Monetary and Fiscal Policy: Crash Course Government and Politics #48

Crash Course: U.S. Government and Politics
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Hello, I'm Craig and this is Crash Course Government and Politics and today we're finally gonna talk about a topic I know that you've all waiting for: Monetary and Fiscal policy. Hurray!

You haven't been waiting for monetary and fiscal policy? Are you sure? I've been talking it up for weeks, you know? Well, let me see if I can't convince you to be as excited as I am. Monetary Policy! Wooo! Fiscal Policy! Yeah! I want to get fiscal, fiscal. Come on and get fiscal…okay let's start the show.

[Theme Music]

Let's start with monetary policy because it's not at all controversial. Well, it kind of is controversial, but it's less contentious than fiscal policy.

The Federal Reserve System was created in 1913 to serve as America's central bank.

One of these is the bank reserve requirement, or the amount of money in cash that a bank has to have on hand.

Now the amount of money that a bank holds in reserve is only a fraction of the total amount of money held in deposit at the bank – that's why it's called fractional reserve banking – but the reserve requirement is there so that you don't get catastrophic bank runs like we saw during the Great Depression when so many frightened depositors took their money out of banks that the banks failed.

Raising the reserve requirement reduces the amount of money in circulation and lowering it pumps more money into the economy.

The Federal Reserve also sets the interest rate banks charge to lend money to each other, which again controls the amount of money that circulates.

If banks are charging each other a lot of money to borrow, they won't borrow as much, and they won't lend as much to firms and individuals and there will be less money in the economy as a whole.

There's at least one more important way that the Fed influences the money supply in the U.S. and that's through Open Market Operations.

This is a fancy way to say that the Fed buys and sells government debt in the form of treasury bills, or government bonds. When the Fed sells bonds, it takes money out of the economy, and when it buys them more money goes into the economy.

This is the idea behind what was known as Quantitative Easing, which is really complicated. To be honest, I'm not crazy about wading into economics here, and thankfully there's a whole other series to do that, but I have to mention inflation at this point.

Inflation is a general rise in prices that can be caused by a number of things, but one of them is the amount of money that circulates. If there's more money around, there's more that can be spent and this makes it possible for prices to go up.

But this isn't an absolute rule, as of 2016 we've had years of basically zero interest rates, which means it's really cheap to borrow money, which means that there should be a lot of money in circulation, yet inflation remains quite low.

Hey, it's real cheap to borrow money. Can I borrow two bucks? No! [punches eagle] He never has any money.

Usually low interest rates tend to cause inflation and reduce unemployment, and high interest rates are expected to cool down an overheating economy, but that hasn't happened much in the past few years. I'll say again, I glad this isn't an economic series.

It's important to note here that the Federal reserve is an independent body, meaning that its board of governors and chairperson are not elected or really subject to much regulation from Congress. And they throw the best parties. That's probably why.

This is intentional and probably a good idea. Ideally, you want people in charge of the money supply to be able to look after broader interests than their own re-election, and this is why the Fed is supposed to be insulated from politics and remain independent.

Ok, so that's monetary policy, which is one lever that the federal government can use to influence the economy. Increasingly it's the only lever, because in America we have a hard time with fiscal policy.

What's that, you might be asking? Fiscal policy refers to the government's ability to raise taxes and spend the money it raises. Since I know that by this episode you've been paying a lot of attention to American politics, you know that in the past 20 or 30 years, at least, Americans have generally been reluctant to raise taxes, and somewhat reluctant to have the government spend money. The difference between these two goals – spending money and not raising taxes – largely explains why we have deficits.

Before we get into tax policy, which I know is what you've been waiting for, calm down, I need to point out that the way the government can spend more money on programs than it takes in taxes is by borrowing it, which the government does by, you guessed it, selling bonds. Good thing we talked about Open Market Operations.

Let's tax the Thought Cafe people with a lot of work, by talking about taxes and spending in the Thought Bubble.

First, ever since Ronald Reagan came to office there has been a hostility towards higher taxes and government spending that is theoretically based in an idea called supply side economics. I'm not going to discuss the details of the theory or even whether it's right or wrong or somewhere in between, but the basic thrust is that if you lower taxes on businesses and individuals, the individuals will be able to spend more, the businesses will be able to invest more, and the economy as a whole will grow. It's a simple and politically powerful idea and has set the terms of the debate for a generation.

In general, over the past 30 years the trend is for there to be lower federal taxes and for them to be less progressive, meaning that wealthier people pay a lower percentage of their income in Federal taxes. The wealthy still pay the largest share of federal taxes overall, though, so it's not completely accurate to say that they aren't paying. Since Reagan, and especially during the presidency of George W. Bush, income tax rates on the highest earners have fallen, as have taxes on estates (although they did go up again) and on capital gains and dividends. President Obama did raise tax rates, but primarily on people earning above $450,000 a year.

Corporate tax rates have also declined and Social Security taxes have gone up, which is important because this is the federal tax that most of us are most likely to pay. Overall the percentage of revenue that the federal government receives from taxes has held pretty steady at between 43% and 50%. If you're interested in the numbers, for 2013 the Government received almost $2.8 trillion in tax revenues. And it spent $3.5 trillion, which math tells us means a deficit of around 700 billion dollars.

Thanks, Thought Bubble. When people say that they need to cut spending and balance the budget, this is what they are talking about, but it's not quite as simple as just spending less, because there are some places where the government can't cut spending even if they want to.

There are certain items in the federal budget that must be spent because they are written into law by Congress. These are called uncontrollables, or mandatory spending.

One uncontrollable that relates to monetary policy is interest payments on federal debt. The government can't not pay its interest, otherwise no one would lend us money. that's just how lending works, or is supposed to work.

Farm price supports – subsidies – are also counted as uncontrollables, and they are important, but not nearly as important as the two big-ticket mandatory spending items. These are social security and Medicare, and they are paid for with dedicated federal taxes.

They provide income and health insurance for elderly people and it's unlikely that the amounts the government spends on them is going to decline anytime soon for three reasons.

First, is that the population is aging, meaning that the percentage of older Americans is rising in proportion to younger Americans. This means that more people will be receiving Social Security payments, which leads us to the second reason they are unlikely to go down: people like them.

The third reason is more political: older people tend to vote more regularly, so a politician who wants to keep their job is unlikely to vote for cuts in Social Security or Medicare.

So, here's the thing about the Federal Reserve and economics: The American economy is really huge, and really complicated, and has some issues that need addressing.

Whether you care a lot about budget deficits or don't think they're a big deal will depend a lot on your feelings about economics in general, but there are a couple of things to keep in mind.

First, there's only a limited range of programs on which the government can choose to spend or not spend. These are called discretionary spending and when people call for cuts in government spending, this is what they mean.

By far the largest chunk of government spending goes into defense, over $600 billion in 2013, but the next largest item is healthcare for the poor, Medicaid, at $498 Billion. Nothing else even comes close. Spending on the Department of Education, for example was $41 billion in 2013.

The second thing to bear in mind is that in addition to cutting spending, the government could balance its budget by doing what everyone loves - raising taxes. It's done this on occasion, but the political consequences can be pretty tough. Just ask George H.W. Bush.

Finally, the combination of Americans' aversion to raising taxes and the government's limited ability to cut spending means that monetary policy becomes its major lever in broad-based macroeconomic policy.

That's why we paid so much attention to the Federal Reserve system at the beginning of this episode, and why you probably should too. Thanks for watching. See you next time.

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