**10. Economic Policy and the Budget**

Introduction: Although the federal government has run deficits for most years since 1969, Americans have never liked the idea of government spending more money than it receives. Deficits occur when the government spends more than it takes in during a given year. The national debt is the accumulation of deficits over the years. The public is split over two main philosophies of economic management: manipulating supply or controlling demand. Policy-makers face two big issues: the tax burden, which includes deficits and debt; and economic growth.

Economic Health

The deficits of the past 35 years have raised ongoing policy debates, yet the **surpluses of 1999 and 2000** created controversy as well. Republicans wanted to return the 1999 surplus to the public, while Democrats wanted to use it for new programs.

Both sides got some of what they wanted in 2001. Republicans enacted one of the three large tax cuts in World War II, and spending on some federal programs increased.

In the best of times, **economic forecasts are uncertain**. When the unexpected occurs, they are more uncertain. The September 11 attacks and subsequent military actions had significant economic implications. These were followed by a recession, in which tax revenues were sharply reduced and social and military programs required more spending.

Our aging population is also a problem because it is creating **huge new demands for retirement and medical benefits**. The recession that began in 2007 was also largely unpredictable.

Some causes of the recession were the inexpensive cost of borrowing money from the Federal Reserve Bank, the inability of people and businesses to pay back borrowed money, **the failure of multiple banks and investment companies**, a huge squeeze on available credit, and ensuring collapse of the stock market.

The government’s response produced unprecedented spending. In April of 2011, Standard and Poor’s downgraded the country’s credit rating, **largely as a result of the national debt**. In August of 2011, a bi-partisan “super committee” was created to identify an additional $1.5 billion debt reduction.

Voters see connections between their own economic circumstances, the president, and the nation as a whole. **The Tea Party (which stands for Taxed Enough Already)** movement is one example of the voters’ response to economic conditions.

Politicians, especially presidential candidates, worry about the so-called pocketbook issue just before an election. Congressional candidates, especially challengers, can easily evade responsibility for economic conditions, but **presidents are the ones who get the blame or the credit for the economy.**

Voters tend to reelect incumbents if their economic fortunes are and good and vote them out of office if their economic fortunes have worsened. Yet voting behavior and economic conditions **are not always correlated at national and individual levels**. People do not *always* vote their pocketbooks because they understand the government cannot be held accountable for everything.

The reactions of politicians to the pocketbook issue vary. While candidates might take strong stances favoring benefits, such as veterans’ pensions and Social Security, in order to gain more votes, incumbents **do not always know how to produce desirable economic outcomes.**

Ideology can play a large role in shaping policy choices, with Democrats favoring a reduction in unemployment and Republicans favoring a reduction in inflation (when increasing prices make the dollar worth less). **Republicans favor supply-side economics while Democrats favor Keynesianism.**

The Politics of Taxing and Spending

AP TIP – Keynesianism, supply-side economics, and monetarism are ways of managing the economy and may appear on the AP exam.

When struggling over the politics of taxing and spending, politicians offer conflicting recommendations. These include **lowering or raising taxes, reducing or increasing the federal debt**, and introducing new programs or eliminating old ones that are often costly.

Some of the most prominent economic theories can be summarized as follows:

**Monetarism:** Monetarists believe that the best way to control the economy is by **managing the money supply and interest rates**. Advocated by the famous economist Milton Friedman, monetarism claims that inflation occurs when there is too much money in the economy chasing after too few goods.

Monetarism advocates **increasing the money supply** at a rate about equal to economic growth, then letting the free market operate. When a recession hits, interest rates should be lowered so that it is easier to borrow money.

**Keynesianism:** Derived from the work of the English economist John Maynard Keynes, Keynesianism holds that government should create the right level of demand (influencing demand through government spending is called **fiscal policy**). The theory assumes that the health of the economy depends on **how much of their incomes people save or spend.**

When demand is too low, government should pump money into the economy **by spending more than it collects in taxes**. When demand is too high, government should take money out the economy by increasing taxes or cutting expenditures.

Keynesianism focuses on fiscal policy, which means **managing the federal budget to control economic growth**. Keynesian economists are willing to tolerate some inflation in order to lower the rate of unemployment.

**Economic planning:** Some view the free market as too undependable to ensure healthy economic activity. They argue that **government should plan parts of a country’s economic activity** when markets fail to account for the public good.

For instance, the prominent economist John Kenneth Galbraith advocated **wage and price controls when markets are unable to constrain inflation**. Others have argued that government should direct some investments to needed industries that are unable to attract private investment. This is not a popular view in the United States, but it is often found in European, Asian, and African economies.

**Supply-side tax cuts:** Advocates of supply-side tax cuts **stress lower taxes and less governmental inference** in the market. Lower taxes create incentives for investment, and the greater economic productivity that results will produce more tax revenue. Supply-side economists are willing to tolerate a higher level of unemployment in order to reduce inflation.

The Machinery of Economic Policy-Making

Economic policy-making is complicated, and it is conducted by several actors:

**Congress:** As the most important player in the economic policy-making, **Congress approves all taxes and almost all expenditures**. Revenue bills **must begin in the House** **of Representatives**. Congress consents to wage and price controls when appropriate. It is also internally fragmented with numerous committees setting economic policy.

**Council of Economic Advisers (CEA):** Part of the Executive Office, the CEA includes professional economists sympathetic to the president’s view of economics. It **forecasts economic trends and analyzes issues**. It also prepares the annual economic report that the president sends to Congress.

**Office of Management and Budget (OMB):** Also part of the Executive Office, the OMB prepares estimates of amounts to be spent by federal government agencies, as well as negotiates department budgets. It also ensures that the department’s legislative proposals are compatible with the president’s program by creating the budget and president submits to Congress.

**Secretary of the Treasury:** As a member of the president’s cabinet, the secretary, is often close to or drawn from the world of business and finance, is expected to argue the point of view of the financial community. The secretary **provides estimates of the government’s revenues** and represents the nation with bankers and other nations.

**The Federal Reserve Board (The Fed):** Members of the Fed are appointed by the president, confirmed by the Senate, and serve nonrenewable fourteen-year terms. Members are removable for cause. The chairman of the Fed serves for four years. **The Fed is independent of both the president and Congress**. Its most important function is to regulate, insofar as it can, the supply or money (both in circulation and through reserve rates) and the price of money (in the form of **interest rates**).

Voters and interest groups may **lobby for policies that might help only a specific sector**. For instance, some interest groups support free trade because free trade makes it easier to sell their goods abroad. Other groups seek subsidies and nontariff trade restrictions because they find it hard to compete with foreign imports.

The Basis of the Federal Government’s Budgetary Power

* In **Article I, Section 8, Clause 1**, the Congress is given the power to “lay and collect taxes to pay the debts, and provide for the common defense and general welfare of the United States.”
* Article I also gives the House of Representatives the power to initiate the process of **passing all appropriations** (the act of setting apart something for its application to a particular usage, to the exclusion of all other uses)
* Article I establishes the power of Congress to impose excise taxes in the form of tariffs
* However, Article I Section 9 prohibits export taxes
* Article I directs Congress to impose taxes that are equally apportioned
* Thus, as a result of the ratification of the **Sixteenth Amendment**, the income tax is the only direct tax levied
* Any indirect taxes, such as gasoline, tobacco, and liquor, must be uniform
* The Supreme Court’s decision in McCulloch v. Maryland (1819) established the principle that **states could not tax the federal government**
* Congress is also given the power to “borrow money on the credit of the United States” in Article I.
* Congress can appropriate only money that is budgeted.

The Budget

**Even though Congress is given the constitutional power of the purse, the players involved in the process include:**

* **The president**
* **Executive staff and agencies**
* **Special interest groups**
* **The media, and**
* **The public**

A budget is **a policy document that announces how much the government expects to collect in taxes, spend in revenues, and how those expenditures will be allocated among various programs**.

There was no federal budget before 1921 and no overall presidential budget until the 1930s. Even after presidents began submitting budgets to Congress, congressional committees continued to act on the budget independently.

The **Congressional Budget Act of 1974** established procedures to standardize the budgeting process:

* **The president submits the budget**.
* The house and Senate budget committees study the budget after receiving an analysis from the Congressional Budget Office (CBO).
* Each committee proposes **a budget resolution** that sets a total budget ceiling, as well as ceilings for each of several spending areas.
* Congress is expected to adopt these resolutions in order to guide its budget debates.
* Congress considers **appropriations bills** (bills that actually fund programs within established limits) and sees whether they are congruent with the budget resolution.

Big changes in the budget are not possible because **approximately two-thirds government spending is tied up in entitlements** (federal programs like Medicare and Social Security that provide benefits to people who meet stipulated criteria).

Several efforts have been made to reduce federal spending. The passage of the **Gramm-Rudman Balanced Budget Act (1985**) was the first to place a cap on spending. It called for automatic cuts from 1986 to 1991 until the federal deficit disappeared.

If the president and Congress disagreed on the total spending level, automatic across-the-board cuts would be made. Nevertheless, the president and Congress **still found ways to increase spending.**

A second attempt was made with the **Budget Enforcement Act of 1990**. Congress voted a tax increase, and the Budget Enforcement Act capped discretionary funding. If entitlement spending increased, either discretionary spending had to be cut or taxes had to be raised. The law expired in 2001.

Current tax policy reflects a blend of majoritarian and interest group politics. The tax burden is kept reasonably low (**Americans pay less than citizens of most other democratic nations do**). Most Americans are required to at least pay something. A progressive tax structure in the United States requires higher-income people to pay taxes at higher than those for lower-income residents.

In addition, tax loopholes (**deductions, exemptions, and exclusions**) favor certain groups and usually reduce the progressivism of the tax structure. The extent to which taxes are progressive is a matter of dispute. The economic and political results of taxes on income have also been questioned by politicians and economists who think taxes on consumption are fairer and easier to collect.

**Income taxes are the major source of federal revenues**. Most revenue was derived from tariffs until ratification of the **sixteenth Amendment** (1913), which authorized income taxes.

For many years **tax rates varied, being high during wars and low during peacetime**. A sweeping tax reform act (the Tax Reform Act of 1986) lowered rates and decreased deductions. The Bush tax cuts enacted in 2002 were set to expire in 2010, but President Obama signed a two-year extension of the tax cuts (favored by Republicans) as part of an agreement with Republicans in Congress to extend unemployment benefits (favored by Democrats).

Presidents in the last two decades have often advocated increasing rates while keeping deductions low. The desire to balance the budget has switched policy debates to issue of tax cuts, but entitlement programs such as **social Security and Medicare remain a challenge to fund.**

Attaining national economic health is difficult. While the government can influence the economy’s performance through tax policy, monetary policy, the budget, and spending on social programs, a healthy economy requires **considerable cooperation across branches of government**, accurate economic forecasts, and the right psychology to bring about investment and consumer spending.

Deficit Spending

What exactly is deficit spending? Ross Perot, during the 1992 campaign, suggested that the problem was so serious that is grandchildren would potentially face the problem of the nation going broke.

Very simply put, deficit spending **is when expenditures exceed revenues**. Beginning with the Revolutionary War, the United States has been forced to be a nation in debt. The debt usually increased after the United States had to react to either **a domestic or foreign policy crisis**.

For instance, during the depression the country faced one of the largest deficits in its history as a result of the implementation of Roosevelt’s New Deal programs. However, the extent of the deficit became unmanageable beginning in the 1980s and reaching new heights in 2010 because of its size and the interest on the debt.

To place the figures in perspective, during World War I we borrowed $23 billion; during the Depression, another $13 billion, and during World War II, $200 billion. By 2009 the deficit was up to over $11 trillion.

**The federal government is the only level of government able to borrow more money than it receives**. State budgets must be balanced by law. To make matters worse, the interest on the deficit also increases the size of the debt. So, even if the government can reduce the size of the debt over a number of years, it still must repay the interest. Who does the federal government borrow money from? It borrows from all of the following:

* Trust funds such as Social Security
* Foreign investors
* Federal Reserve banks
* Commercial banks
* State and local governments
* Individuals who own savings bonds
* Money market funds in the form of treasury bonds
* Insurance companies
* Corporations, and
* Other areas such as pension funds, brokers, and other groups

Because the Constitution does not place limits on the extent or method of borrowing, **Congress sets limits on the debt**. The deficit increased so rapidly in the 1980s due partly to a massive tax decrease proposed by Reagan and passed by Congress without a corresponding cut in expenses. In fact, the defense budget showed a dramatic increase, while the cost of entitlement programs continued to escalate.

During the 1990s, President Clinton, working with the Republican-controlled Congress, signed **a balanced budget** that led to a surplus in 2000. After George W. Bush’s election, there was a mild economic recession followed by the events of September 11th and the wars against Afghanistan and Iraq.

These events, along with one of the largest tax cuts signed into law by George W. Bush, again led to large deficits. These deficits were made worse after President Obama took office and signed an $800 billion economic stimulus bill, which he said would help end the economic recession that began in 2008.

Economic Differences

Basic differences between Republicans and Democrats and ideological differences between conservatives and liberals are great when economic issues are raised.

Traditionally, **Republicans** have been identified as the party favoring the rich and big business, whereas the **Democrats** have been viewed as being sympathetic to labor and the poor.

Democrats have accused Republican presidents of having **unsuccessful “trickle-down, supply-side”** economic policies, resulting in a recessionary trend and higher unemployment. Republicans accuse Democratic presidents of following a “tax and spend, regulatory” program, **causing runaway inflation.**

The conservative congressional coalition sides with policies aimed at dramatically reducing the deficit, whereas liberals believe government-sponsored economic stimulus programs result in a strong economy.

These differences translate into major political themes in presidential campaigns. From the classic arguments of William Jennings Bryan favoring a free silver base, to the laissez-faire arguments of Herbert Hoover, to Ronald Reagan and George W. Bush’s dramatic tax reform proposals, **campaigns have focused on the economic problems facing the nation.**

Polling has indicated that **voters point to the economy** as the primary reason for choosing one candidate over another When Ronald Reagan ran against Jimmy Carter in 1980, he asked voters whether they were better off then or before Jimmy Carter had become president.

Because runaway inflation was rampant at that time, Carter was hard pressed to counter Reagan’s argument. Thus voter selection **is determined by one’s personal situation.**

If your family is unemployed during a Republican administration, you will probably vote Democratic. If your business is expanding and making profits when a Republican is president, you’re more apt to keep that president in office.

The 1992 presidential election and 2010 midterm election provided proof of what Bill Clinton strategist James Carville pointed out to candidate Clinton in 1992 that he should not forget: **“It’s the economy, stupid.”**

Government plays a dual role in being linked to the nation’s economy. It measures the economic status of the nation and attempts to develop effective measures to keep the economy on the right track. **The Department of Labor** (Bureau of Labor Statistics), the Congressional Budget Office, and the Executive Office of the Council of Economic Advisers all report to the country vital economic statistics such as:

* **The Unemployment rate** (adjusted index of people obtaining jobs)
* **Consumer Price Index (CPI)** – According to the U.S. Census Bureau, “the CPI is a measure of the average change in prices over time in a fixe ‘market basket’ of goods and services purchased either by urban wage earners and clerical workers or by all urban consumers. “It is also a primary measure of inflation when the index rises over a defined period of time.
* **Gross National Product (GNP)** – The Census Bureau defines GNP as “the total output of goods and services produced by labor and property located in the United States, valued at market prices.”
* **Gross Domestic Product (GDP)** – Lately the GDP has become the key economic measure analyzing an upward or downward economic trend, on a quarterly basis, of the monetary value of all the goods and services produced within the nation. Other factors such as consumer confidence, the actual inflation rate, and the stock market give a complete picture of the economy.

The government’s primary policy role, therefore, is to develop a healthy economic policy. Programs such as the New Deal’s three Rs—Relief, Recovery, and Reform—set in motion policies that have succeeded in preventing the country from experiencing a depression of the magnitude of the one occurred in the 1930s. Many of Roosevelt’s programs such as **Social Security** (relief), the **Securities and Exchange Commission** (reform) , and **jobs programs** prototypes (recovery) are still part of the economic fabric of the country today.

**Review**

**Essential Learning Points:**

* Congress must generate a budget that addresses both discretionary and mandatory spending, and as entitlement costs grow, discretionary spending opportunities will decrease unless tax revenues increase or the budget deficit increases
* Economic health depends on many complex and often unpredictable factors.
* Politicians and economists have conflicting views on how to regulate the economy.
* Economic policy-making involves several parts of the government.
* The budget indicates how much the government will collect in taxes, spend in revenues, and allocate among various programs.

**Key Terms**

Appropriations bills Monetarism

Budget Office of Management and Budget (OMB)

Budget resolution Pocketbook issue

Congressional Budget Act of 1974 Progressive tax structure

Council of Economic Advisors (CEA) Secretary of the Treasury

Deficit economic planning entitlements Sixteenth Amendment

Economic planning Tax Reform Act of 1986

Entitlements Unemployment

Federal Reserve Board Supply-side tax cut

Gramm-Rudman Act Surplus

Inflation Tax Cut

Income Tax Tax Loopholes

Keynesianism