## Classical vs. Keynesian Economic Theory

The underlying assumptions behind arguments to strengthen the US economy are based on either classical or Keynesian economic theory. The fundamental difference between the theories evolves around the level of government intervention needed in the marketplace.

Making changes to monetary policy is another way that the government can fine-tune the economy. Monetary policy looks at the supply of money in the economy, inflation and interest rates. The Federal Reserve Board controls the money supply by overseeing the US banking system. They can adjust the required reserve held by banks and the interest rates that are charged, thereby expanding or contracting the amount of money floating through the financial system. This can make it cheaper or more expensive to buy items on credit, and more/less rewarding to keep funds in the bank earning interest.

* Classical economic theory
* Keynesian economic theory

### Classical economic theory

Classical economic theory traces its roots back to 1776 when economist and philosopher Adam Smith published his book, “The Wealth of Nations.” The book contended that wealth is produced due to a combination of land, labor, and capital, and that economies can be self-regulating. He coined the term the invisible hand, which is based on the belief that all individuals are guided by their own desire to pursue their own self-interest. If individuals are allowed to make choices freely (meaning they only buy and sell what they want), the market will naturally fall into an efficient equilibrium.

For example, let’s say that a large number of people love peach pies. However, there is a limited supply that can be made. A baker makes ten pies and sells the pies for one dollar each. The delicious pies are gone in an hour, with the first ten customers buying a pie each, producing ten dollars in sales. The next day, the baker knows he can charge more for this popular item. He increases his price to two dollars per pie since his goal is to make as much money as possible. Once again, the ten pies are sold, though a couple of customers dislike the higher price so it takes longer to sell them. He makes twenty dollars for the day. The baker then increases his price to three dollars per pie. At the end of the day, four pies remain on the shelf and he only makes eighteen dollars for the day. So he must lower the price somewhere between two and three dollars to sell all his pies and make the most money possible—this is the market price where supply and demand meet perfectly.

While our example is simple, these same principles can be applied across an entire economy for all goods and services. Businesses will look to operate as efficiently as possible so the cost of producing goods and services remains low. This allows them to charge lower prices on the market and attract as many buyers as possible. In turn, consumers enjoy the savings of lower prices and can buy more with their income. The business becomes profitable which attracts investors who want to maximize their returns. Investors allow the business to grow and hire more workers. More working individuals means household incomes increase as a whole. Those households buy more goods and the cycle continues until essentially everyone who wants to work is fully employed and buying goods at a fair and stable price. No government intervention is required in this process.

The view that the market is self-adjusting and should be left alone by the government is fundamental to classical theory. Supply-side economics is associated with the tenets of classical theory. The long-term growth and expansion of productive capacity, as illustrated in the example above, improves standards of living and benefits all members of society through the availability of more goods and stable prices.

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## Measuring Economic Health

There are several ways of measuring the performance of the economy. Gross domestic product (GDP) is the nation's total production of goods and services for a year valued in terms of market prices. Annual GDP growth has been an average of 3 percent over the last fifty years with the GDP for 2015 estimated at $18.1 trillion. The [unemployment rate](http://data.bls.gov/timeseries/LNS14000000) is the percentage of individuals actively looking for work but unable to find it. Those who cannot work, choose not to work, or have stopped looking for employment are not included in these numbers. The national unemployment rate averages about 5.5 percent in 2015.

The inflation rate measures the eroding value of the dollar and is often paired with the [consumer price index](http://www.bls.gov/cpi/). Inflation rates look at how rapidly the price of a good changes. The consumer price index is an average of the prices paid by consumers in major metropolitan areas (27 areas in total, defined by the Census Bureau). Fundamentally, these numbers tell us about buying power. The higher the inflation rate, the less we are able to purchase with the money we have on hand. There are many options that policymakers have in order to encourage economic stability and growth which include adjustments to labor and taxation policies.

## Labor Policies

The United States retains a free market system, but regulations, especially regarding labor policies, have increased significantly in the past century. Many of these regulations evolve around the health and welfare of the US workforce. At a federal level, the [Department of Labor (DOL)](https://www.dol.gov/) administers and enforces more than 180 laws that ensure safe work conditions and fair pay. There are also hundreds of state and local regulations regarding employment.

In addition to laws offering protections for US workers, US labor policies are focused on preparing the workforce for the future and ensuring that the country has the right skilled workers to retain its competitive edge in the global marketplace. We look at several other indicators – income distribution, wealth distribution and wages relative to the average cost of living – to gauge upward mobility and measure inequality. Economists do not want stagnation, or a period of very slow growth and high unemployment. Having skilled, productive workers who are earning a good, living wage is the engine behind a healthy economy. Policies may include workforce training (and cross-training or retraining for new industries), supportive social programs to ensure that single parents can continue to work, and adjustments to the minimum wage.

## Government Spending: The Federal Budget

There are close ties between how the government budgets and spends its money and the overall health of the economy. So it is important to understand how the federal budget is put together and how the government is funding its policies.

The formal budgetary process begins with the [White House Office of Management and Budget (OMB)](https://www.whitehouse.gov/omb) preparing the president’s budget by getting input from all the government agencies. Generally, each department or sub-department has its own set of OMB examiners to work with on budgetary matters.

The president’s budget is presented to Congress in January for the upcoming fiscal year, beginning October 1. The House and Senate budget committees review the budget in detail, hold hearings with witnesses from different government agencies, and ensure everything looks sound (and if not, they discuss what funding they're willing to offer to agencies). Budget resolutions are drafted explaining target funding levels or program conditions that must be met. Once both houses pass the budget resolution, the programs are authorized through legislation (establishing programs and defining how money can be spent). Finally, appropriations acts outline the specific amounts of money that must be spent on government programs for the year.

Often, you will see the budget language in conflict. For example, there might be large programs authorized with very minimal funds appropriated (or none at all). The process is imperfect and agencies must work with congressional staffers to understand the legislative intent for authorization or appropriations language.

This formalized process occurs every year but is met with mixed success. While budget analysts work closely with policymakers to ensure programs are properly funded to meet their goals, supplemental appropriations can occur. This is additional spending used in emergencies (e.g. disaster relief) or for issues like wartime spending, though it is very commonplace to find special projects that buy political favors funded under supplemental appropriations (e.g. funding for a nonessential project in a specific district that may be important in an upcoming election; extending funding without a detailed review for a program that was set to expire but would result in significant job losses in an important district).

## Government Spending:The Federal Budget Continued...

Continuing resolutions (CR) are another means for funding government activities. Quite frequently, Congress and the president cannot agree on a budget before October 1, so a CR authorizes agencies to keep spending their money for a specific period at the previous year's level. This results in hiring freezes or federal agencies not being able to bring on new staff because of a CR (paying for that extra person is going above a previous budgetary level, so the agency cannot hire them until the CR is over and the budgeted position is approved).

Despite these strict budgetary procedures, government spending seemingly continues to automatically rise. So what is causing this phenomenon? Budget requests usually come in the form of increases over base instead of zero-based budgeting (and evaluating the programs as a whole). This is a direct result of incremental policymaking. Fragmented decision-making is another factor. Budget requests come from agencies, through the OMB, to form the president's budget, which is an aggregate of requests across the entire bureaucracy. Defending one’s budget happens across several appropriations and authorization committees. Duplicative efforts are rarely identified. Seldom does anyone seek out opportunity for synergy across programs. The opportunity for supplemental appropriations is hard to resist. Any centralized decision-making when it comes to the budget can be circumvented with a supplemental bill. Often, a critical item must be funded (e.g., defense spending), and other noncritical items are added to "ride along” and get passed in whole.

## Government Spending:The Federal Budget Continued...

Finally, entitlements, especially Social Security and Medicare, are the third rail of politics; no one wants to cut them and make Grandma go hungry or without her medications (else you commit political suicide). There is a seemingly constant growth of entitlements with the US population growing and aging.

As such, government debt continues to expand (as of the fall of 2015, there was $18.1 trillion in federal debt, $11.6 trillion of which is held by the public). This negatively impacts confidence in the United States to pay its debts. Right now, the Treasury sells new bonds to pay off the old ones, rolling over its debt. Approximately 7 percent of the fiscal year 2014 annual budget (around $229 billion) was comprised of interest payments alone. This percentage has varied over the past two decades ranging between 6 and 12 percent if one compares budgets across the Clinton, Bush, and Obama administrations.

In 2011, the United States reached its debt ceiling, which is the legal limit that the government can borrow (think of it like maxing out a credit card limit). In the past, the government has raised its own limit because it can. The debt ceiling is technically not tied to any formal budget action, but the debates over the summer of 2011 tied it to an overall push for budget reform. Why does raising the debt ceiling matter? The government can pay interest only or minimums on its debts, which causes the deficit to grow, gives an impression of instability, and can have trickle down effects on the whole financial system (ex. everyone else raises interest rates, the cost of borrowing goes up for all, stifling economic growth or recovery). Congress and the President agreed to spending cuts as a way to address the deficit, but circumstances can always change, putting the US back on a path towards accruing even greater debt.

## Tax Policy

When considering economic policy, taxation is perhaps the most important intersection between individuals, private enterprise, and the government. Taxes are the main form of revenue for the government.

Federal taxes consist of: individual income tax, Social Security payroll deductions, corporate income taxes, excise taxes on certain consumer items, estate and gift taxes, customs duties, and other charges and fees. In 2015, this means that the government expects to receive approximately $2.6 trillion in income taxes, $1.6 trillion in social security and unemployment taxes, and $1.4 trillion in sales and property taxes. Remember that individuals and businesses also pay a variety of state and local taxes as well.

The US tax code is full of complexities and a host of exemptions, deductions, exclusions, and credits which reduce individual tax liabilities. This is the result of social and economic policies finding their way into the tax code. Our current system is progressive, meaning higher income groups pay a larger percentage toward taxes. In fact, 48.9% of all taxes collected in 2013 were paid by those who earn $250,000 or more per year. Those who earned less than $50,000 per year account for only 6.2% of all tax revenue collected. When you break it down further, the top 0.1% of families in the US pay 37.9% of taxes and the bottom 20% of families actually have negative tax rates (the more people make or save, the more they pay in taxes).

Many citizens have expressed dissatisfaction with the current tax system in America and several lawmakers are advocating for tax reform. The current system is too complex and average US citizens have to hire professionals or purchase software to navigate the tax code. Loopholes in the tax code make the system seem unfair. Decisions about savings and investments (key determinants of economic health) are strongly influenced and sometimes even discouraged by our current tax policies. The underground economy can thrive where receipts go untaxed. High marginal rates tend to discourage work and investment (the more you make or save, the more you pay in taxes).

## Proposed Reforms

## Two proposed reforms are instituting a flat tax or creating a national sales tax.

* Flat Tax
* National Sales Tax

### Flat Tax

A flat tax would eliminate all exemptions, exclusions, deductions, and any special treatment with a set rate for all forms of income. Filing taxes would be a simpler process, easier to complete (saving money on preparation costs), and is expected to reduce fraud. The tradeoff is that we lose the incentives built into the tax code (e.g. education credits to encourage people to go back to school or mortgage deductions that support home ownership).

Both of these reforms come under criticism because of their regressive element. Would those who are in the lowest income brackets (who often end up paying no tax at all under our current system) now have to pay? Moreover, what will changes in tax policies do to the economy? Tax structure affects economic growth. Specifically, the proportion of tax revenue raised by taxing personal income has a negative correlation with economic growth.

Special interests who are in favor or not in favor of reforms include: industries, real estate and housing, oil and gas, investment firms, labor unions, even charities and foundations (that receive charitable donations as a result of tax writeoffs). The constant tug between interests and partisanship in Congress means that tax reform may stay on the political agenda, but is highly unlikely to reach the stage of significant reform.

[Watch - How Tax Reform Can Save the Middle Class (from Moyers & Company)](https://youtu.be/T8WcOv7CPLo) [View transcript](https://edge.apus.edu/access/content/group/arts-and-humanities-common/Universal/POLS/410/elf/lesson-2/assets/docs/transcript.txt)

## Knowledge Check

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## *Keynesian economic theory assumes that economies and markets are self-adjusting and should be left alone by the government.*

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* + True
	+ False

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