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Recession, Debt, Taxes, and Social Security

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Introduction

This unit is designed to help students make informed decisions about issues that are as contemporary as the day's newspaper headlines and as old as discussions concerning the welfare state. These issues include: balancing the federal budget, raising taxes, reducing government spending, dealing with the aftermath of the subprime mortgage crisis, and resolving the upcoming shortfall in the Social Security Trust Fund.

By studying this unit, students will learn of the seriousness of our national debt problem, the history of the progressive income tax and the tax burden of various income groups, John Maynard Keynes's theory of the multiplier, the underlying cause of the recent recession, the theories that support and oppose spending stimulus money to end it, and the benefits and drawbacks of extending compensation to the unemployed. They also learn how the Social Security program was designed, the reasons it faces systemic problems, and the arguments for and against privatization. In addition they are provided with a multi-page review of each chapter to help them prepare for a unit test.

Each chapter includes numerous multiple-choice questions, as well as thought-provoking essay questions. In addition, teacher's pages provide an overview of each chapter, a list of objectives, and teaching strategies.

CHAPTER 1
KEYNES AND THE MULTIPLIER

Overview

To help students make comparisons between the recession that started in 2007 and the Depression that started in 1929, this chapter starts by explaining why President Herbert Hoover avoided deficit spending. Students then learn the theory of John Maynard Keynes's multiplier and are assigned to chart the relationship between Gross National Product, investment spending, and government spending between 1929 and 1944. They learn that New Deal spending did relatively little to end the Depression as compared to wartime spending. The latter helped restore GNP to pre-Depression levels and doubled GNP while running up a very large debt.

Objectives

Students will:

- learn of the severity of the Great Depression
- learn the reasons that Hoover did not try to "spend his way out" of the Depression
- learn the reasoning behind Keynes's theory of the multiplier
- graph changes in GNP, investment spending (I), and government spending (G) for the period 1929–1944, and explain whether the statistics prove that Keynes was right and whether they think the increased debt was acceptable.

Strategies

Day 1: Determine whether all students have done their homework by reviewing students' answers to the multiple-choice questions. Then ask them to recall the severity of the economic situation in 1933 and compare that to what they know about the economy today. Review the concept of the multiplier and make sure that all students understand it. Proceed by asking whether they know what the formula **GNP = C + I + G** stands for, and if needed, review this concept (also covered in Book II of this series). Note that a reduction in investment spending of over $15 billion between 1929 and 1932 could account for the threefold reduction in GNP by about $46 billion

over those years. Pass out copies of the graph at the end of this chapter and help students begin doing the graphing assignment that should be completed by the next time they come to class.

Day 2: Check to see whether students completed their assigned homework. Ask students to meet in small groups to explain what the results of the graphing exercise tells them about the effects of government spending. Have them note the extent of government spending and the increase in the debt and GNP between 1939 and 1942, and the growth of GNP during those years. Ask whether what they learned from this exercise provides a lesson on what the federal government should do today.

Assignment

Assign Chapter 2, passing out the student reading and activities pages. Ask students to complete their assignment on their own paper if they run out of room on the handouts.

CHAPTER 1

KEYNES AND THE MULTIPLIER

Introduction

When confronted with a recession, a president may wish to learn what past presidents have done in similar situations. Because this unit examines the recession of 2007–10, we start with a description of what happened 79 years earlier by looking at the Great Depression of the 1930s. The Depression started with the collapse of the U.S. stock market in 1929 in much the same way the recent recession began with the bursting of the housing market bubble. Herbert Hoover was president when the Depression began and proved unable to prevent its downward spiral.

Let us look at the economy of the 1930s four years after Herbert Hoover became president: Gross National Product had gone from $104 billion in 1929 to $59 billion in 1932; average family income from $3000 to $1800 a year. Stocks fell from $310 to $34 per share. Farm income was down from $790 to $200 a year; a bushel of wheat that cost 45 cents to grow, was selling for 38 cents. Thirteen million people, 25% of the workforce, were unemployed and many people were starving.

During the four years that Herbert Hoover faced this situation, he consulted his advisers. They told him to balance the budget and not increase government spending. Hoover's advisors told him that the worst thing the government could do was increase the national debt. They thought this would drive up interest rates and wages and would make it more difficult for businesses to borrow money and expand. Furthermore, they warned, increasing the debt would raise doubts that it could be paid off and cause a lack of confidence in the federal government. Finally, they believed, raising the debt would be unfair to the children and grandchildren who eventually would have to pay it off.

One economist, an Englishman named John Maynard Keynes, disagreed with those who spoke in favor of a balanced budget. He said the way to get out of the Depression was for the government to spend its way out. In this chapter you will be asked to decide whether Keynes's unconventional economic advice actually brought the U.S. out of the Depression.

Gross National Product and the Multiplier

In 1929, our Gross National Product[1] (GNP) was $104.4 billion; in 1930, it was $91.1 billion; in 1932, it was $58.5 billion.

	1929	1930	1932
Consumption spending (billions $)	79.0	71.0	49.3
Investment spending (billions $)	16.2	10.3	0.9
Government spending (billions $)	8.1	9.2	8.1
Gross National Product (billions $)	104.4	91.2	58.5

A closer look at the chart shows that the largest percentage change between 1929 and 1930 was in investment spending. In fact, investment decreased by 35% while consumption declined only by 10%. By 1932, investment had decreased by 95% to $0.9 billion, while consumption only decreased by 38% to $49.2 billion. Economists had long noted that investment spending declines much more rapidly than consumption spending and concluded that depressions may be caused by declines in investment spending.

Careful studies of past fluctuations in business cycles have indicated that each dollar of reduced investment spending will result in a far greater negative change in GNP. Likewise, every dollar of increased investment spending will result in a much larger positive change in GNP. Here is how it works:

Suppose Henry Ford decided to spend $1 million to expand one of his factories in Detroit. The money is paid directly to his workers or to other businessmen who will use it indirectly to pay their labor costs, dividends, etc. Studies have shown that people tend to spend about two-thirds of their increased incomes. Therefore, those receiving the dollars that Ford pumped into the economy will spend about $666,666 and save the other $333,333. The increased spending will put cash in the hands of grocers, car salesmen, clothing-store salespeople, etc. Two-thirds of this money would then be spent by those receiving it, and this process will continue in an endless chain as illustrated by the following chart:

1. GNP is similar to GDP, but without accounting for balance of trade (imports – exports).

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Stage	Amount ($)
1. Ford's investment	1,000,000
2. Money spent by Ford's workers (2/3 × 1,000,000)	666,666
3. Money spent by grocers etc. (2/3 × 666,666)	443,556
4. Money spent by those who received from stage 3 (2/3 × 443,556)	295,403
5. Same as stage 4 (2/3 × 295,403)	196,741
6. Same as stage 5 (2/3 × 196,741)	131,030
7. Total of all spending so far	2,733,396
8. All steps from stage 6 to infinity	266,604
9. Total of stages 1 to infinity	3,000,000

You should now understand the importance of business investment to the nation's economic well being. Each additional dollar invested results in as much as a threefold increase in GNP.

Savings and Investment

Most economists before the Great Depression assumed that money saved by some individuals would eventually be borrowed by businesses and invested. This assumption was so widely accepted that it was called Say's law, after the French economist J.B. Say. Yes, economists admitted, in the short run, savings may not go directly into investment. But the economy is basically self-correcting. In a recession, interest rates will drop low enough to entice businesses to borrow money again. Wages will come down because unemployed workers will take whatever job they can get. As more and more people secure jobs, the recession ends and recovery begins. This leads to more buying, borrowing, and employing. According to conservatives, interest rates, wages, and employment would adjust automatically as long as governments do not interfere.

Subscribing to the economic wisdom of his day, Herbert Hoover waited four years for the business cycle to correct itself. During his waiting, the GNP got lower and lower, unemployment increased, businesses failed, and banks closed their doors and went out of business. The Depression got worse every year.

Keynes Advocates Deficit Spending

John Maynard Keynes was much less optimistic than Herbert Hoover or Say about the power of the economy to correct itself. Keynes had seen no sign that the U.S. economy was correcting itself in any way. He concluded that, contrary to Say, savings are not automatically reinvested. He noted that the decline in the value of stocks and the loss of money through bank failures

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completely destroyed the savings of millions.

According to Keynes, there was both bad and good news: The bad news was that a nation may skid along at the bottom of a business cycle almost indefinitely—contrary to Say, there may be no automatic way out of a depression. The good news was that government spending could have the same beneficial multiplier effect as business spending. The multiplier, Keynes claimed, would work just as effectively if the government borrowed and spent money as when businesses spent it. According to Keynes, a nation could spend its way back to prosperity using government spending (G) rather than business spending (I).

A Summary

Both Say and Keynes would likely agree on the importance of savings and investment. However, Say assumed investment and savings would always tend to equalize in the long run. The government's job according to Say, was not to interfere with these self-correcting forces. Keynes disagreed and said that government spending can and should make up for decreases in business spending. Keynes believed the government could and should spend its way out of a Depression and not worry about balancing the budget. The budget would be balanced after the depression ended. Once the economy recovered, government spending would be replaced by business spending. At that point the government could collect enough taxes to pay off its debt. In short, Keynes believed that government spending could end depressions and create self-sustaining growth, which could continue without the government spending more money.

Did Government Spending End the Depression?

When Keynes met with President Franklin Roosevelt, he told the president to increase government spending by between $12 and $15 billion (about $250 billion in 2011 dollars) a year. Roosevelt in fact increased government spending, but only by a few billion dollars. When the President decreased government spending to balance the budget in 1937 (see chart below), GNP declined sharply, more quickly than the rate of decline from 1929 to 1933. Roosevelt pumped more money into the economy in 1938 and GNP went up. Beginning in 1939, the U.S. government effectively began preparing for World War II. During the war, government spending increased sharply, and by 1944, GNP was twice as high as GNP in 1929.

The National Association of Manufacturers, however, stayed with the conventional wisdom that increased government spending hurts rather than helps the economy. This businessmen's organization published a report in 1941, restating its long-standing opposition to deficit spending:

> Deficit spending has actually discouraged a greater amount of new private spending than it replaced. It has had little effect other than cause a staggering debt burden. The theory that by deficit financing we can achieve economic recovery overlooks the fact that government spending by itself cannot begin to provide the plant and equipment needed to put people back to work, that recovery is dependent on the stimulation of

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private investment, and that investors must be confident that private enterprise will be permitted to employ capital and labor properly (without government interference).[2]

One might say that history has proved the NAM wrong. But it is a far more open question whether deficit spending has ever created Keynes's predicted result of self-sustaining growth. As the $14 trillion ($370 billion in 1930s dollars) deficit of the year 2011 proves, it is far easier for the government to go into debt than it is for the government to reduce its debt.

GNP, Expenditures, Deficits, and Unemployment						
Year	**Total GNP (billions)**	**Total C (billions)**	**Total I (billions)**	**Total G (billions)**	**Surplus or deficit**	**Percent unemployed**
1929	104.4	79.0	16.2	8.5	+ 1.2	3.2
1930	91.1	71.0	10.3	9.2	+ 0.3	8.7
1931	76.3	61.3	5.5	9.2	– 2.1	15.9
1932	58.5	49.3	0.9	8.1	– 1.5	23.6
1933	56.0	46.4	1.4	8.0	– 1.3	24.9
1934	65.0	51.9	2.9	9.8	– 2.9	21.7
1935	72.5	56.3	6.3	10.0	– 2.6	20.1
1936	82.7	62.6	8.4	11.8	– 3.5	16.9
1937	90.8	67.3	11.7	11.7	– 0.2	14.3
1938	85.2	64.6	6.7	12.8	– 2.0	19.0
1939	91.1	67.6	9.3	13.3	– 2.2	17.2
1940	100.6	71.9	13.2	14.1	– 1.4	14.6
1941	125.8	81.9	18.1	24.8	– 5.1	9.9
1942	159.1	89.7	9.9	59.7	– 33.2	4.7
1943	192.5	100.5	5.6	88.6	– 46.7	1.9
1944	211.4	109.8	7.1	96.5	– 54.6	1.2

C = private consumption; I = gross investment; G = government spending

2. *Fallacies about the Free Enterprise System* (National Association of Manufacturers, 1941), p. 26

Name: ____ Date: ___________

Student Activities

Keynes and the Multiplier

A. Multiple-choice:

1. Herbert Hoover was:

   a. the president of the U.S. who believed in the multiplier

   b. president of the U.S. during the first four years of the Great Depression

   c. the president who ended the Depression

   d. an advisor to President Roosevelt.

2. Which of the following was not true of the Great Depression?

   a. GNP declined by about one-half

   b. On the average, it cost more to grow wheat than it sold for

   c. Stocks took a beating by falling about 90%

   d. Twenty million people were unemployed

3. President Hoover was advised not to borrow a lot of money to try and end the Depression because:

   a. it would cause interest rates to go up

   b. the next generation would have to pay it back

   c. it would make people lose confidence in the government

   d. all of the above.

4. John Maynard Keynes was:

   a. a socialist

   b. the economist who advised Roosevelt to spend the U.S. out of the Depression

   c. an advisor to Herbert Hoover

   d. all of the above.

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