CHAPTER

14

Government Revenue and Spending

CONCEPT REVIEW

A **modified free enterprise economy** is an economic system, like that of the United States, that includes some government involvement that influences the free enterprise system.

CHAPTER 14 KEY CONCEPT

A **tax** is a mandatory payment to a local, state, or national government, while **revenue** is government income from taxes and other nontax sources.

WHY THE CONCEPT MATTERS

Taxes are a part of your everyday life—from the income tax withheld from your paycheck to the sales tax you pay on the snack you bought at the sandwich shop. The revenues raised from these taxes fund programs that are familiar to you. For example, the highways you drive on, the police that protect you, and the parks that you use are all paid for by government revenues.

Online Highlights

More at ClassZone.com

Economics Update

Go to **ECONOMICS UPDATE** for chapter updates and current news on sales taxes on Internet purchases. (See Case Study, pages 440–441.)

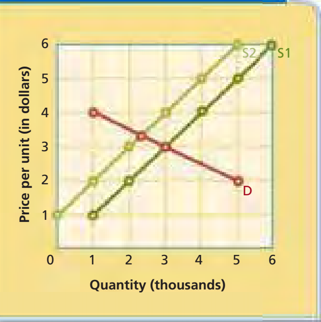
Animated Economics

Go to **ANIMATED ECONOMICS** for interactive lessons on the graphs and tables in this chapter. ▶

Interactive Review

Go to **INTERACTIVE REVIEW** for concept review and activities.

FIGURE 14.3 SHIFTING TAX INCIDENCE



Who pays more of a tax—the consumer or the producer? See Figures 14.3 and 14.4 on page 415.

SECTION 1

How Taxes Work

OBJECTIVES

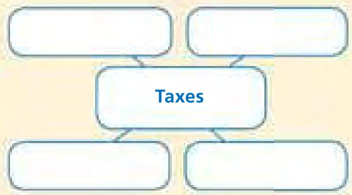
In Section 1, you will
- explain why the government establishes taxes
- identify the principles and structure of taxes
- examine the incidence of taxes
- describe how taxes affect the economy

KEY TERMS

tax, *p. 410*
revenue, *p. 410*
tax base, *p. 412*
individual income tax, *p. 412*
corporate income tax, *p. 412*
sales tax, *p. 412*
property tax, *p. 412*
proportional tax, *p. 412*
progressive tax, *p. 412*
regressive tax, *p. 412*
incidence of a tax, *p. 415*
tax incentive, *p. 417*

TAKING NOTES

As you read Section 1, complete a cluster diagram, using the key concepts and other helpful words and phrases. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



Government Revenue

QUICK REFERENCE

A **tax** is a mandatory payment to a government.

Revenue is government income from taxes and other sources.

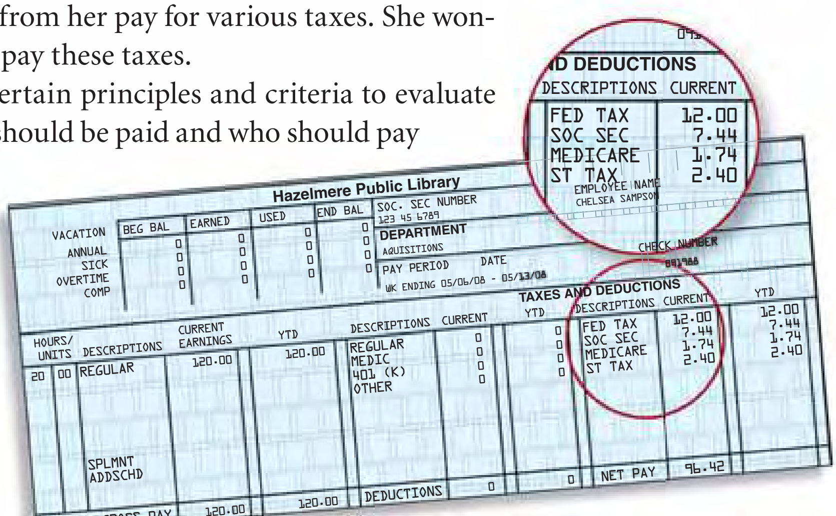
KEY CONCEPTS

Governments provide certain public goods that generally are not provided by the market, such as street lighting, highways, law enforcement, and the court system. Government also provides aid for people in need. Where does the money come from to pay for such goods and services? The most important source is taxes. A **tax** is a mandatory payment to a local, state, or national government. **Revenue** is government income from taxes and nontax sources. Nontax sources include borrowing and lotteries. The rights of government to tax are set down in the U.S. Constitution and in state constitutions.

Principles of Taxation

When Chelsea started her 20-hour-per-week job at the local library, she expected to receive $120 in her weekly paycheck. However, she was surprised to see that some money was deducted from her pay for various taxes. She wondered why she had to pay these taxes.

Economists use certain principles and criteria to evaluate whether or not taxes should be paid and who should pay them. These principles most often are based on the benefits taxpayers receive from taxes and their ability to pay.



Benefits-Received Principle The benefits-received principle of taxation holds that people who benefit directly from public goods should pay for them in proportion to the amount of benefits received. One example of this principle is the financing of road construction and maintenance through taxes on gasoline. However, it is difficult for governments to assess exactly how much different taxpayers benefit from services like national defense, national parks, local police and fire protection, and public education.

Ability-to-Pay Principle The ability-to-pay principle of taxation holds that people should be taxed on their ability to pay, no matter the level of benefits they receive. According to this principle, people with higher incomes will pay more than people with lower incomes. The level of benefits received is not a consideration. Yet, income alone might not completely determine someone's ability to pay taxes. Other questions also arise. For example, should everyone pay the same percentage of income, which still results in wealthier people paying more in taxes, or should those with higher incomes pay a higher percentage of their income in taxes?

Criteria for Taxation

Tax systems attempt to meet three criteria: equity, simplicity, and efficiency. However, the criteria are sometimes in conflict, and a given tax may not meet all of the criteria equally well.

Simplicity One criticism of the U. S. tax code is that it is too complicated.

Equity The equity, or fairness, of a tax is established by how uniformly the tax is applied. Equity requires that people in similar situations pay a similar amount of taxes. For example, everyone who buys gasoline pays the same tax, or all people with the same level of income pay the same amount in taxes. In addition, some believe that equity requires that people with higher incomes pay more than people with lower incomes.

Simplicity The simplicity of a tax is determined by how easy it is for the taxpayer to understand and how easy it is for the government to collect. In addition, there should be no confusion about the time the tax is due and the amount to be paid. The sales tax, which you'll read about on the next page, meets the criterion of simplicity. A set percentage of the price of a taxed item is collected every time that item is purchased.

Efficiency The efficiency of a tax can be judged by how well the tax achieves the goal of raising revenue for the government with the least cost in terms of administration. From the taxpayers' viewpoint, tax efficiency can be judged by the amount of effort and expense it takes to pay the tax. Of all the types of taxes levied, the individual income tax—which you'll learn more about on the next page—best meets the criterion of efficiency.

Economics Update
Find an update on taxation at **ClassZone.com**

APPLICATION Drawing Conclusions

A. Businesses and homeowners both benefit from police protection. How does this statement show the limitations of the benefits-received principle of taxation?

Tax Bases and Structures

KEY CONCEPTS

Government imposes taxes on various forms of income and wealth in order to raise the revenue to provide public goods and various other services. Each type of wealth subject to taxes is called a **tax base.** The four most common tax bases are individual income, corporate income, sales, and property.

QUICK REFERENCE

A **tax base** is a form of wealth—such as income, property, goods, or services—that is subject to taxes.

Individual income tax is based on an individual's income from all sources.

Corporate income tax is based on a corporation's profits.

Sales tax is based on the value of goods or services at the time of sale.

Property tax is based on the value of an individual's or a business's assets.

A **proportional tax** takes the same percentage of income from all taxpayers.

A **progressive tax** places a higher percentage rate of taxation on high-income people.

A **regressive tax** takes a larger percentage of income from low-income people.

Tax Bases

Individual income tax is a tax based on an individual's income from all sources: wages, interest, dividends, and tips. All taxes are ultimately paid from income, but using income as a tax base means that the amount of tax is directly linked to a person's earnings. For most individuals, income is earned mainly from work in the form of wages or tips. It may also come from savings and investment in the form of interest and dividends. Corporations pay income tax too. **Corporate income tax** is a tax based on a corporation's profits.

Sales tax is a tax based on the value of designated goods or services at the time of sale. Generally, sales taxes are imposed on a wide range of goods and services. The tax usually is a percentage of the posted price of the good or service and is included in the final price that the buyer pays. The seller then passes the tax revenue collected from customers on to the government that has imposed the tax.

Property tax is a tax based on the value of an individual's or business's assets, generally real estate. Homeowners and business owners pay property taxes based on the value of their buildings and the land on which the buildings stand. Property tax is generally included in the rents charged by property owners to individuals or businesses that rent the property, whether it is an apartment, an office, a factory, or a retail store. Property tax may also be imposed on other assets such as automobiles.

You may have heard references to a particular government's tax base growing or shrinking. Such statements refer to the amount of wealth that is available to be taxed. If overall personal income rises, the individual income tax base grows. If there are fewer homes or businesses in a certain locality or if their value declines, the property tax base shrinks because there is less wealth for the government to tax.

Tax Structures

The way in which taxes are imposed on the different tax bases gives rise to three different tax structures. These tax structures are distinguished from one another based on the percentage of income that a particular tax takes. A **proportional tax** takes the same percentage of income from all taxpayers regardless of income level. A **progressive tax** places a higher percentage rate of taxation on high-income earners than on low-income earners. A **regressive tax** takes a larger percentage of income from people with low incomes than from people with high incomes.

Proportional Tax A proportional tax is sometimes called a flat tax, because the rate of tax is the same for all taxpayers. For example, all taxpayers in a given country or state might be charged a flat 15 percent tax on their income, no matter how much

MATH CHALLENGE

FIGURE 14.1 Understanding a Progressive Tax

Step 1: Study the table to the right, which shows income tax brackets for a progressive tax. Each marginal tax rate is applied only to the income in that tax bracket. For example, for a taxable income of $12,000, $10,000 is taxed at 10 percent and the remaining $2,000 is taxed at 15 percent.

Income Bracket	Marginal Tax Rate
$0–$10,000	10%
$10,000–$30,000	15%
$30,000–$50,000	25%

Step 2: Assume you have a taxable income of $40,000. The table to the right shows how much of that income is in each tax bracket.

Income in Each Bracket	Tax Bracket
$10,000	10%
$20,000	15%
$10,000	25%

Step 3: Calculate the marginal tax for the income in each bracket. Add these figures to get the total tax for a taxable of income of $40,000. The total tax on $40,000 of taxable income is $6,500.

Income in bracket	×	Marginal tax rate	=	Marginal tax
$10,000	×	10%	=	$1,000
$20,000	×	15%	=	$3,000
$10,000	×	25%	=	$2,500
				Total tax: $6,500

More Calculations Repeat calculations for taxable incomes of $25,000 and $45,000.

NEED HELP?

Math Handbook, "Understanding Progressive Taxes," page R7

their income is. An individual who earns $20,000 would pay $3,000 in taxes, and an individual who earns $50,000 would pay $7,500 in taxes. In the United States, some state and local governments have proportional taxes on individual income. For example, the state of Michigan has a flat income tax rate of 3.9 percent, while the state of Massachusetts has a 5.3 percent rate. Similarly, the city of Bowling Green, Ohio, collects a flat rate of 1.92 percent on its residents' incomes.

Progressive Tax As you saw above, even with a proportional tax, the amount of tax increases as income increases. A progressive tax is one in which the tax rate also increases as a person's income increases. In other words, under a progressive tax structure, a high-income person not only pays more in the amount of taxes but also pays a higher percentage of income in taxes. Figure 14.1 shows how a progressive income tax works. You can see that a progressive tax is most closely linked to the ability-to-pay principle.

In the United States, the federal income tax is a progressive tax, because the tax rate increases as income increases. (You'll learn more about the federal income tax in Section 2.) Many states, including California, Kansas, New York, and South Carolina, also have progressive income taxes.

ECONOMICS ESSENTIALS

FIGURE 14.2 Three Types of Tax Structures

What is the impact of each of the tax structures?

Proportional Tax
A proportional tax takes the same percentage of income from all taxpayers, regardless of income level.

Progressive Tax A progressive tax is based on income level. It takes a larger percentage of income from high-income earners and a smaller percentage of income from low-income earners.

Regressive Tax
A regressive tax hits low-income earners harder than it hits high-income earners. This is because the proportion of income that goes to taxes falls as income rises.

ANALYZE CHARTS

Look again at the description of the various tax bases on page 412. Consider which kind of tax structure applies to each of these tax bases. Write a brief paragraph explaining your choices.

Regressive Tax With a regressive tax, the percentage of income paid in taxes decreases as income increases. Some taxes are regressive because they are applied to sales, not income. For example, although a sales-tax rate is applied equally to all items subject to the tax, the tax as a percentage of income is regressive. This is because low-income earners tend to spend a higher proportion of income than do high-income earners. Suppose that a state charges 5 percent sales tax on certain goods sold in the state. If the Jones family earns $20,000 and spends $15,000 on taxable goods, they pay $750 in sales taxes (5 percent of $15,000), or 3.75 percent of their income. If the Smith family earns $50,000 and spends $25,000 on taxable goods, they pay $1,250 in sales tax (5 percent of $25,000), or 2.5 percent of their income.

For similar reasons, property taxes on homes are also considered regressive. Low-income homeowners usually spend a higher percentage of their income on housing than do high-income homeowners. Therefore, property taxes take a higher percentage of their income. In addition, poorer communities often charge a higher tax rate, because the property has a lower value and therefore the property tax base is smaller. Even those who do not own homes are subject to the regressive property tax, because property taxes are generally passed on to renters. Figure 14.2 above shows the impact of each type of tax structure on low-income earners and high-income earners.

APPLICATION Comparing and Contrasting

B. How do proportional, progressive, and regressive taxes meet the criteria of simplicity and equity?

Who Pays the Tax?

KEY CONCEPTS

The impact of a tax can also be measured by who actually pays it. The **incidence of a tax** is the final burden of that tax. In other words, it is the impact of the tax on a taxpayer. For example, taxes imposed on businesses may get passed on to the consumer in the form of higher prices or rents. To understand this, you need to apply the concepts of supply and demand.

QUICK REFERENCE

The **incidence of a tax** is the final burden of the tax.

Effect of Elasticity on Taxes

Suppose that the government imposes a $1 tax on a product. Demand elasticity influences the incidence of this tax. If a product has elastic demand, the seller pays more of the tax, because the seller faces decreased quantity demanded if prices rise. If the product has inelastic demand, the consumer pays more of the tax in the form of higher prices. The seller recognizes that quantity demanded will go down only slightly for goods or services that have inelastic demand, because they are less price-sensitive. Figures 14.3 and 14.4 illustrate the difference in tax incidence between products with elastic and inelastic demand.

FIGURES 14.3 AND 14.4 SHIFTING TAX INCIDENCE

FIGURE 14.3 ELASTIC DEMAND AND TAXES

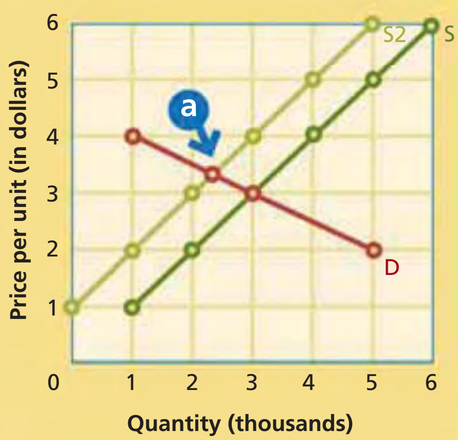


FIGURE 14.4 INELASTIC DEMAND AND TAXES

When a $1 tax is imposed, the supply curve (S1) shifts to the left (S2) by the amount of the tax.

- **a** In Figure 14.3, the equilibrium price increases to $3.40, and the seller pays more of the tax.
- **b** In Figure 14.4, the equilibrium price rises to $3.80, and the consumer pays more of the tax.

ANALYZE GRAPHS

1. In Figure 14.3, how does quantity demanded at equilibrium change?
2. Which producer's revenues would be least affected by the $1 tax?

Animated Economics

Use interactive demand elasticity curves at **ClassZone.com**

APPLICATION Applying Economic Concepts

C. Who would bear the greater incidence of these taxes: a. $1 tax on movie tickets? b. $1 tax on gasoline? Give reasons for your answers.

Impact of Taxes on the Economy

KEY CONCEPTS

Taxes do more than provide government with the revenue that allows it to provide public goods and other programs. Taxes have an economic impact on resource allocation, productivity and growth, and the economic behavior of individuals and businesses. Government chooses what to tax and how to tax based on the amount of income it wants to raise and the other economic effects it wants to achieve.

IMPACT 1 Resource Allocation

A tax placed on a good or service will increase the costs of production and therefore shift the supply curve to the left. If the demand remains the same, the price of the good or service will go up. This shift will likely result in a shift in resources. Recall what you learned about tax incidence earlier. If a supplier is not able to pass increased costs along to the consumer in the form of higher prices, the supplier may choose to shift production to another good that will be more profitable.

For example, if the government imposed a 10 percent tax on luxury yachts, which have elastic demand, the producer of the yachts would not be able to raise prices enough to cover the full cost of the tax. If it were no longer profitable to sell the yachts because of the extra cost of the tax, the producer might decide to shift resources to producing small fishing boats or go into a different business.

IMPACT 2 Productivity and Growth

When taxes on interest and dividends are high, people tend to save less than when taxes on this source of income are low. Therefore, taxes also have an impact on the amount of money available to producers to invest in their businesses. Some economists also believe that high taxes reduce incentives to work. They suggest that people may spend more time on activities other than work if a large percentage of their income goes to taxes.

Other economists suggest that the underground economy is a result of high taxes. The underground economy refers to jobs, services, and business transactions conducted by word of mouth and, for the most part, paid for in cash to avoid paying taxes. For example, Bob has a part-time landscaping business. He works on the weekends, charges lower prices than larger landscaping companies, and insists that his customers pay him in cash. Since there are no records of Bob's business transactions, it is difficult for the government to tax his income.

Underground Economy Bob avoids paying taxes on his landscaping business by working on a cash-only basis.

IMPACT 3 Economic Behavior

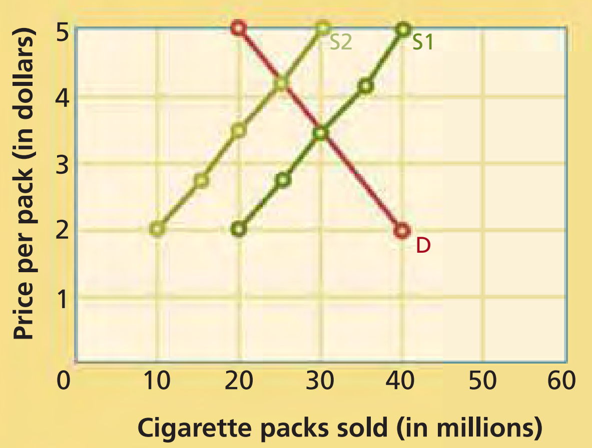
A **tax incentive** is the use of taxes to encourage or discourage certain economic behaviors. By providing tax credits or rebates, the government may encourage behavior that it believes is good for the economy and for society. For example, it may give tax rebates to businesses for opening new factories, offices, and stores in economically depressed areas. Or government may give tax credits to consumers for activities such as recycling or using energy more efficiently. The positive tax incentive with the widest impact is perhaps the home mortgage interest deduction, which is designed to encourage home ownership. (You'll learn more about tax deductions later in this chapter.)

So-called sin taxes are often imposed on products or activities considered to be unhealthful or damaging to society, such as gambling, alcohol, and cigarettes. These taxes are generally levied on products or activities for which there is relatively inelastic demand, so that the incidence of the tax will fall on the consumer. Yet because demand for such products is relatively inelastic, the government knows that decline in quantity demanded will not cause tax revenues to decrease dramatically. (Figure 14.5 shows how the quantity demanded of cigarettes changes when states enact higher cigarette taxes.) Demand for sin-tax products becomes somewhat more elastic as tax increases get steeper. For example, cigarette sales in Washington fell by nearly 19 percent in the year after the state imposed a 60-cents-per-pack tax increase in 2002. Even so, since the tax increase was so large, cigarette tax revenues went up by more than 40 percent.

QUICK REFERENCE

A **tax incentive** is the use of taxes to influence economic behavior.

FIGURE 14.5 THE EFFECT OF CIGARETTE TAXES ON QUANTITY DEMANDED



When a tax is imposed on cigarettes, the supply curve shifts to the left by the amount of the tax. On this graph, a 75-cent tax shifts the supply curve from $3.40 per pack to $4.15 per pack. The increased price results in less demand.

ANALYZE GRAPHS

1. How does the quantity demanded of cigarettes change when the price rises from $3.40 to $4.15 per pack?
2. How does this graph illustrate the concept of tax incentives?

APPLICATION Analyzing Effects

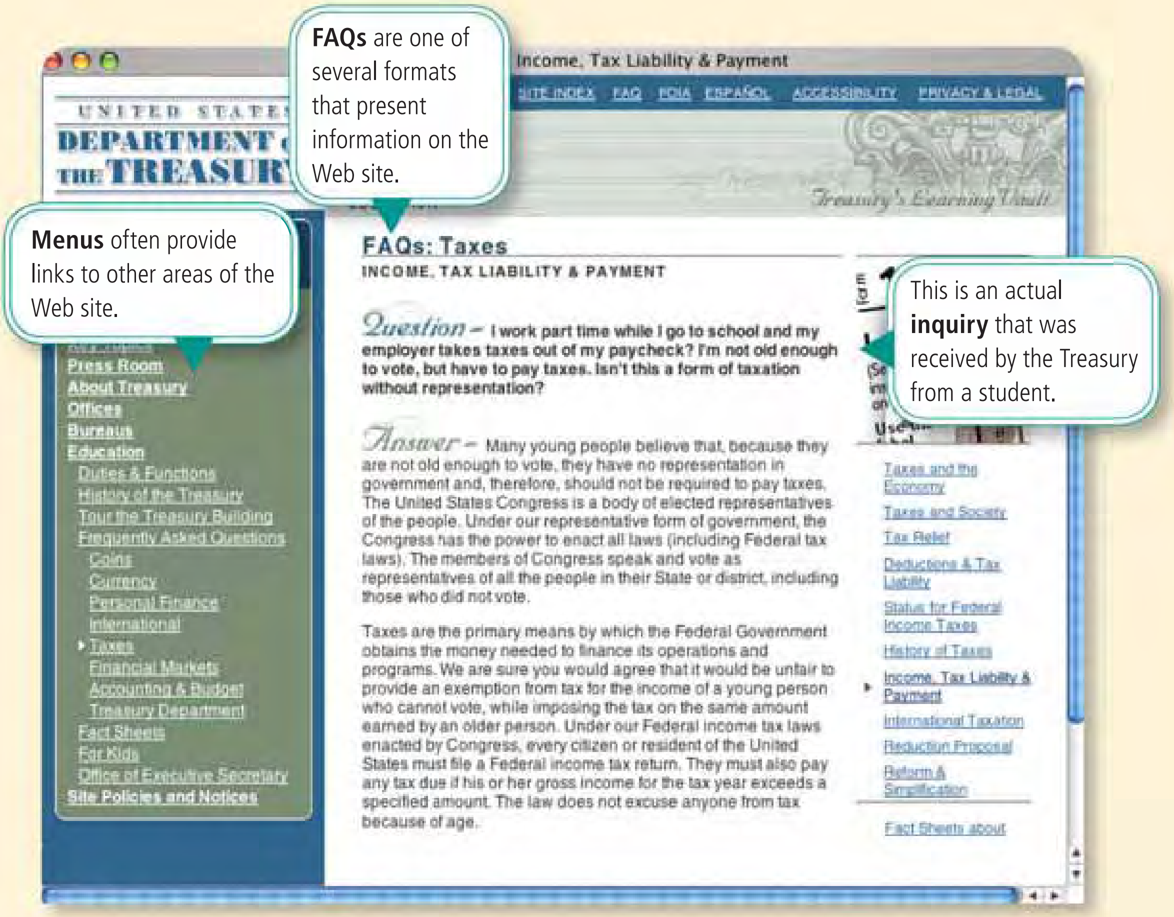
D. What effect does the underground economy have on government revenue?

For more information on evaluating sources, see the Skillbuilder Handbook, page R28.

Using the Internet for Research

The Internet is a powerful tool for researching information. The Web site of the U.S. Treasury Department, for example, provides information on government revenue and spending.

RESEARCHING ON THE INTERNET Below is an example of FAQs, or "frequently asked questions." Use the following tips to help you navigate this and similar Internet Web sites that you might use for research.



Source: U.S. Department of the Treasury

THINKING ECONOMICALLY Using the Internet

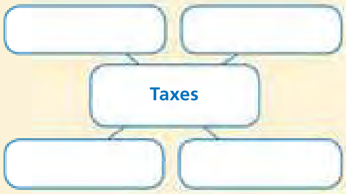
1. Why do you think the student used the phrase "taxation without representation"? (If you are unfamiliar with the phrase, use a search engine to research its origin.)
2. How might you navigate this page of the U. S. Department of the Treasury Web site to locate a press release on new tax legislation?
3. Access this Web site and use the FAQs to discover how the Treasury Department answers the question: Why do I have to pay taxes?

SECTION 1 Assessment

Online Quiz
ClassZone.com

REVIEWING KEY CONCEPTS

1. Explain the difference between the terms in each of these pairs.
   - **a.** *tax* / *revenue*
   - **b.** *sales tax* / *property tax*
   - **c.** *progressive tax* / *regressive tax*
2. Why do governments collect taxes?
3. What are the four most used tax bases?
4. How does demand elasticity influence the incidence of a tax?
5. What is the purpose of a tax incentive?
6. **Using Your Notes** What are the major criteria for a good tax system? Refer to your completed cluster diagram.



   Use the Graphic Organizer at **Interactive Review @ ClassZone.com**

CRITICAL THINKING

7. **Categorizing Economic Information** Colorado has a state income tax of 4.63 percent on all income and a sales tax of 2.9 percent. Are these taxes proportional, progressive, or regressive? Give reasons for your answers.
8. **Drawing Conclusions** In 2005, Hurricane Katrina destroyed many homes and businesses along the Gulf Coast of the United States. How did this natural disaster affect the tax bases in communities in that region?
9. **Analyzing Effects** Where does the burden of an increase in a sin tax usually fall? Illustrate your answer with supply and demand curves.
   Use SMARTGrapher @ ClassZone.com to complete this activity.
10. **Applying Economic Concepts** Demand for insulin is highly inelastic. Would the government be likely to use a tax on insulin as a tax incentive? Why or why not?
11. **Challenge** Pennsylvania and Illinois each have state income taxes of about 3 percent of income. In Illinois, the first $2,000 of individual income is exempt from taxation. Pennsylvania has no similar individual tax exemptions. Is one state's tax more progressive than the other? Why or why not? (You'll learn more about tax exemptions in Section 2.)

ECONOMICS IN PRACTICE

Driver's license

Evaluating Taxes

Review what you have learned about the principles and criteria used to evaluate the effectiveness of a tax, and then complete the following activities.

Draw Conclusions Evaluate the effectiveness of each tax listed in the chart below by indicating with a checkmark whether it meets each principle and criterion.

Tax	Principles		Criteria		
	Benefits received	Ability to pay	Equity	Simplicity	Efficiency
Fee for driver's license					
Sales tax					
Flat rate income tax					
Progressive income tax					
Highway tolls					
Property tax					
Corporate income tax					

Challenge How would you evaluate a tax to support public education that was imposed only on families with children?

SECTION 2

Federal Taxes

OBJECTIVES

In Section 2, you will

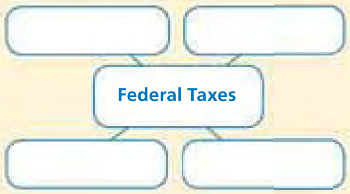
- describe the process of paying individual income taxes
- explain taxes for Social Security, Medicare, and unemployment
- identify other taxes that are collected by the federal government

KEY TERMS

withholding, *p. 421*
taxable income, *p. 421*
tax return, *p. 421*
FICA, *p. 423*
Social Security, *p. 423*
Medicare, *p. 423*
estate tax, *p. 425*
gift tax, *p. 425*
excise tax, *p. 425*
customs duty, *p. 425*
user fee, *p. 425*

TAKING NOTES

As you read Section 2, complete a cluster diagram using the key concepts and other helpful words and phrases. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



Individual Income Tax

KEY CONCEPTS

The federal government takes in around $2.5 trillion in revenue each year. This money comes from several sources, including individual income tax, social insurance taxes, corporate income taxes, estate taxes, gift taxes, excise taxes, and customs taxes. The largest source of taxes for the federal government is the individual income tax. (You can see the contribution of the various taxes to total revenue in Figure 14.8 on page 425.) The government began using the income tax after the Sixteenth Amendment to the U.S. Constitution, which recognized this type of direct taxation on individuals, was ratified in 1913. Prior to that time, excise taxes and customs duties were the main sources of federal revenue. (Figure 14.8 shows that today only a very small portion of federal tax revenue comes from excise taxes and customs duties.) Social insurance taxes are the second largest source of federal tax revenue. Workers and employers share the burden of these taxes.

EXAMPLE Paying Your Taxes

If taxpayers had to pay their income taxes in one lump sum at the end of each year, some people would have difficulty coming up with all the money at once. Also, receiving revenue just once a year would create problems for the government. Drawing up a budget for the year would be very difficult, and developing sound economic plans for the future would be almost

impossible. Therefore, to make it easier for taxpayers and the government, a payroll tax—a tax that is taken from a worker's paycheck—is collected. The payroll tax is deducted from a paycheck as **withholding**, or money taken from a worker's pay before the worker receives it.

To see how this works, let's look at the example of Scott, who works part-time during the school year and full-time during the summer at the Main Street Grocery Store. For every hour Scott works, he earns $6. Because of withholding for taxes, the amount he receives in his paycheck is less than the total amount he earns. In this way, he pays his taxes as he earns income, and the government receives a steady stream of revenue. The Main Street Grocery Store forwards the money withheld from Scott's paycheck to the Internal Revenue Service (IRS). The IRS is the government agency that collects the money for the federal government and administers the federal tax system.

The federal income tax is a progressive tax based on the ability-to-pay principle of taxation. This means that people with higher incomes not only pay more in total taxes but also pay a higher percentage of their income in taxes. The amount owed is based on **taxable income**, the portion of income subject to taxation. Under federal income tax laws, taxpayers may take certain exemptions and deductions from their total earned income to reduce the amount of their taxable income. Exemptions are allowed for each individual adult and child, so larger families reduce their taxable income by a greater amount than do smaller families. In addition, taxpayers may take a standard deduction or itemize deductions, such as interest paid on a home mortgage, state and local taxes, charitable contributions, and a certain portion of medical expenses. Figure 14.6 below provides information on some of the itemized deductions taken by taxpayers in 2004.

Each year, taxpayers must complete a **tax return**, a form used to report income and taxes owed to various levels of government. The federal tax return shows how much income has been earned, the exemptions being claimed, and how much tax has been paid through withholding. State and local tax returns show similar, but less detailed, information. Taxpayers who have too much tax withheld receive a refund for overpayment. Taxpayers who have not had enough withheld must then pay any additional taxes owed directly to the IRS or to state or local revenue departments.

QUICK REFERENCE

Withholding is money taken from pay before the worker receives it.

Taxable income is the portion of income subject to taxation.

A **tax return** is a form used to report income and taxes owed to government.

FIGURE 14.6 SELECTED ITEMIZED DEDUCTIONS ON INDIVIDUAL INCOME TAX RETURNS

Deduction	Number of Returns	Amount Claimed (in $)
Interest Paid	37,961,584	346.0 billion
State and Local Sales and Income Taxes	44,685,865	217.2 billion
Charitable Contributions	40,594,576	156.2 billion
Medical and Dental Expenses	9,458,443	61.3 billion

Source: Internal Revenue Service, 2004 figures

About 132.4 million individual income tax returns were filed in 2004. Some 46.2 million—or 35 percent—of these returns claimed itemized deductions to taxable income. Total itemized deductions equaled close to $972 billion, or just over $21,000 for each return.

ANALYZE GRAPHS

1. Which was the largest deduction taken in terms of the dollar amount claimed?
2. What percentage of total deductions taken in 2004 did state and local sales and income taxes represent?

EXAMPLE Indexing

Tax Return Checking your taxable income against the various tax brackets is an important step in completing your tax return.

Because the federal income tax is a progressive tax, the tax rate increases as taxable income increases. The level of income that causes someone to pay a higher rate of tax is the dividing point between tax brackets. The tax bracket is identified by the tax rate for that income span. For example, the tax schedule at the bottom of this page shows that in 2006 a single taxpayer with $7,550 or less in taxable income is in the 10 percent tax bracket. Someone with taxable income between $7,550 and $30,650 is in the 15 percent tax bracket, someone with taxable income between $30,650 and $74,200 would be in the 25 percent bracket, and so on.

Look again at the tax schedule below. Suppose that Scott has $7,000 in taxable income. He is in the 10 percent bracket and pays 10 percent, or $700, in taxes. If, however, he had $8,000 in taxable income, he would be in the 15 percent tax bracket. He would pay 10 percent on the first $7,550 of his earnings and 15 percent on the remaining $450. His total taxes would be $822.50 ($755 + $67.50) or about 10.3 percent of his income.

Indexing is a revision of tax brackets to prevent workers from paying more taxes due to inflation. For example, suppose Scott's taxable income rises from $8,000 to $8,320—a 4 percent increase—due to inflation. Without indexing, $770 of his income is taxed at the 15 percent rate and he pays $870.50 in taxes, or about 10.5 percent of his income. With indexing, the beginning level of the 15 percent bracket is adjusted by 4 percent to $7, 852. So Scott continues to pay 10.3 percent of his income in taxes. Indexing, therefore, combats the effect of inflation and keeps the rate of taxation relatively constant.

Economics Update

Find an update on tax schedules at **ClassZone.com**

2006 Tax Rates: Schedule X—Single

If your 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	**$15,108 plus 28% of the amount over $74,200**
154,800	336,550	**$37,676 plus 33% of the amount over $154,800**
336,550	No limit	**$97,653 plus 35% of the amount over $336,550**

APPLICATION Analyzing Effects

A. How much of Scott's income of $8,320 would be taxed at 15 percent if the 10 percent tax bracket were indexed and increased to $7,780? What effect would this have on his overall tax rate?

FICA: Taxes to Ease Hardships

KEY CONCEPTS

FICA is the Federal Insurance Contributions Act, a payroll tax that provides coverage for the elderly, the unemployed due to disability, and surviving family members of wage earners who have died. Also known as social insurance, FICA encompasses Social Security and Medicare. Both employees and employers make payments into FICA accounts.

Social Security **Social Security** is a federal program to aid older citizens who have retired, children who have lost a parent or both parents, and people with disabilities. The program began during the Great Depression of the 1930s as a way to help people who were in desperate need of economic assistance. The employer and employee each pay 6.2 percent of the employee's income up to an annual maximum. In 2006, Social Security tax was applied to $94,200 of earned income. The limit generally rises each year.

Medicare Introduced in 1966, **Medicare** is a national health insurance program for citizens over 65 and certain other groups of people. Employers and employees each pay 1.45 percent of employee income. There is no limit on the amount of income subject to the tax for Medicare.

Unemployment Taxes Unemployment compensation is a program funded by federal and state taxes and administered by the states. It provides benefits for a certain period of time to employees who lose their jobs through no fault of their own. Unemployment tax applies to the first $7,000 earned by an employee and, for the most part, is paid only by employers.

QUICK REFERENCE

FICA is the Federal Insurance Contributions Act.

Social Security is a federal program to aid older citizens, children who have lost a parent, and the disabled.

Medicare is a national health insurance program mainly for citizens over 65.

Source: www.CartoonStock.com

FICA Accounts As the American population ages, fears are growing that there will not be enough workers to fund FICA.

APPLICATION Applying Economic Concepts

B. How would the employee portion of total FICA taxes for an individual earning $100,000 be split between Social Security and Medicare? Show your calculations.

Corporate Income and Other Taxes

KEY CONCEPTS

The federal government collects more than individual income and FICA taxes. It also uses corporate income, estate, gift, and excise taxes, as well as customs duties and user fees, to finance its operations.

Corporate Income Taxes

As you recall from earlier in this chapter, corporate income tax is tax on corporate profits. This tax is the third largest source of tax revenue for the federal government. Between 1941 and 1968, corporate income tax was the second largest source of revenue. Since that time, however, it has been surpassed by social insurance taxes. As Figure 14.7 shows, corporate income tax receipts have increased in total dollars since the mid-1900s, but have decreased relative both to total federal tax revenues and to the overall size of the economy.

Only certain types of corporations are subject to corporate income tax. These corporations are about 8 percent of all businesses that file tax returns. While the tax rate for most corporations is 35 percent of profits, most pay only about 26 percent of their profits in taxes. Like individuals, corporations can deduct certain expenses from their profits to reduce their taxable income. Some of the most important tax breaks for corporations include deductions for investment in buildings, equipment, and research, and rules that benefit multinational corporations.

A common criticism of the corporate income tax is that corporate profits are subject to double taxation. Profits are taxed at the corporate level and again at the individual level, since shareholders pay taxes on the income they receive in the form of dividends or capital gains. In recent years, the tax rate on capital gains has decreased in answer to this criticism.

FIGURE 14.7 CORPORATE INCOME TAX RECEIPTS, 1950–2009

	Receipts (in millions of $)	As Percentage of Total Federal Tax Revenue	As Percentage of GDP
1950–59	185,406	27.5	4.8
1960–69	262,891	21.3	3.8
1970–79	437,564	15.0	2.7
1980–89	675,358	9.3	1.7
1990–99	1,434,246	10.5	1.9
2000–09*	2,189,162	10.0	1.8

Source: The Budget of the United States, FY 2007

*Reflects government budget estimates for 2006–2009

ANALYZE GRAPHS

1. What overall trend is shown in the chart?
2. Which decade diverges from this overall trend? How does it differ from the overall trend?

Other Taxes

Several miscellaneous taxes provide a small part of total federal revenue, as you can see in Figure 14.8 below. The **estate tax** is a tax on property that is transferred to others on the death of the owner. Most estates are not subject to this tax, because the government only taxes large estates. In 2006, estates valued at less than $2 million were not subject to this tax. The **gift tax** is a tax on money or property given by one living person to another. As with the estate tax, there are exemptions to the gifts that are subject to the tax. For the most part, these exemptions allow family members to give money to other family members tax-free.

The **excise tax** is a tax on the production or sale of a specific product, such as gasoline or telephone service. The sin taxes discussed earlier in this chapter are other examples of excise taxes. In general, the government places excise taxes on goods or services for which there is relatively inelastic demand in order to maintain a steady stream of revenue. The **customs duty** is a tax on goods imported into the United States from another country. Customs duties are basically excise taxes on imports and are also known as tariffs. (You'll read more about tariffs in Chapter 17.)

The **user fee** is money charged for the use of a good or service. These fees are based on the benefits-received principle of taxation. For example, the federal government charges entrance, parking, and camping fees to visitors to national parks. So the people enjoying the parks the most pay for the benefits provided by the parks.

QUICK REFERENCE

The **estate tax** is a tax on property transferred to others on the death of the owner.

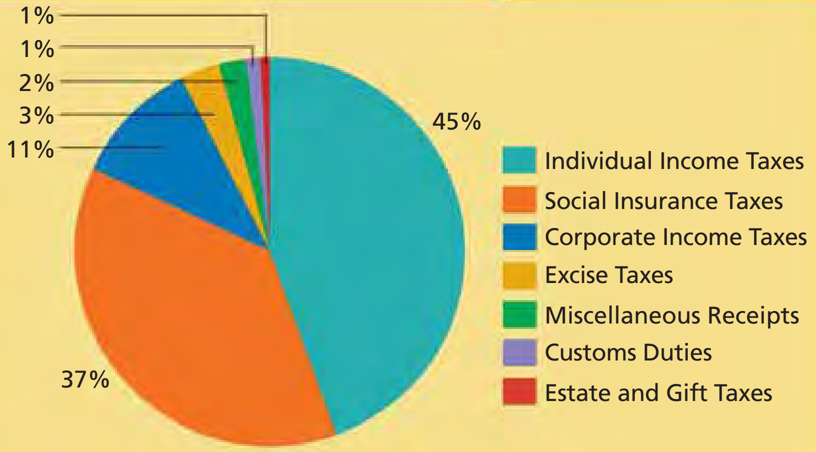
The **gift tax** is a tax on assets given by one living person to another.

The **excise tax** is a tax on the production or sale of a specific good or service.

Customs duty is a tax on goods imported into the United States.

A **user fee** is money charged for the use of a good or service.

FIGURE 14.8 SOURCES OF FEDERAL TAX REVENUE



Source: Budget of the United States Government, estimated figures for 2007

Individual income taxes account for almost half of federal tax revenue.

Corporate income taxes contribute about one-fourth the revenue of individual income taxes

ANALYZE GRAPHS

1. What percentage of federal tax revenue comes from individual income taxes and social insurance taxes combined?
2. If total tax revenue for 2007 is estimated to be about $2.35 trillion, about how much revenue will come from individual income taxes?

APPLICATION Drawing Conclusions

C. There are plans to eliminate the estate tax. Who will benefit most from this?

ECONOMICS PACESETTER

Maya MacGuineas: Reforming the Tax System

For the most part, tax reform measures of the last few years have involved tinkering with tax rates, exemptions, and deductions. Maya MacGuineas, a tax policy analyst, thinks that it's time for far more dramatic change—a complete overhaul of the U.S. tax system, in fact.

A Tax Revolution?

Why does MacGuineas think that such drastic action is needed? The present tax system, she says, is complicated, inefficient, and unfair, and doesn't raise the revenue to fund all of the government's programs. The new tax system, she argues, ought to be based on simplicity, efficiency, equity, and responsible budgeting.

To this end, MacGuineas suggests that the income tax should be simplified by ending most tax deductions and exemptions. This, she says, would also make the system more equitable, since taxpayers in higher marginal tax brackets gain the greatest benefit from these measures. In part for reasons of efficiency, MacGuineas believes that the corporate income tax should be phased out. She also supports new environmental taxes, a different approach to how the estate tax is levied, and a complete restructuring of the nation's entitlement programs.

Perhaps MacGuineas's most revolutionary measure involves FICA taxes, which she thinks should be replaced with a progressive consumption tax. Such a tax would be tied to total spending rather than income, with rates rising as spending levels rise. For example, the first \$20,000 spent would be tax-free, spending between \$20,000 and \$50,000 would be taxed at 10 percent, spending between \$50,000 and \$175,000 would be taxed at 15 percent, and so on. In other words, people who spend more would face progressively higher marginal tax rates. A progressive consumption tax would not only be simpler and fairer, MacGuineas argues, it would also provide tremendous incentives to save.

Tax Reform Maya MacGuineas wants to make the tax system more equitable and less complex.

FAST FACTS

Maya MacGuineas

Title: President, Committee for a Responsible Federal Budget: Program Director, New American Foundation

Born: February 21, 1968

Previous Positions Held: Senior Research Analyst, Brookings Institution; Policy Analyst, Concord Coalition; Researcher, PaineWebber

Board Memberships: Common Cause (government watchdog group); Centrists.Org and Third Millennium (nonpartisan policy think tanks)

Publications: Articles published in *Atlantic Monthly, Boston Globe, New York Times, Washington Post, Los Angeles Times, Financial Times*

Economics Update

Find an update on Maya MacGuineas at **ClassZone.com**

APPLICATION Making Inferences

D. Should spending on education and housing be exempt from MacGuineas's consumption tax? Why or why not?

SECTION 2 Assessment

Online Quiz
ClassZone.com

REVIEWING KEY CONCEPTS

1. Explain the relationship between the terms in each of these pairs.

   a. *taxable income*
   tax return

   b. *FICA*
   Social Security

   c. *estate tax*
   gift tax

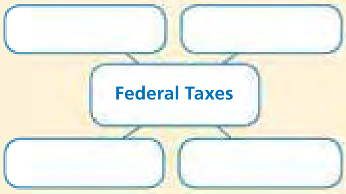
2. Why is indexing important to taxpayers?

3. What is the role of the IRS in relationship to federal taxes?

4. How are excise taxes and customs duties similar? How are they different?

5. How are payroll taxes and user fees different?

6. **Using Your Notes** What two programs are financed by FICA? Refer to your completed cluster diagram. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



CRITICAL THINKING

7. **Analyzing and Interpreting Data** In 2005, the 10 percent tax bracket limit was $7,300. In 2006, it increased to $7,550. By what percentage did the tax bracket limit increase? How does this example illustrate the concept of indexing?

8. **Applying Economic Concepts** The Social Security tax rate for employees is 6.2 percent, and the Medicare tax rate is 1.45 percent. Are both parts of the FICA tax proportional? Give reasons for your answer.

9. **Drawing Conclusions** Study these two statements about tax payments for the 2005 tax year:

   - On average, an individual with $100,000 in taxable income paid about 29.5 percent in combined income and FICA taxes.
   - On average, an individual with $150,000 in taxable income also paid about 29.5 percent in combined taxes.

   Why were the combined tax rates the same for these two taxpayers?

10. **Challenge** Review the data in Figure 14.7. As a share of federal tax revenue and as a share of GDP, by what percentage have corporate income taxes declined between the 1950s and the first decade of the 21st century?

ECONOMICS IN PRACTICE

Analyzing Tax Schedules

The IRS provides tax schedules, or tables, to help taxpayers calculate their taxes.

Calculate Taxes Suppose that you work for a tax preparation company. Use the tax schedule on page 422 to answer the questions about the taxpayers described below.

a. Chris has $8,500 in taxable income. What is her tax bracket, how much tax does she pay, and what is her actual tax rate?

b. Miguel earned $35,000 in taxable income this year. How much more does he pay in taxes than if he had earned $30,000?

c. Meredith had $125,000 in taxable income and had $30,000 in taxes withheld. Will she receive a refund or owe money? How much?

Challenge Calculate the FICA taxes and tax rates for each of the above taxpayers.

SECTION 3

Federal Government Spending

OBJECTIVES

In Section 3, you will

- compare the two types of government expenditures
- explain how the federal budget is developed
- describe how government payments are made
- identify the impact that federal spending has on the economy

KEY TERMS

mandatory spending, *p. 428*
discretionary spending, *p. 428*
entitlements, *p. 428*
Medicaid, *p. 429*
federal budget, *p. 431*
fiscal year, *p. 431*
appropriations, *p. 431*
transfer payments, *p. 432*
grant-in-aid, *p. 432*
private sector, *p. 432*

TAKING NOTES

As you read Section 3, complete a hierarchy diagram to track main ideas and details. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**

Federal Spending

main idea	main idea
details	details

Federal Expenditures

KEY CONCEPTS

As you have seen, the federal government takes in a huge amount of money in taxes. The programs and services the federal government funds with this revenue are divided into two categories. These are **mandatory spending**, or spending that is required by current law, and **discretionary spending**, or spending that the government must authorize each year. For example, the law requires that the government spend money to fund the Social Security and Medicare programs. However, the federal government can decide to fund or not fund highway construction or maintenance of national parks. The federal government, then, has certain expenses that must be paid under current law, while other expenses are covered with what is left after those required expenses have been met.

QUICK REFERENCE

Mandatory spending is required by law.

Discretionary spending has to be authorized each year.

Entitlements are social welfare programs with specific requirements.

TYPE 1 Mandatory Spending

Mandatory spending makes up well over half of all federal spending. Most of this spending is in the form of **entitlements**, which are social welfare programs with specific requirements. Social Security and Medicare are entitlement programs that provide payments to anyone who is eligible based on age or disability. Many

Medicare About 42 million Americans are enrolled in the Medicare program.

of these programs are not "means tested." In other words, anyone who meets the eligibility requirements receives the benefits, regardless of income level. For some other programs, however, income level is part of the requirement.

Social Security The Social Security program takes the largest amount of federal spending. It provides benefits to older retired workers, disabled workers with limited incomes, and survivors of workers who have died. Social Security is financed through a payroll tax. Therefore, workers must have worked for a certain period of time before they are eligible to receive full benefits under the program.

As the population of the United States has gotten older and more people have retired, costs for Social Security have increased. To help control costs, the government has gradually raised the age of full retirement—the point at which a worker is eligible to receive maximum benefits. Full retirement age ranges from 65 to 67, depending on the person's year of birth. Retirement benefits are not means tested. However, if retirees have additional income, benefits may be subject to withholding. For example, in 2006 retirees could earn $1,040 a month and still receive full Social Security benefits. However, retirees who earned more than this amount had their benefits reduced by $1 for every $3 over the income limit.

Economics Update

Find an update on Social Security at **ClassZone.com**

Medicare The Medicare program was introduced in 1966 as an additional old-age benefit under Social Security. Originally, Medicare provided hospital insurance, funded by a payroll tax, for people over 65, as well as optional medical coverage for items such as doctor bills. This part of Medicare is funded by premiums paid by those choosing the coverage and by general tax revenues.

Because of increasing numbers of retirees and increasing health care costs, Medicare costs have risen dramatically since the program began. Beginning in 2006, reforms to the program required Medicare to compete with private health insurance providers. Means testing was added for all but the lowest-income group of senior citizens. In addition, some coverage was added for prescription drugs.

QUICK REFERENCE

Medicaid is a government medical insurance program for low-income people.

Medicaid Established at the same time as Medicare, **Medicaid** is a joint federal-state medical insurance program for low-income people. The federal government funds about 63 percent of the costs of the program, and the states pay about 37 percent. In recent years, states have tightened their eligibility requirements for Medicaid in an effort to control costs.

Other Mandatory Spending Programs There are a variety of other mandatory spending programs that define eligibility requirements and are then funded based on an estimate of how many people meet those requirements. The Food Stamp program provides funds for about 26 million low-income people to purchase food. Veterans' benefits include health care coverage and disability payments for service-related illness or injury. People who have served in the military are also eligible for education assistance. The federal government spends about $50 billion a year on veterans' benefits.

Payments for the federal portion of unemployment insurance are also part of mandatory spending. In addition, the federal government pays its workers some retirement benefits. Federal employees hired after 1983 are also eligible for some Social Security retirement benefits.

Services for Veterans The Veterans Administration serves the needs and represents the interests of some 26 million veterans and their dependents.

TYPE 2 Discretionary Spending

More than one-third of federal revenue is devoted to discretionary spending. The programs covered by discretionary spending fall into several different categories. These categories include

- interstate highway system and transportation programs, such as Amtrak;
- natural resources and the environment, including conservation programs, pollution clean-up, and national parks;
- education, most notably college tuition assistance;
- science, space, technology, and other research programs;
- justice administration, including enforcement agencies, such as the Federal Bureau of Investigation (FBI), and the federal court system.

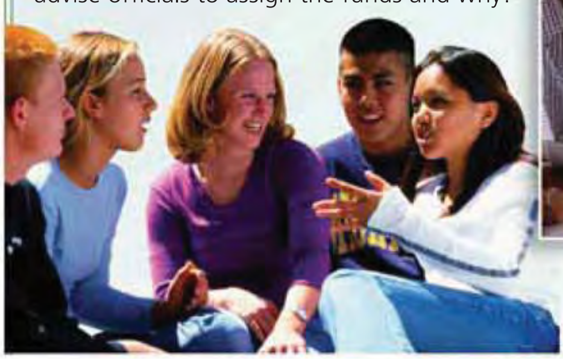
The largest discretionary expenditure category, however, is national defense, which takes up about 50 percent of the total discretionary budget. National defense includes a large amount of the nation's military spending, including the salaries of military personnel, weapons, and the construction and maintenance of military bases. Not all national defense spending is discretionary. Some spending on homeland security—border protection and the enforcement of some immigration laws, for example—falls in the mandatory expenditures category. In addition, certain military spending, such as additional funding requests for the wars in Iraq and Afghanistan, is outside the basic federal budget.

YOUR ECONOMIC CHOICES

DISCRETIONARY SPENDING

How will you assign discretionary spending funds?

Two programs are competing for $100 million in discretionary funds—an initiative to improve math and science education in high schools and a research project to test new developments in toy safety. How will you advise officials to assign the funds and why?



Math class

Safer toys

APPLICATION Categorizing Economic Information

A. Categorize the following items as either mandatory spending or discretionary spending: AIDS prevention programs, air traffic regulation, medical coverage for low-income people, pollution control, retirement benefits for older workers.

The Federal Budget and Spending

KEY CONCEPTS

Each year the President and Congress work together to establish the **federal budget**, a plan for spending federal tax money. The budget is prepared for a **fiscal year**, a 12-month period for which an organization plans its expenditures. The federal government's fiscal year runs from October 1 through September 30. The President's budget is prepared by the Office of Management and Budget (OMB) and takes into account estimated tax receipts and requests by all federal departments and agencies. Figure 14.9 shows the OMB budget estimate for fiscal year 2007.

QUICK REFERENCE

The **federal budget** is a plan for spending federal tax money.

A **fiscal year** is a 12-month period for which an organization plans its expenditures.

Appropriations are specific amounts of money set aside for specific purposes.

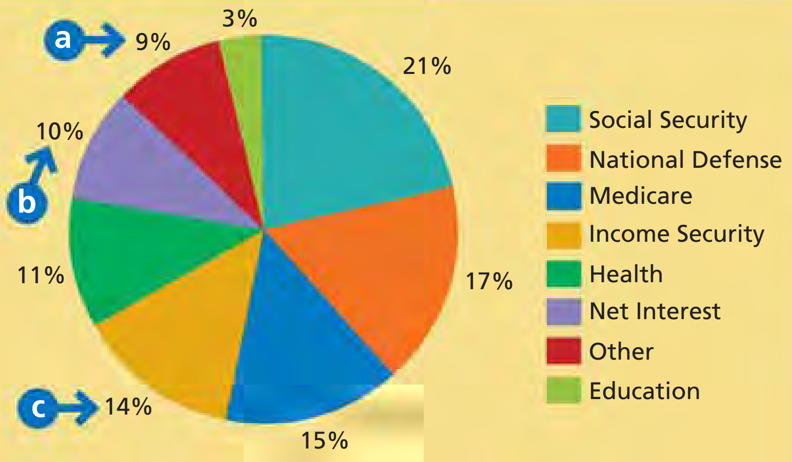
Congress Acts on the Budget

The Congressional Budget Office helps the House and Senate develop guidelines for different **appropriations**, which are set amounts of money set aside for specific purposes. Members of Congress often make deals to gain votes for appropriations that they support. Congress votes on the final budget and sends it to the president for approval. If the budget is not approved by the beginning of the new fiscal year, Congress passes resolutions to keep the government running on a day-to-day basis.

Methods of Federal Spending

After budget approval, the funds are spent in several ways. One way is direct spending, by which the government buys goods and services that it needs to operate, such as military equipment and office supplies. Paying the salaries of government

FIGURE 14.9 THE FEDERAL BUDGET



Source: The Budget of the United States, FY 2007

a This category includes spending for veterans' benefits, energy, the environment, transportation, and other government programs.

b Net interest is the interest that the federal government pays on loans it has taken out.

c Income security includes retirement for certain government employees and housing and food programs for low-income people.

ANALYZE GRAPHS

1. What is the largest category of spending in the federal budget?
2. Approximately how much of the federal budget goes to health and education?

QUICK REFERENCE

Transfer payments are money distributed to individuals who do not provide anything in return.

A **grant-in-aid** is a transfer payment from the federal government to state or local governments.

The **private sector** is the part of the economy owned by individuals or businesses.

employees is another type of direct spending. A second way the government spends the money is through **transfer payments**—money distributed to individuals who do not provide goods or services in return. A **grant-in-aid** is a transfer payment from the federal government to state or local governments.

Transfer Payments These payments are generally part of the mandatory spending you learned about earlier. For example, Social Security retirement or disability benefits and health care benefits from Medicare or veterans' programs are transfer payments from the government to individuals. The individuals do not provide specific goods or services in exchange for these government funds.

Grants-in–aid These grants are transfer payments between levels of government. The federal government makes grants to states, local governments, and regions. The grants are designated for specific categories of activities such as highway construction, certain school services, or Medicaid funding.

The Impact of Federal Spending

Because the federal government spends trillions of dollars, it is a big factor in the economy. The federal government influences the economy in three ways: resource allocation, income redistribution, and competition with the **private sector**, which is that part of the economy owned by individuals or businesses.

Resource Allocation The federal government makes choices concerning where to spend money and on what to spend it, and that influences how resources are allocated. For example, if money goes to urban transit, it cannot go to fix rural roads. Similarly, money spent on weapons systems for the military cannot be spent on some other program, such as environmental protection.

Income Redistribution Government spending affects the incomes of families, individuals, and businesses. Transfer payments for health care, retirement, and Food Stamp benefits, for example, provide income support for many low-income earners. How the government awards work contracts can also influence the distribution of income. For example, if the government awards a contract to build several submarines to a shipyard in the Northeast, workers there will be assured work and an income. However, workers at a California shipyard that failed to get the contract may lose their jobs. In turn, they will not have income to spend at local businesses.

Competition with the Private Sector The government may produce goods or services that are also produced in the private sector. Examples include veterans' hospitals that compete with privately owned hospitals, or federal housing that competes with homes and apartments provided by private developers and landlords.

Government Contracts A government contract, such as one to build submarines, has a huge impact on local, state, and regional economies.

APPLICATION Drawing Conclusions

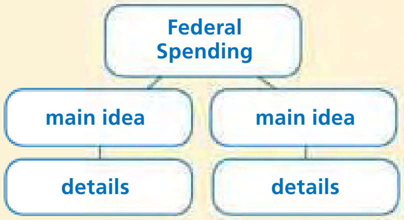
B. How are transfer payments related to income redistribution?

SECTION 3 Assessment

Online Quiz
ClassZone.com

REVIEWING KEY CONCEPTS

1. Explain the relationship between the terms in each of these pairs.
   a. *mandatory spending* / *entitlement*
   b. *federal budget* / *fiscal year*
   c. *transfer payment* / *grant-in-aid*
2. What is the difference between mandatory spending and discretionary spending?
3. Why is Medicaid an example of an entitlement program?
4. What does Congress do when it decides on appropriations?
5. How does the government compete with the private sector?
6. **Using Your Notes** How is the federal budget established? Refer to your completed hierarchy diagram. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**



CRITICAL THINKING

7. **Making Inferences** Between 2007 and 2009, spending on Social Security is projected to remain at 21.5 percent of the federal budget, while spending on education is projected to decline from 3.4 percent to 3.1 percent of the budget. How does this show the difference between mandatory and discretionary spending?
8. **Categorizing Economic Information** Categorize each of these examples of federal spending as direct spending, transfer payment, or grant-in-aid:
   - computers for IRS
   - disability benefits
   - flood control in Gulf Coast region
   - highway funds for states
   - medical care for elderly
   - money for urban housing
   - price supports for farmers
   - repair of space shuttle
   - salaries for national park rangers
9. **Challenge** Molly's grandmother was born in 1943. If she retires in 2005, she'll receive $750 per month in Social Security benefits. If she waits until 2009, she will receive $1,000, and if she waits until 2010, her monthly benefit increases to $1,080. Why do you think Congress structured the Social Security benefit payments program in this way?

ECONOMICS IN PRACTICE

Military base entrance

Studying Economic Impact
Consider what you have learned about the impact of federal spending on the economy. The chart below shows information on the impact of a hypothetical military base on an area's economy.

Direct military base employment	27,400 jobs, $1 billion payroll
Additional related jobs	19,500 jobs, $800 million payroll
Payments to private health care providers	$19 million
Contracts for goods and services	$115 million
State and local taxes	$102.8 million

Analyze Data Study the chart to answer these questions:

- What is the total number of jobs attributable to the military base?
- How much does the base spend on health care?

Challenge Write a summary of the economic impact of the military base.

SECTION 4

State and Local Taxes and Spending

OBJECTIVES

In Section 4, you will

- identify the major sources of revenue for both state and local governments
- examine the concept of a balanced budget
- describe the major categories of state and local expenditures

KEY TERMS

balanced budget, *p. 436*
operating budget, *p. 436*
capital budget, *p. 436*
tax assessor, *p. 437*

TAKING NOTES

As you read Section 4, complete a chart using the key concepts and other helpful words and phrases. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**

State Government		Local Government	
Revenue	Spending	Revenue	Spending

State Revenues

KEY CONCEPTS

As you recall from earlier in this chapter, all levels of government may impose taxes to raise revenue to support their activities. The federal government has the broadest tax base, while the smallest tax base is at the local level. There are thousands of local governmental units, from towns, cities, and counties to districts set up to handle a specific problem such as mosquito control or sewage treatment.

State revenues come from a variety of sources, the largest of which is intergovernmental revenue, mostly grants-in-aid from the federal government. States also raise funds from state sales taxes and from state income tax, both on individuals and on corporations. (See Figure 14.11 on page 437.)

TYPE 1 Sales and Excise Taxes

Economics Update

Find an update on state sales taxes at **ClassZone.com**

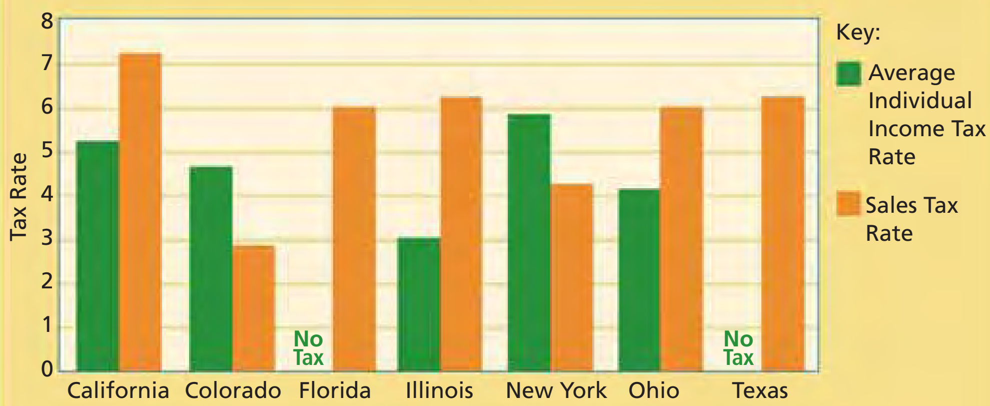
All states except Alaska, Delaware, New Hampshire, Montana, and Oregon levy a state sales tax. Rates range from 2.9 percent in Colorado to 7.25 percent in California. These taxes generally are applied to most goods and services sold within the state. However, many states exempt food and prescription drugs from sales tax. Some other states tax these goods, over-the-counter drugs, and certain other medical supplies at a lower rate. In addition, charitable, religious, and educational organizations are often exempt from paying sales taxes.

All states also have excise taxes on cigarettes, alcohol, gasoline, and diesel fuel. Certain government organizations, volunteer fire-fighting companies, and farmers may be exempt from fuel taxes. Many states also have special sales taxes that mostly affect tourists, such as taxes on car rentals and hotel and motel room rates.

TYPE 2 Income Tax and Other Revenue Sources

Income taxes account for some 16 percent of states' total revenue. Most states levy taxes on both individual and corporate income. However, Alaska, Florida, and Texas have no individual income tax. And Nevada, South Dakota, Washington, and Wyoming levy neither individual nor corporate income taxes. Most states have progressive tax rates on individual income and flat tax rates on corporate income. Individual income tax rates range from a low of 0.36 percent for the lowest tax bracket in Iowa to 9.5 percent for the highest tax bracket in Vermont. Figure 14.10 below compares average individual income tax rates and sales tax rates for several states.

FIGURE 14.10 COMPARING STATE TAXES



Source: Federation of Tax Administrators

Individual income tax rates for California, New York, and Ohio are averages of lowest and highest brackets. Colorado and Illinois have a flat rate income tax. Florida and Texas have no state income tax.

ANALYZE GRAPHS

1. Which state has the highest income tax rate? Which has the highest sales tax rate?
2. Which state has the heaviest tax burden?

The average state corporate tax rate is about 6.8 percent, ranging from a low of 1 percent for the lowest brackets in Alaska and Arkansas to Pennsylvania's flat rate of 9.99 percent. Many state governments structure their corporate tax rates to attract businesses to the state. These governments have used billions of dollars in tax cuts and incentives for businesses to promote economic development. However, states receive benefits from these tax practices in the increased economic activity that development brings.

States also raise revenue from several other sources. Many of these sources, including estate taxes and user fees, are the same as those used by the federal government. (See Figure 14.8 on page 425.) Most states also levy property taxes. In addition, most states charge several fees related to business operations. These include registration fees for certain types of businesses and license fees for doctors, dentists, lawyers, and accountants.

APPLICATION Comparing Economic Information

A. How do state income tax rates compare to federal income tax rates?

State Budgets and Spending

KEY CONCEPTS

All states except Vermont are required to have a **balanced budget**, in which total government revenue from all sources is equal to total government spending. However, balanced-budget requirements usually apply only to certain kinds of spending. Further, nearly every state has a reserve fund or may run a surplus, both of which can be used to balance the budget in subsequent years.

QUICK REFERENCE

A **balanced budget** requires that total government revenue is equal to total government spending.

An **operating budget** is a plan for day-to-day expenses.

A **capital budget** is a plan for major expenses or investments.

State Budgets

States actually work with two types of budgets—an **operating budget,** a plan for day-to-day expenses, and a **capital budget**, a plan for major expenses or investments. The operating budget generally covers expenses that occur each year, such as salaries for state government employees, payments for health and welfare benefits, and funds for education systems. Capital budgets provide funds for large construction and maintenance projects on state buildings, roads, and bridges, as well as for land acquisition for state construction needs or state parks. Usually, operating budgets are subject to balanced-budget requirements. Capital budgets are not, because they are usually funded through borrowing. In fact, capital budgets often are run at a deficit, meaning that more is spent than is collected in revenues.

Deficit Spending Both federal and state governments practice deficit spending—spending more than they collect in revenues—to cover their expenses.

State Expenses

Education is a major expense for the states, which not only support community colleges and state university systems but also provide assistance to local school districts. For example, state assistance accounted for about 49 percent of public school funding in 2002. Public safety, too, is a significant state expense. Spending on public safety includes state police, crime labs, and prisons and other correctional facilities. States also support a court system.

Public welfare expenses involve funds for state-run hospitals as well as cash assistance and medical care payments to the needy. States also fund programs that help citizens with problems related to housing, disability, unemployment, and job training. Other expenses include state government administration, retirement funds for state employees, natural resources, and economic development.

APPLICATION Categorizing

B. Would a grant to a city to build a new sewage treatment plant be part of the city's operating budget or capital budget?

Local Revenue and Spending

KEY CONCEPTS

Local government units include counties, cities, towns, villages, townships, school districts, and other special districts. They have fewer options for raising revenue than do other levels of government. Their major revenue sources are intergovernmental revenue—or transfers—from state and federal governments and property taxes. Local governments also tap other sources, many of which are similar to the state tax base. Figure 14.11 shows revenue sources for state and local governments.

Property Tax

Recall that you read about property tax in the first section of the chapter. This tax can be levied on real estate and on personal property such as motor vehicles, boats, expensive jewelry, or computers. Local governments rely on a **tax assessor**, a government official who determines the value of the property. They then enact a tax based on a percentage of the property's value.

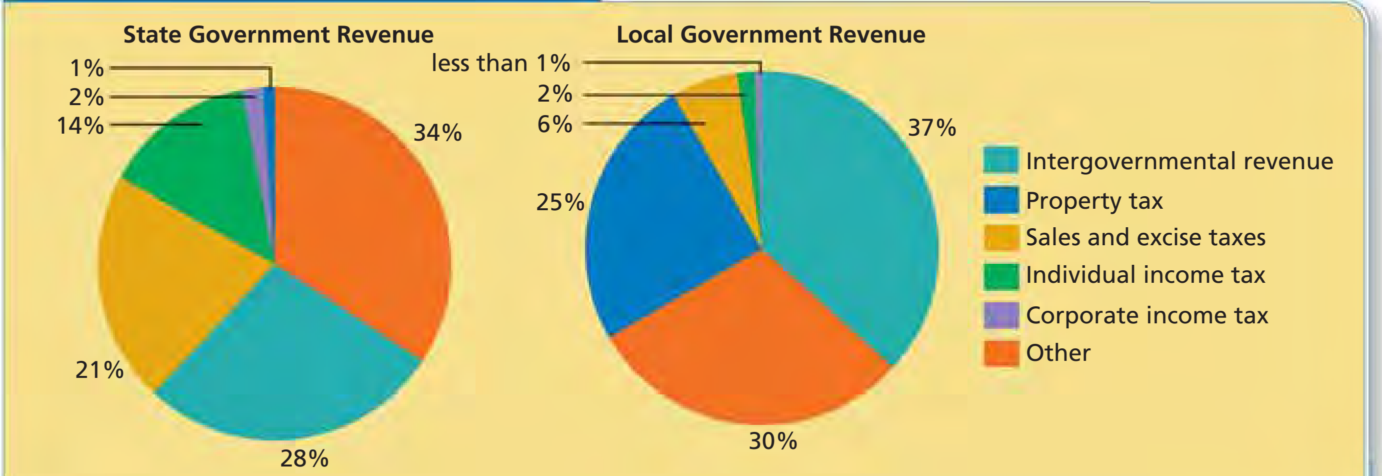
QUICK REFERENCE

A **tax assessor** determines the value of property.

Other Taxes

Local governments also use sales taxes, sin taxes on activities such as gambling, hospitality taxes on hotels and restaurants, entertainment taxes on tickets or entrance fees, and payroll taxes. The local payroll tax is a tax on people who work in a city but live outside the city. Such a tax is often used in large metropolitan areas where workers from the suburbs benefit from city services such as police and fire protection.

FIGURE 14.11 SOURCES OF STATE AND LOCAL GOVERNMENT REVENUE



Source: U.S. Census Bureau, figures for 2002–2003

ANALYZE GRAPHS

1. What are the two largest sources of revenue for both state and local governments?
2. Which type of government gets a larger percentage of its revenue from sales and excise taxes?

Local Spending

Local governments provide most of the direct services that citizens receive. To deliver these services, local governments employ almost three times the number of workers as state governments do. Some of the most important areas of local spending are described below.

Public Schools Local governments have the main responsibility for elementary and secondary schools. About 46 percent of local government spending goes to education. Government funds pay for construction and maintenance of school buildings, salaries for teachers, administrators, and other personnel, as well as for items such as textbooks and computers. Reliance on the property tax has led to difficulties for many local governments, since communities with lower property values have smaller tax bases to finance education.

Public Safety Local governments provide police and fire protection to secure lives and property in their communities. They are also responsible for emergency medical equipment and personnel to provide on-site treatment and transportation to medical facilities. Local governments maintain the 911 emergency telephone number system. Other expenditures in this category include animal control, consumer protection, and preparation for and response to natural disasters.

Public Safety Ensuring the safety of life and property in the community—by providing fire protection, for example—is the responsibility of local government.

Public Welfare Local governments spend less than state governments on direct payments for medical care and assistance to the needy. However, many local governments maintain public health departments, and some own and operate their own hospitals. Local health departments are concerned with immunization programs, environmental health, and maintaining birth and death records. They also are responsible for making sure that restaurants meet health standards.

Other Responsibilities Local governments also have primary responsibility for providing most public utilities such as water, public transit, sewage systems, and trash removal. They maintain local highways, roads, and streets, including traffic control lights and signs, snow removal, and pothole repair. Finally, local governments provide many kinds of recreational and cultural facilities including parks, recreation centers, swimming pools, and libraries.

APPLICATION Drawing Conclusions

B. Why do local governments rely more on property taxes as a source of revenue than do state governments?

SECTION 4 Assessment

Online Quiz
ClassZone.com

REVIEWING KEY CONCEPTS

1. Use each of the three terms below in a sentence that illustrates the meaning of the term.

a. *balanced budget* **b.** *capital budget* **c.** *tax assessor*

2. What is the difference between an operating budget and a capital budget?

3. How is an operating budget related to a balanced budget?

4. What is the largest revenue source for state governments? What is the largest source for local governments?

5. Why do local governments need tax assessors?

6. Using Your Notes What kinds of education do state and local governments spend money on? Refer to your completed chart. Use the Graphic Organizer at **Interactive Review @ ClassZone.com**

State Government		Local Government	
Revenue	Spending	Revenue	Spending

CRITICAL THINKING

7. Comparing and Contrasting What are the similarities and differences in the sources of revenue for state and local governments?

8. Analyzing Effects Which level of government would be most affected if the federal government decided to limit the amount of money that it spent on the Medicaid program? Give reasons for your answer.

9. Making Inferences Voters in your city must decide whether to raise revenue by increasing the rate of property tax for owners of homes and businesses or by placing a new tax on motel and hotel room rates and car rentals. Which tax are voters more likely to choose? Give reasons for your answer.

10. Challenge Between 1992 and 2002, average state funding for public schools increased from 46 percent of all state expenditures to 49 percent of all state expenditures. At the same time, local government funding of public schools decreased from 47 percent to 43 percent. Why do you think the source of school funding has changed in this way?

ECONOMICS IN PRACTICE

School board meeting

Using a Decision Making Process

Suppose that you are on a local school board. Total budget for the school district is $25,000,000. The chart below lists the items to be funded out of this budget.

Spending Category	Priority
Administrative salaries	
Classroom computers	
School lunch program	
Special education programs	
Teacher salaries	
Textbooks and other instructional materials	
Utilities	

Decide on Funding Priorities Use a decision-making process to decide how to allocate the budget. Complete the chart by ranking the items from 1 to 7, from most important to least important.

Challenge Based on your priorities, allocate a percentage of the budget to each category.

Case Study

Economics Update
Find an update on this Case Study at **ClassZone.com**

Should Online Sales Be Taxed?

Background In 1992 the Supreme Court upheld a law making Internet retailers exempt from collecting most sales taxes. The ruling was based on the fact that, at the time, the various state and local rules for tax collection varied widely. The differing rules would have placed a heavy burden on Internet retailers charged with having to collect taxes on what they sold.

Today, however, tax collection is becoming simpler and more streamlined. In addition, Internet purchases have become commonplace, with shoppers buying everything from computers to airplane tickets. Many online shoppers fail to realize that they are required to pay sales tax for Internet purchases at their home state's rate. To date, most states have tried to collect Internet sales tax on a voluntary basis. Needless to say, results have been poor. Given this and other considerations, Internet sales tax once again is a subject for debate.

What's the issue? Should there be sales tax on Internet purchases? Study these sources to discover arguments for and against taxing purchases online.

A. Online News Story

This news story on whether to impose the "iPod tax"—a tax on digital products—illustrates the differences of opinion on online sales tax.

Entertainment Lovers May Soon Pay Tax on Downloads

Wisconsin governor and legislators disagree over "iPod" tax.

Wisconsin Gov. Jim Doyle now wants his state to start collecting taxes on digital music, videos and software. Key Republicans in the GOP-dominated legislature say they will block the proposal, but administration officials say they're just trying to make things fair.

"It's an issue of tax equity," said Jessica Iverson, a spokeswoman for the Wisconsin Department of Revenue. "If you go into a Main Street business and purchase a CD, you are paying tax. . . ."

Economists are split . . . as to whether adding these kinds of taxes is a good idea. Some say that taxes on digital goods will hamper the growth of a potentially vibrant new marketplace, while others say that having taxes only on offline versions of the same goods distorts the operation of free markets.

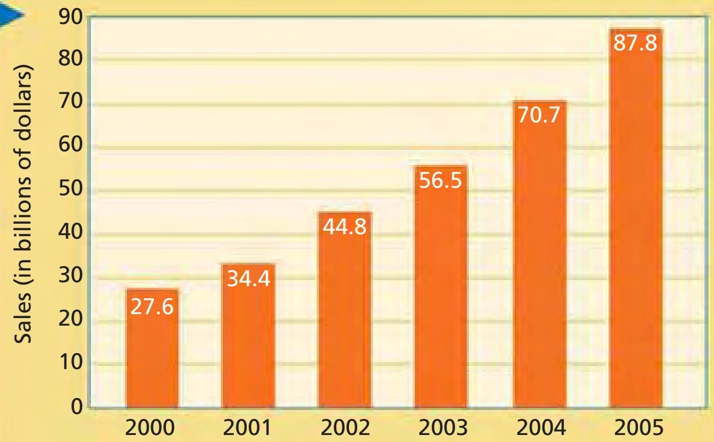
Source: News.com, March 10, 2005

Thinking Economically What do you think economists mean when they say that taxing only offline versions of the same goods "distorts the operation of free markets"?

FIGURE 14.12 U.S. ONLINE PURCHASES

B. Graph

This graph shows the growth of online purchases during the 2000s.



Source: U.S. Census Bureau

Thinking Economically How might state and local governments use the information in the graph to support their demand to levy sales taxes on online purchases?

C. Newspaper Editorial

Some states are becoming proactive in their efforts to promote Internet sales tax. This newspaper editorial describes one multistate project to facilitate the collection of the tax.

Internet Sales Tax

Eighteen states agree to establish uniform sales tax rules.

Last week, 18 state tax collectors met in Chicago to announce an interstate agreement establishing uniform sales tax rules. Starting in October, the group will offer free software that will allow any business to easily collect the required taxes online.

The states' demonstration project will drive home the point that online sales-tax collection can be done nationwide. Many retailers already collect the taxes. Now Congress should step up and pass a law overturning the court's exemption in states that have streamlined their tax systems. That would allow hard-pressed states to take in roughly $20 billion a year in annual sales tax revenue that is rightfully theirs, and perhaps much more, depending on the growth in online shopping. It would also help level the playing field between local and online retailers.

Source: **"Internet Sales Tax,"** ***New York Times*****, July 5, 2005**

Thinking Economically What impact has Internet shopping had on state and local revenues? Explain your answer.

THINKING ECONOMICALLY Synthesizing

1. Summarize the arguments for and against an Internet sales tax as presented in the documents.
2. Who is most likely to benefit from Internet sales tax revenue? Explain your answer, using information from the documents.
3. How has government responded to e-commerce—the selling of goods and services online? Use information from the documents in your answer.

Interactive Review

Review this chapter using interactive activities at **ClassZone.com**

- Online Summary
- Quizzes
- Vocabulary Flip Cards
- Graphic Organizers
- Review and Study Notes

Online Summary

Complete the following activity either on your own paper or online at **ClassZone.com**

Choose the key concept that best completes the sentence. Not all key concepts will be used.

ability-to-pay principle of taxation	proportional tax
balanced budget	regressive tax
benefit principle of taxation	revenue
capital budget	tax
discretionary spending	tax base
entitlement	tax incentive
incidence of tax	tax return
indexing	taxable income
mandatory spending	transfer payment
progressive tax	withholding

__1__ is a mandatory payment to a government. __2__ is government income. The __3__ holds that people should be taxed on their ability to pay, no matter the level of benefits they receive.

A __4__ is the income, property, goods or services subject to taxes. A __5__ takes the same percentage of income from all taxpayers. A __6__ places a higher rate of taxation on high-income people, and a __7__ takes a larger percentage of income from low-income people. The __8__ is the final burden of tax.

__9__ is money taken from a worker's pay before the worker receives it. __10__ is a revision of tax brackets to prevent workers from paying more taxes due to inflation. Social Security is an example of an __11__, a social welfare program with specific requirements. Such programs make up most of federal __12__, which is spending that is required by law.

States are required to have a __13__, in which government revenue and spending are equal.

CHAPTER 14 Assessment

REVIEWING KEY CONCEPTS

How Taxes Work (pp. 410–419)

1. What is the relationship between tax and revenue?
2. Identify three ways that taxes affect the economy.

Federal Taxes (pp. 420–427)

3. What is the largest source of federal revenue?
4. Which tax pays for Social Security and Medicare?

Federal Government Spending (pp. 428–433)

5. What are three programs that make up most mandatory spending?
6. How does federal spending affect the economy?

State and Local Taxes and Spending (pp. 434–441)

7. What are the two types of state budgets?
8. What tax base are tax assessors concerned with?

APPLYING ECONOMIC CONCEPTS

Look at the chart below showing average combined city and state tax rates for families with different incomes in several cities.

FIGURE 14.13 STATE AND LOCAL TAXES FOR A FAMILY OF FOUR

City	Total taxes paid as a percent of income				
	$25,000	$50,000	$75,000	$100,000	$150,000
Atlanta	8.1	10.3	11.4	11.5	11.7
Chicago	9.3	9.5	10.0	9.7	9.3
Houston	6.2	6.0	6.3	5.9	5.5
Jacksonville	4.3	4.6	5.0	4.8	4.6
Los Angeles	8.6	8.7	10.3	11.2	12.3
New York	5.6	10.8	12.7	13.4	14.1
Philadelphia	11.0	13.2	13.0	12.6	12.2

Source: *Statistical Abstract of the United States, 2002 figures*

9. Which city has the lowest tax rate for the lowest-income families? Which has the lowest tax rate for the highest-income families?
10. Which combined city and state tax structures are progressive and which are regressive?

CRITICAL THINKING

11. **Creating Graphs** The state legislature proposes new 10 percent excise taxes on the following goods and services: gasoline, ice cream, local telephone service, and sports cars. For each good or service create supply and demand curves showing the supply curve before the tax and how the supply curve shifts after the tax. Under each graph, write a caption explaining who will pay more of the tax—the consumer or the producer—and why.

    Use SMARTGrapher @ **ClassZone.com** to complete this activity.

12. **Analyzing Data** Shandra earns $30,000 per year from her job as a radiology technician. She takes a personal exemption of $3,200 and the standard deduction of $5,000 to reduce her taxable income.
    - **a.** If she pays 10 percent tax on the first $7,300 of taxable income and 15 percent on the rest, how much does she pay in income tax?
    - **b.** Shandra's FICA tax rate is 7.65 percent. What are her FICA taxes?
    - **c.** How much total tax does Shandra pay? What is her effective tax rate as a percentage of her taxable income and of her total income?

13. **Making Inferences** When Rajiv goes shopping for a new MP3 player, he notices that he pays 7.35 percent sales tax on the purchase. He knows that the state sales tax rate is 4.22 percent. What accounts for the difference?

14. **Comparing and Contrasting** All states have excise taxes on cigarettes and gasoline. What are the similarities and differences in the reasons why states tax these two items?

15. **Challenge** In 2003, Congress reduced the tax rate paid by individual investors on dividends and capital gains to 15 percent. Previously the rate for dividends had been as high as 38.6 percent, and capital gains had been taxed at 20 percent. Which of these changes addressed the charge that corporate income is subject to double taxation? Give reasons for your answer.

SIMULATION

Develop a Federal Budget

Step 1 Choose a partner. Imagine that you are members of Congress who must determine the discretionary spending portion of the federal budget. The table below shows the categories of spending. You have a total of $960 billion to spend. Determine your spending priorities by deciding what percent of the budget to allocate to each category.

FEDERAL DISCRETIONARY SPENDING CATEGORIES

Administration of justice	Health (non-Medicaid)
Agriculture	International affairs
Community & regional development	National defense
Education	Natural resources & environment
Energy	Science, space & technology
General government	Transportation

Step 2 Form a group with two or three other pairs of students so that there are now a total of four groups in the class. Compare your budgets, noting areas of agreement and disagreement. Negotiate to develop a single budget proposal for your group.

Step 3 Present your group's budget proposal to the class. Include a list of reasons to support your budget choices.

Step 4 As a class, decide on a final recommendation that resolves any differences among the four budget proposals.

Step 5 Present your final budget to your teacher, who is acting as the President. Make necessary changes to the budget to resolve any differences between the Congress and the President.