Govt. 101 Prof. John Kincaid

Monetary and Fiscal Policy

1. Monetary Policy vs. Fiscal Policy

   A. Monetary policy: regulation of the size and rate of growth of the country's money supply

      1) If the money supply grows too fast, inflation will likely increase

         a. U.S. inflation target is 2% to 3%

      2) If the money supply is too slow, the economy will likely slow down

   B. Fiscal policy: regulation of taxing and spending

2. Monetary Policy

   A. Money supply is controlled by the Federal Reserve System by

      1) Increasing interest rates via the discount rate to slow economic growth and inflation

      2) Reducing interest rates via the discount rate to stimulate economic growth

      3) Increasing the amount of money banks must keep in their vaults (reserve requirement) in order to slow economic growth

      4) Reducing the amount of money banks must keep in their vaults (reserve requirement) in order to stimulate economic growth

      5) Sales of U.S. securities to member banks to reduce the money supply

      6) Purchases of U.S. securities from member banks to increase the money supply

   B. Federal Reserve System established in 1913 is an independent regulatory agency

1) National Federal Reserve Bank, including Federal Reserve Board and Federal Open Market Committee, in Washington, DC, and twelve regional Federal Reserve Banks around the country

2) Federal Reserve Board consists of seven governors nominated by the president and confirmed by the Senate.

3) Each governor serves a 14-year term; terms are staggered so that one board member's term expires every two years.

4) The Fed Chairman is nominated for a four-year term; current chairman is Ben Bernanke, whose chair term expires January 31, 2014.

C. Congress mandated three objectives for the Federal Reserve System

1) Maximize employment

2) Foster stable prices (i.e., control inflation)

3) Promote moderate long-term interest rates

D. Federal Reserve has four basic tasks:

1) Formulate and implement monetary policy

2) Maintain stability of the U.S. financial system

3) Regulate banks and protect consumer credit rights

4) Provide financial services to the U.S. government

3. Fiscal Policy—Taxation

Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except **death and taxes**.
Benjamin Franklin, 1789

The income tax has made more liars out of the American people than golf has.
Will Rogers, 1924

The hardest thing in the world to understand is income taxes.
Albert Einstein

A. The purposes of taxation

   1) Raise money to pay for the functions of government

   2) Regulate the economy

   3) Encourage human behaviors preferred by government

   4) Discourage behaviors disliked by government

B. Two key principles of taxation

   1) Ability-to-pay principle (e.g., progressive income tax)

   2) Benefit tax principle (e.g., bridge toll and motor-fuels taxes)

C. Two main objects of taxation

   1) Taxes on income (e.g., income tax and capital-gains tax)

      a. Do income taxes discourage work and saving?

   2) Taxes on consumption (e.g., sales tax, excise tax, and VAT)

      a. Do consumption taxes disadvantage lower income people?

D. Two types of taxes in terms of incidence

   1) Progressive taxes apply lower rates to low-income people and higher rates to upper income people as per the ability-to-pay principle

   2) Regressive taxes are usually flat taxes in which the tax takes a higher proportion of a poor person's income than a rich person's income.

a. Sales tax example:

John's income is $15,000. He spends $9,000 on goods subject to a 6% sales tax. His total tax is $540, which equals **3.6**% of his total income

Sally's income is $150,000. She spends $9,000 on goods subject to a 6% sales tax. Her total tax is also $540, but this equals only **0.36**% of her total income

b. This is why most state sales taxes exempt: prescription drugs and food, while some states also exempt clothing

E. Two types of income tax

1) Progressive tax (e.g., federal income tax)

2) Flat tax (e.g., Social Security and Medicare taxes)

3) 43 states have a broad-based income tax

a. 7 states have a flat tax (e.g., MA = 5.3% / PA = 3.07%)

b. 36 states have slightly progressive tax, with California being the most progressive with a top rate of 10.55% on income over $1 million

c. Many of the above states couple their income tax to the federal income tax code

d. No income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming

F. Total federal government tax revenue in 2012 = $2.45 trillion

1) 55% from individual income taxes

2) 35% from Social Security, Medicare, and other social insurance

3) 9% other

4. Fiscal Policy—Spending

A. Total federal government spending in 2012 = $3.6 trillion

B. Top three spending items from tax revenue in 2011 =

1) Social Security 20.3%

2) National Defense 20.2%

3) Medicare 13.5%

C. Keynesian Theory--John Maynard Keynes (1883-1946)--emphasizes government spending and intervention into the economy

1) During economic depressions or recessions, federal government should

a. Reduce interest rates (monetary policy)

b. Borrow money to increase government spending to stimulate the economy

c. Spend money on infrastructure especially

2) Most often supported by Democrats

D. Supply-side economic theory emphasizes less government spending and less intervention into the economy; government should get out of the way of the private sector

1) During economic depressions or recessions, federal government should

a. Reduce taxes

b. Reduce borrowing

c. Reduce spending

d. Reduce regulation

2) Most often supported by Republicans

E. Borrowing is another major source of federal government revenue

   1) Treasury Notes mature in one year or less

   2) Treasury Notes mature in 2-10 years

   3) Treasury Bonds mature on 20-30 years

   4) Treasury Inflation-Protected Securities mature at 5-year, 10-year, and 30-year intervals

   5) U.S. Savings Bonds

F. Deficit spending: government spends more in a year than it receives in tax revenue

G. Currently, the federal government borrows 46 cents of every dollar it spends

H. George Bush Deficits:

FY 2007:	$ 161 billion
FY 2008:	$ 458 billion

I. Bush-Obama Deficit

FY 2009:	$1,413 billion

J. Barack Obama Deficits:

FY 2010:	$1,294 billion
FY 2011:	$1,300 billion
FY 2012:	$1,087 billion
FY 2013:	$ 973 billion (estimate)
FY 2014:	$ 744 billion (estimate)