

The Transition from Classical Economics:
How Keynesian Economics Became “The New Deal” of American Economic Policy

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Paper

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Process Paper

I chose my topic, which is the New Deal, over the summer. It was inspired by my economics class as I found it to be intriguing when we talked about different economic theories. It was interesting to learn how the New Deal pioneered a type of economic theory that did not even have a name until a few years after the entire New Deal went into effect. It was truly an intellectual frontier that helped negate the effects of the Great Depression, despite the fact that it took another world war for the global economy to be able to recover and sustain itself and its citizens once more.

I did my research in the most unique and unorthodox way I ever have for this project. I initially did not plan on using this for an NHD project; I only wanted to study Keynesian economic theory a bit more. However, as I learned more about it, I came to realize that the point at which it began to be widely used was after World War I. And then I recognized that America had policies that followed the theory in the Great Depression, and since I already had pages of notes on the economic theory aspect, it would be incredibly easy to research the historical aspect and create a full-blown project out of it. I then went to resources where I could easily find academic sources, like school and university databases. I found some extremely helpful academic papers through Boise State's database, and these greatly helped me understand Adam Smith's work. I used the Library of Congress and the National Archives to find things like speeches, writings, and other primary sources that would help me write out my paper effectively.

I chose to write a paper because it is what I've always done for my NHD projects. I love to write, and I love improving my writing. I also think that writing helps me better learn subjects and engrain concepts into my brain. I have voluntarily written papers for math and chemistry simply because writing helps me understand more thoroughly, so if it helps, why not do it? I

began creating this paper by writing a research question, researching and looking for evidence, drafting a thesis statement, writing an outline in the form of a mind map, and then finally, writing, editing, and revising the paper. I had some trusted friends and peers look over it and give me advice, especially where I described more technical aspects of economics.

The New Deal easily relates to this year's NHD theme, Frontiers in History: People, Places, Ideas. It falls under the "ideas" category as it set a new precedent for American economic policy. There was a clear transition here from minimal government influence in the economy to greater government influence in the economy during times of both natural recession the economy and larger depressions. It was truly a novel idea as, at the time, capitalism was only believed to flourish without any governmental intervention.

Historical Paper

“The only thing we have to fear is fear itself.” – Franklin D. Roosevelt¹

President Franklin D. Roosevelt took office for the first time in 1933, less than four years after the crash of the American stock market that initiated the Great Depression. President Roosevelt was replacing President Hoover, who believed that the economy would fix itself, a common belief at the time. Roosevelt, however, began his presidency by immediately presenting new programs and policies, the most impactful being the New Deal. The New Deal was full of new deals for the nation, and it represents the transition from the usage of classical economics in government policy to the use of Keynesian economics, which allows for government influence in the economy. Because of the unprecedented ideas Roosevelt’s New Deal adopted, it altered the political landscape of America forever and created new American economic policies.

Classical Economics, Keynesian Economics, and the New Deal

President Roosevelt was voted into in the middle of an ambiguous political landscape caused by the Great Depression. Former President Herbert Hoover had stayed true to his beliefs of limited government in the first few years of the depression, imploring a “spirit of volunteerism” among America’s businessmen to keep Americans employed. Additionally, he called on the average American to embrace American individualism, the belief that hard work brings great reward.² This view was popular among majority of politicians at the time; after all, every economy has times of growth and times of recession, so it was assumed that the if the

¹ Roosevelt, Franklin. 2019. “Inaugural Addresses of the Presidents of the United States : From George Washington 1789 to George Bush 1989.” Yale.edu. https://avalon.law.yale.edu/20th_century/froos1.asp.

² “President Hoover’s Response – U.S. History.” 2014. Hawaii.edu. May 7, 2014. <http://pressbooks-dev.oer.hawaii.edu/ushistory/chapter/president-hoovers-response/>.

people worked hard to maintain their livelihoods, the economy would fix itself. This is the basis of Adam Smith's theory of classical economics.

Classical economics, on the most basic level, is a group of economic theories that focus on economic growth and economic freedom, especially stressing free competition and minimal government intervention.³ According to this theory, Hoover's initial response to the Great Depression was accurate, as Adam Smith articulates that "labor [...] is the real measure of the exchangeable value of all commodities."⁴ Smith essentially means the amount of labor in the economic market determines the value of everything exchanged in the market, i.e., money, goods, and services. The more labor in a market, the more valuable and effective the market is. President Hoover attempted to accomplish this by encouraging the average American to work even harder and businesses to hire as many people as possible. He aimed to add more labor to the market, therefore increasing the overall market value. As Adam Smith wrote, "parsimony, and not industry, is the immediate cause of the increase of capital [...] parsimony, by increasing the fund which is destined for the maintenance of productive hands, tends to increase the number of those hands whose labor adds to the value of the subject upon which it is bestowed."⁵ Additional labor in a market increases the value of all commodities within the market as well as the overall value of the market, and this was Hoover's goal with his encouragements to both businesses and American laborers.

This economic theory was followed up until the Great Depression because it perfectly fits American values: most Americans did not want government intervention in the economy because the country originated from a monarch that restricted trade, what could be produced, and heavily

³ "Classical Economics." 2019. <https://www.britannica.com/topic/classical-economics>

⁴ Smith, Adam p. 43. 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations*.

⁵ Smith 431

taxed the economy. Americans wanted competition to be fostered and to grow the economy themselves, which, up until the Great Depression, worked very well. Hoover failed to get reelected in 1932 because the American public felt he did too little, too late to aid the average citizen during the country's largest economic depression in its history.

President Roosevelt enters presidential office in 1932, and within three months of his term, he has passed Phase 1 of the New Deal, establishing a new role of the government in the economy. British economist John Keynes studied the Great Depression in the mid-1930's and, after studying the New Deal and its effects on the economy, laid the groundwork for what is now called Keynesian economic theory. In his book, *General Theory of Employment, Interest, and Money*, Keynes describes the economy based on the circular flow of money: Person 1's spending goes towards Person 2's earnings, Person 2 spendings their earnings to go towards Person 3's earnings, etc.⁶ Because of this circular flow of the economy, Keynes' solution to a poor economic state is for the government to invest in the economy and increase spending, either by increasing the money supply or buying directly into the economy.⁷ This is exactly what President Roosevelt did by creating the New Deal. He created programs that allowed the government to invest in the economy and be more responsible for the welfare of its citizens.

The New Deal: Phase 1

Phase One of the New Deal focused on what is now called the three R's: relief, recovery, and reform. Relief was centered on the unemployed and created additional jobs through new government programs. One of these programs was the Civilian Conservation Corps (CCC), which employed men in federal jobs on government lands, often in national or state parks.⁸ This

⁶ Keynes, John Maynard. 1936. *General Theory of Employment, Interest, and Money*.

⁷ Keynes 137

⁸ Roosevelt, Franklin. 10 March 1933. Review of Executive Orders from March-April 1933.

is the most classically economic program the New Deal created because it increased labor, which according to the theory of classical economics, is the way to increase value and money in the national market.

Recovery was the second R of the first phase of the New Deal, and it focused on the recovery of the economy through both federal spending and job creation. The job creation portion of recovery was covered by programs such as the CCC; however, it was harder to increase federal spending in a time where limited government was ideal and during an economic depression. Here is where the ideas behind Keynesian economics come in to the New Deal. President Roosevelt put money directly into the economy through the National Recovery Act (NRA), boosting businesses' profits and workers' wages by setting up industry codes that set minimum prices and wages and guaranteeing workers the right to organize into unions.⁹ Initially, these minimum wages were provided by the government and was the first time the government bought into the economy. They were able to restructure the circular flow of the economy by investing in it. Because of this, more money was put in the private sector (all parts of the economy but the government), so individuals and businesses were able to buy products from the private sector, reinvigorating the circular flow of currency.

Reform was the third R and is arguably the most important of the three. It essentially focuses on the reform of American capitalism through the use of government legislature and the creation of welfare programs. The Federal Deposit Insurance Corporation (FDIC) guaranteed individuals that a specific amount of money they deposited in a bank would be repaid by the federal government if the bank went out of business, such as what happened when the stock market crashed.¹⁰ Roosevelt backed the passage of the Securities and Exchange Commission (SEC),

⁹ Roosevelt, Franklin. 16 April 1933. Review of Executive Orders from March-April 1933.

¹⁰ Roosevelt, Franklin. 24 April 1933. Review of Executive Orders from March-April 1933.

bringing important federal government oversight and regulation to the stock market with the intention of preventing it from crashing in the future. These reforms pushed the government to constantly have the well-being of the economy in mind because they would have to invest in it if it begins to go severely downhill. Again, this is a prime example of Keynesian economics: the government invests in the economy when it goes into a depression in order to maintain the circular flow of money.¹¹ The economy will not fix itself without government intervention, like what was believed with classical economic theory. This set new precedent to economic policy in America. The government was now allowed to intervene in the economy.

The New Deal: Phase 2

The second phase of the New Deal is considered to have started in late 1934, and this is the section of the New Deal that are still part of law today, although they have most definitely have been reformed to fit modern times. The only program that is not still in place is the Works Progress Administration (WPA), which ended in 1943. It employed millions in public work projects in various public services, from construction to painting murals and writing plays for Americans to enjoy.

Acts like the Social Security Act and the Fair Labor Standards Act were passed in the mid-1930's and are still in place today. The Social Security Act required wage-earners to contribute to a trust fund through a payroll tax. The fund makes monthly payments to retired people and to the long-term disabled. Regardless of the political implications social security has today, it was extremely successful at its initial creation. It gave numerous families with no income something to live off of until a younger member of the family could get a job with one of

¹¹ Keynes 137

the other programs Roosevelt implemented.¹² The Fair Labor Standards Act mandated a 40 hour work week for full time employees (as well as time and a half for overtime). This act also established a minimum wage (which was recalculated based on costs of living) and restricted child labor. This legislation established further economic precedence that the government was partially responsible for the welfare of its citizens, thereby radically changing the government's role in the economy. These acts were extremely controversial, and each political party developed their own ideas about how the government should affect the economy.

Short Term and Long Term Effects of the New Deal

Essentially, the New Deal used what is now called Keynesian economics to stimulate the economy through federal spending and the creation of new jobs. The government was able to institute a more circular flow of money through this legislation. From a citizen's perspective, it was much preferable to Hoover's ideas that the economy would fix itself because he encouraged businesses to hire more workers and citizens to work harder. The immediate short term goal of the New Deal was to aid America's citizens through the Great Depression and to facilitate the recovery of the economy. The New Deal most certainly accomplished the former: it employed millions of Americans in its various programs, the largest of which being the CCC and the WAP. It brought social security for the elderly and disabled and introduced federal regulation to industry. It was overall celebrated by the American people because of its improvements to their livelihoods. It did not, however, fully recover the American economy. It took the economic boost of the Second World War to help the American economy become productive once again.

¹² "New Deal Causes and Effects." n.d. Encyclopedia Britannica. <https://www.britannica.com/summary/New-Deal-Causes-and-Effects>.

While the New Deal was popular with the average citizen, many politicians were weary of the new precedence set. The Supreme Court of the United States (SCOTUS) attempted to declare certain aspects of the New Deal unconstitutional in 1937, but after some negotiations, Roosevelt was able to get SCOTUS to drop the case.¹³ However, this did begin to spark the debate that continues to this day: how much should the government be allowed to meddle in economic affairs?

This has become one of the divides between political parties. Before the New Deal, both parties believed the government should have little to no influence or involvement in the economy, other than creating trade regulations and creating currency. However, because the New Deal created precedent for governmental interference in the economy, the government's role in the economy is now highly debated. Democratic presidents like President Barack Obama and President Joe Biden have expanded the programs that have withstood time, like social security, and have created new welfare programs like Medicare and Medicaid that further improve American livelihoods. Republican Presidents like President George W. Bush and President Donald Trump imposed significant tax cuts and lessened the impact of social security and welfare, allowing the American people to spend more of their money in the private sector and improving livelihoods in a more roundabout way. Economic policy has just become another difference between the parties, with the Democrats wanting more government interference while the Republicans value limited government influence more. This debate would not have been initiated in the same way if not for the New Deal. This debate, however, is not over, but Keynesian economic policy continues to be prominent in not just American economic policy, but in global economic policy.

¹³ "New Deal Causes and Effects." n.d.

Conclusion

The New Deal was truly the first type of legislation of its kind, and it set new precedent for American economic policy. It allowed the government to cultivate a healthy economy and follow the new principles of Keynesian economics instead of the old ways of classical economics, which, as Hoover demonstrated, did not work well in a vast economic depression. It also affected the political landscape in general in American because it changed the role of the government. “Before the 1930s [and the New Deal], national political debate often revolved around the question of *whether* the federal government should intervene in the economy. After the New Deal, debate rested on *how* it should intervene.”¹⁴ The New Deal was truly a new frontier: it set new legal precedence for economic policy and reconstructed ideas of how politicians and governments should care for the welfare of their people.

¹⁴ Foner, Eric. 2016. Give Me Liberty! (emphasis added)

Annotated Bibliography

Primary Sources

Keynes, John Maynard. 1936. *General Theory of Employment, Interest, and Money*. Palgrave Macmillan.

Keynes' writing is the beginning of Keynesian economic theory, and his original book was used during the background section and in various places throughout the paper. It was extremely helpful to understanding the concept as his writing is fairly simplistic, so little outside analysis was needed beyond my own.

Roosevelt, Franklin. March-April 1933. Review of Executive Orders from March-April 1933. FDR Library. Accessed March 13, 2023.

http://www.fdrlibrary.marist.edu/_resources/images/eo/eo0001.pdf.

Executive orders from Roosevelt during his first months in office were used to help me gain context about certain parts of the New Deal, and I used it in the sections about Phase 1 and Phase 2 of the paper. It was an interesting read.

Roosevelt, Franklin. 1933. "Inaugural Addresses of the Presidents of the United States : From George Washington 1789 to George Bush 1989." Yale.edu. Washington, D.C. : U.S. G.P.O. : for sale by the Supt. of Docs., U.S. G.P.O., 1989. 2019.

https://avalon.law.yale.edu/20th_century/froos1.asp.

Roosevelt's first inaugural speech was integral to his initial success as a president, and it showed me his specific values and ideals for our nation. A quote from this speech was used at the beginning of my paper, and bits of it are used throughout to demonstrate Roosevelt's ideas and ideals.

Smith, Adam. 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations*.

Adam's Smith original writing on classical economics is a valuable resources for this paper as it outline American government economic policy up until the mid-1930's. It was heavily in the background section of my paper to illustrate the "old way" of doing economics before going into the new ideas the New Deal presented.

Secondary Sources

"Classical Economics." 2019. In Encyclopedia Britannica.

<https://www.britannica.com/topic/classical-economics>.

This short encyclopedia entry gave me a brief overview of classical economics, helping me create my background information section and ensure that I described classical economics in simple terms that just about anyone can understand.

Editors, History com. n.d. "Great Depression History." HISTORY.

https://www.history.com/topics/great-depression/great-depression-history#section_7.

This article gave me a short overview of the Great Depression, which is why the New Deal was needed, and some ideas from it were used briefly in my background section, but it isn't cited. It was mostly to allow me to remember that I did know things from this time period.

Foner, Eric. 2016. *Give Me Liberty!* 6th ed. Vol. 1. W W Norton.

This book was cited only for a specific quote that was used in my conclusion, but I felt as though it really summed up the changes the New Deal made in the political landscape of America.

Khan Academy. 2018. "The New Deal." Khan Academy. 2018.

<https://www.khanacademy.org/humanities/us-history/rise-to-world-power/great-depression/a/the-new-deal>.

This short article gave me a very brief overview of the New Deal, which was helpful when starting my research because I'd forgotten everything from the 1900s onward in U.S. history because COVID hit the year I was taking it. While it isn't directly cited in the article, many of the same ideas are present, which is why I kept it in the bibliography.

Monette, Simon B. n.d. "Classical Economics: Theories of Growth." Www.academia.edu.

Accessed March 13, 2023.

https://www.academia.edu/37832043/Classical_Economics_Theories_of_Growth.

This academic article analyzes of different theories of economic growth within classical economic theory, and it helped me better understand Adam Smith's work. It was never directly cited, but it was utilized to help flush out my background information.

Monette, Simon B. n.d. "Classical Economics: Theories of Value." Www.academia.edu.

Accessed March 13, 2023.

https://www.academia.edu/37832043/Classical_Economics_Theories_of_Value.

This academic article was written by the same author as the previous entry, and analyzes of different theories of value within classical economic theory, and it helped me better understand Adam Smith's work. It was never directly cited, but it was utilized to help flush out my background information.

"New Deal Causes and Effects." n.d. Encyclopedia Britannica.

<https://www.britannica.com/summary/New-Deal-Causes-and-Effects>.

This encyclopedia entry gave me a starting point to research more of the effects of the New Deal. It is only paraphrased in the paper, and many of its ideas are expanded upon in various sections.

“President Hoover’s Response – U.S. History.” 2014. Hawaii.edu. May 7, 2014.

<http://pressbooks-dev.oer.hawaii.edu/ushistory/chapter/president-hoovers-response/>.

This academic article gave me information about President Hoover’s political values, which are vastly different than Roosevelt’s. I used this information in my background section to allow me to compare both the presidents and their way of dealing with the Great Depression.