NAME ______________________ DATE ____________ CLASS ________

Reading Essentials and Study Guide

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Chapter 14: Taxes and Government Spending

Lesson 2 Federal Government Finances

ESSENTIAL QUESTION

How does the government collect revenue, and on what is that revenue spent?

Reading HELPDESK

Academic Vocabulary

coincide to happen or exist at the same time or in the same position

instituted put into action

Content Vocabulary

fiscal year 12-month financial planning period that may coincide with the calendar year; October 1 to September 30 for the federal government

appropriations bill legislation authorizing spending for certain purposes

continuing budget resolution an agreement to fund a government agency at certain levels

budget deficit a negative balance after expenditures are subtracted from revenues

budget surplus a positive balance after expenditures are subtracted from revenues

payroll withholding system method of automatically removing deductions from a paycheck

indexing adjustment of tax brackets to offset the effects of inflation

payroll tax tax on wages and salaries to finance Social Security and Medicare costs

FICA Federal Insurance Contribution Act; tax levied on employers and employees to support Social Security and Medicare

corporate income tax tax on corporate profits

excise tax general revenue tax levied on the manufacture or sale of selected items

estate tax tax on the transfer of property when a person dies

gift tax tax on donations of money or wealth that is paid by the donor

customs duty tax on imported products

user fee fee paid for the use of a good or service; form of a benefit tax

public sector that part of the economy made up of the local, state, and federal governments

earmarks (pork) a line item budget expenditure that circumvents normal budget building processes and procedures and benefits a small number of people or businesses

mandatory spending federal spending authorized by law that continues without the need for annual approvals of Congress

discretionary spending spending for federal programs that must receive annual authorization

transfer payments payments for which the government receives neither goods nor services in return

Medicaid joint federal-state medical insurance program for low-income people

deficit spending annual government spending in excess of taxes and other revenues

national debt the total amount borrowed from investors to finance the government's deficit spending

Lesson 2 Federal Government Finances, *Continued*

balanced budget annual budget in which expenditures equal revenues

trust funds special account used to hold revenues designated for a specific expenditure such as Social Security, Medicare, or highways

per capita per person basis; total divided by population

private sector that part of the economy made up of private individuals and businesses

crowding-out effect higher than normal interest rates and diminished access to financial capital faced by private investors when government increases its borrowing in financial markets

"pay-as-you-go" provision requirement that new spending proposals or tax cuts must be offset by reductions elsewhere

line-item veto power to cancel specific budget items without rejecting the entire budget

spending caps limits on annual discretionary spending

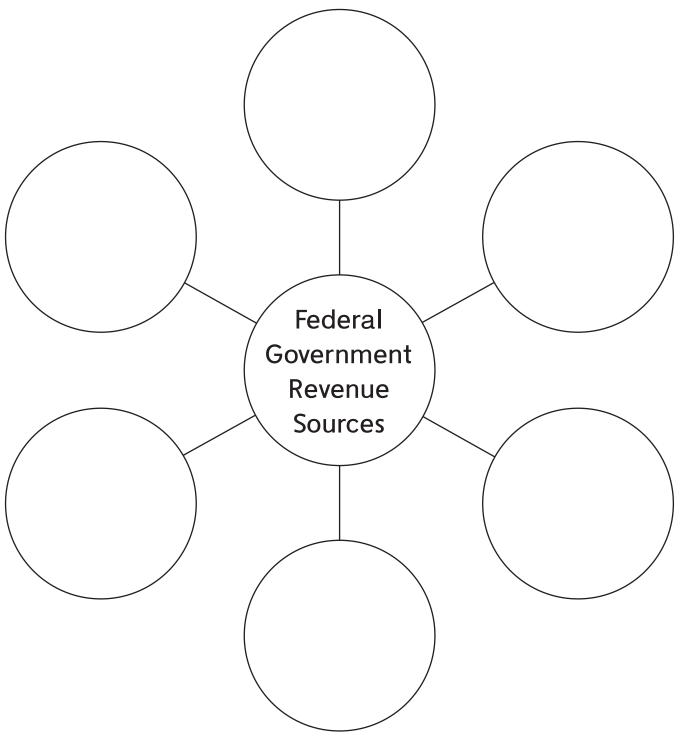
entitlements program or benefit using established eligibility requirements to provide health, nutritional, or income supplements to individuals

sequester a law that required automatic budget cuts

debt ceiling total amount of money the federal government is allowed to borrow

TAKING NOTES*: Key Ideas and Details*

Use a graphic organizer like the one below to identify ways the federal government raises revenues.



Establishing the Federal Budget

Guiding Question *How does the federal government determine an annual budget?*

*The federal budget covers a **fiscal year**. A fiscal year is a 12-month financial planning period that may or may not **coincide** with the calendar year. The government's fiscal year starts on October 1 and ends on September 30 of the next year.*

Executive Formulation

The president's Office of Management and Budget (OMB) creates the federal budget. The OMB is part of the executive branch of government. But the president's budget is only a request. Congress can approve, change, or disapprove it. The law requires that the budget must go to both houses of Congress by the first Monday in February. After February, the process of approving the budget slows down a lot.

Congressional Action

*The president's budget request first goes to the House of Representatives. The House breaks it into 12 major expenditure categories and gives each one to a separate House subcommittee. Each subcommittee then prepares an **appropriations bill**. The appropriations bill is an act of Congress that lets federal agencies spend money for a specific purpose. Subcommittees have meetings, and debate and vote on each bill. Then they send the approved bill to the full House Appropriations Committee. If they approve it, they send it to the entire House for a vote.*

The Senate gets the budget after the House has approved it. The Senate may approve the budget as it is, or the Senate may change it. If the House and Senate do not agree, a joint House-Senate group tries to work out a compromise. During this process, the House and the Senate often ask for advice from the Congressional Budget Office (CBO). The CBO is a nonpartisan congressional organization that studies the impact of the budget. The CBO also projects future revenues and expenditures that the budget may cause.

Final Approval

If the House and Senate both approve the compromise bill, they send it to the president to sign. The final budget may look very different from what it was at the beginning. Congress has taken it apart, rewritten it, and put it back together. Many times, a bill may have changed a lot, with new items that were not in the original budget.

If the budget is too different, the president can veto it and force Congress to make it closer to the original. But once the president signs it, the budget becomes official for the next fiscal year that starts on October 1. If there is no agreement, Congress can pass a ***continuing budget resolution***. This is an agreement to fund a government organization at the same, lower, or even higher levels. Congress has used many continuing resolutions since 2001 because of spending disagreements.

The 2016 Fiscal Year Budget

*The federal budget in Figure 14.5 is called the fiscal year (FY) 2016 budget. Its title is 2016 because most of the months are in 2016. The figure shows $3,336 billion (or $3.3 trillion) of revenue and $3,952 billion (or $3.9 trillion) of spending. This creates a budget deficit of about $616 billion. A **budget deficit** is a negative balance that happens when expenditures are greater than revenues. If expenditures were less than revenues, the result would be a **budget surplus**.*

As the year continues, the size of the deficit or surplus is likely to change a lot because of unexpected events. For example, changes in business conditions could affect tax collections, or changes in political opinion could affect spending.

Reading Progress Check

Describing Why does it take so long for the federal budget to be approved?

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Federal Government Revenue Sources

Guiding Question *What are the main sources of government revenue?*

The federal government gets its revenue from different sources. Taxes are the main source of revenue, but borrowing is also a source. As you can see in Figure 14.5, the four largest sources of government revenue are individual income taxes, borrowing, Social Security taxes, and corporate income taxes.

Individual Income Taxes

Today the individual income tax makes up about half of all federal government revenue. The government usually collects the tax through a ***payroll withholding system****. This system requires an employer to automatically deduct income taxes from a worker's paycheck and send them directly to the IRS.*

Workers sometimes get pay raises to cover the costs of inflation. The raise can push a worker up into a higher tax bracket. But the tax code is indexed to stop this from happening. **Indexing** is an upward revision of the tax brackets to keep workers from paying more in taxes just because of inflation. Otherwise, workers might pay more taxes when they aren't really making more money.

Borrowing

Borrowing is a large source of federal revenue. Borrowing has always been an important source of revenue, but the government is borrowing more now. First, the government has increased spending on Social Security and Medicare as our population has aged. Second, the government increased spending on national defense after the 9/11/2001 terrorist attacks. Third, there have been lower tax rates since in the 1980s. Lastly, there were lower tax collections during and after the Great Recession.

The government would still need to borrow even without these major events. This is because tax revenues fluctuate. The government never knows exactly how much it will have, or how much it will need to spend each year. So if the government does not collect enough money in taxes and fees, or if it has more expenses than it can pay for, it borrows by selling bonds to investors.

Figure 14.5 shows that the federal government has become dependent on this source of funds. It borrows almost double the total amount of taxes it collects from private corporations.

Payroll Taxes

Another important federal revenue source is called the ***payroll tax****. The government takes this tax directly from paychecks. The official name is* ***FICA****, the Federal Insurance Contributions Act tax. Employers and employees equally pay FICA for Social Security and Medicare.*

In 2014, the Social Security part of FICA was 6.2 percent of wages and salaries up to $117, 000. The government does not collect Social Security taxes above this amount. This means that a person with taxable income of $117,000 pays the same Social Security tax—$7,254—as the person who earns $1,000,000,000.

In 1965, Congress added Medicare to the Social Security program. The government taxes the Medicare part of FICA at a flat rate of 1.45 percent. Unlike Social Security, there is no cap on the amount of income taxed, which makes it a proportional tax.

Corporate Income Taxes

The fourth-largest source of federal revenue is the ***corporate income tax****. This is the tax a corporation pays on its profits. The government taxes corporations separately from individuals because corporations have a separate legal identity.*

Corporations pay a slightly progressive tax, but their actual tax rate is low because there are many business tax breaks. For example, in 2013 a Senate subcommittee found that Apple Computer did not pay any taxes on its $30 billion profits. Apple used a complicated network of international corporations to avoid paying taxes to any government. And the subcommittee concluded that Apple did not violate any U.S. tax laws.

Excise, Estate, and Gift Taxes

The ***excise tax*** *is the fifth-largest source of federal government revenue. It is a tax on the manufacture or sale of certain items such as gasoline and liquor. There were early excise taxes on carriages, snuff, and liquor. Today there are excise taxes on telephone services, tires, gasoline, legal betting, and coal. Excise taxes tend to be regressive because low-income families spend larger portions of their incomes on some of these goods than do high-income families.*

An **estate tax** is the tax on the transfer of property when a person dies. The estate includes everything a person owned. Estate taxes can range from 18 to 50 percent of the value of the estate, but estates worth less than $3,500,000 are exempt. Because the exemption is so high, fewer than 2 percent of all estates pay any federal tax at all.

A **gift tax** is a tax on the transfer of money or wealth. The person who gives the gift pays the tax. The government uses the gift tax to make sure that wealthy people do not try to avoid taxes by giving away their estates before they die. Figure 14.5 shows that estate and gift taxes make up only a small fraction of total federal government revenue.

Exploring the Essential Question

Let us suppose that you have started a part-time job at the local coffee shop. You are working 15 hours a week and get paid the minimum wage in your state. You get paid every two weeks. Write a paragraph describing the taxes you will pay to the federal government every two weeks. Describe any issues you have with paying these taxes and why.

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Other Revenue Sources

*A **customs duty** is a charge on goods brought into the United States from other countries. Customs duties apply to many types of goods. These range from automobiles to silver. The duties are relatively low. They produce little federal revenue today, but before the government started collecting income taxes they were the largest income source.*

Finally, the government collects a very small portion of federal revenue through different fees. One example is a **user fee**. This is a charge for the use of a good or service. President Ronald Reagan promoted user fees because they were a revenue source that did not come from taxes.

User fees include entrance charges at national parks. They also include the fees ranchers pay when their animals graze on federal land. These fees are basically taxes based on the benefit principle. Only the people who use the services pay the tax. People also seem more comfortable with them since they are not called "taxes."

Reading Progress Check

Explaining Why are corporations taxed separately from individuals?

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Federal Government Expenditures

Guiding Question *How does the federal government determine an annual budget?*

*The **public sector** is the part of the economy made up of federal, state, and local governments. Public sector spending was relatively low before the Great Depression. Since then, attitudes have changed, and spending has increased sharply. Some of the spending was in the form of **earmarks**, or **pork**. These terms describe the expense for a single item in a budget that circumvents normal budget rules. More recently, most spending has been for things like national defense, highways, parks, and other categories.*

Social Security

The largest category of expenses in the federal budget is for payments to aged and disabled Americans through the Social Security program. Retired persons receive benefits from the Old-Age and Survivors Insurance (OASI) program. People who cannot work receive payments from disability insurance (DI) programs.

Spending for Social Security is sometimes called **mandatory spending**. Mandatory spending is legally approved spending that does not need annual approvals from Congress. This is because the total Social Security payments in any year depend on the number of people who are eligible and the level of benefits that Congress has already approved. Our population continues to get older, and more people are reaching retirement. So Social Security will continue to be the largest federal cost unless the government changes the program.

National Defense

National defense made up the largest category of spending for most of the late 1900s. Now Social Security is bigger. National defense includes military spending by the Department of Defense and defense-related atomic energy activities. These include developing nuclear weapons and removing nuclear wastes.

We call defense costs **discretionary spending**. This is spending that must get approval from Congress every year. Social Security payments go up as the population gets older. But annual defense costs can go up, down, or remain the same. It all depends on the president and Congress.

Income Security

*Income security is a wide range of programs. The programs include unemployment assistance, food and nutrition assistance, and retirement benefits for federal civilian employees and retired military. Other programs support people who cannot fully care for themselves. Most of these expenses are **transfer payments**. The government does not get goods or services in return for transfer payments.*

Other transfer payments include Social Security, unemployment compensation, welfare, and aid for people with disabilities. They also include child care, foster care, and adoption assistance. People who cannot support themselves receive Supplemental Security Income (SSI), subsidized housing, federal child support, Temporary Assistance for Needy Families (TANF), and food stamps. Most income security expenditures are mandatory, which means they do not need approval from Congress every year.

Medicare and Medicaid

Medicare began in 1966 and is another mandatory program. It provides an insurance plan that covers major hospital costs for senior citizens. Medicare also offers optional insurance for more health services. It can cover doctor and laboratory fees, outpatient services, and some medical equipment costs.

Recently, Medicare costs have greatly increased. The population has aged and the cost of caring for the elderly has gone up. Economists expect these increases to continue because medical costs are rising and the population is getting older.

Health-care services for low-income people, preventing disease, and consumer safety make up a large part of the federal budget. **Medicaid**, for example, is a joint federal-state medical insurance program for low-income people. Medicaid is a mandatory expenditure program because Congress has already approved payments. Other mandatory programs include health-care services for working and retired federal employees.

Some programs in this category are discretionary. Again, this means they need approval from Congress every year. One example is the Occupational Safety and Health Administration (OSHA), which oversees job safety and health in the workplace. Other discretionary programs include AIDS and breast cancer research, drug addiction treatment, and mental health services.

Other wide categories of the federal budget include education, training, employment, and social services. They also include veterans' benefits, transportation, administration of justice, and natural resources and the environment. They include both mandatory and discretionary spending.

Reading Progress Check

Summarizing What steps are involved in establishing the federal budget?

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From Deficits to Debt

Guiding Question *How do annual budget deficits add up to the national debt?*

The federal budget has a history of ***deficit spending****. This means spending more than revenues bring in. Sometimes the government plans deficit spending. At other times, revenues drop and expenses rise at the same time. This happened during and after the Great Recession. It caused a single annual deficit to reach the trillions.*

Deficits Add to the Debt

Panel A *of* ***Figure 14.6*** *shows the history of the federal budget deficit since 1965. During that period, the federal budget had a surplus only five times. The first was in 1969, and the last four were in the years 1998 to 2001. When the federal government runs a deficit, it must pay for the revenue shortage by borrowing. It borrows by selling U.S. Treasury notes and other securities to the public. If we add up all outstanding federal notes, bonds, and other debts, we get the* ***national debt****, which is the total amount the government has borrowed from investors to pay for its deficit spending.*

As you can see in **Panel B** in Figure 14.6, the national debt grows whenever the government runs a deficit. If the federal budget runs a surplus, then the government pays back some of the borrowed money. Then the amount of total debt goes down, as it did from 1998 to 2001. When the federal government has a **balanced budget**, the national debt does not change. A balanced budget is an annual budget in which expenses equal revenues.

A Growing Public Debt

The national debt has grown almost without stopping since 1900. The debt was $1.3 billion at that time. By 1929 it was $16.9 billion, and by 1940 it was $50.7 billion. By 2014 the total national debt reached $18 trillion.

Some of this debt is money that the government owes itself. For example, about $5 trillion of this debt is in government **trust funds**. These are special accounts that pay for certain types of costs such as Social Security and Medicare. When the government collects the FICA or payroll taxes, it puts the revenues in these trust accounts. Then the government invests the money in government securities until it needs it.

Most economists ignore trust fund balances because they represent money the government owes to itself. Instead, they see the public portion of the debt as the most important part. The public portion was about $13 trillion in 2014.

Figure 14.7 shows two alternative views of the total national debt. **Panel A** shows the debt as a percentage of GDP, and **Panel B** shows the national debt on a **per capita**, or per person, basis. Both are relatively large historically.

Public vs. Private Debt

The country can never go bankrupt even though the public debt is so high because of differences between public and private debt. First, we owe most of the national debt to ourselves; we owe the private debt to others.

Another difference is repayment. When private citizens borrow, they usually plan to repay the debt by a specific date. When the government borrows, it doesn't think much about repayment. It prints new bonds to pay off the old bonds.

A third difference is in purchasing power. When people repay debts, they give up purchasing power because they have less money to buy goods and services. But the federal government does not always give up purchasing power because it doesn't really pay out money. It simply transfers the taxes collected from some groups to others. This does not include the 34 percent of the public debt that foreigners own. When the government pays back investors outside the United States, it loses some purchasing power from the U.S. economy.

Reading Progress Check

Contrasting What is the main difference between public and private debt?

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Impact of the National Debt

Guiding Question *How does the transfer of purchasing power between generations affect you?*

Even though we owe most of the national debt to ourselves, it still affects the economy. The national debt affects the economy by transferring purchasing power, reducing economic incentives, and causing a crowding-out effect.

Transferring Purchasing Power

The national debt can cause a transfer of purchasing power from the ***private sector*** *to the public sector. The private sector is the part of the economy made up of private citizens and privately owned businesses. When public debt increases, taxes increase. Then people usually have less money for themselves.*

Purchasing power can also transfer from one generation to another. If the government borrows today and leaves the repayment to future taxpayers, then today's adults will consume more and their children will have less. So one generation's debt can hurt the next generation.

Reducing Economic Incentives

Government borrowing can affect private economic incentives if it seems like the government is spending money carelessly. For example, a community may use a federal grant to buy expensive equipment. But its citizens would not want to pay for the expensive equipment themselves. If the taxpayers that benefit from a project would not want to pay for it themselves, other taxpayers would probably not want their taxes to pay for it either.

Crowding Out

When the federal government uses deficit spending, it must borrow money in financial markets. This is a supply-and-demand situation in the markets for borrowing money. If the demand for funds increases but the supply of available funds does not increase, the price of borrowed money will go up. The price of borrowed money is the interest rate. Higher interest rates force all borrowers to pay more.

The government can compete with the private sector for the supply of available funds because it borrows so much. This competition can cause a **crowding-out effect**. The crowding-out effect begins with higher-than-normal interest rates caused by heavy government borrowing. Then the higher interest rates squeeze private borrowers out of the market. The private borrowers are businesses and citizens such as potential home buyers. The firm or potential homeowner that would have been able to borrow funds at 5 percent may no longer be able to afford those investments if interest rates rise to 7 percent.

Reading Progress Check

Describing How can the government's role as a borrower impact economic incentives?

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Reducing Deficits and the Debt

Guiding Question *Why is it difficult to reduce the national debt?*

To reduce the national debt, we have to first fix the federal budget deficit because budget deficits add to the debt. People are worried about deficit spending, so they have tried different ways to fix it since the 1980s.

Early Legislative Failures

One of the first efforts to fix the federal deficit was when Congress tried to mandate a balanced budget. Congress called the law the Balanced Budget and Emergency Deficit Control Act of 1985, also called Gramm-Rudman-Hollings (GRH) Act, after its supporters.

People had high hopes, but GRH failed for two reasons. First, Congress discovered that it could get around the law by passing spending bills that took effect two or three years later. Second, the economy began to weaken in 1990, which stopped the budget cuts.

In 1990, Congress passed the Budget Enforcement Act (BEA). The BEA's main feature was a **"pay-as-you-go" provision**. This was a requirement that Congress balance new spending with decreases in the budget. If Congress could not agree on decreases, then automatic, wide-ranging spending cuts would be **instituted**. Congress soon discovered that cutting spending was more difficult than it had thought. It suspended the provision in order to increase spending.

In 1996, Congress gave the president a **line-item veto**, which is the power to cancel specific budget items without rejecting the entire budget. But the Supreme Court said it was unconstitutional. The Balanced Budget Agreement of 1997 came next. This had rigid **spending caps**, which are legal limits on annual discretionary spending, to assure that Congress balanced the budget by 2002. But the caps required politically unpopular spending cuts in many programs such as health, science, and education, so Congress gave up the caps too.

Raising Revenues

Raising revenues is another way to reduce deficits. President Clinton's Omnibus Budget Reconciliation Act of 1993 was an effort to cut $500 billion from the deficit over five years. The act combined spending reductions and tax increases that made the individual income tax more progressive. This was especially true for the wealthiest 1.2 percent of taxpayers.

Higher tax rates, along with strong economic growth, combined to produce four years of budget surpluses from 1998 through 2001. But in 2001, Congress expected annual surpluses to last for another 10 years. Congress cut tax rates instead of paying down the debt. It also increased spending, which made the situation worse.

Unexpected Spending

In 2001, terrorists attacked the United States. These attacks led to unplanned government spending on homeland security and wars in Iraq and Afghanistan. The federal government also had fewer tax revenues to spend because this was the first year of President Bush's tax cuts. Also, there were fewer revenues because economic activity was low. As a result, very high federal budget deficits returned in 2002.

It was also difficult for Congress to reduce spending because the budget had so many **entitlements**. Entitlements are broad social programs with admission requirements to provide health, nutritional, or income supports to individuals. People can receive benefits if they meet the requirements. Congress can revise entitlements even though most are in the mandatory spending category. Still, it is difficult for members of Congress to revise them because the programs are so popular.

Sequester

In 2011, President Obama and Congress agreed to a deficit reduction solution that would start in 2013. It included a ***sequester*** *that required automatic, wide budget cuts to begin in 2013 if Congress could not agree on major deficit reductions before then. The cuts affected all discretionary programs such as education, energy, medical research, and even national defense.*

Congress made the sequester so unattractive that Democrats and Republicans would prefer to get together and agree on a better way to reduce the deficit. But when 2013 came, Congress could not agree on a deficit reduction program, so the automatic sequester cuts took place.

The result was that some spending reductions happened, but almost everyone was unhappy with them. Congress still could not agree on how to reduce the deficit. The federal debt continued to rise, although at a slower rate. Finally, by late 2013 the federal debt reached the legal limit that Congress had set earlier.

Enforcing the Debt Ceiling

*The **debt ceiling** is the total amount of money that the government is allowed to borrow to pay commitments like Social Security, Medicare, interest on the national debt, military salaries, and payment of tax refunds. Economists also call the ceiling the debt limit. The debt limit does not allow spending on new programs. Instead, it only permits borrowing for expenses that Congress and the president have already approved.*

As you saw in Figure 14.5, interest payments on the federal debt is the sixth largest expense in the federal budget. If interest rates go up, this cost will grow and the government will either have to run a bigger deficit or cut spending somewhere else.

Reading Progress Check

Describing How have the budget and spending crises of the Obama administration illustrated the partisan disagreements of how to allocate federal spending?

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