12th Grade

Economics

NAME ______________________ DATE ______________ CLASS __________

Guided Reading Activity

networks

Taxes and Government Spending

Lesson 1 *Taxes*

Review Questions

Directions: Read each main idea and complete the statements below. Refer to your textbook as you write the answers.

A. Economic Impact of Taxes

Main Idea: Taxes impact the economy. They may alter behavior, spending, income distribution, an economic growth and productivity.

1. When a tax is placed on a product, its ______________ increase, so ______________ for it may decrease. People react to the higher price by buying ______________.

2. A ______________ tax is a relatively high tax intended to discourage certain undesirable ______________.

3. Taxes affect the ______________ of income, or the way in which it is allocated among families, individuals, or other groups.

4. Taxes can affect ______________ and economic growth by changing the ______________, or motivation, to save, invest, and work.

5. The ______________ of a tax refers to who bears the final ______________ of the tax. Indirect taxes can be ______________ to others, while a direct tax cannot.

B. Characteristics and Types of Taxes

Main Idea: Ideally, taxes should be fair, efficient, and effective. Tax money collected by the government should be used to benefit taxpayers, and taxes should be levied based on the ability to pay. There are three types of taxes: progressive, regressive, and proportional.

1. Tax ______________, or fairness, is undermined by the tax ______________ that some use to avoid paying their fair share of taxes.

2. ______________, another criteria for effective taxes, means that tax laws should be written so that both ______________ and tax collectors can understand them.

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3. Taxes should also be _______________ or relatively easy to administer and reasonably _______________ at generating revenue.

4. The _______________ principle of taxation states that those who benefit from government goods and services should pay in _______________ to the benefits they receive.

5. Another principle of taxation states that the _______________ to pay should be the most important criterion in the _______________ of tax paid, regardless of the _______________ they receive.

6. Medicare deductions from wages are an example of a _______________ tax because the same _______________ in tax is deducted from everyone's paycheck.

7. In a _______________ tax system, the higher your _______________ the higher the percent of income you pay in taxes.

C. Alternative Tax Approaches

Main Idea: The flat tax and the value added tax are two types of alternatives to the current tax code that have been proposed to replace it.

1. The flat tax is a _______________ tax in which everyone pays the same _______________ of tax on their income after a certain threshold has been reached.

2. One disadvantage of the flat tax is that it removes _______________ that are currently built into the tax code, such as deductions for homeowners that _______________ homeownership.

3. The _______________ - _______________ tax differs from a sales tax in that some tax is applied at each step in the _______________ process.

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Guided Reading Activity *cont.*

Taxes and Government Spending

D. Tax Reform Highlights

Main Idea: The tax code has been revised, or reformed, at many times during this nation's history. Reforms may raise or lower taxes on different groups depending on the political and economic conditions at the time. Tax reform may address tax inequities, budget surpluses, or the need for economic growth.

1. In 1981, President Reagan reformed the tax code by ______________ taxes on individuals and ______________ to encourage ______________ growth.

2. In 1986, tax law was reformed to include the alternative ______________ tax to ensure that the wealthy could not ______________ paying any taxes.

3. After some tax ______________ were closed, Congress lowered the tax on ______________ gains to allow rich investors to pay less tax on investment.

4. In 2001, there was a tax ______________, so taxes were ______________ accordingly.

5. President Bush tried to enact permanent tax ______________, but with two wars to pay for, these cuts led to great ______________ in the U.S. budget.

6. The Great Recession of 2008-2009 ended the ______________ tax cuts and led to a period of ______________ federal spending to ______________ the economy.

Summary and Reflection

Directions: Summarize the main idea in this lesson by answering the following questions.

If you were in a debate about taxes, what arguments would you make? Would you argue for the importance of everyone paying his or her fair share of taxes? Or would you argue in favor of lowering, "flattening," or even eliminating taxes? Prepare solid reasons to support your argument, and use evidence to support it as well.

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Guided Reading Activity

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Taxes and Government Spending

Lesson 3 *State and Local Government Finances*

Review Questions

Directions: Read each main idea and complete the statements below. Refer to your textbook as you write the answers.

A. State Government Revenue Sources

Main Idea: State governments get their revenue from the federal government, from sales taxes, from fees and licenses, from tuition, from income taxes (in the states that have them), etc.

1. States receive ______________ revenue, or funds collected by one level of government that are distributed to another level of government, from the ______________ government to increase their revenues.

2. Some states have ______________ tax, which is a general tax on consumer purchases of nearly all products and adds to the final ______________ paid by the customer.

3. In those states with individual ______________ tax, the tax may be progressive or ______________.

B. State Government Expenditures

Main Idea: Most states must balance their budget. State budgets include expenditures on public welfare, building and maintenance of public services such as highways and bridges, higher education funding, and funding of state employee benefit plans.

1. A ______________ budget amendment a constitutional provision requiring that annual spending not ______________ revenues.

2. Among states' ______________ expenditures are payments made to municipalities and towns to help them cover infrastructure and ______________.

3. In addition to funding state ______________ and universities, states spend money on corrections, roads and highways, employee ______________ funds, hospitals, and so on.

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Taxes and Government Spending

C. Local Government Revenue Sources

Main Idea: Local governments receive revenue from the federal and state government and may also receive money from certain taxes and fees.

1. Local governments receive the largest part of their revenues—slightly more than one-third—in the form of ______________ transfers from ______________ governments.

2. The tax on ______________ estate is the ______________ tax that raises the most money for local governments.

3. States may institute a tax on ______________ such as water, ______________, sewerage, and even telecommunications.

4. Many ______________ impose their own small ______________ tax on goods sold within the city limits.

D. Local Government Expenditures

Main Idea: Local governments pay for elementary and secondary education, utilities, public health and safety, local highway maintenance, and similar expenses.

1. At the local level, power to ______________ spending often rests with the mayor, the city ______________, the county judge, or some other elected representative or body, but the methods for approval are likely to vary considerably from one local ______________ to the next.

2. Local government is responsible for many aspects of education, salaries for ______________ and administrators, school ______________ and upkeep, and textbooks.

3. For most local governments, spending on ______________ like electricity and water is the second-largest ______________ in the budget.

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Guided Reading Activity *cont.*

Taxes and Government Spending

4. Many communities maintain a full-time, paid __________ force and professional firefighters; however some communities maintain __________ fire departments to keep costs down.

Summary and Reflection

Directions: Summarize the main idea in this lesson by answering the following questions.

Local governments have some very important expenditures that closely affect the lives of citizens. How do you think local governments might respond if the amount of money they receive from the federal government is sharply decreased? What state or local programs, if any, should they cut? What means of raising additional revenue at the local level would you support? Use examples to support your answer.

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2. A unit of account
3. A store of value

Barter

1. Without money, people would acquire goods and services through barter.
2. Many parts of the world still use bartering but as an economy becomes more specialized, it becomes too difficult to establish the relative value of items to be bartered.
3. Money, therefore, makes exchanges much easier.
4. It also provides a means for comparing the value of goods and services.
5. Except during periods of inflation, money usually functions as a good store of value.

Currency

1. The coins and paper bills people use as money are called currency.
2. In the past, people have used many things as currency including cattle, salt, precious stones, fur, and dried fish.
3. These things would not serve as good currency in today's world because they lack at least one of the six characteristics of money.

There are six characteristics of money

1. Durability
2. Portability
3. Divisibility
4. Uniformity
5. Limited supply
6. Acceptability

Durability

1. Money must be able to withstand the physical wear and tear that comes with being used over and over again.

Portability

1. Money must be easily carried by people. Paper money and coins work because they are small and light.

Divisibility

1. Money must be easily divided into smaller denominations.

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Divisibility

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Uniformity

1. People must be able to count and measure money accurately.

Limited Supply

1. Money would lose its value if there was an unlimited supply of it.
2. Therefore, the Federal Reserve regulates the amount of money in circulation in the United States.

Acceptability

1. Everyone in an economy must be able to take the objects that serve as money and exchange them for goods and services.

What makes Money Valuable?

1. There are actually several possible sources of money's value depending on whether it is **commodity money, representative money**, or **fiat money**.

Commodity Money

1. Commodity money consists of objects that have value in and of themselves, like cattle, and that are also used as money.
2. Commodity money lacks several characteristics that make objects good to use as money, such as divisibility and portability

Representative Money

1. Representative money makes use of objects that have value solely because the holder can exchange them for something else of value.
2. Early representative money took the form of paper receipts for gold and silver.
3. People left their gold in goldsmith's safes and would carry paper ownership receipts to show how much gold they owned.
4. During the American Revolution, problems arose with representative money called Continentals because the Continentals were not backed by gold or silver and were therefore useless.

Flat Money

1. United States money today is fiat money, which has value because a government has decreed that it is an acceptable means to pay debts.
2. Citizens have confidence that the money will be accepted.
3. Because the Federal Reserve controls the supply, it remains in limited supply, which makes it valuable.

Assessments

2. After the American Revolution, the new nation's leaders decided that they needed to establish a safe, stable banking system.
3. This need led to a tireless disagreement on how to organize the national banking system.

Two Views of Banking

1. Federalists wanted a centralized banking system and Alexander Hamilton, as Secretary of the Treasury, proposed a national bank in 1789.
2. Antifederalists, like Thomas Jefferson, opposed this plan.

   They favored a decentralized banking system in which states established and regulated banks within their borders.

The Second Bank of the United States

1. To eliminate the chaos, Congress charted the Second Bank of the United States in 1816.
2. Stability was restored but many were still wary of the Bank's powers. In 1832, when Congress tried to renew the Bank's charter, President Andrew Jackson vetoed the renewal

The Free Banking Era

1. As state-charted banks flourished once again from 1837 to 1863, the sheer number of banks gave rise to a variety of problems, including: Bank runs and panics
2. Wildcat banks that were inadequately financed and had a high rate of failure Fraud Many different currencies

Stability in the late 1800s

1. The National Banking Acts of 1863 and 1864 gave the federal government the power to: Charter banks Require that banks hold an adequate amount of gold and silver reserves Issue a national currency
2. In the 1870s the nation adopted the gold standard, which set a definite value for the dollar.

Banking in the early 1900s

1. Problems persisted despite the stabilizing efforts of a national currency and adopting the gold standard.
2. In 1913, the Federal Reserve Act established the Federal Reserve System, which reorganized the federal banking system to include: 12 Federal Reserve Banks, The Federal Reserve Board, Short-term loans, Federal Reserve notes

Banking and the Great Depression

1. The Fed, however, was unable to prevent the Great Depression.
2. President Franklin Roosevelt acted to restore the banking system in the 1930s by established the FDIC, which insured customer deposits if a bank failed.

3. FDR also changed the American currency to fiat money so the Fed could adequately control the money supply.

The Saving and Loan Crisis

1. In the late 1970s and 1980s, Congress passed laws to deregulate several industries.
2. This deregulation led to a crisis for the Savings and Loan industry, which was unprepared for the intense competition it faced after deregulation. High interest rates and risky loans added to the crisis.
3. In 1989, Congress passed legislation that abolished the independence of the Savings and Loan industry.

Sub-Prime Mortgage Crisis

1. Mortgage companies and banks began to loan people money who could not afford to pay these loans back.
2. When interest rates rose, many people couldn't afford to pay their mortgages, which led to foreclosures.
3. The ripple effect of the mortgage crisis hit banks and creditors hard and many economists worried that the crisis would send the U.S. economy into a recession.

Assessment

Section 3: Banking Today

What banking services do financial institutions provide? Financial institutions issue credit cards, make loans, provide mortgages, manage ATMS, and provide numerous electronic services.

Section 1 Key terms and definitions

money supply: all the money available in the United States economy

liquidity: the ability to be used, or directly converted into, cash

demand deposit: money in a checking account that can be paid out "on demand" or at any time

money market mutual fund: a fund that pools money from small savers to purchase short-term government and corporate securities

fractional reserve banking: a banking system that keeps only a fraction of its funds on hand and lends out the remainder

default: failing to pay back a loan

mortgage: a specific type of loan that is used to buy real estate

- Money market accounts, which allow people to save and write a limited number of checks
- CDs, which offer a guaranteed rate of interest but cannot be removed until after a specified period of time.

Loans

1. Financial institutions lend money to consumers and charge interest on those loans.
2. Loans help consumers:
   a. Buy homes
   b. Pay for college
   c. Start and grow businesses
3. Many banks loan money to other financial institutions and individuals. A banking system that only keeps a fraction of its funds on hand and lends out the rest is called fractional reserve banking.

Mortgage and Credit Card

1. A mortgage is a specific type of loan that is used to buy real estate.
2. Banks issue credit cards, which entitle their owners to buy goods and services based on the owners promise to pay.
3. Banks usually charge high interest rates on credit cards.

Simple and Compound Interest

1. Banks pay simple interest only on the principle of a deposit.
2. Compound interest is interest paid on both principal and accumulated interest.

Types of Financial Institutions

Commercial Banks: Offer checking accounts, accept deposits, and make loans

Savings and Loan Associations: Allow people to save up and borrow enough for their own homes

Savings Banks: Owned by depositors who make smaller deposits than a commercial bank would handle

Credit Unions: Cooperative lending associations established for particular groups

Finance Companies: Make installment loans to consumers

Electronic Banking

credit card: a card entitling its owner to buy goods and services based on the owner's promise to pay for those goods and services

interest: the price paid for the use of borrowed money

principal: the amount of money borrowed

debit card: a card used to withdraw money from a bank account

creditor: a person or institution to whom money is owed

Introduction

What banking services do financial institutions provide?

Financial institutions:

Provide electronic services

Issue credit cards

Make loans to businesses

Provide mortgages to prospective home buyers

Manage ATM machines

Measuring the money supply

1. To keep track of the different kinds of money, economists divide the money supply into categories.
2. M1 represents money that people can gain access to easily. This includes: Currency held by the public
3. Deposits in checking accounts
4. Traveler's checks
5. M2 consists of all the assets in M1 plus several additional assets. These funds cannot be used as cash directly, but can be converted to cash fairly easily.

Functions and Financial Institution

1. Banks and other financial institutions provide a wide range of services to customers.
2. **Storing money**
    a. They provide a safe place to store money
3. **Saving money**
    b. They offer people ways to save money through:
        - Savings accounts
        - Checking accounts

1. With the increased importance of computers in today's world, electronic banking has seen an upsurge.
2. ATMs allow customers to deposit money, withdraw cash, and obtain information.
3. Debit cards can be used at an ATM or in a store to purchase goods. These cards require a PIN for security reasons.
4. Home banking—More and more people use the Internet to check balances, transfer money, automatically deposit paychecks, and pay bills

ACHs and Store Value Cards

1. Automated Clearing Houses (ACHs) allow consumers to pay bills without writing checks.
2. Stored-value cards carry money on them and can be used by college kids on campus or by people using a phone card with stored minutes.

Assessment

Guided Reading Activity

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Taxes and Government Spending

Lesson 2 *Federal Government Finances*

Review Questions

Directions: Read each main idea and complete the statements below. Refer to your textbook as you write the answers.

A. Establishing the Federal Budget

Main Idea: The federal budget is for a fiscal year and is prepared by the executive branch. However, all spending must be approved and the budget finalized by both houses of Congress.

1. A 12-month ____________ year does not have to coincide with a ____________ year.

   The government's fiscal year starts on October first and expires on September 30 of the following calender year.

2. The Office of ____________ and Budget, part of the executive branch, prepares the initial ____________ budget. However, the president's budget is only a ____________.

3. After being discussed and evaluated, each House ____________ prepares an ____________ bill, which is an act of Congress that allows federal agencies to spend money for a specific purpose.

4. Both the House and the ____________ often seek expert, nonpartisan advice from the Congressional ____________ Office about fiscal aspects of the bill.

5. If the House and Senate both approve the ____________ bill that they worked out, they send it to the ____________ for approval.

6. If there is no ____________ on a budget, a continuing budget ____________ can be approved to keep the government functioning.

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Guided Reading Activity *cont.*

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Taxes and Government Spending

B. Federal Government Revenue Sources

Main Idea: The federal government gets revenue from payroll, income, and corporate taxes, from excise and estate taxes, from fees and customs duties, from borrowing, etc.

1. About one-third of all government ______________ comes from ______________ ______________ taxes; in most cases, these taxes are collected through a ______________ withholding system.

2. Because tax revenues ______________ based on economic conditions, the government never knows exactly how much revenue it will have or how much it will need to spend in a year, so sometimes it must ______________ money.

3. Social Security and ______________ are funded through ______________ taxes deducted from people's paychecks.

4. The tax a corporation pays on its profits, known as the ______________ ______________ tax, is the fourth-largest source of federal revenue.

5. Tobacco and alcoholic beverages are subject to an ______________ tax, which is incorporated into the ______________ and is the same for everyone.

6. The ______________ tax is the tax on the transfer of property when a person dies. Fewer than 2 percent of estates ______________ any tax.

7. Customs ______________ are taxes applied to goods brought into the United States from ______________ countries.

8. User ______________ are charged for the use of a good or service, such as entrance to a ______________ park.

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Taxes and Government Spending

C. Federal Government Expenditures

Main Idea: The federal government spends money on Social Security, national defense, social services for the needy, and activities that promote the national and citizen welfare, such as food and airline safety.

1. ______________, or pork, is are terms used to describe a line-item budget expenditure that circumvents normal budget-building procedures.

2. ______________ spending is authorized by law and continues without any need for annual ______________ by Congress.

3. National ______________ is a kind of ______________ spending that takes up a large part of the budget.

4. Social ______________ are a form of ______________ payments for which the government receives neither goods nor services.

5. Although Medicaid spending is ______________, other programs, such as cancer research and occupational safety are considered ______________ spending.

D. From Deficits to Debt

Main Idea: If budget deficits are too deep or go on too long, the nation must borrow to meet its financial obligations. Borrowing increases the national debt, or money borrowed from others.

1. ______________ spending involves annual government spending in excess of ______________ and other revenues.

2. The United States sells ______________ notes to make up for revenue shortfalls, but this leads to an increase in the ______________ debt.

3. One way public debt differs from ______________ debt in that the latter affects the debtor's ______________ power. Also, most of the national debt is debt we owe to ______________, while private debt is owed to others.

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Guided Reading Activity *cont.*

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Taxes and Government Spending

E. Impact of the National Debt

Main Idea: The national debt tends to transfer purchasing power from the private to the public sector. If the government borrows too much money, it may crowd out others, such as homebuyers, who also need to borrow money from a limited pool of available credit.

1. The national debt can cause a transfer of ________________ power from the private sector; when public debt increases, taxes ________________ and people have less money for themselves.

2. Because the government borrows so much, it can compete with business and individuals for the ________________ of available funds; this competition causes a ________________-________________ effect.

F. Reducing Deficits and the Debt

Main Idea: Proposals for eliminating deficits and reducing the debt include "pay-as-you-go" provisions, spending caps, line-item vetoes, increasing revenue by raising taxes and through other means, and cutting social programs.

1. "Pay-as-you-go" provisions require that all ________________ spending be offset by spending ________________ elsewhere in the budget.

2. A spending ________________ is a legal limit on ________________ spending.

3. Other approaches to deficit reduction include raising ________________ and cutting ________________, such as disability benefits, unemployment benefits, and nutritional aid to poor children.

4. In a budget stalemate, a ________________ may require deep and ________________ cuts in all government spending.

5. The debt ________________ only permits borrowing for expenditures that have already been ________________ by Congress.

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Guided Reading Activity *cont.*

Taxes and Government Spending

Summary and Reflection

Directions: Summarize the main ideas in this lesson by answering the following question.

The government has many obligations to provide services to its tax-paying citizens. If you were in Congress, how would you balance the need for the government to spend money on necessary things with a prudent approach to controlling to the debt and the deficit? Use examples in your answer.

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NAME ____________________ CLASS __________ DATE __________

Section 1: Guided Reading and Review

Money

A. As You Read

As you read Section 1, supply the requested information in the spaces provided.

Describe the three uses of money.

1. ____________________
2. ____________________
3. ____________________

Define the six characteristics of money.

4. ____________________
5. ____________________
6. ____________________
7. ____________________
8. ____________________
9. ____________________

B. Reviewing Key Terms

Match the definitions in Column I with the terms in Column II. Write the letter of the correct answer in the blank provided.

Column I

____ 10. something that keeps its value if held

____ 11. objects that have value because the holder can exchange them for something else of value

____ 12. money that has value because the government says it is acceptable for paying debts

____ 13. anything that is used to determine value during the exchange of goods and services

____ 14. exchange of one set of goods or services for another

____ 15. coins and paper bills used as money

____ 16. way to compare the value of goods and services relative to each other

____ 17. anything used as a medium of exchange, a unit of account, and a store of value

____ 18. objects that have value in themselves as well as for their use as money

Column II

a. barter
b. store of value
c. fiat money
d. currency
e. money
f. medium of exchange
g. commodity money
h. unit of account
i. representative money

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Section 2: Guided Reading and Review

The History of American Banking

A. As You Read

As you read Section 2, fill in two supporting facts or details under each main idea by answering each question.

Main Idea: Before the Civil War, banking in the United States shifted between a centralized system and independent state and local banks.

1. What were the first two attempts to centralize U.S. banking, and when were they in operation? ______________________

____

2. What problems were associated with the Free Banking Era (1837–1863), dominated by state-chartered banks? ______________________

____

Main Idea: Reforms of the late 1800s stabilized the banking system.

3. How did the National Banking Acts of 1863 and 1864 promote stability? ______________

____

4. How did the gold standard promote stability? ______________________

____

Main Idea: Banking reforms early in the twentieth century helped strengthen and centralize American banking.

5. How did the Federal Reserve System, established in 1913, begin to manage the money supply? ______________________

____

6. What guarantee was made available to bank customers in 1933? ______________

____

B. Reviewing Key Terms

Complete each sentence by writing the correct term in the blank provided.

7. One advantage of the ______________ was that the government could only issue currency if it had gold in the treasury to back it.
8. The ______________ was a paper currency printed with green ink that was issued by the U.S. Treasury during the Civil War but not backed by gold or silver.
9. A(n) ______________ receives, keeps, and lends money.
10. The nation's central banking system is the ______________.

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Section 3: Guided Reading and Review

Banking Today

A. As You Read

As you read Section 3, supply the requested information on the lines provided.

Define M1.

1. ______________________________

____

Define M2.

2. ______________________________

____

List five services that banks offer.

3. ______________________________
4. ______________________________
5. ______________________________
6. ______________________________
7. ______________________________

Describe four types of financial institutions.

8. ______________________________
9. ______________________________
10. ______________________________
11. ______________________________

B. Reviewing Key Terms

Define the following terms.

12. money supply ______________________________
13. liquidity ______________________________
14. demand deposit ______________________________
15. money market mutual fund ______________________________
16. fractional reserve banking ______________________________
17. default ______________________________
18. mortgage ______________________________
19. credit card ______________________________
20. interest ______________________________
21. debit card ______________________________
22. creditor ______________________________

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Section 1: Quiz

The Federal Reserve System

A. Key Terms

Briefly define or identify each of the following.

1. Board of Governors ______________________

2. Federal Reserve Districts ______________________

3. Federal Advisory Council (FAC) ______________________

4. Federal Open Market Committee (FOMC) ______________________

B. Main Ideas

Write the letter of the correct answer in the blank provided.

____ 5. What does "monetary policy" mean?
a. political policies pursued by the federal government
b. actions the Federal Reserve takes to influence the economy
c. Federal Reserve policies on creating new banks
d. decisions about how much the Federal Reserve charges members

____ 6. Why does the Federal Reserve System have a high degree of political independence?
a. the system has only advisory power
b. it is divided into geographical districts
c. the governors are appointed for life terms
d. the system is owned by the banks

____ 7. Who appoints the members of the Board of Governors of the Federal Reserve?
a. the U.S. President
b. the U.S. senate
c. the state governors
d. the state legislatures of the states represented

____ 8. How many Federal Reserve Districts are there?
a. 8
b. 12
c. 24
d. 52

____ 9. What banks must join the Federal Reserve system?
a. all nationally chartered banks
b. all state-chartered banks
c. all banks of any kind
d. no banks must join; membership is voluntary

____ 10. What is the subject of Federal Open Market Committee decisions?
a. appointment of members of the Federal Reserve's Board of Governors
b. chartering of new banks and other lending institutions
c. level of interest rates and growth of the money supply
d. scheduling of banking days and hours for member banks

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Section 2: Quiz

Federal Reserve Functions

A. Key Terms

Briefly define or identify each of the following.

1. check clearing ______________________

2. bank holding company ______________________

3. federal funds rate ______________________

4. discount rate ______________________

5. net worth ______________________

B. Main Ideas

Write the letter of the correct answer in the blank provided.

____ 6. What does a "fractional reserve banking system" mean?
a. one that uses fractional paper currency as well as coins
b. one that is required to report daily deposits to the Federal Reserve
c. one that must keep most deposited money in reserve
d. one that keeps only a small part of customers' deposits on hand

____ 7. Who issues U.S. paper currency?
a. the Treasury Department
b. the U.S. Mint
c. the district Federal Reserve Banks
d. the U.S. bank examiners

____ 8. In the United States, what does the general level of a family's income have to do with the amount of cash the family is likely to hold?
a. The higher the real income, the more cash the family will hold.
b. The higher the real income, the less cash the family will hold.
c. The lower the real income, the more cash the family will hold.
d. The two factors are not related to each other.

____ 9. What is the function of a bank examiner?
a. to make sure banks are obeying laws and regulations
b. to respond to banks about their daily reports to the Fed
c. to carry on day-to-day functions within the bank
d. to oversee decisions about major loans by each bank

____ 10. Why does a high interest rate discourage people from holding their money in cash?
a. They cannot be sure that cash will hold its value.
b. They are more concerned that it will be stolen.
c. They are fearful of inflation.
d. They can get interest for it when it is invested.

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NAME ________________ CLASS ________ DATE ________

Section 3: Guided Reading and Review

Monetary Policy Tools

A. As You Read

As you read Section 3, answer the following questions.

1. If you deposit $1,000 of borrowed money in a bank checking account, by how much do you increase the money supply? ________________
2. Why does the Federal Reserve establish a required reserve ratio? ________________
3. What three tools could the Federal Reserve use to adjust the money supply? ________________
4. What two effects, leading to an increased money supply, could a reduced RRR have? ________________
5. Why does the Fed seldom, if ever, change bank reserve requirements? ________________
6. How do banks respond to a lowered discount rate? ________________
7. How does a raised discount rate affect bank loans and the money supply? ________________
8. What effect does the Fed's purchase of government bonds have on the money supply? ________________
9. How does the Fed's sale of bonds reduce the money supply? ________________
10. Which of its monetary policy tools does the Federal Reserve use most often? ________________

B. Reviewing Key Terms

Rewrite each statement below as needed to make it correct.

11. *Money creation* is the process by which money is manufactured. ________________
12. The *required reserve ratio* is the ratio of reserves to loans required of banks by the Federal Reserve. ________________
13. The size of loans created with each demand deposit is measured by the *money multiplier formula.* ________________
14. *Open market operations* refers to the buying and selling of banks by the Federal Reserve. ________________

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NAME ______________________ CLASS ____________ DATE ____________

Section 4: Guided Reading and Review

Monetary Policy and Macroeconomic Stabilization

A. As You Read

As you read Section 4, complete the following sentences.

1. The cost of borrowing or having money is the ________________.
2. If the money supply is high, interest rates will be ________________.
3. Lower interest rates give firms more opportunities for ________________.
4. The Fed may follow an easy money policy when the macroeconomy is experiencing a ________________.
5. The Fed may follow a tight money policy when the macroeconomy is experiencing a ________________.
6. The goal of stabilization policy is to smooth out fluctuations in the ________________.
7. If expansionary policies take effect while the macroeconomy is already expanding, the result could be higher ________________.
8. One reason for inside lags is that it takes time to ________________.
9. A second reason for inside lags is that it can take additional time to ________________.
10. Monetary policy can be put in place almost immediately by the ________________.
11. The outside lag can be relatively short for ________________ policy.
12. Outside lags for monetary policy can be lengthy because they primarily affect ________________.
13. We rely more on the Fed to combat the business cycle because fiscal policy is often delayed by ________________.
14. Economists who usually recommend enacting fiscal and monetary policies believe that economies ________________.

B. Reviewing Key Terms

Define the following terms.

15. monetarism ____
16. easy money policy ____
17. tight money policy ____
18. inside lag ____
19. outside lag ____

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My Economic class is to view this video on **Money**

https://youtu.be/DWTjJZxS64Y

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Chapter 14: Taxes and Government Spending

Lesson 2 Federal Government Finances

ESSENTIAL QUESTION

How does the government collect revenue, and on what is that revenue spent?

Reading HELPDESK

Academic Vocabulary

coincide to happen or exist at the same time or in the same position
instituted put into action

Content Vocabulary

fiscal year 12-month financial planning period that may coincide with the calendar year; October 1 to September 30 for the federal government
appropriations bill legislation authorizing spending for certain purposes
continuing budget resolution an agreement to fund a government agency at certain levels
budget deficit a negative balance after expenditures are subtracted from revenues
budget surplus a positive balance after expenditures are subtracted from revenues
payroll withholding system method of automatically removing deductions from a paycheck
indexing adjustment of tax brackets to offset the effects of inflation
payroll tax tax on wages and salaries to finance Social Security and Medicare costs
FICA Federal Insurance Contribution Act; tax levied on employers and employees to support Social Security and Medicare
corporate income tax tax on corporate profits
excise tax general revenue tax levied on the manufacture or sale of selected items
estate tax tax on the transfer of property when a person dies
gift tax tax on donations of money or wealth that is paid by the donor
customs duty tax on imported products
user fee fee paid for the use of a good or service; form of a benefit tax
public sector that part of the economy made up of the local, state, and federal governments
earmarks (pork) a line item budget expenditure that circumvents normal budget building processes and procedures and benefits a small number of people or businesses
mandatory spending federal spending authorized by law that continues without the need for annual approvals of Congress
discretionary spending spending for federal programs that must receive annual authorization
transfer payments payments for which the government receives neither goods nor services in return
Medicaid joint federal-state medical insurance program for low-income people
deficit spending annual government spending in excess of taxes and other revenues
national debt the total amount borrowed from investors to finance the government's deficit spending

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Reading Essentials and Study Guide

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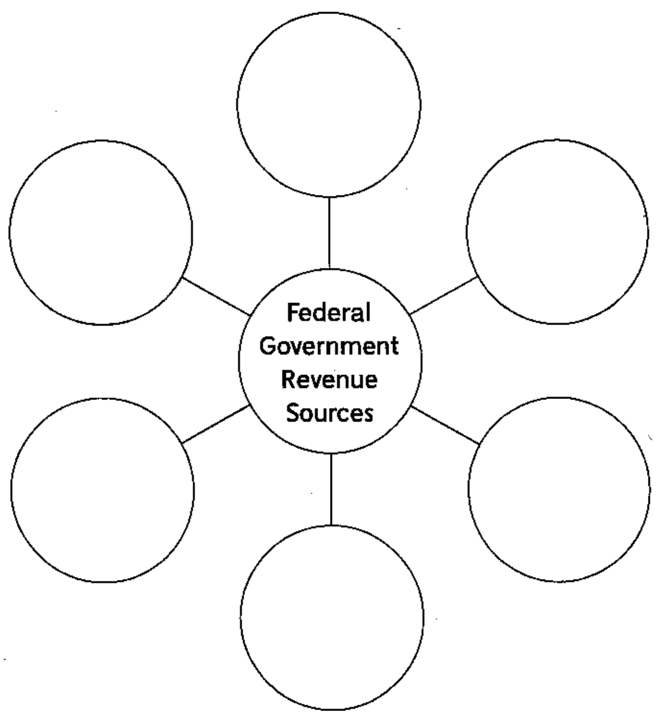
Chapter 14: Taxes and Government Spending

Lesson 2 Federal Government Finances, *Continued*

balanced budget annual budget in which expenditures equal revenues
trust funds special account used to hold revenues designated for a specific expenditure such as Social Security, Medicare, or highways
per capita per person basis; total divided by population
private sector that part of the economy made up of private individuals and businesses
crowding-out effect higher than normal interest rates and diminished access to financial capital faced by private investors when government increases its borrowing in financial markets
pay-as-you-go provision requirement that new spending proposals or tax cuts must be offset by reductions elsewhere
line item veto power to cancel specific budget items without rejecting the entire budget
spending caps limits on annual discretionary spending
entitlements program or benefit using established eligibility requirements to provide health, nutritional, or income supplements to individuals
sequester a law that required automatic budget cuts beginning in 2013
debt ceiling total amount of money the federal government is allowed to borrow

TAKING NOTES: *Key Ideas and Details*

Use the graphic organizer below to identify the six ways the federal government raises revenues.



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Establishing the Federal Budget

Guiding Question *How does the federal government determine an annual budget?*

The federal budget covers a ***fiscal year****. A fiscal year is a 12-month financial planning period that may or may not* ***coincide*** *with the calendar year. The government's fiscal year starts on October 1 and ends on September 30 of the next year.*

Executive Formulation

The president's Office of Management and Budget (OMB) creates the federal budget. The OMB is part of the executive branch of government. But the president's budget is only a request. Congress can approve, change, or disapprove it. The law requires that the budget must go to both houses of Congress by the first Monday in February.

After February, the process of approving the budget slows down a lot.

Congressional Action

The president's budget request first goes to the House of Representatives. The House breaks it into 13 major expenditure categories and gives each one to a separate House subcommittee. Each subcommittee then prepares an ***appropriations bill****. The appropriations bill is an act of Congress that lets federal agencies spend money for a specific purpose. Subcommittees have meetings, and debate and vote on each bill. Then they send the approved bill to the full House Appropriations Committee. If they approve it, they send it to the entire House for a vote.*

The Senate gets the budget after the House has approved it. The Senate may approve the budget as it is, or the Senate may change it. If the House and Senate do not agree, a joint House-Senate group tries to work out a compromise. During this process, the House and the Senate often ask for advice from the Congressional Budget Office (CBO). The CBO is a nonpartisan congressional organization that studies the impact of the budget. The CBO also projects future revenues and expenditures that the budget may cause.

Final Approval

If the House and Senate both approve the compromise bill, they send it to the president to sign. The final budget may look very different from what it was at the beginning. Congress has taken it apart, rewritten it, and put it back together. Many times, a bill may have changed a lot, with new items that were not in the original budget.

If the budget is too different, the president can veto it and force Congress to make it closer to the original. But once the president signs it, the budget becomes official for the next fiscal year that starts on October 1. If there is no agreement, Congress can pass a ***continuing budget resolution***. This is an agreement to fund a government organization at the same, lower, or even higher levels. Congress has used many continuing resolutions since 2001 because of spending disagreements.

The 2014 Fiscal Year Budget

The federal budget in ***Figure 14.5*** *is called the fiscal year (FY) 2014 budget. Its title is 2014 because most of the months are in 2014. The figure shows $2,712 billion (or $2.7 trillion) of revenue and almost $3,685 billion (or $3.7 trillion) of spending. This creates a* ***budget deficit*** *of about $973 billion. A budget deficit is a negative balance that happens when expenditures are greater than revenues. If expenditures were less than revenues, the result would be a* ***budget surplus****.*

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As the year continues, the size of the deficit or surplus is likely to change a lot because of unexpected events. For example, changes in business conditions could affect tax collections, or changes in political opinion could affect spending.

Reading Progress Check

Describing Why does it take so long for the federal budget to be approved?

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Federal Government Revenue Sources

Guiding Question *What are the main sources of government revenue?*

The federal government gets its revenue from different sources. Taxes are the main source of revenue, but borrowing is also a source. As you can see in Figure 14.5, the four largest sources of government revenue are individual income taxes, borrowing, Social Security taxes, and corporate income taxes.

Individual Income Taxes

Today the individual income tax makes up about half of all federal government revenue. The government usually collects the tax through a ***payroll withholding system****. This system requires an employer to automatically deduct income taxes from a worker's paycheck and send them directly to the IRS.*

Workers sometimes get pay raises to cover the costs of inflation. The raise can push a worker up into a higher tax bracket. But the tax code is indexed to stop this from happening. **Indexing** is an upward revision of the tax brackets to keep workers from paying more in taxes just because of inflation. Otherwise, workers might pay more taxes when they aren't really making more money.

Borrowing

Borrowing is the second-largest source of federal revenue. Borrowing has always been an important source of revenue, but the government is borrowing more now. First, the government has increased spending on Social Security and Medicare as our population has aged. Second, the government increased spending on national defense after the 9/11/2001 terrorist attacks. Third, there have been lower tax rates since in the 1980s. Lastly, there were lower tax collections during and after the Great Recession.

The government would still need to borrow even without these major events. This is because tax revenues fluctuate. The government never knows exactly how much it will have, or how much it will need to spend each year. So if the government does not collect enough money in taxes and fees, or if it has more expenses than it can pay for, it borrows by selling bonds to investors.

Figure 14.5 shows that the federal government has become dependent on this source of funds. It borrows more than the total amount of taxes it collects for Social Security or from private corporations.

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Payroll Taxes

The third most important federal revenue source is called the ***payroll tax****. The government takes this tax directly from paychecks. The official name is* ***FICA****, the Federal Insurance Contributions Act tax. Employers and employees equally pay FICA for Social Security and Medicare.*

In 2014, the Social Security part of FICA was 6.2 percent of wages and salaries up to $117, 000. The government does not collect Social Security taxes above this amount. This means that a person with taxable income of $117,000 pays the same Social Security tax—$7,254—as the person who earns $1,000,000,000.

In 1965, Congress added Medicare to the Social Security program. The government taxes the Medicare part of FICA at a flat rate of 1.45 percent. Unlike Social Security, there is no cap on the amount of income taxed, which makes it a proportional tax.

Corporate Income Taxes

The fourth-largest source of federal revenue is the ***corporate income tax****. This is the tax a corporation pays on its profits. The government taxes corporations separately from individuals because corporations have a separate legal identity.*

Corporations pay a slightly progressive tax, but their actual tax rate is low because there are many business tax breaks. For example, in 2013 a Senate subcommittee found that Apple Computer did not pay any taxes on its $30 billion profits. Apple used a complicated network of international corporations to avoid paying taxes to any government. And the subcommittee concluded that Apple did not violate any U.S. tax laws.

Excise, Estate, and Gift Taxes

The ***excise tax*** *is the fifth-largest source of federal government revenue. It is a tax on the manufacture or sale of certain items such as gasoline and liquor. There were early excise taxes on carriages, snuff, and liquor. Today there are excise taxes on telephone services, tires, gasoline, legal betting, and coal. Excise taxes tend to be regressive because low-income families spend larger portions of their incomes on some of these goods than do high-income families.*

An **estate tax** is the tax on the transfer of property when a person dies. The estate includes everything a person owned. Estate taxes can range from 18 to 50 percent of the value of the estate, but estates worth less than $3,500,000 are exempt. Because the exemption is so high, fewer than 2 percent of all estates pay any federal tax at all.

A **gift tax** is a tax on the transfer of money or wealth. The person who gives the gift pays the tax. The government uses the gift tax to make sure that wealthy people do not try to avoid taxes by giving away their estates before they die. Figure 14.5 shows that estate and gift taxes make up only a small fraction of total federal government revenue.

Exploring the Essential Question

Let us suppose that you have started a part-time job at the local coffee shop. You are working 15 hours a week and get paid the minimum wage in your state. You get paid every two weeks. Write a paragraph describing the taxes you will pay to the federal government every two weeks. Describe any issues you have with paying these taxes and why.

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Other Revenue Sources

A customs duty is a charge on goods brought into the United States from other countries. Customs duties apply to many types of goods. These range from automobiles to silver. The duties are relatively low. They produce little federal revenue today, but they were the largest income source for the government before income taxes.

Finally, the government collects a very small portion of federal revenue through different fees. One example is a **user fee**. This is a charge for the use of a good or service. President Ronald Reagan promoted user fees because they were a revenue source that did not come from taxes.

User fees include entrance charges at national parks. They also include the fees ranchers pay when their animals graze on federal land. These fees are basically taxes based on the benefit principle. Only the people who use the services pay the tax. People also seem more comfortable with them since they are not called "taxes."

Reading Progress Check

Explaining Why are corporations taxed separately from individuals?

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Federal Government Expenditures

Guiding Question *How does the federal government determine an annual budget?*

The ***public sector*** *is the part of the economy made up of federal, state, and local governments. Public sector spending was relatively low before the Great Depression. Since then, attitudes have changed, and spending has increased sharply. Some of the spending was in the form of* ***earmarks****, or* ***pork****. These terms describe the expense for a single item in a budget that circumvents normal budget rules. More recently, most spending has been for things like national defense, highways, parks, and other categories.*

Social Security

The largest category of expenses in the 2014 federal budget is for payments to aged and disabled Americans through the Social Security program. Retired persons receive benefits from the Old-Age and Survivors Insurance (OASI) program. People who cannot work receive payments from disability insurance (DI) programs.

Spending for Social Security is sometimes called **mandatory spending**. Mandatory spending is legally approved spending that does not need annual approvals from Congress. This is because the total Social Security payments in any year depend on the number of people who are eligible and the level of benefits that Congress has already approved. Our population continues to get older, and more people are reaching retirement. So Social Security will continue to be the largest federal cost unless the government changes the program.

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National Defense

National defense made up the largest category of spending for most of the late 1900s. Now Social Security is bigger. National defense includes military spending by the Department of Defense and defense-related atomic energy activities. These include developing nuclear weapons and removing nuclear wastes.

We call defense costs **discretionary spending**. This is spending that must get approval from Congress every year. Social Security payments go up as the population gets older. But annual defense costs can go up, down, or remain the same. It all depends on the president and Congress.

Income Security

Income security is a wide range of programs. The programs include unemployment assistance, food and nutrition assistance, and retirement benefits for federal civilian employees and retired military. Other programs support people who cannot fully care for themselves. Most of these expenses are ***transfer payments****. The government does not get goods or services in return for transfer payments.*

Other transfer payments include Social Security, unemployment compensation, welfare, and aid for people with disabilities. They also include child care, foster care, and adoption assistance. People who cannot support themselves receive Supplemental Security Income (SSI), subsidized housing, federal child support, Temporary Assistance for Needy Families (TANF), and food stamps. Most income security expenditures are mandatory, which means they do not need approval from Congress every year.

Medicare and Medicaid

Medicare began in 1966 and is another mandatory program. It provides an insurance plan that covers major hospital costs. Medicare also offers optional insurance for more health services. It can cover doctor and laboratory fees, outpatient services, and some medical equipment costs.

Recently, Medicare costs have greatly increased. The population has aged and the cost of caring for the elderly has gone up. Economists expect these increases to continue because medical costs are rising and the population is getting older.

Health-care services for low-income people, preventing disease, and consumer safety make up a large part of the federal budget. **Medicaid**, for example, is a joint federal-state medical insurance program for low-income people. Medicaid is a mandatory expenditure program because Congress has already approved payments. Other mandatory programs include health-care services for working and retired federal employees.

Some programs in this category are discretionary. Again, this means they need approval from Congress every year. One example is the Occupational Safety and Health Administration (OSHA), which oversees job safety and health in the workplace. Other discretionary programs include AIDS and breast cancer research, drug addiction treatment, and mental health services.

Other wide categories of the federal budget include education, training, employment, and social services. They also include veterans' benefits, transportation, administration of justice, and natural resources and the environment. They include both mandatory and discretionary spending.

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Reading Progress Check

Summarizing What steps are involved in establishing the federal budget?

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From Deficits to Debt

Guiding Question *How do annual budget deficits add up to the national debt?*

The federal budget has a history of ***deficit spending****. This means spending more than revenues bring in. Sometimes the government plans deficit spending. At other times, revenues drop and expenses rise at the same time. This happened during and after the Great Recession. It caused a single annual deficit to reach the trillions.*

Deficits Add to the Debt

Panel A *of* ***Figure 14.6*** *shows the history of the federal budget deficit since 1965. During that period, the federal budget had a surplus only five times. The first was in 1969, and the last four were in the years 1998 to 2001. When the federal government runs a deficit, it must pay for the revenue shortage by borrowing. It borrows by selling U.S. Treasury notes and other securities to the public. If we add up all outstanding federal notes, bonds, and other debts, we get the* ***national debt****, which is the total amount the government has borrowed from investors to pay for its deficit spending.*

As you can see in **Panel B** in Figure 14.6, the national debt grows whenever the government runs a deficit. If the federal budget runs a surplus, then the government pays back some of the borrowed money. Then the amount of total debt goes down, as it did from 1998 to 2001. When the federal government has a **balanced budget**, the national debt does not change. A balanced budget is an annual budget in which expenses equal revenues.

A Growing Public Debt

The national debt has grown almost without stopping since 1900. The debt was $1.3 billion at that time. By 1929 it was $16.9 billion, and by 1940 it was $50.7 billion. By 2014 the total national debt reached $13.3 trillion.

Some of this debt is money that the government owes itself. For example, about $5 trillion of this debt is in government **trust funds**. These are special accounts that pay for certain types of costs such as Social Security and Medicare. When the government collects the FICA or payroll taxes, it puts the revenues in these trust accounts. Then the government invests the money in government securities until it needs it.

Most economists ignore trust fund balances because they represent money the government owes to itself. Instead, they see the public portion of the debt as the most important part. The public portion was about $13.3 trillion in 2014.

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Lesson 2 Federal Government Finances, *Continued*

Figure 14.7 shows two alternative views of the total national debt. **Panel A** shows the debt as a percentage of GDP, and **Panel B** shows the national debt on a **per capita**, or per person, basis. Both are relatively large historically.

Public vs. Private Debt

The country can never go bankrupt even though the public debt is so high because of differences between public and private debt. First, we owe most of the national debt to ourselves; we owe the private debt to others.

Another difference is repayment. When private citizens borrow, they usually make plans to repay the debt by a specific date. When the government borrows, it doesn't think much about repayment. It simply prints new bonds to pay off the old bonds.

A third difference is in purchasing power. When people repay debts, they give up purchasing power because they have less money to buy goods and services. But the federal government does not always give up purchasing power because it doesn't really pay out money. It simply transfers the taxes collected from some groups to others. This does not include the 34 percent of the public debt that foreigners own. When the government pays back investors outside the United States, it loses some purchasing power from the U.S. economy.

Reading Progress Check

Contrasting What is the main difference between public and private debt?

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Impact of the National Debt

Guiding Question *How does the transfer of purchasing power between generations affect you?*

Even though we owe most of the national debt to ourselves, it still affects the economy. The national debt affects the economy by transferring purchasing power, reducing economic incentives, causing a crowding-out effect, and redistributing income.

Transferring Purchasing Power

The national debt can cause a transfer of purchasing power from the ***private sector*** *to the public sector. The private sector is the part of the economy made up of private citizens and privately owned businesses. When public debt increases, taxes increase. Then people usually have less money for themselves.*

Purchasing power can also transfer from one generation to another. If the government borrows today and leaves the repayment to future taxpayers, then today's adults will consume more and their children will have less. So one generation's debt can hurt the next generation.

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Reducing Economic Incentives

Government borrowing can affect private economic incentives if it seems like the government is spending money carelessly. For example, a community may use a federal grant to buy expensive equipment. But its citizens would not want to pay for the expensive equipment themselves. If the taxpayers that benefit from a project would not want to pay for it themselves, other taxpayers would probably not want their taxes to pay for it either.

Crowding Out

When the federal government uses deficit spending, it must borrow money in financial markets. This is a supply-and-demand situation in the markets for borrowing money. If the demand for funds increases but the supply of available funds does not increase, the price of borrowed money will go up. The price of borrowed money is the interest rate. Higher interest rates force all borrowers to pay more.

The government can compete with the private sector for the supply of available funds because it borrows so much. This competition can cause a **crowding-out effect**. The crowding-out effect begins with higher-than-normal interest rates caused by heavy government borrowing. Then the higher interest rates squeeze private borrowers out of the market. The private borrowers are businesses and citizens such as potential home buyers.

Reading Progress Check

Describing How can the government's role as a borrower impact economic incentives?

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Reducing Deficits and the Debt

Guiding Question *Why is it difficult to reduce the national debt?*

To reduce the national debt, we have to first fix the federal budget deficit because budget deficits add to the debt. People are worried about deficit spending, so they have tried different ways to fix it since the 1980s.

Early Legislative Failures

One of the first efforts to fix the federal deficit was when Congress tried to mandate a balanced budget. Congress called the law the Balanced Budget and Emergency Deficit Control Act of 1985, also called Gramm-Rudman-Hollings (GRH) Act, after its supporters.

People had high hopes, but GRH failed for two reasons. First, Congress discovered that it could get around the law by passing spending bills that took effect two or three years later. Second, the economy began to weaken in 1990, which stopped the budget cuts.

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Lesson 2 Federal Government Finances, *Continued*

In 1990, Congress passed the Budget Enforcement Act (BEA). The BEA's main feature was a **"pay-as-you-go" provision**. This was a requirement that Congress balance new spending with decreases in the budget. If Congress could not agree on decreases, then automatic, wide-ranging spending cuts would be **instituted**. Congress soon discovered that cutting spending was more difficult than it had thought. It suspended the provision in order to increase spending.

In 1996, Congress gave the president a **line-item veto**, which is the power to cancel specific budget items without rejecting the entire budget. But the Supreme Court said it was unconstitutional. The Balanced Budget Agreement of 1997 came next. This had rigid **spending caps**, which are legal limits on annual discretionary spending, to assure that Congress balanced the budget by 2002. But the caps required politically unpopular spending cuts in many programs such as health, science, and education, so Congress gave up the caps too.

Raising Revenues

Raising revenues is another way to reduce deficits. President Clinton's Omnibus Budget Reconciliation Act of 1993 was an effort to cut $500 billion from the deficit over five years. The act combined spending reductions and tax increases that made the individual income tax more progressive. This was especially true for the wealthiest 1.2 percent of taxpayers.

Higher tax rates, along with strong economic growth, combined to produce four years of budget surpluses from 1998 through 2001. But in 2001, Congress expected annual surpluses to last for another 10 years. Congress cut tax rates instead of paying down the debt. It also increased spending, which made the situation worse.

Unexpected Spending

In 2001, terrorists attacked the United States. These attacks led to unplanned government spending on homeland security and wars in Iraq and Afghanistan. The federal government also had fewer tax revenues to spend because this was the first year of President Bush's tax cuts. There were fewer revenues because economic activity was low as well. As a result, very high federal budget deficits returned in 2002.

It was also difficult for Congress to reduce spending because the budget had so many **entitlements**. Entitlements are broad social programs with admission requirements to provide health, nutritional, or income supports to individuals. People can receive benefits if they meet the requirements. Congress can revise entitlements even though most are in the mandatory spending category. Still, it is difficult for members of Congress to revise them because the programs are so popular.

Sequester

In 2011, President Obama and Congress agreed to a deficit reduction solution that would start in 2013. It included a ***sequester*** *that required automatic, wide budget cuts to begin in 2013 if Congress could not agree on major deficit reductions before then. The cuts affected all discretionary programs such as education, energy, medical research, and even national defense.*

Congress made the sequester so unattractive that Democrats and Republicans would prefer to get together and agree on a better way to reduce the deficit. But when 2013 came, Congress could not agree on a deficit reduction program, so the automatic sequester cuts took place.

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The result was that some spending reductions happened, but almost everyone was unhappy with them. Congress still could not agree on how to reduce the deficit. The federal debt continued to rise, although at a slower rate. Finally, by late 2013 the federal debt reached the legal limit that Congress had set earlier.

Enforcing the Debt Ceiling

*The **debt ceiling** is the total amount of money that the government is allowed to borrow to pay commitments like Social Security, Medicare, interest on the national debt, military salaries, and payment of tax refunds. Economists also call the ceiling the debt limit. The debt limit does not allow spending on new programs. Instead, it only permits borrowing for expenses that Congress and the president have already approved.*

As you saw in Figure 14.5, interest payments on the federal debt is the sixth largest expense in the federal budget. If interest rates go up, this cost will grow and the government will either have to run a bigger deficit or cut spending somewhere else.

Reading Progress Check

Describing How have the budget and spending crises of the Obama administration illustrated the partisan disagreements of how to allocate federal spending?

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