

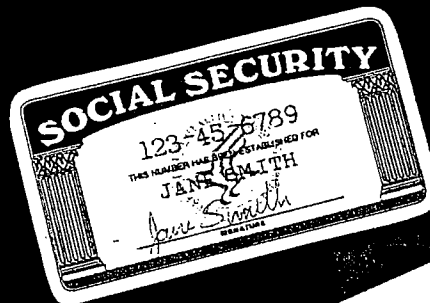
# CHAPTER 16

## Government Spends, Collects, and Owes

### Why It's Important

Who owns national parks and museums? How are tax dollars and your high school related? This chapter will explain why the government collects tax dollars from you, and what it spends those funds on.

To learn more about the federal government's debt, view the **Economics & You** Chapter 15 video lesson: **How Government Spends, Collects, and Owes**



**ECONOMICS**  
*Online*

**Chapter Overview** Visit the *Economics Today and Tomorrow* Web site at [ett.glencoe.com](http://ett.glencoe.com) and click on **Chapter 16—Chapter Overviews** to preview chapter information.

1040 Department of the Treasury — Internal Revenue Service  
**U.S. Individual Income Tax Return**

**Label**  
(See instructions on page 18.)  
Use the IRS label. Otherwise, please print.

**Filing Status**  
1 Single  
2 Married (filing separate returns)  
3 Married (filing joint return)  
4 Qualifying widow(er) with dependent child

**Exemptions**  
a ☐ Yourself  
b ☐ Spouse  
c ☐ Dependents

**Do you want \$3 to go to the fund?**  
If a joint return, does your spouse want \$3 to go to the fund?  
If a joint return, does your spouse want \$3 to go to the fund?

**Do you want \$3 to go to the fund?**  
If a joint return, does your spouse want \$3 to go to the fund?  
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If a joint return, does your spouse want \$3 to go to the fund?  
If a joint return, does your spouse want \$3 to go to the fund?

# Growth in the Size of Government

## COVER STORY

THE NEW YORK TIMES, APRIL 14, 1999

The [White House] is expected to announce as early as next week requirements for cleaner gasoline and tougher pollution standards for the nation's automobiles. The expected regulations would also force sport utility vehicles and pickup trucks to meet the stricter standards for passenger cars for the first time.

Environmentalists are pleased, but the oil and auto industries say gasoline prices for all drivers and the costs of sport utility vehicles and pickup trucks would be increased.

■ ■ ■ ■

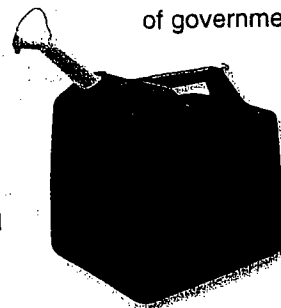
### READER'S GUIDE

#### Terms to Know

- public-works projects
- Medicare

#### Reading Objectives

1. What are two measurements of government growth?
2. What do some economists believe caused the growth of government?



As you learned in Chapter 2, the United States is not a pure market economy. In addition to the market forces of supply and demand, other forces affect the distribution of resources throughout the economy. As revealed in the *Cover Story* above, the government is one of the most important of these forces. As you read this section, you'll learn that government at every level—local, state, and federal—is involved in almost every aspect of the United States economy.

## Government Growth

Government has grown considerably in the last 70 years or so. In 1929, just before the Great Depression began, government at

all levels employed slightly more than 3 million civilian workers. During the Depression, however, there was a demand for more government services.

Today, about 2.9 million people work for the federal government alone. If you add local and state employees, the government employs over 20 million civilian workers. This figure represents more than a sixfold increase during a period in which the population a little more than doubled.

The number of government workers has increased because the number of government functions has risen. **Figure 16.1** shows one way of looking at the government activities that affect our lives.

**Figure 16.2** on page 426 shows another way of looking at the economy. As you can see from the graph, the different levels of government have grown at different rates. During the late 1960s, state and local governments spent less than the federal government. The federal government paid for national defense; the salaries of

## FIGURE 16.1

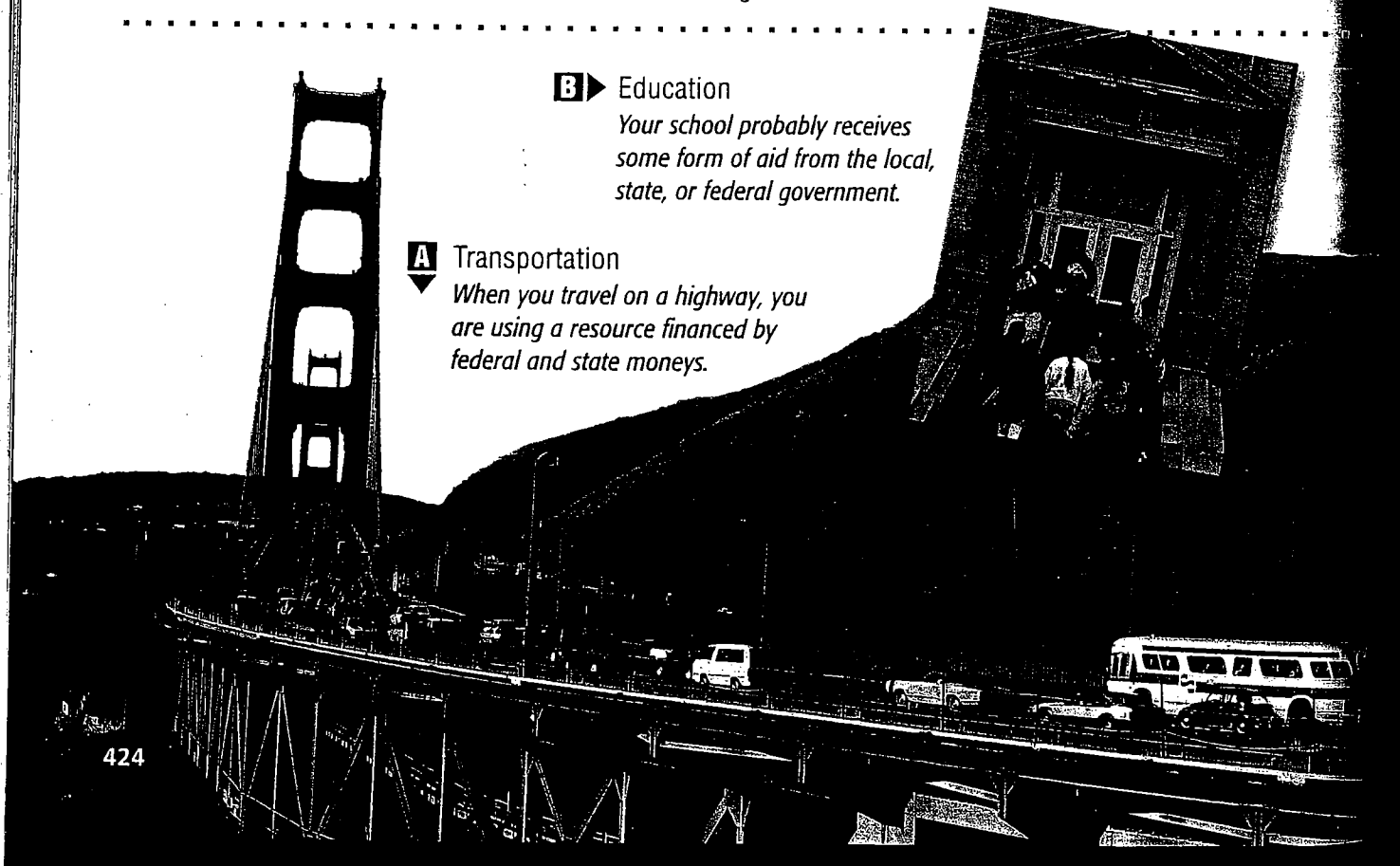
**Government Involvement in the Economy** Government plays a major role in most aspects of our lives. Some individuals believe that government has grown too large and that the private sector should provide goods and services without government intervention. Others argue that government should be even larger.

### **B** Education

*Your school probably receives some form of aid from the local, state, or federal government.*

### **A** Transportation

*When you travel on a highway, you are using a resource financed by federal and state moneys.*



members of Congress, federal judges, and the employees of executive departments such as the State Department; and public-works projects. **Public-works projects** are publicly used facilities such as schools and highways that are built and paid for with tax dollars.

This situation continued until about 1970. At that time, federal funds diminished, while state and local government spending for such items as sewers, roads, and schools increased rapidly.

**public-works projects:** publicly used facilities, such as schools and highways, built by federal, state, or local governments with public money

## Why Has Government Grown?

Economists have often tried to explain the huge growth in government spending. During the Great Depression, there appeared to be a need for more government services. In the 1940s, the government spent billions of dollars to pay for World War II. Why has the government continued to grow since then?

One theory is that as the nation became richer, especially in the late 1960s and early 1970s, people demanded more government services to even out certain income inequities. Today, total government *purchases* represent about 18 percent of GDP. This figure does not include such items as interest payments on the national debt and transfer payments such as welfare programs. If you add these items, total government *outlays* easily exceed one-third of GDP. See **Figure 16.3** on page 426.

**C** **Product Safety**  
*Many goods that you buy are produced in accordance with local, state, and federal regulations.*

**D** **Worker Safety**  
*If you have a job, government safety and other regulations often determine your working conditions.*

**E** **Taxation**  
*If you own property, buy goods, or earn money income, you probably pay taxes that help pay for many government activities.*



**The True Size of Government** The size of government cannot be measured merely by the cost of government spending. Any discussion of the government's size must include *where* government spends this money.

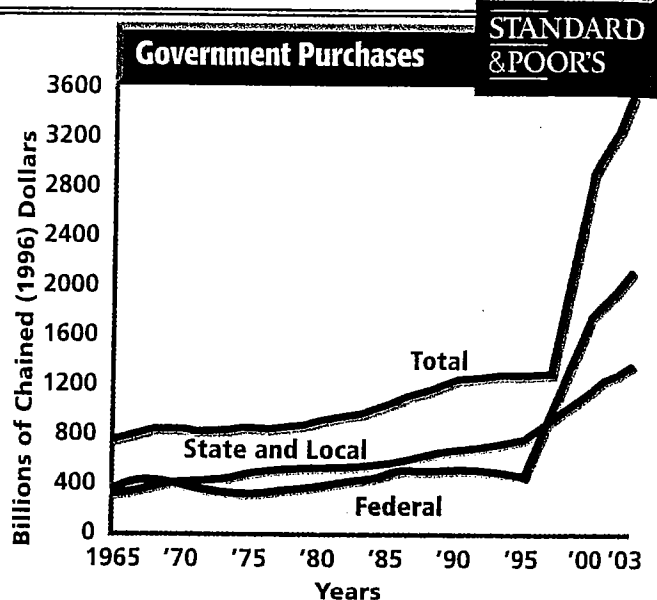
When the government taxes you to provide you with a particular service, such as **Medicare** (health care for the aged), this cost of government is included in government spending. What if the

**Medicare:** government program that provides health care for the aged

**FIGURE 16.2**

### Government Consumption Expenditures and Gross Investment

Government purchases of goods and services (excluding Social Security and other welfare payments and interest) corrected for inflation show an increase in all levels of government spending.



Source: Standard & Poor's

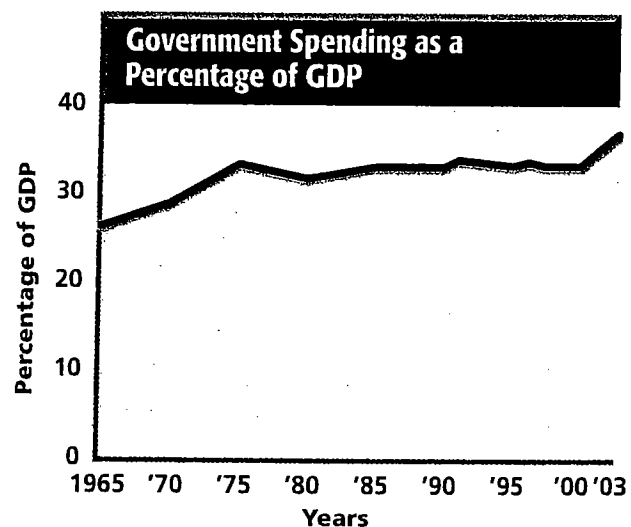


For an online update of this graph, visit [ett.glencoe.com](http://ett.glencoe.com) and click on **Textbook Updates—Chapter 16**.

**FIGURE 16.3**

### Government Spending as a Percentage of GDP

Total government expenditures—including Social Security and other welfare payments, as well as interest payments—expressed as a percentage of GDP have grown from 1965 to the present.



Source: Economic Report of the President, 2003

government also requires that your employer provide that same service? State governments are doing just that. In Massachusetts, for example, employers with six or more employees must provide medical insurance for each employee. So, the federal government taxes employees to pay for government-provided health insurance, and a state government requires that employers provide health insurance directly. The true size of government, then, may be even greater than government estimates show because some "private sector" spending is required by law.

### The Growth of Government—Good or Bad?

We know that government in the United States grew throughout the 1900s. Can we say whether this is good or bad for society? Although no one can know how much government is good for society, a general rule to remember is that government taxing and spending has opportunity costs. Government activity displaces private economic decision making along the production possibilities curve, which you learned about in Chapter 1. This private decision making involved in buying and selling is at the core of wealth creation and a rising standard of living for all citizens.

## CAREERS

### City Manager

#### Job Description

- Elected to enforce laws, oversee budgets, and ensure that programs are carried out
- Encourages business investment and economic development

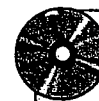
#### Qualifications

- Master's degree in public administration recommended
- Courses in planning, budgeting, and civil engineering

**Median Salary:** \$75,000

**Job Outlook:** Below average

—Occupational Outlook Handbook, 2002–03



Practice and assess key skills with **Skillbuilder Interactive Workbook, Level 2.**

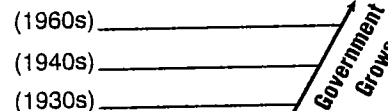
## SECTION 1 Assessment

### Understanding Key Terms

1. **Define** public-works projects, Medicare.

### Reviewing Objectives

2. What are two measurements of government growth?
3. **Graphic Organizer** Create a diagram like the one shown in the next column to explain what has caused the growth of government since the 1930s.



### Applying Economic Concepts

4. **The Role of Government** Do you think it is easier to increase or decrease government spending? Why?

### Critical Thinking Activity

5. **Synthesizing Information** According to **Figure 16.2**, by how much did government spending at all levels increase since 1970?

# People & Perspectives



## John Maynard Keynes

ECONOMIST (1883–1946)

- Educated and later taught at Cambridge University
- Served as adviser to the British government in the 1930s and 1940s
- Keynesian economics named after him
- Most influential publication was *The General Theory of Employment, Interest, and Money* (1936)

John Maynard Keynes originated the school of economic thought referred to as Keynesian economics, which supports the use of government spending and taxing to help the economy.

Keynes believed that there was a need for government intervention, in part because an economy may reach an equilibrium level of employment that is below full employment.

Keynes added that the equilibrium level of employment depends on the level of investment. If the level of investment is low, full employment cannot be achieved:

*“Thus, to justify any given amount of employment there must be an amount of current investment sufficient to absorb the excess of output over what the community chooses to consume when employment is at a given level. . . . It follows, that . . . the equilibrium level of employment, [that is] the level at which there is no inducement to*

*employers as a whole either to expand or contract employment, will depend on the amount of current investment.”*

Keynes believed that his theory explained why large pockets of poverty exist in otherwise rich communities or nations:

*“ . . . This analysis supplies us with an explanation of the paradox of poverty in the midst of plenty.*

*. . . Moreover the richer the community, the wider will tend to be the gap between its actual and its potential production; and therefore the more obvious and outrageous the defects of the economic system.”*

### ***Checking for Understanding***

1. According to Keynes, what is the relationship between employment and current investment?
2. According to Keynes, what is the equilibrium level of employment?

## SECTION 2

# The Functions of Government

## COVER STORY

THE NEWS STAR, AUGUST 12, 2003

Louisiana's senior U.S. senator believes senior citizens may have prescription drug coverage through Medicare by early next year.



Senator John Breaux told a group of senior citizens . . . that a congressional overhaul of the nation's Medicare program will likely include for the first time prescription drug coverage in the aging Medicare program.

Medicare was created in 1965 and has not kept pace with the changing face of health care, Breaux said.

### READER'S GUIDE

#### Terms to Know

- public goods
- income redistribution
- social insurance programs
- Social Security
- workers' compensation
- public-assistance programs
- welfare
- Supplemental Security Income
- Temporary Assistance for Needy Families
- Medicaid
- externalities

#### Reading Objectives

1. What are public goods?
2. Through what two general categories does government redistribute income?
3. What are some criticisms of government involvement in the economy?

The general purpose of government in the United States is to protect individual rights, to promote a stable legal environment for economic activity, and to promote policies that support the general well-being of all citizens. In this section, you'll learn that government tries to accomplish this purpose in four ways: (1) providing public goods, (2) redistributing income, (3) regulating economic activity, and (4) ensuring economic stability.



**public goods:** goods or services that government supplies to its citizens; can be used by many individuals at the same time without reducing the benefit each person receives

## Providing Public Goods

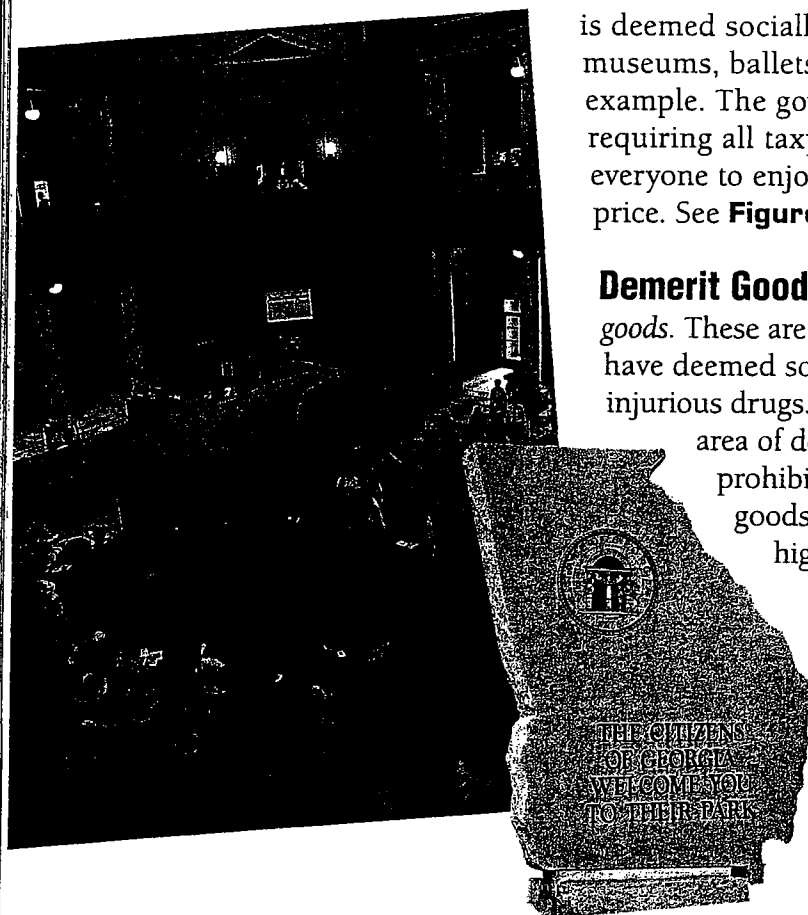
**Public goods** are a special type of goods or services that government tries to supply to its citizens. Many people can use public goods—such as streetlights—at the same time, without reducing the benefit each person receives.

National defense is one of the few public goods only the federal government provides. Usually, the different levels of government share responsibility for other types of public goods—the legal system, for example. Federal, state, and some local governments maintain separate systems of courts, correctional institutions, and law-enforcement agencies.

The most important public good that only government can provide is a sound system of property rights. In such a system, individuals have the right to own factors of production, to risk investment, and to discover new ways of production.

**Merit Goods** In any society, certain goods and services are considered to have special merit. A *merit good* is one that is deemed socially desirable by government leaders—museums, ballets, and classical music concerts, for example. The government may subsidize such goods by requiring all taxpayers to support them. This allows everyone to enjoy such goods for less than the full market price. See **Figure 16.4**.

**Demerit Goods** The opposite of merit goods are *demerit goods*. These are goods that elected government officials have deemed socially undesirable, such as gambling and injurious drugs. The government exercises its role in the area of demerit goods by taxing, regulating, or prohibiting the manufacture, sale, and use of such goods. For example, governments justify very high taxes on alcohol and tobacco products because they are demerit goods.



**FIGURE 16.4** . . . . .

**Merit Goods** Museums and parks fall under the government function of providing merit goods.

. . . . .

# Redistributing Income

Some Americans do not have many of the factors of production. Therefore they are on the bottom of the distribution of income in this country. These people profit from another function of government: to provide for the public well-being by assisting specific groups. These groups include the aged, the ill, and the poor. Through their elected representatives, Americans have chosen to see that almost everyone in the nation is provided with a certain minimum level of income and health-care support. This task is accomplished primarily through **income redistribution**, or using tax receipts to assist citizens in need. Tax dollars are used to subsidize two general categories of assistance: social insurance programs and public-assistance programs.

**Social Insurance Programs** When you receive a paycheck, you will notice that a portion of your pay has been withheld by various levels of government. Some of this money is earmarked for **social insurance programs**—programs that pay benefits to retired and disabled workers, their families, and the unemployed. These benefits are financed by taxes that you, other workers, and employers pay into the programs. Examples of social insurance programs include **Social Security**, a federal program that provides monthly payments to people who are retired or unable to work. Upon retirement, you are also eligible for Medicare, a federal program that provides low-cost health care for the aged.

Another social insurance program is **workers' compensation**, a state program that provides payments for medical care to workers injured on the job. People who have lost jobs altogether can receive payments through *unemployment insurance*.

**Public-Assistance Programs** Public-assistance programs, often called **welfare**, are different from social insurance programs. Public-assistance programs make payments to individuals based on need, regardless of whether a person has paid taxes into the program.

Included in this category are **Supplemental Security Income**, a federally financed and administered program that makes payments to the aged, blind, and disabled; and **Temporary Assistance for Needy Families**, a state-run program that provides assistance and work opportunities to needy families raising young children. **Medicaid**, a state and federal program that helps pay health care costs for low-income and disabled persons, is another public-assistance program.

**income redistribution:** government activity that takes income from some people through taxation and uses it to help citizens in need

**social insurance programs:** government programs that pay benefits to retired and disabled workers, their families, and the unemployed

**Social Security:** federal program that provides monthly payments to people who are retired or unable to work

**workers' compensation:** government program that extends payments for medical care to workers injured on the job

**public-assistance programs/ welfare:** government programs that make payments to citizens based on need

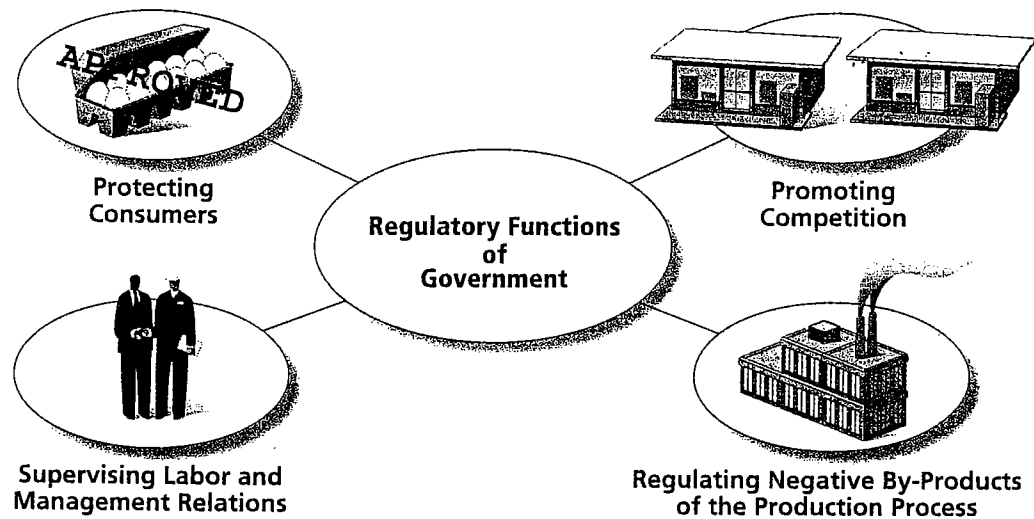
**Supplemental Security Income:** federal programs that include food stamps and payments to the disabled and aged

**Temporary Assistance for Needy Families:** state-run program that provides assistance and work opportunities to needy families

**Medicaid:** state and federal public-assistance program that helps pay health care costs for low-income and disabled persons

## FIGURE 16.5

**Government Regulations** Government under the American free enterprise system regulates certain aspects of the economy.



## Regulating Economic Activity

Figure 16.5 illustrates four ways in which the government intervenes in economic activity. One of the most important regulatory functions concerns the side effects of the production process—also called **externalities**. When a steel mill produces steel, for example, the resulting pollution from the smokestacks may cause health problems in the surrounding area. In the absence of legal rules that limit such pollution, the steel mill does not have to correct these negative externalities. Government has often stepped in to require plants to install equipment that will reduce pollution.

**externalities:** economic side effects or by-products that affect an uninvolved third party; can be negative or positive

## Ensuring Economic Stability

Ensuring economic stability has meant smoothing the ups and downs in the nation's overall business activity. Such intervention has been sought to shield citizens from the harmful effects of business fluctuations, including unemployment, high inflation, recessions, and even depressions. In Chapter 17, you'll learn more about the government's attempt to stabilize the economy.

## Critics of Government Involvement

There are many critics of government involvement in the economy. They point out that merit goods, for example, should be provided by private organizations. If people pay fewer taxes, they have more disposable income and can choose to fund symphonies or other merit goods if they really want such services.

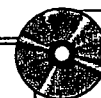
Opponents of redistribution programs think that most government assistance discourages personal initiative, affects incentives, and harms self-development. Critics of government regulations argue that most regulations raise the prices of goods and services. A better approach, these critics say, would be to encourage market solutions to such problems as pollution.

## Global Economy

### Working in Britain

In the mid-1940s, the British government established a welfare system designed to provide its citizens with economic security "from cradle to grave." Over the years, the system grew and now accounts for more than 30 percent of the government's annual budget. Almost half of all Britons receive some form of assistance—from retirement pensions to housing benefits.

In 1999 Prime Minister Tony Blair called for an overhaul of the system. "If you can work," he stated, "you should work." He suggested that people who receive welfare assistance would have to actively seek employment or risk losing their benefits: "The days of an automatic right to benefit will go." ■



Practice and assess  
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Workbook, Level 2.*

## SECTION 2 Assessment

### Understanding Key Terms

1. **Define** public goods, income redistribution, social insurance programs, Social Security, workers' compensation, public-assistance programs, welfare, Supplemental Security Income, Temporary Assistance for Needy Families, Medicaid, externalities.

### Reviewing Objectives

2. What are public goods?
3. **Graphic Organizer** Create a chart like the one below to list the programs through which government redistributes income.

Social Insurance Programs	Public-Assistance Programs

4. What are some criticisms of government involvement in the economy?

### Applying Economic Concepts

5. **The Role of Government** List five ways that local, state, and federal government are involved in your daily life. Provide specific examples in your list.

### Critical Thinking Activity

6. **Summarizing Information** In a paragraph, list at least three activities or "goods" that you think should be considered merit goods, or goods that are deemed socially desirable by government leaders. Then describe why you think the government should or should not be involved in providing merit goods to society.

## SPOTLIGHT ON THE ECONOMY

### Social Security Is Aptly Named

**Check It Out!** In this chapter you learned that one function of government is to provide for the public well-being. In this article, read to learn how distributing income through Social Security can increase the well-being of the elderly.

One result of the current Social Security debate has been to concentrate the public's mind on the true economic condition of the elderly—and to give the lie to those who describe them as “greedy geezers.”

While the top 20% of seniors are relatively affluent, reports the Center on Budget & Policy Priorities, almost all of the rest are highly dependent on Social Security.

In 1997, the average Social Security retirement benefit was just \$765 a month, and the average check to 65-year-olds was \$819 a month—a tidy sum, but hardly a bonanza. Yet, according to the center's analysis, the program provided at least half of the total income of more than 55% of senior citizens and at least 75% of the total income of more than a third.

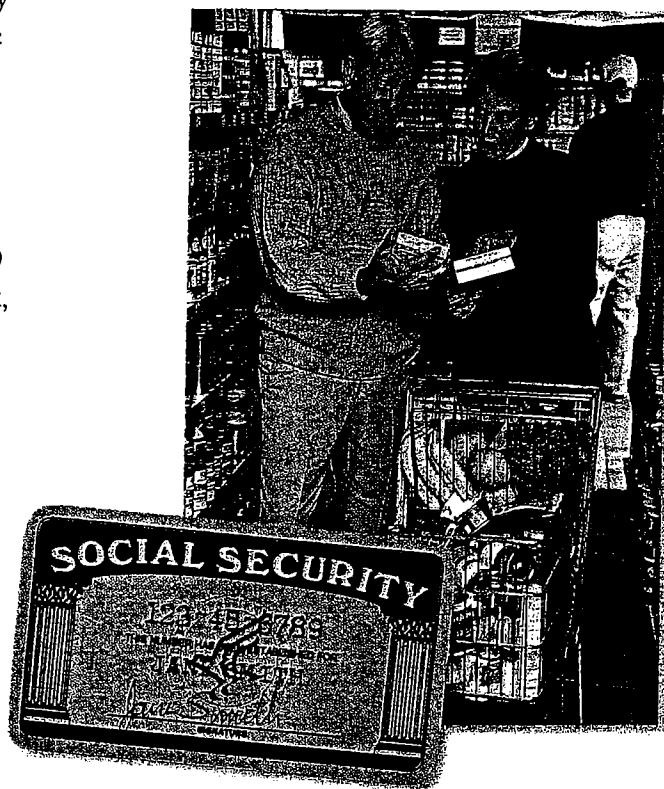
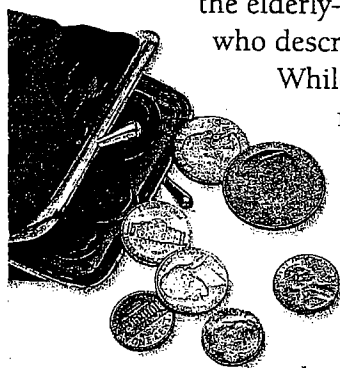
Social Security's impact on poverty among older Americans is equally revealing. Based on 1997 Census Bureau data, the center finds that the retirement program lifted 11.4 million seniors—or nearly half of the 65-and-older

population—out of poverty, cutting the elderly's poverty rate from 47.6% to 11.9%. Means-tested programs, such as Supplemental Security Income, lowered the rate still further to 10.5%—bringing it close to that of other adult Americans.

—Reprinted from May 10, 1999 issue of *Business Week* by special permission, copyright © 1999 by The McGraw-Hill Companies, Inc.

#### Think About It

1. What percentage of senior citizens rely on Social Security to provide half of their income?
2. How many seniors were lifted out of poverty by Social Security payments?



## SECTION 3

# The Federal Budget and the National Debt

### COVER STORY

THE NEW YORK TIMES, JANUARY 31, 1999

The federal budget deficit is gone, transformed by a strong economy into a string of projected surpluses that should grow larger for years to come. . . .

Eliminating the deficit is hardly the end of the government's financial troubles, however. . . . [T]he national debt was built up over decades of deficit spending—the federal government has not run steady surpluses since the 1920s—and it remains an economic millstone of considerable proportions.



### READER'S GUIDE

#### Terms to Know

- fiscal year
- budget deficit
- deficit financing
- national debt
- budget surplus

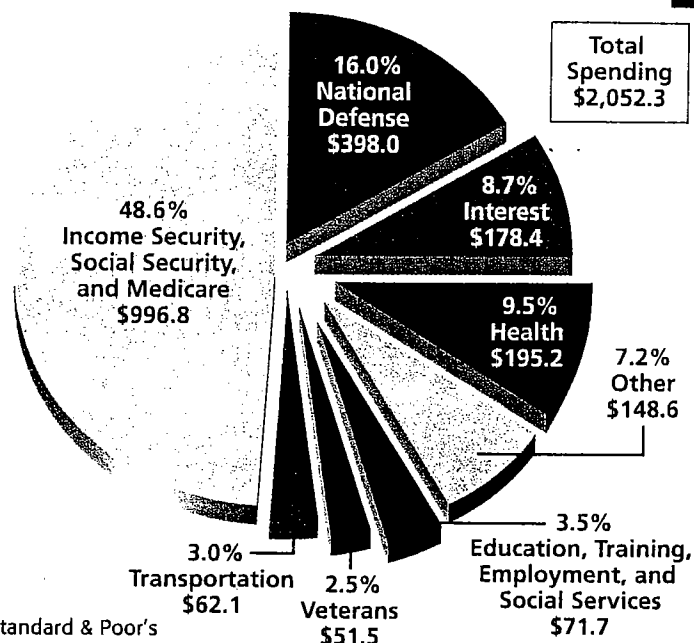
#### Reading Objectives

1. What are the steps in the federal budget-making process?
2. What are the five largest federal expenditures?
3. What are the five largest state and local government expenditures?
4. How does deficit spending increase the national debt?

To carry out all of its functions, government must spend huge sums of money. As a result, the federal budget is huge and has numerous categories. Because all resources are scarce, an increase in spending in one area will cause a decrease in spending in some other area. **Parts A and B of Figure 16.6** on page 436 show the major areas in which the federal, state, and local governments spend their money. As you read this section, you'll learn how the government prepares its budget and decides where to spend its funds.

**FIGURE 16.6****Part A Federal Spending**

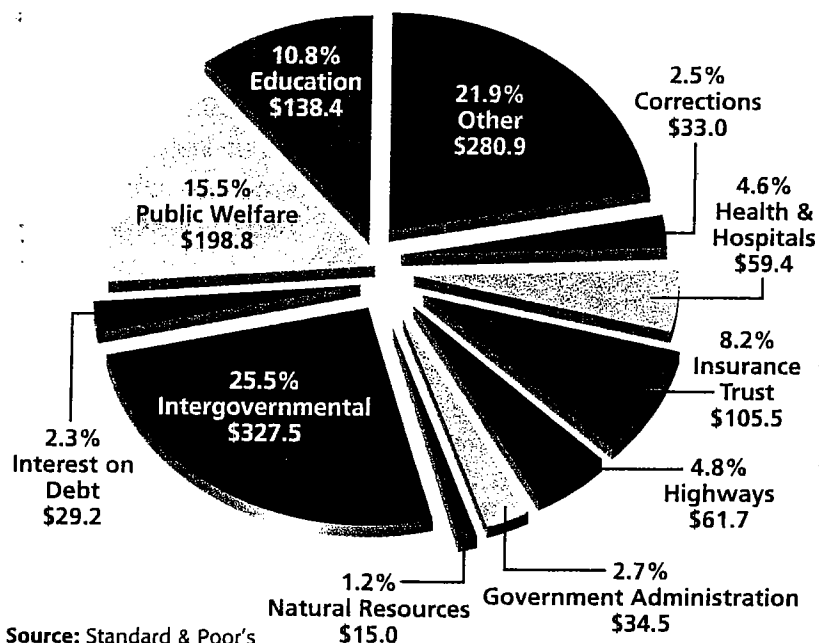
The federal budget is based on a fiscal year, rather than the calendar year. Spending is calculated from the beginning of the budget year on October 1 of one year to September 30 of the next year.

**A Spending by the Federal Government (in billions of dollars)****STANDARD & POOR'S**

Source: Standard &amp; Poor's

**Part B State and Local Government Spending**

State and local government expenditures have increased in recent years, as these governments cover the rising costs of social welfare programs.

**B Spending by State Governments (in billions of dollars)**

Source: Standard &amp; Poor's



For online updates of these graphs, visit [ett.glencoe.com](http://ett.glencoe.com) and click on **Textbook Updates—Chapter 16**.

## FIGURE 16.7

### The Federal Budget-Making Process

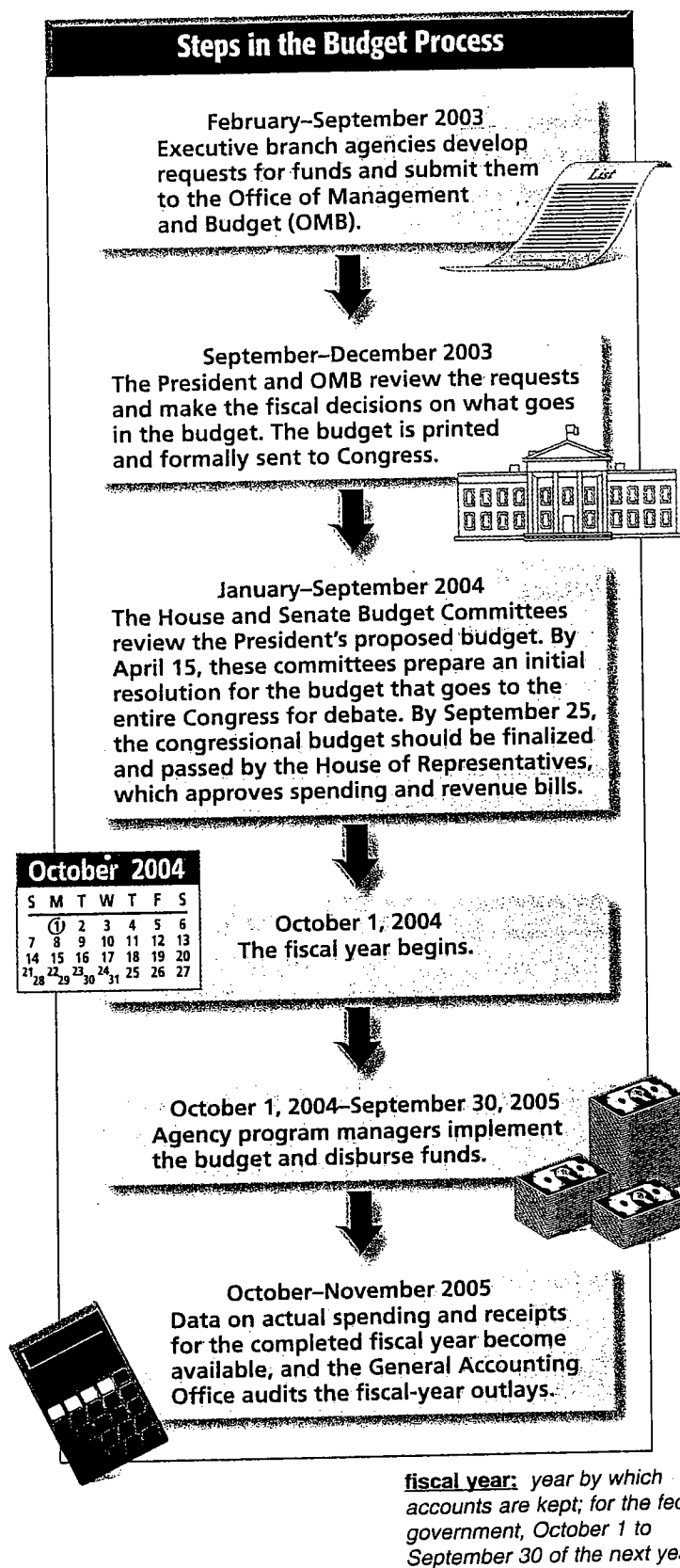
The Office of Management and Budget (OMB) starts the budget process, with the advice of the Council of Economic Advisers and the Treasury Department.

Part B of Figure 16.6 shows how state and local governments spend the tax revenues they collect. The largest single category by far in state and local expenditures is education. The "other" expenditure includes expenditures for such things as state parks, sewers, and libraries.

### The Budget-Making Process

Considerable debate and compromise are necessary in preparing an annual budget. A complicated budget-making process goes on every year, not just in Washington, D.C., but in every state and local government unit as well.

**The Federal Budget** About 18 months before the **fiscal year** begins on October 1, the executive branch of the government begins to prepare a budget, as Figure 16.7 shows. Working with the President, the Office of Management and Budget (OMB) makes an outline of a tentative budget for the next fiscal year. The various departments and agencies receive this outline and usually start bargaining with the OMB for a larger allocation of federal funds.

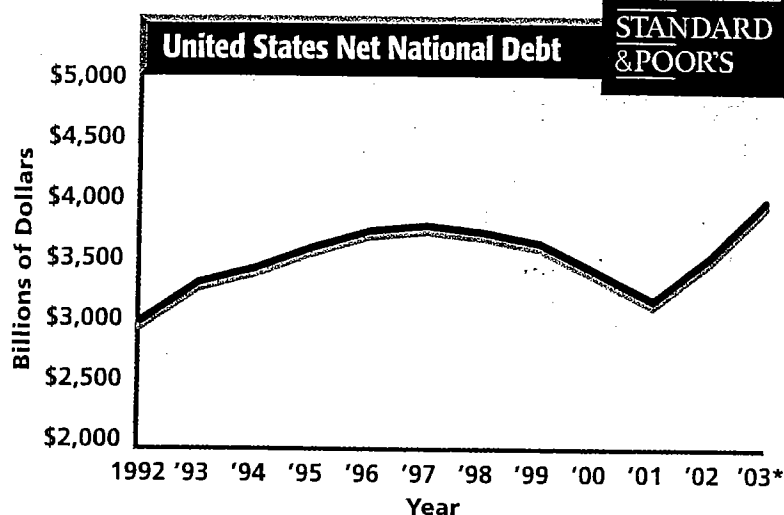




**FIGURE 16.8**

**Net National Debt** The net national debt of the United States increased almost 26 percent between 1992 and 1997, started to decline in 1998, then rose again in 2002.

.....



Source: Standard &amp; Poor's

\* Author's Estimate



For an online update of this graph, visit [ett.glencoe.com](http://ett.glencoe.com) and click on **Textbook Updates—Chapter 16**.

The President reviews and approves the budget plan. The budget is printed, and the President submits the budget to Congress by January. Then various committees and subcommittees of Congress examine the budget's proposals, while the Congressional Budget Office (CBO) advises the committees about different aspects of the budget. Throughout the year, each committee holds a series of discussions.

Congress is supposed to pass two budget resolutions that set binding limits on spending and taxes for the upcoming fiscal year. In practice, however, the required budget resolutions often do not get passed on time. Moreover, when they are passed, the resolutions are not always treated as binding. As a result, the fiscal year sometimes starts without a budget, and the government must operate on the basis of a continuing congressional resolution. Agencies that allocate funds can continue spending as they spent the year before until the new budget resolution is passed.

## Deficit Spending and the National Debt

In spite of the budget process outlined above, federal government revenues have not always been equal to government expenditures. Most years, the federal government spent more than it collected in taxes, causing a **budget deficit**. When a budget deficit occurs, the government must raise the extra funds through

**budget deficit:** situation when the amount of government spending exceeds its receipts during the fiscal year

borrowing. This borrowing is similar to an individual overspending his or her income and using credit. The government's overspending is called **deficit financing**.

**Government Borrowing** Government borrows money to cover the deficit by selling securities to individuals and businesses. Federal securities include Treasury bonds, notes, and bills. When you buy United States savings bonds, you are also lending funds to the federal government. In addition, individual agencies of the federal government, such as the Tennessee Valley Authority, are authorized to sell bonds. State and local governments can borrow by selling bonds to finance some of their activities.

Each year the federal government creates new debt by issuing new securities. At the same time, it retires old debt by paying off bonds, notes, and bills as they come due. The total amount of outstanding debt for the federal government is called the **national debt**, or public debt.

As you can see from **Figure 16.8**, from 1992 until 1997, the amount of the net national debt grew. The government began to run a **budget surplus**—government revenues exceeded government expenditures during the fiscal year—in 1998. However, the planned surpluses of 2001 and later years seemed unlikely to occur after terrorism struck the United States in September 2001. The federal government had to spend more to fight terrorism.

**deficit financing:** government policy of spending more money than it is able to bring in through revenues

**national debt:** total amount of outstanding debt for the federal government

**budget surplus:** situation when the amount of government receipts is larger than its expenditures during the fiscal year



Practice and assess key skills with **Skillbuilder Interactive Workbook, Level 2.**

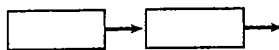
## SECTION 3 Assessment

### Understanding Key Terms

1. **Define** fiscal year, budget deficit, deficit financing, national debt, budget surplus.

### Reviewing Objectives

2. **Graphic Organizer** Create a diagram like the one below to describe the steps in the federal budget-making process.



3. What are the five largest federal expenses?
4. What are the five largest state and local expenses?

5. How does deficit spending increase the size of the national debt?

### Applying Economic Concepts

6. **Trade-Offs** If you had to reduce spending at the state and local levels, which categories shown in **Part B of Figure 16.6** would you reduce? Why?

### Critical Thinking Activity

7. **Categorizing Information** What is your share of the national debt today? Search the Internet under *national debt* for the debt total, then divide that number by an estimate of the current population.

## READER'S GUIDE

### Terms to Know

- benefits-received principle
- ability-to-pay principle
- proportional tax
- progressive tax
- regressive tax

### Reading Objectives

1. What are the two principles of taxation?
2. What effect do the three forms of taxation have on taxpayers?

## COVER STORY

THE WASHINGTON POST, APRIL 12, 1999

"We'll cut your taxes" is the most repeated campaign promise in the history of American politics. Yet somehow it is still considered visionary, worth a fight. Worth, indeed, a crusade.

Why? It's in our blood. Historically, Americans have hated taxes, and not merely because we had to pay them. We've hated taxes because we've perceived them to be an infringement on our liberty—and the source of big, powerful, and mischievous government. This was true from the beginning. It wasn't just "taxation without representation" that bothered us so much. It was taxation. Period.



**Y**ou, the American taxpayer, are the source of most of the money the government spends. Almost all federal, state, and local government revenue comes from taxes. In this section, you'll learn about the major kinds of taxes paid in this country.

## Principles of Taxation

**Figure 16.9** lists the major taxes that the various levels of government use to raise revenue. Taxes are usually justified according to one of two major principles. Under the **benefits-received principle**, those who use a particular government service should support it with taxes in proportion to the benefit they receive. Those who do not use a service do not pay taxes for it. A gasoline

**benefits-received principle:** system of taxation in which those who use a particular government service support it with taxes in proportion to the benefit they receive; those who do not use a service do not pay taxes for it

**FIGURE 16.9 Major Taxes**

Tax	Description	Type
<b>Personal income</b>	Tax is a percentage of income and a major source of federal revenue; many state governments also levy	Progressive at the federal level, but is sometimes proportional at the state level
<b>Social insurance</b>	Taxes covered by the Federal Insurance Contributions Act (FICA); second-largest source of federal revenue	Proportional up to income of \$80,400 in 2001, regressive above that (as estimated by the Social Security Administration)
<b>Corporate income</b>	Federal tax as a percentage of corporate profits; some states also levy	At the federal level, progressive up to \$18.3 million, proportional above that
<b>Excise</b>	Tax paid by the consumer on the manufacture, use, and consumption of certain goods; major federal taxes are on alcohol, tobacco, and gasoline; some states also levy	Regressive if people with higher incomes spend a lower proportion of income on taxed items
<b>Estate</b>	Federal tax on the property of someone who has died; some states also levy	Progressive; rate increases with the value of the estate
<b>Inheritance</b>	State tax paid by those who inherit property	Varies by state
<b>Gift</b>	Federal tax paid by the person who gives a large gift	Progressive; rate increases with the value of the gift
<b>Sales</b>	Tax paid on purchases; almost all states as well as many local governments levy; rate varies from state to state and within states; items taxed also vary	Regressive if people with higher incomes spend a lower proportion of income on taxed items
<b>Property</b>	State and local taxation of the value of property; both real property (such as buildings and land) and personal property (such as stocks, bonds, and home furnishings) may be taxed	Proportional; rate is set by state and local governments
<b>Customs duties</b>	Tax on imports; paid by the importer	Proportional

# Economic Connection to... History

## The Constitution and Taxes

**A**rticle 1, Section 8 of the Constitution states that "Congress shall have the power to lay and collect taxes. . ." for the purpose of paying debts and providing for the nation's defense and general welfare. Any taxes imposed must apply equally to all parts of the United States. The Constitution also made direct taxes, such as income taxes, difficult to impose because they had to be in proportion to each state's population. This meant

the states with more people would pay higher taxes. The 16th Amendment, passed in 1913, enabled the federal government to impose income taxes on individuals. ■ *Why does the Constitution give Congress the power to tax? How have the original restrictions on taxation been changed?*

tax to pay for highway construction and repair is based on the benefits-received principle. Frequent users of the highways often buy more gasoline and, therefore, pay more in gasoline taxes.

A tax based on the benefits-received principle is useful in raising funds to pay for a service only certain individuals use. Many government services—national defense, for example—benefit everyone equally, however. Also, those who most require services, such as the aged and poor, are the individuals least able to pay taxes.

Under the **ability-to-pay principle**, those with higher incomes pay more taxes than those with lower incomes, regardless of the number of government services they use. For example, in most cities all property owners, even those without school-aged children, must pay property taxes to support the local school system. Property taxes are calculated as a percentage of the value of a person's home. Thus, wealthier people with more expensive homes pay more property taxes.

**ability-to-pay principle:** principle of taxation in which those with higher incomes pay more taxes than those with lower incomes, regardless of the number of government services they use

**ECONOMICS**  
*Online*



**Student Web Activity** Visit the *Economics Today and Tomorrow* Web site at [ett.glencoe.com](http://ett.glencoe.com) and click on **Chapter 16—Student Web Activities** to learn how the federal government spends your tax dollars.

## Forms of Taxation

Actual taxes are classified according to the effect they have on those who are taxed. In the United States today, these classifications include proportional, progressive, and regressive taxes.

**Proportional Tax** A **proportional tax** is the easiest type of tax to understand. The taxes you owe are simply a proportion of the money income you have earned. If there is a tax of 10 percent on all income and you earn \$1,000, then you pay \$100 in taxes. If you earn \$10,000, you pay \$1,000 in taxes, and so on.

**proportional tax:** tax that takes the same percentage of all incomes; as income rises, the amount of tax paid also rises

**Progressive Tax** With a **progressive tax**, when an individual earns a higher income, his or her taxes increase more than in proportion to the increase in money income. A good example of a progressive tax is our federal individual income tax system. As you make more reported income, you pay an increasingly higher percentage of that additional income in taxes to the federal government. A progressive income tax has often been justified on the basis of the ability-to-pay principle.

**progressive tax:** tax that takes a larger percentage of higher incomes than lower incomes; justified on the basis of the ability-to-pay principle

**Regressive Tax** As you might expect, a **regressive tax** is the opposite of a progressive tax. The percentage that you pay in taxes actually goes down as you make more money income. Some economists believe that a good example of a regressive tax is the sales tax on food. They point out that poorer families spend a larger proportion of their income on food. Therefore, the sales tax they pay on food takes up a larger proportion of their total income than a wealthier family pays.

**regressive tax:** tax that takes a larger percentage of lower incomes than of higher incomes



Practice and assess key skills with *Skillbuilder Interactive Workbook, Level 2.*

## SECTION 4 Assessment

### Understanding Key Terms

1. **Define** benefits-received principle, ability-to-pay principle, proportional tax, progressive tax, regressive tax.

### Reviewing Objectives

2. What are the two principles of taxation?
3. **Graphic Organizer** Create a chart like the one in the next column to explain the three forms of taxation and their effect on taxpayers.

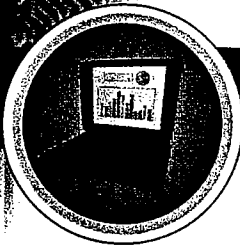
Type of Tax	Effect on Taxpayer	Example

### Applying Economic Concepts

4. **Taxation** List and describe the kinds of taxes you personally pay.

### Critical Thinking Activity

5. **Making Comparisons** Which of the two principles of taxation do you think is the more equitable? Explain your answer.



## Technology Skills

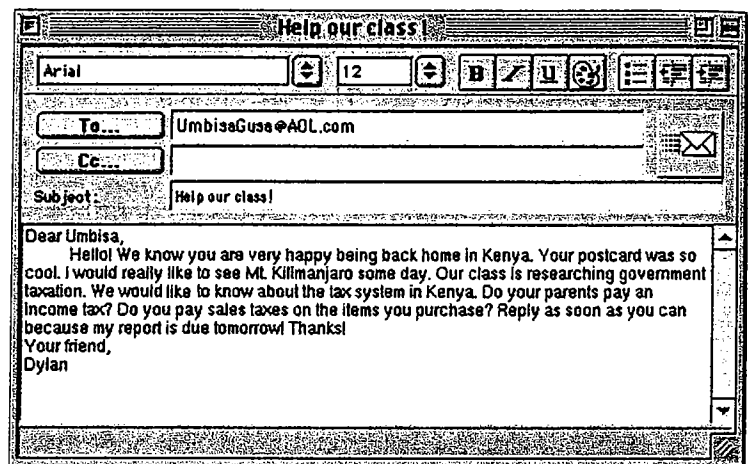
# Using E-Mail

Electronic mail, or E-mail, refers to communicating at a distance through the use of a computer. A computer is ready to "talk" to other computers after two things are added to it: (a) a modem—a device that allows communication through a telephone line, and (b) communications software, which lets your computer prepare and send information to the modem.

1. Select the "Message" function from your communications software.
2. Type in your message, and proofread it for errors.
3. Type in the E-mail address of the recipient, and select the "Send" button.
4. The E-mail system places the message in the receiver's electronic mailbox. He or she may read the message at any time, and send you a return message.
5. When you receive E-mail, the sender's address is on the message—add it to your electronic address book at that time.

### Learning the Skill

To send an E-mail message, follow the steps listed on the left.



After you type in your message, you may send it, forward it, and even save it to a file.

### Practicing the Skill

Select a current issue concerning government taxation to research. Then browse the Internet to obtain the E-mail address of a federal official concerned with the issue. E-mail the official, sharing opinions about the issue, asking questions about the issue, and requesting information.

### Application Activity

E-mail a classmate. Forward the information you received from the government official concerning the issue above. Working together, write a summary of the E-mail correspondence with the official.

# CHAPTER

# 16

# Summary

## ECONOMICS Online



**Chapter Overview** Visit the *Economics Today and Tomorrow* Web site at [ett.glencoe.com](http://ett.glencoe.com) and click on **Chapter 16—Chapter Overviews** to review chapter information.

### SECTION 1 Growth in the Size of Government

- Government at every level—local, state, and federal—is involved in almost every aspect of the United States economy.
- All levels of government employ about 20 million civilian workers.
- Government finances highways, education, and other **public-works projects**. It also regulates product and worker safety.
- Total government outlays, including actual purchases as well as transfer payments, exceed one-third of GDP.

### SECTION 2 The Functions of Government

- One function of government is to provide **public goods**, such as national parks and national defense.
- Another function of government is to provide for the public well-being through **social insurance programs**—such as **Social Security, Medicare, and workers' compensation**—and **public-assistance programs**—such as **Supplemental Security Income and Medicaid**.

- A third function of government is to regulate the negative **externalities** of the production process.
- A fourth function—ensuring economic stability—has meant smoothing the ups and downs in the nation's overall business activity.

### SECTION 3 The Federal Budget and the National Debt

- The federal government's largest expenditures include Social Security/Medicare/income security, national defense, interest on the national debt, and health.
- The executive and legislative branches prepare a federal budget for each **fiscal year**.
- Spending more in a fiscal year than it collects in taxes results in the government running a **budget deficit**.
- The total amount accumulated by annual budget deficits is the **national debt**.

### SECTION 4 Taxation

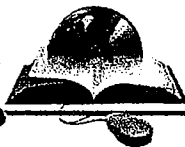
- Under the **benefits-received principle**, people who use a particular government service support it with taxes in proportion to the benefit they receive.
- Under the **ability-to-pay principle**, those with higher incomes pay more taxes than those with lower incomes, regardless of the number of government services they use.
- Major types of taxes include personal income, social insurance, corporate income, sales, and property taxes.
- Taxes are classified according to the effect they have on those who are taxed: **proportional, progressive, or regressive**.



# CHAPTER 16

## Assessment and Activities

### ECONOMICS *Online*



**Self-Check Quiz** Visit the *Economics Today and Tomorrow* Web site at [ett.glencoe.com](http://ett.glencoe.com) and click on **Chapter 16—Self-Check Quizzes** to prepare for the Chapter Test.

### Identifying Key Terms

Write the letter of the definition in Column B that correctly defines each term in Column A.

#### Column A

1. benefits-received principle
2. public goods
3. ability-to-pay principle
4. income redistribution
5. national debt
6. Medicare
7. Social Security
8. Medicaid

#### Column B

- a. public-assistance program that provides free health care to low-income persons
- b. taking tax dollars from some to give to others in the form of aid
- c. system by which those with higher incomes pay higher taxes
- d. provides monthly payments to the retired
- e. payment for a particular government service by those who use the service

- f. goods and services whose use by one person does not reduce use by another
- g. provides health care for the aged
- h. amount of money the government owes

### Recalling Facts and Ideas

#### Section 1

1. In what ways has the government grown since the Great Depression?
2. What percent of GDP is accounted for by total government purchases?

#### Section 2

3. What are government's main functions?
4. Give five examples of public goods.
5. What would be a negative externality of having an airport built near your home? What would be a positive externality?

#### Section 3

6. About how long does it take the federal government to prepare a budget?
7. What causes the nation's public debt?

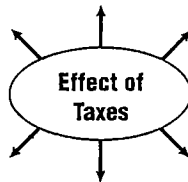
#### Section 4

8. What are the principal taxes that exist in the United States today?
9. If all income were taxed at exactly the same rate, what type of tax would be in existence?

### Thinking Critically

1. **Analyzing Information** Look at **Figure 16.2** on page 426. When did federal government purchases drop below state and local purchases? Why do you think this situation occurred?

2. **Drawing Conclusions** Create a diagram like the one below to explain how you think taxes can encourage or discourage consumer and business behaviors.



## Applying Economic Concepts

**Principles of Taxation** You learned about two principles of taxation, one of which was the benefits-received principle. Assume that you want to use this principle to justify a progressive income tax system. Write a list of the reasons explaining why, as a person's income goes up, that person receives more benefits from the government and therefore should be taxed progressively.

## Cooperative Learning Project

Work in groups representing at least three regions of the United States. Each member should choose one or more states in the group's region to research. Determine which states in the region have the highest tax rate. The information needed will be:

- Highest tax rate applied to personal income
- Highest tax rate applied to corporate income
- Sales tax rate

Share your information with the rest of your group, and then have the groups present the information to the rest of the class. Which state in which region has the highest tax rate? Which region in general has the highest tax rate?

## Reviewing Skills

**Using E-Mail** Using your communications software, type a message asking 10 registered voters for their opinions on the national debt. In your E-mail, ask the recipients questions such as the following:

1. How serious do you think the national debt is for the future of the United States?
2. What measures, if any, should the federal government take to reduce the national debt?
3. If we do not reduce the national debt, what consequences do you foresee, particularly for the generation currently attending high school?
4. What sacrifices do you think you would be willing to make to help reduce the debt?

## Technology Activity



**Developing Multimedia Presentations** Develop a video tracing your daily routine and examining each part of your life in which the government is involved. For example, if you take a bus to school, videotape the bus and explain that this is an example of property taxes being used to fund school transportation. Continue filming throughout the day as you come in contact with other government services. Show your completed video to the class.

## Analyzing the Global Economy

Compare the federal income tax rate of the United States to other industrialized nations, including the Netherlands, Germany, Sweden, Japan, and France. Which nation has the highest tax rate?

# The Trek Bicycle Corporation

**O**n July 27, 2003, American Lance Armstrong rode through the streets of Paris, France, greeted by thousands of wildly cheering spectators. He was on his way to his fifth consecutive victory in the Tour de France—the world's greatest bicycle race. Armstrong is the first American to have won the tour more than two times in a row. The race lasts about three weeks and covers more than 2,000 miles. It was an "all-American" victory, for Armstrong was riding an American-made bike—a Trek.

## The Bike Barn

Trek bikes got their start in Waterloo, Wisconsin, more than 25 years ago. Richard Burke and his friends loved tinkering with bicycles, even making their own bike frames. When other people started admiring their handiwork, they realized they had a real business opportunity.

In 1976 Burke and his friends set up Trek Bicycle Corporation in a rented barn in Waterloo. The company had just five workers and made one product—hand-built steel bike frames. Over time, Trek Bicycle expanded its business, making its own road bicycles using quality parts from American manufacturers. In the early 1980s, Trek introduced a line of mountain bikes. By the end of the decade, Trek was producing bicycle clothing, safety equipment, and children's bikes.

As a result, Trek expanded its production facilities, building three factories in Wisconsin—one right next door to the barn in Waterloo. It also opened facilities in Europe and Japan. Today Trek employs about 1,500 people worldwide



Lance Armstrong



Police patrol on Y bikes

and has yearly sales in excess of \$550 million. It ranks as one of the world's leading quality bicycle manufacturers.

### Building a Better Bike

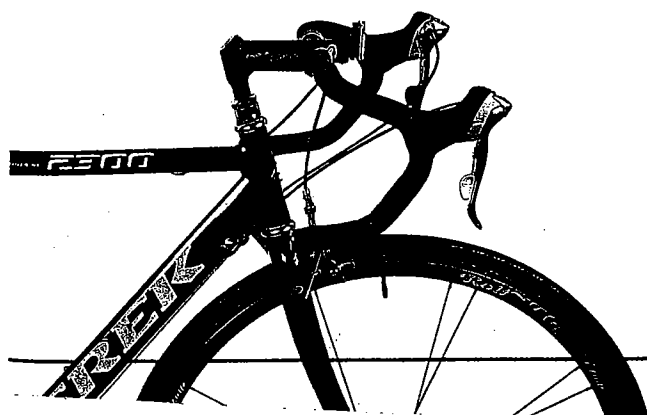
Trek Bicycle's success is due to its commitment to product improvement. Trek has continually made research and development one of its top priorities. This focus has resulted in many innovations in bicycle construction. Their carbon fiber frame is one example. Weighing less than 2.5 pounds, it was designed using the same technology that developed the Stealth fighter.

Another example is the aluminum-frame Y bike. The technology used in its construction combined the comfort of mountain bikes with the quickness of road bikes. The Y bike is popular in an unusual market—law enforcement. Many police forces use the Y bike for their bicycle units. Even the President's Secret Service squad patrols the White House grounds on specially designed Y bikes!

Trek's innovations also are popular with people in the industry. In 1995 the Trek engineers who designed the Y bike won *Popular Mechanics* magazine's Design Engineer of the Year Award. In 1996 the Industrial Designers Society of America gave Trek's Y bike its Gold Industrial Excellence Award.

### Future Plans

Trek Bicycle plans to continue developing new and exciting products for cycling enthusiasts. The most recent is a line of bikes built especially for riding in the city—the Urban Assault Vehicle. Trek also wants to solidify itself as an American operation. At present, some 70 percent of Trek bikes are made at the company's Wisconsin facilities. In the next few years, Trek hopes to push this figure higher. For Richard Burke and other Trek executives, "Made in America" is an important and proud boast.



### Free Enterprise in Action

1. What is the key to Trek Bicycle Corporation's success?
2. How do Trek Bicycle's future plans show that the company takes the statement "Made in America" seriously?