

Government Macroeconomic Policy and Contempt for the Poor



NEWS UPDATE

- The question now is how the Federal Reserve will respond to the inflation caused by the Russian invasion of Ukraine, and more generally, how our government will respond to the economic instability triggered by the assault. While Fed experts say they don't expect the attack to alter an anticipated interest rate hike in March, there may well be a future response. On February 24, the day of the assault, Federal Reserve Bank of Cleveland President Loretta Mester said the implications of the conflict would be "a consideration" as Fed officials plan their longer-term strategy (Abha Bhattacharai, et al., *The Washington Post*, February 25, 2022).
- The invasion's effect on the United States is as yet still uncertain, but as Louis Johnston, an economics professor at the College of St. Benedict and St. John's University stated, "Right now, the chances are it's not going to push us into a recession. But it's definitely going to slow us down. We're going to get more inflation and less GDP growth than we thought" (Kavita Kumar, "Invasion to Cause Economic Ripple Effects," *Minneapolis Star Tribune*, Feb. 25, 2022). We will watch to see if there is a fiscal and/or monetary policy response to the invasion and its impact on the U.S. macroeconomy.

PURPOSE

This is the third chapter that addresses the efficiency and stability issues in our economy, and it focuses on macroeconomic policy. I think this is a chapter that instructors have to be careful with. We want our students to have a working understanding of the topic, but we also probably want to avoid the complexities of the Keynesian cross, the workings of the banking system, the math of the multiplier, and so on. We need to keep the economics straightforward in order to use it to emphasize the issues. On the other hand, I often find this chapter enlightening for students. Whereas the concepts of demand and supply opened up the world of markets for them, aggregate demand and aggregate supply open up the world of macroeconomic policy. Nevertheless, they seem to be difficult concepts for students to grasp and we need to work at it. Populism enters at the end of the chapter, and along with it, a discussion of contempt for the poor.

WHAT'S NEW?

1. New material is used to address the use of fiscal policy in numerous presidential administrations, including those of former Presidents Reagan, Clinton, George W. Bush, Obama, and Trump; and current President Biden. (There is also new material on monetary policy under Trump and Biden.)
2. New material is also presented on fiscal policy amid the coronavirus pandemic under the Trump and Biden administrations.

TEACHING SUGGESTIONS

➤ *Student Interest*

- Whereas some students will appreciate acquiring an understanding of fiscal, monetary, and supply side policy, others will find it a bit on the dull side. It will help if you can address these in the context of our current economy and actual policy.
- Students may be interested in the material on supply-side policy, trickle-down philosophy, populism, and contempt for the poor, as they are all linked.

➤ *Controversy*

- Early on, the Biden administration faced controversy over monetary policy, with many people concerned about inflation and an absence of a strong response to this by the Federal Reserve under Jerome Powell. This relative inaction may change over time.
- Supply-side policy is always controversial, since it is most likely ineffective and it shifts resources from the poor to the rich.
- Ask your students whether the government should attach a value to homemaking services and include it in GDP statistics. It seems our society values production that has a price attached. How many homemakers, when asked what they do, say, “I’m just a homemaker”? How many farm wives who do the milking, the gardening, the canning, and the care of the livestock say, “I’m just a housewife” instead of “I am a farmer”? I’ve even heard women in developing countries — where cooking means growing, harvesting, and processing the food; where housekeeping means building, repairing, and painting the house; and where childcare means providing medicine, education, healthcare, and clothing for the children — say that they don’t have a job and do not feel valued unless they earn a monetary income.
- Another problem with not counting the value of homemaking services is that comparisons become distorted. For example, in the 1950s, many homemakers cared for their homes and families by themselves, without paying for additional help. In more recent decades, many women work outside their homes and pay for childcare services, laundry services, housekeeping services, and so on. The very same homemaking services might have been performed in the past but were not tabulated as part of GDP.

➤ *Economic Theory and Models*

- We begin by contrasting the demand and supply model of the tutoring market in Chapter 1 with an aggregate demand/aggregate supply model of the entire economy. We continue with the AD/AS model to examine a shift in AD and then a shift in AS, noting the impact in each case.
- We next use the AD/AS model to visualize the three types of inflation: demand pull, cost push, and profit push. We use the same model to examine the impact of expansionary fiscal policy, expansionary monetary policy, and supply-side policy.
- In Appendix 15–1, we use the AD/AS model to 1) explain the downward slope of the AD curve based on the international trade effect, wealth effect, and interest rate effect, and 2) consider expansionary AD-side policy with a more realistic AS curve that includes flat, upward-sloping, and vertical ranges.
- In Appendix 15–2, we use the AD/AS model to show the shifts in AS that occur if the various tools of supply side policy are effective.

- Aggregate demand and aggregate supply are difficult for students. You may find some of the following suggestions helpful.
 - I've found that it helps to provide students with a list of symbols so they don't get lost along the way. I include gross domestic product (GDP), full employment gross domestic product (GDP_F), aggregate demand (AD), aggregate supply (AS), the money supply (M), and the interest rate (i), along with their definitions. I have deliberately avoided the use of $GDP = C + I + G$, since it seems more useful to frame the discussion with students as "which groups purchase GDP?"
 - Again, students should be reminded we are addressing *purchases* when considering aggregate demand, so that, for example, they do not confuse government *spending* on national defense with the *production* (supply) of national defense. For this reason, I use the term "purchases" rather than "spending" when I talk about AD. I also make a point of only shifting one curve per graph so students are reminded of the difference between a shift in AD versus AS.
 - It's important to continually remind students that *investment spending* refers to things like business purchases of factories and machines, or they'll confuse it with financial investment. This is another reason I've avoided the symbol "I" for business purchases.
 - It needs to be pointed out to students that there is no necessary relationship between government spending and taxes. For example, they may want to assume that an increase in government spending automatically means there is an increase in taxes to finance it. Not true!
 - It is important to emphasize that monetary policy affects the aggregate demand curve and not the aggregate supply curve. Students sometimes want to shift the AS curve forward with expansionary monetary policy (perhaps because they link money *supply* and aggregate *supply* in their minds).
 - I find that it's helpful whenever addressing the AD curve to remind students that the groups purchasing U.S. GDP are consumers, businesses, government, and foreigners (though you may wish to simplify by ignoring foreigners). I do this so that students keep these sectors in mind at every opportunity. This helps them when they attempt to think through fiscal and monetary policy.
 - I also find it useful to use arrows when summarizing consecutive events. For example, I write that:

$$M \uparrow \rightarrow i \downarrow \rightarrow \text{business purchases} \uparrow \rightarrow AD \uparrow \text{ and}$$

$$\text{transfers} \uparrow \rightarrow \text{income} \uparrow \rightarrow \text{consumption purchases} \uparrow \rightarrow AD \uparrow.$$
 This helps students keep the processes straight and simple.
 - You may need to remind students several times that GDP and employment *move together* in the AD/AS model. We need more workers to produce higher levels of GDP. Students may also struggle with the concept of full employment GDP, and it helps to emphasize this is a *theoretical* concept and may well differ from actual GDP.
 - You may also need to remind students many times that an increase in aggregate supply is a *forward* shift in the aggregate supply curve. Remind them to think about the output (GDP) axis.
 - I have been surprised to realize that, despite my instructions to shift the AD or AS curve first, and then read the change in the average price level and GDP off the graph, some students still try to guess at the changes and *then* shift the curve accordingly. This results in as many wrong answers as right answers. Therefore, I regularly reinforce the need to shift the curve of the group most directly and immediately affected by the change (i.e., purchasers or producers), *and then* read the changes in P and GDP from the graph.

- I draw the aggregate supply curve as upward sloping in this class, as it enables students to think of the intermediate situation when a rise in aggregate demand causes both an increase in GDP and the average price level, at least in the short run. A more realistic version of the slope of the AS curve is addressed in Appendix 15–1.
- Also, I've learned not to discuss the reasons for the downward slope of the aggregate demand curve as I go through the chapter material. Students are not savvy enough about the difference between a shift of a curve and a movement along a curve at this point, and they tend to confuse the international trade effect and the interest rate effect, for example, as reasons for the downward slope instead of as sources of shifts in the aggregate demand curve. For this reason, the slope of the aggregate demand curve is discussed in Appendix 15–1 so you can decide whether to cover this material.
- Also note that I've deliberately simplified this chapter by ignoring the effect of the multiplier in the macroeconomic examples. Instructors can add this to the discussion in a nontechnical manner if they wish. It is addressed in the Notes section of the chapter.
- Finally, I like students to understand the economic explanation as well as the philosophical viewpoint behind the various types of macro policy. The *Viewpoint* section is intended to help students understand this so they can form their own opinions about what is best for our economy and our citizens.

➤ *Data and Terminology*

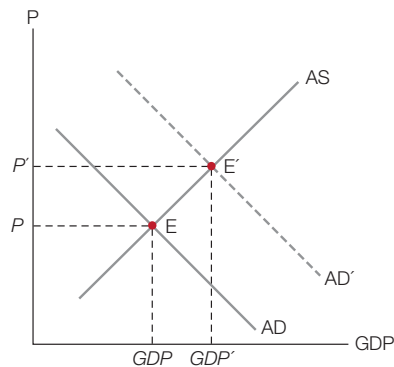
- Students will learn the concept of gross domestic product, its measurement, and its limitations as an indicator of economic conditions and standards of living. They will learn the same about gross national product and gross national income. We will also address these variables in per capita terms and with real versus nominal values.
- Data on U.S. unemployment and inflation rates are updated, as are data for other countries in the world.

➤ *Fundamentals*

- The supply-side policy tools, as used by former President Reagan and, to a lesser extent, by subsequent Republican presidents and even former President Clinton, serve to improve the circumstances of the rich (through tax cuts) while harming the position of the poor (through spending cuts). I believe an attitude of contempt for the poor underlies this.
- Supply-side policies can also translate into systemic racism. For example, former President Reagan's budget cuts were made under his assumption that people were "welfare cheats" and "welfare queens." He assumed they were lazy and would not work if they received government benefits. He and many others believed that benefits based on the number of children in the family would encourage women to keep having more children. Similar attitudes are held today by those state politicians who refuse to accept expanded federal funding for social programs amid the coronavirus pandemic.

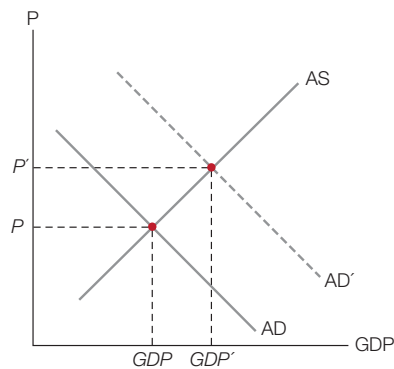
CLASSROOM EXERCISES

1. In the following aggregate AD/AS graph, label the initial equilibrium point (E) within the graph, and label the initial equilibrium average price level (P) and equilibrium level of output (GDP) along their respective axes. Shift the curve to show what happens with an increase in government income transfers that increase the incomes of consumers. [Aggregate Demand increases from AD to AD'.] Label the new equilibrium point (E') within the graph, and label the new equilibrium average price level (P') and level of output (GDP') along their respective axes. What is the effect on GDP and employment? [Increase] On the average price level? [Increase]

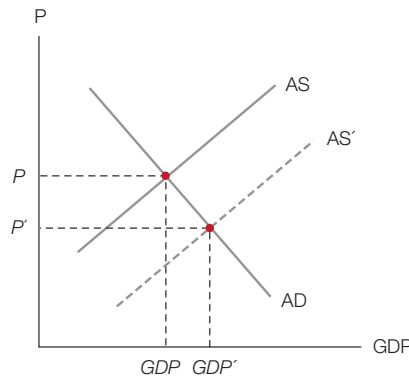


(Note that on questions like this, instructors need to be careful to distinguish between changes in taxes and transfers as fiscal policy tools versus supply-side policy tools. This can be done by referencing the effects of taxes and transfers on *income* versus *work incentives*.)

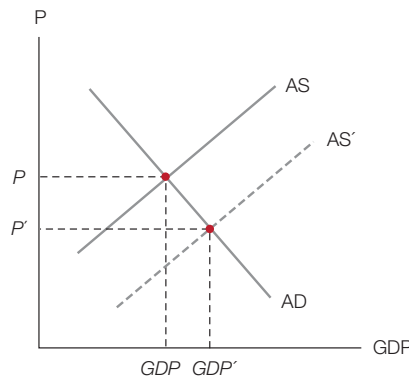
2. Use the same procedures as in #1 to work with the following graphs.
 - a. Shift the curve to show what happens with an increase in government purchases of public libraries. What is the effect on GDP and employment? [Increase] On the average price level? [Increase]



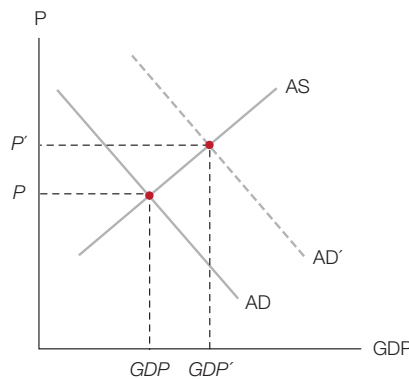
- b. Shift the curve to show what happens with fewer government safety regulations on cars, thereby lowering the costs of producing cars. What is the effect on GDP and employment? [Increase] On the average price level? [Decrease].



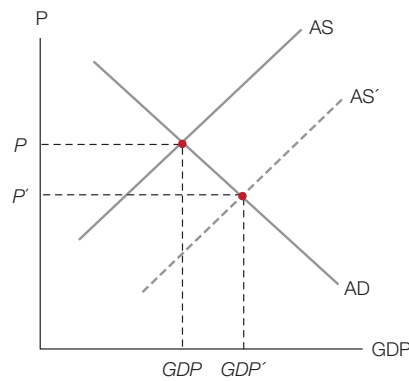
- c. Shift the curve to show what happens if tax rate cuts successfully increase work incentives and work effort by labor. What is the effect on GDP and employment? [Increase] On the average price level? [Decrease]



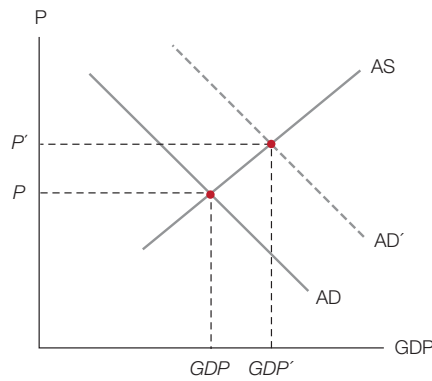
- d. Shift the curve to show what happens if tax cuts increase the after-tax income of consumers. What is the effect on GDP and employment? [Increase] On the average price level? [Increase]



- e. Shift the curve to show what happens if the government reduces transfers, assuming this increases work incentives and work effort by labor. What is the effect on GDP and employment? [Increase] On the average price level? [Decrease]

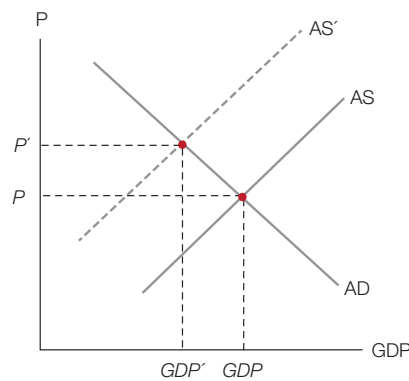


- f. Shift the curve to show what happens if the Federal Reserve increases the money supply, thereby lowering interest rates. What is the effect on GDP and employment? [Increase] On the average price level? [Increase]

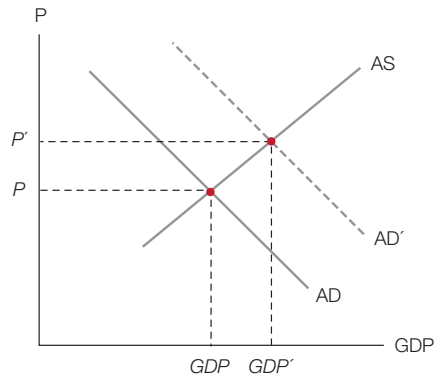


3. Shift the curve to show what happens with each type of inflation.

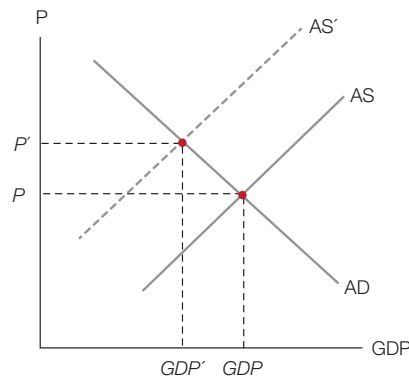
- a. Cost-push inflation



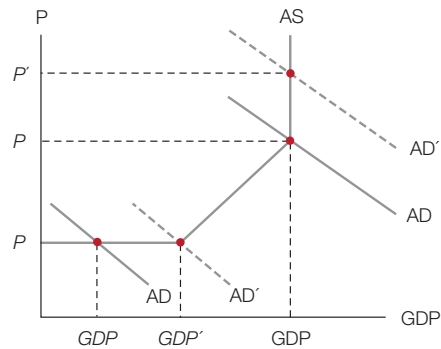
b. Demand-pull inflation



c. Profit-push inflation



4. (Appendix 15-1) Using the more complex graph of aggregate supply below, show the effect of an increase in AD in the horizontal portion of AS. What is the effect on GDP? [Increase] What is the effect on the average price level? [No change] Now show the effect of an increase in AD in the vertical portion of AS. What is the effect on GDP? [No change] What is the effect on the average price level? [Increase]



SAMPLE TEST QUESTIONS

Multiple Choice Questions

1. Which of the following is true about gross domestic product?
 - a. It includes output at all stages of production (intermediate goods as well as final goods).
 - b. It is expressed in terms of physical quantities not values.
 - c. It includes services as well as goods.**
 - d. All of the above

2. When referring to GDP over time, we should use:
 - a. real GDP.**
 - b. nominal GDP.
 - c. GDP calculated using actual (current) prices.
 - d. none of the above

3. Gross national product (GNP) differs from gross domestic product (GDP) in that GNP refers to production:
 - a. by the economy.**
 - b. in the economy.
 - c. of goods only.
 - d. of services only.

4. Underground activity:
 - a. includes illegal activity.
 - b. includes activity not reported in order to evade taxes.
 - c. is sizable for many countries.
 - d. all of the above**

5. Consumer purchases of GDP include consumer purchases of:
 - a. durable goods.
 - b. nondurable goods.
 - c. services.
 - d. all of the above**

6. Business purchases of GDP include:
 - a. purchases of stocks.
 - b. purchases of bonds.
 - c. purchases of factories.
 - d. all of the above**

7. Which of the following is *not* true? Government purchases of goods and services include:
 - a. government purchases of food for nutrition programs.
 - b. government purchases of police protection for citizens.
 - c. government income transfers to low-income individuals.**
 - d. government purchases of the teaching services of public school teachers.

8. Demand-pull inflation is caused by:
- anything that increases aggregate demand.**
 - anything that increases costs of production.
 - market power that increases profits.
 - anything that pulls down aggregate demand.
9. Which of the following is a tool of expansionary fiscal policy?
- Increased taxes
 - Reduced transfers
 - Reduced regulations
 - Increased government purchases of goods and services**
10. Monetary policy is under the direct control of the:
- president.
 - Congress.
 - Federal Reserve.**
 - major city mayors.
11. Which of the following can be a tool of (expansionary) supply-side policy?
- Cuts in tax rates
 - Cuts in transfers
 - Cuts in government regulations
 - All of the above**
12. Which of the following is *not* associated with trickle-down philosophy?
- Economic growth and prosperity
 - Benefits to all
 - Special concern for the poor through government programs for them**
 - Conservative economics
13. Which of the following is included in GDP?
- Homemakers' services
 - Volunteer activities
 - Services such as healthcare and education**
 - Productive work that you do for yourself without being paid
14. Which of the following represents the largest share of aggregate demand?
- Consumer purchases**
 - Business purchases
 - Government purchases
 - Foreigner purchases
15. Examples of income transfers include:
- food stamps.
 - housing assistance for the poor.
 - Social Security cash benefits.**
 - all of the above

16. Which of the following is *not* an example of expansionary fiscal policy?
- Reduction in taxes
 - Increase in government purchases
 - Increase in the money supply**
 - Increase in government income transfers
17. Which of the following is a tool of (expansionary) supply-side policy?
- Reduction in tax rates**
 - Increase in government regulations
 - Increase in government transfers
 - All of the above
18. Business purchases include:
- purchases of machinery.
 - purchases of factories.
 - “purchases” of inventories.
 - all of the above**
19. Stagflation includes:
- recession.
 - inflation.
 - unemployment.
 - all of the above**
20. Expansionary monetary policy involves:
- an increase in the money supply.
 - a reduction in interest rates.
 - an increase in business and consumer purchases.
 - all of the above**
21. In general, which of the following policies would conservatives be *least* likely to support?
- Reduced taxes to increase private purchasing power
 - Government purchases for social programs**
 - Government defense spending
 - Lowered interest rates to increase private spending
22. Which country listed in the table in the text has the highest level of GDP in the world?
- The United States**
 - China
 - Japan
 - Germany
23. Which of the following could cause an increase (forward shift) in aggregate supply?
- Lower costs of production
 - Good weather
 - Improved technology
 - All of the above**

24. (*Appendix 15-1*) Which of the following can change the slope of the aggregate demand curve?
- Changes in international trade
 - Changes in wealth
 - Changes in interest rates
 - All of the above**
25. (*Appendix 15-1*) An increase in aggregate demand within the vertical range of the aggregate supply curve will result in:
- an increase in the average price level.**
 - an increase in GDP.
 - an increase in both the average price level and GDP.
 - None of the above

True / False Questions

- The letter “P” on the vertical axis of the graph of the aggregate demand and aggregate supply model refers to the average price level in the economy. **(T)**
- Gross domestic product is the market value of all final goods and services produced in the economy over a particular time period. **(T)**
- Aggregate supply is the quantity of total output supplied (produced), assuming that the average price level in the economy is constant. **(F)**
- If we are interested in the value of GDP during the current year only, then we use real GDP. **(F)**
- Underground activities refer to activities such as homemakers’ services, which do not create incomes. **(F)**
- The composition of GDP refers to the goods and services that GDP consists of. **(T)**
- Durable goods are those goods that last longer than one year. **(T)**
- Business purchases of GDP include the purchases of stocks, bonds, and treasury bills. **(F)**
- Fiscal policy includes government purchases of goods and services, government taxes, and Federal Reserve decisions about the money supply in the economy. **(F)**
- Supply-side policy can include deregulation and cuts in tax rates. **(T)**
- The price I pay for my current purchase of a 10-year-old house is part of current GDP. **(F)**
- The price the consumer pays for a gallon of gasoline, including any sales and excise taxes, is called the market price of gasoline. **(T)**
- Production by a U.S. citizen in a foreign country is part of U.S. GDP. **(F)**
- Production by a U.S. citizen in a foreign country is part of U.S. GNP. **(T)**
- Two different types of fiscal policy may result in identical levels of GDP but a different composition of GDP. **(T)**
- Expansionary monetary policy results in increased interest rates. **(F)**
- Changes in government income transfers can be considered as fiscal or supply-side policy. **(T)**
- Homemakers’ unpaid services are not considered as part of GDP. **(T)**
- Nominal GDP is calculated with “constant prices.” **(F)**
- Increased costs of production throughout the economy will cause an increase in aggregate supply. **(F)**
- Policy that shifts AD generally causes a trade-off between unemployment and inflation. **(T)**

22. Policy that shifts AS generally causes a trade-off between unemployment and inflation. (F)
23. The Federal Reserve under President Biden did not initially pursue active contractionary monetary policy during Biden's first year of office. (T)
24. (*Appendix 15-1*) The aggregate demand curve is downward sloping because higher average price levels directly reduce our purchasing power by making goods and services more expensive. (F)
25. (*Appendix 15-1*) One of the reasons for the downward sloping aggregate demand curve is that a higher average price level is associated with higher interest rates, thereby reducing consumer and business purchases. (T)
26. (*Appendix 15-1*) An increase in aggregate demand along the Keynesian (flat) portion of aggregate supply results in increased GDP and a higher average price level. (F)
27. (*Appendix 15-1*) The slope of the aggregate demand curve is influenced by the average price level. (T)
28. (*Appendix 15-1*) The vertical range of the aggregate supply curve corresponds to the Great Depression. (F)
29. (*Appendix 15-1*) The usual upward slant to the aggregate supply is associated with a trade-off between unemployment and inflation. (T)
30. (*Appendix 15-2*) Recent evidence shows that supply-side policy is extremely effective in expanding our economy. (F)

Critical Thinking Questions

1. Economists and policymakers often place great importance on GDP as an indicator of economic prosperity, and they seek to increase GDP it over time. What do you think of this strategy? Are there other strategies that are equally important? Are there ways that economic growth can actually be harmful to our well-being? What types of policies would you advocate?
2. How could expansionary fiscal policy be used to improve the lives of the poor? Does an expansion of GDP always improve their lives? What are the effects of supply-side policy on the poor? Do you agree that contempt for the poor underlies supply-side policy?