A major economic policy issue is how to maintain stable economic growth without falling into either excessive unemployment or inflation (rising prices). Key concept: **Inflation**, a sustained rise in the general price level of goods and services.

I. GOOD TIMES, BAD TIMES

The U.S. economy experiences booms and busts. The busts are called *recessions*. Key concept: **Recession**, two or more successive quarters in which the economy shrinks instead of grows.

A. Unemployment

Political leaders have a powerful incentive to keep the rate of unemployment down. Key concept: **Full employment**, an arbitrary level of unemployment that corresponds to normal *friction* in the labor market. In 1986, a 6.5 percent rate of unemployment was considered full employment. Today, it is assumed to be around 5 percent. The average unemployment rate in 2009 was more than 9 percent.

1. ***Unemployment Becomes an Issue.*** The federal government did not concern itself with unemployment until the Great Depression of the 1930s. At the beginning of the depression, unemployment passed 25 percent, the highest rate in U.S. history. Since the 1930s, the federal government offers unemployment insurance as a benefit. Not all members of the labor force are eligible for the insurance, however. Only about one-third of the unemployed receive benefits.
2. ***Measuring Unemployment.*** The Department of Labor and the Bureau of the Census have competing methods of calculating unemployment. Standard figures, however, do not include *discouraged workers* who have given up on looking for a job.

B. Inflation

Inflation can be measured by changes in the Consumer Price Index (CPI). Key concept: the **Consumer Price Index (CPI)**, a measure of the change in price over time of a specific group of goods and services used by the average household. Over time, inflation adds up.

C. The Business Cycle

Economists refer to the regular succession of economic expansions and contractions as the *business cycle*. An extremely severe recession is called a *depression*.

II. FISCAL POLICY

Fiscal policy is concerned with achieving economic policy goals through changes in spending or levels of taxation. Generally, the incumbent president and his party are blamed by the public for an economic downturn. However, any changes in fiscal policy are likely to be initiated by the president and passed by Congress. A fiscal policy approach to stabilizing the economy is often associated with a twentieth-century economist named John Maynard Keynes.

A. Keynesian Economics

Fiscal policy is typically based on the ideas of the British economist John Maynard Keynes (1883–1946). Keynes believed that after falling into a recession or depression, a modern economy may become trapped in an ongoing state of less than full employment.

1. ***Government Spending.*** Therefore, in a recession or depression, the government should engage in spending to make up for the spending that is not happening in the private sector.
2. ***Government Borrowing.*** For this to work, the spending must be paid for by borrowing, not new taxes. In other words, the government must run a **budget deficit**. The borrowing undertaken by the government makes up for the borrowing that is not happening in the private sector.
3. ***Discretionary Fiscal Policy.*** This is the discretionary (voluntary) use of fiscal policy to fine-tune the economy. John F. Kennedy was the first president to explicitly accept Keynesian economics, and he proposed a tax cut in line with the theory. The tax cut proved to be a successful economic stimulus.
4. ***Discretionary Fiscal Policy Failures.*** Keynesian theory calls for reducing or eliminating the budget deficit during boom times, the opposite of what is done during a recession. Lyndon Johnson, Kennedy's successor, refused to ask Congress for tax increases to pay for the Vietnam War, at a time when the economy was booming. The result of Johnson's running an increased budget deficit during boom times was to initiate a 15-year period of substantial inflation.

B. The Thorny Problem of Timing

With fiscal policy, timing is a problem. By the time an antirecessionary increase to the budget deficit has made it through Congress, the country might be back in a boom.

C. Automatic Stabilizers

Some government programs work to counteract the business cycle automatically. For example, even with no changes to the law, relatively less income tax is collected in a recession (putting up the deficit) and relatively more is collected in a boom (reducing the deficit). Unemployment compensation has the same effect.

D. Deficit Spending and the Public Debt

The government funds its deficit primarily by selling **U.S. Treasury bonds**. Twenty years ago, only 15 percent of these bonds were held abroad. Today the figure is nearly 50 percent.

1. ***The Public Debt in Perspective.*** Key concept: **Net public debt**, the accumulation of all past federal government deficits; the total amount owed by the federal government to individuals, businesses, and foreigners. (It does not include what the government owes to itself.) We measure the seriousness of the net public debt by measuring it against the **gross domestic product (GDP)**, the dollar value of all final goods and services produced in a one-year period.
2. ***Are We Always in Debt?*** From 1960 until the last few years of the twentieth century, the federal government spent more than it received in all but two years. Politicians have been happy to implement Keynesianism during recessions, but shy away from it during booms. In 1993, however, President Bill Clinton deliberately obtained a tax increase as the nation was entering a boom. The apparent results of the policy were quite beneficial. From 1998 to 2002, the government actually ran a budget surplus. Since the dot-com bust and the 2001–2002 recession related to the September 11 attacks, however, George W. Bush has followed a policy of high spending and tax cuts that have increased the budget deficit greatly.

III. MONETARY POLICY

Key concept: **Monetary policy**, the utilization of changes in the amount of money in circulation to alter credit markets, employment, and the rate of inflation.

A. Organization of the Federal Reserve System

The Federal Reserve System (The Fed), sets monetary policy, not the president or Congress. The key body for carrying out the policy is the **Federal Open Market Committee**.

B. Loose and Tight Monetary Policies

The Fed implements policy by increasing or reducing the rate of growth of the money supply. Increasing the rate of growth is **loose monetary policy**. Reducing the rate is **tight monetary policy**. If the Fed implements a loose monetary policy (i.e., an "expansionary" policy), the supply of credit increases and its cost falls. If it implements a tight monetary policy (i.e., a *contractionary policy*), the supply of credit falls and its cost increases. A loose monetary policy is often implemented to encourage economic growth.

C. Time Lags for Monetary Policy

Like fiscal policy, monetary policy has a problem with time lags, but the Fed can make a policy change more quickly than Congress.

D. The Way Federal Reserve Policy is Announced

The Fed announces changes to monetary policy by raising or lowering the *federal funds rate*, a government-controlled interest rate for funds that banks borrow from each other. This interest rate actually has little effect on the economy. The true effect of the Fed's policy comes from controlling the size of the money supply.

E. Monetary Policy versus Fiscal Policy

If interest rates go high enough, people *will* stop borrowing and inflation will subside. Monetary policy, however, cannot *force* people to borrow money in a recession. Therefore, although monetary policy is more powerful against inflation, fiscal policy is more effective against recessions, because the government does the borrowing itself.

IV. WORLD TRADE

Although a majority of the public is skeptical of the benefits of world trade, almost all economists of all political persuasions support it.

A. Imports and Exports

Key concepts: **Imports** are goods and services produced outside a country but sold within its borders. **Exports** are goods and services produced domestically for sale abroad. Imports make up about 15 percent of our consumption, and exports make up about 13 percent of our production. Whereas world output has increased by approximately eight times since 1950, world trade has increased by more than twenty-one times.

B. The Impact of Import Restrictions on Exports

"*In the long run, imports are paid for by exports*." If we restrict the ability of the rest of the world to sell goods and services to us, then the rest of the world will not be able to purchase all of the goods and services that we want to sell to them.

1. ***Protecting American Jobs.*** If imports are restricted to save American jobs, the price of the good or service in question goes up, hurting consumers. For example, economists calculate that restrictions on imports of clothing have cost U.S. consumers $45,000 per year for each job saved and restrictions on imports of steel $750,000 per year for each job saved. Further, there will be job losses in export industries.

2. ***Quotas and Tariffs.*** Imports are restricted by **tariffs**, or taxes, on imports or by **import quotas** that restrict the value or number of items of a particular good or service that can be imported. A severe new tariff in 1930 worsened the impact of the Great Depression.

3. ***Free Trade Areas and Common Markets.*** Groups of nations have created alliances to lower trade restrictions. The most important of these, once

called the Common Market, has evolved into the European Union, a confederation of states. In North America, the North American Free Trade Association (NAFTA) reduces trade barriers between the United States, Mexico, and Canada.

C. The World Trade Organization

Since 1997, the principal institution overseeing tariffs throughout the world has been the World Trade Organization (WTO). The WTO seeks to lower trade barriers worldwide so that all nations can benefit from free international trade.

1. ***What the WTO Does.*** The WTO's tasks include administering trade agreements, acting as a forum for trade negotiations, settling trade disputes, and reviewing national trade policies. The WTO also has a dispute-resolution mechanism that nations may use.
2. ***The WTO and Globalization.*** The WTO has become the focus of those who fear the supposed dangers of globalization. It is true that neither the United States nor any other country has veto power within the WTO. The work of the WTO has been opposed in many regions of the world.

D. The Balance of Trade and the Current Account Balance

Key concept: The **balance of trade**, or the difference between the value of a nation's exports of goods and its imports of goods. The U.S. balance of trade has been significantly negative for many years.

1. ***The Current Account Balance.*** This is a broader concept than the balance of trade. The **current account balance** includes the balance of trade in services, unilateral transfers, and other items. It is also negative and has been growing more so.
2. ***Are We Borrowing Too Much from Other Countries?*** Because imports and exports must balance, the current account deficit means that we have been exporting dollars or future claims on our production. Another way of looking at this is to say that foreigners are lending us money. Is America using this money wisely? If productively invested, the borrowed money can pay for itself. If it is merely used for consumption, however, we have a problem.

V. THE POLITICS OF TAXES

Currently, Americans pay taxes that total about 30 percent of the GDP.

A. Federal Income Tax Rates

Not all of your income is taxed at the same rate. The first few dollars you make are not taxed at all. The highest rate is imposed on the "last" dollar you make. This highest rate is the marginal tax rate. High marginal tax rates inspire major efforts to avoid the taxes.

B. Loopholes and Lowered Taxes

Special interests may lobby Congress for **loopholes** that will allow them to shelter income from taxation. Loopholes make the tax system dauntingly complex.

1. ***Progressive and Regressive Taxation.*** Key concepts: **Progressive tax**, a tax that rises in percentage terms as incomes rise. **Regressive tax**, a tax that falls in percentage terms as incomes rise.
2. ***Who Pays?*** Liberals tend to favor progressive taxes. Conservatives either favor taxes that are less progressive, or even flat or regressive. The following taxes are progressive: federal and (most) state income taxes, the federal corporate income tax, and the estate tax. The following taxes are regressive: the Social Security tax, the Medicare tax, state sales taxes, and the local property tax. Almost half of all American households pay no federal income taxes at all, while the top 25 percent of all households pay more than 85 percent of all income taxes. Thus, the federal income tax is progressive, but the tax burden overall is much more complicated.

VI. THE SOCIAL SECURITY PROBLEM

Social Security was established in 1935 with the intent of providing a type of insurance for a large segment of the public. Employees and their employers pay a tax on a percentage of the employees' wages. To pay for Social Security, as of 2008, a 6.2 percent rate is imposed on each employee's wages up to a maximum of $106,800. Employers must contribute an equal percentage. In addition, a combined employer/employee 2.9 percent tax rate is assessed for Medicare on all wage income, with no upper limit.

A. Social Security Is Not a Pension Fund

However, unlike private insurance programs where the individual insured makes payments in to an account for his/her own policy, the money paid into the Social Security program is used to provide benefits for people who have already retired, or who are qualified to receive funds.

B. Workers per Retiree

Initially for every recipient of Social Security there were forty workers paying into the general fund—a 1:40 ratio. Today, the ratio is more like 1:3, and it will get worse in future years. The ballooning cost of Medicare, however, may strain the system even more than the cost of Social Security.

C. What Will It Take to Salvage Social Security?

1. ***Raise Taxes.*** One proposal for fixing Social Security is to raise taxes. This could be accomplished by increasing the percentage of taxes withheld, or by eliminating the current cap on wages on which the payroll tax is withheld. Such proposals, however, would not provide a complete fix.

2. ***Other Options.*** Another proposal is to reduce benefit payouts. This could be done by increasing the age of full eligibility to 70 or by imposing a means test for benefits. Another proposal is to reform immigration policies so that more immigrants are admitted to pay the tax.

3. ***Privatizing Social Security.*** Some propose partially privatizing the Social Security system in the hope of increasing the rate of return on individuals' retirement contributions. Privatization would allow workers to invest a specified portion of their Social Security payroll taxes in the stock market and other investments. If the economy is good and the stock market grows, then the increased value of these investments would provide more benefits to individuals when they retire. Opponents fear that the diversion of Social Security funds into individual investment portfolios could jeopardize the welfare of future retirees, who would be at the mercy of the stock market. Opponents also point out that such a plan might mean that workers would have to pay for two systems for many years since the benefits for today's retirees cannot simply be abolished.