

Seventh Edition

# FINANCIAL MANAGEMENT

for Public, Health, and  
Not-for-Profit Organizations



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Steven A. Finkler / Thad D. Calabrese / Daniel L. Smith



# FINANCIAL MANAGEMENT FOR PUBLIC, HEALTH, AND NOT-FOR-PROFIT ORGANIZATIONS

Seventh Edition

## Dedications

Steven A. Finkler

*To Max, Livi, Judah, and Josie*

Thad D. Calabrese

*To Abby, Benjamin, Noah, and Ethan*

Daniel L. Smith

*To Tara, Madison, and Hudson*

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# FINANCIAL MANAGEMENT FOR PUBLIC, HEALTH, AND NOT-FOR-PROFIT ORGANIZATIONS

Seventh Edition

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FOR INFORMATION:

CQ Press

An Imprint of SAGE Publications, Inc.

2455 Teller Road

Thousand Oaks, California 91320

E-mail: [order@sagepub.com](mailto:order@sagepub.com)

SAGE Publications Ltd.

1 Oliver's Yard

55 City Road

London, EC1Y 1SP

United Kingdom

SAGE Publications India Pvt. Ltd.

B 1/1 Mohan Cooperative Industrial Area

Mathura Road, New Delhi 110 044

India

SAGE Publications Asia-Pacific Pte. Ltd.

18 Cross Street #10-10/11/12

China Square Central

Singapore 048423

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Printed in the United States of America

*Library of Congress Cataloging-in-Publication Data*

This book is printed on acid-free paper.

Sponsoring Editor: Anna Villarruel

Production Editor: Rebecca Lee

Typesetter: Hurix Digital

Proofreaders: Eleni Maria Georgiou,  
Scott Oney

Indexer: Integra

Cover Designer: Scott Van Atta

Marketing Manager: Jennifer Haldeman

22 23 24 25 26 10 9 8 7 6 5 4 3 2 1

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# Preface

To effectively administer and steward organizations serving the public, managers and policy makers must have a working knowledge of financial management to ensure organization missions are met while not sacrificing long-term survival. This does not mean that all managers and policy makers of government, not-for-profit, and health-care organizations must be financial managers or experts. However, they cannot simply rely on others to be aware of the financial issues that may be of concern to the organization, nor can today's managers depend solely on others to make consequential financial decisions. All managers must be able to understand and make use of financial information. This is particularly true at a time when mergers are increasingly common in the not-for-profit and health sectors—every merger requires, at a minimum, that managers read numerous documents with financial data.

This book provides a foundation in financial management to allow people to understand and use financial information. The intent of the book is not to make the reader an accountant. Rather, its goal is to provide enough of the language and tools of financial management to make the reader conversant in the field and a competent entry-level financial analyst in the public, health, or not-for-profit sector. The primary goal is to provide the skills necessary to use financial information. However, the text also provides technical skills needed to generate that information. In addition, the book strives to provide the foundation for additional coursework in such areas as debt financing, government budgeting and accounting, and health or not-for-profit management.

One of the skills that all users of financial information must have is a strong financial vocabulary. The fields of accounting, finance, and public finance are heavily laden with jargon. Any accountant can bury a non-accountant in debits and credits, journals, and reversing entries. A major emphasis of this book is on providing a working vocabulary for communication so that the reader can develop the ability to ask the right questions and interpret the answers.

In addition to vocabulary, this book describes a wide variety of methods, processes, and tools of accounting and finance. The book does not describe them in sufficient detail for the reader to fire the treasurer and controller and take over their jobs. (How many of you really want to do that?) Instead, there is sufficient detail so that the reader can comfortably use the wide variety of financial reports that are generated in the typical organization. Also, the user of this book will have an awareness of the techniques available that can provide information to help improve decision making.

The focus of the book is on the financial management of government, health, and not-for-profit organizations. Most financial books are oriented toward the for-profit corporate sector. Historically, they have had a heavy emphasis on manufacturing or financial markets. Recently, as the service sector of society has grown, there has been some shift in financial management toward service industries. However, government, health, and not-for-profit organizations are not typical service industries. The public sector that these organizations represent has developed its own financial management style and rules. Unusual public sector accounting approaches, such as fund accounting, heighten the challenge of studying financial management. As a result, it is vitally important to have a targeted book such as this one.

Some users of this book will indeed want to go farther in the field of financial management and gain a specialized knowledge. They will need to be able not only to use, but also to generate financial information. Some of the more technical aspects needed by those individuals are contained in the appendices to a number of the chapters in the book.

It is our hope and belief that this book fills a void in a number of ways. First, a substantial effort has been made to present all the material the target audience needs, while not including excess material that would obfuscate more than it would clarify. It is difficult to achieve the balance of being sufficiently inclusive to adequately cover the topic and yet not so inclusive as to overwhelm the reader. It is a balance that we have devoted substantial efforts to achieve.

Second, the book has been written with an awareness that there is considerable movement of managers among the three sectors covered in this book. “Public service” is a broad concept. Often people who enter public service find that their careers take unexpected twists and turns, moving from one part of the public sector to another. By providing information on government, health, and not-for-profit organizations, this book provides the user with the background needed for future opportunities in public service careers that may yet be beyond the reader’s imagination.

Third, this book presents the order of material in a revolutionary way. Historically, accounting education has predominantly been targeted to those going into public accounting with the primary goal of becoming certified public accountants. As such, the elements of accounting most necessary for public accountants are taught first. Financial accounting, an area primarily involving the generation of information to be reported to people outside the organization, is generally taught before any of the elements of managerial accounting. However, most readers of this text will be managers rather than auditors. Their needs are oriented toward getting and using financial information to make decisions and manage effectively. Most managers will be exposed to budgets long before they see their organization’s audited financial statements. Therefore, the book reverses the normal order of most financial management texts, providing the foundation of managerial accounting before the discussion of financial accounting.

The order in which the material is presented in this book is unique yet logical. The process of developing a plan for the future, implementing the plan, controlling operations to keep to the plan, reporting results, analyzing results, and using that information to improve future plans is the normal flow of financial information within an organization. It is the way that most managers deal with financial information. In using this book in the classroom, it has become apparent that this flow also helps readers get a better grasp of the entire financial management process.

The book is organized as follows: Chapter 1 provides an introduction and overview of financial management. The chapter also provides background information on the primary sources and uses of money in the public sector. The text then moves on to the organization’s mission and the planning process in Chapters 2 through 6. A variety of budgeting techniques are discussed, and special attention is given to planning and measuring costs. Once made, plans must be implemented, with an effort to run the organization efficiently and to achieve its goals. Therefore, implementation and control issues are discussed in Chapters 7 and 8. These chapters focus on the management of short-term resources and obligations, and on issues of accountability and control. Managers need feedback to measure whether actual results are varying from the plan so that midstream corrections can be implemented. This feedback, in the form of variance reports, is also discussed in Chapter 8. At year-end the organization needs to aggregate the events of the year and prepare a report of what has transpired. This report contains a set of financial statements, which are discussed in Chapters 9 and 10. Special reporting concerns of health, not-for-profit, and governmental organizations are addressed in Chapters 11, 12, and 13. Finally, managers must analyze these results to understand the organization’s financial position and performance. Financial statement analysis and financial condition analysis are covered in Chapters 14 and 15. A glossary is provided at the end of the book so that the reader can quickly access definitions of key terms used throughout the text, or terms that may be important in financial management in general.

## NEW IN THIS SEVENTH EDITION

This seventh edition of *Financial Management for Public, Health, and Not-for-Profit Organizations* continues the work of the team of Steve Finkler, Thad Calabrese, and Dan Smith. Since the last edition was published, both the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) have implemented significant changes to the treatment of important concepts and reporting. As such, the primary focus of the changes in this edition is on the material presented in the second half of the text.

Instructors using this text are reminded that they have access to case studies in both managerial and financial accounting online at <https://edge.sagepub.com/finkler7e>. The authors have updated these cases to reflect the changes presented in the seventh edition of the text. Faculty using this book who have developed their own cases over the years are encouraged to send them to us for possible inclusion with attribution in subsequent editions of the book (see our email addresses at the end of this preface).

One of the most important changes since the sixth edition relates to the Financial Accounting Standards Board's (FASB) Accounting Standards Codification 606 - Revenue from Contracts with Customers, commonly referred to as Topic 606. Under Topic 606, discounts are considered to be explicit price concessions, and are excluded from revenue. Further uncollectible amounts that can be anticipated are referred to as implicit price concessions and are also excluded from revenues. Bad debt expense now only is used for uncollectible amounts that could not have been anticipated and estimated.

Chapter 1 has been updated. We have added a new appendix to Chapter 4 to detail how to use Excel's Goal Seek function to analyze breakeven data. Our hope is that students and instructors will find this addition increases the use of spreadsheets in teaching and learning managerial accounting topics. To further emphasize the use of Excel over financial calculators, we switched the two appendices in Chapter 5 that detail their uses.

In Chapter 10, we have updated the text to reflect the adoption of FASB ASU No. 2014-09 related to revenue recognition. The sixth edition included language that reflected the original standards because the new standards were still in the process of implementation; this seventh edition, by contrast, fully reflects current FASB standards. In Chapter 10 we also discuss the new FASB Topic 606. In addition, the financial statements that illustrate topics in Chapters 9 and 10 now reflect the changes resulting from recent FASB changes.

Chapter 11, which examines unique accounting issues for not-for-profit and health-care organizations, no longer distinguishes between voluntary health and welfare organizations and other not-for-profits, primarily because the accounting treatment of not-for-profits is moving toward homogeneity. The chapter now emphasizes the similarity of not-for-profit financial accounting regardless of the type of not-for-profit organization.

In addition, the chapter no longer focuses on donated services as in prior editions. FASB ASU 2020-07 was issued to clarify how not-for-profits should account for the contribution of nonfinancial assets such as capital assets, donated supplies, and contributed services. Chapter 11 now discusses donated services in light of this updated change in accounting.

The financial statement analysis in Chapter 14 incorporates these FASB changes. Also, we have changed the name of the organization so that it is differentiated from a similarly named organization used in earlier chapters. This decision was made simply to make clear where prior examples began and ended.

Governmental accounting standards have continued to evolve since the sixth edition of the book was published. Chapter 12 now begins by introducing the new GASB term for governmental financial reports: the Annual Comprehensive Financial Report (ACFR). It also highlights that governments still use the traditional treatment of accounting for bad debts,

which Topic 606 changed for private organizations. Further, while GASB has changed and implemented several new standards, we have chosen to edit the existing chapters largely to minimize changes to textbook users. Chapter 15 updates the sources of data for analyzing the financial condition of governments.

In addition to the above, minor clarifications and general updates have been made for all chapters throughout the book. Homework problems at the end of each chapter have been updated and expanded. The resources available online for instructors, including Homework Excel Templates, Homework Solutions, PowerPoint slides, and Test Bank problems, have all been revised, updated, and expanded. We have used embedded Excel objects in the solutions files and PowerPoint class notes to make it easier for students and instructors to review the calculations and examine the impact of changes in any of the variables.

This new edition is accompanied by materials on the Web. Instructor resources are available at <https://edge.sagepub.com/finkler7e>. The online materials include

- Word document solutions to all assignment material;
- Excel templates for selected homework problems (These may be made available to students at faculty discretion; however, they may not be posted on open-access internet sites accessible to those outside your class.);
- Excel solutions to selected homework problems; and
- Case Studies and expanded PowerPoint class notes.

We very much appreciate the feedback we have received directly from you—our students, colleagues, and friends. This book was a major undertaking. The results were substantially improved by the valuable comments and suggestions made by our colleagues and students. We offer our thanks to our many colleagues around the country who reviewed the manuscript for this and earlier editions and made important suggestions, including Khaled Amin, Emily Crawford, Tim Ettenheim, Santa Falcone, Dall Forsythe, Francesca Frosini, Patrice Iatarola, Dick Netzer, Pam Ouellette, Yousuf Rahman, Mark Robbins, Shanna Rose, Amy Schwartz, Bill Voorhees, and Robert Winthrop and Anubhav Gupta. We are grateful to David Strungis, who reviewed all the problems and solutions for the fourth edition, as well as Laura Hogue, who reviewed all the assignment material for the second edition. Special thanks go to Dwight Denison, Marty Ives, Bernard Jump Jr., Ken Kriz, Dean Mead, William Moore, Ross Rubenstein, and Leanna Stiefel, whose efforts went beyond the call of duty. We would also like to thank the publisher's reviewers, whose comments led to a number of improvements:

Anubhav Gupta, National University of Singapore;  
 Robert Bartolacci, CarnMellon University (2nd Edition);  
 James Caillier, University of Alabama (4th Edition);  
 Thomas Carment, Rogers State University (4th Edition);  
 Gang Chen, University at Albany-SUNY (6th Edition);  
 Susan Convery, Michigan State University (4th Edition);  
 Tom Courtney (1st Edition);  
 Thomas Crothers, Western Michigan University (6th Edition);  
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Lara Khouri, Columbia University (4th Edition);  
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 Laura Peck, Abt Associates (2nd Edition);  
 Chester A. Robinson, Jackson State University (5th Edition);  
 Ross Rubenstein, Georgia State University (4th and 5th Editions);  
 Jay Ryu, Ohio University (4th and 5th Editions);  
 Randy Serrett, University of Houston-Downtown (4th Edition);  
 H. "Charlie" Sparks, University of Alaska (4th Edition);  
 Megan Streams, Tennessee State University (4th Edition);  
 William Zelman, University of North Carolina (1st Edition).

Bernard (Bunny) Jump Jr. of the Maxwell School gets the medal of valor for having used the earliest drafts of the first edition of this book with his classes before even the most obvious and significant errors were removed. His tenacity in going through a number of different drafts of the book and his conceptual and technical comments throughout the process were invaluable. It is with great sadness that we note the passing of Bunny on August 21, 2019, at the age of 81. Bunny served The Maxwell School for over three decades as faculty member, chair of the Department of Public Administration and in many other leadership roles.

Ken Milani has been particularly generous in both reviewing our text over numerous editions, and also allowing us to include material he authored on budgeting as well as on the unrelated business tax. Our thanks also go to Robert Purtell, Dwight Denison, Drew Franklin, Santiago Guerrero, Ed Roche, Khaled Amin, and Louis Stewart for specific valuable contributions to the book. Louis Stewart passed on September 19th, 2012, at the age of 60. He was a good colleague and friend to the lead author of this text. Robert Purtell coauthored the fifth edition with us and contributed many of the homework problems and case studies that appear in the online resources. Dwight Denison authored a number of homework problems that appear at the end of chapters throughout the book as well as the Ponderosa case study, which appears in the online resources.

We would like to thank the entire CQ Press team for their remarkable job in getting this book to the reader. We thank our acquisitions editor, Anna Villarruel, for overseeing the entire project. Production editor Rebecca Lee managed the production process, and Eleni Maria Georgiou and Scott Oney did a fantastic job proofreading the manuscript.

Any errors that remain are our responsibility. We welcome all comments and suggestions. Please feel free to contact either Dan Smith or Thad Calabrese by email.

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## Case Examples

**T**hroughout this text there are running case examples regarding the town of Millbridge, the Hospital for Ordinary Surgery, Meals for the Homeless, and Save the Children. These organizations and their managers are fictitious, and any similarity to any real organization or person is strictly coincidental.

# About the Authors

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Dr. Steven A. Finkler is Professor Emeritus of Public and Health Administration, Accounting, and Financial Management at New York University's Robert F. Wagner Graduate School of Public Service (NYU Wagner). At NYU Wagner he headed the specialization in health services financial management for more than 20 years. Dr. Finkler is an award-winning teacher, author, and researcher.

Among his publications are 31 books, including *Financial Management for Nurse Managers and Executives*, 5th ed. (with Cheryl Jones and Christine T. Kovner, 2018); *Accounting Fundamentals for Health Care Management*, 3rd ed. (with Thad Calabrese and David Ward, 2019); and *Finance and Accounting for Nonfinancial Managers*, 5th ed. (2017). He has also published more than 200 articles in many journals, including *Health Services Research*, *Journal of Public Policy and Management*, and *Healthcare Financial Management*.

He received a bachelor of science degree in economics (dual major in accounting and finance), and a master of science degree in accounting from the Wharton School at the University of Pennsylvania, and a master of science degree in economics and doctorate in business administration at Stanford University.

Dr. Finkler, who is also a certified public accountant, worked as an auditor with EY (formerly known as Ernst and Young) and was on the faculty of the Wharton School before joining NYU. He is a past member of the executive board of the International Society for Research in Healthcare Financial Management and the editorial board of *Health Care Management Review*, and he served as treasurer and a member of the board of governors of the Daughters of Israel Geriatric Center. He was the editor of *Hospital Cost Management & Accounting* for 12 years and is a past member of the National Advisory Council for Nursing Research at the National Institutes of Health. He consults extensively, both around the country and abroad.

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Thad D. Calabrese, PhD, is associate professor of public and nonprofit financial management at NYU Wagner, and is director of the school's finance specialization. His research focuses on not-for-profit and government accounting and finance and is published in the *Journal of Public Administration Research and Theory*, *Public Administration Review*, *Public Budgeting & Finance*, *Journal of Accounting and Public Policy*, *Nonprofit and Voluntary Sector Quarterly*, *National Tax Journal*, *Public Finance Review*, and *Nonprofit Management & Leadership (NML)*, among others. In addition, he has served in several member-elected positions, including Chair of the Association for Budgeting and Financial Management and Treasurer for the Association for Research on Nonprofit Organizations and Voluntary Action. He currently serves on the Governmental Accounting Standards Advisory Council. Prior to entering academia, he worked as a financial manager in the not-for-profit sector and in local government.

### Daniel L. Smith

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## 1

# Introduction: Setting the Stage

## Introduction to Financial Management

This book is written for current and future public service managers and policy makers. Each person working in such a capacity—in government, in health care, or in a not-for-profit organization—will need to generate and/or use financial information. Some will become financial specialists and will use this book as their introduction to the field. For many readers, however, this book may be their only formal exposure to the concepts of financial management.

By the end of this book, the reader should be comfortable with the basics of financial management. That means the reader should be able to prepare and analyze budgets and financial statements, read and interpret financial information, and perform financial analyses. The reader should also have an appreciation for some of the things that financial management can do and know when to call on a financial expert. Most importantly, the reader should have an improved ability to use financial information in making managerial and policy decisions.

Even those who do not expect their careers to focus primarily on financial issues will find that an understanding of basic financial concepts is essential. All organizations are dependent on obtaining adequate financial resources and putting them to their best use. Resources are scarce, and financial management provides information about how scarce those resources will be and how they will be or have been used. Financial management gives managers tools that will aid them in achieving both the broad and the specific goals of the organization.

This chapter begins with an overview of financial management. The chapter next moves on to examine public sector resource flows. From where does each of the major public service sectors get its resources, and on what does it spend those resources? The chapter then addresses the question of why government, health-care, and not-for-profit organizations are all included in this one text.

The discussion next turns to whether such organizations should earn a profit from their activities. This gives rise to consideration of the tax implications if a public sector organization

### LEARNING OBJECTIVES

**The learning objectives of this chapter are to:**

- define financial management;
- define accounting and finance;
- discuss the sources and uses of resources in the public sector, including the federal government, state and local governments, health-care organizations, and not-for-profit organizations;
- explain why public service organizations should be concerned with financial management;
- explain why public service organizations should earn profits; and
- introduce a hypothetical ongoing example to be used throughout the text.

does earn a profit. The chapter concludes with the introduction of a hypothetical example that will be used throughout the text.

In this and every chapter, a great deal of new vocabulary is introduced. The first time a new term appears in the text, it is shown in bold. Words in bold are listed in the Key Terms section at the end of each chapter. These words are defined in the glossary at the end of the book.

## WHAT IS FINANCIAL MANAGEMENT?

**Financial management** is the subset of management that focuses on generating financial information that can be used to improve decision making. In **proprietary**, or for-profit, organizations, the unifying goal of all decisions is to maximize the wealth of the owners of the organization. In public service organizations—the term by which we may collectively refer to public, health, and not-for-profit organizations—the decisions are oriented toward achieving the various goals of the organization while maintaining a satisfactory financial situation. Financial management encompasses the broad areas of **accounting** and **finance**.

Accounting is a system for keeping track of the financial status of an organization and the financial results of its activities. It is often referred to as the language of business. The vocabulary used by accounting is the language of nonbusiness organizations as well. Governments, health-care organizations, and not-for-profit organizations often do not see themselves as being “in business.” Yet they must deal with many of the same financial issues as other types of organizations or risk “going out of business.” **Receivables, payables, inventory, net assets, depreciation, and debt** are just a few of the accounting terms that managers of public service organizations encounter in their interactions with the organization’s financial managers. These terms, and many others, will be introduced and explained throughout the book.

Accounting is subdivided into two major areas: **managerial accounting** and **financial accounting**. Managerial accounting relates to generating any financial information that managers can use to improve the future results of the organization. This includes techniques designed to generate any financial data that might help managers make more-effective decisions. Major aspects of managerial accounting include making financial plans for the organization, implementing those plans, and then working to ensure that the plans are achieved. Some examples of managerial accounting include preparing annual operating budgets, generating information for use in making major investment decisions, and providing the data needed to decide whether to buy or lease a major piece of equipment.

Financial accounting provides retrospective information. As events that have financial implications occur, they are recorded by the financial accounting system. From time to time (usually monthly, quarterly, or annually), the recorded data are summarized and reported to interested users. The users include both internal managers and people outside the organization. Those outsiders include those who have lent or might lend money to the organization (**creditors**), those who might sell things to the organization (suppliers or **vendors**), those who might seek the organization’s services (e.g., clients or patients), and other interested parties. These interested parties may include regulators, legislators, and citizens. Financial statements provide information on the financial status of the organization at a specific point in time, in addition to reporting the past results of the organization’s operations (i.e., how well it has done from a financial perspective).

Finance focuses on the alternative sources and uses of the organization’s financial resources. Obtaining funds when needed from appropriate sources and the deployment of resources within the organization fall under this heading. In addition, finance involves the financial markets (such as stock and bond markets) that provide a means to generating funds for organizations. Chapters 5, 6, and 7 discuss finance as it relates to public service organizations.

## PUBLIC SECTOR RESOURCE FLOWS

The public, health, and not-for-profit sectors in the United States are large. Federal government receipts were over \$3.4 trillion in the fiscal year 2020.<sup>1</sup> In addition, state and local government receipts exceed \$3.3 trillion annually.<sup>2</sup> Spending on health care, meanwhile, now exceeds \$3.8 trillion each year and is expected to pass \$5.2 trillion by 2025.<sup>3</sup> Finally, not-for-profit organizations reported a total of \$2.6 trillion in revenue as of 2016, the most recent year for which data are available.<sup>4</sup> Public service organizations obtain their financing from a variety of sources. The focus here will be on the major sources and uses of money in the public sector.

### Governments

**THE FEDERAL GOVERNMENT** The federal government represents a major component of the entire American economy. Where does the federal government get all its money, and how does it spend it? Table 1-1 provides a summary of the inflows to the federal government. Many organizations choose a year-end for accounting purposes that differs from the calendar year. The reasons for such a choice are discussed later in this book. Such years are referred to as **fiscal** years. The federal 2023 fiscal year begins on October 1, 2022, and ends on September 30, 2023.

**TABLE 1-1** Federal Receipts for the Fiscal Year Ending September 30, 2019 and 2020\* (in Billions, On- and Off-budget)

Receipts	2019	2020
Individual Income Taxes	\$1,718	\$1,609
Social Insurance Taxes	1,243	1,310
Corporation Income Taxes	230	212
Other	<u>273</u>	<u>290</u>
Total	<u>\$3,464</u>	<u>\$3,421</u>

\* 2020 values are estimates.

Source: Abstracted from “Table B–47, Federal receipts and outlays, by major category, and surplus or deficit, fiscal years 1955–2020,” *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 512.

Several types of receipts make up the bulk of federal government collections. These are individual income taxes, social insurance taxes (the majority of which are Social Security taxes), and corporation income taxes. Notice in Table 1-1, that individual income taxes declined in 2020. This was the first decline since 2010, which was the tail end of the Great Recession of 2008. Corporate income taxes also declined in 2020. These declines are the first indications of

<sup>1</sup>“Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020,” *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 512.

<sup>2</sup>“Table B-50, State and Local Government Revenues and Expenditures, Fiscal Years 1956–2018,” *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

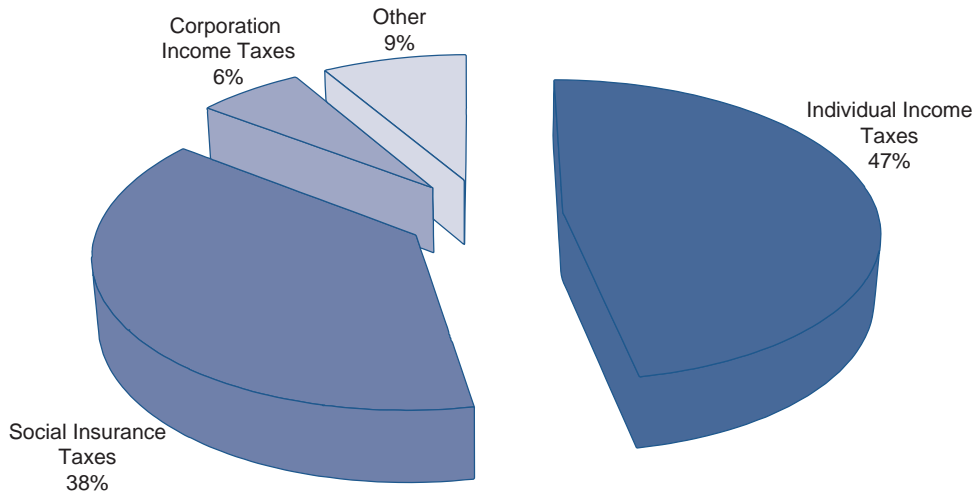
<sup>3</sup>Centers for Medicare & Medicaid Services, Office of the Actuary. National Health Statistics, “Table 16: National Health Expenditure (NHE), Amounts and Average Annual Growth From Previous Years Shown, By Type of Sponsor, Selected Calendar Years 2012–2028.” <https://www.cms.gov/research-statistics-data-and-systems/statistics-trends-and-reports/nationalhealthexpenddata>.

<sup>4</sup>NCCS Project Team, *The Nonprofit Sector in Brief 2019* (The Urban Institute, National Center for Charitable Statistics, June 2020). <https://nccs.urban.org/publication/nonprofit-sector-brief-2019#finances>.



the impact of the COVID-19 pandemic of 2020-21 (COVID). We will see more impacts below. The relative proportions of the different categories of total federal receipts in 2020 can be seen in Figure 1-1. The “other” category in Figure 1-1 includes things such as taxes on cigarettes and liquor, estate (inheritance) and gift taxes, and customs duties (charges on imports).

**FIGURE 1-1** Federal Receipts by Source (in Percentages) for the Fiscal Year Ending September 30, 2021 (Estimates)



*Source:* Derived from “Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020,” *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

During the second decade of this century, Social Security and national defense have been the largest federal outlay categories. However, in 2020 the income security and other categories leapt ahead of Social Security and national defense (see Table 1-2). The “other” category in Table 1-2 includes a wide variety of areas, such as education, the space program, agriculture, commerce, housing, transportation, and general government administration.

**TABLE 1-2** Federal Outlays for the Fiscal Years Ending September 30, 2019 and 2020\* (in Billions, On- and Off-budget)

Outlays	2019	2020
Income Security	\$ 515	\$1,263
Social Security	1,044	1,096
Medicare	651	776
Health	585	748
National Defense	686	726
Net Interest	375	345
International Affairs	53	68
Other	539	1,531
Total	<u>\$4,448</u>	<u>\$6,553</u>

\* 2020 values are estimates.

*Source:* Abstracted from “Table B-47, Federal receipts and outlays, by major category, and surplus or deficit, fiscal years 1955–2020,” *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 512.