


# Taxing and Spending

### Why It's Important

**Paying for Government** The services provided by government cost money. You and almost everyone else pay taxes to support government spending. What are the effects of government spending? In this chapter you will learn how government policy affects prices, jobs, and your economic decisions.

 To better understand why taxes are necessary, view the *Democracy in Action* Chapter 20 video lesson:

#### Taxing and Spending

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**GOVERNMENT**  
*Online*



**Chapter Overview** Visit the *United States Government: Democracy in Action* Web site at [gov.glencoe.com](http://gov.glencoe.com) and click on **Chapter 20-Overview** to preview chapter information.

# Raising Money

## Reader's Guide

### Key Terms

taxes, taxable income, dependent, withholding, securities, national debt

### Find Out

- How does the income tax compare with other sources of federal revenue in terms of the amount collected?
- How does the federal government use tax laws to affect economic decisions?

### Understanding Concepts

**Civic Participation** How are income taxes collected from citizens of the United States?

## COVER STORY

### Income Tax Coming

CHEYENNE, WYOMING, FEBRUARY 1913

Wyoming has become the 36th and final state needed to ratify the Sixteenth Amendment. First proposed in 1909, the constitutional amendment authorizes Congress to levy an income tax on many Americans. Approval of the amendment concludes a long struggle to enact a permanent income tax after an emergency tax on incomes during the Civil War expired in 1872. Calls for the amendment began in 1895, when the Supreme Court declared an income tax law passed the previous year to be unconstitutional. Congress is expected to act quickly to pass a new tax bill, which President-elect Woodrow Wilson has promised to sign.



Americans paying income taxes

Collecting taxes is one way the federal government plays a role in the United States economy. The amount of money the government collects in revenues and the government's budget are calculated in figures too large for most people to comprehend. In 2003 the national government took in about \$2 trillion in revenues. That figure represents an average of nearly \$6,300 for each person in the nation. What are the sources of all this money? Two major sources are taxes and borrowing.

## Taxes as a Source of Revenue

★ Benjamin Franklin once said, "In this world, nothing is certain but death and taxes." Taxes are payments by individuals and businesses to support the activities of government. The Constitution states that Congress

"... shall have power to lay and collect taxes, duties, imposts, and excises, and to pay the debts and provide for the common defense and general welfare of the United States. . . ."

—Article I, Section 8

Today taxes are the chief way the federal government raises money.

**Individual Income Tax** The individual income tax is the federal government's biggest single source of revenue. About 50 cents of every dollar the government collects comes from this source. In a recent year, the individual income tax produced almost \$850 million.

The federal income tax is levied on a person's **taxable income**, or the total income of an individual minus certain deductions and personal exemptions. People may elect to take deductions for contributions made to charity, for state and local income taxes paid, for home mortgage interest, and for other expenses.



◀ **Government Processes** Paying taxes often requires filling out complex tax forms. Congress has been asked to review and simplify the taxpaying process.

**Citizen Processes** By and large, most Americans no longer violently protest government taxes. Here a couple fills out income tax forms.



▼ **Taxes and Public Opinion** *Do you think public opinion places any limits on the government's ability to tax?*

Or, people may take a standard deduction that the government calculates. The government also permits personal exemptions that reduce the amount of income that is taxable. Such exemptions are based on the number of people who are dependent on the wage earner who pays the income tax. A **dependent** is one who depends primarily on another person for such things as food, clothing, and shelter.

The income tax is a **progressive tax**, one based on a taxpayer's ability to pay. The higher a person's taxable income, the higher the tax rate. People with higher incomes, however, can often take advantage of deductions that lower their taxes. Nevertheless, the wealthiest taxpayers—those with incomes above \$50,000—pay about 80 percent of the taxes.

The deadline for filing income tax returns each year is April 15. Nearly everyone with taxable income in the preceding calendar year must file income tax returns by that date. During the year employers withhold a certain amount of money from the workers' wages. This **withholding** pays the anticipated taxes ahead of the April 15 filing date. Self-employed people—including business owners, tradespeople, and professionals—who do not receive regular salaries are expected to file estimates of their income four times a year and make payments with each estimate. In this way those taxpayers avoid having to make one large annual payment on April 15. At the

same time, the government receives a steady flow of income throughout the year.

The **Internal Revenue Service (IRS)**, a bureau of the United States Treasury Department, collects these taxes through its regional centers. The IRS receives and processes about 200 million returns and supplemental documents each year. IRS staff members use computers to quickly check each return. They **audit**, or check more closely, a small percentage of returns each year. The IRS also investigates many suspected criminal violations of the tax laws each year.

**Corporate Income Tax** Corporations, as well as individuals, must pay income taxes. The federal government taxes all the earned income of a corporation beyond its expenses and deductions. Corporate income taxes represent about 10 percent of federal government revenues. Nonprofit organizations such as colleges, labor unions, and churches are exempt from this tax.

**Social Insurance Taxes** The federal government collects huge sums of money each year to pay for Social Security, Medicare, and unemployment compensation programs. The taxes collected to pay for these major social programs are called **social insurance taxes**. Employees and employers share equally in paying the tax for Social Security

and Medicare. Employers deduct it directly from each worker's paycheck, add an equal amount, and send the total to the federal government. The unemployment compensation program is a combined federal-state operation financed largely by a federal tax on the payrolls of businesses. All these social insurance taxes are often called payroll taxes.

Social insurance taxes are the fastest-growing source of federal income. In 1950 they amounted to only \$4 billion. In fiscal year 2002, these taxes brought in over \$700 billion. Already the second-largest source of federal tax income, social insurance taxes are projected to grow to \$810 billion by 2005.

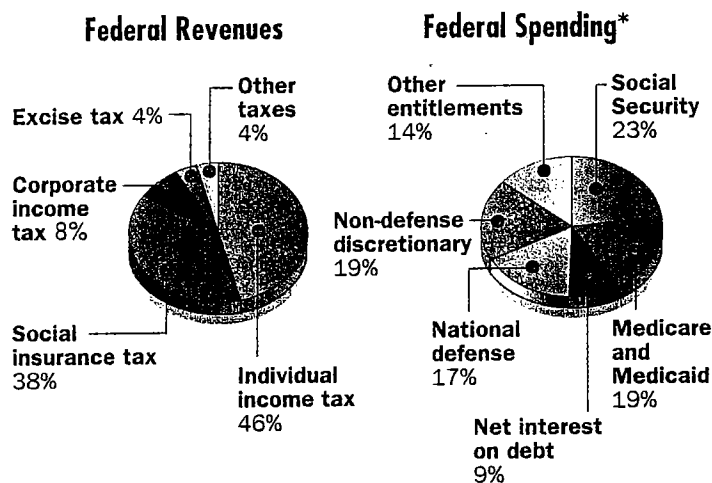
Unlike other taxes, social insurance taxes do not go into the government's general fund. Instead, they go to Treasury Department special trust accounts. Congress then appropriates money from these accounts to pay out benefits. These taxes are **regressive taxes** because people with lower incomes usually pay a larger portion of their income for these taxes than do people with higher incomes.

**Excise Taxes** Taxes on the manufacture, transportation, sale, or consumption of goods and the

performance of services are called **excise taxes**. The Constitution permits levying excise taxes, and since 1789 Congress has placed taxes on a variety of goods. Some early targets for excise taxes were carriages, snuff, and liquor. Today the government imposes excise taxes on gasoline, oil, cigars, cigarettes, liquor, airline tickets, long-distance telephone service, and many other things. Some excise taxes are called luxury taxes because they are levied on goods such as cigarettes and liquor not considered to be necessities. Excise taxes contribute about \$70 billion a year to the federal government, with highway and airport taxes bringing in the most income.

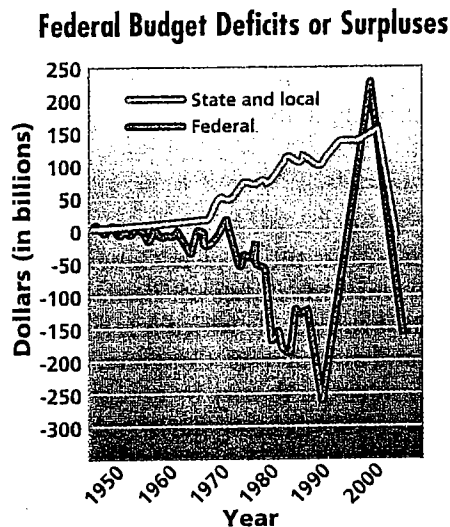
**Customs Duties** Taxes levied on goods imported into the United States are called **customs duties**, tariffs, or import duties. The federal government imposes customs duties to raise revenue or to help protect the nation's industries, businesses, and agriculture from foreign competition. A high customs duty is called a **protective tariff**. Many business, labor, and farm groups support protective tariffs because they raise the price of foreign goods, making them less competitive compared to American goods on the domestic market.

## Federal Taxing and Spending, 2002



\* Totals more than 100 percent due to rounding.

Source: Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2004, [www.whitehouse.gov/omb/budget/fy2004](http://www.whitehouse.gov/omb/budget/fy2004).



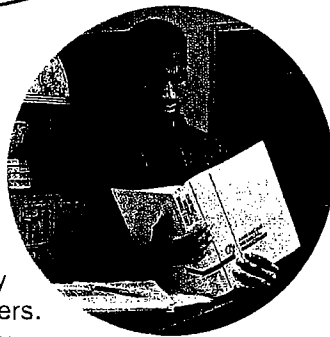
**Critical Thinking** The budget deficit began to increase dramatically in the 1980s. Why do you think the budget deficit began to decline after 2000?

## GOVERNMENT and You

### Why We Pay Taxes

**G**overnment makes life better in many ways. If you are an average teen, you probably drive on area roads and highways, attend public schools, and use the local library. Your safety and property are protected by police and firefighters. You do not expect to be poisoned by the food you eat and the water you drink, or that products you use will harm you. You live free from fear of foreign invasion or guerrilla attack.

No one charges you for these and many other services, benefits, and protections that you enjoy. However, as the old saying goes, "there is no such thing as a free lunch." Taxes on gasoline maintain highways. Sales, property, and income taxes finance local and state services. Federal income taxes also support many programs and services. In fact, most government activities that enhance the quality of life in the United States are made possible by the taxes we pay.



Using books paid for by taxes

### — Participating — IN GOVERNMENT ACTIVITY

**Investigate** Determine the role of government in providing and paying for some facility, program, or service you enjoy in your community.

The Constitution gives Congress the authority to levy customs duties on many imported items. Congress can decide which foreign imports will be taxed and at what rate. Congress, in turn, has given the president authority by executive order to raise or lower the existing tariff rates. In doing so, however, the president must take trade agreements with other nations into account.

Before the income tax, customs duties were a major source of federal income. As other sources of taxes grew, customs duties declined as a share of federal revenue. In a recent year they produced about \$19 billion, or less than 2 cents of every tax dollar collected.

**Estate and Gift Taxes** An estate tax is collected on the assets (property and money) of a person who dies and a gift tax on gifts of money from a living person. First levied in 1916, the estate tax was assessed on estates of more than \$1,000,000 in 2003. The gift tax is charged on individual gifts of more than \$11,000 given in one year. The gift tax prevents people from avoiding an estate tax by giving money to relatives and friends before death. Money given to a spouse is exempt.

In the 1990s, the estate tax became controversial. Critics argued that it discouraged savings and prevented small business owners and farmers from passing their businesses on to their families. In 2001 President Bush convinced Congress to cut taxes. The new tax law repealed the federal estate tax, phasing it out gradually over several years.

### Taxes and the Economy



The tax laws in the United States are very complex and can affect actions of citizens. The federal government sometimes uses taxes to influence economic decisions. For example, individual income tax deductions for home

mortgage interest provide an incentive for home ownership and aid the construction industry.

Groups affected by tax increases have sometimes influenced Congress to pass special exemptions in order to reduce the taxes they have to pay. The result is that the tax system contains many special provisions designed to benefit certain groups.


**Tax Loopholes** Many people believe that provisions, or tax exemptions, favoring certain groups are unfair. These exemptions are often referred to as **tax loopholes**. Some people can afford to hire attorneys and tax specialists who can find loopholes in the complicated tax laws. People in

high-income brackets have used strategies such as declaring business losses or investing in tax shelters to avoid paying taxes. Other exemptions represent government efforts to encourage an activity. A tax exemption on oil exploration encourages people to invest their money in businesses searching for new energy sources.

**Tax Reforms** In 1985 President Reagan proposed tax changes to eliminate what he termed a “source of confusion and resentment.” The resulting Tax Reform Act of 1986 reduced various tax deductions, tax credits, tax shelters, and the number of tax brackets or rates. In 2003 President Bush signed the Job and Growth Act, which made permanent the massive tax cut passed in 2001. This gave millions of taxpayers a tax reduction and also increased the child tax credit from \$600 to \$1,000. These cuts were meant to stimulate spending and boost the economy.

**Tax Credits** The federal government today provides tax credits generally to people in lower income brackets. **Tax credits** allow taxpayers to reduce their income tax liability. Each dollar of tax credit offsets a dollar of tax liability. The earned-income credit enables many families with lower incomes to receive refunds. Workers who must pay for the care of their children or other dependents receive a tax credit for that expense. Certain elderly and retired people may be entitled to a tax credit, depending on the amount of their income.

## Borrowing for Revenue

 In addition to collecting taxes, the federal government borrows money. In 2002, borrowing amounted to about \$220 billion, or about 9 cents for every dollar the government raised.

**Bonds and Other Securities** The government borrows by selling federal securities—financial instruments that include bonds, notes, and treasury bills. Federal government securities are popular with investors because they are safe and interest may not be taxable. The most popular bonds for small investors are savings bonds. In return for lending the government money, investors earn interest on their bonds. The federal government pays a huge amount of interest.

**The National Debt** When the government's spending is greater than its income, it runs a deficit. Government borrowing to fund annual budget deficits over time creates the **national debt**. The size of the national debt affects the federal budget and the economy.

### GOVERNMENT

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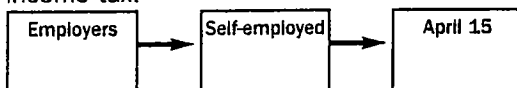


**Student Web Activity** Visit the *United States Government: Democracy in Action* Web site at [gov.glencoe.com](http://gov.glencoe.com) and click on **Chapter 20—Student Web Activities** for an activity about raising money.

## Section 1 Assessment

### Checking for Understanding

1. **Main Idea** Use a graphic organizer like the one below to show the steps in collecting federal income tax.



2. **Define** taxes, taxable income, dependent, withholding, securities, national debt.
3. **Identify** progressive tax, IRS, social insurance taxes, regressive tax, tax loophole.
4. What is the federal government's biggest single source of tax revenue?

### Critical Thinking

5. **Identifying Alternatives** Why does the government raise most of its revenues through taxing rather than borrowing?

### Concepts IN ACTION

**Civic Participation** Obtain a paycheck stub—yours or a family member's. Note the categories and amounts of money deducted for city and state taxes, FICA, and Social Security. Create a graph that shows the percentage of the earned wages deducted in each category.

# Preparing the Federal Budget

## Reader's Guide

### Key Terms

fiscal year, uncontrollables, entitlement, incrementalism

### Find Out

- How do the executive and legislative branches work together to produce an annual budget for the federal government?
- Why is it so difficult for the federal government to reduce spending or raise taxes in order to balance the budget?

### Understanding Concepts

**Public Policy** What factors prevent the budget from changing very much from year to year?

## COVER STORY

### Washington Retires

PHILADELPHIA, PENNSYLVANIA, SEPTEMBER 1796

George Washington announced today that he will not seek a third term as president. In a statement released to the press, he also expressed his concerns for the nation. Washington urged government leaders to avoid unnecessary spending. "Cherish public credit," the president advised, "avoiding likewise the accumulation of debt." He admonished that "toward the payment of debts there must be revenue," which will mean taxes. "No taxes can be devised which are not more or less inconvenient and unpleasant," Washington said. He warned that the alternative would be a national debt that will unfairly burden future generations of Americans.



George Washington

From Washington's day to the present, the nation has always accounted for its revenues and expenditures. Today, the federal budget enables the government to predict and control revenue and spending for each year. The federal budget operates in a fiscal year—a 12-month accounting period that extends from October 1 of one year to September 30 of the next year.

The budget is an important policy document. It reflects the federal government's view of the nation's needs and priorities. By showing how much will be spent on various national concerns such as defense and social welfare, it serves as a blueprint for the federal government's spending.

George Washington was able to put all the figures for the national government's expenditures for one year on one large sheet of paper. Today the federal budget consists of more than 1,000 pages of small type.

Preparation of the budget involves the efforts of thousands of people and goes on continually. Work on a budget starts a full 19 months before a fiscal year begins. Thus, before one year's budget is completed, work on the next year's budget is already under way.

The executive and legislative branches share in the preparation of the budget—an example of checks and balances at work. Under the president's leadership, the executive branch draws up a proposed budget. Congress uses the president's budget as a basis for preparing a tax and spending plan to submit back to the president.

## Drawing Up the President's Budget

During much of American history, presidents have traditionally played a limited role in researching and drawing up the budget. Various federal agencies usually sent their budget requests directly to the secretary of the treasury, who passed them on to Congress.



The Budget and Accounting Act of 1921 changed this procedure in an effort to streamline the process. As a result of this law, the president is responsible for directing the preparation of the budget and making the major decisions about national budget priorities. The law requires the president to propose to Congress the budget for the entire federal government each fiscal year. This budget must be delivered within 15 days after Congress convenes each January.

The actual day-to-day preparation of the budget is the responsibility of the **Office of Management and Budget (OMB)**. The OMB, along with the president's Council of Economic Advisers (CEA), confers with the president on a wide range of budgetary matters.

**Start of the Process** Budget making begins in early spring for the budget that is to go into effect a year from the following October. Each federal agency draws up a list of its own spending plans and sends these requests to the OMB.

The Director of the OMB takes the first set of figures to the president, along with OMB's analysis of the nation's economic situation. At this point the president, assisted by the secretary of the treasury and the CEA, makes key decisions about the impact of the preliminary budget on the administration's general economic policy and goals. They discuss such questions as: Will the budget increase or reduce federal spending? Which federal programs will be cut back and which will be expanded? Will the federal government need to borrow more money? Should taxes be raised or lowered?

**Agencies Review Their Budgets** The White House returns its decisions on the budget to the agencies and departments with guidelines to help them prepare their final budgets. The Department of Defense, for example, may be told to cut its budget by \$5 billion, and the Transportation Department may be told it can increase its budget by \$1 billion.

Over the next few months, the executive departments and agencies work on detailed budget plans fitting the president's guidelines. During this time OMB officials and agency heads negotiate cuts and additions to bring each agency's budget in line with the president's decisions.

## Steps in the Budget Process

February–  
December  
2002

### Formulation of the president's budget fiscal year 2002

Executive branch agencies develop requests for funds and submit them to the Office of Management and Budget (OMB). The president reviews requests and makes fiscal decisions on what goes in the budget.

December  
2002–  
February  
2003

### Budget preparation by the president

The budget is formulated in the OMB.

March–  
September  
2003

### Congressional action on the budget

Congress reviews the president's proposed budget, develops its own budget, and approves spending and revenue bills.

October 1,  
2003

### Implementing the budget

The fiscal year begins.

October 1,  
2003–  
Sept. 30,  
2004

Agency program managers execute the budget provided in law.

October–  
November  
2004

Data on actual spending and receipts for the completed fiscal year become available.

Source: *A Citizen's Guide to the Federal Budget* (Washington, D.C.: Government Printing Office, 1997).

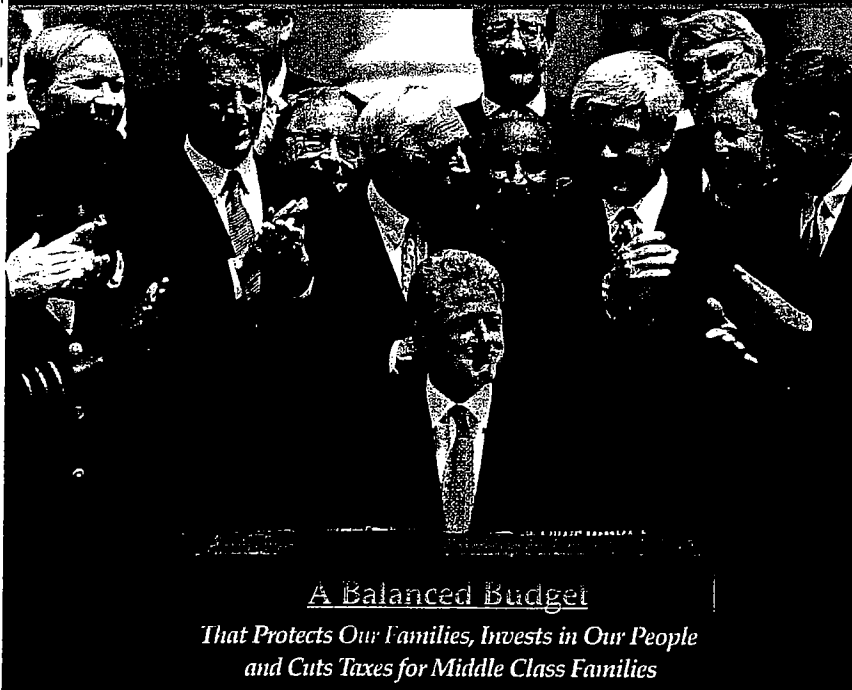
**Critical Thinking** The Budget and Accounting Act of 1921 requires the president to propose a budget to Congress. What system established in the Constitution guides the budget process?

**Final Presidential Review** Sometime during the fall, the OMB submits a complete budget document to the president for final review and approval. Some last-minute juggling always takes place. Agency heads may make last-ditch efforts to convince the president to overrule an OMB decision and save a particular program. The president may order changes in parts of the budget in response to pressure from interest groups or political party members.

Finally, the administration rushes the president's budget to the printer—often only days or perhaps hours before the January deadline. The president formally sends the budget to Congress



## Bipartisan Celebration



**Balancing the Budget** President Clinton and Vice President Gore joined with members of Congress to celebrate passage of a balanced-budget bill in 1997. This was the first balanced-budget bill passed in nearly 30 years. **Do you think an unbalanced budget is a problem? Why or why not?**

along with an annual budget message. Congress then takes the next steps in working out the federal budget.


**Uncontrollables** Despite having a key role in the budget process, the president does not have complete freedom in making budgetary decisions. About 70 percent of the federal budget consists of what are called uncontrollables. Uncontrollables are expenditures required by law or resulting from previous budgetary commitments.

A large portion of the uncontrollables are called **entitlements**, or benefits that Congress has provided by law to individuals, and which they have an established legal right to receive. Entitlements include Social Security, pensions for retired government employees, Medicare, Medicaid, and veterans' benefits.

Another largely uncontrollable item in the budget is the interest that must be paid on the national debt. As yearly budgets have forced the

federal government to borrow more and more money, the interest on the debt has grown. In fiscal year 2003, interest on the debt amounted to more than 7 percent of the federal government's total expenses.

## Congressional Budget Action

 Article I, Section 9, of the Constitution requires that Congress approve all federal spending. Thus, the president draws up budget proposals, but only Congress has the power to raise revenue and pass appropriations. No money may be spent and no taxes may be collected until Congress approves.

Congress may revise the president's budget proposals as it sees fit. Conflict between Congress and the president over the budget is inevitable. If the opposing party, not the president's party, controls either house of Congress, that house may loudly criticize the president's budget. Even if the president's own party controls Congress,

lawmakers may have different ideas than the president as to how money should be allocated. Key lawmakers and the president often must negotiate over different parts of the budget. Compromises are usually necessary on both sides before a budget is passed.

**Congressional Budget Act of 1974** For years separate subcommittees of the Senate and House handled each agency's requested expenditures. This separation made it difficult for Congress to keep track of the total annual budget. To remedy this situation, Congress passed the Congressional Budget Act in 1974. This law set up House and Senate Budget Committees and the **Congressional Budget Office (CBO)**.

The CBO's job is to carefully evaluate the overall federal budget for Congress. The CBO has its own professional staff of experts. They report to Congress and act as a counterbalance to the OMB in the executive branch.

**Gramm-Rudman-Hollings Act** By the mid-1980s the size and growth of the national debt worried economists. In 1985 Congress enacted the Balanced Budget and Emergency Deficit Control Act, known as Gramm-Rudman-Hollings (GRH) after the senators who designed it. This law was aimed at forcing the president and Congress to work together to reduce budget deficits.

GRH and later amendments required the OMB and CBO to issue a joint report each year estimating how much the proposed budget would exceed income and how much it should be cut to meet deficit-reduction targets. The federal budget deficit continued to grow because the president and Congress could not agree on budgetary priorities. The failure to meet deficit-reduction targets prompted Congress to search for another remedy.

### **Budgetary Enforcement Act of 1990**

After lengthy negotiations President George H.W. Bush and the Democratic Congress agreed on the Budgetary Enforcement Act (BEA). The BEA divided the budget into three areas: domestic policy, defense, and international affairs. Spending that exceeded the budgeted limit in any area would come out of the next year's funding for that area.

A recession in 1990–1991, however, temporarily derailed the deficit-cutting plan. When the economy improved beginning in 1993, tax receipts increased, making the job of reducing the deficit easier. Some members of Congress called for a balanced budget. President Clinton and other members of Congress, however, were satisfied that the annual deficits had been reduced from more than \$300 billion to about \$145 billion. In 2000 the national debt equaled more than \$5.5 trillion. The debt represented 57 percent of the nation's gross domestic product.

### **Key Steps in Congressional Budget Making**

The budget-making process generally follows three steps. First, House and Senate Budget Committees review the major features of the president's budget proposals. On April 15 these committees prepare a concurrent resolution. With the president's proposals as a starting point, this resolution sets forth the total federal spending and tax plan for the coming fiscal year.

The next step, called reconciliation, occurs between April 15 and June 15. During reconciliation various House and Senate committees reconcile, or fit, the spending and taxing plans set out in the

## *We the People*

### **Making a Difference**

#### **Leonard Sanders**



**T**axes pay for many community services, but a private citizen can also step in to meet a need. Leonard Sanders, a retired mine worker in the tiny town of Elkhville, Illinois, won the state lottery in 1995. Sanders had plenty of uses for the money. After dividing up his winnings with his wife and children, however, he decided to direct some of his extra cash to improving his hometown. Sanders helped restore the 90-year-old church where his wife worshiped as a child. Then he bought and refurbished an empty grocery store to convert into a community center. He purchased two new pool tables, exercise equipment, furniture, and a

television set for the center. Friends pitched in to build a small kitchen. The kitchen is stocked with free food and drinks which are paid for by a trust. Sanders set up the trust to fund the operation for future generations. The new community center provides a place for Elkhville residents to gather for recreation and conversation. Sanders's additional plans for his town include a pavilion for the baseball park.

"Money will never change my attitude toward life," he said. "Elkhville is really a nice place with a nice bunch of intelligent people. I've known most of them for 20 or 30 years, and we have always gotten along."

# TIME


## For the Record

**Taxing Problem** Like any other citizen, U.S. presidents can choose to keep their tax records private. Still, since the early 1970s, most presidents have made at least part of their returns public. In 2003, for example, President and Mrs. Bush reported a taxable income of \$727,083; they paid \$227,490 in federal taxes. Vice President Dick Cheney and wife Lynne had an even better year, with a taxable income of \$813,226; they paid \$258,779 in federal taxes.

concurrent resolution with existing programs. The committees put the changes made during this process into a reconciliation bill that both the House of Representatives and Senate must vote on and approve. The House then passes an appropriations bill, officially setting aside money for all expenditures approved through the reconciliation process. Congress is supposed to complete this bill by June 30, but the bill is often delayed because of the complexity of the details that must be approved by both houses.

The final step in the budget process involves the procedures spelled out in the GRH Act. The fiscal year begins on October 1. On October 15 the OMB issues a final report and may make cuts in the budget to fit deficit-reduction targets.

## Incremental Budget Making

 Some analysts use the term *incrementalism* to explain the budget-making process. *Incrementalism* means that generally the total budget changes only a little (an increment) from one year to the next. Thus, the best forecaster of this year's budget is last year's budget, plus a little more.

Incrementalism means that usually federal agencies can assume they will get the same amount of money they received in the previous year. *Incrementalism* also means that most budget debates focus on a proposed increment or reduction for an agency. For example, budget battles rarely center on whether the FBI should continue to exist, but rather on how much of an increase or decrease the FBI should get for that particular year.

A budget may reflect a president's specific policy. President Bush's proposed budget for 2002 included decreased funding for transportation, agriculture, and environmental protection. The president and his aides portray the cuts as an attack on pork barrel projects—ones that supply funds for local improvements designed to foster good relations between legislators and the people they represent.

## Section 2 Assessment

### Checking for Understanding

- 1. Main Idea** Use a graphic organizer like the one below to show how the budget process is affected if Congress and the president are from different political parties.



- 2. Define** fiscal year, uncontrollables, entitlement, incrementalism.
- 3. Identify** Office of Management and Budget, Congressional Budget Office.
- 4. Identify** four entitlements that are a part of the federal budget.

### Critical Thinking

- 5. Expressing Problems Clearly** Why does the federal government find it difficult to raise taxes or reduce spending to balance the budget?

## Concepts IN ACTION

**Public Policy** Imagine that you are a part of a presidential committee set up to decide the spending priorities for next year's government budget. Your job is to list the four top areas that you think should have the greatest share of the budget. Prepare a supporting argument for the four areas you have chosen.



# SHOULD THE FEDERAL INCOME TAX BE REPLACED?

*For decades the income tax has provided the bulk of federal government revenue. The system operated by the IRS has been reliable in generating consistent federal tax revenues for many years. Despite this record, many people believe that the income tax should be replaced or undergo a major overhaul.*

## TAXPAYER COMPLAINTS

American taxpayers provide the Internal Revenue Service (IRS) with information about their earnings each year. By filing their income tax returns, taxpayers save the government millions of hours of work. Many people complain, however, that the system is too complicated. Others argue that tax rates are unfair because people earning more money pay a higher percentage of their income. Some people report that the IRS is unresponsive to taxpayer questions and that it aggressively targets taxpayers who complain.

## A POLITICAL ISSUE

Some politicians have suggested that the whole tax structure should be replaced. Steve Forbes, a former presidential candidate, suggested

replacing the income tax with a flat tax.

Another alternative would be a national sales tax. A sales tax, unlike the income tax, would not require an army of IRS agents to enforce the tax and check taxpayer returns. Tax loopholes that have developed with the current income tax would all be eliminated if the income tax were replaced.

Supporters of the income tax, however, point out that it is a progressive tax, collecting a larger percentage from more wealthy taxpayers than from poorer ones. The income tax can be used to redistribute wealth by giving tax credits to the poorest citizens. Making the system more efficient, not abandoning it, is the answer, they argue.



IRS logo

## Debating the Issue

### WOULD YOU SUPPORT OR REPLACE THE FEDERAL INCOME TAX?

Assume that you are a taxpayer testifying at a congressional committee hearing, weighing the advantages and disadvantages of the income tax.

#### KEY ISSUES

- ✓ How much time and effort does it take for the average person to complete and file his or her income tax returns?
- ✓ Is the IRS responsive to taxpayer questions?
- ✓ What are the advantages and disadvantages of this system of collections?

- ✓ What other form of taxation would provide fairer taxation with less effort?

**Debate** Prepare a statement in support of or against the income tax. Allow time for two people on each side of the argument to present their statements to the class.

**Vote** Make your decision. Then have the class vote for or against replacing the current income tax with another tax.

# Managing the Economy

## Reader's Guide

### Key Terms

fiscal policy, monetary policy, gross national product (GNP), discount rate, reserve requirement, open-market operations

### Find Out

- What is the difference between fiscal policy and monetary policy?
- What are the four major categories of federal government spending?

### Understanding Concepts

**Public Policy** Why must the Fed operate free of pressures from Congress or the president?

## COVER STORY

### Rate Cuts Seek Stability

NEW YORK, NOVEMBER 6, 2001

The Federal Reserve slashed interest rates by one-half point today in a bold move to prevent the economy from slipping into a recession. It was the tenth rate cut this year and the third since terrorist attacks rocked the financial district last month. The central bank has acted aggressively to shore up the economy, dropping the federal funds rate from 6.5 percent to just 2 percent in less than a year. The cost of borrowing money is now at its lowest level since 1961.

Consumer confidence sank following a four-day shutdown of the New York Stock Exchange triggered by the terrorist attacks that destroyed the World Trade Center, just blocks away. It was the longest shutdown since the Great Depression.



Cartoon depicting Chairman Greenspan

Federal government policy has a significant bearing on the economy. The Federal Reserve Board's decisions affect the money supply. Officials in both the executive and the legislative branches make difficult decisions to try to promote a healthy economy.

## Where the Money Goes

The federal government was spending about \$4.6 billion a year when Franklin D. Roosevelt became president in 1933. Today, that amount would pay for less than one day of the federal government's expenditures. The government currently spends more than \$2 trillion a year.

How can a person imagine such a large amount of money? Perhaps it is more meaningful to break the total amount down into its four major components. In addition to interest on the national debt, the main spending items are direct benefit payments to individuals, national defense, and discretionary spending.

**Direct Benefit Payments** Spending for Social Security and social-welfare and health-care programs has become a big part of the federal budget. Almost half of every dollar spent goes for such items. In a recent budget, the federal government allocated about \$960 billion for direct benefit payments of one kind or another.

Uncontrollable expenditures account for a large portion of this budget item. The biggest entitlement program is Social Security. In 2002 Social Security benefits totaled over \$450 billion.

**National Defense** Spending for national defense was one of the biggest items in the budget beginning with World War II. When Ronald Reagan became president in 1981, he made a bigger Defense Department budget a major objective of his administration. He felt that the world situation called for further increases in spending for military equipment and training.


When changes in the Soviet Union and Eastern Europe signaled an end to the Cold War, President George H.W. Bush announced adjustments in United States defense. He vowed to eliminate some nuclear weapons and to end the around-the-clock alert posture of strategic bombers, and he asked the Soviets to do the same. The Clinton administration reduced the share of the budget that goes to defense. In 1996 defense spending represented about 17 percent of total outlays, down from 22 percent in 1992.

By the 2000 election, many people felt that defense spending had been reduced too much. President George W. Bush fulfilled a campaign promise to increase spending for the military. In 2001 the defense budget increased by over \$11 billion. The military response following the September 11, 2001, terrorist attacks against the United States demanded more increases. By 2003 the defense budget had increased by \$81 billion from its 2000 figure.

**Discretionary Spending** The federal government spends a sizable portion of tax revenues on the environment, transportation, criminal justice, and other areas. Much of this discretionary spending is in the form of grants to states and localities. State and local governments use federal grants for road repair, public housing, police training, school lunch programs, flood insurance, and so on.

States and communities have come to rely on this intergovernmental revenue for an increasing share of their total revenue. Between 1980 and 1989, however, federal grants to state and local governments declined. More recent federal budgets have increased federal aid to states while shifting federal grants away from infrastructure investments and toward public-welfare programs.

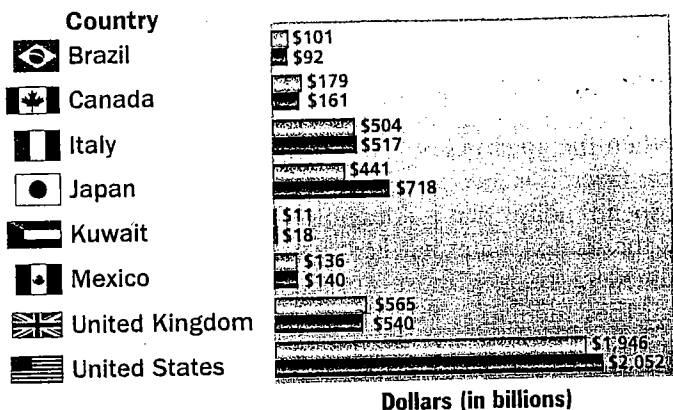
## Fiscal and Monetary Policy

 Beginning with the Great Depression of the 1930s, the federal government has taken an increasing role in managing the nation's



## COMPARING Governments

### Government Revenue and Expenditures



Source: CIA, *The World Fact Book* 2003 (Washington, D.C.: 2003).

**Critical Thinking** Many countries in the world spend more money than they take in as revenue. Which governments represented in the graph received more revenue than they spent?

economy. Arguments continue over just how large a part the government should play. Debates arise because, in the modified free-enterprise system, control over the economy is divided between government and the private sector—individuals and businesses. Yet most Americans expect the federal government to play a significant role in moderating the economy's ups and downs, while promoting steady economic growth.

The government uses two primary devices to influence the direction of the economy: (1) fiscal policy and (2) monetary policy. Fiscal policy involves using government spending and taxation to influence the economy. Monetary policy involves controlling the supply of money and credit to influence the economy. This control is exercised through the Federal Reserve System.

**Fiscal Policy** The federal budget is a major tool of fiscal policy because it shapes how much money the government will spend and how much it will collect through taxes and borrowing. The president and Congress can use the budget to pump money into the economy to stimulate it, or to take money out of the economy to slow it down.

To stimulate the economy, the government may spend more money than it takes in. Through increased spending the government aims to put more people back to work and increase economic activity.

Another way that the government can stimulate the economy is through reducing taxes. Lower taxes give consumers and investors more purchasing power.

When the government increases spending or reduces taxes, it is likely to run a deficit because it must spend money that it does not have. Since the 1930s the United States has had deficit, or unbalanced, federal budgets most of the time. One reason for these deficits is that for many years these unbalanced budgets were thought to benefit the economy. In addition, this policy was very popular politically because it allowed the government to spend heavily on social programs that many Americans were demanding.

This policy of deficit spending led to increasingly large budget deficits and a growing national debt. During the 1970s and early 1980s, economists began to worry about the effects this would have on the nation's future.


Demands for cutting the deficit and even balancing the budget grew. Many economists, however, argued that a balanced budget would mean the federal government could not use fiscal policy to shape the economy. Some said that the deficit as a percentage of the gross national product (GNP) was more important than the deficit alone. The GNP is the sum of all goods and services produced in the nation in a year. They pointed out that the deficit still represented only 5 to 6 percent of the GNP.

Other economists disagreed. They pointed to the rapid growth of the deficit and of the national debt itself. When Congress promised to balance the budget in 1981, the gross federal debt was \$930 billion. In 2003 it reached \$3,939 billion (\$3.9 trillion). Interest payments on the debt nearly equaled half of that spent for defense.

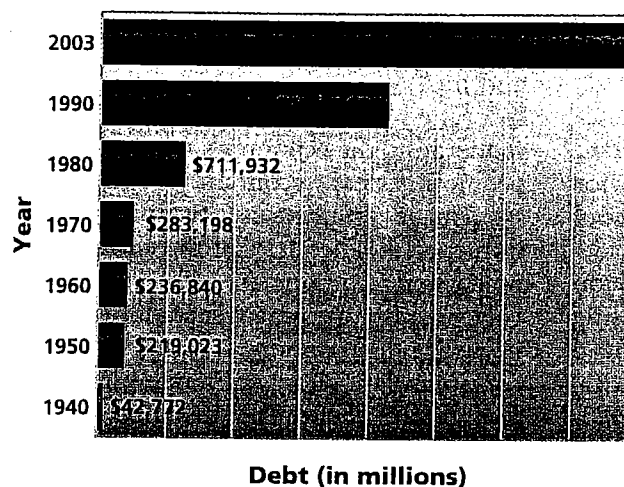
**Monetary Policy** The United States economy is a market economy. Americans exchange goods and services through a vast system of money and credit. The Constitution gives the national government authority to "coin money [and] regulate the value thereof." Today, the federal government tries to regulate the economy through its monetary policy.

Monetary policy involves controlling the supply of money and the cost of borrowing money—credit—according to the needs of the economy. The government controls the money supply through the Federal Reserve System.

## The Federal Reserve System

 The Federal Reserve System, known as the Fed, is the central banking system of the United States. When people or corporations need money, they may borrow from a bank. When banks need money, they may go to the Fed. Thus, in reality, the Federal Reserve System is a banker's bank.

### The Public Debt,\* 1940–2003



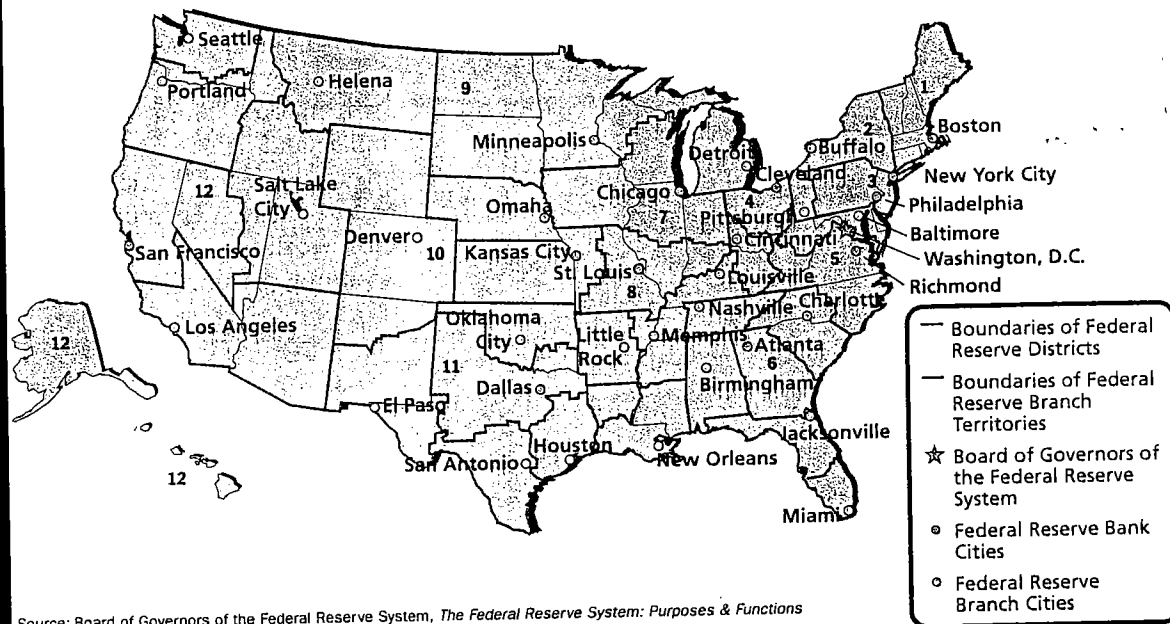
\*Public debt does not include money the government owes itself.

Source: Bureau of the Public Debt, 2003.

**Critical Thinking** The public debt increased by almost \$4 trillion from 1940 to 2003. What factors or policies contribute to a budget deficit?



## Federal Reserve Districts



**Critical Thinking** The United States is divided into 12 Federal Reserve Districts. Federal Reserve Districts are privately owned but publicly controlled. What do low discount rates from the Federal Reserve encourage banks to do?

**Organization of the Fed** The United States is divided into 12 Federal Reserve Districts. Each district has 1 main Federal Reserve Bank. In addition, most Federal Reserve Banks have branch banks within their districts.

About 5,700 of the approximately 13,600 banks in the United States are members of the Federal Reserve System. These include all the large banks in the country. These member banks control the largest share of total bank deposits in the United States.

**Board of Governors** A 7-member Board of Governors in Washington, D.C., supervises the entire Federal Reserve System. The president selects these members whose appointments must be ratified, or approved, by the Senate. The president selects one of the board members to chair the Board of Governors for a 4-year term.

Once appointed, board members and the chairperson are independent of the president. Even Congress exercises little control or influence

over the board, since the board does not depend on Congress for an annual appropriation for operating expenses. This allows the Board of Governors to make economic decisions independent of political pressure.

**Making Monetary Policy** The Board of Governors has two major responsibilities in forming monetary policy. First, it supervises the operations of the Federal Reserve Banks in the 12 districts across the country. Second, and most important, it determines the general money and credit policies of the United States.

The Fed uses three main tools to control the financial activities of the nation's banks and, through them, the nation's monetary policy. First, the Fed can raise or lower the discount rate. The discount rate is the rate the Fed charges member banks for loans. Low discount rates encourage banks to borrow money from the Fed to make loans to their customers. High discount rates mean banks will borrow less money from the Fed.

## Controller of the Money Supply



**Federal Reserve Chairman** Alan Greenspan and the Board of Governors try to preserve economic growth by regulating the money supply. **Should the federal government have more or less control over the nation's economy? Explain.**

Second, the Fed may raise or lower the reserve requirement for member banks. Member banks must keep a certain percentage of their money in Federal Reserve Banks as a reserve against their deposits. If the Fed raises the reserve requirement, banks must leave more money with the Fed. Thus,

they have less money to lend. When the Fed lowers the reserve requirement, member banks have more money to lend.

Third, the Fed can put money into the economy by buying government bonds and other securities on the open market. These **open-market operations** stimulate and help expand the economy. The Fed may also sell government securities.

As investors spend their money on these securities, money is taken out of the economy, causing it to slow down.

**Conflicting Policies** In recent years the Fed has become an independent policy-making institution. While the president and Congress largely control taxing and spending, they have little control over the Fed, which determines monetary policy. Thus, the Fed's policy may aid or hinder presidential and congressional economic programs.

### The seal of the Federal Reserve

Conflicting economic policies sometimes arise, causing presidents or Congress to complain that the Fed is interfering with their economic programs.

Because of such conflicts, some people would like to limit the Fed's role and make it less independent. Others maintain that the nation needs an institution removed from political pressures to watch over monetary policy.

## Section 3 Assessment

### Checking for Understanding

1. **Main Idea** Use a graphic organizer like the one below to compare recent federal grants with those in the 1980s.

Federal Grants	
1980s	Recently

2. **Define** fiscal policy, monetary policy, gross national product (GNP), discount rate, reserve requirement, open-market operations.
3. **Identify** the Federal Reserve System, Board of Governors.
4. Analyze why the federal government adopted policies that created a huge debt.

### Critical Thinking

5. **Identifying Alternatives** What methods could the federal government use to stimulate the economy during a time when people were opposed to deficit spending?

## Concepts IN ACTION

**Public Policy** Research several back issues of *The Wall Street Journal* or selections from the *Readers' Guide to Periodical Literature* to analyze Federal Reserve Board decisions that affect the economy. Create a poster of headline captions showing the Fed's actions.

# Skills

## Critical Thinking

### Analyzing News Media

**E**very citizen needs to be aware of current issues and events in order to make good decisions when exercising citizenship rights. To stay informed, people use a variety of news sources, including print media, broadcast media, and electronic media.

#### Learning the Skill

To get an accurate profile of current events, you must learn to think critically about the news. The steps below will help you think critically.

- First, think about the source of the news story. Reports that reveal sources are more reliable than those that do not. If you know the sources, you can evaluate them.
- Many news stories analyze and interpret events. Such analyses may be more detailed than other reports, but they also reflect a reporter's biases. Look for biases as you read or listen to news stories.
- Ask yourself whether the news is even-handed and thorough. Is it reported on the scene or secondhand? Does it represent both sides of the issue? How many sources are used? The more sources cited for a fact, the more reliable it usually is.

#### Practicing the Skill

Follow the steps below to analyze two types of print media.

1. Find two articles, one in a current newspaper and the other in a newsmagazine, on the issues of government taxing or spending.



2. What points were the articles trying to make? Were the articles successful? Can the facts be verified?
3. Did either of the articles reflect a bias toward one viewpoint or the other? List any unsupported statements.
4. Do the articles seem to represent both sides fairly?
5. How many sources can you identify in the articles? List them.

#### Application Activity

Think of an issue in your community or in the nation on which public opinion is divided. Read newspaper features and editorials and monitor television reports about the issue. Can you identify any biases? Which reports more fairly represent the issue? Which reports are the most reliable?

# Assessment and Activities

## GOVERNMENT

## Online



**Self-Check Quiz** Visit the *United States Government: Democracy in Action* Web site at [gov.glencoe.com](http://gov.glencoe.com) and click on **Chapter 20-Self-Check Quizzes** to prepare for the chapter test.

## Reviewing Key Terms

Insert the terms below into the following paragraph to describe how the federal government regulates the economy. Do not use a term more than once.

withholding	securities
national debt	taxes
taxable income	incrementalism
fiscal policy	GNP
monetary policy	fiscal year
entitlements	uncontrollables

The federal government collects more than \$1 trillion in (1) each year. Through (2) wage earners pay taxes on their (3) during the year. The government's (4) begins on October 1. Because of (5) such as (6) in the budget, government spending often exceeds revenue, which enlarges the (7). Some economists are not alarmed because deficits are only about 5 percent of the (8). Others would like to see changes in (9) to control spending or raise

taxes. By its (10) the Fed may stimulate economic growth to relieve some of these concerns.

## Recalling Facts

1. What is the deadline for filing individual income tax returns?
2. Identify three institutions that are exempt from the federal income tax.
3. What are three responsibilities of the Internal Revenue Service?
4. What are four types of taxes that the federal government collects?
5. What executive agency is charged with preparing the federal budget?
6. Why are federal securities such as bonds popular with investors?
7. What is the goal of the Gramm-Rudman-Hollings Act?
8. What factors make it difficult for Congress to cut spending?
9. Identify state and local uses of intergovernmental revenues.

## Understanding Concepts

1. **Public Policy** Why has the United States been unable to balance the national budget most of the time beginning in the 1930s?
2. **Public Policy** What kinds of banks are members of the Federal Reserve System?

## Chapter Summary

### Revenue

- Individual income tax
- Corporate income tax
- Social insurance taxes
- Excise taxes
- Customs duties
- Estate and gift taxes
- Borrowing (by selling bonds, notes, and certificates)

### Federal Budget

President directs budget preparation and sets budget priorities; day-to-day budget preparation is carried out by the Office of Management and Budget (OMB) along with the Council of Economic Advisers (CEA)

### Expenditures

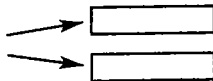
- Social Security
- Social welfare programs
- Healthcare benefits
- National defense
- Discretionary spending (grants to state and local government for road repair, public housing, police training, school lunch programs, etc.)

## Chapter 20

### Critical Thinking

1. **Making Generalizations** Why would business groups support protective tariffs?
2. **Analyzing Information** Why must the Federal Reserve Board of Governors operate free of pressure from the president or Congress?
3. **Identifying Alternatives** Use a graphic organizer like the one below to show two measures the federal government could take if the national debt seemed to be growing too fast.

Rapidly  
Growing  
Debt



### Interpreting Political Cartoons Activity



1. What is this man doing?
2. How does he seem to feel about this?
3. Do you think this man's feelings are representative of the general feeling of taxpayers? Explain.

### Analyzing Primary Sources

One of the first major taxes the new constitutionally based government placed on the fledgling American republic was a 1794 tax on whiskey. Western farmers saw this tax as a direct attack on their business, and in Pennsylvania in particular, they revolted against this tax, often with arms. George Washington, the nation's first president, quelled the rebellion with troops. Read the excerpt from Washington's proclamation about the Whiskey Rebellion and then answer the questions that follow.

"... [C]ombinations to defeat the execution of the laws laying duties upon spirits distilled within the United States and upon stills have from the time of the commencement of those laws existed in some of the western parts of Pennsylvania. ... [T]he said combinations, proceeding in a manner subversive equally of the just authority of government and of the rights of individuals, have hitherto effected their dangerous and criminal purpose by the influence of certain irregular meetings whose proceedings have tended to encourage and uphold the spirit of opposition by misrepresentations of the laws calculated to render them odious ... employing for these unwarrantable purposes the agency of armed banditti disguised in such manner as for the most part to escape discovery."

1. What type of resistance did opponents of the whiskey tax employ to express their disapproval of the government's actions?
2. Why do you think taxes are not protested so violently today?

### Participating in Local Government

Review the various kinds of taxes that are sources of revenue for local governments. Working in groups of three, complete the following tasks:

1. Identify three needs that your community has.
2. Estimate the amount of taxes that would need to be raised to meet these needs.
3. Determine whether any current tax rate may be increased to meet one or more of these needs.
4. Decide on any additional fair tax to raise money to benefit the needs that you have identified.
5. Discuss whether people will be in favor of additional taxes to meet these needs. Summarize your findings in an informational brochure or flyer.

