Chapter 7

SECTION 3: Financing Government

(pp. 206–213)

Main Idea

By collecting taxes and borrowing money, the federal government is able to generate the funds it needs to run the nation. The government then assigns these funds to create a federal budget for the upcoming year.

Reading Focus

1. How does the federal government pay for its operations?
2. What are the two types of government spending?
3. How does the federal budget process work?
4. How do fiscal and monetary policy affect the nation's economy?

Key Terms

income tax
progressive tax
payroll tax
regressive tax
proportional tax
bond
federal debt
mandatory spending
discretionary spending
fiscal policy
monetary policy

Paying for Government (pp. 207–209)

To pay for the programs and services it provides, the federal government relies on collecting revenue, or income, and borrowing money. The revenue comes from taxes, fees, and other nontax sources.

Income Taxes In 1913 the Sixteenth Amendment gave Congress the power to levy, or charge, an **income tax**, which is a tax on a person's or corporation's income. Today the income tax brings in the largest share of the government's revenue. The income tax is a **progressive tax**—a tax whose rates increase as the amount that is subject to taxation increases. The rates range from 10 percent for very low-income earners to 35 percent for high-income earners.

Payroll Taxes Another big source of federal revenue is payroll taxes, which are collected to help pay for Social Security, Medicare, and other forms of social insurance. A **payroll tax**, which makes up about 34 percent of federal revenues, is money that is withheld from a person's paycheck by his or her employer. The payroll tax is a **regressive tax**, or a tax that has a greater impact on lower-income earners than on upper-income earners. The Social Security tax is an example of a regressive tax. It applies only to income up to a certain amount.

The Medicare tax is a **proportional tax**, or a tax that is applied at the same rate against all income. Since this rate does not change according to the amount earned, the Medicare tax is also a regressive tax.

Other Sources of Revenue The federal government collects several other taxes and nontax revenues for about 6 percent of all federal funds. These include excise taxes

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and tariffs. Tariffs are taxes on imported goods. Another federal tax is the estate tax, which is placed on money and property that is passed on to the heirs of someone who dies. Gift taxes are those placed on property that is given from one living person to another. The federal government also collects nontax revenue from several sources, including fees at national parks. The largest source, however, is earnings by the Federal Reserve System, which loans money to banks and charges interest.

Borrowing Money When the federal government cannot cover its expenses through revenue, it borrows money. It does so through the selling of bonds. A **bond** is a financial instrument, or tool, by which a borrower agrees to pay back borrowed money, plus interest, at a future date. Historically, the government only borrowed money in emergencies. Today it runs a deficit, or shortage, as a matter of course. The total sum of money that the federal government has borrowed and not yet repaid is known as the **federal debt**. Today the federal debt is more than $9 trillion. Some people fear that unless the debt is reduced, there will not be enough money to pay benefits, such as Social Security, to the aging population.

Reading Check Summarizing What are the main sources of government revenue?

Government Spending (p. 209)

Each year, Congress creates a budget that tells how much the government will spend on its various programs. The two types of spending are mandatory and discretionary.

Mandatory Spending **Mandatory spending** is spending required by laws and not subject to the annual budget process. A large percentage of mandatory spending goes to entitlement programs, or government programs that people are entitled to by law, such as Social Security. Today about 69 percent of the budget goes toward mandatory programs.

Discretionary Spending **Discretionary spending** is spending subject to the annual budget process. It is from this pool of funds that the government must pay for any optional, or not required, program or activity. The president creates a budget, Congress makes changes and passes the budget, and the president signs it. Because discretionary funds are limited to around 31 percent of the budget, disputes often take place over how the money will be spent.

Reading Check Contrasting What is the difference between mandatory and discretionary spending?

The Budget Process (pp. 210–211)

The federal budget is the nation's spending plan for one fiscal year. The term *fiscal* means "financial," or "having to do with money." The government's fiscal year begins on October 1 and runs to September 30 of the following year.

The President's Budget The creation of the federal budget begins with the president. The proposed budget is made up of the president's legislative priorities. The Office of Management and Budget (OMB) helps the president in making the budget. The OMB director collects funding requests from all departments and agencies. Then the OMB puts the budget together based on these requests and the president's guidelines. The budget is complete by the January before the fiscal year starts. It shows not only spending proposals but also revenue and spending estimates for the future.

The Budget in Congress The president must present the budget to Congress by the first Monday in February. Then, all budget work takes place in Congress. Congress

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reviews the president's budget and makes any necessary changes. The Congressional Budget Office (CBO) assists in this work. Steps for passing the budget are:

1. Congress agrees on spending and revenue totals and passes a concurrent resolution to guide future budget work. To pass the resolution, House and Senate Budget Committees hold hearings to gather input from members of Congress.
2. House and Senate Appropriations Committees consider the individual funding and revenue resolutions in the budget and decide exactly how the discretionary funds will be spent.
3. The Appropriations Committees pass appropriations bills that formalize the spending decisions of the budget.
4. The appropriations bills are sent to the president for signature.

If Congress does not finish its work by the beginning of the fiscal year, it must pass a continuing resolution for the president's approval to allow temporary funding of the government. Disagreement over these resolutions has on occasion led to the shutdown of government programs.

Reading Check **Sequencing** What are the steps for creating the federal budget?

Fiscal and Monetary Policy (pp. 211–213)

By creating the federal budget and tax laws, Congress and the president are making a **fiscal policy** for the United States. When the government alters the amount of money in circulation and the interest rates at which money is borrowed, it is creating a **monetary policy** for the United States. Together, these policies aim toward a four-part economic goal: economic growth, low unemployment, stable prices for goods and services, and a balanced budget.

Fiscal Policy The goal of fiscal policy is to provide enough funds for government without hurting the overall economy. When the economy is growing slowly or shrinking, the government can either spend more or cut taxes. The goal is to stimulate the economy by increasing public demand for goods and services and by promoting long-term economic growth. However, if the government spends too much and cuts taxes, it can create large budget deficits. It must then borrow money. When it borrows money through selling bonds, it sometimes must pay higher interest to attract buyers for the bonds. This raises the overall interest rates at which businesses borrow money. This can cause businesses to spend less and thus slows the economy.

Too much government spending can also cause inflation—a rise in prices for goods and services. Inflation cuts into people's and businesses' purchasing power. Government can fight inflation by reducing spending, raising taxes, or raising interest rates.

Monetary Policy Monetary policy controls the amount of money in circulation and the interest rates at which money is borrowed. This policy is set and carried out by the Federal Reserve System, or the Fed. The Fed is an independent regulatory commission that acts as the nation's central banking system. It has a seven-person board with one member acting as chairperson. The Fed Board is nominated by the president and confirmed by the Senate. The Fed chairperson's decisions have a great impact on the U.S. economy.

The Fed carries out monetary policy in several ways. It sets rules for how much money banks must have in reserve, which affects how much money is circulating in the economy. It also adjusts interest rates it charges to its customers—the nation's other banks. These banks borrow money from the Fed at rates set by the Fed. Adjusting rates

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determines how much banks will borrow. Finally, the Fed buys and sells government bonds. Buying bonds puts money in circulation. Selling them reduces the amount of money in circulation.

In general, more money in circulation will create economic growth but may also trigger inflation. Less money in circulation may reduce inflation but also slow economic growth. Any change in policy takes time to put in place. This means the effects of a change may not be felt for months. A change in an economic problem may also require yet another change in policy.

Reading Check Identifying Supporting Details Why is inflation bad for the economy?

Section 3 Assessment

1. **Define** What is a **bond**?

2. **Define** What is meant by the terms **mandatory spending** and **discretionary spending**?

3. **Recall** How often must the federal government prepare a budget?

4. **Identify** What are the main goals of the federal government's **fiscal policy** and **monetary policy**?

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