Why It Matters

The federal government affects your life in many different ways. Two major ways result from the government’s taxing and spending decisions.

If you have a job, and your employer deducts taxes from your paycheck, you have already felt the impact of federal taxes. What kinds of taxes the government imposes and the sizes of those taxes affect important parts of your life, such as what you buy and how much you work.

How the government spends the tax revenues affects you, too. For example, how much it spends on education directly affects you now and in the future.

The more you know about the government’s taxing and spending policies, the better able you will be to prepare for and deal with these policies.

Most would agree that tax dollars spent for firefighting equipment and firefighters’ salaries is money well spent. Much of the government’s process of taxing and spending is, however, open for debate—a debate that you will participate in as a citizen and taxpayer throughout your adult life.
The following events occurred one day in October.

5:30 P.M. As the Stevens family eats dinner, Mary Stevens tells the family about something she read today in *Time* magazine. Mary says, “I read today that the rich in America are getting richer and the poor are getting poorer.” “I don’t think that’s true,” Frank Stevens, Mary’s husband, says. Jimmy, the littlest Stevens in the family asks, “What’s for dessert?”

- Are the rich getting richer and the poor getting poorer?

5:32 P.M. Vernon and Maria Cole are eating dinner. Maria says, “I think we spend too much money in this country on national defense. We ought to spend less on national defense and more on education, health care, and environmental concerns.” Vernon says, “How much do we spend on national defense?” “I don’t know,” Maria says, “but I’m sure it’s a lot.”

- How much does the federal government spend on national defense?

6:04 P.M. Clark and Eddie, two friends at college, are eating dinner together in the dining hall. “I found it interesting,” says Eddie, “that Russia has a flat tax.” “What’s so interesting about that?” Clark asks. “Well,” says Eddie, “Russia used to be part of the Soviet Union, a communist country, and a flat tax is usually associated with countries where low taxes are all the rage. I don’t know, it just seems to me that a flat tax and a formerly communist country don’t go together.”

- What is a flat tax, and what countries in the world have a flat tax?

7:16 P.M. The Martinez family is eating dinner. Elise Martinez says, “I heard today that the federal government pays hardly anything for education. I think that is wrong. If the federal government doesn’t pay for education, who does?” Ken Martinez, Elise’s husband, says, “I agree with you. I bet the federal government spends more on road construction than education. And educating our kids is perhaps the most important job we have.”

- Does the federal government spend little on education?
Focus Questions
- What are the three major federal taxes?
- What are three types of taxes people pay in addition to the three major federal taxes?
- What is the purpose of the alternative minimum tax?
- How do proportional, progressive, and regressive income taxation differ?
- What is a fair tax?

Key Terms
proportional income tax
progressive income tax
regressive income tax

Three Major Federal Taxes

The government has three levels: federal, state, and local. At the federal level are three major taxes: the personal income tax, the corporate income tax, and the Social Security tax. In 2005, the federal government took in tax revenues of $2,057 billion. Of this total, about 92.3 percent was from personal income, corporate income, and Social Security taxes. Exhibit 14-1 shows the estimates of the Congressional Budget Office for the tax revenue that each of the three taxes will generate from 2006 to 2011.

Personal Income Tax

The personal income tax is the tax a person pays on his or her income. A federal personal income tax is applied by the federal government, and many (but not all) states have a personal income tax. At the federal government level, the personal income tax raised $899 billion in 2005, which accounted for approximately 44 percent of total federal tax revenue that year. In other words, for every $1 the federal government received in taxes in 2005, 44 cents of that dollar came from the personal income tax.

Corporate Income Tax

The tax corporations pay on their profits is the corporate income tax. The federal government applies a corporate income tax, as do many states. At the federal government level, the corporate income tax raised $216 billion in 2005. This amount was about 10.3 percent of the total federal tax revenue in 2005.

Taxes

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Social Security Tax

The Social Security tax is a federal government tax placed on income generated from employment. Half of the tax is placed on the employer, and half is placed on the employee. In 2005, at the federal government level, the Social Security tax raised approximately $790 billion, or about 38 percent of the total federal tax revenue. (See Exhibit 14-2.)

A Student Asks

QUESTION: Don’t tax revenues steadily climb for the U.S. government? In other words, aren’t tax revenues always higher for a later year than an earlier year?

ANSWER: Over a long period of time, tax revenues rise, but tax revenues in a later year are not always higher than in an earlier year. For example, in 2000, federal tax revenues were $2,025 billion, but in 2001 they fell to $1,991.2 billion. One year later, in 2002, they fell again to $1,853.2 billion. In other words, federal tax revenues fluctuate.

Three Other Taxes

The taxes just described are not the only taxes people pay. In most states, people must also pay a state income tax. In addition, other major taxes are sales taxes, excise taxes, and property taxes.

Sales Tax

Sales taxes are applied to the purchase of a broad range of goods—cars, computers, clothes, books, and so on—when they are purchased. State governments typically raise tax revenue through sales taxes. The federal government does not collect a (national) sales tax.

Sales taxes differ among states. For example, in Florida the sales tax rate is 6 percent, but in Georgia it is 4 percent. In most states, food purchases (at a grocery store) are not subject to the sales tax, although some states tax food sales at a rate that is lower than the regular sales tax. In most states, no sales tax is charged for prescription drugs.

Excise Tax

Excise taxes are taxes placed on the purchase of certain goods, such as tobacco products and gasoline. Every time people buy gasoline at a gas station, they pay an excise tax. The federal government applies excise taxes, as do many states.

EXAMPLE: Edward goes to the gas station and fills up his car with gas. He looks at the price per gallon: $2.75. He might not realize it, but an excise tax is included in that $2.75 per gallon. Both federal and state excise taxes apply on gasoline. While the federal tax is uniform across the country, the state excise taxes vary from state to state. To pick one state, Connecticut, the sum of federal and state excise taxes on a gallon of gasoline is about 50 cents. In other words, out of every gallon of gas purchased in the state of Connecticut, 50 cents goes for excise taxes. ♦

Property Tax

Property tax is a tax on the value of property (such as a home). It is a major revenue source for state and local governments.

EXAMPLE: Yvonne buys a house. In the state in which she lives, the property tax rate is 1.25 percent of the market price of the house. She paid $300,000 for her house, so her property taxes each year amount to $3,750, or $312.50 a month. ♦

For each dollar the federal government raises from taxes, 44 percent comes from the personal income tax, 10.3 percent comes from the corporate income tax, 38 percent comes from the Social Security tax, and 7.7 percent comes from other federal taxes. (These percentages are for 2005.)
Chapter 14 Taxing and Spending

Since the inception of Social Security, the Social Security tax has been split between the employer and the employee. For example, in 2005, the Social Security tax rate was 12.4 percent. Half of this tax, or 6.2 percent, was placed on the employer, and the other half was placed on the employee. In other words, the employee was expected to pay $6.20 per $100 of gross earnings (up to a limit), as was the employer.

It is commonly believed that if a tax is placed on someone, then that someone actually pays the tax. However, the placement of a tax is different from the payment of a tax. Just because the government places a tax on Anderson, it does not necessarily follow that Anderson pays the tax. The same is true for the Social Security tax. Just because the government places half the tax on the employer does not necessarily mean that the employer pays the tax.

To better understand this concept, suppose the Social Security tax is $2 a day and that $1 of the tax is placed on the employer and $1 placed on the employee. An earlier chapter explained that wage rates are determined by supply and demand. For example, the demand for labor and the supply of labor go together to determine the wage rate. Suppose that the equilibrium wage rate before the tax is placed on the employer is $10 an hour.

What will the tax that is placed on the employer do to the employer's demand for labor? A tax will lower the employer's demand for labor. Employers will not want to hire as many employees as they might otherwise, if they have to pay a $1 tax per employee per day.

In other words, as a result of the Social Security tax being fully placed on the employer, the demand for labor falls. Now if the demand for labor falls, and the supply of labor is constant, we know (through our supply-and-demand analysis) that the wage rate will fall, say, from $10 an hour to $9.35 an hour.

So, in our example, have employees paid for any of the Social Security tax that was placed on the employer? Yes, they have paid in terms of lower wages. In other words, without the tax, employees' wages would be higher ($10 an hour) than they are with the tax ($9.35 an hour). Some of the Social Security tax (in our example, 65 cents of the $1 tax) is paid for by the employees in the form of lower wages, even though the tax was placed on the employer.

The first moral of the story is this: many people think that the employer pays half the Social Security tax and the employee pays the other half when, in fact, the employee ends up paying more than half the Social Security tax. The employee pays the employee half of the tax, and then pays some of the employer's part of the tax in the form of (earning) lower wages.

Second moral of the story: the legislature can place a tax on anyone it chooses, but it is not the legislature that determines who pays the tax. The laws of economics (in this case, the laws of demand and supply) determine who pays the tax.

Think About It

Every market has two sides: a demand side (buying side) and a supply side (selling side). If a tax is placed on one side of the market, it can affect the other side. Do you agree or disagree? Explain your answer.
The Alternative Minimum Tax

The alternative minimum tax (AMT) is a tax that some people have to pay on top of their regular income tax. The original idea behind the tax was to prevent persons with high incomes from paying little or no taxes because of their claiming certain tax benefits. Congress enacted the AMT in 1969 following testimony by the secretary of the Treasury that 155 people with adjusted gross income above $200,000 had paid zero federal income tax on their 1967 tax returns.

How It Works

The name—alternative minimum tax—comes from the way the tax is designed to work. In short, for a given income, a minimum tax is computed; then, if you are paying at least that amount of taxes, you don’t pay the alternative minimum tax, but if you are not paying at least that amount, you do.

Suppose the minimum amount of taxes usually paid by a person earning $75,000 a year is $15,000. This $15,000 becomes the benchmark against which others are measured. If Smith, who earns $75,000, is not paying at least $15,000 in taxes, then he is subject to the alternative minimum tax. If Jones, who earns $75,000, is paying at least $15,000 in taxes, then he is not subject to the alternative minimum tax.

Why It Is Affecting More People

When the alternative minimum tax was first put into place in 1969, fewer than 1 percent of all taxpayers were affected by it. Today, more than 3 percent pay AMT. If the alternative minimum tax retains its current structure, 20 percent of taxpayers, or 30 million Americans, will be subject to it by 2010. By 2015, the AMT will affect 50 million people.

What happened? Why have so many more people fallen under the umbrella of the alternative minimum tax in recent years? Two factors are responsible.

Inflation The first is inflation. Because of inflation, individuals find that their dollar incomes increase. Think of it this way: A person sells apples at 20 cents each. Inflation raises the prices of most goods, including apples, which rise to a price of 30 cents each. Before inflation, the apple seller received an “income” of 20 cents an apple; now she receives an “income” of 30 cents an apple.

The regular income tax is adjusted for inflation; the government doesn’t simply look at your higher dollar income and conclude that you are better off because of it. Government realizes that although you have a higher dollar income, prices are higher too, and your higher dollar income might not buy you any more at the higher prices than your lower dollar income bought you at lower prices.

Even though the regular income tax is adjusted for inflation, the AMT is not. When inflation raises a person’s dollar income, it moves him upward toward the income level at which the alternative minimum tax kicks in.

Tax Cuts The second factor causing more people to be subject to the AMT is the income tax cuts in 2001 and 2003. We realize this statement sounds odd, but keep in mind that the federal income tax cuts in 2001 and 2003 were made in the regular income tax, not in the AMT. Because taxpayers must pay the greater of either their AMT or regular income tax liability, the decline in regular income tax liability without any change in the AMT pushed many taxpayers into the AMT. In other words, what the regular income tax cuts gave with one hand were (for many people) taken away by the AMT with the other hand.

QUESTION: Is everybody subject to the AMT, or only people above a certain income?

ANSWER: Only persons above a certain income. In 2006, that income is $67,890 for a person filing jointly with two children.
**Proportional, Progressive, and Regressive Income Taxes**

Income taxes can be proportional, progressive, or regressive. See Exhibit 14-3.

**Proportional Income Taxation**

With a **proportional income tax**, everyone pays taxes at the same rate, whatever the income level. For example, if Kuan’s taxable income is $100,000, she will pay taxes at the same rate as Arehart, who has a taxable income of $10,000. Suppose this rate is 10 percent. Kuan then pays $10,000 in income taxes, and Arehart pays $1,000. Notice that Kuan, who earns ten times as much as Arehart, pays ten times as much in taxes ($10,000 as opposed to $1,000). However, Kuan pays at exactly the same rate—10 percent—as Arehart. Sometimes a proportional income tax is called a **flat tax**, because everyone pays the same flat tax rate. Interestingly enough, many (but not all) countries that today have a flat tax system were once communist countries. In Exhibit 14-4 you will find a list of some countries with flat taxes.

A common, but mistaken, belief is that a flat tax is necessarily a low tax. It does not have to work this way. For example, some people today think that Lithuania’s flat tax of 33 percent is too high. (See Exhibit 14-4.)

**Progressive Income Taxation**

A **progressive income tax** is a tax that people pay at a higher rate as their income levels rise. Suppose that Davidson pays taxes at the rate of 10 percent on a taxable income of $10,000. When his income doubles to $20,000, he pays at a rate of 12 percent. A progressive income tax is usually capped at some tax rate; it rises to some rate and then stops. For instance, perhaps no one will pay at a rate higher than 35 percent, no matter how high his or her income.

The United States has a progressive income tax structure. For example, in 2005, the tax rates were 10, 15, 25, 28, 33, and 35 percent. If you would like to find out whether the tax rate structure is the same today, go to www.emcp.net/taxrate and key in “tax rates” in the Search box. A list of documents will then come up. Pick the document that specifies the tax rates for the current year, such as tax rates for 2006.

**Regressive Income Taxation**

With a **regressive income tax**, people pay taxes at a lower rate as their income levels rise. For example, Lowenstein’s tax rate is 10 percent when her income is $10,000 and 8 percent when her income rises to $20,000.

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**Exhibit 14-3** Three Income Tax Structures

<table>
<thead>
<tr>
<th>Type</th>
<th>Same tax rate for every taxpayer. Tax rate remains constant as taxable income rises.</th>
<th>Tax rate rises as taxable income rises.</th>
<th>Tax rate falls as taxable income rises.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proportional</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Progressive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regressive</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Exhibit 14-4** Countries with a Flat Tax

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate</th>
<th>Year Introduced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>26%</td>
<td>1994</td>
</tr>
<tr>
<td>Lithuania</td>
<td>33%</td>
<td>1994</td>
</tr>
<tr>
<td>Latvia</td>
<td>25%</td>
<td>1995</td>
</tr>
<tr>
<td>Russia</td>
<td>13%</td>
<td>2001</td>
</tr>
<tr>
<td>Serbia</td>
<td>14%</td>
<td>2003</td>
</tr>
<tr>
<td>Ukraine</td>
<td>13%</td>
<td>2004</td>
</tr>
<tr>
<td>Slovakia</td>
<td>19%</td>
<td>2004</td>
</tr>
<tr>
<td>Georgia</td>
<td>12%</td>
<td>2005</td>
</tr>
<tr>
<td>Romania</td>
<td>16%</td>
<td>2005</td>
</tr>
</tbody>
</table>

**A flat tax is the same type of tax as which of the three taxes described in Exhibit 14-3? If the U.S. government switched from its current tax structure to a flat tax, do you think it would see tax revenues rise, fall, or stay the same? Explain.**

**Do you think that one of these types of income tax makes more sense or is more fair than the others? If so, explain.**
On Sunday, May 29, 2005, Danica Patrick became the first woman to lead the Indianapolis 500 and the highest-finishing (fourth) woman in the race’s history. Leading as late as Lap 193 in the 200-lap race, Patrick’s winnings that day were $378,855. As of June 2005, her racing winnings totaled $613,755.

Now let’s turn to Maria Sharapova, tennis star, who on June 13, 2005, was ranked second in the World Tennis Association rankings. Her tennis prize money as of that day (in 2005) was $1,012,721. (Her income was much higher for 2005 if we take into account endorsements.)

By the standards of most people, both Danica Patrick and Maria Sharapova were having a good year in 2005. Both were earning quite a bit of money. However, money earned and money kept are two different things. One can earn a million dollars, but because of taxes, one doesn’t keep a million dollars.

If we calculate Danica Patrick’s taxes on her total winnings of $613,755 (as of a certain date), and Sharapova’s taxes on $1,012,721, what would they be? Because we do not know the financial particulars of either of these women athletes, we have to make some rough estimates. For example, we do not know the actual dollar deductions or exemptions for either person, so we will assume that each takes the $5,000 standard deduction and the $3,200 personal exemption only, for a total of $8,200 for each person.

If we subtract this dollar amount from Patrick’s winnings (as of June 2005), it leaves her with a taxable income of $605,555. Now if we consult the 2005 IRS tax table, we learn that for anyone who earns more than $326,450 a year, she must pay in federal income taxes “$94,727.50 plus 35 percent of everything over the amount of $326,450.” Danica Patrick owes taxes equal to $94,727.50 + 0.35(605,555 – $326,450). Her tax liability amounts to $192,414.25. If we subtract this amount from her gross earnings of $613,755, Danica Patrick is left with $421,340.75.

What about Sharapova? If we subtract our $8,200 in deductions and exemptions from her gross tennis earnings (as of a certain date), we are left with a taxable income of $1,004,521. Her tax liability is $94,727.50 + 0.35(1,004,521 – $326,450), or $332,052.35. If we subtract her tax liability from her gross income of $1,012,721, her after-tax income is $680,668.65.

Keep in mind, also, that we did not calculate the state income tax that both Patrick and Sharapova might have to pay. Our after-tax dollar amounts are higher than they would be after state income taxes were paid.

Both Danica Patrick and Maria Sharapova, you will notice, had to pay in taxes 35 percent of everything they earned over $326,450. For every dollar they earn over this amount, 35 cents has to be paid in taxes to the federal government. Suppose that Sharapova is playing tennis and the winning prize is $1 million. As she is playing tennis, she ought to think of a prize somewhat smaller. How much smaller? Thirty-five percent smaller—the prize for her, after she pays her taxes on the $1 million prize, would be $650,000.

Suppose Danica Patrick and Maria Sharapova had to pay 70 cents out of every dollar earned over $326,450. Do you think it would affect Patrick’s desire to race cars or Sharapova’s desire to play tennis? Explain your answer.
How Many Days Do You Have to Work to Pay Your Taxes?

Individuals, then, pay an assortment of taxes to the federal, state, and local government. How many days each year does the average person have to work to pay all his or her taxes? It was calculated that if a person began work on January 1, 2005, he or she would have to work until April 17, 2005, before earning enough to pay all taxes owed. Exhibit 14-5 shows how long the average taxpayer had to work to pay taxes in selected years. We should mention that the number of days a person has to work to pay his or her entire tax bill differs between states, because taxes are higher in some states than in other states. If you want to find out how many days a person in your state has to work to pay all his or her taxes, you can go to www.emcp.net/taxes and click on your state. For example, in Nebraska a person works from January 1, 2005, to April 13, 2005, to pay all of his or her taxes for the year. In New York, a person works until April 29.

Example: The average worker works about 35 hours a week, 49 weeks a year, or about 1,715 hours a year spent working. How many of those hours are spent working in order to earn enough money to pay one’s total tax bill (for the year)? The answer is about 490 hours, or slightly more than 28 percent of all working hours. Or you can look at it this way: If you start work at 9 a.m. each day, take an hour for lunch, and leave work at 5 p.m., you work from 9 a.m. to a few minutes before 11 a.m. each day in order to pay your taxes. After 11 a.m., what you earn stays with you.

A Student Asks

QUESTION: I know the federal income tax in the United States is progressive, but aren’t some taxes in the United States regressive? Do some taxes “hit” poor people harder than rich people?

ANSWER: A state sales tax is an example of a tax that is regressive. To understand this concept, suppose a state sales tax is 6 percent. In other words, for every $1 purchase, a person will pay 6 cents in state sales tax. Now suppose that two individuals, A and B, each buy a $1,000 computer. Both will end up paying a state sales tax of $60. Because A has a larger income than B has, A will pay a smaller percentage of A’s income in sales taxes than B will. For example, if A’s income is $5,000 a month and B’s income is $3,000 a month, then $60 is 1.2 percent of $5,000, but it is 2.0 percent of $3,000.

What is the federal income tax in the United States?
Who Pays What Percentage of Federal Income Taxes?

Do the wealthy in the United States pay their fair share of taxes? Polls taken in the United States indicate that most people think that the wealthy do not pay their fair share.

Several issues are important in the discussion of taxes and the share paid by different income groups. First, it is important to define what we mean by “wealthy Americans.” Are wealthy Americans those persons who are in the top 1 percent of income earners, or top 5 percent, or top 10 percent?

Second, it is important to define what we mean by a “fair share” of taxes. For example, is it unfair if wealthy Americans pay only 5 percent of all federal income taxes, but fair if they pay 20 percent?

Third, it is important to get some idea of what wealthy Americans pay in taxes compared to what they earn in income.

Let’s compare tax data for people in different income groups (see Exhibit 14-6). How does each income group’s share of income compare to its share of taxes? Do you notice a pattern with regard to the average tax rates for the different groups? After studying the data, do you have an opinion about whether or not the wealthy pay a fair share of the total income tax?

### Defining Terms

1. Define
   a. proportional income tax
   b. progressive income tax
   c. regressive income tax

### Reviewing Facts and Concepts

2. What three federal taxes together account for approximately 92.3 percent of federal government tax revenues?

3. Which federal tax raises the greatest tax revenue?

4. What percentage of the year did the average taxpayer have to work in 2000 to pay all his or her taxes?

### Critical Thinking

5. “It is possible for a high-income earner to pay more in taxes than a low-income earner under a regressive income tax.” Do you agree or disagree? Explain your answer.

### Applying Economic Concepts

6. Is a sales tax regressive, proportional, or progressive? Explain your answer.

### Exhibit 14-6

<table>
<thead>
<tr>
<th>Income group</th>
<th>Income split point</th>
<th>Group’s share of total U.S. income</th>
<th>Group’s share of federal income taxes</th>
<th>Average tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 1%</td>
<td>above $285,424</td>
<td>18.12%</td>
<td>33.71%</td>
<td>21/25%</td>
</tr>
<tr>
<td>Top 5%</td>
<td>above $126,525</td>
<td>30.55%</td>
<td>53.80%</td>
<td>22.95%</td>
</tr>
<tr>
<td>Top 10%</td>
<td>above $92,663</td>
<td>41.77%</td>
<td>65.73%</td>
<td>20.51%</td>
</tr>
<tr>
<td>Top 25%</td>
<td>above $56,401</td>
<td>64.17%</td>
<td>83.90%</td>
<td>16.99%</td>
</tr>
<tr>
<td>Top 50%</td>
<td>above $28,654</td>
<td>85.77%</td>
<td>96.50%</td>
<td>14.66%</td>
</tr>
<tr>
<td>Bottom 50%</td>
<td>below $28,654</td>
<td>14.23%</td>
<td>3.50%</td>
<td>3.21%</td>
</tr>
</tbody>
</table>

Source: Internal Revenue Service (2003).

▲ This exhibit compares the amount of total U.S. income earned to the amount of taxes paid for by selected income groups. The “Income split point” (second column) is simply a term for the amount of income a person had to earn to be in a particular group. For example, a person had to earn at least $285,424 to be in the top 1% of earners. Note from the last column, reading from the bottom up, that the more money a person earns, the higher average tax rate the person pays. For how many groups was the percentage of the total tax bill higher than the percentage of total income? For which group was this percentage difference the greatest?
Filing an Income Tax Return

If you haven’t already, you will soon have to file an annual federal income tax return. Is it hard to do? In most cases, it is not hard at all. You have taken numerous tests in high school that are much harder than filing your tax return.

An Overview

Let’s look at the big picture of what you will be doing. First, you will identify all the income you earned in a given year. Let’s say this amount is $50,000. Second, you subtract certain dollar items from this $50,000. These items come with different names: exemptions, deductions, adjustments. Third, you end up with a certain dollar amount of taxable income. Let’s say this amount is $40,000. Fourth, you simply consult an IRS tax table to see how much you will pay in taxes based on this taxable income.

These simple steps are really all there is to it. It is a matter of a little addition and subtraction and consulting one (fairly simple) tax table.

The Step-by-Step Process

Now let’s outline the steps in a little more detail.

1. Gather together all your tax documents. They include things such as your W2 statement (a statement you receive from your employer stating how much you earned during the year).

2. Most likely, the first several years you will be able to use Form 1040EZ, which is the simplest form. For example, you can use this form if you earned less than $100,000 during the year, do not plan to claim any dependents (anyone who is dependent upon you for some support), and have interest income of $1,500 or less. If you are unsure of which form to file, go to www.emcp.net/taxforms.

3. Go to www.emcp.net/printtaxforms and print off one or two copies of the correct form.

4. Start filling out the form. Take things slowly, line by line.

5. You need to determine your filing status. You must file as one of the following: a single person, head of household, qualifying widow, married filing jointly, or married filing separately.

6. You next claim an exemption for yourself and for any dependents you may have. You cannot claim a personal exemption for yourself if anyone, such as your parents, has claimed you as a dependent.

7. You must state the amount of income you earned in the last year. Your W2 form comes in handy here. It identifies the dollar amount of income you earned working at your job.

8. You may also list certain adjustments to your income. These adjustments include expenses that you incurred over the year (moving expenses, tuition and
fees deduction, health savings account deductions, and more) that will lower your taxable income and thus reduce the amount of taxes you must pay.

9. You may take the standard deduction (which is something else that will lower your taxable income). The amount of standard deduction you take depends upon your filing status.

10. If you do not take the standard deduction, you may take certain “itemized deductions” instead. Like exemptions, adjustments, and the standard deduction, itemized deductions lower your taxable income and thus lower the amount of taxes you must pay.

11. At this point, you add up all your exemptions, deductions, and adjustments and subtract them from your total income. What is left is your taxable income.

12. To figure out how much you have to pay in taxes, you consult a tax table. These tables can be found at www.emcp.net/taxtables or in the tax booklet that you received from the IRS.

The accompanying table is for a single person filing in 2005. Using the table, you can figure your tax liability. For example, let’s suppose your taxable income was $40,000. Using the table, we see that $40,000 falls between $29,700 and $71,950. Therefore your tax liability is $4,090 plus 25% of the amount over $29,700. If we subtract $29,700 from your taxable income of $40,000, the amount is $10,300. Twenty-five percent of $10,300 is $2,575. So $4,090 + $2,575 = $6,665, the amount you owe in taxes.

13. It is also likely that you paid taxes throughout the year. You have probably noticed that a certain amount of money is deducted from your paychecks to pay federal income taxes. Let’s say the total amount of taxes deducted from your paychecks over the year was $6,000. Given that you already paid $6,000 of the $6,665 you owe in taxes, you now need to write out a check to the IRS for $665.

14. If by chance, the total amount of taxes deducted from your paychecks over the year was $7,000, then you paid more in taxes than you owe. You will be entitled to a tax refund of $335.

15. Finally, you can file your tax return over the phone, online, or via regular mail.

<table>
<thead>
<tr>
<th>If taxable income is over—</th>
<th>But not over—</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$7,300</td>
<td>10% of the amount over $0</td>
</tr>
<tr>
<td>$7,300</td>
<td>$29,700</td>
<td>$730 plus 15% of the amount over 7,300</td>
</tr>
<tr>
<td>$29,700</td>
<td>$71,950</td>
<td>$4,090 plus 25% of the amount over 29,700</td>
</tr>
<tr>
<td>$71,950</td>
<td>$150,150</td>
<td>$14,652.50 plus 28% of the amount over 71,950</td>
</tr>
<tr>
<td>$150,150</td>
<td>$326,450</td>
<td>$36,548.50 plus 33% of the amount over 150,150</td>
</tr>
<tr>
<td>$326,450</td>
<td>no limit</td>
<td>$94,727.50 plus 35% of the amount over 326,450</td>
</tr>
</tbody>
</table>

My Personal Economics Action Plan

Here are some points you may want to consider and some guidelines you might want to put into practice.

1. In most cases, computing your tax liability and filing your tax return is a fairly simple process.

   I will make a serious effort to complete and file my own return.

2. Even if you use computer software to do your taxes, or get a tax return service to file your tax return, it is important that you know how your taxes are computed.

3. Some people refer to their tax refund as “free money.” It is not free money; it is (most likely) money you worked to earn.
How Does the Federal Government Spend Money?

In 2005, the federal government spent approximately $2,451 billion. How was this money spent? The federal government breaks down its spending according to categories, a few of which are briefly discussed here.

National Defense

In 2005, the federal government spent $497 billion on national defense (and about $31 billion on homeland security). If we sum national defense and homeland security, this total amount was about 21.5 percent of total federal government spending in that year. In other words, out of every dollar the federal government spent in 2005, 21.5 cents went to national defense and homeland security. This money largely goes to pay the men and women in the armed services and to buy and maintain military weapons.

Income Security, Retirement, and Disability

Income security refers to government programs such as housing assistance, food and nutrition assistance for the poor, unemployment compensation (for those persons who have lost their jobs), food stamps, child nutrition programs, federal employee disability payments, and so on. The federal government spent $197 billion on income security in 2005. On other retirement and disability programs it spent $147 billion. The sum total here is $344 billion or 14 percent of total federal government spending.

Social Security

The federal government in 2005 spent $516 billion on Social Security payments, which largely go to retired persons. These payments were a little more than 21 percent of total federal government spending.

Medicare

In 2005, the federal government spent $297 billion on Medicare, which is hospital
and medical insurance for Social Security beneficiaries. This amount was 12.1 percent of total federal government spending.

**Net Interest on the National Debt**

When the government spends more money than it receives in tax revenues, it is said to run a budget deficit. For example, if the government spends $2,000 billion and its tax revenue is $1,800 billion, the budget deficit is $200 billion. The government has to borrow the $200 billion, in much the same way that people have to borrow money if their expenditures are greater than their income. The federal government borrowed much money over the years; on October 24, 2005, its total debt—referred to as the national debt—was $8,009 billion or $8.009 trillion. If you want to know what the national debt is today, go to www.emcp.net/nationaldebt. This Web site will show you the national debt to the penny.

The federal government has to pay interest on this debt, in much the same way that people make interest payments on their general credit card bills (such as Visa or MasterCard). In 2005, the interest payment the government had to make on the national debt was approximately $177 billion, or 7.2 percent of total federal government spending.

If we combine national defense spending, spending on homeland security, income security spending, spending on retirement and disability, Social Security spending, Medicare spending, and spending on the national debt, we see that we have accounted for 75.8 percent of all federal government spending. Just looking at national defense (plus homeland security) and Social Security (plus Medicare) accounts for over half of all federal spending, at a total of 54.6 percent.

Exhibit 14-7 shows projected federal government spending for the period from 2006 to 2011.

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected spending (billions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$2,511</td>
</tr>
<tr>
<td>2007</td>
<td>2,625</td>
</tr>
<tr>
<td>2008</td>
<td>2,754</td>
</tr>
<tr>
<td>2009</td>
<td>2,881</td>
</tr>
<tr>
<td>2010</td>
<td>3,008</td>
</tr>
<tr>
<td>2011</td>
<td>3,157</td>
</tr>
</tbody>
</table>

Source: Internal Revenue Service (2005).
A Student Asks

**QUESTION:** Does the federal government spend much on education? What percentage of total federal spending goes for education?

**ANSWER:** In 2002, the federal government spent approximately $54.6 billion on elementary and secondary education, which was about 2.2 percent of total federal spending. Keep in mind, though, that most spending on elementary and secondary public education occurs at the state level. In other words, state governments are the major spenders on education. Spending on education usually takes the biggest slice of a state government’s budget. In 2002, per-student spending in a public school was $7,524. In other words, it takes about that much to educate you if you are in a public school. If you would like some detailed data on schools in your state, you can go to www.emcp.net/schools. Once there, simply click on the state you are interested in. You will find information on total number of schools in your state, total number of students, total number of teachers, pupil/teacher ratio, total dollar amount spent on education, and much more.

The Costs and Benefits of Government Spending Programs

According to economists, a government spending program is not worth pursuing unless the benefits of that program outweigh the costs. In other words, if the program generates $100 billion in benefits and costs $40 billion, then we have $60 billion in net benefits, and the program is worth pursuing.

In reality, though, things don’t always turn out this way. Sometimes spending programs that have greater costs than benefits get passed in Congress. Why? Let’s look at the following example.

<table>
<thead>
<tr>
<th>Person</th>
<th>Benefits</th>
<th>Costs</th>
<th>Vote</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$130</td>
<td>$100</td>
<td>Yes</td>
</tr>
<tr>
<td>B</td>
<td>120</td>
<td>100</td>
<td>Yes</td>
</tr>
<tr>
<td>C</td>
<td>102</td>
<td>100</td>
<td>Yes</td>
</tr>
<tr>
<td>D</td>
<td>50</td>
<td>100</td>
<td>No</td>
</tr>
<tr>
<td>E</td>
<td>10</td>
<td>100</td>
<td>No</td>
</tr>
</tbody>
</table>

Five people, A–E, are represented in the table above. Suppose these people are considering buying a statue for their town square, the total cost of which is $500. They have agreed that if they decide to buy the statue, they will split the cost equally, each member paying $100. Now, they take a vote on whether or not to buy the statue. How will each person vote? Each person has to compare his or her personal benefits from the statue to the personal costs. In this case, their costs are all the same—$100. But to determine the benefits, each person must place a dollar value on what he or she thinks the benefits are worth. This dollar amount is essentially what the person is willing to pay for the statue. If the person’s benefits are greater than the costs, the person will vote yes for the statue; if the person’s benefits are less than the costs, the person will vote no.

As you can see in the table, persons A, B, and C vote yes for the statue because for each of them the benefits are greater than the costs. Persons D and E vote no because for them benefits are less than costs—they don’t believe they will receive $100 worth of benefits from the statue.

More yes votes (3) than no votes (2) means the community of five persons buys the statue. Notice one thing, however: the total benefits to the community of five persons is less than the total cost to the community of five persons. Even though the total benefits ($412) are less than the total costs ($500), the community buys the statue.

On a personal level, you would never buy anything if the total benefits to you were less than the total costs. However, the government buys things every day where the total benefits are less than the costs, because government decides whether something will be bought based on voting. And voting, as we showed, can lead to things being bought even though the total benefits of something are less than the total costs.
Thorstein Veblen (1857–1929), an economist, believed that people sometimes buy goods for the wrong reasons. He coined the term *conspicuous consumption*—that is, purchasing designed to show off or to display one’s status.

Consider the fact that today you can buy several different makes of watches, two of which are a Timex and a Rolex. A Timex costs under $100, and a Rolex costs many thousands of dollars. Both brands of watches keep good time, but the Rolex does something else: it “says” that you have the money to buy something expensive. In other words, a Rolex is a status symbol.

In 2005, Tom Cruise and Katie Holmes, both movie actors, got engaged (to be married). Tom Cruise gave Katie Holmes a 4-carat diamond engagement ring. Cost: $200,000.

Does our culture today promote status? Some economists believe that it does. The race for status, these economists contend, is a relative race and is wasteful.

Some economists argue that the race for status comes with certain opportunity costs, one of which is lost leisure. If we try to leapfrog each other, we work harder and longer to achieve a status position we could all achieve at lower cost.

Another opportunity cost of the race for status may be that society has to do without certain goods that it wants. For example, suppose society wants the government to spend more money on medical research, education, and infrastructure. Currently, three individuals—A, B, and C—are locked into a race for status with the other two. A is richer than B, and B is richer than C, so A can buy more status goods (big houses, fancy cars, etc.) than B, who can buy more status goods than C.

Suppose the government proposes that it increase taxes on each of the individuals by 10 percent. A, B, and C argue against the higher tax rate because it reduces their ability to buy status goods. They fail to realize, however, that even though higher tax rates may make it less likely that each individual can buy as many status goods, their relative positions in the race for status will not change. After the higher taxes are paid, A will still have a higher after-tax income than B, who will have a higher after-tax income than C. Higher taxes will not stop the race for status, nor will higher taxes prevent anyone from showing off. The higher taxes simply reduce the amount of money that the individuals can spend in their race to show off.

Are any benefits derived from the higher taxes? According to some economists, the additional tax revenue can finance more medical research, education, and infrastructure. In other words, some benefits may come from using higher taxes to slow down the race for status.

One criticism of this reasoning is that the additional tax funds may not be used in the way people want them to be used. The funds may go for “public conspicuous consumption,” such as expensive federal buildings, and other similar things. The critics also point out that higher taxes dampen people’s incentives to produce, which may lead to less economic growth and wealth in the future. Finally, the critics point out that if the race for status is hobbled by higher taxes, the race will not slow down; it will simply take a different form. Instead of competing for status in terms of goods, people will compete for status in terms of power over others. In the end, the critics argue, it may be better to have people compete for status by buying goods than by trying to control others.

**Think About It**

Do people in your high school try to achieve status by purchasing certain goods? If so, what goods?
The Budget Process

Just as individuals may have budgets in which they specify how they will spend their incomes—such as $300 a month for food and $100 a month for clothes—the federal government has a budget, too. In the federal budget, the federal government specifies how it will spend the money it has. It may decide to spend $250 billion on national defense, $100 billion on health care, and so on.

It Begins with the President

Preparing a budget and passing it into law is a long process. It begins with the president of the United States, who, with others in the executive branch of government, prepares the budget. The president’s budget recommends to Congress how much should be spent for such things as national defense and income security programs. The president must submit the budget to Congress on or before the first Monday in February of each year.

Disagreements and Compromises

Once the president’s budget is in the hands of Congress, it is scrutinized by the members of the many congressional committees and subcommittees. The Congressional Budget Office advises the members of the committees and subcommittees on technical details of the president’s budget.

Members of Congress may disagree with the president about how money should be spent. For example, the president may want to spend more money for health care than do many members of Congress.

Disagreements may also arise over how much tax revenue is likely to be raised over the next few months. Perhaps the president estimated that the federal government will take in $2,100 billion in tax revenues, but Congress estimated tax revenues to be $1,900 billion. Both the executive and legislative branches must estimate tax revenues, because no one knows for sure how the economy will perform. For example, if the economy is sluggish and many millions of people are out of work, less income is earned, and thus income taxes will be down. Many details of the president’s budget may be changed to reflect compromises between the president and Congress.

Public Opinion Counts

Where are the American people in the budget process? Do they have a role to play? Once the president submits a budget to Congress, the people get a chance to hear about it. Usually numerous newspaper stories and newscasts cover the president’s proposals. The American people can write to or call their congresspersons and express their preferences on the president’s budget. Also during this time, special-interest groups may lobby members of Congress and express their preferences on the president’s budget.

The Budget Becomes Law

Congress is obligated to pass a budget by the beginning of the fiscal, not the calendar, year. (A calendar year begins on January 1 and runs through December 31; a fiscal year can begin on the first day of another month and run for the next 12 months. The fiscal year under which the federal government operates begins on October 1 and runs through September 30.) Once Congress passes the budget, the details of spending outlined in the budget become law for that fiscal year. Then, the whole process begins again in only a few months.
Suppose you and five friends go out to dinner. In setting A, you and your friends agree to pay for your own meals. If you have lobster for dinner, you pay for lobster. If you have a hamburger for dinner, you pay for the hamburger. The same holds for your friends.

In setting B, you and your friends agree to split the bill evenly. If the total bill comes to $150, then you will split this bill six ways ($25 each).

Now in which of the two settings, A or B, do you think (1) you will order more expensive food and (2) the total bill will be higher?

In other words, do you think you will order a more expensive meal when you have to pay for what you order, or when you pay one-sixth of what everyone orders?

Do you think the total bill will be greater when everyone pays for what he or she ordered, or when everyone pays an equal share?

One might think that a person would buy exactly the same meal in both settings, and so the total bill in both settings will be the same. However, some evidence indicates that people seem to buy more expensive things (food, clothes, etc.) when they view themselves as paying a fraction of the cost.

Think of it this way. If you are considering the lobster, and you know that you will have to pay for it, you consider the full price of the lobster—say, $35. If, however, you agree to split the bill, then the price (to you) of purchasing lobster is not $35, but one-sixth of $35, which is $5.83. Few people will choose the lobster at a price of $35, but many will at $5.83.

What holds for you holds for everyone at the dinner table. Because splitting the bill causes the items on the menu to appear cheaper (for each individual), each individual is more likely to buy expensive meals. But if everyone buys meals they wouldn’t likely buy if they had to pay the full price, the dinner total is likely to be high indeed.

The dinner under two different settings goes a long way to explaining why government spending can zoom upward quickly. As you saw in Exhibit 14-7 on page 377, projected federal government spending in 2006 is $2,511 billion. But the people who lobby government for benefits aren’t paying for all the benefits that they may receive. For example, let’s say that the farmers ask Congress for subsidies. If Congress and the president agree to the subsidies, the taxpayers will have to foot the bill. Now the farmers are taxpayers, so they will have to pay for some of the benefits they receive. But they only pay for a fraction of the benefits they receive in a country with more than 100 million taxpayers. For the farmers this is like going to dinner with 100 million people at the table, all having agreed to split the check.

Now if 100 million people are going to split the check, anything you order is going to be cheap indeed. What’s the lobster cost now? Dessert? I’ll have 15.

In politics, almost everyone has an incentive to order big off the government menu. Yet, if everyone has an incentive to order big, and does order big, the total spending bill is going to be huge.
What Is a Fair Share?

Most people say that it is only right for everyone to pay his or her fair share of taxes. The problem is, how do we decide what a fair share is? And who decides? Historically, two principles of taxation touch on this issue: the benefits-received principle and the ability-to-pay principle.

Benefits-Received Principle

The benefits-received principle holds that a person should pay in taxes an amount equal to the benefits he or she receives from government expenditures. For example, if you drive often on government-provided roads and highways, you ought to pay for the upkeep of the roads. This goal is usually met through the excise tax on gasoline. People who drive a lot buy a lot of gas, so they pay more in gas taxes than people who drive very little. Because gas tax revenues are used for the upkeep of the roads, the major users of the roads end up paying the bulk of road upkeep costs.

Ability-to-Pay Principle

With some government-provided goods, it is easy to figure out roughly how much someone benefits. For instance, in the roads-and-highways example, we can assume that the more a person drives on the road or highway, the more benefit he or she obtains from it.

With other government-provided goods, however, it is not as easy to relate benefits received to taxes paid. For example, we could say that almost all Americans benefit from national defense, but we would have a hard time figuring out how much one person benefits compared to another person. Does Jackson, down the street, benefit more than, less than, or the same as Paul, who lives up the street? The benefits-received principle is hard to implement in such cases.

Often, the ability-to-pay principle is used instead. This principle says that people should pay taxes according to their abilities to pay. Because a rich person is more able to pay taxes than a poor person, a rich person should pay more taxes than a poor person. For example, a millionaire might pay $330,000 a year in income taxes, whereas a person who earns $50,000 a year might pay $8,000.

BY THE NUMBERS

The federal income tax came into existence in 1913. In that year, the top tax rate that anyone paid was 7 percent. As you learned in this chapter, the top (stated) tax rate today is 35 percent. The top tax rate has been different in different years. The following list shows the top tax rate for a few selected years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Top Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1913</td>
<td>7.0%</td>
</tr>
<tr>
<td>1916</td>
<td>15.0</td>
</tr>
<tr>
<td>1919</td>
<td>73.0</td>
</tr>
<tr>
<td>1922</td>
<td>58.0</td>
</tr>
<tr>
<td>1929</td>
<td>24.0</td>
</tr>
<tr>
<td>1938</td>
<td>79.0</td>
</tr>
<tr>
<td>1944</td>
<td>94.0</td>
</tr>
<tr>
<td>1952</td>
<td>92.0</td>
</tr>
<tr>
<td>1962</td>
<td>91.0</td>
</tr>
<tr>
<td>1967</td>
<td>70.0</td>
</tr>
<tr>
<td>1986</td>
<td>50.0</td>
</tr>
<tr>
<td>1999</td>
<td>39.6</td>
</tr>
<tr>
<td>2005</td>
<td>35.0</td>
</tr>
</tbody>
</table>
Budgets: Balanced and in Deficit

Adam Smith, the eighteenth century economist, said, “What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom.” In other words, if it is right and reasonable for a family to do something, it is probably also right and reasonable for a great nation to do the same. If it is right for a family to save and avoid debt, then it is right for a nation to do the same.

For many years this notion carried over to the discussions of U.S. federal budget policy. Most people believed that the federal budget should be balanced—that is, government expenditures should be equal to tax revenues. Budget deficits, which occur when government expenditures exceed tax revenues, were acceptable, but only during wartime. (As an aside, a budget surplus exists if tax revenues exceed government expenditures.)

The Great Depression

Conditions began to change around the time of the Great Depression (1929–1933), a period of great economic distress in this country. During this time, unemployment skyrocketed, the production of goods and services plummeted, prices fell, banks closed, and companies went bankrupt. Until this time, many people in the United States thought that free enterprise was a stable, smooth mechanism. The economic downturn of the Great Depression gave these people cause for doubt, however, and slowly many previously accepted ideas of budget policy began to be discarded. One notion in particular that fell by the wayside was the idea that the federal budget should be balanced. People began to accept budget deficits as a way of reducing unemployment.

Reducing Unemployment

What do budget deficits have to do with reducing unemployment? Suppose the federal budget is balanced. Government spending is $2,000 billion, and tax revenues are $2,000 billion. However, unemployment is high, say, about 10 percent. The president, along with Congress, wants to reduce the unemployment rate by implementing expansionary fiscal policy (increase government spending or decrease taxes). Together, they decide to increase government spending to $2,200 billion. Tax revenues, we’ll assume, remain constant at $2,000 billion. In this instance, expansionary fiscal policy leads to a budget deficit.

Many people came to see budget deficits as necessary, given the high unemployment that plagued the economy. According to them, the choice was simple: (1) either keep the federal budget balanced and suffer high unemployment (and the reduced output of goods and services that results), or (2) accept the budget deficit and reduce the unemployment rate. For many people, it was “better to balance the economy than to balance the budget.” Exhibit 14-8 shows projected budget deficits from 2006 to 2011.

One would expect that the people living in the houses on the left are more able to pay taxes than the people who live in the housing shown on the right. Do you think the people living in the more expensive housing should have to pay a higher percentage of their income in taxes? If so, why?
QUESTION: Do all economists think that enacting expansionary fiscal policy (even if it causes a budget deficit) is the way to reduce the unemployment rate?

ANSWER: No. Remember what we said in the last chapter. Some economists believe that if the government spends more (enacts expansionary fiscal policy by raising its spending), members of the private sector (you, for example) will spend less. In the case of complete crowding out (a term from the last chapter), $1 more spent by the government will lead to $1 less spent by the private sector. This means no additional spending occurs in the economy to push the unemployment rate down.

National Debt

The only way an individual can spend more than he or she earns is to borrow the difference and incur a debt. (We are ruling out monetary gifts to this person.) For example, if Harry earns $30,000 a year and spends $32,000, he would have had to borrow $2,000. This $2,000 is Harry’s debt.

What is true for Harry is true for the federal government. If it spends more than it receives in tax revenues, it has to borrow the difference and incur a debt. Of course, another way to say this is that every time the federal government runs a deficit, it has to borrow money and incur a debt. In short, deficits lead to debt. The debt of the federal government is called the national debt.

As we stated earlier, the national debt as of October 24, 2005, was $8.009 trillion. If we divide the national debt by the U.S. population, we get per capita national debt, which is approximately $25,950. The per capita national debt is sometimes referred to as each “citizen’s share” of the national debt.

A Student Asks

QUESTION: Will I have to pay off some of the national debt one day?

ANSWER: Whenever you pay federal taxes, you are helping to pay off the national debt. Remember, one of the spending categories of the federal government is “net interest on the national debt.” In 2005, this amounted to $177 billion. Whoever paid federal taxes that year helped pay off some of the national debt.

Higher Future Taxes

When the government spends more than it collects in tax revenues, it has to borrow the difference. Deficits lead to debt. But what does debt lead to? Some economists argue that it leads to higher taxes in the future.

When the government borrows the money to pay for the excess of its spending over tax revenues, it has to borrow that money from people. Those people will have to be repaid one day; the debt has to be paid off. (If you borrowed money from a bank, you would have to repay the money one day, with interest.) What happens when the government’s debt has to be paid off? Taxes must be used, so taxes have to be higher than they would have been had the debt not been incurred in the
first place. Some economists say that as far as future taxpayers are concerned, current budget deficits are a form of “taxation without representation.”

**Example:** Suppose that in a particular year a government needs $2.0 trillion to buy all the different things that year, and to pay interest on its national debt. The government calculates that it would need only $1.9 trillion in taxes were it not for the interest on the debt. Taxpayers would be able to keep $0.1 trillion for themselves if the government had not gone into debt.

Is it ethical for one generation to buy things that another generation ends up partly paying for? Some people say no, but others say it depends on whether what the first generation buys benefits the next generation. For example, suppose the present generation decides to buy an interstate freeway system for $10 billion. The present generation decides to pay $2 billion itself through taxes and to borrow $8 billion. The present generation knows that the future generation will have to pay off the $8 billion (plus interest), but it reasons that the future generation will use the freeway system, so it should pay for some of it. If the current generation purchased $10 billion of something from which only it could benefit, the situation would be different.

If the government spends more than it takes in, it incurs a debt that must be paid off eventually. **Do you think it’s fair to pass on to the next generation the responsibility for paying off this debt?**

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### Defining Terms

1. Define:
   a. national debt
   b. budget deficit
   c. budget surplus

### Reviewing Facts and Concepts

2. How does the federal government spend its tax revenues?

### Applying Economic Concepts

6. Suppose the Fed were to create enough money to pay off the entire public debt. What would happen to prices? Explain your answer.

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### Tax Advantages

Globalization sometimes makes it easier for a company to lower its taxes. Firms might design a good in one country, manufacture it in another, and sell it in a third. This approach gives these firms some flexibility in lowering their tax bills by shifting operations from country to country. For example, foreign subsidiaries of U.S. companies often report higher profits in low-tax countries and lower profits in high-tax countries.

**Economic Thinking**

How do you expect the high-tax countries to respond to growing difficulties in collecting taxes in a global economy?
Chapter 14 Taxing and Spending

Economics Vocabulary

To reinforce your knowledge of the key terms in this chapter, fill in the following blanks on a separate piece of paper with the appropriate word or phrase.

1. A(n) _____ exists when government spending is greater than tax revenues.
2. A proportional tax is sometimes called a(n) _____ tax.
3. A tax rate that falls as income rises is a(n) _____ tax.
4. The _____ is the idea that each person should pay taxes according to his or her ability to pay.
5. The _____ is the idea that each person should pay taxes according to the benefits that he or she receives from government expenditures.
6. A gas tax is consistent with the principle of _____ taxation.
7. The _____ tax is applied to corporate profits.
8. A(n) _____ exists if federal government spending is less than federal government tax revenues.
9. A tax rate that rises as income rises is a(n) _____ tax.

Understanding the Main Ideas

Write answers to the following questions to review the main ideas in this chapter.

1. What are the three major types of federal taxes?
2. Which level of government—federal, state, or local—typically collects sales taxes?
3. Name two factors that have caused more and more people to pay the alternative minimum tax.
4. In what ways can a budget deficit be reduced or eliminated?
5. Explain how a budget deficit can cause a future generation to pay for what a current generation buys.
6. What did Adam Smith mean when he said, “What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom”?
7. What role does the Congressional Budget Office (CBO) play in the budget process?
8. What is the difference between a calendar year and a fiscal year?
9. What three federal taxes raise more than 90 percent of all federal tax revenues?
10. Smith paid $40,000 in federal income taxes, and Abuel paid $20,000. Is the income tax progressive, proportional, or regressive, or is it impossible to tell? Explain your answer.
11. Explain the benefits-received principle of taxation.
12. What is a flat tax?

**Doing the Math**

Do the calculations necessary to solve the following problems.

1. According to Exhibit 14-1, what percentage of total taxes is the personal income tax projected to account for in 2009?
2. According to Exhibit 14-5, approximately what percentage of a year did the representative taxpayer work to pay his or her taxes in 1980?
3. According to Exhibit 14-7, what percentage increase in government spending is expected between 2008 and 2009?

**Solving Economic Problems**

Use your thinking skills and the information you learned in this chapter to find solutions to the following problems.

1. **Application.** Suppose a local government were to lower the property tax from 1.25 percent of the assessed value of property to, say, 0.75 percent. How might this affect the price of property? Explain your answer.
2. **Cause and Effect.** Do you think a proportional tax or a progressive tax is more likely to lead to unequal after-tax pay? Explain your answer.
3. **Writing.** Write a one-page paper outlining your arguments either for or against the benefits-received principle of taxation.
4. **Economics in the Media.** Find an article in the local newspaper that addresses the current state of the federal budget, personal income taxes, sales taxes, or the national debt. Identify the major ideas of the article.

**Working with Graphs and Tables**

1. Look at Exhibit 14-9(a) below. Each bar represents a certain type of federal income tax in 2005. Identify the kind of tax that goes with each bar.
2. Look at Exhibit 14-9(b). Each bar (A, B, and C) represents a certain federal spending program in 2005. Identify the program that goes with each bar.
What Is Government’s Role When It Comes to the Economy?

People often disagree as to what the federal government’s role should be regarding the economy. For example, some people argue that the federal government should try to stabilize the economy. These people say that if the economy is in a recession, the government should implement expansionary monetary and fiscal policy to stimulate the economy. This may mean increasing the money supply and cutting taxes to stimulate spending. Others argue that if the government hadn’t implemented the wrong monetary and fiscal policies in the past, there would be no recession to combat. The question becomes: does government mainly make the patient (the economy) sick, or does it mainly make the patient (the economy) well when it is sick?

Sometimes people disagree about what goods and services the federal government should provide to the citizens. Is it government’s role to deliver the mail and care for the sick and elderly, or is it better if government limited itself to building the roads and providing for the national defense? How much or how little should government do? Let’s listen in to what some people have to say.

Hamid Khatami, computer consultant

It seems to me that the Great Depression settled the issue of government’s role in the economy. I believe that if government hadn’t come to the rescue, and provided people with jobs, and stimulated spending in the economy, that the Great Depression would have gone on much longer than it did.

Before the Great Depression, many people used to think that a free enterprise economy could take care of itself. It wouldn’t produce too much inflation and it wouldn’t bring on an economic contraction. Well, then, how do you explain the Great Depression? The unemployment rate rose to 25 percent during that time. The government had to do something.

Francine Watermaker, registered nurse

I’m not sure that Hamid has the explanation of the Great Depression correct. I don’t think it was free enterprise that failed. I think it was government doing the wrong things. It was the government overspending in the 1920s and planting the seeds of the economic contraction. It was the government placing high tariffs on imported goods and making the contraction worse than it would have been. It was the Fed cutting the money supply too much. If anything, the Great Depression was a failure of government, not free enterprise. The way I see it, government makes more problems for the economy than it solves. Sure, the government can do some things right, but government today is into more things than it can do. I am in favor of the government limiting itself to doing what individuals or businesses can’t do. For example, I don’t believe that either individuals or businesses can supply the country with the national defense that it needs. National defense then should be left to government. Use the tax money to provide for the national defense, not to subsidize the farmers. And in my opinion, it doesn’t make sense for the government to be involved in programs such as Medicare and Social Security.
Here’s what I would like to know. If government is so bad—as Francine seems to imply—why has this country been as militarily and economically strong for so long? We have the largest economy in the world and we have the strongest and most capable military in the world. And we’ve done both of these things at the same time that the federal government has been getting bigger. If government bigness is so bad, how does someone explain that our economy is as strong and as big as it is?

I think Yong is making a mistake here. Just because you see two things at the same time, or nearly the same time, it doesn’t mean that one is the cause and the other is the effect. There are more dogs in the United States today than there were in 1950. Does it follow that a rising dog population is what causes the economy to be strong? Not at all. There are a lot of things that happen at around the same time that have nothing to do with each other.

But I have a better point to make with respect to Yong’s comment. Isn’t it possible that we would have an even stronger economy, and a mightier military, if the government hadn’t grown so large? With a smaller, less intrusive government, perhaps our economy would be even larger than it is today. And perhaps our military would be even stronger.

I think what we are talking about here is that neither free enterprise nor government is perfect at doing everything. Sometimes the free enterprise economy does need government to help it out. For instance, when the economy is slumping, or we need something that free enterprise won’t produce, such as protection against terrorists, government needs to step in.

But certainly this doesn’t mean that government has been perfect. Government can make mistakes. I think government can implement the wrong monetary policy—perhaps causing high inflation. I believe that government may implement a particular fiscal policy that doesn’t work because of, say, complete crowding out. My guess is that sometimes government does more to make things worse than to make things better.

Maybe what we are learning over time is what government should and should not do, and what free enterprise should and should not do. In other words, maybe the last 50 years have been a learning period for us.

What Do You Think?

1. What is your opinion as to the proper role for government, especially when it comes to economic issues?
2. What goods and services do you think government should provide (using taxpayer money)? Is there anything that government currently does that you don’t think it should do? Explain your answer.