

Chapter 12

Taxes and Taxation

Who and what should be taxed?

■ 12.1 Introduction

On February 14, 1929, in a garage on Chicago's north side, a crime was committed that would shock the nation. Seven men—all but one of whom were members of an organized crime gang—were brutally gunned down by members of a rival gang dressed as police officers. The killings, which made headlines all over the country, were dubbed the Saint Valentine's Day Massacre.

The man believed to have been behind the massacre was Al Capone, one of the most notorious gangsters in American history. Capone, who went by the sinister nickname "Scarface," was a Chicago mob boss during the Prohibition era of the 1920s. At the time, the sale of alcohol was banned by the Eighteenth Amendment. Capone made a fortune from the illegal liquor trade, gambling, and other criminal activities.

By ruthlessly eliminating his rivals, Capone rose to the top of Chicago's criminal world. Federal law enforcement agents, led by Eliot Ness, tried for years to arrest him on murder and racketeering charges. But Capone was slippery—he always had an alibi. In addition, no one was willing to testify against him.

Then, in 1930, a key piece of evidence was found during a routine warehouse raid. Finally, federal prosecutors were able to bring their man to justice. Al Capone—the man branded "Public Enemy Number One"—was charged with the crime of . . . tax evasion.

Every year, millions of Americans have to fill out forms like these to pay taxes to the government.

Speaking of Economics

tax equity

The idea that a tax system should be fair. Although people agree with tax equity in principle, they often disagree on how to achieve it.

tax incidence

The allocation of the burden of a tax between consumers and producers. Tax incidence is said to fall on the group that bears the burden of tax, no matter from whom the tax is collected.

deadweight loss

A loss of productivity or economic well-being for which there is no corresponding gain. A tax causes deadweight loss when the costs to taxpayers of paying the tax exceed the revenues gained by the government.

tax rate

The percentage that is levied on the value of whatever is being taxed, such as income or property.

proportional tax

A tax that takes the same share of income at all income levels. A proportional income tax applies the same tax rate to all taxpayers, regardless of income.

progressive tax

A tax that takes a larger share of income as income increases. A progressive income tax applies a higher tax rate to high incomes than to low incomes.

regressive tax

A tax that takes a smaller share of income as income increases. A regressive tax applies the same tax rate to everyone. But the tax paid represents a larger share of a poorer taxpayer's income than of a wealthier taxpayer's income.

For several years in the late 1920s, Capone had failed to pay income tax. Yet he lived like a king, spending extravagantly on cars, clothes, and other luxuries. The Justice Department knew that such lavish spending was a sign of substantial income, but they could not prove it until they found a coded set of accounts that belonged to Capone. When they filed charges, Capone is said to have responded, “The income tax law is a lot of bunk. The government can’t collect legal taxes from illegal money.”

But Capone was wrong. In 1931, he was convicted of tax evasion and sentenced to 11 years in prison. He was also forced to pay \$80,000 in fines and court costs, and his career as a mobster was over.

Capone learned the hard way the truth of Benjamin Franklin’s famous saying, “In this world nothing is certain but death and taxes.” By comparing taxes to the one truly inevitable event in life—death—Franklin was saying that taxes are an unavoidable consequence of living in society.

In this chapter, you will learn about taxes and how they are used to finance government operations. You will read about the various types of taxes and how they are collected and spent by governments at the local, state, and national levels.

■ 12.2 What Are Taxes and How Should They Be Levied?

Most people know what a tax is—a mandatory payment to the government. But ask them if they *like* taxes, and you are sure to get no for an answer. No one enjoys giving up hard-earned income to the government. For many people, the experience is downright painful. The physicist Albert Einstein is reported to have said, “The hardest thing in the world to understand is the income tax.”

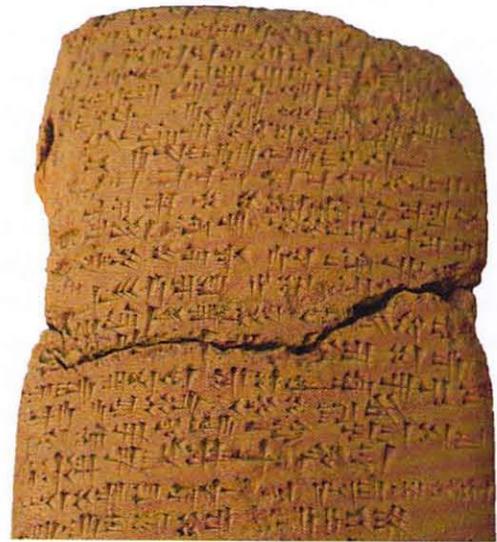
Taxes: The Price of Civilization

Many people share Einstein’s opinion. However, although taxes may be burdensome, they also make government possible. Without taxes, there could be no public institutions—no legislature, courts, or system of law enforcement. Therefore there would be no ordered society. “Taxation,” said Supreme Court justice Oliver Wendell Holmes Jr., “is the price we pay for civilization.”

Taxes have existed for as long as societies have been organized under common rule. In early civilizations, such as those of Egypt, Mesopotamia, and China, taxation took many forms. Farmers and craft workers had to give up a share of the goods they produced to the government, and traders were taxed on their commerce. In addition, people had to provide labor for building temples, city walls, and other public works. Taxes were paid in the form of goods and labor for centuries, but eventually these were replaced by taxes in the form of money.

Today taxes are collected and used for various purposes. They supply revenues to support the functions of government, such as national defense and criminal justice. They are used to pay for **infrastructure**, such as roads and bridges, and to fund welfare and public services, such as education and health care.

Taxes are also used to promote social and economic goals. For example, a tax may be placed on certain goods and services to limit their use. A tax on cigarettes or alcohol, for instance, can discourage their consumption. Taxes can also be used to redistribute income. For instance, higher taxes might be placed on one group, such as the wealthy, to provide benefits or services to another group, such as the poor.



In ancient Mesopotamia, tax records were recorded in Cuneiform writing on clay tablets similar to this one. One of the common taxes on Mesopotamian citizens was a labor tax, which could range from farming and other manual labor to military service.

Despite their many useful functions, taxes have never been popular with the citizens who pay them. Thomas Paine referred to taxes collected by Europe's monarchs as "plunder," or stolen goods. Throughout history, resentment over taxes has given rise to tax protests, riots, and rebellions, including the rebellion that launched our country's fight for independence.

How Our Nation's Founders Viewed Taxation

Taxation was the main issue that sparked the American Revolution. At the time, Britain taxed the American colonies but gave them no representation in Parliament. The colonists believed they should have a say in how they were taxed. The popular slogan "No taxation without representation" became a rallying cry for colonial discontent. As protests mounted, some members of Parliament called on the British government to change its tax policy. "Your scheme yields no revenue," declared the statesman Edmund Burke. "It yields nothing but discontent, disorder, disobedience."

After independence, the American people retained a cautious attitude toward taxation. Although they accepted the need for taxes, they also wanted to limit the government's tax powers.

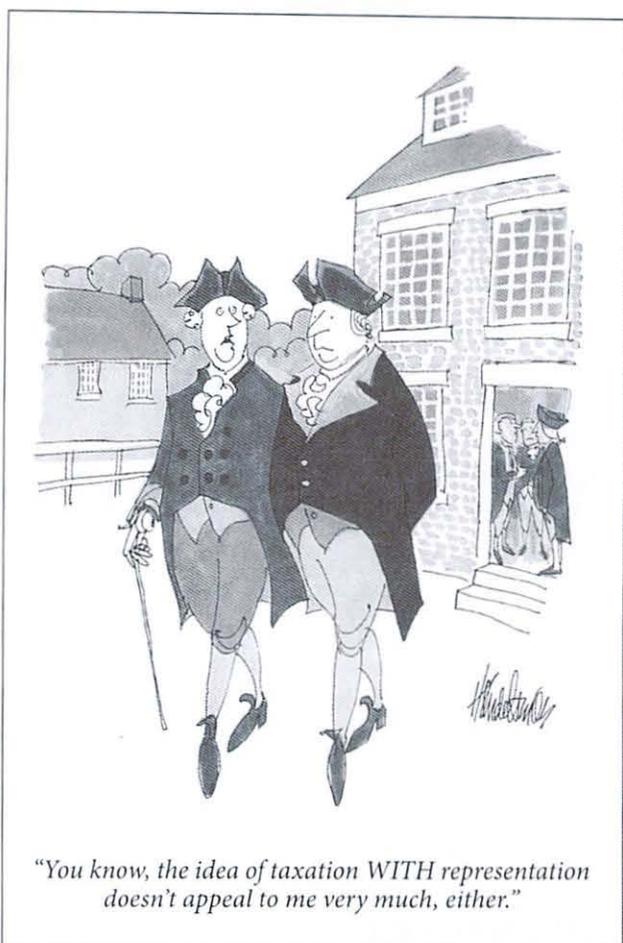
Some of these limits are written into the U.S. Constitution. Article I, Section 8, Clause 1, which provides the basis for federal tax law, says that Congress shall have the power "to lay and collect Taxes, Duties, Imposts and Excises." But the clause goes on to limit this power in two key ways.

- Taxes can be levied, or collected, only for the country's "common Defence and general Welfare," not for the benefit of individual citizens.
- Federal taxes must be the same in every state.

The framers of the Constitution also inserted a clause that limited the power of Congress to tax individual income. This clause was overridden in 1913, however, by passage of the Sixteenth Amendment, which allowed for the establishment of the federal income tax.

Adam Smith's Four Tax Maxims

Shortly before Americans declared independence in 1776, Adam Smith published *The Wealth of Nations*, his famous book on economics. In it, Smith laid down four maxims, or guiding principles, of taxation that



Because American colonists had no vote in the British Parliament, they complained about "taxation without representation." As this cartoon implies, however, people need no excuse to complain about taxes.

have influenced thinking about taxes ever since.

Equity. The first of Smith's maxims is equity, or fairness. In his view, wealthy citizens benefit most from government and can most afford to pay its costs. He wrote, "It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion." In other words, Smith believed that the rich should pay a higher percentage of their income in taxes than do the poor.

Certainty. Smith's second maxim is that the taxes a citizen owes should be "certain, and not arbitrary." He wrote, "The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor." Otherwise, government officials may be tempted to abuse the tax system for their own benefit.

Convenience. The third maxim is convenience. Smith wrote, “Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.” In other words, the tax system should not be overly complicated. Taxpayers should find the process of paying their taxes simple, straightforward, and predictable.

Efficiency. Smith’s fourth maxim—efficiency—is designed to keep the economic costs of the tax system to a minimum. Smith believed that taxes should produce maximum gain for the government, while causing minimum loss for taxpayers. “Every tax,” he wrote, “ought to . . . take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.”

The Tax Equity Debate: Who Should Pay and Why?

Most economists would agree in theory with Smith’s four maxims. Nevertheless, they often disagree about how to put those maxims into practice. One of the most hotly debated issues is the principle of **tax equity**, the idea that the tax system should be fair. Although economists support the principle of equity, they differ over how best to achieve it.

The crucial issue in the tax equity debate is who should pay. Economists offer two basic approaches to this problem: the ability-to-pay principle and the benefits-received principle.

The **ability-to-pay principle** mirrors Smith’s first maxim. It says that citizens should be taxed according to their income or wealth. People with higher incomes should pay more tax. People with lower incomes should pay less tax. Federal and state income taxes are based on this principle. For example, a lawyer who earns \$200,000 a year pays a higher percentage of income in taxes than does a teacher who earns \$50,000 a year.

The **benefits-received principle** says that those who benefit from a particular government program should pay for it. For example, people who drive should pay for the upkeep of the highway system. Gasoline taxes that fund road repairs are based on this principle, as are highway and bridge tolls.

Who Ends Up Paying Taxes and Why?

One of the difficulties with devising a fair tax system is figuring out who bears the burden of a tax. To many people, the answer seems obvious. The producer or consumer who is legally required to pay the tax bears the burden, right? Not necessarily. The economic burden of a tax—what economists call **tax incidence**—may not fall on the person who pays the tax bill.

To see why, consider the tax on hotel rooms. Many state and local governments levy “occupancy” taxes on the use of hotel and motel rooms. Hotel and motel owners are required to pay this tax revenue

Key Concept

Tax Equity

Tax equity begins with the belief that taxation should be fair to all who are taxed. Economists often cite two principles in debates over tax equity: the ability-to-pay principle and the benefits-received principle.

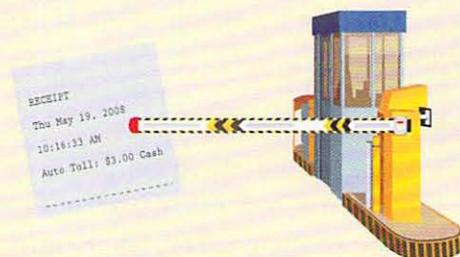
Ability-to-Pay Principle

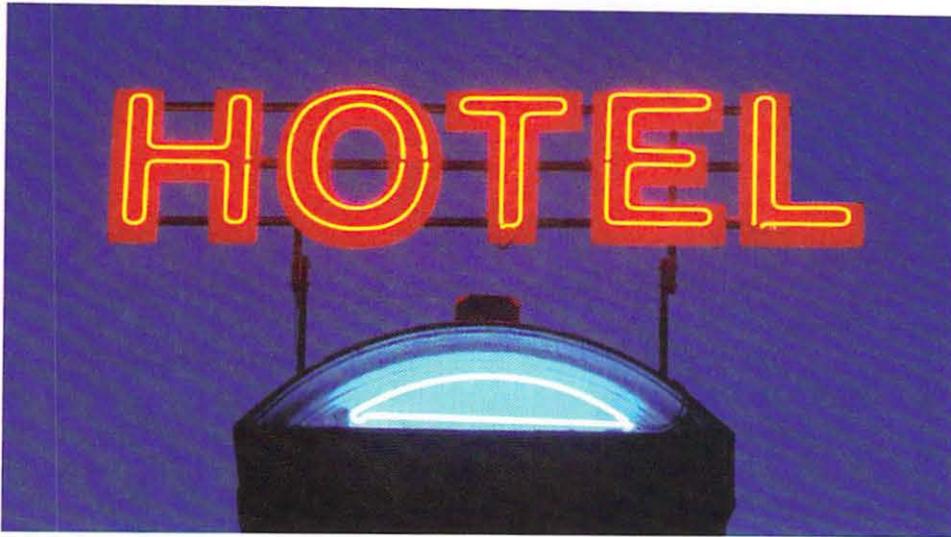
A tax on luxury items, such as diamond necklaces, is based on the ability-to-pay principle. The idea is that buyers of luxury goods have high incomes and can thus afford to pay more in taxes.



Benefits-Received Principle

Bridge and highway tolls are taxes based on the benefits-received principle. The idea is that drivers—the people who benefit from the road system—should pay the cost of road improvements.





Many states and cities levy occupancy taxes on the use of hotel and motel rooms. Such taxes are typically charged to the customer. But if a hotel lowers its room rates to keep the cost to customers down, the incidence of the tax falls at least in part on the hotel owner.

to the government. Most hotels simply add the tax, which is a percentage of the room rate, onto a customer's bill. When this happens, the customer bears the burden. But this extra cost might cause some hotels to lose customers. If a hotel owner responds by lowering room rates to reduce the overall cost to the customer, then the hotel owner, not the customer, is bearing some of the burden of the tax.

As this example illustrates, tax incidence is affected by elasticity of supply and demand. Elasticity, you may recall, is a measure of sensitivity to a change in price. In a market with very elastic demand, consumers are highly sensitive to price changes. A tax that raises prices may drive some consumers out of the market. If demand is inelastic, however, adding a tax to the price of a good or service will have much less effect on consumers' willingness to buy.

Similarly, in a market with very elastic supply, producers are highly sensitive to price changes. A tax that raises the cost of doing business may drive some producers out of the market. If supply is inelastic, however, adding taxes to other costs will not have much effect on producers' willingness to sell a good or service.

In general, the burden of a tax will fall on the side of the market that is less elastic. If consumers are more likely to leave the market if prices rise, then producers will bear more of the tax burden. But if producers are more likely to abandon the market, the incidence of taxation will fall more heavily on consumers.

Any government hoping to create an equitable tax system must take tax incidence into account. Yet many people are unaware that tax burdens can, and often do, shift. As economist N. Gregory Mankiw points out,

Many discussions of tax equity ignore the indirect effects of taxes and are based on what economists mockingly call the flypaper theory of tax incidence. According to this theory, the burden of a tax, like a fly on flypaper, sticks wherever it first lands. This assumption, however, is rarely valid.

Taxes and Efficiency: Deadweight Losses and the Costs of Compliance

There is less debate among economists about Smith's fourth maxim—efficiency. There are many ways to raise revenue through taxation. One tax system is considered more efficient than another if it raises the same amount of revenue at less cost to taxpayers. Obviously, a tax is, itself, a cost that taxpayers must bear. But taxes also impose two other kinds of costs: deadweight losses and the cost of tax compliance.

A **deadweight loss** occurs when the cost to consumers and producers from a tax—due to lost productivity or sales—is larger than the size of the tax revenue it generates. As economics writer Charles Wheelan put it, a deadweight loss “makes you worse off without making anyone else better off.”

Taxes can create deadweight losses by reducing people's incentives to be as productive as they

would otherwise choose to be. For example, consider the effect of state and federal income taxes on a job seeker who is offered a position that involves long hours of overtime. If she could keep every dollar she would earn by working the extra hours, the job might look attractive. But knowing that she will have to pay at least a third of her earnings in taxes, she decides it is not worth working that hard. She turns down the job and continues looking for work. Not only is she still unemployed, but the economy has lost what she might have produced had she taken the job. That lost productivity is a deadweight loss.

Another source of tax inefficiency is the cost of complying with the tax code. Every year, U.S. taxpayers spend many hours, and often hundreds of dollars, preparing their income tax forms. Moreover, as Figure 12.2 shows, the overall cost of compliance has been rising yearly. The time and money spent on tax preparation are resources that, if we had a more efficient tax system, could be used productively in other ways.

12.3 What Kinds of Taxes Will You Pay in Your Lifetime?

Every year on April 15, as midnight approaches, post office parking lots fill up around the country. Harried taxpayers hurry inside to get a place in line. The clock ticks. The race is on to get federal income tax forms postmarked before the April 15 filing deadline.

Taxation Basics: Tax Base and Tax Rates

In 2013, that April 15 deadline almost coincided with another tax-related day, known to some as “tax freedom day.” This is the date every year when it is estimated that average Americans will have earned enough to pay all their taxes for that year. In 2013, that date was April 18—108 days into the year. This means that Americans spent nearly one-third of 2013 working to pay their federal, state, and local taxes.

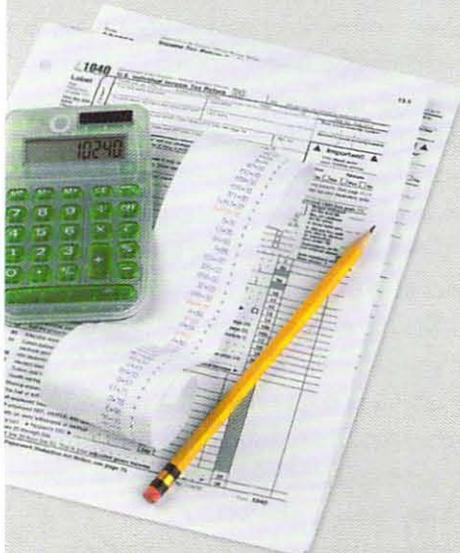
Many kinds of taxes make up the average American’s tax burden. All these taxes consist of two basic elements: the tax base and the tax rate.

Figure 12.2

Measuring the Cost of Tax Compliance

According to the Tax Foundation, a nonprofit organization dedicated to educating U.S. taxpayers, the cost of tax compliance is rising year by year.

- The foundation estimated that in 2005, individual taxpayers spent 2.8 billion hours filling out 387 million federal income tax forms.
- That same year, the cost of federal tax compliance by all taxpayers—individuals, firms, and nonprofits—was more than \$265 billion.



Source: The Tax Foundation.

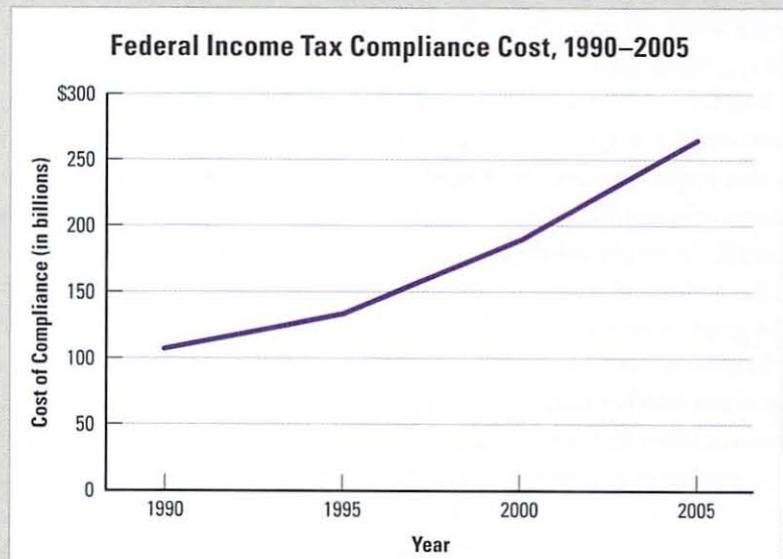
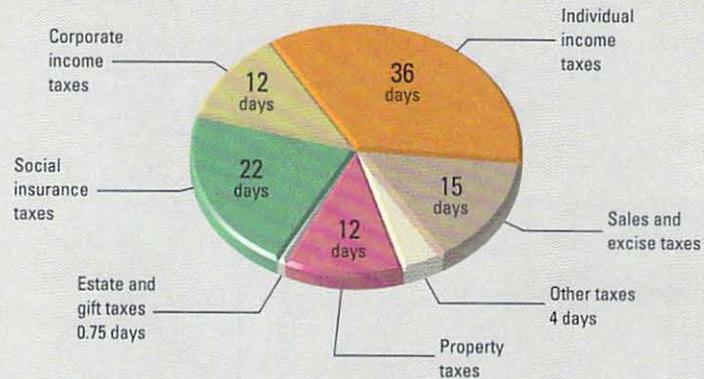


Figure 12.3A

Comparing Taxes with Other Spending Categories

This graph shows how many days in a year the average American spends working to pay different federal, state, and local taxes. Note that the number of days worked to pay individual income taxes exceeds any other category.

How Long Americans Work to Pay Taxes, 2011



Source: The Tax Foundation.

The **tax base** is the thing that is taxed, such as personal income, a good sold at a store, or a piece of property. Taxes are defined according to their tax base. For example, income tax is based on personal income. A property tax is based on the value of property, such as a home.

The **tax rate** is the percentage of income—or of the value of a good, service, or asset—that is paid in tax. For example, if the income tax rate were set at 20 percent, taxpayers would have to pay an amount equal to 20 percent of their taxable income.

Tax Structures: Proportional, Progressive, and Regressive

Taxes are also defined by their structure, which in turn depends on tax rates. Economists identify three types of tax structures: proportional, progressive, and regressive. Each structure has its advocates and critics.

Proportional taxes. A **proportional tax** is a tax that takes the same share of income at all income levels. For example, a proportional income tax of 10 percent would tax all incomes at that rate.

Critics of proportional taxes argue that such taxes fail the test of fairness, because they tax the rich and the poor at the same rate, even though the poor have less ability to pay than do the rich. A 10 percent income tax levied on a person who makes \$25,000 a year, for example, represents a greater sacrifice than the same tax levied on a person who makes \$250,000 a year.

Advocates of this tax structure, however, claim that a proportional tax is fair precisely because everyone pays an equal share. They also point out that proportional taxes are efficient because they are simple to calculate and easy to collect.

In recent years, Estonia and several other Eastern European countries have adopted a proportional income tax, or **flat tax**. For example, Slovakia introduced a flat tax in 2004 so that rich and poor alike pay a 19 percent tax on income. Supporters argue that this helps the economy by attracting foreign investors. Its simplicity also leads to less tax evasion. However, critics point out that a flat tax can hurt the middle class. In 2013, Slovakia abolished the flat tax in favor of a progressive tax.

Progressive taxes. A **progressive tax** is a tax that takes a larger share of income as income increases. A progressive tax is based on the ability-to-pay principle. Most federal taxes, including the federal income tax, are progressive.

The main argument in favor of progressive taxation is the equity argument. A progressive tax gets larger as income increases. Thus it places a greater tax burden on the wealthy—where advocates believe it should be—than on the poor.

Critics of progressive taxation, however, believe that placing an unequal burden on the rich is fundamentally unfair. In effect, they argue, such a tax punishes people for accumulating wealth and may create a disincentive to work, save, and invest. They

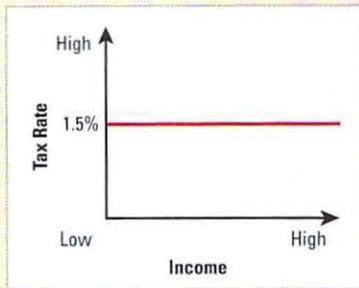
Key Concept

Proportional, Progressive, and Regressive Tax Structures

The three basic tax structures differ in how they tax individuals or firms with various levels of income.

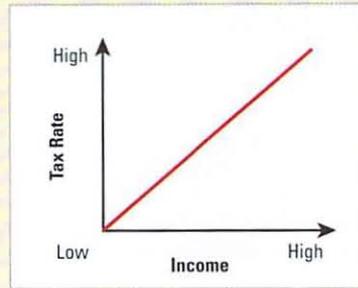
Proportional Tax

In a proportional tax structure, tax rates remain fixed as income increases.



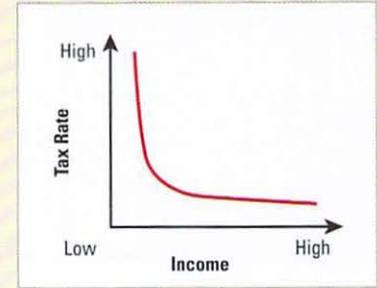
Progressive Tax

In a progressive tax structure, tax rates increase with rising income.



Regressive Tax

In a regressive tax structure, tax rates take a smaller share of income as income increases.



also complain that creating different rates for different income levels leads to a more complex, and therefore less efficient, tax system.

Regressive taxes. The third tax structure, the **regressive tax**, is a tax that takes a smaller share of income as income increases. Governments do not set out to impose higher tax rates as incomes fall. But a tax that is proportional—that applies a single rate to everyone—can effectively function as a regressive tax if it takes a bigger bite out of the incomes of poor people than those of wealthy people.

Sales taxes, for example, are regressive. To understand why, consider a low-income person who earns \$20,000 a year and spends \$10,000 of it on taxable goods and services. If the sales tax rate is 5 percent, that person pays \$500 in sales tax a year. This amount represents 2.5 percent of the low earner's income.

Compare that with the tax burden of a person who earns \$100,000 a year and spends \$30,000 on taxable goods and services. At the same tax rate, the high earner pays three times as much sales tax, or \$1,500. But that figure represents only 1.5 percent of the high earner's income. When the percentage of income claimed by a proportional tax goes down as income goes up, the tax is considered regressive.

Critics of taxes that tend to be regressive argue that they turn the ability-to-pay principle on its head. Instead of taxing most heavily those who are

most able to pay, such taxes place the greatest burden on those least able to pay.

Advocates of proportional taxes, however, argue that they need not be regressive. High earners, they point out, may choose to spend the same percentage of their income on taxable goods and services as people with lower incomes. In such cases, the tax is flat, not regressive, with high earners paying more as they consume more.

Individual Income Taxes

The largest share of tax revenue taken in by the federal government comes from individual income taxes. The majority of states also impose an income tax on their residents. The federal income tax and most state income taxes are progressive taxes.

The federal income tax applies to all U.S. citizens and residents with income above a certain minimum level. For example, a single adult who earned less than \$9,750 in the year 2012 was not required to file a federal income tax form.

The Internal Revenue Service is responsible for issuing federal income tax forms and processing tax returns. The IRS also works to ensure compliance with the **tax code**, the set of laws that govern federal taxes. Over time, these laws have grown in size and complexity. Between 1954 and 2005, for example, Congress enacted 35 significant changes to

the income tax code. The tax code is now estimated to contain nearly 4 million words, though nobody actually knows exactly how long it is.

The IRS collects taxes from workers using a “pay as you earn” system. Under this system, also known as **withholding**, employers take out a certain amount of tax from each paycheck. At the beginning of each year, most workers receive a **W-2 form**, which lists their wages for the previous year and the amount of tax that was withheld.

Taxpayers submit tax returns between January 1 and April 15. They are required to declare all their income for the previous year, including wages, investment earnings, business profits, and other types of income. If the IRS questions the accuracy of a taxpayer’s return, it may order an **audit**, or formal review of the return. Taxpayers who fail to comply with tax laws may face fines or, like Al Capone, imprisonment.

Figure 12.3B shows the federal income tax rates for single adults in various income brackets for 2013. As income rises, the marginal tax rate rises as well. The **marginal tax rate** is the rate at which the last dollar a person earns in a given year is taxed. The table in Figure 12.3B shows seven marginal tax rates for single adults in 2013, ranging from 10 to 39.6 percent. These rising rates make the income tax a progressive tax.

Suppose you earned \$15,075 in 2013. The first \$8,925 of your income would be taxed at the lowest rate of 10 percent. The remaining \$6,150 would be taxed at the next highest rate of 15 percent. This rate—15 percent—would be your marginal tax rate, because it is the rate you would pay on the last dollar earned that year.

Because your income is taxed at two different rates, your average tax rate will be lower than your marginal tax rate. In this case, your average tax rate in 2013 would be just over 12 percent. The graph in Figure 12.3B shows both marginal and average tax rates at different income levels.

Payroll Taxes

The second-largest share of federal tax revenue comes from payroll taxes. A **payroll tax** is a tax on the wages a company pays its employees. Of the several kinds of payroll taxes, the two most important are the Social Security tax and the Medicare tax. Both are used to fund large federal social insurance programs.

The **Social Security tax** is set at a fixed rate, which is paid half by the employer and half by the employee. People who are self-employed pay the entire tax themselves. In 2013, the total Social Security tax rate was 12.4 percent.

Figure 12.3B

Comparing Marginal and Average Federal Income Tax Rates

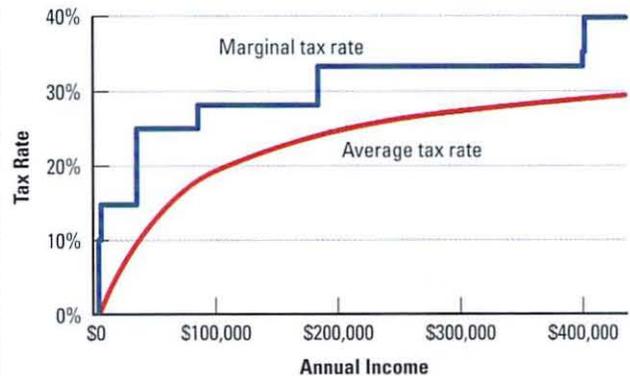
The federal income tax is a progressive tax. The table shows how marginal tax rates for a single taxpayer rise as income increases. You can see from the graph that the average tax rate for most taxpayers is less than their marginal tax rate. This is true because not all income is taxed at that marginal rate.

2013 Income Tax Rates for Single Adults

Taxable Income	Marginal Tax Rate
\$0 to \$8,925	10%
\$8,926 to \$36,250	15%
\$36,251 to \$87,850	25%
\$87,851 to \$183,250	28%
\$183,251 to \$398,350	33%
\$398,351 to \$400,000	35%
\$400,001 and above	39.6%

Source: Tax Policy Center

Marginal and Average Tax Rates, 2013



Because its rate is fixed, the Social Security tax appears, at first glance, to be a proportional tax. But it is actually regressive, for two reasons. First, the Social Security tax applies only to wages, salaries, and self-employment income. It does not apply to income from investments. Second, only earnings up to a specified maximum amount, or cap, are taxed. In 2013, that cap was \$113,700. Earnings over that amount are not taxed. Thus Social Security claims a smaller share of income as income rises.

The **Medicare tax** is also split evenly between employer and employee. In 2013, the total Medicare tax rate was 2.9 percent, half of which—1.45 percent—was withheld from employees' earnings. The Medicare tax is not capped. However, starting in 2013, income above \$200,000 will face a Medicare tax of an additional 0.9 percent.

Many states also levy payroll taxes. An **unemployment tax** is a state payroll tax that is used to assist workers who lose their jobs. Some states also levy a **state disability tax**, which funds state programs to help workers who are injured on the job.

Property Taxes

Taxes on property are a major source of revenue for many state and local governments. **Property taxes** are commonly levied on real property, which consists of land and buildings. Some governments also tax personal property, such as cars and boats.

Property taxes are proportional taxes that charge a fixed percentage of the value of a property. That value is calculated by an assessor, a public official who determines the value of a property for taxation purposes. If the **assessed value** of a property changes—a common occurrence in the real estate market—property taxes change, too.

In many communities, property taxes are a major source of revenue for public schools. However, the practice of funding public schools with property taxes has many critics. Some charge that it is unfair to require all property owners to pay such taxes when not all of them use the public schools. Others question the equity of basing school funding on property taxes. These critics point to the fact that lower-income school districts with low property values cannot raise as much revenue as higher-income school districts can. Funding schools in this way puts lower-income students at an educational disadvantage.

Sales Taxes

Another important source of state and local revenue is the **sales tax**. Such a tax levies a percent charge on the purchase of a wide variety of goods and services, from manufactured items to meals served in restaurants.

Sales taxes are relatively easy to collect and provide critical funding for state and local governments. But as you read earlier, sales taxes tend to be regressive, because people with high incomes typically spend less on goods and services as a share of their income than do lower-income individuals. To limit the regressive effects of a sales tax, many cities and states do not tax necessities, such as food and medicine.

Corporate Income Taxes

Governments at all levels levy various types of business taxes. The largest business tax is the federal **corporate income tax**, which is applied to the profits of corporations. Like individual income taxes, corporate taxes are progressive, applying a higher tax rate to higher levels of corporate income.

It might seem that placing high taxes on corporations and other businesses would help relieve the tax burden on ordinary citizens. In reality, the cost of corporate taxes is passed along to individuals—to customers in the form of higher prices, to employees in the form of lower wages, and to shareholders in the form of smaller dividend checks. As one economist put it, “Purely and simply, business taxes, like all other taxes, . . . are paid for by people.”

Excise and Luxury Taxes

Federal, state, and local governments also earn revenue from excise and luxury taxes, both of which tax consumption of certain goods and services.

Excise taxes are typically levied on goods and services a government wants to regulate. For example, alcohol and cigarettes are taxed to discourage their use. Because of their association with alcohol and cigarettes, excise taxes are sometimes called **sin taxes**. Like other sales taxes, excise taxes are generally regressive.

Luxury taxes, as the name implies, are levied on the sale of luxury goods, such as fur coats and private jets. Luxury taxes are progressive, because the consumption of luxury goods increases as income increases. The theory behind such taxes is that a person who can afford to buy a fur coat or a private jet can easily afford to pay an extra tax on it.

In practice, however, luxury taxes have not always worked the way lawmakers intended. In 1990, for example, Congress passed a luxury tax on expensive furs, jewelry, cars, private airplanes, and yachts. Because of the tax, wealthy people who might have purchased such products decided not to.

As demand for the luxury goods dropped, the firms that supplied them laid off workers. Within a year, according to a government study, the tax had destroyed 330 jewelry industry jobs, 1,470 aircraft industry jobs, and 7,600 jobs in the boat-building industry. In 1991, these job losses cost the federal

Key Concept

Federal, State, and Local Taxes

Governments at the federal, state, and local levels collect a wide range of taxes. Some of the most common types of taxes are described here. Each is further defined by three criteria: (1) its structure—proportional, progressive, or regressive; (2) its incidence, or who carries the burden; and (3) the particular branches of government that levy it.



Individual Income Taxes

A tax levied on personal income earned from wages and returns on investments.

Structure: Progressive—Rates rise with income.

Incidence: Single adults and married couples

Levied by: Federal, state, and local governments



Corporate Income Taxes

A tax on company profits.

Structure: Progressive—Rates rise with profits.

Incidence: Corporations, which then pass the expense on to consumers, employees, or shareholders

Levied by: Federal, state, and local governments



Payroll Taxes

Taxes deducted directly from employee paychecks. The two largest payroll taxes fund Social Security and Medicare.

Structure: Medicare tax—proportional; Social Security tax—regressive

Incidence: Employers and employees

Levied by: Federal and state governments



Excise and Luxury Taxes

Taxes on the sale of certain goods, services, and high-priced luxury items. Called sin taxes when applied to alcohol, cigarettes, and gambling.

Structure: Excise tax—regressive; Luxury tax—progressive

Incidence: Individual consumers

Levied by: Federal, state, and local governments



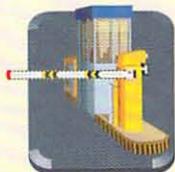
Property Taxes

Taxes levied on the value of real property, such as land and homes, or on personal property, such as cars and boats.

Structure: Proportional—Rates are the same for all.

Incidence: Property owners

Levied by: State and local governments



User Fees and Tolls

Taxes charged for the use of public facilities and services and for permits and licenses.

Structure: Proportional—Rates are the same for all.

Incidence: Individual users

Levied by: Federal, state, and local governments



Sales Taxes

A tax on the sale of goods, paid by the customer at the time of purchase. Most states and many cities have a general sales tax.

Structure: Regressive—The poor pay a larger proportion of their income in sales taxes than do the wealthy.

Incidence: Individual consumers

Levied by: State and local governments



Estate and Inheritance Taxes

Taxes levied on some or all of the estate (property and possessions) a person leaves behind at death.

Structure: Progressive—Rates rise with value of the estate.

Incidence: Heirs of large estates

Levied by: Federal and state governments

government more than \$24 million in lost income tax revenue and unemployment benefits paid to laid-off workers. This amount was more than all of the revenue generated by the luxury tax that same year.

The 1990 luxury tax illustrates the unintended consequences of poorly thought-out tax legislation. In this case, lawmakers failed to realize that the demand for luxury goods is actually quite elastic. In 1993, Congress repealed the luxury tax on everything except cars costing more than \$30,000. The luxury car tax expired in 2003.

User Fees and Tolls

Have you ever paid an entrance fee to a national park or a toll on a bridge? Like charges to park in public lots, swim in public pools, or use public highways, these are examples of user fees and tolls. **User fees** and tolls are fixed charges levied on the use of a public service or facility. Fees and tolls are based on the benefits-received principle, because those who use a facility pay the tax.

User fees and tolls are proportional taxes in that everyone pays the same rate, regardless of income. They become regressive or progressive only when a given fee tends to fall more heavily on low-income or high-income taxpayers.

Estate and Inheritance Taxes

The federal government imposes an **estate tax** on assets left to heirs by someone who dies. The heirs,

or inheritors of such assets, pay the tax. Many states also levy an estate tax, sometimes called an **inheritance tax**, on top of the federal tax.

Estate taxes are progressive, because larger estates are taxed at a higher rate. Some critics argue, however, that estate taxes are unfair because they impose an additional tax on property and wealth that may already have been taxed during a person's lifetime. Estate taxes may also discourage saving. Critics who oppose the estate tax sometimes call it a "death tax." "Death and taxes may be inevitable," one critic has said, "but they shouldn't be related."

12.4 How Do U.S. Governments Spend the Revenue They Raise?

In 2012, the federal government collected about \$2.3 trillion—that is, \$2,300,000,000,000—in tax revenue from its citizens. Such an enormous sum raises an obvious question: what does the federal government do with it all?

Federal Revenue Sources

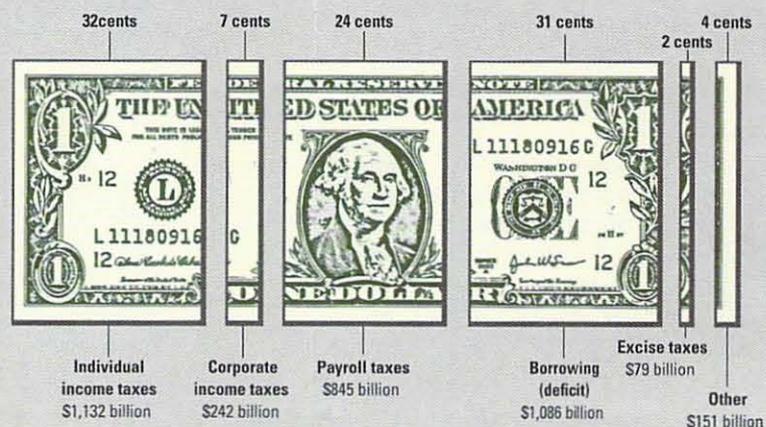
Most of the federal government's tax revenue comes from four sources. Individual income tax is the largest source, followed by payroll taxes and the corporate income tax. The fourth main source is excise taxes. Figure 12.4A shows these sources, along with the share of total revenue provided by each type.

Figure 12.4A

Analyzing Sources of Federal Revenue

Individual income taxes provide the largest share of federal revenue. Payroll taxes, which fund Social Security and Medicare benefits, also provide a large portion of revenue. Because tax revenues did not cover spending in 2012, the government also borrowed money to cover the deficit.

Sources of Federal Revenue, Fiscal Year 2012



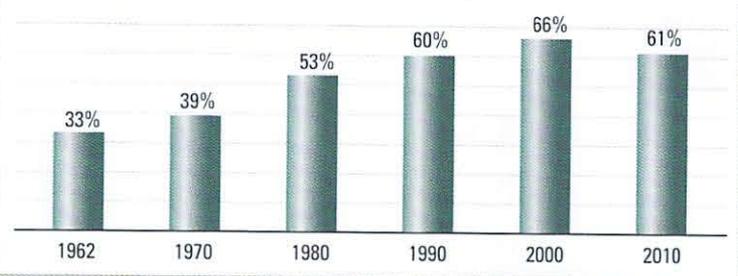
Source: Budget of the U.S. Government.

Figure 12.4B

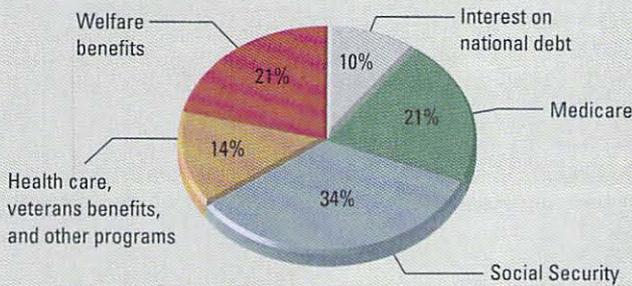
Tracking Mandatory and Discretionary Spending

Over the years, the percentage of federal revenue dedicated to mandatory spending has grown. Most recently, about two-thirds of federal revenue has been spent on interest and entitlement benefits. The remaining third has been used for discretionary spending. By far the largest discretionary item is defense spending.

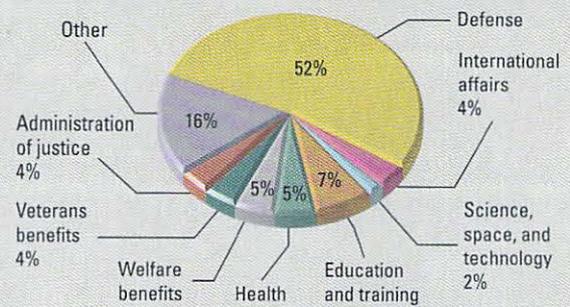
Growth of Mandatory Spending, 1962–2010



Mandatory Spending, Fiscal Year 2012



Discretionary Spending, Fiscal Year 2012



Source: Budget of the U.S. Government.
Note: Percentages do not add to 100 due to rounding.

Even with these four major taxes, the government typically does not take in enough revenue to cover all its expenditures. This gives rise to the **federal deficit**, the shortfall between tax revenues and government expenditures in any given year.

To make up this difference, the government borrows money. Federal borrowing takes place through the sale of government bonds, which include Treasury bills, savings bonds, and other government-issued certificates of debt. When the government sells a bond to an investor, it is taking on a debt that it promises to repay with interest in the future.

Selling government bonds to make up for a federal deficit adds to the national debt, however. The **national debt** is the total amount owed by a nation's government as a result of borrowing.

Federal Spending: Mandatory and Discretionary

Every year, the federal government draws up a budget to determine how it will spend its revenues. Like all government budgets, it is based on a fiscal year, rather than a calendar year. A **fiscal year** is a

12-month accounting period. The federal fiscal year begins on October 1 and is identified by the year in which it ends. Fiscal year 2013, for example, ended on September 30, 2013.

In the federal budget, spending is divided into two broad categories: mandatory and discretionary. These broad categories and their subdivisions are represented in the circle graphs in Figure 12.4B.

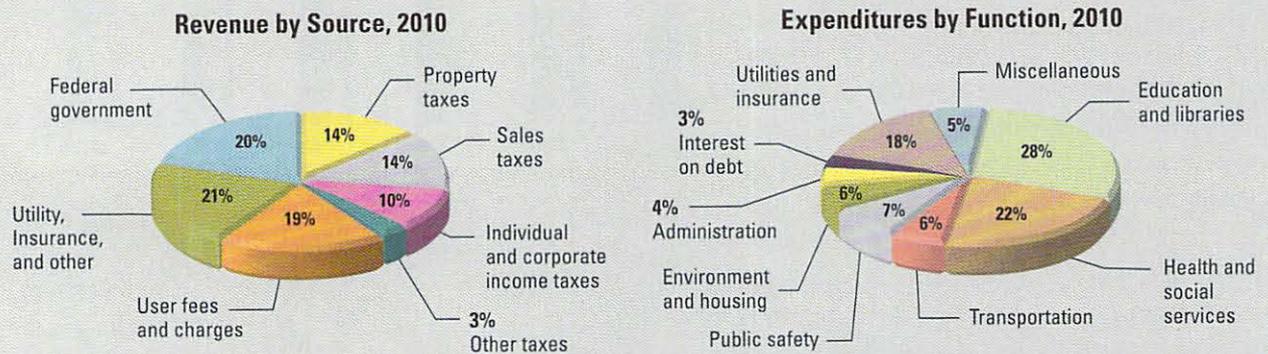
Mandatory spending is spending that is fixed by law. The only way for Congress to change the amount of money allocated to mandatory spending is to enact new legislation.

The two main categories of mandatory spending are interest on the national debt and entitlements. **Entitlements** are programs through which individuals receive benefits based on their age, income, or some other criteria. Entitlement programs include Social Security, Medicare, and welfare. The amount of money spent on such programs depends on the number of people who sign up for them. As the bar graph in Figure 12.4B indicates, the percentage of federal revenue dedicated to mandatory spending has

Figure 12.4C

Analyzing State and Local Spending and Revenue

State and local governments rely on revenue from various sources and spend their money in different ways. As these graphs show, revenues in 2010 came mainly from taxes and federal funding, while around half of all expenditures went to education and health and social services.



Source: U.S. Census Bureau. Note: Percentages do not add to 100 due to rounding.

grown significantly over the past several decades.

The other main category of spending, **discretionary spending**, is made up of expenditures that may be raised or lowered as Congress sees fit. As mandatory spending has grown in recent years, the share of revenue available for discretionary spending has shrunk. By far the biggest chunk is spent on national defense. The rest supports government funding for education, scientific research, health care, and foreign aid, among other activities. A portion also funds federal grants to state and local governments.

State and Local Government Revenue Sources

Like the federal government, state and local governments get most of their money from taxes. However, state and local officials face certain problems in raising revenue that the federal government does not face.

Some state constitutions, for example, prohibit state lawmakers from enacting certain types of taxes. Seven states, for instance, ban individual income taxes. Other states limit how much certain taxes can increase from year to year. In Massachusetts, for example, property taxes cannot increase by more than 2.5 percent a year. Such restrictions can be changed only if voters approve amending the state constitution.

In addition, citizens play a much larger role in tax policy at the local and state levels than at the federal level. Many states and localities require voters to approve tax hikes through **tax referendums**—direct popular votes on an issue. Some states, such as California, require a two-thirds majority of voters to approve increases in many types of taxes.

In part because of these limitations, state and local governments rely on certain revenue sources that are not used at the federal level, such as property and sales taxes. Many states also run **lotteries**, large-scale legal gambling games organized to raise money for a public cause. As of 2013, 43 states, along with the District of Columbia, U.S. Virgin Islands, and Puerto Rico, held lotteries. The first graph in Figure 12.4C shows the percentages of state and local revenue that come from various sources.

Spending by State and Local Governments

The second graph in Figure 12.4C shows categories of spending by state and local governments. Unlike the federal government, which spends the bulk of its revenue on entitlements and defense, state and local governments devote large shares of their revenue to services that directly affect young people and their families.

The most important of those services is education. As of 2012, nearly 50 million children were enrolled in public elementary and secondary schools throughout the United States. The average amount spent on each of these students was \$11,467 per year. About 88 percent of that money came from state and local governments.

Law enforcement and fire protection are two other responsibilities relegated mainly to local governments. In many communities, police protection is the second-largest public expense after education.

State and local governments also fund a variety of health and social services, often with assistance from the federal government. Typical examples include public health clinics for low-income families, health care centers for the mentally ill, and childcare for low-income working families.

Many other services are funded at the state and local levels. For example, state and local governments spend money to build and maintain roads and bridges. They create and maintain parks and playgrounds for the public to enjoy. They also fund public libraries, civic auditoriums, and museums.

All these services have been developed in response to public demand. The ever-present challenge is finding the money to pay for what the public wants. Because many state constitutions require balanced budgets, states that run short of funds must either raise taxes or cut programs. Either way, people are likely to object.

The fact is that although most people want the services that government provides, few people are happy to pay the taxes needed to fund those services. Former U.S. senator Russell Long once poked fun at this contradiction by reciting this jingle:

Don't tax you.

Don't tax me.

Tax that fella behind the tree.

Taxes may not be a big issue in your life yet. But once you begin earning a regular income, they will be. You may be shocked when you get your first paycheck to see how much is deducted in income and payroll taxes. At that point, the question we started with—*Who and what should be taxed?*—may seem more important. And it should. No matter what form they take, in the end, all taxes are paid by individuals just like you.

Summary

Taxes are necessary to fund government operations and services. The three levels of U.S. government—federal, state, and local—levy various types of taxes to supply the revenues they need.

What are taxes and how should they be levied? Taxes are mandatory payments to some form of government. Ideally taxes should be designed with equity and efficiency in mind, though economists differ on how to achieve these goals. The burden, or incidence, of a tax does not always fall on the person taxed. Instead, it may be divided between consumers and producers, based on the forces of supply and demand.

What kinds of taxes will you pay in your lifetime? Taxes are structured in three basic ways—proportional, progressive, or regressive—depending on their tax rates and effects. Among the main types of taxes are income taxes, payroll taxes, property taxes, sales taxes, and excise taxes.

How do U.S. governments spend the revenue they raise? The federal government spends most of its money on entitlements, interest payments, and national defense. State and local governments spend their revenues on a variety of services, mainly in the areas of education, public safety, and social welfare.