ECONOMIC POLICY 101 KEY

Revised 3/2015

I. Economics: The Basics

1. *Economics* – the social science that studies the production, distribution, and consumption of goods and services.

2. *Microeconomics* – studies how individuals, households and firms and some states make decisions to allocate limited resources; typically in markets where goods or services are being bought and sold.

   ➢ *Supply and Demand* – backbone of a market economy.

   a. *Demand* = how much (quantity) of a product or service is desired by buyers. Examples: High demand for iPhone; gasoline subject to demand, etc. Other examples?

   b. *Supply* = how much the market can offer. The quantity supplied refers to the amount of a certain good producers are willing to supply when receiving a certain price. Examples: Apple creates demand by producing limited number of iPhones; supply of oil US subject to all kinds of things like demand abroad (China, India), wars in middle east, terrorist attacks (after 9/11), natural disasters (Hurricane Katrina damaged refineries on Gulf coast), time of year

   c. The correlation between price and how much of a good or service is supplied to the market is known as the supply relationship. Price, therefore, is a reflection of supply and demand > Higher the demand and the less of the supply, the higher the price and vice versa; strive for price equilibrium

3. *Macroeconomics* – deals with the performance, structure, and behavior of a national or regional economy as a whole.

II. The Tools and Theories of Economic Policy

1. *Fiscal Policy* - an attempt to use taxes, expenditures and borrowing to affect the economy (examples: federal budget, income tax and other revenues, etc.)

   a. *Keynesian Economics* - government takes responsibility for an increase in aggregate demand by spending during business slumps and curbing spending during booms; Keynes argued that the solution to depression was to stimulate the economy ("inducement to invest") through some combination of two approaches: a reduction in interest rates, and government investment in infrastructure; Keynesian Presidents considered to be FDR "Grand Pooh-Bah of Keynesian Economics," LBJ, Obama, etc.

   b. *Supply Side Economics* - production can be stimulated by large tax cuts, reducing government regulations in which the initial loss of fed revenue will be offset by the taxes generated from expanded economic activity; emphasis on free-market economy; Supply-side presidents: Reagan "Grand Pooh-Bah of Keynesian Economics," Bush 41, Bush 43

   ➢ Reality: All modern presidents from Reagan to Obama have used both Keynesian AND Supply-side Economics > they all had deficit spending that increased the national debt, and moved to cut taxes.

2. *Monetary Policy* - an attempt to use the amount of money and bank deposits and the price of money i.e. interest rates to affect the economy > KEY POINT: The printing of money is NOT monetary policy (and only the Dept. of the Treasury does that!)

   a. *What is the Federal Reserve Board and what does it do?* - 7 members appointed by the Pres. that serve fixed 14 yr term; make decisions re: amount of money in the economy through member banks, control interest rates

   Tools of the Fed? (What can the Fed do to influence monetary policy): 1) Set reserve requirement for member banks i.e. how much banks have to hold back for loans; Fed has increased reserve requirements for banks like Citi who engaged in irresponsible practices that helped lead to the banking crisis in 2008-9; 2) Raise or lower the discount rate (the interest banks have to pay to receive a loan from the Fed); 3) Buying and selling government securities (bonds).

   b. *Two primary strategies of the Fed:*

   ➢ *Expansionary policy* - to combat unemployment and recession, the Fed increases the total supply of money in the economy by lowering discount interest rates which then the banks can pass on to customers; jump start the economy by making money cheaper > the lower the interest rates makes home mortgages, car loans, small business loans, cheaper so consumers more likely to spend, businesses more likely to invest.

   ➢ *Contractionary policy* – to combat inflation, the Fed raises interest rates to decrease the money supply; slow down an over-heated economy > addresses inflation like in the 1990s

III. Budget Terminology

1. *Budget* – documents that announces how much government will collect in taxes and spend in revenues, and how those expenditures will be allocated among various programs; 2015 budget is $3.9 trillion

2. *Budget Deficit* – when government expenditures (spending) exceeds revenue in 1 fiscal year; $468 billion deficit in 2015

3. *National Debt* - total of our deficits - surpluses over the years; currently over $18 trillion

4. *Revenues* - monies/assets brought in by fed government from various sources; $1.12 trillion for FY 2015

5. *Continuing Resolution (CR)* - if Congress and President unable to agree on budget by Oct 1, the end. of fiscal yr, Cong. must pass a CR to keep $ flowing so that the fed government can continue to operate

6. *Appropriations Bills* - Congress decides how much money will be spent each year for authorized programs, federal departments and agencies

7. *Gross Domestic Product* (GDP)- estimate of total amount of goods produces domestically within the borders of a country (includes foreign corporations with business in the U.S. ex: Toyota); GDP now the favored index by economists
2013 GDP – US economy still leads the world: #1 US GDP = $16.7 trillion v. #2 China GDP - $9.2 trillion

VI. Where does the Government get its revenues i.e. taxes?

1. *Progressive Tax* - people with high incomes pay larger percentage of tax i.e. leveling; income tax top bracket 39.9% for single individuals earning more than $400,000

2. *Regressive Tax* - lower income people pay higher % than do higher income; presents a greater burden to lower income people because it takes a greater percentage of their income (ex: sales tax, gasoline tax)

3. *Payroll (Entitlement) Tax* - employer and employee taxes to support Social Security

4. *Excise Tax* - consumer tax on a specific kind of merchandise ex: gasoline, tobacco, alcohol ("sin tax")

5. *Corporate Tax* - income tax on corporations; tax rate varies 15% -35%

6. *Capitol Gains Tax* - government tax on assets have for more than 1 year; sale of investments such as home, business, farm, corporate stock; top CG rate is 20% for those earning more than $400,000

IV. Where does the government spend its money?

1. *Mandatory Spending* – authorized by law; federal spending that is uncontrollable i.e. must be spent

   a. *Entitlement Programs* – government benefits that all citizens meeting eligibility criteria (age, income level, etc.) are legally entitled to receive

      - *Social Security* – combination of entitlement programs paid for by employer & employee; includes: retirement, health insurance, support for disabled workers, children of deceased parents
      - *Medicare* - national health insurance program for the elderly and disabled
      - *Medicaid* - fed program that provides medical benefits for low-income persons

   b. *Interest on the Debt* - mandatory payment

2. *Discretionary Spending* – only 1/3 of all federal spending which the President and Congress deal w/ each yr. through the 15 annual appropriations bills

   - *List Five Examples of Spending* –
     - Defense/Military Spending (DOD)
     - Other Executive Department Examples: Departments of Education, Health and Human Services, State, Justice, Treasury, Agriculture, Commerce, Transportation, etc.
     - Independent Agencies Examples: EPA, NASA