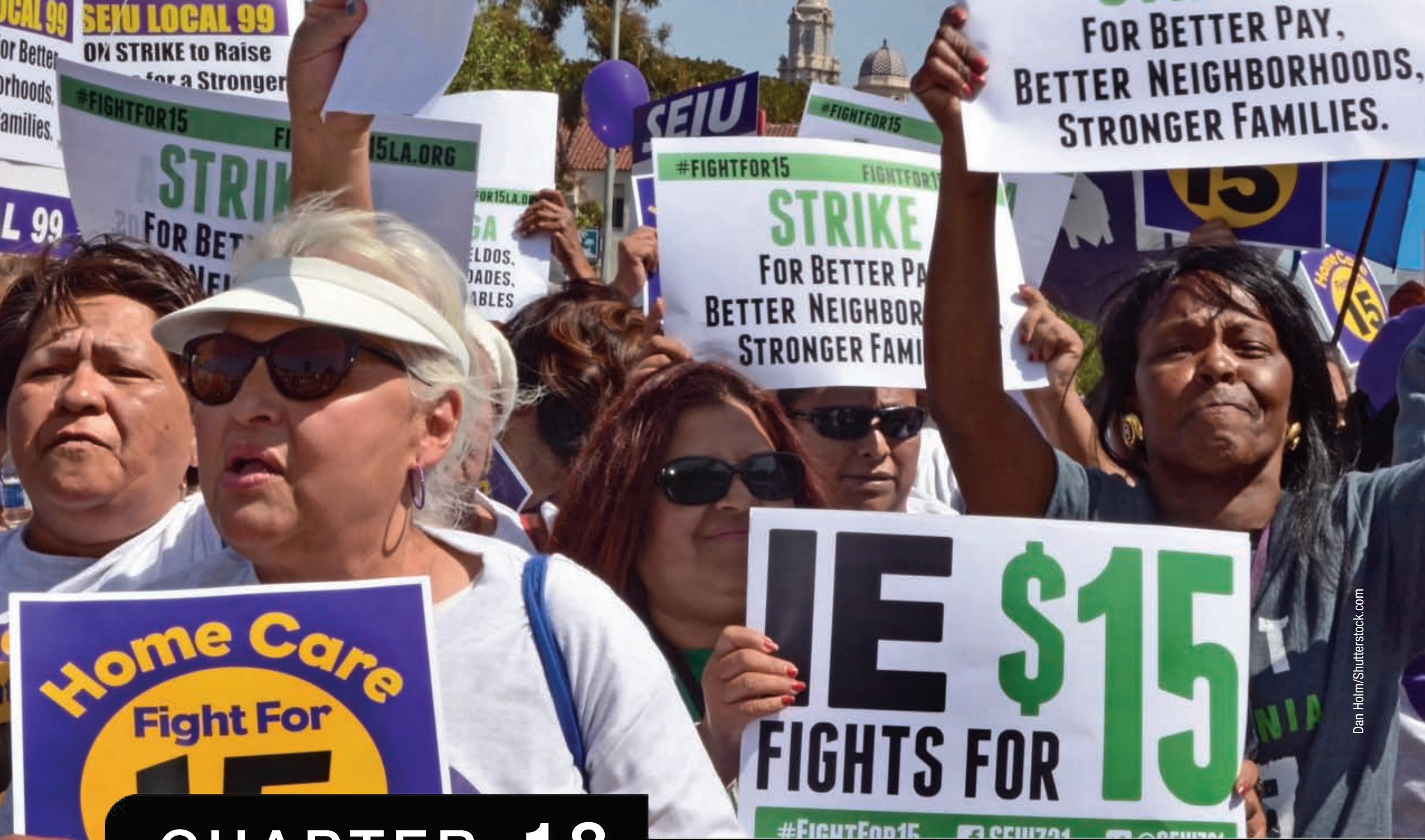

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# CHAPTER 18

# Economic Policy

## LEARNING OBJECTIVES

**18-1** Summarize how politics and public opinion shape economic policy.

**18-2** Summarize four main theories of economic policymaking.

**18-3** Describe how American institutions work to set economic policy.

**18-4** Explain the budget process, and in particular state why it is difficult to either cut spending or increase taxes.

***deficit*** The result of 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.

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 you 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** (see Figure 18.1). 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**. In 2015, the national debt rose to over $18 trillion.

For the last four decades, the government in Washington got away with routine deficit spending and nonstop increases in the national debt. But over the last several years, for both economic and political reasons, this has begun to change rather dramatically.

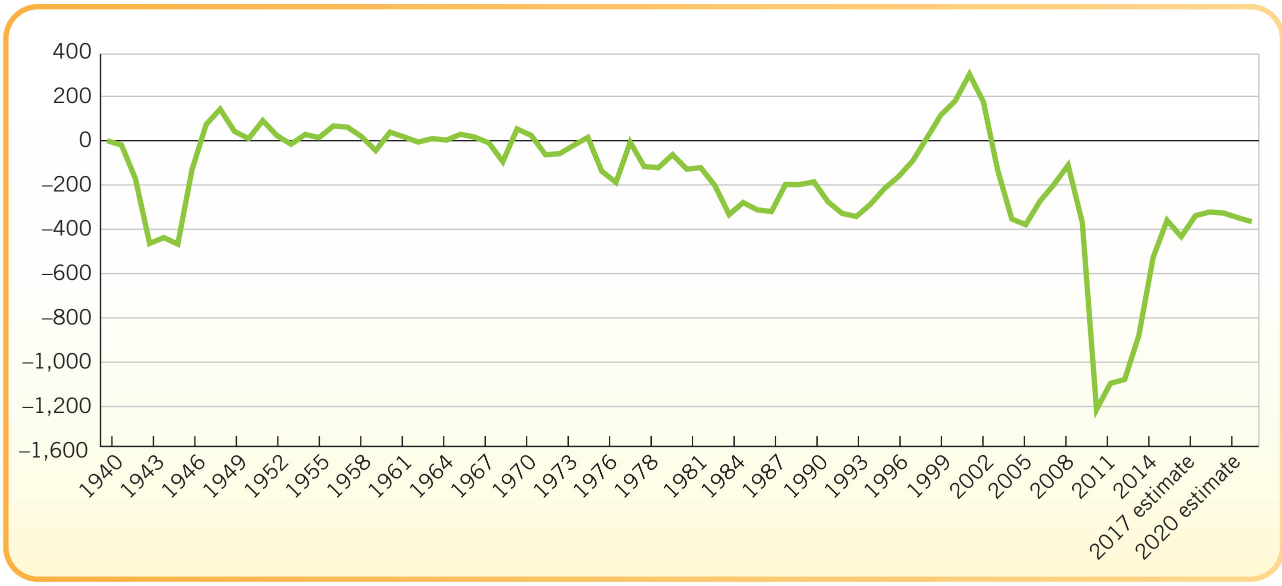
## THEN

Deficits that result in debt are important economically 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 has regarded the American dollar as stable and valuable. As a result, people have lined up to buy U.S. Treasury bonds whenever they are sold. 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. Prior to 1980, annual deficit spending was relatively minor and large deficits occurred only during wartime. Washington began its deficit spending and debt accumulation spree in the mid-1970s, interrupted only by several years during the 1990s when the government ran surpluses. Despite the huge deficits and mounting debt, most people, including most major domestic and foreign investors and experts on public finances, nonetheless considered America to be a good credit risk. In particular, concerns about "too much debt" were often dismissed as unduly alarmist, and presidents and congressional leaders in both parties quietly and consistently increased the national debt ceiling so that Washington could keep right on spending and borrowing.

## NOW

In April 2011, Standard & Poor's, a credit rating agency that has been grading U.S. Treasury bonds since the 1930s, issued a first-ever warning about America's national debt, downgrading it from "stable" to "negative," and forecasting a one-third chance that the country would lose its

**FIGURE 18.1** **Federal Budget Deficit or Surplus, FY1940–2020, In Billions of Constant FY2009 Dollars**




***Source:*** Office of Management and Budget, Historical Tables (Table 1.3).

"triple-A" credit rating before 2014. It did not take that long. In August 2011, Standard & Poor's itself downgraded the United States to "double-A" status. The annual federal deficit topped a trillion dollars for the first time in 2009, and in 2010 another trillion-dollar deficit was recorded. In December 2010, members of a bipartisan presidential commission, the National Commission on Fiscal Responsibility and Reform, proclaimed that dire, long-term economic consequences would follow unless Washington acted at once to rein in deficit spending and slow debt accumulation. For example, the total value of all the goods and services the nation produces each year is called **gross domestic product**, or GDP. The Commission warned that the national debt would soon exceed the nation's annual GDP, and that annual interest payments on the national debt could rise to almost 4 percent of GDP (from about 2.3 percent of GDP in 2012) over the next decade. In 2011, several competing deficit and debt reduction plans were circulated by members of Congress and by the White House, but bitterly partisan and ideological politics greeted each plan, and a heated public debate ensued regarding the once-routine business of raising the national debt ceiling. In accordance with key provisions of the final bipartisan deal that raised the debt ceiling, in August 2011, a dozen members of Congress (half from the House and half from the Senate, half Democrats and half Republicans) were appointed to a "super committee" and charged with identifying $1.5 trillion in additional debt reduction; if they failed to agree, or if Congress rejected their plan, then across-the-board spending cuts (half in defense and half in domestic programs) were to be "triggered." They failed, but various measures were adopted to avoid making all the "automatic" cuts.

Today's debates about deficit spending and debt accumulation are so rancorous in part because they have taken shape in the midst of a weak economy. A serious recession occurs when businesses fail, unemployment rises, and economic growth stops. This happened, starting in 2007 and continuing through 2010 and—depending on which economists one believes—perhaps beyond. The debates are also made more intense by the fiscal challenges that policymakers see just over the horizon. One such challenge is that our population is getting older. This creates huge new demands for Social Security retirement benefits and medical payments under Medicare and the part of Medicaid that covers long-term care (see Chapter 17). When a recession and an older population occur together, our national debt and interest payments to support it will shoot up.

But the core reason why ongoing debates over economic policy are so divisive is that people disagree, often fundamentally, not so much over the sheer size of our national debt, but over what we buy with all this borrowed money. Most families borrow to buy long-lasting items, such as 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 enhance 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.

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

It should not be surprising that politicians typically avoid seriously debating, let alone making, hard choices on economic policy. Since they know 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 mainly by conservatives, is by cutting spending; the other, offered mainly 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 are hard to reconcile, maybe now more than ever. National polls find that while Americans think budget deficits are problematic, and while they support smaller government in theory, they oppose cuts to nearly all programs, as we explain below. Many Americans simultaneously want lower taxes and more spending, which is not sustainable in the long term. Thus, any truly far-reaching fiscal reforms will require politicians in both parties to win back public trust while telling the people what few care to hear.

## 18-1 The Economy and Elections

In more normal economic times, however, economic policy is not nearly so hard for politicians to fashion without fighting big legislative battles or risking public ire. 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 connections between their own well-being and that of the nation, and they tend to hold politicians responsible for the state of the country.

As we discussed in Chapter 10, the health of the overall economy strongly shapes presidential elections. But when people evaluate "the economy," what do they look to? Do they look at their own economic fortunes, labeled "pocketbook voting"? Or do they instead look to the health of the nation's economy as a whole, labeled "sociotropic (other-regarding) voting"?

People do look, to some degree, to their own economic circumstances. Those who think their own economic circumstances have deteriorated are more likely to vote against the incumbent party.[1] For example, in the 2008 election, taking place amidst the start of a protracted recession, 42 percent of Americans thought their family's financial situation was worse today than it was four years ago, and 24 percent thought it was better. Those who thought their family's financial situation had gotten worse were much more likely to vote for Obama: 71 percent of those voters supported Obama, versus only 37 percent of those who thought their financial situation had gotten better.[2]

But people do not simply vote with their own pocketbooks. Instead, they look more at the overall health of the economy when casting a ballot for president. When assessing "the economy," they consider the national economy: Did unemployment go up or down? Did inflation increase or decrease? They use these national-level indicators as their assessment of the economy, and reward the incumbent president (and his or her party) accordingly.[3] In presidential elections, those who think national economic trends are bad are much more likely to vote against the incumbent, *even when* their own personal finances have not worsened.[4]

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.[5] 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. A big part of the explanation is that people understand what government can and cannot be held accountable for. If you lose your job at an 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.[6]

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 think that they do just this.

Since the 19th 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 until such adjustments were made automatic in 1975 (see Chapter 17).

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 of these desirable outcomes. Moreover, doing one of these things often may 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 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 complexities of the economy, presidents can lose elections over economic issues 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.

In 2012, however, Barack Obama won reelection despite widespread concerns about the economy's performance. Indeed, Obama is the first president since Franklin Delano Roosevelt in 1940 to be reelected despite an unemployment rate on Election Day that was higher than the unemployment rate on the day of his first inauguration. As we discussed in Chapter 10, voters were convinced by Obama's argument that while the economy was still recovering, it had improved over the course of his first term (and hence he should be reelected).

All this means that politicians must make choices about economic policy, choices affected by uncertainty and ignorance. No one knows how perfectly to balance unemployment and inflation, how to set the ideal tax rate, and so forth. Given this, the debate between the parties continues on these policies.

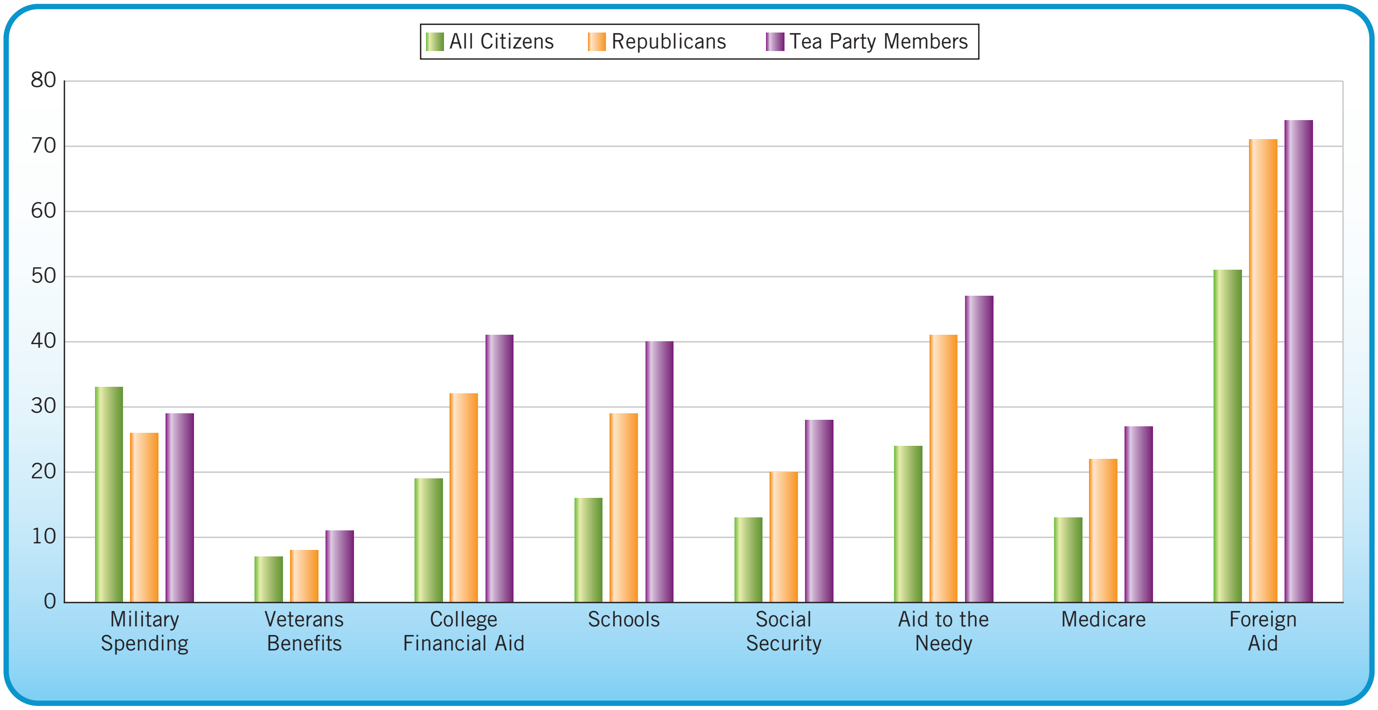
## Public Opinion and Government Spending

Of course, presidents and other actors do not operate in a vacuum. The policies they pursue are constrained and shaped by what the public wants. 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. Politicians confront 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. In short, public opinion supports a conundrum: Americans want more spending without more taxes or bigger government.[7]

Figure 18.2 illustrates this general tendency: Americans claim to not like big government in principle, but they certainly seem to like it in practice. The figure shows the percentage of Americans, Republicans, and Tea Party supporters who support cuts to spending across various federal programs. In all cases, there is very little public support for spending cuts, especially in areas like Social Security, Medicare, public education, and aid to the needy. While Republicans and especially Tea Partiers are more supportive of spending cuts, even here, a minority supports cutting spending in these areas. Indeed, the overall survey asked about 18 different types of spending (we cannot include them all here in the interest of space). In 17 of 18 areas, there was minority support for cutting spending. There was only one area where a majority of Americans wanted to cut spending: foreign aid. Unfortunately, foreign aid is such a small part of the federal budget—less than 1 percent—that cutting foreign aid would generate no real savings. The major government expenses—programs such as Social Security, Medicare, defense spending, and so forth (see Figure 18.4)—are popular, and the public opposes cuts in these areas.

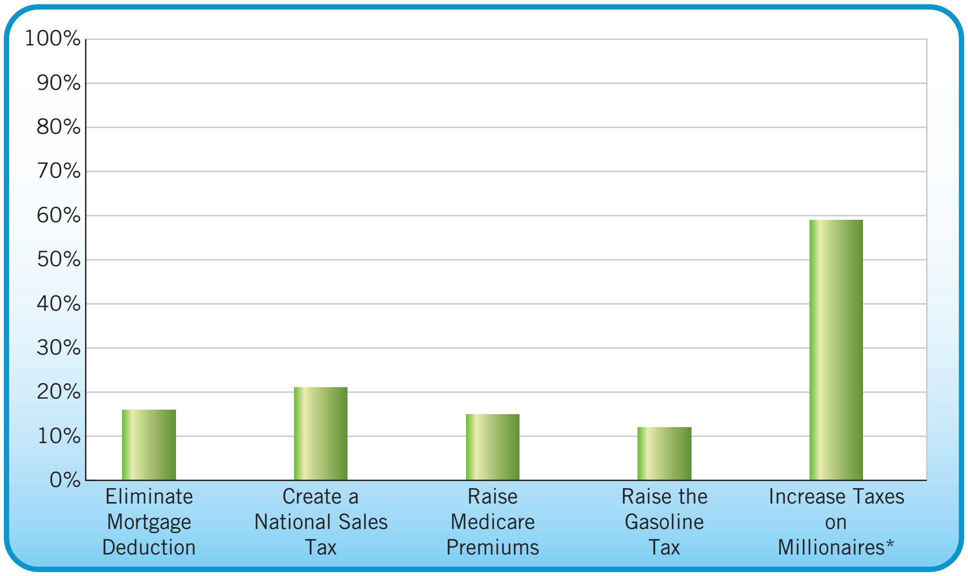
Such opposition to spending cuts is not problematic if the public is also willing to support increased taxes. Unfortunately, they are not. Figure 18.3 shows the support for various tax increases. In general, the American public is very hostile toward creating new taxes, such as a national sales tax, or increasing existing taxes, like the gasoline tax. Furthermore, they are also strongly opposed to eliminating popular tax deductions, such as the deduction for home mortgage interest, or increasing fees for government programs (such as the premiums seniors pay for Medicare). The Gallup polling firm has been asking Americans whether they think the amount they pay in taxes is too high since the late 1950s. Every time the question has been asked, a majority or near majority (at least 46 percent) say

**FIGURE 18.2** **Support for Spending Cuts**




***Source:*** Author's analysis of the Pew Research Center's February 2011 political survey.

**FIGURE 18.3** **Support for Tax Increases**




***Source:*** Author's analysis of the Pew Research Center's December 2010 political survey; starred item comes from the Associated Press/GfK Poll, April 2013, accessed via the Roper Center iPoll.

their taxes are too high.[8] Not all Americans agree with the Tea Party, but many agree with their slogan: they think Americans are Taxed Enough Already.

There is one area, however, where Americans support increasing taxes: when someone else pays the taxes. In Figure 18.3, there is majority support for only one tax increase: increasing the taxes on millionaires (more generally, taxing the rich, defined in various ways, is typically popular).

It is not only the rich who are the target of such targeted tax increases. For example, the State Children's Health Insurance (SCHIP) Program is partially funded via cigarette taxes.[9] The SCHIP program subsidizes health insurance for low-income children, and has remained a popular program since its inception in the 1990s. Using cigarette taxes is a way of keeping such a program popular, as smokers represent a minority, while nearly everyone supports health insurance for children. In short, if you want to raise taxes, it would behoove you to paint it as a tax increase on some unpopular group.


AP Images/J. Scott Applewhite

*Tea Party activists protest in Washington after a government audit reveals that the Internal Revenue Service targeted for special scrutiny applications by politically conservative groups for tax-exempt status.*

Most voters would like to have lower taxes, less debt, and new (or expanded) programs. Unfortunately, this is logically impossible. 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.

Given public opinion on taxes and spending, therefore, the solution is that American politicians deficit-spend. Americans support increased spending on a wide variety of programs, but not a commensurate increase in taxes (or really, any increase in taxes, except for someone else). The end result is that politicians grow the size of the deficit over time. This delays the difficult decision—cutting spending or raising taxes—until some point in the future.

# 18-2 Economic Theories and Political Needs

There are four main theories about how to improve the economy, and many of the economists picked by presidents represent one or more of these theories. In general, conservative economists tend to support monetarism and supply-side economics, while liberal economists are more likely to embrace Keynesianism and planning. Here, we give a highly simplified account of them and what each implies about ending a recession.

## Monetarism

A **monetarist**, such as the late economist Milton Friedman, believes that inflation occurs when too much money chases too few goods. The federal government has the power to create money (in ways to be described on page 471); according to monetarists, inflation occurs when it prints too much money. When inflation becomes rampant and government tries to do something, 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. When the economy goes into a recession, however, many monetarists think the Federal Reserve Bank ("the Fed") should cut interest rates to make it easier for people and businesses to borrow money. That is what the Fed did during 2008.

## Keynesianism

***monetarist*** 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.

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 collects 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.

The American Recovery and Reinvestment Act of 2009 (more commonly known as the stimulus bill) is an example of Keynesian thinking. The bill spent approximately $800 billion of federal money to help jump-start the economy by giving tax breaks to individuals, providing aid to state and local governments, and spending money on public-works projects, such as infrastructure. The idea behind the bill was that federal government spending would both prevent further cuts from state and local governments, and help spur additional economic spending by giving people tax breaks and creating jobs by infrastructure investments.

## Planning

Some economists have too little faith in the workings of the free market to be pure Keynesians, much less monetarists. They believe 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

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

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.

Planning has never been popular in America, but when the TARP program began investing in banks, some people began to suggest that perhaps the government should own the banks. That way, they said, the government might get back some of the money it had spent on them. The government was already the largest single stockholder in Bank of America and Citigroup (though in each case it owned less than half the stocks). Such plans were never put into place, and the government has largely ended its stake in the banks (as expected).

## Supply-Side Economics

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 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.

Politicians looking to cut taxes have frequently invoked supply-side arguments. For example, in the 1980s, Ronald Reagan and his economic advisors used a supply-side logic to justify his tax cuts, as have more contemporary Republicans.

Unfortunately, there is no definitive answer from economists as to which theory—monetarism, Keynesianism, planning, or supply-side economics—actually works the best in practice. Such an answer likely does not exist even in theory, as the "best" theory likely depends a great deal on the particular circumstances. As a result, the debate among economists—and politicians—will continue into the future.

### 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.

# 18-3 The Machinery of Economic Policymaking

Predicting what will happen to the economy is extraordinarily hard. Because the U.S. economy is complex, and depends on so many variables, even the smartest economists often miss the mark in their economic forecasts. Few economists, for example, foresaw the recession that began in 2007. Furthermore, even if economists could perfectly predict the economy, that does not mean the president could necessarily respond to their predictions. 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. Obama picked Keynesians; Bush 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.

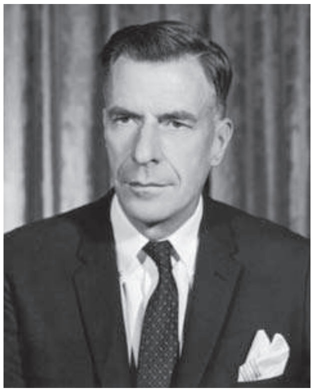
*From the Russian word for a carriage pulled by three horses.


Keystone-France/Gamma-Keystone/Getty Images

*Milton Friedman*


Tim Gidal/Stringer/Getty Images

*John Maynard Keynes*


Hulton Archive/Archive Photos/Getty Images

*John Kenneth Galbraith*


Walter Bennett/Time & Life Pictures Collection/Getty Images

*Arthur B. Laffer*

The OMB originally was 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 often is 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 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. Dozens, if not hundreds, of parts of the government contribute to 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, and the Export-Import Bank becomes more important as well (we discuss this feature in the Policy Dynamics: Inside/Outside the Box feature on page 470)

## The Federal Reserve System

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 14-year, nonrenewable terms and may not be removed except for cause. (No member has been removed since it was created in 1913.) The chairperson 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, to the extent possible, 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 471 shows how the Fed does this. In 2001, it lowered interest rates 11 times in order to help reduce the recession. From 2004 to 2006, it raised these rates 17 times in order to prevent inflation. In 2007 and 2008, it lowered rates 10 times to respond to the ongoing recession.[10]

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

Just how independent the Fed is can be a matter of dispute. For example, the Nixon administration pressured Fed chairman Arthur Burns to expand the money supply in 1971 and 1972 (to benefit Nixon in the 1972 election), and many argue this created inflation later in the decade.[11] This suggests that the Fed is not terribly independent of the administration, but other examples suggest otherwise. For example, the Fed's policies in the late 1970s and early 1980s to tighten the money supply were unpopular at the time, but worked to solve persistently high inflation. While political leaders and the Fed both desire the same outcome—a healthy economy—how best to get there is often in dispute.

## Congress

The most important part of the economic policymaking machinery, of course, is Congress. It must approve all

## POLICY DYNAMICS: INSIDE/OUTSIDE THE BOX

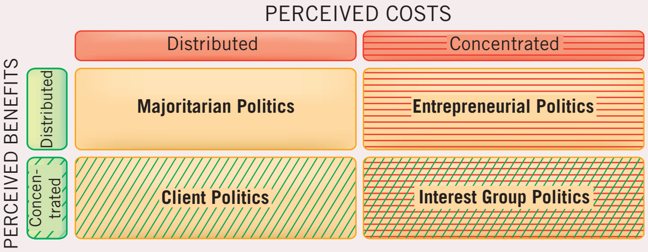
### The Export-Import Bank: Interest Group and Entrepreneurial Politics

In 1934, President Franklin Delano Roosevelt established the Export-Import Bank to help American companies sell their goods and services abroad. The bank serves as a guarantor to help foreign companies obtain loans to buy U.S. goods. For example, the bank helps foreign airlines buy Boeing airliners, such as the new Boeing Dreamliner. Because new airplanes cost hundreds of millions of dollars, even wealthy airlines can have trouble obtaining private financing for them. To help them purchase such expensive goods, the bank (and therefore implicitly the U.S. government) serves as a loan guarantor, making it much easier for foreign companies to buy U.S. goods. In 2015, the Bank's authorization was set to expire, and a vigorous political battle ensued.

The Bank and its loan guarantees can be seen as interest-group politics. While the bank benefits many companies, none benefit more so than Boeing, because Boeing's airplanes are so expensive. The benefits of the bank ensue primarily to a concentrated constituency—namely, Boeing and its employees and shareholders. One interpretation of the costs is that domestic airlines pay the cost. Because they cannot get Export-Import Bank loan guarantees, they argue that this creates an unfair advantage for foreign airlines. The loan guarantees allow foreign airlines to pay lower interest rates on their loans for new jets, which lowers their borrowing costs, which means they can lower ticket prices for consumers. For example, Delta Airlines has advanced this position, claiming that the Export-Import Bank loan guarantees allow foreign competitors like Emirates or Air India to undercut it on profitable international flight routes.

But Delta and other domestic airlines are not the only ones working against the bank. Many fiscal conservatives, and allied interest groups such as the Club for Growth and Freedom Partners, are also working to eliminate the bank. Such calls are an example of entrepreneurial politics: eliminating loan guarantees would impose concentrated costs on Boeing and other exporters, but give dispersed benefits to all Americans in the form of lower federal spending and debt. These groups are trying to raise the salience of the issue by launching a media campaign depicting the bank as an example of crony capitalism, with large manufacturers like Boeing benefitting at the expense of ordinary Americans. These groups are willing to pay the price of being an entrepreneur because of their ideological position: they believe in smaller government, so they want to eliminate the Bank and other entities like it.

As the book went to press, there was no resolution. The bank's authorization expired at the end of June 2015, and Congress has not yet reauthorized it. Congress planned to hold a vote to reauthorize the bank later in 2015, but what will happen is unclear.




***Source:*** Jonathan Weisman and Eric Lipton, "Air Skirmish in War over Ex-Im Bank," *New York Times*, April 7, 2015.

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

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

## 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 to 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 a rather small one, on how much money the banks will lend.

#### Federal Reserve Board (seven 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 members)

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

#### Member Banks (6,000 members)

- 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.

(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 in the United States. That means these countries can ship goods—such as shoes, textiles, and beef—to American buyers 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 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

J.M. Eddins, Jr/McClatchy-Tribune/Tribune Content Agency LLC / Alamy

*Janet Yellen, Chair of the Federal Reserve Board of Governors, testifies before Congress.*

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

***income inequality*** the extent to which income is unevenly distributed throughout society

on it than are those who stand to benefit from it.

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 had key Senate races in 2002, and were critical to President Bush's reelection bid in 2004. Though Bush put the tariffs in place in 2002, he was forced to lift them at the end of 2003 in response to action by the World Trade Organization. This example highlights how international institutions—such as the World Trade Organization—add an even further layer of complexity to U.S. economic policies.

## 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. We all experience globalization in our everyday lives. If your computer develops a problem and you call technical support, you are likely to speak with a technician based in India. If you go to a shopping mall and buy a new shirt, it is likely made not in America, but in Bangladesh or Vietnam. Your cell phone or computer may be made in China. All of these are examples of globalization.

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. For example, they have pushed for free trade agreements with Central America (enacted 2005), Panama, Columbia, and South Korea (all enacted in 2011).

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. Whether the U.S. continues to sign new free trade agreements largely depends on whether voters and politicians find supporters or opponents of globalization's arguments more compelling.

## Income Inequality

In recent years, debates over **income inequality** have entered the public consciousness. For example, the nonpartisan Congressional Budget Office calculates that since 1979, the incomes of the top 1 percent have increased by 174 percent, while the incomes of the bottom 80 percent only increased 16 percent—the top 1 percent saw their incomes increase 11 times faster than the vast majority of Americans.[12] A myriad of other statistics point to the same conclusion: The economic gains of the recent decades have been largely concentrated among those at the very top of the economic ladder.[13]

The causes of inequality are quite complex, and economists have put forth a number of different explanations, including the rising premium attached to higher education and higher-skilled jobs,[14] the substitution of higher-wage jobs in manufacturing with lower-wage jobs in the service industry,[15] and the decline of unions.[16] However, part of the explanation stems from shifts in government policy as well, particularly tax and spending policies that tend to favor the well-off.[17] This becomes a particular political concern, especially in light of the finding that policy is more responsive to the most affluent (see Chapter 7). In particular, there are fears that rising inequality helps to perpetuate itself: those at the top do well by virtue of being born at the top, while those at the bottom struggle even if they do well.[18]

In response to such concerns, income inequality has become a hot political issue. The most visible image of this trend was the Occupy Wall Street movement in 2011 and its slogan "We are the 99 Percent." The slogan highlighted the trend seen in the previous paragraph: Many of the benefits of the economy accrued to those at the top (the 1 percent), rather than most Americans (the 99 percent). While scholars debate the long-term effects of the Occupy movement, it is clear that it raised the salience of income inequality and brought the issue more into the political sphere.

As a result, there has been more debate in recent years about policies that would ameliorate this inequality. One striking example is the debate over the minimum wage. While the federal minimum wage has been constant at $7.25 since 2009, many states and localities have increased their minimum wage since then. For example, in the 2014 election, voters approved minimum wage increases in Alaska, Arkansas, Nebraska, and South Dakota. The fact that these proposals passed in typically Republican states underscore that such policies are popular across party lines, a fact also borne out by public opinion data.[19] It remains unclear, however, what effect such policies, and others like them, will have on overall inequality. You can consider this issue more in the What Would You Do? box on page 479.

## 18-4 The Budget, Spending, and Taxes

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 2013" or "FY 2013" means the year ending on September 30, 2013.

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. Much 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' benefits, food stamps, and money the government owes investors who have bought Treasury bonds (i.e., the interest on the national debt). For mandatory spending programs, the federal government does not decide to increase or decrease the amount of money spent on these programs. The amount spent is determined by the eligibility rules, and who chooses to apply. For example, Congress does not decide how much to spend on food stamps. The amount spent is based on the number of people who qualify for these benefits and choose to comply. To control the amount spent on food stamps, the federal government would have to change the eligibility rules or benefits levels (as they did in 2008).

Other spending is **discretionary**—that is, the amount of spending that is not mandated by law, but is instead set by Congress through the appropriations process. Discretionary spending is all of the remaining non-mandatory spending: defense, housing and community development, transportation, education, and so forth. In FY2014, mandatory spending including interest payments was $2.34 trillion, versus about only $1.17 trillion for discretionary spending. Because of how the federal government calculates discretionary spending, however, even much of that discretionary spending could not really be cut without a political outcry; for example, health benefits for veterans and military personnel are discretionary spending, but are quite popular.[20] As a result, what can be cut is a rather modest share of the budget, and as we will see below, even cutting this is challenging.

***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.

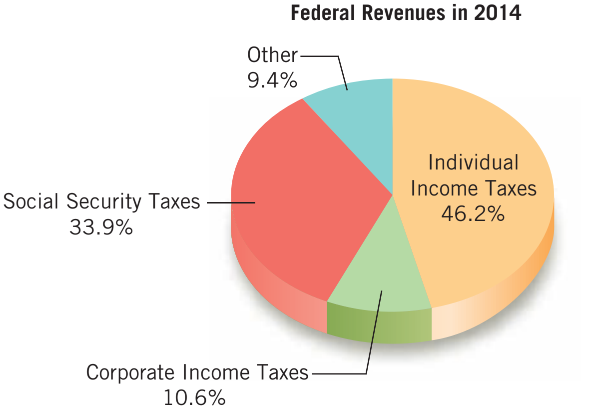
***budget resolution*** A congressional decision that states the maximum amount of money the government should spend.

***mandatory*** Money that the government is required to spend by law.

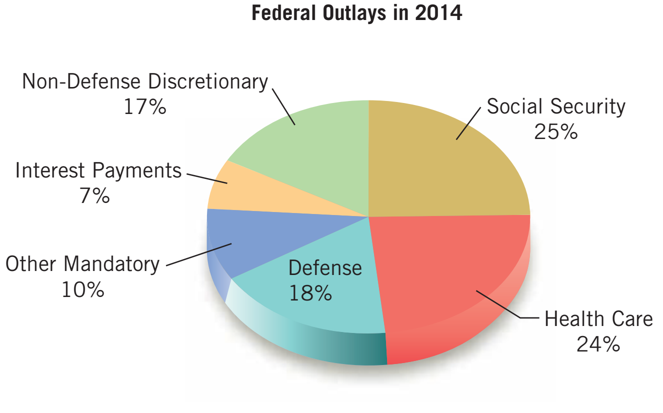
***entitlements*** A claim for government funds that cannot be changed without violating the rights of the claimant.

***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**




***Source:*** Office of Management and Budget, Historical Tables (Table 2.2).




***Source:*** Congressional Budget Office, Updated Budget Projections, 2015 to 2025.

Over time, mandatory spending has expanded dramatically. In the 1960s, discretionary spending accounted for two-thirds of federal spending, but today, mandatory spending makes up that much of the budget.[21] Much of this is due to the growth of entitlement programs, predominantly Social Security, Medicaid, and Medicare (and other health care-related spending). As we see in Figure 18.4, Social Security eats up approximately one-quarter of federal spending, with health care spending consuming another quarter. The lion's share of this spending on health care goes to Medicare, which alone accounts for approximately 15 percent of federal outlays.

As we see in Figure 18.5, over time, these programs have come to make up a larger share of U.S. GDP. In 1970, Medicare was under 1 percent of U.S. GDP, but today is almost 4 percent, and that figure is expected to rise to over 6 percent by 2050 with a rapidly aging population; the figures for Social Security show a similar, albeit less dramatic, rise. Over time, the growth in these programs will make it even more difficult to restrain the overall growth of government spending (we return to this point below).

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.

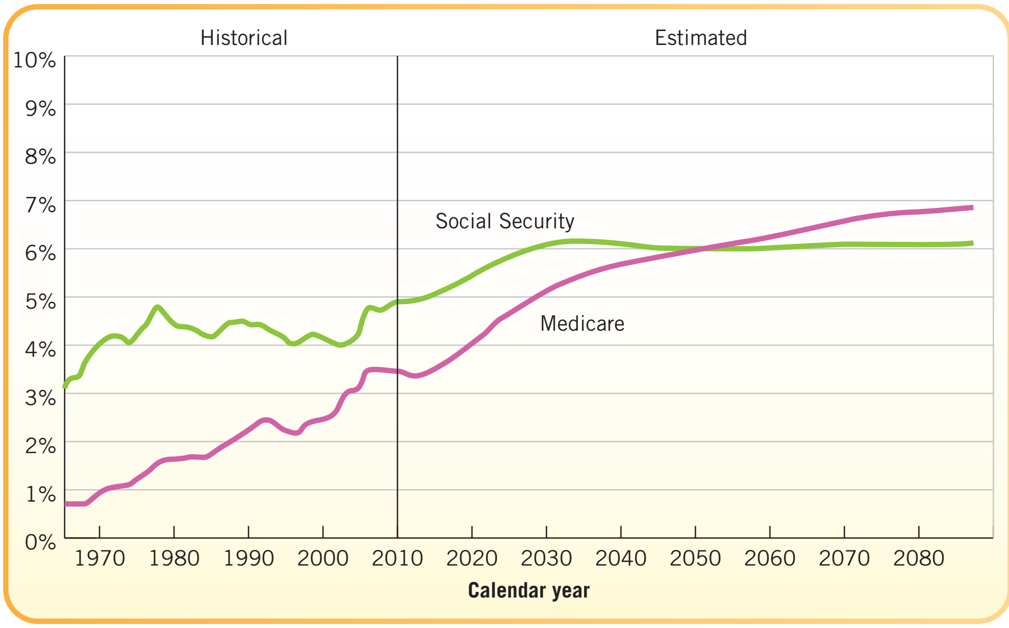
The object was to get members of Congress to vote for a total package of cuts before they could vote on any particular cut. Republican control of the Senate and an alliance between Republicans and conservative Southern Democrats in the House allowed this strategy to succeed. The first budget resolution ordered Senate and House committees to reduce federal spending during fiscal year 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. Unfortunately, it has not worked well since then.

## 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, called the Gramm-Rudman

**FIGURE 18.5** **Social Security and Medicare Cost as a Percentage of GDP**




***Source:*** Social Security Administration, A Summary of the 2014 Annual Reports, www.ssa.gov/oact/TRSUM/index.html.

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.

But nobody much liked the idea, and 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. 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, and it has not been put back in place (though we discuss other efforts below).

There have been various proposals put forth about how to restrain federal government spending. One popular idea is a balanced budget amendment, which would prohibit the government from spending more money than it taxes in from taxes and fees (i.e., the government could not deficit-spend). Such proposals have been implemented in a number of states, and have been proposed multiple times at the federal level. The evidence, however, suggests that they do not work. State legislators and governors use accounting tricks to get around their limits, and they do not serve as an effective check on government spending.[22]

***sequester*** Automatic spending cuts.

Recently, the federal government returned to the idea of a sequester (automatic, across-the-board spending cuts) to try and reign in spending. The Budget Control Act of 2011 established the Joint Select Committee on Deficit Reduction, more commonly known as the "Super Committee." This group of legislators was supposed to find $1.2 trillion in savings, or there were automatic spending cuts that would go into effect (the sequester). The committee was not able to reach consensus on what to cut, so the automatic cuts (the sequester) went into effect. Congress responded by removing the most painful cuts, but the spending limits remain in place through 2021 unless Congress removes them. However, the fact that Congress removed the most painful cuts illustrates the difficulty of actually restraining spending.

In general, all of the efforts to control spending run up against a fundamental dilemma: Americans want a government that does more for them at less cost, which is ultimately not sustainable. A large majority of Americans wants more generous social spending on a variety of programs, but they don't want a bigger government or higher taxes. Furthermore, as we explained in Chapter 8, because programs create constituencies who lobby for their continuation and expansion, once programs are in place, they are difficult to remove.

Restraining spending is effectively entrepreneurial politics. The benefits of spending on any given program are relatively concentrated, while the benefits are dispersed to the public as a whole (in the form of a more balanced budget). An entrepreneur needs to take up the cause. Some members of Congress have been willing in recent years to do this. Given the growing salience attached to U.S. deficit spending, they have capitalized on this salience to call for more restraint in government spending. For example, Wisconsin representative (and 2012 vice presidential candidate) Paul Ryan is an example of one such individual. Whether their actions are successful in the long run, however, remains to be seen.

Of course, if we cannot restrain spending, there is another alternative: raising taxes. Below, we consider the feasibility of this option.

## 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 generally has 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 the How We Compare box on page 478). 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.) And federal income taxes here are progressive: The bottom 50 percent of earners paid about 3 percent of income taxes, but the top 10 percent paid about 68 percent of taxes.[23]

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 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

### CONSTITUTIONAL CONNECTIONS

#### The Power to Tax and Spend

> *"The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States...."(Article I, Section 8)*

The clause above is the source of the federal government's ability to tax and to spend money. But what exactly does that power entail? Even the founding fathers disagreed over this. Some—most notably Alexander Hamilton—supported a more expansive interpretation, which would strengthen the government's ability to tax and spend (see his discussion in *Federalist* No. 30). Others—such as James Madison—thought the federal government's powers in this area should be more strictly limited to those defined in the Constitution: to pay the government's debts and provide for the common defense and general welfare. Hamilton, in short, wanted a broad reading, giving rise to a stronger federal government, whereas Madison wanted a narrow reading, giving rise to a more constrained federal government.

In general, in the early decades of the new government, the more limited view reigned. For example, in 1822, President James Monroe vetoed a bill to fund improvements on the Cumberland Road on the grounds that it was primarily a state, not a national, project—Congress could only provide for the general (i.e., national) welfare, not fund more local projects.

In the 20th century, however, the power to tax and spend took on a more expansive connotation. The modern interpretation begins with *United States v. Butler* (1936), where the Supreme Court held that Congress could spend money as long as it was in the general welfare of the nation. But because the Court gave Congress wide latitude in determining the general welfare, this greatly expanded the tax and spending powers of the federal government. Subsequent court decisions, most notably *South Dakota v. Dole* (1987), have furthered this logic, and allow the federal government very broad latitude to tax and spend for a wide variety of purposes.

who had 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 19th century, there was no federal income tax (except for a brief period during the Civil War). The money the government needed came mostly from tariffs (i.e., 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.[24] To change this, Congress proposed, and in 1913 the states ratified, the Sixteenth Amendment, which authorized such a tax.

For the next 40 years or so, tax rates tended to go up during wartime and down during peacetime (see Figure 18.6). 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. Economists call the key tax rate the "marginal rate." This is the percentage of the last dollar you earn that must be paid out in taxes.

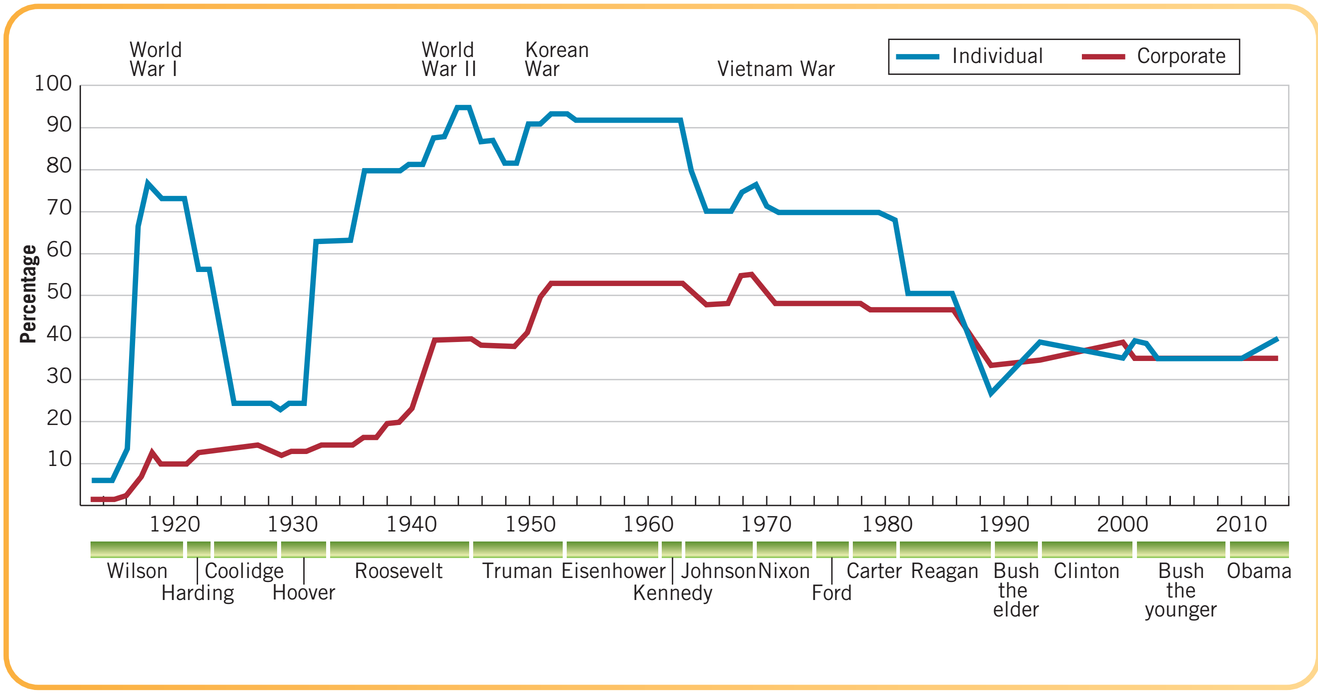
An income tax offers the opportunity for majoritarian politics to become class politics. The majority of the citizenry earn average incomes and control most of the votes. In theory there is nothing to prevent the mass of people from voting for legislators who will tax only the rich, who, as a minority, will always be outvoted. During the early decades of the 20th century, that is exactly what the rich feared would happen. Since the highest marginal tax rate was 94 percent, you might think 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 20th 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 30 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 opinion poll showed that

**FIGURE 18.6** **Federal Taxes on Income, Top Percentage Rates, 1913–2013**




***Source:*** Internal Revenue Service, Tax Tables, 2013.

## HOW WE COMPARE

### Tax Burdens in Democratic Nations

Measured by taxes as a percentage of income of a family with two children (for an average wage-earner), America as of 2014 had a moderate tax burden, lighter than many other OECD countries.

Greece: 44.5%

France: 41.6%

Belgium: 41%

Italy: 36.2%

Finland: 37.7%

Germany: 33.8%

Netherlands: 30.8%

United Kingdom: 27%

Japan: 26%

United States: 20.3%

Canada: 19%

Switzerland: 9.5%

Ireland: 6.8%

***Source:*** OECD, Taxing Wages 2015, "Comparison of Total Tax Wedge by Family Type."

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.[25]

Interest groups organized around each loophole. Homebuilders 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 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 effective rates low. In 1990, President George H. W. 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 Bill 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 and 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 was clear: Should the tax cuts, now expiring at the end of 2010, be made permanent? The issue deeply divided the parties in Congress. But, in December 2010, President Barack Obama signed into law a compromise bill featuring a two-year extension of the Bush tax cuts (favored by most Republicans) as well as additional money for unemployment insurance (favored by most Democrats). Under the American Taxpayer Relief Act of 2012, the top individual tax rate reverted back to its pre-Bush level, 39.6 percent, but the lower, Bush-era tax rates for many other income levels were retained.

Moving forward, it is unclear what will happen with future tax rates. While increasing spending is popular, increasing taxes is not. And unlike in 1986, the deductions

## What Would You Do?

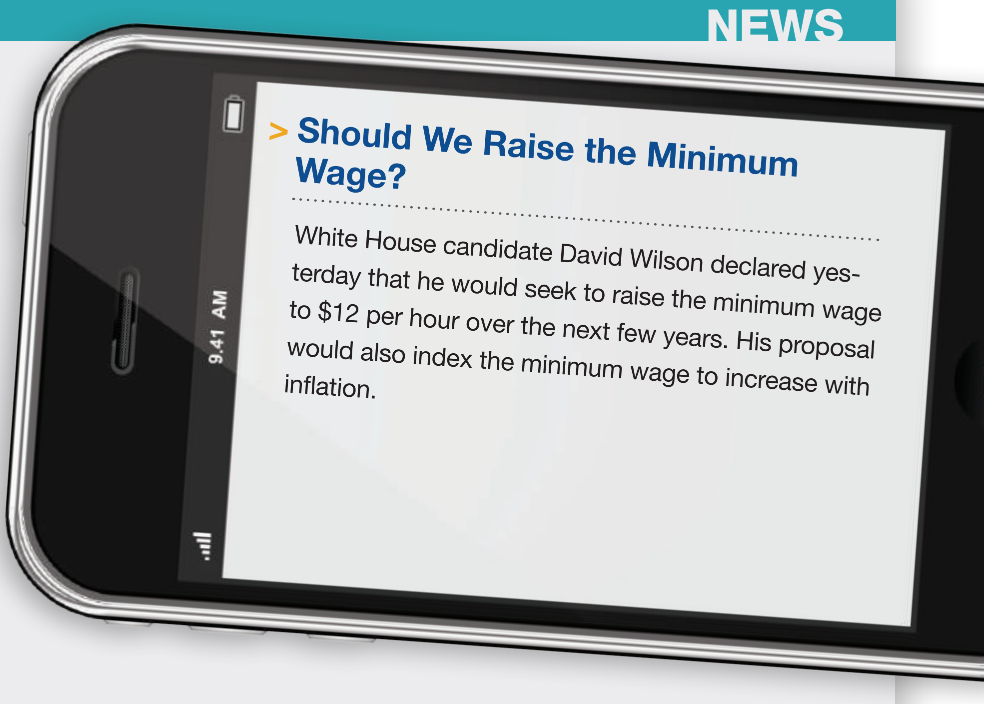
### MEMORANDUM

**To:** *Elizabeth Gilbert, chairperson, Council of Economic Advisers*

**From:** *Edward Larson, White House speechwriter*

**Subject:** *Raise the minimum wage*

The President would like your advice on whether to push for an increase in the federal minimum wage to $12 per hour, indexed to inflation.




### Arguments for:

1. A higher minimum wage benefits those at the bottom of the economic ladder, helping them to meet their basic needs. Studies suggest that a higher minimum wage reduces poverty.
2. Minimum-wage earners are no longer teenagers with summer jobs. Their average age is 35; most work full time; more than one-fourth are parents; and, on average, they earn half of their families' total income. They need this boost just to make ends meet.
3. Over time, inflation eats away at the minimum wage if it is not indexed to rise as costs rise. Adjusted for inflation, the minimum wage from 1969 would be $9.39 today, far above the current $7.25 per hour.

### Arguments against:

1. It will likely reduce employment, especially for unskilled workers, according to the Congressional Budget Office.
2. A higher minimum wage results in higher prices, which are then passed on to consumers.
3. A higher minimum wage keeps people in minimum-wage jobs longer, blocking younger workers with fewer skills from entry-level positions.

***Sources:*** Congressional Budget Office, "The Effects of a Minimum Wage Increase on Employment and Family Income," February 2014; Mike Konczal, "Economists Agree: Raising the Minimum Wage Reduces Poverty," *Washington Post blog*, January 4, 2014.

**Your decision** ◯ **Support** ◯ **Oppose**

that are worth significant money are all considered sacrosanct by middle-class (and upper-middle class) Americans: the home mortgage interest deduction, employer-sponsored health insurance, and so forth. Cutting these policies would be extremely difficult indeed. After the 2014 elections, for example, both parties discussed the need for comprehensive tax reform. However, given their very different visions for governmental priorities in the decades ahead, there was very little progress. Whether that changes in the years ahead remains to be seen.

## LEARNING OBJECTIVES

### 18-1 Summarize how politics and public opinion shape economic policy.

The politics of taxing and spending are so difficult mainly because most people don't like being taxed but do value government spending on a wide variety of government programs. Most voters want lower taxes, less debt, and new programs, but if we have more spending, we have to pay for it, either with higher taxes or with more borrowing (and hence more, not less, debt).

### 18-2 Summarize four main theories of economic policymaking.

The four main theories of economic policy are monetarism (inflation occurs when too much money chases too few goods), Keynesianism (the government should spend more money when there is a recession and less when the economy is doing well), economic planning (the government should actively plan the economy), and supply-side economics (lower taxes will stimulate economic growth). Unfortunately, there is no consensus among economists about which one is best.

### 18-3 Describe how American institutions work to set economic policy.

The difficulty is that many different actors play a role: the president, Congress, the Federal Reserve System, the Council of Economic Advisors, the secretary of the treasury, and hundreds of other agencies all contribute to economic policy. All of these actors have very imperfect control of the economy.

### 18-4 Explain the budget process, and in particular state why it is difficult to either cut spending or increase taxes.

Restraining spending or raising taxes are difficult for several reasons. First, most government spending is mandatory spending required by law. Second, the general public and members of Congress like government spending, and dislike taxes. Given this, restraining the growth of government is quite complicated.

## TO LEARN MORE

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

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

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