HOW GEORGE W. BUSH MISPORTRAYS HIS BUDGET/TAX PLAN AND WHY AMERICANS BELIEVE HIM: AN EXAMINATION OF FISCAL FINETUNING

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I. Introduction

This thesis is an examination of the Keynesian theory that fiscally finetuning the economy is possible. My motivation for exploring this subject is the result of an interest I have recently developed in the Bush budget/tax plan. Before I had more thoroughly researched this topic George W. Bush’s recent tax cut seemed like an attempt to fine-tune markets using discretionary fiscal policy. In the economics courses I’ve taken at Duke University fiscal finetuning has always been portrayed as impractical. Thus, I was confronted with a paradox. This paper is an attempt to make sense of that paradox.

In order to substantiate the widespread refutation of fiscal finetuning publications in the worlds of academia, government, international organizations, think tanks, and media organizations will be scrutinized. Next, having established the disrepute of counter-cyclical fiscal action, rhetoric in the Bush tax cut that seems consistent with fiscal finetuning will be examined. Finally, answers to the question of why the average citizen might support a policy explained to them using an outdated economic theory will be explored.

II. The Refutation of Fiscal Finetuning

Contemporary mainstream economics is dominated by a neoclassical monetarist mentality. Laissez-faire economics is one of the defining tenets of this economic school of thought. It is unsurprising therefore that most contemporary mainstream economists agree that the role fiscal policy should play in markets is limited. Fiscal stimuli should be employed during periods of prolonged or intense recessions, à la Keynes, and long-term automatic fiscal stabilizers such as Medicare, Social Security, and Welfare should be used to limit the swing of business cycles\(^2\). Discretionary fiscal stabilization, or fiscal finetuning, is a mostly discredited theory\(^3\).

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\(^2\) Macroeconomics, pgs. 241 and 319-333

\(^3\) Macroeconomics, pg. 232
A. Academia

The origin of most theories concerning modern fiscal policy is *The General Theory of Employment, Interest and Money*. John Maynard Keynes wrote “The General Theory,” and it was published in 1936. In this book, as well as various other essays criticizing the laissez-faire economics of the early 20th century, Keynes expounded the benefits of fiscal policy. His primary assertion was that government spending could be used to ease unemployment while simultaneously stimulating the economy via “indirect employment”. Until this point, the classical model of fluid prices, fluid wages, and continuous full employment had not encountered a true challenge. *The General Theory of Employment, Interest and Money* led to an explosion of discussion concerning the possibility of stabilizing the economy via short-term discretionary fiscal action, otherwise known as fiscal finetuning. The following is a brief examination of how the academic community has addressed the topic of fiscal finetuning over the last fifty years.

Milton Friedman, a Nobel Prize winner and now Senior Research Fellow at the Hoover Institution, is a celebrated monetarist economist. He sees discretionary fiscal policy as an unabashed economic evil. Friedman contends that fiscal finetuning is impractical due to the nature of the government and the structure of the economy:

> In the United States the revival of belief in the potency of monetary policy was strengthened also by increasing disillusionment with fiscal policy, not so much with its potential to affect aggregate demand as with the practical and political feasibility of so using it. Expenditures turned out to respond sluggishly and with long lags to attempts to adjust them to the course of economic activity, so emphasis shifted to taxes. But here political factors entered with a vengeance to prevent prompt adjustment to presumed need, as has been so graphically illustrated in the months since I wrote the first draft of this talk. “Fine tuning” is a marvelously evocative phrase in this electronic age, but it has little resemblance to what is possible in practice – not, might I add, an unmixed evil (The Role of Monetary Policy, pg. 3).

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4 *Can Lloyd George Do It*, pg. 104-106
5 Macroeconomics, pg. 197
Additionally, Friedman believes that short-term discretionary fiscal policies can foster inflation if used to reduce cyclic surpluses:

When high incomes cause tax collections to exceed expenditures, legislatures may destroy this automatic anti-inflation effect by cutting tax rates or by spending recklessly (The Problem of Economic Instability, pg. 521).

Friedman also alludes to the fact that discretionary fiscal finetuning can lead to corruption when lobbyists and special interest groups exert their influence on politicians:

Whether discretionary action is to operate on public works and work relief expenditures, “transfer payments,” or tax rates, or on the general level of government activities, two related problems must be solved: (1) Who is to have the authority to decide when action is to be taken and what kind is appropriate?; and (2) What criteria can and should this authority use in reaching its decisions?…. Each separate action is likely to become enmeshed in political controversy. On the other hand, delegation of authority means surrendering in some measure what have hitherto been exclusive prerogatives of the legislature and thus strengthens the executive arm of the government. It means, not the elimination of political pressures, but concentration of these pressures on an executive authority rather than on the legislature (The Problem of Economic Instability, pg. 524)

Martin Eichenbaum, an associate editor of The Journal of Money, Banking, and Credit and The Journal of Monetary Economics, advocates a fully monetary approach to stabilization policy. He cites two major flaws of fiscal finetuning: the impossibility of knowing A) how to time discretionary counter-cyclic fiscal policy, and B) how much fiscal stimulus to apply. Eichenbaum also contends that fiscal finetuning can lead to deficits, which hamper long-term growth:
The inability to find a satisfactory way of formulating discretionary fiscal policy as an implementable rule and a set of practical institutions to support that rule has led even most Keynesians to be skeptical of attempts to use discretionary fiscal policy to stabilize business cycles. It is an interesting curiosity that Keynesians and real-business-cycle (RBC), analysts agree that, in principle, increases in government purchases and decreases in distortionary taxes increase aggregate employment and output, at least in the short run. And most economists would agree that, as a practical matter deficits would increase output in the short run but probably decrease it in the long run.

Of course most RBC models do not embody the recommendation that fiscal policy should be used for stabilization purposes; and most Keynesian models do. But in practice, most Keynesians exhibit at best lukewarm enthusiasm for countercyclical fiscal policy, beyond that embedded in automatic stabilizers. The problem is that countercyclical fiscal policy has to be implemented in the context of a particular institutional environment. Even if policymakers had the hubris to think that they knew just when and how much expansionary fiscal policy to apply, the lags inherent in the institutions for setting fiscal policy are such that it never happens in either the desired quantity or the desired time frame (Some Thoughts on Practical Stabilization Policy, pg. 237).

Thus, Eichenbaum, like Friedman, cites bureaucratic inefficiencies as obstacles to the success of any attempt to fiscally finetune the economy.

James R. Schlesinger, who became an assistant director of the Bureau of the Budget in 1969 (7 years after publishing the following article)\(^8\), also supports the notion that fiscal finetuning is impractical. Schlesinger perceives inflationary pressure as an important negative side-effect of frequent short-term fiscal management. He also addresses the notion that fiscal policy might be “too crude” to achieve the subtle adjustments that the economy requires:

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7 http://www.faculty.econ.northwestern.edu/faculty/eichenbaum/

Part of the difficulty of the perfectionist [pro-fiscal finetuning stance that assumes perfect forecasting and short legislative lags] view lay in the economic realm. The biggest error, perhaps, was the failure to appreciate the strong upward pressure on wages, costs, and prices which would exist under full employment conditions (Emerging Attitudes Toward Fiscal Policy, pgs. 8-9).

and,

Although it is a very powerful instrument, fiscal policy is also a crude one and may not be sufficiently subtle to achieve the delicate kinds of adjustment required in an economy which is dependent upon the voluntary action of individuals to achieve necessary adjustments (Emerging Attitudes Toward Fiscal Policy, pg. 8).

Like Friedman and Eichenbaum, Schlesinger also states that the political arguments concerning the impractiality of fiscal finetuning are compelling. He contends that the presumption that a nation’s fiscal machinery is run by rational and detached experts is one of the most important of these arguments:

Failure to take account of its economic limitations has not, however, proved to be the chief drawback to fiscal policy in the postwar period. A far graver defect was the failure of its proponents to recognize the limits to its political workability, especially in the context of the American political system. Under ideal conditions, it could be expected that flexible use of fiscal policy could prevent unemployment, except for very short periods, outside of depressed areas. But such a result presupposes that the nation’s fiscal machinery is controlled by rational and detached experts uninfluenced by pressures, interests, or impassioned controversies. Such is not the case, although at one time fiscal theorists naively assumed it was. The nation’s fiscal policy is decided by members of Congress subject to the strong and somewhat irrational demands of ordinary voters and of special interest groups (Emerging Attitudes Towards Fiscal Policy, pgs. 9-10).
Schlesinger also cites a tendency towards “lopsidedness” as a persuasive “political” argument against finetuning:

According to the original conception, fiscal policy was intended to be a dual-purpose weapon, effective in dealing with excessive as well as insufficient demand. In times of inflation, budgetary surpluses would restrain total expenditures and ease inflationary pressures, just as in times of depression, demand was maintained by a budgetary deficit. In practice, nothing has been so hard to attain or to retain as a budgetary surplus. Paying taxes is burdensome and unpleasant to the voters, so that Congress is under constant pressure to reduce taxes. Moreover, expanded expenditures are quite satisfying to whatever groups are benefited, and Congress is under steady pressure to increase its outlays…. Fiscal policy readily serves as a stimulant in periods of depression, but not as a restraint in periods of excessive demand. Whenever a surplus appears, there is a strong tendency either for expenditures to creep up or for tax cuts to be given – either action intensifying the pressure and throwing a larger burden on monetary policy (Emerging Attitudes Towards Fiscal Policy, pgs. 9-10)

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There is a second facet to the lopsidedness of fiscal policy. If the onset of a recession brings about discretionary increase of expenditures on the part of the government, vested interests are created in such expenditures and, with the return of prosperity, it becomes difficult to reduce them. Associated with the reluctance to increase tax rates, the result could be perennially unbalanced budgets…. This tendency of government expenditures to creep up in recession without receding in prosperity has made political conservatives, at any rate, suspicious of the aggressive use of fiscal policy (Emerging Attitudes Toward Fiscal Policy, pgs. 10-11).
Furthermore, Schlesinger claims that trends of lopsidedness are nearly impossible to reverse. This is due to the redistributational nature of tax and spending cuts. Each restructuring of the tax system coincides with a level of social tension that Schlesinger labels as “disturbing.” He contends that the continued modification of the tax structure could lead to an undermining of the fiscal policy instrument itself.\(^9\)

Rendigs Fels, a professor emeritus at Vanderbilt University who received a Ph.D in Economics from Harvard University,\(^10\) also supports the contention that fiscal finetuning is currently politically impractical:

Discretionary fiscal policies are too slow when dependent on action by Congress, too little when limited to present legal possibilities, too risky if new and adequate powers were to be conferred on the President without a sound criterion for determining when to exercise them (The Recognition-Lag and Semi-Automatic Stabilizers, pg.284).

However, there are academics that espoused the notion of fiscal finetuning during the 60’s and 70’s\(^11\). John Cornwall is one such economist. He describes fiscal finetuning as a powerful tool that can be extraordinarily effective given better economic forecasts:

Several writers have recently alleged that contracyclical policy can be destabilizing in the sense of either increasing the amplitude of cycles or their frequency or both compared with a do-nothing policy.\(\ldots\) It is argued here that the contracyclical models used to illustrate this paradox are not really discretionary contracyclical policies but are closely related to built –in stabilization policies. It is further argued that discretionary contracyclical policy correctly defined must be stabilizing for whatever variable one chooses to stabilize if forecasts are perfect. Thus, by implication, whether a dynamic discretionary policy is stabilizing or not

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\(^9\) Emerging Attitudes Toward Fiscal Policy, pg. 12
\(^10\) http://www.vanderbilt.edu/Econ/faculty.html
\(^11\) Though the strongest academic support for fiscal finetuning seems to have taken place during the 40’s (Emerging Attitudes Toward Fiscal Policy, pg. 1).
will depend on the degree of accuracy of the forecast (The Structure of Fiscal Models, pg. 608).

Cornwall also argues that neo-classical models are highly simplified, unrealistic, and thus inferior to the existing fiscal models. He also states that many supply-determined models tend to concentrate on implications that are too far in the future to be accurately modeled:

Even without going into the relative merits of the arguments about the direction of causation and the nature of the ceiling, it can be argued that attempts to explain the time path of an economy beyond a twenty or thirty year period with a fixed parameter model should not be taken too seriously. The question then arises as to the relevance of the supply-determined models which have tended to concentrate on the long-run implications…. It is hard to think of the neoclassical models as statements about the real world, even if they are meant to be, although this has not diminished their popularity. Few believe that markets are cleared in the manner assumed in these models. The stability properties of the fiscal and Kaldor models are of more interest because both can at least be taken seriously as first approximations (The Structure of Fiscal Models, pg. 622).

On the whole, however, economists espousing discretionary counter-cyclic policy are in the minority.

It seems that the overwhelming majority of academics were and still are opposed to the doctrine of fiscal finetuning.

B. Government

Debates concerning the role of fiscal policy are recurrent in Washington DC. Lobbyists are constantly pushing for increased government spending, politicians know that the promise of tax-cuts can keep them in office, and the American people count on the government to keep the economy running smoothly. Consequently, despite periods when government seems reluctant to engage in short-term fiscal stabilization, these policies are always a matter of debate. Through
an analysis of hearings and published reports it will be suggested how government has addressed the question of fiscal fine-tuning over the last fifty years.

During the 1950’s there was an atmosphere of fiscal restraint in government. Republican Dwight D. Eisenhower was in office (1953-1961), and fiscal policy was regarded as potentially dangerous due to a booming post-war economy and inflationary fears\textsuperscript{12}. Fiscal policy was recognized as a powerful tool to stimulate the economy, but there was a strong sentiment that government spending needed to be scaled back and that short-term stabilization should be avoided. Walter D. Fackler, Assistant Director of the Department of Economic Research for the United States Chamber of Commerce, made the following comments in a hearing before Congress in 1957:

Now, to sum up some implications for spending policy, on which I think there is a fairly widespread agreement:

1. Government spending should play a secondary role behind monetary policy and perhaps even behind tax policy as a stabilizing measure. At minimum, variations in governments spending should not reinforce instability in private demand.

2. Though spending policy should normally reinforce monetary policy capricious variation in spending for stability reasons should be avoided…

4. Ways and means to get greater automatic countercyclical flexibility into Federal long-range spending programs should be patiently and persistently pursued (Federal Expenditure Policy For Economic Growth and Stability, pg.189).

However, in the 1960s the government’s attitude towards stabilization of the economy via fiscal fine-tuning underwent a complete reversal. Hearings were held by the Subcommittee on Fiscal Policy of the Joint Economic Committee concerning the effectiveness of tax changes for short-term stabilization. During these hearings, prominent economists almost unanimously supported the concept of varying tax rates to fine-tune the economy:

\textsuperscript{12} PBS’s American Experience, http://www.pbs.org/wgbh/amex/presidents/frames/featured/featured.html
….I conclude that shortrun changes in tax rates can and should be relied upon as a supplement to built-in flexibility in taxes and expenditures and monetary policy in our efforts to avoid or minimize recessions and inflationary booms. As I see it, the question to be answered is not whether it would be desirable to employ discretionary tax flexibility for this purpose, but, rather, what form should it take and what are the ground rules under which it should operate (Hearings concerning “Tax Changes for Shortrun Stabilization,” Statement by Harvey E. Brazer, Professor of Economics and Research Assistant at the University of Michigan, pg. 3).

and,

A review of the past leads me to the following conclusions regarding the impediments to flexible fiscal policy:

1. Fiscal policy should not be considered a failure, as I am afraid it sometimes is, simply because tax rates are lowered one year and raised the next. Indeed, if such changes produce greater stability, they should rather be considered a success.

2. The view that tax schedules are largely fixed, or should seldom be changed, forces inflexibility on Government policy. If fiscal action is thus made essentially irreversible, one is much more cautious in taking it. There is a tendency to wait until there is reasonable certainty that the action is absolutely necessary and will not have to be rescinded; yet small steps taken early may provide much more stability than large ones taken later (Hearings concerning “Tax Changes for Shortrun Stabilization,” Statement by E. Cary Brown, Professor of Economics at the Massachusetts Institute of Technology, pgs. 7-8).

Practically every witness who testified at this hearing endorsed fiscal fine-tuning. It was no surprise that two months later, when the Joint Economic Committee published their report, it
advocated fiscal policies intended to stabilize the economy from short-term price and GDP fluctuations:

Rapid tax changes in the appropriate direction could contribute importantly to stability of employment, output, incomes, and prices and the Government should move to develop procedures and techniques to make such rapid tax changes a practical instrument of public policy (Tax Changes for Shortrun Stabilization, pg. 4).

The government’s approach to fiscal fine-tuning in the 1970’s was less enthusiastic than it had been in the 1960’s. One explanation for this might be that fiscal restraint and tight monetary policies were necessary to combat the run-away inflation of the decade. Large budget deficits were another factor that cooled politicians’ ardor to cut taxes and to spend excessively. Nonetheless, taxes, especially the personal income tax, were still recognized as fast and effective devices to stabilize the economy:

Promptness is the great advantage of changes in the individual income tax for stabilizing the economy. At times, the Congress has been able to work out a tax change bill within two to four months, and the Treasury is able to translate the completed action into changes in the take-home pay of millions of Americans within weeks after the enactment (Understanding Fiscal Policy, pg. 38).

Another good example of this can be found in Studies in Fiscal Policy: The Economic Impact of Alternative Fiscal Policies, a report published by the Joint Economic Committee. In this report discretionary fiscal fine-tuning was compared to other long-term fiscal policies and endorsed as superior to them all:

In almost all cases discretionary [fiscal] policy proved superior to blind adherence to either of the fiscal policy “rules.” In some cases the experimental discretionary policy was significantly better than the policy actually used (Studies in Fiscal Policy, pg. 18).
The 1980s brought about a huge wave of fiscal expansion via Republican president Ronald Reagan’s tax cuts and increased military spending (1981-1989)\textsuperscript{13}. Early in the president’s first term the economy slumped and it seemed that “Reaganomics” was ineffective if not destructive. A couple of years later however, it seemed that President Reagan’s supply-side approach to the economy had succeeded: The rate of inflation had remained steady, unemployment was down and GDP was on the rise. Unfortunately, this boom resulted in a ballooning US deficit and an ever-increasing disparity between the rich and poor\textsuperscript{14}. Fiscal fine-tuning, as opposed to long-term fiscal expansion, wasn’t endorsed in the Reagan administration though. Reagan urged that the country “stay the course” during the recessionary period marking the beginning of the decade and not to make short-term adjustments in the tax structure or the budget. In hearings before the Committee on the Budget, Donald T. Regan, Secretary of the Treasury, backed the president and advised against short-term adjustment of fiscal or monetary policies:

> In setting policy for the remainder of the 1980’s we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past. For these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither (Hearings before the Committee on the Budget, pg. 5).

In the 1990s, there was a return to prosperity after an economic downturn late in the 1980s. Keynesian economics had been discredited after an economic meltdown in 1987, and the government attitude concerning fiscal fine-tuning was predominantly negative. In attempts at fiscal restraint and reduction of the deficit Congress imposed limits on discretionary spending in

\textsuperscript{13} PBS’s American Experience, http://www.pbs.org/wgbh/amex/presidents/frames/record/record.html

\textsuperscript{14} PBS’s American Experience, http://www.pbs.org/wgbh/amex/presidents/frames/featured/featured.html
the budget resolution of 1994. Long-term as opposed to short-term stabilization had become the policy prescription of choice, and expansionary spending programs were considered dangerous:

Another key policy, which helps to explain the economy's excellent sustained performance, relates to the long-term growth-promoting effects of government spending restraint. Empirical evidence suggests that beyond some point, an increasing share of government spending has a negative effect on economic growth (Assessing The Current Expansion, pg. 8).

At the dawn of the new millennium government regards fiscal fine-tuning as a discredited and outdated notion based on past experience with high inflation and high interest rates. Thus, fiscal fine-tuning was an accredited concept throughout only two decades of the last 50 years. Except during the 1960s and 1970s the government has preferred to take a more long-term approach to stabilization and expansion of the economy.

C. International Organizations

International organizations such as the World Bank and the International Monetary Fund are last resorts for countries in the midst of economic crisis. These countries often suffer from corrupt banking systems, economies that lack transparency, unsustainable fixed exchange rates, and massive amounts of public and private debt. International organizations offer loans to needy countries contingent upon the elimination of these market flaws. Due to the enormous amount of funding the IMF and World Bank have at their disposal the policies they advocate are quite influential. An examination of fiscal fine-tuning would therefore be incomplete without an analysis of these policies. Through an examination of reports published by the IMF and The World Bank, as well as the terms of the loans they have issued, it will be determined how prominent international organizations address the subject of short-term fiscal management.

Thailand and South Korea are examples of countries that have recently benefited from IMF bailouts. In August, 1997 Thailand received a loan of 17.2 billion dollars after expending

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15 Section 12(b) of H. Con. Res. 64
all of its foreign currency reserves defending the Baht from a series of speculative attacks. South Korea received a 20 billion dollar bailout in December of the same year. The loan packages these governments received from the IMF place an emphasis on tight monetary and fiscal policies. The IMF advocates such policies because it believes they are the necessary, albeit painful, solution for economies in need of structural reform (tight fiscal policy is imposed as a method of debt reduction, and tight monetary policy is used to suppress inflation). The theory behind these policy recommendations is predominately neo-classical and monetarist. The loan packages the fund approved for Thailand and South Korea reflect these biases:

At the core of the program is a comprehensive restructuring of the financial sector and a strengthening of the fiscal position. Other policies to support external current account adjustment will also be needed, including monetary and wage restraint, and structural reforms, notably privatization and civil service reforms. Improvements in the financial positions of both the central government and the state enterprises are envisaged, the former supported by expenditure restraint and revenue measures, the latter by increases in public enterprise prices and cuts in lower-priority investment projects consistent with World Bank and international feasibility standards (Letter of Intent of the Government of Thailand for financial support from the IMF, pgs. 2+4).

and,

The main objective of monetary policy is to contain inflation to 5 percent in 1998 and limit downward pressure on the won. To demonstrate the government’s resolve to confront the present crisis, monetary policy will be tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. For 1998, a tight fiscal policy will be maintained to alleviate the burden on monetary policy and to provide for the still uncertain costs of restructuring the financial sector (Letter of

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16 http://foe.org/imf/asia.html
Surprisingly however, despite the fundamentally neo-classical and monetarist approaches the IMF advocates, the loan packages approved for Thailand and South Korea encourage short-term management of the economy via both fiscal and monetary means:

The day-to-day conduct of monetary policy will be guided by movements in the exchange rate and short-term interest rates which will be used as indicators of the tightness of monetary conditions (Letter of Intent of the Government of Korea for financial support from the IMF, pg. 3).

As VAT [value added tax] increases noted below will also increase local authorities’ revenues, we plan to lower, by a corresponding amount, expenditure of the central government on projects presently carried out for local authorities. In the event of shortfalls from our budgetary targets, we will introduce additional expenditure and revenue measures, i.e., increasing selective tax rates and broadening the effective tax base. Such a contingency package of measures could be up to 1% of GDP and could be implemented quickly if needed (Letter of Intent of the Government of Thailand for financial support from the IMF, pg. 4).

This notion of fine-tuning the economy is markedly Keynesian, and runs contrary to the mainstream consensus of academic and US government economists.

One explanation for the IMF’s support of fine-tuning is its aversion to fiscal disequilibrium, or debt. IMF economists identify increasing levels of debt worldwide as a threat to global prosperity. These economists describe abnormally high interest rates and high inflation/inflationary expectations as the most dangerous consequences of large fiscal deficits:
A prominent feature of the recent global economic scene is fiscal disequilibrium. Over the past decade, the fiscal deficit as a percentage of gross national product (GNP) has roughly doubled for the world as a whole…. The channels through which high fiscal deficits and rising public debts influence the economy are both varied and complex. A first and clear one is the rises in interest rates that are made necessary by the high absorption of savings, domestic as well as foreign. The process is likely to distort incentives and worsen the performance of the economy in terms of output, employment, and growth. A second channel is the impact of the rise in interest rates on the scope for prospective fiscal management as debt financing preempts future resources for debt servicing. A third and related channel is the consequences of the entrenchment of inflation and inflationary expectations, which, by stimulating indexation, further complicate the task of controlling inflation and, by imparting rigidity to the debt-servicing bill, can also reduce the effectiveness of fiscal management (Fiscal Policy, Economic Adjustment, and Financial Markets, pg. 112-121).

The IMF seems to regard any policy that reduces public debt, even fiscal finetuning, as more advantageous (due to its correction of fundamental flaws in the structure of a faltering economy), than disadvantageous (due to inefficiencies and inflationary pressures identified by prominent monetarist and neo-classical economists).

Additionally, in an IMF report entitled *Fiscal Policy Rules*, George Kopits states that discretionary fiscal policy is theoretically superior to fixed long-term policies in countries that have severe current account deficits\(^\text{18}\). He espouses the benefits of long-term fiscal rules for countries with fundamentally sound economic systems, but contends that long-term fiscal management may be unrealistic for countries without a history of fiscal discipline. This helps to explain the IMF’s approval of fiscal fine-tuning. The International Monetary Fund advocates the implementation of an inflexible long-term fiscal policy, but only after several years of discretionary short-term adjustment\(^\text{19}\).

\(^\text{18}\) Fiscal Policy Rules, pg. 23

\(^\text{19}\) Fiscal Policy Rules, pg. 23
The World Bank shares the IMF’s conviction that fiscal balance is essential to economic success. It identifies inflation, credit shortages, distorted interest and exchange rates, current account imbalances, and the crowding out of private investment as the consequences of large fiscal deficits\textsuperscript{20}. However, The World Bank disagrees with the IMF’s belief that fine-tuning the economy is a viable option. The World Bank expresses the belief that fiscal fine-tuning via government expenditures is ineffective, and that only bolstering incentives and strengthening the tax base will reduce deficits in the long-term:

Sustained deficit reductions were achieved primarily through revenue enhancements and to a lesser extent through reductions in capital spending. Targeted reductions in current expenditures proved to be more elusive. Fiscal adjustments were not sustained in countries that reduced their deficits through short-term shifts in revenue or expenditure. Most countries that made fiscal improvements over the longer term did so by increasing revenue (not by increasing tax rates but by broadening tax bases and simplifying tax systems (Fiscal Management in Adjustment Lending, pg. 2).

Thus, the IMF advocates discretionary policy for countries with poorly functioning economies, high levels of debt, or low levels of fiscal discipline. The IMF advocates long-term fiscal policy for established economies with low levels of deficit or well-established fiscal discipline. The World Bank advocates long-term fiscal policy regardless of the state of a country’s economy, believing short-term discretionary policy to be ineffective. The success or failure of countries employing short-term discretionary policies to soften their recoveries following the Asian Crisis of the late 1990s should help to illustrate the relative value of fiscal finetuning in structural reorganization and macroeconomic adjustment.

D. Non-Governmental Research Organizations

Non-governmental research institutions, more commonly known as think tanks, should voice an important opinion in the fiscal finetuning debate. These institutions are more closely connected to the world of public policy than academia, but exist as entities separate and

\textsuperscript{20} Fiscal Management in Adjustment lending, pg. xi
theoretically uninfluenced by government and special interest groups. The unique niche NGRI’s occupy in US politics give them the perspective to shed invaluable light onto subjects that government officials aren’t in a position to be objective about. Through an examination of publications by The American Enterprise Institute for Public Policy Research and The National Bureau of Economic Research the matter of fiscal finetuning will further be examined.

The American Enterprise Institute for Public Policy Research is a think tank founded in 1943 and counts Dick Cheney (the current Vice President), Paul H. O’Neill (the current secretary of the treasury), and Lawrence B. Lindsey (the current assistant to the president for economic affairs), among its former scholars. The AEI cites Milton Friedman in voicing its disapproval of fiscal finetuning:

I should note that the view that a stimulus could now be effective is not an endorsement of Keynesian tax policy. Back in the 1960’s, many Keynesians believed that economic fluctuations could be offset by tax policy. If consumers tend to consume too little in a downturn, then government could, it was thought, fix that with tax policy. A big tax cut, timed correctly, would boost spending and help push the economy out of the doldrums…. It was Nobel-laureate economist Milton Friedman who first pointed out the key problem with such a policy regime: It only works if citizens are extremely shortsighted. Consider: If a temporary tax cut gives you $1000 today, but you know that you will have to pay it back next year – with interest – how much will you change your behavior? If you’re like most people, not very much (Putting Our Tax House in Order, pg. 2).

Research conducted by The National Bureau of Economic Research also discredits fiscal finetuning. In Macroeconomic Volatility in Latin America: A View and Three Case Studies, a working paper written by Ricardo J. Caballero in July 2000, fiscal finetuning is recognized as the traditional fiscal policy in Latin American countries. Caballero contends however, that exogenous financial shocks might be better managed through a more pro-cyclical policy stance:

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http://www.aei.org/n1/nlfeb01.htm
Grounded on Keynesian mechanisms, optimal fiscal policy over the business cycle is traditionally thought of as being counter-cyclical. The pattern of procyclical fiscal deficits in Latin America has thus been interpreted as a seriously sub-optimal policy, and most likely the result of the financial constraints faced by the governments themselves. However, when external financial shocks are an important source of fluctuations, the economy should optimally distribute the scarce available international resources across domestic economic agents so as to smooth differences in financial distress. It is highly unlikely that government expenditure, unless used very selectively to solve financial distress in the private sector, is the right place to allocate the marginal dollar. *Fiscal policy may need to be pro-cyclical after all* (Macroeconomic Volatility in Latin America: A View and Three Case Studies, pg. 40).

Caballero states that the government won’t distribute international resources (through discretionary spending), as efficiently as the market system might. He adds that fiscal finetuning might be appropriate if the financial constraints on the private sector are prohibitively high during crises.\(^{22}\)

Surprisingly, however, it is extremely difficult to find literature published by think tanks that addresses the concept of fiscal finetuning. It is far easier to find research supporting tax/budget cuts based on a supply side analysis, or op-ed pieces that recommend increased government spending (on public goods, for example), to improve social welfare. It seems that most think tanks regard fiscal finetuning as a discredited economic theory and a non-issue.

Thus, fiscal finetuning seems not to be endorsed by think tanks.

**E. Media Organizations**

The media plays an important role in gathering, dispersing, and analyzing information for the public. In fulfilling this function the media acts as a filter and a translator. Newspapers, periodicals, and magazines take publications issued from the worlds of academia, government, international organizations, and think tanks, and consolidate the consensus among them. This consensus is then simplified for laymen. Additionally, many economists voice their own

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\(^{22}\) http://www.nber.org/papers/w7782
opinions about theory and policy through periodicals such as *The New York Times* or *The Economist*. For these reasons, publications by media organizations should be reflective of how experts in economics and public policy view fiscal finetuning.

Paul Krugman is an ardent neo-classical economist. In a New York Times Op-ed column, he examines historical evidence to discredit short-term fiscal management:

…monetarists wanted to get the government out of the business of short-term economic management. First and foremost this meant rejecting the use of fiscal policy – discretionary tax cuts or spending increases – to fight recessions. By and large this was an argument that the monetarists won on the evidence…. But almost all economists now agree with the position that monetary policy, not fiscal policy is the tool of choice for fighting recessions (Getting Fiscal, pg. 1).

First, on their face Mr. Cheney’s remarks were those of a vulgar Keynesian – a believer in the now discredited doctrine that taxes and spending should be routinely twiddled in an attempt to “fine-tune” the economy. Decades of experience shows that this is a bad idea, that when governments try to fight garden-variety recessions by cutting taxes or increasing spending they almost always get it wrong. By the time Congress has finished negotiating who gets what, and puts the new law into effect, the recession is usually past – and the fiscal stimulus arrives just when it is least needed (Cheny Gets Vulgar, pg. 1).

Krugman’s contention is that discretionary fiscal policy has never worked well in situations of mild economic decline. He states that government usually drafts ineffective fiscal policy, or that the economy often recovers before sound policy comes into effect. He goes on to state that the inevitable result of fiscal stimuli on a well-functioning economy is inflation. Krugman does acknowledge, however, that “fiscal pump-priming” can be an appropriate policy measure when the economy is in a “deep and persistent slump.”
In *Business Week*, self-professed Keynesian economist Laura D’Andrea Tyson, chair of the Council on Foreign Relations Task Force on Japan, defends the use of “well-timed” fiscal policy, but only during periods of deep and persistent recession:

Cutting taxes to prime the pump should be limited to rare circumstances of deep and persistent recessions that cannot be cured by aggressive monetary easing. Such circumstances engulfed the U.S. during the Great Depression and Japan during the 1990s. Except in such dire circumstances, fiscal policy should be shaped by long-run priorities. And as the experience of the Clinton Administration demonstrates, long-run fiscal discipline, by fostering lower interest rates, provides the most secure foundation for short-term growth (Bush’s New Tax-Cut Logic is No Better Than the Old, pg. 1).

and,

The prospects for fine-tuning the economy's performance in 2001 through changes in fiscal policy are even bleaker. In theory, John Maynard Keynes was right: A well-timed boost in aggregate demand through tax cuts or spending hikes--an option that President-elect Bush neglects to mention--can forestall a recession or ameliorate one already in progress. The key condition, however, is that the medicine be “well-timed.” Experience in the U.S. and elsewhere reveals that this condition is rarely met. When governments try to fight recessions by cutting taxes or increasing spending, they almost always get the timing wrong. By the time the tortuous budgetary process yields a new policy, the recession is over and the fiscal stimulus is no longer warranted. Nor, unfortunately, is it easily reversed, especially if it takes the form of a tax cut. And a more expansionary fiscal policy during the recovery means a more restrictive monetary policy with higher interest rates, lower investment, and slower long-run growth than would otherwise be the case (Bush’s New Tax-Cut Logic is No Better Than the Old, pg. 1).
Thus Tyson, while accepting the theory behind fiscal finetuning, proclaims it unreasonable for policy makers to expect to apply effective and timely fiscal stimuli to the economy.

Editorials written by editorial boards at *The New York Times*, *The Economist*, and *The Wall Street Journal* also discredit fiscal finetuning:

And there, in timing, is precisely the rub in using tax changes as countercyclical policy. Given the political delay in crafting tax legislation, tax cuts will arrive at the right time only through blind luck. What’s more, taxpayers watching the political tides anticipate tax changes, often in perverse ways (On Economic Cures, pg. A26, *The New York Times*).

and,

The nation does not find itself in a serious depression requiring a major overhaul of its fiscal policy. In the short term, tax policy is not an effective means of fine-tuning the economy. It takes too long to pass Congress and kick in. Fine-tuning is the preserve of monetary policy and of Mr. Greenspan, who can respond more quickly than Congress, and is clearly prepared to take the proper steps on interest rates (When the Economy Slows, pg. A34, *The Wall Street Journal*).

and,

One of the clearest economic lessons of the past few years is that it is almost impossible to fine-tune an economy by fiscal means (spending increases or tax cuts). The reason is that the political timetable rarely matches the state of the economic cycle. By the time Congress gets round to discussing a tax cut, the recession has usually started; by the time the money ends up in consumers’ wallets, the recession is usually over. Mr. Greenspan explicitly referred to this line of argument when he said (in his inimitable way), “Such tax initiatives historically have proved difficult to implement in the time-frame in which recessions have developed and ended.” He did not follow the logic of this position
through, but insofar as it means anything it must mean he fundamentally disagrees with Mr. Bush’s assertion that a tax cut is needed to jump—start the economy now (Lexington: Alan Greenspan, fiscal fiddler, pg. 36, *The Economist*).

After reading several of these editorials and op-ed pieces it seems that fiscal fine-tuning, at least by mainstream media sources, is regarded in a negative light. Monetarists dislike the theory behind short-term fiscal management, and Keynesians dismiss it as an impractical policy solution due to the long time lags between the identification of a recession and the passing of legislation.

**F. Research Analysis**

Upon the examination of publications from academia, government institutions, international organizations, think tanks, and media organizations, it becomes clear that most experts do not favor the concept of fiscally finetuning the economy. These experts contend:

1. That fiscal finetuning is inflationary.
2. That fiscal finetuning may encourage excessive deficit spending and debt accumulation.
3. That fiscal finetuning may encourage corruption.
4. That it is impossible to correctly forecast when to apply discretionary counter-cyclic fiscal policy.
5. That it is impossible to forecast how much fiscal stimulus to apply.
6. That the complex bureaucracy of a democracy makes timely fiscal action impossible.
7. That it is politically difficult to maintain surpluses and that fiscal finetuning thus cannot fulfill its theoretical dual purpose (to act as stimulant in times of depression and a restraint in times of prosperity).
8. That fiscal finetuning only works if consumers are extremely shortsighted.
9. That fiscal finetuning has never worked in the past.

Yet, certain anomalies are present in the research.

The International Monetary Fund’s endorsement of fiscal finetuning in developing countries contradicts the consensus of professional opinion. A possible explanation for the
IMF’s stance is that governments in developing countries are less bureaucratic than those in “first world” nations. Legislative delays in countries such as Thailand or Korea should be less pronounced than in countries with more politically complex systems. Shorter legislative delays do make “timely” fiscal policy more feasible. It is possible that the IMF regards the option to actively and quickly combat crises in developing nations with flexible discretionary policy as more valuable than the costs inherent in finetuning (i.e. properly predicking how much fiscal stimulus to apply, inflationary pressure, etc.). Additionally, the IMF’s publications demonstrate the organization’s strong aversion to debt. Perhaps debt can be most easily targeted for reduction via discretionary mechanisms.

Another anomaly is the lack of consistency between government and academic publications from the period of 1960-1980. There is government literature published in the 1970s that supports fiscal finetuning over adherence to policy rules. I found very little support for this view in publications from the academic community of the 1970s however. One explanation for this is that government economists were less up to date on material than academics. Another explanation is that publications espousing fiscal finetuning in the 1960s and 1970s weren’t incorporated as readily into online databases (such as J-Stor), due to the biases of database organizers. Such conscious or subconscious biases could be a result of the contemporary rejection of fiscal finetuning.

III. An Examination of the Rhetoric President George W. Bush Uses to Foster Support for his Current Budget Plan

President George W. Bush’s current tax plan is a structural shift in marginal income tax rates. It may be designed to stimulate the economy via supply-side initiatives. Another possible goal of the plan might be to reduce future government surpluses so as to limit the necessity of government involvement in security markets. The tax plan hasn’t been described this way to the American people. In describing his plan, George W. Bush uses catch phrases like “prime the pump” and “stimulate the economy.” These phrases were often used to portray policies drafted in order to fiscally finetune the economy. Bush alludes to fiscal finetuning and ignores a

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23 See pg. 10
discussion of the supply side theory that might more accurately explain his budget plan. Section II is an examination of speeches George W. Bush has made concerning his tax cut.

A. Allusions to Fiscal Finetuning

Although he has advocated tax cuts ever since his campaign for office began, George W. Bush only announced the specifics of his budget plan on February 12, 2001. In building support for the tax-cut, Bush was careful to mix misleading Keynesian rhetoric with allusions to sound monetary policy. This was especially necessary after Alan Greenspan testified to the Senate Budget Committee in late January that tax cuts wouldn’t do much to ease the current slowdown:

Lately there has been much discussion of cutting taxes to confront the evident pronounced weakening in recent economic performance. Such tax initiatives, however, historically have proved difficult to implement in the time frame in which recessions have developed and ended. In today’s context, where tax reduction appears required in any event over the next several years to assist in forestalling the accumulation of private assets, starting that process sooner rather than later likely would help smooth the transition to longer-term fiscal balance (Excerpts From Fed Chairman’s Testimony Before Senate Budget Committee, Jan. 26, 2001, pg. C4).

This is Bush’s interpretation of Greenspan’s statements:

I was pleased to hear Mr. Greenspan’s words. I felt they were measured and just right. He recognizes that we need good monetary policy and sound fiscal policy to make sure the economy grows. So I was pleased.... What Alan Greenspan was saying to the Nation is that in order to make sure our economy grows we’ve got to have good monetary policy and sound fiscal policy, a component of which is wise spending, as well as tax relief (Remarks prior to a Meeting with Congressional Education Leaders and an Exchange with Reporters, Jan. 29, 2001, pg. 223).
This statement is not terribly misleading. Greenspan had stated that a tax cut would lower future surpluses and thus help avoid government interference in security markets. Just a week after this statement, however, Bush had given a different spin to Greenspan’s testimony. He implied that cutting taxes would give the economy a “second wind” and provide a short-term solution to the nation’s economic woes:

...it’s also a budget that recognizes we must provide tax relief to the people who pay the bills. I feel strongly about this issue. And of course I hope you join me. It is so important for us to understand some facts. One, the economy is slowing down. And it's important for us to combine good monetary policy with good fiscal policy. And good fiscal policy is a sound budget, coupled with giving people some of their own money back, to serve as a second wind to an economy (Remarks at the Republican Congressional Retreat in Williamsburg, Virginia, Feb. 5, 2001, pg. 253).

In this inaccurate reinterpretation of Greenspan’s message, Bush alludes to the Keynesian notion that putting money back in the hands of consumers will raise consumption, thus raising aggregate demand (and GDP), and stimulating the economy in the short-run. The implication of Bush’s statement is that fiscal policy should be used as a stimulus to trigger aggregate demand even when the economy is not in a deep or prolonged recession. Essentially, Bush describes his tax cut as a discretionary fiscal policy that will flatten out the business cycle. While Bush’s plan is not a good example of fiscal finetuning that is how it is portrayed to the public sector.

Other examples of inaccuracies and misrepresentations of the tax cut can be found in President Bush’s radio addresses to the American people and speeches to Congress:

Americans are hearing, and some feeling, the economic slowdown. Americans hear about the news - many are beginning to feel what it means to be in an economic slowdown. Consumer confidence has slumped. Many business leaders are worried. A warning light is flashing on the dashboard of our economy. And we just can’t drive on and hope for the best. We must act without delay. My job is to lead. A president should not wait on events. He must shape them. And the
warning signs are clear. All of us here in Washington, the President and the
Congress, are responsible to confront the danger of an economic slowdown and to
blunt its effects. Today I am sending to Congress my plan to provide relief to all
income taxpayers, which I believe will help jump-start the economy (Remarks on
transmitting proposed tax cut plan to Congress, Feb. 12, 2001, pg. 271).

and,

There’s a lot of talk in Washington about paying down the national debt, and
that’s good, and that’s important. And my budget will do that. But American
families have debts to pay, as well. A tax cut now will stimulate our economy
and create jobs (The President’s radio address, Feb. 12, 2001, pg. 257).

and,

Question: Mr. President, do you think the tax cut should be retroactive to the first
of the year?
The President: A lot of Members of Congress have talked to me about that. And
I do. And we look forward to working with Congress to expedite money into the
pockets of the American people. I strongly believe that a tax relief plan is an
important part of helping our country’s economy recover. And I think expediting
money into peoples’ pockets is going to be a key ingredient (Remarks
258).

George W. Bush’s most obvious allusion to fiscal finetuning however, is when he refers
to tax cuts advocated by President John F. Kennedy:

Tax relief is right and tax relief is urgent. The long economic expansion that
began almost 10 years ago is faltering. Lower interest rates will eventually help,
but we cannot assume they will do the job all by themselves. Forty years ago and
then 20 years ago, two presidents, one Democrat, one Republican, John F. Kennedy and Ronald Reagan, advocated tax cuts to, in President Kennedy’s words, “get this country moving again.” They knew then, what we must do now: to create economic growth and opportunity, we must put money back into the hands of the people who buy goods and create jobs. We must act quickly. The chairman of the Federal Reserve has testified before Congress that tax cuts often come too late to stimulate economic recovery. So I want to work with you to give our economy an important jump start by making tax relief retroactive (Transcript of President Bush’s Message to Congress on His Proposal, Feb. 28, 2001, pg. A12).

Kennedy was president from 1961 until his assassination in 1963. During the early 1960’s government economists favored the doctrine of fiscal finetuning. Luckily, government economists don’t “do now, what they knew then.” As previously substantiated, fiscal finetuning is currently a discredited economic theory.

B. Research Analysis

It seems that President Bush is misrepresenting his tax plan. He is probably doing so because he believes that the public will support a budget plan that will quickly “give the economy a second wind.” In the next section possible reactions by the public to Bush’s misleading portrayal of his budget plan will be investigated.

IV. How an Informed Public Can Support a Discredited Economic Theory like Fiscal Finetuning

In a recent Gallup survey, 53% of the respondents polled approved of President George W. Bush’s performance as President of the United States, 29% disapproved of his performance, and

24 http://www.pbs.org/wgbh/amex/presidents/frames/record/ken/kensnap.html
25 see pgs. 8-9
18% were neutral\textsuperscript{26}. Only 13% of those that disapproved of Bush’s performance cited his tax plan as the cause of their disapproval however. This is surprising because the president has portrayed his cut as a policy that fiscally finetunes the economy. Economists in academia, government, international organizations, think tanks, and media organizations have denounced fiscal finetuning. One would thus expect the percentage of respondents that disapproved of Bush’s tax cut to be higher. Why doesn’t a larger segment of the public sector disapprove of Bush’s budget plan? For the purposes of Section III a corollary to this question will be examined: Why might the public sector approve of fiscal finetuning?

A. Psychology and Economics

Why is it that despite the refutation of fiscal finetuning people seem so predisposed to support it? After all, a “rational” economic agent would never support a program that wasn’t in his own best long-term interests. Does this imply that there is something wrong with the economics discipline’s conception of rationality? These questions are among those addressed by Matthew Rabin, a professor of economics at the University of California-Berkley\textsuperscript{27}, in an article written for \textit{The Journal of Economic Research}. In the first portion of this section, studies conducted by psychologists examining rationality, preferences, and biases will be examined. In the second half of this section, the implications of these studies as they might influence an individual’s perception of fiscal finetuning will be explored.

1. Consumer Psychology

Rabin extensively explores consumer psychology as it relates to behavior and preferences. One of his first contentions is that humans are more concerned with changes in their reference levels (of wealth, utility, etc.), than the absolute value of them. Rabin also states that reference levels incorporate levels of past consumption and expectations about future consumption:

Overwhelming evidence shows that humans are more sensitive to how their current situation differs from some reference level than to the absolute

\textsuperscript{26} http://www.gallup.com/Poll/releases/pr010404.asp
\textsuperscript{27} http://emlab.berkeley.edu/users/rabin/webcv.html
characteristics of the situation (Harry Helson 1964)…. Understanding that people are often more sensitive to changes than to absolute levels suggests that we ought to incorporate into utility analysis such factors as habitual levels of consumption. Instead of utility at time t depending solely on present consumption, it may also depend on a reference level determined by factors like past consumption or expectations of future consumption (Psychology and Economics, pg. 14).

Another of Rabin’s contentions is that individuals are adverse to losses. His description of loss aversion resembles current economist theories about risk-aversion in investors and the concavity of utility curves. An interesting aspect of Rabin’s description of loss aversion is his explanation of the endowment effect. The endowment effect states that individuals value goods more once they possess them. This notion is inconsistent with economic theories describing a rational economic agent:

In a wide variety of domains, people are significantly more averse to losses than they are attracted to same sized gains (Kahneman, Jack Knetsch, and Thaler 1990). One realm where such loss aversion plays out is in preferences over wealth levels (Psychology and Economics, pg. 14)

and,

Loss aversion is related to the striking endowment effect identified by Thaler (1980): Once a person comes to possess a good, she immediately values it more than before she possessed it. Kahneman, Knetsch, and Thaler (1990) nicely illustrate this phenomenon. They randomly gave mugs worth about $5 each to one group of students. Minimal selling prices were elicited from those given the mugs. Minimal “prices” – sums of money such that they would choose that sum rather than the mug – were elicited from another group of subjects not given mugs. These two groups, “sellers” and “choosers,” faced precisely the same

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28 Rabin favors a “reference-based kink” in utility functions as opposed to the generic concavity of utility curves in standard economic models however.
choice between money and mugs, but their reference points differed: Those who were randomly given mugs treated the mugs as part of their reference levels or endowments, and considered leaving without a mug to be a loss, whereas individuals not given mugs considered leaving without a mug as remaining at their reference point (Psychology and Economics, pg. 14)

Rabin also supports the existence of time-variant preferences. This theory states that individuals are often prone to pursue immediate gratification even when it is not in their best long-term interests. Rabin disputes the assumption commonly held by economists that individuals discount streams of utility over time exponentially, and thus are time-consistent:

People have a taste for immediate gratification. We procrastinate on tasks such as mowing the lawn that involve immediate costs and delayed rewards and do soon things such as seeing a movie that involve immediate rewards and delayed costs. Economists traditionally model such tastes by assuming that people discount streams of utility over time exponentially. An important qualitative feature of exponential discounting is that it implies that a person’s intertemporal preferences are time-consistent: A person feels the same about a given intertemporal tradeoff no matter when she is asked. Casual observation, introspection, and psychological research all suggest that the assumption of time-consistency is importantly wrong. Our short term tendency to pursue immediate gratification is inconsistent with our long term preferences…. Hence, a person’s preferences today over her future delays in rewards are different than her future preferences over those same delays, so that preferences are not time consistent (Psychology and Economics, pg. 29).

Yet a fourth of Rabin’s contentions is that nominal prices and wages are more important to people than real prices and wages:

Kahneman, Knetsch, and Thaler (1986a) provide survey evidence that people are very attentive to nominal rather than real changes in wages and prices in assessing
the fairness of firm behavior. A nominal wage increase of 5 percent in a period of 12 percent inflation offends people’s sense of fairness less than a 7 percent decrease in a time of no inflation. More generally, people react more to decreases in real wages when they are also nominal decrease, and react negatively to nominal price increases even if they represent no increase in real prices (Shafir, Diamond, and Tversky (1997) (Psychology and Economics, pg. 28).


If one accepts Rabin's analysis of reference levels, and agrees with the perception of individuals as loss averse, it can be deduced that a downward revision in a reference level describing the state of the economy will be associated with decreased utility due to reductions in expectations concerning purchasing power and wealth. Rabin states that individuals will be very sensitive to these downward revisions. Similarly, if one accepts the endowment effect, and considers a “booming economy” in the same manner as a commercial good, the loss of this good (i.e. a slump in the economy), will be associated with an irrationally large decrease in utility.

If one incorporates time-variant preferences into this model, it is possible that consumers would support any policy that resulted in the short-term nominal maintenance (or increase), of the status quo. Informed individuals could therefore recognize that their long-term purchasing power might be reduced if attempts to fine-tune the economy were made (via a tax-cut for example), and still support policies based on the rhetoric of discredited theory. According to Rabin, the instant gratification individuals would receive due to the higher nominal levels of wealth associated with cutting taxes might be too tempting to resist.

B. Politics as Entertainment

In an article entitled "Toward a Theory of the Press" Micheal C. Jensen, a Professor of Business Administration at Harvard Business School\(^\text{29}\), proposes that individuals have no demand for accurate, detailed, political information. He claims that men are resourceful, evaluative, and act so as to maximize their own self-interest. Jensen adds that because political information doesn’t help workers increase their productivity in the workplace (and thus earn higher salaries), this information plays the same role that sports programs, fictional novels, and

\(^{29}\) http://www.people.hbs.edu/mjensen/
soap operas do. Political information is simply a type of entertainment:

I assert that most of the demand for the product of various “news” services derives, not from the individuals’ demands for “information,” but rather from their demands for *entertainment*. In that sense, the news media are in competition with drama, soap operas, situation comedies, fictional writing, sports events, and so on.... Once we understand that the primary function of the news media is to provide entertainment of a specialized form, we are in a position to understand why the press reports as it does. By entertainment, of course, I mean the phenomenon that is reflected in the demand for horror stories, burning skyscraper movies, romantic adventures and so on (Toward a Theory of the Press, pg. 5).

Jensen further provides support for this belief by contending that the economic programs or political leaders selected to run a nation, while having an effect on national prosperity and thus on individuals, aren’t selected by any individual in particular. He contends that because individuals have a negligible effect on policy decisions it doesn’t “pay” for them to be informed:

It doesn’t pay them to seriously consider the issues involved (i.e. expend resources) in deciding how to organize the “good” society, any more than it pays then to expend resources to discover how a presidential candidate would in fact run the country. Their opinions and actions as *individuals* cannot possibly have any impact on the outcome (Toward a Theory of the Press, pg. 13).

Therefore, according to Jensen, one reason why individuals might be predisposed to support policies that finetune the economy is simply because such policies are more exciting than the alternatives. After all, when one fiscally finetunes the economy the effects are short-term as opposed to long-term. Perhaps more importantly, the effects of fiscal policies intended to manage the short-term condition of the economy are tangible. In the case of a tax cut for instance, people have more nominal dollars in their pockets. Similarly, if the government increases spending on public goods the effects of such spending should be cleaner state parks, larger highways, etc.
Conversely, if one “finetunes” the economy using monetary policy the effects are less evident and less exciting. It’s unlikely that consumers would recognize a change in the monetary base or supply, for instance. Supply-side initiatives might also seem dull in comparison to fiscal finetuning; the results of supply-side initiatives tend to target long-term as opposed to short-term economic conditions.

Finally, there is something alluring, high-tech, and sophisticated about the phrase fiscal finetuning. The phrase implies active, efficient, subtle, manipulation of the economy. In an increasingly technologically sophisticated culture like our own the concept of active interaction in markets may appeal to individuals.

C. Educated Ignorance

The majority of Americans aren’t economics experts. By the same token, many citizens are not laymen in economics. Introductory economics is usually offered in high school, and almost always in universities. The core material of introductory macroeconomics courses is often Keynesian economics. Issues that make fiscal finetuning impractical to apply such as political lopsidedness and inaccurate forecasting are often glossed over in these introductory courses. Thus, for citizens that have a rudimentary knowledge of economics the notion of fiscally fine-tuning the economy may seem very plausible. After all, fiscal finetuning works in the simplified models first-year students are taught! Recessionary gaps can be eliminated by increasing autonomous government spending by a straightforward, easily calculable sum, or by cutting taxes in a similar manner. Inflationary gaps can be eliminated by cutting government expenditures or by raising taxes. Most authors of introductory textbooks are sure to add precautionary paragraphs warning about the practical problems of fiscally finetuning the economy. These small paragraphs may be ignored or forgotten by many students in the years following economics courses however. Students are far more likely to remember the basics of

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30 Except perhaps in interest rates.
31 See citation from *The Role of Monetary Policy*, pg. 2
32 \( \frac{\text{Potential GDP}-\text{Actual GDP}}{1/\text{marginal propensity to save}} \), see *Macroeconomics* (6th edition) by Ralph Byrns and Gerald Stone pgs. 236-237
33 \( \frac{\text{Potential GDP}-\text{Actual GDP}}{1- (1/\text{MPS})} \), see *Macroeconomics* (6th edition) by Ralph Byrns and Gerald Stone pgs. 237-238
the models they studied than the “disclaimers” their professors gave at the end of detailed lectures.

Additionally, citizens with a rudimentary knowledge of economics might not recognize the differences between employing fiscal policy to alleviate deep prolonged recessions, and using fiscal policy to eliminate minor business cycles. I believe this is a key element in explaining why citizens might support policies that are portrayed in terms of fiscally finetuning the economy.

Exacerbating the problem of “educated ignorance” in America is the fact that fiscal finetuning was a widely accredited theory until the late 1970’s. Many older Americans may have taken macroeconomics courses in which fiscal finetuning was the appropriate policy prescription for an economic slowdown.

A quotation by H. L. Mencken, a celebrated journalist of the early 1900’s, might provide insight into why intelligent, fairly well informed, individuals might support fiscally finetuning the economy:

The truth is a commodity that the masses of undifferentiated men cannot be induced to buy. The causes thereof lie deep down in the psychology of the Homoboobus, or inferior man – which is to say, of the normal, the typical, the dominant citizen of a democratic society. This man, despite a superficial appearance of intelligence, is really quite incapable of anything properly describable as reasoning. The ideas that fill his head are formulated, not by a process of ratiocination, but a process of mere emotion. What pleases him most in the department of ideas, and hence what is most likely to strike him as true, is simply whatever gratifies his prevailing yearnings…. And therefore, in all his miscellaneous reactions to ideas, he embraces invariably those that are the simplest, the least unfamiliar, the most comfortable – those that fit in most readily with his fundamental emotions, and so make the least demands upon his intellectual agility, resolution, and resourcefulness (On Journalism, pgs. 64-65)

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34 See pgs. 9-10
35 http://www.pratt.lib.md.us/slrc/hum/mencken.html
Mencken poses a cynical view of the psychology of man that any economist would perceive as naive. Nonetheless, I believe Mencken makes a valid point: Men accept ideas that are simple and seem logical to them.

The models many educated citizens have studied that suggest the feasibility of fiscal finetuning are simple (and incomplete). Thus, fiscal finetuning seems logical to many citizens.

D. Research Analysis

I believe all the explanations explored in this section are somewhat valid in addressing why individuals might support discredited theories like fiscal finetuning. As Rabin contends, it is unlikely that individuals are rational as described in the disciple of economics. As Jensen contends, and as is proposed in section IIIC, it is unlikely that individuals are perfectly informed (i.e. have perfect information).

I find Rabin’s analysis of time-variant preferences especially interesting, and for the most part plausible. The idea that individuals will support practically any plan that endorses tax cuts is disturbing. Further research on how to incorporate this new knowledge into economic models would prove interesting. It might also prove interesting to approach this subject from a historical standpoint: Has the public sector ever opposed a tax cut?

I find Jensen’s argument that individuals regard news as a form of entertainment intriguing, but only mildly persuasive. In my personal experience, individuals do seek out accurate information. Nonetheless, there may be elements of truth in his description of man’s reaction to politics. Individuals lack the incentive to be informed if they have a negligible effect on policy decisions. Lack of incentive could explain why some individuals perceive fiscal finetuning as efficient, subtle, and high-tech, when in truth fiscal finetuning lacks subtlety, or efficiency, and is impractical.

I believe that a state of “educated ignorance” does exist in America. This might help explain why Americans support fiscal finetuning. One interpretation of Section IIIC is that individuals may be rational but misinformed. The problem may be (as discussed in the previous paragraph), that there aren’t any incentives for individuals to become better informed.

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36 Or at least don’t disapprove of it more ardently.

37 Media organizations don’t seem to exacerbate or contribute to this problem as it pertains to fiscal finetuning, see pg. 22. It should be noted that many of these articles were written in regard to the Bush budget plan.
This is a difficult problem to solve in a democratic society. One solution might be non-mandatory “quizzes” on current affairs/economic theory administered by private non-biased organizations several times a year. Individuals that “pass” these quizzes could be eligible for tax exemptions or cash prizes. Due to the infeasibility of this solution and others like it, however, “educated ignorance” and the misrepresentation of economic theory by politicians may be a persistent social problem in America.

V. Conclusions

Fiscal finetuning is undesirable due to political considerations, forecasting difficulties, and the concern that it may be inflationary. George W. Bush has misrepresented his tax/budget plan as an exercise in fiscal finetuning. The American public has not been as critical of the tax plan (as portrayed by Bush), as one might expect them to be given the refutation of fiscal finetuning. Several explanations for this lack of disapproval in the plan, and/or support of the plan, are proposed. One explanation can be found through examination of recent discoveries in the discipline of psychology (the existence of time-variant preferences, the fact that individuals prefer increases in nominal wages to increases in purchasing power, etc.). Another explanation is that citizens lack incentives to be well informed, and thus perceive information concerning politics or the economy as entertainment. The final explanation examined in this dissertation is that consumers believe themselves well informed due to incomplete educations and thus come to incorrect conclusions regarding politics and economic theories. Each explanation is plausible, and each most likely plays a role in skewing the public’s perception of economic theory.
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