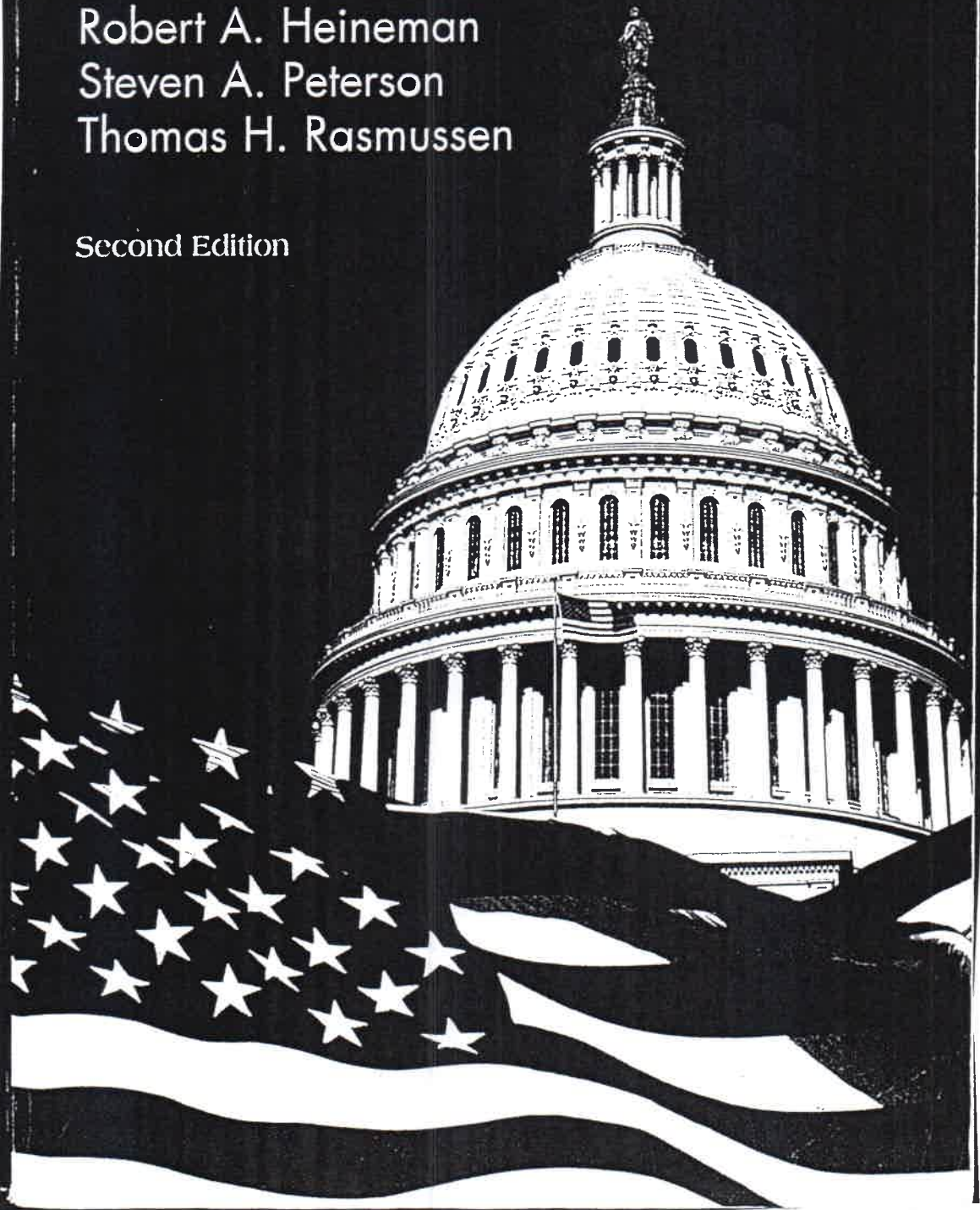


American Government

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Second Edition



process for each? Third, what view of “who has power” seems to work best in understanding the decisions actually reached?

Recommended Reading

- James Anderson: *Public Policymaking: An Introduction*, 2d ed., Houghton Mifflin, New York, 1993.
- John W. Kingdon: *Agendas, Alternatives, and Public Policies*, Little, Brown, Boston, 1984.
- Janet M. Martin: *Lessons from the Hill*, St. Martin’s, New York, 1994.
- B. Guy Peters: *American Public Policy*, 3d ed., Chatham House, Chatham, N.J., 1993.
- Paul E. Peterson: *City Limits*, University of Chicago Press, Chicago, 1981.
- Randall B. Ripley and Grace A. Franklin: *Policy Implementation and Bureaucracy*, 2d ed., Dorsey, Chicago, 1986.

CHAPTER 13

Economic Policy

Time Line

- 1776 In *The Wealth of Nations*, Adam Smith argues that governments should not interfere with the natural workings of the economy
- 1890s Abuses of corporate power lead to calls for some government regulation
- 1936 In *The General Theory of Employment, Interest and Money*, John Maynard Keynes explains how governments can use fiscal and monetary policy to prevent depression or inflationary price increases
- 1973–1980 Rising petroleum prices trigger a period of high unemployment and high inflation
- 1983–1994 Large budget and trade deficits, low levels of saving and investment, intensified global competition, and emergence of a twin-tier economy of high- and low-wage jobs pose difficult economic challenges

A major responsibility of government today is to promote steady economic growth, low unemployment, and stable prices. How can we attain these laudable goals? This chapter describes four policy perspectives (laissez-faire, fiscal, monetary, and supply-side) which recommend how government can best pursue these economic goals. It also assesses recent economic performance, describes key institutions which make economic policy, and discusses budgetary issues in an era of \$200 billion deficits. Since government taxing and spending account for one-fourth of our gross national product, the budgetary process inevitably shapes our economy.

The Politics of Economic Policy

Americans produce and exchange a multitude of goods and services, and government is part of this economic activity. Government builds highways, educates our children, and disposes of our waste products. Government regulates economic activity, preventing monopoly pricing, insider stock trading, careless dumping of solid waste, and packaging of unwholesome food. Government enacts food stamp and medical care programs, builds military weapons, and taxes tobacco and gasoline. These spending and taxing decisions affect where people work and what they produce. Government manipulates the strength of our currency, which affects how much grain American farmers can export and how many Japanese and South Korean textiles we import. Government uses its taxing, spending, and money-printing powers to counter soaring unemployment or rising prices.

The fortunes of every American citizen are profoundly affected by governmental economic policy-making. Every time government makes a decision, some people win and others lose. The resulting conflicts are the very stuff of politics. Consider the following examples:

1. Government must manage the economy, and policy decisions affect rates of unemployment and inflation. In the early 1980s, the Reagan administration chose to control inflation at the cost of higher unemployment. This decision helped retirees on fixed incomes and workers in no danger of being laid off, while hourly workers lost.
2. Government regulatory decisions improve living conditions for some while raising costs for others. Environmental regulations improve the quality of our air and water at the expense of polluting factories and their customers. Regulation of workplace conditions and consumer product safety imposes costs on producers for the benefit of workers and consumers.

3. Some people pay more in taxes than do others. The 1981 tax reform law cut taxes for corporations and wealthy individuals, while higher social security taxes came out of worker paychecks. The Deficit Reduction Act of 1993 cut the federal deficit by \$500 billion over 5 years by raising taxes on incomes of wealthy individuals and on gasoline and tobacco sales.

4. Citizens benefit heavily from particular government spending programs and support these programs. Farmers receive crop subsidies, veterans are entitled to education and health care benefits, and students enjoy low-interest loans. The interest groups which represent farmers, veterans, and students and universities fight to retain these programs because group members alone benefit while all taxpayers share in the cost. Representatives and senators fight to keep military bases in their districts or states, get urban development grants for their cities, and win government contracts for local factories. Government spending creeps upward over time because voters, interest groups, and elected politicians fight hard to keep programs beneficial to their parochial interests. And other taxpayers pick up the tab.

5. Government policies affect the broad distribution of income. Indexing social security payments to changes in the cost of living in the late 1970s helped today's retirees at the expense of tomorrow's workers. President Reagan's budget cuts in 1981 and 1982 hit particularly hard at food stamp, housing subsidy, and other programs that supplement the incomes of poor people. Legislation to protect jobs in textile, shoe, and automobile manufacturing from foreign competition help particular industries at the expense of consumers denied low-cost, high-quality imports.

Managing the Economy: Four Perspectives

Over the 200-year history of our republic, people have tended to move from farm to city, and the average standard of living has risen. However, if economic growth has made material prosperity possible, change in a dynamic economy also imposes great hardship. Events such as the devastating Great Depression of the 1930s, high rates of unemployment and inflation in the 1970s, massive budget deficits in the 1980s, and the swelling tide of imports manufactured in Japan, South Korea, China and Brazil have forced economic policymakers to continually rethink what government policy actions will best help the American economy.

There are four main perspectives on how government can best promote a growing economy with stable prices, low unemployment, and rising standards of living:

Laissez-faire policy. The government should keep its hands off the economy, allowing price changes to determine what the economy produces and where people work.

Keynesian fiscal policy. The government should make taxing and spending decisions to promote full employment.

Monetary policy. The government should increase or decrease the supply of money to promote stable prices.

Supply-side policy. The government should lower tax rates to encourage more savings and investment in high productivity.²

Laissez-Faire Policy

We saw in Chapter 1 that advocates of laissez-faire dominated eighteenth- and nineteenth-century economic policy. Liberals believed that the interests of society would be best served if individuals were allowed to pursue their own self-interest. Price changes in markets would signal changes in relative supply and demand of labor, capital, and raw materials. Free market exchanges between buyers and sellers would allocate scarce resources efficiently, contributing to the prosperity of society as a whole. So Adam Smith argued in *The Wealth of Nations*, an influential book published in 1776. Advocates of laissez-faire were reacting against the economic policies of kings, who sold exclusive economic rights to court favorites and used economic activity to foster state power rather than to provide for the people's material needs.

Support for laissez-faire as economic policy began to fade in the late nineteenth century when critics charged that great concentrations of wealth and power under laissez-faire industrial capitalism did not serve the people well. For example, factory owners could hire women and children to work long hours in poor conditions for little pay. And capitalism was vulnerable to periodic depressions. Major depressions in 1893 and 1929 threw people out of work, disrupted lives, and eroded support for a political system seemingly unable to stabilize the economy.

Laissez-faire is still relevant today. In the 1980s, President Reagan charged that big government stifled the economy. In his view, the clumsy efforts of the government in Washington to solve problems for people had failed miserably and expensively. The federal government should tax and spend less, reduce government regulation of industry, and cease redistributing wealth through government programs. Republicans pledged to promote these ideas after they won control of the House of Representatives and the Senate in the November 1994 elections.

The process of transferring responsibility for providing services to private firms is called privatization. Privatization is a contemporary example of laissez-faire economic policy at work.³ It assumes that private firms can provide some

services better and at less cost than government. For example, Conrail, the once federally owned railroad, has been sold to private buyers. Reformers suggest that parents should be allowed to choose between paying tax dollars to support their public schools and paying tuition at private schools.

Advocates of laissez-faire policy prefer that citizens purchase goods and services from privately owned firms rather than pay government to provide services with tax dollars. However, Table 13.1, which compares the role of government in advanced industrial democracies, shows that Americans do not rely heavily on government to provide goods and services. In Western Europe, social welfare programs such as subsidized medical care and unemployment benefits are funded at more generous levels than in the United States. Governments in European democracies are more committed to providing day care for the children of working parents, free schooling, free health care, unemployment insurance, a retirement income, and other social welfare benefits. Their citizens have demanded that government provide strong social welfare and income security programs.

Keynesian Fiscal Policy

The idea that government can stimulate or dampen the level of economic activity by adjusting its taxing and spending policies developed in response to capitalism's periodic depressions. John Maynard Keynes published *The General Theory of Employment, Interest and Money* in 1936, in the depth of the Great Depression, when one-fourth of the labor force was out of work and the production of goods and services had fallen sharply. Keynes and his followers addressed the problem of reversing the slide into deeper and deeper

Table 13.1 Tax Burdens in Ten Industrial Countries

Country	Tax Revenues as a Percentage of Gross Domestic Product
Sweden	57%
Norway	48%
Netherlands	48%
France	45%
Ireland	40%
United Kingdom	38%
Italy	36%
Canada	34%
Japan	30%
United States	30%

Source: Statistical Abstract of the United States 1990, p. 845.

depression. When the demand for goods and services slipped, workers were laid off, causing a further reduction in demand for goods and services and leading to even more unemployment. Once the economy started down the slope of economic decline, modest recession accelerated to deep depression.

Keynes proposed that government adjust its taxing and spending practices in light of economic conditions. When private-sector demand declined, government could stimulate demand for goods and services by spending more than it collected in taxes. That is, government would deliberately run a deficit, with the amount of the deficit being a net addition to the demand for goods and services in the economy. Government would be hiring more people, buying more paper clips, building more tanks, and making larger social security payments.

What happens when the economy rights itself? Then factories are busy, unemployment is low, and industries are able to raise their prices. Inflation, a general increase in the price of goods and services, is now the problem. Government could cool the fires of inflation by running a budget surplus, taking in more taxes than it spent on government programs.

Keynesian fiscal policy prescribes balancing the budget when levels of inflation and unemployment are normal, running a budget deficit to stimulate demand when unemployment and recession loom, and accumulating a budget surplus when prices begin to rise in a fully employed economy. Over the full economic cycle, the budget is balanced, but in any given year, government runs either a deficit or a surplus to counter recession or inflationary trends in the private economy.

For 50 years, fiscal policy has been a well-established tool for managing the economy to prevent depression. In the late 1930s, large government deficits incurred for rearmament ended the Great Depression. In 1963, the Kennedy-Johnson tax cut successfully headed off recession and made possible another five years of economic expansion with stable prices. In the mid-1980s, a series of \$200 billion budget deficits pulled the economy out of recession.

However, fiscal policy is less useful for managing the economy in the 1990s. Projected annual deficits of \$300 billion in the 1990s impose a growing debt burden on the economy, drive up interest rates, and slow long-term economic growth. That is why President Bill Clinton made deficit reduction his first order of business in 1993. But many experts feared that taking money out of the weak economy (as deficit reduction would do) invited renewed recession.

Keynesian fiscal policy has not been used to combat inflation. To do so, the government would have to tax more than it spent, running a budget sur-

plus and weakening demand. Since 1960, the budget has been balanced only once, and no one expects a balanced budget any time in the 1990s. The reason is political. Both spending cuts and tax hikes are required for government to generate a budget surplus which would dampen economic activity. The president, Congress, and the people who elect them are reluctant to cut valued spending programs or raise taxes.⁴

Monetary Policy

The intellectual father of the idea that monetary policy can combat inflation effectively is Nobel prizewinning economist Milton Friedman.⁵ Monetary policy regulates interest rates, which are the cost of borrowing money, by increasing or decreasing the supply of money. The Federal Reserve Board, known as the Fed, determines how much money will be available for lending. If the Fed increases the supply of money, interest rates tend to fall. If the Fed decreases the supply of money, interest rates tend to rise. Why? Because banks charge as much as possible on their loans. If the money supply is low, only those borrowers willing to pay a high interest rate will receive loans. If banks have a great deal of money available, they lower their rates to attract additional borrowers.

How can government use monetary policy to regulate the economy? If interest rates go up, the level of economic activity tends to decline. Consumers willing to borrow money to buy a new car at an interest rate of 8 percent are likely to keep their old car on the road for one more year if the rate rises to 12 percent. A young couple who can afford to buy a home if the money to be borrowed costs 8 percent might not be able to afford the monthly mortgage payment if the loan rate rises to 12 percent. In that case, the couple will remain in their small apartment. The factory owner may build a more modern building or invest in more productive equipment at a 6 percent interest rate, but not at 10 percent. Therefore, if the government wishes to combat rapid economic growth and rising prices, it raises the interest rate to discourage borrowing.

In the 1970s, large budget deficits and escalating energy prices caused inflationary price increases. The Reagan administration used monetary policy to combat inflation by keeping interest rates high, at a cost of slower economic growth and higher unemployment.⁶ The architect of inflation-fighting monetary policy was Paul Volcker, powerful chairman of the Fed from 1979 to 1987. High interest rates attracted a flood of Japanese and European investment. The dollar strengthened relative to other currencies, making Japanese cars, South Korean steel, and Brazilian shoes cheaper in the United States and making American exports more costly to foreign buyers.

To illustrate, let's say that it costs Toyota 1.4 million yen to produce a small car and transport it to America. At an exchange rate of 100 yen to the dollar, the cost of that car in America is \$14,000 (1,400,000 yen divided by 100 yen to the dollar). As the dollar strengthens to 140 yen, because Japanese buy dollars to invest in high-interest-yielding American bonds, that car now costs the American buyer \$10,000. The price has fallen by \$4,000 just because of the exchange rate. The inflation rate plummets because American consumers buy Japanese automobiles, South Korean textiles, and Brazilian shoes at lower prices.

What happens to American producers? As the dollar strengthens, American exports fall. Let's say it costs the American farmer \$4 to sell a bushel of grain in Japan. At 140 yen to the dollar, the cost to the Japanese consumer rises from 400 to 560 yen. Farmers in Australia or Canada can now undersell the American farmer. Similarly, a strong dollar means that John Deere cannot sell farm machinery and Proctor & Gamble cannot sell soap overseas. Inflation declines because Americans can buy foreign-made products cheaply. But unemployment rises in automobile, textile, and other industries because Americans buy foreign-made products and American firms cannot compete overseas.

America's growing trade imbalance in the early 1980s was in large part due to the strong dollar, and the dollar was strong due to our monetary policy, which kept interest rates high. Asian and European investors were eager to invest their funds in high-yield American corporate stocks and government bonds.

The strong dollar was not the only reason for America's large trade deficit in the early 1980s. Labor costs were lower in Brazil and South Korea, although not in Japan. Moreover, our Asian competitors used the most modern equipment and sophisticated management techniques, which enabled them to make high-quality products at low cost. But two-thirds of the deterioration in the balance of trade was due to the federal government's high-interest-rate policy during the early 1980s, which strengthened the dollar in international trading.⁷

In the late 1980s, the trade deficit remained large despite a stronger dollar and lower labor costs in manufacturing. Continued weakness in the economies of our major trading partners reduced their demand for American exports.⁸

In the early 1990s, Volcker's successor as chairman of the Fed, Alan Greenspan, continued to restrain inflation by limiting the supply of money. This policy did bring down the rate of inflation to a historic low of 3 percent, but at the cost of a sluggish 2 percent economic growth and a high 7.5 percent unemployment rate. As economic growth fell to zero in 1991–1992 and the 1992 presidential election approached, the Fed lowered interest rates to stimulate the lagging economy. But unemployment peaked in early 1992, and continued economic weakness cost President Bush his job in the November 1992 election.

Supply-Side Policy

Supply-side policy promotes lower tax rates to encourage citizens to save more and to invest their savings in high productivity. In relying heavily on private initiative to generate strong economic growth, supply-side policy is a close relative of *laissez-faire* policy. Supply-side policy gained a following during the 1980s when it became apparent that America had lost much of its competitive edge in global manufacturing and trade. Consumption was rising faster than productivity, causing inflationary price increases. Individual Americans saved a paltry 4 percent of their income, while the savings rate of our Japanese and South Korean competitors approached 25 percent.⁹

Supply-side advocates within the Reagan administration argued that high tax rates were stifling the incentive of our most highly paid and potentially most productive workers. If we lowered tax rates, people would save and invest more and work harder. The economy's rate of growth would accelerate, and the additional tax revenues would more than offset the cost of the initial tax reduction. The benefits of an expanding economy would "trickle down" to low-income earners in the form of more jobs and higher wages.¹⁰

President Reagan's Economic Recovery Tax Act of 1981 was inspired by supply-side thinking within his administration. Most of the cuts benefited higher-income taxpayers, who tend to save more than do low-wage taxpayers. Also in the supply-side spirit, President Bush championed an investment tax credit to encourage capital formation. But Democrats in Congress dismissed his proposal as another Republican tax giveaway to the rich.

By the early 1990s, most economists doubted that the 1981 supply-side tax cut had had much positive impact on productivity. Six years of modest, recession-free economic growth lasting through 1988 were followed by four years of economic stagnation. America's low national savings rate remained low.

Economic Policy-Making Institutions

After the bitter experience of the Great Depression, most Americans became convinced that the federal government should manage the economy to promote steady economic growth, low unemployment, and stable prices. Several institutions share economic policy-making responsibilities.

Council of Economic Advisers

The Employment Act of 1946 specifically charged the president to pursue its economic goals. To help the president, Congress created the Council of Economic Advisers (CEA). CEA members are appointed by the president.

They prepare an annual report on the state of the economy and advise the president on economic policies. CEA members are professional economists whose first loyalty is often to their profession, not to the president who appointed them. While economic policymakers read CEA analyses and recommendations with great interest, the chairperson of the CEA is often not a part of the inner circle of people who meet with the president to decide economic policy. The CEA is an advisory, not a policy-making, institution.

Office of Management and Budget

The Office of Management and Budget (OMB) is crucial to the president's efforts to manage the economy through spending policy. With a staff of 600, the OMB is one of the most powerful agencies in government. Each spring, the OMB's director meets with the president to discuss the economic situation and spending priorities. The OMB then sends guidelines to every government department, assembles preliminary budget requests, and drafts the official budget which the president presents to Congress in February. Agencies tend to request the dollars they need to do their jobs well, which is usually more dollars than are available. The OMB decides how much money each agency will receive in the budget, placing the OMB at the center of intense political activity.¹¹

The director of the OMB is powerful because he or she meets regularly with the president to set budget priorities and to evaluate whether individual agency requests are consistent with those priorities. Recent Republican presidents have also used the OMB to prevent government agencies from imposing costly regulations on business.

The Treasury Department

The Treasury Department employs tax experts and bankers who advise the president on taxation and monetary policy. The secretary of the treasury is usually a close confidant of the president, appointed by the president and sensitive to the president's political needs. During the Bush administration, Secretary of the Treasury Nicholas Brady and OMB director Richard Darman had bitter disagreements over control of economic policy-making. Their conflict prevented the administration from responding in timely fashion to slow economic growth in 1990–1991.¹²

The Federal Reserve Board

The Federal Reserve Board, known as the Fed, is America's central bank. The Fed controls the money supply through three kinds of activities.

1. The Fed establishes reserve requirements, the amount of money banks must keep on deposit in the central bank. The higher the reserve requirements, the less money the local bank can loan to potential customers.
2. The Fed also sets a discount rate, which is the interest rate banks must pay to borrow money from the federal reserve system. The higher the discount rate, the higher the interest rate banks must charge their borrowers.
3. The Fed buys and sells government securities. When it sells government securities, the money received from the buyer is removed from the economy. Because the supply of money is reduced, interest rates tend to rise. When the Fed buys government securities, money is put into the economy and interest rates tend to fall.

The Fed's seven members are appointed by the president for 14-year terms, while the chairperson serves a 4-year term that overlaps the president's. This appointment pattern gives the Fed considerable autonomy and provides a check on a president who might pursue unsound policies for short-term political advantage. The current president never appoints a majority of the Fed's seven members, and even a president who disapproves of the Fed's monetary policy cannot fire its members.

Presidents sometimes do disapprove of Fed policy. The Fed is an institution of bankers who are more sensitive to the dangers of inflation than to problems of slow economic growth and falling incomes.¹³ Presidents are more responsive to the concerns of voters who cannot pay their bills when a shortened work week shrinks their paychecks. In recent years, Presidents Reagan, Bush, and Clinton have attempted to persuade the Fed to lower interest rates. Since the mid-1980s, Fed chairmen Paul Volcker and Alan Greenspan have tended to follow a tight money policy to further reduce the rate of inflation.

Recent Economic Performance: An Evaluation

How well have these institutions promoted steady economic growth with low inflation and low unemployment? Table 13.2 summarizes some important measures of economic performance since 1977.

Under President Reagan

During the 1980 presidential campaign, candidate Ronald Reagan effectively exploited the poor economic performance of President Carter's last two years. Escalating energy prices and high food prices after crop failures in the Soviet Union caused inflationary price increases. High unemployment re-

Table 13.2 Economic Performance, 1977-1992

Year	Real Economic Growth Rate (%)	Unemployment Rate (%)	Inflation Rate (%)
1977	5.1	7.1	6.5
1978	4.8	6.1	7.6
1979	2.0	5.8	11.3
1980	-1.6	7.1	13.5
1981	2.0	7.6	10.3
1982	-1.4	9.7	6.2
1983	5.2	9.6	3.2
1984	7.8	7.5	4.3
1985	3.6	7.2	3.6
1986	3.0	7.0	1.9
1987	2.7	6.2	3.6
1988	3.0	5.5	4.1
1989	1.8	5.3	4.8
1990	0.4	5.5	5.4
1991	-1.8	6.7	4.2
1992	2.6	7.4	3.0
1993	2.9	6.8	2.6

Source: *Economic Report to the President January 1994*, pp. 351, 390, 415. Washington, D. C., US Government Printing Office, 1994.

flected expansion of the labor force. More women were entering the labor force in the 1970s, and the baby boom generation born during the 1950s was reaching adulthood in the late 1970s. By 1980, young adults competed fiercely for jobs in a depressed economy. November 1980 was a bad time to be running for reelection, and the American people turned away from Jimmy Carter, handing Ronald Reagan a landslide victory.

President Reagan's economic policy sought to defeat unemployment by creating a combination of supply-side policy (cutting income tax rates in the hope of stimulating investment in high productivity) and fiscal policy (running an economy-stimulating deficit in the federal budget). Reagan and the Fed tackled inflation by driving up interest rates, which discouraged consumer spending on such big-ticket items as cars and houses, discouraged business from investing in new plant and equipment, and strengthened the dollar (which lowered the price of imported goods).

These policies were not particularly consistent. They did squeeze the inflation out of the American economy, with help from falling oil prices (which declined from \$34 per barrel in 1980 to \$14 in 1984) and a flood of high-quality, low-priced foreign imports. However, the cost of defeating inflation was

recession and high unemployment. The jobless rate rose in 1982-1983 to the highest levels since the Great Depression; the collapse of oil prices shattered the economies of Texas, Oklahoma, and other oil-producing states; the loss of export markets because of the strong dollar depressed farm state economies; and many industrial states lost jobs to heavy imports of cars, steel, textiles, and shoes. By 1983, inflation and unemployment levels were showing improvement, although at the cost of large budget deficits and a stubborn trade deficit.

Reagan was reelected in 1984 by a huge majority, in part because economic performance, weak in the first two years, was strong in the second half of his term. In politics, timing is everything. Voters tend to think that recent experience is the best guide to the future. One study demonstrates that each 1 percent increase in disposable personal income yields a 2.5 percent net increase in the two-party vote received by the incumbent party's candidate.¹⁴

Under President Bush

A strong economy contributed heavily to George Bush's victory in 1988. President Bush supported the Fed's effort to tighten monetary policy, hoping to slow the rate of inflation without slowing the economy. As Table 13.2 shows, the effort was not successful. Unemployment rose to 7.4 percent in 1992 and the economy grew at an anemic 2.6 percent rate. Should the federal government have pursued a more expansionary fiscal or monetary policy to stimulate the economy during 1990 and 1991? President Bush's own CEA, with the benefit of hindsight, thought a more expansionary policy would have stimulated economic growth without setting the fires of inflation ablaze.¹⁵ As the 1992 election approached, the Fed eased interest rates to stimulate the lagging economy. But poor economic performance cost George Bush his job.

Several factors contributed to the economic weakness which plagued George Bush's presidency. First, European and Asian states were hit by recession, meaning that our largest trading partners were buying fewer goods. Second, cuts in military spending hurt communities where bases were closed or military suppliers lost orders. Third, construction was slow because of the glut of commercial real estate built during the 1980s. Fourth, low birth rates in the late 1960s meant that fewer young families were forming households, building homes, and buying appliances.¹⁶

Under President Clinton

When Bill Clinton took office, ever higher budget deficits were projected. Slow economic growth hurt revenues. And most spending occurred in rela-

tively uncontrollable categories such as social security, Medicare and Medicaid, and interest payments on the national debt. Clinton sponsored his Deficit Reduction Act of 1993 in one more attempt to bring the federal deficit under control. Clinton's deficit reduction plan raised taxes more than it cut spending. The tax increases targeted small businesses and wealthy individuals. The plan was painful, as indicated by single-vote margins of victory in the House and the Senate in August 1993.

The danger in Clinton's plan was that removing \$100 billion per year from the economy might slow economic recovery. Also, higher taxes on job-creating small business might inhibit economic recovery. But Clinton's gamble was that deficit reduction would keep interest rates low, stimulating factory owners to invest in new plants and encouraging consumers to build houses and buy automobiles.

Can Government Manage the Economy?

Can policymakers manage the economy? They can in the sense that we now know how to use fiscal and monetary policy to cool off an inflationary economy or to stimulate a sluggish, high-unemployment economy. The stock market crash of 1929 deepened into the Great Depression of the 1930s largely because the United States and Western European governments followed precisely the wrong fiscal and monetary policies. Had governments stimulated demand by spending more than they collected in taxes and lowering interest rates, economies would have righted themselves much more quickly. These principles are now well understood, and a deep depression triggered by inadequate demand is not likely.

The sheer size of government spending also serves to stabilize the economy. The federal government spends about 23 percent of the gross national product. Nearly half that spending consists of the government writing checks to individuals (social security, Medicare and Medicaid, income maintenance, veterans benefits); most of this money goes to immediate purchase of goods and services.

However, our ability to use fiscal and monetary policy to stabilize the economy is limited. First, institutional fragmentation restricts coordination of policy. The president's chief economic advisers have different backgrounds and different organizational perspectives, and they may disagree on priorities. Should government policy emphasize high employment or stable prices? Once priorities are set, the president's advisers may disagree on how best to achieve them.

Second, we live in an economically interdependent world. American, Japanese, and German governments cannot easily coordinate fiscal and mon-

etary policies because each government is inclined to put the interests of its own people first. The United States argued, for example, that Germany and Japan should stimulate their economies so that Germans and Japanese would buy more American goods and reduce the American trade deficit. The long-term health of the world economy requires that the American trade deficit shrink, but our trading partners are reluctant to risk higher rates of inflation by stimulating their economies and to risk higher unemployment by importing more goods and exporting less.¹⁷

The oil supply disruptions of the 1970s also remind us that confrontations in the Middle East (and other regional hot spots) may have economic consequences that are beyond the control of economic policymakers. In 1973, the price of oil climbed from \$3 to \$18 per barrel as members of the Organization of Oil Exporting Countries (OPEC) curtailed the supply to gasoline-hungry Americans. After several years of price relief, oil supplies were curtailed again following the outbreak of the Iran-Iraq war in 1979. Prices climbed again, this time to \$34 per barrel. Higher energy prices led to inflationary price increases in everything that Americans buy. Inflation contributed heavily to Jimmy Carter's election defeat in 1980.

Finally, efforts to manage the economy must take political priorities into account. Do we wish to hold down inflationary price increases or the unemployment rate? Do we wish to protect jobs in industries hard hit by foreign competition or allow consumers to benefit from low-priced, high-quality imports? These questions are political, and political questions must be answered before we know what fiscal and monetary policies are appropriate. As we saw in Chapter 8, members of Congress tend to be responsive to the parochial interests of their constituents back home. Elected officials may try to stimulate the economy immediately before elections to reduce unemployment and curry favor with voters.¹⁸ But fine-tuning a complex economy is difficult.

The Budgetary Process

Taxing, Spending, and Income Distribution

The budgetary process is an important political battlefield where participants clash over the distribution of wealth and income. Some argue that government should use taxing and spending policy to temper extremes of wealth and poverty, while others are disinclined to tamper with the natural result of differences in talent. To what extent do taxation and social spending serve to narrow the gap between the rich and poor?

The federal income tax code, developed since the enactment of the Sixteenth Amendment in 1913, is mildly progressive, which means that high-

income earners are taxed at a higher rate than are low-income earners. Households earning \$20,000 may pay 5 percent of their income in federal income tax, whereas households earning \$60,000 may pay 15 percent. With social security, state sales taxes, and alcohol and tobacco taxes, however, it's the other way around; low-income households pay a higher percentage of their income on these regressive taxes than do upper-income households. When all taxes are taken into account, most Americans pay about 25 percent of their income in taxes, with poor families paying a few percentage points less.¹⁹

Government also redistributes income to poor people through transfer payments, which are checks written to individuals for social security, food stamps, housing subsidies, unemployment insurance, and medical payments. In 1966, President Lyndon B. Johnson's Great Society programs increased transfer payments to the poor, and typically about 40 percent of federal social welfare spending goes to poor people. Table 13.3 shows the distribution of family incomes after the mildly progressive effects of taxation and social service transfer payments are taken into account.

The poorest 20 percent of Americans receive about 5 percent of total family income, whereas the richest 20 percent receive 44 percent of total income. Since 1982, income growth after taxes has been concentrated in the wealthiest 20 percent of American households; the income of the poorest 20 percent has actually declined.²⁰

The Politics of the Budgetary Process

The budgetary process generates intense political conflict because it asks questions about our priorities. At what levels should the government tax and spend? How should dollars be divided among various spending categories?²¹

Table 13.3 Distribution of Family Income, After Taxes and Transfers, 1966 and 1989

Income Percentile	Year	Year
	1966	1989
Lowest 20%	4.3%	5.0%
Second 20%	10.3%	10.9%
Third 20%	16.4%	16.5%
Fourth 20%	23.3%	23.4%
Highest 20%	45.7%	44.1%

Source: Joseph A. Pechman, *Who Paid the Taxes, 1966–1985?*, Brookings Institution, Washington, D.C., 1989; Bureau of the Census, "Measuring the Effect of Benefits and Taxes on Income and Poverty," *Current Population Reports*, September 1990.

Every government program has its articulate defenders among the agencies which spend the money and the people who benefit from the programs. Bureaucrats in the Department of Agriculture know that the services they provide for the nation's farmers are valuable, and the department has much support among farm groups and the general public in farm states. The employees of the Consumer Product Safety Commission are committed to protecting consumers from the hazard of poorly designed or badly manufactured products, and their activities are supported by organized consumer groups.

Agencies and their supporters commonly seek to maintain or increase their share of the governmental pie. Their political maneuvering is complex because budgetary responsibility is divided between the president and Congress. The president, through the OMB, proposes a budget, but Congress has the power to authorize spending programs, appropriate funds, and set tax rates. Table 13.4 compares patterns of federal spending in selected years since 1970.

Military Spending

In the early 1970s, the U.S. government cut back on military spending. Relations with the Soviet Union were improving, and the Vietnam war ended. By the late 1970s, it was clear that the Soviet Union was increasing its military spending and that America's historic military superiority diminished. President Carter increased military spending in 1979 and 1980, and President Reagan resolved that even more dramatic military spending increases were needed if America was to protect the world from the expansionist aims of the "evil empire," as he referred to the Soviet Union.

Following the collapse of the Soviet Union in 1991 (see Chapter 15), military spending was cut sharply. Military strategy in 1994 assumes that the United States must have the capacity to respond quickly and decisively to two regional crises at the same time. So long as the United States wishes to be able to respond militarily to simultaneous challenges, few additional cuts in military spending are possible.

Entitlement Payments to Individuals

Payments to individuals have grown steadily, a trend which is likely to continue. Individuals legally entitled to social security, Medicare and Medicaid, and military and federal employee retirement benefits must be paid. We can see from Table 13.4 that nearly half of federal spending goes to individuals eligible to receive payment under various entitlement programs. Retirees receive social security payments, students get low-interest loans, the unemployed draw unemployment insurance, and veterans are eligible for medical care.

Table 13.4 Federal Spending, 1970–1992 (\$ billion)

Category	Year									
	1970	1980	1985	1988	1992	1970	1980	1985	1988	1992
Military	264	44	187	23	261	26	283	28	259	21
Payments to individuals	184	31	395	47	459	46	480	47	593	49
Interest payments	42	7	74	9	137	14	147	14	165	14
Other	108	18	176	21	144	14	117	11	176	15
Total	598	100	832	100	1001	100	1027	100	1215	99

Source: *Statistical Abstract of the United States, 1992, p. 320.*

Social security is the largest and fastest-growing entitlement program because Americans are living longer and payments are adjusted annually to reflect increases in the cost of living. Declining birth rates pose difficult moral and political questions for our future social security system. The large cohort of people born during the baby boom of the 1950s will reach age 65 and begin receiving social security payments after the year 2020. They will be supported by the much smaller cohort of workers born in the late 1960s and the 1970s, whose parents chose to have one or two children, not three or four as their parents did in the 1950s. The moral and political question which must be addressed in the 1990s is how much present workers should pay for the support of retired workers.²²

Interest Payments

Recent federal budget deficits amounting to hundreds of billions of dollars reflect our reluctance to tax ourselves to pay for desired spending programs. We send the bill to future generations. We have not had a balanced budget since 1960 and are not likely to balance the budget any time in the near future.

Does it matter? Probably not, if the economy grows faster than the debt. Between 1960 and 1982, the economy grew faster than our public debt, which means that the percentage of national income devoted to making interest payments on the national debt did not increase. After 1982, slow economic growth and \$200 billion annual budget deficits combined to increase the burden of the national debt on taxpayers. Present and future taxpayers are devoting a growing percentage of their tax dollars, 14 percent in 1993, to pay for past consumption.²³

The "Other" category in Table 13.4 contains most federal programs, including law and justice; international affairs; environment and natural resources; transportation; housing; and energy. This category consumes only 15 percent of the budget. Many of these programs were cut sharply in the 1980s. Since much of this spending provides essential government services which enjoy strong political support, further cuts are hard to justify.

Deficit Reduction

President Reagan's program of military spending increases and income tax cuts during the early 1980s drove the federal budget deficit to unprecedented heights. The House of Representatives, with a large Democratic majority, insisted that constituents back home did not want large cuts in domestic spending or large increases in military spending. In addition, Democrats were certainly not going to propose politically unpopular tax hikes unless President Reagan agreed to go along with the idea publicly. The inevitable result of this continuing political stalemate was a series of distressingly large budget deficits.

The Gramm-Rudman-Hollings Act

On the spending side, Congress reluctantly went along with many of President Reagan's proposed deep domestic spending cuts in 1981 and 1982 but resisted thereafter. Congress increased military spending, but at a much slower pace than President Reagan desired. On the taxing side, the 1981 tax cut reduced the government's income by about \$250 billion per year, but this was partially offset by increases in social security taxes. Large budget deficits persisted because President Reagan refused to consider raising taxes and Congress could not agree on a plan to cut spending.

As an alternative, Congress enacted a mandatory deficit reduction law in 1985. Known as the Gramm-Rudman-Hollings Act for its Senate sponsors, the law required that the budget deficit be reduced by about \$35 billion each year until 1991, when the budget would at last be in balance. If Congress and the president could not agree on a \$35 billion spending-cut package, Gramm-Rudman-Hollings provided that most government programs would be cut automatically until the deficit reduction target was achieved. Half the cuts would come from domestic spending, and half would come from military spending programs. A few programs including social security, the strategic defense initiative, and interest payments on the national debt, were specifically exempt.²⁴ Gramm-Rudman-Hollings was a flawed approach to deficit reduction. Across-the-board cuts weaken all programs, slashing into the muscle rather

than trimming the fat. Upon implementing this law, Congress abandoned its responsibility to decide which programs serve the people well and which ones are expendable. But Congress could agree on no other approach.

Ultimately, Gramm-Rudman-Hollings failed to reduce the deficit. Its revenue and spending projections were based on rosy economic forecasts and accounting gimmickry; by 1990, the annual deficit had reached \$220 billion, not zero as the agreement had projected. And \$300 billion deficits were forecast for the early 1990s.

In this context, President Bush and Congress agreed in 1990 to a package of spending cuts and tax increases. President Bush abandoned his famous “Read my lips—no new taxes” pledge made during the 1988 presidential campaign. But the weak economy cut into federal revenues, and projected deficits climbed to over \$300 billion per year in the mid-1990s in spite of the 1990 budget agreement.²⁵ Americans grew increasingly frustrated with the failure of Washington to make progress toward controlling the deficit; this mood contributed to Ross Perot’s winning 19 percent of the popular vote in the 1992 presidential election.

The 1993 Deficit Reduction Act

Newly elected President Clinton proposed a plan that would reduce the deficit by \$100 billion per year over five years beginning in 1993. The controversial act raised taxes on gasoline and on high-income taxpayers and accelerated military spending cuts. Further progress in reducing the federal budget deficit will have to come at the expense of social security and other entitlement programs, which account for nearly half the federal budget.

Today’s economic policy challenges are complex, and easy solutions are hard to find. We expect government to foster a steadily growing economy with stable prices and low unemployment—but there is no consensus on what mix of fiscal and monetary policy will best achieve these ends. We need to cut large budget deficits, but prospects for doing so are uncertain because narrowing the deficit will require unpopular tax increases or painful cuts in popular spending programs. We must narrow the persistent balance of trade deficit, preferably by saving more and investing in new factories and advanced technology. But the owners of factories, their workers, and their communities are working together to protect the automobile or textile industries from overseas competition.

Economic policy issues provide much fuel for arguments over the distribution of political power. From a democratic perspective, technical economic

issues inhibit effective participation. How many Americans have the time and interest to understand the effect of large budget deficits on interest rates and the strength of the dollar? Yet Americans do seem to prefer budget deficits to spending cuts or tax increases, and the political system records this preference.

From a pluralist perspective, high levels of spending reflect the intense support of special interests who benefit from particular programs. They are better organized and more effective than opponents whose pleas for responsible tax increases and smaller deficits have no natural political constituency.

From an elitist perspective, continuing economic crises since the first enormous increases in oil prices in 1973 have shifted power and income from the poor to the rich. The supply-side tax cuts of 1981 favored upper-income taxpayers. The costs of economic transformation have largely been borne by the poor, primarily through the inflation-busting recession of 1981 and 1982 as well as cuts in social welfare spending during the early 1980s.

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