Political Economy

1. **What is Political Economy?**

DEF: *Influence of politics and economy on each other; what government should do in the economy.*

The definitions given by Adam Smith, David Ricardo, John Stuart Mill, and Karl Marx were inspired by Aristotle, who saw the government, society and the economy as one thing.

Recently the term has revived. Radicals use the term “political economy” instead of Marxism to describe their criticisms of capitalism and the unfair distribution of wealth among and within nations. Conservatives use the term to try to get back to the pure market system advocated by Adam Smith.

Virtually all public policy choices have economic ramifications: whatever the issue, health care, environment, energy, or welfare, will be connected to the economy.

Everyone wants the government to induce economic prosperity. Earlier in the twentieth century, many governments followed “classic liberal” doctrines and generally kept their hands off the economy. With the outbreak of the Great Depression in 1929, however, the hands-off policies tended to make things worse, and people demanded government intervention.

A book by economist John Maynard Keynes proposed to cure depressions by dampening the swings of the business cycle (*tendency of economy to alternate between growth and recession over several years*) to make recessions shorter and milder.

After World War II, government regulation of the economy was out; the free market was in. Then the 2008 financial meltdown hit and many economists quickly rediscovered Keynes.

1. **Government and the Economy**

U.S economic problems since the 1960s:

INFLATION

The Vietnam War brought an inflation that took on a life of its own and lasted into the 1980s.

TAX HIKE

President Johnson was reluctant to ask for a tax increase to pay for Vietnam for two reasons: first, he had just gotten a tax cut, and second, he did not want to admit that he had gotten the country into a long and costly war. The lesson he learnt was that in war, you must increase taxes to mop up the increased government spending.

BALANCE OF PAYMENTS

Starting in the late 1950s, the United States spent more abroad than it sold. With the war-induced prosperity of the 1960s, America sucked in imports without exporting enough to cover them. Large balance-of payments (*the value of what a country exports compared with what it imports*) deficits grew. The value of the dollar in relation to foreign currencies meant it was cheaper to buy foreign goods but harder to sell U.S. goods in foreign markets.

FLOATING THE DOLLAR

In an effort to correct this imbalance, in 1971 President Nixon cut the link between the dollar and gold, but the inflation of U.S. dollars worldwide made our stock of gold way too cheap. This floating exchange rate devalued the dollar by about one fifth.

WAGE-PRICE FREEZE

Nixon froze wages and prices to knock out inflation. There was no corresponding freeze on profits so that businesses benefited unduly. When wage-price freezes are removed, pent-up demand pushes inflation higher than ever. Many economists think Nixon’s eighteen-month freeze just set the stage for greater inflation.

OIL SHOCKS

International oil deals were made with U.S. dollars. The dollar’s loss in value meant that the oil exporters were getting less and less for their black gold. The OPEC quadrupled the prices following the Mideast war. Oil prices plunge with even a small oversupply but soar with even a small shortage.

STAGFLATION

The manifold increase in petroleum prices produced inflation everywhere while simultaneously depressing the economy. During the 1970s, stagflation appeared to describe inflation with stagnant economic growth. Previously, economists had seen a connection between economic growth and inflation; as one went up, so did the other. In the 1970s, this connection was broken. As a result, since 1973, average Americans, after inflation, have had little or no income growth.

INTEREST RATES

Carter attempted to stimulate the economy, but this made inflation worse. The Fed finally stemmed inflation by boosting interest rates to record levels. This brought slower economic growth and curbed inflation but also brought the greatest rate of unemployment since the Depression.

TAX CUTS

Again, trying to stimulate the economy, Reagan turned to an approach called “supply-side economics,” which focuses on investment and production rather than on consumer demand. The idea was that lowering tax rates stimulates economic growth and ultimately generates more tax revenue. As a result, that American taxpayers’ purchasing power had stayed the same, but they found themselves in ever-higher tax brackets.

BUDGET DEFICITS

Reagan and Bush 43 had presented Congress with budgets that featured both tax cuts and major increases in defence spending to force Congress to cut domestic and welfare spending drastically. But Congress cut little, and the U.S. federal budget reached record deficits (*spending more in a given year than you take in*).

Much of the U.S. budget deficit was covered by foreign investment, but this could go on only as long as foreigners trusted the dollar. In 2011, Obama ran a $1.3 trillion annual budget deficit and by 2015, the deficit fell to around a third of a trillion, and the dollar strengthened again.

TRADE DEFICITS

The United States for several decades has consumed more than it produced and imported much more than it exported. U.S. imports now top exports. The foreign-trade deficit makes the United States the world’s greatest debtor nation. This leads to the buying up of American assets by foreigners.

Some economists argue that the U.S. trade deficit is irrelevant because the U.S. economy is sufficiently strong and foreign creditors know they will be repaid. With increasing urgency, however, others caution that too many hangs on confidence in the dollar; if it collapses, the world would have no standard “reserve” currency to do business with, leading to global recession.

GOVERNMENT DEBT

Republican gains on Capitol Hill bring determined efforts to trim government spending and end the chronic budget deficits, which every year are added to the national debt.

FISCAL CLIFF

Deficit, debt, and taxation problems came together at the start of 2013 in what was popularly called a “fiscal cliff.”

We never went over the fiscal cliff, but the compromise to avoid it satisfied few and “kicked the can down the road” for likely repeats every few years.

INEQUALITY

Since the 1970s, Americans’ incomes have grown less equal and the middle class smaller. Offshoring cuts the number and pay of American blue-collar manufacturing jobs. Top executives and money managers are compensated extravagantly, while growth of inequality fuels political anger.

BUBBLES

Financial markets tend to produce bubbles (*market that has gone too high*) fast growth in investments that let people ignore risk until the bubbles pop. Some economists blame alternating manias and panics.

Keynes urged government intervention to dampen both.

The big underlying problem with all: Government policy promoting homeownership encouraged banks and investors to lend recklessly and to believe there was little risk, and this encouraged high levels of debt. With easy credit, everyone was encouraged to use their credit cards and home equity to borrow more and more. This brought the home-mortgage crisis.

Giant institutions literally end up not knowing their own worth, so their shares tumbled, and several went bankrupt or were taken over.

1. **What is Poverty?**

Poverty has been defined by the U.s Labour Department with a formula developed in 1963 that became standard, although many argue it is out of date: scientists found that families spent about one-third of their incomes on food, so a “poverty line” is three times a minimal food budget for nonfarm families of four.

African American and Hispanic rates are much higher, and more than one-fifth of America’s children are below the poverty line.

Liberals complain that the poverty line is set much too low while Conservatives point out that poverty figures do not include noncash benefits transferred to the poor by government programs (ex. food stamps). Taking such benefits into account raises some poor families above the poverty line.

Some blame the increase of poverty and homelessness on offshoring, while left people with low-paid service jobs or unemployment.

* 1. **Welfare versus Entitlements**

The federal budget is divided into two general categories: discretionary, which can be raised or lowered from year to year and mandatory, which cannot be easily modified.

Mandatory spending in turn is divided into interest payments on the national debt and entitlements (*U.S. federal expenditure mandated by law, such as Social Security and Medicare*); together they are around half of the federal budget. Interest payments are totally untouchable. There is not much wiggle room in the U.S. federal budget.

Entitlements are extremely difficult to cut because people are used to them and expect them as a right. There is no annual cap on entitlement spending; it grows as more people are entitled, what is called “uncontrollable” spending. The only way to change entitlement expenditures is to change the law.

Only a small fraction of federal payments is traditional “welfare” spending.

Some people argue that if we eliminated “welfare” spending we could cut taxes, but “welfare” makes up such a small share of the budget that government spending would be affected very little, and cuts would inflict hardship on society’s most vulnerable members. Entitlements are where real savings could be found, but politicians pretend otherwise because they fear the wrath of the middle class who want their entitlement benefits just as much or more than they want their tax cuts.

1. **The Cost of Welfare**

FOOD STAMPS

Begun as a modest trial program under Kennedy in 1961, the Food Stamp program was implemented nationwide under Johnson in 1964. One-third of families headed by women receive food stamps.

Reagan, citing an apocryphal story of a young man who used food stamps to buy vodka, tightened eligibility requirements in an effort to eliminate fraud and misuse, but fraud and waste have not been major factors.

All food stamps are now debit cards, which fights the fraud problem.

WELFARE REFORM

In 1996, President Clinton signed a major welfare reform. This ended the old Aid to Families with Dependent Children because it was accused of promoting fatherless children and welfare dependency. Because many recipients were non-white, the issue became connected with the struggle for racial equality.

Since then, many states developed workfare (*Programs limiting the duration of welfare payments and requiring recipients to work or get job training*).

Workfare, which has been tried for years, does not always work and initially costs more than traditional welfare programs because it must provide both welfare and training for a while. Some recipients who took jobs were still quite poor because for every dollar they earned, they lost most of it in ancillary benefits.

The EITC, a Republican idea, helps low-paid workers cut their income taxes and even gives some additional cash. Some analysts call EITC the best welfare program because it encourages people to work their way out of poverty.

The 1996 reform came when the U.S. economy was excellent, and most people bumped off welfare found jobs. The real test of welfare reform is how it holds up during recession. With some 9 percent unemployed in 2010 and 2011, more needed help. How long they should be helped sharply divided Republicans and Democrats.

HEALTHCARE REFORM

The Democrats’ healthcare reform, the Affordable Care Act, was barely passed. It does not go nearly as far as most European and Canadian medical insurance and lacks a “public” option: it operates mostly through private insurers. Critics, not all of them Republicans, worry that the plan is too long, too complex, and too expensive. Some charge that the Affordable Care Act does not sufficiently control the ballooning costs of health care.

Both Medicare and Medicaid grew so rapidly that benefits had to be limited and eligibility requirements tightened. As millions of baby boomers started to reach sixty-five in the 2010s, Medicare costs began to climb.

At least two factors induce exponential growth in medical assistance: More people become eligible and medical costs soar. Medicare is especially expensive, for all get it upon reaching age sixty-five, even rich people.

Plus, hospitals and doctors, once they are assured of payment, have no incentive to economize, hospitals and doctors were monitored on costs and on how long they kept patients hospitalized. Hospices were made allowable under Medicare. People were being shoved out of their private insurance plans for either having pre-existing conditions.

1. **How Big Should Government Be?**

The bulk of federal spending goes not to welfare for the poor but to entitlements for the middle class; it is impossible to repeal or seriously cut most middle-class programs.

Politicians are wary about limiting Social Security or Medicare expenditures, but it can cost them votes.

The American welfare state is small compared with that of other advanced industrialized countries American political culture says to keep government small and to suspect and criticize the expansion of government power. But we also recognize that we need government intervention in the economy, education, energy planning and environmental protection. We have trouble making up our minds about how much government we want.

The general reluctance to expand government’s role, however, may redound to America’s long-term advantage. Government programs tend to expand, bureaucracy is inherently inefficient. Government programs become so sprawling and complex that officials do not even know what is in operation or how to control it.

it is probably wise to act with caution in expanding government programs.