U.S. Economy: Challenges Ahead of the Next President

Political Science 276 Lecture
By Don Mar and Michael Bar, Economics
Overview of the presentation

1. Signs of recovery
2. Challenges ahead and Candidates’ Policies
3. Questions
Signs of Recovery

1. **Delinquency rate** on loans is declining.
   - (Delinquency rate - loans that have delinquent payments greater than a few months as % of all loans).

2. **Unemployment rate** is declining.
   - (Unemployment rate - the percentage of the total labor force that is unemployed but actively seeking employment and willing to work).

3. **Economic growth** is resuming, i.e. real GDP is growing.
Signs of Recovery: Delinquency on Loans

Delinquency Rate On All Loans, All Commercial Banks

Source: Board of Governors of the Federal Reserve System/FRED
Signs of Recovery: Unemployment Rate

Civilian Unemployment Rate

Signs of Recovery: Economic Growth

Real Gross Domestic Product, 1 Decimal

Percent Chg. From Year Ago

Jan-00 Oct-01 Jul-03 Apr-05 Jan-07 Oct-08 Jul-10 Apr-12

Source: U.S. Department of Commerce: Bureau of Economic Analysis/FRED
Some Problems and Concerns

1. Federal Debt and Deficit.
   - Federal Public Debt - the money borrowed by the federal government of the United States.
   - Federal Budget Deficit = Outlays – Receipts.


Problem: Government Debt and Deficit

U.S. Federal Government Deficit and Debt, as % of GDP

Year

% of GDP

Deficit
Debt

Sources: Department of the Treasury and Office of Management and Budget.
Problem: Government Debt and Deficit

U.S. Federal Government Deficit and Debt, as % of GDP

Sources: Department of the Treasury and Office of Management and Budget.
## Public Debt – International Comparison, 2011

<table>
<thead>
<tr>
<th>Rank in the World</th>
<th>Country</th>
<th>Public Debt as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Japan</td>
<td>211.70</td>
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<tr>
<td>4</td>
<td>Greece</td>
<td>161.70</td>
</tr>
<tr>
<td>8</td>
<td>Italy</td>
<td>120.10</td>
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<tr>
<td>17</td>
<td>United Kingdom</td>
<td>86.30</td>
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<tr>
<td>20</td>
<td>France</td>
<td>84.70</td>
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<tr>
<td>23</td>
<td>Germany</td>
<td>81.80</td>
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<tr>
<td>35</td>
<td>United States</td>
<td>67.70</td>
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<tr>
<td>72</td>
<td>China</td>
<td>43.50</td>
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<tr>
<td>89</td>
<td>Taiwan</td>
<td>36.30</td>
</tr>
</tbody>
</table>

Source: CIA, The World Factbook  
Problem: Government Debt and Deficit

U.S. Federal Gov. Interest Payment as % of Receipts

Sources: Department of the Treasury and Office of Management and Budget.
Problem: Government Debt and Deficit

• No country in the world has zero public debt.

• Rising debt is a problem because the government needs to pay interest – debt burden.

• In 2011, the U.S. federal government spent 325 billion on interest payments, and 133.4 billion on education.

• My objective regarding debt is not to repay all of it, but to stabilize the fraction of debt/GDP around 40%.

• Key point: the debt problem can be alleviated if GDP grows faster than the debt.
How to Reduce Government Budget Deficit?

- **Federal Budget Deficit** = Outlays – Receipts

There are 3 ways to reduce deficit:

1. Cut spending (outlays),
2. Increase receipts (government income, mainly from taxes),
3. Combination of changes in spending and receipts.
Government Deficit – Differences Between Candidates

• Both Barack Obama and Mitt Romney announce that they want to decrease deficit. See:
  www.barackobama.com/taxes
  www.mittromney.com/issues/tax
  www.mittromney.com/issues/spending

• Barack Obama Plan: (a) Increase Taxes on high income earners, and (b) Lower Spending.

• Mitt Romney Plan: (a) Lower Taxes on everybody, and (b) Lower Spending.
Government Deficit: Spending Cuts

• Both candidates propose spending cuts.
• The details of what exactly will be cut, are not clear yet.
Government Spending

Federal Expenditures, 2011

- Income security: 33%
- National defense: 19%
- General public service: 12%
- Education: 4%
- Recreation and culture: 0%
- Health + Medicare: 25%
- Housing and community services: 2%
- Public order and safety: 1%
- Economic affairs: 4%
Government Spending

Income Security

- Retirement: 49%
- Disability: 16%
- Welfare and social services: 17%
- Other: 9%
- Unemployment: 9%

Income Security
Government Budget – Changing Priorities

Social Security and Health Spending as % of Receipts

Year

Sources: Department of the Treasury and Office of Management and Budget.
Government Budget – National Defense

National Defense Spending as % of Receipts

Sources: Department of the Treasury and Office of Management and Budget.
Government Budget – National Defense

National Defense Spending as % of Receipts

Year


Sources: Department of the Treasury and Office of Management and Budget.
Government Deficit: Obstacles to Spending Cuts

• Difficult to reach and agreement, when the president and the congress majority are from different parties.
  o On Friday, August 5, 2011 the Standard and Poor’s (S&P) – one of the leading credit rating agencies in the world – *lowered the rating on U.S. government long term bonds from AAA to AA+ because* “Republicans and Democrats have only been able to agree to relatively modest savings on discretionary spending”.

• Interest groups, who support the candidates, need to be satisfied with the proposed cuts.

• Many items are outside of government control.
Government Budget and Related Issues

• The budget is more than the 2 figures: Outlays and Receipts. Many social and political issues are related to fiscal (budget) policies:

1. Health (spending on public health programs).
2. Income inequality (tax laws, and welfare spending).
3. Foreign policy (National defense spending).
4. Education.
Size of Government – Ideological Differences.

• Size of government: Romney “As president, Mitt’s goal will be to bring federal spending below 20 percent of GDP by the end of his first term”.
Size of Government

U.S. Federal Government Outlays, as % of GDP

Sources: Department of the Treasury and Office of Management and Budget.
Size of Government Debate

• Laozi 老子 (6th century BC ?). The founder of Taoism - the first cohesive school to advocate little or no interference by the government in economic and social affairs.

• Laozi advocated minimal government intervention and low taxes.
Government Deficit: Tax Policies

- **Obama** wants to *increase taxes on high income earners*: “No household making more than $1 million each year should pay a smaller share of their income in taxes than a middle-class family pays.”

- **Romney** wants to *lower taxes for everybody*: “Make permanent, across-the-board 20 percent cut in marginal rates.”
## Government Deficit: Tax Policies

### 2012 Tax Parameters

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<td>208,250</td>
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<td>388,350</td>
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<td>0.396</td>
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<td><strong>Married Filing Jointly</strong></td>
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</tr>
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</table>

Source: [www.taxpolicycenter.org](http://www.taxpolicycenter.org)
Tax Rate vs. Tax Revenue

• Higher tax rates do not necessarily lead to higher tax revenues.

• Key idea to understand – taxes affect economic activity, i.e. tax base.

  Tax revenue = (Tax Base)*(Tax Rate)

• Higher tax rate lowers the tax base, and the revenue can increase or decrease.
  
  o Radical example: A company with 20% corporate tax brings $X in tax revenue. Suppose the corporate tax rate increases to 30%, and the business is outsourcing its activity, leading to tax revenue of 0%.
Tax Rate vs. Tax Revenue

- Laffer Curve – describes the theoretical relationship between tax rate and tax revenues.
Tax Rate vs. Tax Revenue

• Conclusion: for each tax law, need to consider the effects on the tax base (economic activity being taxed).

• Whether lowering tax rate brings more tax revenue, depends on which side of the Laffer curve we are.
### Tax Revenue – International Comparison, 2011

<table>
<thead>
<tr>
<th>Rank in the World</th>
<th>Country</th>
<th>Tax Revenues as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Cuba</td>
<td>75.8</td>
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<tr>
<td>6</td>
<td>Macau</td>
<td>65.7</td>
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<tr>
<td>11</td>
<td>Norway</td>
<td>58.0</td>
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<tr>
<td>16</td>
<td>Sweden</td>
<td>51.6</td>
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<td>33</td>
<td>Germany</td>
<td>43.4</td>
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<tr>
<td>63</td>
<td>Denmark</td>
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<tr>
<td><strong>193</strong></td>
<td><strong>United States</strong></td>
<td><strong>15.3</strong></td>
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<tr>
<td>211</td>
<td>Afghanistan</td>
<td>8.7</td>
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<tr>
<td>213</td>
<td>Burma</td>
<td>3.9</td>
</tr>
</tbody>
</table>

**Source:** CIA, The World Factbook  
Issues with Tax Policies

• Besides the bottom line of tax revenues, tax laws have many effects on our lives:
  o Incentives (e.g. subsidies on education may influence decision to go to college).
  o Income inequality and redistribution (“fairness”?, “social justice”?)
US Earnings Distribution 1913-2010: Income Shares of Top 1%, Next 4%, and Next 5%
Source: Piketty and Sainz
Explanations for the increase in Earning Inequality

• Supply related based on an increase in low skill workers:
  o Increase in low skilled immigrants.
  o Increase in first time women workers.

• Increase in International trade increased the demand for high skill workers and lowered demand for low skill workers.

• Technological change increased the demand for high skill workers and lowered demand for low skill workers.

• Institutional change:
  o Slow growth of minimum wages.
  o Fall in unionization?

• Change in compensation schemes:
  o “Tournament” based compensation schemes.
  o Industrial restructuring.

• Greater impact of intergenerational inequality.
Income Inequality vs. Equality of Opportunity

• Income Inequality per se, is not necessarily a bad thing.
• Perfect equality of income eliminates all incentives to work hard, invest in your education, entrepreneurship.
• The real challenge is to achieve equality of opportunity, i.e. to guarantee that regardless of race and socioeconomic background, people have access to opportunities (e.g. access to quality education, business).
Taxes and Income Redistribution

- A tax is called **progressive** if the tax rate increases as the taxable quantity (say income) increases.
- In simple words, the income tax is progressive, if rich pay higher fraction of their income as tax, than poor. Therefore, progressive tax **redistributes** income.
- The U.S. tax code is progressive, but with many provisions (loopholes?), which reduce it’s progressivity.
Taxes and Income Redistribution

• What is the justification for progressive income tax (i.e. income redistribution)?

• There are ideological and subjective reasons for why taxes in most countries are progressive. These usually rely on subjective sense of “fairness” and “social justice”.

• There are purely economic, objective reasons, for some level of income redistribution:
  o Life Lottery (a part of the success of rich people is luck)
  o Social unrest (very high inequality leads to class tension)
Taxes and Income Redistribution

• Although a generalization, Romney advocates for more “flat”, or less progressive tax, while Obama advocates for more progressivity (more income redistribution).

• Romney: “Long-term goal: pursue a flatter, fairer, simpler structure”.

• All parties support “simplifying” the tax code, and this was one of the promises of Obama in 2008.
US Health Care: Not Worth What We Pay.
US Expenditure on Health as Percentage of GDP by Comparison

Health expenditure as a share of GDP, OECD countries, 2007

- United States: 16.0%
- France: 11.0%
- Switzerland: 10.8%
- Germany: 10.4%
- Belgium: 10.1%
- Canada: 10.1%
- Portugal: 10.0%
- Netherlands: 9.9%
- Denmark: 9.9%
- Greece: 9.8%
- Iceland: 9.8%
- New Zealand: 9.6%
- Sweden (OECD Average): 8.9%
- Norway: 8.9%
- Italy: 8.7%
- Spain: 8.7%
- Australia (1): 8.5%
- Spain (1): 8.4%
- Finland: 8.1%
- Japan (1): 7.7%
- Slovak Republic: 7.6%
- Iceland: 7.4%
- Hungary (1): 7.3%
- Korea: 6.8%
- Czech Republic: 6.8%
- Poland: 6.4%
- Mexico: 5.9%
- Turkey (2): 5.7%

Historical Spending on Health Care

Average Health Care Spending per Capita, 1980–2009
Adjusted for differences in cost of living

Dollars

Source: OECD Health Data 2011 (June 2011).
US Life Expectancy Compared
US Infant Mortality Rate Compared
Source: Charting the Economy.com
Problems with the US Health Care Economy

• Inefficient: other countries get more for less.

• Monopoly/Imperfect Competition leads to higher prices and less health care.

• Imperfect information about health care quality, prices, and need for care.

• Inelastic demand: people are willing to pay for care at higher prices.

• Adverse Selection: for profit insurance keeps healthier population to control costs leaving less health population to more costly health care.

• Moral Hazard: with insurance, people will use more health care then they may need.

• Enormous amounts spent on last years of life.

• Inequality and access.
Regulation of Financial Markets: Did We Learn the Lessons from the “Great Recession?”
What Caused the “Great Recession”?

Many analysts blame the financial crisis on at least three interrelated causes:

1. Rapid growth and subsequent collapse of U.S. house prices (housing “bubble”);

2. A general decline in mortgage underwriting standards, reflected in a growing proportion of home purchases financed by nonprime mortgages;

3. Widespread mismanagement of financial risks by firms engaged in originating, distributing, and investing in mortgages, mortgage-backed securities, and derivative financial instruments.
Historical Regulation of Financial Markets

• The Banking Act of 1933: Glass-Steagall:
  - Enacted in the midst of financial crisis of the Great Depression.
  - Created the FDIC and SEC.
  - Limited scope of banking activities.

• The Gramm-Leach-Bliley Act of 1999.
  - Financial markets developed for wide range of investments.
  - Increasing world wide competition in financial markets.
  - Removed many restrictions imposed by Glass-Steagall.

• The Dodd-Frank Act of 2010.
  - Enacted in current crisis.
  - Enormously complex –created new oversight agencies, shifted responsibilities, provided more consumer protections.
Need for Regulation

• Financial markets are necessary.

• Many financial markets have developed so quickly that there is imperfect information and problems assessing the risk and return of many assets.

• Monopolies may lead to moral hazard problem of “too big to fail.”

• Government implicit “guarantees” facilitate irresponsible risk-taking by financial institutions.

• International financial instability.
The Candidates’ Economic Plans
Mitt Romney
Source: www.mittromney.com

• Reduce income and corporate tax rates.
• Reduce regulations on industries and financial markets.
• Increase free trade agreements.
• Increase domestic energy production (primarily oil).
• Amend NLRA and allow high skilled immigrants permanent residency.
• Reduce the deficit by cutting spending and enacting a balanced budget amendment.
• Move Medicaid to states, proposed changes to Medicare.
Barack Obama
Source: www.barackobama.com

- Increase taxes for highest income earners and maintain Bush era tax cuts for all other earners.
- Increase US manufacturing with tax breaks and ending tax breaks for off-shoring companies.
- Enact “fair trade agreements.”
- Obama did make changes to health care, increased access.
- Obama did enact Dodd-Frank to regulate.
- Obama did increase spending in order to reduce the impacts of the crisis.