UNIT 6

# Government and the Economy

## Chapters in This Unit



# It's April 15. Where's your tax return?

Every year Americans rush to file their Federal Income Tax return by midnight on or around April 15. Whether you'll be receiving a refund or have to pay, you're probably asking yourself a few questions as you slip the envelope addressed to the IRS into the mail slot:

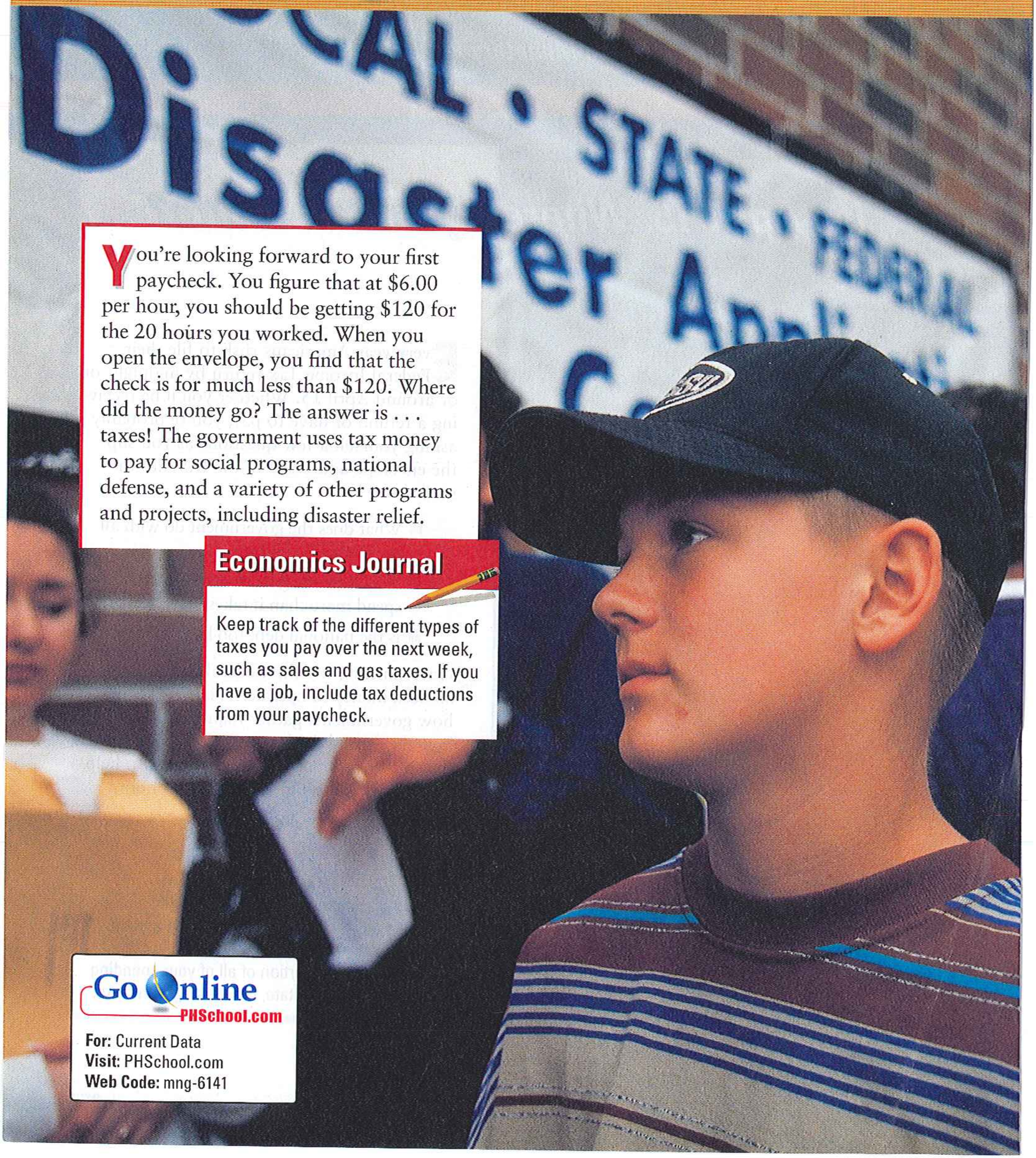
- What does the government do with all the money it collects?
- Why does the government sometimes spend more than it takes in?
- Is the national debt too large?

Governments, whether federal, state, or local, all need money to operate. This unit focuses on how governments gather financial resources, how they spend these resources, and the actions that the government sometimes takes to help ensure the health of the nation's economy.

### Focus Activity

Keep track of all the transactions you make in one day—whether you're buying a bottle of juice or putting money in a parking meter. Calculate what portion of all of your spending goes to the local, state, or federal government.

# Chapter 14 Taxes and Government Spending




You're looking forward to your first paycheck. You figure that at $6.00 per hour, you should be getting $120 for the 20 hours you worked. When you open the envelope, you find that the check is for much less than $120. Where did the money go? The answer is . . . taxes! The government uses tax money to pay for social programs, national defense, and a variety of other programs and projects, including disaster relief.

## Economics Journal

Keep track of the different types of taxes you pay over the next week, such as sales and gas taxes. If you have a job, include tax deductions from your paycheck.

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# Section 1 What Are Taxes?

## Preview

### Objectives

**After studying this section you will be able to:**

1. **Understand** how the government uses taxes to fund programs.
2. **Identify** the roots of the concept of taxation in the United States Constitution.
3. **Describe** types of tax bases and tax structures.
4. **List** the characteristics of a good tax.
5. **Identify** who bears the burden of a tax.

### Section Focus

Local, state, and national governments generate revenue by charging taxes. The Constitution spells out specific limits on governments' powers to tax. Taxation can take several different forms, and people disagree over which method of taxation is most fair.

### Key Terms

**tax**
**revenue**
**tax base**
**individual income tax**
**sales tax**
**property tax**
**corporate income tax**
**proportional tax**
**progressive tax**
**regressive tax**
**incidence of a tax**

Looking at all of the taxes taken from your paycheck can be discouraging. It can feel like all of that money is being taken from you for someone else's use. Frustration over taxes is, after all, what led American colonists to go to war against Britain and declare independence. How, then, is anything different today?

Although money is taken from your paycheck, it is not done without your consent. As citizens of the United States, we authorize the government, through the Constitution and our elected representatives in Congress, to raise money in the form of taxes. Why?

## Funding Government Programs

A **tax** is a required payment to a local, state,
r national government. Taxation is the
nary way that the government collects
v. Taxes give the government the
t needs to operate.
ome received by a government
and other nontax sources is
. Without revenue from
ment would not be able to
nd services that we not only benefit from, but that we expect the government to provide. For example, we authorize the government to provide national defense, highways, education, and law enforcement. We also ask the government to provide help to people in need.

All of these goods and services cost money—in workers' salaries, in materials, in land and labor. All members of our society share these costs through the payment of taxes.

on

tax

**tax** *a required payment to a local, state, or national government*

**revenue** *income received by a government from taxes and nontax sources*

## Taxes and the Constitution

Taxation is a powerful tool. The founders of the United States did not, without careful consideration, give their new government the power to tax. The Constitution they created spells out specific limits on the government's power to tax.

### The Power to Tax

The Framers of the Constitution gave each branch of government certain powers and duties. The first power granted to Congress is the power to tax. This is Article 1, Section 8, Clause 1:

*To lay and collect taxes, duties, imposts and excises, to pay the debts, and provide*

**tax base** *income, property, good, or service that is subject to a tax*

**individual income tax** *a tax on a person's earnings*

**sales tax** *a tax on the dollar value of a good or service being sold*

**property tax** *a tax on the value of a property*

**corporate income tax** *a tax on the value of a company's profits*

*for the common defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States.*

This clause is the basis for federal tax laws.

### Limits on the Power to Tax

The Constitution specifically limits certain kinds of taxes. Two of those limits are in the taxation clause. First, the purpose of a tax must be for the "common defense and general welfare." A tax cannot bring in money that goes to individual interests. Second, federal taxes must be the same in every state. The federal gas tax, for example, cannot be $.04 a gallon in Maryland and $.10 a gallon in South Dakota.

Other provisions of the Constitution also limit the kinds of taxes Congress can impose. For example, Congress cannot tax church services because that would violate the freedom of religion promised by the First Amendment. Another clause of the Constitution prohibits taxing exports. The government can collect taxes only on imports—goods brought into the United States. (Congress can limit or prohibit the export of certain goods, however, such as technology or weaponry.)

Yet another clause of the Constitution (Article 1, Section 9, Clause 4) prohibits Congress from levying, or imposing, taxes unless they are divided among the states according to population. Because of this provision, it took the Sixteenth Amendment to legalize the income tax. This amendment was ratified in 1913.

## Tax Bases and Tax Structures

Despite these limits, the government actually collects a wide variety of taxes. Economists describe these taxes in different ways. First, they describe a tax according to the value of the object taxed. Second, they describe how the tax is structured.

### Tax Bases

A **tax base** is the income, property, good, or service that is subject to a tax. The tax base might be a person's earnings (**individual income tax**), the dollar value of a good or service being sold (**sales tax**), the value of a property (**property tax**), or the value of a company's profits (**corporate income tax**). When government policymakers create a

***Figure 14.1*** **Three Types of Tax Structures**

| Type of Tax | Description | Example | Ron's taxes on $50,000 income | Mary's taxes on $150,000 income |
|---|---|---|---|---|
| Proportional | A constant percentage of income is taken in taxes as income increases | "Flat" tax | $7,500, or 15 percent of income | $22,500, or 15 percent of income |
| Progressive | A larger percentage of income is taken in taxes as income increases | Income tax | $5,000, or 10 percent of income | $45,000, or 30 percent of income |
| Regressive | A smaller percentage of income is taken in taxes as income increases | Sales tax | $2,000, or 5 percent of total purchases of $40,000; tax bill is 4 percent of income | $3,000, or 5 percent of total purchases of $60,000; tax bill is 2 percent of income |

BUILDING KEY CONCEPTS

This chart shows how three different tax structures would affect a taxpayer named Ron with an income of $50,000 and a taxpayer named Mary with an income of $150,000. **Income How does Mary's higher income affect the taxes she pays in each type of tax structure?**

new tax, they first decide what the base will be for the tax: income, sales, property, profits, or some other category.

Next, the government decides how to structure the tax on that particular base. As shown in Figure 14.1, economists describe three different tax structures: proportional, progressive, and regressive.

### Proportional Taxes

A **proportional tax** is a tax for which the percentage of income paid in taxes remains the same for all income levels. Leslie Wilson, a corporate executive, earns $350,000 a year. Tony Owens, a nurse, earns $50,000 a year. If a 6 percent proportional tax were levied on their incomes, Leslie would pay 6 percent of $350,000, or $21,000, in taxes. Tony would pay 6 percent of $50,000, or $3,000. With a proportional income tax, whether income goes up or down, the percentage of income paid in taxes stays the same.

### Progressive Taxes

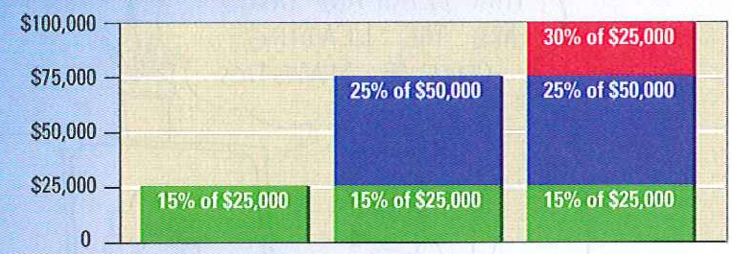
A **progressive tax** is a tax for which the percentage of income paid in taxes increases as income increases. As income rises, the percentage of income paid in taxes also rises. People with very small incomes might pay no tax at all.

The federal income tax is the clearest example of a progressive tax in the United States. A sample progressive income tax system is shown in Figure 14.2. Notice that the tax rate in this example rises from 15, to 25, and then to 30 percent as income rises. This is a progressive tax rate structure because as income rises, the percentage of income paid in taxes also rises.

### Regressive Taxes

A **regressive tax** is a tax for which the percentage of income paid in taxes decreases as income increases. For example, although the sales tax rate remains constant, a sales tax is regressive. This is because higher-income households spend a lower proportion of their incomes on taxable goods and services. As a result, although they may pay more actual dollars in sales taxes, the proportion of their income spent on sales taxes is lower than that of lower-income households.

**Figure 14.2 Progressive Income Tax**




**Total taxable income: $100,000**

1. You would be taxed at a rate of 15 percent on the first $25,000 of your taxable income — 15% of $25,000 = $3,750
2. You would be taxed at a rate of 25 percent on your taxable income above $25,000 but below $75,000 ($50,000) — 25% of $50,000 = $12,500
3. You would be taxed at a rate of 30 percent on your taxable income above $75,000 ($25,000) — 30% of $25,000 = $7,500

Total tax = $23,750

BUILDING KEY CONCEPTS

In a progressive tax structure, the higher a taxpayer's income, the greater percentage he or she must pay in taxes. This chart shows a sample progressive income tax for a taxpayer with total taxable income of $100,000.

**Income According to the chart, what would be the total tax on taxable income of $65,000?**

## Characteristics of a Good Tax

Though it is sometimes difficult to decide whether a specific tax is proportional, progressive, or regressive, economists do generally agree on what makes a good tax. A good tax should have four characteristics: simplicity, efficiency, certainty, and equity, or fairness.

- *Simplicity* Tax laws should be simple and easily understood. Taxpayers and businesses should be able to keep the necessary records, prepare their own tax forms, and pay the taxes on a predictable schedule.
- *Efficiency* Government administrators should be able to collect taxes without spending too much time or money. Similarly, taxpayers should be able to pay taxes without giving up too much time. They should also not have to pay too much money in fees.

**proportional tax** *a tax for which the percentage of income paid in taxes remains the same for all income levels*

**progressive tax** *a tax for which the percentage of income paid in taxes increases as income increases*

**regressive tax** *a tax for which the percentage of income paid in taxes decreases as income increases*


▲ **This political cartoon makes fun of the saying, "The only sure things in life are death and taxes." Why are taxes necessary?**

- *Certainty* Certainty is also a characteristic of a good tax. It should be clear to the taxpayer when a tax is due, how much money is due, and how the tax should be paid.
- *Equity* The tax system should be fair, so that no one bears too much or too little of the tax burden.

### Determining Fairness

Although everyone agrees that a tax system should be fair, people often disagree on what "fair" means. Over time, economists have proposed two different ideas about how to measure the fairness of a tax.

The first idea is called the benefits-received principle. According to this principle, a person should pay taxes based on the level of benefits he or she expects to receive. People who drive, for example, pay gasoline taxes that are used to build and maintain highways. In this way, the people who receive the most benefit from the roads also contribute the most to their upkeep.



The second idea about fairness is called the ability-to-pay principle. According to this principle, people should pay taxes according to their ability to pay. The ability-to-pay principle is the idea behind a progressive income tax: people who earn more income pay more taxes.

### Balancing Tax Revenues and Tax Rates

How much revenue does a good tax generate? The answer is "enough, but not too much." That is, enough so that citizens' needs are met, but not so much that the tax discourages production. For example, if a company has to pay $100,000 in taxes, it will not be able to use that $100,000 to expand production. If tax rates are lower, however, the company can use more of its income to stimulate production rather than to pay taxes. Ultimately, many people argue, the economy benefits from lower, rather than higher, tax rates.

## Who Bears the Tax Burden?

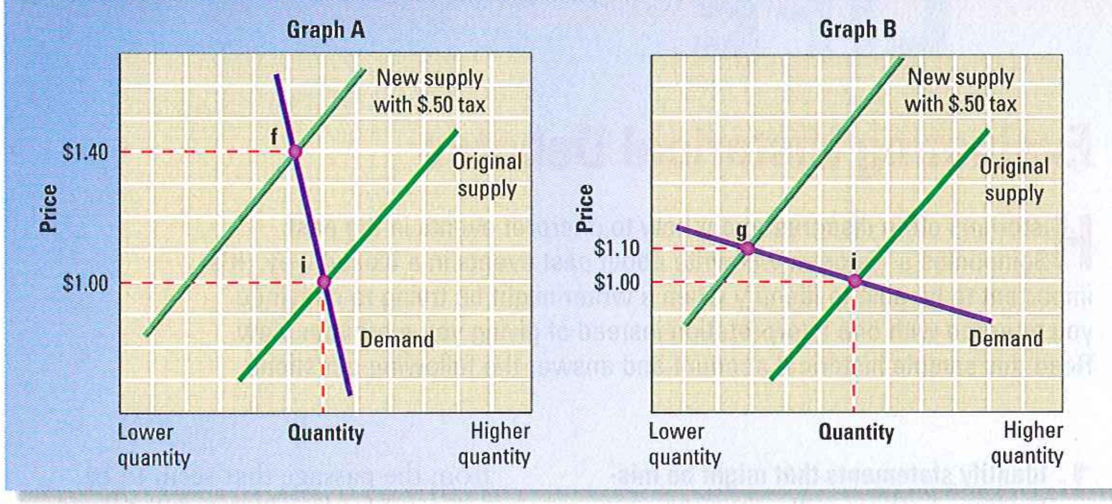
To fully evaluate the fairness of a tax, it is important to think about who actually bears the burden of the tax. Taxes affect more than just the people who send in the checks to pay them. Why? The answer lies in supply and demand analysis.

Suppose that the government imposes a gasoline tax of $.50 per gallon and collects the tax from service stations. You may think that the burden of the tax falls only on the service stations, because they mail the checks to the government. Graphs A and B in Figure 14.3, however, provide a different set of answers.

Both Graphs A and B show two supply curves: an original supply line and a line showing the supply after the $.50 tax is imposed. When a tax is imposed on a good, the cost of supplying the good increases. The supply of the good then decreases at each and every price level. This shifts the supply curve to the left.

Before the tax, the market was in equilibrium, and consumers bought gas at $1.00

*Figure 14.3* **Elasticities of Demand and Tax Effects**




**BUILDING KEY CONCEPTS**

If demand for a good is relatively inelastic (Graph A), a new tax will increase the price by a relatively large amount, and consumers will pay a large share of the tax.

**Supply and Demand** **Who bears the burden of a tax if demand is relatively elastic?**

per gallon. This is shown as point i on Graph A above. If demand for gas is relatively inelastic (that is, if consumers buy about the same amount no matter what the price), the tax will increase the price of each gallon by a relatively large amount. Consumers will bear a large share of the tax. This is shown in Graph A. Demand is inelastic, so the demand curve is relatively steep, and a $.50 tax increases the equilibrium price by $.40 (from $1.00 to $1.40 from point i to point f). In other words, consumers pay about four fifths of the tax.

In contrast, if demand is relatively elastic, the demand curve will be relatively flat, as in Graph B. Consumers will pay a relatively small part of the tax. As Graph B shows, a $.50 tax increases the equilibrium price by only $.10 (from $1.00 to $1.10 from point i to point g). In this case, consumers pay only one fifth of the tax. The service stations pay the other four fifths.

This example shows the **incidence of a tax**—that is, the final burden of a tax. When policymakers consider a new tax, they examine who will actually bear the burden. As in the example above, producers can "pass on" the burden to consumers. Generally, the more inelastic the demand, the more easily the seller can shift the tax to consumers. The more elastic the demand, the more the seller bears the burden.

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

## Section 1 Assessment

**Progress Monitoring *Online***
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**Web Code:** mna-6145

### Key Terms and Main Ideas

1. Why do governments impose taxes?
2. What is the difference between a **progressive tax** and a **regressive tax**?
3. What are the four characteristics of a good tax?
4. Describe the benefits-received principle. How does it differ from the ability-to-pay principle?

### Applying Economic Concepts

5. ***Try This*** Suppose that your town decides to levy a tax to raise funds for construction, maintenance, and other expenses for local schools. Should the tax be proportional, progressive, or regressive? Explain your answer.
6. ***Critical Thinking*** Analyze the impact of the power to tax as expressed in the Constitution on tax policies today.

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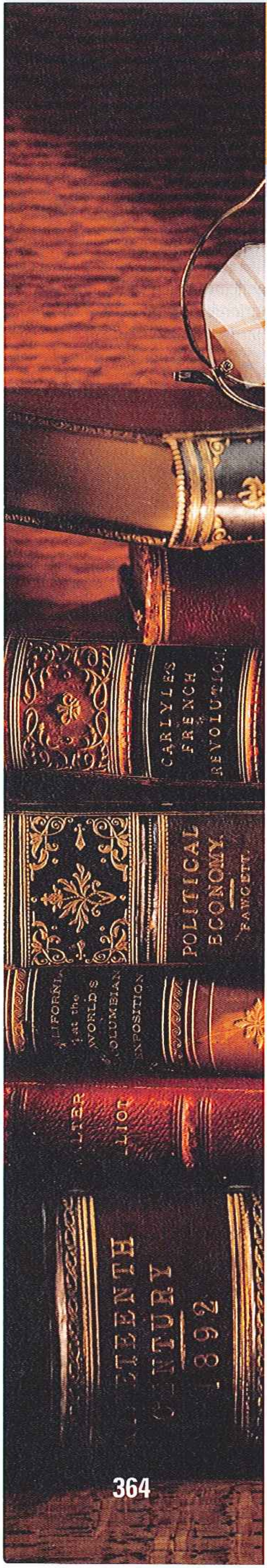



Skills for

# LIFE

## Evaluating Historical Debates

Historians often disagree about how to interpret events in the past. Sometimes a historian will write about past events in a biased way. It's important to be able to identify when a writer might be trying to convince you to agree with one interpretation instead of giving you a broader view. Read this sample historical account and answer the following questions.

> The Social Security program was developed during the Great Depression. At first, Social Security was proposed as a public pension system that would save some amount of a worker's earnings and then give that amount back to him when he was elderly. The people who needed money most were already elderly when the plan was announced, though, and they wouldn't get anything from it because they hadn't already been paying in. Congress and the general public had no interest in the plan.
>
> The only enthusiastic supporters of Social Security were a team of economists who came up with a plan for old-age insurance. In this plan, the pension would be supported by a general revenue tax, like the income tax. President Roosevelt changed the plan so that the pension payments came out of a special payroll tax instead. This change was supposed to help the system be more self-sufficient.
>
> Although no one really wanted to pass Social Security legislation, President Roosevelt had been convinced by the economists that it was the right answer for the country's problems. In order to convince Congress, Roosevelt had to make some deals. He offered to fund other social service programs in return for support for Social Security. After all the deals were made, Congress passed Roosevelt's flawed version of the economists' plan for Social Security.

1. **Identify statements that might be misleading.** Authors will sometimes oversimplify their statements or use broad generalizations in order to make their arguments look stronger than they really are. (a) List three sentences from the passage that seem to be using misleading oversimplications. (b) Why do you think those sentences are oversimplifications?

2. **Determine the author's point of view or interpretation.** If you think that an author is misleading to persuade you, think about what the author's point of view is. (a) Based on this passage, what do you think the author's opinion of the Social Security system is? (b) What specific sentences or phrases led you to that conclusion?

3. **Look at how facts are used to support the author's interpretation.** Historical accounts should always be based on facts, but individual facts can be used to support different interpretations. (a) Identify three facts in the passage that could be verified by other sources. (b) Show how the author uses those facts to support her interpretation of the historical event. (c) Think of another interpretation that could be supported by the same facts.

### Additional Practice

Think of an event in your own past that could have more than one interpretation. Write a short historical account that supports one possible interpretation, and then write a second account that uses the same facts but supports a different interpretation.

# Section 2 Federal Taxes

## Preview

### Objectives

**After studying this section you will be able to:**

1. **Describe** the process of paying individual income taxes.
2. **Explain** the basic characteristics of corporate income taxes.
3. **Understand** the purpose of Social Security, Medicare, and unemployment taxes.
4. **Identify** other types of taxes.

### Section Focus

The federal income taxes that households and families pay help to fund government programs. Other types of taxes are levied on specific items for specific purposes.

### Key Terms

**withholding**
**tax return**
**taxable income**
**personal exemption**
**deductions**
**FICA**
**Social Security**
**Medicare**
**estate tax**
**gift tax**
**tariff**
**tax incentive**

During fiscal year 2004, the federal government took in about $1.88 trillion in taxes. If you divide up this federal tax revenue among all the people in the United States, it comes to about $6,300 per person. How does the government get all this money?

The federal government has six major sources of tax revenue. They are individual and corporate income taxes, social insurance taxes, excise taxes, estate and gift taxes, and taxes on imports.

## Individual Income Taxes

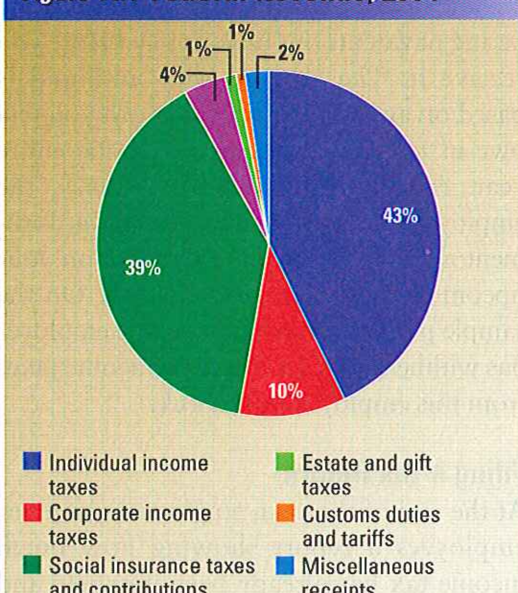
The federal government levies a tax on individuals' taxable income. As Figure 14.4 shows, individual income taxes make up the federal government's main source of revenue. About 45 percent of the federal government's revenues come from the payment of individual income taxes.

### "Pay-As-You-Earn" Taxation

The amount of federal income tax a person owes is determined on an annual basis. In theory, the federal government could wait until the end of the tax year to collect individual income taxes. In reality, that would be a problem for both taxpayers and the government. Like other employers, the government has to pay regularly for rent, supplies, services, and employees' salaries. A single annual payment from all the nation's taxpayers at once would make meeting these expenses difficult.

Similarly, many people might have trouble paying their taxes in one large sum. For these reasons, federal income tax is collected in a "pay-as-you-earn" system. This means that individuals usually pay

*Figure 14.4* **Federal Revenue, 2004**




Note: Because of rounding, totals may be less or greater than 100 percent.

Source: U.S. Department of the Treasury

**BUILDING KEY CONCEPTS**

Sources of government revenue include the taxes shown on this graph. **Government** **Analyze the categories of revenue in the federal budget. What are the largest sources of federal revenue?**

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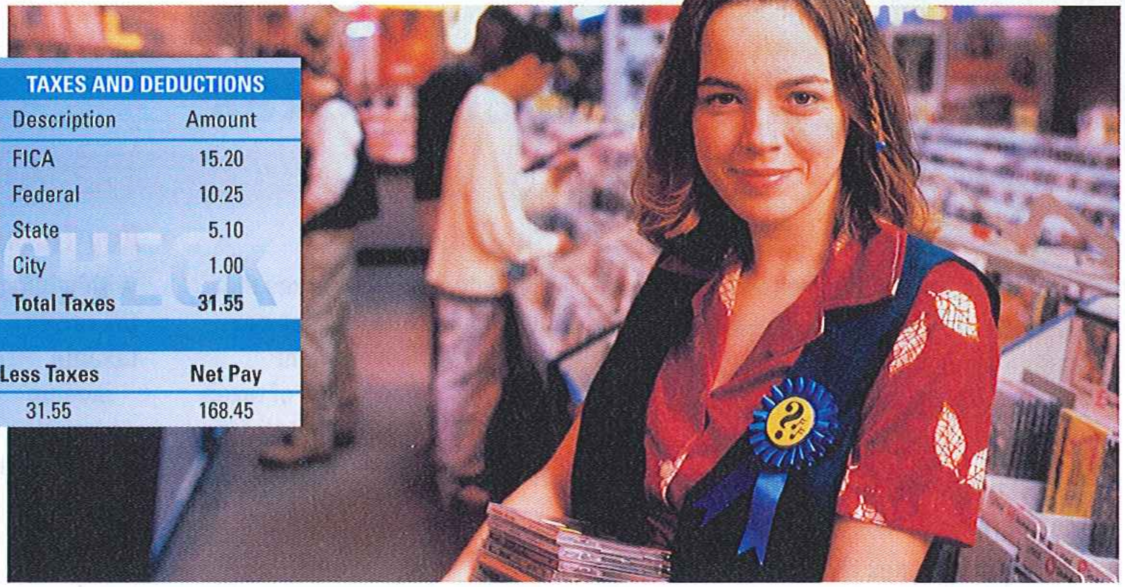
| HOURS AND EARNINGS | | TAXES AND DEDUCTIONS | |
|---|---|---|---|
| Hours | Earnings | Description | Amount |
| 20 | 200.00 | FICA | 15.20 |
| | | Federal | 10.25 |
| | | State | 5.10 |
| | | City | 1.00 |
| | | Total Taxes | 31.55 |

| TOTAL | | |
|---|---|---|
| Taxable Wages | Less Taxes | Net Pay |
| 200.00 | 31.55 | 168.45 |



▲ **This young worker's pay stub shows that her employer, as required by law, has withheld part of her earnings for taxes. What percentage of this worker's pay was withheld for federal taxes? For total taxes?**

**withholding** *taking tax payments out of an employee's pay before he or she receives it*

**tax return** *form used to file income taxes*

**taxable income** *income on which tax must be paid; total income minus exemptions and deductions*

**personal exemption** *set amount that you subtract from your gross income for yourself, your spouse, and any dependents*

**deductions** *variable amounts that you can subtract, or deduct, from your gross income*

most of their income tax throughout the year as they earn income. In mid-April, they pay any additional income taxes they owe.

## Tax Withholding

Employers are responsible in part for carrying out the system for collecting federal income taxes. They do so by **withholding**, or taking payments out of your pay before you receive it. The amount they withhold is based on an estimate of how much you will owe in federal income taxes for the entire year. After withholding the money, the employer forwards it to the federal government as an "installment payment" on your upcoming annual income tax bill. On the sample pay stub shown above, the employer has withheld $10.25 in federal income taxes from this employee's paycheck.

## Filing a Tax Return

At the end of the year, employers give their employees a report showing how much income tax has already been withheld and sent to the government. The employee then completes a tax return. A **tax return** is a form used to file income taxes. On it you declare your income to the government and figure out your taxable income.

**Taxable income** is a person's gross (or total) income minus exemptions and deductions. Gross income includes earned income—salaries, wages, tips, and commissions. It also includes income from investments such as interest on savings accounts and dividends from stock.

**Personal exemptions** are set amounts that you subtract from your gross income for yourself, your spouse, and any dependents. **Deductions** are variable amounts that you can subtract, or deduct, from your gross income. Deductions include such items as interest on a mortgage, donations to charity, some medical expenses, and state and local tax payments.

Completing a tax return allows you to determine whether the amount of income taxes you have already paid was higher or lower than the actual amount of tax you owe. If you have paid more than you owe, the government sends you a refund. If you have paid less than you owe, you must pay the balance to the government. All federal income tax returns must be sent to the Internal Revenue Service, or IRS, by midnight on April 15 (or the next business day if April 15 falls on a weekend).

## Tax Brackets

The federal income tax is a progressive tax. In other words, the tax rate rises with the amount of taxable income. The tax rate schedule in Figure 14.5 shows that in 2005, there were six rates. Each applied to a different range of income, or tax bracket. For example, married couples who filed a return together (a joint return) and had a taxable income of $14,600 or less paid 10 percent income tax. The highest rate—35 percent—was paid by high-income single people or married couples on the portion of their taxable incomes that exceeded $326,450. Each year, the IRS publishes new tax rate schedules that reflect any changes in the federal tax code.

# Corporate Income Taxes

Like individuals, corporations must pay federal income tax on their taxable income. Corporate taxes made up less than 10 percent of federal revenues in recent years.

Determining a corporation's taxable income can be a challenge because businesses can take many deductions. That is, they can subtract many expenses from their income before they reach the amount of income that is subject to taxation. For example, companies deduct the cost of employees' health insurance. Many other costs of doing business can also be deducted.

Like individual income tax rates, corporate income tax rates are progressive. In 2005, rates began at 15 percent on the first $50,000 of taxable income. The highest corporate income tax rate was 35 percent on all taxable corporate income above $10,000,000.

# Social Security, Medicare, and Unemployment Taxes

In addition to withholding money for income taxes, employers withhold money for taxes authorized under the Federal Insurance Contributions Act, or FICA. **FICA** taxes fund two large government programs, Social Security and Medicare. Employees and employers share FICA payments.

## Social Security Taxes

Most of the FICA taxes you pay go to the Social Security Administration to fund Old-Age, Survivors, and Disability Insurance (OASDI), or **Social Security.** Social Security was established in 1935 to ease the hardships of the Great Depression.

**FICA** *taxes that fund Social Security and Medicare*

**Social Security** *Old-Age, Survivors, and Disability Insurance (OASDI)*

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*Figure 14.5* **Federal Income Tax Rates, 2005**

| Schedule | If your taxable income is over– | but not over– | the tax is | of the amount over– |
|---|---|---|---|---|
| Schedule X–use if your filing status is single | $0 | $7,300 | ....... 10% | $0 |
| | $7,300 | $29,700 | $730.00 plus 15% | $7,300 |
| | $29,700 | $71,950 | $4,090.00 plus 25% | $29,700 |
| | $71,950 | $150,150 | $14,652.40 plus 28% | $71,950 |
| | $150,150 | $326,450 | $36,548.50 plus 33% | $150,150 |
| | $326,450 | ....... | $94,727.50 plus 35% | $326,450 |
| Schedule Y–use if your filing status is married filing jointly | $0 | $14,600 | ....... 10% | $0 |
| | $14,600 | $59,400 | $1,460.00 plus 15% | $14,600 |
| | $59,400 | $119,950 | $8,180.00 plus 25% | $59,400 |
| | $119,950 | $182,800 | $23,317.50 plus 28% | $119,950 |
| | $182,800 | $326,450 | $40,915.50 plus 33% | $182,800 |
| | $326,450 | ....... | $88,320.00 plus 35% | $326,450 |

BUILDING KEY CONCEPTS

According to these sample individual income tax tables, a single individual with $5,000 of taxable income would pay $5,000 X .10, or $500 in taxes.
**Income What would be the tax for a married couple filing jointly with $75,000 in taxable income?**

## Global Connections

***Value-Added Tax*** Individual income taxes and sales taxes play a smaller role in generating government revenue in many European nations than they do in the United States. Instead, in much of Europe, a value-added tax, or VAT, has been implemented. A VAT taxes the increase in value that a good gains in each step of its production. For example, in the United States, consumers usually pay taxes when they buy a car. Under a VAT system, the price of a car already includes the tax paid by the mine that extracts the iron ore used to make the car. It also includes the tax the steel mill paid based on the value added to the iron ore when it was turned into steel. Similarly, the car's price includes the tax the car manufacturer paid on the value the steel gained when it was made into a car. In this way, the consumer doesn't directly pay the tax. Rather, the total price of the car already includes the tax. **Would you recommend a VAT for the United States? Why or why not?**

**Medicare** *a national health insurance program that helps pay for health care for people over age 65 or with certain disabilities*

**estate tax** *a tax on the estate, or total value of the money and property, of a person who has died*

**gift tax** *a tax on money or property that one living person gives to another*

Originally, Social Security was simply a retirement fund to provide old-age pensions to workers. Today, it also provides benefits to surviving family members of wage earners and to people whose disabilities keep them from working.

Each year the government establishes an income cap for Social Security taxes. In 2005, the cap was $90,000. No Social Security taxes could be withheld from a taxpayer's wages and salaries above that amount.

### Medicare Taxes

FICA taxes also fund Medicare. The **Medicare** program is a national health insurance program that helps pay for health care for people over age 65. It also covers people with certain disabilities.

Both employees and self-employed people pay the Medicare tax on all their earnings. There is no ceiling as for Social Security payments.

### Unemployment Taxes

The federal government also collects an unemployment tax, which is paid by employers. In effect, the tax pays for an insurance policy for workers. If workers are laid off from their jobs through no fault of their own, they can file an "unemployment compensation" claim and collect benefits for a fixed number of weeks. In order to collect unemployment benefits, an unemployed person usually must show that he or she is actively looking for another job. The unemployment program is financed by both state and federal unemployment taxes.

## Other Types of Taxes

What are the taxes on gasoline and cable television service called? If you inherit money from your great aunt, will you have to pay a tax? Why are some imported products so expensive? To answer these questions, you need to look at excise, estate, gift, and import taxes.

### Excise Taxes

As you read in Chapter 5, an excise tax is a general revenue tax on the sale or manufacture of a good. Federal excise taxes apply to gasoline, cigarettes, alcoholic beverages, telephone services, cable television, and other items.

### Estate Taxes

An **estate tax** is a tax on the estate, or total value of the money and property, of a person who has died. It is paid out of the person's estate before the heirs receive their share. A person's estate includes not only money, but also real estate, cars, furniture, investments, jewelry, paintings, and insurance.

In 2005, if the total value of the estate is $1.5 million or less, there is no federal estate tax. Because an estate tax is a progressive tax, the rate rises with increasing value. That is, a $5 million estate will be taxed by the federal government at a higher rate than a $2 million estate.

### Gift Taxes

The **gift tax** is a tax on money or property that one living person gives to another. The goal of the gift tax, established in 1924, was to keep people from avoiding estate taxes by giving away their money before they died. The tax law sets limits on gifts, but still allows the tax-free transfer of fairly large amounts each year. Under current law, a person can give up to $11,000 a year tax-free to each of several different people.

### Import Taxes

Taxes on imported goods (foreign goods brought into the country) are called **tariffs.** Today, most tariffs are intended to protect American farmers and industries from foreign competitors rather than to raise revenue. Tariffs raise the price of foreign items and help keep the price of American products competitive. You will read more about tariffs in Chapter 17.

### Taxes That Affect Behavior

The basic goal of taxation is to create revenue. However, governments sometimes use tax policies to discourage the public from buying harmful products. Taxes are also used to encourage certain types of behavior. The use of taxation to encourage or discourage behavior is called a **tax incentive.**

Federal taxes on tobacco products and alcoholic beverages are examples of so-called sin taxes. While they do bring in revenue, their main purpose is to discourage people from buying and using tobacco and alcohol.

▲ **The owner of this house is installing solar panels. He or she may be able to take advantage of tax incentives designed to encourage energy conservation.**

Taxes have also been imposed on the purchase of vehicles that get low gas mileage. The goal of these taxes is to encourage people to purchase more fuel-efficient cars. Similarly, certain tax deductions encourage energy conservation. Homeowners and businesses may deduct some of the cost of certain improvements, such as adding solar heating, from their taxable income.

**tariff** *a tax on imported goods*

**tax incentive** *the use of taxation to encourage or discourage certain behavior*

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## Section 2 Assessment

### Key Terms and Main Ideas

1. Explain "pay-as-you-earn" taxation.
2. Describe **withholding** and explain how it would affect a student with a part-time job.
3. What is the purpose of **FICA**?

### Applying Economic Concepts

4. ***Critical Thinking*** The founders of the United States wanted to avoid establishing a permanent aristocracy, or group of wealthy families who could control a great deal of the nation's wealth. How is this idea related to estate and gift taxes?
5. ***Try This*** Contributions to organizations such as the American Cancer Society are tax deductible (that is, they can be deducted from taxable income). Explain the reason for this tax policy.
6. ***Using the Databank*** Study the bar graph showing Government Receipts by Source on page 543 of the Databank. Approximately how much money (in billions of dollars) do the top three sources of government income generate?

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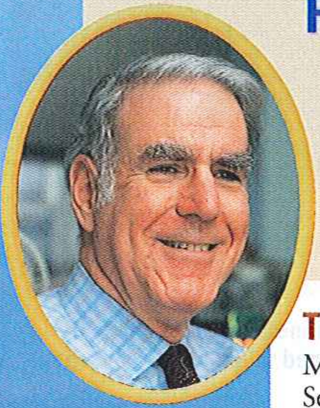
Economist

Entrepreneur

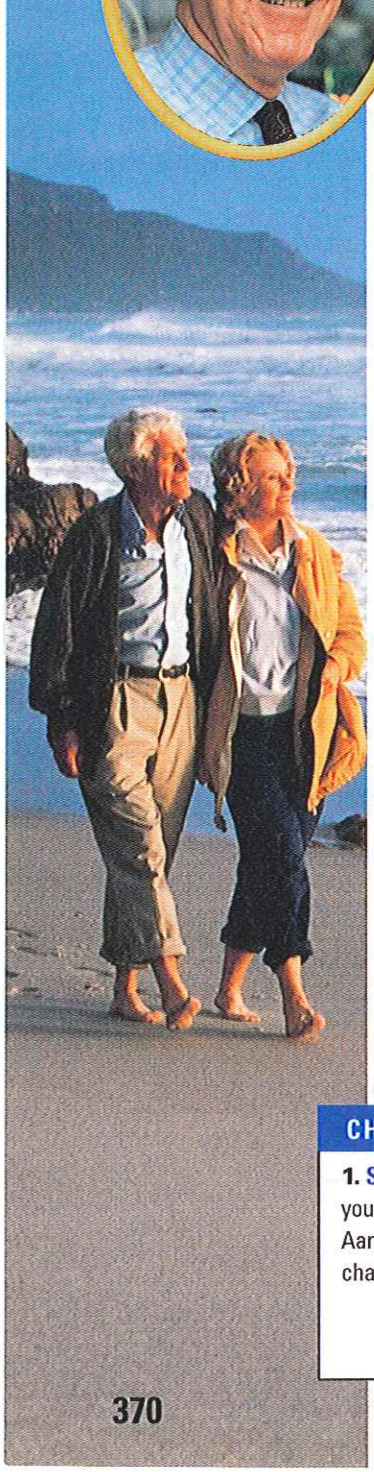
ECONOMIC

# Profile

## Henry J. Aaron (b. 1936)



*During the 1990s, a movement to "save Social Security" became a major crusade among Washington politicians. The debate worried many Americans, who wondered if the nation's retirement system was about to collapse. A prominent economist says, however, that the Social Security system works, so don't try to fix it.*



### The Sky Is Not Falling

Many studies predict that the Social Security system will go bankrupt once the Baby Boom generation begins to retire, despite hikes in the Social Security tax and huge surpluses in the program today. Not everyone agrees. Among the harshest critics of this alarming prediction is economist Henry Aaron.

### An Expert on Entitlements Issues

Henry Aaron is senior fellow in economic studies at the Brookings Institution, a Washington "think tank" that analyzes economic and social issues. Before joining Brookings, he served on the staff of the Council of Economic Advisors, and in the 1970s, served as Assistant Secretary for Planning in the Department of Health, Education, and Welfare.

In 1978, Aaron was selected to chair the Social Security Advisory Council, which reviews the status of the Social Security system every four years. He has become recognized as an expert on government entitlements and tax policy.

### The Dangers of Unwise Reforms

Much of the concern over Social Security has arisen because increasing numbers of retirees are being supported by the taxes of working Americans. Aaron agrees that the ratio of retirees to workers will continue to rise. However, he argues that this increase is offset by a lower ratio of children to workers and by growing numbers of women entering the work force. Both trends reduce the ratio of nonworking dependents per worker, Aaron argues, so the overall tax burden on workers' wages will remain about the same.

One popular proposal is to replace Social Security with a private retirement savings program. Aaron warns that this would require a 50-year transition, during which people would have to make their private contributions while also supporting current retirees through a 10 percent sales tax.

For those who would reform the existing system by raising the retirement age or reducing benefits, Aaron has dire warnings. He notes that no one really knows how expectations about old age affect the saving, working, and spending decisions that people make. Aaron cautions that major changes in the current system could have unforeseen consequences for the entire economy.

### CHECK FOR UNDERSTANDING

1. **Source Reading** Summarize in your own words the argument that Aaron makes to oppose any major changes in the Social Security system.

2. **Critical Thinking** What trends and conditions are responsible for the increase in the ratio of retirees to workers? Why might this development be a potential threat to the future of Social Security?

3. **Learn More** Research and report on changes that Congress has made in Social Security in recent years.

# Section 3 Federal Spending

## Preview

### Objectives

**After studying this section you will be able to:**

1. **Distinguish** between mandatory and discretionary spending.
2. **Describe** major entitlement programs.
3. **Identify** categories of discretionary spending.
4. **Explain** the impact of federal aid to state and local governments.

### Section Focus

Although the federal budget is extremely large, about three quarters of the government's spending is required by current laws. Major categories of government spending include Social Security, defense, interest on the national debt, Medicare, and health care.

### Key Terms

**mandatory spending**
**discretionary spending**
**entitlement**
**Medicaid**

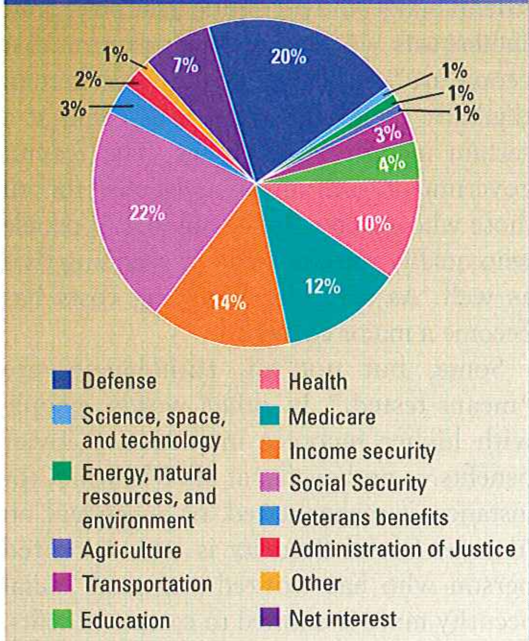
Suppose that each year you were given almost $1.9 trillion to spend. So much money! So many choices! In reality, when the federal government receives this amount of revenue in the form of taxes, most of it is already accounted for. That is, after the government fulfills all its legal obligations, only about 26 percent of the money remains. In this section you will look at the many items on which the federal government spends its tax revenues. In Chapter 15, you will read about how the federal government, as part of the budget process, plans for that spending.

## Mandatory and Discretionary Spending

The graph in Figure 14.6 shows the major categories of federal spending. Some of these categories, such as Social Security and Medicare, are "mandatory." **Mandatory spending** refers to money that lawmakers are required by existing laws to spend on certain programs or to use for interest payments on the national debt. Others, such as defense and education, are "discretionary." **Discretionary spending** is spending about which government planners can make choices.

In general, the percentage of federal spending that is mandatory has grown in recent years. The percentage of discretionary spending has decreased. These trends worry many budget planners and politicians.

***Figure 14.6* Federal Spending, 2004**




Note: Because of rounding, totals may be less or greater than 100 percent.
Source: Office of Management and Budget

**mandatory spending** *spending on certain programs that is mandated, or required, by existing law*

**discretionary spending** *spending category about which government planners can make choices*

**BUILDING KEY CONCEPTS**

The federal government spends the funds it collects from taxes and other sources on a variety of programs.
**Government Analyze the categories of expenditures in the federal budget. Which categories receive the most federal funds?**

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▲ **People who receive entitlement benefits such as Social Security, Medicare, and Medicaid include veterans, people with disabilities, and the elderly.**

**entitlement** *social welfare program that people are "entitled to" if they meet certain eligibility requirements*

## Entitlement Programs

Except for interest on the national debt, most of the mandatory spending items in the federal budget are for entitlement programs. **Entitlements** are social welfare programs that people are "entitled to" if they meet certain eligibility requirements, such as being at a certain income level or age. The federal government guarantees assistance for all those who qualify. As the number of people who qualify rises, mandatory spending rises as well. As a result, managing costs has become a major concern.

Some, but not all, entitlements are "means-tested." In other words, people with higher incomes may receive lower benefits or no benefits at all. Medicaid, for instance, is means-tested, or dependent on income. Social Security is not. A retired person who has worked and paid Social Security taxes is entitled to certain benefits. Similarly, military veterans and retired federal employees are entitled to receive pensions from the government.

Entitlements are a largely unchanging part of government spending. Once Congress has set the requirements, it cannot control how many people become eligible for each kind of benefit. Congress can change the eligibility requirements or reduce the amount of the benefit in order to try to keep costs down. Such actions, however, require a change in the law.

### Social Security

Social Security is the largest category of federal spending. More than 50 million retired or disabled people and their families and survivors receive monthly benefits. The Social Security Administration became an independent agency in 1995. Before that, its spending was part of the budget for the Health and Human Services Department.

### Medicare

Medicare serves about 42 million people, most of them over 65 years old. The program pays for hospital care and for the costs of physicians and medical services. It also pays health care bills for people who suffer from certain disabilities and diseases.

Medicare is funded by taxes withheld from people's paychecks. Monthly payments paid by people who make certain levels of taxable income and receive Medicare benefits also pay for the program.

### Medicaid

**Medicaid** benefits low-income families, some people with disabilities, and elderly people in nursing homes. It is the largest source of funds for medical and health-related services for America's poorest people. The federal government shares the costs of Medicaid with state governments. The state share of the costs varies from 50 percent to 83 percent. In 2004, 54.6 million people were covered by Medicaid—about 18 percent of Americans.

### Other Mandatory Spending Programs

Other means-tested entitlements benefit people and families whose incomes fall below a certain level. Requirements vary from program to program. Federal programs include food stamps, Supplemental Security Income (SSI), and child nutrition. The federal government also pays retirement benefits and insurance for federal workers, as well as veterans' pensions and unemployment insurance.

### The Future of Entitlement Spending

Spending for both Social Security and Medicare has increased enormously in recent years and is expected to increase further in the next few decades. Social Security payments will rise as people in the large "baby boomer" generation, born between 1945 and 1964, start to retire. When the "baby boomers" reach 65, they will become eligible for Medicare as well.

Medicare costs have been growing rapidly, partly as a result of expensive technology, but also because people are living longer. Who will pay these costs? The following fact indicates the basic problem facing Medicare. In 1995, there were four people paying Medicare taxes for every Medicare recipient. By 2050, there will only be two people paying taxes for every recipient.

## Discretionary Spending

Spending on defense accounts for about half of the federal government's discretionary spending. The remaining funds available for discretionary spending are divided among a wide variety of categories.

### Defense Spending

Defense spending has dropped somewhat since the end of the cold war as a percentage of the total federal budget. As you can see from the graph in Figure 14.6, defense spending consumes about 20 percent of the federal budget.

The Department of Defense spends most of the defense budget. It pays the salaries of all the men and women in the army, navy, air force, and marines, as well as the department's civilian employees. There are about 1.4 million men and women in uniform, along with about 654,000 civilian workers, working for the armed forces.

Defense spending, of course, also buys weapons, missiles, battleships, tanks, airplanes, ammunition, and all the other equipment the military needs. The defense budget also includes funds for maintaining equipment and military bases.

### Other Discretionary Spending

You may be surprised at how small a portion of federal spending goes into the category that could be labeled "everything else." Here are some of the many programs that this category of federal spending pays for.

- education
- training
- scientific research
- student loans
- technology
- national parks and monuments
- law enforcement
- environmental cleanup
- housing

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*In the News Read more about federal spending in "Rethinking the Digital Divide," an article in* The Wall Street Journal Classroom Edition.

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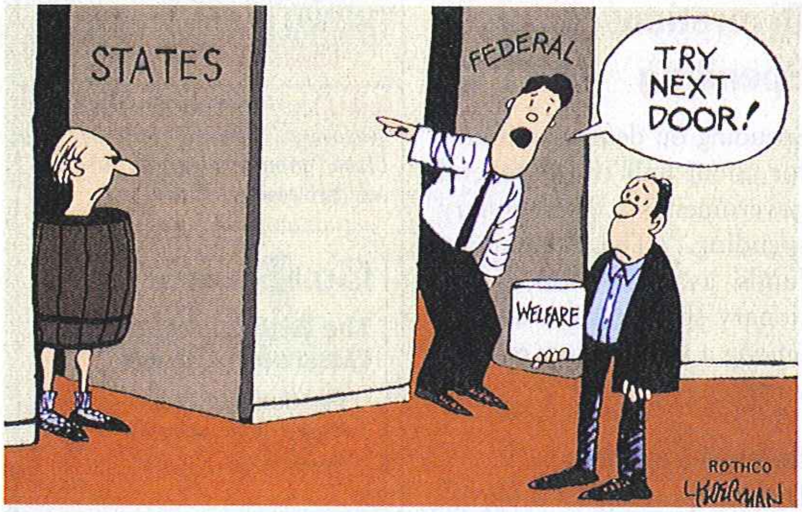
**Medicaid** *entitlement program that benefits low-income families, some people with disabilities, and elderly people in nursing homes*




▲ **As the federal government reduces its size, the burden of providing public assistance programs falls more heavily on the states. How does the cartoonist portray the ability of state governments to handle this responsibility?**

- land management
- transportation
- disaster aid
- foreign aid
- farm subsidies

This part of the federal budget also pays the salaries of the millions of people who work for the civilian branches of the federal government. They include members of Congress, Cabinet secretaries, park rangers, FBI agents, file clerks, geologists, CIA agents, meat inspectors, and many others.

## Federal Aid to State and Local Governments

Some federal tax dollars find their way to state and local governments. In total, about $406 billion a year in federal monies is divided among the states. This is an average of about $1,400 per person.

As you have read, state and federal governments share the costs of some social programs, including Medicaid, unemployment compensation, and some of the programs that help children, families, refugees, and others. State and federal governments also share the costs of some highway construction. Additional federal money goes to the states for education, lower-income housing, mass-transit, health care, highway construction, employment training, and dozens of other programs.

Federal grants-in-aid are grants of federal money for certain closely defined purposes. States must use the federal funds only for the purpose specified and obey the federal guidelines for which aid is given. Beginning with the Reagan administration in the early 1980s, many grant-in-aid programs were converted to a block grant format. As you read in Chapter 13, block grants are lump sums of money intended to be used in a broadly defined area of public need, such as education or highways.

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## Section 3 Assessment

### Key Terms and Main Ideas

1. How does **discretionary spending** differ from **mandatory spending**?
2. What is an **entitlement** program?
3. Why is the cost of the Social Security program expected to increase in the next decades?
4. What is the largest category of **discretionary spending**? Identify three additional examples of discretionary spending.

### Applying Economic Concepts

5. ***Try This*** Suppose that you are running for political office. **(a)** Would you propose any new entitlement programs? If so, what would they be? **(b)** Would you propose eliminating or modifying any existing entitlement programs? Explain your answers.
6. ***You Decide*** Which categories of federal spending would you lower? Which would you raise? Give specific reasons for the changes you suggest.

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# Section 4 State and Local Taxes and Spending

## Preview

### Objectives

**After studying this section you will be able to:**

1. **Explain** how states use a budget to plan their spending.
2. **Identify** where state taxes are spent.
3. **List** the major sources of state tax revenue.
4. **Describe** local government spending and sources of revenue.

### Section Focus

Like the federal government, state and local governments use the revenue from taxes to pay for a variety of programs and services. In general, states spend the largest amounts on grants to local governments, education, and public welfare.

### Key Terms

**operating budget**
**capital budget**
**balanced budget**
**tax exempt**
**real property**
**personal property**
**tax assessor**

You and your family are thinking about colleges. Which one offers the courses you want? How much does it cost? During your research, you find that colleges within your state's university system are far less expensive than private schools. The reason is that your state government is paying part of the cost of running the state colleges. In fact, higher education is one of the largest areas of state government spending.

What else do states spend money on? In this section you will look at patterns of taxing and spending by state and local governments.

## State Budgets

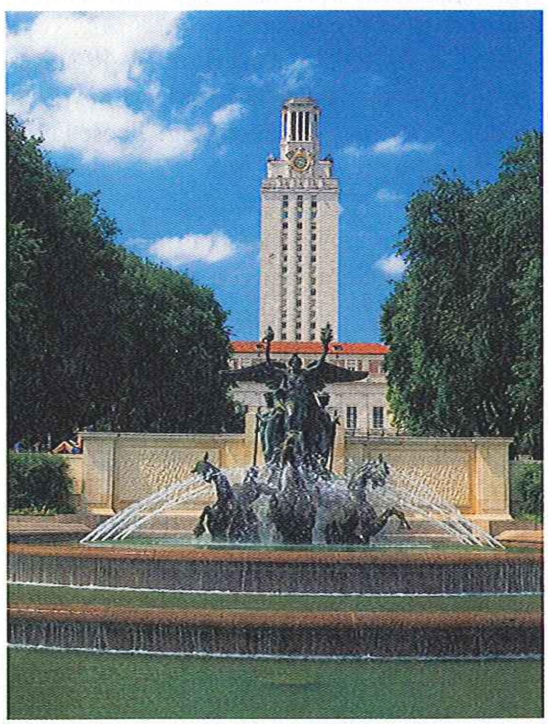
Like families and individuals, governments must plan their spending ahead of time. The federal government has just one budget for all kinds of spending. States have two budgets: operating budgets and capital budgets.

### Operating Budgets

A state's **operating budget** pays for day-to-day expenses. Those include salaries of state employees, supplies such as computers or paper, and maintenance of state facilities, from the state capitol to recreation areas and roadside parks.

### Capital Budgets

A state's **capital budget** pays for major capital, or investment, spending. If the state builds a new bridge or building, the money comes from this budget. Most of these expenses are met by long-term borrowing or the sale of bonds.

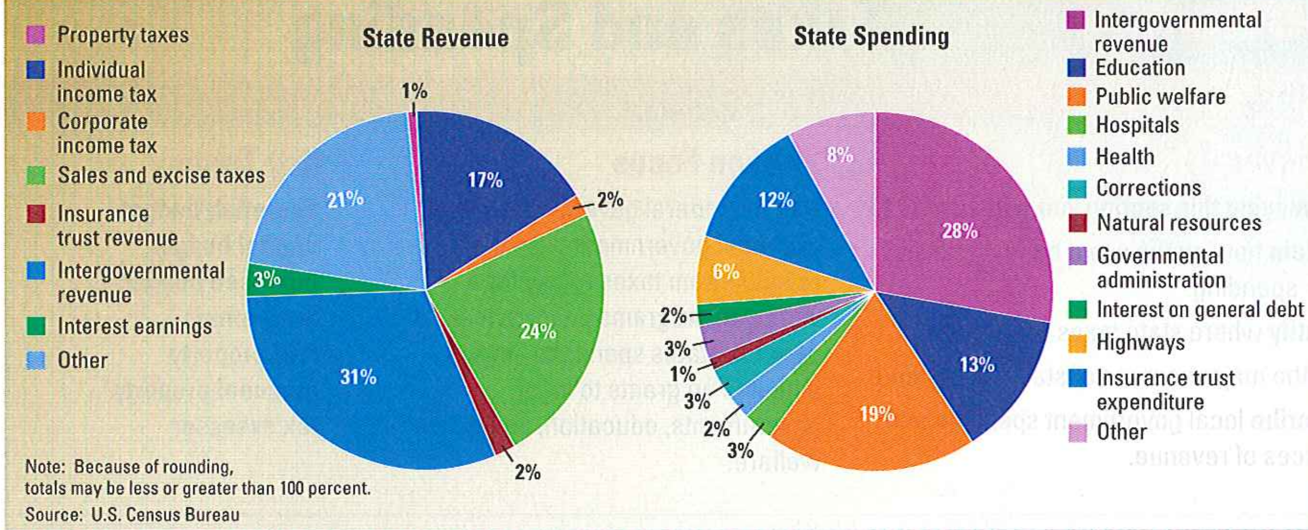


▲ **State colleges and universities, such as the University of Texas at Austin, receive state funding.**

**operating budget** *budget for day-to-day expenses*

**capital budget** *budget for major capital, or investment, expenditures*

*Figure 14.7* **State Revenue and Spending, 2002**

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**BUILDING KEY CONCEPTS** Major sources of state revenue include individual income taxes, sales and other taxes, insurance premiums, and local and federal funds ("intergovernmental revenue").
**Government** **What are the major categories of state government spending?**

**balanced budget** *budget in which revenues are equal to spending*

## Balancing State Budgets

In most states, the governor prepares the budget with the help of a budget agency. The legislature then discusses and eventually approves the budget.

Unlike the federal government, 49 states require **balanced budgets**—budgets in which revenues are equal to spending. These laws, however, apply only to the operating budget, not the capital budget. That makes it easier to balance state budgets than to balance the federal budget.

Some states can borrow money for several years. In other states, lawmakers must cut programs or raise taxes to balance the budget. In the early 2000s, deficits forced cuts and tax hikes in many states.

# Where Are State Taxes Spent?

Spending policies differ among the fifty states. You are probably most familiar with state spending on education, highways, police protection, and state recreation areas. You can see other significant spending categories in Figure 14.7.

## Education

Every state has at least one public state university. Some, such as California, have large systems with many campuses throughout the state. In many states, tax dollars also support agricultural and technical colleges, teacher's colleges, and two-year community colleges.

State governments also provide financial help to their local governments, which run elementary, middle, and high schools. Some states pay a larger share of local schools' costs than other states do. The amount of money that each state spends per student also varies. The national average is $7,920 per student per year.

## Public Safety

State police are a familiar sight along the nation's highways. This police force enforces traffic laws and helps motorists in emergencies. State police also maintain crime labs that can assist local law-enforcement agencies.

State governments build and run corrections systems. These institutions house people convicted of state crimes.

### Highways and Transportation

Building and maintaining highway systems is another major state expense. State crews resurface roads and repair bridges. Some money for roads comes from the federal government. In turn, states contribute money to federal and interstate highway systems.

States pay at least some of the costs of other kinds of transportation facilities, such as waterways and airports. Money for such projects may also come from federal and local government budgets.

### Public Welfare

States look after the health and welfare of the public in various ways. State funds support some public hospitals and clinics. State regulators inspect water supplies and test for pollution.

As you read in Section 2, states also help pay for many of the federal programs that assist individuals, such as unemployment compensation benefits. Because states determine their own benefits, they can meet local needs better than the federal government can. For example, during a local recession, they may decide to extend the number of weeks that people can claim benefits.

### Arts and Recreation

If you've hiked in a state forest or picnicked in a state park, you've enjoyed another benefit of state tax dollars. Parks and nature reserves preserve scenic and historic places for people to visit and enjoy. States also run museums and help fund music and art programs.

### Administration

Besides providing services, state governments need to spend money just to keep running. Like the federal government, state governments have an executive branch (the governor's office), a legislature, and a court system. State tax revenues pay the salaries of all these and other state workers, including maintenance crews in state parks, the governor, and state court judges.

## State Tax Revenue

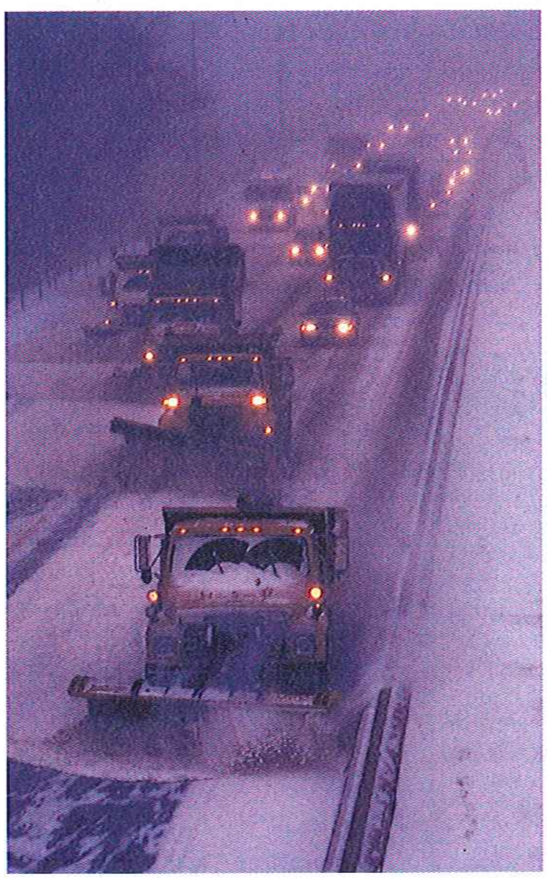
For every dollar a state spends, it must take in a dollar in revenue. Otherwise, it cannot maintain a balanced budget. The 50 states now take in more than $500 billion a year from taxes. Where does this money come from? Sales and individual income taxes provide the largest part of state revenues. The pie chart on the left in Figure 14.7 shows you other sources of state revenue.

### Limits on State Taxation

Just as the United States Constitution limits the federal government's power to tax, it also puts limits on the states. Because trade and commerce are considered national enterprises, states cannot tax imports or exports. They also cannot tax goods sent between states.

State governments cannot tax federal property, such as military bases. Nonprofit organizations, religious groups, and charities are usually **tax exempt**; that is, they are not subject to taxes.

**tax exempt** *not subject to taxes*



◀ **Funds for plowing state highways are included in state budgets. Would you expect these funds to be included in a state's operating budget or capital budget?**

**real property** *physical property such as land and buildings*

**personal property** *possessions such as jewelry, furniture, and boats*

## Sales Tax

As Figure 14.7 shows, sales taxes are a main source of revenue for state governments. As you read in Section 1, a sales tax is a tax on goods and services. The tax—a percentage of the purchase price—is added on at the cash register and paid by the purchaser.

All but a few of the 50 states collect sales taxes. Sales tax rates range from 3 to 8 percent. Some local governments have their own, additional, sales tax.

In every state, some categories of products are exempt from sales tax. Many states do not charge sales tax on basic needs such as food and clothing. Some do not tax prescription medicines.

Even states without a sales tax impose excise taxes that apply to specific products and activities. Some are sin taxes—taxes that are intended to discourage harmful behavior—on products like alcoholic beverages and tobacco. Other taxes apply to hotel and motel rooms, automobiles, rental cars, and insurance policies. Many states also tax gasoline. This state gasoline tax is in addition to the federal tax.

## State Income Taxes

Individual income taxes are another large contributor to many states' budgets. People pay this state income tax in addition to the federal income tax. Figure 14.7 shows that state individual income taxes contribute about 17 percent of state revenue.

Some states tax incomes at a flat percentage rate (that is, as a proportional tax). Some charge a percentage of a person's federal income tax. Others have progressive rates, with a tax structure like the federal income tax. A few states tax only interest and dividends from investments, not wages and salaries.

**FAST FACT**

*New Hampshire legislators were faced with a dilemma: how to fund the state's education system, without placing undue hardship on low- and middle-income taxpayers. Their solution: establish an education trust fund. This fund created a uniform statewide education property tax with provisions for tax relief for certain qualified taxpayers. It also dedicated to education revenue from increases in the tobacco tax and from tobacco settlement funds, as well as from various tax increases on businesses.*

## Corporate Income Tax

Most states collect corporate income taxes from companies that do business in the state. Some states levy taxes at a fixed, flat rate on business profits. A few charge progressive rates—that is, higher tax rates for businesses with higher profits.

As you can see from Figure 14.7, corporate income taxes contribute only a small percentage of state tax revenues—about 2 percent. Nevertheless, corporate income taxes can influence a state's economy.

Low corporate taxes, along with a well-educated work force and good public services, can make it easier to attract new businesses to a state. Politicians deciding on state corporate tax rates keep this fact in mind when they determine their state's policies.

## Other State Taxes

Besides the corporate income tax, businesses pay a variety of other state taxes and fees. Do you want to be a hairdresser, a carpenter, or a building contractor? If so, you will have to pay a licensing fee. A licensing fee is a kind of tax that people pay to carry on different kinds of business within a state.

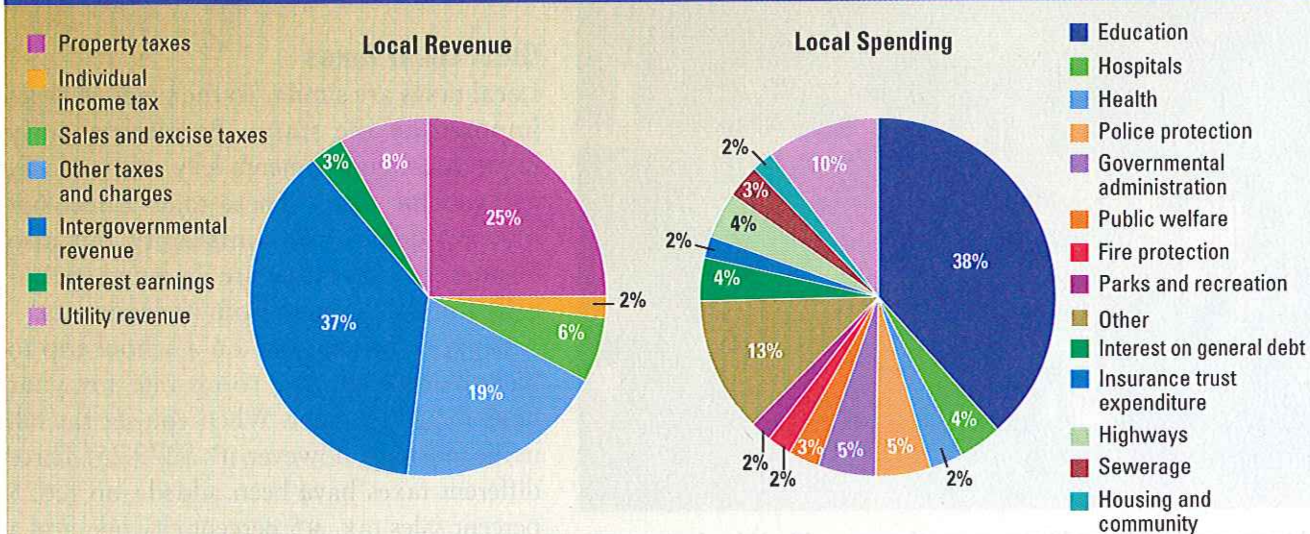
Some states charge a transfer tax when documents such as stock certificates are transferred and recorded. Other states tax the value of the stock shares that corporations issue.

Many states have rich natural resources, such as gold, oil, natural gas, fish, or lumber. Some states place a tax, called a severance tax, on companies that take (or "sever") these resources from the state's land and waters.

As you read in Section 2, the federal government taxes the estate of a person who has died. States, in turn, usually charge an inheritance tax on the value of the property that goes to each heir.

Some states also tax property. That includes **real property,** such as land and buildings, or "real estate." It also includes **personal property,** such as jewelry, furniture, and boats. Some states even tax intangible property, such as bank accounts, stocks, and bonds. Today, however, most property taxes, especially on real estate, are levied by local governments.

*Figure 14.8* **Local Revenue and Spending, 2002**




Note: Because of rounding, totals may be less or greater than 100 percent.
Source: U.S. Census Bureau

**BUILDING KEY CONCEPTS**

Major sources of local revenue include property taxes and state and federal funds ("intergovernmental revenue").
**Government** **What are the major categories of local government spending? How do they differ from the major categories of state government spending shown on page 376?**

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# Local Government Spending and Revenue

Your local government plays a part in many aspects of everyday life, including public grade, middle, and high schools. Local governments hire police and firefighters. They build roads, libraries, hospitals, and jails. They pay teachers. Even though this is the level of government closest to you, it may be the one you know the least about.

## Forms of Local Government

You probably think of "local government" as a town or city. There are other types as well, including townships, counties, and special districts, such as school districts. All units of local government are created by the state government. The state gives them their powers and authority.

Today, there are more than 87,000 local government units in the United States. Together they collect about $370 billion in tax revenues.

## The Jobs of Local Government

Local governments carry major responsibilities in these areas:

- Public school systems
- Law enforcement (local police, county sheriff's departments, park police)
- Fire protection
- Public facilities such as libraries, airports, and public hospitals
- Parks and recreational facilities such as beaches, swimming pools, and zoos
- Public health (restaurant inspectors, water treatment plants, sewer systems)
- Public transportation
- Elections (voter registration, preparation of ballots, election supervision, vote counting)
- Record keeping (birth/death certificates, wills, marriage licenses, and the like)
- Social services (food stamps, child care and welfare, and similar programs)

Many of these responsibilities are reflected in the graph showing local spending (above right). In some towns and cities, separate commissions or private

▲ Local taxes pay for city and town recreation areas like this playground.

**tax assessor** *an official who determines the value of a property*

corporations carry out some of these jobs. You can see, though, that local governments touch our lives every day.

## Property Taxes

Property taxes are levied on property owners in local communities to offset the expense of services such as street construction or maintenance. An official called a **tax assessor** determines the value of the property. Property taxes are usually figured as a fixed dollar amount per $1,000 of the assessed value. They are a main source of funding for public schools.

## Other Local Taxes

Local taxes are similar to the types of taxes imposed by the states. Besides property taxes, local governments levy sales, excise, and income taxes. These taxes affect not only residents of a community but also visitors. In fact, many are designed specifically to raise revenue from nonresidents.

Suppose you've gone on a school trip to New York City. The room rate for your hotel is $200 a night. When you see the bill in the morning, however, it's $229.25! Three different taxes have been added—an 8.625 percent sales tax, a 5 percent city tax, and a $2 per room occupancy tax. Many other cities have taxes aimed at tourists and business travelers. They include sales taxes on hotel rooms and rental cars, airport taxes, and taxes on movie or theater tickets.

Some large cities collect income taxes as payroll taxes. In these cities, many workers are commuters who pay property taxes and sales taxes in the suburbs where they live. If the city did not take taxes from their paychecks, these workers would get a "free ride" on the city's services. They would be using police, street cleaning, and other services paid for only by the people who live in the city.

# Section 4 Assessment

**Progress Monitoring *Online***
For: Self-quiz with vocabulary practice
Web Code: mna-6148

## Key Terms and Main Ideas

1. Describe the difference between a state's **operating budget** and its **capital budget**.
2. What is a **balanced budget**?
3. What are the main sources of state revenue? How do they differ from the main sources of local revenue?
4. Describe the difference between **real property** and **personal property**.

## Applying Economic Concepts

5. ***Using the Databank*** Study the bar graph showing Income Taxes per Capita on page 542 of the Databank. **(a)** Which are higher, federal income taxes or state and local income taxes? **(b)** How much are total income taxes per capita?
6. ***You Decide*** Turn to Figure 14.8 and study the main categories of local spending. Write a brief essay stating whether you agree with the spending priorities shown on the graph.

**Go Online**
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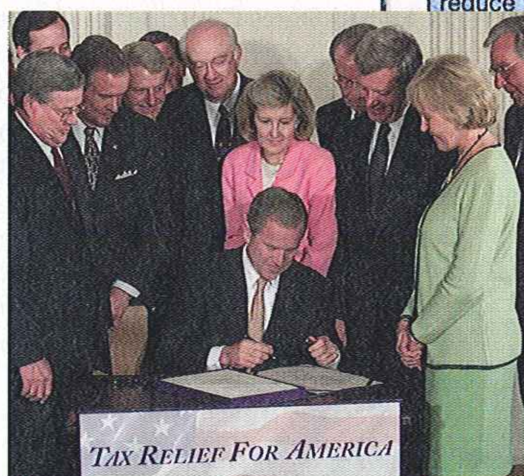
Real-life Case Study

# The Bush Tax Cuts

On June 7, 2001, President George W. Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001, called "TRA 2001" for short. This law largely fulfilled his campaign promise to reduce taxes in light of the projected federal budgetary surplus. Two years later, on May 28, 2003, President Bush signed a second major tax cut bill. President Bush argued that this bill, known as the Jobs and Growth Tax Relief Reconciliation Act of 2003, would encourage growth in a sluggish economy.




▲ President George W. Bush signs the 2001 tax bill.

**Lower Tax Brackets** The 2001 law reduced the four highest tax brackets from their 2000 levels. It also created a new lowest tax bracket with a 10% tax rate. The 2003 tax cut moved up several tax rate reductions planned for the late 2000s in the first tax cut. Overall, the top marginal income tax rate was lowered from 39.6% to 35%.

**Children and Students** The Bush tax bills increase the tax credit for dependent children under 17 from $500 in 2000 to $1000 in 2003. The Treasury mailed tax refund checks to eligible parents during the summer of 2003 in order to anticipate this increased deduction.

The new laws also make it easier for parents to afford to send their children to school. The amount that can be saved in an Education IRA grew from $500 to $2000 a year. Students will be able to withdraw money from special tuition-saver programs without having to pay taxes. More students and their parents will be able to deduct tuition expenses and student loan interest from their taxable income.

**Easier Retirement Savings** Taxpayers will also be able to contribute more to their retirement accounts. For example, the allowable contribution to an Individual Retirement Account (IRA) goes up from $2000 a year in 2000 to $4000 in 2005 and $5000 in 2008. Workers over age 50 will be allowed to contribute an extra $500 a year (until 2005) and $1000 a year (starting in 2006).

**Will These Changes Last?** Nearly all the changes in the new tax laws were phased in over several years, and then will disappear by the early 2010s when the laws expire. This means that future Congresses and future presidents will have to decide whether to extend these provisions or return to the law as it was in 2000.

## Applying Economic Ideas

1. Why did concerns about the slow economy generate support for the president's second tax cut plan?
2. What are some potential problems with having a tax cut that evaporates in 2011? Why might Congress have decided to do it this way?

# Chapter 14 Assessment

## Chapter Summary

A summary of major ideas in Chapter 14 appears below. See also the **Guide to the Essentials of Economics,** which provides additional review and test practice of key concepts in Chapter 14.

### *Section 1 What Are Taxes? (pp. 359–363)*

The United States Constitution gives the government power to collect taxes to fund government programs. A **tax base** is a value on which a tax is calculated, such as income, property, or profits. Economists describe three different types of tax structures: **proportional, progressive,** and **regressive.** Many taxes in the United States are based on a principle of ability-to-pay. Other taxes are based on a benefits-received principle. Economists use supply and demand analysis to determine the **incidence of a tax,** or who bears the final burden of a tax.

### *Section 2 Federal Taxes (pp. 365–369)*

The federal government has six major sources of **revenue,** or income. They are **individual income taxes, corporate income taxes,** social insurance payments (including **Social Security, Medicare,** and unemployment taxes), **excise taxes, estate** and **gift taxes,** and **tariffs,** or taxes on imports. Individual income taxes are paid on a pay-as-you-earn basis through payroll **withholding.** Each year, people with income must file a **tax return** and pay taxes on all **taxable income.**

### *Section 3 Federal Spending (pp. 371–374)*

Much of the federal government's spending is **mandatory spending,** that is, it is required by existing law. The remainder of the budget is **discretionary spending.** Major categories of government spending include **entitlements,** such as **Social Security** and **Medicare,** defense, and interest on the national debt.

### *Section 4 State and Local Taxes and Spending (pp. 375–380)*

Like the federal government, state and local governments fund their programs by levying taxes. States have two budgets, an **operating budget** and a **capital budget.** Most state and local government revenues fall into the following categories: **income tax, sales tax,** severance tax, inheritance tax, and property tax.

## Key Terms

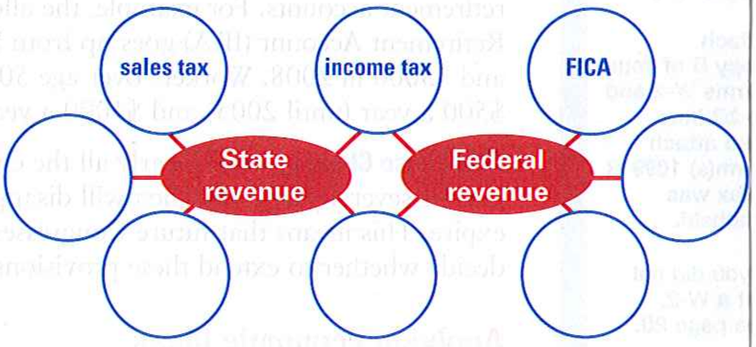
Match the following terms with the definitions listed below. You will not use all of the terms.

| | |
|---|---|
| **taxable income** | **balanced budget** |
| **revenue** | **withholding** |
| **discretionary spending** | **mandatory spending** |
| **progressive tax** | **real property** |

1. Income received by a government from taxes and nontax sources
2. Physical assets such as land and buildings
3. Budget category in which funds are committed to certain programs by law
4. Total income minus exemptions and deductions
5. Tax structure with a rate that increases with the amount or value being taxed
6. Amount taken out of an employee's paycheck as a prepayment on taxes

## Using Graphic Organizers

7. Copy the double web map below on a separate sheet of paper. Complete the double web map by writing examples of sources of federal and state government revenue in the circles. You may add more circles as needed.



## Reviewing Main Ideas

8. Why are some taxes considered to be regressive?
9. How can you determine the incidence of a tax?
10. List and describe four sources of state government revenue.
11. What are entitlement programs? Give three examples of entitlement programs and explain their purposes.

## Critical Thinking

12. **Synthesizing Information** Review the powers of and limits to taxation in the United States. How does the Constitution limit federal and state powers of taxation?
13. **Predicting Consequences** Assume that you are a representative to Congress. What forms of mandatory and discretionary spending do you support? What are possible consequences of showing your support or lack of support for different forms of spending?
14. **Making Comparisons** Create a table in which you identify types of taxes at the local, state, and national levels and describe the economic importance of each.
15. **Expressing Problems Clearly** In your opinion, should a tax be applied at the same rate to all people, or should those who are wealthier be expected to pay at a higher rate? Support your opinion with concrete examples.

## Problem-Solving Activity

16. Review the criteria economists use for determining a good tax. Then create a proposal for a new tax that meets those criteria. Would you be willing to pay the tax you've just proposed?

### Economics Journal

*Essay Writing* Review your Economics Journal entry for this chapter. Write a summary of the types of taxes you pay on a regular basis, and indicate whether you think the taxes you pay are fair or not.

## Skills for Life

***Distinguishing Fact from Opinion*** Review the steps shown on page 364; then answer the following questions using the selection below.

17. Which statements in the excerpt below are facts?
18. Which statements in the excerpt below are opinions?
19. What phrases indicate that the statements are opinions?
20. Does Representative Johnson present evidence to support his opinions?
21. Has Representative Johnson supported his opinions well? Explain your answer.

Representative Sam Johnson:
"Working to Reduce Your Tax Burden"

I believe that our current tax code is economically destructive, impossibly complex, and overly intrusive. It has impeded our ability to create jobs, encourage savings and investment, and realize the American dream.

This is illustrated by the fact that our current tax code has grown from 11,000 words to over 7 million. According to West Publishing, who is an official publisher of the tax code, it takes two volumes and 1,168 pages to publish the code, plus, an additional 6,439 pages of Federal Tax Regulations that apply to income taxes. To make it easier to comply with these regulations, the IRS has created about 480 forms with an additional 280 to explain how to fill out the 480. I think this is ridiculous. That is why this system should not be changed, but replaced. . . .

### Progress Monitoring *Online*

For: Chapter 14 Self-Test Visit: PHSchool.com
Web Code: mna-6141

As a final review, take the Economics Chapter 14 Self-Test and receive immediate feedback on your answers. The test consists of 20 multiple-choice questions designed to test your understanding of the chapter content.

Economics Simulation

# Voluntary Contributions

One reason that governments tax their citizens is to pay for services that benefit the entire community, including education, public transportation, garbage collection, and fire protection. Ideally, all these public services could be provided by voluntary contributions. People would help pay for these services simply because it is the right thing to do. In reality, many people would take a "free ride" and not contribute. In this simulation, you will have a chance to look at the kind of choices citizens might make and the results of those choices. You'll see how "free riders" affect the general good.

### Materials

Notebook paper
Play money (or handmade equivalent): one $10, three $5, and five $1 bills for each citizen-group, plus the state treasury of $500 in mixed bills

▲ In this town meeting, citizens are discussing how to pay for public education. Can it be paid for through voluntary contributions?

## Preparing the Simulation

Suppose you live in a state in which the money spent on public education causes a decrease in other costs in the state budget. For every dollar contributed to education, the cost of welfare and criminal justice decrease by a total of three dollars. These budget savings are returned to citizens as tax refunds. Each citizen's refund equals the total budget savings divided by the number of citizens—regardless of the amount each citizen contributes. See the budget table for an example of how these savings would be calculated.

**Step 1:** Select two students from your class who will act as state treasurer and budget director. The rest should form groups of three to five students. Each group works together and makes decisions as one "citizen." One member of each citizen-group should be in charge of the group's money and record keeping.

**Step 2:** Each citizen-group begins the simulation with $30: one $10 bill, three $5 bills, and five $1 bills. The state treasurer has $500 in mixed bills. He or she can also write "IOUs" for citizen tax refunds. Each citizen-group should use a sheet of notebook paper to make a contributions and refunds record, using the table on the next page as a model.

**Step 3:** The state budget director should use a sheet of notebook paper to make a budget worksheet using the table on the next page as a model.

## Conducting the Simulation

This simulation is run in three sessions.

**Session 1:** Each citizen-group decides whether it wants to make a contribution to public education, and if so, how much it wants to give. Each group can choose to contribute between $0 and $10 in each session. Record your contribution on your Contributions and Refunds Record, and give the money in cash to the state treasurer.

The state budget director adds up all the first session's contributions to education. Then he or she figures the state's budget savings using the Budget Worksheet, keeping in mind that every dollar collected for education results in three dollars saved from welfare and criminal justice. The state budget director gives this information to the state treasurer, who then gives each citizen-group its refund in dollars. If no cash is available, the treasurer will issue IOUs.

**Session 2:** Each citizen-group again decides whether to make a contribution to public education. Even if you have received a refund, you can still contribute only $10 each day. Record your contribution on your Contributions and Refunds Record, and give the money to the treasurer.

The state budget director again adds up the total contributions, using the Budget Worksheet. He or she figures the savings, and the treasurer gives each citizen-group its refund.

**Session 3:** Each citizen-group decides again whether to make a contribution to education, using the same process as in earlier sessions. When refunds for this session have been calculated and given, each group adds up all the money it has in cash and IOUs. The total amount of money is the citizen-group's score.

**Budget Table for a 10-Citizen State**

| Total Contributions | State Budget Savings | Tax Refund per Citizen |
|---|---|---|
| $20.00 | $60.00 | $6.00 |
| $50.00 | $150.00 | $15.00 |
| $80.00 | $240.00 | $24.00 |
| $100.00 | $300.00 | $30.00 |

## Contributions and Refunds Record

| | Session 1 | Session 2 | Session 3 |
|---|---|---|---|
| Balance at beginning of session | $ | $ | $ |
| – Contribution | – $ | – $ | – $ |
| + Refund | + $ | + $ | + $ |
| = New balance | = $ | = $ | = $ |

## Budget Worksheet

| | Session 1 | Session 2 | Session 3 |
|---|---|---|---|
| Total contributions x $3.00 = Total budget savings | $ X $3.00 $ | $ X $3.00 $ | $ X $3.00 $ |
| Total budget savings ÷ Number of citizen-groups = Tax refund per citizen-group | $ ÷ ___ $ | $ ÷ ___ $ | $ ÷ ___ $ |

## Simulation Analysis

**Discuss these questions as a group.**

1. From the state treasurer's Budget Worksheet, analyze whether all the citizen-groups were equally generous in their contributions. Did any citizens try to get a free or almost-free ride? Did this tactic pay off for them? How did that affect other groups that did make contributions?
2. Each citizen-group began with $30. How does this compare with the amount that each one has now?
3. Which session brought in the largest total amount of contributions to education?
4. **Determining Relevance** What does this experiment demonstrate about the need for governments to use taxes to pay for public services?