

# Sources of Government Revenue

## Why It Matters


You have just received your first paycheck and are looking forward to being paid \$8 per hour for the 20 hours you worked. You look at your check and . . . “What? This check isn’t for \$160! Where’s the rest of my money?” Make a list of the deductions that might be subtracted from your earnings. Read Chapter 9 to learn more about how governments raise revenue.

## The BIG Idea

All levels of government use tax revenue to provide essential goods and services.

When we receive paychecks for our work, a portion of our earnings goes to the government for taxes. ▶



**Economics**  **ONLINE** **Chapter Overview** Visit the *Economics: Principles and Practices* Web site at [glencoe.com](http://glencoe.com) and click on *Chapter 9—Chapter Overviews* to preview chapter information.



# The Economics of Taxation

## GUIDE TO READING

### Section Preview

In this section, you will learn that taxes are the most important way of raising revenue for the government.

### Content Vocabulary

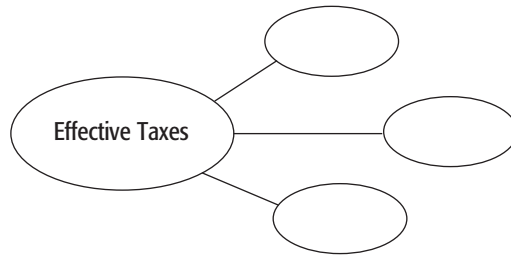
- sin tax (p. 230)
- incidence of a tax (p. 231)
- tax loophole (p. 232)
- individual income tax (p. 232)
- sales tax (p. 233)
- tax return (p. 233)
- benefit principle of taxation (p. 234)
- ability-to-pay principle of taxation (p. 234)
- proportional tax (p. 235)
- average tax rate (p. 235)
- Medicare (p. 235)
- progressive tax (p. 235)
- marginal tax rate (p. 235)
- regressive tax (p. 236)

### Academic Vocabulary

- validity (p. 230)
- evolved (p. 234)

### Reading Strategy

**Defining** As you read the section, complete a graphic organizer similar to the one below by listing the criteria for taxes to be effective. Then define each of the criteria in your own words.



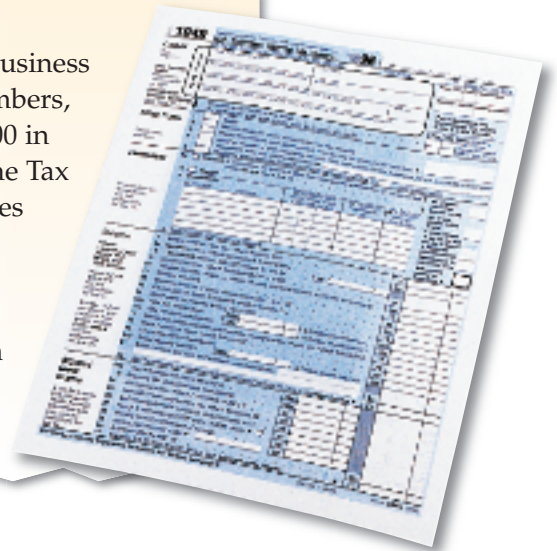
## PEOPLE IN THE NEWS

—Atlanta Journal-Constitution

### Teenage Tax Preparers

Since the tax season got under way . . . [Oakwood High School's business management students] have prepared 44 returns for community members, fellow students and faculty members, so far netting more than \$50,000 in refunds for their clients. The only high school-based Volunteer Income Tax Assistance program in [Georgia], Oakwood provide[s] free tax services for lower-income residents, nonspeakers of English and the disabled.

The student volunteers are saving taxpayers money. "Since we're targeting the low-income, many are not in a position to pay \$200 or \$300," [said Gloria Carithers, a senior tax specialist in the IRS Atlanta office]. "That could make the difference in paying a bill or buying something for the family." ■



An enormous amount of money is required to run all levels of government—and the need seems to be growing every year. Taxes are the primary way to do this, and taxes affect the things we do in more ways than you think.

Governments levy a variety of taxes, from sales taxes on items we purchase in

stores to the income tax we have to pay on our wages. One way in which we try to minimize taxes is by finding all the exemptions and deductions we are allowed to claim when we file our income tax returns. That is what the students in the news story were doing: helping their clients get the largest refund possible.



**sin tax** relatively high tax designed to raise revenue and discourage consumption of a socially undesirable product

## Economic Impact of Taxes

**MAIN Idea** Taxes affect the decisions we make in a variety of ways.

**Economics & You** Have you ever not bought something because you could not afford the tax on it? Read on to find out how taxes affect our behavior.

Taxes and other governmental revenues influence the economy by affecting resource allocation, consumer behavior, and the nation's productivity and growth. In addition, the burden of a tax does not always fall on the party being taxed.

### Resource Allocation

The factors of production are affected whenever a tax is levied. A tax placed on a good or service at the factory raises the cost of production and the price of the product.

People react to the higher price in a predictable manner—they buy less. When sales fall, some firms cut back on production, which means that some resources—land, capital, and labor—will have to go to other industries to be employed.

### Behavior Adjustment

Taxes are sometimes used to encourage or discourage certain types of activities. For example, homeowners can use interest

payments on mortgages as tax deductions—a practice that encourages home ownership. Interest payments on other consumer debt, such as credit cards, are not deductible—a practice that makes credit card use less attractive.

A so-called **sin tax**—a relatively high tax designed to raise revenue while reducing consumption of a socially undesirable product such as liquor or tobacco—is another example of how a tax can change behavior. For the tax to be effective, however, it has to be reasonably uniform from one city or state to the next so that consumers do not have alternative sales outlets that allow them to avoid the tax.

### Productivity and Growth

Taxes can affect productivity and economic growth by changing the incentives to save, invest, and work. For example, some people think that taxes are already quite high. Why, they argue, should they work to earn additional income if they have to pay much of it out in taxes?

While these arguments have **validity**, it is difficult to tell if we have reached the point where taxes are too high. For example, even the wealthiest individuals pay less than half of their taxable income to state and local governments in the form of income taxes. Are these taxes so high that people do not have the incentive to earn

### Home Ownership

People who purchase homes can deduct the interest on their mortgages. **How do deductions affect the total amount of taxes people owe?**



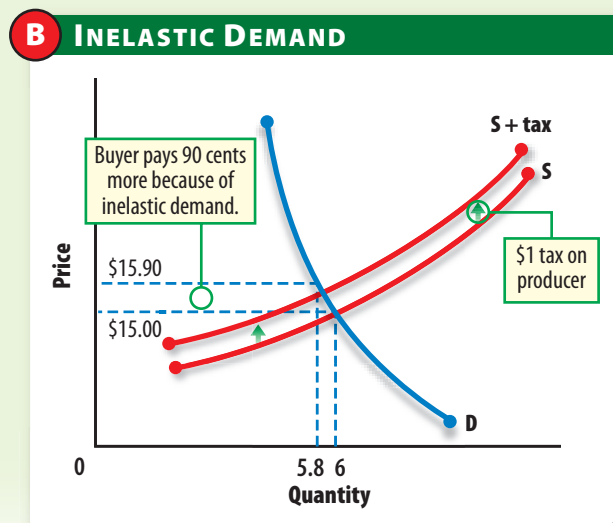
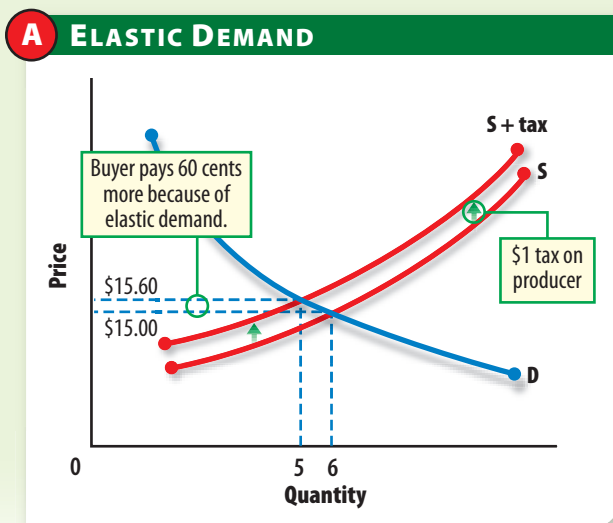
## Figure 9.1 ▶ Shifting the Incidence of a Tax

Graphs In Motion

See StudentWorks™ Plus  
or [glencoe.com](http://glencoe.com).

- ▶ A tax on the producer increases the cost of production and causes a change in supply. Less of the tax can be shifted back to the taxpayer if demand is elastic, as in panel A. More of the tax can be shifted to the taxpayer if demand is inelastic, as in Panel B.

**Economic Analysis** *If a tax is placed on medicine, who is likely to bear the greater burden—the producer or the consumer?*



an additional \$10 million because they can only keep half of it? Would they work any harder if income taxes took only 30 percent of their income? While we do not have exact answers to these questions, we do know that there must be some level of taxes at which productivity and growth would suffer.

### Incidence of a Tax

Finally, there is the matter of who actually pays the tax. This is known as the **incidence of a tax**—or the final burden of the tax.

Suppose a city wants to tax a local electric utility to raise revenue. If the utility is able to raise its rates, consumers will likely bear the burden of the tax in the form of higher utility bills. However, if the company's rates are regulated, and if the company's profits are not large enough to absorb the tax increase, then shareholders may get smaller dividends—placing the tax burden on the owners. The company

also might delay a pay raise—shifting the burden to its workers.

Supply and demand analysis can help us analyze the incidence of a tax. To illustrate, **Figure 9.1** shows an *elastic* demand curve in **Panel A** and an *inelastic* demand curve in **Panel B**. Both panels have identical supply curves labeled S. Now, suppose that the government levies a \$1 tax on the producer, thereby shifting the supply curve up by the amount of the tax.

In Panel A, the product's market price increases by 60 cents, which means that the producer must have absorbed the other 40 cents of the tax. In Panel B, however, the same tax on the producer results in a 90-cent increase in price, which means that the producer absorbed only 10 cents of the tax. The figure clearly shows that it is much easier for a producer to shift the incidence of a tax to the consumer if the consumer's demand curve is relatively inelastic.

**✓ Reading Check** **Summarizing** How do taxes affect businesses and consumers?

**incidence of a tax** final burden of a tax

### Skills Handbook

See page R39 to learn about **Formulating Questions**.



Student Web Activity

Visit the *Economics: Principles and Practices* Web site at [glencoe.com](http://glencoe.com) and click on *Chapter 9—Student Web Activities* for an activity on the individual income tax.

## Criteria for Effective Taxes

**MAIN Idea** To be effective, taxes must be equitable, easy to understand, and efficient.

**Economics & You** Do you look forward to preparing your personal income tax returns? Read on to learn why you may be apprehensive about tax time.

Some taxes will always be needed, so we want to make them as fair and as effective as possible. To do so, taxes must meet three criteria: equity, simplicity, and efficiency.

### Equity

The first criterion is equity, or fairness, which means that taxes should be impartial and just. Problems arise when we ask, *what is fair?* You might believe that everyone should pay the same amount. Your friend may think that wealthier people should pay more than those earning less.

There is no overriding guide to make taxes completely equitable. However, it does make sense to avoid **tax loopholes**—exceptions or oversights in the tax law that allow some people and businesses to avoid paying taxes. Loopholes are fairness issues, and most people oppose them based on equity. As a result, taxes generally are viewed as being fairer if they have fewer exceptions, deductions, and exemptions.

### Simplicity

A second criterion is simplicity. Tax laws should be written so that both taxpayers and tax collectors can understand them. People seem more willing to tolerate taxes when they understand them.

The **individual income tax**—the federal tax on people’s earnings—is a prime example of a complex tax. The entire federal code is thousands of pages long, and even the simplified instructions from the Internal

**tax loophole**  
exception or oversight in the tax law allowing a taxpayer to avoid paying certain taxes

**individual income tax**  
federal tax levied on the wages, salaries, and other income of individuals

## CAREERS

### Certified Public Accountant

#### The Work

- \* Prepare, analyze, and verify financial reports that inform the general public and business firms
- \* Provide clients with sound advice on tax advantages and disadvantages, and prepare their income tax statements
- \* Establish an accounting system and manage cash resources

#### Qualifications

- \* Strong mathematical skills and ability to analyze and interpret numbers and facts
- \* Ability to communicate results of analyses to clients and managers, both verbally and in writing
- \* Bachelor’s degree in accounting, with many positions requiring an additional 30 hours beyond the usual 4-year bachelor’s degree
- \* Successful completion of Uniform CPA Examination



#### Earnings

- \* Median annual earnings: \$50,770

#### Job Growth Outlook

- \* Faster than average

Source: *Occupational Outlook Handbook*, 2006–2007 Edition



## Highway Taxes

In many states, you have to pay a toll to use certain roads.

**What does this photo imply about the efficiency of tolls?**

Revenue Service (IRS) are lengthy and difficult to understand. As a result, many people dislike the individual income tax code.

A **sales tax**—a general tax levied on most consumer purchases—is much simpler. The sales tax is paid at the time of purchase, and the amount of the tax is computed and collected by the merchant. Some goods such as food and medicine may be exempt, but if a product is taxed, then everyone who buys the product pays the tax.

## Efficiency

A third criterion for an effective tax is efficiency. A tax should be relatively easy to administer and reasonably successful at generating revenue.

The individual income tax satisfies this requirement fairly well. An employer usually withholds a portion of an employee's pay and sends it to the IRS. At the end of the year, the employer notifies each employee of the amount of tax withheld so that the employee can settle any under- or overpayment with the IRS. Because of computerized payroll records, this withholding system is relatively easy.

After the close of the tax year on December 31 and before April 15 of the next year, employees file a **tax return**—an

annual report to the IRS summarizing total income, deductions, and taxes withheld. Any difference between the amount already paid and the amount actually owed is settled at that time. Most differences are due to deductions and expenses that lower the amount of taxes owed, as well as additional income not subject to tax withholding. State and local governments usually require tax returns to be filed at the same time.

Other taxes, especially those collected in toll booths on state highways, are considerably less efficient. The state has to invest millions of dollars in heavily reinforced booths that span the highway. The cost to commuters, besides the toll, is the wear and tear on their automobiles as they brake for toll booths along the road.

Efficiency also means that a tax should raise enough revenue to be worthwhile while not harming the economy. One example is the federal luxury tax on small private aircraft in the early 1990s. The IRS collected only \$53,000 in revenues during the first year of this tax because few planes were sold. This turned out to be less than the unemployment benefits paid to workers who lost jobs in that industry, so Congress quickly repealed that luxury tax.

**sales tax** general state or city tax levied on a product at the time of sale

**tax return** annual report by a taxpayer filed with the local, state, or federal government detailing income earned and taxes owed

✓ **Reading Check** **Stating** Why is equity important?



### benefit principle of taxation

belief that taxes should be paid according to benefits received regardless of income

### ability-to-pay principle of taxation

belief that taxes should be paid according to level of income, regardless of benefits received

## Two Principles of Taxation

**MAIN Idea** Taxes can be levied on the basis of benefits received or the ability to pay.

**Economics & You** Do you think the taxes you pay are fair? Read on to see if you prefer one principle of taxation over another.

Taxes in the United States are based on two principles that have **evolved** over the years. These principles are the benefit principle and the ability-to-pay principle.

### Benefit Principle

The **benefit principle of taxation** states that those who benefit from government goods and services should pay in proportion to the amount of benefits they receive.

Gasoline taxes are a good example of this principle. Because the gas tax is built into the price of gasoline, people who drive

### Benefit Principle

Gasoline and tire taxes are used to pay for the upkeep of roads. **What are the limitations of gasoline taxes?**

more than others pay more gas taxes—and therefore pay for more of the upkeep of our nation’s highways. Taxes on truck tires operate on the same principle. Since heavy vehicles like trucks are likely to put the most wear and tear on roads, a tire tax links the cost of highway upkeep to the user.

Despite its attractive features, the benefit principle has two limitations. The first is that those who receive government services may be the ones who can least afford to pay for them. Recipients of welfare payments or people who live in subsidized housing, for example, usually have the lowest incomes. Even if they could pay something, they would not be able to pay in proportion to the benefits they receive.

The second limitation is that benefits are often hard to measure. After all, the people who buy the gas are not the only ones who benefit from the roads built with gas taxes. Owners of property, hotels, and restaurants along the way are also likely to benefit from the roads that the gas tax helps provide.

### Ability-to-Pay Principle

The belief that people should be taxed according to their ability to pay, regardless of the benefits they receive, is called the **ability-to-pay principle of taxation**. An example is the individual income tax, which requires people with higher incomes to pay more than those who earn less.

This principle is based on two factors. First, we cannot always measure the benefits derived from government spending. Second, it assumes that people with higher incomes suffer less discomfort paying taxes than people with lower incomes.

For example, a family of four with an annual taxable income of \$20,000 needs every cent to pay for necessities. At a tax rate of about 13 percent, this family pays \$2,623—a huge amount for them. A family of four with taxable income of \$100,000 can afford to pay a higher average tax rate with much less discomfort.

**Reading Check** **Explaining** Which principle of taxation do you prefer, and why?



## Figure 9.2 ▶ Three Types of Taxes

▶ Progressive, proportional, and regressive are the three main types of taxes.

**Economic Analysis** *Under which type of tax do individuals with lower incomes pay a smaller percentage than do those with higher incomes?*

Type of tax	Income of \$10,000	Income of \$100,000	Summary
<b>Proportional</b> (City income tax)	\$97.50 or 0.975% of income	\$975.00 or 0.975% of income	As income goes up, the percentage of income paid in taxes <i>stays the same</i> .
<b>Progressive</b> (Federal income tax)	\$1,000 paid in taxes, or 10% of total income	\$25,000 paid in taxes, or 25% of total income	As income goes up, the percentage of income paid in taxes <i>goes up</i> .
<b>Regressive</b> (State sales tax)	\$5,000 in food and clothing purchases, taxed at 4% for a total tax of \$200 or 2% of income	\$20,000 in food and clothing purchases, taxed at 4% for a total tax of \$800 or 0.8% of income	As income goes up, the percentage of income paid in taxes <i>goes down</i> .

## Three Types of Taxes

**MAIN Idea** All taxes can be broken down into three categories—proportional, progressive, and regressive.

**Economics & You** You just learned about two principles of taxation. Find out how the principles apply to different types of taxes.

Three general types of taxes exist in the United States today—proportional, progressive, and regressive. As **Figure 9.2** shows, each type of tax is classified according to the way in which the tax burden changes as income changes. To calculate the tax burden, we divide the amount that someone pays in taxes by their taxable income. If a person pays \$100 in taxes on a \$10,000 income, then the tax burden is 0.01, or 1 percent.

### Proportional Tax

A **proportional tax** imposes the same percentage rate of taxation on everyone, regardless of income. If the income tax rate is 20 percent, an individual with \$10,000 in taxable income pays \$2,000 in taxes. A person with \$100,000 in taxable income pays \$20,000.

If the percentage tax rate is constant, the **average tax rate**—total tax paid divided by the total taxable income—also is constant, regardless of income. If a person’s income goes up, the *percentage* of total income paid in taxes does not change.

Few proportional taxes are used in the United States. One example is the 15 percent tax rate on corporate dividends. Regardless of overall income and how much someone receives in corporate dividends, individuals only pay 15 percent of that amount in personal income taxes.

Another example is the tax that funds **Medicare**—a federal health-care program available to all senior citizens, regardless of income. The Medicare tax is 1.45 percent of income, with no limit on the amount of income taxed. As a result, everyone who receives a paycheck pays exactly the same rate, regardless of the size of the paycheck.

### Progressive Tax

A **progressive tax** is a tax that imposes a higher percentage rate of taxation on higher incomes than on lower ones. This tax uses a progressively higher **marginal tax rate**, the tax rate that applies to the next dollar of taxable income.

**proportional tax** tax in which the percentage of income paid in tax is the same regardless of the level of income

**average tax rate** total taxes paid divided by the total taxable income

**Medicare** federal health-care program for senior citizens

**progressive tax** tax in which the percentage of income paid in tax rises as the level of income rises

**marginal tax rate** tax rate that applies to the next dollar of taxable income





**regressive tax**  
tax in which the percentage of income paid in tax goes down as income rises

For example, suppose the law required everyone to pay a rate of 10 percent on all taxable income up to \$7,500, and then a rate of 15 percent on all income after that. If someone had taxable income of \$5,000, this person would have to pay 10 percent on the 5,001st dollar earned. In this case, the marginal tax rate on the 5,001st dollar would be 10 percent.

However, if the same person had taxable income of \$7,500, then the marginal tax rate would be 15 percent on the 7,501st dollar earned. In either case, the marginal tax is always the tax that is paid on the very next dollar of taxable income.

The individual income tax code used in the United States today is structured just this way. It currently starts at 10 percent and then jumps to 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent, depending on the amount of taxable income. One important outcome of this structure is that progressively higher marginal brackets also cause the average tax rate to go up as taxable income goes up.

## Regressive Tax

A **regressive tax** is a tax that imposes a *higher* percentage rate of taxation on low incomes than on high incomes. For example, a person in a state with a 4 percent sales tax and an annual income of \$10,000 may spend \$5,000 on food and clothing and pay sales taxes of \$200 (or .04 times \$5,000). A person with an annual income of \$100,000 may spend \$20,000 on food and clothing and pay state sales taxes of \$800 (or .04 times \$20,000).

On a percentage basis, the person with the lower income pays 2 percent (or \$200 divided by \$10,000) of income in sales taxes, while the person with the higher income pays 0.8 percent (or \$800 divided by \$100,000). As a result, the 4 percent sales tax is regressive because the individual with the higher income pays a smaller percentage of income in sales taxes than does the individual with the lower income.

**✓ Reading Check** **Synthesizing** Which of the types of taxes should be used for income taxes? Why?

### SECTION

# 1

## Review

### Vocabulary

- 1. Explain** the significance of sin tax, incidence of a tax, tax loophole, individual income tax, sales tax, tax return, benefit principle of taxation, ability-to-pay principle of taxation, proportional tax, average tax rate, Medicare, progressive tax, marginal tax rate, and regressive tax.

### Main Ideas

- 2. Describing** Use a graphic organizer like the one below to describe the economic impact of taxes.



- 3. Identifying** What are the criteria for effective taxes?
- 4. Summarizing** What are the main points of the two principles of taxation?

### Critical Thinking

- 5. The BIG Idea** Compare and contrast the characteristics of proportional, progressive, and regressive taxes.
- 6. Evaluating** Using the criteria described in this chapter, how would you evaluate the effectiveness of the personal income tax?
- 7. Analyzing Visuals** School districts often are supported by property taxes. These taxes are based on a percentage of the value of a house or other real estate. Look at Figure 9.2 on page 235. In which category of taxes does the property tax fall?

### Applying Economics

- 8. Equity** Which of the two principles of taxation—the benefit principle or the ability-to-pay principle—do you think is more equitable? Explain your answer. Be sure to include in your answer how the two principles differ from one another.

# Profiles **in** Economics

## Monica Garcia Pleiman (1964– )

- president and CEO of OMS, a technology consulting firm
- publisher of Hispanic lifestyles magazine *Latino SUAVE*
- cofounder of the Latina Chamber of Commerce

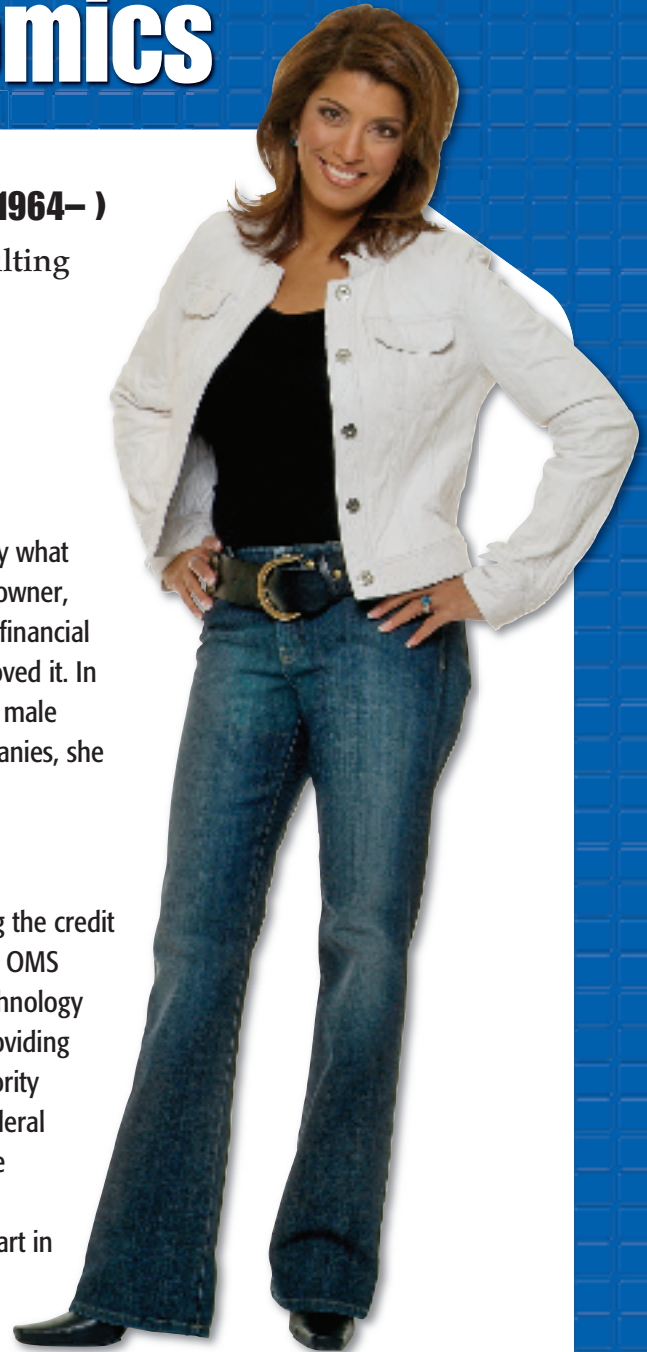
### Small Start

Denver-based businesswoman Monica Garcia Pleiman knew early what she wanted to do with her life. As the daughter of a small business owner, she learned that “hard work and entrepreneurial skills” could bring financial success. She also took her high school’s only computer class—and loved it. In 1987 Pleiman earned a degree in Information Science, a 95 percent male program. After working for both large corporations and small companies, she formed the consulting firm Optimum Management Systems (OMS).

### Small Business

Pleiman uses several successful strategies. Her practice of sharing the credit and allowing employees to grow in their jobs has resulted in a loyal OMS workforce—unusual in today’s highly competitive, ever-changing technology sector. She tries to maintain a small-business environment while providing large-company benefits. She also focuses on serving small and minority businesses. Finally, she has taken advantage of assistance by the federal government’s Small Business Administration, including attending the Minority Business Executive Program sponsored by the SBA.

These strategies have paid off. OMS grew 910 percent from its start in 1998 to 2003. Revenues over \$7 million per year make it one of the country’s most successful minority-owned businesses. This success allowed Pleiman to branch out and publish a new bilingual lifestyle magazine, *Latino SUAVE*.



*Pleiman descends from a long line of hard workers. Her Spanish ancestors settled Colorado 200 years ago. With six brothers, “I learned how to compete against men, to prove I could make it as a woman and as a minority.”*

### Examining the Profile

1. **Summarizing** What strategies helped Pleiman become a successful entrepreneur?
2. **For Further Research** What types of assistance does the Small Business Administration offer to entrepreneurs?



SECTION  
**2**

# Federal, State, and Local Revenue Systems

## GUIDE TO READING

### Section Preview

In this section, you will learn that federal, state, and local governments rely on different revenue sources.

### Content Vocabulary

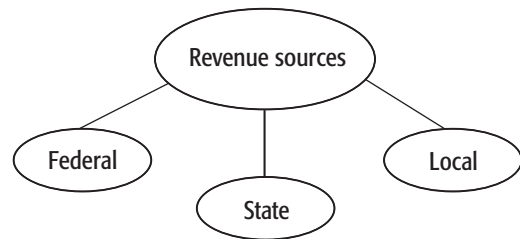
- Internal Revenue Service (IRS) (p. 238)
- payroll withholding system (p. 239)
- indexing (p. 239)
- FICA (p. 239)
- payroll tax (p. 239)
- corporate income tax (p. 240)
- excise tax (p. 240)
- estate tax (p. 241)
- gift tax (p. 241)
- customs duty (p. 241)
- user fee (p. 241)
- intergovernmental revenue (p. 242)
- property tax (p. 244)
- tax assessor (p. 244)
- natural monopoly (p. 244)

### Academic Vocabulary

- implemented (p. 242)
- considerably (p. 243)

### Reading Strategy

**Describing** As you read the section, complete a graphic organizer like the one below to identify and describe the revenue sources for federal, state, and local governments.



## ISSUES IN THE NEWS

—The Columbus Dispatch

### Taxing Tycoons

Come to Newport, Rhode Island, and see what America was like before the income tax. The Elms is a Gilded Age mansion graced by a Louis XV ballroom and tapestries from Imperial Russia. Its owner made his tax-free fortune off the coal mines of Pennsylvania and West Virginia.

[B]ut by the dawn of the 20th century, American farmers, miners, and factory workers started thinking that the Vanderbilts and their ilk should contribute more to the country. And so on October 3, 1913, President Wilson signed the bill that created an income tax. It touched only the wealthiest 4 percent of Americans. ■



**Internal Revenue Service (IRS)** branch of the U.S. Treasury Department that collects taxes

**T**he first federal income tax was enacted by the Union government in 1861 to help finance the Civil War. It was repealed in 1872. A later income tax was found unconstitutional in 1893, but it had the potential to be a major source of revenue.

It was not until the ratification of the Sixteenth Amendment in 1913 that Congress

could enact the current individual income tax. Since then, the top marginal tax rate has varied widely, from 1 percent for incomes over \$3,000 in 1913 to 94 percent for the highest incomes during World War II. The **Internal Revenue Service (IRS)** is the branch of the U.S. Treasury Department in charge of collecting taxes today.

# Federal Government Revenue Sources

**MAIN Idea** Individual income taxes, FICA, and borrowing constitute the main sources of government revenue.

**Economics & You** Have you ever wondered what “FICA” on your pay stub means? Read on to find out about one of the main federal revenue sources.

The federal government gets its revenue from a number of sources. Taxes are the primary source of revenue, but borrowing also plays a big part. As shown in **Figure 9.3**, the four largest sources of government revenue are individual income taxes, Social Security taxes, borrowing, and corporate income taxes.

## Individual Income Taxes

The main source of federal government revenue is the individual income tax. In most cases, the tax is collected with a **payroll withholding system**, a system that

requires an employer to automatically deduct income taxes from a worker’s paycheck and send them directly to the IRS.

Because inflation can push a worker into a higher tax bracket, the tax code is also indexed. **Indexing** is an upward revision of the tax brackets to keep workers from paying more in taxes just because of inflation. Workers might otherwise move into a higher tax bracket when they receive a pay raise that makes up for inflation.

## FICA Taxes

The second most important federal revenue source is FICA. **FICA** is the Federal Insurance Contributions Act tax, which is levied on employers and employees equally to pay for Social Security and Medicare. These two taxes are sometimes called **payroll taxes** because they are deducted from paychecks.

In 2007 the Social Security component of FICA was 6.2 percent of wages and salaries up to \$97,500. Above that amount, Social Security taxes are not collected, regardless of income. This means that a person with

**payroll withholding system** system that automatically deducts income taxes from paychecks on a regular basis

**indexing** adjustment of the tax brackets to offset the impact of inflation

**FICA** Federal Insurance Contributions Act; tax levied on employers and employees to support Social Security and Medicare

**payroll tax** tax on wages and salaries deducted from paychecks to finance Social Security and Medicare

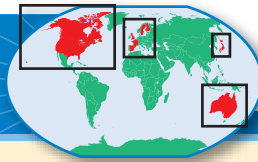
**Figure 9.3** Federal Government Revenue Sources



Source: *Economic Report of the President*, 2006

► In 2001 the federal government saved 1.7¢ of every dollar it spent. By 2007, the government was borrowing 12.8¢ for every dollar spent. The federal government now borrows more from investors than it collects from corporations in taxes.

**Economic Analysis** What is the percentage of total revenue for the first four items?

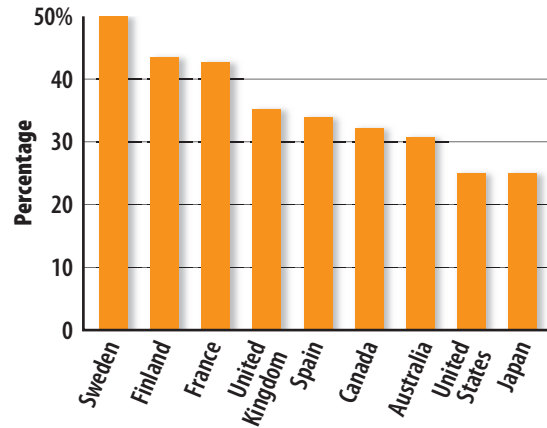


## High Taxes—Are You Sure?

You examine your paycheck and are dismayed to see how much money has been taken out for taxes. Before you get too outraged, however, do the math. What percentage of the total amount has been withheld for taxes? Ten percent? Twenty percent? This is a far cry less than would be withheld in many other countries.

One measure of a country's tax burden is the ratio of its tax revenues to gross domestic product (GDP). Despite the criticism over high taxes in the United States, our federal government's revenues as a percentage of GDP are much lower than people realize. Sweden is usually ranked first as the country with the world's highest taxes, whereas the United States boasts one of the lowest tax revenue-to-GDP ratios in the industrial world.

**TOTAL TAX REVENUE AS A PERCENTAGE OF GDP**



Source: Organization for Economic Co-operation and Development (OECD)

**corporate income tax** tax on corporate profits

**excise tax** general revenue tax levied on the manufacture or sale of selected items

taxable income of \$97,500 pays the same Social Security tax—\$6,045—as does someone who earns \$1,000,000,000.

In 1965 Congress added Medicare to the Social Security program. The Medicare component of FICA is taxed at a flat rate of 1.45 percent. Unlike Social Security, there is no cap on the amount of income taxed, which makes it a proportional tax.

### Borrowing

Borrowing by the federal government is the third-largest source of federal revenue. Because tax revenues fluctuate, the government never knows exactly how much it will need to borrow. Therefore, it continues with its spending as allocated in the budget. If it does not collect enough money in taxes and user fees, it simply borrows the rest by selling bonds to investors.

Figure 9.3 shows that the federal government has become dependent on this source of funds, with the amount of money borrowed exceeding the total amount of taxes collected from corporations. The increased

borrowing has been mainly due to the increased levels of government spending since 2001 that have outpaced federal revenue collection.

### Corporate Income Taxes

The fourth-largest source of federal revenue is the **corporate income tax**—the tax a corporation pays on its profits. The corporation is taxed separately from individuals because the corporation is recognized as a separate legal entity.

Several marginal tax brackets, which are slightly progressive, apply to corporations. The first is at 15 percent on all income under \$50,000. The marginal brackets then rise slightly after that, and eventually a 35 percent marginal tax applies to all profits in excess of \$18.3 million.

### Excise Taxes

The **excise tax**—a tax on the manufacture or sale of selected items such as gasoline and liquor—is the fifth-largest source of federal government revenue. Some early



excise taxes were on carriages, snuff, and liquor. Today federal excise taxes are levied on telephone services, tires, legal betting, and coal. Because low-income families spend larger portions of their incomes on these goods than do high-income families, excise taxes tend to be regressive.

## Estate and Gift Taxes

The **estate tax** is the tax on the transfer of property when a person dies. Estate taxes can range from 18 to 50 percent of the value of the estate, although estates worth less than \$2,000,000 are exempt. The exemption will be raised to \$3,500,000 by 2009, but because these amounts are so high, fewer than 2 percent of all estates pay any tax at all.

The **gift tax** is a tax on the transfer of money or wealth and is paid by the person who makes the gift. The gift tax is used to make sure that wealthy people do not try to avoid taxes by giving away their estates before they die. Figure 9.3 shows that estate and gift taxes account for only a small fraction of total federal government revenues.

## Customs Duties

A **customs duty** is a charge levied on goods brought into the United States from other countries. The Constitution gives

Congress the authority to levy customs duties. Congress then can decide which foreign imports will be taxed and at what rate. Many types of goods are covered, ranging from automobiles to silver ore. The duties are relatively low and produce little federal revenue today. Before the enactment of the income tax amendment, however, they were the largest income source for the federal government.

## Miscellaneous Fees

Finally, only a fraction of federal revenue is collected through various miscellaneous fees. One example of a miscellaneous fee is a **user fee**—a charge levied for the use of a good or service. User fees were widely promoted by President Ronald Reagan, who wanted to find revenue sources that did not involve taxes.

User fees include entrance charges at national parks, as well as the fees ranchers pay when their animals graze on federal land. These fees are essentially taxes based on the benefit principle, because only the individuals who use the services pay them. People also seem more comfortable with them since they are not called “taxes.”

**✓ Reading Check** **Explaining** Why are corporations taxed separately from individuals?

**estate tax** tax on the transfer of property when a person dies

**gift tax** tax paid by the donor on transfer of money or wealth

**customs duty** tax on imported products

**user fee** fee paid for the use of a good or service

Ron Niebrugge/Alamy Images



**User Fees** Visitors to national parks such as Kenai Fjords National Park in Alaska have to pay an entrance fee. **How are user fees assessed?**



**intergovernmental revenue** funds that one level of government receives from another level of government

## State Government Revenue Sources

**MAIN Idea** States rely on funds from the federal government in addition to income taxes and sales taxes.

**Economics & You** Do you ever wonder why you pay a tax on items you purchase in a store? Read on to learn about sales taxes.

State governments collect their revenues from several sources. **Figure 9.4** shows the relative proportions of these sources, the largest of which are examined below.

### Intergovernmental Revenues

The largest source of state revenue consists of **intergovernmental revenue**—funds collected by one level of government that are distributed to another level of government for expenditures. States receive the majority of these funds from the federal

government to help fund the state's expenditures for welfare, education, highways, health, and hospitals.

### Sales Taxes

Most states also have **implemented** sales taxes to add to their revenue. A sales tax is a general tax levied on consumer purchases of nearly all products. The tax is a percentage of the purchase price, which is added to the final price the consumer pays. Merchants collect the tax at the time of sale. The taxes are then turned over to the proper state government agency on a monthly or other periodic basis. Most states allow merchants to keep a small portion of what they collect to compensate for their time and bookkeeping costs. The sales tax is the second largest source of revenue for states, although five states—Alaska, Delaware, Montana, New Hampshire, and Oregon—do not have a general sales tax.

**Skills Handbook**

See page R50 to learn about **Using Bar and Circle Graphs**.

**Figure 9.4** ▶

**State and Local Government Revenue Sources**

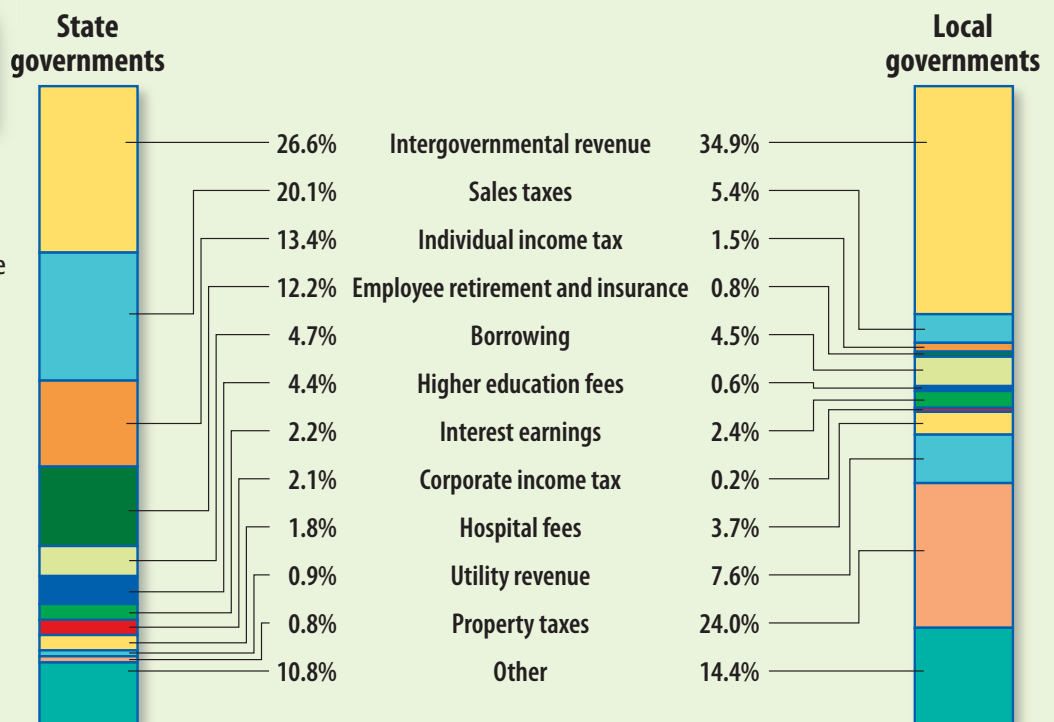
**Graphs in Motion**

See StudentWorks™ Plus or [glencoe.com](http://glencoe.com).

▶ State and local governments have their own sources of revenue. While many have an individual income tax, this is not a major source of funding.

**Economic Analysis**

**What are the two largest sources of state and local revenues?**





Harley Schwadron/www.CartoonStock.com

**Taxes** Most people have to pay taxes to all levels of government. *What does the cartoon imply about the impact of taxes on people?*

"DON'T WORRY! SINCE 28% OF MY SALARY GOES TO THE GOVERNMENT, I'VE DECIDED TO WORK 72% OF THE TIME."

### Individual Income Taxes

All but seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—rely on the individual income tax for revenue. The tax brackets in each state vary considerably, and taxes can be progressive in some states and proportional in others.

### Other Revenues

States rely on a variety of other revenue sources, including interest earnings on surplus funds; tuition and fees collected from state-owned colleges, universities, and technical schools; corporate income taxes; and hospital fees.

While the percentages for revenue sources in Figure 9.4 are representative of most states, wide variations among states exist. For example, Alaska is the only state without either a general sales tax or an income tax, so it has to rely on other taxes and fees for its operating revenue.

**Reading Check** **Contrasting** How do states without individual income taxes find sources of revenue?

## Local Government Revenue Sources

**MAIN Idea** Local governments rely mostly on intergovernmental revenue and property taxes.

**Economics & You** Do you hope to own a house some day? Read on to learn how this will add another tax to those you are already paying.

Like state governments, local governments have a variety of revenue sources, as shown in Figure 9.4. These sources include taxes and funds from state and federal governments. The main categories are discussed below.

### Intergovernmental Revenues

Local governments receive the largest part of their revenues—slightly more than one-third—in the form of intergovernmental transfers from state governments. These funds are generally intended for education and public welfare. A much smaller amount comes directly from the federal government, mostly for urban renewal.

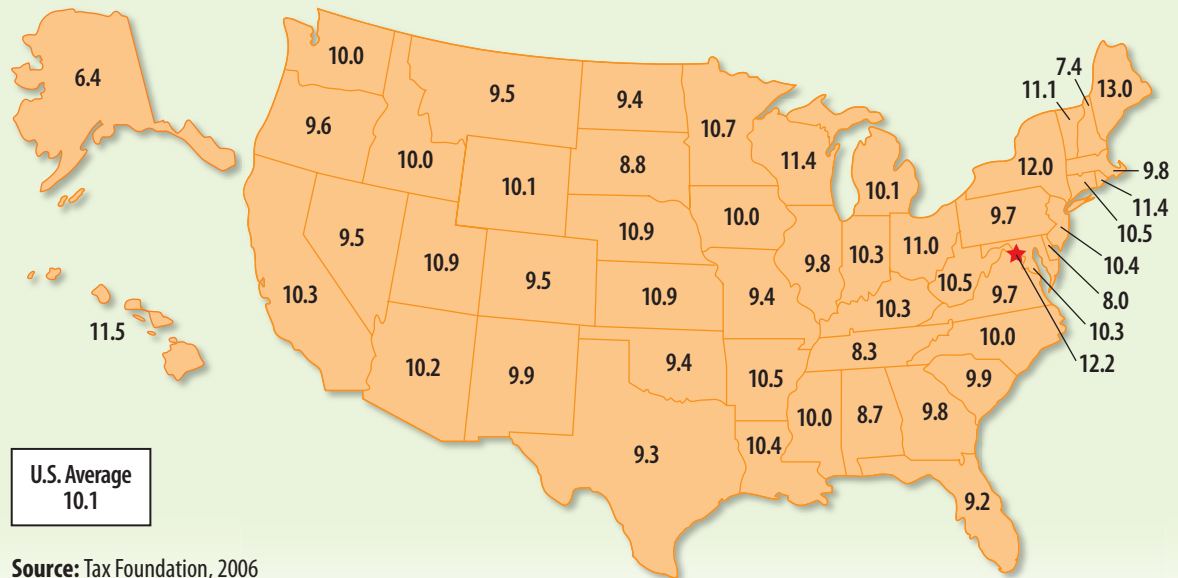


Figure 9.5 ▶

## State and Local Taxes as a Percentage of State Income

- ▶ State income is the sum of all income earned by all people in the state. State and local governments receive a percentage of that income as tax revenue from a number of sources. The five states without sales taxes—Alaska, Delaware, Montana, New Hampshire, and Oregon—rely on other taxes to provide state revenues.

**Economic Analysis** Which states have the highest level of taxes? The lowest level?



Source: Tax Foundation, 2006

### property tax

tax on tangible and intangible possessions such as real estate, buildings, furniture, stocks, bonds, and bank accounts

### tax assessor

person who examines and assesses property values for tax purposes

### natural monopoly

market structure in which average costs of production are lowest when a single firm exists (also see page 176)

## Property Taxes

The second-largest source of revenue for local governments is the **property tax**—a tax on tangible and intangible possessions. Such possessions usually include real estate, buildings, furniture, farm animals, stocks, bonds, and bank accounts. Most states also assess a property tax on automobiles.

The property tax that raises the most revenue is the tax on real estate. Taxes on other personal property, with the exception of automobiles, are seldom collected because of the problem of valuation. For example, how would the **tax assessor**—the person who assigns value to property for tax purposes—know the reasonable value of everyone’s wedding silver, furniture, clothing, or other tangible property? Instead, most communities find it more efficient to hire one or more individuals to assess the value of a few big-ticket items such as buildings and motor vehicles.

## Utility Revenues

The third-largest source of local revenue is the income from public utilities that supply water, electricity, sewerage, and even telecommunications. Because of economies of scale, many of these companies are **natural monopolies**.

A community needs only one set of electrical power lines or underground water pipes, for example, so one company usually supplies all of the services. When people pay their utility bills, the payments are counted as a source of revenue for local governments.

## Sales Taxes

Many cities have their own sales taxes. Merchants collect these taxes along with the state sales taxes at the point of sale. While these taxes typically are much lower than state sales taxes, they are the fourth most important source of local government revenues.



## Other Revenue Sources

Figure 9.4 on page 242 shows a variety of ways in which local governments collect their remaining revenues. Some local governments receive a portion of their funds from hospital fees. Others may collect income taxes from individuals and profit taxes from corporations. Still another revenue source for local governments is the interest on invested funds.

If local governments spend more than they collect in revenues, they can borrow from investors. While borrowed funds are small compared to those of the federal government, they form an important source of local government funding.

Local governments look for revenues in a number of ways. Still, the revenue sources available in general are much more limited than those available to the state and federal levels of government.

**Reading Check** **Recalling** Which property tax earns the most revenue for local governments?



**Tax Assessments** Tax assessors determine the value of property for tax purposes. *Why are property taxes important for local communities?*

### SECTION

# 2

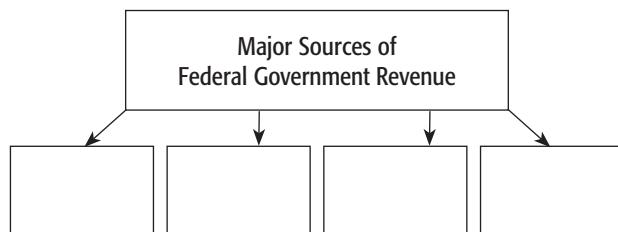
## Review

### Vocabulary

1. **Explain** the significance of Internal Revenue Service (IRS), payroll withholding system, indexing, FICA, payroll tax, corporate income tax, excise tax, estate tax, gift tax, customs duty, user fee, intergovernmental revenue, property tax, tax assessor, and natural monopoly.

### Main Ideas

2. **Listing** Use a graphic organizer like the one below to list the federal government's major revenue sources.



3. **Describing** How do the major revenue sources for state and local governments differ?

### Critical Thinking

- The BIG Idea** Federal, state, and local governments receive revenue from various sources. Which source do you think best satisfies the tax criteria discussed in Section 1? Defend your answer in a written paragraph.
- Drawing Conclusions** Why do you think sales taxes are generally applied to food and beverages purchased in restaurants, but not to those purchased in stores?
- Analyzing Visuals** Look at Figure 9.4 on page 242. Why do you think the revenue from income taxes and property taxes differ so much between state and local governments?
- Synthesizing** How do excise taxes differ from other taxes such as sales taxes or estate taxes?

### Applying Economics

8. **User Fees** User fees have been compared to taxes based on the benefit principle of taxation. Define user fees in your own words. What are the pros and cons of user fees for national parks?



# CASE STUDY

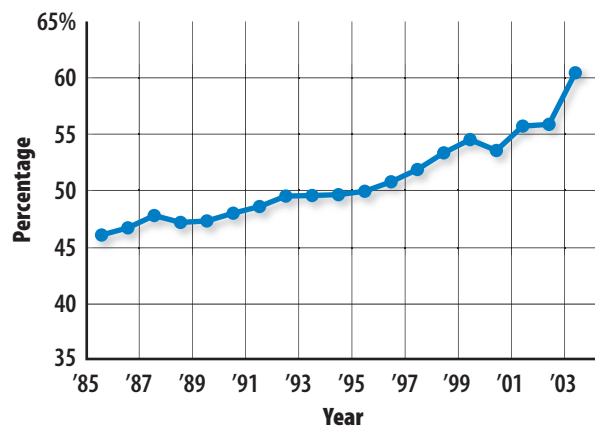
## Dreaded Tax Returns

### Buried in Paper

Every spring, you can tell it's close to the April 15 tax deadline by the anxious faces of frustrated taxpayers and exhausted accountants. The U.S. tax system is one of the most complicated in the world, with almost 17,000 pages of tax code and more than 600 forms. Record keeping, education, and compliance cost the nation \$265 billion annually. In 2005 it took about 115,000 Internal Revenue Service (IRS) employees and almost \$10.7 billion to collect about \$1 trillion from 125 million taxpayers and 7 million businesses.



### PERCENTAGE OF TAXPAYERS USING PROFESSIONAL HELP



Source: Internal Revenue Service

### Time is Money

Because the tax code has become so complex, more and more Americans hire tax preparers to help them with their returns. On top of that, about 2.2 million taxpayers overpay—by an average of \$438—because they either don't itemize deductions or don't include all deductions or exemptions they could claim. Although many Americans file their tax returns online, they still spend an average of 17 hours completing the forms. The complexity of the system has caused many people to long for a simpler flat-tax system.

### The European Solution

Several eastern European countries have adopted a flat tax, where everyone pays the same percentage above an exempt amount, regardless of income. The first was the Baltic republic of Estonia, which adopted a flat tax rate of 26 percent in 1994. Most Estonians take only 5 to 20 minutes to complete and electronically file an "e-postcard." The country's tax department spends one penny for every dollar of income tax collected, compared to 25 cents the IRS spends in the United States.

### NEWS FLASH

#### The Longest Return

General Electric's 2006 tax return was 24,000 pages long. Had they filed a paper return, it would have been a stack 8 feet high; instead, they filed a 237-megabyte electronic return.

### Analyzing the Impact

- Summarizing** Why is the U.S. income tax system so complicated?
- Drawing Conclusions** Do you think it is easier for a small country like Estonia to implement a flat tax than it would be for the United States? Explain.



SECTION  
**3**

# Current Tax Issues and Reforms

## GUIDE TO READING

### Section Preview

In this section, you will learn that one consequence of tax reform was to make the individual tax code more complex than ever.

### Content Vocabulary

- payroll withholding statement (p. 248)
- accelerated depreciation (p. 249)
- investment tax credit (p. 249)
- alternative minimum tax (p. 249)
- capital gains (p. 250)
- flat tax (p. 251)
- value-added tax (VAT) (p. 252)

### Academic Vocabulary

- concept (p. 251)
- controversial (p. 252)

### Reading Strategy

**Listing** As you read the section, complete a graphic organizer like the one below by listing the advantages and disadvantages of the flat tax. Include a definition of *flat tax* in your own words.

	Advantages	Disadvantages
Flat tax		
Value-added tax		

## ISSUES IN THE NEWS

—The San Francisco Chronicle

### A Trophy Loophole

One of the looniest tax loopholes imaginable . . . [is] . . . a tax break for big-game hunters who can deduct the cost of an expensive safari when they donate the stuffed trophy to a museum. By using tax-code provisions designed to encourage charitable donations, a hunter can give away a trophy specimen.

This gives a fat tax break to the hunter. It's also created a system of tax dodging and shady dealing. Little-known museums exist largely to take in the trophies and sign tax receipts.

Senator Charles Grassley . . . wants to end such hunting deductions [but] a similar proviso is missing from a tax overhaul in the House. . . . ■



**T**he individual tax code is incredibly complex. The complete code is about 17,000 pages long and contains approximately 9 million words. It has been estimated that Americans spend more than 7 billion hours every year filling out their federal tax returns for the IRS.

Every year, magazines like *Money* ask professional tax preparers to fill out tax returns for a hypothetical family—only to

find out that no two returns are the same. If experts can't get it right, then the rest of us will obviously have a difficult time. Also, it is all too easy for lawmakers to insert special-interest provisions in the tax code, such as the one in the news story above.

It is no wonder that the tax code has been amended about 14,000 times in the last 20 years—and Congress is still not done with changes!



### payroll withholding statement

document attached to a paycheck summarizing pay and deductions

### Personal Finance Handbook

See pages R24–R27 for more information on paying taxes.

## Examining Your Paycheck

**MAIN Idea** The income taxes you pay are summarized on the stub that is attached to your paycheck.

**Economics & You** Do you have a job where your taxes are taken out before you are paid? Read on to learn how these taxes are deducted from your paycheck.

Most of the federal, state, and local taxes are deducted directly from your paycheck. Employers list these deductions on the **payroll withholding statement**—the stub attached to a paycheck that summarizes income, tax withholdings, and other deductions, as shown in **Figure 9.6**.

The worker to whom the check belongs makes \$10 an hour and receives a check every two weeks. If the length of the workweek is 40 hours, the worker’s gross pay amounts to \$800. The worker is single, has no deductions, and lives and works in Kentucky.

According to withholding tables the federal government supplied for that year, biweekly workers making at least \$800, but

less than \$820, have \$104.70 withheld from their paychecks every pay period. Similar tables for the state of Kentucky specify that \$40.01 is withheld for state income taxes. Because these are both estimates, and because even minor differences between the amounts withheld and the amount actually owed can grow, the worker will file state and federal tax returns between January 1 and April 15 of the following year to settle the differences.

Another deduction is the half-percent city income tax that amounts to \$4. Because the amount is relatively small, most cities do not require taxpayers to file separate year-end tax forms.

The FICA tax amounts to 7.65 percent (6.20 percent for Social Security and 1.45 percent for Medicare) of \$800, or \$61.20. The FICA is deducted from the gross pay, along with \$3.20 in miscellaneous deductions, which leaves a net pay of \$586.89.

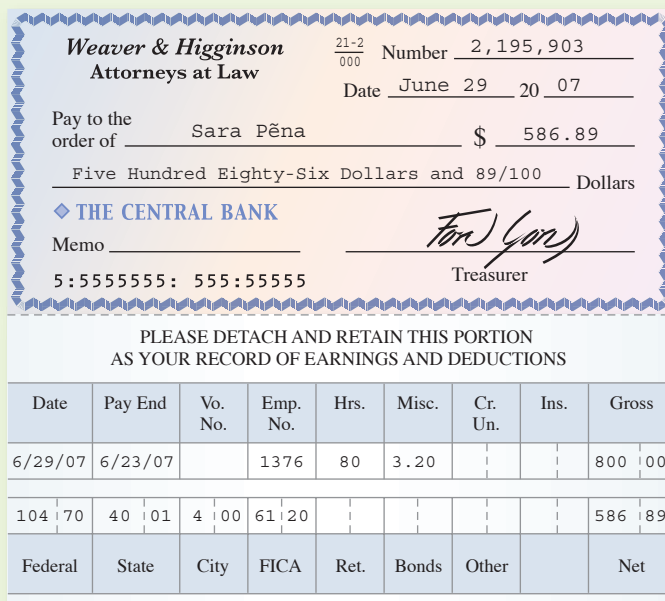
If the worker has insurance payments or retirement contributions, or puts money into a credit union, more deductions will appear on the pay stub.

**Reading Check Summarizing** How are payroll deductions calculated?

**Figure 9.6** ▶ **Biweekly Paycheck and Withholding Statement**

▶ The withholding statement attached to your paycheck summarizes the federal and state tax deductions from your pay. Other withholdings may include city income taxes and voluntary deductions, such as health insurance payments and savings plans.

**Economic Analysis** *What percentage of this individual’s pay has been deducted from the paycheck?*



**Figure 9.7** ▶ **Tax Table for Single Individuals, 2006**

If taxable income is over . . .	But not over . . .	The tax is:
\$0	\$7,550	10% of the amount over \$0
\$7,550	\$30,650	\$755 plus 15% of the amount over \$7,550
\$30,650	\$74,200	\$4,220 plus 25% of the amount over \$30,650
\$74,200	\$154,800	\$15,107.50 plus 28% of the amount over \$74,200
\$154,800	\$336,550	\$37,675.50 plus 33% of the amount over \$154,800
\$336,550	no limit	\$97,653.00 plus 35% of the amount over \$336,550

Source: IRS Schedule X

▶ According to the individual income tax table, a single individual with \$6,000 of taxable income would pay  $\$6,000 \times .10$ , or \$600 in taxes.

**Economic Analysis**

*How much in taxes would an individual with \$40,000 of taxable income pay?*

## Tax Reform

**MAIN Idea** Numerous changes have been made to the federal income tax code since 1981.

**Economics and You** Do you or your family pay federal income taxes? Read on to learn why keeping up with the tax code is so difficult.

Tax reform has received considerable attention recently. Since 1981, there have been more changes in the tax code than at any other time in our nation’s history.

### Tax Reform in 1981

When Ronald Reagan was elected president in 1980, he believed that high taxes were the main stumbling block to economic growth. In 1981 he signed the Economic Recovery Tax Act, which included large tax reductions for individuals and businesses.

Before the Recovery Act, the individual tax code had 16 marginal tax brackets ranging from 14 to 70 percent. The act lowered the marginal rates in all brackets, capping the highest marginal tax at 50 percent. In comparison, today’s tax code, shown in **Figure 9.7**, has six marginal brackets ranging from 10 to 35 percent.

Businesses also got tax relief in the form of **accelerated depreciation**—earlier and larger depreciation charges—which allowed firms to reduce federal income

tax payments. Another section of the act introduced the **investment tax credit**—a reduction in business taxes that are tied to investment in new plants and equipment. For example, a company might purchase a \$50,000 machine that qualified for a 10 percent, or \$5,000, tax credit. If the firm owed \$12,000 in taxes, the credit reduced the tax owed to \$7,000.

### Tax Reform: 1986, 1993

By the mid-1980s, the idea that the tax code favored the rich and powerful was gaining momentum. In 1983 more than 3,000 millionaires paid no income taxes.

In 1986 Congress passed sweeping tax reform that made it difficult for the very rich to avoid taxes altogether. The **alternative minimum tax**—the personal income tax rate that applies whenever the amount of taxes paid falls below a designated level—was strengthened. Under this provision, people had to pay a minimum tax of 20 percent, regardless of other circumstances or loopholes in the tax code.

As the United States entered the 1990s, the impact of 10 years of tax cuts was beginning to show. Government spending was growing faster than revenues, and the government had to borrow more. The resulting tax reform of 1993 was driven more by the need for the government to balance its

**accelerated depreciation** schedule that spreads depreciation over fewer years to generate larger tax reductions

**investment tax credit** tax credit given for purchase of equipment

**alternative minimum tax** personal income tax rate that applies to cases in which taxes would otherwise fall below a certain level

**Skills Handbook**

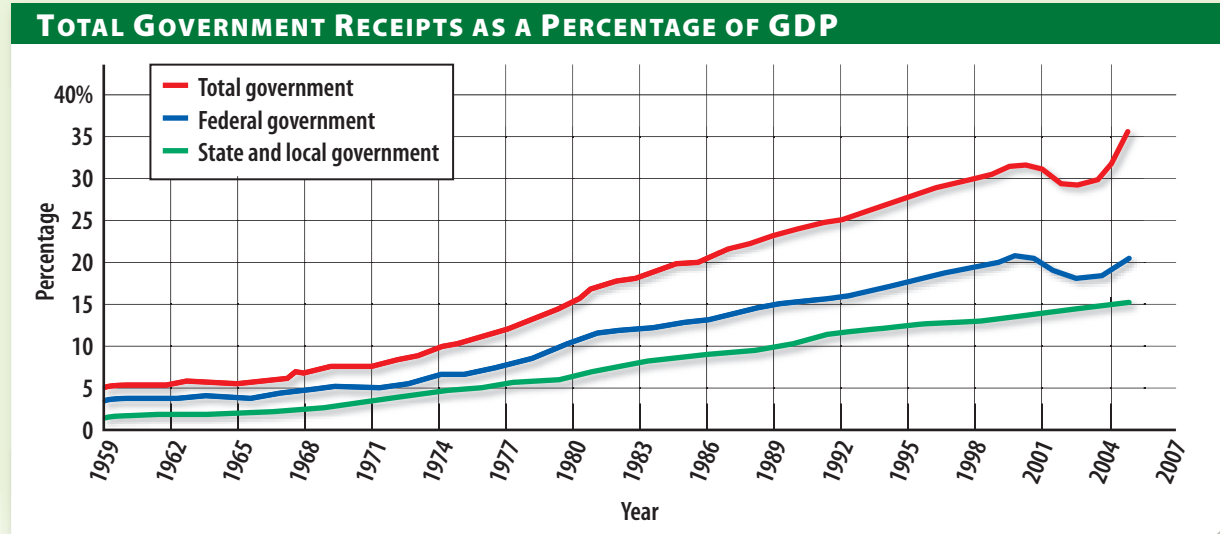
See page R54 to learn about **Understanding Percentages**.

Figure 9.8 ▶

## Total Government Receipts per Capita, Adjusted for Inflation

▶ Although a recession in 2001 reduced revenues from 2002 to 2003, total revenue collections by all levels of government have grown dramatically over the years.

**Economic Analysis** How does the graph reflect the tax reforms since 1981?



Source: *Economic Report of the President, 2006*

**capital gains**  
profits from the sale of an asset held for 12 months or longer

budget than to overhaul the tax brackets. As a result, two top marginal tax brackets of 36 and 39.6 percent were added.

### Tax Reform in 1997

The next significant reform followed four years later with the Taxpayer Relief Act of 1997. The forces that created it were both economic and political.

On the economic side, the government found itself with unexpectedly high tax revenues in 1997. The two new marginal tax brackets of 36 and 39.6 percent that had been added in 1993, along with the closure of some tax loopholes, meant that most people paid more taxes than before.

On the political side, the Republicans had gained a firm majority in Congress and now saw a need to fulfill a commitment to their supporters. They reduced the tax on **capital gains**—profits from the sale of an asset held for 12 months or longer—from 28 to 20 percent. The new law also lowered inheritance taxes.

Some people thought that the tax cuts favored the wealthy, and even the government agreed. An analysis by the United States Treasury Department determined that nearly half of the benefits went to the top 20 percent of wage and income earners. The lowest 20 percent received less than 1 percent of the tax reductions. With all its changes, the 1997 federal tax law became the most complicated ever.

### Tax Reform in 2001

By 2001 politicians faced a new issue: the federal government was actually collecting more taxes than it was spending. These surpluses were projected to continue to the year 2010. Surpluses could have been used to repay some of the money the government borrowed in the 1980s or to fund new federal spending. The government also could cut taxes to “give the money back to the people.” In the end, President Bush backed a massive \$1.35 billion, “temporary” 10-year tax cut due to expire in 2011.



The main feature of the 2001 tax reform was to reduce the top four marginal tax brackets of 27, 30, 35, and 38.6 percent to 25, 28, 33, and 35 percent by 2006. The law also introduced a 10 percent tax bracket and eliminated the estate tax on the wealthiest 2 percent of taxpayers by 2010.

### Tax Reform in 2003

Slow economic growth in 2002 convinced the Bush administration and Congress to accelerate many of the 2001 tax reforms. Specifically, the top four marginal tax brackets were reduced immediately rather than in 2006.

For lower income taxpayers, the top end of the 10 percent bracket was increased modestly. The child tax credit was also expanded from \$600 to \$1,000. Finally, the 20 percent capital gains tax bracket was reduced from 20 to 15 percent.

The 2003 tax cuts put the federal government back in the same situation as in 1993. A series of tax cuts reduced taxes in upper income brackets, and government was still spending more than it collected in taxes.

### Permanent Tax Cuts by 2011?

The tax cuts of 2001 and 2003 were “temporary” in the sense that they were due to expire in 2011. Whether that happens or not will depend on several things.

One complicating factor is that the rate of economic growth in the six years following the 2001 tax cuts was slightly lower than the rate of growth in the six years following the 1993 tax increase. This makes it difficult to argue that lower taxes are needed for higher rates of growth.

However, the biggest factor will be the extent to which the federal government continues to spend more than it collects in taxes. If the present trend continues, it will be difficult to preserve the tax cuts because the government will need so much additional revenue.

**Reading Check** **Inferring** Why have tax reforms occurred so frequently in recent years?

## Alternative Tax Approaches

**MAIN Idea** The need for new federal revenues will influence future tax reform.

**Economics and You** You learned earlier about state sales taxes. Read on to find out how another tax is similar to the sales tax.

Some people want to change the personal income tax; others want to replace it with something else. Because of this, we hear a lot about two alternatives: the flat tax and the value-added tax.

### The Flat Tax

The **concept** of a **flat tax**—a proportional tax on individual income after a specified threshold has been reached—did not receive much attention until Republican candidate Steve Forbes and others raised the issue in the 1996 presidential elections.

The primary advantage of the flat tax is the simplicity it offers to the taxpayer. A person would still have to fill out an income tax return every year but could skip many current steps, such as itemizing deductions. A second advantage is that a flat tax would close most tax loopholes if it did away with most deductions and exemptions. Finally, a flat tax reduces the need for tax accountants, tax preparers, and even a large portion of the IRS. As a result, Americans would no longer have to spend 7 billion hours every year preparing tax returns.

However, a flat tax also has disadvantages because it would remove many of the incentives built into the current tax code.

**flat tax** proportional tax on individual income after a specified threshold has been reached

## Did You Know?

**Tax Exempt?** Each year taxpayers take advantage of a long list of deductions and tax credits to reduce their tax burden. In the year 2006, the Tax Foundation reported that a record 43.4 million tax returns from 91 million individuals showed no taxes due. Combined with the 15 million Americans who don't file returns at all, about 41 percent of the U.S. population did not contribute to the federal treasury.



**Figure 9.9** ▶

## The Value-Added Tax

- ▶ The VAT is like a national sales tax added to each stage of production. As a result, it is built into the final price of a product and is less visible to consumers. The third and fifth columns show the value added at each stage, and the fourth and sixth columns show the cumulative values.

**Economic Analysis** *Is a VAT regressive, proportional, or progressive? Why?*

		No taxes		With a 10% value-added tax	
		Value added	Cumulative value	Value added with a 10% VAT	Cumulative with VAT
Step 1	Loggers fell trees and sell the timber to the mills for processing.	\$1	\$1	$\$1 + \$.10 = \$1.10$	\$1.10
Step 2	Mills cut the timber into blanks that will be used to make bats.	\$1	\$2	$\$1 + \$.10 = \$1.10$	\$2.20
Step 3	Bat manufacturers shape and paint or varnish the bats and sell them to wholesalers.	\$5	\$7	$\$5 + \$.50 = \$5.50$	\$7.70
Step 4	Wholesalers sell the bats to retail outlets where consumers can buy them.	\$1	\$8	$\$1 + \$.10 = \$1.10$	\$8.80
Step 5	Retailers put the bats on the shelves and wait for consumers.	\$2	\$10	$\$2 + \$.20 = \$2.20$	\$11.00
Step 6	Consumers buy the bats for:		\$10		\$11.00

**value-added tax (VAT)** tax on the value added at every stage of the production process

For example, the tax code now allows homeowners to deduct interest payments on home mortgages. Other incentives include deductions for education, training, and child care.

Another problem is that no one knows exactly what rate is needed to replace the revenues collected under the current tax system. Supporters of the flat tax argue that a 15 percent rate would work. Other estimates by the U.S. Treasury put the tax closer to 23 percent—which represents more of a burden on low-income earners because their taxes would increase compared to current rates.

Finally, there is no clear answer as to whether a flat tax would further stimulate economic growth. After all, the extraordinary growth of the American economy in the 1990s, the longest period of peacetime prosperity in our history, took place when taxes were much higher.

### The Value-Added Tax

Another **controversial** proposal is to adopt the equivalent of a national sales tax by taxing consumption rather than income. This could be done with a **value-added tax (VAT)**—a tax placed on the value that manufacturers add at each stage of production. The United States currently does not have a VAT, although it is widely used in Europe.

To see how the VAT works, consider how the tax impacts the manufacturing and selling of wooden baseball bats. First, loggers cut the trees and sell the timber to lumber mills. The mills process the logs for sale to bat manufacturers. The manufacturers then shape the wood into baseball bats.

After the bats are painted or varnished, they are sold to a wholesaler. The wholesaler sells them to retailers, who sell them to consumers. As **Figure 9.9** shows, a VAT tax is levied at each stage of production.



The VAT has several advantages. First, it is hard to avoid because it is built into the price of the product being taxed. Second, the tax incidence is widely spread, which makes it harder for a single firm to shift the burden of the tax to another group.

Third, the VAT is easy to collect, because firms make their VAT payments directly to the government. Consequently, even a relatively small VAT can raise a tremendous amount of revenue, especially when it is applied to a broad range of goods and services.

Finally, some supporters claim that the VAT would encourage people to save more than they do now. After all, if none of your money is taxed until it is spent, you might think more carefully about purchases, decide to spend less—and save more.

The main disadvantage of the VAT is that it tends to be virtually invisible. In the baseball bat example, consumers may be aware that bat prices went from \$10 to \$11, but they might attribute this to a shortage of good wood, higher wages, or some other factor. In other words, it is difficult for taxpayers to be vigilant about higher taxes if they cannot see them.

## Inevitability of Future Reforms

The tax code is more complex now than at any time since 1981—a fact that virtually guarantees future attempts to simplify it. The recent flat tax movement provides just one such example. While simplification is desirable, unexpected events often require new expenditures—which in turn may require changes in the tax code. The unexpected cost of the war in Iraq, along with the enormous damage inflicted by hurricane Katrina in 2005, are two examples of such unexpected costs.

Reform also can result from political change, which tends to be abrupt as one party leaves office and another enters. New administrations often display a sense of urgency to finally do things the “right” way, or to clean up the presumed excesses of their predecessors.

Finally, it is difficult for politicians to give up the power to modify behavior, influence resource allocation, support pet projects, or grant concessions to special interest groups by changing the tax code.

**Reading Check** **Describing** How does a value-added tax work? Why is it useful?

### SECTION

# 3

## Review

### Vocabulary

- 1. Explain** the significance of payroll withholding statement, accelerated depreciation, investment tax credit, alternative minimum tax, capital gains, flat tax, and value-added tax (VAT).

### Main Ideas

- 2. Identifying** What are the major types of federal, state, and local taxes on the payroll withholding statement?
- 3. Listing** Use a graphic organizer like the one below to list the advantages and disadvantages of the value-added tax.

Value-Added Tax	
Advantages	Disadvantages

### Critical Thinking

- 4. The BIG Idea** What factors led to the tax reform measures passed in 1981, 1986, 1997, and 2001?
- 5. Summarizing** What changes would you recommend if you were in charge of revising the federal tax code? Explain your answer in a written paragraph.
- 6. Analyzing Visuals** Look at Figure 9.7 on page 249. How can you tell whether this tax is progressive, regressive, or proportional?
- 7. Cause and Effect** Describe the factors that are likely to cause future revisions of the tax code.

### Applying Economics

- 8. Flat Tax** Use examples to explain what might happen to donations for charitable organizations under a flat tax.



A flat tax has often been debated in the United States. Today Russia and several countries in Eastern Europe utilize it as a way to keep taxes simple and avoid tax loopholes. This has spurred Western Europe to take a closer look.

## Europe Circles the Flat Tax

The flat tax. In the eyes of many fiscal conservatives, it's the Holy Grail of public policy: One low income tax rate paid by all but the poorest wage-earners, who are exempt. No loopholes for the rich to exploit. No graduated rates that take a higher percentage of income from people who work hard to earn more. No need for a huge bureaucracy to police fiendishly complex tax laws. U.S. conservatives have been pushing the idea for decades. But it has gotten its first real road test in the former Soviet bloc, where at least eight countries, from minuscule Estonia to giant Russia, have enacted flat taxes since the mid-1990s.

Most of these countries' economies are growing at a far-healthier clip than those of their neighbors to the west. So it's no surprise that calls for a flat tax are now being heard in Western Europe, the most heavily taxed zone on the planet. . . . Even without pressure from the East, many Western European governments face growing complaints about the complexity of their tax regimes. . . .



Drawn by low taxes, Kia built a manufacturing plant in Slovakia.

There's no guarantee, of course, that flat taxes would work as well in Western Europe as they have in the countries to the east. In the former Soviet bloc, most of the countries that enacted flat taxes gained revenue as people who had worked in the shadow economy began reporting their income and paying taxes. The former tax dodgers figured that with rates so low, it was no longer worth running the risk of breaking the law. Moscow, which introduced a flat tax in 2001, saw its income tax revenues more than double in real terms from 2000 to 2004.

—Reprinted from *BusinessWeek*

FLAT TAXES		
Country	Year	Rate
Estonia	1994	23%
Latvia	1995	25%
Russia	2001	13%
Serbia	2003	14%
Slovakia	2003	19%
Ukraine	2003	13%
Georgia	2004	12%
Romania	2005	16%

Source: Hoover Institution

### Examining the Newsclip

- Analyzing** According to the article, why do fiscal conservatives promote a flat tax?
- Determining Cause and Effect** Why might Western European countries not see similar revenue increases?

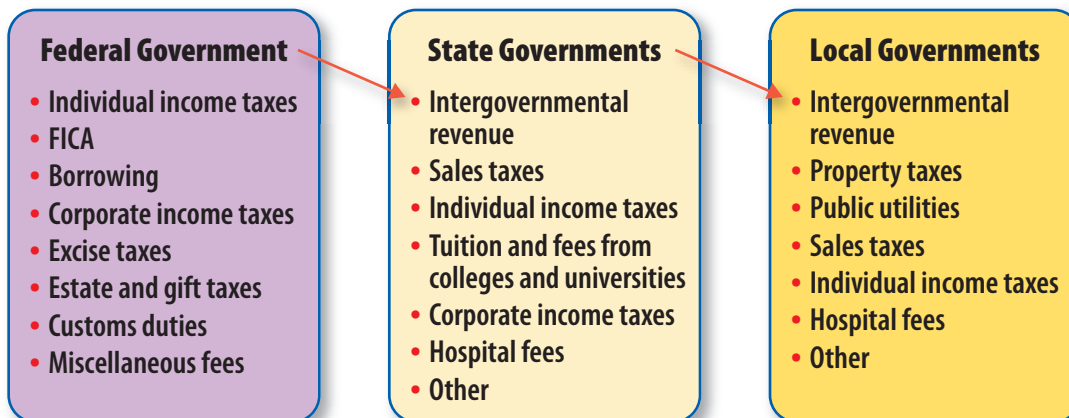


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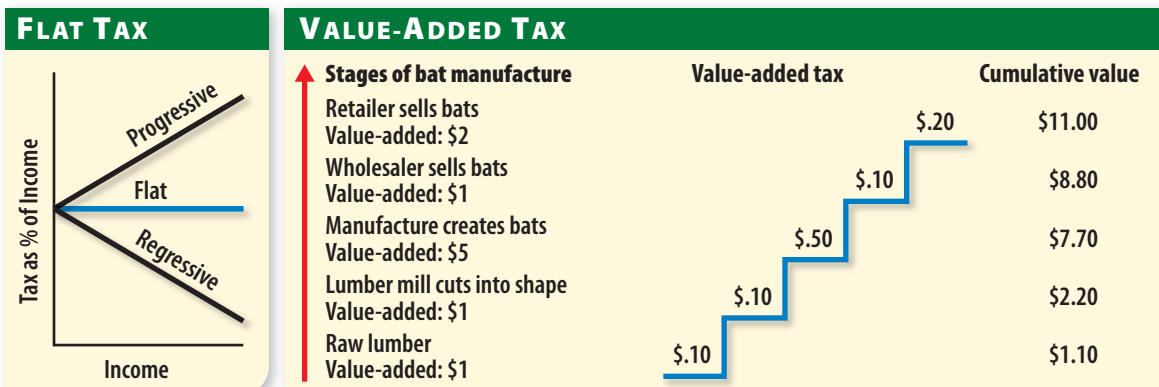
▶ **Types of Taxes** All taxes in the United States can be broken down into three categories: proportional, progressive, and regressive.

Proportional	Progressive	Regressive
<ul style="list-style-type: none"> <li>Percentage of income paid in taxes stays the same regardless of income</li> <li>Example: Medicare</li> </ul>	<ul style="list-style-type: none"> <li>Percentage of income paid in taxes goes up as income goes up</li> <li>Example: individual income tax</li> </ul>	<ul style="list-style-type: none"> <li>Percentage of income paid in taxes goes down as income goes up</li> <li>Example: sales tax</li> </ul>

▶ **Government Revenue Sources** Federal, state, and local revenue sources differ. Much of the federal revenue is sent on to state and local governments.



▶ **Alternative Tax Approaches** Because the federal tax code has become so large and cumbersome, people have discussed the flat tax and the value-added tax as two alternatives.



# Assessment & Activities

## Review Content Vocabulary

On a separate sheet of paper, choose the letter of the term identified by each phrase below.

- |                   |                   |
|-------------------|-------------------|
| a. ability-to-pay | f. VAT            |
| b. payroll tax    | g. tax return     |
| c. estate tax     | h. regressive tax |
| d. excise tax     | i. sales tax      |
| e. FICA           | j. capital gains  |
- tax on wages and salaries withheld from paycheck
  - average tax per dollar decreases as taxable income increases
  - profits from an asset held 12 months or longer
  - tax on the manufacture or sale of certain items
  - annual report to the government detailing income earned and taxes owed
  - large source of revenue for state governments
  - national sales tax on value added at each stage of production
  - Social Security and Medicare taxes
  - tax on the transfer of property when a person dies
  - tax paid by those who can most afford to pay

## Review Academic Vocabulary

Replace the underlined word in each sentence below with the appropriate synonym from the following list: *validity, evolved, implement, considerably, concept, and controversial*.

- The tax code has developed into a complicated system.
- The idea of a flat tax has been debated for a long time.
- The government needs tax revenue to fulfill its goals.
- The IRS questioned the legitimacy of the deduction.
- The tax code has changed substantially since its origin.
- Abolishing tax deductions would be an unpopular move by the government.

## Review the Main Ideas

### Section 1 (pages 229–236)

- Describe** how taxes can be used to affect people's behavior.
- Describe** the limitations of the benefit principle of taxation.
- Explain** why a sales tax is considered to be a regressive tax.
- Explain** the three criteria used to evaluate taxes.

### Section 2 (pages 238–245)

- Identify** the two components of FICA.
- Distinguish** between excise taxes, estate and gift taxes, and customs duties.
- List** the main sources of revenue for state and local governments by using a graphic organizer like the one below.

Sources of Revenue	
State	Local

### Section 3 (pages 247–253)

- Discuss** the deductions that are withheld from paychecks.
- Describe** the major tax reform bills enacted since 1981.
- Explain** why Congress enacted the alternative minimum tax.
- Identify** the advantages and disadvantages of a flat tax.

## Critical Thinking

- The BIG Idea** If you were an elected official who wanted to increase tax revenues, which of the following taxes would you prefer to use: individual income, sales, property, corporate income, user fees, VAT, or flat? Provide reasons for your decision.

- 29. Inferring** Why do you think Alaska has no sales tax or personal income tax?
- 30. Comparing and Contrasting** What were the goals of the Economic Recovery Tax Act of 1981, the 1986 tax reform, and 2001 tax changes?
- 31. Synthesizing** For one week, keep a list of all taxes you hear or read about in the news media or pay in your community. Classify your journal entries into three categories: federal, state, and local taxes. Then draw a matrix like the one below and classify each in the appropriate place. Which taxes appeared in the news most frequently?

	Ability-to-pay principle	Benefit principle
Regressive		
Proportional		
Progressive		

- 32. Analyzing** What provisions of tax measures enacted in the last 20 years benefit taxpayers with higher incomes?

### Applying Economic Concepts

- 33. User Fees** In your own words, write a rationale for a user fee that you think should be enacted.
- 34. Taxes** Some people object to state and local governments imposing sales and property taxes. What would you say to these people in defense of the two taxes?

### Thinking Like an Economist

- 35. Critical Thinking** Describe how an economist might go about analyzing the consequences of shifting from the individual income tax to a consumption tax like the VAT.

### Writing About Economics

- 36. Expository Writing** Does the concept of a flat income tax meet the three criteria for effective taxes? Write a brief summary of your findings and use it to either support or oppose such a proposal.

### Math Practice

- 37.** After deductions and exemptions, Mindy's unmarried brother had taxable income of \$98,000 in 2006. According to the tax table in Figure 9.7 on page 249, what will he owe in federal income taxes? What did he pay in Social Security taxes? What did he pay in Medicare taxes?

### Analyzing Visuals

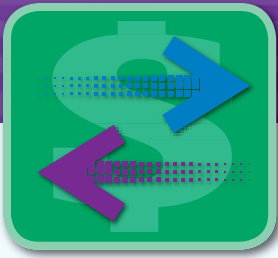
- 38.** Look at Figure 9.3 on page 239 and compare the revenue from the various sources for the years 2001 and 2007. In which categories did revenues decrease? How did the federal government make up these decreases?

### Interpreting Cartoons

- 39. Critical Thinking** Look at the cartoon below. Who are the people seated in the chairs? Whom do the figures in the bottom left corner represent? What statement is the cartoonist trying to make?



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# DEBATES IN ECONOMICS

## Should E-Commerce Be Taxed?

A lot of buying and selling occurs on the Internet—so much, in fact, that rumblings of an e-commerce sales tax have become a roar. In 2005 more than 700,000 people in the United States earned either full- or part-time income on eBay. This statistic alone ensures that a tax showdown between the IRS and e-commerce retailers is on the horizon.

Can you sift through the debate to determine whether or not buying and selling online should be subject to taxation? As you read the selections, ask yourself: “Should e-commerce be taxed?”

### PRO SALES TAX REVENUE LOSSES

Inability to collect the [e-commerce sales] tax potentially has a number of important implications. Firms have an incentive to locate production and sales activity to avoid tax collection responsibility, thereby imposing economic efficiency losses on the overall economy. The sales tax becomes more regressive as those who are least able to purchase online are more likely to pay sales taxes than those who purchase online more frequently.

Further, state and local government tax revenues are reduced. . . . [T]he Census Bureau reports a combined \$1.16 trillion in . . . e-commerce transactions by manufacturers, whole salers, service providers, and retailers, and Forrester Research, Inc.’s expectations continue to be for strong growth in e-commerce in coming years. Thus, the revenue erosion continues to represent a significant loss to state and local government.

—Dr. Donald Bruce and  
Dr. William F. Fox,  
Professors, Center for Business  
and Economic Research,  
University of Tennessee

#### Internet sales in 2003

\$1.27 trillion

#### Taxable internet sales in 2003

\$751 billion

#### Sales on which taxes were not collected

\$236.3 billion in 2003  
\$329.2 billion in 2008\*

#### State and local revenue loss

\$15.5 billion in 2003  
\$21.5–33.7 billion in 2008\*

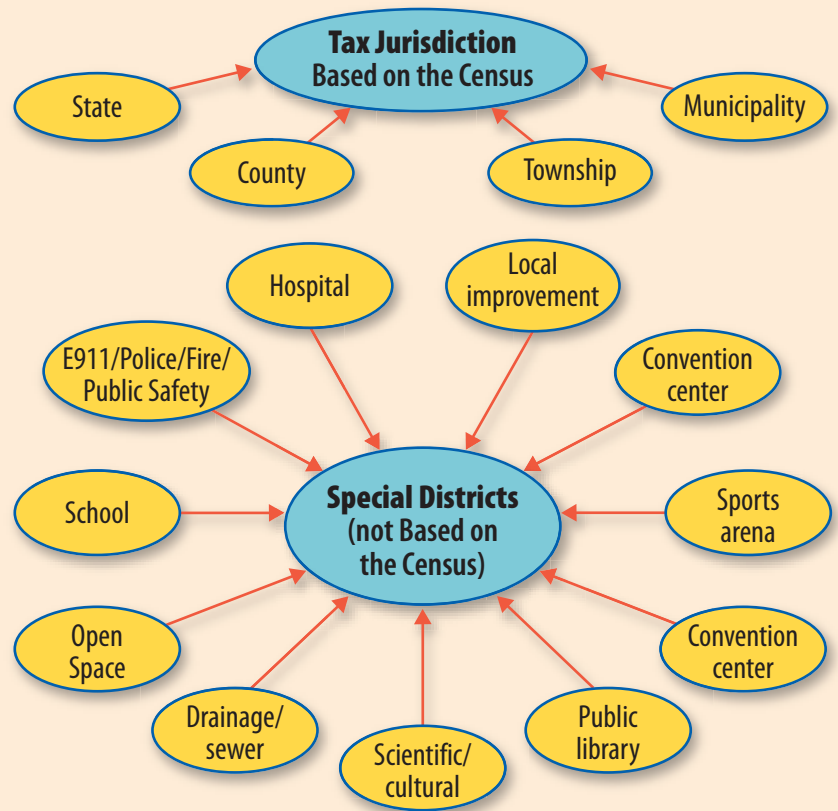
\* 2008 figures are estimated



## CON ONLINE TAX PROPOSAL MISGUIDED

The Direct Marketing Association (DMA) is cautioning legislators about bills introduced . . . that would allow states to force online sellers to collect sales taxes for all state and local taxing jurisdictions. . . . The failure of . . . these bills to address a reduction in the number of tax jurisdictions is a key flaw, and remains a critical obstacle to a workable streamlined sales tax program. There are currently approximately 7,600 different sales tax jurisdictions in this country, including states, counties and municipalities, and even block-by-block areas that collect additional sales taxes, such as sewer districts, sports arena districts or library districts. Currently, only businesses with a physical presence or “nexus” within a state are required to collect taxes for the jurisdictions within that state. . . .

The bills would also create a barrier to entry for small entrepreneurs, who rely on the Internet to help create markets, and a barrier to growth for medium-sized businesses seeking to grow



operations or expand a customer base. Many would not be able to afford the effort and expense it would take to collect and remit sales taxes for each of the thousands of jurisdictions, much less the cost of a possible audit at any time by 46 different state revenue departments.

—Direct Marketing Association,  
[www.the-dma.org](http://www.the-dma.org)

### Analyzing the Issue

- 1. Identifying** What is the main argument in support of an e-commerce sales tax?
- 2. Summarizing** Why does the DMA think it is not possible for online merchants to implement sales taxes?
- 3. Deciding** With which opinion do you agree? Explain your reasoning.

