CHAPTER 9

Sources of Government Revenue

Economics & You

Have you wondered or questioned why the paychecks you've seen have so many deductions? In **Chapter 9,** you will learn more about taxes and revenues raised by all levels of government. To learn about the different types of taxes collected by state and federal governments, view the Chapter 15 video lesson:

How Government Collects

ECONOMICS Online

Chapter Overview Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on **Chapter 9—Chapter Overviews** to preview chapter information.

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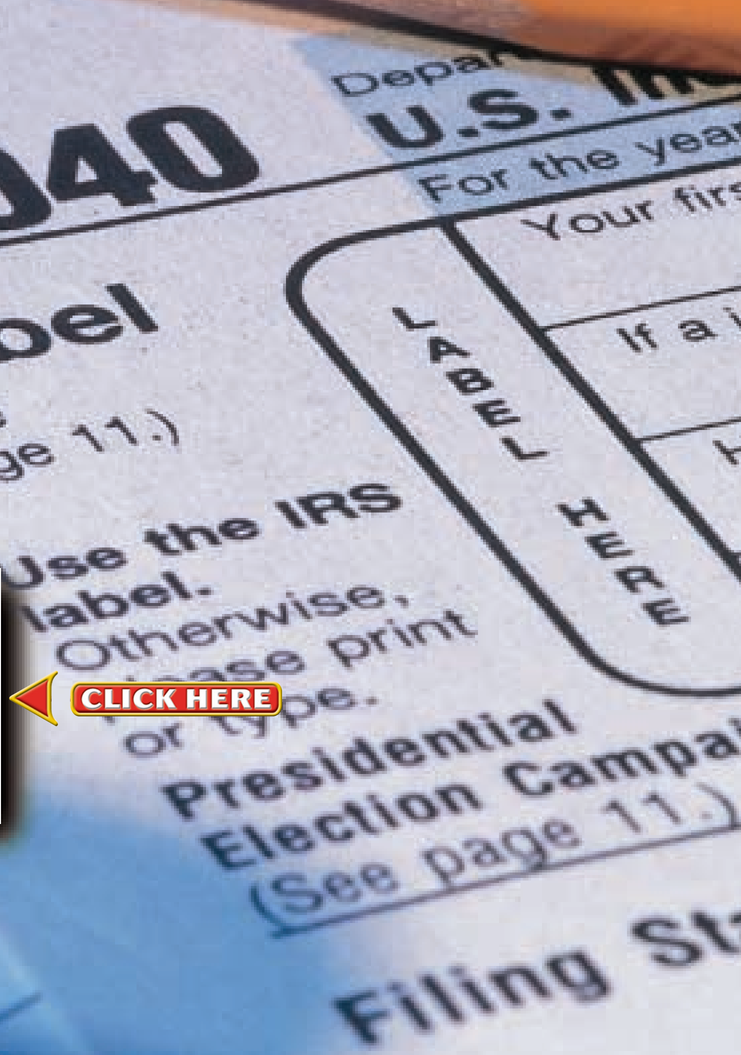


While governments receive revenue from a variety of sources, the most important source is taxes.

SECTION 1

The Economics of Taxation

Study Guide

Main Idea
Taxes are the single most important way of raising revenue for the government.

Reading Strategy
Graphic Organizer 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.

Key Terms
sin tax, incidence of a tax, tax loophole, individual income tax, sales tax, benefit principle of taxation, ability-to-pay principle of taxation, proportional tax, average tax rate, progressive tax, marginal tax rate, regressive tax

Objectives
After studying this section, you will be able to:
1. **Explain** the economic impact of taxes.
2. **List** three criteria for effective taxes.
3. **Understand** the two primary principles of taxation.
4. **Understand** how taxes are classified.

Applying Economic Concepts
Equity Read to find out what role equity, or fairness, plays in administering taxes.

Cover Story

Tax Freedom Day

[On] April 15, 1999, the Tax Foundation [made public] its annual calculation of Tax Freedom Day. It is May 11th this year, the latest date ever. When Tax Freedom Day is May 11th across the country, what does that mean? It means that if the government withheld all the money from every American's paycheck starting on January 1, 1999, it would have to continue doing so until May 11 to collect enough to fund government at all levels.

—Tax Foundation, April 15, 1999

Many tax dollars go to national defense.

An enormous amount of money is required to run the federal, state, and local governments of the United States. In 1999, all three levels of government collected approximately $2.8 trillion—or about $10,300 for every man, woman, and child in the United States. Whether we count the dollars, or the days needed to earn the dollars as illustrated in the cover story, it all adds up to a staggering sum.

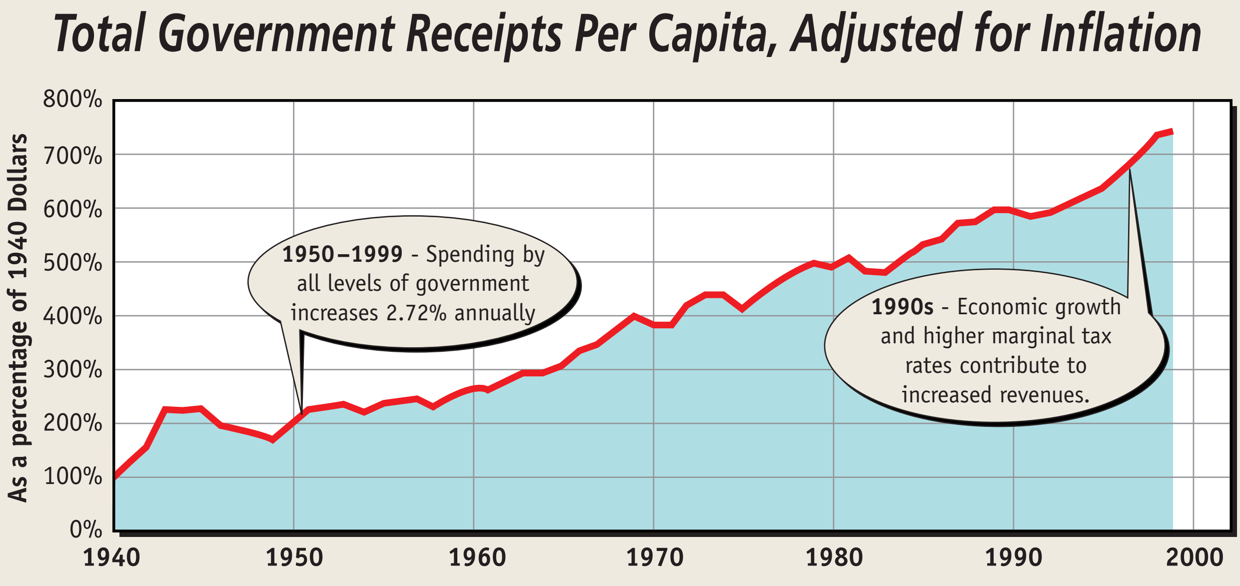
Total revenue collections by all levels of government have grown dramatically over the years. **Figure 9.1** shows that these revenues, even when adjusted for inflation and population growth, increased by nearly 800 percent since 1940.

Economic Impact of Taxes

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, because some of the tax can be transferred to others.

STANDARD & POOR'S

Figure 9.1



Source: Bureau of Economic Analysis and the Department of the Census, various forms

Using Graphs Total receipts by all levels of government have increased significantly over time. **What information does the graph show for the period 1980 to 2000?**

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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, which shifts the supply curve to the left. If demand remains unchanged, the equilibrium price of the product goes up.

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

In 1991, for example, Congress enacted a luxury tax on expensive cars, private aircraft, yachts, and other costly items in order to raise additional tax revenue from the wealthy. Because the demand for luxury goods was elastic, however, higher prices drove customers away, and unemployment soared in some of these industries.

Behavior Adjustment

Often taxes are used to encourage or discourage certain types of activities. For example, homeowners are allowed to use interest payments on mortgages as tax deductions—a practice that encourages home ownership. Interest payments on other consumer debt, such as credit cards, is not deductible—a practice that makes credit card use less attractive.

The so-called **sin tax**—a relatively high tax designed to raise revenue and reduce consumption of a socially undesirable product such as liquor or tobacco—is another example of how a tax can be used to change behavior. Canada used a sin tax in the 1980s when it quadrupled the tobacco tax, pushing the price of a pack of cigarettes to more than $4, and reducing cigarette consumption by one-third.

Efforts to tax tobacco in the United States, however, show that tobacco, because of its addictive nature, is still an inelastic product. For example, it is estimated that a $1 tax per pack is not enough to significantly affect consumption—and thus the government could raise billions of dollars in tax revenues.

Productivity and Growth

Finally, taxes can affect productivity and economic growth by changing the incentives to save, invest, and work. Some people think that taxes are already so high that it affects their incentive to work. Why, they argue, should a person earn additional income if much of it will be paid 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 they do not have the incentive to earn an additional $10 million because they can only keep half? Would they work any harder if income taxes only took thirty percent of their income? Or, would they work just as hard if they paid seventy percent of the extra income in taxes?

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. This is just one of many reasons why people favor lower taxes.

The Incidence of a Tax

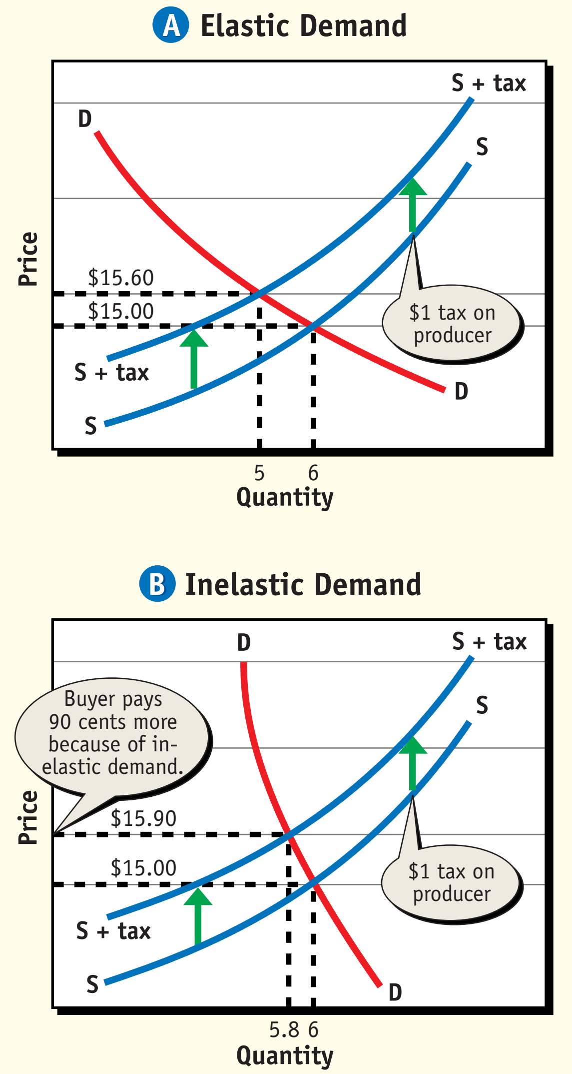
The party being taxed is not always the one that bears the burden of a tax. For example, suppose a city wants to tax a local utility company to raise revenue. If the utility is able to raise its rates, consumers will likely bear most of the burden in the form of higher utility bills. If a company's rates are regulated, and if the company's profits are not large enough to absorb the tax increase, shareholders may receive smaller dividends—placing the burden of the tax on the owners. Another alternative is that the company may postpone a pay raise—shifting the burden of the tax to its employees.

The **incidence of a tax**—or the final burden of the tax—can be predicted with the help of supply and demand analysis. Examine the demand curve in **Panel A** of **Figure 9.2.** You see that it is relatively more elastic than the one shown in **Panel B,** although the supply curves are exactly the same in both. A $1 tax

ECONOMICS AT A GLANCE

Figure 9.2

Shifting the Incidence of a Tax



Using Graphs 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 A. More of the tax can be shifted to the taxpayer if demand is inelastic, as in B. **Who is likely to bear the greater burden—the producer or the consumer—if a tax is placed on medicine?**

STANDARD &POOR'S INFOBYTE

Taxable Income Taxable income is the amount of income that is subject to taxation by the state and federal government. It is the adjusted gross income of wages, salaries, dividends, interest, capital gains, etc., less allowable adjustments deductions, which include but are not limited to contributions to retirement accounts, business expenses, and capital losses.

on the producer in **Panel A** increases the price of the product by 60 cents—which means that the producer must have absorbed the other 40 cents. On the other hand, the demand curve in **Panel B** is relatively inelastic. Here we can see that the exact same tax on the producer results in a 90-cent increase in price, which means that the producer must have absorbed the other 10 cents. 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. The more elastic the demand curve, the greater the portion of the tax that will be absorbed by the producer.

In the case of the 1991 luxury tax on private aircraft, the burden of the tax fell on the producer because the demand for small private aircraft was relatively elastic. The unemployment that resulted in the aircraft industry, along with the costs of coping with the unemployment, convinced Congress to remove the tax.

Criteria for Effective Taxes

Some taxes will always be needed, so we want to make them as effective as possible. To do so, taxes must meet criteria: they must be equitable, simple, and efficient.

Equity

The first criterion is equity or fairness. Most people feel that taxes should be impartial and just. Problems arise, however, when we ask, *what is fair?* You might believe that a tax is fair only if everyone pays the same amount. Your friend concludes, on the other hand, that a tax is fair only if wealthier people pay more than those with lower incomes.

There is no overriding guide that we can use 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 a fairness issue, and most people oppose them on the grounds of equity. 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 the taxpayer and the tax collector can understand them. This task is not easy, but people seem more willing to tolerate taxes when they understand them.

The **individual income tax**—the tax on people's earnings—is a prime example of a complex tax. The entire code is thousands of pages long, and even the simplified instructions the Internal Revenue Service (IRS) sends out to taxpayers are lengthy and often difficult to understand. As a result, many people dislike the individual income tax code, in part because they do not fully understand it.

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, child care, and medicine may be exempt, but if a product is taxed then everyone who buys the product pays it.

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Student Web Activity Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on **Chapter 9—Student Web Activities** for an activity on the individual income 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. Whenever someone is paid, the employer withholds a portion of the 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. Because most payroll records are now computerized, neither the employer nor the employee is unduly burdened by this withholding system.

Other taxes, especially those collected in toll booths on state highways, are considerably less efficient. The state invests 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. After giving a few quarters and dimes to the attendant, drivers take off again to repeat the process a few miles down the road.

Efficiency also means that the tax should raise enough revenue to be worthwhile. If it does not, or if it harms the economy in other ways, the tax has little value. One example is the luxury tax on small private aircraft in 1991. According to the IRS, only $53,000 in luxury tax revenues were collected that year because so few planes were sold. This turned out to be less than the unemployment benefits paid to workers who lost jobs in that industry. This is the reason Congress quickly repealed the luxury tax on small aircraft.

Two Principles of Taxation

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

Many taxes are based on the **benefit principle of taxation:** Those who benefit from government goods and services should pay in proportion to the amount of benefits they receive.

Think about the taxes you pay for gasoline. Because the gas tax is built into the price of gasoline at the pump, people who drive more than others pay more gas taxes—and therefore pay for

Principles of Taxation

Ability-to-Pay The veterinarian (left) and the firefighters (right) both have to pay taxes. **According to the ability-to-pay principle, how is the amount each person has to pay determined?**

more of the upkeep of our nation's highways. Taxes on truck tires operate on the same principle. Because heavy vehicles like trucks are likely to put the most wear and tear on roads, the tire tax is another way to tie the cost of repair and upkeep to the user.

The benefit principle has two limitations. The first is that many government services provide the greatest benefit to those who can least afford to pay for them. People who receive welfare payments or 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 the benefits often are hard to measure. Are people who pay for gas the only ones who benefit from the roads built with gas taxes? What about property owners whose property increases in value because of the improved access? What about hotel and restaurant owners who profit from tourists arriving by car or bus? These people may buy very little gasoline, but they still benefit from the facilities that the gas tax helps provide.

Ability-to-Pay Principle

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

The ability-to-pay principle is based on two factors. First, it recognizes that societies 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.

ECONOMICS AT A GLANCE

Figure 9.3

Three Types of Taxes

Type of Tax	Income of $10,000	Income of $100,000	Summary
Proportional	***City Occupational Tax*** $97.50 or .975% of income	***City Occupational Tax*** $975.00 or .975% of income	As income goes up, the percent of income paid in taxes *stays the same.*
Progressive	***Federal Income Tax*** $1,000 paid in taxes, or 10% of total income	***Federal Income Tax*** $25,000 paid in taxes, or 25% of total income	As income goes up, the percent of income paid in taxes *goes up*.
Regressive	***State Sales Tax*** $5,000 in food and clothing purchases, taxed at 4% for a total tax of $200 or 2% of income.	***State Sales Tax*** $20,000 in food and clothing purchases, taxed at 4% for a total tax of: $800 or .8% of income	As income goes, up the percent of income paid in taxes *goes down*.

Using Tables Proportional, progressive, and regressive are the three main types of taxes. **Under which type of tax do individuals with lower incomes pay a smaller percentage than do those with higher 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 14 percent, this family pays $2,800–a huge amount for them. On the other hand, a comparable family with a $100,000 taxable income could afford to pay a higher tax rate and suffer much less discomfort.

Types of Taxes

Three general types of taxes exist in the United States today–proportional, progressive, and regressive. Each type of tax is classified according to the way in which the tax burden changes as income changes.

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 taxable income divided by the total income–is constant, regardless of income. If a person's income goes up, the *percentage* of total income paid in taxes does not change.

A **progressive tax** is a tax that imposes a higher percentage rate of taxation on persons with higher incomes. A progressive tax claims not only a larger absolute (dollar) amount but also a larger percentage of income as income increases. Progressive taxes usually use a **marginal tax rate,** the tax rate that applies to the next dollar of taxable income, that increases as the amount of taxable income increases. Therefore, the *percentage* of income paid in taxes increases as income goes up.

Suppose the tax system requires a person to pay $1,000 on $10,000 of taxable income, $4,000 on $20,000 of taxable income, or $30,000 on $100,000 of taxable income. The tax is progressive over this range because the percent of income paid in taxes–10, 20, and 30 percent respectively–rises as income rises.

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 with an annual income of $10,000 may spend $5,000 on food and clothing, while another person with an annual income of $100,000 may spend $20,000 on the same essentials. If the state sales tax is 4 percent, the person with the lower income is paying a higher percentage of total income in taxes.

Section 1 Assessment

Checking for Understanding

1. **Main Idea** Using your notes from the graphic organizer activity on page 223, list the ways that taxes influence the economy.
2. **Key Terms** Define sin tax, incidence of a tax, tax loophole, individual income tax, sales tax, benefit principle of taxation, ability-to-pay principle of taxation, proportional tax, average tax rate, progressive tax, marginal tax rate, regressive tax.
3. **Describe** the economic impact of taxes.
4. **List** three criteria used to evaluate taxes.
5. **Summarize** the two main principles of taxation.
6. **Explain** the characteristics of proportional, progressive, and regressive taxes.

Applying Economic Concepts

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

Critical Thinking

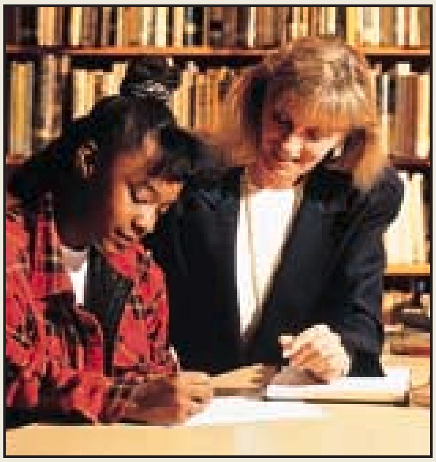
8. **Drawing Inferences** Think about the last tax you paid. Using the criteria for progressive, proportional, and regressive taxes, determine which type of tax you think it is and explain why.

Practice and assess key social studies skills with the Glencoe Skillbuilder Interactive Workbook, Level 2.

STUDY AND WRITING Skill

Using Library Resources

Your teacher has assigned a major research report, so you go to the library. As you wander the aisles surrounded by books, you wonder: Where do I start my research? Which reference works should I use?



Deciding where to start your research and which reference works to use are important in doing a research report.

Learning the Skill

Libraries contain many resources. Here are brief descriptions of important ones:

Reference Books Reference books include encyclopedias, biographical dictionaries, atlases, and almanacs.

- An encyclopedia is a set of books containing short articles on many subjects arranged alphabetically.
- A biographical dictionary includes brief biographies listed alphabetically by last names.
- An atlas is a collection of maps and charts for locating geographic features and places. An atlas can be general or thematic.
- An almanac is an annually updated reference that provides current statistics and historical information on a wide range of subjects.

Card Catalogs Every library has a card catalog, either on cards or computer or both, which lists every book in the library. Search for books by author, subject, or title. Computerized card catalogs will also advise you on the book's availability.

Periodical Guides A periodical guide is a set of books listing topics covered in magazines and newspaper articles.

Computer Databases Computer databases provide collections of information organized for rapid search and retrieval. For example, many libraries carry reference materials on CD-ROM.

Internet Libraries can often suggest clearinghouse sites, online databases, and other reputable sites.

Practicing the Skill

Suppose you are assigned a research report dealing with the introduction of the U.S. income tax. Read the questions below, then decide which of the sources described above you would use to answer each question and why.

1. During which year was the federal income tax established?
2. What was the purpose of the income tax when it was introduced in 1913?
3. How did the public react to the tax?

Application Activity

Using library resources, research the origins of Social Security taxes. Present the information you find to the class.

Practice and assess key social studies skills with the Glencoe Skillbuilder Interactive Workbook, Level 2.

SECTION 2

The Federal Tax System

Study Guide

Main Idea
The federal government raises revenue from a variety of taxes.

Reading Strategy
Graphic Organizer As you read the section, complete a graphic organizer like the one below to identify the federal government's most important revenue sources.

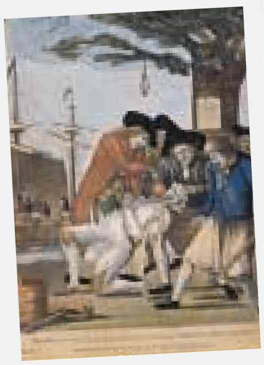
Key Terms
payroll withholding system, Internal Revenue Service (IRS), tax return, indexing, FICA, medicare, payroll tax, corporate income tax, excise tax, luxury good, estate tax, gift tax, customs duty, user fee

Objectives
After studying this section, you will be able to:
1. **Explain** the progressive nature of the individual income tax.
2. **Describe** the importance of the corporate tax structure.
3. **Identify** other major sources of federal revenue.

Applying Economic Concepts
Federal Taxes You, the American taxpayer, are the source of most of the money the government spends. Almost all federal government revenue comes from taxation.

Cover Story

The Costs of Taxation


American colonists protested against British taxes and collectors.

Taxes are often a source of heated political debate. In 1776 the anger of the American Colonies over British taxes sparked the American Revolution. More than two centuries later Ronald Reagan was elected president on a platform of large cuts in personal income taxes, and during his eight years in the White House the top tax rate on income fell from 70 percent to 28 percent. In 1992 Bill Clinton was elected in part because incumbent George Bush had broken his 1988 campaign promise, "Read my lips: no new taxes."

—N. Gregory Mankiw, *Microeconomics*, 1998

The federal government collects taxes from a number of sources. The most important sources of government revenue are individual income taxes, Social Security taxes, and corporate income taxes.

Individual Income Taxes

In 1913 the Sixteenth Amendment to the United States Constitution was ratified, allowing Congress to levy an income tax. The amendment states that:

> *The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.*

Since the amendment was ratified, the federal government has relied heavily on the individual income tax—the tax on people's earnings—to finance its operations. As **Figure 9.4** shows, the federal government collected about 48 percent of its total revenue from taxes on people's earnings.

Payroll Deductions

In most cases, the individual income tax is paid over time through a **payroll withholding system,** a system that requires an employer to automatically deduct income taxes from an employee's paycheck and send it directly to the government. The agency that receives the tax payment is the **Internal Revenue Service (IRS),** the branch of the U.S. Treasury Department in charge of collecting taxes.

After the close of the tax year on December 31, and before April 15 of the following year, the employee files a **tax return**—an annual report to the IRS summarizing total income, deductions, and the taxes withheld by employers. Any difference between the amount already paid and the amount actually owed, as determined by official tax tables like those shown in **Figure 9.5,** is settled when the return is filed. Most differences are caused by deductions and expenses that lower the amount of taxes owed, as well as by additional income received that was not subject to tax withholding.

People who are self-employed do not have money withheld from their paychecks. Instead, they are required to send quarterly estimates of their taxes to the Internal Revenue Service. These individuals must also make a final settlement for the previous year sometime before April 15.

A Progressive Income Tax

The individual income tax is a progressive tax. According to the individual tax tables shown in **Figure 9.5,** single individuals paid a flat 15 percent on all income up to $26,250. After that, the marginal tax rate jumps to 28 percent, 31 percent, 36 percent, and 39.6 percent, depending on the amount of taxable income. The tax schedule is

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Figure 9.4

Federal Government Revenues by Source

Source: *Budget of the United States Government* and *Economic Report of the President*, various years

Using Graphs During the 1990s, individual income taxes were made more progressive, Social Security taxes were raised on the wealthiest recipients, and strong economic growth generated higher corporate tax collections. These occurrences reduced the government's need to borrow. **How did government borrowing change between 1990 and 2000?**

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CONTENTS

ECONOMICS AT A GLANCE

Figure 9.5

Tax Table for Single Individuals

If the amount on Form 1040, line 39, is *over . . .*	*but not over . . .*	enter on Form 1040, line 40			*of the amount over . . .*
$0	$26,250	-----------		15%	$0
$26,250	$63,550	**$3,937.50**	+	**28%**	**$26,250**
$63,550	$132,600	**$14,381.50**	+	**31%**	**$63,550**
$132,600	$288,350	**$35,787.00**	+	**36%**	**$132,600**
$288,350	-----------	**$91,853.00**	+	**39.6%**	**$288,350**

Source: Schedule X, IRS Individual Tax Table

Using Tables According to the individual income tax table, a single individual with $20,000 of taxable income would pay $20,000 x .15, or $3,000 in taxes. **How much in taxes would an individual with $40,000 of taxable income pay?**

similar for married individuals, with rates scaled so that couples earning higher incomes pay a larger percentage of their income in taxes.

When a tax is progressive, the average tax rate goes up when income goes up. **Figure 9.6** illustrates this point. The single individual with $10,000 of taxable income pays an average of 15 cents for every dollar earned. If the person has $35,000 of taxable income, the marginal tax rate is higher (at 28 percent), which raises the average tax on every dollar to 18.3 cents. Likewise, the individual with $145,000 of taxable income pays an average of 27.8 cents on every dollar.

Indexing

Suppose a worker receives a small raise, just enough to offset the rate of inflation. Although that worker is no better off, the raise may still push the worker into a higher tax bracket. Because of this possibility, the individual income tax has a provision for **indexing,** an upward revision of the tax brackets to keep workers from paying more in taxes just because of inflation.

To illustrate, suppose that a single individual with no dependents had exactly $26,250 of taxable income in 2000. If the person receives a 5 percent raise the following year to offset expected inflation, the $1,313 raise would be taxed at the next marginal tax bracket of 28 percent. The result is that the individual gets pushed into a higher tax bracket simply because of inflation. If the bracket is indexed, or adjusted upward by 5 percent, the 28 percent marginal rate for the year 2001 would not apply until $27,563 is earned.

FICA Taxes

The second most important federal tax is FICA. **FICA** is the Federal Insurance Contributions Act tax levied on both employers and employees to pay for Social Security and medicare. **Medicare** is a federal health-care program available to all senior citizens, regardless of income. Employees and employers share equally in paying the tax for Social Security and medicare. These two taxes are also called **payroll taxes** because they are deducted from your paycheck.

Social Security Taxes

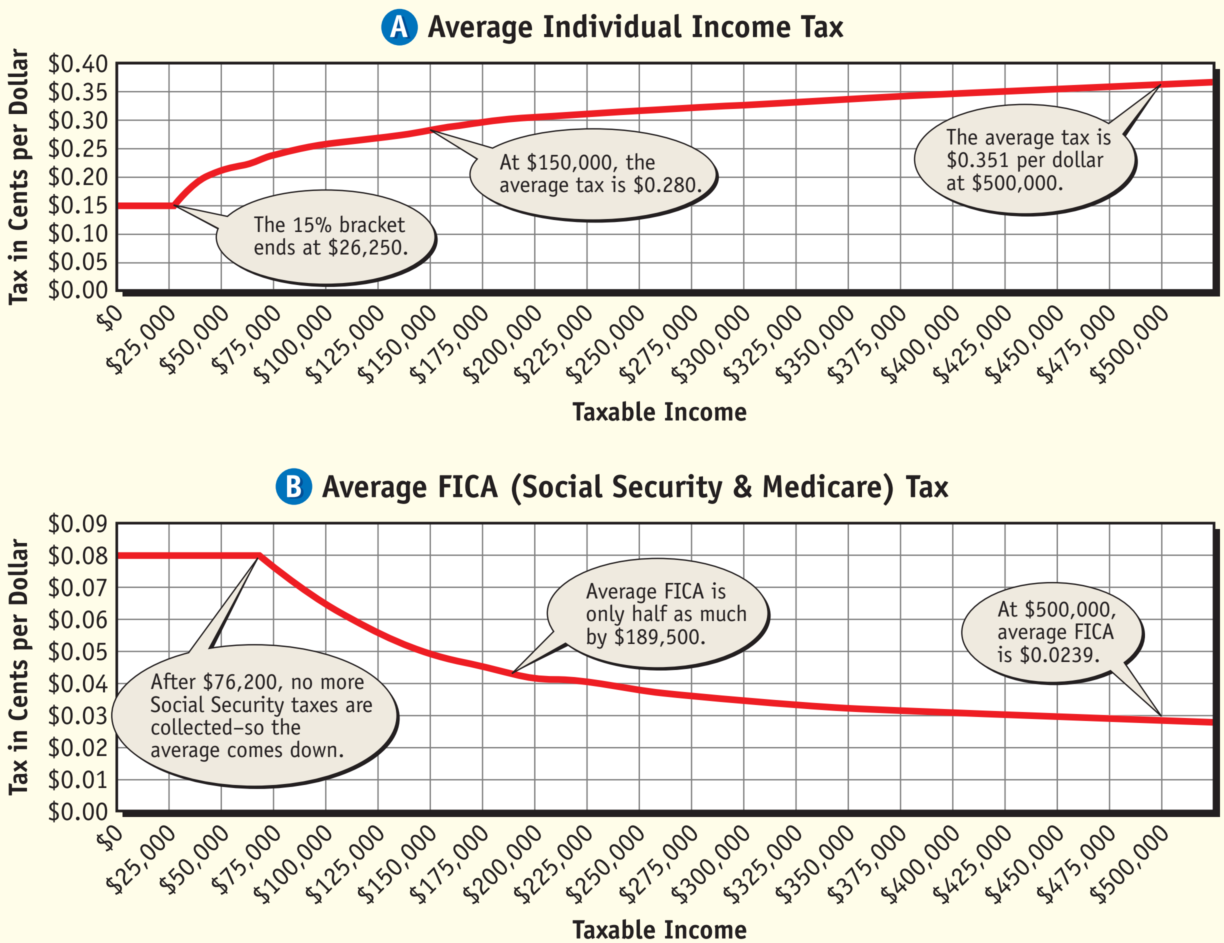
In 2000 the Social Security component of FICA was 6.2 percent of wages and salaries up to $76,200. After that amount, Social Security taxes are not collected, regardless of income. This means that a person with taxable income of $76,200 pays a Social Security tax of $4,724, the same as someone who earns $1,000,000.

Because the Social Security tax is capped, it is proportional up to $76,200, and regressive thereafter. For example, a single individual with $76,200 of taxable income would pay an average of 6.2 cents of Social Security taxes on every dollar earned (.062 times $76,200). If that same individual

ECONOMICS AT A GLANCE

Figure 9.6

Average Individual and FICA Taxes, Single Individuals, 2000



Source: Internal Revenue Service

Using Graphs **The individual income tax is a progressive tax, meaning that people with higher incomes pay a larger percentage of that income as taxes than do persons with lower income. Is the FICA tax a progressive or regressive tax? Explain your reasoning.**

made $300,000, the average tax per dollar would drop to 1.6 cents (.062 times $76,200 divided by $300,000).

Medicare

In 1965 Congress added medicare to the Social Security program. More than 30 million senior citizens participate in medicare. The basic plan pays a major share of an eligible person's total hospital bills. 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 means that wealthy individuals pay the same percent of income to medicare taxes as do the poor.

When medicare and Social Security are considered together, as in **Panel B** of **Figure 9.6,** we can see the overall regressive nature of the FICA tax.

For single individuals in 2000, the tax was level at 7.65 percent up to $76,200, and then declined. A single individual earning $35,000 in 2000 paid an average FICA tax of 7.65 cents per dollar. If that same individual made $150,000, the average FICA tax paid dropped to 4.60 cents per dollar.

Corporate Income Taxes

Corporations as well as individuals must pay income taxes. The third largest category of taxes the federal government collects 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, are placed on corporations. The first is at 15 percent on all income under $50,000. The second is at 25 percent on income from $50,000 to $75,000. The third tax bracket is at 34 percent on income starting at $75,000. Eventually, a 35 percent marginal tax applies to all profits in excess of $18.3 million.

Other Federal Taxes

In addition to income, FICA, and corporate taxes, the federal government receives revenue in the form of excise taxes, estate and gift taxes, and customs duties.

Excise Taxes

The **excise tax**—a tax on the manufacture or sale of selected items, such as gasoline and liquor—is the fourth largest source of federal government revenue. The Constitution permits levying excise taxes, and since 1789 Congress has placed taxes on a variety of goods. Some early targets for excise taxes were carriages, snuff, and liquor. Today, federal excise taxes also are found 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.

In 1991 Congress expanded the excise tax to include certain luxury goods. An economic product is called a **luxury good** (or service) if the demand for the good rises faster than income when income grows. At first, the 19 percent luxury tax was indexed to keep up with inflation and was applied to many goods, including passenger vehicles in excess of $30,000. The tax was unpopular, however, so boats, aircraft, jewelry, and furs were dropped in 1993. Later, Congress decided to phase out the luxury tax by the year 2002.

Estate and Gift Taxes

An **estate tax** is the tax the government levies on the transfer of property when a person dies. Estate taxes can range from 18 to 55 percent of the value of the estate. Estates worth less than $650,000 were exempt in 1999, although this limit will soon be raised to $1,000,000.

The **gift tax** is a tax on donations 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 their deaths. As shown in **Figure 9.4,** these two taxes account for only a small fraction of total federal government revenues.

Federal Taxes

Excise Taxes The Constitution permits levying excise taxes. Since 1789 Congress has placed taxes on a variety of goods, including gasoline, coal, and luxury goods. ***What are luxury goods?***

The estate tax and the gift tax are progressive taxes—the larger the estate or gift, the higher the tax rate. In the year 2000, these two taxes accounted for about 1.4 percent of federal government revenue.

Customs Duties

A **customs duty** is a charge levied on goods brought in from other countries. The Constitution gives Congress the authority to levy customs duties. Congress can decide which foreign imports will be taxed and at what rate. Congress, in turn, has given the president authority by executive order to raise or lower the existing tariff rates by as much as 50 percent. Many types of goods are covered, ranging from automobiles to silver ore. The duties are relatively low, and they produce little federal revenue today, although they were the largest source of federal government income prior to 1913.

Miscellaneous Fees

Finally, about 1.9 percent of federal revenue is collected through various miscellaneous fees. Since the 1980s, when taxes were politically unpopular, **user fees**—charges levied for the use of a good or service—have been suggested with increasing frequency. President Ronald Reagan was one of the first presidents to aggressively push for user fees instead of taxes.

These fees include entrance charges you pay to visit 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; politicians just seem to think that we won't recognize them as taxes if they call them "user fees" instead.

CYBERNOMICS SPOTLIGHT

E-Filing

There are benefits to filing taxes online. E-filing speeds up tax-processing time so that computer users can get their refunds twice as fast as those who mail in paper. E-filing also prevents errors, since no IRS keypunchers are needed to type in the information from paper returns. In 1998, 20 percent of taxpayers filed their tax returns online. By the year 2007, the IRS hopes to have 80 percent of returns filed electronically.

Section 2 Assessment

Checking for Understanding

1. **Main Idea** Using your notes from the graphic organizer activity on page 231, list the federal government's most important revenue sources.
2. **Key Terms** Define payroll withholding system, Internal Revenue Service, tax return, indexing, FICA, medicare, payroll tax, corporate income tax, excise tax, luxury good, estate tax, gift tax, customs duty, user fee.
3. **Describe** the progressive nature of the individual income tax.
4. **Identify** the main marginal tax brackets in the corporate income tax structure.
5. **Describe** the other sources of government revenue.

Applying Economic Concepts

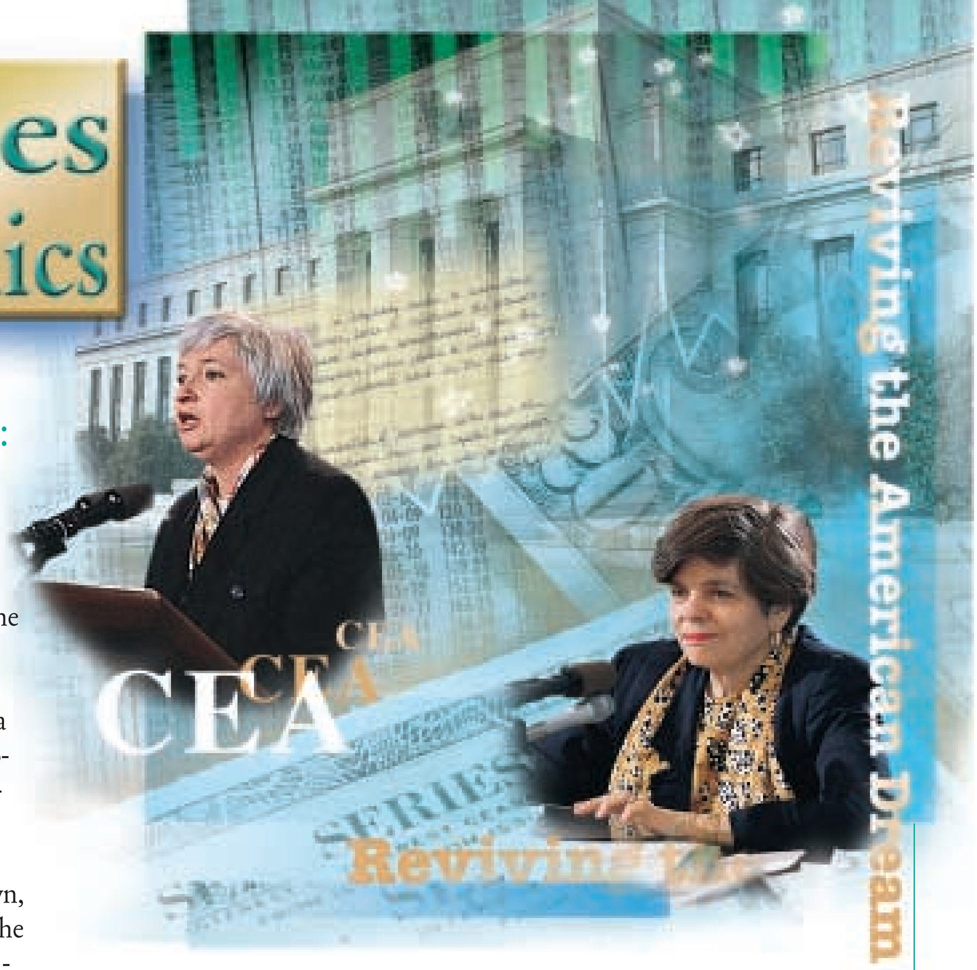
6. **Federal Taxes** User fees have been compared to taxes based on the benefit principle of taxation. Define user fees in your own words. What are the pros and cons of having user fees as a way to charge admission to national parks?

Critical Thinking

7. **Categorizing Information** Explain and use an example to explain the regressive nature of the current FICA tax.
8. **Finding the Main Idea** What is indexing? What is its purpose?

Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

Profiles in Economics



Adviser to a President: Janet Yellen

(1946–)

Janet Yellen, former Chair of the President's Council of Economic Advisers (CEA), has a knack for explaining things. When she was a student pursuing her Ph.D. in economics in the early 1970s, the lecture notes she took became a legend in their own time. The "Yellen Notes," as they were known, were passed around and became the unofficial textbook for several generations of graduate students.

As a member of the Board of Governors of the Federal Reserve, she frequently briefed the White House on labor markets and welfare reform. As a result of these encounters, President Clinton knew just where to look when he needed a new Chair for the CEA in early 1997.

As Chair of the CEA, Yellen's top priorities were a balanced federal budget and welfare reform, including measures that would punish fathers who do not support their children. The distribution of income was another priority. "I'm concerned about rising inequality of earnings and its long-term social implications," Dr. Yellen said. "Education is the answer."

A Powerful Economic Voice: Alice Rivlin

(1931–)

Alice Rivlin, founding director of the Congressional Budget Office (CBO), former Director of the Office of Management and Budget (OMB) in the Clinton administration, and former Vice Chair of the Fed's Board of Governors, is one of the most respected economists in Washington. As a seasoned professional with a wealth of experience, her knowledge of government finance is virtually unparalleled.

She has written extensively and is known for the straightforward—sometimes searing—views put forth in her many writings. Rivlin is a blunt and outspoken critic of budget deficits, and argues that spending cannot be brought under control until Congress is willing to reform the politically sensitive spending measures, such as pension systems, subsidies, and other types of transfer payments. Rivlin is now a senior fellow for the Brookings Institute, a Washington-based research group.

Examining the Profiles

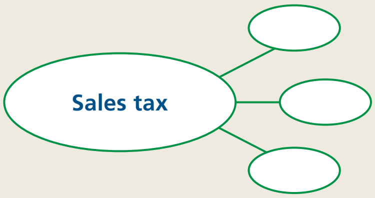
1. **Making Comparisons** Compare and contrast the work and views of Yellen and Rivlin.
2. **Synthesizing Information** What significance is there in the fact that both Yellen and Rivlin are women?

State and Local Tax Systems

Study Guide

Main Idea
State and local governments each rely on different revenue sources.

Reading Strategy
Graphic Organizer As you read the section, complete a graphic organizer like the one below by describing why sales taxes are effective ways to raise revenue.



Key Terms
intergovernmental revenue, property tax, tax assessor, payroll withholding statement

Objectives
After studying this section, you will be able to:
1. **Explain** how state governments collect taxes and other revenues.
2. **Differentiate** between state and local revenue systems.
3. **Interpret** paycheck deductions.

Applying Economic Concepts
Sales Tax Read to find out why, when you purchase an item in most states, you pay a fee in the form of a sales tax.

Cover Story

Death Taxes Raise Ire

As opposition grows against the death tax, small business is emerging as the levy's leading adversary.

A decade of strong revenues and record surpluses already threatened federal and state death taxes, a meager government money source to begin with. Furthering the cause is that 34 states don't tax inherited assets. . . .

Will death taxes doom family-run businesses?

The state tax landscape varies greatly, including both levies on inheritance and estates. . . . Death-tax supporters say eliminating the levy amounts to a tax-break for the rich. They point out that most people aren't fortunate enough to even be eligible for the tax.

But for small businesses [there is] belief that death taxes prevent family-run enterprises from being passed down to heirs. . . .

—*CNNfn*, April 13, 1999

State and local governments, like the federal government, raise revenue in many ways. They receive funds from sales taxes, property taxes, utility revenues, and through other methods. Sometimes, as we saw in the cover story, they even tax us when we die.

State Government Revenue Sources

State governments collect their revenues from several sources. **Figure 9.7** shows the relative proportions of each source, the largest of which are examined below.

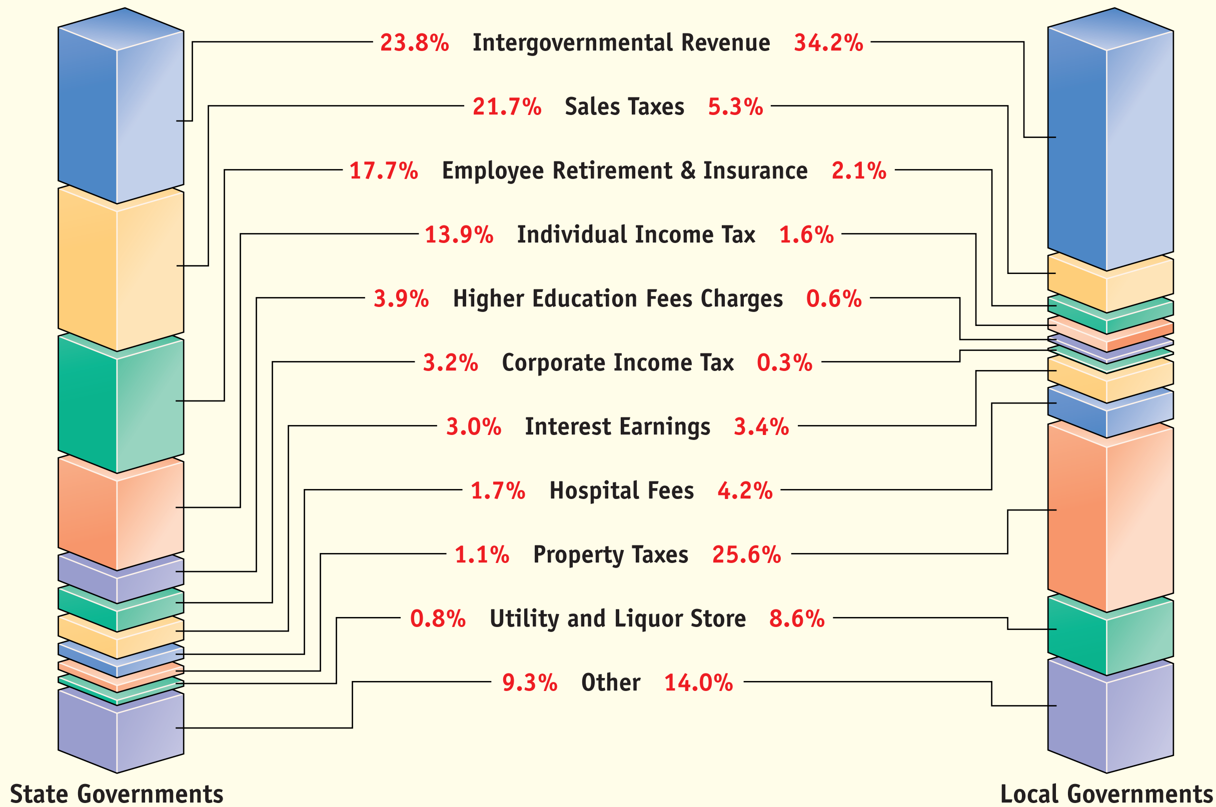
Intergovernmental Revenues

The largest source of state revenue is the category called **intergovernmental revenue**–funds collected by one level of government that are distributed to another level of government for expenditures. States receive these funds from the federal government to help with expenditures on welfare, education, highways, health, and hospitals. As **Figure 9.7** shows, they represent nearly one-quarter of all state revenues.

ECONOMICS AT A GLANCE

Figure 9.7

Sources of State and Local Government Revenue



Source: *Statistical Abstract of the United States,* 1999

Using Charts State and local governments have their own sources of revenue. **What are the two largest sources of state revenue?**

ECONOMICS Online

Visit epp.glencoe.com and click on ***Textbook Updates—Chapter 9*** for an update of the data.

CLICK HERE

Taxes and Fees

The 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 weekly or monthly 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, accounting for 21.7 percent of total revenues collected. Only five states–Alaska, Delaware, Montana, New Hampshire, and Oregon–do not have a general sales tax.

Many states levy taxes, fees, or other assessments on their employees to cover the cost of state retirement funds and pension plans. **Figure 9.7** shows that employee retirement contributions were the third largest source of state revenue.

On average, the fourth largest source of state revenues is the individual income tax. Overall, individual income tax revenues are about five times as large as the income tax collected from corporations.

Other Revenues

The remaining revenues that state governments collect are interest earnings on surplus funds; tuition and other fees collected from state-owned colleges, universities, and technical schools; corporate income taxes; and hospital fees.

Note that while the percentages in **Figure 9.7** are representative for most states, wide variations among states still exist. For years, New Hampshire took pride in the fact that it had neither a sales tax nor an income tax. Even so, as **Figure 9.8** shows, the state made up the difference with other types of taxes. The same is true for Alaska, Delaware, Montana, and Oregon—the other four states without a general sales tax.

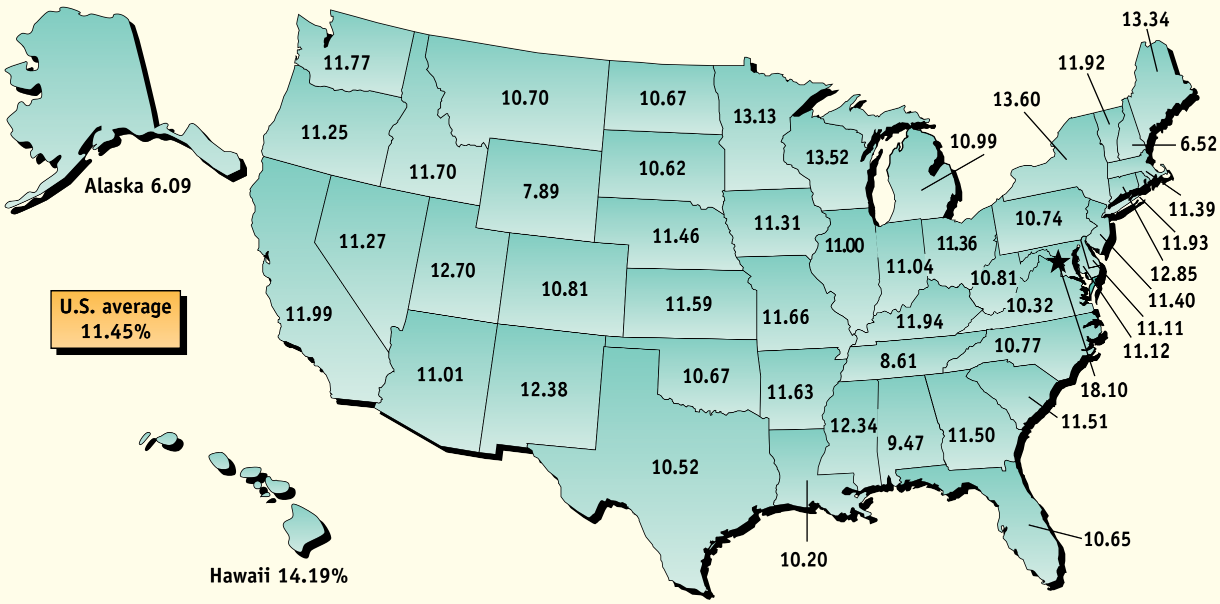
The Choice of Tax

The choice of tax is something that most states feel strongly about. Sooner or later, however, they all discover that if they do not use one kind of tax, then they have to rely on another. In the end, the

ECONOMICS AT A GLANCE

Figure 9.8

State and Local Taxes as a Percentage of State Income



Source: Tax Foundation

Using Maps State and local governments receive 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. **What states have the highest level of state and local taxes? The lowest level?**

ECONOMICS Online

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choices that states face are like the choices individuals face—and we already know that there is no such thing as a free lunch.

Nearly three-fourths of the states run public lotteries to raise revenue. Lotteries became the fastest-growing source of state revenues in the 1980s. The states spend about half the lottery income on prizes and 6 percent on administration.

Local Government Revenue Sources

The major sources of local government revenue are also shown in **Figure 9.7.** These include taxes and funds from state and federal governments. The main categories are discussed below.

Intergovernmental Revenues

Local governments receive the largest part—slightly more than one-third—of their revenues 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.

ECONOMICS AT A GLANCE

Figure 9.9

Biweekly Paycheck and Withholding Statement

Weaver & Higginson
Attorneys at Law

21-2/000 Number 2,195,903

Date June 25 19 99

Pay to the order of Sara Peña $ 586.89

Five Hundred Eighty-Six Dollars and 89/100 Dollars

THE CENTRAL BANK

Memo

5:5555555: 555:55555

Treasurer

PLEASE DETACH AND RETAIN THIS PORTION
AS YOUR RECORD OF EARNINGS AND DEDUCTIONS

Date	Pay End	Vo. No.	Emp. No.	Hrs.	Misc.	Cr. Un.	Ins.	Gross
6/7/99	6/18/99		1376	80	3.20			800 00
104 70	40 01	4 00	61 20					586 89
Federal	State	City	FICA	Ret.	Bonds	Other		Net

Understanding Percentages The withholding statement attached to your paycheck summarizes many of the federal, state, and local taxes. Federal and state income tax withholdings are always shown, as is the FICA (Social Security and medicare) tax. Other withholdings may include city income taxes and voluntary deductions, such as health insurance payments and savings plans. **What percentage of this individual's pay has been deducted from her paycheck?**

Property Taxes

The second largest source of revenue for local governments is the **property tax**—a tax on tangible and intangible possessions such as real estate, buildings, furniture, automobiles, farm animals, stocks, bonds, and bank accounts.

The property tax that raises the most revenue is the tax on real estate. Taxes on other personal property, with the exception of automobiles, is 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, coin collections, clothing, and other tangible property items? Instead, most communities find it more efficient to hire one or more individuals to assess the value of a few big-ticket items like buildings, real estate, and motor vehicles.

Other Sources

The third largest source of local revenue is derived from the earnings of public utilities and

CONTENTS

state-owned liquor stores. **Figure 9.7** shows that local governments acquired 8.6 percent of their revenues from these sources.

Many towns and cities have their own sales taxes. Merchants collect these taxes right along with the state sales tax, at the point of sale. As indicated in **Figure 9.7,** sales taxes are the fourth most important source of local government revenues.

Local governments also collect a portion of funds in the form of hospital fees and personal income taxes. In general, the revenue sources available to local governments are much more limited than those available to the state and federal levels of government.

Examining Your Paycheck

Many of the taxes you pay to federal, state, and local governments are deducted directly from your paycheck. By examining the **payroll withholding statement**—the summary statement attached to a paycheck that summarizes income, tax withholdings, and other deductions—shown in **Figure 9.9,** we can identify many of the revenue sources described in this chapter.

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. 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 1998 to settle the differences.

Another deduction is the half-percent city income tax that amounts to $4. Because the amount is relatively small, cities seldom require workers to file separate year-end tax forms.

The federal 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 the worker with a net pay of $586.89.

If the worker has insurance payments or retirement contributions, purchases savings bonds, or puts money into a credit union, even more deductions will appear on the paycheck.

Section 3 Assessment

Checking for Understanding

1. **Main Idea** Using your notes from the graphic organizer activity on page 238, write a definition in your own words of what intergovernmental revenues are.
2. **Key Terms** Define intergovernmental revenue, property tax, tax assessor, payroll withholding statement.
3. **Explain** the four major sources of state tax revenues.
4. **Explain** the difference between state and local revenue systems.
5. **List** the major types of state, local, and federal taxes reflected on a paycheck.

Applying Economic Concepts

6. **Sales Taxes** Why do you think sales taxes are applied to food and beverages purchased at restaurants, but not to food and beverages purchased at grocery stores?

Critical Thinking

7. **Drawing Conclusions** State and local governments receive revenue from various sources. Which source do you think best satisfies the tax criteria listed in the chapter? Defend your answer.

Practice and **assess** key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

BusinessWeek

JANUARY 18, 1999

Newsclip

The Sixteenth Amendment, which gives Congress the power to tax people's incomes to generate revenue for the federal government, was added to the Constitution in 1913. Today, taxes are placed on income, sales, and property to raise money for services such as transportation and education.

Do Taxes Spell Good News?

Taxes, as the saying goes, may be as unavoidable as death, but do they have to be so high?

. . . In recent years, federal individual income and payroll taxes have been claiming an ever larger share of personal income. . . .

As some critics see it, this growing tax bite is squeezing consumers. With more income being siphoned off by taxes, they say, struggling households have had to dip into savings simply to maintain consumption patterns. And the fact that the monthly savings rate recently turned negative for the first time in 60 years underscores the problem.

Does it? Economist Paul L. Kasriel of Northern Trust Co., who has long favored lower marginal tax rates, is dubious. For one thing, he regards the picture of tax-beleaguered households struggling to maintain consumption as highly exaggerated. In actuality, he notes, people have been spending with exuberance. . . .

As for the rising tax take, Kasriel claims that the main cause has been increases in inflation-adjusted income, which have been pushing tax filers into higher marginal brackets. . . .

Similarly, more income has become subject to taxation as more households have moved off welfare rolls and onto payrolls in response to welfare reform and a tight labor market. . . .

Finally, Kasriel points to a development others have cited in explaining the falling savings rate and rising tax bite: the huge increase in household net worth generated by the stock market boom. With the value of their past savings and investments rising so rapidly, consumers have felt free to curtail current savings so they can enjoy the fruits of their past thrift now. . . .

Examining the Newsclip

1. **Making Inferences** How would having negative monthly savings rates imply that taxes are too high?
2. **Drawing Conclusions** Do you agree with Paul Kasriel's opinion about taxes and lower savings rates? Why or why not?

Current Tax Issues

Study Guide

Main Idea
The consequence of tax reform was to make the individual tax code more complex than ever.

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

Flat tax

Advantages | Disadvantages

Key Terms
accelerated depreciation, investment tax credit, surcharge, alternative minimum tax, capital gains, value-added tax (VAT), flat tax

Objectives
After studying this section, you will be able to:
1. **Describe** the major tax reforms since 1980.
2. **Debate** the advantages and disadvantages of the value-added tax.
3. **Explain** the features of a flat tax.
4. **Discuss** why future tax reforms will occur.

Applying Economic Concepts
Flat Tax Have you ever noticed how much time your parents spend filling out their income tax returns? Read to find out what a flat tax would mean to them.

Cover Story

How the Tax Code Got This Way

Every year at this time, Congress discovers, with a great public show of dismay and indignation, the existence of the American tax code and the agency that administers it, the Internal Revenue Service.

There are high-minded calls for abolishing the current tax system and replacing it. . . .

Around April 15, Congress likes to pretend that the tax code just sort of appeared or [just] happened. But the Constitution puts the burden of taxes solely, exclusively and entirely on Congress' shoulders.

The tax code is the way it is because a majority of Congress wants it that way. Hope you enjoyed this year's tax day.

—*Denver Rocky Mountain News*, April 16, 1999

IRS employee sorts tax returns

The editorial in the cover story sums it up quite well. The complexity of our tax code is not accidental: it is the result of adjustments and amendments by Congress to both influence and reward behavior.

Tax Reform in the 1980s and 1990s

Tax reform has received considerable attention in recent years, due to more changes in the tax code, and more changes in direction, than at any 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. Accordingly, he proposed the Economic Recovery Tax Act of 1981, which substantially reduced taxes for individuals and businesses.

Before the Recovery Act, the individual tax code had 16 marginal tax brackets ranging from 14 percent to 70 percent. In comparison, today's tax code, shown in **Figure 9.5,** has five marginal brackets ranging from 15 to 39.6 percent. The 1981 act lowered the marginal rates in all brackets, but, more importantly, it capped the highest marginal tax wealthy individuals paid at 50 percent.

Businesses also got tax relief in the form of **accelerated depreciation**—larger than normal 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 plant 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.

These provisions produced a dramatic impact on the federal budget. In 1980, the proportion of total federal government revenues from the corporate income tax was 12.5 percent. This dropped to 10.2 percent in 1981, and then to 8.0 percent in 1982, and finally to 6.2 percent in 1983.

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. Additionally, many corporations were able to legally avoid paying taxes. Boeing, ITT, General Dynamics, Transamerica, and Greyhound were profitable from 1981 to 1984. Instead of paying corporate income taxes, however, these companies applied tax losses in earlier years to current profits—and then collected tax *refunds* during each of those four years.

In 1986 Congress passed the most sweeping tax reform act since income taxes were enacted in 1913. First, it ended the traditionally progressive individual income tax structure by reducing the 16 marginal tax brackets to two brackets (essentially the 15 percent and 28 percent brackets in **Figure 9.5**). Then, a 5 percent **surcharge**—or additional tax above and beyond the base rate—was added to bring the top bracket to 31 percent.

The law also made it difficult for the very rich to avoid taxes altogether. The **alternative minimum tax**—the personal income rate that applies whenever the amount of taxes paid falls below some 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.

Finally, the reform act shifted about $120 billion of taxes from individuals to corporations over a five-year period by removing a number of tax breaks for business. As a result, the proportion of total federal government revenues from the corporate

Taxation

Reform Some people think any tax is too high, but this viewpoint is not very realistic. ***What tax credits were part of the Taxpayer Relief Act of 1997?***

income tax increased to 9.8 percent in 1987, and to 10.3 percent in 1988–percentages much closer to the 10.1 percent shown in **Figure 9.4.**

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 Omnibus Budget Reconciliation Act of 1993 was driven more by the need for the government to balance its budget than to overhaul the tax brackets. As a result, the law added the two top marginal tax brackets of 36 and 39.6 percent, shown in **Figure 9.5.**

Tax Reform in 1997

In 1997 the largest tax reduction since the 1981 act was passed. The law was known as the Taxpayer Relief Act of 1997, and 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 higher marginal tax brackets introduced in 1993, along with the closure of some tax loopholes, meant that individuals and corporations paid more taxes than before. In addition, unexpectedly strong economic growth resulted in an increased number of people and businesses paying taxes.

On the political side, the balance of power had dramatically shifted in the 1996 elections. Both political parties felt they had commitments to fulfill to the people who had voted them into office. For many Republicans, this meant a tax break for people with long-term investments in stocks, bonds, and other assets. The tax on **capital gains**–profits from the sale of an asset held for 12 months–was reduced from 28 to 20 percent. Inheritance taxes–the so-called "death taxes" discussed in the cover story on page 244–were also lowered, which tended to favor the well-to-do.

The tax reductions reflected the "family-friendly" theme of the 1996 elections. Tax credits of $500 per child and other deductions for educational expenses were included in the legislation. The marginal tax brackets in **Figure 9.5** remained unchanged, however, which resulted in an unbalanced distribution of tax cuts. People who had neither children nor capital gains from the sale of houses, stocks, or bonds received virtually no benefit.

In the end, 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 categories, the 1997 federal tax law became the most complicated ever.

The Value-Added Tax

Some people want to change the personal income tax; others want to scrap it altogether. One controversial proposal is to shift the tax from income to consumption. This shift would be accomplished with the use of a **value-added tax** (VAT)–a tax placed on the value that manufacturers add at each stage of production.

The VAT has the potential to raise enormous amounts of revenues for the federal government. The United States currently does not have a VAT, although it is widely used in Europe.

The Concept of Value Added

The production of almost any good or service involves numerous steps. Consider wooden baseball bats. First, loggers cut the trees and sell the timber to lumber mills. Then 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, and retailers sell them to consumers. The whole process is illustrated in **Figure 9.10.** The first column of numbers shows the value added at each stage of production. With the VAT, the consumer ends up paying $11 for each bat.

Did you know?

Tax Freedom Day It takes 40 days, on average, for most Americans to earn enough money to pay for their food supply for the entire year. It takes the average American 129 days—until the second week of May—to earn enough money to pay federal, state, and local taxes for the year.

Advantages of a VAT

As a way of raising revenue, the VAT has several advantages. First, it is hard to avoid because the tax collector levies it on the total amount of sales less the cost of inputs. 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 to the government along with their regular tax payments. Consequently, even a relatively small VAT can raise a tremendous amount of revenue, especially when it is applied to a broad range of products.

Finally, some supporters claim that the VAT would affect people's behavior in a manner that encourages them to save more than they do now. After all, if none of your money is taxed until it is spent, you might prefer to spend less—and save more—than you do now.

Disadvantages of a VAT

The main disadvantage of the VAT is that it tends to be invisible to consumers. 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, consumers

ECONOMICS AT A GLANCE

Figure 9.10

The Value-Added Tax

		No Taxes		With a 10% Value-Added Tax	
		Value Added	Cumulative Value	Value Added with a 10% VAT	Cumulative Value 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	The 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, paint, or varnish the bats and sell them to wholesalers.	$5	$7	$5 + $.50 = $5.50	$7.70
Step 4	The wholesalers sell the bats to retail outlets where consumers can buy them.	$1	$8	$1 + $.10 = $1.10	$8.80
Step 5	The retailers put the bats on the shelves and wait for the consumers.	$2	$10	$2 + $.20 = $2.20	$11.00
Step 6	The consumer buys the bat for:		$10.00		$11.00

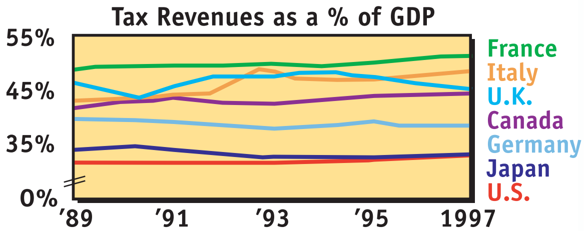
Using Tables The VAT is like a national sales tax added to each stage of production. As a result, it is built into the final price of a product and is less visible to consumers. **Is a VAT regressive, proportional, or progressive? Why?**

THE GLOBAL ECONOMY

High Taxes? Are You Sure?

The ratio of tax revenues to the GDP is one measure of a country's tax burden.

Have you ever thought about living in another country to avoid high taxes in the United States? If you did move, you would be in for a surprise. For all the complaints about high taxes, our federal government's revenues as a percentage of GDP are much lower than many people realize. In fact, the rate is one of the lowest in the industrial world.



Source: *A Citizen's Guide to the Federal Budget*, FY 2000

Critical Thinking

1. **Analyzing Information** What is measured in the graph?
2. **Sequencing Information** Describe the pattern for Canada from 1991 to 1996.

cannot be vigilant about higher taxes when they cannot see them.

Another difficulty is that the VAT would compete with state sales taxes. Because the VAT is a federal tax, adding a VAT is like adding a federal sales tax to already-existing state taxes. If some of these bats were sold in Indiana, Arizona, or Texas, would those states want to forgo their sales tax simply because a federal VAT was in place? Or would those states simply add their own sales taxes, thereby raising the price to $11.50 or even higher?

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. Supporters promoted the flat tax as a way to both simplify taxes and stimulate growth.

A "Progressive" Flat Tax?

A pure flat tax would tax all income at a specific rate, such as 15 or 20 percent. Since the lowest tax rate for all Americans is already 15 percent, critics viewed the proposal as a way to provide tax breaks for the wealthy. As a result, most flat tax proposals exempt some income.

Consider a 15 percent flat tax that exempts the first $20,000 of income. According to this system, a person with exactly $20,000 pays nothing in taxes, and therefore has a zero average tax rate. Someone who earns twice as much would pay nothing on the first $20,000, and 15 percent on the next $20,000. Taxes would amount to $3,000, for an average tax rate of 7.5 percent ($3,000 divided by $40,000). Likewise, someone who earned $60,000 would pay $6,000 (15 percent of $40,000), and have an average tax rate of 10 percent ($6,000 divided by $60,000).

Because the average tax in the example above—0, 7.5, and 10 percent respectively—increases as income increases, the tax is progressive. As a result, a flat tax can be progressive as long as some income is exempted.

Advantages of the Flat Tax

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 many current procedures, such as itemizing deductions, could be skipped.

A second advantage is that a flat tax closes or minimizes most tax loopholes. Under today's tax code, for example, the donation of a single artwork can substantially reduce a millionaire's tax liability.

A third advantage is that a flat tax reduces the need for tax accountants, tax preparers, and even large portions of the IRS. Overall, the savings to everyone could be as high as $100 billion annually.

Disadvantages of the Flat Tax

The first disadvantage of the flat tax is that it removes many of the behavior incentives already built into the tax code. For example, the current tax code allows homeowners to deduct interest payments on home mortgages. Other incentives include deductions for donations to charitable organizations, and education and training.

Eliminating these incentives is likely to encounter some resistance. For example, *Money Magazine* warned that a 15 percent flat tax would hurt homeowners because they could no longer deduct mortgage interest payments. The writer also noted that, "under his own plan, multimillionaire Steve Forbes could see his personal tax bill cut by almost two-thirds." This, of course, highlights the second problem with the flat tax—namely that it will benefit those with high incomes at the expense of lower-income individuals.

To illustrate, suppose that a single individual has $50,000 of taxable income and is subject to the tax rates shown in **Figure 9.5.** Taxes for this individual would amount to $3,862.50 plus 28 percent of the difference between $50,000 and $25,750—for a total tax bill of $10,653. Under a 15 percent flat tax that exempts the first $40,000, the same individual would owe taxes of $1,500—a total tax saving of $9,153!

On the other hand, if that same person had taxable income of $1,000,000, the total amount of taxes owed according to **Figure 9.5** would be $374,073. Under the same 15 percent flat tax plan, the individual would owe $144,000 instead—for a tax saving of $230,073.

Who benefits the most? The person with a $50,000 income who gets an 86 percent tax reduction and saves $9,153, or the person with a $1,000,000 income who gets a 61.5 percent tax reduction and saves $230,073? Any flat tax, regardless of the size of the up-front exemption, is a dramatic shift away from the ability-to-pay principle of taxation.

Flat Tax Proposals

Several congressional candidates during the 1996 election campaign presented various flat tax proposals. Shortly after the election, Republican House Majority Leader Dick Armey presented his version. Armey's plan offered a 17 percent flat tax on individual income that would exempt the first $35,400 earned by a family of four. Businesses would also be subject to a 17 percent tax rate.

Would taxpayers be better off under this proposal? The answer depends on how much you make and how you make it. For example, only labor income from wages, tips, salaries, and pensions would be taxed under the Armey plan. Incomes from dividends, interest, and capital gains are excluded. Critics argued that these exclusions—especially capital gains—favored the wealthy.

Careers

Public Accountant

Accountants prepare, analyze, and verify financial reports that provide information to the general public and to business firms.

The Work

They check clients' financial records, ensuring that they conform to standard procedures for reporting. They give advice on tax advantages and disadvantages, on setting up an accounting system and on managing cash resources, and they prepare income tax statements.

Qualifications

Most firms require applicants to have, at the minimum, a bachelor's degree in accounting or some closely related field. Accountants must be good at mathematics, be able to compare, analyze, and to interpret numbers and facts, and to make sound judgments.

House Minority Leader Dick Gephardt countered Armey's proposal with a "10% Plan." Under Gephardt's plan, a family of four would pay no taxes on income up to $27,500, and then would pay at a 10 percent rate up to $61,000. After that level, the marginal tax bracket would increase in increments to the maximum rate of 34 percent.

Would a flat tax stimulate economic growth? Critics point out that the extraordinary growth of the American economy in the 1990s, the longest period of peacetime prosperity in our history, sheds doubt on the claim that the current system hinders growth.

Second, no one knows exactly what rate is needed to replace the revenues already collected under the current system. Estimates by economists who proposed the tax, as well as estimates done by the United States Treasury, place the tax closer to 23 percent—which represents more of a burden on low-income earners.

The Inevitability of Future Reforms

There were more changes, additions, deletions, exceptions, and exclusions made to the federal tax code in the 1980s and 1990s than at any time in our history. Several factors ensure further change.

First, the tax code is more complex now than ever—a fact that guarantees future attempts to simplify it. The flat tax movement, for example, has moved beyond the point of being a campaign strategy to the stage where Congress is seriously considering such a tax.

Second, the strong economy of the 1990s resulted in record tax collections. For the first time in 30 years, the government collected more revenues than it spent. As a result, many political leaders began to consider ways to lower taxes.

Third, political change is not like economic change, which is gradual and generally evolutionary. Political change is more abrupt, with less continuity from one period to the next, as one party leaves office and another enters. New administrations often display a sense of urgency, a desire to finally do things the "right" way, or to clean up the excesses of their predecessors.

Yet, dramatic change is tempered by the reluctance of politicians to give up some of the power they currently exercise through the tax code—power vested in the ability to modify behavior, influence resource allocation, support pet projects, and grant concessions to special interest groups. As the editorial in the cover story aptly put it, "The tax code is the way it is because a majority of Congress wants it that way."

Section 4 Assessment

Checking for Understanding

1. **Main Idea** What is the purpose of tax reform?
2. **Key Terms** Define accelerated depreciation, investment tax credit, surcharge, alternative minimum tax, capital gains, value-added tax, flat tax.
3. **Describe** three major tax reform bills since 1980.
4. **Explain** the advantages and disadvantages of the VAT.
5. **Describe** the features of the flat tax.
6. **Identify** three forces that are likely to cause future revision of the tax code.

Applying Economic Concepts

7. **Flat Tax** What do you think might happen to donations to charitable organizations if there was a flat tax? If possible, support your answer with examples.

Critical Thinking

8. **Summarizing Information** What changes would you recommend in the federal tax code if you were in charge of revising it? Explain your answer.

Practice and **assess** key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

Chapter 9 Summary

Section 1

The Economics of Taxation

(pages 223–229)

- Taxes affect the allocation of resources, behavior, and economic growth.
- The **incidence of a tax,** or final burden of a tax, is affected by elasticity–when demand for a product is elastic, less of the tax can be shifted to the buyer; more can be shifted when demand is inelastic.
- Equity, simplicity, and efficiency are the criteria used to judge the effectiveness of a tax.
- Two principles, the **benefit principle of taxation** and the **ability-to-pay principle of taxation,** have been used to help select the group or groups that bear the burden of the tax. Both involve value judgments, and both types of taxes are widely used today.
- Taxes can be placed into three groups–**proportional taxes, progressive taxes,** and **regressive taxes**–depending on the way in which the tax burden changes as income changes.

Section 2

The Federal Tax System (pages 231–236)

- The main source of revenue for the federal government is the **individual income tax.**
- **Indexing** is used to change the **marginal tax rates** to offset the effects of inflation.
- The second largest revenue source is the **FICA** tax, collected to cover Social Security and **medicare.**
- The **corporate income tax** is the third largest source of federal revenue.
- Other sources of federal revenue include **excise taxes, gift taxes, customs duties,** and **user fees,** which is a different name for a benefit tax.

Section 3

State and Local Tax Systems

(pages 238–242)

- **Intergovernmental revenues** are the largest source of state revenues.
- Local governments receive intergovernmental revenues from state and federal governments. Local governments also raise revenue from **property taxes,** utility and liquor store sales, sales taxes, and other sources.
- The **payroll withholding statement** attached to a person's weekly, biweekly, or monthly paycheck provides a summary of wages, taxes, and other withholdings.

Section 4

Current Tax Issues (pages 244–250)

- A **value added tax** (VAT) is a tax on consumption rather than income. It is built into a product's every stage of production, is largely invisible, is regressive, and can raise huge sums.
- The Economic Recovery Tax Act of 1981 lowered marginal tax rates for all levels of income, and added **accelerated depreciation** and the **investment tax credit** for businesses.
- The 1986 tax reform law closed tax loopholes opened in 1981, and reduced the individual income tax code to two brackets, making it more proportional.
- The Budget Deficit Reduction Act of 1993 added two marginal tax brackets, restoring the progressive nature of the tax removed in 1986.
- The Taxpayer Relief Act of 1997 provided the wealthy with long-term investment tax breaks, and provided modest tax relief for individuals with child and educational expenses.
- Flat tax proposals can be mildly progressive, but in general reject the ability-to-pay principle of taxation.

Chapter 9 Assessment and Activities

ECONOMICS Online

Self-Check Quiz Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 9—Self-Check Quizzes*** to prepare for the chapter test.

CLICK HERE

Identifying Key Terms

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

a. **ability-to-pay**
b. **corporate income tax**
c. **estate tax**
d. **excise tax**
e. **FICA**
f. **indexing**
g. **individual income tax principle**
h. **progressive tax**
i. **proportional tax**
j. **regressive tax**
k. **sales tax**
l. **sin tax**
m. **VAT**

1. annual adjustment of tax brackets to keep pace with inflation
2. average tax per dollar decreases as taxable income increases
3. average tax per dollar increases as taxable income increases
4. average tax per dollar unchanged as taxable income rises
5. designed to discourage consumption of socially undesirable goods or services
6. tax on the manufacture or sale of certain items
7. largest source of revenue for the federal government
8. large source of revenue for state governments
9. national sales tax on value added at each stage of production
10. Social Security and medicare taxes
11. tax on the transfer of property when a person dies
12. tax paid by those who can most afford to pay
13. third largest source of income for the federal government

Reviewing the Facts

Section 1 (pages 223–229)

1. **Describe** how taxes can be used to affect people's behavior.
2. **Illustrate,** using supply and demand curves, how the burden of a tax can be shifted.
3. **Explain** the three criteria used to evaluate taxes.
4. **Name** the two principles of taxation.

Section 2 (pages 231–236)

5. **Describe** the main features of the individual income tax.
6. **Identify** the two components of FICA.
7. **Describe** the corporate income tax.
8. **Distinguish** between excise taxes, estate and gift taxes, and customs duties.

Section 3 (pages 238–242)

9. **Identify** the main sources of revenue for state governments.
10. **List** the main sources of revenue for local governments.
11. **Identify** the main types of taxes that are normally withheld from a worker's paycheck.

Section 4 (pages 244–250)

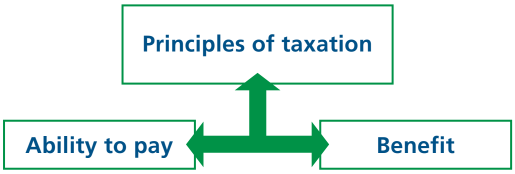
12. **Describe** the four major tax reform bills enacted since 1980.
13. **List** the advantages and disadvantages of a VAT.

Chapter 9 Assessment and Activities

14. **Identify** the income group that will receive the most benefit under a flat tax.
15. **Explain** why future tax reforms are inevitable.

Thinking Critically

1. **Synthesizing Information** 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.
2. **Making Comparisons** Distinguish between the benefit and the ability-to-pay principles of taxation. Use a web like the one below to help you organize your answer.



Applying Economic Concepts

1. **User Fees** In your own words, prepare the rationale for a user fee that you think should be enacted.
2. **Sales 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?
3. **Flat Taxes** Evaluate the concept of a flat income tax using the three criteria for effective taxes. Write a brief summary of your support or opposition to such a proposal.

Math Practice

After deductions and exemptions, Mindy's unmarried brother had taxable income of $87,000 in 1999. According to the tax table in **Figure 9.5,** what will he owe in federal income taxes? What did he pay in Social Security taxes? What did he pay in medicare taxes?

Thinking Like an Economist

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

Technology Skill

Using a Database For one week, keep a journal of all taxes you hear about on television or read about in the newspaper. Classify your journal entries into three categories: Federal, State, and Local taxes.

Create a database that has a record for each of the articles you used to find your information. Each record should have a separate field for the following: Title; Author; Year of publication; Tax category (Federal, State, Local); Criteria of taxation (equity, simplicity, efficiency).

Using your computer's software, sort the records by tax category (Federal, State, Local). Create a hard copy of this report. Share your database with the rest of the class.

Building Skills

Classifying Information Make a list of five taxes, charges, or user fees that you pay in your community. Draw a matrix like the one below and classify each of your five taxes in the appropriate place.

	Ability-to-Pay Principle	Benefit Principle
Regressive		
Proportional		
Progressive		

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