ECONOMIC POLICY

2008

The recent experience of terror on our own soil aside, the health of the economy is the nation's most important domestic issue. Political leaders who forget this point do so at their own risk. The fact that the country was in a recession certainly hurt the re-election changes of President George Bush, while the economy's strong performance during Clinton's second term allowed him to weather scandal and impeachment. Stable prices, low unemployment, economic growth, and a shift from budget deficits to a budget surplus characterized the American economy in the mid-to-late 1990s.

The Goals of Economic Policy

Stable prices mean that inflation is under control. This has been an important goal of the federal government's economic policy since the 1970s, a period that not only saw the rate of inflation move into double digits, but high prices were sometimes accompanied by high unemployment. This unusual combination was called **stagflation**. There is general agreement that the Federal Reserve Board, which we discuss next, did an effective job of keeping prices at the same level through its control over interest rates. There are circumstances that neither the Federal Reserve nor the other agencies that deal with economic policy can influence — events in the Middle East may lead to a spike in oil prices; a drought in the Midwest or a freeze in California can impact the cost of groceries at the supermarket.

Low unemployment is the sign of a sound economy. Between 1990 and 1999, for example, the national **unemployment rate** (the percentage of the civilian labor force out of work) dropped from more than 5.5% to just over 4%. The rate was either somewhat higher or lower depending on the sector of the economy, the type of occupation, and region of the country. Generally, however, the problem that faced the nation was that there were not enough people to take the jobs that were available. This is a potentially dangerous situation because it forces employers to raise wages to attract workers and contributes to inflationary pressures in the process. Conversely, an early sign that the economy may be headed for a recession is an increase in the number of unemployed people.

The basic measure of economic growth is the **gross domestic product** (GDP), which is the total output of the goods and services that the United States produces. When the GDP grows between 2%–2.5% a year, the economy is considered strong; if the percentage drops below 2%, it is a sign the economy is weakening. A standard definition of a **recession** is a decline in the real GDP for two consecutive quarters.

For a good part of the twentieth century, the federal budget ran a deficit, in other words, government expenditures exceeded revenues. The deficit grew dramatically during the 1980s for a variety of reasons. First, a recession cut into revenues that a large tax cut further reduced. At the same time, the Reagan administration increased defense spending significantly, and the funding for **entitlements** expanded rapidly. Entitlements are benefit programs like social

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security and Medicaid that individuals qualify for by age, income, or a similar criteria; their costs are set by law and are not subject to congressional action. Attempts to shrink the deficit through legislation were not very successful. A combination of a robust economy and political compromise between the Clinton administration and the Republican Congress on the budget finally generated a surplus in 1998.

Economic Policy in Theory

There are various theories and models that attempt to explain how the economy works and how to make it work better. The first, and for a long time the only, widely accepted economic theory was outlined by Adam Smith in his *Wealth of Nations* (1776). A product of its time, Smith's ideas emphasized low taxes, free trade, and, quite importantly, a minimal role for the government. **Laissez-faire economics** held that the government should not interfere in the economy; there are inevitable booms and busts in the business cycle, and the market will self-correct if only it is left alone. A pure laissez-faire approach never really existed in the United States. The federal government encouraged business with high protective tariffs and subsidized the railroads with land grants; when railroads and monopolies proved incapable of acting in the public interest, the federal government stepped in again with regulations and legislation designed to curb the worst abuses.

Writing in the midst of the Depression, the British economist John Maynard Keynes argued for a much more active government role. He saw the key fact of the worldwide economic collapse during the 1930s as largely a problem of demand. Government action such as public works projects and cutting taxes can stimulate demand. Public works projects open up new jobs and tax cuts put money in people's pockets. As spending power increases, factories hire more workers to meet the demand for more goods. Under **Keynesian economics**, deficit spending is acceptable.

Keynes also recognized that the economy may get overheated—demand is too great, threatening inflation. The solution is to reduce federal spending and increase taxes. Using taxes and spending to impact the economy is also known as **fiscal policy**.

Monetarism ties a healthy economy to the ability to control the supply of money; the institution largely responsible for implementing monetary policy is the Federal Reserve System. Twelve regional banks under the jurisdiction of a board of governors compose the Federal Reserve System. The president appoints and the Senate confirms the seven members of the Federal Reserve Board for a 14-year term, which effectively insulates the Board from any single administration. The Federal Reserve Board's chair is one of the most influential economists in the country. A key way in which the Federal Reserve controls the money supply is through the **discount rate**, which is the interest rate that the Federal Reserve banks charge to their member banks for loans. When the discount rate is low, banks across the country are more likely to borrow money, and have more money to lend to businesses. In other words, the Federal Reserve can stimulate the economy by lowering the discount rate. It can also operate in the other direction. Raising the discount rate has the effect of restricting the amount of money available, and acts to cool down the economy as a check on inflation.

A model popular in the 1980s was **supply-side economics**. The argument was that a combination of tax cuts, particularly for corporations and wealthier Americans, and deregulation would lead to economic growth. Tax cuts would give companies incentive to expand and put more money in the hands of individuals likely to invest and/or spend. Businesses would hire more workers and develop new products. Deregulation was a means of decreasing the cost of doing business and stimulating competition, which in turn would improve efficiency. The Reagan administration adopted this approach in some respects. While tax cuts and deregulation went forward, so did federal spending on a massive defense buildup. Supply-side economics did not assume deficit spending on that scale.

The Budget Process

Under the Budget and Accounting Act of 1921, the president was given the authority to prepare the budget. The legislation created the Bureau of the Budget to provide assistance to the president and became the **Office of Management and Budget (OMB)** in 1970. The budget year runs from October 1 to September 30. Work on the budget begins at least nine months before the OMB actually submits it to Congress. The OMB reviews and modifies funding requests submitted by executive departments and federal agencies. The OMB modifies the requests, if necessary, to conform to the administration's spending priorities. The final product, the Budget of the United States Government, is sent to the Congress early in the new year. It is important to emphasize that the budget is only a request at this point.

The Budget Committees of the House and Senate hold hearings on the president's proposal, and listen to a wide range of testimony from inside and outside of the government. The **Congressional Budget Office (CBO)** provides both committees with reports on the economic outlook for the country and an analysis of the budget itself. Based on this information, budget resolutions are prepared for action by the full House and Senate. A budget resolution includes total spending broken down by function, for example, defense, natural resources and the environment, and social security, total revenues, and information on the anticipated deficit or surplus. Members can make amendments during the floor debates. A conference committee must reconcile the House and Senate budget resolutions that ultimately pass.

With a concurrent budget resolution adopted, usually but not always by April 15, the House and Senate Appropriations Committees and their subcommittees develop the actual spending bills for the areas of government for which they are responsible. They act within the limits set for **discretionary spending** in the resolution. (Discretionary spending is not required by law.) A conference works out the differences between the appropriation bills that each house passes, and the president ultimately receives the final legislation for action. But additional legislative action may be necessary to make sure that the budget targets are met. The budget resolution often includes **reconciliation instructions**, which are directives to the congressional committees that have jurisdiction over **mandatory spending**, for example, entitlements such as social security or veterans' benefits, and taxes to make changes in existing laws. Reconciliation legislation may cut benefits under Medicare or raise taxes. There is still no guarantee that the targets of the budget resolutions will be met. The rise in unemployment and the significant increase in spending in the wake of September 11, 2001, is a case in point.

Taxation and Tax Policy

Until the beginning of the twentieth century, the federal government relied on revenues from two sources: tariffs (taxes on goods imported into the country) and the sale of public lands. In 1895, the Supreme Court struck down an early federal income tax enacted by Congress, and it took the Sixteenth Amendment (1913) to restore it. Most Americans paid little or no federal income tax until World War II when rates rose significantly, and even today, we pay less in taxes than most other industrialized nations. Personal income tax is, however, the single most important source of receipts for the federal government, and accounted for over 50% of revenues in 2000.

The income tax is an example of a **progressive tax**, which means that the amount of tax owed varies with income—the more money you make, the higher the tax rate. A **regressive tax** falls equally on everyone, regardless of income; the rich and poor alike pay the same local sales tax on a new television. Federal excise taxes that fall on airline tickets and commodities such as gasoline are also regressive. Such taxes on alcohol and tobacco are sometimes called "sin taxes" because the purpose is not just to raise revenue, but to increase the price to the point where people think twice about using them.

Tax policy is the litmus test of American politics. Republicans often attack Democrats as the "tax and spend" party, while Democrats criticize Republicans for giving tax breaks to corporations and the rich. President George Bush broke his pledge not to raise taxes during his administration, and suffered serious political consequences.

Taxes always figure prominently in presidential elections. Steve Forbes made the **flat tax** the focus of his 1996 campaign for the Republican nomination. A flat tax sets a single low rate for all Americans, irrespective of income, coupled with the elimination of all exemptions. Proponents claimed that this radical change in the tax system would allow individuals to file their taxes on a post card and eliminate the need for the Internal Revenue Service (IRS). When budget deficits were high, there was a proposal for a **value-added tax (VAT)** that taxes an item at each stage of its production, distribution, and sale. This is essentially a national sales tax, and is extremely regressive. Conservatives have called for significantly reducing the **capital-gains tax**, which is a tax on the income derived from the sale of real estate or stock, and for the elimination of the estate tax or the so-called death tax.

Over the last 20 years, there have been dramatic changes in tax policy. Early in the Reagan administration, Congress approved the largest tax cut in American history. This was followed by the 1986 Tax Reform Act that consolidated and lowered individual tax brackets and lowered the top rate for corporations. While key deductions such as home mortgage interest were kept in the legislation, many others were eliminated. In 1997, President Clinton agreed to a number of tried and true Republican tax issues in the Taxpayer Relief Act, including a cut in capital-gains and the child tax credit. The latest policy direction is the Bush administration's Economic Growth and Tax Relief Reconciliation Act (2001), which provided Americans with a tax rebate, reduced tax rates significantly, provided numerous tax breaks to families, education, and those with retirement plans, and the phased elimination of the estate tax by 2010.

The Budget Process

The budget process: it seems so confusing that you may wonder whether there is any logic to it at all. In fact, Congress goes through certain procedures every year to figure out how much it will spend or receive in taxes. Here's a rough sketch of a complicated process:

The President's Budget

The budget-making season begins each February when the President submits a budget with his plan for the following fiscal year to Congress. This budget has been devised by the OMB after discussions with cabinet leaders and agencies about their needs in the coming year. One thing that often surprises people is that the Congress may choose to ignore parts of the President's budget. Congress ultimately has "power of the purse," as established in the Constitution, and it is Congress that ultimately makes the budget decisions. Why does the President bother with a budget, then? Because presidential leadership is a way to establish national priorities. The funding requests for all federal independent agencies and cabinet departments are included in the President's budget request and they each supply details and documentation to Congress to urge for their funding requests. The President then works with Congress to try and get those priorities enacted into law.

Congress Takes Over – The Budget Resolution

The first step in developing a budget in Congress is to put together and vote on a budget resolution. The resolution is a set of instructions that guides Congress in spending and taxing decisions. House and Senate Committees hold hearings on the President's budget and the Budget Committees report a concurrent resolution on the budget that sets each committee's allocation of spending authority for the next fiscal year and aggregate spending and revenue levels for 5 years. The budget resolution also establishes aggregate totals with respect to revenues and spending for the entire federal budget. The resolution establishes how much revenue needs to be raised and how much spending should be cut, but leaves it up to congressional committees to determine how they will meet those targets.

Note that the budget resolution is not a law and does not get sent to the president to be signed. Before the 1970s, Congress did not vote on a resolution and the budget was developed by the actions of numerous committees without any consideration of the sum of their decisions. The budget resolution is a way for Congress to survey the entire budget and set priorities, including deficit reduction targets. The budget resolution establishes such things as the total amount to be spent that year, the total amount of revenues, and the total public debt.

Once both houses pass the resolution, Members of the House and Senate meet in Conference to work out differences between the two houses' versions. The conference report must be approved by both the House and Senate.

The budget resolution is a relatively simple document consisting of Congress's statement of how much it wants to spend in each of 19 broad budget functions and how much total revenue the government will collect for the next five or more years. The difference between the two totals – the spending ceiling and the revenue floor – represents the deficit (or surplus) expected for each year.

Working Out the Nitty Gritty

1) Appropriations Bills

Because the budget resolution only sets goals for spending and taxes, the next step is for Congress to enact legislation to meet these targets. There are two legislative tracks in the budget process. On one of the tracks are the 13 annual appropriations bills for defense and domestic discretionary spending. These bills cover such areas as crime, environment, education, medical research, and transportation. The House of Representatives begins passing these bills in May or June, after which they must be passed by the Senate.

As these bills move through hearings, markups, Floor consideration, and conference they are constrained by the levels and allocations in the budget resolution and the enforcement of the Budget Act and through House and Senate rules.

All discretionary spending requires an annual appropriations bill. The spending is set by the House and Senate Appropriations Committees. Mandatory spending for entitlement programs and other mandated spending such as the interest on the national debt, salaries of federal judges, veterans' disability benefits, federal civilian and military retirement benefits, and unemployment insurance are not controlled by annual appropriations.

2) Reconciliation Legislation

The other legislative track changes the permanent laws governing taxes and entitlement spending (programs like Social Security, Medicare, and farm supports). This track is where the money is: changes in tax law and entitlement programs are crucial for reducing the deficit. All of these changes are rolled into one reconciliation bill every year. A reconciliation bill is the only piece of legislation (other than the budget resolution itself) that cannot be filibustered on the Senate floor, so it can pass by a majority vote.

How does the reconciliation process work? If Congress decides to use the reconciliation process, language known as a "reconciliation directive" must be included in the budget resolution. The reconciliation directive instructs various committees to produce legislation by a specific date that meets certain spending or tax targets. The Budget Committees then package all of these bills together into one bill that goes to the floor for an up-or-down vote, with only limited opportunity for amendment. After the House and Senate resolve the differences between their competing bills, a final conference report is considered on the floor of each house and then goes to the President for his signature or veto.

3) Consideration of Authorization Legislation

Congress considers numerous measures authorizing the appropriation of funds on a myriad of programs each fiscal year. This decision-making is constrained by the Budget Act and through House and Senate rules. Committees with jurisdiction over certain policy areas such as Education or Transportation can authorize programs to make policy decisions. Authorizing legislation typically either changes the rules for a federal program or provides a limit on how much money can be appropriated for it. The Appropriations Committee and its subcommittees decide on funding levels for a program within the authorized funding level. For example, the education committees could produce legislation that authorizes a certain amount to be spent on Title I reading and math programs for disadvantaged children. However, none of that money can be spent until the annual Labor-HHS *appropriations* bill — which includes education spending — sets the actual dollar level for Title I funding for the year, which is frequently less than the authorized limit.

Putting it All Together

The fiscal year begins on October 1. By then, Congress is supposed to have enacted all 13 appropriations bills and the reconciliation bill, if it was necessary. In most years, the deadline is missed. Then, in a flurry of last minute confusion, congressional and administration officials work out the final legislative details in bills that sometimes measure more than a foot high. This is when earmarked pork barrel projects and special exceptions to spending cuts or tax increases can be slipped in.

Adapted from: http://www.concordcoalition.org/learn/primers/budget-process

http://www.cbpp.org/3-7-03bud.pdf.

http://www.rules.house.gov/POP/budget_stages.htm