CHAPTER 9

ECONOMIC POLICY

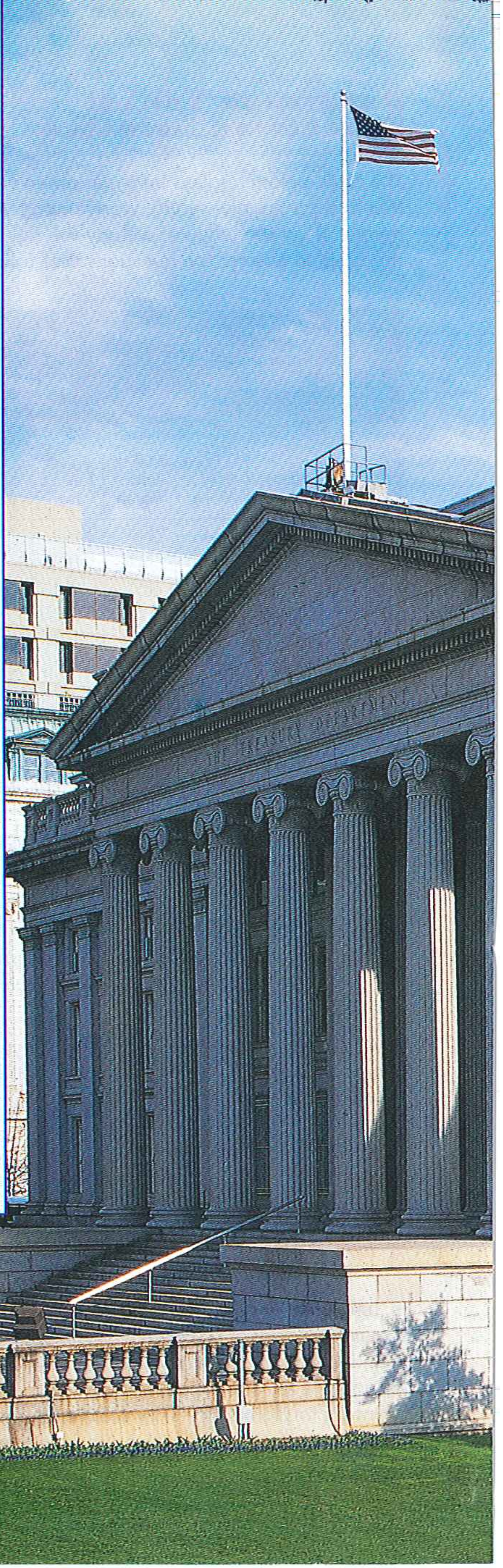
Imagine that you are preparing to start a T-shirt-manufacturing company and have to find a way to finance it. You know that you can raise money from selling the T-shirts, but how do you go about making them in the first place? You need to buy fabric and equipment to produce the T-shirts and hire people to design and sew them. You also need managers to coordinate these employees.

All of this is just to create the T-shirts. You still have to find a place to keep them, stores to buy them, and a way to transport them to the stores.

As you can see, running an individual company involves hundreds of fundamental decisions. Now imagine the process that the U.S. government must go through to finance its operations. It can raise money through taxes and other means, but that is only part of the process. Lawmakers must then decide how to spend the money in a way that will provide for the public good of the more than 260 million people in the United States. In recent years the federal government has spent as much as $1.5 trillion annually trying to accomplish this task. In this chapter you will learn about how the government raises and spends that money.

Government Notebook

In your Government Notebook, describe what impact you think the government's economic policies have on your daily life.



SECTION 1

RAISING REVENUE

Political Dictionary

RESEARCHER CD-ROM

- revenue
- tax
- exemption
- deduction
- excise tax
- estate tax
- gift tax
- customs duty
- standard of living

Objectives

- ★ What are the major types of federal taxes?
- ★ How does the federal government collect taxes?
- ★ What sources of revenue, other than taxes, does the federal government have?
- ★ What factors have affected the political debate over tax policy in recent decades?

As you can imagine, the federal government cannot develop and sustain its programs without **revenue**—the income it collects. Today, **taxes**—charges laid on individuals and businesses by a government—are the federal government's primary source of revenue.

Federal Taxes

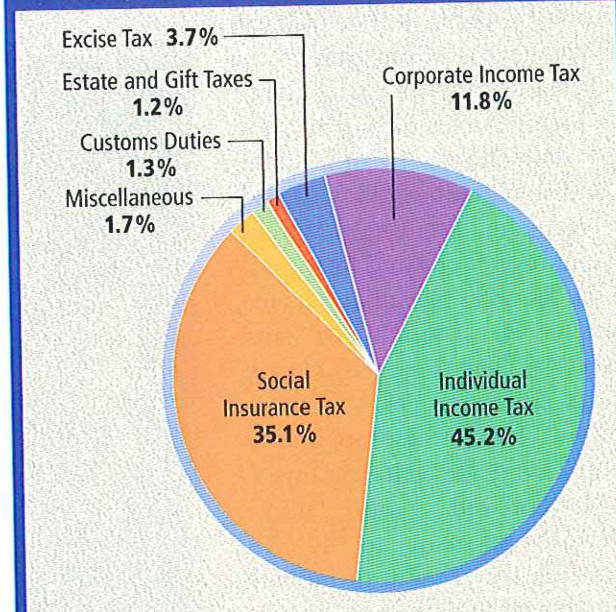
For fiscal year 1996, federal taxes totaled just over $1.4 trillion. (A fiscal year is a 12-month financial period that might or might not follow the regular calendar year. The federal government's fiscal year begins on October 1 and ends on September 30.) The federal government relies on several types of taxes for revenue. The graph on this page shows the percentage of revenue that each tax generates.

Individual Income Tax The individual income tax makes up the federal government's largest source of revenue. Around 45 percent of all federal revenue currently comes from this tax. The individual income tax is levied on a person's taxable income, including wages or salaries, business profits, tips, interest, and dividends (payments received as a return on an investment). It is a progressive tax, which means that it takes a larger percentage from a high-income person than from a low-income person.

The income tax is not assessed on a person's entire yearly income. Rather, taxable income is the sum of all sources of a person's income minus certain deductions and exemptions. Each taxpayer is allowed a standard **exemption**—an amount of income upon which the government does not levy a tax. Plus, other exemptions exist for each dependent—or additional person reliant on the taxpayer's income—for example, a child.

Deductions are amounts that the government allows taxpayers to subtract from their taxable income. For example, the government allows people who have borrowed money to pay for a home to deduct interest payments on the loan from their taxable income. If a person has an income of

Federal Revenue, 1996



Source: *Economic Report of the President: 1997*

Federal revenue comes from several sources. The social insurance tax and the individual income tax make up more than four fifths of this revenue. ***What type of tax makes up the smallest percentage of federal revenue?***

CITIZENSHIP *People who have borrowed money to pay for a home are allowed to deduct interest payments on their loan from their taxable income.* ***What other types of income tax deductions does the government allow individuals?***

$50,000, interest payments totaling $5,000 would reduce taxable income to $45,000. A person may also deduct certain charitable donations. In addition, certain kinds of income are nontaxable; for instance, interest income that is earned on money that has been borrowed by a state or local government is not taxable.

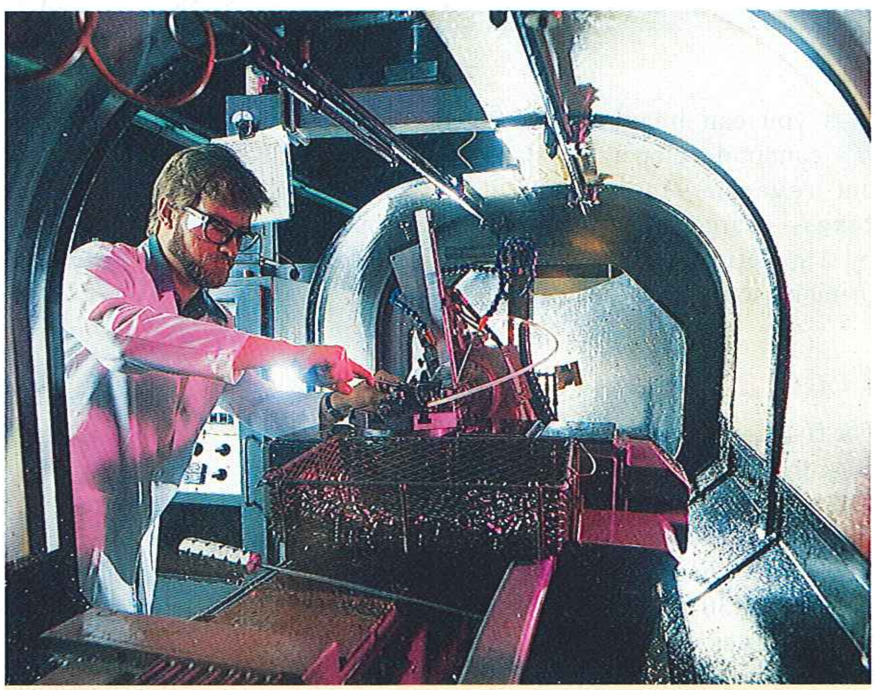
Most employees pay individual income taxes through a payroll deduction system. Under this system, employers withhold a certain amount of money from an employee's pay and forward it to the Internal Revenue Service (IRS)—the branch of the Treasury Department in charge of tax collection. This "pay-as-you-go" system also applies to people who are self-employed. Self-employed people make quarterly payments to the IRS based on the amount of income they expect to earn over the calendar year. Overpayments are typically refunded in the next calendar year.

Do you recognize the date April 15? This day—Tax Day—inspires dread in many people around the country. On or before April 15, all U.S. residents who earned taxable income in the preceding year must file their tax returns with the IRS. Tax returns list all sources of a person's income, any exemptions and deductions the person can legally claim, and the amount of money that he or she owes to or is owed by the IRS.

Corporate Income Tax A corporation—a form of business organization—also must pay a federal income tax. The corporate income tax is based on a corporation's net income—that is, all income earned above the cost of maintaining the business.

The corporate income tax is the most complicated federal tax because of the numerous deductions that the government allows a corporation to take. Many of these tax breaks are granted to help achieve certain national goals. For example, to promote industrial growth, the government may allow a corporation to deduct the costs of expansion and modernization. In addition, corporations may deduct a certain percentage of their charitable donations.

Corporate income taxes are the federal government's third-largest source of revenue. In 1996, for example, corporate income taxes accounted for 11.8 percent of all federal revenue.



PUBLIC GOOD *Corporations may be allowed to take tax deductions for modernizing their equipment and facilities.* ***What other types of deductions can corporations take?***

Social Insurance Taxes In addition to the revenue it receives from income taxes, the federal government collects huge sums of money each year to finance two social welfare programs:

- Old-Age, Survivors, and Disability Insurance (OASDI)—or Social Security—and
- Medicare, which provides health care to the elderly, regardless of their income level.

These social programs are funded through taxes collected under the Federal Insurance Contributions Act (FICA). FICA taxes are paid by both the employee and the employer. As with individual income taxes, FICA taxes are withheld from workers' pay. The employer matches the amount paid by the employee and sends the full payment to the government. Self-employed people must pay the entire FICA tax themselves, although they can deduct 50 percent of the money paid in FICA taxes from their taxable income.

Excise Taxes The government also receives revenue from **excise taxes**, which are levied on the manufacture, sale, or consumption of certain goods or services. The federal government places excise taxes on such goods and services as tobacco, gasoline, alcohol, and telephone systems. In 1996, excise taxes accounted for around 4 percent of federal revenue.

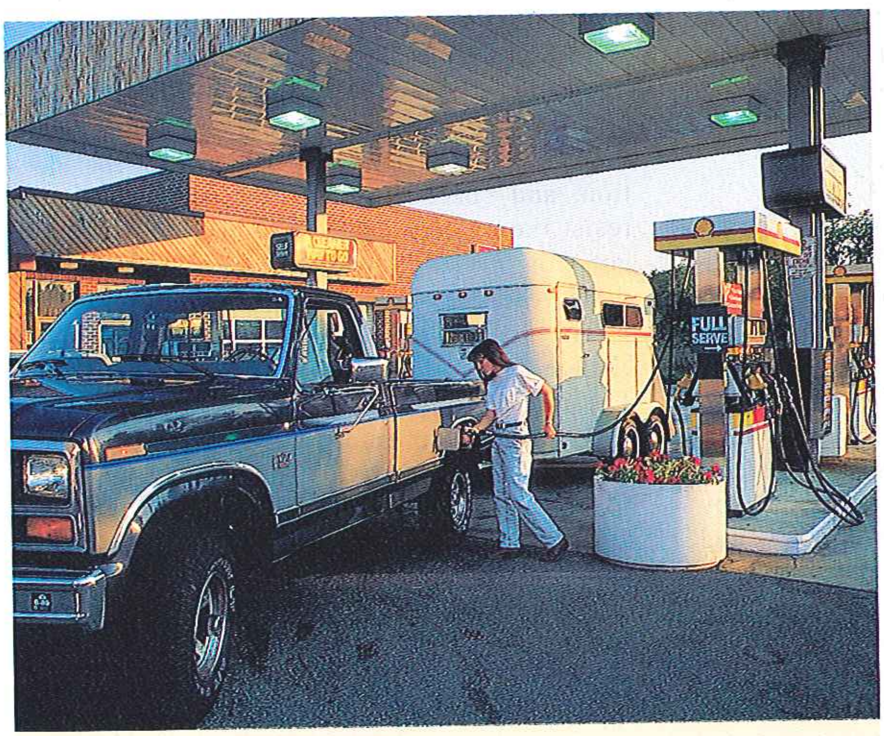
An excise tax is a regressive tax, for it charges all taxpayers the same rate. Because the excise tax imposes the same tax on everyone purchasing a certain good or service, it takes a larger percentage of a lower income than it does of a higher income.

Estate and Gift Taxes The federal government also generates revenue through estate and gift taxes. An **estate tax** is a tax placed on a deceased person's assets when they are transferred to someone else. Federal estate taxes are levied on all such assets worth more than $600,000 (to be gradually increased to $1.2 million over the next few years). A **gift tax** is a tax placed on the transfer of certain gifts of value to individuals. Gift taxes are paid by anyone giving gifts the total value of which exceeds a certain amount in a given year. Federal estate and gift taxes account for only about 1 percent of total federal revenue.

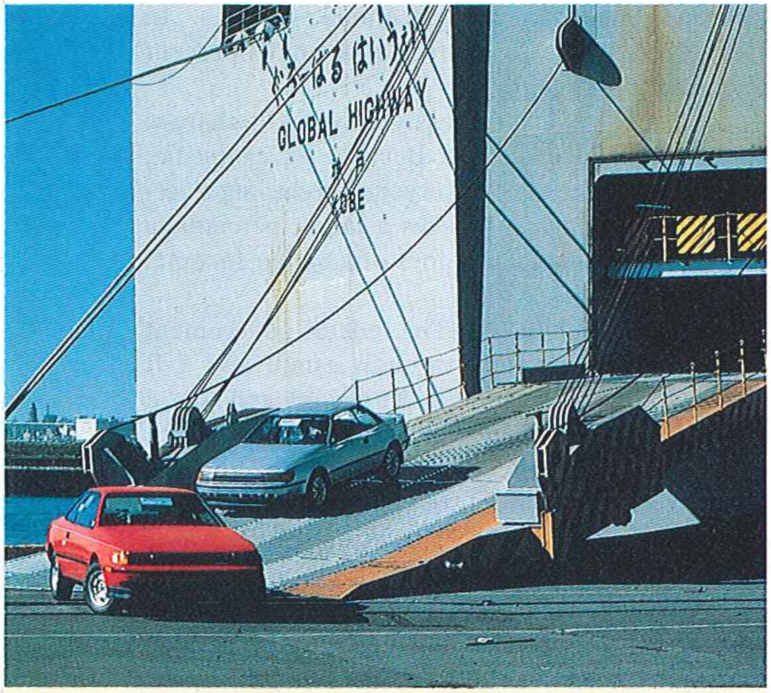
Customs Duties Also known as tariffs or import duties, **customs duties** are taxes levied by the federal government on goods brought into the United States from abroad. The United States collects these duties not only to raise revenue but also to protect U.S. business, agriculture, and industry from harmful foreign competition.

The Constitution gives Congress the power to levy customs duties. Congress has, in turn, authorized the president to raise or lower these duties by certain percentages, as well as to make agreements with foreign countries to help reduce trade barriers. The president's decisions generally are based on the recommendations of the U.S. International Trade Commission (ITC). If the president does not follow the recommendations of the ITC, Congress can override presidential decisions by a two-thirds vote.

Before the introduction of the federal income tax, customs



CONSTITUTIONAL GOVERNMENT *Consumers must pay an excise tax each time they purchase goods such as gasoline, tobacco, and alcohol.* ***What type of a tax is an excise tax?***



POLITICAL FOUNDATIONS *Customs duties are placed on goods brought into the United States from abroad. Congress has the power to levy customs duties.* ***Why does the U.S. government collect customs duties?***

duties were the most important source of revenue for the United States. Today, however, customs duties amount to only about 1.3 percent of federal revenue.

Nontax Revenue

Taxes are not the only source of revenue for the federal government. In fact, in 1996 the net federal receipts—the total amount of money raised by the federal government—included more than $25 billion in nontax revenue.

This money comes from several sources. The main source of nontax revenue is composed of earnings by Federal Reserve banks. (The Federal Reserve system and its role in the U.S. economy are more fully explained in Section 2.) Fees and fines collected by various government agencies also provide revenue for the federal government.

Do you have a passport? Whenever you pay the processing fee for a federal service such as a passport, you are contributing to federal revenue. Other nontax revenue includes fees paid for patents, trademarks, or copyrights; fines imposed by the federal courts; and money earned from the sale or lease of federal lands.

Politics of Making Tax Policy

When lawmakers create tax policy, they must address two questions: How high should taxes be, and what tax advantages should be offered? These questions have been answered in different ways during U.S. history. In tax debates during recent decades, Democrats—motivated in part by the desire to fund government programs to aid less-advantaged citizens—generally have favored higher and more progressive taxes. Many Democrats also have opposed tax advantages for the wealthy. Republicans generally have favored lower taxes.

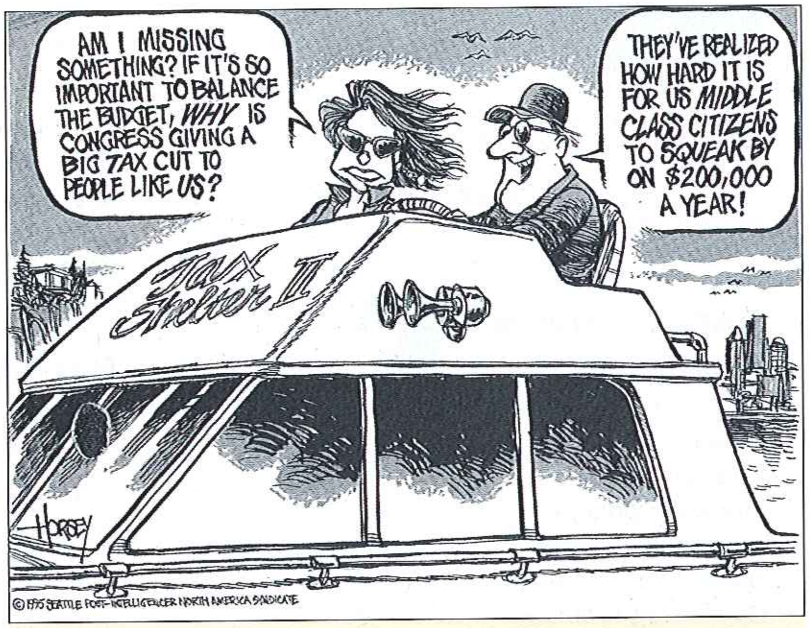
The most significant feature of the tax debate since the 1970s, however, has been growing public opposition to taxes. By the late 1970s, disillusionment with government led people to question the usefulness of much government spending. Around the same time, supply-side economics was gaining support among Republicans. Supply-side economists argued that taxes should be cut to stimulate economic growth. According to this view, if less income were taxed, people would produce more because they would get to keep more of their earnings.

In 1980 Jack Kemp, then a Republican member of Congress from Buffalo, New York, persuaded presidential candidate Ronald Reagan to adopt the supply-side theory. Reagan made the call for a cut in income taxes one of the major themes of his campaign. Reagan won the election, and—because Democrats were unable to resist the public's tax-cutting zeal—in 1981 he got Congress to accept a 25 percent cut over three years.

The tax cut of 1981 was one of two major changes in tax law during Reagan's presidency. The other change was the Tax Reform Act of 1986. Income tax rates were slashed again and made less progressive. This time, many tax advantages enjoyed by the wealthy also were repealed. One might say the legislation reflected the main ideas of each party—Republican support for low tax rates and Democratic opposition to tax advantages for the wealthy.

In 1990, huge budget shortfalls that had appeared in the late 1980s inspired compromise on a tax increase, which Congress passed and President George Bush signed. In 1993 President Bill Clinton unveiled a plan for taking further action to reduce the budget shortfalls. The

Democrat-dominated Congress responded by passing a sharp increase in the top income tax rate, affecting about 1.2 percent of all taxpayers. After the elections of 1994, however, when Republicans became a majority in Congress, tax cuts were back on the national agenda. As you will learn in Section 4, Congress and the president reached an agreement on modest tax cuts within the framework of a plan to balance the budget by the year 2002.



PUBLIC GOOD *Some people believe that government should redistribute wealth through taxes.* ***What criticism does this cartoon make of government tax policy?***

Tax Policy and the Public Good

Tax policy decisions affect both the U.S. **standard of living**—that is, how well people in general are doing—and the distribution of economic benefits. People disagree about whether or not government should redistribute wealth through taxes. Supporters of redistribution argue that the natural distribution of the income and wealth produced by the U.S. economy is unfair. Unequal opportunities and sometimes sheer luck have too big an impact on economic success, they say. Therefore, the government should equalize wealth through income redistribution.

Opponents of income redistribution make several counterarguments. First, they hold that the uneven distribution of income broadly reflects important differences in people's efforts to earn a living as well as in their contributions to society. They also argue that redistribution schemes hurt economic growth and hence tend to reduce people's overall standard of living. High taxes on wealthy individuals take away some of the personal benefit from their economic endeavors and thus discourage them from making larger contributions to society.

SECTION 1—REVIEW

1. Define the following terms: revenue, tax, exemption, deduction, excise tax, estate tax, gift tax, customs duty, standard of living.
2. What type of tax generates the most revenue for the U.S. government? What are the other types of taxes?
3. Explain the pay-as-you-go system of tax collection. How do self-employed people pay taxes to the federal government?
4. What are the primary sources of the federal government's nontax revenue?
5. Discuss the issues that have influenced tax policy in recent decades. How have Republicans and Democrats differed in their views?
6. **Thinking and Writing Critically** In addition to raising revenue, what purposes might excise, estate, and gift taxes serve?
7. **Applying CONSTITUTIONAL GOVERNMENT** The federal government's power to tax is stated in the Constitution. Why might it be necessary to have such powers outlined in the Constitution? Explain your answer.

SECTION 2

INFLUENCING THE ECONOMY

Political Dictionary

free enterprise
recession
inflation
fiscal policy
monetary policy
disposable income
Federal Reserve system
reserve requirements
discount rate
open-market operations
bond
Keynesianism
deficit
monetarism

Objectives

- ★ How is the U.S. economy organized?
- ★ What are the goals of economic stabilization policy?
- ★ What tools does the U.S. government use to stabilize the economy?

The ways in which the U.S. government chooses to spend \$1.5 trillion a year directly affect the overall national economy. There is more to economic policy, however, than just raising money and spending it on government programs. The government also attempts to stabilize the economy and promote economic growth.

The two main goals in economic stabilization are full employment and low inflation. The government uses two tools to achieve these goals: fiscal policy and monetary policy. It also uses industrial policy to promote growth in the economy. This chapter will explain just what each of these terms means. To understand how government economic policies work, however, you must first understand how the U.S. economy is organized.

Organization of the U.S. Economy

The United States has what is known as a **free-enterprise** economy—one in which business can be conducted freely, with little government intervention. A free-enterprise system is dependent on a market in which goods and services are exchanged freely.

Free-Enterprise System The free-enterprise system of the United States is based on five main rights:

- ★ to own private property and enter into contracts,
- ★ to make individual choices,
- ★ to engage in economic competition,
- ★ to make decisions based on self-interest, and
- ★ to participate in the economy with limited government involvement and regulation.

A major benefit of the free-enterprise system is that it produces what consumers want. If consumer demand for blue jeans is higher than that for formal gowns, for instance, more jeans

POLITICAL FOUNDATIONS *In a free-enterprise system, individuals can choose which goods and services they want to buy.* ***Why do some people believe that private ownership and free markets provide the best environment for economic growth?***

will be produced than gowns. In addition, producers who offer lower-quality jeans at the same price as their competitors' higher-quality jeans will likely sell little merchandise or even go out of business. Supporters of free enterprise believe that private ownership and free markets will provide the best environment for economic growth, because businesspeople wanting to make money are driven constantly to look for new things to produce or better ways to produce them.

Government and the Economy Economic policy in the U.S. free-enterprise system often has been a source of political controversy. The basic political disputes involve the extent to which government should intervene in the operation of the free market (such as when consumer demands shift from American-made products to goods made abroad).The free market leaves some people unemployed or with low-paying jobs. Some people believe that government should address this problem by making the distribution of income and wealth more even. Others believe that government should reduce the pain when disruptions occur.

In addition, although the free market usually works well to achieve economic growth, many people think that there are situations in which government intervention can produce stronger economic growth than the free market can when left alone. Similarly, some argue that the government should play a role in stabilizing the economy by taking steps to lessen the cycles of boom and **recession**—economic downturns—that many economists see as characteristic of a free-market system.

Democrats have traditionally favored greater government intervention in the economy. In general, they support greater equality in income and do not believe as strongly that the free market will solve all economic problems. These ideas gain greater electoral support from lower-income voters, who are more likely to suffer from economic disruption or instability. Republicans have been inclined toward minimizing government involvement, a policy often called laissez-faire (French for "let [the people] do [as they will]"). Laissez-faire policy reflects a greater belief in the ability of the market to create high overall standards of living, as well as a worry that government intervention tends to hurt rather than help the economy. Support for laissez-faire policy often comes from higher-income voters, who have more of a cushion against economic disruption or instability.

Stabilization Goals

The terms *economic growth* and *economic stabilization* mean different things to the U.S. economy. Economic growth determines a country's long-term standard of living. It determines whether a country will achieve more wealth or remain poverty-ridden. Economic stability involves changes in unemployment and **inflation**—the general rise in prices that often accompanies economic booms. Economic growth rates determine how high the economic airplane is flying; economic stability determines how bumpy the ride is. It is possible for a growing economy to be unstable. Likewise, it is possible for a poor country to have a low rate of inflation and unemployment.

The government attempts to fulfill two main goals with a stabilization policy. These are full employment and low inflation.

Full Employment Full employment is an obvious goal for government because people need income to survive. During economic downturns, employment levels drop, sometimes dramatically. Loss of a job can cause serious problems even for two-income households, which can have difficulty paying all of their monthly bills—such as payments on a home loan—on a single income. In addition, unemployment hurts the general public because it lowers the total output of the economy.

Low Inflation During economic upswings, harmful, inflationary pressures can develop. Thus, stabilization policy is designed to avoid major growth booms in the economy, as well as recessions.

Inflation creates significant problems, such as hindering economic growth. It pushes up interest rates beyond the level justified by the current rate of inflation, as banks cushion themselves against the risk of even higher inflation in the future when the borrowed money will be paid back. Because higher interest rates mean an increased cost of borrowing money, they discourage investment in new plants and equipment.

Inflation also has significant psychological effects. When prices start going up rapidly, people feel insecure, as if an earthquake were shaking under them. In a famous line many people think was a key element in his landslide victory in the 1980 presidential campaign, Ronald Reagan asked during a televised debate with President Jimmy Carter, "Are you better off today than you were four years ago?" In fact, the numbers showed that many people *were* better off: real per capita spendable income in 1980 was nearly 7.5 percent higher than when Carter left office in 1976, and the unemployment rate was lower. A lot of people *felt* worse, however. The biggest reason was that inflation had been running at a rate of more than 10 percent.

Tools for Economic Stabilization

Government may use both fiscal and monetary policies to deal with unemployment and inflation. **Fiscal policy** is a set of government spending, taxing, and borrowing policies used to achieve desired levels of economic performance. **Monetary policy** is a set of procedures designed to regulate the economy by controlling the amount of money in circulation as well as the level of interest rates.

Fiscal Policy

The federal government uses the budget to develop fiscal policy through its taxing and spending plans. By increasing spending or by lowering taxes, the government can increase the overall level of demand for goods and services in the economy, thereby putting more money into a slow-moving economy and stimulating growth. On the other hand, the government may decide to decrease spending if a rapidly growing economy produces inflation.

In addition to adjusting spending, the federal government also uses taxation as a tool for stabilizing the economy. If unemployment is very high, for example, the government may respond by cutting taxes. A tax cut will increase people's **disposable income**—the amount they have to spend after accounting for financial obligations such as taxes—and allows businesses to keep more of their profits. When people have more money, demand for goods and services rises. When businesses have more, they are able to invest money and hire more workers, thus decreasing unemployment.

If inflation is high, however, policy makers may raise taxes. Higher taxes reduce a person's disposable income and a corporation's net profits. This reduces the amount of money people spend and slows business activity, which, in turn, tends to lower prices.

Monetary Policy

The second way in which the federal government tries to influence the economy is through its monetary policy. Monetary

How the Government May Use Fiscal Policy

TO ENCOURAGE GROWTH

Increased Spending, Lower Taxes

- The government spends more money to stimulate growth in the economy.
- The government cuts taxes to increase individual spending and business output.
- Businesses expand and create jobs.

Result

Increased growth in the economy and higher employment

TO ENCOURAGE STABILIZATION

Increased Taxes, Lower Spending

- The government increases taxes to slow a rapidly growing economy and widespread price increases.
- Individuals spend less and businesses make smaller profits.
- Slower business activity and decreased spending lead to lower prices.

Result

Low inflation rates and stable growth in the economy

The government's taxing and spending plans may be used to achieve different results.
What results may be achieved if the government increases taxes?

Linking Government and Economics

Raising the Minimum Wage

Thirteen million Americans work in minimum-wage jobs in the service, retail, and agricultural industries. Many of these people, often trying to support a family as well as themselves, applauded congressional efforts in 1996 to raise the minimum wage.

President Bill Clinton backed the plan. "If we value work, if we value families, we ought to raise the value of the minimum wage. Now is the time to put politics aside . . . and help lift the lives of millions of America's workers." However, 1996 also was an election year, and the proposal to raise the minimum wage became entangled in politics. Politicians, business owners, economists, and the public aired differing views about the government's role in helping workers and the possible economic impact of the legislation.

Many restaurant owners predicted that raising the minimum wage would make earning a profit extremely difficult—"I would probably end up out of business," concluded Nevada pizzeria owner Sandra Murphy. The National Restaurant Association warned that raising the minimum wage would mean that many minimum-wage workers would lose their jobs, because these workers did not produce enough to justify a higher wage. Economists warned that because employers would have to pay more to employees, fewer new jobs would be created.


Many workers received an increase in their wages after Congress passed a bill to raise the minimum wage.

Some politicians agreed with restaurant owners and strongly opposed the wage hike. Senator Don Nickles, for example, criticized it as the response of a heavy-handed federal government interfering in the free market. Bob Dole, the Republican presidential candidate in 1996, accused the Democrats, most of whom supported the increase, of caving in to pressure from labor unions.

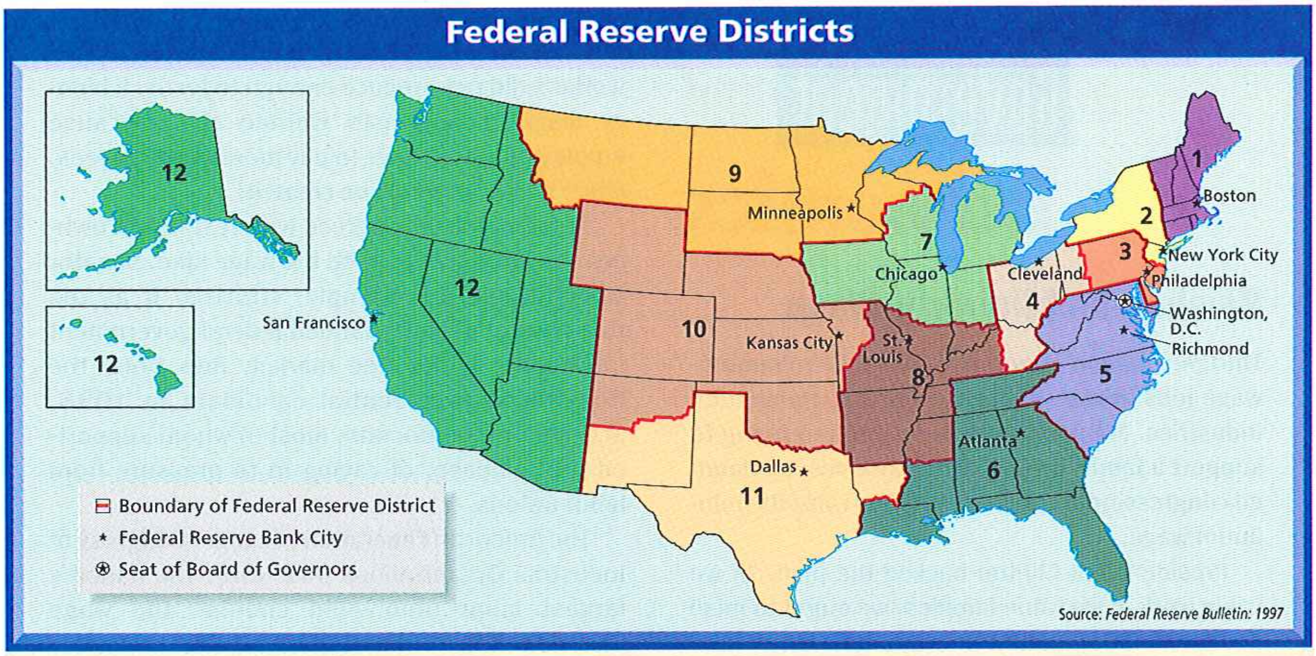
The American Federation of Labor–Congress of Industrial Organizations (AFL–CIO)—the nation's largest labor union—did endorse the wage increase. The union noted that the minimum wage had not increased since 1991. Union leaders argued that minimum-wage workers' pay, when adjusted for inflation, was near a 40-year low. They predicted that raising the minimum wage would ease poverty and help lower taxes by enabling people to rely less on food stamps and other public assistance.

Both sides of the debate used economists' studies to support their position. Supporters of a minimum-wage increase pointed to research showing that the 1990 and 1991 minimum-wage increases caused little if any job loss. Critics of the wage hike, however, emphasized studies that predicted the increase would reduce the number of minimum-wage jobs by 20 percent.

In this war of conflicting numbers, public support proved the most important. Polls showed that 80 percent of Americans favored an increase in the minimum wage. Eventually, Republicans joined with Democrats to pass the measure. In August 1996 President Clinton signed into law a two-step increase in the minimum wage, which brought the minimum wage to $5.15 in September 1997.

What Do You Think?

1. Do you think that the 1996 minimum-wage increase promoted the public good? Why or why not?
2. What were the major arguments against the minimum-wage increase?



The Federal Reserve system is divided into 12 districts. Each district has its own Federal Reserve bank, which is owned by other banks in the district. ***In which Federal Reserve district is your state located?***

policy is controlled through the **Federal Reserve system**—or the "Fed"—which is the central banking system of the United States. The Fed, created by the Federal Reserve Act of 1913, is an independent government agency.

The Fed is not a bank like your neighborhood bank. You cannot set up an account there. It gives out no automated teller cards, and it will not lend you money. Rather, the Fed is a "central bank" that controls how much money is in circulation. The Fed is organized unlike any other government agency. It is made up of 12 regional Federal Reserve banks and thousands of privately owned member banks.

The Fed's two main decision-making bodies are the Board of Governors and the Federal Open Market Committee (FOMC). The Board of Governors, located in Washington, D.C., heads the Federal Reserve system. It is made up of seven members who are appointed by the president and confirmed by the Senate for 14-year terms. The chair of the Board of Governors is also appointed by the president. The board supervises the Fed's banking services and issues policies that regulate the U.S. money supply. It also oversees the activities of the district and member banks and approves the appointments of their presidents. The FOMC steers the strategy of the Fed's monetary policy. The seven members of the Board of Governors and the president of the Federal Reserve Bank of New York are permanent members of the FOMC. The remaining four members are presidents of district Federal Reserve banks who serve one-year terms on a rotating basis.

The Federal Reserve system is divided into 12 geographic districts, each of which houses one Federal Reserve bank. The 12 district banks, which are not operated for profit, perform regulatory functions for banks in their district. After subtracting their operating costs, the district banks send their yearly income to the U.S. Treasury.

Each Federal Reserve bank is owned by other banks in the district, which buy stock in the district bank. These banks are called member banks. There are around 9,700 commercial banks in the United States. Of these, more than 3,700 are members of the Federal Reserve system.

Making Monetary Policy

The Federal Reserve uses three tools to implement monetary policy. These are

- reserve requirements,
- the discount rate, and
- open-market operations.

Reserve Requirements The first tool the Fed uses to implement monetary policy involves rules for banks. These **reserve requirements** determine the minimum amount of money that a bank must keep on hand at all times and thus not lend out to its patrons. By raising reserve requirements, the Fed lowers the amount of money that banks can lend, thereby decreasing the money supply in the economy. A lowering of reserve requirements has the opposite effect.

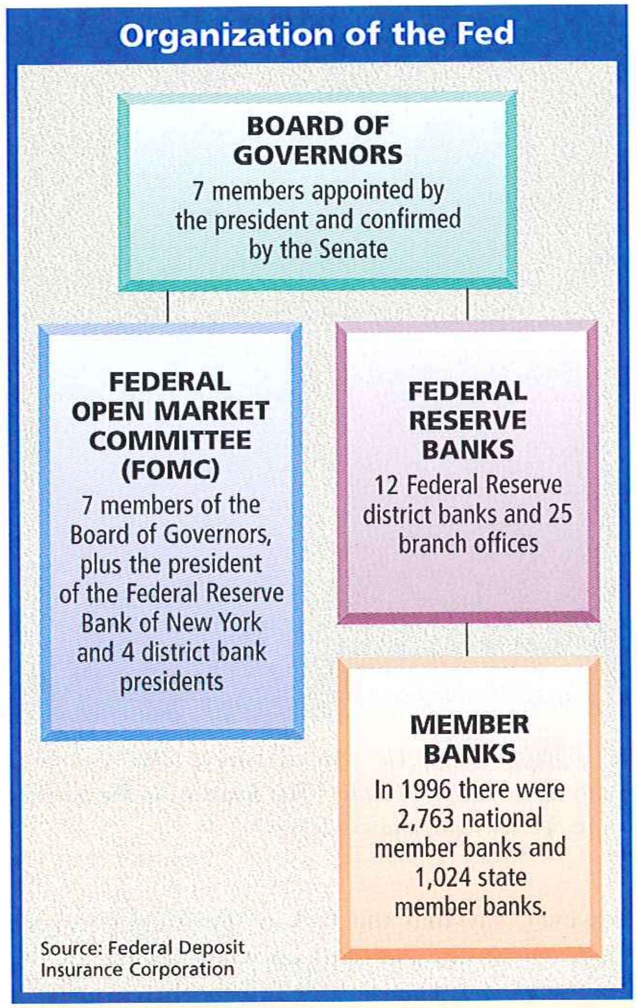
The Fed rarely changes reserve requirements, for to do so creates uncertainty in the banking system. Changes may also make it more difficult for banks to make long-term loans and investments.

Discount Rate A second tool that the Federal Reserve uses is the **discount rate**—the interest rate that it charges to banks. Remember that the Fed is a banker's bank. If a bank wants to borrow money so that it can, in turn, loan the money to a person or business, it can do so by borrowing from the Fed. The lower the discount rate, the more inclined banks are to borrow from the Fed; the higher the rate, the less inclined they are. Thus, because the overall money supply in the U.S. economy increases when banks lend more money to customers, the Fed can influence the economy by adjusting the discount rate.

The Fed also sets the federal funds rate—the interest rate at which banks can borrow funds from each other. Raising or lowering the federal funds rate can encourage or discourage banks from borrowing from each other. Although it does not affect the money supply directly, raising or lowering the federal funds rate does have an impact on banking and the economy in general.

Open-Market Operations The most common way the Federal Reserve influences the economy is through **open-market operations**—the purchase or sale of bonds in order to finance the operations of government. **Bonds**, or securities, are certificates issued by a government to a lender from whom it has borrowed money. By buying or selling these bonds, the Fed is able to increase or decrease the money supply in the economy.

When the Federal Reserve buys government bonds from private investors, the money supply increases because the Fed pays by adding funds to the general economy. In contrast, when the Fed sells bonds, it tightens the money supply by accepting funds that had been in circulation.



The Federal Reserve supplies money to member banks across the country. Member banks must follow the rules and regulations established by the Fed. ***Which branch of the Fed steers overall monetary strategy?***

Monetary Versus Fiscal Policy

Monetary policy can work much faster than fiscal policy. Fiscal policy is tied to annual budgets and involves a lag between when an economic problem occurs and when shifts in fiscal policy are actually felt. A change in monetary policy, on the other hand, works much more quickly, since a change in policy is effective immediately.

Remember that fiscal policy is made entirely by the president and Congress. They decide how much to tax and how much to spend. Monetary policy, however, is controlled by an independent agency that is not elected by the people. For this reason, some people believe that the Fed's role in making economic policy is too great. Others,

PUBLIC GOOD *The Federal Reserve influences the economy by buying and selling bonds.* ***What happens to the money supply when the Fed sells government bonds?***

however, say that the lack of political pressure ensures that the Fed will do what is best for the economy, not what is best for a political party.

The country can be guided most effectively when fiscal and monetary policy are used together. For example, if inflation is the most important economic problem, monetary and fiscal policies should work together to curb demand and thus reduce prices. The Fed would need to reduce the money supply and the availability of credit, while Congress and the president would need to agree on a fiscal policy that involves decreased federal spending, increased taxes, or both.

Economic Policy and the Public Good

Between the 1930s and the 1960s the most important economic policy debates between Democrats and Republicans involved stabilization policy. Democrats wanted government to play an active role in stabilizing the economy, and Republicans opposed such a role. During the last two decades, stabilization policy debates have become less important as political leaders have turned their attention to issues of long-term economic growth.

The economic doctrine supporting active government stabilization is most often called **Keynesianism** (KAYN-zee-uh-ni-zuhm), after John Maynard Keynes. Keynes was a British economist who called for the government to stimulate the economy during the Great Depression of the 1930s. The basic argument that Keynesians make is that active government stabilization policies can counteract instability in the normal operation of a free-market economy. In response to an economic slowdown, Keynesian fiscal policy calls for the government to run a budget **deficit**—or let expenses exceed revenue—and to use its monetary policy to provide low interest rates to stimulate the economy.

The high point for Keynesianism came during the 1960s. In 1963 President John Kennedy proposed a tax cut, hoping that consumers would respond by spending more money and thus stimulating the economy. The proposed tax cut was not to be offset by government spending cuts, however, and would therefore result in a budget deficit. Kennedy hoped that the deficit would eventually disappear as the economy improved.

The tax cut, which was actually passed during President Lyndon Johnson's administration, contributed to increased economic growth and seemed to support Keynesian ideas. Loosening restrictions on spending made it possible to expand spending on public aid while running budget deficits.

During the 1970s Keynesian doctrine became subject to growing intellectual and political challenges. The benefits of the economic boom in the years after the Kennedy-inspired tax cut were increasingly undercut by inflation. Then in 1973 an increase in oil prices after an embargo by oil-producing nations resulted in a mixture of high inflation and lower economic growth. In this climate, Milton Friedman, a University of Chicago professor and leading economic conservative, popularized **monetarism**.

Monetarists argue that a market economy, working properly and left alone, most likely will operate at full employment and low inflation.

They believe that economic downturns—including the Great Depression—have occurred not because of economic instability, but because mistaken government policies have intervened in the economy's operation and drastically cut the supply of money. Monetarists believe that government's only role in terms of economic stabilization should be to keep the money supply expanding at a steady pace to accommodate economic growth.

Industrial Policy and Economic Growth

Stabilization policy aims to even out the bumps in the economy. By contrast, over the past 15 years there also have been debates about whether government aid (often called industrial policy) can increase overall economic growth.

When the phrase *industrial policy* was introduced in the early 1980s, it frequently referred to attempts to prop up declining industries. Arguments on behalf of aid to such industries involve maintaining the current number of jobs in these inefficient industries rather than improving the overall economy. In recent years, however, the phrase has been used almost exclusively to refer to aiding "industries of the future." These industries—particularly high-tech ones such as computer technology, semiconductors, telecommunications, and biotechnology—hold promise for future economic growth. Supporters suggest that aiding such industries would improve overall economic growth by allowing these new industries to move forward more quickly.

Supporters of industrial policy also have argued that Japan has successfully followed a bold policy to target important industrial sectors, particularly those involving high-tech consumer goods. They also point to various internationally successful sectors of the U.S. economy, such as agriculture, computer technology, biotechnology, and aviation, which have benefited both from significant government research money and from government purchases (particularly for defense). Industrial policy supporters argue that if such industries are not supported by the government, they will lag behind their global competitors in basic scientific research and development, for market forces alone will not support such future-oriented endeavors.

On the other hand, opponents of industrial policy have expressed skepticism about the ability of government to improve on the operation of the free market. They hold that the government cannot do a better job than private investors in picking the economic winners of the future and should thus stay on the sidelines.

The most insistent criticism of industrial policy has to do with the way the U.S. political system works. Even if a good case might be made for industrial policy in theory, opponents argue, pork-barrel politics and interest group influence are likely to result in the wrong industries being chosen for government help.

SECTION 2—REVIEW

1. Define the following terms: free enterprise, recession, inflation, fiscal policy, monetary policy, disposable income, Federal Reserve system, reserve requirements, discount rate, open-market operations, bond, Keynesianism, deficit, monetarism.

2. Describe the organization of the U.S. economy.

3. What two factors are most important in making economic policy?

4. What is the difference between monetary and fiscal policy?

5. **Thinking and Writing Critically** Consider the institutions involved in making both fiscal and monetary policy. Why is it important that these two types of policies be used together?

6. **Applying PRINCIPLES OF DEMOCRACY** Conduct an Internet search on the Federal Reserve system. You may want to consult the chart on page 201 that shows the organization of the Fed to find search words that you might use. Briefly describe the information you find.

SECTION 3

THE FEDERAL BUDGET

Political Dictionary

federal budget
Office of Management and Budget
Congressional Budget Office
resolution
reconciliation

Objectives

- How has the federal budget-making process changed over the years?
- What role does the president play in planning the budget?
- Why are attempts at reducing the budget politically controversial?

In 1789 Congress created the Treasury Department as one of the original executive departments. Alexander Hamilton, the first secretary of the treasury, established the role of the federal government in the economy by promoting a form of national economic planning. Hamilton believed that the country required a national spending program based on the priorities and needs of the nation as a whole. The executive branch would submit departmental estimates of funding to Congress, asking for the money needed to carry out the programs. Today, the U.S. national spending program is known as the **federal budget**.

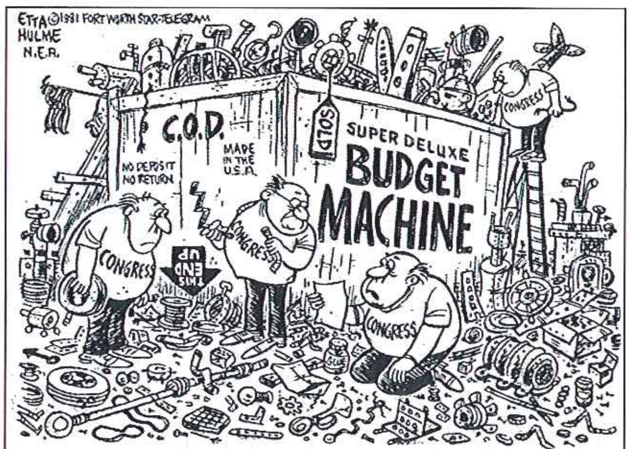
Changes in the Budget Process

Though the idea of preparing a federal spending plan came from Alexander Hamilton, the means by which the budget is prepared has changed dramatically over the past two centuries. In fact, the budgetary process as it now stands is fairly new. Before the early 1900s the United States had no formal system for planning how to spend the revenues that it collected. Each federal department simply issued requests for funds as the money was needed. By the early 1900s many people in government, including President William Howard Taft, were calling for a more orderly budget process.

Budget and Accounting Act of 1921 A significant step in reforming the national budget process was made in 1921 with the passage of the Budget and Accounting Act. This legislation gave a newly established Bureau of the Budget the power to raise or lower agencies' spending requests before they were sent to Congress.

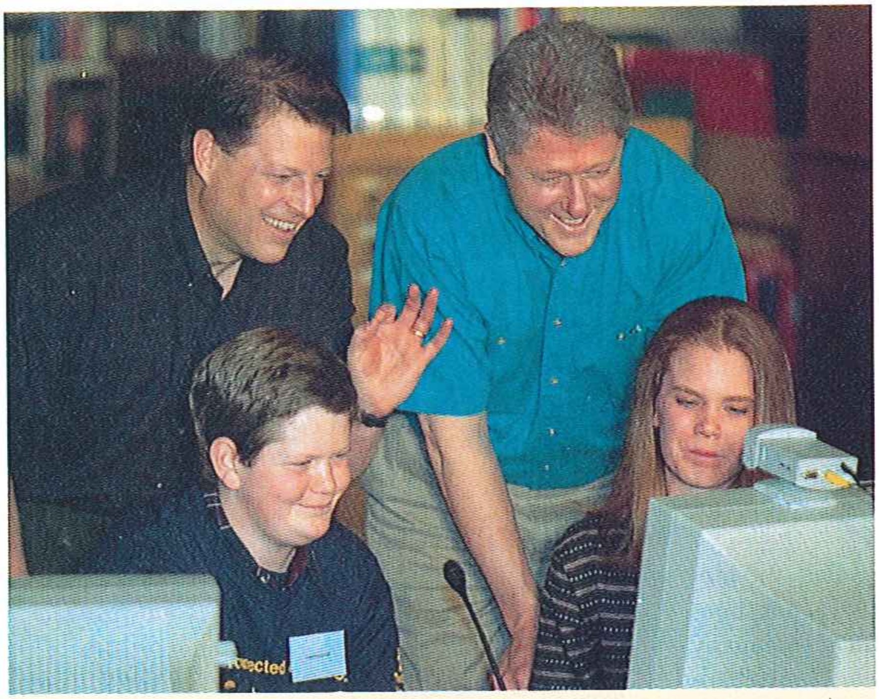
Office of Management and Budget In 1939 the Bureau of the Budget was moved from the Treasury Department to the Executive Office of the President. This made it easier for the president to influence the budget and thus increased the president's role in making economic policy. The position of director of the **Office of Management and Budget** (OMB)—as the bureau was renamed in 1971—has cabinet-level status.

Congressional Budget and Impoundment Control Act of 1974 The process by which Congress examines the president's budget proposal has changed considerably over the last two decades. For nearly 200 years, there was no process by which Congress could consider the budget as a whole. Congress never voted on overall



"...Comes unassembled. Does not include batteries or instructions...."

POLITICAL PROCESSES *The budget process has undergone numerous changes over the past 100 years, yet it is still a complex procedure that does not always run smoothly.* ***What does this cartoon imply about Congress's ability to prepare the budget?***



PUBLIC GOOD *One of President Bill Clinton's campaign promises was to provide funding to public schools for Internet access. Here, President Clinton and Vice President Al Gore visit a computer facility at a public school.* ***What is the president's role in the preparation of the budget?***

spending levels but rather on a series of separate appropriations bills for different agencies over several months. This made it difficult to compare one appropriation with another. In theory, a member could vote in favor of every proposal to spend money and against every proposal to levy taxes.

To amend this situation, Congress passed the Congressional Budget and Impoundment Control Act of 1974, which limited presidential impoundments and set ceilings for the budgets each year. (An impoundment is a refusal by the president to spend funds that Congress has authorized and appropriated.)

The 1974 Budget Act created budget committees in the House and Senate to allow Congress to review the president's budget proposal more systematically. The law also created the **Congressional Budget Office** (CBO) to provide economic data, information, and analysis to both houses of Congress.

Preparing the Budget Today

When preparing a budget, agencies do not begin with a blank slate. Rather, they—and the president and members of Congress—look over the previous year's budget to determine which areas of government should receive more, or less, funding than last year. That is, if an agency received an appropriation of $1 billion last year and is asking for $1.1 billion this year, examination typically will not center on the $1 billion, but on whether the additional $100 million is justified.

President's Role The budget process begins with the Office of Management and Budget's guidelines about the overall fiscal situation that detail the kinds of programs the president wants to support or reduce. Each agency then uses those guidelines to develop a spending proposal, which is considered by OMB. Two considerations tend to drive OMB's evaluation of a proposal: keeping spending in line and remaining loyal to the president's priorities.

Members of the OMB staff review the agencies' requests and present their overall recommendations to the president. Over the next several months, each federal agency, OMB, and the president review and negotiate a working budget proposal. Upon completion, the budget proposal is submitted to Congress before the established deadline, which is January 1.

Appropriations Process According to the U.S. Constitution, "No money shall be drawn from the Treasury, but in consequence of appropriations made by law." Once the president's proposed budget has been submitted, Congress takes the lead in the budgetary process. It must draft and approve spending and revenue bills for the coming fiscal year. As noted in Chapter 6, spending for a program must first be authorized, and then funds are appropriated for it. Authorizations and appropriations are arrived at after a long process of review, debate, and compromise.

The Budget Committees of both the House and Senate set overall spending targets and revenue goals, based at least partly on the president's proposal. Congress then must pass a resolution setting

Careers in Government

RESEARCHER CD-ROM

Economist

On a given day, economists at the Congressional Budget Office (CBO) might be called on by Congress to analyze the potential economic impact of a major bill, prepare a report on how the economy will fare in the next five years, and strategize about how to reduce the deficit. At the General Accounting Office (GAO), economists might wade through the budget of a government agency, looking for ways to cut costs.

Aside from colleges and universities, the federal government is the largest employer of economists. State and local governments also employ many economists to work in areas such as welfare and urban economics, monetary and fiscal policy, and industrial organization. Other economists work at universities as teachers and researchers. In addition, economists work for businesses and industries in areas such as finance, marketing, and economic growth and development.

People with skill at crunching numbers may find a position in economics fulfilling. Laura D'Andrea Tyson—an economics professor at the University of California at Berkeley and former chair of the National Economic Council (NEC)—became an economist for several reasons. "I felt (economics) was a wonderful combination of being able to be engaged in public-policy problems and, at the same time, use my analytic skills," she explained.

In 1993 Tyson became the first woman to serve as chair of the Council of Economic Advisers. As chair, she advised the president on tough issues such as the budget deficit and health-care reform. She also testified before Congress on economic issues. In 1995 she joined the NEC, taking on the high-pressure job of coordinating the president's overall economic strategy.

Laura D'Andrea Tyson was the chair of President Clinton's Council of Economic Advisers and, later, of the National Economic Council. She now teaches economics at the University of California at Berkeley.

Most people who go on to become economists first sharpen their analytic skills by earning a college degree in economics. Many also pursue advanced degrees. Economists in key government posts, such as those Tyson has held, have extensive research and teaching experience as well.

In a time when the federal government is spending billions of dollars a day, the number-crunching skills of government economists are increasingly important in helping create sound public policies. With the government facing such high-stakes issues as eliminating the deficit, reforming welfare, and promoting economic growth, government economists at all levels will continue to be in high demand.

forth these goals. A **resolution** is a formal declaration or statement that does not require the signature of the president and does not have the force of law. In the case of the budget, Congress passes a concurrent resolution—a formal declaration by both houses. This resolution details the complete federal spending and tax plan for the upcoming fiscal year. Congress must complete the concurrent resolution for the next fiscal year by April 15, although it may later revise the resolution. Congressional review of the budget continues with extensive hearings by the committees and subcommittees that have jurisdiction over the programs or agencies to be funded. Legislators examine agencies' requests and hear testimony from administration officials.

The various congressional committees, overseen by the House and Senate Appropriations

The Budget Process

EXECUTIVE ROLE

1. OMB sends guidance for spending proposals to federal agencies.
2. Each federal agency develops a spending proposal.
3. OMB considers agency spending proposals and presents recommendations to the president.
4. The president reviews and negotiates a working budget with OMB.
5. OMB submits a final budget proposal to the president.
6. The president approves the proposal and submits it to Congress.

CONGRESSIONAL ROLE

7. Appropriations and Budget Committees review the president's budget proposal in committee hearings.
8. Appropriations and Budget Committees draft a concurrent resolution detailing the overall taxing and spending plan.
9. Appropriations and Budget Committees complete the reconciliation process to come up with a reconciliation bill representing final spending limits.
10. Congress passes a reconciliation bill.
11. Congress passes appropriations bills.
12. Congress sends the appropriations bills to the president for approval or veto..

The budget preparation process requires members of the legislative and executive branches to complete several steps. ***What is the role of OMB in this process?***

Committees, then prepare detailed spending and tax legislation but must keep within the limits set in the resolution. This process is called **reconciliation**, because the bills must be reconciled not only with the plan set forth in the concurrent resolution but also with already authorized spending for existing programs. Reconciliation thus is a two-step process. First, Budget Committees receive instructions on how much revenue needs to be generated or how much spending needs to be cut in order to meet goals set out in the resolution. Second, the committee recommendations are combined in a reconciliation bill that represents the final spending limits for all appropriations.

Congress passes a limited number of major appropriations bills each year. The funding for the Departments of Commerce, Justice, and State, for example, may be grouped together into one bill. The U.S. Department of Defense, on the other hand, receives a large portion of the budget and therefore has its funding addressed in a separate appropriations bill. After passing both houses, the appropriations bills go to the president for final approval or veto.

SECTION 3 —REVIEW

1. Define the following terms: federal budget, Office of Management and Budget, Congressional Budget Office, resolution, reconciliation.
2. Why was it necessary to revise the federal budget-making process in the early 1900s? What changes have been made to the process?
3. Who is responsible for making the original budget proposal for the federal government? How is that duty executed?
4. What groups are involved in the budget-making process after submission of the original proposal? What influences these groups' decisions in the appropriations process?
5. **Thinking and Writing Critically** How do the changes in the federal budget-making process reflect the greater complexity of the federal government itself?
6. **Applying POLITICAL PROCESSES** Conduct an Internet search for the types of appropriations that Congress will pass this year. What types of programs will be funded by each appropriation?

Section 4

Deficit Spending and the Economy

Political Dictionary

gross domestic product
entitlements
national debt
Gramm-Rudman-Hollings Act

Objectives

★ What factors cause the federal government to operate at a deficit?
★ How does the national debt influence the U.S. economy?
★ In what ways do the national debt and the federal deficit influence each other?

In this chapter, you have learned how the government takes in money and how decisions are made to spend it. What you may also know, however, is that the government at times has spent a lot more money than it raised. This has led to the accumulation of a huge national debt.

Federal Deficit

As you have read, if the government spends more than it takes in, in both tax and nontax revenue, the budget is in deficit. Between 1789 and 1932, two thirds of federal budgets showed a surplus, meaning the government raised more revenue than it spent. Since 1932, however, the budget has shown a surplus only eight times.

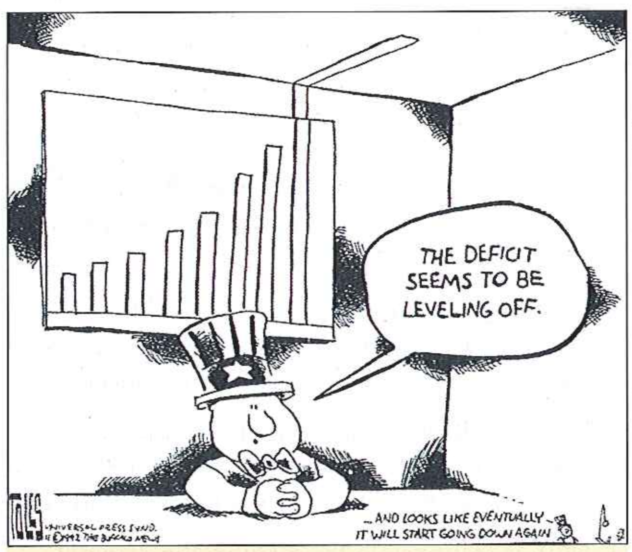
As noted in Section 1, at the beginning of Ronald Reagan's first presidential term in 1981, individual income taxes were cut 25 percent. Overall government spending continued to rise, however. As a result, between 1981 and 1982 the deficit increased by about 62 percent. The next year it again grew by around 62 percent. By 1983 the deficit was around 6 percent of the **gross domestic product** (GDP)—the total dollar value, or price, of all finished goods and services produced within a country during one year.

Budget Deficit and Politics

The budget deficit became a major political issue in the 1990s. Deficit reduction, however, has been difficult for three main reasons: political disagreements over which programs to cut, uncontrollable spending, and a reluctance of the general public to accept either tax increases or major spending cuts in programs.

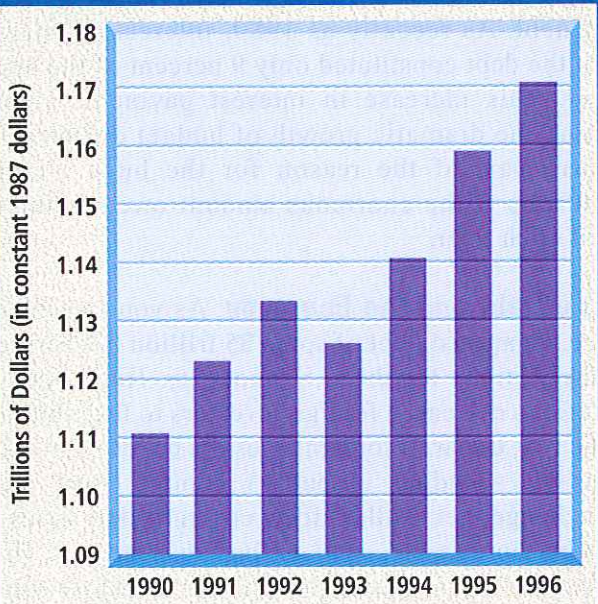
Political Disagreements Budget cutting involves making tough choices about which programs to cut and by how much. Almost everyone involved in politics can come up with a plan to reduce the deficit significantly by producing a budget in line with their own political views. For example, Democrats may propose cutting defense spending and raising taxes, particularly on the wealthy. Republicans may propose cutting domestic social spending. The problem lies in obtaining a political majority for a plan that fairly distributes the pain of deficit reduction to all groups.

Uncontrollable Spending Much of the budget consists of so-called uncontrollable spending—a term that refers to spending based on the government's prior legal commitments. This type



POLITICAL PROCESSES *Many citizens are concerned about the size of the deficit yet are opposed to spending cuts.* ***What point of view is illustrated in this cartoon?***

The Federal Budget, 1990–1996



Source: *Statistical Abstract of the United States: 1996*

The federal budget increased significantly between 1990 and 1996. Uncontrollable spending makes budget cutbacks difficult. ***How much did the budget increase between 1993 and 1996?***

of spending occurs each year without specific appropriation.

Major examples of uncontrollable spending include (1) payments on the national debt; (2) current payments under contracts the government has signed in the past (for example, the government must pay rent on any buildings it leases); and (3) **entitlements**, or benefits that federal law requires be given to all persons who legally qualify for them (for example, benefits from Social Security and Medicare, as noted in Section 1).

In 1995 about 58 percent of the budget consisted of entitlements. The largest entitlements are Social Security (mostly pensions for elderly people), Medicare (health-care benefits for elderly people), and Medicaid (health-care benefits for the poor). Other important entitlement programs are veterans' benefits, crop support payments to farmers, food stamps, civilian and military retirement, unemployment insurance, and government-backed loans for college students.

Many budget debates of recent years have been over entitlement programs, particularly Social Security, Medicare, and Medicaid. Senior citizens have been well organized in opposing entitlement cutbacks. They argue that such cuts not only would break the government's promise to provide the entitlements but also would hurt the disadvantaged. Supporters of entitlement cutbacks argue that the nation simply can no longer afford to spend as much on Medicare and other programs as it has in the past. Many of the recent deficit reduction proposals have involved lowering entitlement benefit levels (as with college student loans and Medicare) or ending a program's entitlement status entirely (as with welfare).

Reluctant Public People usually oppose higher taxes and are generally unhappy that the government spends such huge amounts of money overall. However, at the same time, widespread

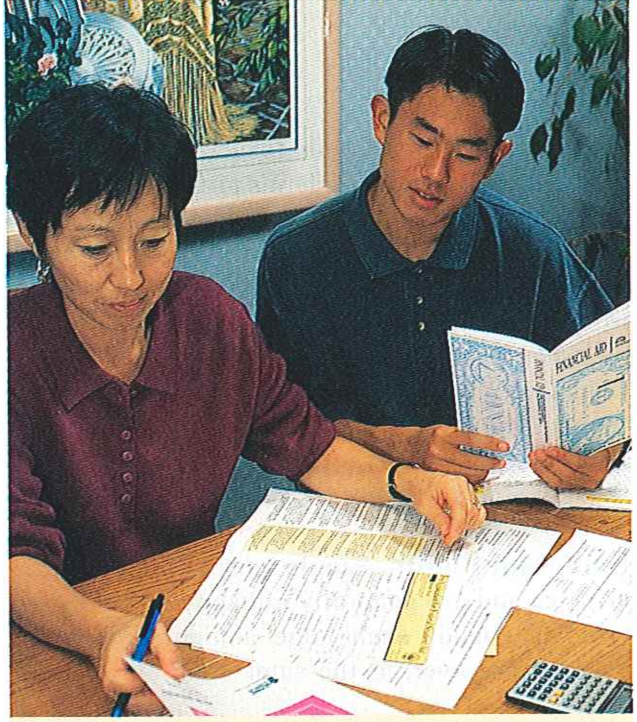
Comparing Governments

Budget Deficits Around the World

At about $107 billion, the 1996 U.S. budget deficit dwarfed the budget shortfalls of many other industrial nations. Yet by another measure the 1996 deficit seems rather small, having made up only 1.4 percent of the nation's gross domestic product (GDP). Even Japan, which in recent history has boasted budget surpluses, racked up a budget deficit in 1995 that was 3.9 percent of its GDP.

In the early 1990s, widening budget deficits in Europe caused so much concern that leaders of the 15 Western European nations agreed to a common economic goal. The 1993 Maastricht Treaty—which aimed to establish a common currency among European Union members—required members to reduce their 1997 budget deficit to no more than 3 percent of their GDP. In 1996, experts predicted that more than half of the European nations would overshoot this deficit mark.

Many nations' deficits have similar causes—higher spending on social programs, growing unemployment, a stubborn economic recession. To address these concerns and to balance their books, governments around the world will have to make difficult choices.



PUBLIC GOOD *Students planning to attend college may apply for government-backed student loans. Student loans are just one form of entitlement program funded by the federal government.* ***What is one group that has opposed entitlement cutbacks in recent years?***

public support for costly government programs has been consistent. Part of the reason that politicians have difficulty cutting spending is the public's reluctance to allow favored programs to be scaled back or eliminated.

The National Debt

When the government's expenditures are higher than its revenue, it must borrow money to make up the difference, thus increasing the debt. The **national debt** is the sum of all money the U.S. government owes as a result of borrowing.

The Size of the National Debt The national debt has skyrocketed from about $908 billion in 1980 to $5.18 trillion in 1996. Just how much money is $5.18 trillion? If you wanted to pay off the national debt by paying $1 million a day, it would take you more than 14,000 years—and that does not even include interest payments.

Interest Payments on the Debt If you were to borrow money from the bank, you would have to pay back the amount you borrowed, plus any interest that had accumulated. The federal government also must pay interest on the money it borrows.

About 15 percent of the current federal budget consists of interest payments on the national debt. As recently as 1980, interest payments on the debt constituted only 9 percent of the budget. This increase in interest payments stems from the dramatic growth of budget deficits. In turn, part of the reason for the huge budget deficits is the enormous amount owed in interest each year.

The Debt and the Economy As you can imagine, a national debt of some $5 trillion has serious implications for the U.S. economy. Huge budget deficits can cause foreign investors to lose faith in the U.S. dollar. If foreign investors believe that U.S. deficit spending is out of control, they may exchange their dollars for a currency that appears to be more stable, such as the Japanese yen. This action, in turn, causes the U.S. dollar to lose some of its value in relation to other currencies.

In recent years, because the deficit has shrunk considerably, the value of the dollar has increased. When the government borrows billions of dollars to finance deficit spending, the investment funds that are available for the economy in general decrease substantially. In other words, there is a limited amount of money available to be borrowed. When the government borrows huge amounts of money, the competition for the remaining available funds causes interest rates to rise, which in turn slows down the economy.

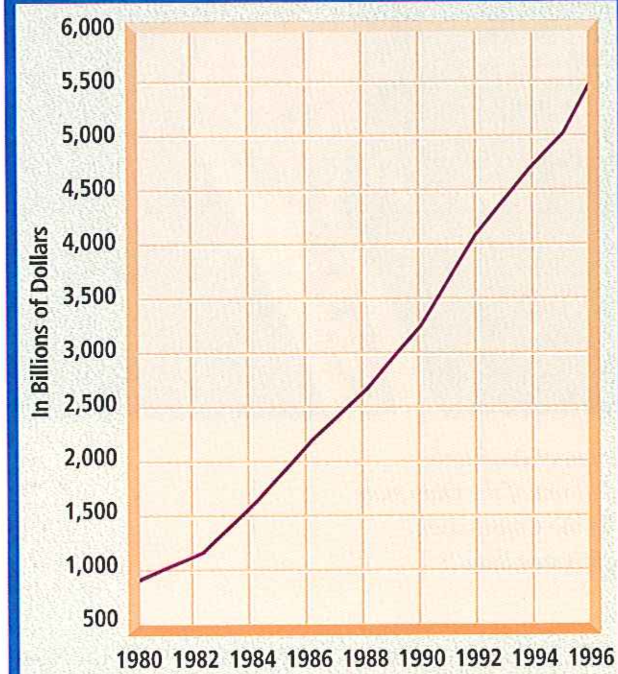
Balancing the Budget

The issue of how to address the budget deficit has long been a matter of debate. In 1997, however, the president and Congress agreed on a plan to balance the budget by the year 2002. As the history outlined below shows, such attempts have been made before, and it remains to be seen whether this plan will in fact lead to a balanced budget.

Gramm-Rudman-Hollings Act In response to the huge budget deficits of the 1980s, Congress passed the Balanced Budget and Deficit Reduction Act of 1985, known as the **Gramm-Rudman-Hollings Act** (GRH). The legislation was designed to force Congress and the president to work together to reduce the mounting budget deficits.

The GRH required the president's budget staff and the Congressional Budget Office to produce

The National Debt, 1980–1996



Source: *Statistical Abstract of the United States: 1996*

The national debt has grown rapidly in the last several years. ***How can a debt of this size affect the economic growth rate?***

a joint report on the budget. This report would include estimates on how much the proposed budget would exceed expected revenue and how much the budget would need to be cut to meet deficit reduction targets. An official in the General Accounting Office (GAO), called the comptroller general, would then be allowed to make budget cuts if the president and Congress could not agree on how to do so. In 1986, however, the U.S. Supreme Court ruled that this method of cutting spending was unconstitutional. In response, Congress amended the procedures and moved the dates for achieving a balanced budget from 1991 to 1993.

CASE STUDY

Budget Enforcement Act

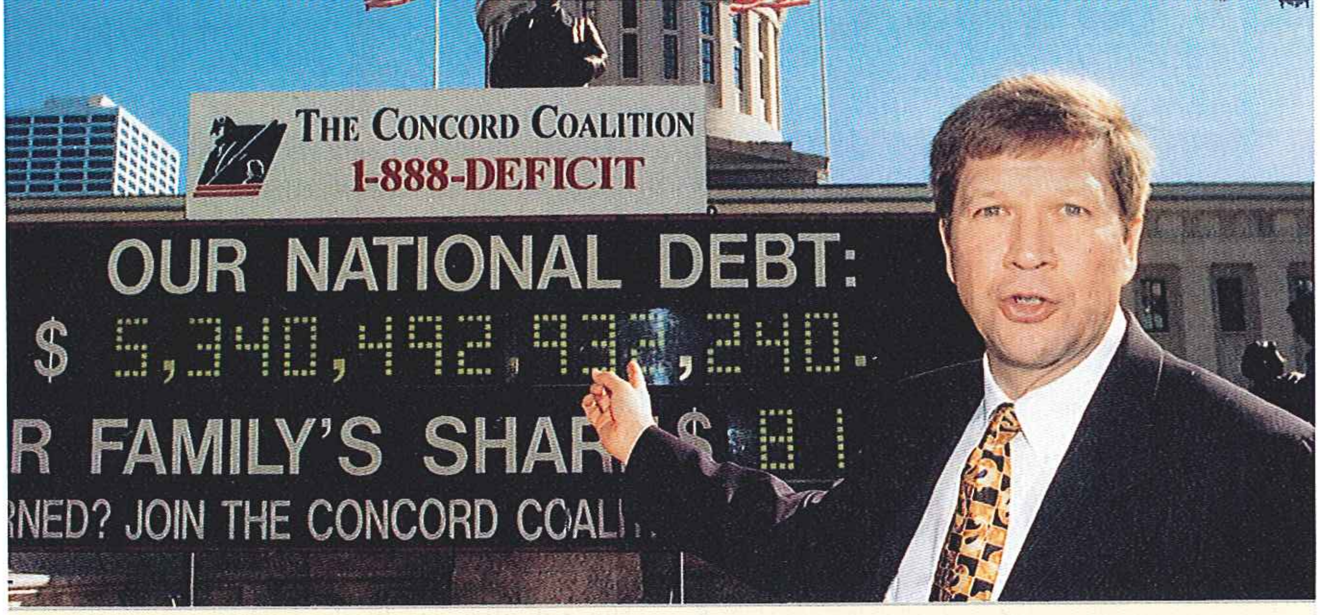
POLITICAL PROCESSES By 1990 the Gramm-Rudman-Hollings (GRH) Act had come under attack in the halls of Congress. Critics of the balanced budget law charged that it just was not working, because budget makers were getting around the law by clever accounting tricks.

Still committed to tackling the deficit, members of Congress worked out new legislation to reform the budget process. President George Bush signed the Budget Enforcement Act (BEA) into law in November 1990.

The BEA changed the budget process in many ways. Instead of focusing on just one year, budget makers are now required to predict what will be included in the budgets of the next five years. The act also established what are known as "pay-as-you-go" (PAYGO) restrictions. PAYGO restrictions require that any increase in spending be paid for by an increase in taxes and that any decrease in taxes be offset by spending cuts. The law set specific limits on spending for defense, social programs, and foreign aid. That way, money saved in one area cannot be spent in another. The BEA also establishes the maximum amount of the deficit for each year.

Despite the strict new spending rules, the deficit soared to record highs in 1991 and 1992. A recession and large increases in social spending not covered by the BEA caused the leap. Though the BEA alone has not eliminated deficits, it has proved to be an important tool in curbing out-of-control spending.

Balanced Budget Amendment Some lawmakers believe that a constitutional amendment requiring a balanced budget is ultimately the only way to solve the deficit problem. In March 1997, however, the Senate rejected a proposed constitutional amendment that would have required the federal government to maintain a balanced budget each year. (The House had previously passed a similar measure.) Many lawmakers, as well as President Clinton, who called the balanced budget amendment "both unnecessary and unwise," were against the amendment. They argued that a balanced budget should come by reaching a mutually agreed upon budget proposal, not by amending the Constitution.



POLITICAL PROCESSES *U.S. Representative John Kasich, chairman of the House Budget Committee, stands near the National Debt Clock, located in front of the Ohio state house. Kasich strongly supported a Balanced Budget Amendment to the Constitution.* ***What are some arguments made by critics of the Balanced Budget Amendment?***

The 1993 Clinton Plan The budget deficit began a steady decline in 1993. An important step in the turnaround was an economic package proposed during President Clinton's first year in office and adopted over Republican congressional opposition. The plan increased taxes on wealthier Americans and decreased spending on some programs.

In 1996 the budget deficit stood at just 1.4 percent of GDP, the lowest percentage in almost 20 years. Currently, the annual U.S. deficit as a percentage of the GDP is among the lowest of industrialized nations. (See Comparing Governments on page 209.) Low inflation (which reduces interest rates and thus interest payments on the national debt) and strong economic growth (which increases tax revenues) have helped lower the deficit.

Balanced Budget Act of 1997

Lawmakers have continued to work on means to eliminate the deficit entirely. In August 1997, President Clinton signed into law the Balanced Budget Act of 1997. The act was intended to eliminate budget deficits for the first time in 30 years. President Clinton said about the act that it "prepares Americans to enter the next century, stronger than ever. By large, bipartisan majorities in both Houses, we have risen to that challenge."

SECTION 4 — REVIEW

1. Define the following terms: gross domestic product, entitlements, national debt, Gramm-Rudman-Hollings Act.
2. What is uncontrollable spending? What other factors cause a budget deficit?
3. Why is the national debt a concern for the United States?
4. How does the accumulation of debt contribute to the deficit?
5. **Thinking and Writing Critically** In the 1990s the president and Congress faced an ongoing debate over the Balanced Budget Amendment. Why do you think this issue has posed such a problem?
6. **Applying PUBLIC GOOD** Make a list of the most effective methods that you think the federal government could use to reduce the deficit. What might be the arguments against some of these means?

CHAPTER 9 — SUMMARY

SECTION 1 Taxes are the federal government's primary source of revenue. There are several different kinds of taxes—the individual income tax, the corporate income tax, social insurance taxes, excise taxes, estate and gift taxes, and customs duties. The federal government also generates revenue from several nontax sources. These include fees, fines, and earnings of the banks in the Federal Reserve system.

Tax policy is politically controversial. Democrats generally have favored higher and more progressive taxes and have opposed tax advantages for the wealthy, while Republicans generally have favored lower taxes.

SECTION 2 The U.S. economy is a free-enterprise system in which economic policy is controversial. The basic political disputes involve the extent to which government should intervene in the operation of the free market. Democrats generally have favored greater government intervention, while Republicans have been inclined toward minimal government involvement.

The goals of economic stabilization are full employment and low inflation. The tools that the government uses to achieve these goals are fiscal and monetary policy. Fiscal policy is a set of government spending, taxing, and borrowing policies used to achieve desired levels of economic performance. Monetary policy is designed to regulate the economy by controlling the amount of money in circulation. The government also uses industrial policy to promote economic growth. Supporters of economic aid to industries have argued that this aid should be applied to industries of the future because these industries, particularly high-tech ones, hold great economic promise.

SECTION 3 The budget process has changed a great deal during the 1900s. Today, the budget process begins with the Office of Management and Budget's setting guidelines about the overall budget situation. Each agency uses those guidelines to develop a spending proposal. The staff of the OMB reviews the agencies' requests and submits a recommendation to the president. After all changes are made, the president's proposal is submitted to Congress.

Congress then reviews the proposal, and congressional committees work to draft a concurrent resolution based on it. After reconciling all congressional recommendations and changes made to the original proposal, spending limits are set in a reconciliation bill, which both houses of Congress must pass. Congress then passes a limited number of appropriations bills. Afterward, they go to the president for approval or veto.

SECTION 4 In recent decades the federal government has consistently spent more than it takes in, causing the budget to be in deficit. The budget deficit became a major issue in the 1990s. Deficit reduction has been difficult because of political disagreements over which programs to cut, increased uncontrollable spending, and a reluctance of the general public to accept either tax increases or spending cuts.

To support deficit spending, the government must borrow money. This has caused a huge national debt. Politicians recently have focused on how to balance the budget, and a plan for achieving a balanced budget by 2002 was adopted in 1997.

Government Notebook

Review what you wrote in your Government Notebook at the beginning of the chapter. After reading the chapter, do you believe the government is more or less involved in the economy than you originally thought? Record your answer in your Notebook.

CHAPTER 9

REVIEW

REVIEWING CONCEPTS

1. Define tax deductions and give several examples.
2. What are the two primary social welfare programs financed by the federal government?
3. Name and describe the main policies that government uses to stabilize the economy and promote economic growth.
4. What three tools does the Fed have for creating monetary policy? Describe how each is used.
5. How did the Congressional Budget and Impoundment Control Act change the way the president's budget proposal is considered?
6. Define uncontrollable spending and list three examples.

THINKING AND WRITING CRITICALLY

1. **PUBLIC GOOD** Should government redistribute wealth through taxes? Write a paragraph that states and supports your opinion on the issue. Be sure to consider how tax policy decisions affect the standard of living in the United States.
2. **PRINCIPLES OF DEMOCRACY** Why do you think that individual rights are a key element of the free-enterprise system?
3. **POLITICAL PROCESSES** Why is it important for Congress to examine overall spending rather than separate appropriations? How has the creation of the Office of Management and Budget helped increase the president's role in making economic policy?
4. **PUBLIC GOOD** Why do you think the public is reluctant to support cuts in public spending? How does deficit reduction promote the public good?

CITIZENSHIP IN YOUR COMMUNITY

As noted in this chapter, the individual income tax is a major source of federal revenue. The Internal Revenue Service (IRS) provides several aids to citizens filing federal tax returns. For example, the IRS maintains hotlines people can call for answers to their questions about filing taxes. It also has established an Internet site that enables people to file their returns electronically. Create a pamphlet for citizens in your community, providing information on filing federal tax returns. Include information on where they can pick up tax forms and the types of tax preparation assistance available in your community.

INDIVIDUAL PORTFOLIO PROJECT

Imagine that you are a member of the Board of Governors for the Federal Reserve system. The chair of the Board of Governors has asked you to prepare a handbook for foreign governments interested in setting up a national bank system similar to the Fed. In the handbook, describe both how the Fed is organized and the regulations that it places on member banks.

PRACTICING SKILLS: UNDERSTANDING CHARTS AND GRAPHS

The circle graph, or pie chart, on page 191 illustrates the various sources of federal revenue. The graph has seven "slices" that together represent total federal revenue in 1996. Read the labels on the graph, and study the relative size of the slices to answer the questions that follow.

1. What three types of taxes account for the largest portion of total federal revenue?
2. Approximately what fraction of total federal revenue comes from the corporate income tax?
3. What percent of federal revenue comes from estate and gift taxes?

The Internet: Learning Online

Conduct an Internet search to learn more about the Balanced Budget Amendment. You might start with search words such as *federal budget, federal spending,* and *Balanced Budget Amendment.* What information is available on Web sites? Are individuals expressing their opinions on the amendment? Is information on both sides of the debate available on the Internet? Write a paragraph describing the information you find.

Analyzing Primary Sources

Notes on the New Deal

The theories of British economist John Maynard Keynes have greatly influenced the economic policies of many countries. In 1934 Keynes visited President Franklin D. Roosevelt. While in the United States, Keynes recorded his thoughts on the New Deal, Roosevelt's plan for helping the United States cope with the effects of the Great Depression. Read this excerpt from Keynes's notes and answer the questions that follow.

> *"These are a few notes on the New Deal by one who has come here on a brief visit of pure inquisitiveness—made under the limitations of imperfect knowledge, but gaining, perhaps, from the detachment of a bird's-eye view.*
>
> *My purpose is to consider the prospects rather than the past. . . . I am in sympathy with most of the social and reforming aims of this legislation; and the principal subject of these notes is the problem of consolidating economic and business recovery. . . .*
>
> *Obstacles can [not] be overcome in a day or by a stroke of the pen. The notion that, if the government would retire altogether from the economic field, business, left to itself, would soon work out its own salvation, is, to my mind, foolish; and, even if it were not, it is certain that public opinion would allow no such thing. This does not mean that the administration should not be assiduously [diligently] preparing the way for the return of normal investment enterprise [business]. But this will unavoidably take time. When it comes, it will intensify and maintain a recovery initiated by other means. . . .*
>
> *I believe that there is much devoted and intelligent work in progress there [in Washington], and that the fittest ideas and the fittest men are tending to survive. In many parts of the world the old order has passed away. But, of all the experiments to evolve a new order, it is the experiment of young America which most attracts my own deepest sympathy. For they are occupied with the task of trying to make the economic order work tolerably well, while preserving freedom of individual initiative and liberty of thought and criticism.*
>
> *The older generation of living Americans accomplished the great task of solving the technical problem of how to produce economic goods on a scale adequate to human needs. It is the task of the younger generation to bring to actual realization the potential blessings of having solved the technical side of the problem of poverty. The central control which the latter requires involves an essentially changed method and outlook. The minds and energies which have found their fulfillment in the achievements of American business are not likely to be equally well adapted to the further task. That must be, as it should be, the fulfillment of the next generation."*

1. What did Keynes believe public opinion would not allow?
2. According to Keynes, why is it hard to make the economic order work tolerably well, while preserving freedom of individual initiative?
3. What task did Keynes say the older generation of living Americans accomplished?