
PEDAGOGICAL FEATURES

p. 479 Figure 14.1: The Federal Government Dollar (Fiscal Year 2001 Estimate)
p. 481 Figure 14.2: Federal Revenues
p. 483 Figure 14.3: Total National Debt
p. 486 Table 14.1: Tax Expenditures: The Money Government Does Not Collect
p. 487 Table 14.2: How Much Is Too Much?
p. 488 Making a Difference: Robert McIntyre
p. 490 Figure 14.4: Federal Expenditures
p. 491 Table 14.3: How Big Is Too Big?
p. 494 Figure 14.5: Trends in Social Service Spending
p. 498 You Are the Policymaker: Spending the Budget Surplus
p. 499 How You Can Make A Difference: The Federal Government and Student Loans
p. 501 Real People on the Job: Linda Ricci
p. 502 For Further Reading
p. 502 Internet Resources

LEARNING OBJECTIVES

After studying this chapter, students should be able to:

• Identify the major sources of federal revenue.

• Determine how tax expenditures benefit middle- and upper-income tax payers and corporations.

• Identify the major recipients of federal tax expenditures.
• Discuss how the *rise of the national security state* and the *rise of the social service state* are associated with government growth in America.

• Explain how political scientists sometimes use the term *incrementalism* to describe the spending and appropriations process.

• Explain the impact that “uncontrollable” expenditures and entitlements have on the federal budget.

• Evaluate the ways in which the budget affects the scope of government.

**CHAPTER OVERVIEW**

**INTRODUCTION**

The central political issue for many years has been how to pay for policies that most people support. The president and Congress have been caught in a *budgetary squeeze*: Americans want them to balance the budget, maintain or increase the level of government spending on most policies, and still keep taxes low. Thus, two questions become central to public policy: Who bears the burdens of paying for government? Who receives the benefits?

**SOURCES OF FEDERAL REVENUE**

Probably no government policy affects as many Americans as tax policy. In addition to raising revenues to finance its services, the government can use taxes to make citizens’ incomes more or less equal, to encourage or discourage growth in the economy, and to promote specific interests. This chapter focuses on how tax policies can promote the interests of particular groups or encourage specific activities.

This section looks at the substance of the budget to see how the American government raises money and where that money is spent. The three major sources of federal revenues are the *personal* and *corporate income tax*, *social insurance taxes*, and *borrowing and deficit spending*. Only a small portion comes from *excise taxes* (such as tax on gasoline) and other sources. Although corporate taxes once yielded more revenues than individual income taxes, today corporate taxes yield only about eight cents of every federal revenue dollar, compared with forty-five cents coming from individual income taxes.

Today the *federal debt* — all of the money borrowed over the years and still outstanding — exceeds $5.5 trillion. Fourteen percent of all federal expenditures go...
to paying off the debt. When the federal government wants to borrow money, the Treasury Department sells bonds, guaranteeing to pay interest to the bondholder. Citizens, corporations, mutual funds, and other financial institutions purchase the bonds. Most observers are concerned about the national debt. Many have called for a balanced budget amendment.

A tax loophole is presumably some tax break or tax benefit. The IRS Code is riddled with exemptions, deductions, and special cases. For example, H. Ross Perot (1992 presidential candidate) hired a former Internal Revenue Service commissioner in 1975 to aid him in having the tax code changed to benefit him to the tune of approximately $15 million. The bill was killed on the House floor when the press reported that only Perot would benefit from the provision.

Loopholes are really a type of tax expenditure, which represent the difference between what the government actually collects in taxes and what it would have collected without special exemptions. Tax expenditures are essentially monies that government could collect but does not because they are exempted from taxation.

Early in his administration, President Reagan proposed a massive tax-cut bill, which was passed by Congress in July 1981. Families with high incomes received significant tax reductions with the 1981 bill, but those at the lower end of the income ladder did not notice much change in their tax burden because social insurance and excise taxes (which fall disproportionately on the poor) rose during the same period. Many blamed the massive deficits of the 1980s and 1990s at least partially on the 1981 tax cuts, as government continued to spend more but reduced its revenues.

The Tax Reform Act of 1986 was one of the most sweeping alterations in federal tax policy in history. It eliminated or reduced the value of many tax deductions, removed several million low-income individuals from the tax rolls, and changed the system of fifteen separate brackets to just two generally lower rates (28 percent and 15 percent). In 1990, a third bracket of 31 percent was added for those with higher incomes. In 1993, President Clinton proposed, and Congress approved, a plan to raise the income tax rate to 36 percent for families with incomes over $140,000 and add an additional surcharge of 3.6 percent to those families with incomes over $250,000. Corporate income taxes and energy taxes also rose.

**FEDERAL EXPENDITURES**

Among the most important changes of the twentieth century is the rise of large governments. American governments — national, state, and local — spend an amount equal to one-third of the Gross National Product (GNP). Expenditures of the national government alone equal over 20 percent of the GNP. Nevertheless, the United States actually has one of the smallest public sectors among Western nations relative to the size of the Gross Domestic Product (GDP).
Two conditions associated with government growth in America are the rise of the national security state and the rise of the social service state. After World War II, the “cold war” with the Soviet Union resulted in a permanent military establishment and expensive military technology. President Eisenhower coined the phrase military-industrial complex to characterize the close relationship between the military hierarchy and the defense industry that supplies its hardware needs. The Pentagon wants weapons systems and arms makers want contracts, so they tend to be mutually supportive. In the 1990s, defense expenditures have decreased in response to the lessening of tensions in Europe. The budget of the Department of Defense now constitutes only about one-sixth of all federal expenditures.

The Social Security Act (passed in 1935) was originally intended to provide a minimal level of sustenance to older Americans. Lyndon Johnson’s “Great Society” initiatives in the mid-1960s greatly expanded America’s social services network, adding Medicare and Medicaid to the Social Security system and creating many new programs designed to aid the poor. Today, more than 40 million Americans receive payments from the Social Security system.

Social Security is not the only social policy of the federal government that is costly. The rise of the social service state has contributed to America’s growing budget in health, education, job training, and scores of other areas. Liberals often favor these programs to assist individuals and groups in society. Conservatives see them as a drain on the federal treasury.

The picture of the federal budget is one of constant, slow growth. Expenditures mandated by an existing law or obligation (such as Social Security) are particularly likely to follow a pattern of incrementalism, which means that the best predictor of this year’s budget is last year’s budget plus a little bit more — that is, an increment. More and more of federal spending has become “uncontrollable.” An uncontrollable expenditure is one that is mandated under current law or by a previous obligation. About two-thirds of the federal budget is uncontrollable —based on expenditures that are determined not by how much Congress appropriates to an agency but by how many eligible beneficiaries there are for a particular program.

In February 1998, President Clinton presented the first balanced budget in nearly 30 years. Whether the budget can remain in balance in the face of an economic downturn (in which tax revenues would decrease and expenditures would increase) remains to be seen.

UNDERSTANDING BUDGETING

Almost all democracies have seen a substantial growth in government in the twentieth century. Economists Allen Meltzer and Scott Richard argue that government grows in a democracy because of the equality of suffrage. Poorer voters will always use their votes to support public policies that redistribute benefits
from the rich to the poor. Indeed, the most rapidly growing expenditures are items like Social Security, Medicaid, Medicare, and social welfare programs (all of which benefit the poor more than the rich).

One often thinks of elites — particularly corporate elites — as being opposed to big government. However, Lockheed and Chrysler corporations have appealed to the government for large bailouts when times got rough. Corporations support a big government that offers them contracts, subsidies, and other benefits. Poor and rich voters alike have voted for parties and politicians who promised them benefits. Government often grows by responding to groups and their demands.

Conversely, some politicians compete for votes by promising not to spend money (such as Ronald Reagan). In contrast with other nations, Americans have chosen to tax less and spend less on public services than almost all other democracies with developed economies. Paradoxically, Americans want to spend but they do not want to pay taxes. Being a democracy, that is exactly what the government does—and the inevitable result is red ink.

**CHAPTER OUTLINE**

**I. INTRODUCTION**

A. The president and Congress have been caught in a budgetary squeeze: Americans want them to balance the budget, maintain or increase the level of government spending on most policies, and still keep taxes low.

   1. A **public budget** is a policy document allocating burdens (taxes) and benefits (expenditures).

      a. Because budgets are so important to almost all other policies, the budgetary process is the center of political battles in Washington and involves nearly everyone in government.

      b. The distribution of the government’s budget is the outcome of a very complex budgetary process involving thousands of policy choices and prompting a great deal of politics.

B. The central political issue for many years has been how to pay for policies that most people support.

   1. Resources have been scarce because the national government has run up a large budget deficit each year during the 1980s and the 1990s. (A budget **deficit** occurs when **expenditures** exceed **revenues**.)

   2. The total national **debt** rose sharply during the 1980s, increasing from less than one trillion dollars to about $5.6 trillion dollars by 2000.

**II. THE GOVERNMENT’S SOURCES OF REVENUE**

A. Where it comes from.
1. The three major sources of federal revenues are the personal and corporate income tax, social insurance taxes, and borrowing. Only a small portion comes from excise taxes (such as tax on gasoline) and other sources.

2. Income tax.
   a. The first peacetime income tax was enacted in 1894.
      (1) The tax was declared unconstitutional in Pollock v. Farmer’s Loan and Trust Co. (1895).
      (2) The Sixteenth Amendment was added to the Constitution in 1913, explicitly permitting Congress to levy an income tax. Congress had already started one before the amendment was ratified, and the Internal Revenue Service (IRS) was established to collect it.
   b. Corporations also pay income taxes. Although corporate taxes once yielded more revenues than individual income taxes, today corporate taxes yield only about ten cents of every federal revenue dollar, compared with forty-eight cents coming from individual income taxes.

3. Social insurance taxes.
   a. Social Security taxes come from both employers and employees.
   b. Unlike other taxes, these payments do not go into the government’s general money fund; they are specifically earmarked for the Social Security Trust Fund to pay benefits.
   c. Social Security taxes have grown faster than any other source of federal revenue.

   a. When the federal government wants to borrow money, the Treasury Department sells bonds, guaranteeing to pay interest to the bondholder.
      (1) Citizens, corporations, mutual funds, and other financial institutions purchase the bonds.
      (2) Today the federal debt — all of the money borrowed over the years and still outstanding — exceeds $5.5 trillion.
      (3) Eleven percent of all federal expenditures go to paying off the debt.
   b. Government borrowing crowds out private borrowers.
      (1) The bulk of all the net private savings in the country goes to the federal government.
      (2) The American government is also dependent on foreign investors (including other governments) to fund its debt.
      (3) Most economists believe that this competition to borrow money increases interest rates and makes it more difficult for businesses to invest in capital expenditures.
   c. Concerns about the national debt have led to some calls for a balanced budget amendment.
Opponents argue that it is difficult to estimate both expenditures and revenues more than a year ahead since we cannot predict what will happen to the economy. Both Congress and the president could circumvent the intention of the amendment by adjusting economic assumptions or even by changing the dates of the fiscal year. Unlike state and local governments and private businesses, the federal government does not have a capital budget, a budget for items that will serve for the long-term. These purchases are counted as current expenditures and run up the deficit.

B. Taxes and public policy.

1. Tax loopholes.
   a. A tax loophole is presumably some tax break or tax benefit.
      (1) The IRS Code is riddled with exemptions, deductions, and special cases.
      (2) In 1975, H. Ross Perot (1992 and 1996 presidential candidate) hired a former Internal Revenue Service commissioner to aid him in having the tax code changed to benefit him to the tune of approximately $15 million. (The bill was killed on the House floor when the press reported that only Perot would benefit from the provision.)
   b. Although loopholes may offend Americans’ sense of fair play, they actually cost the federal government very little; loopholes are really a type of tax expenditure.

2. Tax expenditures.
   a. What does cost the federal budget a substantial sum is the system of tax expenditures, which represent the difference between what the government actually collects in taxes and what it would have collected without special exemptions.
      (1) Tax expenditures are essentially monies that government could collect but does not because they are exempted from taxation.
      (2) The Office of Management and Budget estimated that the total tax expenditures in the mid-1990s would be about a third of the total federal receipts.
      (3) Individuals receive most of the tax expenditures, and corporations get the rest.
   b. Tax expenditures amount to subsidies for some activity, such as:
      (1) Deductions for contributions to charities;
      (2) Deductions by homeowners for mortgage interest; and
      (3) Business deductions of investment in new plants and equipment at a more rapid rate than they can deduct other expenses.
c. On the whole, tax expenditures benefit middle- and upper-income taxpayers and corporations. Poor people (who tend not to own homes) cannot take advantage of most such provisions.

3. Tax reduction.
   a. Early in his administration, President Reagan proposed a massive tax-cut bill, which was passed by Congress in July 1981.
      (1) Over a three-year period, Americans would have their federal tax bills reduced 25 percent, corporate income taxes were also reduced, new tax incentives were provided for personal savings and corporate investment, and taxes were indexed to the cost of living.
      (2) Families with high incomes received significant tax reductions with the 1981 bill, but those at the lower end of the income ladder did not notice much change in their tax burden because social insurance and excise taxes (which fall disproportionately on the poor) rose during the same period.
   b. Many blamed the massive deficits of the 1980s and 1990s at least partially on the 1981 tax cuts, as government continued to spend but reduced its revenues.

   a. When President Reagan first revealed his massive tax simplification plan in 1986, the president actually had more problems obtaining the support of his own party than from the Democrats.
   b. The Tax Reform Act of 1986 was one of the most sweeping alterations in federal tax policy in history.
      (1) It eliminated or reduced the value of many tax deductions, removed several million low-income individuals from the tax rolls, and changed the system of fifteen separate brackets to just two generally lower rates (28 percent and 15 percent).
      (2) In 1990, a third bracket of 31 percent was added for those with higher incomes.
      (3) In 1993, Congress agreed to President Clinton’s proposal to raise the income tax rate to 36 percent for families with incomes over $140,000 and add an additional surcharge of 3.6 percent to those families with incomes over $250,000. Congress also increased the top corporate income tax and an energy tax.

III. FEDERAL EXPENDITURES: WHERE REVENUES GO
   A. Federal expenditures.
      1. Comparisons over time are somewhat misleading because they do not take into account changes in the value of the dollar.
         a. However, it is clear that expenditures keep rising.
   B. Among the most important changes of the twentieth century is the rise of large governments.
1. The United States actually has one of the smallest public sectors among Western nations relative to the size of the Gross Domestic Product (GDP).
3. Expenditures of the national government alone equal over 20 percent of the GDP.
4. Two conditions associated with government growth in America are the rise of the national security state and the rise of the social service state.

C. The rise of the national security state.
1. President Eisenhower coined the phrase military industrial complex to characterize the close relationship between the military hierarchy and the defense industry that supplies its hardware needs. The Pentagon wants weapons systems and arms makers want contracts, so they tend to be mutually supportive.
2. After World War II, the “cold war” with the Soviet Union resulted in a permanent military establishment and expensive military technology.
   a. In the 1990s, defense expenditures have decreased in response to the lessening of tensions in Europe. (see Chapter 16)
   b. The budget of the Department of Defense now constitutes only about one-sixth of all federal expenditures.
   c. Payrolls and pensions constitute a large component of the defense budget, as does research, development, and procurement (purchasing) of military hardware.
3. The cost of advanced technology makes any weapon, fighter plane, or component more expensive than its predecessors, and cost overruns are common.

D. The rise of the social service state.
1. The Social Security Act (passed in 1935) was originally intended to provide a minimal level of sustenance to older Americans.
2. Lyndon Johnson’s “Great Society” initiatives in the mid-1960s greatly expanded America’s social services network, adding Medicare and Medicaid to the Social Security system and creating many new programs designed to aid the poor.
3. Today, more than 43 million Americans receive payments from the Social Security system.
   a. The typical retired worker received nearly $700 a month in 1997.
   b. Disability insurance was included in the 1950s, which included workers who had not retired but were disabled.
   c. Medicare was added to the system in 1965, providing both hospital and physician coverage to the elderly.
4. Essentially, money is taken from working members of the population and spent on retired members; but demographic and economic realities now threaten to dilute this intergenerational agreement.
a. In 1945, fifty workers paid taxes to support each Social Security beneficiary.
b. In 1980, about three workers supported each beneficiary.
c. By the year 2040, fewer than two workers will be supporting each beneficiary.

5. Social Security is not the only social policy of the federal government that is costly. The rise of the social service state has contributed to America’s growing budget in health, education, job training, and scores of other areas.
   a. Liberals often favor these programs to assist individuals and groups in society.
   b. Conservatives see them as a drain on the federal treasury.

E. The rise of the social service state and the national security state together are linked with much of American governmental growth since the end of World War II.

F. Why is the increasing federal budget so difficult to control?
   1. Incrementalism.
      a. Incrementalism means that the best predictor of this year’s budget is last year’s budget plus a little bit more (an increment).
         (1) The picture of the federal budget is one of constant, slow growth.
         (2) Expenditures mandated by an existing law or obligation (such as Social Security) are particularly likely to follow a neat pattern of increase.
         (3) There are exceptions, however; incrementalism does not fully describe all budgetary politics.
      b. There is a never-ending call for budgetary reform.
      c. Causes of incrementalism.
         (1) The support of relevant interests for spending programs makes it difficult to pare the budget.
         (2) The budget is too big to review from scratch each year.
         (3) More and more of federal spending has become “uncontrollable.”
   2. “Uncontrollable” expenditures.
      a. An uncontrollable expenditure is one that is mandated under current law or by a previous obligation.
         (1) Uncontrollable expenditures result from policies that make some group automatically eligible for some benefit.
         (2) Congress has in effect obligated itself to pay a certain level of benefits to a particular number of recipients. Such policies are called entitlements.
      b. About two-thirds of the federal budget is uncontrollable—based on expenditures that are determined not by how much Congress appropriates to an agency but by how many eligible beneficiaries there are for a particular program.
(1) Although Congress legally can control such expenditures, it could do so only by changing a law or existing benefit levels.

(2) Cutting benefits or tightening eligibility restrictions would provoke a monumental outcry from millions of older voters.

c. The biggest uncontrollable expenditure is the Social Security system, including Medicare, which costs more than $600 billion; other uncontrollable expenditures include veterans aid, agricultural subsidies, military pensions, civil service workers’ retirement benefits, and interest on the national debt.

d. In 1995 and 1996, the Republican majorities in Congress attempted to reduce the growth of Medicare benefits and to change programs, including Medicaid and welfare, from entitlements into block grants to the states.

3. In 1998, President Clinton presented the first balanced budget in nearly 30 years, but it remains to be seen whether the budget can remain balanced in the event of an economic downturn.

IV. UNDERSTANDING BUDGETING

A. Democracy and budgeting.

1. Almost all democracies have seen a substantial growth in government in the twentieth century.

2. Economists Allen Meltzer and Scott Richard argue that government grows in a democracy because of the equality of suffrage.

   a. Poorer voters will always use their votes to support public policies that redistribute benefits from the rich to the poor.

   b. The most rapidly growing expenditures are items like Social Security, Medicaid, Medicare, and social welfare programs (all of which benefit the poor more than the rich).

3. One often thinks of elites—particularly corporate elites—as being opposed to big government.

   a. However, Lockheed and Chrysler corporations have appealed to the government for large bailouts when times got rough.

   b. Corporations support a big government that offers them contracts, subsidies, and other benefits.

4. Poor and rich voters alike have voted for parties and politicians who promised them benefits.

   a. Policymakers spend money for things voters like (and will remember on election day).

   b. Citizens are not the unwilling victims of big government and its big taxes; they are at least co-conspirators.

5. Government also grows by responding to groups and their demands.

6. Some politicians compete for votes by promising not to spend money (such as Ronald Reagan).

7. Americans have chosen to tax less and spend less on public services than almost all other democracies with developed economics. (see Chapter 1)
a. Americans want to spend but not pay taxes.
b. Being a democracy, that is exactly what the government does—and the inevitable result is red ink.

B. The budget and the scope of government.
   1. In many ways, the budget is the scope of government—the bigger the budget, the bigger the government.
   2. The budget can be a force for reining in the government as well as for expanding its role.
      a. One could accurately characterize policy-making in the American government since 1980 as the “politics of scarcity” — scarcity of funds for programs like health care reform and education.
      b. America’s large budget deficit is as much a constraint on government as it is evidence of a burgeoning public sector.

**KEY TERMS AND CONCEPTS**

**Authorization bill**: an act of Congress that establishes a discretionary government program or an entitlement, or that continues or changes such programs.

**Budget**: a policy document that allocates burdens (taxes) and benefits (expenditures).

**Entitlements**: expenditures for which the total amount spent is not by Congressional appropriation but by rules of eligibility established by Congress.

**Expenditures**: money spent by the government in any one year.

**Federal debt**: all of the money borrowed by the government over the years that is still outstanding.

**Income tax**: the portion of money individuals are required to pay to the government from the money they earned.

**Incrementalism**: the best predictor of this year’s budget is last year’s budget plus a little bit more.

**Medicare**: in 1965, this program was added to Social Security to provide hospital and physician coverage to the elderly.

**Revenues**: money received by the government in any given year.

**Sixteenth Amendment**: passed in 1913, permits Congress to levy an income tax.
Social Security Act (1935): passed to provide a minimal level of sustenance to older Americans.

**Tax expenditures**: revenue losses due to special exemptions, exclusions, and deductions.

**Uncontrollable expenditures**: result from policies that make some group automatically eligible for benefits.

TEACHING IDEAS: CLASS DISCUSSION AND STUDENT PROJECTS

- *Tax expenditures* are essentially monies that government could collect but does not because they are exempted from taxation. The Office of Management and Budget estimated that the total tax expenditures in 2001 would be more than $700 billion—about one-third of the total federal receipts (see Table 14.1). If this estimate is correct, the government could close its budget deficit by taxing things it does not currently tax, such as Social Security benefits, pension fund contributions, and charitable contributions. Ask your class to vote on whether such taxes should be adopted. Ask them to analyze political and social implications of the positions they take.

- For class discussion, have students debate the value of a balanced budget amendment. In particular, have them examine the costs and benefits of balancing the budget given that most of the budget expenditures are mandated. Insist that students identify which benefits and which obligations should be the first to go.

- For a reading and writing connection, have students identify and investigate the number of federal agencies they and their families received benefits from within the last five years. Then have them evaluate the importance of these services to their and their families’ standard of living. Finally, have them identify what they would have to do if these services were no longer available to them.

- If teaching at a state institution, have students investigate the sources of funding of higher education in the state. What proportion of costs does their student tuition cover? Who pays for the rest? What justification is there for state subsidies of higher education, i.e., who benefits?

- Have students locate public opinion data on public support for government programs (i.e., spending questions), using data sources such as the National Elections Studies or General Social Survey available on the Internet. Have students assess the extent to which the public supports reducing expenditures in
various areas, as well as the extent to which the level of support depends on the exact question wording used. Based on these aggregate patterns, do students believe that support for reductions in spending generally applies to all government spending—or only spending on programs that benefit others?

• Have students access a website that provides simulation of the federal budget or provides student with other budgetary tradeoff or analysis games. Develop a current “balanced” budget. Have students compare their decisions in class, debating the value of their expenditure and revenue choices. (See, for example, the budget game available at www.washingtonpost.com. Also, try searching for “federal balanced budget game” to see other current options.)

• Invite a staff member from a representative’s office to brief the class about the current status of the federal budget. Who’s involved? Who wants what out of the budget? If a representative or their staffer is not available, consider inviting a state senator or representative to discuss the same questions, as well as differences between the federal and state budgetary process.

BACKGROUND READING


MEDIA SUGGESTIONS

*Getting Out of Business: Privatization and the Modern State.* A video program distributed by Films for the Humanities and Sciences which examines government benefits to industry through providing employment and infrastructure.