An Outline of the U.S. Economy: Chapter 7: Monetary and Fiscal Policy
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The role of government in the American economy extends far beyond its activities as a regulator of specific industries. The government also manages the overall pace of economic activity, seeking to maintain high levels of employment and stable prices. It has two main tools for achieving these objectives: fiscal policy, through which it determines the appropriate level of taxes and spending; and monetary policy, through which it manages the supply of money.

Much of the history of economic policy in the United States since the Great Depression of the 1930s has involved a continuing effort by the government to find a mix of fiscal and monetary policies that will allow sustained growth and stable prices. That is no easy task, and there have been notable failures along the way.

But the government has gotten better at promoting sustainable growth. From 1854 through 1919, the American economy spent almost as much time contracting as it did growing: the average economic expansion (defined as an increase in output of goods and services) lasted 27 months, while the average recession (a period of declining output) lasted 22 months. From 1919 to 1945, the record improved, with the average expansion lasting 35 months and the average recession lasting 18 months. And from 1945 to 1991, things got even better, with the average expansion lasting 50 months and the average recession lasting just 11 months.

Inflation, however, has proven more intractable. Prices were remarkably stable prior to World War II; the consumer price level in 1940, for instance, was no higher than the price level in 1778. But 40 years later, in 1980, the price level was 400 percent above the 1940 level.

In part, the government's relatively poor record on inflation reflects the fact that it put more stress on fighting recessions (and resulting increases in unemployment) during much of the early post-war period. Beginning in 1979, however, the government began paying more attention to inflation, and its record on that score has improved markedly. By the late 1990s, the nation was experiencing a gratifying combination of strong growth, low unemployment, and slow inflation. But while policy-makers were generally optimistic about the future, they admitted to some uncertainties about what the new century would bring.

Fiscal Policy -- Budget and Taxes

The growth of government since the 1930s has been accompanied by steady increases in government spending. In 1930, the federal government accounted for just 3.3 percent of the nation's gross domestic product, or total output of goods and services excluding imports and exports. That figure rose to almost 44 percent of GDP in 1944, at the height of World War II, before falling back to 11.6

percent in 1948. But government spending generally rose as a share of GDP in subsequent years, reaching almost 24 percent in 1983 before falling back somewhat. In 1999 it stood at about 21 percent.

The development of fiscal policy is an elaborate process. Each year, the president proposes a budget, or spending plan, to Congress. Lawmakers consider the president's proposals in several steps. First, they decide on the overall level of spending and taxes. Next, they divide that overall figure into separate categories -- for national defense, health and human services, and transportation, for instance. Finally, Congress considers individual appropriations bills spelling out exactly how the money in each category will be spent. Each appropriations bill ultimately must be signed by the president in order to take effect. This budget process often takes an entire session of Congress; the president presents his proposals in early February, and Congress often does not finish its work on appropriations bills until September (and sometimes even later).

The federal government's chief source of funds to cover its expenses is the income tax on individuals, which in 1999 brought in about 48 percent of total federal revenues. Payroll taxes, which finance the Social Security and Medicare programs, have become increasingly important as those programs have grown. In 1998, payroll taxes accounted for one-third of all federal revenues; employers and workers each had to pay an amount equal to 7.65 percent of their wages up to $68,400 a year. The federal government raises another 10 percent of its revenue from a tax on corporate profits, while miscellaneous other taxes account for the remainder of its income. (Local governments, in contrast, generally collect most of their tax revenues from property taxes. State governments traditionally have depended on sales and excise taxes, but state income taxes have grown more important since World War II.)

The federal income tax is levied on the worldwide income of U.S. citizens and resident aliens and on certain U.S. income of non-residents. The first U.S. income tax law was enacted in 1862 to support the Civil War. The 1862 tax law also established the Office of the Commissioner of Internal Revenue to collect taxes and enforce tax laws either by seizing the property and income of non-payers or through prosecution. The commissioner's powers and authority remain much the same today.

The income tax was declared unconstitutional by the Supreme Court in 1895 because it was not apportioned among the states in conformity with the Constitution. It was not until the 16th Amendment to the Constitution was adopted in 1913 that Congress was authorized to levy an income tax without apportionment. Still, except during World War I, the income tax system remained a relatively minor source of federal revenue until the 1930s. During World War II, the modern system for managing federal income taxes was introduced, income tax rates were raised to very high levels, and the levy became the principal sources of federal revenue. Beginning in 1943, the government required employers to collect income taxes from workers by withholding certain sums from their paychecks, a policy that streamlined collection and significantly increased the number of taxpayers.

Most debates about the income tax today revolve around three issues: the appropriate overall level of taxation; how graduated, or "progressive" the tax should be; and the extent to which the tax should be used to promote social objectives.

The overall level of taxation is decided through budget negotiations. Although Americans allowed the government to run up deficits, spending more than it collected in taxes during the 1970s, 1980s, and the part of the 1990s, they generally believe budgets should be balanced. Most Democrats, however, are willing to tolerate a higher level of taxes to support a more active government, while Republicans generally favor lower taxes and smaller government.

From the outset, the income tax has been a progressive levy, meaning that rates are higher for people with more income. Most Democrats favor a high degree of progressivity, arguing that it is only fair to make people with more income pay more in taxes. Many Republicans, however, believe a steeply progressive rate structure discourages people from working and investing, and therefore hurts the overall economy. Accordingly, many Republicans argue for a more uniform rate structure. Some even suggest a uniform, or "flat," tax rate for everybody. (Some economists -- both Democrats and Republicans -- have suggested that the economy would fare better if the government would eliminate the income tax altogether and replace it with a consumption tax, taxing people on what they spend rather than what they earn. Proponents argue that would encourage saving and investment. But as of the end of the 1990s, the idea had not gained enough support to be given much chance of being enacted.)

Over the years, lawmakers have carved out various exemptions and deductions from the income tax to encourage specific kinds of economic activity. Most notably, taxpayers are allowed to subtract from their taxable income any interest they must pay on loans used to buy homes. Similarly, the government allows lower- and middle-income taxpayers to shelter from taxation certain amounts of money that they save in special Individual Retirement Accounts (IRAs) to meet their retirement expenses and to pay for their children's college education.

The Tax Reform Act of 1986, perhaps the most substantial reform of the U.S. tax system since the beginning of the income tax, reduced income tax rates while cutting back many popular income tax deductions (the home mortgage deduction and IRA deductions were preserved, however). The Tax Reform Act replaced the previous law's 15 tax brackets, which had a top tax rate of 50 percent, with a system that had only two tax brackets -- 15 percent and 28 percent. Other provisions reduced, or eliminated, income taxes for millions of low-income Americans.

Fiscal Policy and Economic Stabilization

In the 1930s, with the United States reeling from the Great Depression, the government began to use fiscal policy not just to support itself or pursue social policies but to promote overall economic growth and stability as well. Policy-makers were influenced by John Maynard Keynes, an English economist who argued in *The General Theory of Employment, Interest, and Money* (1936) that the rampant joblessness of his time resulted from inadequate demand for goods and services. According to Keynes, people did not have enough income to buy everything the economy could produce, so prices fell and companies lost money or went bankrupt. Without government intervention, Keynes said, this could become a vicious cycle. As more companies went bankrupt, he argued, more people would lose their jobs, making income fall further and leading yet more companies to fail in a frightening downward spiral. Keynes argued that government could halt the decline by increasing spending on its own or by cutting taxes. Either way, incomes would rise, people would spend more, and the economy could start growing again. If the government had to run up a deficit to achieve this purpose, so be it, Keynes said. In his view, the alternative -- deepening economic decline -- would be worse.

Keynes's ideas were only partially accepted during the 1930s, but the huge boom in military spending during World War II seemed to confirm his theories. As government spending surged, people's incomes rose, factories again operated at full capacity, and the hardships of the Depression faded into memory. After the war, the economy continued to be fueled by pent-up demand from families who had deferred buying homes and starting families.

By the 1960s, policy-makers seemed wedded to Keynesian theories. But in retrospect, most Americans agree, the government then made a series of mistakes in the economic policy arena that eventually led to a reexamination of fiscal policy. After enacting a tax cut in 1964 to stimulate economic growth and reduce unemployment, President Lyndon B. Johnson (1963-1969) and Congress launched a series of expensive domestic spending programs designed to alleviate poverty. Johnson also increased military spending to pay for American involvement in the Vietnam War. These large government programs, combined with strong consumer spending, pushed the demand for goods and services beyond what the economy could produce. Wages and prices started rising. Soon, rising wages and prices fed each other in an ever-rising cycle. Such an overall increase in prices is known as inflation.

Keynes had argued that during such periods of excess demand, the government should reduce spending or raise taxes to avert inflation. But anti-inflation fiscal policies are difficult to sell politically, and the government resisted shifting to them. Then, in the early 1970s, the nation was hit by a sharp rise in international oil and food prices. This posed an acute dilemma for policy-makers. The conventional anti-inflation strategy would be to restrain demand by cutting federal spending or raising taxes. But this would have drained income from an economy already suffering from higher oil prices. The result would have been a sharp rise in unemployment. If policy-makers chose to counter the loss of income caused by rising oil prices, however, they would have had to increase spending or cut taxes. Since neither policy could increase the supply of oil or food, however, boosting demand without changing supply would merely mean higher prices.

President Jimmy Carter (1973-1977) sought to resolve the dilemma with a two-pronged strategy. He geared fiscal policy toward fighting unemployment, allowing the federal deficit to swell and establishing countercyclical jobs programs for the unemployed. To fight inflation, he established a program of voluntary wage and price controls. Neither element of this strategy worked well. By the end of the 1970s, the nation suffered both high unemployment and high inflation.

While many Americans saw this "stagflation" as evidence that Keynesian economics did not work, another factor further reduced the government's ability to use fiscal policy to manage the economy. Deficits now seemed to be a permanent part of the fiscal scene. Deficits had emerged as a concern during the stagnant 1970s. Then, in the 1980s, they grew further as President Ronald Reagan (1981-1989) pursued a program of tax cuts and increased military spending. By 1986, the deficit had swelled to $221,000 million, or more than 22 percent of total federal spending. Now, even if the government wanted to pursue spending or tax policies to bolster demand, the deficit made such a strategy unthinkable.

Beginning in the late 1980s, reducing the deficit became the predominant goal of fiscal policy. With foreign trade opportunities expanding rapidly and technology spinning off new products, there seemed to be little need for government policies to stimulate growth. Instead, officials argued, a lower deficit would reduce government borrowing and help bring down interest rates, making it easier for businesses to acquire capital to finance expansion. The government budget finally returned to surplus in 1998. This led to calls for new tax cuts, but some of the enthusiasm for lower taxes was tempered by the realization that the government would face major budget challenges early in the new century as the enormous post-war baby-boom generation reached retirement and started collecting retirement checks from the Social Security system and medical benefits from the Medicare program.

By the late 1990s, policy-makers were far less likely than their predecessors to use fiscal policy to achieve broad economic goals. Instead, they focused on narrower policy changes designed to strengthen the economy at the margins. President Reagan and his successor, George Bush (1989-1993), sought to reduce taxes on capital gains -- that is, increases in wealth resulting from the appreciation in the value of assets such as property or stocks. They said such a change would increase incentives to save and invest. Democrats resisted, arguing that such a change would overwhelmingly benefit the rich. But as the budget deficit shrank, President Clinton (1993-2001) acquiesced, and the maximum capital gains rate was trimmed to 20 percent from 28 percent in 1996. Clinton, meanwhile, also sought to affect the economy by promoting various education and job-training programs designed to develop a highly skilled -- and hence, more productive and competitive -- labor force.

Money in the U.S. Economy

While the budget remained enormously important, the job of managing the overall economy shifted substantially from fiscal policy to monetary policy during the later years of the 20th century. Monetary policy is the province of the Federal Reserve System, an independent U.S. government agency. "The Fed," as it is commonly known, includes 12 regional Federal Reserve Banks and 25 Federal Reserve Bank branches. All nationally chartered commercial banks are required by law to be members of the Federal Reserve System; membership is optional for state-chartered banks. In general, a bank that is a member of the Federal Reserve System uses the Reserve Bank in its region in the same way that a person uses a bank in his or her community.

The Federal Reserve Board of Governors administers the Federal Reserve System. It has seven members, who are appointed by the president to serve overlapping 14-year terms. Its most important monetary policy decisions are made by the Federal Open Market Committee (FOMC), which consists of the seven governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve banks who serve on a rotating basis. Although the Federal Reserve System periodically must report on its actions to Congress, the governors are, by law, independent from Congress and the president. Reinforcing this independence, the Fed conducts its most important policy discussions in private and often discloses them only after a period of time has passed. It also raises all of its own operating expenses from investment income and fees for its own services.

The Federal Reserve has three main tools for maintaining control over the supply of money and credit in the economy. The most important is known as open market operations, or the buying and selling of government securities. To increase the supply of money, the Federal Reserve buys government securities from banks, other businesses, or individuals, paying for them with a check (a new source of money that it prints); when the Fed's checks are deposited in banks, they create new reserves -- a portion of which banks can lend or invest, thereby increasing the amount of money in circulation. On the other hand, if the Fed wishes to reduce the money supply, it sells government securities to banks, collecting reserves from them. Because they have lower reserves, banks must reduce their lending, and the money supply drops accordingly.

The Fed also can control the money supply by specifying what reserves deposit-taking institutions must set aside either as currency in their vaults or as deposits at their regional Reserve Banks. Raising reserve requirements forces banks to withhold a larger portion of their funds, thereby reducing the money supply, while lowering requirements works the opposite way to increase the money supply. Banks often lend each other money over night to meet their reserve requirements. The rate on such loans, known as the "federal funds rate," is a key gauge of how "tight" or "loose" monetary policy is at a given moment.

The Fed's third tool is the discount rate, or the interest rate that commercial banks pay to borrow funds from Reserve Banks. By raising or lowering the discount rate, the Fed can promote or discourage borrowing and thus alter the amount of revenue available to banks for making loans.

These tools allow the Federal Reserve to expand or contract the amount of money and credit in the U.S. economy. If the money supply rises, credit is said to be loose. In this situation, interest rates tend to drop, business spending and consumer spending tend to rise, and employment increases; if the economy already is operating near its full capacity, too much money can lead to inflation, or a decline in the value of the dollar. When the money supply contracts, on the other hand, credit is tight. In this situation, interest rates tend to rise, spending levels off or declines, and inflation abates; if the economy is operating below its capacity, tight money can lead to rising unemployment.

Many factors complicate the ability of the Federal Reserve to use monetary policy to promote specific goals, however. For one thing, money takes many different forms, and it often is unclear which one to target. In its most basic form, money consists of coins and paper currency. Coins come in various denominations based on the value of a dollar: the penny, which is worth one cent or one-hundredth of a dollar; the nickel, five cents; the dime, 10 cents; the quarter, 25 cents; the half dollar, 50 cents; and the dollar coin. Paper money comes in denominations of $1, $2, $5, $10, $20, $50, and $100.

A more important component of the money supply consists of checking deposits, or bookkeeping entries held in banks and other financial institutions. Individuals can make payments by writing checks, which essentially instruct their banks to pay given sums to the checks' recipients. Time deposits are similar to checking deposits except the owner agrees to leave the sum on deposit for a specified period; while depositors generally can withdraw the funds earlier than the maturity date, they generally must pay a penalty and forfeit some interest to do so. Money also includes money market funds, which are shares in pools of short-term securities, as well as a variety of other assets that can be converted easily into currency on short notice.

The amount of money held in different forms can change from time to time, depending on preferences and other factors that may or may not have any importance to the overall economy. Further complicating the Fed's task, changes in the money supply affect the economy only after a lag of uncertain duration.

Monetary Policy and Fiscal Stabilization

The Fed's operation has evolved over time in response to major events. The

Congress established the Federal Reserve System in 1913 to strengthen the supervision of the banking system and stop bank panics that had erupted periodically in the previous century. As a result of the Great Depression in the 1930s, Congress gave the Fed authority to vary reserve requirements and to regulate stock market margins (the amount of cash people must put down when buying stock on credit).

Still, the Federal Reserve often tended to defer to the elected officials in matters of overall economic policy. During World War II, for instance, the Fed subordinated its operations to helping the U.S. Treasury borrow money at low interest rates. Later, when the government sold large amounts of Treasury securities to finance the Korean War, the Fed bought heavily to keep the prices of these securities from falling (thereby pumping up the money supply). The Fed reasserted its independence in 1951, reaching an accord with the Treasury that Federal Reserve policy should not be subordinated to Treasury financing. But the central bank still did not stray too far from the political orthodoxy. During the fiscally conservative administration of President Dwight D. Eisenhower (1953-1961), for instance, the Fed emphasized price stability and restriction of monetary growth, while under more liberal presidents in the 1960s, it stressed full employment and economic growth.

During much of the 1970s, the Fed allowed rapid credit expansion in keeping with the government's desire to combat unemployment. But with inflation increasingly ravaging the economy, the central bank abruptly tightened monetary policy beginning in 1979. This policy successfully slowed the growth of the money supply, but it helped trigger sharp recessions in 1980 and 1981-1982. The inflation rate did come down, however, and by the middle of the decade the Fed was again able to pursue a cautiously expansionary policy. Interest rates, however, stayed relatively high as the federal government had to borrow heavily to finance its budget deficit. Rates slowly came down, too, as the deficit narrowed and ultimately disappeared in the 1990s.

The growing importance of monetary policy and the diminishing role played by fiscal policy in economic stabilization efforts may reflect both political and economic realities. The experience of the 1960s, 1970s, and 1980s suggests that democratically elected governments may have more trouble using fiscal policy to fight inflation than unemployment. Fighting inflation requires government to take unpopular actions like reducing spending or raising taxes, while traditional fiscal policy solutions to fighting unemployment tend to be more popular since they require increasing spending or cutting taxes. Political realities, in short, may favor a bigger role for monetary policy during times of inflation.

One other reason suggests why fiscal policy may be more suited to fighting unemployment, while monetary policy may be more effective in fighting inflation. There is a limit to how much monetary policy can do to help the economy during a period of severe economic decline, such as the United States encountered during the 1930s. The monetary policy remedy to economic decline is to increase the amount of money in circulation, thereby cutting interest rates. But once interest rates reach zero, the Fed can do no more. The United States has not encountered this situation, which economists call the "liquidity trap," in recent years, but Japan did during the late 1990s. With its economy stagnant and interest rates near zero, many economists argued that the Japanese government had to resort to more aggressive fiscal policy, if necessary running up a sizable government deficit to spur renewed spending and economic growth.

A New Economy?

Today, Federal Reserve economists use a number of measures to determine whether monetary policy should be tighter or looser. One approach is to compare the actual and potential growth rates of the economy. Potential growth is presumed to equal the sum of the growth in the labor force plus any gains in productivity, or output per worker. In the late 1990s, the labor force was projected to grow about 1 percent a year, and productivity was thought to be rising somewhere between 1 percent and 1.5 percent. Therefore, the potential growth rate was assumed to be somewhere between 2 percent and 2.5 percent. By this measure, actual growth in excess of the long-term potential growth was seen as raising a danger of inflation, thereby requiring tighter money.

The second gauge is called NAIRU, or the non-accelerating inflation rate of unemployment. Over time, economists have noted that inflation tends to accelerate when joblessness drops below a certain level. In the decade that ended in the early 1990s, economists generally believed NAIRU was around 6 percent. But later in the decade, it appeared to have dropped to about 5.5 percent.

Perhaps even more importantly, a range of new technologies -- the microprocessor, the laser, fiber-optics, and satellite -- appeared in the late 1990s to be making the American economy significantly more productive than economists had thought possible. "The newest innovations, which we label information technologies, have begun to alter the manner in which we do business and create value, often in ways not readily foreseeable even five years ago," Federal Reserve Chairman Alan Greenspan said in mid-1999.

Previously, lack of timely information about customers' needs and the location of raw materials forced businesses to operate with larger inventories and more workers than they otherwise would need, according to Greenspan. But as the quality of information improved, businesses could operate more efficiently. Information technologies also allowed for quicker delivery times, and they accelerated and streamlined the process of innovation. For instance, design times dropped sharply as computer modeling reduced the need for staff in architectural firms, Greenspan noted, and medical diagnoses became faster, more thorough, and more accurate.

Such technological innovations apparently accounted for an unexpected surge in productivity in the late 1990s. After rising at less than a 1 percent annual rate in the early part of the decade, productivity was growing at about a 3 percent rate toward the end of the 1990s -- well ahead of what economists had expected. Higher productivity meant that businesses could grow faster without igniting inflation. Unexpectedly modest demands from workers for wage increases -- a result, possibly, of the fact that workers felt less secure about keeping their jobs in the rapidly changing economy -- also helped subdue inflationary pressures.

Some economists scoffed at the notion American suddenly had developed a "new economy," one that was able to grow much faster without inflation. While there undeniably was increased global competition, they noted, many American industries remained untouched by it. And while computers clearly were changing the way Americans did business, they also were adding new layers of complexity to business operations.

But as economists increasingly came to agree with Greenspan that the economy was in the midst of a significant "structural shift," the debate increasingly came to focus less on whether the economy was changing and more on how long the surprisingly strong performance could continue. The answer appeared to depend, in part, on the oldest of economic ingredients -- labor. With the economy growing strongly, workers displaced by technology easily found jobs in newly emerging industries. As a result, employment was rising in the late 1990s faster than the overall population. That trend could not continue indefinitely. By mid-1999, the number of "potential workers" aged 16 to 64 -- those who were unemployed but willing to work if they could find jobs -- totaled about 10 million, or about 5.7 percent of the population. That was the lowest percentage since the government began collecting such figures (in 1970). Eventually, economists warned, the United States would face labor shortages, which, in turn, could be expected to drive up wages, trigger inflation, and prompt the Federal Reserve to engineer an economic slowdown.

Still, many things could happen to postpone that seemingly inevitable development. Immigration might increase, thereby enlarging the pool of available workers. That seemed unlikely, however, because the political climate in the United States during the 1990s did not favor increased immigration. More likely, a growing number of analysts believed that a growing number of Americans would work past the traditional retirement age of 65. That also could increase the supply of potential workers. Indeed, in 1999, the Committee on Economic Development (CED), a prestigious business research organization, called on employers to clear away barriers that previously discouraged older workers from staying in the labor force. Current trends suggested that by 2030, there would be fewer than three workers for every person over the age of 65, compared to seven in 1950 -- an unprecedented demographic transformation that the CED predicted would leave businesses scrambling to find workers.

"Businesses have heretofore demonstrated a preference for early retirement to make way for younger workers," the group observed. "But this preference is a relic from an era of labor surpluses; it will not be sustainable when labor becomes scarce." While enjoying remarkable successes, in short, the United States found itself moving into uncharted economic territory as it ended the 1990s. While many saw a new economic era stretching indefinitely into the future, others were less certain. Weighing the uncertainties, many assumed a stance of cautious optimism. "Regrettably, history is strewn with visions of such `new eras' that, in the end, have proven to be a mirage," Greenspan noted in 1997. "In short, history counsels caution."