CHAPTER

18

Economic Policy

★

WHO GOVERNS?

1. Who in the federal government can make our economy strong?

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TO WHAT ENDS?

1. Why does the federal government ever have a budget deficit?

Like most Americans, you probably think about the way the government spends its money the same way you think about how you ought to spend yours. If you spend more than you earn, you will have to borrow money and pay it back to the bank. If you want to buy a car or a house, you will have to get a loan and make monthly payments on it. It you run up so many charges on your credit card that it is maxed out, you won't be able to charge anything more on it. If you keep spending more than your earn, you will have to declare bankruptcy. Surely the government ought to work the same way: spend no more than it earns and pay back its loans.

But it doesn't. With just a few exceptions, the government has spent more money than it takes in every year since at least 1960. The amount it spends in excess of what it takes in each year is called the **deficit.** It is financed by selling government bonds, issued by the Treasury Department, to Americans and foreigners. The total amount of all deficits is the **national debt.** How can the government in Washington get away with this?

There are three reasons, one economic, one substantive, and one political. The economic reason is that a debt is important only insofar as the government cannot make the payments on its bonds in a currency that people regard as stable and valuable. Happily, almost everybody around the world regards the American dollar as stable and valuable. As a result, people line up to buy Treasury bonds whenever they are sold. And so the government in Washington, like the owners of Wal-Mart, can pay for whatever they want. But to keep our currency stable, people must believe that the dollar will always be valuable and that the government is not borrowing more than it can pay back. Some observers have complained that a big government debt will cause prices to rise (inflation) or investment in new businesses to suffer. But inflation will not occur if the government does not print a lot of money. And low levels of investment will not occur if the government does not take a lot of money out of circulation. Later in this chapter we will explain how these things might occur.

The government must pay the interest on the federal debt just as you have to pay the interest on your car loan. The total federal debt is a very large number (around $8 trillion), but the number, while huge, doe not mean much when taken alone. They key is what fraction of our federal spending is used to pay interest on the debt. In 2006, that interest was about 8 percent of all federal expenditures, making interest the third most expensive program (behind social welfare and defense). It is a lot of money, but the percentage is a lot less than what many families pay in interest on their car and home.

The economy can afford paying this interest. Federal interest payments take up about 1.7 percent of the total value of all of the goods and services the nation produces. This output is called **gross domestic product,** or GDP. In two years while Bill Clinton was president we had no deficit, but those brief surpluses did not reduce the total debt by very much.

The American economy can easily pay the annual deficit, but it may have greater trouble managing the total public debt after one realizes that as our population ages there will be huge new demands placed on Washington for Social Security retirement benefits and medical payments under Medicare (see Chapter 19). Unless we change these programs, our interest payments in the decades ahead will balloon.

The substantive argument about our debt is what we buy with this money. Most families borrow to buy long-lasting items, like a home, a new car, or a college education. We don't really know what the federal debt is used for. It would be nice if we knew that we borrowed only to pay for long-lasting things that enhanced security and economic growth, such as schools, aircraft carriers, and basic health care research. But our government borrows whenever it needs the money without much regard for what it gets.

The political argument is easier to understand: since they know that the public is opposed to the government going into debt, politicians will also oppose the debt, but they offer two opposed ways to combat it. One, advanced by conservatives, is by cutting spending; the other, offered by liberals, is raising taxes. But since the people do not want less spending on programs they favor and certainly don't want higher taxes, these contradictory political strategies often lead to no change at all.

★ How Reliable Are Projections About the Future?

Not very. President Clinton and the American economy produced budget surpluses between 1998 and 2000, leading many people to hope for big cuts in the total public debt. But in 2001 terrorists rammed hijacked aircraft into the World Trade Center, leading to a brief shutdown of the New York Stock Exchange and all American airlines, a cutback in economic activity, and huge new federal expenditures for public relief, national defense, and helping the airlines recover.

But it is not just an unforeseen disaster that can make guesses about the future unreliable. Suppose we cut taxes, as President George W. Bush and Congress did in 2001. If you think that a tax cut means less revenue coming to Washington, then you will say the deficits will go up. But if you think that tax cuts will stimulate economic growth and thus produce, from taxes on it, more federal revenue, then you will slay that the deficits will go down. For a little while, the deficit went up and then it began to fall sharply. In the short run, lower taxes meant a bigger deficit, but in the longer run it meant a smaller one (see Figure 18.1).

There are two federal agencies that try hard to make reasonable statements about the future, the Office of Management and Budget (OMB) in the White House and the Congressional Budget Office (CBO) in Congress. Good people work for these agencies, but they have the same trouble we all do in predicting the future. Moreover, when taxes go up or down, they assume that nothing will happen to the economy. But something does happen, and that affects the GDP.

Between 1993 and 1997 the OMB and CBO predicted that we would have a bigger deficit than we actually had. In 1997 they thought that our deficit would be almost nine times greater than it really was (see Figure 18.2). In 1995 the CBO guessed that these deficits would continue until 2002, but by 1999 it had changed its mind: instead we would have big surpluses.[1] If they were wrong about more deficits, would they be right about new surpluses? In 1999 the CBO said that over the next ten years the government would take in $2.9 trillion more than it would spend. But just three years later, in 2002, the CBO said that we would have a deficit of $121 billion in 2003 and $51 billion in 2004.

★ The Politics of Economic Prosperity

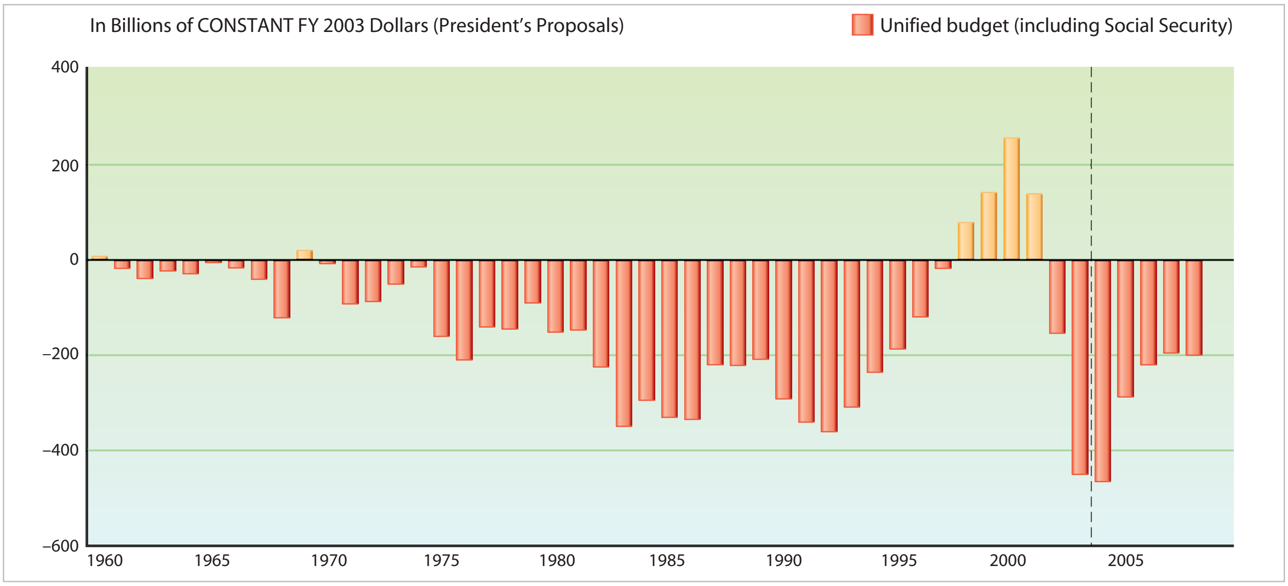
The health of the American economy creates majoritarian politics. Hardly anyone wants inflation or unemployment; everyone wants rapid increases in income and wealth. But this fact is a bit puzzling. You might think that people would care about their own jobs and worry only about avoiding their own unemployment. If that were the case, they would vote for politicians who promised to award contracts to firms that would hire them or who would create programs that would benefit them, regardless of how well other people were getting along. In fact, though, people see

deficit *What occurs when the government in one year spends more money than it takes in from taxes.*

national debt *The total deficit from the first presidency down to the present.*

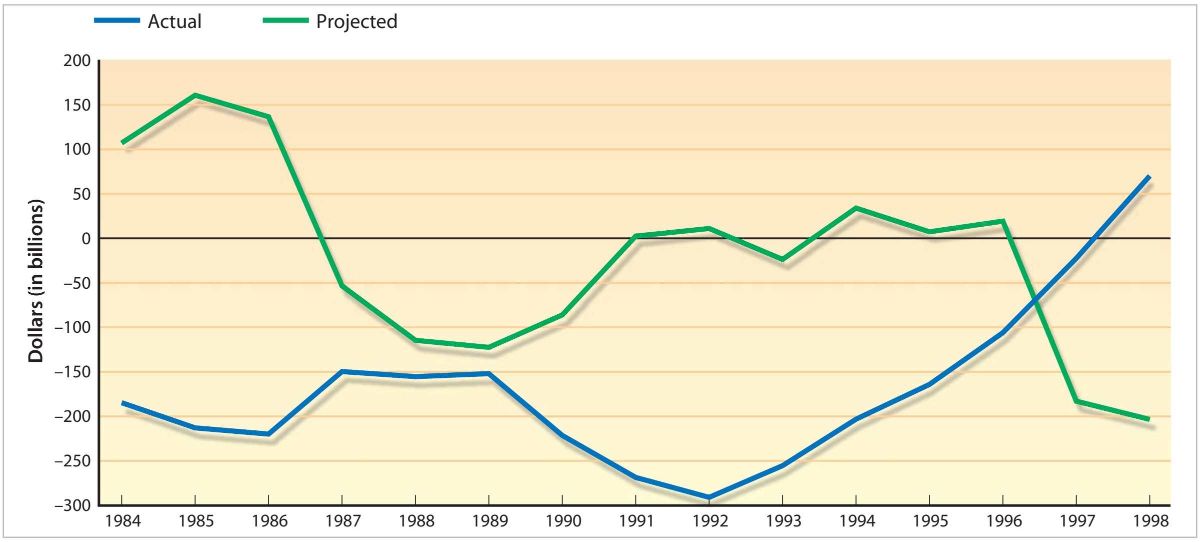
gross domestic product *The total of all goods and services produced in the economy during a given year.*

Figure 18.1 Federal Budget Deficit (or Surplus), FY 1960–2008 in Billions of CONSTANT FY 2003 Dollars (President's Proposals)



Source: Budget of the U.S. Government, FY 2004 updated by OMB's Mid-Session Review, July 2003 © 2003, AAAS. Reprinted with permission.

Figure 18.2 Bad Economic Guesses



Note: The figure compares the actual budget deficit or surplus with the president's projection made five years earlier.
Source: National Journal (January 30, 1999), 251.

connections between their own well-being and that of the nation, and they tend to hold politicians responsible for the state of the country.

Everybody knows that just before an election politicians worry about the *pocketbook issue*. We have seen in Chapter 10 that economic conditions are strongly associated with how much success the incumbent party has in holding on to the White House and to the seats held by the White House's party in Congress. But whose pocketbook are voters worried about?

In part, of course, it is their own. We know that low-income people are more likely to worry about unemployment and to vote Democratic, and higher-income people are more likely to worry about inflation and to vote Republican.[2] We also know that people who tell pollsters that their families' finances have gotten worse are more likely than other people to vote against the incumbent president.[3] In 1980 about two-thirds of those who said that they had become worse off economically voted for Ronald Reagan, the challenger, while over half of those who felt that they had become better off voted for Jimmy Carter, the incumbent.[4] In 1992 people who felt economically pinched were more likely to vote for Clinton than for Bush. Clinton campaign aides often reminded each other, "It's the economy, stupid!"

But people do not simply vote their own pocketbooks. In any recession the vast majority of people still have jobs; nevertheless, these people say that unemployment is the nation's biggest problem, and many of them vote accordingly—against the incumbent during whose watch unemployment went up.[5] Why should employed people worry about other people's unemployment?

By the same token younger voters, whose incomes tend to go up each year, often worry less about inflation than do retired people living on fixed incomes, the purchasing power of which goes down with inflation.[6] In presidential elections those people who think that national economic trends are bad are much more likely to vote against the incumbent, *even when* their own personal finances have not worsened.[7]

In technical language voting behavior and economic conditions are strongly correlated at the national level but not at the individual level, and this is true both in the United States and in Europe.[8] Such voters are behaving in an "other-regarding" or "sociotropic" way. In ordinary language voters seem to respond more to the condition of the national economy than to their own personal finances.

It is not hard to understand why this might be true. Part of the explanation is that people understand what government can and cannot be held accountable for. If you lose your job at the aircraft plant because the government has not renewed the plant's contract, you will be more likely to hold the government responsible than if you lose your job because you were always showing up drunk or because the plant moved out of town.

And part of the explanation is that people see general economic conditions as having indirect effects on them even when they are still doing pretty well. They may not be unemployed, but they may have friends who are, and they may worry that if unemployment grows worse, they will be the next to lose their jobs.

What Politicians Try to Do

Elected officials, who have to run for reelection every few years, are strongly tempted to take a short-run view of the economy and to adopt those policies that will best satisfy the self-regarding voter. They would dearly love to produce low unemployment rates and rising family incomes just before an election. Some scholars think that they do just this.

Since the nineteenth century the government has used money to affect elections. At first this mostly took the form of patronage passed out to the party faithful and money benefits given to important blocs of voters. The massive system of Civil War pensions for Union army veterans was run in a way that did no harm to the political fortunes of the Republican party. After the Social Security system was established, Congress voted to increase the benefits in virtually every year in which there was an election (see Chapter 19).

But it is by no means clear that the federal government can or will do whatever is necessary to reduce unemployment, cut inflation, lower interest rates, and increase incomes just to win an election. For one thing, the government does not know how to produce all these desirable outcomes. Moreover, doing one of these things may often be possible only at the cost of not doing another. For example, reducing inflation can, in many cases, require the government to raise interest rates, and this in turn can slow down the economy by making it harder to sell houses, automobiles, and other things that are purchased with borrowed money.

If it were easy to stimulate the economy just before an election, practically every president would serve two full terms. But because of the uncertainties and

Protesters denounce a planned tax increase by the Texas legislature.

complexities of the economy, presidents can lose elections over economic issues that they do not manage to the satisfaction of voters. Ford lost in 1976, Carter in 1980, and George H.W. Bush in 1992. In all cases economic conditions played a major role.

All this means that politicians must make choices about economic policy, choices that are affected by uncertainty and ignorance. Those choices are shaped significantly by the ideological differences between the two political parties over what ought to be the principal goal of economic policy. Democrats and Republicans alike would prefer to have both low unemployment and no inflation, but if they must choose (and choose they must), then the Democrats mainly attempt to reduce unemployment and the Republicans chiefly attempt to reduce inflation.[9]

This tendency mirrors to some degree what Democratic and Republican voters want their parties to do. Polls regularly show that those who think of themselves as Democrats are much more worried about unemployment than those who think of themselves as Republicans.[10] (There is not as much of a difference between Democratic and Republican voters in worrying about inflation.) Because of these beliefs, voters concerned about unemployment not only are more likely to vote against the incumbent but also are more likely to vote Democratic.

★ The Politics of Taxing and Spending

People want prosperity, but they also want no tax increases, no government deficit, and continued (or higher) government spending on the things they like, such as education, medical care, the environment, and retirement benefits. What politicians confront are two inconsistent kinds of majoritarian politics: everybody wants general prosperity, and large majorities want more government spending on popular programs. But the more the government spends on popular programs, the more money it requires, and the more it takes in, the less that is left over for private investment that produces prosperity.

Most voters would like to have all three things—lower taxes, less debt, and new programs. But the difficulty with this is that the policies being endorsed are inconsistent with one another. We cannot have lower taxes, no debt, and higher spending on politically popular programs such as health care, education, the environment, and retirement benefits. If we have more spending, we have to pay for it, either with higher taxes or with more borrowing.

People who want new programs have to either cut existing programs, let the government go deeper in debt, or raise taxes. But how do you raise taxes without alienating voters? The answer is that you raise taxes on *other people*.

The "other people" are always a minority of the voters. For example, if you want to put more money into medical research (something that everybody likes), you raise taxes on cigarettes (only a minority smoke them). If you want to pay for new education programs or bigger environmental programs, you raise taxes on affluent voters. In this way you can find a majority of voters who will support—or at least not oppose very strongly—tax increases on a small group of voters—cigarette smokers or high-income people.

Legislators who like high rates say that "people who can afford it should pay a lot." Legislators who want low rates say that their opponents are trying to "soak the rich" by denying tax cuts to the people who now pay the biggest share of taxes.

Because cutting taxes to any meaningful extent is politically difficult, politicians have a strong tendency to get reelected by spending public money on specific programs that are popular. Some of these programs may involve majoritarian politics (such as Social Security or highway construction); some may involve client politics (such as grants to businesses, universities, or other special interests). This means that increasing spending will tend to be more popular than cutting taxes.

★ Economic Theories and Political Needs

Since most tax issues are majoritarian issues, they involve the president. He takes a direct and visible lead in these matters. If everyone who advised him knew what effect a change in tax laws would have, it would probably be easier for him to make economic policy. But the economic health of a nation is an extraordinarily complex, poorly understood matter. Nations, such as Cuba and North Korea, that try to manage their economies centrally have done poorly.

Presidents rely on economic advisers, but the advice they get varies dramatically depending on what kind of advisers they have. There are at least four major theories about how best to manage the economy. Each theory, if fully stated, would be quite complicated; moreover, many experts combine parts of one theory with parts of another. What follows is a highly simplified account of these theories that highlights their differences.

Monetarism

A monetarist, such as the late economist Milton Friedman, believes that inflation occurs when there is too much money chasing too few goods. The federal government has the power to create money (in ways to be described on page 494); according to monetarists, inflation occurs when it prints too much money. When inflation becomes rampant and government tries to do something about it, it often cuts back sharply on the amount of money in circulation. Then a recession will occur, with slowed economic growth and an increase in unemployment. Since the government does not understand that economic problems result from its own start-and-stop habit of issuing new money, it will try to cure some of these problems with policies that make matters worse—such as having an unbalanced budget or creating new welfare programs. **Monetarism** suggests that the proper thing for government to do is to have a steady, predictable increase in the money supply at a rate about equal to the growth in the economy's productivity; beyond that it should leave matters alone and let the free market operate.

Keynesianism

John Maynard Keynes, an English economist who died in 1946, believed that the market will not automatically operate at a full-employment, low-inflation level. Its health depends on what fraction of people's incomes they save or spend. If they save too much, there will be too little demand, production will decline, and unemployment will rise. If they spend too much, demand will rise too fast, prices will go up, and shortages will develop. According to **Keynesianism,** the key is to create the right level of demand. This is the task of government. When demand is too little, the government should pump more money into the economy (by spending more than it takes in in taxes and by creating public-works programs). When demand is too great, the government should take money out of the economy (by increasing taxes or cutting federal expenditures). There is no need for the government's budget to be balanced on a year-to-year basis; what counts is the performance of the economy. Keynesians, unlike monetarists, tend to favor an activist government.

Planning

Some economists have too little faith in the workings of the free market to be pure Keynesians, much less monetarists. They believe that the government should plan, in varying ways, some part of the country's economic activity. One form of **economic planning** is price and wage controls, as advocated by John Kenneth Galbraith and others. In this view big corporations can raise prices because the forces of competition are too weak to restrain them, and labor unions can force up wages because management finds it easy to pass the increases along to consumers in the form of higher prices. Thus during inflationary times the government should regulate the maximum prices that can be charged and wages that can be paid, at least in the larger industries.

Supply-Side Tax Cuts

Exactly the opposite remedy for declining American productivity is suggested by people who call themselves supply-siders. The view of economists such as Arthur Laffer and Paul Craig Roberts is that the market, far

monetarism *The belief that inflation occurs when too much money is chasing too few goods.*

Keynesianism *The belief the government must manage the economy by spending more money when in a recession and cutting spending when there is inflation.*

economic planning *The belief that government plans, such as wage and price controls or the direction of investment, can improve the economy.*

Landmark Cases

Federal Laws About Commerce

- ***Lochner v. New York* (1905):** Struck down as unconstitutional a New York law limiting the number of hours that may be worked by bakers.
- ***Muller v. Oregon* (1980):** Upheld as constitutional an Oregon law limiting the number of hours worked by women; in effect, it overruled the Lochner decision.
- ***West Coast Hotel Co. v. Parrish* (1937):** Upheld as constitutional a Washington State minimum wage law for women.
- ***Youngstown Sheet & Tube Co. v. Sawyer* (1952):** The president does not have the authority to seize private steel mills even in wartime.

To explore these landmark cases further, visit the *American Government* web site at college.hmco.com/pic/wilsonAGlle.

from having failed, has not been given an adequate chance. According to **supply-side theory,** what is needed is not more planning but less government interference. In particular, sharply cutting taxes will increase people's incentive to work, save, and invest. Greater investments will then lead to more jobs, and if the earnings from these investments and jobs are taxed less, it will lessen the tendency of many individuals to shelter their earnings from the tax collector by taking advantage of various tax loopholes or cheating on their income tax returns. The greater productivity of the economy will produce more tax revenue for the government. Even though tax *rates* will be lower, the total national income to which these rates are applied will be higher.

supply-side theory *The belief that lower taxes and fewer regulations will stimulate the economy.*

Reaganomics *The belief that a combination of monetarism, lower federal spending, and supply-side economics will stimulate the economy.*

Ideology and Theory

Each economic theory has clear political consequences, and so it is no accident that people embrace one theory or another in part because of their political beliefs. If you are a conservative, monetarism or supply-side tax cuts will appeal to you, because both imply that the government will be smaller and less intrusive. If you are a liberal, Keynesian economics will appeal to you, because it permits (or even requires) the federal government to carry on a wide range of social welfare programs. And if you are a socialist, economic planning will appeal to you, because it is an alternative to the free market and the private management of economic resources.

Of course, there are many exceptions to these patterns. Many advocates of so-called industrial policy are not socialists; some liberals have become skeptical of Keynesian economics; and quite a few conservatives think that supply-side economics is unrealistic. But in general one's economic theory tends to be consistent with one's political convictions.

"Reaganomics"

When Ronald Reagan became president in 1981, he set in motion changes in federal economic policies that were soon called **Reaganomics.** These changes were not dictated by any single economic theory but by a combination of monetarism, supply-side tax cuts, and domestic budget cutting. The president wanted to achieve several goals simultaneously—reduce the size of the federal government, stimulate economic growth, and increase American military strength. As it turned out for him (as for most presidents), the things that he wanted were not entirely consistent.

Spending on some domestic programs was reduced. These reductions slowed the rate of growth of federal spending on these programs but did not actually decrease the spending. Military spending was sharply increased. The money supply was held under control in order to combat inflation (at the price of allowing interest rates to rise). Finally, and most important, there were sharp across-the-board cuts in personal income taxes, but for many people these cuts were more than offset by increases in Social Security taxes.

The effect of lowering taxes while increasing spending was to stimulate the economy (by pumping more money into it) and to create large deficits. The stimulated economy resulted in a drop in the unemployment rate and a rise in business activity. The large deficits increased dramatically the size of the national debt. The effects of the tax cuts on productivity and investment were probably large.

John Maynard Keynes, had he been alive, would have been startled. A conservative president (aided, of course, by Congress) created a massive budget deficit that helped reduce unemployment—just as Keynes, a liberal, might have recommended.

★ The Machinery of Economic Policy Making

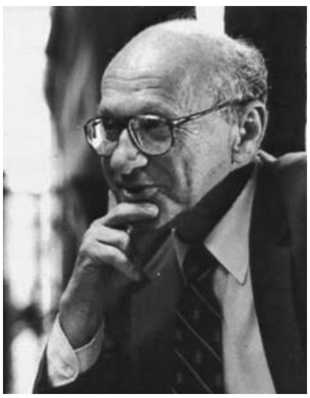
Even if the president knew exactly the right thing to do, he would still have to find some way of doing it. In our government that is no easy task. The machinery for making decisions about economic matters is complex and not under the president's full control. Within the executive branch three people other than the president are of special importance. Sometimes called the troika,* these are the chairman of the Council of Economic Advisers (CEA), the director of the Office of Management and Budget (OMB), and the secretary of the treasury.

The CEA, composed of three professional economists plus a small staff, has existed since 1946. In theory it is an impartial group of experts responsible for forecasting economic trends, analyzing economic issues, and helping prepare the economic report that the president submits to Congress each year. Though quite professional in tone, the CEA is not exactly impartial in practice, since each president picks members sympathetic to his point of view. Kennedy picked Keynesians; Reagan picked supply-siders and monetarists. But whatever its philosophical tilt, the CEA is seen by other executive agencies as the advocate of the opinion of professional economists, who despite their differences generally tend to favor reliance on the market.

The OMB was originally the Bureau of the Budget, which was created in 1921 and made part of the executive office of the president in 1939; in 1970 it was renamed the Office of Management and Budget. Its chief function is to prepare estimates of the amount that will be spent by federal agencies, to negotiate with other departments over the size of their budgets, and to make certain (insofar as it can) that the legislative proposals of these other departments are in accord with the president's program. Of late it has acquired something of a split personality; it is in part an expert, nonpartisan agency that analyzes spending and budget patterns and in part an activist, partisan organization that tries to get the president's wishes carried out by the bureaucracy.

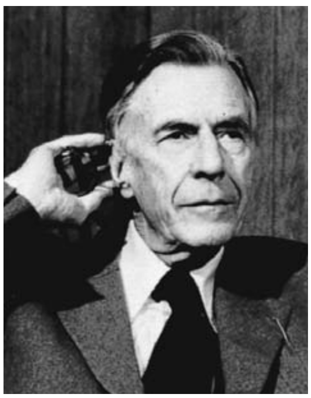
The secretary of the treasury is often close to or drawn from the world of business and finance and is expected to argue the point of view of the financial community. (Since its members do not always agree, this is not always easy.) The secretary provides estimates of the revenue that the government can expect from existing taxes and what will be the result of changing tax laws. He or she represents the United

*From the Russian word for a carriage pulled by three horses.

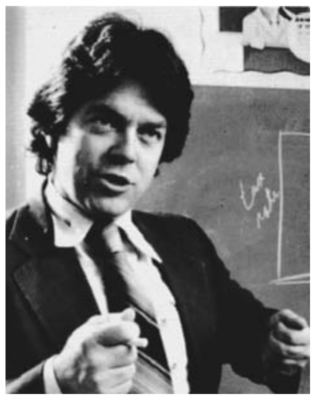


Milton Friedman

John Maynard Keynes



John Kenneth Galbraith



Arthur B. Laffer

How Things Work

The Federal Reserve Board

The Tools by Which the Fed Implements Its Monetary Policy

1. **Buying and selling federal government securities** (bonds, Treasury notes, and other pieces of paper that constitute government IOUs). When the Fed buys securities, it in effect puts more money into circulation and takes securities out of circulation. With more money around, interest rates tend to drop, and more money is borrowed and spent. When the Fed sells government securities, it in effect takes money out of circulation, causing interest rates to rise and making borrowing more difficult.
2. **Regulating the amount of money that a member bank must keep in hand as reserves** to back up the customer deposits it is holding. A bank lends out most of the money deposited with it. If the Fed says that it must keep in reserve a larger fraction of its deposits, then the amount that it can lend drops, loans become harder to obtain, and interest rates rise.
3. **Changing the interest charged banks** that want to borrow money from the Federal Reserve System. Banks borrow from the Fed to cover short-term needs. The interest that the Fed charges for this is called the *discount* rate. The Fed can raise or lower that rate; this will have an effect, though usually rather small, on how much money the banks will lend.

Federal Reserve Board (7 members)

- Determines how many government securities will be bought or sold by regional and member banks.
- Determines interest rates to be charged by regional banks and amount of money member banks must keep in reserve in regional banks.

Regional Federal Reserve Banks (12)

- Buy and sell government securities.
- Loan money to member banks.
- Keep percentage of holdings for member banks.

Member Banks (6,000)

- Buy and sell government securities.
- May borrow money from regional banks.
- Must keep percentage of holdings in regional banks.
- Interest rates paid to regional banks determine interest rates charged for business and personal loans and influence all bank interest rates.

States in its dealings with the top bankers and finance ministers of other nations.

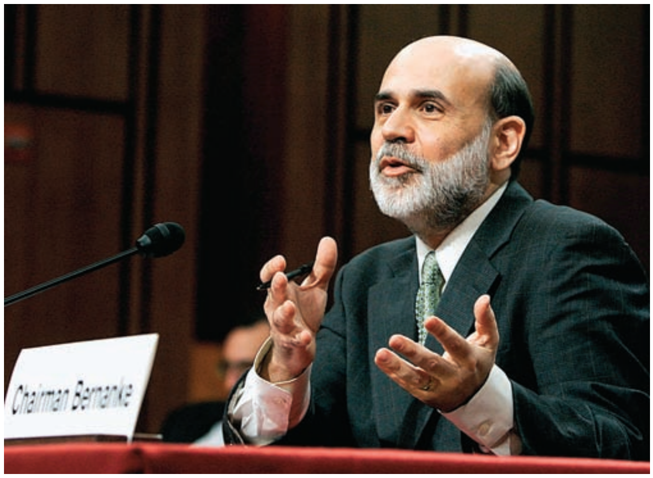
A good deal of pulling and hauling takes place among members of the troika, but if that were the extent of the problem, presidential leadership would be fairly easy. The problem is far more complex. One study found 132 separate government bureaus engaged in formulating economic policy. They regulate business, make loans, and supply subsidies. For example, as foreign trade becomes increasingly important to this country, the secretary of state (among many others) acquires an interest in economic policy. One-third of corporate profits come from overseas investments, and one-fourth of farm output is sold abroad.

monetary policy *Managing the economy by altering the supply of money and interest rates.*

The Fed

Among the most important of these other agencies is the board of governors of the Federal Reserve System (the "Fed"). Its seven members are appointed by the president, with the consent of the Senate, for fourteen-year, nonrenewable terms and may not be removed except for cause. (No member has been removed since it was created in 1913.) The chairman serves for four years. In theory, and to some degree in practice, the Fed is independent of both the president and Congress. Its most important function is to regulate, insofar as it can, the supply of money (both in circulation and in bank deposits) and the price of money (in the form of interest rates). The Fed sets **monetary policy,** that is, the effort to shape the economy by controlling the amount of money and bank deposits and the interest rates charged for money. The box on page 494 shows how the Fed does this. In 2001, it lowered interest rates eleven times in order to help reduce the recession. From 2004 to 2007, it raised these rates seventeen times in order to prevent inflation.

Just how independent the Fed is can be a matter of dispute. During the 1980 election Fed policies helped keep interest rates at a high level, a circumstance that did not benefit President Carter's reelection bid. On the other hand, whenever a president is determined to change monetary policy, he usually can do so. For example, the term of Fed chairman Arthur F. Burns, appointed by President Nixon, came up for renewal in 1978. President Carter, seeking to influence Burns's decisions, held out the prospect of reappointing him chairman. When Burns balked, he was passed over, and G. William Miller was appointed in his stead. Presidents Truman, Johnson, and Nixon were all able to obtain changes in monetary policy. When Alan Greenspan, a conservative, became Fed chairman in 1987 under President Reagan, he was so successful in curbing inflation that he was reappointed by President Clinton, a Democrat.



Ben Bernake, chairman of the Federal Reserve, speaks to a congressional committee.

Congress

The most important part of the economic policy making machinery, of course, is Congress. It must approve all taxes and almost all expenditures; there can be no wage or price controls without its consent; and it has the ability to alter the policy of the nominally independent Federal Reserve Board by threatening to pass laws that would reduce its powers. And Congress itself is fragmented, with great influence wielded by the members of key committees, especially the House and Senate Budget Committees, the House and Senate Appropriations Committees, the House Ways and Means Committee, and the Senate Finance Committee. The decisions Congress makes about how high taxes should be and how much money the government should spend create the nation's **fiscal policy.**

In sum, no matter what economic theory the president may have, if he is to put that theory into effect he needs the assistance of many agencies within the executive branch, such independent agencies as the Federal Reserve Board, and the various committees of Congress. Though members of the executive and legislative branches are united by their common desire to get reelected (and thus have a common interest in producing sound economic growth), each part of this system may also be influenced by different economic theories and will be motivated by the claims of interest groups.

The effect of these interest group claims is clearly shown in the debate over trade restriction. Usually the economic health of the nation affects everyone in pretty much the same way—we are all hurt by inflation or helped by stable prices; the incomes of all of us tend to grow (or remain stagnant) together. In these circumstances the politics of economic health is majoritarian.

Suppose, however, that most of us are doing pretty well but that the people in a few industries or occupations are suffering. That is sometimes the result of foreign competition. In many countries labor costs are much lower than they are in the United States. That means that these countries can ship to American buyers goods—such as shoes, textiles, and beef—that sell at much lower prices than American producers can afford to charge. By contrast, if the price of a product is based chiefly on having advanced technology rather than low labor costs, American manufacturers can beat almost any foreign competitor.

When Congress passes laws governing foreign trade, it is responding to interest group politics. Industries that find it easy to sell American products abroad want free trade—that is, they want no taxes or restrictions on international exchanges. Industries that find it hard to compete with foreign

fiscal policy
Managing the economy by the use of tax and spending laws.

Union members demonstrate against the North American Free Trade Agreement (NAFTA) that was passed in 1993.

imports oppose free trade—that is, they want tariffs and other limitations on imports.

When the North American Free Trade Agreement (NAFTA) was passed by Congress in 1993, the free traders won, and tariffs on our commerce with Canada and Mexico were largely abolished. But when the government later suggested creating free trade with all of Latin America, the critics of free trade opposed the idea, and it died. This is a good example of how people who bear the costs of a policy are often much more effective in influencing the votes on it than are those who stand to benefit from it.

globalization *The growing integration of the economies and societies of the world.*

Not only has the United States not extended the NAFTA idea to other countries, but it has done things that reward certain economic interest groups. Even though Republicans tend to support free trade, President George W. Bush imposed sharp increases in the taxes that must be paid on imported steel. The reason is not hard to find. Steel is produced in certain states, such as Ohio and Pennsylvania, that the president wanted to carry in 2004.

Globalization

Trying to block free trade is a part of the opposition of some people to **globalization,** the growing integration of the economies and societies of the world. You can experience globalization easily : if your computer develops a problem and you call technical support, you are likely to speak with a technician based in India.

Supporters of globalization argue that it has increased the income, literacy, and standard of living of people in almost every country involved in the worldwide process of economic growth. These supporters favor free trade because it makes products cheaper. Opponents of globalization make several different and not always consistent arguments. Some (such as labor union leaders) argue that free trade undercuts the wages of American workers as less expensive foreign workers make things that are sold here. Others argue that globalization is driven by selfish corporate interests that exploit people in poor countries when they work for American firms. Still others feel that globalization means imposing one culture on everyone in ways that hurt local cultures.

★ Spending Money

If only the economic health of the nation mattered, then majoritarian politics would dominate, and the president and Congress would both work to improve economic conditions. Although they still might work at cross-purposes because they held to different economic theories, the goal would be the same.

But the government must also respond to the demands of voters and interest groups. While these demands are no less legitimate than the voters' general interest in economic health, they produce not majoritarian but client and interest group politics.

The sources of this conflict can be seen in public opinion polls. Voters consistently say that they want a balanced budget and lower government spending. They believe that the government spends too much and that if it wanted to, it could cut spending. When the government runs a deficit, the reason in the voters' eyes is that it is spending too much, not that it is taxing too little. But these same polls show that the voters believe that the government should spend more on education, homelessness, childcare, and crime control.

The voters are not irrational, thinking that they can have more spending and less spending simultaneously. Nor are they hypocrites, pretending to want less spending overall but more spending for particular programs. They are simply expressing a variety of concerns. They want a limited government with no deficit; they also want good schools, cleaner air, better health care, and less crime. They believe that a frugal government could deliver what they want by cutting out waste. They may be wrong about that belief, but it is not obviously silly.

What this means for the government is easy to imagine. Politicians have an incentive to make two kinds of appeals: The first is, "Vote for me and I will keep government spending down and cut the deficit." The second is, "Vote for me and I will make certain that your favorite program gets more money." Some people will vote for the candidate because of the first appeal; some will vote for him or her because of the second. But acting on these two appeals is clearly going to lead to inconsistent policies. These inconsistencies become evident in the budget.

★ The Budget

A **budget** is a document that announces how much the government will collect in taxes and spend in revenues and how those expenditures will be allocated among various programs. (Each budget covers a **fiscal year,** which runs from October 1 of one year through September 30 of the next. A fiscal year is named after the year in which it *ends:* thus, "fiscal 2008" or "FY 2008" means the year ending on September 30, 2008.

In theory the federal budget should be based on *first* deciding how much money the government is going to spend and *then* allocating that money among different programs and agencies. That is the way a household makes up its budget: "We have this much in the paycheck, and so we will spend X dollars on rent, Y dollars on food, and Z dollars on clothing, and what's left over on entertainment. If the amount of the paycheck goes down, we will cut something out—probably entertainment."

In fact the federal budget is a list of everything the government is going to spend money on, with only slight regard (sometimes no regard at all) for how much money is available to be spent. Instead of being a way of *allocating* money to be spent on various purposes, it is a way of *adding up* what is being spent.

Indeed, there was no federal budget at all before 1921, and there was no unified presidential budget until the 1930s. Even after the president began submitting a single budget, the committees of Congress acted on it separately, adding to or subtracting from the amounts he proposed. (Usually they followed his lead, but they were certainly free to depart from it as they wished.) If one committee wanted to spend more on housing, no effort was made to take that amount away from the committee that was spending money on health (in fact, there was no machinery for making such an effort).

The Congressional Budget Act of 1974 changed this somewhat. Now after the president submits his budget in February, two budget committees—one in the House, one in the Senate—study his overall package and obtain an analysis of it from the Congressional Budget Office (CBO). Each committee then submits to its house a **budget resolution** that proposes a total budget ceiling and a ceiling for each of several spending areas (such as health or defense). Each May Congress is supposed to adopt, with some modifications, these budget resolutions, intending them to be targets to guide the work of each legislative committee as it decides what should be spent in its area. During the summer Congress then takes up the specific appropriations bills, informing its members as it goes along whether or not the spending proposed in these bills conforms to the May budget resolution. The object, obviously, is to impose some discipline on the various committees. After each committee approves its appropriations bill and Congress passes it, it goes to the president for his signature.

These appropriations bills, however, can rarely make big changes in government spending. About two-thirds of what the government spends is mandatory—that is, the money goes to people who are entitled to it. **Entitlements** include Social Security and Medicare payments, veterans'

budget *A document that states tax collections, spending levels, and the allocation of spending among purposes.*

fiscal year *For the federal government, October 1 through the following September 30.*

budget resolution *A congressional decision that states the maximum amount of money the government should spend.*

entitlements *A claim for government funds that cannot be changed without violating the rights of the claimant.*

Under Secretary of Defense David Chu speaks to a Senate committee about death benefits for the families of military personnel.

benefits, food stamps, and money the government owes investors who have bought Treasury bonds (that is, the interest on the national debt). In theory the government could change these entitlements by, for example, cutting Social Security payments, but that would be a political disaster. In reality the government can change only about one-third of federal spending in any year.

There is a big loophole in the current budget process: nothing in the process requires Congress to tighten the government's financial belt. It can pass a budget resolution authorizing spending that is more or less than what the president has proposed. Nonetheless, the process has made a difference. Congress is now conscious of how its spending decisions match up with estimates of tax revenues.

When President Reagan took office, he and his allies in Congress took advantage of the Congressional Budget Act to start the controversial process of cutting federal spending. The House and Senate budget committees, with the president's support, used the first budget resolution in May 1981 not simply to set a budget ceiling that, as in the past, looked pretty much like the previous year's budget but to direct each committee of Congress to make *cuts*—sometimes deep cuts—in the programs for which it was responsible. These cuts were to be made in the authorization legislation (see Chapter 15) as well as in the appropriations.

The object was to get members of Congress to vote for a total package of cuts before they could vote on any particular cut. Republican control of the Senate and an alliance between Republicans and conservative southern Democrats in the House allowed this strategy to succeed. The first budget resolution ordered Senate and House committees to reduce federal spending during fiscal 1982 by about $36 billion—less than the president had first asked, but a large sum nonetheless. Then the individual committees set to work trying to find ways of making these cuts.

Note how the *procedures* used by Congress can affect the *policies* adopted by Congress. If the Reagan plan had been submitted in the old piecemeal way, it is unlikely that cuts of this size would have occurred in so short a time, or at all. The reason is not that Congress would have wanted to ignore the president but that, then as now, Congress reflects public opinion on economic policy. As stated at the beginning of the chapter, the public wants less total federal spending but more money spent on specific federal programs. Thus, if you allow the public or Congress to vote first on specific programs, spending is bound to rise. But if you require Congress to vote first on a budget ceiling, then (unless it changes its mind as it goes along) total spending will go down, and tough choices will have to be made about the component parts of the budget.

That, at least, is the theory. It worked once, in 1981, but it did not work very well thereafter. During the rest of the Reagan years the budget process broke down in the warfare between the president and Congress. President Reagan represented the part of public opinion that wanted less government spending in general; most members of Congress represented the part of public opinion that wanted more spending on particular programs. The result was a stalemate. It continued with Presidents Clinton and both the elder and younger Bush.

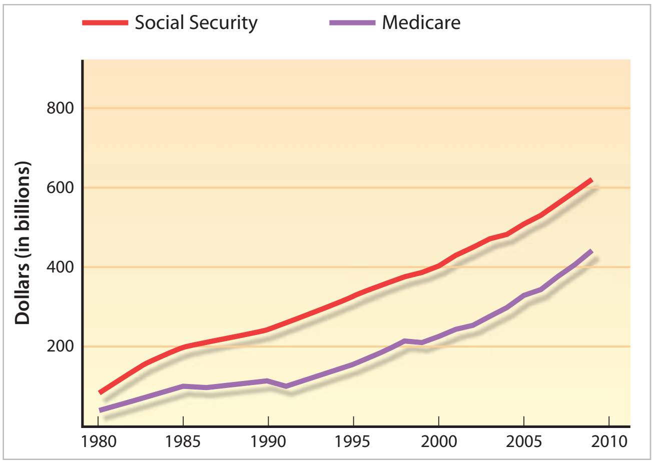
★ Reducing Spending

Because the 1974 Congressional Budget Act did not automatically lead to spending cuts, people concerned about the growing federal deficit decided to find ways to put a cap on spending. The first such cap was the Balanced Budget Act of 1985, now called the Gramm-Rudman Act after two of its sponsors, Senators Phil Gramm (R-Tex.) and Warren Rudman (R-N.H.). The law required that each year from 1986 to 1991 the budget would automatically be cut until the federal deficit had disappeared. What made the cuts automatic, its authors hoped, was a provision in the bill, called a **sequester,** that required across-the-board percentage cuts in all federal programs (except for entitlements) if the president and Congress failed to agree on a total spending level that met the law's targets. No one liked this plan, but it seemed necessary. Senator Rudman called it a "bad idea whose time has come."

But the plan failed. By various devices that people began to call "smoke and mirrors," Congress and the president found ways to get new spending that was higher than the targeted amounts. By 1990 it was evident that a new strategy was needed if the government was going to help eliminate the deficit.

That strategy had two parts. First, Congress voted for a tax increase. Second, it passed the Budget Enforcement Act of 1990 that set limits on **discretionary spending.** This phrase refers to those government expenditures that are not required by existing contracts, payments on the national debt, or entitlement programs such as Social Security. (Only about one-third of the budget involves discretionary spending.) According to the 1990 act, if Congress were to spend more on a discretionary program, it would have to cut spending on another discretionary program or raise taxes. The law expired in 2001, but in 2007 some members of Congress hoped to revive it. As Figure 18.3 makes clear, something has to be done to manage huge future increases in spending on Social Security and Medicare.

Figure 18.3 When Will the Crunch Come? Projections of the Growth in Federal Spending



Source: Congressional Budget Office, *The Economic and Budget Outlook: An Update* (July 1, 1999).

★ Levying Taxes

Tax policy reflects a mixture of majoritarian politics ("What is a 'fair' tax law?") and client politics ("How much is in it for me?"). In the United States a fair tax law has generally been viewed as one that keeps the overall tax burden rather low, requires everyone to pay something, and requires the better-off to pay at a higher rate than the less-well-off. The law, in short, was viewed as good if it imposed modest burdens, prevented cheating, and was mildly progressive.

Americans have had their first goal satisfied. The tax burden in the United States is lower than it is in most other democratic nations (see Figure 18.4). There is some evidence that they have also had their second goal met—there is reason to believe that Americans evade their income taxes less than do citizens of, say, France or Italy. (That is one reason why many nations rely more on sales taxes than we do—they are harder to evade.) Just how progressive our tax rates are is a matter of dispute; to determine whether the rich really pay at higher rates than the poor, one has to know not only the official rates but also the effect of deductions, exemptions, and exclusions (that is, of loopholes).

Keeping the burden low and the cheating at a minimum are examples of majoritarian politics: most people benefit, most people pay. The loopholes, however, are another matter—all manner of special interests can get some special benefit from the tax law that the rest of us must pay for but, given the complexity of the law, rarely notice. Loopholes are client politics par excellence.

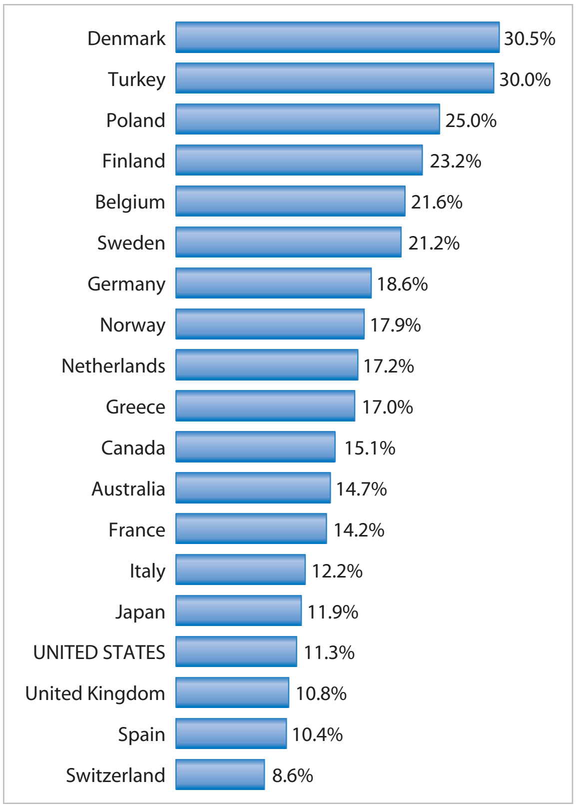
Because of that, hardly any scholars believed that tax reform (dramatically reducing the loopholes) was politically possible. Every interest that benefited from a loophole—and these included not just corporations but universities, museums, states, cities, and investors—would lobby vigorously to protect it.

Nevertheless, in 1986 a sweeping tax reform act was passed. Many of the most cherished loopholes were closed or reduced. What happened? It is as if scientists who had

sequester *Automatic spending cuts.*

discretionary spending *Spending that is not required to pay for contracts, interest on the national debt, or entitlement programs such as Social Security.*

Figure 18.4 Tax Burdens in Democratic Nations (Taxes as a Percentage of Income of a Family with Two Children)



Source: Statistical Abstract of the United States, 2003, Table 1344.

proved that a bumblebee could not fly got stung by a flying bumblebee.

The Rise of the Income Tax

To understand what happened in 1986, one must first understand the political history of taxation in the United States. Until almost the end of the nineteenth century, there was no federal income tax (except for a brief period during the Civil War). The money that the government needed came mostly from tariffs (that is, taxes on goods imported into this country). And when Congress did enact a peacetime income tax, the Supreme Court in 1895 struck it down as unconstitutional.[11] To change this, Congress proposed, and in 1913 the states ratified, the Sixteenth Amendment, which authorized such a tax.

For the next forty years or so tax rates tended to go up during wartime and down during peacetime (see Figure 18.5). The rates were progressive—that is, the wealthiest individuals paid at a higher rate than the less affluent. For example, during World War II incomes in the highest bracket were taxed at a rate of 94 percent. (The key tax rate is called by economists the "marginal rate." This is the percentage of the last dollar that you earn that must be paid out in taxes.)

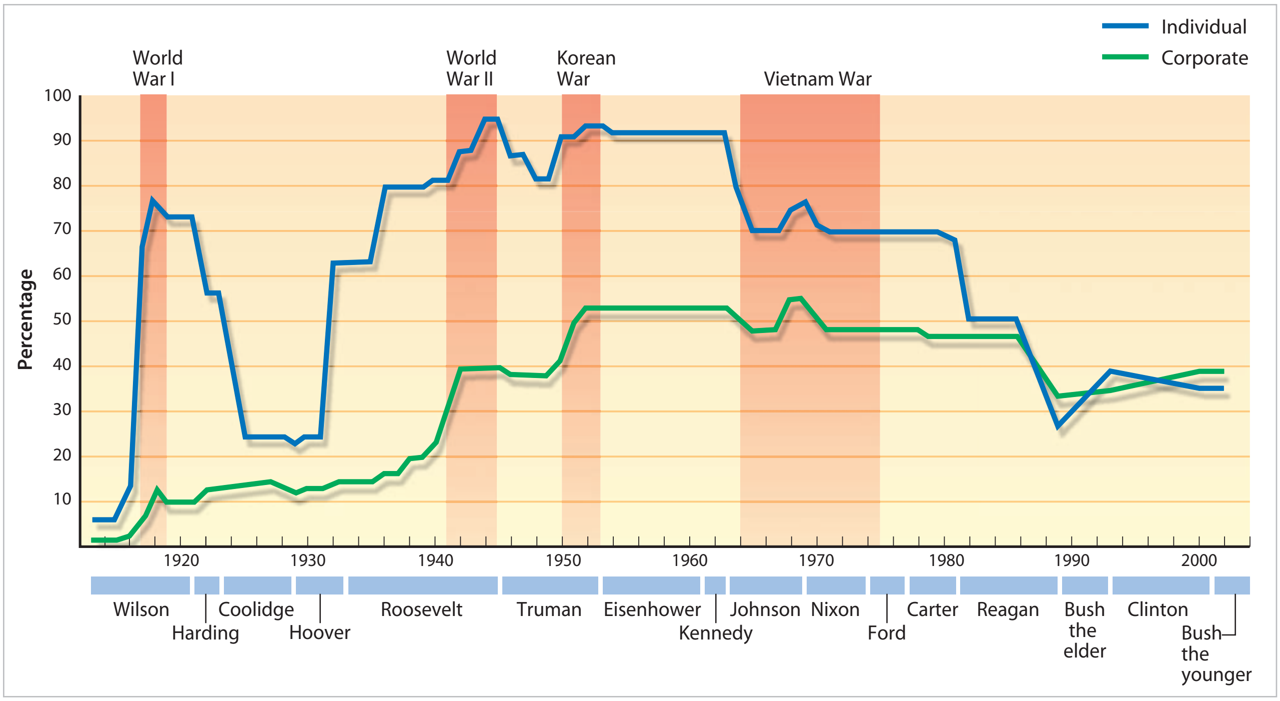
An income tax offers the opportunity for majoritarian politics to become class politics. The majority of the citizenry earn average incomes and control most of the votes. In theory there is nothing to prevent the mass of people from voting for legislators who will tax only the rich, who, as a minority, will always be outvoted. During the early decades of this century, that is exactly what the rich feared would happen. Since the highest marginal tax rate was 94 percent, you might think that that is in fact what did happen.

You would be wrong. Offsetting the high rates were the deductions, exemptions, and exclusions by which people could shelter some of their income from taxation. These loopholes were available for everyone, but they particularly helped the well-off. In effect a political compromise was reached during the first half of the twentieth century. The terms were these: the well-off, generally represented by the Republican party, would drop their bitter opposition to high marginal rates provided that the less-well-off, generally represented by the Democratic party, would support a large number of loopholes. The Democrats (or more accurately, the liberals) were willing to accept this compromise because they feared that if they insisted on high rates with no loopholes, the economy would suffer as people and businesses lost their incentive to save and invest.

For at least thirty years after the adoption of the income tax in 1913, only a small number of high-income people paid any significant amount in federal income taxes. The average citizen paid very little in such taxes until World War II. After the war, taxes did not fall to their prewar levels.

Most people did not complain too much, because they, too, benefited greatly from the loopholes. They could deduct from their taxable income the interest they paid on their home mortgages, the state and local taxes they paid, much of what they paid in medical insurance premiums, and the interest they paid on consumer loans (such as those used to buy automobiles). On the eve of the Tax Reform Act of 1986, an

Figure 18.5 Federal Taxes on Income, Top Percentage Rates, 1913–2002



Source: Updated from *Congressional Quarterly Weekly Report* (September 18, 1993), 2488.

opinion poll showed that more people favored small cuts in tax rates coupled with many large deductions than favored big cuts in tax rates coupled with fewer and smaller deductions.[12]

Interest groups organized around each loophole. Home builders organized to support the mortgage-interest deduction; universities supported the charitable-contribution deduction; insurance companies supported the deduction for medical insurance premiums; and automakers supported the deduction for interest on consumer loans.

In addition to these well-known loopholes there were countless others, not so well known and involving much less money, that were defended and enlarged through the efforts of other interest groups: for instance, oil companies supported the deduction for drilling costs, heavy industry supported the investment tax credit, and real estate developers supported special tax write-offs for apartment and office buildings.

Until 1986 the typical tax fight was less about rates than about deductions. Rates were important, but not as important as tax loopholes. "Loophole politics" was client politics. When client groups pressed for benefits, they could take advantage of the decentralized structure of Congress to find well-placed advocates who could advance these interests through low-visibility bargaining. In effect these groups were getting a subsidy from the federal government equal to the amount of the tax break. However, the tax break was even better than a subsidy, because it did not have to be voted on every year as part of an appropriations bill: once part of the tax code, it lasted for a long time, and given the length and complexity of that code, scarcely anyone would notice it was there.

Many of these loopholes could be justified by arguments about economic growth. Low tax rates on a certain kind of investment encouraged more investment of that kind. Deductions for mortgage interest and property taxes encouraged people to own their own homes and boosted the construction industry.

Then the Tax Reform Act of 1986 turned the decades-old compromise on its head: instead of high

WHAT WOULD YOU DO?

Should We Have a Flat Tax?

January 31 BOSTON, MA

White House candidate David Wilson declared yesterday that he would seek a fundamental overhaul of the nation's tax system by creating a single rate for all taxpayers. The President is expected to respond to this in his State of the Union . . .

MEMORANDUM

To: *Elizabeth Gilbert, chairperson, Council of Economics*

From: *Edward Larson, White House speechwriter*

Subject: *Flat tax proposal*

The President would like your advice on whether to endorse a flat tax. His likely opponent is pushing this issue.

Arguments for:

1. A flat tax is fair because it treats all income groups the same. We could leave the lowest income group with no taxes.
2. With a flat tax, we could eliminate almost all deductions and loopholes from the tax code.
3. Countries with a flat tax, such as Lithuania, have achieved great economic prosperity.

Arguments against:

1. A flat tax is unfair because it treats all income groups the same. The rich should be taxed more heavily.
2. Many tax deductions, such as the one for home mortgages, are desirable.
3. We could eliminate undesirable tax loopholes without creating a flat tax.

Your decision:

Support ________ Oppose ________

rates with big deductions, we got low rates with much smaller deductions. The big gainers were individuals; the big losers were businesses.

But soon the old system began to reassert itself. Not long after the 1986 bill became law, tax rates started to go up again, this time with far fewer of the deductions that had once made it easy for affluent citizens to keep their rates low. In 1990 President Bush, after having campaigned on the slogan "Read my lips, no new taxes," signed a tax increase. The top rate was 31 percent. In 1993 President Clinton proposed another tax increase, one that would raise the top rate to over 39 percent (it had been 28 percent in 1986) and make most Social Security benefits taxable for upper-income retirees. His bill narrowly passed by a vote of 218 to 216 in the House, a vote of 51 to 50 in the Senate, with Vice President Al Gore casting the deciding vote. Not a single Republican voted for it. It was the first time since 1945 that the majority party in Congress had passed a major bill without one vote from the minority party.

When President George W. Bush got his tax cut plan through Congress in 2002, many Democrats as well as most Republicans voted for it. The next issue is clear: should the tax cuts, now expiring at the end of 2010, be made permanent? There is no point in guessing what will happen; events more than personalities will determine the outcome.

★ SUMMARY ★

There are three economic factors that make a difference to voters; the policies for each are formulated by a distinctive type of policy-making. The first is the economic health of the nation, the second the amount and kinds of government spending, and the third the level and distribution of taxes.

National economic health has powerful effects on the outcome of elections, as much through people's perception of national conditions as from their worries about their own finances. The politics of inflation, unemployment, and economic growth tend to be majoritarian. The president is held responsible for national conditions. But he must meet that responsibility by using imperfect economic theories to manage clumsy government tools controlled by divided political authorities.

When economic ill health occurs in some industries and places but not others (as a result of such forces as foreign competition), the politics of economic health are shaped by interest group politics. Firms that import foreign products or sell to foreign nations try to avoid trade restrictions, while firms and unions hurt by foreign competition try to impose such restrictions.

The amount of spending is theoretically determined by the budget, but in fact the nation has no meaningful budget. Instead the president and Congress struggle over particular spending bills whose amounts reflect interest group and client pressures. In the 1980s those pressures, coupled with a large tax cut, led to a sharp increase in the size of the federal debt.

The general shape of federal tax legislation is determined by majoritarian politics, but the specific provisions (especially the deductions, exemptions, and exclusions) are the result of client group politics. The Tax Reform Act of 1986 was a remarkable example of the reassertion of majoritarian politics over client group pressures made possible by policy entrepreneurs and political incentives.

RECONSIDERING WHO GOVERNS?

1. ***Who in the federal government can make our economy strong?***

   Nobody. The president, the Congress, the Federal Reserve Board, and countless small agencies play a role. And opinions as to what is the correct course of action (cut or increase taxes, decrease or increase regulations, spend more or less money) are deeply divided. The party that controls the White House usually must take the blame if the economy is in bad shape, but it is limited in what it can do to make it better.

RECONSIDERING TO WHAT ENDS?

1. ***Why does the federal government ever have a budget deficit?***

   It is not because politicians like deficits, it is because events may cause them while leaders disagree over how to fix them. Since the 1930s we have had deficits whenever the economy went into a depression or we had to take part in a war. In fact, a lot of things the government buys, such as new buildings and military supplies, ought to be considered as investments to be paid for over time, just as when private citizens buy cars and houses. And when the deficit goes up, some politicians will want to cut it by raising taxes while others will prefer cutting spending.

WORLD WIDE WEB RESOURCES

Internal Revenue Service: **www.irs.gov**

Tax Foundation: **www.taxfoundation.org**

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