Section 4F

Understanding the Federal Budget

Federal Budget Basics

- In theory, the federal budget works much like your personal budget.
- **Receipts(or income)** – represent money that has been collected
- **Outlays(or expenses)** – represent money that has been spent
- **Net income** – receipts minus outlays
- **Surplus** – when the net income is positive
  - Spent less than what you received
  - Have money left over
- **Deficit** – when the net income is negative

- The only way to survive a deficit is by spending savings or by borrowing money.
- When you borrow, you accumulate a **debt** – total amount of money owed to lenders, which may result from accumulating deficits over many years.
- A deficit is for a single year, a debt is accumulated deficits.

Example 1: Suppose your after-tax income is $28,000. Your annual expenses are $8000 for rent, $4500 for food and household expenses, $1600 for interest on credit cards, and $10,400 for entertainment, travel, and other. Do you have a surplus or a deficit?

- Your receipts are $28,000
- Your outlays are the sum of all expenses:

  $8000 + $4500 + $1600 + $10,400

  = $24,500

- Net income = receipts – outlays

  = $28,000 - $24,500

  = **$3,500**
- Since net income is positive, you have a **surplus of $3,500**.

Example 2: From example 1, next year you expect to get a 2% raise but plan to keep your expenses unchanged. Will you be able to pay off $5200 in credit card debt? Explain.

- Since you receive a 2% raise, your income increases by 0.02 * $28,000 = $560.
- Your new income is $28,000 + $560 = $28,560.
- Since your expenses remain the same, your surplus also increases by $560. Your new surplus is $4,060.
- The amount of credit card debt is more than your surplus, so you will **not** be able to pay it off.

Trends in the Federal Deficit & Debt

- The U.S. government has been running up huge deficits in recent years, which has driven the federal debt to a very large amount.
- The government has run deficits almost every year since the 1930s, with exceptions from 1947 to 1949 and 1998 to 2001.
- Even though there were not deficits during those years, the federal debt still existed.

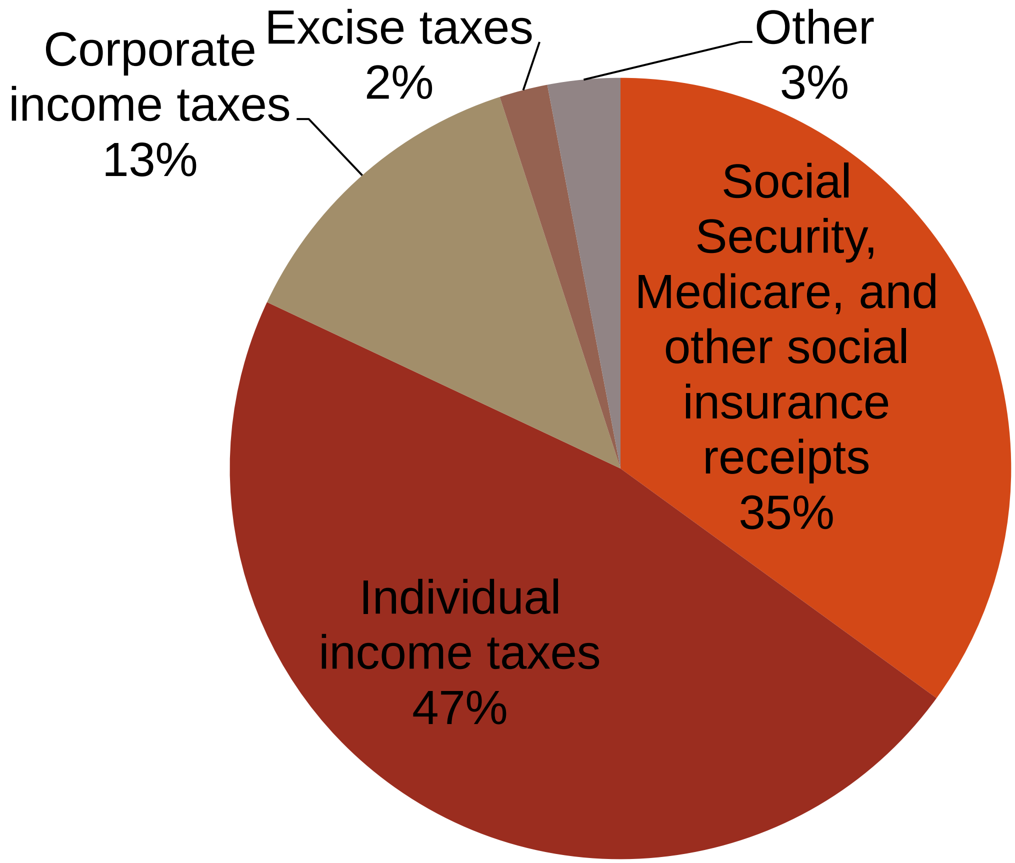
U.S. Federal Budget Summary, 2001 – 2009 (all amounts in billions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total Receipts	$1991	$1853	$1783	$1880	$2154	$2407	$2568	$2524	$2100
Total Outlays	1863	2011	2160	2293	2472	2655	2729	2983	3520
Net Income	128	-158	-378	-413	-318	-248	-161	-459	-1420

Federal Government Receipts

- As of 2009, the approximate makeup of government receipts consisted of:
  - Individual income taxes
  - Corporate income taxes – income taxes paid by businesses
  - Social insurance taxes – primarily FICA taxes for Social Security and Medicare but also include payments into retirement plans by federal employees and taxes for unemployment insurance
  - Excise taxes – taxes on alcohol, tobacco, gasoline, and other products
  - Other – includes such things as gift taxes and fines collected by the government

Approximate makeup of federal government receipts, 2009.



Federal Government Outlays

- **Mandatory outlays** – expenses that will be paid automatically unless Congress acts to change them

  Most are for “entitlements” such as Social Security, Medicare, and other payments to individuals

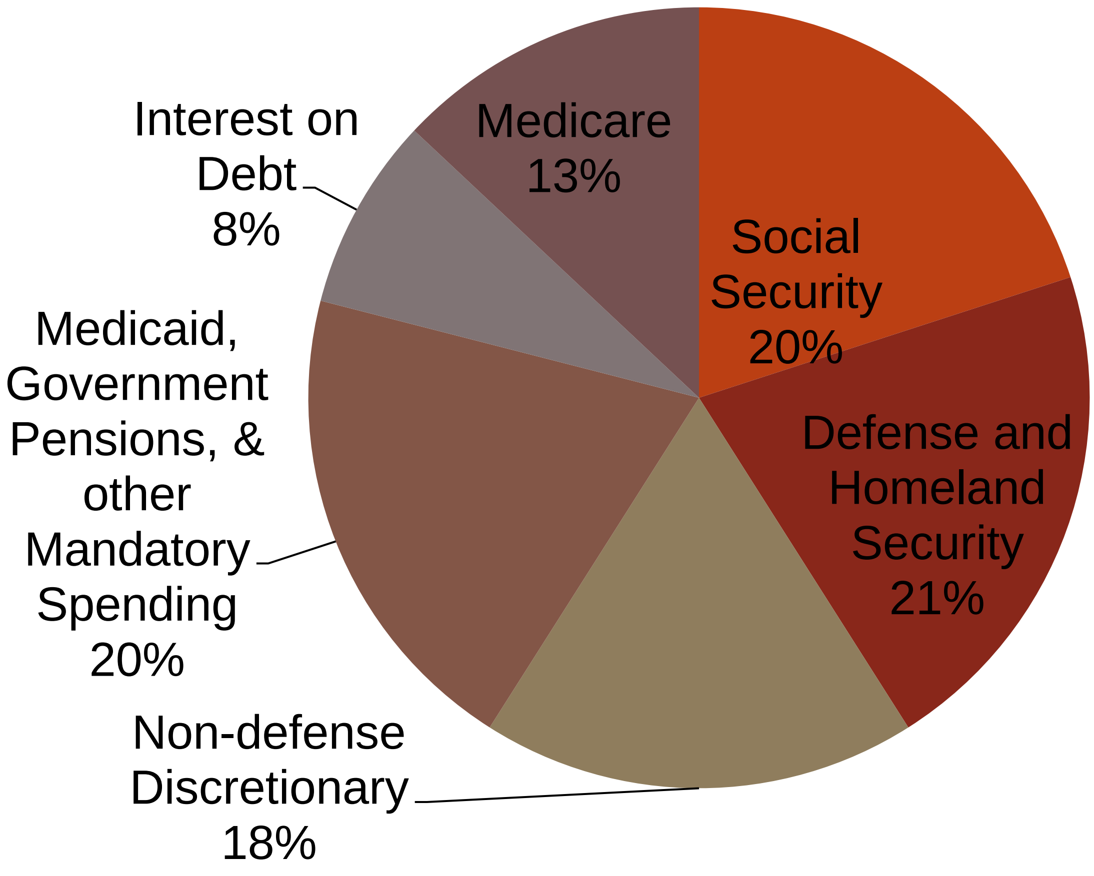
  They are called entitlements because the law specifically states the conditions under which individuals are entitled to them.

  Interest on the debt is also a mandatory outlay because it must be paid to prevent the government from being in default on its loans.

Federal Government Outlays

- **Discretionary outlays** – decided on a year-to-year basis
- The amounts must be approved by Congress in authorization bills, which then must be signed by the President to become law.
- Subdivided into programs for defense (military & homeland security) and non-defense.
- Non-defense discretionary outlays include everything except the mandatory outlays and defense.
  - Some include education, transportation, housing, international aid, the space program, and scientific research.

Approximate makeup of federal government outlays, 2009



Financing the Debt

- The federal government covers their deficits by both borrowing from “savings” and also by borrowing from people and institutions willing to lend to it.
- **Publicly held debt** – debt which the government must eventually pay back to those who hold the Treasury issues
- The government borrows money by selling Treasury bills, notes, and bonds to the public.
- Nearly half of the publicly held debt is currently held by foreign individuals and banks (China is the largest holder of U.S. securities)

Financing the Debt

- The government's "savings" consist of special accounts designed to meet future obligations (called *trust funds*).
- The biggest trust fund is for Social Security, which is primarily a retirement program.
- People "invest" by paying Social Security taxes and then collect Social Security benefits after they retire.
- The government has to date borrowed every penny it ever deposited into these trust funds.
- *There is no money in any of the trust funds, including Social Security.*
- It is instead filled with the equivalent of a stack of IOUs.
- **Gross debt** – includes both the publicly held debt and money the government owes to its own trust funds

- **Unified budget** – represents all federal revenues and spending.
- The unified budget is divided into two parts:

  off-budget – the portion of the unified budget that is involved in Social Security

  on-budget – the rest of the unified budget

Unified net income = on-budget net income + off-budget net income

Future of Social Security

- So far, the government has taken in more each year than what it pays out in Social Security.
- Sometime around 2016, the increasing number of retirees will mean that Social Security payments will exceed the receipts from Social Security taxes.
- At this point, the government will have to begin withdrawing money from the trust fund.

Options:

- 1. could cut spending on discretionary programs in order to free up money to redeem the IOUs
- 2. could borrow the money from the public by issuing more Treasury notes and bonds
- 3. could raise taxes to collect extra cash
- Medicare is expected to face a similar crisis.