Name ______________________ Date ________________ Class ______________ 3.2

STUDY GUIDE Chapter 16, Section 3

For use with textbook pages 447–454

STABILIZATION POLICIES

KEY TERMS

fiscal policy The federal government's attempt to stabilize the economy through taxing and government spending *(page 447)*

Keynesian economics A set of actions designed to lower unemployment by stimulating aggregate demand *(page 448)*

multiplier In Keynesian theory, the idea that a change in investment spending will have a magnified effect on total spending *(page 448)*

accelerator In Keynesian theory, the change in investment spending caused by a change in total spending *(page 448)*

automatic stabilizers Government programs that automatically trigger benefits if changes in the economy threaten people's incomes *(page 449)*

unemployment insurance Government-sponsored insurance that workers who lose their jobs through no fault of their own can collect for a limited amount of time *(page 449)*

supply-side economics Policies designed to stimulate output and lower unemployment by increasing production rather than demand *(page 451)*

Laffer curve A hypothetical relationship between federal tax rates and tax revenues *(page 452)*

monetarism A doctrine that places primary importance on the roles of money and its growth *(page 453)*

wage-price controls Regulations that make it illegal for businesses to give workers raises or to raise prices without the explicit permission of the government *(page 454)*

DRAWING FROM EXPERIENCE

How do you think older people pay their bills once they have retired and no longer receive a salary? If working people lose their jobs, how do they pay their bills? In the last section, you rea[d] about the concepts of aggregate supply and aggregate demand. This section focuses on gover[n]ment policies that try to achieve stability.

ORGANIZE YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think abou[t] how political views affect economic policies.

Approaches to Economic Stability

Supply-side Economics
Main idea:

Demand-side Economics
Main idea:

Monetary Policy
Main idea:

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STUDY GUIDE (continued) Chapter 16, Section 3

READ TO LEARN

Introduction (page 447)

Government economists work to find ways of reaching economic stability. One approach is through spending to help the economy grow. People who make economic policy divide generally into two groups. One group wants to do things to increase aggregate demand. The other group wants to increase aggregate supply. A totally different approach favors influencing the money supply.

1. What are the three approaches that policymakers use to reach economic stability?

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Demand-Side Policies (page 447)

Fiscal policy is the use of government spending and taxation to influence aggregate demand. Fiscal policies come from ***Keynesian economics,*** which are the theories of economist John Maynard Keynes (pronounced *canes*). Keynesian economics were a way of easing the severe unemployment of the Great Depression in the 1930s. Keynes's ideas were followed until the 1970s.

Keynes's basic framework was the output-expenditure model.

Keynes said that unstable spending by the investment sector had an effect on other sectors. For example, when business spending goes down, workers lose their jobs. Therefore, consumers spend less. This whole effect is called the ***multiplier.*** In other words, a change in the amount of money that investors spend will have an increased effect on spending by all sectors. As overall spending declines, investment sector spending goes down even more. This change in investment spending caused by a change in total spending is called the accelerator. It accelerates, or speeds, the conditions that produce economic stability.

Keynes believed that the only way to help this situation was to increase spending by the government sector. This increased government spending could replace the missing investment spending. Government could spend directly or indirectly. One example of direct government spending is the funding of public works projects. Government could work indirectly by reducing taxes. A reduction in taxes increases the buying power of consumers and investors. This action would require deficit spending—the government spending more than the taxes it takes in. This deficit spending was seen as a temporary problem that economic recovery would fix.

Automatic stabilizers are another part of fiscal policy. A decline in the economy that threatens people's incomes automatically triggers these payments. One of these automatic stabilizers is ***unemployment insurance,*** which is money that the government gives to help unemployed workers for a time.

Fiscal policy proved to have problems. Government spending was supposed to simply make up for declines in investment spending. Government spending was supposed to decrease when investment increased. However, in reality, the government continued deficit spending after investment sector spending increased.

2. What did Keynes think caused an unstable economy? What was his solution?

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Supply-Side Policies (page 451)

Demand-side policies focus on spending. ***Supply-side economics,*** by contrast, aim to increase production as a way to increase output and lower unemployment. They became popular in the Reagan administration in the 1980s.

Supply-siders want to reduce government's role in the economy. One major goal is deregulation, which means removing government regulations from different industries, such as airlines. Supply-siders also want to lower taxes. They think that if individuals keep more of the money they earn, they will work harder. One theory was expressed in the ***Laffer curve,*** which was an idea about the relationship between the taxes that the government charged and the income that the government actually took in. The Laffer curve tried to show that lower tax rates would actually bring in more money. However, this never happened.

Supply-side economic ideas have drawbacks. Real-life experience with these ideas is limited. With the Laffer curve, tax collections actually fell. Supply-side policies are aimed more at growth than at ending instability.

3. What are two goals of supply-sider economists?

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Monetary Policies (page 453)

A third, and very different, approach to economic problems focuses on the money supply. The idea called ***monetarism*** proposes that changes in the money supply cause instability. This instability in turn causes inflation and unemployment. Monetarists think that there should be slow, steady, long-term growth in the money supply. That growth, monetarists believe, can control inflation but provide enough extra money to keep the economy growing.

A different approach to inflation was tried in the 1970s. At that time, President Nixon set up ***wage-price controls,*** which limited both price increases and workers' raises. Wage-price controls did not work.

Monetarists also think that too much of an increase in the money supply eventually leads to inflation. The increase in the money supply provides only a temporary solution to unemployment.

4. What is the basic principle of monetarism?

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Name ______________________ Date ______________ Class ______________________

STUDY GUIDE Chapter 9, Section 1

For use with textbook pages 223–229

THE ECONOMICS OF TAXATION

KEY TERMS

sin tax A relatively high tax designed to raise revenue and reduce consumption of a socially undesirable product such as liquor or tobacco *(page 224)*

incidence of a tax The final burden of the tax *(page 225)*

tax loopholes Exceptions or oversights in a tax law that allow some people and businesses to avoid paying taxes *(page 226)*

individual income tax The tax on people's earnings *(page 226)*

sales tax A general tax levied on most consumer purchases *(page 226)*

benefit principle of taxation The principle that states those who benefit from government goods and services should pay in proportion to the amount of benefits they receive *(page 227)*

ability-to-pay principle of taxation The belief that people should be taxed according to their ability to pay, regardless of the benefits they receive *(page 228)*

proportional tax A tax that imposes the same percentage rate of taxation on everyone, regardless of income *(page 229)*

average tax rate Total taxes divided by the total income *(page 229)*

progressive tax A tax that imposes a higher percentage rate of taxation on persons with high incomes than on those with low incomes *(page 229)*

marginal tax rate The tax rate that applies to the next dollar of taxable income *(page 229)*

regressive tax A tax that imposes a higher percentage rate of taxation on low incomes than on high incomes *(page 229)*

DRAWING FROM EXPERIENCE

When you buy certain items, do you have to pay a sales tax? If so, on what items? Do you think taxes are fair? Why or why not?

This section focuses on the different kinds of taxes that governments collect.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about what happens to income with each different type of tax.

General Types of Taxes in the United States	
Proportional	When income increases, the tax rate ______________.
Progressive	When income increases, the tax rate ______________.
Regressive	When income increases, the tax rate ______________.

READ TO LEARN

Introduction *(page 223)*

The federal, state, and local governments of the United States need money to operate. In 2003 all three levels of government collected about $3 trillion, or about $10,300 for every man, woman, and child in the United States.This is an increase, in dollars changed to account for inflation, of nearly 800 percent since 1940.

1. What three types of government use taxes to operate?

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Economic Impact of Taxes *(page 223)*

Taxes affect:

A. ***The way resources are used*** For example, a tax placed on a good at the factory raises the cost to produce the good. People react to the higher price by buying less. Firms cut back on production. Important resources such as land, labor, and entrepreneurs go to other industries.

B. ***Consumer behavior*** Often taxes are used to encourage or discourage consumer behavior. For instance, a sin tax is tax that raises money and tries to prevent consumers from buying harmful products such as liquor or tobacco.

C. ***The ability to produce and grow*** Taxes affect people's desire to save, invest, and work. Why, some people argue, should a person try to earn more money if much of it will be paid to the government in taxes?

Sometimes the effect of taxes is not easily seen because the person or group being taxed is not the one who pays the tax. A producer can pass the ***incidence of a tax,*** or real payment of the tax, to the consumer. The producer does this by raising the price of the good or service. The consumer pays the tax by paying the higher price.

2. Summarize the three ways taxes affect the nation's economy.

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Criteria for Effective Taxes *(page 226)*

To be effective as possible, taxes must be:

A. equitable, or fair.

B. simple and easy to understand.

C. efficient—easy to collect and good at producing money.

To make taxes equitable, or fair, it makes sense for the government to prevent tax loopholes. ***Tax loopholes*** are exceptions or careless parts in the tax laws that let some people and businesses avoid paying taxes. To make taxes simple, tax laws should be written so that both the taxpayer and tax collector can understand them. The ***individual income tax,*** or tax on the money that people earn, is a complicated tax. On the other hand, a ***sales tax***—a general tax on many things that consumers buy—is much simpler. To be efficient, a tax should be easy for collectors to manage and should raise enough money to be worthwhile.

3. Why do you think a sales tax is simpler to collect than individual income tax?

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Two Principles of Taxation *(page 227)*

Taxes are based on two principles or basic ideas. The ***benefit principle of taxation*** states that those people who benefit most from government goods and services should pay more taxes than those who benefit less. One problem with the benefit principle of taxation is that many government services provide the greatest benefits to those who can least afford to pay for them. Another drawback is that the benefits are often hard to measure.

The ***ability-to-pay principle of taxation*** states that people should be taxed according to their ability to pay, no matter what benefits they receive. An example is the individual income tax, which requires people with higher incomes to pay more than those with lower incomes.

4. What are two drawbacks of the benefit principle of taxation?

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STUDY GUIDE (continued) Chapter 9, Section 1

Types of Taxes *(page 229)*

Three types of taxes exist in the United States today:

A. A ***proportional tax*** uses the same percentage rate of taxation on everyone, no matter how much money they make. In other words, people with low incomes and high incomes pay the same percentage of their incomes in taxes. If the percentage tax rate stays the same, the average tax rate, or total taxes divided by total income, also stays the same.

B. A ***progressive tax*** is a tax that has a higher percentage rate on persons with high incomes than on those with low incomes. In other words, a person who makes $10,000 each year might pay a lower percentage in taxes than a person who makes $20,000 a year. Progressive taxes usually use a ***marginal tax rate***—the tax rate that applies to the next dollar of taxable income. As an example, if a person makes $10,000 a year, the tax rate might be 10 percent. If the person makes $10,001, he or she might pay 10 percent on the first $10,000, and 20 percent on the extra dollar. The 20 percent rate might continue until the person's income reaches $100,000. Then, if his or her income went over $20,000, he or she might start to pay 30 percent on any income over $100,000.

C. A ***regressive tax*** affects people on low incomes more than people on high incomes. A person with a lower income pays a higher percentage of his or her *total income* in sales taxes than does a person who makes more money.

5. Explain the difference between a proportional tax and a regressive tax.

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Name ______________________ Date ______________ Class ______________________

STUDY GUIDE Chapter 9, Section 2

For use with textbook pages 231–236

THE FEDERAL TAX SYSTEM

KEY TERMS

payroll withholding system A system that requires an employer to automatically deduct income taxes from an employee's paycheck and send the deducted tax directly to the government *(page 232)*

Internal Revenue Service (IRS) The branch of the U.S. Treasury Department in charge of collecting taxes *(page 232)*

tax return An annual report to the IRS summarizing total income, deductions, and the taxes withheld by employers *(page 232)*

indexing An upward revision of the tax brackets to keep workers from paying higher taxes just because of inflation *(page 233)*

FICA The Federal Insurance Contributions Act tax levied on both employers and employees for Social Security and medicare *(page 233)*

Medicare A federal health-care program available to all senior citizens, regardless of income *(page 233)*

payroll tax Taxes that are deducted from a paycheck *(page 233)*

corporate income tax The tax a corporation pays on its profits *(page 235)*

excise tax A tax on the manufacture or sale of selected items, such as gasoline and liquor *(page 235)*

luxury good An economic product for which the demand rises faster than income when income grows *(page 235)*

estate tax The tax the government levies on the transfer of property when a person dies *(page 235)*

gift tax A tax on donations of money or wealth and is paid by the person who makes the gift *(page 235)*

customs duty A charge levied on goods brought in from other countries *(page 236)*

user fees Charges levied for the use of a good or service *(page 236)*

DRAWING FROM EXPERIENCE

Have you ever earned a paycheck? Did you notice that the amount you earned was not the amount you received? Why was part of the income taken out of your paycheck?

In the last section, you learned about the different kinds of taxes. This section focuses on the importance of income taxes to the federal government.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think of the different sources of the federal government's income.

Sources of Income	Description
Individual Income Taxes	
FICA Taxes	
Corporate Income Taxes	
Other Federal Taxes	

READ TO LEARN

■ Individual Income Taxes *(page 231)*

In most cases, a person's income tax is paid over time through a ***payroll withholding system***. In this method, an employer automatically deducts, or withholds, income taxes from an employee's paycheck. The employer then sends the deducted tax money to the government. The tax payment goes to the ***Internal Revenue Service (IRS),*** which is the branch of the Treasury Department in charge of collecting taxes. Each year the employee files a ***tax return***—a report to the IRS that gives the following information: the person's total income; any deductions (money, such as donations to charities, that the person can subtract from his or her income); and the taxes already deducted by employers. If there is a difference between the amount of taxes already paid and the amount the person owed, the difference is usually caused by deductions that lower the amount of taxes owed. On the other hand, a person may receive additional income besides the salary paid for work—for example, interest on savings. That additional income was not subject to tax withholding and can increase the amount of taxes owed.

The individual income tax is a progressive tax. When a tax is progressive, the average tax rate goes up when income goes up.

The income tax system has a provision for ***indexing,*** which keeps workers from paying more in taxes just because of inflation.

1. Explain what a progressive tax is.

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STUDY GUIDE (continued) Chapter 9, Section 2

FICA Taxes (page 233)

The second most important federal tax is ***FICA,*** or the Federal Insurance Contributions Act tax. Both employers and workers have to pay this tax, which pays for Social Security and Medicare. ***Medicare*** is a federal health-care program for senior citizens. Like income tax, these two taxes are also called ***payroll taxes*** because they are deducted from your paycheck. Social Security taxes are 6.2 percent of wages up to $87,000. After this, the percentage decreases. With Medicare, the wealthy pay the same amount of tax as the poor.

2. What is the purpose of Medicare?

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Corporate Income Taxes (page 235)

The third largest type of taxes the federal government collects is the ***corporate income tax.*** This is the tax a corporation pays on its profits. The corporation is taxed because it is considered to have its own legal identity.

3. What is the difference between personal income tax and corporate income tax?

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Other Federal Taxes (page 235)

The federal government also receives money from excise taxes, estate and gift taxes, and customs duties. The ***excise tax*** is a tax on certain items, such as gasoline and liquor. It is the fourth largest source of the federal government's revenue. In 1991 Congress expanded the excise tax to include certain luxury goods. A product (or service) is called a ***luxury good*** if the people's demand for the good rises faster than their income rises. An example of a luxury good is a very expensive car. The luxury tax is unpopular, so the government has decided to do away with it in the year 2002. The government collects an ***estate tax*** on property that changes hands when someone dies. The ***gift tax*** is a tax on donations of money or wealth and is paid by the person who makes the gift. A ***customs duty*** is a tax on items that tourists from the United States buy in other countries and then bring to the United States. Customs duties are low and produce little revenue today. About 1 percent of federal revenue is collected through ***user fees.*** These are charges for the use of a good or service. They include the entrance fees that people pay to visit national parks, as well as the fees ranchers pay to have their animals graze on land owned by the government.

4. Explain the difference between an estate tax and a gift tax.

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Name ____________________ Date ____________________ Class ____________________

STUDY GUIDE Chapter 10, Section 1

For use with textbook pages 255–258

THE ECONOMICS OF GOVERNMENT SPENDING

KEY TERMS

per capita Per person *(page 255)*

public sector The part of the economy made up of federal, state, and local governments *(page 255)*

private sector The part of the economy made up of private individuals and privately-owned businesses *(page 256)*

transfer payment A payment for which the government receives neither goods nor services in return *(page 257)*

grant-in-aid A transfer payment that one level of government makes to another *(page 257)*

distribution of income The way in which income is allocated among families, individuals, or other designated groups in the economy *(page 258)*

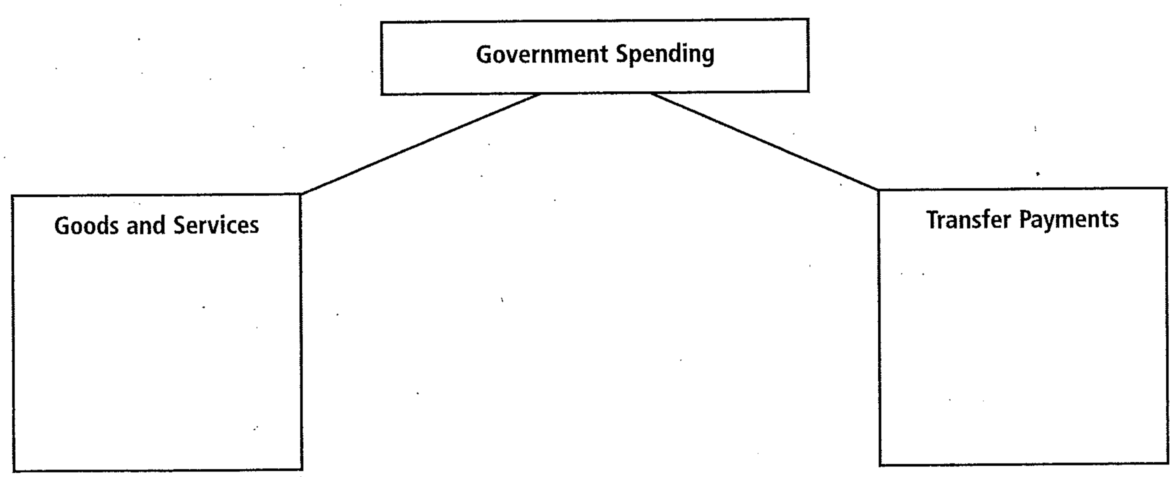
DRAWING FROM EXPERIENCE

What benefits do you think taxes provide in your daily life? Do you think taxes are necessary? Why or why not?

This section focuses on how governments spend their money.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about the different types of goods and services and kinds of transfer payments on which governments spend money.



READ TO LEARN

Government Spending in Perspective *(page 255)*

On a ***per capita,*** or per person, basis, governments spends about $10,300 for every man, woman, and child in the United States. Spending in the ***public sector***—the part of the economy made up of federal, state, and local governments—began its rise in the 1940s. There were several reasons for this increase:

A. World War II spending

B. the change in public opinion toward public spending

C. the success of big public works projects like the TVA, or Tennessee Valley Authority

Some people wonder which services government should provide and which services the ***private sector*** should provide. The private sector is the part of the economy made up of individual people and privately-owned businesses (businesses not owned by the government).

1. Why has government spending increased since the 1940s?

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Two Kinds of Spending *(page 256)*

Government spends money on:

A. ***Payment for goods and services*** The government buys many goods, from tanks, planes, ships, and park lands to office buildings. The government also pays government workers. The more goods and services the government provides, the more goods and services it uses and pays for.

B. ***Transfer payments*** These are payments for which the government receives neither goods nor services. Transfer payments include Social Security, welfare, unemployment compensation, and other help for people who need assistance. A transfer payment that one level of government makes to another is called a ***grant-in-aid.*** Money for interstate highway building is an example of a grant-in-aid. Transfer payments also include ***subsidies***—payments made to people to protect or encourage a certain economic activity. Farmers have often received subsidies from the government.

2. Under which broad kind of spending would aid for persons with disabilities fall?

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3.3

Name ______________________ Date ________________ Class ________________________

Impact of Government Spending *(page 258)*

Government spending directly affects:

A. the way in which resources are used. For example, the government may choose to spend money on developing missiles in rural areas rather than on social welfare programs in cities. The money is spent in the country, not in the city.

B. distribution of income, or the way in which money is distributed among families, individuals, and other groups. For example, transfer payments directly affect the incomes of needy families.

Government spending also affects incomes indirectly. For example, if the government spends money on fighter planes, communities around the factory are helped by the increased spending. Government often competes with producers in the private sector.

3. With whom do county and city health departments compete when they offer free flu shots?

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Name ______________________ Date ______________________ Class ______________________ 3.2

STUDY GUIDE Chapter 10, Section 2

For use with textbook pages 260–265

FEDERAL GOVERNMENT EXPENDITURES

KEY TERMS

federal budget An annual plan outlining proposed revenues and expenditures for the coming year *(page 260)*

mandatory spending Spending authorized by law that continues without the need for annual approvals of Congress *(page 260)*

discretionary spending Programs that must receive annual authorization *(page 260)*

fiscal year A 12-month financial planning period that may or may not coincide with the calendar year *(page 260)*

federal budget surplus An excess of revenues over expenditures *(page 261)*

federal budget deficit The shortfall if expenditures are larger than revenues *(page 261)*

appropriations bill An act of Congress that allows federal agencies to spend money for specific purposes *(page 261)*

Medicaid A joint federal-state medical insurance program for low-income persons *(page 265)*

DRAWING FROM EXPERIENCE

Do you know someone who receives benefits from Social Security? How would life be different for him or her if the government ended the Social Security program?

In the last section, you learned about how governments generally spend their money. This section focuses on specific ways the federal government spends its money.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about the differences between mandatory and discretionary spending

Federal Spending	
Type	**Description**
Mandatory	
Discretionary	

READ TO LEARN

Introduction *(page 260)*

The ***federal budget*** is a yearly plan that describes what the government will take in and pay out for the year. About two-thirds of the federal budget is ***mandatory spending***—spending approved by law that continues without having to be renewed by Congress every year. Social Security and interest on borrowed money are examples of mandatory spending. ***Discretionary spending*** deals with programs, such as the military, the Coast Guard, and welfare that need approval every year. Discretionary spending makes up the other one-third of the budget.

1. Which kind of spending do you think pays for medicare? Explain your answer.

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Establishing the Federal Budget (page 260)

The federal budget is prepared for a ***fiscal year***—a 12-month financial planning period. The government's fiscal year begins on October 1.

The budget is developed in a series of steps:

A. ***Executive formulation*** The president prepares the general budget guidelines for several years but focuses on the upcoming fiscal year. In planning, the president gets help from the Office of Management and Budget (OMB) and other government agencies. In 2004 the budget showed a ***federal budget deficit***—an excess of expenditures over revenues. If the budget had planned for more revenue than spending, there would have been a ***federal budget surplus.***

B. ***Action by the house*** Congress has the power to approve, change, or disapprove the president's proposed budget. The House of Representatives sets targets for discretionary spending. Once the targets are set, the House breaks down the budget. It does this by assigning ***appropriation bills***—acts of Congress that allow federal agencies to spend—to various House subcommittees.

C. ***Action by the Senate*** The Senate receives the budget after the House approves it. The Senate may approve the House's budget or write its own. If the Senate writes its own budget, a committee made up of members of both the House and the Senate works out a budget bill that they agree on. This compromise bill is approved by the House and Senate.

D. ***Final approval*** Congress sends the compromise budget bill to the president. The president can approve the bill by signing it. Or the president can veto (forbid) the bill and force Congress to come up with a bill closer to the president's original budget. Once signed by the president, the budget becomes the official budget for the next fiscal year.

2. List the steps that the federal budget goes through for approval.

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3.3

Name ______________________ Date ________________ Class ______________________

Major Spending Categories *(page 262)*

There are several major budget categories.

A. Social Security payments to elderly people and persons with disabilities make up the largest part of government spending.

B. National defense makes up the largest category of discretionary spending. National defense includes spending on the military and atomic energy activities, such as getting rid of nuclear waste.

C. Income security includes spending for retirement benefits to railroad workers and military workers. Most of this spending is mandatory.

D. Other mandatory costs are medicare, interest on the federal debt, and veterans' benefits.

E. ***Medicaid*** is a medical insurance program for low-income persons. Spending on Medicaid is also mandatory. However, other health care services fall under discretionary spending.

F. Other kinds of discretionary spending by the federal government are education; training; employment; social services; transportation; veterans' benefits; administration of justice; and natural resources and the environment.

3. Do you think the cost of building prisons falls under mandatory or discretionary spending? Explain your answer.

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