Economic Policy

Inquire: What is the Economic Policy of the United States?

Overview

The United States is a huge country with a huge economy. Since the Great Depression, the U.S. government has tried a variety of policies to keep such an economic disaster from occurring again.

The essence of the policy of money: who gets what, when, and how?

The politics of money — what economic policies do we follow? The politics of money — what do we do about the 2018 national debt of over $21 trillion? The politics of money — who should pay and how much?

Big Question: Who owns the U.S. national debt, and what can we do to end deficit spending?

Watch: Who Owns Our Debt?

As of June 2018, the United States owed over $20 trillion in debt. That is a two with 13 zeros! It’s a lot of money.*

Most people understand that it is important to budget your expenses so you do not have to borrow money. If every month a person spends more than they make, eventually they run out of credit cards and friends and relatives. They eventually run out of money and are overwhelmed by the debt.

However, year after year, the United States government spends more money than it collects and simply borrows money whenever it needs to. Most people would love to have that ability, but they do not.

So, who does the U.S. owe this money to? When the average person needs a loan, they go to a bank. Where does America go to get a loan? And, why do we always need to borrow money?

As to the “who,” much of it we owe to ourselves, and a lot of it we owe to foreign countries and foreign investors. The United States is an excellent credit risk (so far), and the U.S. sells bonds and securities to people, entities, and countries who buy them. For example, you might buy a $100 savings bond issued by the U.S. with a guaranteed interest rate of 5% per year. On a one-year bond, at the end of the maturity term (one year), the U.S. will owe you $100 plus the 5% interest, or $105.
As far as who owns the $20 trillion the U.S. owes? Well, other parts of the government, like Social Security, which has extra cash, own $5.6 trillion. Who holds the rest? In general:

- foreign governments and investors - $6.004 trillion.
- mutual funds - $1.671 trillion.
- state and local governments, including their pension funds - $905 billion.
- private pension funds - $553 billion.
- banks - $663 billion.
- insurance companies - $347 billion.
- U.S. savings bonds - $166 billion.
- other holders such as individuals, brokers and dealers, bank personal trusts and estates, corporate and non-corporate businesses, etc. - $1.662 trillion.*

Of those foreign governments and investors, China, the largest single holder of U.S. debt, owned about $1.19 trillion. Japan, at number two, owned $1.04 trillion of U.S. debt.*

Why do we keep borrowing money? Apparently, because we can. There is seemingly no need to live within a budget when you can borrow money to cover the difference.


Read: Balancing the Budget

Overview

A country spends, raises, and regulates money in accordance with its values. According to the Congressional Budget Office, the projected federal government’s budget for 2018 is $4.1 trillion, which is significantly more than the projected revenue of $3.3 trillion, which has been true for almost every year in the last 50 years — leading to a projected $804 billion deficit.

How can America balance the budget? Economists and politicians disagree.

So, where does this money go? And, what can the government do to reduce the deficit?

Approaches to the Economy

Until the 1930s, most policy advocates argued that the best way for the government to interact with the economy was through a hands-off approach formally known as laissez-faire economics. Leave the economy and the businesses alone, and the market would provide the controls.

The Great Depression challenged the laissez-faire view, however. People lost savings because of bank failures. Businesses failed due to the overproduction of goods, and people were laid off. The spiral continued down so deeply that the economy could not recover on its own.

As such, Roosevelt created the New Deal programs, which offered employment and income to millions of Americans doing work for the federal government. As these people acquired money, they bought goods. As they bought goods, the manufacturers needed to make more goods, rehiring those who had been laid off. As the spiral continued upward, people could get off the government payroll and the economy could grow.
The New Deal and World War II brought an end to the Great Depression. By the 1970s, however, high inflation began to slow economic growth. Some economists argued that the increasingly high cost of the social welfare programs and growing government regulations created a situation in which demand for products had outstripped investors’ willingness to increase production.

They called for an approach known as supply-side economics. Supply-siders argued that increased regulation and higher taxes reduce the incentive to invest new money into the economy, so little growth can occur. The supply-side advocates pushed for reduced taxes and reduced government interference to spur economic growth.

President Ronald Reagan was a chief proponent of supply-side economics. It was a central part of his campaign in 1980, as America was wallowing in a severe recession. Reagan implemented this plan after his election in 1980, and the economy began to recover.

Interestingly enough, Roosevelt’s actions did help pull the United States out of the Great Depression, and Reagan’s supply-side economics helped the economy recover in the 1980s. Both of the theories worked, at least for average workers whose jobs returned and salaries improved. Economists and theorists argue about whether the success was real, or significant, or long-lasting. But, that is an economics debate for a different course.

**Mandatory Spending vs. Discretionary Spending**

The Depression-era policy to promote social welfare policy led to a federal budget divided into two broad categories: mandatory spending and discretionary spending. Mandatory spending is the larger of the two. Mandatory spending by the federal government totaled $2.5 trillion in 2017, of which $1.6 trillion was for Social Security and Medicare. This spending constituted approximately 63% of all federal expenditures.

Mandatory spending is earmarked for entitlement programs guaranteed to those who meet certain qualifications, usually based on age, income, or disability. These programs include Medicare and Medicaid, Social Security, unemployment benefits, veterans’ compensation and benefits, and others. The costs of programs fluctuate as the economy changes, and the exact dollar amount is never known. Regardless, the money will be spent, unless Congress does away with the programs.

Portions of the budget not devoted to mandatory spending are categorized as discretionary spending, because Congress must pass legislation to authorize money to be spent each year. About 50 percent of the approximately $1.2 trillion set aside for discretionary spending each year pays for most of the operations of government, including science and technology spending, foreign affairs initiatives, education, and federally provided transportation costs.

The other half of discretionary spending — and the second-largest component of the total budget — is devoted to the military. Only Social Security is larger.

Cutting either of the two spending categories — mandatory or discretionary — impacts huge numbers of voters with very strong opinions. It is hard to get elected on the platform of cutting voter benefits.

**Deficit**

In theory, the amount of revenue raised by the national government should be equal to these expenses, but that is seldom the case. The amount of money the U.S. government needed to borrow to pay its bills in 2016 was still in excess of $400 billion. By 2018, the total debt — the amount of money the
government owes its creditors — was in excess of $19 trillion, according to the Department of the Treasury.

**Tax Policy**

The other option available for balancing the budget is to increase revenue. All governments must raise revenue in order to operate. The most common way to do this is to apply some sort of tax on residents or on the purchase of certain products such as alcohol, tobacco, and vehicles emitting excessive pollutants. These taxes paid are in exchange for the benefits the government provides.

The answer, to some extent, has been America’s *progressive tax* system. For example, in 2015, U.S. taxpayers paid a 10 percent tax rate on the first $18,450 of income, but 15 percent on the next $56,450 (some income is excluded). The rate continues to rise, to up to 39.6 percent on any taxable income over $464,850. According to the Pew Research Center, based on tax returns in 2014, 2.7 percent of filers made more than $250,000. Those 2.7 percent of filers paid 52 percent of the income tax paid.

Supply-siders, and history, would argue that if we continue to raise the rate at the top end, the individuals with the largest ability to help the economy through investment and expansion will stop investing and expanding because the higher tax rates reduce or eliminate their return.

Raising taxes is, like cutting expenditures, very unpopular with the voters. But, to reduce the deficit, something must be done. In a diet, no one likes exercising more or eating less, but this is the best way to lose weight. To cut the deficit, America must exercise more (raise taxes) and eat less (cut expenditures). This message from politicians will not be a popular way to get elected.

**Reflect: Debt or No Debt?**

**Poll**

Are you worried about the debt? Are you worried enough to pay higher taxes and to lose benefits — have fewer student loans or higher rates on student loans? Fewer resources in high school? A smaller Defense Department?

- No, I am not worried about the over $19 trillion debt.
- Yes, I am worried about the over $19 trillion debt.

**Expand: Which Came First… the Government or the Economy?**

**Discover**

Does the government direct the economy, or does the economy direct itself?

Until the 20th century, the country abided by the laissez-faire policy, which required a free market with little intervention from government. With the Great Depression came **Keynesian economics**, or the opposite belief that the government should manage the economy. Today, United States economic policy lies somewhere in between — government should regulate and sometimes manage, but it should allow a free market whenever possible. Political and business leaders disagree on how much control is enough.
Monetary Policy

Monetary policy is the government's control of the money supply. The government can control how much or how little money is in circulation by the amount that they print and coin. If too much money is in circulation, it tends to cause inflation, or the devaluation of the dollar. Too little money causes deflation, which can lead to a recession. The powerful arm of government that controls the money supply is the Federal Reserve System, which is headed by the Federal Reserve Board. The most important way that the "Fed" controls the money supply is by adjusting interest rates. High interest rates discourage borrowing money, which causes less inflation. Lower interest rates stimulate borrowing, which encourages consumer spending.

The Federal Reserve Board's seven members are appointed by the president and are approved by the Senate for 14-year, nonrenewable terms. The president may not remove them from office, so they function quite independently from any controls from the executive branch. The chair is elected by the Board for four years, and may be reelected. The Board heads the Federal Reserve System, which was created by Congress in 1913 to regulate the lending practices of banks. It consists of 12 regional banks, which in turn, supervise a total of about 5,000 banks across the United States.

Fiscal Policy

Fiscal policy affects the economy by making changes in government's methods of raising money and spending it.

- **Raising money.** The most important way that the United States raises money is through taxation. About 40 percent of the government's total tax collections come from income taxes from individuals and businesses. Another 32% come from social insurance taxes, such as Social Security, Medicare, and unemployment compensation. Other sources of income are excise taxes on goods such as liquor, tobacco, gasoline, estate and gift taxes, and tariffs. The government also may borrow money to finance its expenses. For example, it borrows money when it sells treasury bonds to citizens.

- **Spending money.** The government now spends more than $1.5 trillion a year, as provided in the federal budget. Each year, the president submits a federal budget for approval by Congress for money to be spent starting in October of that year. More money is spent in three categories than in any others. The largest amount of money goes to entitlement programs, such as Social Security pensions for older Americans, unemployment insurance, Medicare, and federal retirement pensions. The second largest amount goes to national defense. Today, about 16 percent of the total budget goes to defense, in contrast to 28 percent in 1987 when the Cold War was still on. The third largest amount — about 15 percent — pays interest on the national debt. Other expenditures are highway construction, education, housing, and foreign aid.

Fiscal policy can affect the money supply and can be used to stimulate spending or curb inflation. Tax cuts tend to stimulate consumer spending by leaving more money in the hands of American citizens. Tax increases can be used to slow inflation by removing money from the hands of consumers. The government can also curb inflation by cutting government expenditures.

With respect to these two broad categories — monetary and fiscal policies — there is great disagreement. Some argue that government should be more "hands off" than it is and that taxes should be reduced. Others believe that the government should more actively control the economy and that taxes should be
used to pay down the national debt. Many disagree on the amount of control that government should have, but no one questions the importance of government's setting a strong, effective economic policy.

Lesson Toolbox

Additional Resources and Readings

Monetary and Fiscal Policy: Crash Course Government and Politics #48
- A Crash Course video discussing the controversy of monetary and fiscal policy
- https://www.youtube.com/watch?v=_tULRch1PRQ

Fiscal Policy and Stimulus: Crash Course Economics #8
- A Crash Course video discussing how government uses taxes and spending to influence the economy
- https://www.youtube.com/watch?v=otmgFQHbaDo

Government Regulation: Crash Course Government and Politics #47
- A Crash Course video talking about the broad goals of economic policy and how the government tries to reach those goals
- https://www.youtube.com/watch?v=sDqGzMdhL1M

Lesson Glossary

laissez-faire: an economic policy that assumes the key to economic growth and development is for the government to allow private markets to operate efficiently without interference
New Deal: series of programs, public work projects, financial reforms, and regulations enacted in the United States from 1933 to 1936, in response to the Great Depression
supply-side economics: an economic policy that assumes economic growth is largely a function of a country's productive capacity
mandatory spending: government spending earmarked for entitlement programs guaranteeing support to those who meet certain qualifications
discretionary spending: government spending that Congress must pass legislation to authorize each year
debt: the total amount the government owes across all years
progressive tax: a tax in which the tax rate increases as the taxable amount increases
Keynesian economics: developed during and after the Great Depression, from the ideas presented by John Maynard Keynes in his 1936 book, The General Theory of Employment, Interest and Money
recession: a business cycle contraction which results in a general slowdown in economic activity
excise taxes: considered an indirect tax, meaning that the producer or seller who pays the levy to the government is expected to try to recover their loss by raising the price paid by the eventual buyer of the goods

Check Your Knowledge

1. Discretionary spending is earmarked for entitlement programs guaranteed to those who meet certain qualifications, usually based on age, income, or disability.
   A. True
   B. False
2. Fiscal policy does not affect the money supply and cannot be used to stimulate spending or curb inflation.
   A. True
   B. False

3. The Federal Reserve Board's seven members are appointed by the president and are approved by the Senate for 7-year, renewable terms.
   A. True
   B. False

Answer Key:

Citations

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