

What Are Taxes?

- **How are taxes used to fund government programs?**
- **What are three types of tax structures?**
- **What are the characteristics of a good tax?**
- **Who bears the burden of a tax?**



Funding Government Programs

- **Citizens of the United States authorize the government, through the Constitution and elected officials, to raise money through taxes.**
- **Taxation is the primary way that the government collects money.**
- **Without **revenue**, or income from taxes, government would not be able to provide goods and services.**



Taxes and the Constitution

The Power to Tax

- **Article 1, Section 8, Clause 1 of the Constitution grants Congress the power to tax.**
- **The Sixteenth Amendment gives Congress the power to levy an income tax.**

Limits on the Power to Tax

The power to tax is also limited through the Constitution:

- 1. The purpose of the tax must be for “the common defense and general welfare.”**
- 2. Federal taxes must be the same in every state.**
- 3. The government may not tax exports.**



Tax Bases and Tax Structures

A **tax base** is the income, property, good, or service that is subject to a tax.

- **Proportional Taxes**
 - A **proportional tax** is a tax for which the percentage of income paid in taxes remains the same for all income levels.
- **Progressive Taxes**
 - A **progressive tax** is a tax for which the percent of income paid in taxes increases as income increases.
- **Regressive Taxes**
 - A **regressive tax** is a tax for which the percentage of income paid in taxes decreases as income increases.



Figure 14.1 Three Types of Tax Structures

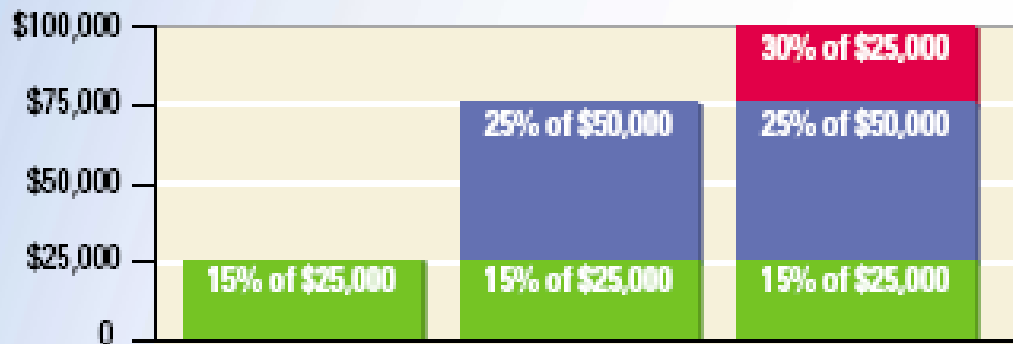
Type of Tax	Description	Example	Ron's taxes on \$50,000 income	Mary's taxes on \$150,000 income
Proportional	A constant percentage of income is taken in taxes as income increases	"Flat" tax	\$7,500, or 15 percent of income	\$22,500, or 15 percent of income
Progressive	A larger percentage of income is taken in taxes as income increases	Income tax	\$5,000, or 10 percent of income	\$45,000, or 30 percent of income
Regressive	A smaller percentage of income is taken in taxes as income increases	Sales tax	\$2,000, or 5 percent of total purchases of \$40,000; tax bill is 4 percent of income	\$3,000, or 5 percent of total purchases of \$60,000; tax bill is 2 percent of income



This chart shows how three different tax structures would affect a taxpayer named Ron with an income of \$50,000 and a taxpayer named Mary with an income of \$150,000.

Income How does Mary's higher income affect the taxes she pays in each type of tax structure?

Figure 14.2 Progressive Income Tax



Total taxable income: \$100,000

- | | |
|---|--|
| 1 You would be taxed at a rate of 15 percent on the first \$25,000 of your taxable income | $15\% \text{ of } \$25,000 = \$3,750$ |
| 2 You would be taxed at a rate of 25 percent on your taxable income above \$25,000 but below \$75,000 (\$50,000) | $25\% \text{ of } \$50,000 = \$12,500$ |
| 3 You would be taxed at a rate of 30 percent on your taxable income above \$75,000 (\$25,000) | $30\% \text{ of } \$25,000 = \$7,500$ |
| | <hr/> |
| | Total tax = \$23,750 |



In a progressive tax structure, the higher a taxpayer's income, the greater percentage he or she must pay in taxes. This chart shows a sample progressive income tax for a taxpayer with total taxable income of \$100,000.

Income According to the chart, what would be the total tax on taxable income of \$65,000?

Characteristics of a Good Tax

- **A good tax has the following characteristics:**
 - **Simplicity**
 - Tax laws should be simple and easily understood.
 - **Economy**
 - Government administrators should be able to collect taxes without spending too much time or money.
 - **Certainty**
 - It should be clear to the taxpayer when the tax is due, how much is due, and how it should be paid.
 - **Equity**
 - The tax system should be fair, so that no one bears too much or too little of the tax burden.

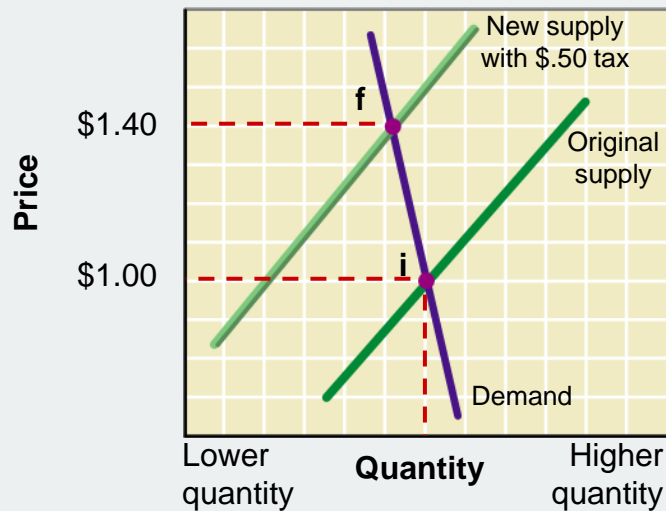


Who Bears the Burden of a Tax?

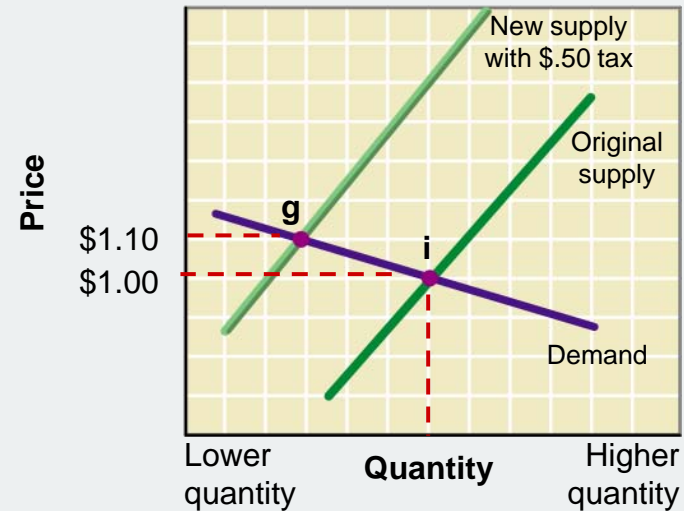
To fully evaluate the fairness of a tax, it is important to think about who bears the burden of the tax. The **incidence of a tax** is the final burden of the tax.

Elasticities of Demand and Tax Effects

Inelastic Demand



Elastic Demand



If demand is inelastic, a tax will increase the price of a good and consumers will bear a large burden of the tax. If demand is elastic, the opposite is true.



Section 1 Assessment

1. The power to tax is granted by the United States Constitution to
 - (a) the Treasury Department.
 - (b) Congress.
 - (c) the President.
 - (d) the Supreme Court.
2. All of the following are characteristics of a good tax except
 - (a) economy
 - (b) certainty
 - (c) revenue
 - (d) equity

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Federal Taxes

- **How do we pay individual income taxes?**
- **What are the characteristics of corporate income taxes?**
- **What is the purpose of Social Security, Medicare, and unemployment taxes?**
- **What are other types of taxes?**

Individual Income Taxes

- “Pay-as-You-Earn” Taxation
 - Federal income taxes are collected throughout the course of the year as individuals earn income.
- Tax Withholding
 - **Withholding** is the process by which employers take tax payments out of an employee’s pay before he or she receives it.
- Tax Brackets
 - The federal income tax is a progressive tax. In 1998, there were five rates, each of which applied to a different range of income.

Filing a Tax Return

- A **tax return** is a form on which you declare your income to the government and determine your taxable income.
- **Taxable income** is a person's total (or gross) income minus exemptions and deductions.

Exemptions are set amounts that you subtract from your gross income for yourself, your spouse, and any dependents.

HOURS AND EARNINGS		TAXES AND DEDUCTIONS	
Hours	Earnings	Description	Amount
20	200.00	FICA	15.20
		Federal	10.25
		State	5.10
		City	1.00
		Total Taxes	31.55
TOTAL			
Taxable Wages		Less Taxes	Net Pay
200.00		31.55	168.45

Deductions are variable amounts that you can subtract from your gross income.

Corporate Income Taxes

- Like an individual, a corporation must pay a federal tax on its taxable income.
- Corporate income taxes are progressive — as a company's profits increase so does the amount paid in taxes.

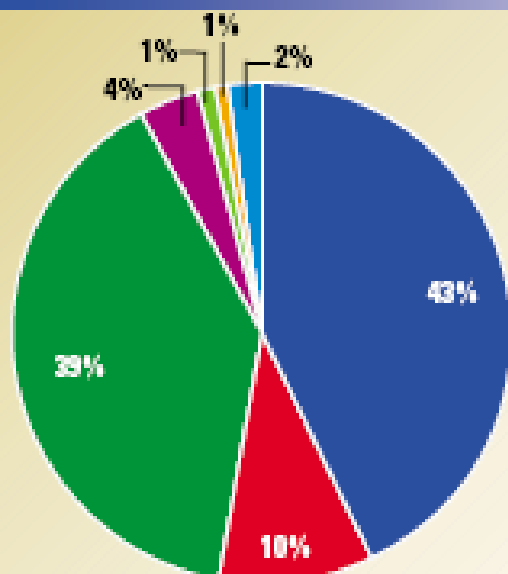
Social Security, Medicare, and Unemployment Taxes

- **Social Security Taxes**
 - This program is funded by the **Federal Insurance Contributions Act (FICA)**. Most of the FICA taxes you pay go to **Social Security**, or Old-Age, Survivors, and Disability Insurance (OASDI)
- **Medicare Taxes**
 - **Medicare** is a national health insurance program that helps pay for health care for people over 65 and for people with certain disabilities. Medicare is also funded by FICA taxes.
- **Unemployment Taxes**
 - Unemployment taxes are collected by both federal and state governments. Workers can collect “unemployment compensation” if they are laid off through no fault of their own and if they are actively looking for work.

Other Types of Taxes

- **Excise Taxes**
 - An excise tax is a tax on the sale or production of a good. Federal excise taxes range from gasoline to telephone services.
- **Estate Taxes**
 - An **estate tax** is a tax on the estate, or total value of the money and property, of a person who has died. Estate taxes are paid before inheritors receive their share.
- **Gift Taxes**
 - A **gift tax** is a tax on the money or property that one living person gives to another.
- **Import Taxes**
 - Taxes on imported goods are called **tariffs**.

Figure 14.4 Federal Revenue, 2004



- Individual income taxes
- Corporate income taxes
- Social insurance taxes and contributions
- Excise taxes
- Estate and gift taxes
- Customs duties and tariffs
- Miscellaneous receipts

Note: Because of rounding, totals may be less or greater than 100 percent.

Source: U.S. Department of the Treasury



Sources of government revenue include the taxes shown on this graph. **Government Analyze** the categories of revenue in the federal budget. What are the largest sources of federal revenue?



Figure 14.5 Federal Income Tax Rates, 2005

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Schedule	If your taxable income is over—	but not over—	the tax is	of the amount over—
Schedule X— use if your filing status is single	\$0	\$7,300	..... 10%	\$0
	\$7,300	\$29,700	\$730.00 plus 15%	\$7,300
	\$29,700	\$71,950	\$4,090.00 plus 25%	\$29,700
	\$71,950	\$150,150	\$14,652.40 plus 28%	\$71,950
	\$150,150	\$326,450	\$36,548.50 plus 33%	\$150,150
	\$326,450	.....	\$94,727.50 plus 35%	\$326,450
Schedule Y— use if your filing status is married filing jointly	\$0	\$14,600	..... 10%	\$0
	\$14,600	\$59,400	\$1,460.00 plus 15%	\$14,600
	\$59,400	\$119,950	\$8,180.00 plus 25%	\$59,400
	\$119,950	\$182,800	\$23,317.50 plus 28%	\$119,950
	\$182,800	\$326,450	\$40,915.50 plus 33%	\$182,800
	\$326,450	.....	\$88,320.00 plus 35%	\$326,450



According to these sample individual income tax tables, a single individual with \$5,000 of taxable income would pay \$5,000 X .10, or \$500 in taxes.

Income What would be the tax for a married couple filing jointly with \$75,000 in taxable income?

Section 2 Assessment

1. Taking taxes out of an employee's wages before he or she receives them is called
 - (a) tax return.
 - (b) social security.
 - (c) FICA.
 - (d) withholding.
2. How is the federal income tax a progressive tax?
 - (a) The higher the income a person has, the higher the percentage that person pays as tax.
 - (b) A person with a higher income pays more money in taxes, although the percentage he or she pays as tax is less.
 - (c) Two married people who file their taxes together will pay more taxes than a single person will.
 - (d) Children pay no taxes, regardless of whether they earn a large income.

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Federal Spending

- **What is the difference between mandatory and discretionary spending?**
- **What are some major entitlement programs?**
- **What are some of the categories of discretionary spending?**
- **How does federal aid impact state and local governments?**

Mandatory and Discretionary Spending

Spending Categories

- **Mandatory spending** refers to money that lawmakers are required by law to spend on certain programs or to use for interest payments on the national debt.
- **Discretionary spending** is spending about which government planners can make choices.

Federal Spending, 1999



Note: Because of rounding, totals may be less or greater than 100 percent.

Source: Office of Management and Budget



Entitlements

An **entitlement program** is a social welfare program that people are “entitled” to if they meet certain eligibility requirements.

- **Social Security**
 - Social Security is the largest category of government spending.
- **Medicare**
 - Medicare pays for certain health benefits for people over 65 or people who have certain disabilities and diseases.
- **Medicaid**
 - Medicaid benefits low-income families, some people with disabilities, and elderly people in nursing homes. Medicaid costs are shared by the federal and state governments.

Discretionary Spending

Defense Spending

- Spending on defense accounts for about half of the federal government's discretionary spending.
- Defense spending pays military personnel salaries, buys military equipment, and covers operating costs of military bases.

Other Discretionary Spending

- Other discretionary spending categories include:
 - Education
 - Training
 - Environmental cleanup
 - National parks and monuments
 - Scientific research
 - Land management
 - Farm subsidies
 - Foreign aid

Section 3 Assessment

1. All of the following are examples of mandatory spending except
 - (a) defense spending
 - (b) Medicare
 - (c) Social Security
 - (d) Medicaid

2. An entitlement program is
 - (a) a program to provide benefits paid to everyone.
 - (b) a program to provide benefits paid to government employees only.
 - (c) a program to provide benefits to people who meet certain requirements.
 - (d) a program to provide benefits to illegal aliens.

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State and Local Taxes and Spending

- **How do states use budgets to plan their spending?**
- **How are state taxes spent?**
- **What are the sources of state tax revenue?**
- **How do local governments obtain and use revenues?**

State Budgets

- **Operating Budgets**
 - A state's **operating budget** pays for day-to-day expenses. These include salaries, supplies, and maintenance of state facilities.
- **Capital Budgets**
 - A state's **capital budget** pays for major capital, or investment, spending.
- **Balanced budgets**
 - Some states have laws requiring balanced budgets. These laws, however, only apply to a state's operating budget.

Where Are State Taxes Spent?

- **Education**
 - State education budgets help finance public state universities and provide some aid to local governments for elementary, middle, and high schools.
- **Public Safety**
 - State governments operate state police systems, as well as correctional facilities within a state.
- **Highways and Transportation**
 - Building and maintaining highways is another state expense. States also pay some of the costs of waterways and airports.
- **Public Welfare**
 - State funds support some public hospitals and clinics. States also help pay for and administer federal benefits programs.
- **Arts and Recreation**
 - State parks and some museums and historical sites are funded by state revenues.
- **Administration**
 - Like the federal government, state governments spend money just to keep running.



State Tax Revenues

- **Limits to State Taxation**
 - **Because trade and commerce are considered national enterprises, states cannot tax imports or exports. They also cannot tax goods sent between states.**
- **Sales Taxes**
 - **Sales taxes are the main source of revenue for many states.**
- **Other State Taxes**
 - **Different states have various other means to collect revenue, such as state income taxes, excise taxes, corporate income taxes, business taxes, and property taxes.**

Local Government Spending and Revenues

The Jobs of Local Government

- The following is a brief list of the many functions that local governments carry out or assist in:
 - Public school systems
 - Law enforcement
 - Fire protection
 - Public transportation
 - Public facilities, such as libraries and hospitals
 - Parks and recreational facilities
 - Record keeping (birth/death certificates, wills, etc.)

Local Government Revenues

- Property taxes are the main source of local revenue. These taxes are paid by people who own homes, apartments, buildings, or land.
- Local governments sometimes collect excise, sales, and income taxes as well.
- Some taxes, such as room and occupancy taxes, are aimed at nonresidents in order for local governments to earn additional revenue.

Section 4 Assessment

1. Which of the following is not a source or revenue for most state governments?
 - (a) education tax
 - (b) intergovernmental revenue
 - (c) income tax
 - (d) sales tax
2. What is a tax assessor?
 - (a) someone who pays high taxes
 - (b) someone who decides which taxes are unfair
 - (c) someone who prepares individual tax statements
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