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ECONOMIC POLICY AND THE BUDGET

Although the federal government has run deficits for most years since 1969, Americans have never liked the idea of the 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 broad 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 health.

KEY TERMS

appropriations bills
budget
budget resolution
Congressional Budget Act of 1974
Council of Economic Advisors (CEA)
deficit
economic planning
entitlements
Federal Reserve Board
Gramm-Rudman Act
Inflation
income tax
Keynesianism ← Demand-side Economics, Tax-cuts
monetarism
Office of Management and Budget (OMB)
pocketbook issue
progressive tax structure
Reaganomics
secretary of the Treasury
Sixteenth Amendment
supply-side tax cut
surplus
tax cut
tax loopholes
Tax Reform Act of 1986
unemployment

KEY CONCEPTS

- 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.

For a full discussion of economic policy and the budget, see *American Government*, 8th ed., Chapter 16 / 9th ed., Chapter 16.

ECONOMIC HEALTH

The deficits of the past thirty-five 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 three large tax cuts since World War II. Democrats received the assurance that tax cuts would end in 2010, and spending on federal programs was increased.

In the best of times, economic forecasts are uncertain. When the unexpected occurs, they are more uncertain. The past few years have brought the September 11 attacks and subsequent military actions, both of which 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. Economic forecasts made before September 11, 2001, had no chance of being accurate.

Voters see connections between their own economic circumstances, the president, and the nation as a whole. 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 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.

Congress avoid bad economy
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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. Republicans tend to

Republicans -

manipulate supply in dealing with the economy. Democrats tend to control demand.

THE POLITICS OF TAXING AND SPENDING

AP Tip

Various views of how government can influence the economy are fundamental to understanding economic policy-making and are likely to appear on the AP exam.

When struggling over the politics of taxing and spending, competing 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** Advocated by the famous economist Milton Friedman, monetarism posits 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. This theory answers the traditional concern that libertarians, conservatives, and Republicans have with inflation.
- **Keynesianism** Derived from the work of the English economist John Maynard Keynes, Keynesianism holds that government should create the right level of demand. 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 of the economy by increasing taxes or cutting expenditures. This theory answers the traditional concern with unemployment among liberals and Democrats.
- **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 that there is a need for less government interference in the

market and for lower taxes—that lower taxes create incentives for investment, and the greater economic productivity that results will produce more tax revenue. This theory fits with traditional libertarian and conservative political values but ignores political concerns about both inflation and unemployment.

- **Reaganomics** Set in motion by President Reagan in 1981, Reaganomics is a combination of monetarism, supply-side tax cuts, and domestic budget cutting. The goals sought by Reagan were not entirely consistent. He wanted to reduce the size of the federal government, to stimulate economic growth, and to increase military strength. The inconsistencies in Reaganomics were the result of trying to combine concerns about inflation, economic freedom, unemployment, and increasing military spending. The effects of Reaganomics included the following:
  - The economy was stimulated.
  - Government spending continued to increase, but at slower rates than before.
  - Military spending increased sharply.
  - The money supply was controlled, cutting inflation but allowing interest rates to rise.
  - Personal income taxes were cut, but Social Security taxes were increased.
  - Large deficits were incurred, dramatically increasing the size of the national debt.
  - Several important industries, such as the airlines and telephone companies, were deregulated.

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 economic policy-making, Congress approves all taxes and almost all expenditures. It 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 departments' legislative proposals are compatible with the president's program by creating the budget the president submits to Congress.
- **Secretary of the Treasury** As a member of the president's cabinet, the secretary, 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 of 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 BUDGET

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 of 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.

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 rates 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. 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 the 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.

Multiple-Choice Questions

1. What is the relationship between voting behavior and economic conditions?
   (A) People who are unemployed are less likely to vote for an incumbent, but voting behavior and economic conditions are not correlated for those who have jobs.
   (B) There is a strong correlation between economic conditions and voting behavior, with people less likely to vote for incumbents in poor economic times.
   (C) Most voters do not believe that the president has much impact on economic conditions, so there is little correlation between voting behavior and the economy.
   (D) Most voters blame Congress when the economy is poor, so incumbent congressmen are more likely than an incumbent president to lose their jobs.
   (E) In poor economic times, incumbents are more likely to be reelected because the public is hesitant to change leadership in hard times.