

Objectives for Class 21 Government Spending

At the end of Class 21, you will be able to answer the following:

1. What is the largest **purchase** and what is the largest **transfer** in the federal budget? What is the difference between a purchase and a transfer?
2. How has the composition of the federal budget changed **over time**?
3. What is the trend of federal purchases as a percent of GDP, transfers as a percent of GDP, and state/local purchases as a percent of GDP over time?
4. What is the difference between **discretionary spending** and **mandatory spending**.
5. What is the **OMB**? What is the **CBO**?
6. What is a "**balanced budget**"? a "**budget deficit**"? a "**budget surplus**"? (Review)
7. What is the "**fiscal year**"?
8. Briefly explain the budget process. What is a **budget resolution**? What is an **appropriations bill**? What is "**pay as you go**"?
9. How does government spending in the United States compare to other countries? In what areas do other governments spend that are not found in the United States?
10. Explain the basic characteristics of the **Social Security System**. What problems is the Social Security System likely to face in the coming years? Why? What remedies have been proposed to solve these problems?
11. Explain the basic characteristics of the **Medicare** program. What problems is the Medicare system likely to face?

Chapter 21: Government Spending (latest revision September 2004)

1. The Budget of the Federal Government

For fiscal year (FY) 2004, the federal government plans to spend \$2,229 billion. The government operates on a year different from the calendar year, called *the fiscal year (FY)*. The fiscal year of the federal government runs from **October 1 to September 30**. So, between October 1, 2003 and September 30, 2004, the federal government of the United States spent \$2,229 billion. There are two ways we can categorize this spending. **One categorization is that government spending is either a purchase or a transfer. With a purchase, the federal government actually buys a product from a private business or person. With a transfer, the government takes incomes from one person and transfers it to another person. The government does not actually buy a product.** In

FY 2004, the largest purchase by the federal government will be for defense. The federal government plans to spend \$390 billion (17.5% of its budget) for defense. The largest transfer by the federal government will for Social Security. The government plans to spend \$493 billion for Social Security (22.1% of its budget) and another \$255 billion for Medicare (11.4% of its budget). **A second categorization is that government spending is either discretionary or mandatory. Discretionary spending must be decided upon each year. Mandatory spending has been written into permanent laws and cannot be changed without totally re-writing the laws.** The President and Congress can change these laws but are not required to. So, for example, Social Security spending is mandatory. The government must provide each eligible person the amount they are entitled to. But defense spending is discretionary. In FY 2004, \$1,234 billion of planned government spending is mandatory (55% of the budget). Another \$176 billion will go to pay interest in the government's debt (also mandatory). **Only \$819 billion (37% of the budget) is discretionary --- areas of spending in which the government had to decide how much to spend.**

Test Your Understanding

Go to the U.S. Government Budget link on my web site

1. What will be the estimated total government spending in the current year?
2. In the current year, what percent is expected to be spent on defense? On Social Security? On Medicare? On other Health Care? On Income Security?
3. In the current year, what percent of the federal budget will be discretionary?
4. Over the next few years, what is projected to happen to each of the following (in total and as a percent of the total budget): (1) defense; (2) social security; (3) Medicare
5. Over the next few years, what is projected to happen to total government spending?
6. Besides defense, what categories of spending are considered discretionary? And besides Social Security, which categories of spending are considered mandatory?

2. The Creation of the Budget

The creation of the government's budget begins with the President of the United States. President Bush began in the spring of 2003 to construct the budget that will go into effect on October 1, 2004. The President sets general priorities for the budget --- more spending in some areas and less spending in other areas. The President has an agency to develop the details --- the **Office of Management and Budget (OMB)**, headed by a **Director** (currently Joshua Bolten). The OMB prepares a detailed budget proposal for the President's approval. By law, the President must present this budget to Congress by the first Monday in February (although Presidents are frequently late).

The Congress has its own agency to analyze the President's budget proposal. This agency is called the **Congressional Budget Office (CBO)** and is also headed by a **Director** (currently Douglas Holtz-Eakin). By April 15, the Congress is to pass a **budget resolution**. The budget resolution includes targets for total government spending, total tax revenues, the total amount of **budget surplus or budget deficit**, and amounts of spending for broad categories (such as defense). Until 2002, there were upper limits, called "**caps**", on the categories of discretionary spending. Also, the law required that any laws that would increase mandatory spending or lower tax revenues be offset by other spending reductions or tax revenue increases (called **pay-as-you-go or PAYGO**).

This was eliminated in 2002. Many people want PAYGO to be reinstated as a way to lower the budget deficits.

Once the budget resolution is passed (and it commonly is late), the Congress must pass 13 **appropriation bills**. It may also choose to change laws governing the mandatory spending, if it wishes. Many committees and sub-committees hold hearings. Ultimately, each bill is passed authorizing spending in a certain area for the coming fiscal year. Each bill must be consistent with the budget resolution. After being passed, the appropriation bills plus any changes to mandatory spending are aggregated into a federal budget. This is to pass both Houses of Congress in September. It is to be signed by the President to go into effect on October 1.

From 1994 to 2000, the President was a Democrat while Republicans controlled both Houses of Congress. This led to some serious disagreements. In 1995, the Republicans in Congress rejected the President's proposed FY1996 budget. From February to September, they wrote a very different budget. In September, President Clinton vetoed their budget. The Congress did not have the 2/3 of the votes needed to over-ride the veto. But the Congress would not accept President Clinton's proposals. There was a stalemate. October 1st came and no budget had been passed. So the Congress and the President agreed to extend the FY 1995 budget through October to give them more time to reach agreement. At the end of October, they still had not reached agreement. So they extended the FY 1995 budget for one more month – through November. By December, they had still not reached agreement. With no budget authorization, **the government shut down** in December of 1995. Laws were passed to fund the military and emergency operations. But many aspects of the federal government simply shut down. Both the President and the leaders of Congress were betting that the public would blame the other side. It turned out that the President was right; the public largely blamed the Republican leaders of Congress for the shut down of the federal government. The FY 1996 budget finally went into effect in January of 1996. The President's popularity, which had been very low, began to rise. He ultimately won re-election in November of 1996. Since that time, budget disagreements have been resolved much more easily. There are still disagreements, of course. But these have been worked out and budgets have generally been passed on time.

Test Your Understanding

Go back to the following site: <http://www.whitehouse.gov> On the home page, there are references to speeches of **President Bush**. Also you may follow the path in the previous question. From this information, write a one-half page (125 word) essay explaining the budget priorities of President Bush. Then, go to the site for the **Congressional Budget Office** <http://www.cbo.gov> Write a one-half page description of their analysis of President Bush's budget proposal.

3. Historical Trends in Government Spending

The table below shows total federal spending as a percent of GDP and spending on national defense as a percent of GDP. Two points stand out in this table. *First, the share of federal government spending out of total spending (GDP) has not changed very much over the past forty years.* This share generally rose during the years of the

Vietnam War (1965 to 1975) and during recession years. During the 1980s and early 1990s, this share was somewhat higher than it had been during the 1960s. Since the early 1990s, this share has fallen back to the levels of the 1960s. But the changes were not very large. *Second, the share of national defense spending out of total spending (GDP) fell.* (This rose again after 2001.) It is now only about 1/3 of what it was in 1960. This share fell in the 1970s, rose again in the 1980s under President Reagan, and then fell in the 1990s following the end of the Cold War. The rising share of GDP for Social Security and Medicare spending has offset the falling share of national defense spending.

Year	Federal Spending as a Percent of GDP	National Defense as a Percent of GDP
1960	17.8	9.3
1961	18.4	9.3
1962	18.8	9.2
1963	18.6	8.9
1964	18.5	8.5
1965	17.2	7.4
1966	17.8	7.7
1967	19.4	8.8
1968	20.5	9.4
1969	19.3	8.7
1970	19.3	8.1
1971	19.4	7.3
1972	19.5	6.7
1973	18.8	5.9
1974	18.7	5.5
1975	21.3	5.5
1976	21.4	5.2
1977	20.8	4.9
1978	20.7	4.7
1979	20.1	4.6
1980	21.6	4.9
1981	22.2	5.1
1982	23.1	5.7
1983	23.5	6.1
1984	22.2	5.9
1985	22.9	6.1
1986	22.5	6.2
1987	21.6	6.1
1988	21.2	5.8
1989	21.2	5.6
1990	21.8	5.2
1991	22.3	4.6
1992	22.2	4.8
1993	21.5	4.4
1994	21.1	4.1
1995	20.7	3.7
1996	20.3	3.5

1997	19.6	3.3
1998	19.1	3.1
1999	18.7	3
2000	18.2	3

4. Comparison of the United States to Other Countries

Compared to other countries, is the United States government a big spender? The answer is “no”. As you see from the data, the federal government of the United States does a bit more than 20% of all of the spending on goods and services produced in the United States. As we will see below, state and local governments spend an additional 10%-15%. So all of the governments in the United States do 30%-35% of the total spending, depending on the year. Some of the numbers for other countries are given below. **You can see that the United States governments do a much lower share of total spending than is done in other countries.**

Government Spending as a Percent of GDP in 1999

United States	35%
Japan	39%
United Kingdom	41%
Canada	41%
New Zealand	41%
Germany	46%
Italy	49%
France	52%
Sweden	60%

These countries have governments that spend a higher percent of their GDP despite the fact that **these countries spend a smaller percent on their militaries**. So what do they buy with this extra spending? The answer is what is called “**social spending**”. Most of these countries have **family allowances**. This means that a certain amount of money is paid every month to every parent for every child up to a certain age (18 in Germany, 16 in Sweden). These allowances range from \$87 per month in Sweden to \$136 per month in Germany. In most of these countries, the governments provide **universal health care coverage**. They also provide **sickness benefits** --- money to replace the loss of income due to illness. In Germany and Sweden, these benefits can replace 70% to 80% of any lost earnings. These policies, as well as several others, combine to form what is called the “**welfare state**”. In the United States, private companies provide many of these functions (such as private health insurance companies).

Test Your Understanding

1. The table below shows the proportion of total federal government spending that was spent on Social Security and Medicare. These programs are discussed below. Social Security basically is retirement income. Medicare is basically medical care for people age 65 and up. Notice how the proportions have risen. Briefly explain why you believe this increase might have occurred.

Year	Social Security	Medicare
1960	12.6%	-----
1965	14.8%	-----
1970	15.5%	3.2%
1975	19.5%	3.9%
1980	20.1%	5.4%
1985	19.9%	7.0%
1990	19.8%	7.8%
1995	22.1%	10.5%
2000	22.9%	11.0%

2. The table below shows total federal government spending and the GDP Deflator. You are to use the GDP Deflator to calculate **Real Total Federal Government Spending**. President Clinton promised to **slow the growth rate of Real Total Federal Government Spending**. By what percent did this grow during his term (1993-2001)? Did it grow slower than it had been doing before?

Year	Federal Government Outlays	GDP Deflator	Real Government Outlays
1980	590.9	57.04	
1981	678.2	62.35	
1982	745.8	66.25	
1982	808.4	68.88	
1984	851.9	71.44	
1985	946.4	73.69	
1986	990.5	75.31	
1987	1004.1	77.58	
1988	1064.5	80.21	
1989	1143.7	83.27	
1990	1253.2	86.51	
1991	1324.4	89.66	
1992	1381.7	91.84	
1993	1409.5	94.05	
1994	1461.9	96.01	
1995	1515.8	98.11	
1996	1560.6	100	
1997	1601.3	101.95	
1998	1652.6	103.22	
1999	1703.1	104.77	
2000	1788.1	107.15	

5. Case: Social Security and Medicare

Of all of the areas in the federal government's budget, the one that received the most attention in the 2000 election campaign was Social Security. This occurred because of some major problems that are likely to exist in the future for both the Social Security and the Medicare programs. Because of their importance, let us use this section to explain

these two programs, the problems associated with them, and the possible solutions that could be undertaken by government.

The **Social Security Act** was passed in 1935. As mentioned above, Social Security today constitutes almost ¼ of all federal government spending and is the largest single spending program of the federal government. As of 1998, 44.5 million people were receiving Social Security benefits. Most of these were retired people and their dependents (the rest were disabled). Since its beginning, the Social Security program has had several defining characteristics. *(1) First, it is compulsory. (2) Second, the monthly cash benefit paid to a retiree is based on that person's past earnings. (3) Third, the monthly cash benefit increases at a decreasing rate as past earnings increase. (4) Fourth, the program is financed by a flat percentage rate tax on earnings up to an earnings limit. (5) Fifth, the tax is split evenly between employer and employee. (6) Sixth, the taxes collected are used to pay the benefits to current recipients (this is called a "pay as you go" system). (7) Finally, in order to assure that the tax money collected for Social Security would be used exclusively for Social Security, this money goes to a special fund, called the Social Security Trust Fund. A government agency, the Social Security Administration, administers the Social Security program.* We will look at each of these points in more detail below.

Let us examine the Social Security system as it is now (2004). **First, to be eligible to collect benefits ("connected"), one must have paid into the system for 40 quarters.** One receives a quarter of credit if one has \$740 of earnings on which one pays Social Security taxes during the quarter. **Second, the normal retirement age for full benefits is age 65 (to become age 66 beginning in 2005 and 67 by 2022).** A worker can retire as early as age 62. But doing so means that one will receive only 80% of one's benefits. **Third, upon retiring, the Social Security Administration calculates the worker's Average Indexed Monthly Earnings (AIME).** It takes the income earned in each month (on which Social Security taxes were paid) over the best 35 years of the worker's life, adjust each month's income for inflation to bring the value up to the purchasing power that exists when the worker turns 62, and then calculates an average. **Fourth, the Social Security Administration calculates the worker's monthly benefit, called the Primary Insurance Amount (PIA).** This is presently (2004) calculated as 90% of the first \$612, 32% of the next \$3,689, and then 15% of the rest. **This Primary Insurance Amount is then adjusted each year according to the cost of living, as measured by the CPI (a COLA).** The benefits for an average worker at age 65 replace about 41% of the income earned while working (only 24% for a worker with maximum earnings). **Finally, a married worker's spouse receives a benefit equal to 50% of the worker's benefit.** You can see in this description the second and third points of the preceding paragraph: **the cash benefits increase as earnings increase but at a decreasing rate.**

Social Security is paid for by the **Federal Insurance Contributions Act (FICA)** tax. This tax money is earmarked for the specific program and cannot be used for any other area of government spending --point 7. **Social Security is financed by a 12.4% tax on earnings up to a limit (\$87,900 in 2004) – point 4.** This tax is split evenly --- 6.2% on the employee and 6.2% on the employer – point 5. **An additional 2.9% on all income, also split evenly, is levied to finance Medicare** (discussed below). The FICA tax presently collects more money than is needed to pay out in benefits. The difference is a

surplus (over \$165 billion was added in 2002) that is accumulated in the trust fund. The total balance in the trust fund was over \$1.3 billion by the end of 2002. So at present, the program is only partially a pay-as-you-go system --point 6. (This surplus is discussed in more detail below.)

Those people who qualify for Social Security are also eligible for **Medicare** at age 65. **Part A of Medicare** covers the cost of hospitals, skilled nursing facilities, home health care, and hospice care. The 2.9% tax mentioned in the preceding paragraph covers the government's costs of Part A Medicare. (There are also some out-of-pocket costs to the patient. Most people buy supplementary insurance, called **Medigap** insurance, to cover these.) People enrolled in Part A can enroll in **Part B of Medicare** by paying a monthly premium that is deducted from their Social Security payments. This premium rose considerably in 2004 as a result of rising medical costs. The rise in this premium is an issue in the 2004 election debate. Part B pays for doctors' services, laboratory tests, ambulances, and so forth, after the patient pays the first \$100 per year (a **deductible**) and 20% of any bills (**coinsurance**). The monthly premiums cover only 25% of the government's cost of Part B. The rest of the cost is paid out of the general revenues of the federal government. (Almost 20% of Medicare recipients are enrolled in a **Medicare plus Choice Plan**. In this, they agree to have all of their health care done by a specific health care provider, such as Kaiser. The government pays the provider a flat fee to provide all required health care to that person.)

Social Security is facing a major demographic problem. The baby boom generation can begin to retire as early as 2007 (when the oldest baby boomers turn 62). The baby boom generation was followed by a baby bust generation. **So the percent of the population over age 65 is projected to rise from 12.7% in 1999 to 16.4% in 2020 and to about 18% by 2030.** By 2030, there are projected to be 43 Social Security beneficiaries for every 100 workers compared to 27 in 1999. Add to this the facts that people tend to retire earlier than they used to and that they tend to live longer. The result is that a pay-as-you-go system is likely to run into trouble with **a smaller proportion of workers supporting a larger proportion of retirees.**

This demographic problem was first addressed in 1983. One part of the solution of that time was to increase the retirement age for full benefits. As noted above, this is to reach 66 in 2005 and 67 by 2022. A second part of the 1983 solution was to start collecting more in FICA taxes that was needed to pay current benefits (that is, to make the baby boom generation pay in advance for its own Social Security benefits). The extra money collected (**the surplus**) is accumulated in the Social Security Trust Fund. Under current projections, that fund will rise from the current \$1.3 billion to its maximum of \$2,900 billion in 2018. After 2020, more will be paid out in benefits than will be collected in taxes, with the Fund financing the difference. The amount in the Fund will drop until it is expected to reach zero in 2042. (The money in the Trust Fund is invested in government bonds -- IOUs from another branch of government, the Treasury Department.)

The impending elimination of the Social Security surplus is the reason for the current political debate. How should the government assure that the Fund will be solvent after 2042 and that Social Security benefits will be available? **Some people argue that benefits to retirees should be reduced.** If this were done, it would likely be done by

either changing the price index used to calculate the COLA or by making more of the Social Security benefit payments taxable. **Some people argue that the FICA tax should be increased.** Under the most pessimistic assumptions, the tax rate would have to rise from the current 12.4% to 18.4% to maintain the solvency of the system. (Under more realistic assumptions, the increase is smaller.) A more likely way this would be accomplished would be to increase the upper limit on the earnings taxed. This has already been done (the upper limit was \$72,600 in 1999 and \$84,000 in 2002). **Some people want the entire Social Security System privatized and then eliminated.** Chile implemented such a plan. Workers would have to save for retirement in a retirement plan similar to an IRA or a 401K. Critics of this idea argue that the administrative costs are very high and that such a plan would expose workers to market risks they are not prepared to handle. (The loss of millions of dollars in retirement savings with the collapse of Enron in 2001 makes it less likely that such a privatization plan would be politically acceptable.) Critics also point to the transition problem; in such a system, how would current retirees and those nearing retirement be paid? **Most of the political debate has concerned a proposal to invest some of the Social Security surplus money in the stock market.** President Clinton and candidate Al Gore proposed having the Fund managers invest some of the surplus in the stock market. Historically, the returns on stocks have been nearly three times greater than the returns on government bonds. Their proposal is similar to the one presently used by the California Public Employees Retirement System and the California State Teachers Retirement System. Having the government invest part of the money in the Trust Fund into stocks would make the government a major owner of America's corporations. This might give the government power that many people do not want it to have. President Bush has proposed having individuals under age 40 invest part of their FICA tax money in the stock market, similar to a 401K plan. This would be partial privatization. The individuals would control these investments, not the government. This would expose workers to stock market risk. This proposal was strongly advocated as the stock market rose greatly between 1992 and 2000. But with the decline of the stock market in 2001, this proposal has become more controversial.

For Medicare, one problem is the increasing costs of health care. In 1998, the federal government spent an amount equal to 2.7% of GDP on Medicare. By 2025, this is projected to rise to 5.3%. The number of Medicare beneficiaries is projected to almost double from 38.8 million in 1998 to 69.3 million in 2025. And the Medicare Fund has no surpluses to pay for future benefits. The Medicare taxes described above are expected to be greater than the medical payments until 2010, but not after that. To try to solve this problem, the government has taken a number of steps to reduce Medicare costs, with only limited success thus far. (The Medicare Plus Choice plan described above was one of the main ways the government tried to lower Medicare costs.) **A second problem involves the benefits that Medicare pays for.** One Medicare issue that has been debated is that of prescription medication benefits. Until 2004, Medicare did not pay for prescription medication costs. Many elderly people strain their finances to pay for prescription medications or go without altogether. In 2000, both presidential candidates agreed that there was a need to provide a Medicare prescription benefit. But each had different ideas as to how this should be done and how much of the cost the patient should be required to

pay. President Bush's plan was enacted in 2004. It helps provide some discount on prescription drugs in 2004 and 2005. The payment by Medicare goes into effect in 2006. There is still considerable controversy about the extent to which seniors will have to pay for prescription drugs, the overall cost of the program, and the unwillingness in the program to use the power of the government to lower prescription drug prices.

The debate over Social Security and Medicare has been significant. These are very important programs to a large number of people. They are politically popular programs. But they are very expensive programs. And they are facing some serious problems in the years ahead. Expect that the debate over these programs will be an important part of American political life for years to come.

Test Your Understanding

1. It has been argued that the existence of the Social Security program has encouraged American workers to retire earlier than they otherwise would have. Explain why this might be so.
2. It has been argued that the existence of the Social Security program has encouraged American people to save less than they otherwise would have. This argument is controversial. Use the life cycle theory of consumption from Chapter 14 to explain why this might be so.
3. Go to the site <http://www.ssa.gov/OACT/TR/TR99/triib.html> Go to Table III.B2. In what year does the outgo of the Fund exceed the income (compare each projection)? What is the maximum value for the assets (in 1996 \$) of the Trust Fund and in what year is it reached (intermediate projection). What is the level of projected outgo in the year the Fund is exhausted?
4. Go on to the Internet. Find articles relating to the prescription drug benefit enacted for Medicare in 2004. Then, write a short essay describing the details of this program.

6. Conclusion

This chapter has examined government spending. We have not attempted to explain why the government spends in the manner it does. These spending decisions are political. But we have looked at the composition of the federal government's budget and the ways by which this composition has changed over time. We have explained how the budget is prepared and finally passed by the legislature and the President. We have compared government spending in the United States to that of other countries. And finally we have examined in detail the Social Security and Medicare systems, their problems, and some proposed solutions to these problems. Now it is time to turn our attention to the other aspect of fiscal policy: tax policy.

Practice Quiz for Class 21

1. The largest **purchase** in the federal budget is for
 - a. defense
 - b. social security
 - c. education
 - d. Medicare
2. The largest **transfer** in the federal budget is for
 - a. defense
 - b. social security
 - c. education
 - d. Medicare
3. The agency that prepares the budget proposal for the **President** of the United States is
 - a. OMB
 - b. CBO
 - c. FICA
 - d. FBI
4. The majority of spending by the federal government is
 - a. mandatory
 - b. discretionary

5. Which of these countries has the **lowest** percent of GDP spent by its government?
a. Sweden b. Canada c. Germany d. United States
6. Which of the following is **discretionary spending**?
a. defense b. social security c. Medicare d. income security
7. The **fiscal year (FY)** for the federal government begins on
a. January 1 b. April 1 c. July 1 d. October 1 e. December 25
8. Which of the following is **NOT TRUE** about Social Security?
a. the program is voluntary
b. Social Security benefits are higher if one's income is higher
c. The higher the income one earned while working, the lower the percent of income received as Social Security benefits
d. Most of the FICA tax money collected is used to pay benefits to current retirees
9. The **FICA tax** for Social Security is
a. a constant percent of all income earned
b. a constant percent of work income up to an upper limit
c. a rising percent of work income earned as that income increases
d. a falling percent of work income earned as that income increases
10. Which of the following **IS** a problem facing Social Security and Medicare?
a. the proportion of the population over age 65 will rise between now and 2030
b. health care prices are rising slower than the prices of other goods or services
c. Social Security funds are currently invested in the stock market
d. all of the above

Answers: 1. A 2. B 3. A 4. A 5. D 6. A 7. D 8. A 9. B 10. A