CHAPTER 18

# Economic Policy

## REVIEWING THE CHAPTER

## CHAPTER FOCUS

The purpose of this chapter is to introduce you to an area of public policy that affects everyone in one way or another: economic policy. The chapter covers both the divided attitudes that voters have toward a "good" economy and the competing theories that economists offer on how to obtain a good economy. The various agencies that participate in formulating government economic policy are reviewed, along with the many stages of producing and implementing the annual federal budget. Finally, the controversial areas of government spending and tax reform are discussed. After reading and reviewing the material in this chapter, you should be able to do each of the following:

1. Show how voters have contradictory attitudes regarding their own and others' economic benefits.
2. List and briefly explain the four competing economic theories discussed in the chapter.
3. Assess the nature and effect of Reaganomics.
4. List the four major federal government agencies involved in setting economic policy, and explain the role of each.
5. Analyze federal fiscal policy in terms of the text's four categories of politics.
6. Trace the history of federal government budgeting practices up to the present day.
7. Comment on the prospects and the desirability of lowering federal spending and reforming the income tax.

## STUDY OUTLINE

I. Introduction
    A. Deficit spending, a feature of the government since 1960
    B. National debt is the total of all deficits
    C. Explanations
        1. Economic reason
            a) Debt is a concern only if payments cannot be met
            b) Or the currency is no longer regarded as stable and valuable
            c) Interest on the debt is affordable—8 percent of all federal expenditures
            d) Future economic demands on the government may create a problem
        2. Substantive reason
            a) We don't know what the federal debt is used for
            b) Borrowing continues regardless of what government gets
        3. Political reason
            a) Politicians oppose debt because the public does

b) But they offer opposing remedies
(1) Conservatives want to cut spending
(2) Liberals want to raise taxes
(3) The tension between the positions often leads to no action

D. How reliable are projections about the future?
1. Not very
a) Unforeseen disasters can have an impact
b) Decisions can have a short-term and long-term impact (cutting taxes)
2. Federal agencies and estimates
a) Office of Management and Budget (OMB)
b) Congressional Budget Office (CBO)
3. Scorecard
a) Predicted deficit would be much higher than it actually was from 1993 to 1997
b) Predictions concerning budget surpluses

II. The politics of American economic prosperity
A. Health of American economy creates majoritarian politics
1. Voters influenced by their immediate economic situation
2. Voters worry about the nation as a whole as well as their own situations
3. Voting behavior and economic conditions correlated at the national level but not at the individual level
a) People understand what government can and cannot be held accountable for
b) People see economic conditions as affecting them indirectly, even when they are doing well
B. What politicians try to do
1. Elected officials tempted to take short-term view of the economy
2. Government uses money to influence elections, but government will not always do whatever is necessary
a) Government does not know how to produce desirable outcomes
b) Attempting to cure one economic problem often exacerbates another
3. Ideology plays a large role in determining policy
a) Democrats tend to want to reduce unemployment
b) Republicans tend to want to reduce inflation

III. The politics of taxing and spending
A. Inconsistency in what people want out of majoritarian politics
1. No tax increases
2. No government deficit
3. Continued (or higher) government spending
B. Difficult to make meaningful tax cuts
1. Politicians get reelected by spending money
2. Strategy: raise taxes on “other people”

IV. Economic theories and political needs
A. Monetarism—inflation occurs when there is too much money chasing too few goods (Milton Friedman); advocates increase in money supply about equal to economic growth
B. Keynesianism—government should create right level of demand
1. Assumes that health of economy depends on what fraction of their incomes people save or spend
2. When demand is too low, government should spend more than it collects in taxes by creating public works programs
3. When demand is too high, government should increase taxes

C. Planning—free market too undependable to ensure economic efficiency; therefore government should control it (John Kenneth Galbraith)
    1. Wage-price controls
    2. Industrial policy—government directs investments toward particular industries
D. Supply-side tax cuts—need for less government interference and lower taxes (Arthur Laffer)
    1. Lower taxes would create incentives for investment
    2. Greater productivity would produce more tax revenue
E. Ideology and theory: people embrace an economic theory partly because of their political beliefs
F. Reaganomics
    1. Combination of monetarism, supply-side tax cuts, and domestic budget cutting
    2. Goals not consistent
        a) Reduction in size of federal government
        b) Increase in military strength
    3. Effects
        a) Rate of growth of spending slowed (but not spending itself)
        b) Military spending increased
        c) Money supply controlled
        d) Federal taxes decreased
        e) Large deficits incurred and dramatically increase the size of the national debt
        f) Unemployment decreased

V. The machinery of economic policy making
A. Fragmented policymaking; not under president's full control
    1. Council of Economic Advisers
        a) Members chosen are sympathetic to president's view of economics and are experts
        b) Forecasts economic trends
        c) Prepares annual economic report for president
    2. Office of Management and Budget
        a) Prepares estimates of federal government agencies; negotiates department budgets
        b) Ensures that agencies' legislative proposals are compatible with president's program
    3. Secretary of the Treasury
        a) Reflects point of view of financial community
        b) Provides estimates of government's revenues
        c) Recommends tax changes; represents the nation before bankers and other nations
    4. The Fed (Federal Reserve Board)
        a) Membership, length of term and removal
        b) Independent of both president and Congress
        c) Sets monetary policy by controlling the amount of money and bank deposits and the interest rates charged for money
    5. Congress creates the nation's fiscal policy
        a) Approves taxes and expenditures
        b) Consents to wage and price controls
        c) Can alter Fed policy by threatening to reduce its powers
B. Effects of interest group claims
    1. Usually majoritarian: economic health good for all
    2. Sometimes interest group: free trade (e.g., NAFTA)
C. Globalization
    1. Growing integration of the economies and societies of the world

2. Supporters
    a) Argue it has increased income, literacy and the standard of living around the world
    b) Favor free trade (makes produces cheaper)
3. Opponents
    a) Oppose free trade because it undercuts wages of American workers
    b) See it as being driven by selfish, corporate interests
    c) Note exploitation of people in poor countries
    d) Concerned about cultural imperialism

VI. Spending money
- A. Conflict between majoritarian and client or interest group politics
- B. Sources of conflict reflected in inconsistencies in public opinion
- C. Politicians have incentive to make two kinds of appeals
    1. Keep spending down and cut deficit
    2. Support favorite programs of voters

VII. The budget
- A. Overview
    1. Document that announces
        a) How much the government will collect in taxes
        b) How much the government will spend in revenues
        c) How expenditures will be allocated among various programs
        d) Over the course of the fiscal year (October 1 to September 30)
    2. Spending decisions made with little regard to how much money is available
- B. Earlier practices
    1. Merely adding expenditures before 1921
    2. No unified presidential budget until 1930s
    3. Separate committee reactions after that
- C. Congressional Budget Act of 1974: procedures
    1. President submits budget
    2. House and Senate budget committees analyze budget
    3. Budget resolution in May proposes budget ceilings
    4. Members informed whether or not spending proposals conform to budget resolutions
    5. Committees approve appropriations bills, Congress passes them, and sends them to the president for signature
    6. Hard to make big changes in government spending because of entitlements
    7. Big loophole: Congress not required to tighten government's financial belt
    8. Failures of the process after 1981

VIII. Reducing Spending
- A. Gramm-Rudman Balanced Budget Act (1985) called for
    1. A target cap on the deficit each year, leading to a balanced budget
    2. A spending plan within those targets
    3. If lack of agreement on a spending plan exists, automatic across-the-board percentage budget cuts (a sequester)
- B. "Smoke and mirrors" and failure of the Act
    1. Plan was unpopular, but "necessary"
    2. Congress and president found ways to increase spending about "target" anyway
- C. New strategies
    1. Congress votes for a tax increase
    2. Passage of Budget Enforcement Act of 1990
        a) Set limits on discretionary spending (i.e., nonentitlements)