

The Policy Tools

How the Government Manages the Ups and downs of the Economy

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Goal: This unit provides an overview of important fiscal and monetary policy tools used by the Federal government daily as it tries to manage economic ups and downs and reduce economic insecurity. It also includes a lively policy debate about the use of economic policies to reform the US health care system.

The federal government plays a central role in managing the economy in good times and in bad. After the Depression and World War II, Congress passed the 1946 Employment Act that for the first time (other than during wartime) gave the federal government significant economic oversight. The act authorized the government to develop fiscal and monetary policies to “promote maximum employment, production, and purchasing power”¹ while maintaining stable prices and employment levels. The federal government also regulates the behavior and practices of business, labor, consumers, and the quality of the environment. It oversees and guides the reorganization of basic institutions that respond to an economic crisis and the smaller changes that follow the downside of a business cycle.

A. Fiscal Policy

Fiscal policy is one way the federal government regulates the economy. It is usually defined as the taxing and spending policies of the federal government. These policies include deciding how much revenue to raise and how much to spend on the provision of goods and services, such as highways, libraries, schools, social welfare and national defense among many others.

1. Fiscal Policy Tools: Taxation and Spending

Fiscal policies include the power of the federal government to tax and spend.² The use of these tools to keep the economy going is sometimes referred to as Keynesian economics after the British economist John Maynard Keynes. Keynes argued that private sector decisions sometimes lead to economic instability. Therefore, he advocated active government fiscal policy to stabilize the business cycle including the creation of modest budget deficits when necessary.

a. Taxes. There are three main types of taxation: Progressive taxation, Regressive taxation and Proportional taxation³. Each is defined in relation to the average tax rate. The average tax rate is calculated by dividing the amount a person owes by their total income.

- Progressive taxation is where the average tax rate increases as income increases. It is based on the principle of “ability to pay”, so that those who earn more pay a higher share of their income in taxes. Since the buying power of the wealthy is far greater than that of the middle and lower classes, the assumption is that they can afford to pay a higher percentage of their income in the taxes needed to cover the costs of running the government without sacrificing the quality of life. Below is a table depicting the structure of the 2015 US Federal Income tax code for married individuals. The qualification “married individuals” is required because tax rates vary based on marital status and whether one files jointly with a spouse or separately.

able Income Is Between:	The Tax Due Is:
0 - \$9,225	10% of taxable income
\$9,226 - \$37,450	\$922.50 + 15% of the amount over \$9,225
\$37,451 - \$90,750	\$5,156.25 + 25% of the amount over \$37,450
\$90,751 - \$189,300	\$18,481.25 + 28% of the amount over \$90,750
\$189,301 - \$411,500	\$46,075.25 + 33% of the amount over \$189,300
\$411,501 - \$413,200	\$119,401.25 + 35% of the amount over \$411,500
\$413,201 +	\$119,996.25 + 39.6% of the amount over \$413,200

Fig. 7.1 2015 US Federal Income Tax Brackets 4

The table shows that different amounts of income are taxed at different levels. For example, someone whose taxable income is \$40,000 per year would pay 10% of the first \$9,225 of their income in taxes, 15% of the portion of their income above \$9,225 but less than \$37,450, and 25% of the rest of their \$40,000 annual income. It can be shown mathematically that taxing different portions of income in this way means that the average tax rate increases as income increases but there’s no need for us to do that here. Thus, the 2015 US federal income tax code is an example of a progressive tax system.

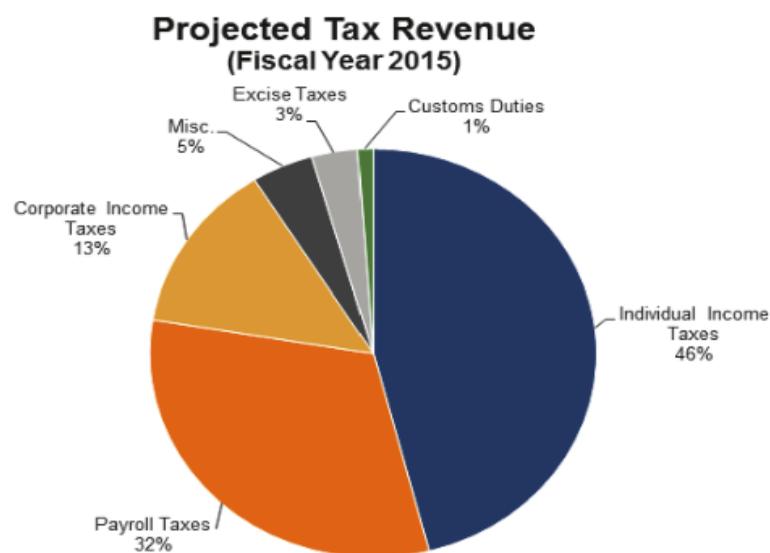
In the US, progressive taxes also include wealth taxes (inheritance, capital gains) and corporate income (profit) taxes. Those who support this approach argue that the more affluent should pay more. As just stated, the US income tax code is considered progressive, but less so than in the past due to fewer tax brackets and a lower tax rate on the top tax bracket.

- Regressive taxation is where the average tax rate decreases when income increases. An example of a regressive tax is the sales taxes on consumer goods and services. When people buy something and pay a sales tax, they may pay a tax rate of, say, 8%. That 8%, however, is 8% of the price of what they bought. So everyone pays that same 8% of the price. But 8% of the price of something will make up a different proportion of different incomes. In fact, 8% of the price of something will make up smaller and smaller proportions of larger and larger incomes. In other words, the average tax rate will decrease as income increases or, what amounts to the same thing, the average tax rate will increase as income decreases. The Social Security payroll tax is also regressive because there is a single rate for everyone and a cap on the amount of income that is subject to the tax.

When people's income rises above the cap, since income above that cap isn't subject to the tax, the amount they pay in the payroll tax makes up a smaller share of their income as their income increases. Those who support regressive taxation, when discussing the regressive nature of the sales tax, argue that people have a choice as to what they want to buy. Those who oppose regressive taxation argue that this method falls heavier on the poor.

- Proportional taxation is where the average tax rate is the same for all incomes, often called a flat tax. Those who support the flat tax argue that everyone should be treated equally. Those who oppose the flat tax say that like the regressive tax it falls heaviest on those with the lowest income. They also fear that it would be set at too low a level, below what is needed to raise sufficient government revenues.

The federal government draws its revenues from the various tax categories. As the following pie chart shows almost half of our tax dollars are based on regressive taxation.



Source: OMB
National Priorities Project

Fig. 7.1 Where Do Our Tax Dollars Come From?⁴

B. Spending. Government spending (also called expenditures or outlays) falls into two categories according to how Congress appropriates the money: discretionary and mandatory spending.

-Discretionary spending refers to the portion of the budget that goes through the annual appropriations process. Congress directly sets the level of spending on these programs. It can decide to increase or decrease this kind of spending in a given year. Thus spending on these programs becomes subject to budget politics. The discretionary budget is about one-third of total federal spending. Figure 7.2 indicates how discretionary spending was divided up for fiscal year 2015.

-Mandatory spending includes programs that Congress pays for based on pre-set eligibility or payment rules. Most of the major entitlement programs fall into this group so it is sometime referred to as the entitlement budget stream. The amount of money that Congress appropriates for the program is not based on annual budget politics. Instead it is automatically determined by estimates as to how many people will apply and become eligible for benefits. If Congress wants to adjust spending, it has to change the rules of eligibility or benefit levels. This kind of programmatic cutback is not taken lightly since the entitlement programs include Social Security, Medicare, SNAP (i.e. Food Stamps), and others used by large numbers of people. However, those in favor of smaller government keep trying to retrench these large programs. Mandatory spending makes up about two-thirds of the total federal budget. The following chart, Figure 7.2, shows the breakdown of different types of mandatory spending for 2015.

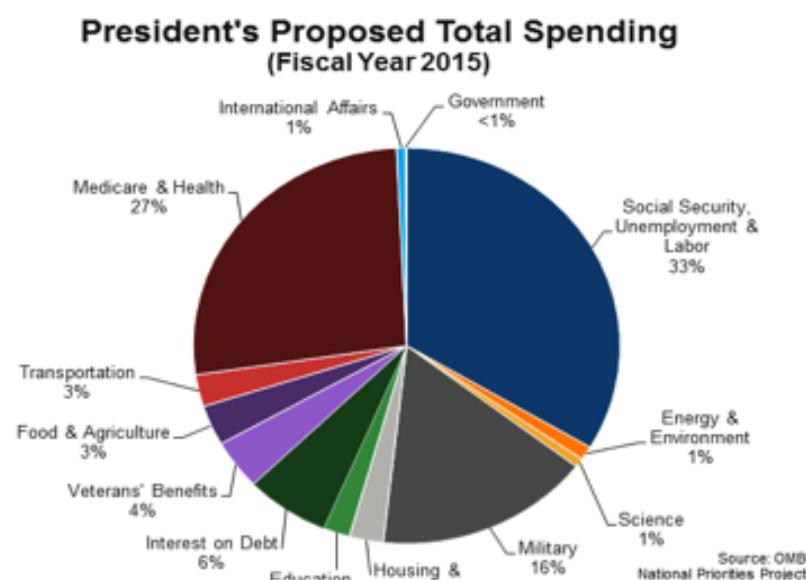


Fig. 7.2 Where Do Our Tax Dollars Go?⁵

Fiscal policy influences the economy in two basic ways. When the government wants to expand or stimulate the economy (to pull out of a recession), it uses expansionary fiscal policy. This injects more dollars into the market by increasing government spending and/or decreasing taxes. When the government wants to slow or cool off the economy or to limit inflation, it uses contractionary fiscal policy, which withdraws dollars from the market by decreasing government spending and/or increasing taxes.

B. Monetary Policy

Monetary Policy refers to the set of decisions a government makes, usually through its central bank, regarding the amount of money in circulation in the economy. In the United States, the central financial institution is the Federal Reserve System, popularly known as “the Fed”.⁶

1. The Goals of Monetary Policy. Monetary policy goals mirror fiscal policy goals. They include helping to promote high employment, economic growth, low inflation, limited unemployment and a sustainable pattern of international transactions. It can be difficult to reconcile the twin goals of maintaining price stability and maximizing employment.

2. The Money Supply. The Federal Reserve System defines “money” as the total of cash in circulation, the deposit liabilities of banks and thrifts (i.e. liquid assets owed to other people) and demand deposits (checking accounts held by individuals and banks) that are available for transactions and investment in the economy. The term “the money supply” implies that a certain amount or supply of money exists at any given time, even though the quantity may be unknown. (The Fed attempts to stabilize the economy by controlling the money supply.)

3. Monetary Policy Tools. The Fed has three tools to manipulate the money supply. They are the reserve requirement, open market operations, and the discount rate.

-The most powerful tool is the reserve requirement or the minimum percentage of its deposits a bank is not allowed to loan. For example, if the reserve requirement were ten percent, then a bank would have to keep at least ten percent of its deposits in its “coffers” in stead of loaning the money out. When the Fed lowers this amount, it requires all the member banks to keep less money at the bank. This increases the amount of money in circulation. When the Fed raises the reserve requirement, the member banks have to keep more money in-house. This means that there is less money in circulation. A bank may have to collect on loans in order to meet the new higher reserve requirement.⁷

Open market operations also control the overall money supply. It influences money and credit operations by buying and selling government securities on the open market. When interest rates are near zero and have not produced the desired economic stimulus, the Fed can increase the supply of money in circulation by purchasing financial instruments such as government bonds and corporate bonds from banks and other financial institutions. This gives the banks the funds needed to create new money that stimulates the economy. Some worry that this quantitative easing (see above) will lead to inflation. If the Fed believes there is too much money in the economy, it sells the securities back to the banks.⁸

-The discount or interest rate refers to the cost of borrowing money. When member banks want to raise money, they can borrow from Federal Reserve Banks. Just like other loans, they must pay the loan back with interest. The Fed can control the amount of borrowing

by raising and lowering the discount or interest rate.⁹ The Fed also controls another interest rate known as the federal funds rate or the interest rates charge to banks when they borrow from each other.

Like fiscal policy, monetary policy can work to expand or contract the economy. To pursue an expansive monetary policy, the Fed can add reserves to the banking system, which stimulates the growth of the money supply, making it easier for member banks to make more loans. It can also stimulate the economy by buying government securities on the open market, putting more money into circulation and lowering interest rates making it less expensive for businesses and consumers to borrow money which they then spend. To contract or “cool off” the economy, the Fed can require banks to keep more cash on reserve and to raise the interest rates.

Policy Debate: The Public Option in Health Care Reform¹⁰

The battle over the inclusion of “the public option” in the health care reform legislation enacted in early 2010, resulting in the Affordable Care Act, reflected this debate over the use of fiscal policy. The public option (sometimes called the single payer plan) would have operated like the Medicare program for seniors or the Veteran Administration’s (VA) for veterans and allowed people to buy government-provided health insurance.

-Proponents of the public option argued that a government-run insurance program would be less expensive because it would eliminate the need to build the cost of advertising and profits into the price of the premium, incur fewer administrative expenses, exercise its massive bargaining power to secure a better deal from both insurance and drug companies, and lead private insurers to lower their premiums for the same package of benefits if they wanted to compete for customers.

-Opponents of the public option, including private health insurers and drug companies, countered that the low-cost of the public option and the government’s negotiating power would put them out of business. They argued that they could not afford to sustain their levels of service or keep paying their investors. They also feared that many people would flock to the public option, resulting in the US having a single payer system in which health care is paid for by one entity, the government. Some doctors also opposed the public option saying its lower reimbursements would lead them to reject patients. Those who generally objected to government programs also lobbied against the public option. While public option was eventually dropped from the bill as a political compromise, some experts believe that it will eventually become part of the payment system.

For Discussion:

The following videos argue for and against an active role for the government in the economy.

Your View of the Government

Interactive Quiz (2011) 20 Questions on Proper Role of Government (for survey scroll down)
<http://www.wnyc.org/articles/its-free-country/2011/feb/28/rolegovernment-poll>

Opposed to Active Government Role (social welfare in particular)¹¹ Milton Friedman (well-known free market economist and welfare-state critic) From Cradle to Grave <http://www.youtube.com/watch?v=VWliEiLeqRA>

Panel of Experts Respond to Friedman's Views

<http://www.youtube.com/watch?v=4FjjDtBhweM&feature=related>

Support Active Government Role

The Role of Government in the Economy (YouTube) (2.5 min)
<http://www.youtube.com/watch?v=sSwmiGPbiaU>

President Obama on the role of government

(Speech) (You Tube: 3.50 min)
<https://www.youtube.com/watch?v=yMeLcBcAnmM>

1. To what extent do you agree or disagree with the different views?
2. What values about money influence your views?
3. What professional values influence your views?
4. State your perspective with consideration to the impact of government social welfare policies on the lives of individuals you know and communities with whom you are familiar. How would you argue for your position?

NOTES

UNIT SEVEN

1. Fisher Louis (2004) Major Acts of Congress, Employment Act of 1946. Retrieved from http://www.encyclopedia.com/topic/Employment_Act_of_1946.aspx <https://www.nationalpriorities.org/budget-basics/federal-budget-101/spending/>
2. Fiscal Policy (n.d) Fiscal Policy. Retrieved from <http://www.businessdictionary.com/definition/fiscal-policy.html>
3. Abramovitz, Mimi & Sandra Morgan (2006) Taxes Are A Women's Issue: Reframing the Debate. New York, NY: The Feminist Press.
4. National Priorities Project -Federal Budget 101, Charts Projected Federal Revenues by Source, FY 2015, (n.d.) Retrieved from <https://static.nationalpriorities.org/images/fb101/2014/projected-tax-revenue.png>
5. National Priorities Project (n.d). Federal Budget 101. Charts. Proposed Total Spending FY2015 Retrieved from: <https://www.nationalpriorities.org/budget-basics/federal-budget-101/spending/>
6. Federal Reserve System (n.d.) Monetary Policy. Retrieved from <http://www.federalreserve.gov/monetarypolicy/fomc.htm>
7. Federal Reserve System (n.d.) Reserve Requirement. Retrieved from <http://www.federalreserve.gov/monetarypolicy/reservereq.htm>; Business Dictionary (n.d.) Reserve Requirements. Retrieved from: <http://www.businessdictionary.com/definition/reserve-requirements.html>
8. Federal Reserve System (n.d.) Open Market Operations. Retrieved from <http://www.federalreserve.gov/monetarypolicy/openmarket.htm>; Business Dictionary (n.d.) Open Market Operations. Retrieved from <http://www.businessdictionary.com/definition/open-market-operations.html>; Business Insider (n.d.) What is Quantitative Easing. Retrieved from <http://www.businessinsider.com/what-is-quantitative-easing-2010-8>.
9. Federal Reserve System (n.d.) Discount Rate. Retrieved from: <http://www.federalreserve.gov/monetarypolicy/discountrate.html>
10. Procon.org (n.d.) The Right to Health Care: Should All Americans Have the Right to Health care? Retrieved from: <http://healthcare.procon.org/>
11. Friedman, Milton. [Speaker] (2010, May 23) From Cradle to Grave [1/7]. Milton Friedman's Free to Choose (1980). [Lecture] <http://www.youtube.com/watch?v=VWliEiLeqRA>.