

# The Role of Government in the Economy

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# Role of Government in a Market Economy

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- Maintain legal and social framework
- Maintain competition
- Provide public goods and services
- Redistribute income
- Correct for externalities
- Stabilize the economy

# Two Types of Policies

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## Fiscal Policy

The use of **spending and taxation** by the federal government (Congress and the President) to affect **economic activity**

## Monetary Policy

The actions of a **central bank** to affect the **availability and cost of money and credit** in order to achieve **national economic goals**

# Roles of Government

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- **Correct for externalities**
- Provide public goods & services
- Redistribute income
- Stabilize the economy

# Externalities

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- Benefits or costs from a transaction extend beyond the buyer or seller.
- Positive externalities
  - Education
  - Technology spillovers or patent protection
- Negative externalities
  - Pollution

# Fiscal Policy Tasks

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- Correct for externalities
- **Provide public goods & services**
- Redistribute income
- Stabilize the economy

# Potential Market Failures

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		Rival in Consumption?	
		Yes	No
Excludable?	Yes	Private Goods	Natural Monopolies
	No	Common Resources	Public Goods

# Potential Market Failures

		Rival in Consumption?	
		Yes	No
Excludable?	Yes	<b>Private Goods</b> <ul style="list-style-type: none"> <li>• Clothing</li> <li>• Congested toll roads</li> <li>• Ice cream</li> </ul>	<b>Natural Monopolies</b> <ul style="list-style-type: none"> <li>• Fire protection</li> <li>• Cable TV</li> <li>• Uncongested toll roads</li> </ul>
	No	<b>Common Resources</b> <ul style="list-style-type: none"> <li>• Fish in the ocean</li> <li>• Environment</li> <li>• Congested non-toll roads</li> </ul>	<b>Public Goods</b> <ul style="list-style-type: none"> <li>• Tornado siren</li> <li>• National defense</li> <li>• Uncongested non-toll roads</li> </ul>

# Potential for Market Failure

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- **Public goods** are subject to a free-rider problem.
  - Lighthouse, basic research
- **Common resources** can lead to the tragedy of the commons.
  - Clean air and water, congested cities

# Natural Monopolies

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- Some industries are characterized by conditions that create barriers to entry.
  - Location
  - Economies of scale
- Utilities are the classic example.
  - Water
  - Cable television
  - Electricity

# Protected Monopolies

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- Barriers to entry in some industries are the result of specific protections granted by government.
  - Licenses
  - Patents
- Examples
  - Concessions in national park
  - Pharmaceuticals

# Fiscal Policy Tasks

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- Correct for externalities
- Provide public goods & services
- **Redistribute income**
- Stabilize the economy

# Federal Government: Receipts

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- Individual income taxes
- Social insurance taxes
- Corporate income taxes
- Other

# Structure of Taxes

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## Regressive

- % of income paid in taxes ↓ as income ↑

## Progressive

- % of income paid in taxes ↑ as income ↑

## Proportional

- % of income paid in taxes is fixed as income changes

# Structure of Taxes

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## Regressive

- Sales tax, Social Security taxes

## Progressive

- US federal income tax, estate taxes

## Proportional

- Flat tax, Medicare tax

# Federal Government: Spending

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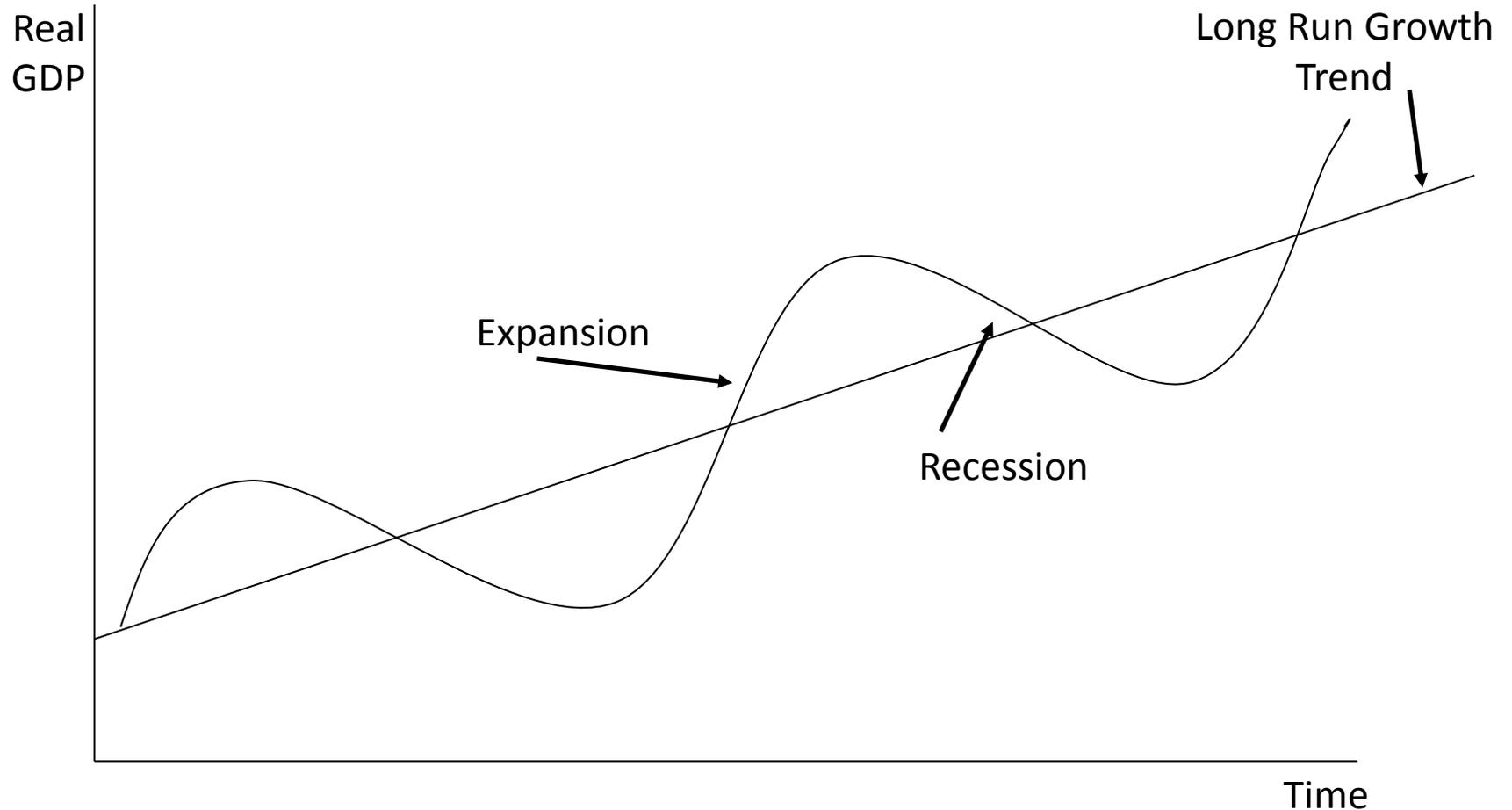
- Social Security
- National defense
- Income security
- Medicare
- Health
- Net interest
- Other

# Fiscal Policy Tasks

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- Correct for externalities
- Provide public goods & services
- Redistribute income
- **Stabilize the economy**

# Business Cycle



# Expansionary Fiscal Policy

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- Response to a recession (Economy is operating below full employment.)
- Seeks to stimulate production (and consumption).
  - Directly (expenditures  $\uparrow$ )
  - Indirectly (taxes  $\downarrow$  to encourage household spending or investment spending)

# Contractionary Fiscal Policy

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- Response to inflation (Economy is operating above full employment and prices are rising.)
- Seeks to reduce production (and consumption).
  - Directly (expenditures ↓)
  - Indirectly (taxes ↑ to discourage household or investment spending)
- Politically difficult

# Fiscal Response to Economic Contractions

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- New Deal
- Great Society
- 2008 Financial Crisis

# Sinking into Depression

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Year	Number of Bank Suspensions	Unemployment Rate	Per Capita Personal Income	Real GDP (in millions of dollars)
1929	659	3.2%	\$698	\$951.7
1930	1352	8.9%	\$619	\$862.1
1931	2294	16.3%	\$526	\$788.8
1932	1456	24.1%	\$399	\$682.9
1933	4004	25.2%	\$372	\$668.6

# New Deal

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“We have two problems: First, to meet the immediate distress; second, to build up a basis of permanent employment. As to immediate relief, the first principle is that this nation, this national government if you like, owes a positive duty that no citizen shall be permitted to starve. In addition to providing emergency relief, the federal government should and must provide temporary work wherever that is possible.”

*Franklin D. Roosevelt*

*October 1932*



# New Deal

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It IS a New Deal



# Goals of the New Deal

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- **Relief** programs to help immediately
- **Recovery** programs to rebuild
- **Reform** programs to prevent the disaster from reoccurring

# Alphabet Soup

**The Agriculture Adjustment Administration (AAA)** of 1933 raised farm prices through subsidies. It paid farmers not to raise certain crops and livestock, hoping that lower production would cause prices to rise. The Supreme Court struck down the tax that funded AAA subsidies to farmers. The Civil Works Administration (CWA) was a public works program funding jobs ranging from ditch digging to highway repairs to teaching. Created in November 1933, it was criticized as "make work" and abandoned in the spring of 1934. It provided a psychological and physical boost to its 4 million workers.

**Emergency Banking Act** On March 6, 1933, FDR shut down all the banks in the nation and forced Congress to pass this Act. It gave the government the opportunity to inspect the health of all banks. This re-established citizens' faith in banks. Inspectors found that most banks were healthy, and two-thirds of all banks were allowed to open soon after.

**The Farm Security Administration (FSA)** was created in 1937 (formerly called the Resettlement Administration in 1935) to aid sharecroppers.

**The Civilian Conservation Corps (CCC)** of 1933 put 2.5 million men to work in a variety of conservation projects: planting trees to combat soil erosion and maintain national forests; eliminating stream pollution; and conserving fish, game and bird sanctuaries; and conserving petroleum, shale, gas, sodium and helium.

**The Fair Labor**

**The Federal Theatre Project (FTP)** of a part of the Works Progress Administration employed 12,700 theatre workers at its The Federal Theatre units presented more than 100 performances each month before nearly 1 million people. There were 1,200 plays produced in the four years.

**Public Works Administration (PWA)** of 1933

**The Federal Deposit Insurance Corporation (FDIC)** was established by the Glass-Steagall Banking Act of 1933 to insure bank deposits of up to \$5,000.

**The Federal Housing Administration (FHA)** worked to improve housing by insuring mortgages.

**The National Recovery Act (NRA)** of 1933 was known as the "Blue Eagle" from its popular symbol. Accompanied by the slogan "We Do Our Part," the NRA established codes for fair business practices. These codes regulated wages, working conditions, production and prices, and set a minimum wage. The Supreme Court invalidated the NRA in 1935. Some think that it hampered recovery by allowing the formation of cartels, restricting competition and reducing employment.

**National Youth Administration (NYA)** created under the Emergency Relief Act of 1935, provided more than 4.5 million jobs for young people. It gave part-time employment to students, established training programs and provided aid to unemployed youth.

**The Rural Electrification Administration (REA)** of 1935 offered loans to electric companies and farm cooperatives for building power plants and extending power lines.

**The Social Security Act of 1935** established the administration of a national pension fund for the aged and unemployed, as well as public assistance for dependent mothers, children and disabled people. It was financed by a payroll tax based on employer and employee contributions.

**The Works Progress Administration (WPA)** was a part of the second phase of the New Deal.

**The National Labor Relations Act (Wagner Act)** of July 1935 legalized collective bargaining and closed shops (workplaces open only to union members). Although it was designed to bring about industrial peace, it led to a wave of strikes, many of which were sit-down strikes. These tactics, although not always successful, proved quite powerful. In 1939, the Supreme Court outlawed the sit-down strike as being too potent a weapon and an obstacle to negotiation.

**The Public Works Administration (PWA)** of 1933 launched projects, such as the Grand Coulee Dam on the Columbia River. It was intended both for industrial recovery and unemployment relief. Eventually more than \$4 billion was spent on 34,000 construction projects. One of these projects was San Francisco's Golden Gate Bridge.

**The Securities and Exchange Commission (SEC)** of 1934 required full disclosure of information on stocks being sold. The SEC regulated the stock market. Congress also gave the Federal Reserve Board the power to regulate the purchase of stock on margin.

**Tennessee Valley Authority (TVA)** The Tennessee Valley Authority was created for the economic development of the Tennessee River watershed. Many jobs were created as a result of 20 dams built to control flooding, generate electricity and increase agricultural production.

**Act of 1935 (Wealth Tax Act)** raised individual incomes that exceeded so increased rates on the income and donations.

# Alphabet Soup

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# Lasting Recovery?

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Year	Unemployment Rate	Real GDP (in billions of dollars)	Federal Spending (in millions of dollars)
1929	3.2%	\$951.7	\$3,127
1930	8.9%	\$862.1	\$3,320
1931	16.3%	\$788.8	\$3,577
1932	24.1%	\$682.9	\$4,659
1933	25.2%	\$668.6	\$4,598
1934	22.0%	\$719.8	\$6,541
1935	20.3%	\$778.2	\$6,412
1936	17.0%	\$888.2	\$8,228
1937	14.3%	\$932.5	\$7,580
1938	19.1%	\$890.8	\$6,840

# Assessment – A New Deal Box

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- Front of box:
  - Name and abbreviation of the program, art relating to the program, purpose of the New Deal program
- Top of box:
  - Dates of program, purpose of program (relief, reform, recovery)
- Side panel one:
  - Following the “Nutrition Facts” format, create a “Program Effects on the Economy,” biographical information about Franklin D. Roosevelt
- Side panel two:
  - Description of the program in paragraph form, description of end of program or its current-day status
- Back panel:
  - Game, word search, puzzle or cartoon

SWEEPING CHANGES ARE EXPECTED  
AFTER MARCH 4TH  
BY MORRIS



# Employment Act of 1946

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- It is the policy and responsibility of the federal government to use all practical means to promote maximum employment, production and purchasing power.
- Three goals
  - Full employment
  - Price stability
  - Economic growth

# Great Society

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- Aid to education
  - Funded students (instead of schools)
- Medicaid and Medicare (1965)
  - Created a new entitlement in perpetuity
- Immigration and Nationality Act of 1965
  - Abolished the national-origin quota system
  - Created family reunification policy

# Full Employment and Balanced Growth Act

## *The Humphrey-Hawkins Act (1978)*

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An Act to translate into practical reality the **right of all Americans** who are able, willing and seeking **to work, to full opportunity for useful paid employment** at fair rates of compensation;

to assert the responsibility of the Federal Government to **use all practicable programs and policies** to promote full employment, production and real income, balanced growth, adequate productivity growth, proper attention to national priorities and reasonable price stability;

to **require the President** each year to set forth explicit short-term and medium-term economic goals;

to achieve a **better integration** of general and structural economic policies;

and to improve the **coordination of economic policymaking** within the Federal Government.



# Fiscal Responses to 2008 Recession

Emergency  
Economic  
Stabilization  
Act of 2008

## American Recovery and Reinvestment Act of 2009

Established  
the Troubled  
Assets Relief  
Program  
(TARP)

Renewable  
energy  
&  
weatherize  
buildings

New  
infrastructure  
(roads,  
bridges and  
mass transit)

Fund Pell  
Grants

Making Work  
Pay tax credit  
&  
Child Tax  
Credit

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