CHAPTER 18 Economic Policy

Learning Objectives

After reading this chapter, you should be able to

* Define the key terms at the end of the chapter.
* Compare laissez-faire, Keynesian, monetarist, and supply-side economic theory with respect to the role of government in the economy.
* Describe the functions of the Federal Reserve System.
* Outline the steps in the budgetary process.
* Show how the Gramm-Rudman Act represented a failure of the legislative and budgetary processes.
* Explain how the Budget Enforcement Act resulted in lower deficits.
* List the major objectives of tax policy.
* Distinguish between progressive and regressive tax policies.
* Compare tax burdens in the United States with those in other Western democracies.
* Assess the effectiveness of U.S. taxing and spending policies in producing greater economic equality.

# Economic Policy and the Challenge of Democracy

The opening case illustrates how government action can influence financial markets. With quick and decisive cuts in the lending rates, the Federal Reserve (Fed) headed off a major economic meltdown. In addition to saving the U.S. markets, these cuts also reversed global economic trends. Even after the historic cuts by the Fed, the White House and Congress cobbled together an economic stimulus package of rebates to Americans worth over $168 billion. Although government was able to avert this economic downturn, the housing meltdown is causing more economic trouble. Politicians will want to solve this problem, too, with more spending, but citizens have mixed feelings about too much spending.

Making economic public policy, which includes making decisions about taxing and spending, is a value-laden political process. First of all, it involves making choices about the role of government. Should the government maintain more of a hands-off approach, as laissez-faire economists (and, to a lesser extent, supply-side economists) believe? Or should it take a more active role? Public economic policy also requires choices between equality and freedom. The structure of the taxing and spending policies themselves reveals a good bit about the public value system. Whereas Americans are interested in political equality, they are much less committed to economic equality. Americans have moved away from progressive taxation, where the rich pay proportionately more and the tax system serves as a means of redistributing wealth and promoting equality.

One reason why the tax system has not been used to promote greater equality is that the government tends to respond to well-organized and well-financed groups. Thus, pluralist politics have given the wealthy more clout than they might have had under a more majoritarian system. Yet the less government intervenes, the more the markets can act in a volatile manner.

On the spending side, too, the impact of pluralism is apparent. Incremental budgeting processes have given rise to clientele groups that pressure Congress to keep their favorite programs alive. Other groups managed to get spending programs established firmly by law as entitlement programs. Measures such as the Gramm-Rudman Act and pay-as-you-go restrictions proved inadequate to rein in uncontrollable outlays. These failures illustrate a problem of the legislative process in a pluralist democracy, where representatives find it too hard to say no to organized groups demanding expenditures or opposing tax increases. The current debate revolves around the need to make the Bush tax cuts permanent or the need to increase revenue to reduce deficits and the national debt.

Chapter Overview

## Theories of Economic Policy

Taxing and spending are the government’s two major policy tools for influencing the economy. Their use depends on policymakers’ beliefs about how the economy works and how much government should be involved in the economy. Policymakers’ (and economists’) differences on this issue are rooted in disagreements over economic theories and their assumptions.

Four important schools of thought are used to explain market, or capitalist, economies, where prices are determined through supply and demand.

* *Laissez-faire doctrine* relies on economic competitors to weed out the weak and preserve the strong. Government should not interfere with the economy.
* *Keynesian theory* relies on the government to deal with the problems of depression and inflation by adjusting fiscal policies (government taxing and spending) and monetary policy (the money supply).
* *Monetarism* argues that the adjustments required by Keynesian theory cannot be made quickly enough or at the right time. Political forces make it difficult to cut spending or raise taxes when Keynesian theory requires. Monetarists, therefore, rely on controlling the money supply through the Federal Reserve System (a more politically independent body) to regulate the business cycle and manage inflation.
* *Supply-side economics* argues that the government should reduce its role in the economy by lowering taxes, thus leaving people with more money. People who have money will invest it in enterprises that will bring them more money. That will create jobs. Tax cuts for the rich will be good for everyone as the benefits will trickle down. Supply-side economics is a partial return to laissez-faire policies. It was also the theoretical underpinning of Reaganomics. In practice, several predictions of supply-side economics did not come true. In particular, under Reaganomics, while inflation and unemployment came down, tax revenues fell off and the federal deficit soared. The budget deficits continued until 1998, when an economic boom led to the first budget surplus since 1969.

## Public Policy and the Budget

Until 1921, the budget was the principal product of the many congressional committees charged with taxing and spending. The highly decentralized budgeting process was not well adapted to the needs of a growing industrial nation, however. A new process was devised, in which the newly created Bureau of the Budget (later called the Office of Management and Budget [OMB]) helped the president submit budget proposals to Congress. This gave the president the opportunity to set the government’s fiscal priorities and take the lead in the budgeting process.

The president’s budget is the result of considerable politicking by departments and agencies. The current budgeting process is described as a creaky conglomeration of traditional procedures combined with structural reforms from the 1970s, external constraints from the 1980s, and changes under the 1990 Budget Enforcement Act. The two-step authorization process divides budgeting responsibilities among several committees. This decentralization leaves many opportunities for interest groups to influence the process, and it makes it difficult to assign responsibility for decisions on the budget as a whole.

In the 1970s, Congress attempted to take back some of the control over the budgetary process that it had surrendered to the president. The new process involved structural reforms and a certain amount of coordination among committees, as well as the creation of the Congressional Budget Office, a source of expertise equivalent to that of the OMB. The new process broke down, however, when Congress was faced with the huge deficits of the 1980s. Alarmed by the growing deficit, Congress tried something more drastic, the Gramm-Rudman-Hollings Act, which was designed to act as an external constraint and force automatic, legislated across-the-board budget cuts whenever the deficit reached a certain size. The government was unable to meet the Gramm-Rudman deficit-reduction targets, however, and simply revised the targets to meet the deficit. Under the pressure of a recession, Congress passed the Budget Enforcement Act of 1990 (BEA), which capped discretionary spending and placed pay-as-you-go restrictions on mandatory spending. Congress bypassed these restrictions to enact the 2001 tax cut and permitted these restrictions to expire altogether in 2002. This change in procedure, coupled with the 9/11 attacks and a lengthy recession, resulted in a return to deficit spending and mounting federal debt. Although Democrats reinstated the BEA restrictions in 2007, the election year politics of 2008 brought about a heavy round of deficit spending.

## Tax Policies

Tax policy is designed to provide the money government spends. Government may use tax policy to serve other purposes as well. Tax policy may be used as a method of making tax burdens more equitable or introducing Keynesian controls on the economy.

In President Reagan’s first term, taxes were cut, and the deficit soared. Beginning in his second term, Reagan urged tax reform—lowering taxes in the highest brackets, reducing the number of tax brackets, and eliminating deductions or loopholes, while neither increasing nor decreasing the overall amount of money raised. Tax reform was backed by both Republicans and Democrats. The movement in Congress gathered enough momentum that reform survived, despite pressure from interest groups for special treatment. The result was a somewhat simpler and considerably less progressive two-bracket tax system. Presidents George H. W. Bush and Clinton each added new brackets at the higher end of the income scale, thereby increasing the progressivity of the tax system. The 2001 tax cut advocated by President George W. Bush reduced the tax rates for upper-income tax payers (reducing progressivity) and resulted in lower federal revenues.

Although the tax burden on Americans has increased (doubling between 1953 and 1993), this has come about largely because of increases in state and local taxes and social security. Still, in comparison with other democracies, Americans are near the bottom of the list in terms of taxes paid.

## Spending Policies

What does the government spend its money on? In 2009 for the first time since 1993, the largest expenditure went to national defense (22 percent); next came Social Security, followed by Medicare, income security, health programs, and then interest on the national debt. Government spending has increased faster than inflation. However, in recent years, although government spending has increased, the nation’s GDP has increased more than spending.

Certain spending programs such as Social Security and Medicare are difficult to cut because they are legally mandated and backed by politically powerful interests, such as the elderly. Incremental budgeting has slowly increased government spending through the last few decades, and Congress has increased spending through earmarks and its undisciplined, discretionary spending. Overall, there are very few places left where government spending can be reduced. Although the public wants the benefits the government provides, it does not want the government to raise taxes to pay for them.

## Taxing, Spending, and Economic Equality

Because it requires redistribution of wealth, economic equality can be attained only at the cost of economic freedom. Limited redistribution of wealth through the income tax has aimed at helping the poor reach a minimum standard of living, not at producing overall equality of outcome. In fact, the nation’s tax policies as a whole favor the wealthy, especially the wealthy who draw their money from investments rather than labor. Although the poor recoup money in transfer payments, regressive taxation claims a higher share of their income. Under capitalism, economic inequality is inevitable, but the degree of inequality may vary. Among Western democracies, the gap between the richest and poorest is largest in the United States. The United States, which prizes political equality, does not pursue the goal of economic equality with anywhere near the intensity of other nations. This may be the result of pluralist politics that give upper-income groups more opportunities to exercise influence outside of the one person, one vote arena of political equality. Yet, overall, American public opinion shows little support for redistributing wealth through progressive taxation. As a result, even a majoritarian tax policy might do little to reduce inequalities.

Key Terms

economic depression

inflation

business cycles

aggregate demand

productive capacity

gross domestic product (GDP)

Keynesian theory

fiscal policies

monetary policies

deficit financing

Council of Economic Advisers (CEA)

monetarists

Federal Reserve System

supply-side economics

fiscal year (FY)

budget authority

budget outlays

receipts

federal debt

Office of Management and Budget (OMB)

tax committees

authorization committees

appropriations committees

budget committees

Congressional Budget Office (CBO)

Gramm-Rudman Act

Budget Enforcement Act (BEA)

mandatory spending

discretionary spending

entitlement

pay as you go

Balanced Budget Act (BBA)

progressive taxation

incremental budgeting

earmark

discretionary outlays

mandatory outlays

transfer payments

# Research and Resources

The Office of Management and Budget publishes current and historical information about the composition of federal receipts and expenditures. The OMB website <[http://www.whitehouse.gov/omb/budget/fy2009](http://www.whitehouse.gov/omb/budget/fy2009/)> provides a very detailed look at the 2009 budget.

For an overview of monetary policy, consult the website of the Board of Governors of the Federal Reserve System. See “About the Fed” at <[http://www.federalreserve.gov](http://www.federalreserve.gov/)>. The Fed website also announces the schedule of upcoming policy meetings and recent decisions about interest rates and the money supply.

The Budget Committees in Congress also offer extensive assessments of government spending and national economic performance. See <[http://www.senate.gov/~budget](http://www.senate.gov/~budget/)> or <[http://www.house.gov/budget](http://www.house.gov/budget/)>.

# Using Your Knowledge

1. Locate the websites maintained by the Democrats on the Senate Budget Committee and the Republicans on the Senate Budget Committee (see link above). How do the members from each party differ in their assessment of the economy and the budget?

2. A major concern of the text is political values. As this chapter indicates, two important sources of information about the values of a society are its tax code and its government’s budget. The taxing and spending policies of a nation give people incentives to do some things but not others. To gain insight into American values, do one of the following:

* Obtain a copy of the filing instructions for the federal income tax. You can find IRS forms online at <[http://www.irs.gov](http://www.irs.gov/)>. Look at the deductions allowed. What activities does the tax code seem to encourage? Do these tax regulations seem more likely to be the result of majoritarian or pluralist politics?
* Obtain a copy of the current U.S. budget from the *Budget of the United States Government* website at <[http://www.gpoaccess.gov/usbudget](http://www.gpoaccess.gov/usbudget/)>. Page (or scroll) through and examine the spending categories and the kinds of activities the government funds. Do these expenditures seem more likely to be the result of majoritarian or pluralist politics? Why?

Sample Exam Questions

Multiple-Choice Questions

1. The economic theory that relies on the narrow pursuit of individual profit to serve the broader ends of society through an invisible-hand mechanism was first advocated by

a. Adam Smith.

b. Arthur Laffer.

c. John Maynard Keynes.

d. Milton Friedman.

e. Alan Greenspan.

2. What is the biggest problem that government has with laissez-faire economics?

a. allows too much control to the president

b. does not allow enough control to Congress

c. relies too much on Adam Smith’s outdated theories

d. has no concern for an economic depression or inflation

e. all of the above

3. What term is used to describe the total value of goods and services that can be produced when the economy works at full capacity?

a. business cycle

b. aggregate demand

c. productive capacity

d. economies of scale

e. gross domestic product

4. The economist who in the 1930s first explained the business cycle, the expansion and contraction of business activity, was

a. Adam Smith.

b. Arthur Laffer.

c. John Maynard Keynes.

d. Milton Friedman.

e. Alan Greenspan.

5. Historically, the major concern of the Federal Reserve System is

a. inflation.

b. economic growth.

c. trade.

d. government tax revenues.

e. government spending.

6. To deal with problems of inflation and unemployment, monetarists would rely heavily on

a. the fiscal tools of Keynesian economics.

b. laissez-faire principles.

c. use of the Federal Reserve System.

d. supply-side economics.

e. government planners to determine the price and quantity of goods produced in the economy.

7. Who was sworn in as chairman of the Federal Reserve Board by President Bush in 2006?

a. Alan Greenspan

b. John Maynard Keynes

c. John Murtha

d. James Paulson Jr.

e. Ben Bernanke

8. The price of which of the following is *not* used to calculate the Consumer Price Index (CPI)?

a. shelter

b. stocks

c. clothing

d. medical services

e. transportation

9. What policies are aimed at increasing the supply of goods and consist mainly of tax cuts and less regulation for business?

a. supply-side policies

b. laissez-faire policies

c. monetary policies

d. Keynesian policies

e. none of the above

10. How would you describe U.S. taxes compared to those of most other democratic nations?

a. much higher

b. slightly higher

c. roughly the same

d. slightly lower

e. much lower

11. Which congressional committees decide which programs are actually funded?

a. Authorization Committees

b. Appropriation Committees

c. Conference Committees

d. Funding Committees

e. Tax Committees

12. The smallest component of the federal budget is

a. foreign aid .

b. defense spending.

c. interest on the national debt.

d. income security programs.

e. Medicare and Medicaid.

13. One of the two major explanations for the general trend of increasing government spending is political. What is the other?

a. monetary

b. fiscal

c. constitutional

d. bureaucratic

e. legal

14. Which of the following has historically been an example of progressive taxation?

a. taxes of income from sales of real estate or stocks

b. federal income tax

c. Social Security tax

d. state sales taxes

e. all of the above

15. On the whole, U.S. tax policies favor which group the *most*?

a. the wealthy who draw their income from capital

b. middle-class workers

c. the poor on welfare

d. the working poor

e. the elderly

16. Which of the following is *not* part of Reaganomics?

a. tax cuts

b. deregulation

c. reducing demand

d. cuts in social programs

e. increased spending on the military

17. After the income tax was repealed in 1871, what did the government rely on for revenue?

a. land sales

b. mineral taxes

c. export taxes

d. tolls

e. tariffs

18. What did the Budget and Accounting Act of 1921 provide for?

a. raised taxes

b. first tax cut in our history

c. increased money supply

d. higher budget deficits

e. president to prepare budget

19. Approximately how much did President Bush propose for outlays in the 2009 budget year?

a. under $1 trillion

b. $1.75 trillion

c. $2.50 trillion

d. $3.10 trillion

e. over $4 trillion

20. We call the amount of money a government agency is authorized to spend for programs

a. off-budget expenditure.

b. tax expenditure.

c. budget authority.

d. budget outlay.

e. incremental budget.

21. According to the Federal Reserve System, the wealthiest 1 percent of American families control almost what percentage of the nation’s household wealth (property, stocks, and bank accounts)?

a. 11 percent

b. 22 percent

c. 33 percent

d. 44 percent

e. 55 percent

22. Which committees of Congress are responsible for raising the revenue to run the government?

a. Authorization Committees

b. Appropriations Committees

c. Conference Committees

d. Funding Committees

e. Tax Committees

23. What was the effective rate that everyone paid to Social Security in 2008?

a. 3.25 percent

b. 7.65 percent

c. 11.85 percent

d. 15.5 percent

e. 19.45 percent

24. What 1990 law established pay-as-you-go restrictions for the first time in Congress?

a. Balanced Budget Act

b. Entitlements First Act

c. Gramm-Rudman Act

d. Budget Enforcement Act

e. Spending Restriction Law

25. What was the largest expenditure in the 2009 annual budget?

a. interest on our national debt

b. military spending

c. Social Security

d. income security expenditures

e. Medicare

Essay Questions

1. Explain the difference between progressive and regressive taxes. Is a flat tax progressive or regressive? Why?

2. What is the process for creating the national budget from the president’s office, through Congress, and back to the president?

3. What were the goals of the 2001 Bush tax cut? How well were they achieved?

4. How have tax laws changed from the Civil War through today?

5. What are the basic ways in which the Federal Reserve System affects the economy?

Answers to Multiple-Choice Questions

1. a

2. d

3. c

4. c

5. a

6. c

7. e

8. b

9. a

10. e

11. b

12. a

13. d

14. b

15. a

16. c

17. e

18. e

19. d

20. c

21. c

22. e

23. b

24. d

25. b