17

Economic Policy

n 2012, lawmakers faced what economists described as "the fiscal cliff." On its current trajectory, the economic policy of the United States government was deemed unsustainable. Revenues would continue to fall short of government spending, and the debt, increasingly owed to foreign countries, would grow exponentially. Projected increases in the cost of health care for an aging population would compound the trend. No easy solution was apparent, or necessarily recommended by policy experts. On the table for discussion were the tax cuts enacted by the Bush administration, set to expire in 2013. The temporary reduction in income and payroll tax rates would also expire. Combined with spending cuts that would automatically go into effect in January 2013 under the Budget Act of 2011, these policy changes were expected to increase federal government revenues by an estimated $607 billion, or 4 percent of the gross domestic product (GDP). While these increased revenues could reduce the deficit for 2012–2013 by $560 billion, the financial impact of higher taxes combined with spending cuts could devastate a weak economy still recovering from the worst recession since the Great Depression. The price tag for deficit reduction would be slower economic growth, higher unemployment, and lower wages in the short term. Alternatively, if lawmakers decided to postpone policy changes, the U.S. debt would continue to outpace the GDP, forcing more drastic austerity measures in the future.[1] The dismal outlook for reining in the debt has already prompted Standard & Poor to downgrade the U.S. credit rating from AAA to AA+.[2]

Republicans, fueled by the Tea Party movement, fought to prevent any new tax increases and to make permanent the tax cuts enacted during the Bush administration, preferring to decrease debt solely through spending cuts. Democrats argued in favor of greater government spending to stimulate the economy and increasing tax revenue by closing loopholes and ending the Bush administration's tax cuts favoring the wealthy. According to Gallup Poll data, 73 percent of the public attributes the deficit to too much spending, compared with 22 percent who blame insufficient taxes.[3] While spending cuts are consistently more palatable than tax increases to reduce the deficit, most Americans recognize the need for a combined approach.[4]

17.1 Trace the evolution of economic policy in the United States , p. 484.

17.2 Assess the impact of the budget process on fiscal policy, p. 490.

17.3 Analyze the effect of the Federal Reserve System on monetary policy, p. 496.

17.4 Describe the evolution of income security policy in the United States, p. 500.

17.5 Evaluate the role of fiscal, monetary, and income security policy in the economic recession and recovery, p. 505.

THE GOVERNMENT OFTEN TAKES A PROMINENT ROLE IN STIMULATING THE ECONOMY Above, John Maynard Keynes, the father of modern macroeconomic theory, which favors government spending to promote economic growth, speaks at a conference in the 1940s. Below, Congressional Budget Office Director Douglas Elmendorf testifies that projected tax hikes and spending cuts for 2013 could put the United States back into recession.

17.1

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economic regulation
Government regulation of business practices, industry rates, routes, or areas serviced by particular industries.

laissez-faire
A French term meaning "to allow to do, to leave alone." It holds that active governmental involvement in the economy is wrong.

business cycles
Fluctuations between periods of economic growth and recession, or periods of boom and bust.

The fiscal policy cliff produced tough choices for economic policy makers. In the long run, debt reduction is an important goal in sustaining strong economic growth. Debt can be reduced by raising taxes, cutting spending, or both. In the short run, however, the need to stabilize the economy as it continues to emerge from recession warrants increased government spending, rather than cuts, but at the risk of running even larger deficits into the future. Ultimately, economic policy making reflects an ongoing debate over the role and size of government. The perfect combination of increased or decreased taxing and spending to guarantee economic stability does not exist; rather, ideological values dictate policy preferences.

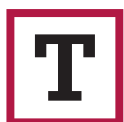
•••

The U.S. economic system is a mixed free-enterprise system characterized by private ownership of property, private enterprise, and marketplace competition. But, the national government has long played an important role in fostering economic development through its tariffs (taxes on imported goods), tax policies, use of public lands, and creation of a national bank. Today the federal government actively uses economic policy making to promote economic stability, as well as to recognize and respond to economic crises. The government also uses built-in "automatic stabilizers," or income security policies—including welfare, unemployment insurance, and progressive income tax rates—to lessen the impact of economic crises, expanding the economy during recessions and contracting it during periods of expansion.

With this greater involvement comes debate over the proper role of government in the economic sector. Those favoring limited government participation are pitted against others who believe the government is responsible for managing the economy through policy. In this chapter, we will consider both viewpoints as we describe the policies of the government in achieving its economic goals.

Roots of Economic Policy

17.1 Trace the evolution of economic policy in the United States.



he government's role in regulating the economy has evolved over our nation's history. During the nineteenth century, the national government defined its economic role narrowly, although it did collect tariffs, fund public improvements, and encourage private development. The national government increased its involvement in **economic regulation** during the Progressive and New Deal eras. In more recent years, it has turned its attention to financial regulation and deregulation.

The Nineteenth Century

For much of the nineteenth century, the national government subscribed to a **laissez-faire** (literally "to allow to do" or "to leave alone") economic philosophy. The laissez-faire economic system holds that active governmental involvement in the economy is wrong, and that the role of government should be limited to the maintenance of order and justice, the conduct of foreign affairs, and the provision of necessary public works. As a result, most national intervention in the economy during this time amounted to setting and adjusting tariffs and maintaining the liberty necessary to fuel economic fires.

But, the Civil War and the growing industrialization of the postwar economy changed the political landscape. Industrialization, for example, led to industrial accidents and disease, labor–management conflicts, unemployment, and the emergence of huge corporations that could exploit workers and consumers. Industrialization also worsened the effects of natural **business cycles,** or fluctuations between periods of economic growth and recession (or periods of boom and bust).

The first major government effort to regulate business came about by growing concern over the power of the railroads. After nearly two decades of pressure from

farmers, owners of small businesses, and reformers in the cities, Congress adopted the Interstate Commerce Act in 1887. Enforced by the new Interstate Commerce Commission (ICC), the act required railroad rates to be "just and reasonable."[5] The act also prohibited such practices as pooling (rate agreements), rate discrimination, and charging more for a short haul than for a long haul of goods.

Three years later, Congress dealt with the problem of **trusts,** the name given to large-scale, monopolistic businesses that dominated many industries, including oil, sugar, whiskey, salt, and meatpacking. The Sherman Anti-Trust Act of 1890 prohibited all restraints of trade, including price fixing, bid-rigging, and market allocation agreements. It also forbade all monopolization or attempts to monopolize, including domination of a market by one or a few companies.

trusts
Large-scale, monopolistic businesses that dominate an industry.

The Progressive Era

The Progressive movement drew much of its support from the middle class and sought to reform America's political, economic, and social systems. Many desired to bring corporate power under the control of government and make it more responsive to

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.
—SIXTEENTH AMENDMENT

As the national government's role in economic regulation grew larger in the late eighteenth century, its administrative costs began to grow. Congress sought to rectify this situation by enacting a law that levied a national income tax. However, in *Pollock* v. *Farmers' Loan & Trust Co.* (1895), a divided Supreme Court held that levying such a tax by statute was unconstitutional.

Ratified on February 3, 1913, the Sixteenth Amendment addressed this shortcoming by modifying the Article I prohibition against levying a "direct tax" on individual property. The first income tax was levied concurrently with adoption of the amendment. At that time, the national government required all Americans to give 2 percent of their income as tax.

Although the U.S. government continues to levy an income tax today, much about the tax rate has changed. Today, national income taxes are progressive, meaning that the tax rate paid by citizens increases with income. If the Bush-era tax cuts are allowed to expire, the tax rate in 2013 for a single American making less than $8,750 in taxable income will be 15 percent. In contrast, those who make more than $390,050 will be required to pay 39.6 percent of their income in taxes.

The national income tax continues to be one of the most controversial federal policies. Few Americans truly enjoy paying taxes, and many citizens find the tax code to be complicated and full of loopholes. Reformers across the political spectrum have suggested ways to alter the tax code to make it fairer, or to ensure that it does not place too great a burden on low-income Americans. Proposals include simplifying the existing tax code to eliminate deductions. In 2011, Warren Buffet made national headlines by complaining that a wealthy man like himself paid a lower percentage of his income in taxes than his secretary paid. Obama proposed the "Buffet Rule," which would require a minimum 30% tax rate for individuals earning in excess of one million dollars. The income tax would remain progressive, and marginal tax rates for everyone would decrease. Opponents, however, perceive the elimination of tax loopholes as a tax increase on the wealthy. Conversely, a flat tax would create a single tax rate for all citizens regardless of income. While proponents of the flat tax perceive this proposal as "fair," the tax is regressive if wealthy taxpayers are still allowed to deduct large portions of their earnings. A more radical reform would create a consumption-based tax system, such as Europe's Value Added Tax. Critics contend that these taxes can be more regressive, but economists argue that they encourage more individual saving because taxes are paid only on the portion of income spent on goods and services.

CRITICAL THINKING QUESTIONS

1. What type of proposed reform to the U.S. tax code seems fairest to all citizens and why?
2. What types of government programs or services would you be willing to pay more taxes for? Which ones would you be willing to give up to lower your taxes?

democratic ends. Progressive administrations under Presidents Theodore Roosevelt and Woodrow Wilson established or strengthened regulatory programs to protect consumers and to control railroads, business, and banking.

The Pure Food and Drug Act and the Meat Inspection Act, both enacted in 1906, marked the beginning of consumer protection as a major responsibility of the national government. These laws prohibited adulteration and mislabeling of food and drugs and set sanitary standards for the food industry.

To control banking and regulate business, Congress passed three acts. The Federal Reserve Act (1913) created the Federal Reserve System to regulate the national banking system and to provide for flexibility in the money supply in order to better meet commercial needs and combat financial panics. Passage of the Federal Trade Commission (FTC) Act and Clayton Act of 1914 strengthened anti-trust policy. These statutes, like the Sherman Anti-Trust Act, sought to prevent businesses from forming monopolies or trusts.

As the national government's functions expanded in the late nineteenth and early twentieth centuries, fiscal constraints forced public officials to focus on new ways to raise federal revenue. Congress attempted to enact an income tax, but in 1895, the Supreme Court held that such a tax was unconstitutional.[6] Consequently, the Sixteenth Amendment to the Constitution was adopted in 1913. The Sixteenth Amendment authorized the national government "to lay and collect taxes on incomes, from whatever source derived" without being apportioned among the states. Personal and corporate income taxes have since become the national government's major source of general revenues.

HOW DID THE PROGRESSIVE ERA CHANGE GOVERNMENT REGULATION OF THE ECONOMY?

During this era, the national government began to pass workplace and product safety measures such as the Meat Inspection Act to prevent the public from eating tainted beef.

The Great Depression and the New Deal

interventionist state
Alternative to the laissez-faire state; the government took an active role in guiding and regulating the private economy.

During the early 1920s, the economy grew at a rapid pace, and many Americans assumed that the resulting prosperity would last forever. But, "forever" came to an end in October 1929, when the stock market collapsed and the catastrophic worldwide economic decline known as the Great Depression set in. Although the Depression was worldwide in scope, it hit the United States especially hard. All sectors of the economy suffered, with no economic group or social class spared.

Initially, Herbert Hoover's administration declared the economy fundamentally sound, a claim few believed. Investors, businesspeople, and others lost confidence in the economy. Prices dropped, production declined, and unemployment rose to staggering levels. According to Bureau of Labor Statistics estimates, about one-fourth of the civilian workforce was unemployed in 1933.[7] Many other people worked only part-time or at jobs below their skill levels. The economic distress produced by the Great Depression, which lasted for a decade, was unparalleled before or since that time.

The Depression and President Franklin D. Roosevelt's New Deal marked a major turning point in U.S. economic history. During the 1930s, the laissez-faire state was replaced with an **interventionist state,** in which the government took an active role in guiding and regulating the private economy. The New Deal, for example, established reforms in almost every area, including finance, agriculture, labor, and industry.

FINANCIAL REFORMS The New Deal first directed attention at reviving and reforming the nation's financial system. Because of bad investments and poor management, many banks failed in the early 1930s. To restore confidence in banks, Roosevelt declared a bank holiday the day after his inauguration, closing all of the nation's banks. Emergency legislation passed by Congress permitted only financially sound banks to reopen. Many unsound banks were closed for good and their depositors paid off.

Major New Deal banking laws included the Glass-Steagall Act (1933). The Glass-Steagall Act required the separation of commercial and investment banking and set up the Federal Deposit Insurance Corporation (FDIC) to insure bank deposits, originally for $5,000 per account. The act aimed to prevent the bank failures of the Great Depression by removing the conflicts of interest and excessive risk-taking associated with securities dealing from savings and loans. Congress also passed legislation to control abuses in the stock markets. The Securities Act (1933) required that prospective investors be given full and accurate information about the stocks or securities being offered. The Securities Exchange Act (1934) created the Securities and Exchange Commission (SEC), an independent regulatory commission. This legislation authorized the SEC to regulate the stock exchanges, enforce the Securities Act, and reduce the number of stocks bought on margin (that is, with borrowed money).

AGRICULTURE American agriculture had struggled even during the prosperous 1920s. The Great Depression only worsened this state of affairs. To protect this important industry, Congress and FDR adopted a number of public policies. The most notable was the second Agricultural Adjustment Act (AAA), enacted in 1938, after the Supreme Court declared the first AAA unconstitutional.

The second AAA provided subsidies to farmers raising crops such as corn, cotton, and wheat who grew on no more than their allotted acreage. The government also made direct payments and commodity loans available to participating farmers. The Supreme Court upheld the constitutionality of the second AAA, finding it an appropriate exercise of Congress's power to regulate interstate commerce.[8]

LABOR The fortunes of labor unions, which strongly supported the New Deal, improved significantly in 1935, when Congress passed the National Labor Relations Act. Better known as the Wagner Act after its sponsor, Senator Robert Wagner

deregulation
A reduction in market controls (such as price fixing, subsidies, or controls on who can enter the field) in favor of market-based competition.

(D–NY), this statute guaranteed workers' rights to organize and bargain collectively through unions of their own choosing. The act prohibited a series of "unfair labor practices," such as discriminating against employees because of their union activities. The National Labor Relations Board (NLRB) was created to carry out the act and to conduct elections to determine which union, if any, employees wanted to represent them. Unions prospered under the protection provided by the Wagner Act.

Another important piece of New Deal legislation designed to protect the rights of laborers was the Fair Labor Standards Act (FLSA). The act set minimum wage and maximum hour requirements at 25¢ per hour and forty-four hours per week, respectively. The act also banned child labor. The FLSA did not cover all employees, however; it exempted farm workers, domestic workers, and fishermen.

INDUSTRY REGULATIONS During the New Deal, Congress established new or expanded regulatory programs for several industries. The Federal Communications Commission (FCC), created in 1934 to replace the old Federal Radio Commission, attained extensive jurisdiction over the radio, telephone, and telegraph industries. The Civil Aeronautics Board (CAB) was instituted in 1938 to regulate the commercial aviation industry. The Motor Carrier Act of 1935 placed the trucking industry under the jurisdiction of the Interstate Commerce Commission (ICC). Like railroad regulation, the regulation of industries such as trucking and commercial aviation extended to such matters as entry into the business, routes of service, and rates. To a substantial extent, government regulation, as a protector of the public interest, replaced competition in these industries. Supporters of these programs believed they were necessary to prevent destructive or excessive competition. Critics warned that limiting competition resulted in users' having to pay more for services.

THE LEGACY OF THE NEW DEAL ERA Just as World War I brought down the curtain on the Progressive era, the outbreak of World War II diverted Americans' attention from domestic reform and brought an end to the New Deal era. Many New Deal programs, however, became permanent parts of the American public policy landscape. Moreover, the New Deal established the legitimacy and viability of national governmental intervention in the economy. Activist government replaced passive government.

Deregulation

In the mid-1970s, President Gerald R. Ford, viewing regulation as one cause of the high inflation that existed at the time, decided to make **deregulation,** a reduction in market controls in favor of market-based competition, a major objective of his administration. Deregulation was also a high priority for Ford's successor, President Jimmy Carter, who supported deregulated commercial airlines, railroads, motor carriers, and financial institutions. All successive presidents have encouraged some degree of deregulation, though it has produced mixed effects, as illustrated by the airline and agricultural sectors.

The Airline Deregulation Act of 1978, for example, completely eliminated economic regulation of commercial airlines over several years. Although many new passenger carriers flocked into the industry when barriers to entry were first removed, they could not compete successfully with the existing major airlines. Consequently, now fewer major carriers exist than was the case under the regulatory regime. Competition has lowered some passenger rates, but disagreement has arisen over the extent to which passengers have benefited. For example, since enactment of the Airline Deregulation Act, small communities across the United States have lost service as airlines make major cuts in their routes, despite government subsidies to help maintain service.[9]

In spite of this mixed record, economic deregulation and reregulation have continued to receive a great deal of attention from citizens and politicians. In the 1980s and 1990s, agricultural price support programs came under increasing attack from conservatives, who claimed that such government price supports promoted inefficiency. In 1996, congressional Republicans passed a landmark agriculture bill with the aim of

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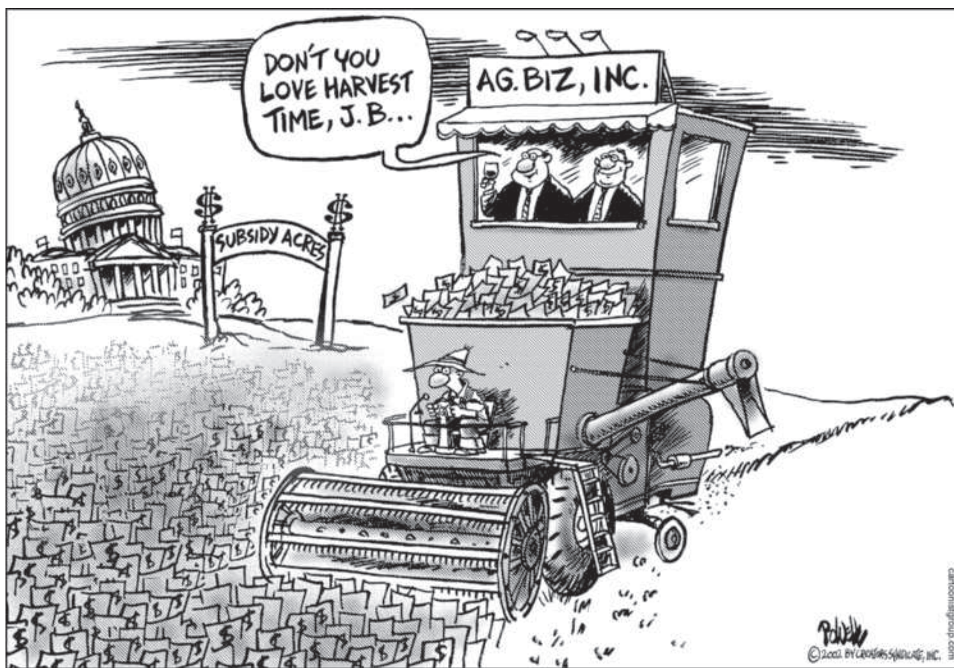


HOW DO AGRICULTURE SUBSIDIES REGULATE THE ECONOMY?

Subsidies are government funds paid to farmers to grow—or not grow—particular crops. They have come under fire in recent years because they disproportionately benefit the wealthiest farmers.

phasing out crop subsidies and making prices more dependent upon the workings of the free market. But five years later, the 2002 farm bill actually increased agricultural subsidies by 70 percent as part of a ten-year, $180 billion package. The political pressure coming from large-scale farms and agribusinesses was obvious. According to one analyst, "Nearly three-quarters of these funds will go to the wealthiest 10 percent of farmers—most of whom earn more than $250,000 per year."[10]

In the banking industry, deregulation in the 1990s played a role in the subprime mortgage crisis that began in 2007, prompting new government policies to provide economic relief. The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act removed restrictions on interstate banking, resulting in a concentration of large banks at the national level and the crowding out of small, locally owned banks. This became an important policy consequence when large financial institutions, deemed "too big to fail," would later receive bailouts from the federal government to prevent serious ripple effects on the economy. In 1994, the Security Exchange Commission created the Consolidated Supervised Entities program, allowing international investment bank conglomerates to voluntarily comply with regulations on the amount of capital they must hold in reserve. In 1996, the Federal Reserve reinterpreted the Glass-Steagall Act to allow bank holding companies to increase their investment portfolios, and then Congress repealed the act entirely with the 1999 Gramm-Leach-Bliley Act. This act allowed banks to consolidate traditional banking services (savings and loans) with riskier securities and insurance business. When large securities investments and trading brokerage firms, including Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns, suffered financially as the housing mortgage crises unfolded with the first wave of subprime mortgage defaults in 2007, their interconnectedness worsened the fallout. The government institutions created to guarantee mortgages, Fannie Mae and Freddie Mac, were also implicated; they had raised their risk by securitizing subprime mortgages in their efforts to increase bank liquidity. Congress passed the Emergency Economic Stabilization Act, creating the Troubled Asset Relief Program, authorizing the U.S. Treasury to purchase mortgage-backed securities to provide some relief to the troubled banking system. Finding the right balance between too much and too little regulation is a constant struggle in economic policy making.

fiscal policy
The deliberate use of the national government's taxing and spending policies to maintain economic stability.

budget deficit
The economic condition that occurs when expenditures exceed revenues.

Fiscal Policy

17.2 Assess the impact of the budget process on fiscal policy.

iscal policy is the deliberate use of the national government's taxing and spending policies to maintain economic growth and stability. Government spending and taxes are the tools used to expand or contract the economy as needed. Deficits or surpluses are the outcomes of these policy decisions. When government spending is not offset by tax revenue, the result is a deficit at the end of the fiscal year. If, however, tax revenue exceeds spending, the result is a government surplus. Economists argue that increased government spending stimulates economic growth, which can help the economy rebound from a recession. However, it also means that government is likely to run a deficit. The continuation of deficits long term, especially after the economy has recovered, can have adverse effects, including inflation and increased national debt. The national debt is the total amount owed by the federal government to its creditors, both domestic and international. Financing a large national debt reduces government savings and the amount of capital available for investment. As the debt grows, interest payments increase and must be offset by tax increases or spending cuts. If investor confidence in the government's ability to manage its finances weakens, lenders will charge the government higher interest rates. High debt also reduces the government's ability to use taxes and spending to address fiscal crises in the future. The right combination of government spending and taxes is a constant source of debate, influenced by economic theory, history, politics, and public opinion.

The Foundations of Fiscal Policy

In the 1930s, British economist John Maynard Keynes revolutionized economic policy theory by arguing that governments could prevent the worst impacts of recession or depression by stimulating aggregate demand, even at the risk of running government deficits. This view represented a departure from laissez-faire capitalism, which suggested that, if left alone, a free market would regulate itself. In contrast, Keynesian economists maintained that increasing demand would increase employment, stimulating a cycle of economic growth much faster than a free market would accomplish on its own. The benefits of more immediate economic growth, they believed, outweighed the costs of government deficits in the short run. Governments could increase demand through increased government spending, tax cuts, or a combination of the two. Economists argued, however, that government spending would increase consumption and demand more directly than tax cuts. This is the case because people do not always spend their tax cuts; they often save the money or use it to pay down existing debt. The precise mix of government spending and taxes, however, is often dictated more by politics than economics.

In the United States, the early 1960s saw the first significant contemporary application of fiscal policy. President John F. Kennedy, a Democrat committed to getting the country moving again, brought economists to Washington, D.C., who believed that greater government spending, even at the expense of an increase in the **budget deficit,** was needed to achieve full employment. This thinking is consistent with Keynesian economics; however, many conservatives opposed budget deficits as bad public policy. To appease these critics, the president's advisers decided that many Americans would find deficits less objectionable if they were achieved by cutting taxes rather than by increasing government spending.

This decision resulted in adoption of the Revenue Act of 1964, which President Lyndon B. Johnson signed into law. The act reduced personal and corporate income tax rates. The tax-cut stimulus contributed to the expansion of the economy throughout the remainder of the 1960s and reduced the unemployment rate to less

than 4 percent, its lowest peacetime rate and what many people then considered to be full employment.[11]

In the short term, budget deficits may have positive economic benefits. However, in the long term, running deficits year after year can have negative consequences. A high national debt such as this can stifle economic growth and cause **inflation,** a rise in the general price levels of an economy. The national debt—as with personal debt in the form of credit cards and student loans—must also be paid back with interest. This repayment can be a costly proposition that diverts attention and money from other governmental programs for years to come.

inflation
A rise in the general price levels of an economy.

While most states are required by constitution or by statute to have a balanced budget—revenues must meet or exceed expenditures—this is not the norm for the federal government. The Constitution does not limit debt at the national level and rarely does the federal budgetary process produce a balanced budget. During the 1980s, President Ronald Reagan cut taxes, in part to stimulate the economy but also to shrink the size of the federal government. The Democratic-controlled Congress, however, refused to make the deep cuts in domestic spending that Reagan proposed. At the same time, defense spending increased in response to the Cold War. Deficits continued, and public intolerance of the escalating national debt pressured Congress to respond with the 1985 Balanced Budget and Emergency Reduction Act. When the new law fell short of deficit reduction goals, Congress passed the Budget Enforcement Act of 1990, setting overall limits on federal government spending. A federal balanced budget amendment was also proposed and debated, and in 1994 the federal government shut down twice when Congress and President Clinton could not agree on budget priorities. Ultimately, the economy expanded during the late 1990s, and the government ran surpluses from 1998 to 2001. This expansion shifted the political focus away from spending cuts and deficit reduction and back to tax cuts. In the context of a budget surplus, the newly elected President Bush and his administration ushered in a series of tax cuts in 2001 and 2003, lowering marginal tax rates. Although politically favorable, tax cuts are difficult to repeal, and economists warn that they reduce the government's flexibility in handling future economic crises, as evident in the recession that started in 2007. Figure 17.1 illustrates the current budget priorities in terms of tax revenues and expenditures.

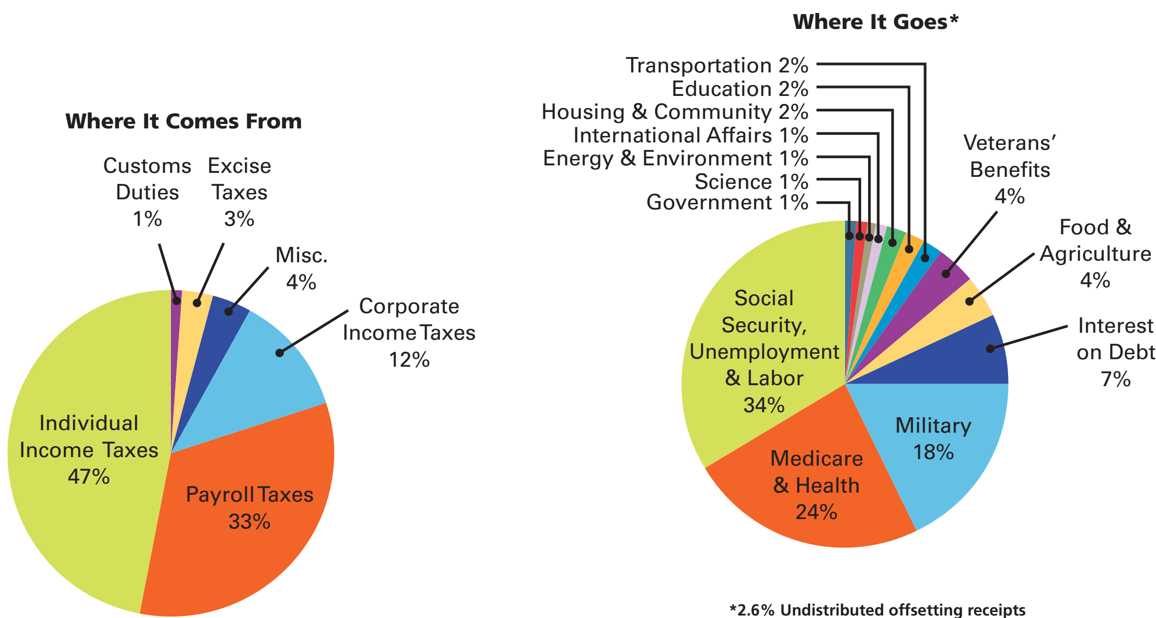


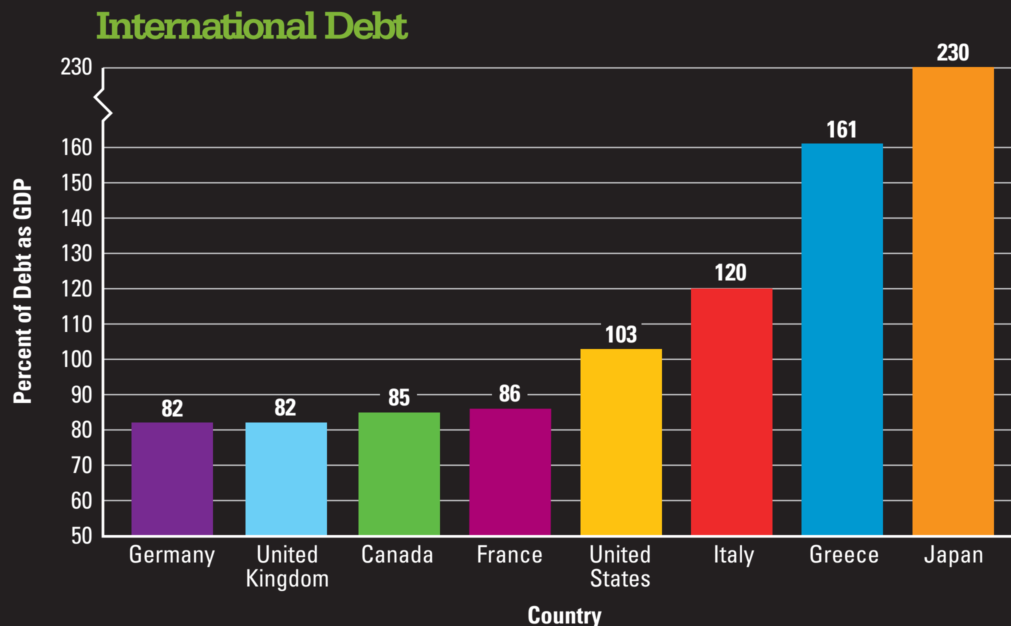
FIGURE 17.1 HOW DOES THE FEDERAL GOVERNMENT RAISE AND SPEND MONEY?

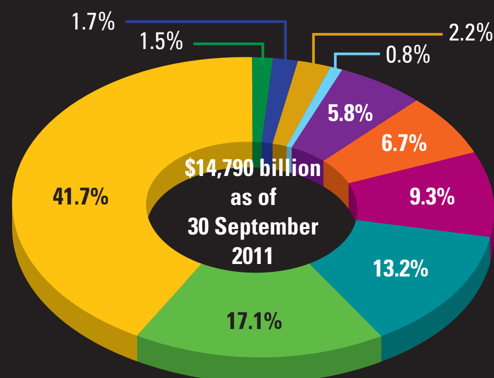
The federal government budget outlines how taxpayer revenues are raised and spent, summarizing the priorities of federal government policy making.

SOURCE: United States Budget, Fiscal Year 2011, www.gpoaccess.gov.

How Much Government Debt Is Too Much?

Around the globe countries have amassed large government debts. The U.S. government debt is neither the highest nor the lowest as a percentage of GDP. An individual country's debt level reflects the history, values, and political choices of its citizens. At what point, however, should the world financial markets worry about an individual country's debt? In 2012, for example, concerns over Greece's inability to pay its debts threatened the stability of the European Monetary Union. Within a country, the level of debt also takes on more significance as the portion that is held by foreigners increases. Paying interest on that portion of the debt transfers income from one country to another. The graphic below shows the distribution of U.S. debt.





Who Owns the U.S. Debt?

- Brazil
- Oil Exporting Countries
- U.S.Military Retirement Fund
- United Kingdom
- U.S. Civil Service Retirement Fund
- Japan
- China
- All Other Foreign Nations
- Social Security Trust Fund
- U.S. Individuals and Institutions

Source: U.S. Treasury Department, Revised March 2012

CRITICAL THINKING QUESTIONS

1. By borrowing money from the Social Security Trust Fund, the federal government has essentially loaned money to itself. Should the federal government have to pay back this loan?
2. How much of the debt is owed to U.S. citizens vs. foreign nations? Why do you think foreign nations want to own our debt?
3. What are some reasons that might justify having the government go into debt? How much debt is too much?

Responding to Recession

At the first signs of an economic slowdown in early 2008, the national government acted quickly to stimulate the economy and reinvigorate consumer spending through fiscal policy. The first government action was to fund a $168 billion stimulus package that included individual tax rebates for most people who had paid taxes for tax year 2007. These payments were designed to encourage lower- and middle-income people to spend money. Most citizens who received a check got $600 if they filed individually or $1,200 if they filed jointly. There were increasing incentives for dependent children, and decreasing incentives for wealthy Americans.

But, in late September 2008, it became clear that, despite the government's attempts to stimulate the economy through tax cuts, economic conditions had worsened. Approximately 2.6 million people had lost their jobs as large companies downsized and many smaller companies struggled to stay in business. Oil and other commodity prices began to rise rapidly—gasoline prices reached $4 and even $5 per gallon in some jurisdictions. Collapse of the subprime mortgage industry had escalated into a full-blown financial crisis necessitating government action. To address this situation, the Bush administration proposed a $700 billion federal bailout package.

The first version of the bailout plan failed to garner enough votes in the House of Representatives, forcing frenzied rounds of House and Senate negotiation. Supporters increased efforts to make the plan more palatable to politicians up for reelection who were facing constituents overwhelmingly opposed to using taxpayer funds for bailing out Wall Street. President George W. Bush, members of his administration, and congressional leaders sought to present the financial bailout plan as an economic rescue plan. They emphasized the extent to which financial collapse on Wall Street and virtually frozen credit markets would affect the ability of those on Main Street to do business, refinance their homes, or buy a car. As a result of these efforts, Congress passed a modified version of the administration's initial bailout plan known as the Emergency Economic Stabilization Act in October 2008. It provided enhanced oversight of the Department of the Treasury use of the $700 billion, an option to use the money to buy equity stakes in faltering banks, some protection to those in danger of losing their homes, and a variety of tax cuts and incentives. Congress intended the plan to reassure the financial markets by allowing the government to buy up the assets that had led to the crisis. This was known as the Troubled Assets Relief Program (TARP), and the monies were TARP funds (Figure 17.2 illustrates how the recovery funds were distributed).

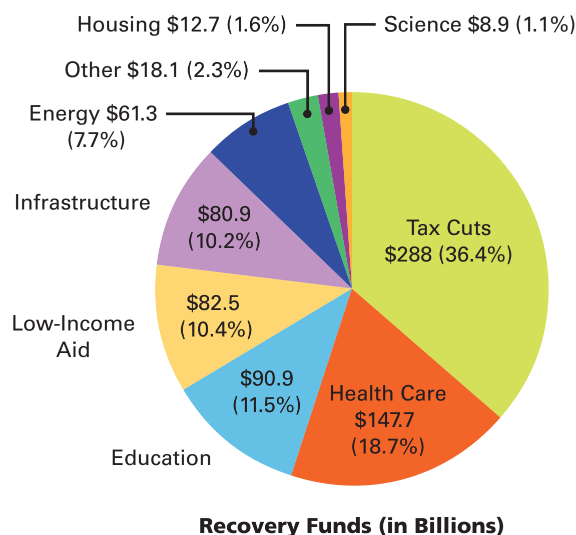


FIGURE 17.2 WHERE DID THE ECONOMIC STIMULUS FUNDS GO?

The American Recovery and Reinvestment Act allocated almost $800 billion to aid in the economic recovery. The largest proportion of these funds—more than one-third—went to tax cuts.

SOURCE: U.S. Government, www.recovery.gov.

Although TARP funds helped to stabilize American banks, individuals were still struggling with the economic downturn. After he took office in early 2009, President Barack Obama made it one of his first priorities to address this situation by working with Congress to pass an economic stimulus and recovery bill, the American Recovery and Reinvestment Act. This legislation authorized the government to spend more than $787 billion on a variety of tax cuts and public works programs designed to stimulate the economy and to maintain and create jobs in transportation, education, health care, and other industries. Among the programs funded by the Recovery Act were road and bridge construction projects, scientific research, and the expansion of Internet access to underserved populations. The federal government also extended and expanded unemployment benefits.

The government's response to the economy—increased government spending plus tax cuts—fits the Keynesian model, and labor market indicators did begin to improve. GDP started to grow steadily by the third quarter of 2009 and employment increased. By July of 2014, unemployment decreased to 6.2 percent from a peak of 10 percent in October 2009. The Recovery Act, however, was designed to be temporary, and the direct impact of these measures was offset in part by state government cuts. Initially, stimulus money was transferred to the states to help fill state budget gaps, but as the money ended, states had to slash their budgets. The public began to doubt the effectiveness of government stimulus packages. Large deficits continued, increasing the national debt to unprecedented levels and ultimately sparking ideological warfare over the size and role of the federal government.

The Debt Ceiling

The extraordinary annual deficits of the past decade resulting from Bush administration tax cuts, the wars in Iraq and Afghanistan, and spending on the bailout and recovery bills have increased the total amount of debt owed by the United States. The national government debt exceeded $10 trillion for the first time in 2008, and reached a limit in 2011 at $14.2 trillion. The soaring debt forced Congress to debate the debt ceiling, or the limit on how much the United States government can borrow. Congress first created a debt ceiling in 1917 with the Second Liberty Bond Act. The debt ceiling is like the credit limit on your credit card, except that Congress has to periodically raise the debt ceiling *after* it has committed to spending beyond the limit. The consequences of not raising a debt ceiling under such circumstances would be default, in which the government would be unable to pay all of its debt obligations.

President Barack Obama and congressional leaders have struggled to reach a compromise linking an increase in the debt ceiling to long-term spending cuts; twice in 2013, their standoff reached crisis levels. The first time was when Congress was unable to agree on budget reductions, thereby triggering a "sequestration" or across-the-board cutback on all government spending, even in such critical areas as national defense, air traffic control, and disease prevention and control. The second time was later that year when frustrated Republicans in the House refused to raise the debt ceiling (the amount that the United States can borrow to pay its bills), which risked a catastrophic default on the national debt that could have triggered a worldwide financial crisis. The refusal caused a two-week shutdown of the federal government, except for services deemed completely essential. Ultimately, Republicans agreed to raise the debt ceiling alongside a reduction in the Bush-era tax cuts, though not without major criticism from fiscal conservatives. By 2014, the national debt increased to $18.2 trillion, over 100 percent of GDP. The federal government budget included a projected $744 billion deficit for fiscal year 2014.[12]

Fiscal Policy in a Global Context

Advances in transportation, communication, and technology have strengthened the links between the United States and the rest of the world and expanded free trade. As a result, international affairs influence business decisions of American companies that wish to reduce labor costs as well as expand their markets. Globalization can be seen in

the greater movement of goods, services, and capital across borders. Offshore outsourcing of production and services has increased. International trade as a percentage of the world GDP has also increased. While these trends have their critics, most economists agree that globalization increases the variety of goods available to consumers, lowers costs, and raises the standard of living in countries that have stable financial and political institutions and policies in place. It is argued that this consumer "surplus" outweighs the job losses—particularly among unskilled labor—accompanied by globalization. International trade also promotes national competitiveness as each country specializes and improves efficiency in order to maintain a global competitive advantage. Increased globalization, though, has risks for fiscal policy, both in the United States and internationally. When creditors are connected internationally, a financial collapse in one country has the potential to trigger an economic crisis in another country. In 2012, world growth was projected to slow down as several Euro area economies entered mild recessions.[13] Financial crises were more critical in Greece and Spain.

gross domestic product (GDP)
The total market value of all goods and services produced in an area during a year.

One way to measure this increasing interdependence is to examine regional shares of the world **gross domestic product (GDP),** or the total market value of all goods and services produced in an area during a year. In 2012, the United States, the European Union, and Asia each represented between 25 and 27 percent of the world's GDP. Latin America and the Middle East each held another 3 to 7 percent of the world's GDP. This distribution represents much greater international equality than in other eras.[14]

Interdependence can also be measured by the transfer of financial capital across borders. This greater equity is at least in part attributable to emerging economies such as Brazil, Russia, India, and China, which are continuing to post robust growth rates, driven by strong domestic demand and fiscal solvency. Oil-rich countries are also posting large surpluses. The United States, on the other hand, has been running persistent deficits. Foreigners held almost $4.5 trillion in U.S. securities in 2011. The confidence of international creditors in the safety of the United States as a credit investment has kept interest rates low, holding down the costs of borrowing money. Still, concerns have arisen regarding the interconnectedness of the financial markets and the global ripple effect that can occur when one market experiences economic crisis. Concerns over this development have increased support for capital controls, or limits on the amount of capital that can flow across borders.

HOW HAS ECONOMIC INTERDEPENDENCE ALTERED THE AMERICAN ECONOMY?

The cheap cost of labor abroad has led many Americans to lose their jobs, particularly at manufacturing plants. Here, workers at a factory in Pakistan assemble soccer balls.

monetary policy
A form of government regulation in which the nation's money supply and interest rates are controlled.

Board of Governors
In the Federal Reserve System, a seven-member board that makes most economic decisions regarding interest rates and the supply of money.

open market operations
The buying and selling of government securities by the Federal Reserve Bank.

Monetary Policy

17.3 Analyze the effect of the Federal Reserve System on monetary policy.

conomic stability is also promoted through **monetary policy,** by regulating the nation's supply of money and influencing interest rates. The Federal Reserve System (informally, "the Fed"), especially its Board of Governors, handles much of the day-to-day management of monetary policy. The Fed is given a number of tools to aid its efforts, including open market operations, manipulation of the discount rate, and the ability to set reserve requirements.

The Federal Reserve System

Created in 1913 to adjust the money supply to the needs of agriculture, commerce, and industry, the Federal Reserve System comprises the Federal Reserve Board, the Federal Open Market Committee (FOMC), the twelve Federal Reserve Banks in regions throughout the country, and other member banks.[15] Today, the Federal Reserve operates under a dual mandate: to control inflation and limit unemployment. These two mandates can come into conflict, however, forcing the government to prioritize which goal is more important at any given time. Government stimulation to increase employment levels, for example, can lead to inflation and higher prices for goods and services. American economist and Nobel Prize winner Milton Friedman first argued in the 1960s that government should avoid inflation. Instead, Friedman promoted "monetarism," arguing that a constant gradual expansion of the money supply is the only government action needed to promote economic growth. The Federal Reserve has responded to economic crises, however, with active use of monetary policy tools to increase employment in the short run, only to have to deal with debt and inflation in the long run.

Typically, the **Board of Governors** of the Federal Reserve System, a seven-member board that makes most economic decisions regarding interest rates and the supply of money, dominates this process. The board is designed to be independent financially as well as politically.

The president appoints (subject to Senate confirmation) the seven members of the Board of Governors, who serve fourteen-year, overlapping terms. The president can remove a member for stated causes, but this has never occurred. The president designates one board member to serve as chair for a four-year term, which runs from the midpoint of one presidential term to the midpoint of the next to ensure economic stability during a change of administrations. It also prevents monetary policy from being influenced by political considerations. The current chair, Ben Bernanke, has served since 2006 and was initially appointed by President George W. Bush. He was reappointed by President Barack Obama for a second term beginning in 2010. Prior to this appointment, he served as chair of President George W. Bush's Council of Economic Advisors (see Figure 17.3 for the structural organization of the Federal Reserve).

The Tools of Monetary Policy

The primary monetary policy tools used by the Fed are open market operations, control of the discount rate, and the setting of reserve requirements for member banks. **Open market operations** are the buying and selling of government securities, or debt, by the Federal Reserve Bank. The Federal Open Market Committee meets periodically to decide on purchases or sale of government securities to member banks. When member banks buy long-term government bonds, they make dollar payments to the Fed and reduce the amount of money available for loans. Fed purchases of securities from member banks in essence give the banks an added supply of money. This action increases the availability of loans and should decrease interest rates.

Explore Your World

In the United States, the Federal Reserve has two mandates: control inflation and limit unemployment. In Europe, the European Central Bank prioritizes the prevention of inflation. In Japan, the main objective of the Bank of Japan is also to maintain price stability. The common focus on inflation is related to each country's past negative experiences with inflation. Inflation occurs when the price of goods and services increases, reducing the purchasing power of consumers and the value of money. Economists advocate using monetary policy to regulate the supply of money to prevent severe inflation. The United States also prioritizes full employment, which is rooted in the idea of the American Dream. Promoting full employment, however, can increase inflation through increased government spending.

The European Central Bank was created in 1998 to promote stable prices and financial integration among member states of the European Union. Its currency, the euro, was introduced in eleven member states electronically in 1999 and in cash form in 2002. Today the bank has 27 member states.

The Federal Reserve was created in 1913 to prevent and contain economic crises. It consists of the Federal Reserve Board and its Chair in Washington, D.C., and twelve regional Federal Reserve Banks.

The Bank of Japan was established in 1882 to regulate monetary policy, to control inflation, and to promote stable economic growth. Currently, the bank is controlled by a policy board, including a governor, deputy governor, and six executive directors. The bank has 32 branches plus an additional 14 local offices.

CRITICAL THINKING QUESTIONS

1. Is it the government's responsibility to minimize the economic impact of recessions, or to prevent depressions?
2. What should a government do when economic goals come into conflict? If, for example, combating inflation increases unemployment, which goal should be prioritized?
3. Should there be more global economic regulation?

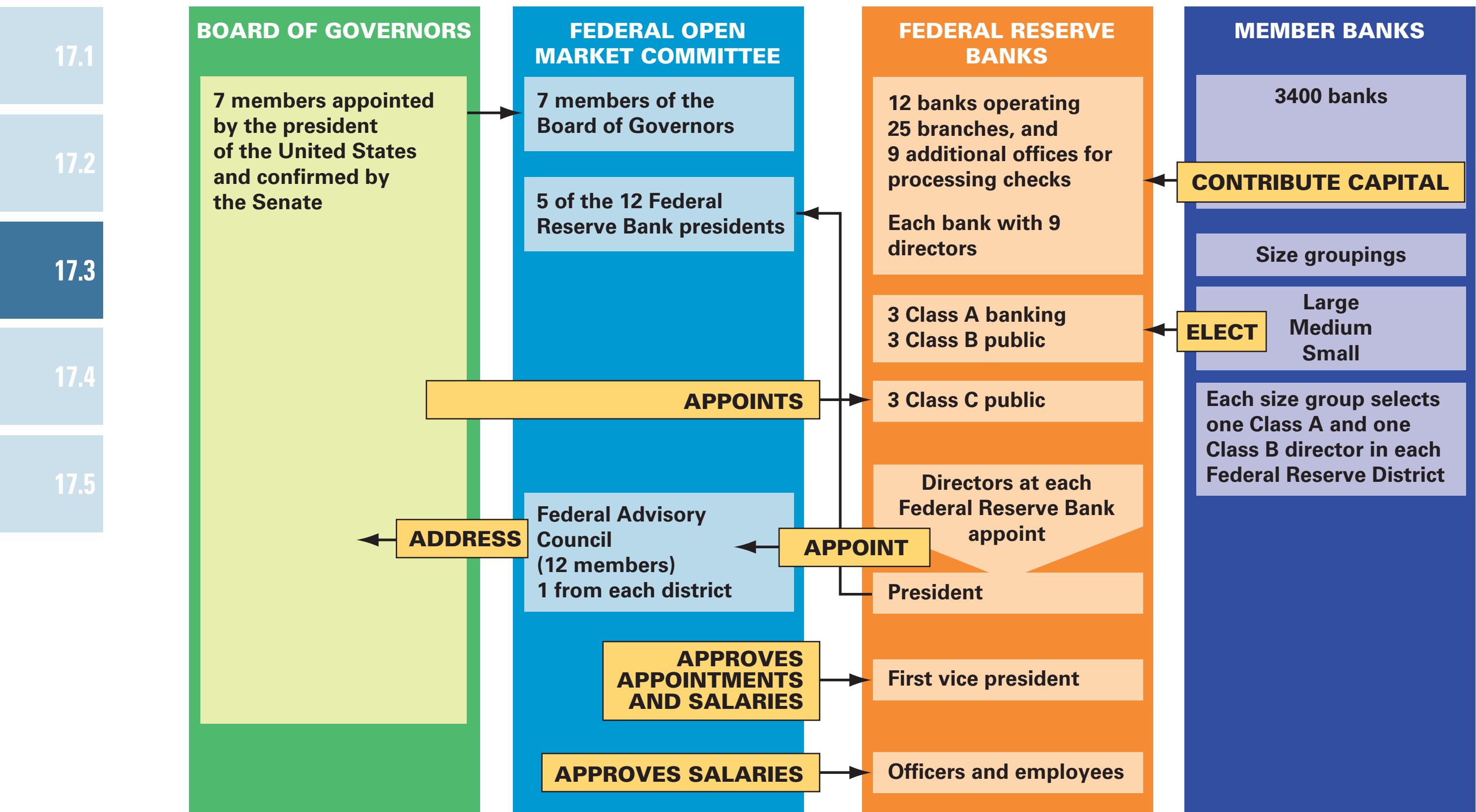


FIGURE 17.3 HOW DOES THE FEDERAL RESERVE SYSTEM WORK?

In making appointments to the Federal Reserve Board, the president is required by law to provide balanced representation of geographic, financial, agricultural, industrial, and commercial interests.

SOURCE: Board of Governors of the Federal Reserve System.

discount rate
The rate of interest at which the Federal Reserve Board lends money to member banks.

reserve requirements
Government requirements that a portion of member banks' deposits be retained as backing for their loans.

The Fed also influences interest rates through the **discount rate,** or the rate of interest at which it lends money to member banks. Lowering the discount rate encourages member banks to increase their borrowing from the Fed and extend more loans at lower rates. This practice expands economic activity, since more people should be able to qualify for car loans or mortgages if rates are lower. As a consequence of cheaper interest rates, more large durable goods (such as houses and cars) should be produced and sold.

Reserve requirements set by the Federal Reserve designate the portion of deposits that member banks must retain on hand. The reserves determine how much or how little banks can lend to businesses and consumers. For example, if the Fed changed the reserve requirements and allowed banks to keep $10 on hand rather than $15 for every $100 in deposits that it held, it would free up additional money for loans. This tool of monetary policy is rarely used, however. Increasing the percentage of deposits that a bank has to keep in reserve may force banks to call in loans. Decreasing reserve requirements, on the other hand, exposes banks to increased risk of failure.

In addition to these formal tools, the Fed can also use "moral suasion" to influence the actions of banks and other members of the financial community by suggestion, exhortation, and informal agreement. Because of its commanding position as a monetary policy maker, the media, economists, and market observers pay attention to verbal signals sent by the Fed and its chair with regard to economic trends and conditions.

In recent years, the Fed has resorted to nontraditional tools when traditional ones failed to stabilize the banking industry in the wake of the recession that started in 2007. The Fed decreased the discount rate, for example, to nearly zero, and yet banks did not substantially increase lending. Moving away from traditional government bonds and securities, the Fed started buying riskier mortgage-backed securities, in an effort to remove guaranteed debt from banks so that more capital was free to lend again. The Fed's purchase of private sector assets, or commercial paper, is referred to as "credit easing." The goal is to relieve banks of enough debt to help their credit flow again. Quantitative easing occurs when the purchase of such debt is funded by the government's creating new

money. These policies are controversial because they can increase inflation dramatically if banks do not start to lend the additional reserves created by the Fed's purchases.

One lesson learned in the recent financial crisis is the danger of allowing banks to become "too big to fail." As the lender of last resort, the Fed was initially reluctant to bail out banks for their risky investment mistakes. In 2007, Bear Sterns went bankrupt; the government ultimately took over Fannie Mae and Freddie Mac as foreclosures escalated on the subprime mortgages they had bought and securitized. The Fed assisted JP Morgan Chase with $29 billion in 2008 to buy Bear Stearns. When Lehman Brothers failed next, the Fed chose instead to send a message that big banks would not be bailed out at taxpayer expense. The financial impact of the collapse of these mammoth institutions, however, threatened to damage the entire financial system. The Fed acted quickly to rescue American International Group (AIG), despite growing public opposition to bailing out Wall Street. The Chairman of the Federal Reserve Board, Ben Bernanke, called for new regulations to strengthen capital requirements for banks to provide better cushions to protect against potential losses and for investigation of the linkages among financial companies to better identify potential channels of financial contagion.

After 18 months of debate, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, a 2,300-page reform of the financial industry. The new legislation created a ten-member Financial Stability Oversight Council to monitor individual financial institutions that pose a risk of economic crisis. Regulators then have authority, as a last resort, to dismantle troubled firms before damage is done. New rules about capital leverage, risk management, and liquidity make it more difficult for banks to grow excessively large. The legislation also created the Consumer Financial Protection Bureau to regulate mortgage lending, credit cards, and consumer loan practices, providing more information and protection for consumers.

HOW HAS THE GOVERNMENT RESPONDED TO THE RECESSION?
President Obama appointed Richard Cordray in 2012 to serve as Director of the new Consumer Finance Protection Bureau. The new agency is charged with assisting consumers in understanding financial products and services, including mortgages and credit cards.

Social Security Act
A 1935 law that established old age insurance; assistance for the needy, aged, blind, and families with dependent children; and unemployment insurance.

Income Security Policy

17.4 Describe the evolution of income security policy in the United States.

Income security programs protect people against loss of income because of retirement, disability, unemployment, or death or absence of the family breadwinner. In 1780, for example, national legislation was passed to provide a pension to the widows of sailors. These programs, however, like many of the other issues, were not a priority for the federal government during much of its first 150 years. Beginning with the passage of the Social Security Act as a part of the 1930s New Deal, the government began to pay greater attention to this policy area. Today, the federal government administers a range of income security programs. These policies fall into two major areas—non–means-tested programs (in which benefits are provided regardless of income) and means-tested programs (in which benefits are provided to those whose incomes fall below a designated level).

Economists refer to income security policies as "automatic stabilizers." If the economy enters a recession, income security policies have the effect of expanding the economy automatically, whether or not the federal government takes action to change fiscal or monetary policy. The money spent by the government to provide assistance to people in need is injected back into the economy through purchases of rent, food, health care, and other basic expenditures. When the economy recovers and fewer people need assistance, government spending automatically decreases, preventing the inflation that could occur with deficit spending in periods of expansion. Income security policies also provide a safety net for times when the government delays recognition or response to economic crises.

The Foundations of Income Security Policy

With the election of President Franklin D. Roosevelt in 1932, the federal government began to play a more active role in addressing the hardships and turmoil that grew out of the Great Depression. An immediate challenge facing the Roosevelt administration was massive unemployment, viewed as having a corrosive effect on the economic well-being and moral character of American citizens. An array of programs to put people back to work would, in Roosevelt's words, "eliminate the threat that enforced idleness brings to spiritual and moral stability."[16]

To address unemployment, Roosevelt issued an executive order in November 1933 that created the Civil Works Administration (CWA). The intent of the CWA was to put people to work as quickly as possible for the stated goal of building public works projects. Within a month of its start, CWA had hired 2.6 million people; at its peak in January 1934, it employed more than 4 million workers. But, critics quickly claimed that it was too political and rife with corruption. The CWA was disbanded in 1934.

In 1935, the Works Progress Administration (WPA) revived the idea of a federal work program. The WPA paid a wage of about $55 a month, which was sizeable for the time, but below what would be available in the private sector. Such a wage was designed to reward work, but not discourage individuals from seeking market-based employment. The WPA attained a number of concrete accomplishments. This program absorbed about 30 percent of the unemployed; the WPA also constructed or improved more than 20,000 playgrounds, schools, hospitals, and airfields.[17] These jobs programs established the concept that, in extreme circumstances, the government might become the employer of last resort.

A more permanent legacy of the New Deal was the creation of the Social Security program. The intent of Social Security was to go beyond various "emergency" programs such as the WPA and provide at least a minimum of economic security for all Americans. Passage of the **Social Security Act** in 1935 thus represented the beginning of a permanent welfare state in America and a dedication to the ideal of greater equity. The act consisted

of three major components: (1) old-age insurance (what we now call Social Security); (2) public assistance for the needy, aged, blind, and families with dependent children (known as SSI); and (3) unemployment insurance and compensation. Since that time, the program has expanded to include a much greater percentage of American workers. It has also become one of the most successful government programs. In the 1930s, poverty rates were highest among the elderly. Today, seniors age sixty-five or older have the lowest rate of poverty among any age group in the United States.

Income Security Programs Today

Modern income security programs help a wide variety of citizens to survive in cases of unintentional loss of income. They also help disabled, elderly, and low-income citizens to make ends meet and provide a minimally decent standard of living for themselves and their families. In 2012, the poverty threshold for a four-person family unit was $23,050. (To learn more about the number of Americans who benefit from income security programs, see Table 17.1.)

Many income security programs are **entitlement programs,** government benefits that all citizens meeting eligibility criteria—such as age, income level, or unemployment—are legally "entitled" to receive. Unlike programs such as public housing, military construction, and space exploration, spending for entitlement programs is mandatory and places a substantial ongoing financial burden on the national and state governments.

Income security programs fall into two general categories. Many social insurance programs are **non–means-tested programs** that provide cash assistance to qualified beneficiaries, regardless of income. These social insurance programs operate in a manner somewhat similar to that of private automobile or life insurance. Contributions are made by or on behalf of the prospective beneficiaries, their employers, or both. When a person becomes eligible for benefits, he or she is paid as a matter of right, regardless of wealth or unearned income. Among these programs are old age, survivors, and disability insurance (Social Security) and unemployment insurance.

In contrast, **means-tested programs** require people to have incomes below specified levels to be eligible for benefits. Benefits of means-tested programs may come either as cash or in-kind benefits, such as help with finding employment or child care. Included in the means-tested category are the Supplemental Security Income (SSI) program and the Supplemental Nutrition Assistance Program (SNAP, also known as food stamps). Temporary Assistance for Needy Families (TANF) is also means-tested, but the program is not an entitlement. States are given discretion to determine TANF eligibility and benefits.

OLD AGE, SURVIVORS, AND DISABILITY INSURANCE The Social Security program is a non–means-tested program that began as old-age insurance, providing benefits

entitlement programs
Government benefits that all citizens meeting eligibility criteria—such as age, income level, or unemployment—are legally "entitled" to receive.

non–means-tested programs
Programs that provide cash assistance to qualified beneficiaries, regardless of income. Among these are Social Security and unemployment insurance.

means-tested programs
Programs that require that beneficiaries have incomes below specified levels to be eligible for benefits. Among these are SSI, TANF, and SNAP.

17.1
17.2
17.3
17.4
17.5

TABLE 17.1 HOW MANY AMERICANS BENEFIT FROM INCOME SECURITY PROGRAMS?

Program Population	Number of Recipients (millions)	Percentage of U.S. Population
Non–means-tested		
Social Security (old-age, survivors, and disability insurance, or OASDI)	56.0	18
Unemployment insurance	4.6	1.5
Means-tested		
Supplemental Security Income	7.9	2.5
Temporary Assistance for Needy Families	4.4	1.4
Supplemental Nutrition Assistance Program	45.8	14.6

SOURCES: Social Security Administration, www.ssa.gov; Center on Budget and Policy Priorities, http://www.cbpp.org/; Department of Health and Human Services, www.acf.hhs.gov; Food Research Action Center, www.frac.org; Veterans' Affairs, Bureau of Labor Statistics, www.bls.gov/cps.

SHOULD SOCIAL SECURITY BE PRIVATIZED?

Social Security privatization has been a hot-button issue. Here, members of Congress speak at a rally opposing privatization.

only to retired workers. Its coverage was extended to survivors of covered workers in 1939 and to the permanently disabled in 1956. Nearly all employees and most of the self-employed are now covered by Social Security. Americans born before 1938 are eligible to receive full retirement benefits at age sixty-five. The full retirement age gradually rises until it reaches sixty-seven for persons born in 1960 or later. In 2012, the average monthly Social Security benefit for retired workers was $1,230, with the maximum monthly benefit set at $2,513.

Social Security is not, as many people believe, a pension program that collects contributions from workers, invests them, and then returns them with interest to beneficiaries. Instead, current workers pay employment taxes that go directly toward providing benefits for retirees. In 2012, for example, a tax of 4.2 percent was levied on the first $110,100 of an employee's wages and placed into the Social Security Trust Fund. An additional 6.2 percent tax was levied on employers.

As a result of this system, in recent years, it has become increasingly apparent that the current Social Security system is on a collision course with itself. Americans are living longer and having fewer children. And, beginning in 2010, the Baby Boom generation (roughly speaking, those born in the two decades immediately following World War II) began to retire. These factors, taken together, skew the number of working Americans per retiree, and lead the Social Security system toward financial insolvency. The trustees of the Social Security Trust Fund have estimated that—barring major policy changes—by 2030, payments to beneficiaries will exceed revenues collected from employees.

A number of proposals have been made to address these shortcomings. Among them is raising the eligibility for beneficiaries, increasing the Social Security tax withheld from employees, or gradually privatizing the system for younger workers. Both of these proposals have received criticism from citizens—seniors and those who will soon retire do not wish to see their benefits cut or limited, and workers do not want to pay additional taxes.

One reform proposal that received a great deal of attention in the 2000 presidential election and the years that followed was Social Security privatization. Essentially, this would amount to the federal government's allowing citizens to work with private industry to administer and invest monies in the Social Security Trust Fund. Some Americans

believe that such a system would increase the government's return on investment and prolong the life of the existing Social Security system with few other changes. Others believe that a privatized Social Security system is risky and will leave behind those who need it the most. The volatility of the stock market during the economic recession has, at least temporarily, reduced enthusiasm for privatization.

UNEMPLOYMENT INSURANCE Unemployment insurance is a non–means-tested program financed by a payroll tax paid by employers. The program benefits full-time employees of companies of four or more people who become unemployed through no fault of their own. Unemployed workers who have been fired for personal faults or who have quit their jobs, or those who are unwilling to accept suitable employment, do not receive benefits.

State governments administer unemployment insurance programs. As a result, unemployment programs differ a great deal in levels of benefits, length of benefit payment, and eligibility for benefits. For example, in 2014, average weekly benefit payments ranged from less than $230 a month in Mississippi to just over $660 a month in Rhode Island. Benefits lasted for only fifty-nine weeks in Mississippi and for seventy-nine weeks in Rhode Island. In general, less generous programs exist in southern states, where labor unions are less powerful. Nationwide, only about half of people who are counted as unemployed at any given time are receiving benefits.

In April 2012, the national unemployment rate stood at 8.1 percent. But, differences were considerable across the country (as illustrated in Figure 17.4). In North Dakota the unemployment rate was 3 percent, while levels of unemployment in many southern and western states such as Florida and California were over 9 percent. Rhode Island and Nevada both experienced unemployment rates over 11 percent. Unemployment rates also varied quite a bit across races and by age. For example, levels of unemployment for African American men were nearly twice that of whites, with unemployment rates exceeding 40 percent or greater common among young African American men.

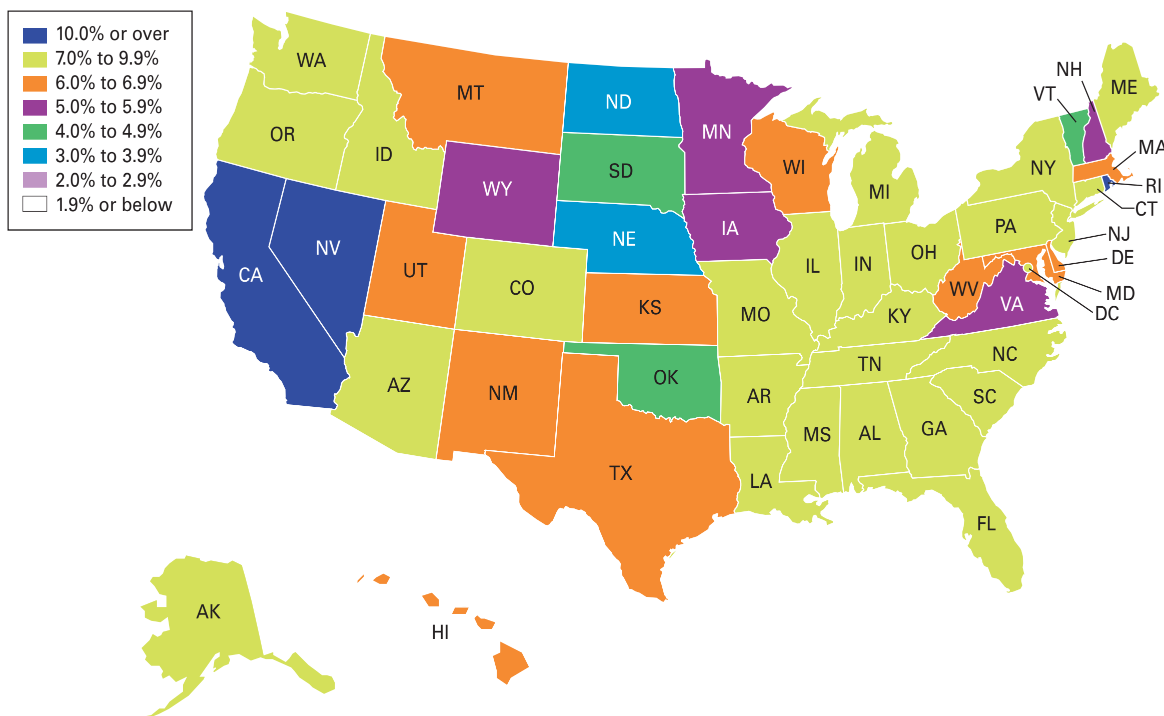


FIGURE 17.4 HOW DO STATE UNEMPLOYMENT RATES VARY?

In July 2012, the national unemployment rate was 8.2 percent. However, this rate varied tremendously across the country, with the highest levels in the South and West, and the lowest levels in the Midwest.

SOURCE: United States Department of Labor, www.dol.gov.

SUPPLEMENTAL SECURITY INCOME The Supplemental Security Income (SSI) program is a means-tested program that began under the Social Security Act as a government benefit for needy elderly or blind citizens. In 1950, Congress extended coverage to needy people who were permanently and totally disabled. The federal government, which provides primary funding for SSI, prescribes minimum national benefit levels. The states may also choose to supplement national benefits, and forty-eight states take advantage of this option.

To be eligible for SSI, beneficiaries can have only limited income; the lower an individual's income, the higher the SSI payment. SSI beneficiaries may also have only a limited number of possessions. The total of an individual's personal resources, including bank accounts, vehicles, and personal property, cannot exceed $2,000. In 2012, monthly payments to eligible beneficiaries were about $517 per person.

FAMILY AND CHILD SUPPORT The Aid to Dependent Children program is a means-tested program that was first established as part of the Social Security Act in 1935. In 1950, it was broadened to include not only dependent children without fathers but also mothers or other adults with whom dependent children were living. At this time, it was retitled the Aid to Families and Dependent Children (AFDC) program. As a result of this change and changes in the American family (including a rise in the birthrate to unwed mothers and a rise in the divorce rate), the family and child support rolls expanded significantly in the latter part of the twentieth century.

By the 1990s, the growth of this program began to attract widespread criticism from many conservatives and moderates, including Democratic President Bill Clinton. Critics pointed to the rising number of recipients and claimed that the AFDC program encouraged promiscuity, out-of-wedlock births, and dependency that resulted in a permanent class of welfare families. To restrict the availability of aid, to ferret out fraud and abuse, and to hold down cost, public officials sought to reform the program.

In what was hailed as the biggest shift in income security policy since the Great Depression, a new family and child support bill, the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) of 1996, created the Temporary Assistance for Needy Families (TANF) program to replace AFDC. The most fundamental change enacted in the new law was the switch in funding welfare from an open-ended matching program to a block grant to the states. PRWORA also gave states more flexibility in reforming their welfare programs toward work-oriented goals.

Significant features of the TANF plan included: (1) a requirement that single mothers with a child over five years of age must find work within two years of receiving benefits; (2) a provision requiring unmarried mothers under the age of eighteen to live with an adult and attend school to receive welfare benefits; (3) a five-year lifetime limit for aid from block grants; (4) a requirement that mothers must provide information about a child's father in order to receive full welfare payments; (5) cutting off food stamps and Supplemental Security Income for illegal immigrants; (6) cutting off cash benefits and food stamps for convicted drug felons; and, (7) limiting food stamps to three months in a three-year period for persons eighteen to fifty years old who are not raising children and not working.[18]

The success of the TANF program has been widely debated. The total number of Americans receiving benefits has fallen. The program is not an entitlement, and states use diversion payments, for example, to minimize the number of TANF recipients. Little evidence supports the success of the program in job training or as a means of reducing economic and social inequality. Despite these potential shortcomings, the act was reauthorized several times during the Bush administration. In 2010, it became the subject of significant political wrangling, and the Emergency Contingency Fund, which provided additional federal revenues to states, was cut.

SUPPLEMENTAL NUTRITION ASSISTANCE PROGRAM The first attempt at this means-tested program (1939–1943), which is more commonly known as food stamps, was primarily an effort to expand domestic markets for farm commodities. Food stamps provided the poor with the ability to purchase more food, thus increasing the

demand for American agricultural produce. Attempts to reestablish the program during the Eisenhower administration failed, but in 1961, a $381,000 pilot program began under the Kennedy administration. It became permanent in 1964 and extended nationwide in 1974.

The method of delivering the food stamp benefit has changed dramatically over time. For much of the program's history, the benefit was administered as actual paper coupons—quite literally, food "stamps"—given to citizens who were eligible for relief. Today, the program is administered entirely using an electronic debt program, much like an ATM card. This change in administration necessitated a formal name change for the program—from food stamps to the Supplemental Nutrition Assistance Program—in 2008. Still, this benefit continues to be an important means of ensuring income security. In 2012, more than 46 million Americans received SNAP aid. The average participant received $133.85 worth of assistance per month.

In addition to SNAP, the national government operates several other food programs for the needy. These programs include a special nutritional program for women, infants, and children, known as WIC; a school breakfast and lunch program; and an emergency food assistance program including cheese and cereal.

economic stability
A situation in which there is economic growth, rising national income, high employment, and steadiness in the general level of prices.

recession
A decline in the economy that occurs as investment sags, production falls off, and unemployment increases.

Toward Reform: Recession and Economic Recovery

17.5 Evaluate the role of fiscal, monetary, and income security policy in the economic recession and recovery.

By 2008, it became increasingly clear that the extended period of American **economic stability**—a situation characterized by economic growth, rising national income, high employment, and steadiness in the general level of prices—was quickly coming to an end. Growing unemployment and government expenditures, coupled with a collapsing mortgage industry, created a severe economic downturn. By the end of 2008, this downturn had become a full-blown **recession,** a decline in the economy that occurs as investment sags, production falls off, and unemployment increases.

The national government identified this crisis situation quickly and, using fiscal, monetary, and income security policies, took a number of actions in an attempt to restart economic growth and stimulate the economy. We consider the ways the government used each of these policies in turn.

Fiscal Policy

In February 2008, realizing the severity of the economic situation, the Bush administration, along with Congress, announced a $168 billion federal stimulus package to provide Americans with tax rebates and relief intended to help boost consumer demand and reduce economic hardship. But, these efforts were insufficient, and the financial meltdown worsened. The collapse of many financial institutions as a result of the subprime mortgage crisis in September 2008 led Congress to pass the Temporary Assets Relief Program (TARP), an approximately $700 billion bailout of the financial industry.

Although these efforts made great strides in preserving American savings and loan companies, they did little to help average citizens. To address these concerns, in February 2009, President Barack Obama signed the $787 billion American Recovery and Reinvestment Act, designed to cut taxes and create jobs through deficit spending.

These fiscal policy choices did improve economic recovery. By 2010, GDP and employment both increased. The long-term consequence of deficit spending, however, is a national debt that, economists argue, is unsustainable. Ending Bush tax cuts combined

with budget cuts could reduce the deficit, but at the expense of slowing the rate of economic recovery. Policy makers face tough choices as they continue to balance ideological preferences regarding the role and size of government.

Monetary Policy

Monetary policy is often the preferred way to address an economic crisis, in part because it can be easily implemented and has fewer long-term financial consequences than the deficit spending typified by fiscal policy and the Recovery Act. In early 2008, the Federal Reserve Board responded quickly to the economic slowdown, taking extraordinary action to lower interest rates and engaging in large open market operations and discount rate reductions to increase liquidity in the markets. In March 2008, the Fed also injected about $200 billion into the U.S. banking system by offering banks low-interest, one-month loans to ease the tightening credit conditions. It later took action to adjust mortgage lending rules and expand the commodities that U.S. markets could borrow against in order to increase the money supply in the market.

Despite signs of an economic recovery in early 2010, the Fed has continued to keep interest rates low in the hope of attracting borrowers who will inject money into the market. In addition to these traditional tools of monetary policy, the Fed has taken extraordinary measures designed to stimulate bank lending, including the purchase of mortgage-backed securities, credit easing, and quantitative easing. New regulations on capital leverage, risk management, and liquidity passed in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2011 attempt to reduce the risks associated with the international interconnectedness of large financial institutions. Critics argue that the new regulations unfairly restrict banks, reducing their global competitive advantage. Others suggest that recent reforms do not go far enough to prevent economic crises in the future. As business cycles increase in severity, finding the right balance of regulation and deregulation is a constant challenge.

Income Security Policy

Income security policies automatically expand the economy during recessions by providing benefits to those affected by worsening economic conditions and rising unemployment. These programs, however, have put pressure on federal and state governments, with severe consequences for state budgets and the national deficit and debt. Recall that states must have balanced budgets—the amount of revenues must be equal to or greater than expenditure levels. Thus, as the rolls for programs such as unemployment insurance and food stamps rise, state costs to administer these programs—and therefore, projected expenditures—rise rapidly. At the same time, however, state revenues in the form of income and sales taxes decline as a result of fewer workers and lower consumer spending. This combination has placed great pressure on state governments. Many states have had to find creative ways to raise revenue or make large budget cuts in other areas in order to make ends meet.

For its part, the national government has engaged in deficit spending in order to fund these and other programs, as well as to help states balance their budgets. The costs of these expenditures will not be fully realized for years, as the nation faces a growing national debt and the threat of economic instability from owing large sums of money to creditors. As the economy recovers, the federal government will also have to deal with the financial insolvency of Social Security and other programs.

Evaluating the Government's Response

Signs of the economic downturn—and the ultimate collapse of financial institutions—were severe enough that both Republicans and Democrats agreed on the need to act in forestalling long-term consequences, both for individuals and for the nation at large. It is, however, worth noting that both parties encouraged responses to the economic collapse that were consistent with their political and economic worldviews.

Take a Closer Look

In May 2012, the Group of Eight Summit was held at Camp David, Maryland, and included world leaders from the United States, Japan, Britain, Germany, France, Italy, Canada, and Russia. The main focus of the conference was how to prevent a growing fiscal crisis in the Euro area from harming the global economy.

U.S. President Barack Obama supports the European Central Bank's using monetary policy to rescue failing European banks from collapse.

French President François Hollande was elected in the spring of 2012 on a platform that rejected the austerity measures advocated by Merkel. Hollande supports increased government spending to stimulate economic growth.

German Chancellor Angela Merkel firmly supports austerity measures to improve economic growth. She argues that reducing deficits is the most important goal in stabilizing the debt crisis faced by many Euro area economies.

CRITICAL THINKING QUESTIONS

1. Should banks be rescued with government bailouts if their collapse threatens the economic stability of a country? Should they be rescued even if they have engaged in risky behavior?
2. Is government debt justified by the creation of jobs? What are the long-term consequences of increased government deficits? What are the long-term consequences of increased employment?
3. Should world leaders coordinate their economic policies to prevent global economic recessions? Who should decide what policies to pursue?

Seeing the signs of a downturn in early 2008, for example, President George W. Bush and the Republican Party urged the Fed to take action to increase the supply of money and lower interest rates. The Bush administration also worked with Congress to pass a tax rebate designed to put more money in citizens' pockets. After taking office in 2009, President Barack Obama, leading the Democrats, significantly increased government spending and provided additional tax relief in addition to the aggressive use of monetary policy tools by the Fed.

As the economy recovers, economists will debate which of these policy approaches was most effective. Not surprisingly, assessments generally break down along partisan lines. White House economists, for example, credit the Recovery Act for bringing about economic growth and increasing employment by late 2009. Conservative scholars and former Republican governmental officials do not dispute this growth, but they argue that it has resulted from monetary policy and decisive bailout actions through the TARP program.[19]

In all likelihood, however, both fiscal policy and monetary policy, as well as the safety net provided by national and state income security programs, have helped improve the American economy. The government shoulders the responsibility of taking decisive action in all three areas—fiscal, monetary, and income security policy—to prevent or reduce the impact of future downturns in the business cycle.

Review the Chapter

Roots of Economic Policy

17.1 Trace the evolution of economic policy in the United States, p. 484.

The government's role in regulating the economy has evolved over the nation's history. During the nineteenth century, the national government defined its economic role narrowly and subscribed to a laissez-faire economic philosophy. By the 1890s, however, it became clear that the national government needed to take greater steps to regulate the economy, which it did by creating the Interstate Commerce Commission and passing anti-monopoly legislation. Later, to help bring the nation out of the Great Depression, President Franklin D. Roosevelt's New Deal in the 1930s brought increased government intervention in a number of economic policy areas including financial markets, agriculture, labor, and industry. In the 1960s and 1970s, the government expanded its role to include social regulations dealing with health, safety, and environmental protection. Finally, at the end of the twentieth century, a backlash occurred against regulation, and deregulation, or the reduction in market controls in favor of market-based competition, gained prominence. In the wake of the recent global economic recession, debate continues over the proper role of government in responding to economic conditions.

Fiscal Policy

17.2 Assess the impact of the budget process on fiscal policy, p. 490.

Fiscal policy is the deliberate use of the national government's taxing and spending policies to maintain economic stability. Many factors influence fiscal policy, including the global economy through increased international interdependence. Government spending and taxes are the tools of fiscal policy; they can be manipulated to stabilize the economy and to counteract fluctuations in federal revenues. Except for a short period from 1998 to 2001, the federal government has generally run a budget deficit, which can have negative consequences for the economy over the long term. The government has responded to economic recession with different combinations of increased government spending and tax cuts. Congress raised the debt ceiling as the long-term continuation of annual deficits increased the national debt, prompting debates over the size and role of the federal government. In 2012, the United States faced what economists referred to as a fiscal cliff, as current policies were deemed unsustainable. Conflicting goals of stimulating a weak economy still recovering from recession and the necessity of reducing long-term debt and the risk of inflation created tough choices for policy makers.

Monetary Policy

17.3 Analyze the effect of the Federal Reserve System on monetary policy, p. 496.

Monetary policy is a form of government regulation in which the nation's money supply and interest rates are controlled. In 1913, the federal government created the Federal Reserve System ("the Fed") to adjust the money supply to the needs of agriculture, commerce, and industry. Today, it handles much of the day-to-day management of monetary policy. It has a number of tools to aid its efforts, including open market operations, which involve the buying and selling of government securities by the Federal Reserve Bank in the securities market; control of the discount rate, or the rate of interest at which the Federal Reserve Board lends money to member banks; and the ability to set reserve requirements, or government requirements that a portion of member banks' deposits be retained as backing for their loans. The Fed has also used nontraditional tools, including the purchase of mortgage-backed securities, credit easing, and quantitative easing, to encourage banks to increase lending.

Income Security Policy

17.4 Describe the evolution of income security policy in the United States, p. 500.

Income security programs protect people against loss of income. These programs also serve as automatic stabilizers, increasing government spending during economic crises. Income security policy was not a priority for the federal government until the 1930s, when it passed the Social Security Act. Today, the federal government administers a range of income security programs that fall into two major areas: non–means-tested and means-tested programs. Non–means-tested programs provide cash assistance to qualified beneficiaries regardless of income; they include old age, survivors, and disability insurance, and unemployment insurance. Means-tested programs require that people have incomes below specified levels to be eligible for benefits; they include Supplemental Security Income (SSI), family and child support and the Supplemental Nutrition Assistance Program (food stamps).

Toward Reform: Recession and Economic Recovery

17.5 Evaluate the role of fiscal, monetary, and income security policy in the economic recession and recovery, p. 505.

By the end of 2008, the nation was in a full-blown recession, a decline in the economy that occurs as investment sags, production falls off, and unemployment increases. The national government identified the crisis situation quickly and took a number of actions to restart economic growth and stimulate the economy through the use of fiscal, monetary, and income security policy. In terms of fiscal policy, the Bush administration offered tax rebates and proposed a $700 billion federal bailout package for the banking industry, known as TARP. When President Barack Obama took office, he worked with Congress to pass the $787 billion American Recovery and Reinvestment Act to help stimulate the economy and to maintain and create new jobs. In terms of monetary policy, the Federal Reserve Board responded to the crisis by cutting interest rates and engaging in open market operations and discount rate reductions. The costs of income security programs during this economic downturn have put a strain on both national and state budgets. As the economy continues to move forward, policy makers will analyze the successes and failures of fiscal policy, monetary policy, and income security policies in responding to the worst economic crisis since the Great Depression.

Key Terms

Study and **Review** the **Flashcards**

Board of Governors, p. 496
budget deficit, p. 490
business cycles, p. 484
deregulation, p. 488
discount rate, p. 498
economic regulation, p. 484
economic stability, p. 505
entitlement programs, p. 501
fiscal policy, p. 490
gross domestic product (GDP), p. 495
inflation, p. 491
interventionist state, p. 487
laissez-faire, p. 484
means-tested programs, p. 501
monetary policy, p. 496
non–means-tested programs, p. 501
open market operations, p. 496
recession, p. 505
reserve requirements, p. 498
Social Security Act, p. 500
trusts, p. 485

Test Yourself

Study and **Review** the **Practice Tests**

1. During the Progressive era, the federal government supported ____ of the banking industry to help stabilize the money supply and prevent financial panics.

- **a.** regulation
- **b.** deregulation
- **c.** socialization
- **d.** monopolization
- **e.** privatization

2. Congressional termination of the Glass-Steagall Act in 1999

- **a.** meant that large multinational banks could no longer merge with other banks.
- **b.** allowed banks to consolidate traditional savings and loans services with riskier securities investments.
- **c.** prohibited banks from borrowing money from the Federal Reserve.
- **d.** helped to prevent bank failures during the recession that began in 2007.
- **e.** reduced the competitiveness of multinational financial institutions.

3. The government makes fiscal policy by increasing or decreasing

- **a.** the supply of money.
- **b.** the interest rate.
- **c.** taxes and government spending.
- **d.** the capital reserve that banks must hold.
- **e.** the amount that banks are charged to borrow money.

4. Economist John Maynard Keynes argued that

- **a.** increasing government spending can stimulate a weak economy.
- **b.** increasing interest rates can decrease consumer spending.
- **c.** decreasing government taxes reduces the national debt.
- **d.** decreasing the supply of money can stimulate borrowing.
- **e.** increasing consumer spending destabilizes the economy.

5. The portion of a bank's deposits that the bank must retain as backing for its loans is known as the

a. loan requirement.
b. reserve requirement.
c. financial backing proportion.
d. earnest money.
e. fiduciary responsibility.

6. The goals of the Federal Reserve include

a. limiting consumption.
b. increasing inflation.
c. decreasing unemployment.
d. decreasing consumer savings.
e. increasing consumer debt.

7. Income security programs intended to assist persons whose income falls below a designated level are called

a. security assistance laws.
b. social insurance statutes.
c. means-tested programs.
d. non–means-tested programs.
e. Medicare and Medicaid.

8. Social Security, an example of an income security policy,

a. provides temporary income to workers who have lost their jobs.
b. is paid for entirely by contributions from employers.
c. is a means-tested entitlement.
d. may be underfunded by 2030 if the system is not reformed.
e. provides jobs to low-income elderly workers.

9. Much of the current economic downturn is attributable to

a. the cost of the war in Iraq.
b. automobile loans.
c. the cost of No Child Left Behind.
d. the cost of presidential campaigns.
e. the subprime mortgage crisis.

10. In response to economic recession, the U.S. federal government

a. enacted austerity measures.
b. increased interest rates.
c. abandoned Keynesian economic policies.
d. stimulated economic growth with increased government spending.
e. decreased government debt.