CHAPTER 18 Economic Policy

Parallel Lecture 18.1

## Economic Policy, Part 1

This lecture closely follows the discussion in the chapter. It covers theories of economic policies and the budgeting process. The remaining topics are covered in Parallel Lecture 18.2.

I. Taxes and spending are the major tools with which government implements policy.

A. Policymakers rely on economic theories to explain how the market economy works.

1. **Laissez-faire** economists believe that government interference with the laws of the market prevents the development of a strong economic system.

2. **Keynesian** theory holds that government policy can alleviate the negative consequences of the expansion and contraction of **business cycles.**

a) Laissez-faire policies cannot do anything about **economic depressions** or raging **inflation.**

b) Keynes explained that business cycle fluctuations result from imbalances between aggregate demand and productive capacity.

(1) **Aggregate demand** is the income available to consumers, business, and government to be spent on goods and services.

(2) The economy’s **productive capacity** is the total value of goods and services that can be produced when the economy works at full capacity.

(3) The **gross domestic product (GDP)** is the value of the goods and services actually produced.

c) Aggregate demand can be adjusted through fiscal and monetary policies.

(1) The government can use **fiscal policies** in two ways.

(a) When demand is too low, it should spend more itself or cut taxes.

(b) When demand is too great, the government should spend less or raise taxes.

(2) By increasing (or decreasing) the money supply, **monetary policies** indirectly increase (or decrease) aggregate demand and inflationary pressures.

d) Most modern economies have resorted to the Keynesian technique of **deficit financing** to stimulate the economy during economic recessions and depressions.

e) In the United States, the **Council of Economic Advisers** was created to provide advice on maintaining a stable economy.

B. **Monetarists** question the political utility of Keynesian fiscal policies and favor reliance on monetary politics.

1. Government spending generally takes too long to enact and often cannot be stopped once started.

2. As an independent board, the governors of the **Federal Reserve System** (the “Fed”) can make financial decisions for the nation without regard to their political implications.

3. The Fed controls the money supply through three basic activities:

a) buying and selling government securities

a) changing the discount rate

c) changing reserve requirements for banks

4. Because the Fed operates independently of the president, problems of economic coordination often arise.

C. **Supply-side economics** resembles laissez-faire economics, because it prefers fewer government regulations and less taxation.

1. Supply-siders stress the supply side of the economic equation and believe that tax cuts stimulate investment and increase productivity, which ultimately produces more tax revenue.

2. Inspired by supply-side theories, Reagan sought and got massive tax cuts in 1981.But he acted contrary to supply-side theory in his political and economic decisions. The blend of tax cuts, deregulation, cuts in spending for social programs, and increases in spending for defense received a somewhat disparaging name of *Reaganomics*

3. Although inflation was greatly reduced under Reagan, the budget deficit increased sharply—contrary to predictions of supply-side economists. (See Figure 18.1 in the text.)

II. Public Policy and the Budget

A. Who’s responsible for the budget? A historical view.

1. Before 1921 Congress prepared the budget. The president’s role was limited to approving revenue and appropriations bills

2. The Budget and Accounting Act of 1921 established the Bureau of the Budget. It helped the president to write “his” budget. All executive agencies’ budget requests had to be funneled for review through it.

3. Since 1921, the president has been responsible for drafting the budget and submitting it to Congress for approval.

4. Congress retained its authority to raise and spend funds, but began its work with the president’s budget as its starting point.

A. Broadly speaking, the budget states how much money government agencies will be allowed to spend on their programs.

1. The budget applies to the **fiscal year** (October 1 to September 30).

2. The budget defines:

a) **budget authority:** how much money agencies are authorized to spend on programs

b) **budget outlays, or expenditures:** how much money agencies are expected to spend

c) **receipts**: expected taxes and revenues.

3. The difference between receipts and outlays is the **budget deficit.** The long-term impact of Bush’s budget deficits worried fiscal conservatives.

4. Economists are more concerned about the national debt, the accumulated sum of borrowing (to finance past annual deficits) that remains to be paid is **the national debt.** The national debt in 2003 was $3.9 trillion**,** of which more than 37 percent was held by institutions and individuals in other countries.

B. The preparation of the budget is supervised by the **Office of Management and Budget (OMB).**

1. During the spring, OMB meets with the president to discuss the economic situation and budgetary priorities.

2. By the summer, government agencies are ready to prepare budgets in agreement with OMB guidelines.

3. By fall they submit their formal budgets to OMB, which analyzes agency requests, and agencies negotiate for funds and defend their own programs. A lot of politicking goes on at this stage.

4. Political negotiations over the budget may extend into early winter until it goes to the printer

C. The budget must then be passed by Congress.

1. The traditional committee structure is active in the budget-making process. Three different types of committees are involved in budgeting:

a) **Tax committees** are responsible for raising the revenue to run government.

b) **Authorization committees** have jurisdiction over spending in a particular policy area.

c) **Appropriations committees** decide which programs passed by the authorization committees will be funded.

2. The traditional committee structure did not allow Congress as a whole sufficient control over the budget process.

a) The authorization/appropriation structure was complex and offered interest groups too many opportunities to influence the budget.

b) There was no single group responsible for the budget as a whole.

3. To combat these problems, in 1974 Congress regained some control over the budgeting process by creating new **budget committees** to supervise a new comprehensive budget-review process.

a) The **Congressional Budget Office (CBO)** was created to allow Congress to present credible alternative budgets.

b) The new budgeting procedures have allowed Congress to structure the budget as a whole, but this comes at the expense of failing to meet Congress’s own deadlines.

4. The Gramm-Rudman-Hollings Act of 1985, or **Gramm-Rudman** for short, mandated that the budget deficit be lowered to a specific level each year until the budget was balanced in 1991.

a) If Congress was unable to meet the deficit targets, across-the-board cuts would be automatically triggered.

b) In 1986, Congress failed to meet its deficit target.

c) In 1987, unable to make the deficit match the law, Congress and the president changed the law to match the deficit.

5. The Budget Enforcement Act of 1990 drew distinctions in spending that drastically altered the significance of defining annual deficit targets.

a) **Mandatory spending** was defined as expenditures required by previous commitments.

(1) Spending was made mandatory for **entitlement** programs (such as social security) that provide benefits to individuals legally entitled to them.

(2) **Pay-as-you-go** restrictions were imposed on mandatory spending and taxes.

b) **Discretionary spending** was defined as authorized expenditures from annual appropriations. The law imposed limits or *caps* on discretionary spending.

6. The Balanced Budget Act (BBA) of 1997 both balanced the budget and produced a budget surplus ahead of schedule.

1. After annual budget deficits were eliminated during the Clinton administration, Republicans and Democrats held opposing views during the 2000 presidential campaign on what to do with budget surplus.
2. Since 2002 the government has run budget deficits, not surpluses.

Parallel Lecture 18.2

## Economic Policy Part 2

This lecture picks up at the conclusion of Parallel Lecture 18.1. It covers tax policies and spending policies and the way the two affect economic equality.

I. Tax policies are designed to provide a continuous flow of revenue without requiring new annual legislation.

A. Nevertheless, tax policy is often adjusted to meet budgetary outlays, to make the tax burden more equitable, or to control the economy.

1. The tax reform bill passed in 1986 represented one of the more sweeping changes in tax history.

a) The 1985 tax code included fourteen tax brackets, ranging from 11 to 50 percent.

b) Under the 1986 law, there were only two brackets: 15 and 28 percent.

c) The new tax policy approached a flat tax, or single tax rate, which violates the principle of **progressive taxation,** by which the rich pay proportionately higher taxes than the poor.

2. Bush first allied himself with Reagan’s tax policy and promised “no new taxes,” but he eventually created a third tax rate –31 percent – for those with highest income

3. In 1993 Clinton have increased the number of tax brackets (to four), creating a fourth level – 40 percent – moving the system in a more progressive direction.

B. The tax burden has increased over time in the United States but is still low compared with the tax rate of major industrialized democratic nations. (See Compared with What? Tax Burdens in Thirty Countries.)

II. Unlike tax policies, which usually do not vary greatly from year to year, government spending is subject to annual changes.

A. The largest expense categories in the FY 2005 budget (see text Figure 18.2) were:

1. Social security ($514 billion)

2. Defense ($450 billion)

3. Income security ($348 billion)

4. Medicare ($294 billion)

5. Interest on the federal debt ($252 billion)

B. Most federal spending has gone to two major categories. (See Figure 18.3.)

1. From the early 1940s to 1971, the largest portion of the budget went for defense expenditures.

2. Beginning in 1971, the largest expense in the federal budget has been payments to individuals, with social security the largest component of that spending.

C. The general trend of increase in the percentage of federal spending relative to GDP from World War II to the present is explained by bureaucratic and political factors. (See Figure 18.4.)

1. **Incremental budgeting** produces a sort of bureaucratic momentum, which continually pushes up federal spending.

a) Bureaucrats base their budgetary requests on the amount they received in the previous year, plus some increment to fund new projects.

b) Members of Congress pay more attention to the size of the increment than to the total size of the agency’s budget.

2. Certain spending programs cannot be reduced, because they are enacted into existing law or protected by powerful interest groups.

a) **Uncontrollable outlays**—payments that must be made according to existing laws—represent about two-thirds of budgetary outlays.

b) Modifying existing laws and entitlements to reduce spending is politically unpalatable.

c) Voters favor cutting government spending, but not on government programs that help needy people and deal with important national problems.

d) The public favors funding most programs at even higher levels than those favored by most lawmakers.

e) Americans have become used to certain government benefits, but they do not like the idea of paying more taxes for them.

III. How have government spending and tax policies affected economic inequality in America? (See Figure 18.6.)

A. **Transfer payments**—government payments to individuals—have had a definite effect, increasing income equality.

B. Although the tax burden of the federal income tax is progressive, the burden of other taxes is highly regressive.

1. The social security payroll tax is the same rate for all wage earners, and there is no tax at all on income in excess of a certain figure.

2. State and local sales taxes are also flat-rate taxes that impose a relatively greater burden on the poor, who spend nearly all they make.

3. The tax code contains many policies that favor the rich, such as lower tax rates on capital gains, no withholding on unearned income, and no federal tax for certain securities.

4. Despite the billions of dollars spent on social programs since 1964, the gap in income between rich and poor has actually *grown*. (See Figure 18.6).

a) The lowest one-fifth of American families made 4.3 percent of the nation’s income in 1966, and they made no more than that in 1999.

b) The top one-fifth of American families made 45.7 percent of the nation’s income in 1966, and they made more than that (50.4%) in 1999.

C. The highly unequal distribution of income in American society can be analyzed from the perspective of the two models of democracy.

1. The pluralist model accounts for well-funded and well-organized groups’ formulating tax policies and spending policies that serve their interests.

2. The majoritarian model offers little hope for redistributing income, for public opinion studies show that most Americans favor more regressive forms of taxation, such as a national sales tax or even a lottery, rather than an increase in income tax rates.

D. Taxing and spending policy in the United States are tipped in the direction of freedom rather than equality.