Economic Policy

The federal government uses **spending**, **taxation**, and **interest rate** changes to influence economic activity. Economic policy is a highly technical field and can be intimidating for the average person, but the choices about which tools to use to influence the economy is fundamentally a political decision that voters must help decide. Debates about economic policy are also entwined with perspectives on economic inequality. Meaning: your views on economic inequality will impact your views on economic policy.

The purpose of government is to make **public policy**. Public policy can be embodied in a law, a regulation, or an order (depending on the branch making policy). Economic policy in the United States has historically reflected the belief that *individual liberty* is the key to economic growth and prosperity. Over time, however, we have decided to restrict the free market in various ways in order to protect the public. Examples include laws that protect competition, consumers, and the environment. Economic policy in the United States has not typically sought to reduce inequality. However, the growth in inequality over the past three decades has spurred new interest in the impact that government policies have on economic inequality.

Americans celebrate the **free market**, but this celebration expresses more of a value judgment than an empirical observation. What do I mean by this? I mean that there is really no such thing as a free market. The government sets the rules by which the economy operates. The most basic rules that government creates and protects are those regarding property rights and contracts. In other words, the government makes economic transactions possible by maintaining a legal environment in which economies can grow. The government also creates money and guarantees its value. On a very basic level, the economic marketplace is created by the government.

The government's role in the economy has historically been limited to these basic activities. In the 19th century the government facilitated economic growth by encouraging industrialization and by providing investments in areas such as railroads. As private industry became more powerful, the government also began to regulate the economy in new ways. The **Progressive Era** expanded the government's role in many aspects of the economy and social life, as well. Despite the fact that government's role in the economy expanded in the late 19th and early 20th centuries, most Americans still held a generally ***laissez-faire*** view of government's role until 1929. The previous belief that the market's ups and downs were normal and self-correcting was abandoned during the **Great Depression**. What changed during the 1930s was the American people's belief that the government *could* play an active role in stabilizing the economy and mitigating the negative effects of inevitable downturns. The new assumption was that downturns like the Great Depression were not normal or even necessary. The government could minimize future downturns and provide economic security for people during future downturns. The idea was that no single individual is responsible for market fluctuations so why should they be held responsible for their unemployment? Do you want to live in a world where market forces beyond your control can result in you no longer being able to pay rent or feed your family? The Americans who came before you answered no. We began to provide unemployment insurance, food stamps, and other forms of **social insurance**. One way to think about the government's role in the economy is to consider the fact that we blame the president and the Congress for how the economy is performing. Whether we realize it or not, we actually do expect government to intervene in the economy and we believe that the government can promote economic stability and growth. Democrats and Republicans expect government intervention, the relevant questions are how well is the intervention working and who is the intervention benefitting. We also benefit when government promotes business development and provides protections to workers and consumers. The government has two important tools to influence the economy: **fiscal policy** and **monetary policy**. The main goals of fiscal policy and monetary policy are to keep unemployment and inflation low.

Fiscal policy is the use of the **federal budget** to influence the economy. Fiscal policy is determined by Congress and the president. Keynesian economic theory is an example of fiscal policy. During the 1930s, *laissez-faire* economics was abandoned and the government's role in the economy expanded significantly. It was not until the 1970s and 1980s that *laissez-faire* regained some influence, but even then it wasn't a return to pre-1929 thinking. The dominant economic philosophy beginning in the 1930s was **Keynesianism**, which was championed initially by Democrats and then received bipartisan support. The new fiscal approach promoted an ongoing role for government in the economy, particularly during economic downturns. When the economy slowed down, when private sector investment and production decreased, the government could stimulate the economy through **public spending** or temporary **tax cuts**. Keynesian economics focuses on **demand** and ways to maintain levels of demand (purchasing power, the buying of goods and services). The government can maintain demand through creating public jobs or making it easier for workers to buy products through tax cuts. *The main goal of Keynesian policy is to increase demand.* Keynesianism identifies high levels of economic inequality as a source of low demand and also promotes reducing unemployment as the most important objective during a downturn. After World War II Keynesian economics became the dominant economic philosophy of the entire industrialized world. **Globalization** created a different economic environment and Keynesianism lost its dominant influence beginning in the 1970s.

The stagflation of the 1970s resulted in a new fiscal policy being promoted by Republicans, most notably, Ronald Reagan. Whereas Keynesian theory focused on demand, **supply-side theory** focused on *supply*. The view of supply-side theory is that fiscal policy should increase the supply of goods by lowering tax rates. The argument is that lowering tax rates will result in people being motivated to work longer hours, invest more, and produce more. In general, **tax cuts** will result in economic growth. Supply-side theory is also referred to as **trickle-down economics** because the assumption is that the wealthy will "supply" more jobs and increase production if they are taxed and regulated less by government. Both supply-side and Keynesian theories believe that tax cuts can be beneficial, but they differ in who should receive tax cuts and how long the tax cuts should last. Because Keynesians want to increase demand they focus on tax cuts for the middle and lower classes. Because supply-siders want "job creators" to increase supply they focus on tax cuts for businesses and the wealthy. Because Keynesians want to increase demand during downturns, their tax cuts are temporary. Because supply-siders believe that taxes inhibit economic growth in general, their tax cuts are permanent. Supply-side economics was embraced by Ronald Reagan and George W. Bush. Their tax cuts resulted in budget deficits and increases in economic inequality (as Ross Perot said in 1992: the wealth didn't trickle down). The debate over supply-side economics is one of the most heated in American politics. The reason that the debate is so toxic is that supply-side is no longer simply a theory; we now have empirical data that can be analyzed to evaluate its merits. The data speaks for itself, but supporters of supply-side remain ideologically committed to it despite the evidence that it hasn't had the impact that they hoped it would. The problem is that Keynesianism doesn't provide all of the answers either. However, Keynesian policies became influential again after the **Great Recession of 2008**. The **American Recovery and Reinvestment Act** stimulated the economy through public spending, aid to state governments, and tax cuts. The legislation was a basic Keynesian response to a severe economic downturn, but it was passed along party-line votes (not a single Republican voted for it).

Monetary policy is how the government controls the **money supply**. The **Federal Reserve Board**, which was created in 1913 to regulate bank lending, determines monetary policy. The Fed, as it is called, is independent of Congress and the president. The Federal Reserve Board is a seven-member group appointed by the president and confirmed by the Senate. Members serve 14-year terms and operate independent of the executive and legislative branches (non-partisan, less ideological). The money supply is the amount of money in circulation and the Fed can influence whether or not banks are able to loan money. The more money banks have to lend, the cheaper borrowing becomes. Businesses and homebuyers need loans, so if there is not enough money to lend to people who desire loans the result is less economic activity. The money supply also impacts **interest rates** and **inflation**. **Monetarism** is an economic theory that argues against having too much money in circulation because it generates inflation. Opponents of Keynesian economics and an active government often point to monetarism as a better approach. Monetarists argue that government should not be active within the economy and should focus on promoting stability by regulating the money supply. Monetarists are less concerned with unemployment rates and more concerned with inflation. They would rather the government not intervene to try to reduce unemployment because intervening will cause more problems. Monetarism became very influential in the 1970s when inflation was a significant problem. Monetarism and supply-side theory are compatible in that they both promote *less government intervention* in the economy. Both approaches to economic theory were influential during Ronald Reagan's presidency and **Milton Friedman**, a monetarist, was an influential economic advisor to Reagan.

The "Reagan Revolution" was the combination of supply-side theory, monetarism, deregulation, and devolution. On all fronts, the aim was to reduce government's role in the economy and society. Cut taxes, get rid of existing regulations, and return decision-making power to the states. The legacy of this shift has been mixed. Getting rid of unnecessary regulations *can* facilitate economic growth and empowering states to experiment with policymaking *can* yield more policy alternatives to important public policy questions. The activities of the Fed since the 1980s *have* kept inflation low. The controversy lies in how beneficial tax cuts have been, or how useful they are at this point in time, and whether or not new regulations are necessary in areas such as finance and the environment. The polarization between Democrats and Republicans has led to a situation where economic policy has become **ideological** rather than **pragmatic**. Rather than employing the economic tools and theories that seem to make the most sense given the particular state of the economy or the particular policy issue under discussion, each side increasingly believes that the only "correct" answer is their preferred economic approach. This results in an unwillingness to ever concede that other economic tools may be beneficial in certain circumstances. Sometimes reducing regulations makes sense. Sometimes reducing taxes makes sense. Conversely, sometimes new regulations are necessary, and additional tax revenues are necessary. The problem is that when politics becomes ideological problems are no longer approached with pragmatism. Instead of trying to solve the problem at hand with whatever approach will work, the ideologue makes their "theory" more important than solving the problem. An ideological approach to governing results in the promotion of political philosophy as an end-in-itself. The politician is in office not to solve problems, but to spread a certain political philosophy and to promote it even in the face of empirical evidence that does not confirm their claims.

Beginning in the 1980s we entered a period where the trend was towards less government, even during Bill Clinton's presidency, but the "lost generation" of the George W. Bush's presidency and the Great Recession of 2008 ushered in a period where more government seemed appropriate. *The problem is that we have not been able to agree on this.* When Franklin Roosevelt was elected in 1932, the American people had been suffering from the Great Depression for three years so there was a broad consensus that government action was necessary. The Great Recession took place during an election year when power switched from one party to the other. The result was instant partisan fighting and the lack of any consensus. In October 2008, **George W. Bush** proposed a massive bailout for the financial sector, but many Republicans opposed the idea. Ultimately, Congress passed the $700 billion emergency bailout called the **Troubled Asset Relief Program (TARP).** This legislation prevented a complete financial collapse. When Barack Obama came into office in January of 2009 he immediately proposed a massive stimulus bill to increase demand and avoid a full-blown economic depression. The $789 billion **American Recovery and Reinvestment Act** included $288 billion in middle and lower class tax cuts, but the Republicans opposed the legislation as "wasteful government spending." The Keynesian response to the Great Recession, which by definition calls for deficit spending during an economic downturn, was criticized as "big government" interfering with the free market. Deficit spending and the national debt all of a sudden became really important to Republicans, who hadn't cared about deficit spending at all during President Bush's two terms in the White House. Tax cuts, wars, Medicare prescription drug programs, Wall Street bailouts; all of this took place before Barack Obama took office. The Bush tax cuts were set to expire in 2010 and President Obama proposed a two-year *extension* of the tax cuts for everyone whose incomes were under $250,000. Meaning: let's keep more money in the pockets of middle class families to maintain high levels of demand, but let's raise some revenue from the top 2% of earners. Republicans opposed the plan as "class warfare" and Congress ultimately extended the tax cuts for *everyone*. In 2012, Congress had the tax fight again and Democrats were able to get the tax rate on income over $400,000 raised from 35% to 39.6%. The economic recovery has been slow. Private sector job growth has increased every year, but wages are not necessarily increasing. The national debt continues to grow. We cannot solve all of our economic problems simply by raising taxes on the wealthy or redistributing wealth to create more equal opportunity. We have to have economic growth in order to pay for the welfare state. We have to grow the pie *and* take a hard look at how we are distributing the pie. Republicans say: just grow the pie! Democrats say: grow the pie *and* distribute it in such a way that you can maintain equal opportunity. Why would we raise taxes on or cut spending which benefits someone making $50,000 or $100,000 when we could raise taxes on someone who makes over $400,000 or $1,000,000? Economic growth and redistribution are significantly impacted by the **budget process**.

The budget determines the amount of **taxing** and **spending** by the government. The budget determines how well a given program will work, how many people will receive services, how generous those services will be, who will pay for the services, and how much they will pay. The budget is a public policy document that allocates **burdens (taxes)** and **benefits (expenditures)**; to many people, it is also a *moral* document that reflects our priorities as a society.

A **budget deficit** occurs when expenditures (spending) exceeds revenues (taxes). The annual budget deficits combine to form a **national debt**. Deficit spending increased dramatically during the Reagan presidency and again during the George W. Bush presidency. Both presidents cut taxes, which reduced the amount of revenue coming into the government, and then either didn't cut spending or actually increased defense spending. Deficit spending continued under Obama to combat the Great Recession and the national debt is now over $18 trillion.

Federal revenue comes from **personal income taxes**, **corporate income taxes**, and **social insurance (payroll) taxes**. The first peacetime income tax was enacted in 1894, but the Supreme Court found it unconstitutional. The **16th Amendment**, ratified in 1913, permitted Congress to levy an income tax. The federal income tax is **progressive**, which means that those with higher incomes are taxed at higher rates. Most of the federal revenue comes from personal income taxes. The current federal income tax rates range from 10% to 39.6%.

The personal income tax is based on tax brackets that tax specific portions of income at various levels. Meaning: an individual does NOT pay an income tax rate of 39.6% on all of their income because they make more than $413,000. An individual pays the highest rate of 39.6% on all income *above* $413,000. Likewise, an individual does NOT pay an income tax rate of 25% on all of their income because they make $75,000. An individual pays 25% on the income *above* $37,000. The chart on the following page demonstrates how the different tax brackets are applied to different portions of an individual's income.

2015 Tax Brackets (income levels simplified)
Example: Single individual with no deductions.

		income **$75,000**	income **$200,000**
		taxes	taxes
10%	$1 - $9,000	$900	$900
15%	$9,000 - $37,000	+ $4,200	+ $4,200
25%	$37,000 - $90,000	+ $9,400	+ $9,400
28%	$90,000 - $190,000	= **$14,500 total taxes**	+ $27,600
33%	$190,000 - $411,000	= **19% of income**	+ $3,500
35%	$411,000 - $413,000		= **$45,600 total taxes**
39.6%	over $413,000		**= 22.8 % of income**

income **$500,000**	income **$1,000,000**	income **$2,000,000**
$154,000 total taxes	**$352,000 total taxes**	**$748,000 total taxes**
31% of income	**35% of income**	**37.4% of income**

Individuals who make below a certain amount annually are not required to pay federal income taxes (they still pay social insurance taxes, sales taxes, etc.). Many of those who do not pay federal income taxes live below the poverty line ($24,000 for family of four) or are senior citizens. The Bush tax cuts *expanded* the number of individuals *exempt* from the federal income tax. Some individuals even qualify for the **Earned Income Tax Credit**, which is a modest wage supplement to bring low incomes up to the federal poverty line. The EITC, despite being a textbook example of **redistribution**, has historically been supported by conservatives because it rewards those who work. 14% of the U.S. population lives in poverty (47 million).

Federal income tax rates are much lower now than they were for most of the 20th century. The highest federal income tax rate was during World War II at 94% for income above $200,000 (roughly $2 million in 1945). The highest federal income tax rate remained 70% until the 1980s. Corporate tax rates vary from 15% to 35%, which is the *highest* in the industrialized world *prior to* tax breaks and subsidies. Social insurance taxes pay for Social Security and Medicare. Employees pay 6.2% of their income (up to $118,500) to Social Security, and 1.45% of all earnings to Medicare. Among industrialized nations, the United States has one of the *lowest* tax burdens, which means we pay much less in taxes than citizens of other countries.

Taxes rates and the method of taxation are constantly being debated. The federal income tax is a **progressive tax**. The higher the income level, the higher the tax rate. The opposite of a progressive tax is a **regressive tax**. Such a tax takes a higher proportion of income from lower income people. A sales tax is a regressive tax because everyone pays the same rate. The result is that people with lower incomes pay a much higher share of their income in sale taxes. People with higher incomes have far more income left over that they can invest or save. The Social Security tax is a regressive tax. 6.2% of income up to $118,500 is paid to Social Security and 1.45% of all income is paid to Medicare. Someone who earns $118,500 will pay 7.65% of their income to these programs, while someone who makes $220,000 will pay 4.55% of their income, again leaving them more income to invest or save.

Critics of the progressive income tax propose a **flat tax**. The flat tax is similar to the sales tax in that everyone pays the same rate regardless of income level. For example, all personal income could be taxed at a rate of 15%, which would raise lower-income tax levels and significantly reduce upper-income tax levels. Most proposals for a flat tax include two different brackets: a lower 15% tax for lower and middle incomes, and a higher 25% tax for higher incomes. Critics of the flat tax point to two obvious results: 1) it involves raising taxes on those making less money and lowering taxes on those making more money; 2) it significantly reduces the amount of revenue that the government would have so significant spending cuts or deficits would follow. Some Republican presidential candidates are promoting a flat tax, while Democrats propose making income taxes more progressive by raising tax rates on the highest income levels. Republican and Democratic politicians are divided over the future of the tax code, but it is unclear how many Republican voters support a flat tax. A majority of Americans support raising taxes on the highest earners.

Government spending increased dramatically during the Great Depression and World War II. Social Security dramatically reduced the number of elderly people living in poverty, while the United States military began fighting a global Cold War against the Soviet Union. Medicare was added to Social Security in the 1965. Both programs cost a lot of money, and are costing more than anticipated because people are living longer, the birthrate is lower, and medical advances make care more expensive. There are proportionately fewer working members to support proportionally more retirees. Financing Social Security and Medicare remains a great challenge, and both programs account for about 1/3 of the federal budget. Should we cut benefits or raise taxes? While our welfare state may seem big and expensive, most of Western Europe and other industrialized democracies actually spend more on services for their people. They do this not only by collecting more taxes than we do, but they also rely on our military to police the world for them!

One of the reasons that the federal budget is difficult to control is **uncontrollable expenditures** called **entitlements**. The word “entitlements” is often used in a misleading way by politicians and the media to criticize those who receive them. An entitlement is simply a service or benefit that a person is entitled to as a result of public policy. We, as a society, passed a law saying that person X gets benefit Y. An example is a veteran receiving tuition assistance, or a disabled elderly person receiving nursing home care, or individuals over 65 receiving Medicare benefits. Social Security and Medicare are entitlements because we created the programs. Of course people over the age of 65 are “entitled” to mostly free health care…that’s the law! They are not receiving a “handout” but are instead receiving what our laws say they deserve as citizens of this country who have also paid into those programs so that others could enjoy the benefits too.

It is important to distinguish between entitlements that are **social insurance programs** and **means-tested welfare programs**. Social Security and Medicare are not welfare programs in the sense that those receiving the benefits have to qualify based on their income. Everyone pays into Social Security and Medicare and everyone receives benefits. Republican and Democratic politicians are divided over the future of entitlements. Many Republicans want to cut Social Security benefits, raise the retirement age for Social Security eligibility, or even convert Social Security to a means-tested welfare program. Many Republicans also want to convert Medicare into a voucher system that would not cover all medical costs for seniors, but instead shift part of the cost onto them. Democrats are a mixed bag. Some are willing to make cuts to Social Security, others want to maintain current benefits, and some want to expand benefits. Most Democrats want to maintain Medicare as it is, while some want to expand Medicare coverage to more of the population. The disagreements over Social Security and Medicare are mainly ideological. Both programs are extremely successful and efficient, but those opposed to government programs want to dismantle them precisely because they are successful examples of government activity.

The **budget process** is somewhat complex and confusing. The **Office of Management and Budget (OMB)** helps prepare the president's budget proposal, which is released in February. The Congress, led by the **House Ways and Means Committee** and **Senate Finance Committee**, then passes a budget (in theory). The **Congressional Budget Office (CBO)** advises Congress on its budget. The Congress can completely ignore the president's budget proposal, which is likely when government is divided (one party controls the White House, while another controls at least one chamber of Congress).
By April, Congress should agree on a **budget resolution**, which sets the total expenditure levels. Think of this as "backwards planning" in that Congress decides beforehand how much money will be spent and then decides through an appropriations bill how much money goes to each department, agency, and program. If Congress is unable to reach an agreement on spending (which has been more common in recent years due to sharp partisan disagreements) then a **continuing resolution** allows spending to remain at the level of the previous year.

The budget process will remain mired in partisan disagreements in the future. After all, the budget is the scope of government activity. Disagreements over the size of government play out in budget negotiations. The budget process determines whether government will shrink or expand. The American people do not make the budget process any easier. Many people want government to solve problems, but they do not want to pay the taxes necessary for government activity. The result has been budget deficits for many years and the two major parties cannot agree on long-term taxing and spending plans.