CHAPTER 16

Financing Government

Chapter Preview

Have you ever celebrated Tax Freedom Day? That is the day on which American taxpayers have earned enough money to pay their total tax debt for the year. The day on which this "holiday" falls varies somewhat from State to State and from year to year. In 1990, taxpayers in Washington, D.C., for example, didn't celebrate Tax Freedom Day until May 23, while residents of South Dakota earned enough to pay all their taxes by April 19. All across the country, people worked three to four months of the year just to pay their taxes!

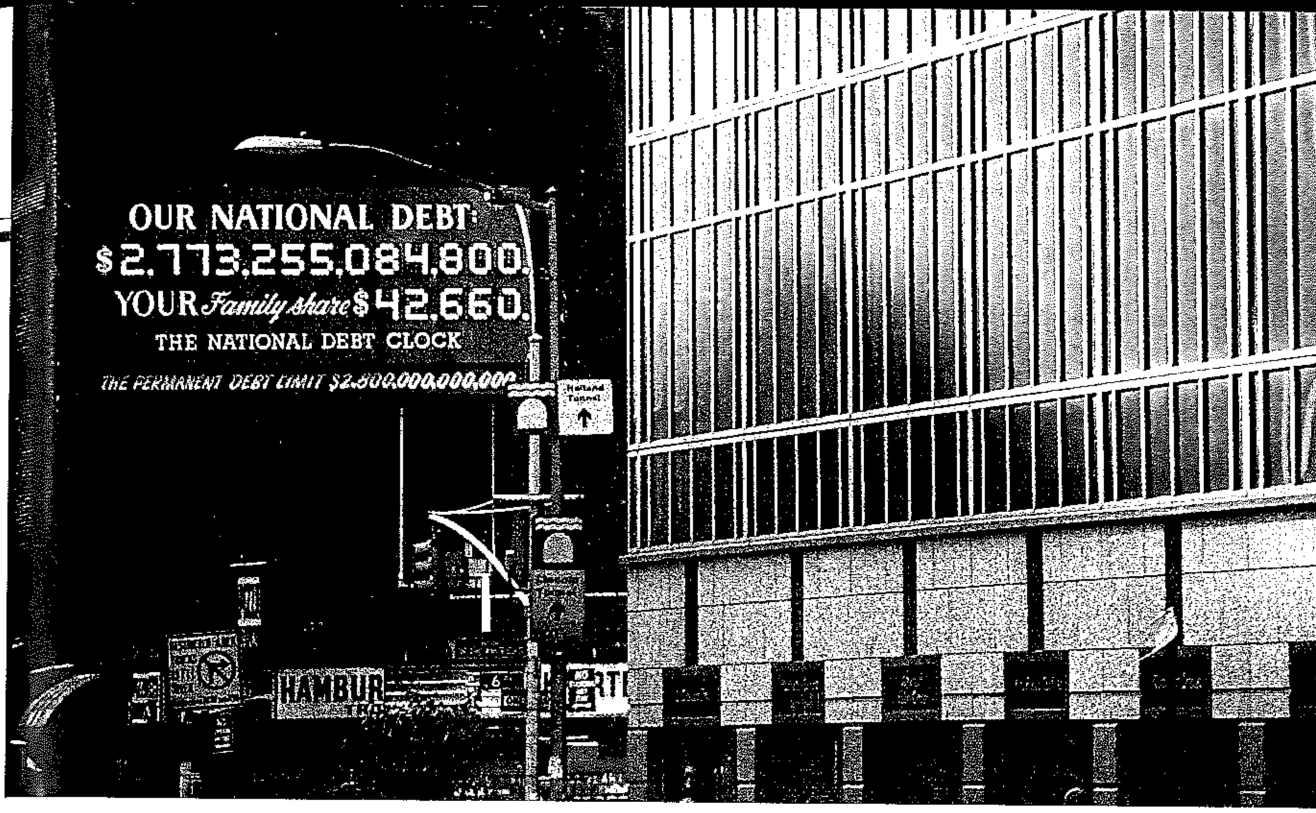
No wonder everyone complains. People with high incomes grumble because they pay the highest taxes. Low-income earners point out that even a low tax rate is too much to bear. People in the middle consider their situation the worst of all—their incomes aren't high but their taxes are. In this chapter you will read about financing the Federal Government—where more than a trillion dollars comes from and where it all goes.

Before you read this chapter:

- **Describe** three types of taxes that you are familiar with.
- **Predict** why most Americans would complain if there were no taxes.

As you read, focus on the main objective for each section. Understand:

1. How the Federal Government raises money.
2. Borrowing as a source of government revenue.
3. How the Federal Government spends money and the complex process of preparing the federal budget.



The National Debt Clock Continues to Tick This clock in New York City gives the public up-to-date figures on the total amount of the national debt. By the end of fiscal year 1994, the figure will likely exceed $4.5 trillion, according to the Office of Management and Budget.

1 Where the Money Comes From: Taxes

Find Out:

- What is the Federal Government's power to tax?
- What kinds of taxes does the Federal Government levy?
- For what purposes may the Federal Government levy taxes?

Key Terms:

progressive tax, tax return, payroll tax, regressive tax, excise tax, estate tax, gift tax, custom duty

According to Benjamin Franklin's oft-quoted assertion, "in this world nothing is certain but death and taxes." In this section, you will consider the second of Franklin's certainties, taxes—and more specifically, those taxes levied by the Federal Government.[1]

[1]On State and local taxes, see Chapter 25.

For fiscal year 1994—the 12-month period beginning October 1, 1993, and ending September 30, 1994—the Federal Government expects to collect almost $1.2 trillion. And, as you will see, it will almost certainly spend more than that stupendous sum.

Those mind-boggling numbers tell you that it now costs every man, woman, and child more than $5,000 on average a year to support the Federal Government. And that fact should tell you how important the subject of governmental finance is.

The Power to Tax

The Constitution underscores the cardinal importance of the power to tax by listing it first among the many powers granted to Congress. In Article I, Section 8, Clause 1, the Constitution gives to Congress the power:

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

First and foremost, Congress exercises the taxing power in order to raise money to finance at least most of what it costs to operate the Federal Government. But Congress also levies some taxes for nonrevenue purposes.

Constitutional Limitations The power to tax is not an unlimited one. Like all of its other powers, Congress must exercise the taxing power in accord with the Constitution. Thus, for example, Congress cannot levy a tax on church services—for such a levy would violate the provisions of the 1st Amendment.

In more specific terms, the Constitution puts four expressed limits and one very significant implied limit on the power of Congress to tax.

First, taxes must be for public purposes only. That is, the Constitution says that Congress may levy taxes only for public purposes, not for the benefit of some private interest.

The second expressed limit is that export taxes are prohibited. Article I, Section 9, Clause 5 declares that "No tax or duty shall be laid on articles exported from any State." Thus, customs duties can be applied only to imports—on goods brought into the United States. This restriction was written into the Constitution as a part of the Commerce Compromise made by the Framers at Philadelphia in 1787 (see Chapter 2, Section 4).

While Congress cannot tax exports, it can and does prohibit the export of certain items—usually for reasons of national security and acting under its expressed power to regulate foreign commerce.

The third expressed limit is that direct taxes must be equally apportioned. Article I, Section 9, Clause 4 originally provided that:

> “No capitation, or other direct tax, shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.”

This restriction was a part of the Three-Fifths Compromise the Framers made at the Philadelphia Convention (see Chapter 2, Section 4). In effect, delegates from the northern States insisted that if slaves were to be counted in the populations of the southern States, then those States would have to pay for them.

Recall that a direct tax is one that must be borne by the person upon whom it is levied—as, for example, a tax on land or buildings, which must be paid by the owner of the property; or a capitation tax—a head or poll tax—laid on each person. Other taxes are indirect taxes. That is, they are levies that may be shifted to another for payment—as, for example, the federal tax on liquor. That tax, placed initially on the distiller, is ultimately paid by the person who buys the liquor.

The direct tax restriction means, in effect, that any direct tax that Congress levies must be apportioned among the States according to their populations. Thus, a direct tax that raised $1 billion would have to produce just about $120 million in California and $10 million in Kansas—because California has just about 12 percent of the nation's population and Kansas 1 percent.

Wealth is not evenly distributed among the States, of course. So, a direct tax laid in proportion to population would be grossly unfair; the tax would fall more heavily on the residents of some States than it would on others. As a result, Congress has not imposed a direct tax—except for the income tax—outside the District of Columbia since 1861.

An income tax is a direct tax. But, recall, it may be laid without regard to population because of the 16th Amendment:

> “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

Congress first levied an income tax in 1861, to help finance the Civil War. The tax, which expired in 1873, was later upheld by the Supreme Court, in *Springer* v. *United States*, 1881. A unanimous Court found that income tax to be an indirect rather than a direct tax. But a later income tax law, enacted in 1894, was declared unconstitutional in *Pollock* v. *Farmers' Loan and Trust Co.*, in 1895. There, the Court held that the 1894 law imposed a direct tax that Congress should have apportioned among the several States.

The impossibility of taxing incomes fairly in accord with any plan of apportionment led to the adoption of the 16th Amendment in 1913.

The fourth expressed limitation on the taxing power is that indirect taxes must be uniform. This is stated in Article I, Section 8, Clause 1.

The limitation imposed here means that all indirect taxes must be levied at the same rate in all parts of the country. Thus, the federal excise tax on gasoline or beer or firearms must be the same in New York as it is in New Mexico.

The Implied Limitation The Federal Government cannot tax the States or any of their local governments in the exercise of their governmental functions. That is, federal taxes cannot be imposed on those governments when they are doing such things as providing public education, furnishing health care, or building streets and highways. Recall, the Supreme Court laid down that rule in *McCulloch* v. *Maryland* in 1819, when it declared that "the power to tax involves the power to destroy." If the Federal Government could tax the governmental activities of the States or their local units, it could conceivably tax them out of existence and so destroy the federal system.

The Federal Government can and does tax those State and local activities that are of a nongovernmental character, however. Thus, in 1893, South Carolina created a State monopoly to sell liquor, and it claimed that each of its liquor stores was exempt from the federal saloon license tax. But, in *South Carolina* v. *United States*, 1905, the Supreme Court held that the State was liable for the tax—because the sale of liquor is not a necessary or usual governmental activity.

Current Federal Taxes

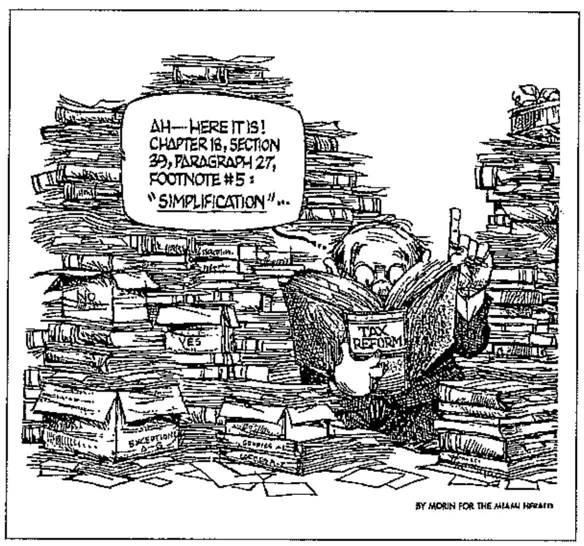
Oliver Wendell Holmes once described taxes as "what we pay for civilized society."[2] Society does not appear to be much more civilized today than it was when Justice Holmes made that observation in 1927. But "what we pay" has certainly gone up. In 1927, the Federal Government's tax collections came to, altogether, less than $3.4 billion. Compare that figure with the figures in the table on page 408.

The Income Tax The income tax is the largest source of federal revenue today. It first became the major source in 1917 and 1918. And, except for a few years during the Depression of the 1930s, it has remained so.

Several features suit the income tax to its dominant role. It is a flexible tax; its rates can be adjusted to produce whatever amount of money Congress thinks is necessary. The tax is also easily adapted to the principle of ability to pay. It is a **progressive tax**—that is, the higher the income and the ability to pay, the higher the tax rate. The tax is levied on the earnings of both individuals and corporations.

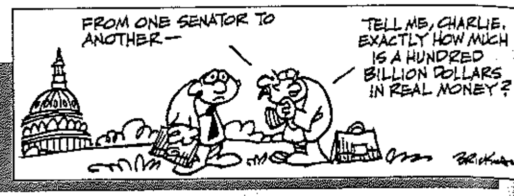
The Individual Income Tax The tax on individuals' incomes regularly produces the largest amount of federal revenue. For fiscal year 1993, the individual income tax is expected to provide more than $500 billion.

The tax is levied on each person's taxable income—one's total income in the previous year minus certain exemptions and deductions. On returns filed in 1993, which covered income that



Interpreting Political Cartoons Filing taxes often requires following complicated instructions. According to this cartoon, how effective was the Tax Reform Bill of 1986 in simplifying tax form preparation?

[2]In a dissenting opinion in an insurance tax case, *Compania General de Tabacos de Filipinas* v. *Collector of Internal Revenue*, 1927.



The Federal Government's Income (by major source for selected fiscal years, in billions of dollars)

	1975	1980	1985	1990	1992	1993 (est.)
Individual income taxes	$122.4	$244.1	$334.6	$466.9	$476.5	$507.0
Corporation income taxes	40.6	64.6	61.3	93.5	100.3	112.2
Social insurance taxes and contributions	84.5	157.8	265.2	380.0	413.7	444.5
Excise taxes	16.6	24.3	36.0	35.3	45.6	48.0
Estate and gift taxes	4.6	6.4	6.4	11.5	11.1	12.8
Customs duties	3.7	7.2	12.1	16.7	17.4	18.1
Miscellaneous receipts	6.7	12.7	18.5	27.3	27.2	20.4
Total receipts	$279.1	$517.1	$734.1	$1,031.2	$1,091.7	$1,162.9

Source: Office of Management and Budget

Interpreting Tables This table reveals that individual income and social insurance taxes account for the largest sources of the government's income. Revenue from which type of tax has increased by the greatest percentage from 1975 to 1993?

was earned in 1992, each taxpayer had a personal exemption of $2,300, plus another exemption of that amount for each dependent.[3] Deductions are allowed for a number of things, including the costs of some medical care, most State and local taxes (except for sales taxes), interest paid on home mortgages, and contributions to charitable organizations.

By April 15, all persons who earned taxable income in the preceding calendar year must file **tax returns**—declarations of that income and of the exemptions and deductions claimed. Those returns are filed with the Internal Revenue Service, the IRS. A husband and wife can file a joint return, even if one of them had no income in the previous year. All taxable income received in 1992 was taxed at one of three rates—at 15 or 28 or 31 percent. Couples who filed joint returns paid 15 percent on income up to $35,800; 28 percent on income up to $86,500; and 31 percent on anything over that amount. Single taxpayers paid 15 percent on income up to $21,450; 28 percent up to $51,900; and the top rate on anything higher.

Most of those who pay income taxes do so through withholding—a pay-as-you-go plan. Employers are required to withhold a certain amount from each employee's paycheck and send that money to the IRS. When the employee files a tax return, he or she will receive a refund if more than the tax due has been withheld; or he or she must pay an additional amount if not enough has been withheld. Those persons who have income from sources not subject to withholding must estimate the income tax they will owe and make quarterly payments on that amount through the year.

The Corporation Income Tax Each corporation must pay a tax on its net income—that is, on all of its earnings above the costs of doing business. The corporate tax has been called the most complicated of all federal taxes because of the many deductions allowed. Nonprofit organizations such as churches and charitable foundations are not subject to the corporation income tax.

[3]The personal exemption is adjusted for inflation each year. From 1991 on, the personal exemption amount is reduced for those with higher incomes. For single taxpayers, it begins to decline on taxable income over $100,000, and it disappears altogether on taxable income over $200,000. For married couples who file joint returns, the exemption is phased down on taxable incomes over $150,000 and disappears at $275,000.

"Small Society" by Brickman. Washington Star Syndicate, Inc.

Interpreting Political Cartoons The Internal Revenue Service is responsible for collecting income tax from both individuals and corporations. What does this cartoon reveal about the feedback that the IRS receives?

For 1993, the corporate tax rates run from 15 percent on the first $50,000 of taxable earnings up to a top rate of 34 percent on taxable incomes of more than $135,000.

Social Insurance Taxes The Federal Government collects huge sums to finance three major social welfare programs: (1) the Old-Age, Survivors, and Disability Insurance (OASDI) program—the basic social security program, established by the Social Security Act of 1935; (2) Medicare—health care for the elderly, added to the social security program in 1965; and (3) the unemployment compensation program—benefits paid to jobless workers, a program also established by the Social Security Act in 1935.

OASDI and Medicare are supported by taxes imposed on nearly all employers and their employees, and on self-employed persons. These levies are often called **payroll taxes** because the amounts owed by employees are withheld from their paychecks. To finance OASDI, employees must now (1993) pay a 6.2 percent tax on the first $57,600 of their yearly salaries or wages. Employers must match the OASDI tax paid by each employee. Those persons who are self-employed pay a 12.4 percent tax on the first $57,600 of their annual income.

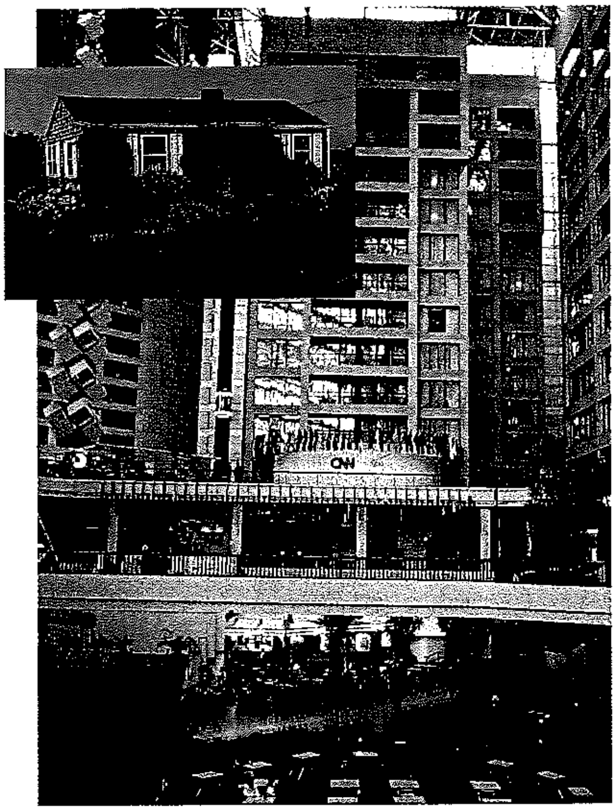
For Medicare, employees now pay a 1.45 percent tax on the first $135,000 of their annual pay. Employers must pay an amount equal to that withheld from their employees' pay. The self-employed are taxed 2.9 percent of their annual incomes, up to the limit of $135,000.

The unemployment insurance program is a joint federal-State operation, to make payments to workers who lose their jobs for reasons beyond their control. The program now covers most workers in this country. Each State and the District of Columbia, Puerto Rico, and the Virgin Islands has its own unemployment compensation law; and the amount of a worker's weekly benefits, and their duration, is determined by State law.

The unemployment compensation program is financed by a combination of federal and State taxes. The federal tax is now 6.2 percent of the first $7,000 an employer pays to each employee in a year. Each employer is given a credit of up to 5.4 percent against that tax for the unemployment taxes that employer pays to the State—so, usually, the federal tax really amounts to 0.8 percent on the taxable wages.

Notice that these social insurance taxes for OASDI, Medicare, and unemployment compensation are not progressive taxes. They are, instead, **regressive taxes**—taxes levied at a flat rate, without regard to the level of a taxpayer's income or his or her ability to pay them.

The IRS collects the social insurance taxes. The money is then credited to trust accounts maintained by the Treasury, and Congress



Both Large and Small Contributors The income tax is collected from both individuals (inset) and huge corporations, like Turner Broadcasting, CNN's parent company.

appropriates funds for the social insurance programs as they are needed.

Excise Taxes An **excise tax** is a tax laid on the manufacture, sale, or consumption of goods and/or the performance of services. The Federal Government has imposed and collected them since Congress acquired its taxing power in 1789.

Today, federal excise taxes are imposed on a long list of things, including gasoline, oil, tires, tobacco, liquor, wine, beer, firearms, telephone services, airline tickets, and more. Many excise taxes are often called hidden taxes because they are collected from producers who then figure them into the price that the retail customer finally pays. Some are called luxury taxes because they are levied on goods not usually considered to be necessities. And some excise taxes are known as sin taxes—in particular, those laid on tobacco products, beer, wine, liquor, and gambling.

Estate and Gift Taxes An **estate tax** is a levy imposed on the assets (the estate) of one who dies.[4] A **gift tax** is one imposed on the making of a gift by a living person. Congress first provided for the estate tax in 1916. It added the gift tax in 1932 to plug a loophole in the estate tax—the giving of money or other property before death to avoid the estate tax.

The first $600,000 of an estate is exempt from the federal tax. So, in fact, most estates are not subject to the federal levy. Deductions are allowed for such things as State death taxes and bequests to religious and charitable groups. Anything a husband or wife leaves to the other is taxed, if at all, only when the surviving spouse dies.

Any person may make up to $10,000 in tax-free gifts to any other person in any one year. Gifts that husbands/wives make to one another are not taxed, regardless of value.

The estate and gift taxes are separate federal taxes, but both are levied at the same rates. For 1993, those rates ranged from a minimum of 18 percent on an estate or a gift with a net value of less than $10,000, on up to a maximum of 55 percent on an estate or gift worth more than $3 million.

Custom Duties A **custom duty** is a tax laid on goods brought into the United States from abroad. They are also known as tariffs, import duties, or imposts. Congress decides which imports will be dutied and at what rates.[5] Most imports, some 30,000 different items, are dutied; but some are not—for example, Bibles, coffee, bananas, and up to $300 of a tourist's purchases abroad.

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[4]An inheritance tax is another form of the so-called death tax. It is not levied on the entire net estate but, instead, on each portion inherited by each heir. Most States impose inheritance, not estate, taxes; most States also levy gift taxes.

[5]Since 1922, Congress has authorized the President to raise or lower any tariff by as much as 50 percent. The President can do so by an executive order, issued on the basis of recommendations made by the United States International Trade Commission, which studies the effect of tariffs and imports on the economy.

Custom duties were the major source of income for the Federal Government for more than a century. Now, they produce less than 2 percent of the money the government takes in.

Taxing for Nonrevenue Purposes

Remember, the power to tax can be, and often is, used for purposes other than the raising of revenue. Usually, that other purpose is to regulate some activity that Congress thinks is harmful or dangerous to the public.

Thus, much of the Federal Government's regulation of narcotics is based on the taxing power. Federal law provides that only those who hold a valid license may legally manufacture, sell, or otherwise deal in those drugs—and licensing is a form of taxation. The government also regulates a number of other things by licensing, including, for example, certain firearms, prospecting on public lands, and the hunting of migratory birds. The federal excise tax on gas-guzzling cars is intended to discourage their purchase.

The Supreme Court first upheld the use of the taxing power for other than revenue purposes in *Veazie Bank* v. *Fenno* in 1869. Congress had established a national paper money system in the midst of the Civil War in 1863. It did so to provide a single, sound currency for the country. Private bank notes, which were also used as paper money, soon interfered with the circulation of the government's new "greenbacks." So, in 1866, Congress composed a 10 percent tax on the issuing of those private notes, and they soon disappeared. In upholding the tax, the Court declared:

> "Having, in the exercise of undisputed constitutional powers, undertaken to provide a currency for the whole country, it cannot be questioned that Congress may, constitutionally, secure the benefits of it to the people by appropriate legislation."

In 1912, Congress used its taxing power to destroy a segment of the domestic match industry. It levied a tax of two cents per hundred on matches made with white or yellow phosphorous—highly poisonous substances that caused serious harm to the workers who produced the matches. Matches made from other substances commonly sold for a penny a hundred, and the two-cent tax drove the phosphorous matches from the market. But Congress cannot use its taxing power in any manner it chooses. As in all other matters, Congress is bound by all of the other provisions of the Constitution.

To illustrate that point, consider several provisions of a 1951 tax law that was aimed at professional gamblers. The law imposed a $50-a-year license tax on bookies, levied other taxes on their activities, and required them to register with and submit detailed reports to the IRS. The law did produce a small amount of income. But its real purpose was to force gamblers into the open and to the attention of State and local police and prosecutors, and to set a federal tax evasion trap for those who failed to comply with the law.

The Supreme Court held the antigambling provisions unconstitutional in *Marchetti* v. *United States*, 1968. The Court did not hold that the taxes had been imposed for some improper purpose. Rather, it held that the tax, registration, and reporting provisions forced gamblers to furnish evidence against themselves—in violation of the 5th Amendment's guarantee against self-incrimination.

Section 1 Review

1. **Define:** tax return, payroll tax, excise tax, estate tax, gift tax, custom duty
2. What is the major exception to the requirement that direct taxes be levied in proportion to each State's population?
3. What are the two largest income producers for the Federal Government?
4. What is the difference between a progressive and a regressive tax?
5. What is the difference between the rate paid for social insurance taxes by those on payrolls and by those who are self-employed?
6. What limits exist on the power to tax for purposes other than raising revenue?

Critical Thinking

7. **Determining Relevance** (p. 19) Explain how you think public opinion might affect and place limits on the government's power to tax.

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2 Nontax Revenues and Borrowing

Find Out:

- What are the major sources of nontax revenues in the United States?
- What is the historical purpose of the power to borrow?
- What is the purpose of much of the current borrowing?

Key Terms:

deficit, public debt

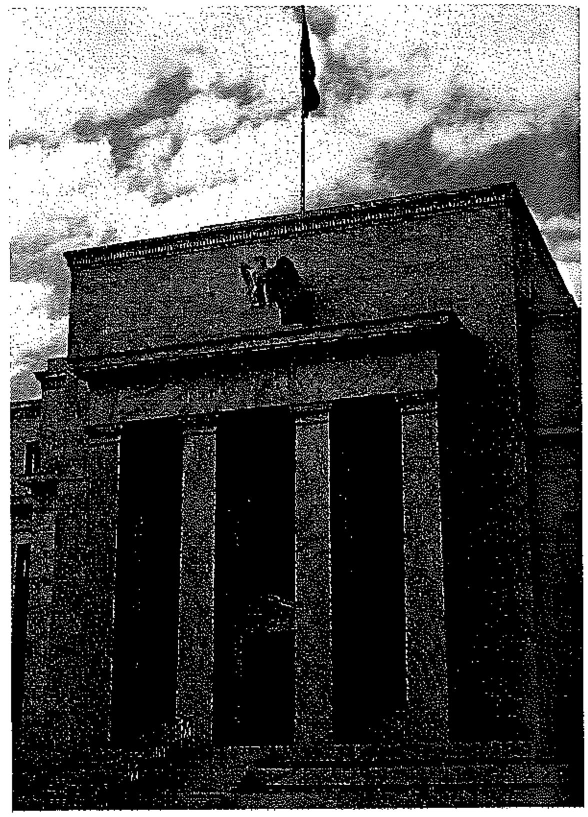
In *Hamlet*, Shakespeare writes: "Neither a borrower, nor a lender be." That may be good advice in some situations. As you will see in this section, however, it certainly has not been followed by the government of the United States.

Nontax Revenues

Large sums of money reach the federal treasury from a multitude of nontax sources. As you can see from the table on page 408, these miscellaneous receipts now come to well over $20 billion a year.

These monies come from dozens of places. A large portion comes from the earnings of the Federal Reserve System, mostly in interest charges. The interest on loans made by several other federal agencies, canal tolls, and fees for such items as passports, copyrights, patents, and trademarks also generate large sums. So do the premiums on veterans' life insurance policies, the sale or lease of public lands, the sale of surplus property, and such other things as the fines imposed by the federal courts.

The Treasury Department maintains what it calls the conscience fund for all the money, several thousand dollars a year, that people send in to ease their minds over their past taxpaying mistakes. Another little-known source of nontax money is seigniorage, the profit the United States Mint makes in the production of coins. That profit is the difference between the value of the metals used and the other costs of production and the monetary value of the minted coins. It is a tidy little sum, more than $500 million in most years. The Philatelic Sales Branch of the United States Postal Service sells more than $100 million in mint stamps to collectors each year; and stamp collectors spend untold millions more at local post offices. Most of the stamps they buy are never used on mail.



Managing the Country's Money Supply Pictured here is a Federal Reserve building in Washington, D.C. There are twelve Federal Reserve banks in this country that supply money to banks throughout the nation.

Borrowing

Congress has the power "to borrow money on the credit of the United States."[6] Historically, the power to borrow has been viewed as a power that makes it possible for the government to (1) meet the costs of short- and long-term crisis situations and (2) finance large-scale

[6] Article I, Section 8, Clause 2.

projects that would not be paid for out of current income. Thus, the Federal Government borrowed huge sums when the United States entered World War I, to combat the Depression of the 1930s, and again during World War II.

In recent decades, the Federal Government has borrowed for yet another reason: deficit financing. Over these years, the government has regularly spent more than it has taken in. That is, it has run up an annual **deficit**—the yearly shortfall between income and outgo; and it has borrowed to make up the difference. Indeed, the Federal Government's financial books have not shown a surplus, more income that outgo, since fiscal year 1969.[7] As the graph on page 414 shows, deficit financing—often called deficit spending—became especially pronounced in the 1980s, and it has continued at a hefty rate in the 1990s.

Congress must authorize any and all federal borrowing. The borrowing itself is done by the Treasury Department, which issues various kinds of securities to investors, principally individuals and banks, investment companies, and other financial institutions. These securities usually take the form of Treasury notes or bills—T-bills—issued for short-term borrowings, or bonds for long-term purposes. They are, in effect, IOUs, promissory notes in which the government agrees to repay a certain sum, with interest, at a certain time.

The government is able to borrow money at lower rates of interest than those paid by private borrowers. This is true largely because investors can find no safer securities than those issued by the United States; if the United States could not pay its debts, no one else would be able to, either. Federal securities are also attractive because the interest they generate cannot be taxed by the States or their local governments.

The Public Debt

Borrowing produces a debt, of course. The public debt is the result of the Federal Government's borrowing over time. More precisely, the **public debt** is the government's outstanding indebtedness, all of the money borrowed and not yet repaid, plus the accrued interest.[8]

The Federal Government has built up a huge debt over time. As you can see in the table on page 414, the nation's debt doubled in the years 1981 through 1985 because of deficit financing; and it had quadrupled by 1992.

The amounts involved here are absolutely mind-boggling. In 1981, when the debt was approaching $1 trillion, President Ronald Reagan said that he found "such a figure—a trillion dollars—incomprehensible." He then drew this verbal picture: "[I]f you had a stack of $1,000 bills in your hand only four inches high, you would be a millionaire. A trillion dollars would be a stack

Campaigning on the Budget Issue Democratic presidential candidate Tom Harkin of Iowa promised to address the deficit problem if elected in 1992.

[7]In fact, since 1930, the Federal Government has ended only seven fiscal years "in the black"—that is, with a surplus: fiscal years 1947, 1948, 1951, 1956, 1957, 1960, and 1969.

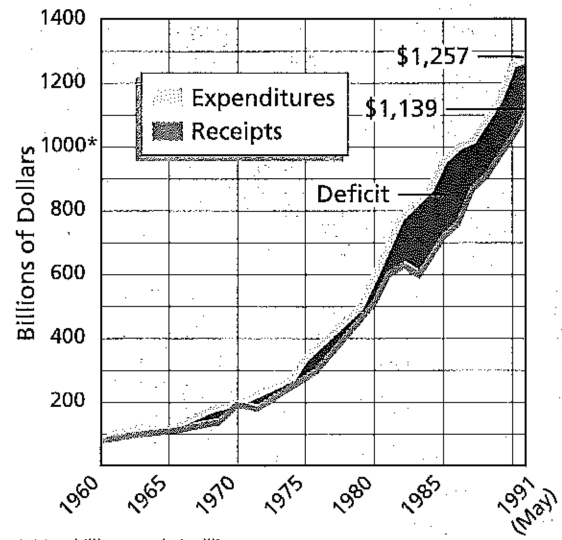
[8]The public debt, often called the national debt, is frequently confused with the government's annual deficits. Notice, however, that each of those deficits amounts to an annual increase in the total of the public debt.

The Public Debt (at end of selected fiscal years)

1916 (pre-World War I)	$ 1.1 billion
1919 (post-World War I)	25.5 billion
1930 (start of Depression)	16.2 billion
1940 (decade of Depression)	43.0 billion
1941 (pre-World War II)	48.9 billion
1946 (post-World War II)	269.4 billion
1950 (pre-Korean War)	256.1 billion
1954 (post-Korean War)	271.3 billion
1964 (pre-Vietnam War)	308.1 billion
1974 (post-Vietnam War)	474.2 billion
1980 (period of steep upturn in deficit financing)	907.7 billion
1985	1.8 trillion
1992	4.0 trillion
1993 estimate	4.5 trillion

Source: Bureau of the Public Debt, Department of the Treasury (1992 estimate by the Office of Management and Budget).

Federal Budget Trends



* 1,000 billion equals 1 trillion

Source: U.S. Office of Management & Budget

Interpreting Tables and Graphs The public debt can be affected by national and world events, as shown in the table at left. Which recent period saw the greatest growth in deficit spending and the public debt? Can you think of any explanation for this growth?

67 miles high." Mr. Reagan's stack would have to be more than 250 miles high to equal the national debt today!

There is no constitutional limit on the amount that may be borrowed, and so there is no constitutional limit on the public debt. Congress has put a statutory ceiling on the debt. But Congress simply adjusts the ceiling upward whenever fiscal realities seem to call for it.

The debt has always been the subject of much controversy; and its rapid rise in recent years has fueled the fire. The annual interest on the debt—the amount that must be paid each year to those from whom the government has borrowed—came to more than $292 billion in 1992; and that figure will be well over $300 billion in 1993. That means that about one in five dollars the Federal Government now spends goes just to service the debt.

Most of those who are most concerned about the size of the debt are worried about its impact on future generations of Americans. In short, they believe that today's deficit financing—that is, today's borrowing to pay for yesterday's and today's spending—is being done at the expense of tomorrow's taxpayers.

Section 2 Review

1. **Define:** deficit, public debt
2. How much revenue does the government raise through nontax sources?
3. Describe the mechanism by which the Federal Government borrows money.
4. Why is the Federal Government able to borrow money at lower rates of interest than private borrowers?

Critical Thinking

5. **Predicting Consequences** (p. 19) (a) What would be the consequences of a decision by Congress to bring the practice of deficit spending to an immediate halt? (b) How would the public respond to that step?

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Debating Key Issues

Should Government Subsidize Private School Education?

Mueller v. *Allen*

A Minnesota law allows those who pay that State's individual income tax to deduct the money they pay to provide "tuition, textbooks, and transportation" for their children who attend elementary or secondary schools in the State. Parents can deduct as much as $500 for each dependent child in grades K through 6 and up to $700 per dependent in grades 7 through 12. The law, originally passed in 1955, allows taxpayers to claim the deduction without regard to whether their children attend public or private schools.

In 1981, two Minnesota taxpayers, Van D. Mueller and June Noyes, challenged the constitutionality of the statute. They brought their case before the federal district court in Minneapolis. There, they claimed the law violated the 1st and 14th Amendments' ban on the establishment of religion. They noted that parents with children in public schools pay little or nothing for "tuition, textbooks, and transportation"; so, the law's real benefits go to those who send their children to private schools. Most private schools in Minnesota are parochial, or church-run, schools; therefore, they claimed, the State's law actually provides for the use of public funds to support religion.

Mueller and Noyes lost their case in the district court and carried an appeal to the U.S. Supreme Court.

Review the following evidence and arguments presented to the United States Supreme Court:

Arguments for Mueller

1. In effect, the law allows parents to pay parochial school expenses with public tax money, and so it violates the 1st and 14th Amendments' Establishment Clause.
2. The law gives an unfair tax advantage to those parents who choose to send their children to private schools.
3. The law weakens the State's system of public education by denying to the State tax monies that could be used to support that system. That loss of funds undercuts the quality of the education that can be offered by the public schools.

Arguments for Allen

1. The law does not seek to promote any particular religion; instead, its aim is to promote the education of the children of the State.
2. Parents with children in private schools bear an unfair double burden. They must pay the costs of the private schools their children do attend and also pay taxes to support the public schools their children do not attend.
3. The people of Minnesota are benefited by the education offered by all of the schools in the State, both public and private.

Getting Involved

1. **Identify** the constitutional grounds on which each side based its arguments.
2. **Debate** the opposing viewpoints presented in this case.
3. **Predict** how you think the Supreme Court ruled in this case and why. Then refer to the Supreme Court Glossary on page 764 to read about the decision in this case. Discuss the impact of the Court's decision on the future of public education.

3 Spending and the Budget

Find Out:

- What does the Federal Government do with the revenue it collects?
- What is the importance of the federal budget?
- How does the budget process work?

Key Terms:

entitlement, continuing resolution

The Federal Government will spend more than $1.5 trillion in fiscal year 1993. If you placed 1.5 trillion dollar bills end to end, they would stretch about 140 million miles, just about the distance from the earth to the sun and halfway back.

Decrease in Military Spending National budget priorities have changed over the last few years. With the end of the cold war, the nation's armed forces are being down-sized.

In this section, you will see how the government spends all that money, and how it plans for that spending, through the budget process.

Federal Spending

Look at the table on page 417. As shown, the largest amount of money is spent by the Health and Human Services Department—largely for social security and other entitlement programs. **Entitlements** are benefits that federal law says must be paid to all those who meet the eligibility requirements. OASDI is the largest federal entitlement program today. Others include Medicare, Medicaid, food stamps, unemployment compensation, and veterans' pensions. In effect, the law says that the people who receive benefits paid under those programs are entitled to them.

Interest on the public debt is today the second largest object of federal spending. And, stoked by deficit financing, it has consumed a larger and still larger part of the federal budget over the last several years. In the table on page 417, interest on the debt is included in the Treasury Department's spending. For 1992, interest paid on the debt came to $292.3 billion.

Defense expenditures are now decreasing, as you can see in the table. But they still account for the third largest slice of the federal budget—$286.6 billion in 1992. Note that the defense spending figures in the table are somewhat misleading. They do not include the defense-related expenditures of other federal agencies—for example, the extensive nuclear weapons research and development work of the Department of Energy.

Controllable and Uncontrollable Spending What the Federal Government spends can be described in terms of controllable and uncontrollable spending. Most specific items in the federal budget are controllable. That is, Congress and the President decide how much will be spent each year on many of the individual expenditures the government makes—for example, on farm subsidies, military equipment, aid to education, and so on. Some spending is uncontrollable, however, such as interest on the debt. That interest is a fixed charge; once the

Federal Spending, Fiscal Years 1989–1993 (by agency, in billions of dollars)

Agency	1989	1990	1991	1992	1993 (est.)
Legislative Branch	2.1	2.2	2.3	2.7	2.8
Judicial Branch	1.5	1.6	2.0	2.3	2.8
Executive Office of the President	0.1	0.2	0.2	0.2	0.3
Funds appropriated to the President (Mostly for foreign economic/military aid)	4.3	10.1	11.7	11.1	11.6
Department of Agriculture	48.3	46.0	54.1	56.4	62.3
Department of Commerce	2.6	3.7	2.6	2.6	2.9
Department of Defense—Military	294.9	289.8	261.9	286.6	278.0
Department of Defense—Civil	23.4	25.0	26.5	28.3	29.3
Department of Education	21.6	23.1	25.3	26.0	30.8
Department of Energy	11.4	12.0	12.5	15.4	16.2
Department of Health and Human Services	399.8	438.7	484.4	539.4	587.7
Department of Housing and Urban Development	19.7	20.2	22.8	24.5	26.1
Department of the Interior	5.2	5.8	6.1	6.6	6.6
Department of Justice	6.2	6.5	8.2	9.8	10.4
Department of Labor	22.7	25.3	34.0	47.2	38.9
Department of State	3.7	4.0	4.3	5.0	5.2
Department of Transportation	26.6	28.6	30.5	32.6	34.5
Department of the Treasury	230.6	255.3	276.4	293.4	310.8
Department of Veterans Affairs	30.0	29.0	31.2	33.7	34.2
Environmental Protection Agency	4.9	5.1	5.8	5.9	6.2
National Aeronautics and Space Administration	11.0	12.4	13.9	14.0	14.1
Office of Personnel Management	29.1	32.0	34.8	35.6	37.5
Small Business Administration	0.8	0.7	0.6	0.4	0.4
Other Independent Agencies	33.9	73.7	81.7	19.3	79.4
Deductions (undistributed offsetting receipts)	-89.1	-99.0	110.0	-117.1	-124.9
Total Outlays	**1,144.1**	**1,251.8**	**1,323.8**	**1,381.9**	**1,503.9**
Deficit (Outlays greater than receipts)	-153.4	-220.4	-269.5	-290.2	-338.5

Columns may not add to totals due to rounding.

Source: Financial Management Service, Department of the Treasury

Interpreting Tables Examine the table above. Which of the cabinet departments now spends the largest amount of money each year? Which department spends the least?

Federal Government borrows the money, the interest on that loan must be paid when it comes due and at the rate the government promised to pay.

Social security benefits, food stamps, and most other entitlements are also largely uncontrollable because, once Congress has set the standards of eligibility for those programs, it has no control over how many people will then meet those standards. Thus, Congress cannot determine how many people covered by social security will become eligible for retirement benefits. Those expenditures are not completely uncontrollable, however. Congress could redefine eligibility standards, or it could reduce the amount of money each beneficiary is to receive. But, clearly, those actions would be politically difficult.

The Office of Management and Budget estimates that the uncontrollable items in the budget total nearly 80 percent of all current federal spending.

The Federal Budget

Recall, the Constitution declares that

"No money shall be drawn from the treasury, but in consequence of appropriations made by law. . . ."[9]

Thus, only Congress can provide the money upon which the Federal Government must depend. But it is the President who initiates the spending process by submitting a budget at the beginning of each congressional session.[10] The budget is a hugely important political document. It is the President's work plan for the conduct of government and the execution of public policy.

The Budget Process The budgeting process is a joint effort of the President and Congress. The President prepares the budget and submits (proposes) it to Congress. Congress then reacts to the President's proposals, over a period of several months. It usually enacts most of them, usually in some altered form, in appropriate measures.

The President and the Budget The process of building the budget is a lengthy one. In fact, that process begins some 18 months before the start of the fiscal year for which it is intended. First, each federal agency prepares detailed estimates of its spending needs for that 12-month period. Each agency submits its spending plans to the Office of Management and Budget, the President's budget-making agency (see Chapter 14, Section 5).

The OMB reviews all of the many agency proposals, often in budget hearings at which agency officials must defend their dollar requests. Following the OMB's review, revised and usually lowered spending plans for all of the agencies in the executive branch are fitted into the President's overall program. They become a part of the budget document the President sends to Capitol Hill.[11]

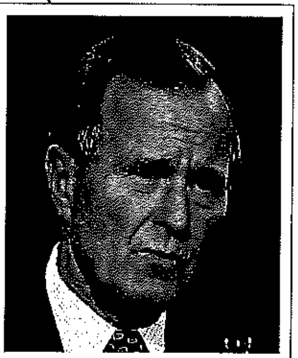
Congress and the Budget Remember that Congress depends upon and works through its standing committees. The President's budget is referred to the Budget Committee in each chamber. There, in both committees, the budget is studied and dissected with the help of the Congressional Budget Office. The CBO is a staff agency, created by Congress in 1974. It provides both houses of Congress and their committees with basic budget and other economic data and analyses. The information that the CBO supplies is independent of the information provided by the OMB, which, recall, is the President's budget agency.

[9]Article I, Section 9, Clause 7.

[10]The word *budget* comes from the French *bougette*, meaning a small pouch or bag with its contents. Originally, the budget was the bag in which in the 18th century the British Chancellor of the Exchequer carried financial documents.

[11]Congress makes and enacts its own budget. The spending requests for the judicial branch, prepared by the Administrative Office of the United States Courts, are included in the President's budget without OMB review.

VOICES on Government



George Bush,
41st President of the United States

On the Thrust of His Proposed Budget

"The budget proposal that we sent up there to Capitol Hill has been well received. I'm not saying that we don't have any critics—but when you look back over your shoulder, I think it's fair to say this one has been well received. It includes a record $76 billion for research and development, one of the most important investments we can make in the long-term economic and military strength of our nation. . . . This isn't an investment in machines, it's an investment in people—in the scientists, the engineers and the educators who will produce the advances of the 21st century."

By permission of Johnny Hart and NAS, Inc.

Interpreting Political Cartoons Mayors, governors, and Presidents strive to balance their budgets. According to this cartoon, what is sometimes required to accomplish this task?

The President's budget is also sent to the House and Senate Appropriations Committees.[12] Their subcommittees hold extensive hearings in which they examine agency requests, quiz agency officials, and take testimony from a wide range of interested parties. The two Appropriations Committees fashion measures that later are reported to the floor of each house. Those measures are the bills that actually appropriate the funds on which the government will operate.

The two Budget Committees propose a concurrent resolution on the budget to their respective chambers. That measure, which must be passed by both houses by May 15, sets overall targets for federal receipts and spending in the upcoming fiscal year. The estimates are intended to guide the committees in both houses as they continue to work on the budget.

The two Budget Committees propose a second budget resolution in early September. Congress must pass that resolution by September 15, just two weeks before the beginning of the next fiscal year; it sets binding spending limits for all federal agencies in that upcoming year. No appropriations measure can provide for any spending that exceeds those limits.

Congress passes 13 major appropriations bills each year. Recall, each of these measures must go to the White House for the President's action. Every year, Congress hopes to pass all 13 of the appropriations measures by October 1—that is, by the beginning of the fiscal year. It seldom does so, however, and Congress must then pass emergency spending legislation to avoid a shutdown of those agencies for which appropriations have not yet been signed into law. That legislation takes the form of a **continuing resolution**, a measure that, when signed by the President, allows the affected agencies to continue to function on the basis of the previous year's appropriations.

[12]If the budget includes any tax proposals, they are referred to the House Ways and Means Committee and to the Senate's Finance Committee.

Section 3 Review

1. **Define:** entitlement, continuing resolution
2. What are the three most expensive items for which the Federal Government spends money?
3. What is the President's role in the budget-making process?
4. What is the role of the Congress in the budget-making process?
5. (a) Why must Congress pass its appropriations measures by October 1? (b) What happens if it does not?

Critical Thinking

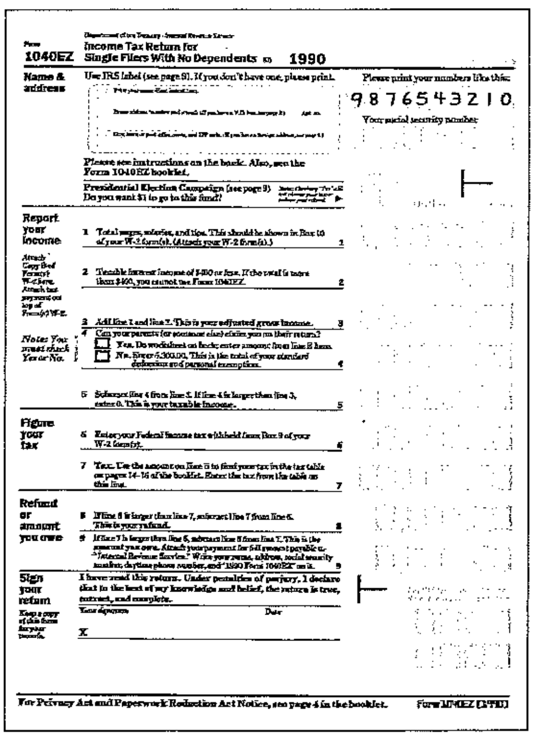
6. **Drawing Conclusions** (p. 19) What does the text mean when it says that redefining the eligibility standards for certain entitlement programs would be politically difficult?

★

How to File a Tax Return

As you know, the Federal Government requires huge sums of money in order to operate. In addition, State and local governments also require money in order to provide the many services they offer. Governments obtain much of this money by taxing citizens. One important tax that many individuals pay is an income tax. The Federal Government, most States, and many cities require people to pay this type of tax. For this reason, wage earners must file by April 15 a tax return on which they report their incomes from the previous year. This process is called filing a tax return. The steps for filing a federal tax return are outlined below.

1. Obtain the proper tax forms. If you have filed a tax return in previous years, you should receive your tax forms in the mail. If you have never filed a return before, you can obtain the forms and instructions at local offices of the Internal Revenue Service, most post offices, and many banks. (a) Look in the phone book under the United States government for the local office of the Internal Revenue Service. (b) Look under your State's and your local government's name to get any State or local forms you need.


Form 1040EZ Income Tax Return for Single Filers With No Dependents 1990

Name & address — Use IRS label (see page 9). If you don't have one, please print.

Please print your numbers like this: 9 8 7 6 5 4 3 2 1 0

Your social security number

Please see instructions on the back. Also, see the Form 1040EZ booklet.

Presidential Election Campaign (see page 9) Do you want $1 to go to this fund?

Report your income

1 Total wages, salaries, and tips. This should be shown in Box 10 of your W-2 form(s). (Attach your W-2 form(s).)

2 Taxable interest income of $400 or less. If the total is more than $400, you cannot use Form 1040EZ.

3 Add line 1 and line 2. This is your adjusted gross income.

4 Can your parents (or someone else) claim you on their return?

Note: You must check Yes or No.

5 Subtract line 4 from line 3. If line 4 is larger than line 3, enter 0. This is your taxable income.

Figure your tax

6 Enter your Federal income tax withheld from Box 9 of your W-2 form(s).

7 Tax. Use the amount on line 5 to find your tax in the tax table on pages 14–16 of the booklet. Enter the tax from the table on this line.

Refund or amount you owe

8 If line 6 is larger than line 7, subtract line 7 from line 6. This is your refund.

9 If line 7 is larger than line 6, subtract line 6 from line 7. This is the amount you owe.

Sign your return — I have read this return. Under penalties of perjury, I declare that to the best of my knowledge and belief, the return is true, correct, and complete.

Your signature — Date

X

For Privacy Act and Paperwork Reduction Act Notice, see page 4 in the booklet.

2. Read the instruction booklets. The booklets that come with the tax forms will answer many of your questions about paying income taxes. They will also help you determine which tax form you will need to fill out. (a) Read the instructions and follow them carefully. (b) Follow the directions for getting help in the instruction booklet.

3. Collect your W-2 forms. Each January, you will receive reports from your employer(s) stating the amount of money you earned during the previous year. Usually, these reports are W-2 forms. W-2's report what you were paid, as well as how much money was withheld from your earnings to pay federal, State, and local taxes. W-2's also list FICA withholdings—your contribution to the social security system. The withholdings on your W-2's represent income taxes that you have already paid.

4. Collect other earnings information. You may also receive other statements of income. For example, any bank where you earned interest will report those earnings to you. You must also gather information about any income you made, such as tips and cash payments you received, that does not appear on a W-2 form. Remember that no money has been withheld on these earnings.

5. Complete the form according to the instructions. (a) Check your arithmetic to be sure you have paid enough tax. (b) Be sure to make copies of your tax return before sending it back to the appropriate agency.

16 Chapter-in-Brief

Scan all headings, photographs, charts, and other visuals in the chapter before reading the section summaries below.

Section 1 Where the Money Comes From: Taxes (pp. 405–411) The power to tax is granted to Congress by the Constitution but that power is not unlimited. Congress may levy taxes only for public purposes, not to benefit any private interest. No tax may be applied to any exported articles. Direct taxes must be apportioned among the States according to their populations. Indirect taxes must be uniform in every State. The Federal Government may not tax any governmental function of either State or local governments.

Income taxes levied on individuals and corporations are progressive taxes and are the largest source of federal revenue. Most individuals pay income taxes through withholding from their paychecks. Nonprofit organizations such as churches are not subject to an income tax. Social insurance taxes (payroll taxes) are regressive and pay for three major social welfare programs: Old-Age, Survivors, and Disability Insurance; Medicare; and unemployment compensation. Excise taxes, estate and gift taxes, and customs duties also contribute to federal revenues. Some taxes are used for nonrevenue purposes. Licensing is used for both regulatory purposes and revenue.

Section 2 Nontax Revenues and Borrowing (pp. 412–414) Many nontax sources contribute to the federal treasury: interest on loans made by federal agencies, the "conscience fund," the profit the U.S. Mint makes in the production of coins, and the sale of mint stamps to collectors by the U.S. Postal Service, for example.

The Constitution gives Congress the power to borrow money on the credit of the United States for crisis situations such as war or for large-scale projects. The Federal Government also borrows for deficit financing and has built up a huge public debt. The public debt is expected to climb to $4.5 trillion in 1993. No constitutional limit exists on the amount that may be borrowed. Congress has put a statutory ceiling on the public debt, however, which may be raised whenever the need arises. The current debt will have to be paid by future taxpayers and has always been the subject of much controversy.

Section 3 Spending and the Budget (pp. 416–419) The Federal Government will spend more than $1.5 trillion in 1993, much of it for social security and other entitlement programs. Interest on the public debt is now the second largest object of federal spending, followed by defense. Nearly 80 percent of federal spending is uncontrollable—it cannot be reduced.

The executive branch initiates the spending process by submitting a budget to Congress each year. Each federal agency submits a detailed spending plan to the Office of Management and Budget. These become a part of the budget document sent to Congress by the President. In Congress, it is referred to the Budget Committee and the Appropriations Committee in each chamber. Congress reviews the budget, holds hearings, and makes appropriations. Funds cannot be spent until appropriated by Congress. Congress passes 13 major appropriations bills every year, each covering a broad slice of federal spending. Each of these measures must go to the President for approval. Congress must often pass emergency legislation in the form of a continuing resolution. This allows the affected agencies to continue to function on last year's appropriations.

16 Chapter Review

Vocabulary and Key Terms

progressive tax (p. 407)
tax return (p. 408)
payroll tax (p. 409)
regressive tax (p. 409)
excise tax (p. 410)
estate tax (p. 410)
gift tax (p. 410)
customs duty (p. 410)
deficit (p. 413)
public debt (p. 413)
entitlement (p. 416)
continuing resolution (p. 419)

Matching: *Review the key terms in the list above. If you are not sure of a term's meaning, look up the term and review its definition. Choose a term from the list above that best matches each description.*

1. imposed on the assets of one who dies
2. a tax that falls most heavily on those who are most able to pay
3. the total amount of money owed by the United States, plus all accrued interest
4. payments that federal law says must be paid to all those who meet the eligibility requirements
5. sometimes called tariffs, import duties, or imposts

True or False: *Determine whether each statement is true or false. If it is true, write "true." If it is false, change the underlined word or words to make the statement true.*

1. Certain taxes that fall most heavily on those who are least able to pay them are sometimes referred to as <u>progressive taxes</u>.
2. If you were to receive $20,000 as a present from a relative, you would have to pay an <u>estate tax</u>.
3. In recent decades, the United States has been consistently unable to spend less than it takes in; thus, the country runs a yearly <u>public debt</u>.
4. A <u>payroll tax</u> is one in which the amount owed by the individual is withheld from the person's paycheck.

Word Relationships: *Replace the underlined definition with the correct term from the list above.*

1. When Congress fails to pass the necessary appropriations by October 1st, they pass a <u>measure that allows affected agencies to continue functioning on the basis of the last year's appropriations</u>.
2. These <u>taxes laid on the manufacture, sale, or consumption of goods and/or the performance of services</u> are sometimes called, luxury, sin, or hidden taxes.
3. Certain items such as bananas and Bibles are exempt from <u>taxes laid on goods brought into the United States from abroad</u>.
4. Wage earners in the United States must file annual <u>declarations of income and exemptions or deductions claimed</u>.

Main Ideas

Section 1 (pp. 405–411)

1. What are the four expressed limitations on the Federal Government's power to tax?
2. What is the implied limitation on that power?
3. What are the different taxes by which the Federal Government raises revenue?

4. For what purposes besides raising revenue can the Federal Government use its power to levy taxes?

Section 2 **(pp. 412–414)**

5. List five of the nontax sources of revenue utilized by the Federal Government.
6. How does the historical use of borrowing differ from the practice of governmental borrowing in recent decades?
7. How has the public debt changed since the 1980s?
8. What is the significance of the public debt for future taxpayers?

Section 3 **(pp. 416–419)**

9. What is the largest item on which the Federal Government spends the money it raises?
10. (a) What is the difference between uncontrollable and controllable spending? (b) About what percentage of the annual budget is controllable?
11. In what sense is the budget-making process a joint effort of the President and Congress?
12. What are the roles of the Budget Committees and the Appropriations Committees?

Critical Thinking

1. **Checking Consistency** (p. 19) Consider the discussion of the purposes for which Congress can levy taxes. Do you think that the Constitution intends for Congress to use its power to tax certain activities as a means of regulating or destroying that activity? Explain your answer.
2. **Predicting Consequences** (p. 19) (a) In your opinion, should the United States seek an amendment to the Constitution requiring a balanced budget? (b) What might be the result of such an amendment?
3. **Testing Conclusions** (p. 19) The text states that "the federal budget is a hugely important political document." Use evidence from the chapter to support and/or explain this statement.

Getting Involved

1. **Writing Your Opinion** Write a questionnaire you could use to determine people's views on the issue of federal taxes. To begin with, identify what you hope to learn from the survey, and write a statement that explains why you are conducting it. Then, create a list of questions that you hope will produce the kind of information you are looking for. Remember, the questions in your survey must be carefully worded to avoid influencing people's responses. Review each question to ensure that it is presented in a straightforward and unbiased manner. Once you have refined your questions, reread them, correct any errors, and make a final draft.
2. **Cooperative Activity** As a class, consider the table on federal spending on page 417. Work together to create a new budget that reflects the shared priorities of the class. To begin with, list each of the cabinet-level departments that appear on the table. Then, as a group, prioritize these budget items, placing them in order of descending importance. Continue the discussion until a majority of the class agrees on a list. Repeat the process, this time distributing specific funds for each department.
3. **Gathering Information** You are interested in obtaining some information about government finance. Using the Government Resources Handbook that begins on page 690, identify possible sources you could use to (a) find the amount of money the government raised from various revenue sources; (b) read about the budget submitted to Congress by the President; and (c) examine certain figures presented in the two congressional Budget Committees' May 15th budgets.