CHAPTER 18
ECONOMIC POLICY

Narrative Lecture Outline

The U.S. economic system is basically a free market one, but one in which government has a role. The government provides laws, contract enforcement mechanisms, rules for business and bankruptcy, definition of property rights, issues patents and copyrights, provides a common monetary system, and grants corporate charters. Few of those governmental powers are controversial or contested. However, government regulation and intervention in the market mechanism are often hotly contested. In this lecture, we will look at the history of the role of government in our economy from the nineteenth century through the Cold War and into the present debates about the nature and extent of government regulation in the economy.

Roots of Government Intervention in the Economy

In the first one hundred years of our country, most economic issues were controlled by the states, not the national government. The national government's roles were limited to public lands policies, a few public works projects, and the encouragement of business and certain economic policies through the use of taxes and tariffs.

The states were quite active in promoting and regulating private business activities. They built the Erie Canal, roads, and railroads. States licensed, regulated, and inspected many factories and businesses. During the nineteenth century, when the country was mostly rural and small-scale, this worked fine.

Following the Civil War, the country became more and more industrialized and many large-scale factories were created. Cities grew up around the factories and were home to large numbers of workers and their families. Industrial accidents, disease outbreaks, labor conflict, unemployment and exploitation of workers were problems too large for state governments alone.

Another problem was the business cycles or fluctuations between periods of economic prosperity and economic downturn that were common and thought to be laws of modern economics. Economic downturns caused real hardships due to unemployment and poverty and prosperity was rarely long enough for all to recover. The economic swings were difficult to deal with personally and as a country.

States were not up to the task. Many people turned to the national government to address the problems. But many people subscribed to the idea of *laissez faire,* that governmental regulation is wrong and the only proper roles for government are to maintain order and justice, to conduct foreign affairs, and provide public works such as lighthouses and roads that would be unprofitable for private businesses.

Many businessmen followed this philosophy, but also demanded that the government protect their industry with tariffs or subsidize the construction of railroads, use the military to put down labor unrest, and give them public lands for free. Hardly ideas Adam Smith would have advocated! Essentially, most businessmen wanted governmental policies that would help them amass huge profits.

Small business, reformers in the cities, the Grangers, and agrarian protest groups banded together over time and forced the national government to reign in what they saw as capitalism run amuck. In 1887, Congress began to regulate the railroads by adopting the Interstate Commerce Act. The Act required that railroad rates be "just and reasonable," prohibited rate discrimination, and the practice of charging substantially more for short hauls than long ones.

Three years later, the same coalition of political forces forced Congress to deal with the "trusts" or large-scale monopolistic businesses that dominated industries like oil, salt, whiskey, meatpacking, and sugar. The Sherman Anti-Trust Act of 1890 prohibits restraints of trade and monopolies.

The Progressive Era

The Progressive Movement was a middle-class reform movement designed to change the political, economic, and social system of the United States. In general, they wanted to rein in corporate power and make it more responsive to society and the democratically elected government.

A variety of legislation was discussed and passed by Congress that made consumer protection an important government mandate, strengthened anti-trust measures, regulated the banking system and evened out the business cycles, and protected American industry through tariffs. Congress created the Food and Drug Administration, the Federal Trade Commission, the Federal Reserve, and more. Government was taking on new roles and growing dramatically.

These extra duties meant that the government needed new sources of revenue. Public officials instituted an income tax. In 1895, the Supreme Court ruled that the income tax was a direct tax and therefore, according to the Constitution, had to be allocated among the states in proportion to their population or was unconstitutional. This ruling made an income tax cumbersome and expensive to implement. So in 1913, Congress passed the Sixteenth amendment to overrule the Court's decision and then initiated an income tax. These taxes are now a major source of revenue for the government.

The Great Depression and the New Deal

World War I ended the Progressive Era. During the 1920s, *laissez faire* returned under Harding, Coolidge, and Hoover. The economy was booming and all was right with the world. Then came October 27, 1929; the Great Depression began with a stock market collapse followed by rising unemployment, dropping prices, falling production, and financial panic. It was a catastrophic worldwide economic downturn that produced large amounts of economic distress. All sectors of the economy were hurt. No social groups or classes were spared, though some fared better than others.

President Hoover announced that there was nothing wrong, and the economy was fundamentally sound. The panic got worse. During the 1932 presidential elections, the country was still gripped by Depression. Franklin Delano Roosevelt called for a "New Deal" for America and favored strong government action to relieve economic distress and reform capitalism. This was a major turning point for the U.S. from a basically *laissez faire* economy to an interventionist state. The New Deal established the national government as a major regulator of private businesses, a provider of Social Security, and as responsible for maintaining a stable economy.

The text provides a lot of historical background and facts about the New Deal and you should familiarize yourselves with those passages in Chapter 18. Much of the "alphabet soup" that was the New Deal became a permanent part of our public policy landscape. The New Deal also signaled the end of a passive government and the rise of an active one and established the legitimacy of national government intervention in the economy.

The Post-World War II Era

During the 1940s and 1950s, most policies remained fairly stable. However, as we came out of WWII, many policy makers worried that the conversion from a wartime to a peacetime economy might trigger another great depression. Two significant developments during this era were the Employment Act and the Taft-Hartley Act—both of these pieces of legislation were controversial and dealt with issues concerning jobs.

The Employment Act was a watered down version of the Murray Bill, introduced by Senator Murray (D-Mont). The Murray Bill guaranteed a right to employment for anyone willing and able to work. The hope was to maintain full employment and stave off another depression. The mechanism Murray advocated to attain full employment was government investment during times when private investment proved inadequate. Conservatives opposed the bill strongly. The resulting compromise was the Employment Act of 1946 that stated the federal government had a responsibility to use all practicable means to promote maximum employment. The Act also created the Council of Economic Advisors to advise the president on economic issues and the Joint Economic Committee in Congress to study economic policy.

The Taft-Hartley Act also dealt with labor issues, but in a different way. The Wagner Act of 1935 that gave trade unions the right to collectively bargain, had been strongly opposed by conservatives and business. In 1946, the Republicans became a majority in Congress and vowed to change the law and increase the power of management in labor disputes. The result was Taft-Hartley. This Act prohibited a number of union activities such as featherbedding, jurisdictional strikes, and coercing employees to join a union. Unions were directed to file detailed reports on finances to the Department of Labor and there was to be an 80-day injunction against strikes. The closed-shop arrangement under which an employer could only hire union workers was prohibited. The goal was to hamstring labor unions that seemed to be getting too powerful.

The Employment Act was a "liberal" demand on government to become involved in employment policy; Taft-Hartley was a "conservative" demand for the same type of involvement. Obviously, the government was now firmly entrenched in the economic life of the country.

The Social Regulation Era

Most of the policies of the 1940s and 1950s were economic regulation, however, in the 1960s and 1970s the government turned to social regulations. Social regulations deal with the quality and safety of products. Agencies such as the Consumer Product Safety Commission, the Occupational Safety and Health Administration, the

Environmental Protection Agency, the National Transportation Safety Administration, and more were created to protect consumers and citizens from a variety of threats.

Four factors contributed to the surge of social regulation: 1) the 1960s and 1970s were a time of social activism. Consumer and environmental movements flourished and public interest groups were formed that demanded government action; 2) modern technology proliferated and highlighted unsafe products like chemicals, DDT, cigarettes, leaded gasoline, the Corvair, phosphates, and more. Industries were spewing toxic substances into the air, pouring them into the water, and burying them in the ground. TV showed us these problems and people got mad; 3) congressmen saw advocating safety and social regulation as a way to enhance their reputations and electoral prospects. This in and of itself was not new, but TV was! 4) the presidents in office (LBJ and Nixon) supported the movement. It was good politics.

Deregulation

In the 1970s and 1980s, a new movement arose—deregulation. Economic regulations came under fire from a variety of angles as anti-competitive and anti-consumer. Many people saw the regulating agencies as protecting the industries' profit margins rather than the public good. During the Carter Administration, deregulation was a high priority and railroads, commercial airlines, financial institutions, and more were deregulated.

Deregulation still has its champions, but it also has its critics. While airline deregulation initially opened up the skies and many new competitors jumped into the business, the new airlines were unable to compete. Some rates were lowered, but today we have fewer airlines than there were under regulation. Also, many routes have been abandoned, the hub and spoke system alienates passengers, and safety is becoming more problematic. Savings and loan deregulation was a debacle, costing taxpayers hundreds of billions of dollars.

The ardor over economic deregulation seems to be waning. Consumer protection is gaining popularity. The corporate scandals and major bankruptcies of companies like Enron and WorldCom, the dotcom bust, and the falling stock market have caused Congress and pundits to look again at the wisdom of total deregulation. Arthur Andersen's problems stemming from its Enron business have led to substantial attention being paid to accounting practices. Telecommunications have been in a freefall, with many analysts blaming deregulation for the problems. And the California power problems were also directly related to too little government oversight.

It seems that the deregulation pendulum has started swinging back towards moderate and rational oversight policies. September 11th, and the accompanying problems for the airline industry, caused many to discuss re-regulating airlines. Environmental legislation is highly popular.

Companies like Coca Cola are leading the way in "cleaning up" the image of corporate America. Coke has announced that it will no longer announce its earnings estimates every quarter. It announced that the stock market, and stock sellers/analysts have been placing way too much emphasis on earnings estimates and not enough on the bottom line of a company. They are going to lead the pack back to a more traditional way to evaluate their stock. Instead of windfall profits and devastating losses each quarter, depending upon whether a company achieved its earning estimates or not, Coke says you should judge it by its manufacturing capabilities, its management strategies, and its sales.

In 2002, Bush signed a six-year agriculture bill that cost an estimated $100 billion. It substantially increases subsidies to farmers, which is a reversal of the traditional Republican call for lower subsidies. This further elaborates the trend toward re-regulation.

<u>Stabilizing the Economy</u>

The government is involved in other economic issue areas as well. The two we will discuss today are economic stabilization (evening out those business cycles) and environmental controls.

Since FDR and the Great Depression, the government has taken a much more activist approach to macroeconomic problems. Following the advice of economist John Maynard Keynes, many presidents have sought to "prime the pump" through deficit spending. In other words, government spending can be used to offset a decline in private spending and help maintain levels of spending, production, and employment, thus avoiding the huge swing of cycles that caused depressions in the past.

Economic stability means the economy is growing, there is rising national income, high employment, and stable prices. Any other condition, such as inflation (rising prices due to an under supply of goods), is to be avoided through government action.

Monetary Policy: Controlling the Money Supply

Monetary policy involves the regulation of the country's money supply and interest rates in order to stabilize the economy. The primary responsibility for monetary policy rests with the Federal Reserve.

The Federal Reserve System

The Federal Reserve System, or the Fed, was created in 1913 and is a mixture of private interests and public authority and consists of:

- Federal Reserve Board (FRB)
- Federal Open Market Committee
- 12 Federal Reserve Banks

The FRB is made up of seven members appointed by the president for 14-year overlapping terms, with approval of the Senate. A member can be removed for stated causes but this has never happened. One board member is designated by the president to serve as chair for a 4-year term. The chair's term runs from midway through one presidential term to the middle of the next to ensure economic stability during changes of administrations.

In order to control the money supply, the Fed has a number of tools or levers including:

- manipulating the reserve requirement—the amount of deposits member banks are required to keep on hand and not loan out. Raising the reserve requirement is a limit on loan making by banks and therefore restricts the money supply

- changing the discount rate—the rate of interest that member banks have to pay to borrow money from the Fed. If the Fed raises the discount rate, it makes loans more expensive and so restricts the money supply
- open market operations—the buying and selling of securities by the Fed in the securities markets. When the FRB buys securities, banks have more money to make loans and therefore the money supply is enlarged. If the FRB sells securities, the opposite is true.

The President and the FRB

Though technically the FRB is independent of the president, there is a lot of informal contact during luncheons and meetings. More formal meetings are also helpful. The president thus expresses his views on monetary policy, and the FRB chair can explain his reasoning to the president.

Fiscal Policy: Taxing and Spending

Fiscal policy involves taxation and government spending policies to influence the overall operation of the economy. Fiscal policy is formulated by the president and Congress through the budget process.

John Kennedy was the first president to actively use fiscal policy. He deliberately ran a deficit in order to fuel economic growth. Tax cuts would stimulate private sector spending, and thus would also be a stimulus to the economy.

The Effects of Globalization

Globalization refers to the process by which countries and businesses are more closely linked than ever despite great geographic distance. Due to major advances in technology, especially communications and transportation, distances are vastly reduced and economies now affect one another far more than they did a mere 50 years ago. International relations have a greater effect on business decisions and on government domestic policies because of globalization.

Free trade has been the most lucrative aspect of globalization for the United States. However, many people are opposed. Protesters at meetings of the World Bank and IMF complained that cities are becoming too crowded, poor people in the developing world are being exploited, resources are being pillaged, and local farmers can't compete with global agribusiness.

Trade unions have been very critical of free trade. They argue that low-paying jobs overseas rob American workers of jobs here in the U.S. They argue that fair trade is more important than free trade since every country has some protectionist policies.

Another impact of globalization seems to be the widening gap between rich and poor around the world and in the United States. In the U.S., the middle 60 percent of wage earners currently have a real after-tax income lower than they had in 1977, while the richest 2 to 3 percent get increasingly wealthier. Many analysts attribute the decline of the middle class to the loss of manufacturing jobs to lower-wage countries, the growth of lower-paying jobs in service industries, supply side tax policies, and weaker trade unions.

The Budget Process

How the Federal Government Raises and Spends Money

The federal budget is primarily funded through individual income taxes and social insurance/retirement receipts (over 80 percent comes from these sources). Most government spending goes to national defense and human resources such as health, income security, and social security.

Congress and the Budget Process

The Budget and Accounting Act of 1921 gave the president authority to prepare an annual budget and submit it to Congress. The Office of Management and Budget (OMB) was created to assist the president in preparing the budget. Federal budgets operate on a fiscal year (not a calendar year) that runs from October 1st to September 30th.

The OMB provides the bureaucracy with instructions and guidance on presidential priorities to help them prepare their budget requests nine months before the president needs to send it to Congress. The president sends his budget to Congress in February each year. The departments develop detailed funding requests, and OMB puts them together. Agency requests are often modified by the OMB.

Congress debates the budget in subcommittee, committee, and finally on the floor of each house. Eventually, appropriations bills are authored and voted on and a budget is passed. Lately, due to a large amount of conflict between Congress and the president, budgets have not been passed before the beginning of the fiscal year and Congress has had to pass continuing resolutions to keep the government and its programs running or let the government shut down. The public was very unhappy in 1995 and 1996 when the government shut down and many blamed the Republican Congress for the inconveniences.

The budget is not a very good tool for stabilizing the economy, due to the lag time (budgets are prepared so far in advance) and the politics (it is hard to get a cogent budget put together).

Budget Initiatives of the George W. Bush Administration

In 2001, Bush signed the Economic Growth and Tax Relief Reconciliation Act that lowered income tax rates across the board, expanded deductions, and provided taxpayers with rebates of $300, $500, or $600 depending upon their tax status. Tax reductions benefited all groups but the highest bracket got a disproportionately large benefit. The hope was that people would spend their rebates and more money to get the economy going. In the highest tax brackets, the hope was that people would invest more in the economy and help get the economy growing again. The Democrats voiced opposition. In early 2002, Bush proposed yet another set of tax cuts designed to stimulate the economy and opponents once again argued that the benefits went disproportionately to the rich. It is too early to tell how well these initiatives achieve their goals.

Bush also focused on the war on terrorism. He made a supplemental budget request in 2002 for over $27 billion for the military and homeland security. He also called on Congress to create a Department of Homeland Security, which it did.

In 2003, Bush called for further tax cuts due to continuing stagnation in the American economy. The goal was to stimulate the economy. After congressional approval, tax rebate checks were sent to most taxpayers with dependent children. (These checks were later counted as part of one's income in the next tax year.)

Many Americans were pleased by the tax rebate, initially. Complaints were heard when taxes were filed because many people were unaware that the money would be taxed. The short-term results were good—people did spend the money and stimulate the economy. Long-term effects are less clear-cut. Deficits are back, and tax cuts made a contribution, as did the war in Iraq. Republicans still argue that the tax cuts were positive, while others argue that the long-term effects are negligible or negative.

The official projected budget deficit for 2006 is $423 billion (around 3.2 percent of GDP). Hurricanes Katrina and Rita, as well as the war in Iraq and Medicare Part D all increased spending dramatically. The 2007 budget proposal looks to cut the deficit to 2.4 percent of GDP through "discretionary spending reductions".

Democrats are complaining about the budget deficit and popular approval for President Bush is hanging in the low 30 percent range in early 2007. Even Republicans aren't backing Bush on this. The normally fiscally conservative wing of the Republican Party is reasserting itself as we approach the 2008 presidential election season.

The Budget Deficit and the Debt

Since the early 1980s, the U.S. has run large budget deficits and has had a rapidly growing national debt. A deficit means that spending is larger than income in a given year, and the debt is the accumulation of deficits over the years.

There is still a lot of debate about how bad, or how good, deficits and debts are for the economy. Congress had tried to pass balanced budget amendments to the Constitution, as well as a number of statutory remedies to overspending. Some were struck down by the courts, some were vetoed by the president, and others didn't pass Congress. One that did pass Congress was Gramm-Rudman-Hollings. This act was passed in 1985 and created a procedure for automatic deficit reduction. If Congress could not decide on cuts to bring about a balanced budget, this act would automatically cut programs and spending. Of course, some programs were exempted like Social Security, Medicaid, veteran's benefits, and the like. The cuts would be automatic and across the board. It didn't work. Clinton and the Republican Congress finally decided that politically it was a good idea to balance the budget and managed to produce a balanced budget (one year without a deficit) in 1997.

Government shutdowns and a Democratic president facing a Republican Congress were the opening acts to the first balanced budget in decades. Clinton and Congress came to a series of compromises that satisfied both major parties. The resulting tax cuts and fiscal restraint led to a budget surplus in 1998.

The budget surplus that emerged in 1998 was the result of a growing economy that led to increased tax revenues, lower military spending, an aggressive monetary policy, slower increases in entitlement spending (health care costs in particular), and the 1997 legislation. In an historic irony, a Republican—Ronald Reagan—will be remembered for the creation of huge deficits and a Democrat—Bill Clinton—will be remembered for creating a budget surplus! However, the situation was short-lived.

The stock market declines, terrorist threats, and a weakening economy led to a renewal of deficit spending. By 2002, deficits were accompanied by growing income inequality, rising poverty rates, sharp declines in the stock market, and massive problems with corporate accountability. The tech stock bubble burst: NASDAQ had fallen 72 percent in just two years. Other indexes were also lower.

The War in Iraq increased government spending. In sum, the Bush Administration said that in 2004 the budget deficit would be over $500 billion in 2004. They add that economic growth and tax cuts will lead to its elimination within a decade.

In May 2006, the national debt stood at $8.37 trillion and interest payments on the debt are a substantial portion of the budget. As a percentage of GDP, the current debt is at an all time high.

The Economics of Environmental Regulation

The government is also involved in regulating the environment. This has many economic implications as well as health impacts. Until the late 1960s, the government did little to control pollution. But pollution soon became an important problem on the national agenda. Clean water and air, safe food, and scenic vistas became the stuff of public policy.

As in most public policy issues, the environment has trade-offs. For example, if you want clean air, you will have to pay more for cars that have emission controls. If you want clean rivers and lakes, you may have to pay more for plastics and manufactured products because it is more expensive to get rid of wastes in environmentally friendly ways. You may even have to decide whether the jobs of 500 loggers is more or less important than the habitat of the spotted owl.

Since 1970, Congress has passed a large amount of environmental legislation including the Clean Air Act, Clean Water Act, Safe Drinking Water Act, and more. It also created the Environmental Protection Agency to oversee such issues. The EPA is the largest regulatory body in the country. In 2006, they had 18,000 employees in Washington, DC and in ten regional offices around the country.

Conclusion

The federal government is involved in economic policies in a large number of ways. Some programs are popular, others are highly controversial, and most are poorly understood by the American people. The bottom line, though, is that the government has managed to prevent any large-scale depressions like those in 1890 and 1929. While we have had bad economic periods—recessions—business cycles are less violent than they were 50 or 100 years ago. This may be due to economic policies like monetarism and fiscal policy. It may be due to something else entirely (like defense spending and the national security state since 1945).

Web Sites for Instructors

The American Enterprise Institute is a conservative think tank that addresses a variety of issues. Their Web site offers information on their calendar of events, a variety of articles, and links.

www.aei.org

The Brookings Institution is the oldest think tank in America and has the reputation of being fairly moderate. Their Web site offers policy briefings, articles, books, *The Brookings Review*, discussion groups, and links.

www.brook.edu

The Cato Institute is a libertarian think tank promoting free market ideas. Their Web site offers a variety of articles and links.

www.cato.org

The Concord Coalition is a nonpartisan, grassroots organization dedicated to eliminating federal budget deficits and ensuring Social Security, Medicare, and Medicaid are secure for all generations; founded by Paul Tsongas (D) and Warren Rudman (R). The Coalition Web site offers lots of information about the debt and deficit, as well as some social policy issues. They offer e-mail newsletters, grassroots initiatives, statistics, and more.

www.concordcoalition.org/

Congressional Budget Office (CBO) Web site offers Congress's opinions on budget matters including statistics, reports, budget reviews, testimony, and more.

www.cbo.gov/

The Council of Economic Advisors Web site offers the Economic Report of the President and CEA publications, as well as basic information about the CEA and its members.

www.whitehouse.gov/cea/about.html

Economic Policy Institute (EPI) is a think tank devoted to economic issues. This Web site offers a variety of reports on economic issues and a monthly newsletter delivered by e-mail. Despite their self-classification as nonpartisan, their board of directors is predominantly left-leaning (liberal).

www.epinet.org/

Federal Reserve Board Web site has basic information about the FRB, its structure, and purpose. It also has publications, announcements, lists of related Web sites, biographies of members, reports, and statistics.

www.federalreserve.gov

U.S. National Debt Clock offers a running account of the public debt and offers links to a variety of groups and organizations interested in the debt and/or deficit.
www.brillig.com/debt_clock

Office of Management and Budget (OMB) Web site offers budget information, reports, testimony, regulatory policies, and more from the perspective of the administration.
www.whitehouse.gov/OMB/

Web Activities for Classes

1) There is a huge debate in this country over the pros and cons of a constitutional amendment requiring a balanced budget. Have students do some research on this topic using the Web. Have them look at the 27 amendments we have and how a budget amendment would fit in. Ask them to discover who supports and who opposes such an amendment in Congress, among interest groups and among governors, and be prepared to discuss why each actor supports or opposes.

2) The Chairman of the Federal Reserve Bank is often described as the most powerful man in America. Have students do some research using the Web to determine why he is so powerful, who he is, and what his policies are. Have them compare our Fed to the Central Bank of another country. Do they have similar powers? (You might suggest the Bank of England, DeutscheBank, or Bank of Japan.)

3) Have students look at the current Congress on the Web and write a paper about some of the bills on economic and environmental policy that are currently under consideration.

General Class Activities and Discussion Assignments

1) Discussion Exercise:
The United States is a mixed free enterprise system. How many other countries of the world have similar economies? Are they as successful as that of the United States? Do some research to determine the answers to these questions. What other types of systems exist? Are any of them "successful"? Why or why not?

2) A major concern of the nineteenth century was the business cycle. Monetary and fiscal policies have minimized these swings to some extent. Have students test the truth of these statements by looking at historical economic trends.

3) The Environmental Protection Agency is the largest regulatory agency in the U.S. government. It has also been attacked, for a variety of reasons, by both Republicans and Democrats. Have students use the information in this chapter as a starting point and do some research about the EPA. How effective is the EPA?

What do they do? Why is it impugned by both parties? What impact does it have on business?

Possible Simulations

1) The huge national debt has led many people to suggest a number of reforms in economic policy. Have students discuss the problem of the debt and deficit as well as the reforms that have been proposed. You could stage a debate: Have one side marshal the arguments that debts and deficits have powerful uses (Keynes, et al) and the other side argue that they are bad (Friedman et al).

2) Give students an economic issue to discuss, from the current news. Have one group of students look at the OMB Web site and another group look at the CBO Web site. Ask them to analyze the different perspectives and explain why they differ.

3) Have the students simulate a Federal Reserve Board meeting. Have students do some preliminary research on the Fed Web site and other Web sites with economic policy orientations. Supply several copies of the *Wall Street Journal* (or other major newspaper with good economic coverage) and have the students determine whether they (as the Fed) should raise or lower interest rates and why.

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