of work and children are out of school. (1994, 16–17)

It is hard to imagine any program that could have quickly and inexpensively solved these problems. On the other hand, the period between the Great Crash in 1929 and the beginning of Roosevelt's first term in 1933 offered little evidence that the economy could recover on its own—a hope maintained throughout this recession by many contemporary economists, businessmen, and others. Economic historian Peter Temin of MIT has presented a particularly convincing account of the failure of the economy to recover spontaneously in the early 1930s, and of the strong economic headwinds faced by the newly elected Roosevelt and Congress in 1933 (1976, 138–68).

Roosevelt initiated what was to become a series of public works programs in his “first 100 days” in office. Macroeconomists have been estimating the numbers of jobs created, as well as the wider impact of the era's fiscal policy changes. Such estimates usually do not include payoffs that are realized gradually over time, as society reaps the economic benefits of bridges, post offices, and other outputs of works programs, which have been impressively documented in Robert D. Leighninger's *Long-Range Public Investment: The Forgotten Legacy of the New Deal* (2007). It is also important to remember that the New Deal included many

Figure 1 Budget Deficits and Growth, 1930–45



Sources: Authors' calculations; Bureau of Economic Analysis; Office of Management and Budget; and Bureau of Labor Statistics. All data accessed through FRED databank, [www.stlouisfed.gov](http://www.stlouisfed.gov).

programs that created jobs in more indirect ways—by improving the affordability of mortgages, stabilizing the banking system, bringing electricity to more rural areas, and so on.

### New Deal Fiscal Stimulus: Ineffectual or Just Not Big Enough?

Roosevelt's jobs programs were massive and ambitious, but the intensity of these efforts varied over time. Roosevelt has been called “a decidedly reluctant and an exceedingly moderate Keynesian” (Kennedy 1999, 361), an apt description for a president who called for a balanced budget in his first national campaign. Roosevelt's Economy Act, passed in March 1933, reduced veterans' benefits and federal employees' salaries by \$500 million (Leuchtenburg 1963, 45). (This is a large amount, considering that total federal outlays were \$4.6 billion that year [OMB 2009]). In 1937, Treasury Secretary Henry Morgenthau Jr. dismayed Keynesians in the White House by calling for spending cuts and “progress toward a balance of the federal budget” (Shlaes 2007, 342). Moreover, even as Washington sharply increased spending from 1933 to 1936, tax-revenue shortfalls were forcing state and local governments to cut their expenditures on roads and other projects. (There are similar problems right

now at the state and local levels, and the resulting fiscal under-tow is partially offsetting an admittedly strong fiscal push from Washington.)

It is interesting to trace the paths of the federal budget deficit and GDP growth starting in the year of the Great Crash, through the New Deal period, and to 1945, the last year of World War II. Figure 1 shows the unsteady path of fiscal policy (represented by the broken line), which is measured on the right axis as the federal government deficit deflated by the Consumer Price Index (CPI).

The CPI equaled approximately 1 in July 1983.<sup>1</sup> By comparison, the inflation-adjusted deficit for fiscal year 2008, which does not appear in the figure, was \$218 billion. The deficit had already been rising for at least two years when the New Deal began. Its rise was interrupted in 1934 and, more sharply, in 1936–37, around the time Morgenthau spoke out against Keynesianism. The 1930s deficits caused great concern but were soon overshadowed by those of the war years. It is hard to find an unambiguous association between the deficit and real GDP growth (depicted in the figure by a solid line), but the resurgence in growth from 1933 to 1937 followed a rapid rise in the deficit. Similarly, the recession of 1937–38 occurred after the deficit fell by half in 1936 and nearly to zero in 1937. As the deficit rebounded from this experiment, growth returned and soon reached nearly 20 percent per year.

Of course, sometimes government deficits occur because households report less taxable income, for example, not because policymakers intentionally stimulate the economy. Hence, there have been efforts by economists to measure the true strength of the push provided by fiscal policy. One classic study by E. Carey Brown found that the net contribution of fiscal policy to the demand for goods and services at all levels of government substantially exceeded 1929 levels in 1931 and 1936 but not in any other year of the decade, an observation that led Brown to write, “Fiscal policy, then, seems to have been an unsuccessful recovery device in the ’thirties—not because it did not work, but because it was not tried” (1956, 863–66). According to Brown, spending increased, but the overall stimulus was small owing to “the sharp increases in tax structures enacted at all levels of government” (867). The surge in growth early in Roosevelt’s presidency is now viewed by Barry Eichengreen (1992) and many other economic historians as resulting from the abandonment of the gold standard and other nonfiscal factors, though few would deny that the New Deal deficits were of

some help. Brown himself concluded that only the much greater economic jolt provided by wartime military expenditures allowed the economy to realize the full potential of fiscal policy (1956, 869).

Perhaps more important than the size of the fiscal stimulus was the number of jobs created by the Works Progress Administration and other federal agencies. An official study by John Kenneth Galbraith found that from 1934 to 1938, employment in federal public works programs equaled 13–15 percent of the total number of workers unemployed, with work relief construction employment amounting to an additional 18–21 percent of that number (1975 [1940], 109). These figures are far from comprehensive, as they do not include, for example, jobs outside of construction or the “multiplier” effects generated when federal workers spent their paychecks at private businesses. However, they do show that the persistence of mass unemployment throughout the 1930s should be blamed mostly on the enormity of the task at hand and Roosevelt’s reluctance to run deficits. (Some misleading employment statistics from the era, which leave out large numbers of public sector workers, have led a number of scholars to understate the success of the governmental effort to reduce unemployment.)

### The Fiscal-policy Skeptics

Since debates about stimulus packages began last year, there has been a flurry of polemics on the effects of fiscal policy in blogs and newspapers (e.g., Barro 2009). Some economists argue that when the government increases deficits or hires new workers, businesses cut production. Often, these arguments depend on the idea of Ricardian equivalence—that taxpayers put aside substantially more money for future tax payments when the government deficit-spends. To show that this effect completely offsets the effects of higher government deficits requires assumptions that seem unrealistic. Also, some analyses implicitly assume that there are no unemployed resources in the economy, so that government cannot hire workers or borrow money without reducing the amount of these “inputs” available to private industry.

In an effort to overcome the limitations of such theories, John Maynard Keynes tried in his 1936 book *The General Theory of Employment, Interest, and Money* to develop a new kind of macroeconomics that would be useful when significant numbers of people were unemployed and machines were idle.

He developed an argument that public spending (and monetary policy) could alleviate such conditions. Looking at the issue from a more pragmatic standpoint, numerous empirical studies done over the years show that fiscal stimulus does matter, though perhaps less than Keynes and many of his contemporaries hoped. Critics point out that a large portion of tax cuts and transfers to consumers is not spent, but with many households' "balance sheets" in bad shape, money set aside to rebuild savings accounts and pay off household debt is perhaps just as beneficial to households, and to the wider economy. The account above suggests that the experience of the New Deal era only strengthens the case for the effectiveness of fiscal policies and jobs programs.

### Nearly Two Years into the Great Recession: Time to Look to Keynes Again?

While many economic indicators hint that the economy is growing once again, Paul Krugman (2009), Nouriel Roubini (2009), and others have been arguing convincingly that a very sluggish recovery or double-dip recession is likely. At this point, renewed and sustained economic growth can hardly be taken for granted, but the most pressing need is to deal with unemployment. Consider just how serious this problem is. The U.S. Department of Labor's broadest measure of civilian unemployment includes both part-time workers "who want and are available for" full-time work and people "who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the recent past." This group now makes up 17.0 percent of the labor force (BLS 2009a). Over half of the workers who were unemployed in September (by the traditional federal definition) had been out of work for 15 weeks or more (BLS 2009b). It is next to impossible to find work when there are 6.0 job seekers per opening, as there were by the most recent count (Shierholz 2009).

In spite of the stimulus packages and other large outlays, the economy remains far from the barrier of full employment, so Keynes's general theory of an economy that often has unemployed resources is still apropos. Moreover, there is good reason to think that what worked in the Great Depression would work again today, though again, the task at hand is enormous. However, we lament that many Keynesian commentators focus almost exclusively on the amount of stimulus needed. Some types of stimulus would be more effective than others in creating

jobs. In particular, a permanent employer-of-last-resort (ELR) program, as proposed by Hyman P. Minsky (1965; 2008 [1986], 308–13), would provide cost-effective and noninflationary insurance against unemployment and allow the government to cut spending on some other safety-net programs. (Papadimitriou 1999 makes the case for an ELR program.) The Levy Institute has proposed other "high quality" forms of fiscal stimulus in past publications (e.g., Papadimitriou and Wray 2001a, 2001b).

Congress, the White House, pundits, and the press are riveted on the all-important health care debate, but we worry that they are also distracted by skirmishes over economic theory and history, while millions wait for a new chance to do meaningful work and effective, if imperfect, policy tools are readily at hand.

### Note

1. The official CPI equals approximately 100 in July 1983, but we divided it by 100 before calculating the inflation-adjusted deficit for each year. This is equivalent to using the definition  $\text{Inflation-adjusted Deficit} = (\text{Deficit} \times 100) / (\text{Official CPI})$ . This adjustment makes Figure 1 easier to read and has no effect on comparisons between any two inflation-adjusted deficits depicted therein. However, the deficits shown in the figure should not be compared with similar deficit series computed using official CPI data.

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