8.7: Budgets and Fiscal Policy

LEARNING OBJECTIVES

1. Understand how budgets are created
2. Understand how fiscal policy can affect economic performance
3. Understand why earmarks are not a big deal, but Social Security and Medicare are

Modern governments spend a lot of money (including efforts to boost productivity). In most states, governments raise and spend money through budgets. That makes budgets, for the most part, a matter of law. For the United States, and most countries, and for any state or local government to raise and spend money, the legislative body of that government must pass a law authorizing how much money will be spent and for what purpose. So, in the U.S., Congress (both the House and the Senate) must agree on a spending bill that authorizes government agencies to spend money in any particular way. Budgets can be a single, large bill containing many categories of spending, or they can be broken up into different bills allowing different kinds of spending. So if you hear or read that Congress has passed a defense appropriations bill, that means they have approved a spending plan for the Defense Department, and through them, all the spending that will take place on behalf of the Army, Navy, Air Force, and Marines.

The federal budget, passed by Congress and signed by the president, spends more than $3 trillion dollars a year, close to one quarter of GDP. The federal budget is paid for by taxes, earnings, transfers and borrowing.

Figure 8.4 [federal budget expenditure and revenue charts]

Budgets typically have two parts: revenue (how much money is coming in) and expenditure (how much money is going out). (A revenue package may come in a separate bill, but budgets are built on the assumption that enough revenue will be available to pay for the spending.) If revenue exceeds spending, that’s a budget surplus. If spending is greater than
revenue, that’s a budget deficit. As we will see, each situation has a mixed effect on the economy. The accumulated deficits are called the national debt.

Figure 8.5 [national debt chart]

For the most part, governments don’t just print money when they need more. They either cut spending, or raise taxes, or they borrow. Do you have a Savings Bond? You are helping to fund the U.S. national debt. Governments issue bonds, which are bought by investors. The bonds pay interest, and after so many years, usually 10 or 20, the investor gets his or her initial investment (principal) back. Investors buy bonds because they are backed by the faith and credit of the issuing government (so U.S. or Canadian bonds are a safer investment than, say, bonds from Zimbabwe or Afghanistan). Governments often also use bonds to fund capital improvements, such as public buildings or transportation projects. The contractors want to get paid right away; the government uses tax revenue to pay back the investors who lent them the money for the project.

One thing you may have heard in recent times is that China lends us money to fund our budget (and/or trade) deficit. That’s not quite the case. Because China has a trade surplus with the U.S. they end up holding more dollars than they know what to do with. So part of what they do is to buy U.S. government treasury securities. It’s a safe place to park your money. But funding the budget deficit doesn’t depend on Chinese investment. The U.S. government does not borrow directly from China; China buys T-bills and Treasury notes on the open market.

Deficits get perhaps a little more attention than they deserve of late, perhaps because during the George W. Bush administration Congress was persuaded to cut taxes and keep spending high. The Bush administration argued that tax cuts would stimulate the economy by putting more money in the hands of more consumers. It’s not clear how much effect this had. Supporters said that helped keep the economy moving; critics tended to say that most of the tax cut went to the wealthiest Americans, who were unlikely to raise their consumption or investment more than they were already doing. The one thing the tax cuts did do was make the budget deficit grow.

Figure 8.6 [deficits as a percentage of GDP]

Then, in the interest of jump starting the economy, President Barack Obama got Congress to increase spending even more. This also was controversial. Conservatives, including members of the so-called Tea Party movement, criticized the president for making the budget deficit larger (the deficits of the Bush years were apparently OK). Supporters pointed out that without the stimulus, the economy likely would have done worse.

Budget deficits obviously can’t grow forever, and no rational person suggests that they should or will. At some point, if nothing else, people will stop lending you money. Conservatives argue that heavy borrowing by government “crowds out” private investment (making it harder or less likely that private firms will get loans or invest in productive enterprises), but there’s basically no evidence that this ever happens. A big budget deficit—government spending extra money—can cause inflation if the economy is already booming. But if it’s not, that doesn’t appear to happen. We’ve had big budget deficits for the last 10 years, but, aside from an occasional spike in oil prices, very little inflation.
Fiscal Policy

Taxes and spending—in essence, the budget—is one way that government can influence economic performance. This is called fiscal policy. In the most basic terms, fiscal policy is using the government’s power to tax and spend to try to influence economic outcomes.

Prior to the 1930s, prevailing economic theory urged policy makers to leave things alone, an economic philosophy often referred to as laissez-faire (French for to leave alone). The Great Depression, however, challenged the assumptions of this theory, since it lingered on for more than 10 years. Despite a relatively hands-off economic policy, the economy did not recover on its own. Unemployment was high, business profits were low, and although top executives’ salaries continued to grow, the wages of most Americans did not. Unemployment was as high as 30 percent.

The economist most associated with active fiscal policy was John Maynard Keynes, a British economist who wrote about this idea in the 1920s and 1930s. He said that when consumer and business spending fell (remember that a drop in aggregate demand is what causes recessions, ultimately), government could restore the economy’s vigor by spending to make up the gap. Keynes even spoke to President Franklin Roosevelt, who, despite his promises of “bold, persistent experimentation” to end the Depression, wasn’t a very forward thinking person when it came to economics. He had little use for Keynes’ ideas. Keynes thought it would be good for government to run a temporary budget deficit to boost demand and get the economy moving again. He also thought that when times are good, you should use the resulting budget surplus to pay off the debt you acquired during the recovery phase.

Why would fiscal policy stimulate the economy? Increasing government spending would increase total demand, leading businesses to sell more product, thereby boosting profits and, hopefully, wages and employment. That increase should multiply throughout the economy, as those business owners and their employees now will have more money, and they, too, are likely to spend some of it. Depending on what government spends on, it's a temporary fix. Opponents of fiscal stimulus would argue that in the long run the economy will fix itself, if left alone. Keynes’ famous response was, yes, but in the long run, we’re all dead.

Fiscal policy takes many forms:

- **Employment:** The U.S. government, for example, employs several million people at a variety of tasks. Those people spend their government paychecks on normal consumer items, such as housing and food, and add to the total demand for goods and services in the economy, while providing services that people often say they want, everything from defense to police and fire services to public education.

- **Transfer payments:** The government processes transfer payments such as money sent to recipients of Social Security, welfare, and unemployment compensation. This raises the income and hence the consumption of people who might otherwise not be spending as much money. This raises overall demand in the economy.

- **Government consumption:** The government buys a large amount of goods and services. This provides jobs for the people who make and sell the goods that government buys, from defense-related materiel to health care and construction equipment.

In more recent times, President Obama’s stimulus package provided money for infrastructure spending, and money to states and local government to permit them to balance their budgets without slashing services and payrolls. Leading up to the 2012 presidential campaign, Republicans liked to call it “the failed stimulus package,” but people who weren’t running for president tended to argue that the stimulus, together with actions taken by the Bush administration in 2007–2008, had kept us from slipping into another Great Depression. Nobel Prize-winning economist Paul Krugman...
said that the only problem with the stimulus package was that it wasn’t big enough. He estimated that the stimulus needed to be about twice as big to push the economy toward full recovery.

It seems to make a difference what government spends our money on. Transfer payments eliminate a lot of human suffering. Before Social Security, for example, senior citizens were overwhelmingly poor. Defense spending tends to be less stimulating (and that’s not the same thing as non-stimulating) to the overall economy, because the items purchased, such as tanks, don’t then circulate elsewhere in the economy. Spending on infrastructure—such as building schools, bridges, roads, ports and other public facilities—may do the most to stimulate the economy since the results—better education or transportation networks—can help the economy to be more productive overall. Spending on education, particularly post-K–12 education and training, also tends to help the economy. The GI Bill, which after World War II allowed millions of American veterans to return to college, provided a huge boost to the post-war economy, by training an entire generation of engineers, scientists, doctors, lawyers, business people and teachers. (Before World War II, not so many people went to college. After World War II and the GI Bill, people expected to.)

Earmarks

One of the budgetary categories you may have heard something about are congressional earmarks. Earmarks are amendments to bills moving through Congress that contain money for projects in a representative’s home district or in a senator’s home state. They’ve generated a lot of heat and noise because some of them look like boondoggles, and a lot of them have been described as boondoggles. But one person’s doggle is another person’s boon. So, for example, in one of the most infamous examples, Ketchikan, Alaska’s “bridge to nowhere” actually would have connected the city to the island where its airport is located. That project is controversial even in Ketchikan. I asked a friend of mine who lives there about it and he replied, “Do you want to see me start a fight?” But many of the examples listed as boondoggles don’t look so bad once you understand them. In my own neighborhood, an earmark project that repaved a beat-up stretch of suburban arterial, adding sidewalks and a turn lane, was listed on a Colorado Republican senator’s list of the worst projects in the country. Apparently, one of his staff had interviewed a restaurant owner whose business was hurt by the traffic disruptions caused by the project. I contacted the senator’s office to ask when they’d actually visited the project. I never heard back from them.

But what you should know about earmarks is that they total less than 1 percent of the entire federal budget. We could make them all go away tomorrow and the federal budget deficit would be nearly as big as ever. So while earmarks are a convenient whipping boy for opponents of federal spending, they’re not a significant source of fiscal calamity.

Social Security and Medicare

Another controversial budget category is Social Security. It is the main retirement program for most citizens of the United States. Most industrialized nations have some sort of public retirement program. Today, more than 100 nations—for Algeria to Zimbabwe—have public retirement programs that operate more or less like Social Security. People pay in something, and get something out when they retire. Arguably, it has been one of the most successful and popular programs in the United States, but still not without controversy as the nation’s demographics evolve toward an older average population.
Social Security got its start in the Great Depression. With the advent of more modern medicine and public health campaigns, average lifespans in the U.S. increased by 10 years from 1900 to 1930. Meanwhile, beginning in 1920, more people lived in cities than on farms for the first time in the nation’s history. So, people were no longer self-sufficient farmers who lived several generations in one home, but increasingly were urban dwellers who lived in single-family homes and apartments. With the onset of the Great Depression and high unemployment, many older people lost their jobs. Although some states had public pension systems, it was hard to qualify for them and most of them were woefully underfunded.

Enter Social Security. The early years of the Great Depression led to a lot of reform, including the Social Security Act of 1935. People started paying Social Security taxes in 1937, with payments kicking in over the next three years. At the time, life expectancies after retirement were not great, so few people if any anticipated that people might, someday, collect benefits for 30 years after retirement. In fact, when the act was passed, the life expectancy for a man born in 1930 was only 58 (62 for women), and the retirement age for benefits was 65. Now, on the other hand, if you were born in 1990, you should expect to live at least another 15 years if you’re a man and nearly 20 years if you’re a woman. That puts a strain on the system. In recent times, there are at least 35 million people over the age of 65 in the United States, and the great majority of them are collecting Social Security.

And part of the reason for that is Social Security. In 2008, Social Security provided more than $600 billion in benefits to more than 50 million Americans, plus another $43 billion paid to 7.5 million people receiving Supplemental Security Income (SSI), a 1974 program that seeks to cover people who may not have qualified for Social Security. Once Congress adopted automatic Cost of Living Adjustments (COLAs) in the 1970s, Social Security served to virtually eliminate the incidence of poverty among senior citizens. And as everybody pays in, and everybody who worked enough in their lifetimes qualifies, for a long time Social Security was described as the “third rail” of American politics—a reference to the electrified “hot” rail that powers some transit trains. Touch it, and you die.

In more recent times, some conservatives have taken aim at the program. President George W. Bush proposed letting people invest part of their own Social Security tax payments in whatever they wanted. The Great Recession of 2007–2009, which saw the stock market tumble, called the wisdom of that into question, but even before then, voters seemed inclined to reject the president’s proposal. (It was never very popular in public opinion polls. And it’s worth noting that both Social Security and Medicare have much lower expense ratios than do their private sector counterparts [Wall Street investment firms and private insurance companies]. So it’s not a given that the private sector would provide these services more efficiently.)

In 2011, another Texas governor, Republican presidential candidate Rick Perry, called Social Security a Ponzi scheme. Charles Ponzi was a con man who was famous in the 1920s for promising high returns on small investments. Ponzi paid off the earlier investors with later contributions. As long as his fund kept growing, he could keep his investors happy. But eventually somebody figures out that the emperor is indeed, buck naked, and the whole scam collapses. The same thing happened with financier Bernie Madoff in the 2000s. (Ponzi and Madoff both ended up in prison.)

Is Social Security a Ponzi scheme? Current contributions do go to pay current expenses, in a way. For all of its history, Social Security’s contributions have gone into a trust fund, which invests the proceeds in U.S. government treasury securities, one of the safest but not always the best-paying investment in the world. As the nation ages—more older people living longer relative to the number of young people still working—the demands on the trust fund grow relative to the amount of money going into it. In theory, it won’t ever run out of money, but the trust fund could be exhausted by
somewhere between 2036 and 2049, depending on who’s doing the estimating. That could mean a decrease in benefit levels.

It’s not impossible to fix this. Several options are available:

- Raise the retirement age. If people have to work longer, they’ll pay more into the system. And, with life expectancies rising, more people are working longer, sometimes just for something to do.
- Raise the tax rate. Never a very popular solution, but one option nonetheless.
- Raise the income threshold. Because wages are taxed for Social Security only up to the first $106,800 you make, there’s a lot of untapped income potential out there. Again, a politically challenging option because Americans, in general, don’t want to pay more taxes.

Medicare is a slightly different story. It operates much like Social Security—working people pay taxes into a trust fund that provides insurance coverage. It was created by Congress in 1965, at a time when only half of seniors had any kind of health care coverage (and 30 percent still lived in poverty).

And nobody needs health care quite like senior citizens do, so there are great demands on the system. Medicare’s trust fund could run dry by 2024, a situation exacerbated by Congress and President George W. Bush adding a prescription drug benefit—without any increase in funding—in 2003. The plan also barred Medicare from bargaining with drug companies (the Veterans Administration gets to bargain and pays half for drugs what Medicare pays).

Again, the solutions are similar to those found in Social Security—some combination of higher taxes and lower benefits. In recent years, Democrats have proposed broader health care reform that would spread the risk among more people. Insurance programs work best when they cover a broad base of people. Republicans, on the other hand, have proposed privatizing the whole operation, which would mean senior citizens pay much more out of pocket for health care expenses.

Taxes

Taxes: The other side of fiscal policy is taxes. Taxes redistribute income from those who have to those who don’t by funding the above-mentioned activities; they also are used to discourage some activities (such as taxes on cigarettes and liquor) and encourage others (like the income tax mortgage interest deduction, which helps make housing more affordable for many people).

The nature of the taxes used to fund the government also has an impact on the economy. Taxes can be flat, progressive or regressive.

- A flat tax is just that—everybody pays the same rate. Flat taxes are the darlings of the ultra-rich, since many of them would pay less tax than they do now. Flat taxes also are regressive, however. Let’s say the tax rate is 10 percent. Ten percent of Bill Gates’ income would be much more money than would 10 percent of my income or yours. But that 10 percent would mean a lot more to someone who makes a lot less. Someone making $1 million a year, although paying $100,000 in taxes, still would have $900,000, on which, we might guess, he or she still would live pretty well. But 10 percent of the income of someone making $40,000 a year—$4,000—would be much more of a hardship for that person. Taxes are regressive when they take a bigger share of low-income people’s money than they take of wealthy people’s money.
- Progressive taxes are those that take a progressively larger share of someone’s income. The federal income tax is graduated, because depending on your income, you may pay 15–35 percent. (Not the whole 35 percent—the top
marginal rate is only applied to your earnings over a given threshold, say $100,000. So the 15 percent applies to the first $20,000 or so of everyone’s income, and the additional rate—in a series of steps—applies only to what you earn over that.) When the top marginal rate was 70 percent, that appeared to have encouraged people to find ways to legally hide their money from the government, as opposed to investing it and making more money. Parking your money in an off-shore bank account in the Cayman Islands doesn’t do much for the U.S. economy (although it’s good for the Caymans); investing in almost anything in the U.S. tends to do more good.

- Any tax that charges everybody the same, regardless of income, is regressive. So a flat tax is regressive, as are most sales taxes.

Tax cuts also can be a tool of fiscal policy. A tax cut can put more money in consumers’ pockets, thus encouraging spending; a tax hike can help cool the economy off by doing the opposite. Despite the claims that tax cuts will spur economic growth, they don’t seem to have that affect. Tax cuts in the early 1960s, in the early 1980s, and in 2001 and 2003 all failed to make the economy grow much. In the last example, the Bush administration said the tax cut would so spur the economy that the budget deficit would disappear, but as with Ronald Reagan’s tax cuts of the early 1980s, that didn’t happen. The budget deficits just got bigger. What Reagan was arguing, and what Bush was perhaps unwittingly agreeing with, is called supply side economics. Supply side economics were the brainchild of Arthur Laffer, once an economics professor at the University of Southern California. At a party with a journalist, Laffer drew what became called the Laffer Curve on a cocktail napkin (I’m not making this up). Laffer’s idea had some logic to it. He suggested that if taxes were too high, economic activity would be discouraged. And if they’re too low, the same thing happens. If they’re too high, people don’t get enough reward for their efforts. If they’re too low, government doesn’t provide enough services to allow the economy to function. The question remains, however, where we might be on the curve—are taxes too high, too low, or just about right? President Reagan’s argument at the time was that taxes were too high, so that cutting them would spur economic activity and actually generate more tax revenue. Instead, Reagan oversaw bigger deficits than those he inherited from his predecessor, Jimmy Carter.

Who Pays the Most Taxes?

How you answer this question depends on how you slice the economic pie. It’s an important question because taxes allow the government to pay for the services and benefits that people say they want. And as Americans, in general, don’t like taxes, it’s a subject of never-ending debate.

First of all, everybody pays something. One of the Fox News buzz phrases about taxes of recent vintage has been that a flat tax would give everybody “a skin in the game,” borrowing a metaphor from the world of golf (which I still don’t understand). The truth of the matter is that while some people make so little money that they effectively pay no federal income tax, everybody who works pays payroll taxes, which contribute to the Social Security and Medicare trust funds. Everyone also pays sales tax in the 45 states that have such a tax. And taxes such as property taxes get passed on to people who rent in the form of higher rent. So everybody, it would appear, has a skin in the game.

As noted elsewhere in this chapter, the United States has a graduated income tax, which means the more you make, the higher your tax rate. The higher tax rate is only applied to income over a certain level. So if the basic rate is 10 percent on your first $8,500 of earnings, everybody pays that, regardless of their total income. The top marginal rate is 35 percent on incomes over $379,150. But no one pays that rate on all their income. People who earn more than $1 million a year, for example, pay an average total rate of 24 percent. The top 400 wage earners in the country paid 18.1 percent in 2008.
Upper income earners do pay the most federal income taxes. The top 1 percent of wage earners—people earning more than $380,000 a year—pay 19 percent of the total federal income tax bill in a typical year. The bottom 50 percent—people earning less than $33,000 a year—pay only 2.7 percent of total federal income tax. (The fact that half the country makes less than $33,000 a year ought to jump out at you, as it raises a whole host of other issues.)

And this is where things get complicated. The top 1 percent also control 50 percent of the nation’s total wealth and earned a little over 20 percent of the nation’s total personal income. Wealth in this case includes stocks, bonds, real estate—anything of measurable value. The top 20 percent control more than 80 percent of the nation’s wealth; the bottom 20 percent is worth effectively zero (meaning that, if anything, they have debt, not wealth). Meanwhile, the very richest Americans—those making more than $10 million a year, pay only about 25 percent of their income in taxes. So while they pay a lot of tax, they still have a lot to live on.

If you take all federal taxes, most of the money comes from the middle class—people earning between $34,000 and $140,000—a year, paying slightly more than 50 percent of the total tax bill. That includes all other federal taxes, including the payroll taxes for Social Security and Medicare.

People who think taxes are too high look at the numbers on share of personal income taxes; people who think they’re too low look at the relative tax burden. The argument for lower taxes tends to be that with more money in their pockets, the wealthy classes will invest more and make the economy grow. The argument against lower taxes, aside from their effect on the federal budget deficit, tends to be that the so-called job creators aren’t really letting much of the wealth trickle down. Corporate profits rose 16 percent from 2001–2007, but average wages rose less than 1 percent over the same time period. You will, as always, have to make up your own mind as to who’s right in this debate.

Another common complaint is that the U.S. has the highest corporate tax rate in the world, which is more less true in any given year (tax rates do change). But few U.S. firms, if any, pay this rate, thanks to a generous array of allowable deductions and credits. According to the Tax Policy Center, a non-partisan research outfit, the total tax burden in the U.S. is a little over 25 percent of GDP. The next six biggest economies in the world have a higher tax total tax burden (almost 34 percent) and the 34 countries of the OECD (Organization for Economic Cooperation and Development) average 34.7 percent. Americans pay slightly more in income taxes, less in corporate taxes, more in property tax and much less in sales taxes than do citizens in other countries.

KEY TAKEAWAYS

- Budget deficits can have a mixed impact on the economy.
- Fiscal policy can be used to stimulate economic activity.
- Tax increases and tax cuts, a part of fiscal policy, can be used to stimulate the economy or cool it down.

EXERCISES

1. What tax rate would discourage you from working more?
2. What do you think the government should spend money on? What do you think it shouldn't spend money on?