**Chapter 15**

**Economic and Environmental Policy:**

**Contributing to Prosperity**

**Chapter Outline**

I. Government as Regulator of the Economy

A. Efficiency through Government Intervention

1. Promoting Competition

2. Making Business Pay for Indirect Costs

3. Deregulation and Underregulation

B. Equity through Government Intervention

C. The Politics of Regulatory Policy

II. Government as Protector of the Environment

A. Conservationism: The Older Wave

B. Environmentalism: The Newer Wave

1. Environmental Protection

2. Global Warming and Energy Policy

III. Government as Promoter of Economic Interests

A. Promoting Business

B. Promoting Labor

C. Promoting Agriculture

IV. Fiscal Policy as an Economic Tool

A. Demand-Side Policy

B. Supply-Side Policy

C. Controlling Inflation

V. Monetary Policy as an Economic Tool

A. The Fed

B. The Politics of the Fed

**Learning Objectives**

Having read the chapter, you should be able to do each of the following:

1. Describe the role of the government as a regulator, including the theoretical basis of the free-market economy and its proscribed level of government intervention.
2. Explain how the government encourages competition in the economy while simultaneously ensuring equity by maintaining the fairness of transactions and managing the indirect costs to the public.
3. Trace the development of environmental policy at the federal level, and explain the difference between the older model of conservationism and the newer model of environmentalism.
4. Explore the debate about global warming and the economic factors that complicate attempted solutions.
5. Discuss the precise ways that government promotes the interests of business, labor, and agriculture.
6. Discuss fiscal policy as a means of maintaining a stable economy, and distinguish between supply-side and demand-side policy.
7. Explain monetary policy as a means of maintaining a stable economy and describe how the Federal Reserve influences the economy.
8. Describe the nature and purpose of the Federal Reserve, its tools for implementing monetary policy, and the nature of influences on its decision-making.

**Chapter Summary**

Although private enterprise is the main force in the American economic system, the federal government plays a significant role through its policies to regulate, promote, and stimulate the economy.

Regulatory policy is designed to achieve efficiency and equity, which require the government to intervene, for example, to maintain competitive trade practices (an efficiency goal) and to protect vulnerable parties in economic transactions (an equity goal). Many of the regulatory decisions of the federal government, particularly those of older agencies (such as the Food and Drug Administration), are made largely in the context of group politics. Business lobbies have an especially strong influence on the regulatory policies that affect them. In general, newer regulatory agencies (such as the Environmental Protection Agency) have policy responsibilities that are broader in scope and apply to a larger number of firms than those of the older agencies. As a result, the policy decisions of the newer agencies are more often made in the context of party politics. Republican administrations are less vigorous in their regulation of business than are Democratic administrations.

Business is the major beneficiary of the federal government’s efforts to promote economic interests. A large number of programs, including those that provide loans and research grants, are designed to assist business firms, which are also protected from failure through measures such as tariffs and favorable tax laws. Labor, for its part, obtains government assistance through laws covering areas such as worker safety, the minimum wage, and collective bargaining. Yet America’s individualistic culture tends to put labor at a disadvantage, keeping it less powerful than business in its dealings with the government. Agriculture is another economic sector that depends substantially on government’s help, particularly in the form of income stabilization programs such as crop subsidies.

The U.S. government pursues policies that are designed to protect and conserve the environment. A few decades ago, the environment was not a policy priority. Today, there are many programs in this area, and the public has become an active participant in efforts to conserve resources and prevent exploitation of the environment. The continuing challenge is to find a proper balance among the nation’s natural environment, its economic growth, and its energy needs.

Through its fiscal and monetary policies, Washington attempts to maintain a strong and stable economy—one characterized by high productivity, high employment, and low inflation. Fiscal policy is based on government decisions in regard to spending and taxing, which are aimed at either stimulating a weak economy or dampening an overheated (inflationary) economy. Fiscal policy is worked out through Congress and the president and consequently is responsive to political pressures. However, because it is difficult to raise taxes or cut programs, the government’s ability to apply fiscal policy as an economic remedy is somewhat limited. Monetary policy is based on the money supply and works through the Federal Reserve, which is headed by a board whose members hold office for fixed terms. The Fed is a relatively independent body, a fact that has given rise to questions as to whether it should play such a large role in influencing national economic policy.

**Focus and Main Points**

This chapter examines economic and environmental policy. As was discussed in the first chapter, public policy is a decision by government to follow a course of action designed to produce a particular result. In this vein, economic policy aims to promote and regulate economic interests and, through fiscal and monetary actions, to foster economic growth and stability. The main ideas presented in this chapter are these:

* *Through regulation, the U.S. government imposes restraints on business activity for the purpose of promoting economic efficiency and equity*.
* *Through regulatory and conservation policies, the U.S. government seeks to protect and preserve the environment from the actions of business firms and consumers.*
* *Through promotion, the U.S. government helps private interests achieve their economic goals*. Business in particular benefits from the government’s promotional efforts, including, for example, tax breaks and loans.
* *Through its taxing and spending decisions (fiscal policy), the U.S. government seeks to generate a level of economic supply and demand that will maintain economic prosperity*.
* *Through its money supply decisions (monetary policy), the U.S. government—through “the Fed”—seeks to maintain a level of inflation consistent with sustained, controllable economic growth*.

**Major Concepts**

economy

A system for the exchange of goods and services between the producers of those goods and services and the consumers of them.

laissez-faire economics

A classic economic philosophy holding that owners of business should be allowed to make their own production and distribution decisions without government regulation or control.

regulation

A term that refers to government restrictions on the economic practices of private firms.

economic efficiency

An economic principle holding that firms should fulfill as many of society’s needs as possible while using as few of its resources as possible. The greater the output (production) for a given input (for example, an hour of labor), the more efficient the process.

externalities

Burdens that society incurs when firms fail to pay the full costs of production. An example of an externality is the pollution that results when corporations dump industrial wastes into lakes and rivers.

deregulation

The rescinding of excessive government regulations for the purpose of improving economic efficiency.

economic equity

The situation in which the outcome of an economic transaction is fair to each party. An outcome can usually be considered fair if each party enters into a transaction freely and is not unknowingly at a disadvantage.

fiscal policy

A tool of economic management by which government can attempt to maintain a stable economy through its taxing and spending policies.

economic depression

A very severe and sustained economic downturn. Depressions are rare in the United States; the last one was in the 1930s.

economic recession

A moderate but sustained downturn in the economy. Recessions are part of the economy’s normal cycle of ups and downs.

demand-side economics

A form of fiscal policy that emphasizes “demand” (consumer spending). Government can use increased spending or tax cuts to place more money in consumers’ hands and thereby increase demand.

budget deficit

The situation when the government’s expenditures exceed its tax and other revenues.

national debt

The total cumulative amount that the U.S. government owes to creditors.

balanced budget

The situation when the government’s tax and other revenues for the year are roughly equal to its expenditures.

budget surplus

The situation when the government’s tax and other revenues exceed its expenditures.

supply-side economics

A form of fiscal policy that emphasizes “supply” (production). An example of supply-side economics is a tax cut for business.

capital-gains tax

The tax that individuals pay on money gained from the sale of a capital asset, such as property or stocks.

graduated (progressive) personal income tax

A tax on personal income in which the tax rate increases as income increases; in other words, the tax rate is higher for higher income levels.

inflation

A general increase in the average level of prices of goods and services.

monetary policy

A tool of economic management based on manipulation of the amount of money in circulation.

Practice Exam

(Answers appear at the end of this chapter.)

**Multiple Choice**

1. Adam Smith

a. wrote *Das Kapital*.

b. wrote *The Wealth of Nations*.

c. advocated a worker-controlled economy.

d. advocated laissez-faire capitalism.

e. both wrote *The Wealth of Nations* and advocated laissez-faire capitalism.

2. The process of deregulation began in 1977 with the \_\_\_\_\_\_\_\_ industry.

a. meat-packing

b. railroad

c. airline

d. dairy

e. steel

3. \_\_\_\_\_\_\_\_ revealed the threat of harmful pesticides such as DDT.

a. *Earth in the Balance*

b. *The Silent Spring*

c. The government

d. The Environmental Protection Agency

e. None of these answers is correct.

4. \_\_\_\_\_\_\_\_ is the single largest source of global carbon emissions on a per-capita basis.

a. China

b. Germany

c. Cuba

d. The United States

e. Russia

5. Which of the following explicitly rejected the Kyoto agreement when he assumed office, saying that it would stunt economic growth?

a. George W. Bush

b. Bill Clinton

c. George H. W. Bush

d. John McCain

e. Barack Obama

6. \_\_\_\_\_\_\_\_ brought an end to the prevailing economic theory held in the U.S. that the economy was self-regulating—that it would correct itself after a downturn.

a. The Civil War

b. Industrialization

c. Immigration

d. The Great Depression

e. The 1970s energy crisis

7. Fiscal policy deals with

a. interest rates.

b. inflation.

c. taxes.

d. government spending.

e. both taxes and government spending.

8. Milton Friedman argued

a. that the Fed should be held more accountable by giving Congress control over the appointment process of the Federal Reserve Board.

b. that corporate tax cuts should be implemented during a downturn in order to stimulate business production.

c. that tax cuts are most desirable during a recession in order to fuel demand among top earners.

d. that governments should spend during recessions in order to make up for the loss in private spending.

e. that supply and demand are best controlled by manipulating the money supply.

9. \_\_\_\_\_\_\_\_ believed that government should spend to improve the economy when it goes into recession or depression.

a. John Maynard Keynes

b. Franklin D. Roosevelt

c. Ronald Reagan

d. George W. Bush

e. Both John Maynard Keynes and Franklin D. Roosevelt

10. The Fed may raise or lower the cash reserve that member banks are required to deposit with the Federal Reserve. The cash reserve is

a. the total amount of money a bank may have invested in private or government securities at any one time.

b. the amount of money each bank must keep invested in government securities at any one time.

c. the amount of money each bank must pay to the federal government in taxes each year.

d. the proportion of a member bank’s total deposits that the bank can loan out at any one time.

e. the proportion of a member bank’s total deposits that the bank must keep on hand.

11. The supply-side economic policy and tax cuts of the Bush administration were similar to that of which previous president?

a. Franklin Roosevelt

b. Johnson

c. Reagan

d. Carter

e. Kennedy

12. The Federal Reserve Board was created in \_\_\_\_\_\_\_\_.

a. 1889

b. 1965

c. 1948

d. 1913

e. 1841

13. Which of the following statements is true?

a. By the late nineteenth century, the large trusts that had dominated many areas of the economy had all been broken up.

b. Railroad companies in the late nineteenth century competed so intensely with each other that they dropped their shipping rates too low to remain profitable.

c. Congress created the Interstate Commerce Commission in 1887 and charged it with responsibility for ensuring that farmers did not overcharge when selling their crops across state lines.

d. Both are true: By the late nineteenth century, the large trusts had all been broken up; and competition led railroads to drop their rates too low to remain profitable.

e. None of these answers is correct.

14. The first national park in the United States was created at

a. Acadia.

b. the Everglades.

c. Yellowstone.

d. Mount Rushmore.

e. the Grand Canyon.

15. What environmental protection-related event happened in 1970?

a. The Endangered Species Act was passed.

b. The Clean Air Act was passed.

c. Rachel Carson’s *The Silent Spring* was published.

d. The Water Quality Act was passed

e. The Environmental Protection Agency was created.

16. At the present time, federal subsidies account for \_\_\_\_\_\_\_\_ of net agricultural income.

a. more than half

b. more than a third

c. more than a fourth

d. about a tenth

e. about a fifth

17. At present the national debt exceeds

a. $1 trillion.

b. $100 billion.

c. $13 trillion.

d. $17 trillion.

e. $33 trillion.

18. What major legislative action did Congress take in 2008 with respect to agriculture in the U.S.?

a. a five-year, $300 billion farm bill for assistance to farmers

b. a massive, $200 billion cut in farm subsidies

c. a 10% rise in tariffs on imports of foreign agricultural goods

d. a series of price controls to keep the cost of basic agricultural products from rising too high

e. a ten-year, $500 billion series of subsidies to American farmers

19. In 2001 the Supreme Court ruled that the EPA

a. cannot apply its environmental standards to foreign companies producing products in the U.S.

b. cannot apply its environmental production standards to foreign companies selling products in the U.S.

c. can only apply Superfund provisions to sites contaminated through actions of the U.S. government.

d. can only take into account public health when establishing air quality standards.

e. can take into account public health and economic factors when establishing air quality standards.

20. Inflation

a. is generally combated by raising government spending and cutting taxes.

b. reached a low, during the twentieth century, in the 1970s.

c. was a major problem before the creation of the Fed, but was reduced dramatically by the introduction of monetary policy as an economic tool.

d. turned into deflation as a result of the Vietnam War.

e. was a minor problem before the late 1960s, rising by less than 4 percent annually.

**True/False**

1. In comparison with the Scandinavian countries, the United States relies more heavily on free-market mechanisms.

a. True

b. False

2. An economic depression is a less severe downturn than an economic recession.

a. True

b. False

3. Interest groups do not attempt to bring pressure to bear on regulation of the economy.

a. True

b. False

4. Government intervenes to bring “equity” into the marketplace when, for example, it requires tobacco companies to place warnings about health risks related to smoking on cigarette packages.

a. True

b. False

5. In general, the economic policy pursued by the U.S. government has been harmful to business interests.

a. True

b. False

6. A government’s fiscal policy is built on its taxing and spending decisions.

a. True

b. False

7. Monetary policy is controlled primarily through congressional actions.

a. True

b. False

8. In comparison with fiscal policy, monetary policy has at least one obvious advantage: It can be initiated more quickly because the Federal Reserve Board (the “Fed”) is a faster-acting body than Congress.

a. True

b. False

9. In 2010, Congress enacted the most substantial deregulation of financial institutions since the Reagan era.

a. True

b. False

10. Congress passed farm legislation in 1996 that extended more farm subsidies to farmers than ever before in American history.

a. True

b. False

**Essay**

1. How do government officials make businesses pay for externalities?
2. When does equity exist in economic policy?
3. What happened during the era of new social regulation?
4. Where did fiscal policy get its origin?
5. Why are there partisan differences in fiscal policy?

Answers to the Practice Exam

**Multiple Choice Answers**

* + 1. e 11. c
    2. c 12. d
    3. b 13. e
    4. d 14. c
    5. a 15. e
    6. d 16. c
    7. e 17. c
    8. e 18. a
    9. e 19. d
    10. e 20. e

Multiple Choice Explanations

1. Smith wrote *The Wealth of Nations* in 1776 and espoused the belief that private individuals and firms should be left alone to make their own production and distribution decisions (e).
2. With the passage of the Airline Deregulation Act (c), government-set airfares and routes were eliminated.
3. The publication of *The Silent Spring* (b) in 1962, by Rachel Carson, revealed the environmental damage caused by pesticides.
4. The United States (d) is the world’s single largest source of carbon-fuel emissions on a per capita basis. The United States emits about 20 percent of the world total.
5. When George W. Bush (a) assumed the office of president in 2001, he explicitly rejected the Kyoto agreement, saying that it would blunt economic growth.
6. The greatest economic catastrophe in American history, the Great Depression (d), shattered the idea that the economy was self-regulating and that it would correct itself after a downturn.
7. Interest rates and inflation are monetary policy issues; fiscal policy deals with government spending and taxing policies (e).
8. The leading theorist of the monetarists, the American economist Milton Friedman, held that supply and demand are best controlled by manipulating the money supply. Therefore, (e) is the correct response.
9. The correct answer is (e); President Roosevelt based his New Deal policies on the philosophy of Keynesian economics.
10. The cash reserve is the proportion of a member bank’s total deposits that the bank must keep on hand, meaning that the bank cannot loan it out. Thus, the answer is (e).
11. As with Reagan, supply-side theory was the basis of President George W. Bush’s economic initiatives, which included reductions in the personal income tax and in the capital-gains tax (c).
12. The Fed was created in 1913 (d) at a time when the nation had not yet established a theory of monetary policy.
13. Large trusts still had undue influence on the national economy in the late nineteenth century, and railroads often charged so much that farmers could not afford to ship their crops. Congress responded by creating the ICC in 1887 to regulate the railroads, so (e) is the correct answer.
14. The first national park was created at Yellowstone (c) in 1872.
15. The correct answer is (e). Congress created the EPA in 1970.
16. As a result of the 2002 Farm Bill, federal subsidies account for more than one-fourth (c) of net farm income.
17. At present, the national debt exceeds $13 trillion (c).
18. In 2008, Congress passed a five-year, $300-billion farm bill that would put farmers in line for hefty government assistance in future years, thus (a) is the correct response.
19. In a 2001 decision, for example, the Supreme Court ruled unanimously that public health is the only thing that the EPA should take into account in establishing air quality standards; the costs to industry are not to be considered. Thus, (d) is the correct answer.
20. Before the late 1960s, inflation was a minor problem; it rose by less than 4 percent annually. But inflation jumped during the last years of the Vietnam War and remained high throughout the 1970s, reaching a postwar record high of 13 percent in 1979. Inflation is usually combated by either cutting government spending or raising taxes, or both. Thus, (e) is the correct answer.

**True/False Answers**

1. a 6. a

2. b 7. b

3. b 8. a

4. a 9. b

5. b 10. b

**Essay Answers**

1. Externalities are burdens that society incurs when industries fail to pay the full costs of production. An example is the pollution that results when corporations dump industrial wastes into the waterways. Until the 1960s, the federal government did not require firms to pay such costs. In 1963 Congress passed the Clear Air Act and followed up in 1965 with the Water Quality Act. These acts required industries to install antipollution devices to keep the discharge of air and water pollutants within prescribed limits. In 1970 Congress created the Environmental Protection Agency to monitor firms and ensure their compliance with federal regulations.

2. Equity exists in economic policy when the outcome of a given economic transaction is fair to each party. A fair outcome occurs when each party enters into a transaction freely and is not unknowingly at a disadvantage. During the twentieth century, many reforms were enacted to promote equity in economic policy. The 1960s and 1970s produced the greatest number of equity reforms. Ten federal agencies were created from 1965 to 1977 to protect workers, consumers, and the general public from the harmful effects of business.

3. The era of new social regulation occurred in the 1960s and 1970s during the third wave of regulatory reform in the United States. During this time, three major policy areas were addressed: environmental protection, consumer protection, and worker safety. Unlike the Progressive and New Deal reforms, most of the regulatory agencies created during the third wave had broader mandates than did their predecessors. They had responsibility not for a single industry but for firms of all types.

4. Fiscal policy has its origins in the economic theories of John Maynard Keynes, a British economist. Keynes argued that employers become overly cautious during a depression and will not expand production, even as wages increase. Keynes claimed that severe economic downturns can be shortened only by increased government spending. Keynes challenged the traditional idea that governments should cut back on spending. Keynes encouraged governments to compensate for the slowdown in private spending by increasing spending.

5. Partisan politics is a significant part of fiscal policy. Today’s Democratic coalition includes the majority of lower-income and working-class Americans. As a result, party leaders are generally sensitive to rising unemployment because blue-collar workers are the first and most deeply affected. Democrats have usually responded to a sluggish economy with increased government spending. This generally offers direct help to the unemployed and stimulates consumption. Republican leaders are more likely to perceive an economic downturn from the perspective of businesses, and typically have sought ways in which to protect or stimulate business activity as a means of economic recovery. Thus, in most cases, Republicans have opposed large increases in government spending.