By evaluating the monetary policies of the Federal Reserve System and the fiscal policies of the government, you will be able to see how specific public policy is developed, and how it affects the major areas of American life—agricultural, business, labor, and consumer. Viewing the history of government regulation, we will conclude the chapter by looking at recent attempts at deregulation and focus on the economy's future.

Perhaps the most definitive indicator of the overall public policy direction the government is taking is the development of the federal budget. This involves key players, a prescribed process, and inherent problems. We will explain the players' roles and what happens each step of the way in the budget process. Problems are caused by the growing budget, and decisions must be made by the president and Congress when considering budget priorities.

We will also look at the specific type of taxes that exist, how they affect people who have different levels of income and wealth, and the types of welfare and entitlement programs—Social Security, Medicare, Medicaid, food stamps, aid to the disabled, and welfare.

Government plays a dual role in being linked to the nation's economy. It measures the economic status of the nation and attempts to develop effective measures to keep the economy on the right track. The Department of Labor (Bureau of Labor Statistics), the Congressional Budget Office, and the Executive Office of the Council of Economic Advisers all report to the country vital economic statistics such as the

- unemployment rate (adjusted index of people obtaining jobs).
- Consumer Price Index (CPI)—According to the U.S. Census Bureau, "the CPI is a measure of the average change in prices over time in a fixed 'market basket' of goods and services purchased either by urban wage earners and clerical workers or by all urban consumers." It is also a primary measure of inflation when the index rises over a defined period of time.
- Gross National Product (GNP)—The Census Bureau defines GNP as "the total output of goods and services produced by labor and property located in the United States, valued at market prices."
- Gross Domestic Product (GDP)—Lately the GDP has become the key economic measure analyzing an upward or downward economic trend, on a quarterly basis, of the monetary value of all the goods and services produced within the nation. Other factors such as consumer confidence, the actual inflation rate, and the stock market give a complete picture of the economy.

The government's primary policy role, therefore, is to develop a healthy economic policy. Programs such as the New Deal's three Rs—Relief, Recovery, and Reform—set in motion policies that have succeeded in preventing the country from experiencing a depression of the magnitude of the one that occurred in the 1930s. Many of Roosevelt's programs, such as Social Security (relief), the Securities and Exchange Commission (reform), and jobs program prototypes (recovery) are still part of the economic fabric of the country today.

## Monetary Policy of the Federal Reserve

Monetary policy is defined as control of the money supply and the cost of credit. Many leading economists believe there is a direct relationship between the country's money supply and the rate of economic growth. The Federal Reserve System, or "the Fed," was established in 1913. It consists of a seven-member board of governors serving by appointment of the president for staggered 14-year terms. The Fed's chairman, appointed by the president and confirmed by the Senate, is a powerful spokesperson for the system and serves four-year renewable terms. The Federal Reserve Board is an independent agency, free of presidential or congressional control. Its chairman during

the 1990s, Alan Greenspan, was very effective and influential in setting monetary policy. More than 6,000 member banks are affected by Fed policy and then influence monetary policies of other banks, ultimately having an impact on the interest rates consumers pay.

The Federal Reserve System regulates the money supply through

- open-market operations—buying and selling of government securities, which affect the money supply and cost of money.
- reserve requirements—establishing the legal limitations on money reserves that banks must keep against the amount of money they have deposited in Federal Reserve Banks (which earn the banks interest). These limits affect the ability of banks to loan money to consumers because actions in this area can increase the availability of money for credit.
- discount rates—determining the rate at which banks can borrow money from the Federal Reserve System. If rates are raised, interest rates for consumers also rise. The Federal Reserve System uses this tactic to keep inflation in check. This is probably the most publicized action taken by the Fed.

A good example of how the Federal Reserve's monetary policy is used in conjunction with a president's fiscal policy was in 1981 after Ronald Reagan was inaugurated. The country's number-one economic problem was double-digit inflation. The Federal Reserve forced a recession by raising the discount rate. The action had the immediate impact of reducing inflation. However, unemployment continued to be a problem. Reagan's fiscal policies (which we will discuss fully in the next section), although eventually creating a long period of prosperity, also saw the greatest increase in the deficit in the nation's history. In 1999, after President Clinton's deficit reduction economic package succeeded in reversing some of the nation's deficit and increased employment, the Fed was forced to raise discount rates as a precautionary measure. It feared that, because the economy was again improving, inflation would tend to increase. The question of having an independent agency be the sole arbiter in these very important functions upsets many economists.

On the other hand, the board must be immune from political pressure and pressure from special interests that would benefit if they had the inside track or could influence the monetary policy of the Fed. Most economists give the Federal Reserve high praise for the way it monitored the economy during the 1990s. The Federal Reserve has also been a key player, lowering interest rates during the economic recession that began in 2008.

Examples of other actions taken by the Federal Reserve came in 2010 and 2012—the Federal Reserve launched a controversial program to buy $600 billion in longer-term Treasury securities by mid-2011 to support a weak economic recovery that was failing to generate jobs. As the economy improved, the Fed reduced the amount of securities it bought.

## Fiscal Policy

Fiscal policy is primarily established by an economic philosophy that determines how the economy is managed as a result of government spending and borrowing and the amount of money collected from taxes. The two contrasting philosophies related to fiscal policy are Keynesian economics, developed by English economist John Maynard Keynes, and supply-side economics, developed by Ronald Reagan's economic team. Keynes advocated an increase in national income so that consumers could spend more money either through investments or purchases of goods and services. He also believed the best strategy to counter an economic recession was an increase in government spending. A corollary to this viewpoint would be that government would also adopt regulatory, distributive, and redistributive policies as tools to ensure consumer enterprise.

To a large extent the differing philosophies can be traced to the laissez-faire philosophy of Hoover versus the regulatory philosophy of Roosevelt. Both presidents' fiscal policies attempted

to manage the country when it was facing an economic downturn or when it was facing too much growth. The key to success is to find the best way to use the fiscal tools available to the government. Should it raise or lower taxes? Should it increase or decrease spending levels? How much regulation is really necessary? These are issues that have perplexed American economists and presidents since the Great Depression.

### Regulation and Deregulation

As much as we have seen the government involved in regulations during the 1970s and 1980s there has also been significant government deregulation of the airline industry, trucking and railroads, and the banking industry. Though the government followed a course of environmental regulation during the 1990s and early 2000s, the government continued deregulation of the banking industry and charted the country through deregulation of the housing industry. As a result, abuses led to a housing bubble that burst in 2008 causing the collapse of many major financial institutions and ushering in a major economic recession. In 2009 and 2010, President Obama signed legislation that reversed the trend creating regulatory reform for banks and Wall Street.

### Banking Reforms

When the banking industry was deregulated in the 1980s, it caused one of the most far-reaching scandals in banking history. Savings and loan (S&L) problems included consumers losing money that was not protected under the Federal Savings and Loan Insurance Corporation; banks closing; and heads of S&Ls under investigation for misconduct and criminality improprieties. The federal government under President George H. W. Bush was forced to bail out the industry, resulting in an increase in the already-inflated federal deficit. The administration was highly criticized for allowing the banks to mismanage their affairs and, after congressional oversight hearings, there was no doubt that the federal government would have to again regulate that industry. The regulation came in the form of a massive government bailout of the banking industry in 2008, after the country's worst recession since the Great Depression. The largest banks failed as a result of their investments in what was called "sub-prime" mortgages. Others had to sell out. Both the George W. Bush and Obama administrations, working closely with the Federal Reserve, the Treasury Department, and Congress, had to pump money into the failing banks. New laws were passed tightening banking regulations and consumer rights.

In looking at the federal budget, we will also trace the history of key legislation affecting the players and the process. Then we will analyze the components of the budget, including where the government gets its income and how it is allocated. Finally, we will discuss some of the reforms that have been proposed to keep the budget in check.

## THE FEDERAL BUDGET

### Budget Approval

Even though Congress has the constitutional "power of the purse," the players involved in the process include:

- the president,
- executive staff and agencies,
- special-interest groups,
- the media, and
- the public.

The president by law must submit a budget proposal to Congress the first Monday after January 3rd. Prior to that date, each federal agency submits detailed proposals outlining its expenses for the next fiscal year. This spending plan is submitted to the Office of Management and Budget, responsible for putting the budget requests together. Following a budget review and analysis, the OMB revises many of the recommendations and prepares a budget for the president to submit to Congress. By the middle of February, the Congressional Budget Office (CBO) evaluates the president's budget and submits a report to the House and Senate budget committees. It is interesting to note that the CBO is a staff agency of the Congress, whereas the OMB is a staff agency of the president. Therefore, the results of budgetary analysis by each group may differ.

Once the appropriations committees of each house receive the proposed budget, they review it and submit budget resolutions to their respective chambers. These resolutions include estimates of expenditures and recommendations for revenues. By April 15 a common budget direction must be passed. This provides the basis for the actual passage of the following year's budget. The fiscal year begins on October 1, and by that date both houses must pass a budget that includes 13 major appropriations bills. If any of these bills are not passed, Congress must then pass emergency spending legislation, called a continuing resolution, to avoid the shutdown of any department that did not receive funding from legislation passed. Shutdowns have occurred during the Reagan, George H. W. Bush, Clinton, Bush, and Obama administrations. The battle over the 1995–1996 budget was particularly significant. It caused not only the most prolonged government shutdown, but also created unique political consequences. After the Republicans assumed control of Congress in 1994, led by conservative freshmen and spurred on by what was called the "Gingrich Revolution," the GOP believed they could force President Clinton to capitulate when the Congress passed a balanced budget.

By September 30, 1995, the end of the fiscal year, it became apparent that the Republicans' balanced budget, which included major social program reductions and an overall objective of reducing the size and scope of the federal government, would be vetoed by President Clinton. After Clinton's veto, the budget battle began. Republicans refused to pass continuing resolutions—a stopgap measure to keep the government operating—unless the president agreed in principle to their budgetary demands. President Clinton, using his bully pulpit in a most effective manner, refused and in fact went on the offensive by suggesting that the Republicans were holding the American people hostage. When the media focused their attention on how the shutdown was affecting government workers and showed dramatic pictures of closed signs posted outside shuttered government agencies and national parks, the Republicans were forced to pass continuing resolutions and reformulate their own budget proposal.

The 1995 and 1996 government shutdowns created an election issue that would carry through the entire 1996 campaign. Shutdowns that occurred in the Obama and Trump administrations reinforced the public perception that the government is broken.

During this entire process, special-interest groups, heads of bureaucratic agencies, the media, and the public are also involved in trying to influence the nature of the budget. Private sector lobbyists argue for increased funding for programs such as entitlements and federal aid, whereas bureaucratic chiefs attend congressional hearings to fight for their departments. The media publicizes the process through news reports and editorials. The public through its contacts with legislators (letter writing and phone calls) also gives its viewpoint regarding such issues as tax increases.

## Deficit Spending

What exactly is deficit spending? Third-party presidential candidate Ross Perot, during the 1992 campaign, suggested that deficit spending was so serious that his grandchildren would potentially face the problem of a nation going broke. Very simply put, deficit spending is when expenditures

In 2010 the Congress and president faced mounting pressure from the American people to deal with the nation's unemployment rate, which was almost 10 percent, and the rising national debt and deficit that was over a trillion dollars. A bipartisan debt commission made a number of recommendations that would have reduced the deficit by dealing with spending and entitlement programs. The Democrats and Republicans have not agreed on a common approach to solve these issues.

## Budget Reforms

Attempting to find a way of helping the economy and closing tax loopholes, President Reagan asked Congress to pass the most far-reaching tax-reform measure since the income tax was instituted. Supported by liberal Democratic Senator Bill Bradley of New Jersey, this law called for tax-code changes that would result in a restructuring of tax brackets and eliminating many tax deductions. The law, supported by both Democrats and Republicans, passed in 1986 and succeeded in these two objectives.

The result was that many Americans received a tax cut. And because many loopholes were addressed, it was hoped that additional income would offset the loss of revenue from the tax cut received by the middle class. The law reduced the number of brackets from 15 to 3, it slightly increased deductions for individuals and families, and it eliminated many other deductions. Even though the law succeeded in its objectives, because the expense side of the budget was not kept in check, the deficit still increased dramatically. From 1981 to 1992 the overall deficit quadrupled. However, Clinton's deficit-reduction programs eliminated the deficit during his administration. By 1998, the federal budget was balanced, and there was an anticipated budget surplus. The political argument then arose as to what should be done with any surplus. Some of the suggested uses for the surplus included reducing the national debt, saving Social Security, decreasing tax rates for all Americans, and increasing spending for government programs. This surplus was short-lived. As previously discussed, the country again faced deficits starting in 2001, which got worse after the economic recession of 2008.

## The Federal Budget

Let us look at some characteristics of recent budgets adopted by Congress.

Money comes from

- federal income taxes—46 percent;
- Social Security and payroll taxes—32 percent;
- corporate taxes—10–15 percent;
- excise taxes on such as liquor, gasoline, and luxury items—2–4 percent; and
- customs and duties collected and other sources—2–4 percent.

Money is expended for

- entitlements (Social Security, Medicare, Medicaid)—40 percent;
- national defense—16 (mandatory) percent;
- interest on the debt—10 percent;
- other mandatory—16 percent; and
- discretionary spending—20 percent.

By 2016 the total budget had risen to over $3 trillion.

## TAXES

As stated earlier, taxes are the major source of income for federal, state, and local governments. Taxes are recognized as an essential ingredient in the ability of government to provide services to the population. The three types of personal taxes are progressive taxes, regressive taxes, and proportional taxes. They each affect taxpayers in different ways. A progressive tax such as the current federal income tax collects more money from the rich than the poor on a sliding scale. If the government takes an equal share from everybody regardless of income, it is a proportional tax, also called a flat tax. California Governor Jerry Brown suggested this approach during the 1992 presidential campaign. After the 1994 election many Republicans suggested this as an alternative to the present tax structure. A regressive tax such as a sales tax has the poor paying a greater share than the rich. After the 1996 election, some Republicans even demanded the abolition of the Internal Revenue Service as well as called for the implementation of a flat-tax structure.

Yet, governments have few alternatives other than collection of taxes to pay for the services they provide, especially for social welfare programs. The foundation for these programs stems from the grandparent of entitlement, Social Security, which mandates contributory payments in the form of payroll taxes from employers and employees. Part of the payments also go to a Medicare program established as part of the Great Society. Because this program is predicated on forced savings, it differs from other programs such as public assistance programs, which are based on a noncontributory approach.

Finally, if government has these programs, are they making a difference in income distribution? Studies have concluded that despite all the efforts made on the part of federal, state, and local governments, the problem of income inequality still exists.

## SEARCHING FOR SOLUTIONS

Universal health care became the battle cry of the Clinton administration. However, the issue had been originally placed on the public agenda by Presidents Truman and Nixon. One would expect that the United States would be a health care world leader. In fact, other countries such as Canada and Great Britain have had universal health care for years. Critics of America's system pointed to the fact that the United States has a lower life expectancy and higher infant mortality rate than countries providing universal coverage. There are those who state that, even without a universal system, America still spends over 15 percent of its Gross National Product on health. But because of such factors as medical malpractice suits, skyrocketing insurance, and health costs, as well as the loss of coverage for many workers who have changed or lost jobs, the cry for reform was taken up. In addition, it became evident that access to health insurance was closely tied to race and income, with whites, who have higher incomes on average than African Americans, more likely to have coverage.

Even with Medicare and Medicaid, the country still lags behind in dealing with health-related coverage. The Family Medical Leave Act of 1993 gave unpaid emergency medical leave for employees with a guarantee that their jobs would not be taken away in the interim. But what President Clinton hoped would be the benchmark of his administration was the adoption of a national health security plan as extensive as the original Social Security Act. Standing before Congress in 1993, Clinton held up a "Health Security Card" and threatened to veto any health security bill that did not include universal health care as its foundation. The bill itself was well over a thousand pages, and spearheading the drive was First Lady Hillary Rodham Clinton. During the summer of 1994 both houses introduced watered-down versions of Clinton's bill. However, the legislation remained tied up as a massive lobbying effort took place. The issues of employer mandates, timing, and the extent of the coverage provided kept Congress from acting on the measure. As a result of the Republican electoral victory in the midterm elections, the issue of health care was placed on the back burner.

However, in 1996, a health-reform bill guaranteeing the portability of health insurance if a worker left a job was signed into law.

In 2010, President Obama signed historic health-care legislation called the Affordable Care Act of 2010. The opponents of the law called it "Obamacare," and made the claim that it was a government takeover of the health system. The law's goal was to fully insure an additional 35 million Americans, reduce the costs of health care, and reduce the federal deficit over a 10-year period. After the law was signed, those who had health insurance policies received additional benefits, such as increased coverage and protection from being dropped from a policy as a result of a pre-existing condition. The law was challenged, and in 2012 the Supreme Court ruled it was constitutional. The initial rollout in 2014 had major problems. The government website crashed, making it very hard to sign up. Even though President Obama promised that if you liked your current health care plan, then you could keep it, many Americans were informed that they had to change their policies to comply with the law. Even with these problems, by 2015 over 16.4 million people gained health insurance coverage since the Affordable Care Act became law nearly five years ago. The coverage gains have delivered the largest drop in the uninsured rate in four decades, bringing that rate down to 13.2 percent by the end of the first quarter of 2015. The law was also challenged in 2015. The United States Supreme Court ruled in *King v Burwell* that tax credits are available to individuals purchasing health insurance on federal and state exchanges.

## Spotlight on Social Security

To illustrate the point, you have to go only as far as to look at the Social Security System. After its board informed the public of the program's deficit, Congress began considering ways of saving the system. The National Commission on Social Security Reform had been created in 1983 by President Reagan. Among the commission's suggestions adopted by Congress were

- a six-month delay in the cost-of-living index adjustment in July 1983;
- a rescheduling of previously approved increases in Social Security payroll taxes, which would have the effect of kicking in scheduled increases at a slower rate;
- a gradual increase in the age when an individual could first receive Social Security benefits (as a result of an increase in life expectancy, it was believed people could also work longer);
- having federal employees contribute to the Social Security System; and
- a portion of Social Security benefits being subject to federal taxes for those people with incomes over $20,000.

These reforms resulted in a surplus in the system. The government began borrowing from the reserve, and as a result the system is again in trouble. Projections indicate that by the second decade of the twenty-first century, the Social Security System will not be able to pay everybody who is eligible. A new bipartisan commission was appointed by President George W. Bush in 2001. Its mission was to investigate alternatives and enhancements to Social Security such as partial privatization. The report suggested that the Social Security System would need to be reformed through means testing and included the feasibility of creating privatized Social Security accounts. Congress did not adopt these reforms. One reason Congress refused to pass any legislation dealing with the recommendations was that Social Security was traditionally considered to be "the third rail" of American politics. After President George W. Bush was reelected in 2004, he made Social Security reform his number one legislative priority. He proposed the creation of "Personal Retirement Accounts" for anyone born after 1950. His critics called it privatization.

The proposals were never voted on by Congress and, in 2006, a newly elected Democratic Congress refused to bring it up. In 2010, a new bipartisan debt commission came out with suggestions regarding Social Security and Medicare. The report aimed to make Social Security solvent over 75