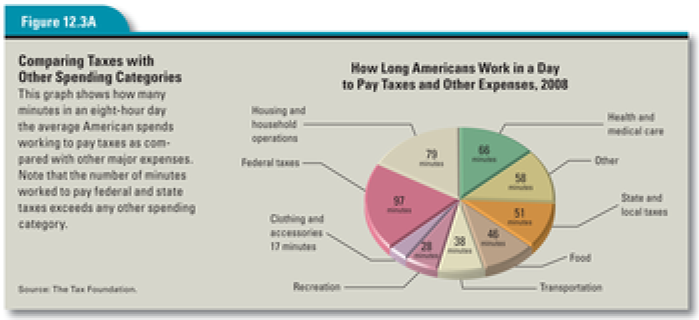
3. What Kinds of Taxes Will You Pay in Your Lifetime?



Every year on April 15, as midnight approaches, post office parking lots fill up around the country.Harried taxpayers hurry inside to get a place in line. The clock ticks. The race is on to get federal income tax forms postmarked before the April 15 filing deadline.

Taxation Basics: Tax Base and Tax Rates

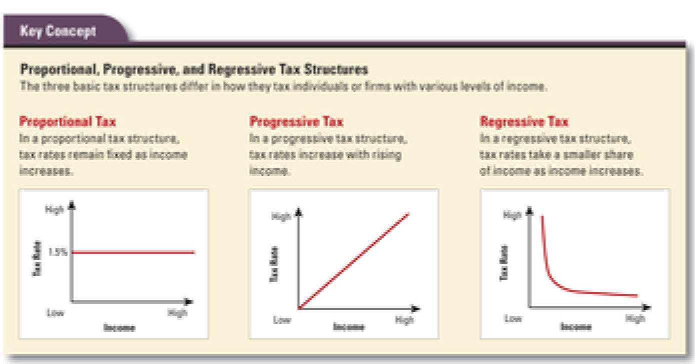
In 2008, that April 15 deadline almost coincided with another tax-related day, known to some as “tax freedom day.” This is the date every year when it is estimated that average Americans will have earned enough to pay all their taxes for that year. In 2008, that date was April 23—113 days into the year. This means that Americans spent nearly one-third of 2008 working to pay their federal, state, and local taxes.

Many kinds of taxes make up the average American’s tax burden. All these taxes consist of two basic elements: the tax base and the tax rate.

The **tax base** is the thing that is taxed, such as personal income, a good sold at a store, or a piece of property. Taxes are defined according to their tax base. For example, income tax is based on personal income. A property tax is based on the value of property, such as a home.

The **tax rate** is the percentage of income—or of the value of a good, service, or asset—that is paid in tax. For example, if the income tax rate were set at 20 percent, taxpayers would have to pay an amount equal to 20 percent of their taxable income.

Tax Structures: Proportional, Progressive, and Regressive



Taxes are also defined by their structure, which in turn depends on tax rates. Economists identify three types of tax structures: proportional, progressive, and regressive. Each structure has its advocates and critics.

Proportional taxes. A **proportional tax** is a tax that takes the same share of income at all income levels. For example, a proportional income tax of 10 percent would tax all incomes at that rate.

Critics of proportional taxes argue that such taxes fail the test of fairness, because they tax the rich and the poor at the same rate, even though the poor have less ability to pay than do the rich. A 10 percent income tax levied on a person who makes $25,000 a year, for example, represents a greater sacrifice than the same tax levied on a person who makes $250,000 a year.

Advocates of this tax structure, however, claim that a proportional tax is fair precisely because everyone pays an equal share. They also point out that proportional taxes are efficient because they are simple to calculate and easy to collect.

In recent years, Estonia and several other Eastern European countries have adopted a proportional income tax, or **flat tax**. In Slovakia, for example, rich and poor alike pay a 19 percent tax on income. Since its inception in 2004, the flat tax has helped the Slovakian economy grow by attracting foreign investors. Its simplicity has also led to less tax evasion. Although most Slovakians support the flat tax, a few worry that the low flat tax rate may result in less money for government services.

Progressive taxes. A **progressive tax** is a tax that takes a larger share of income as income increases. A progressive tax is based on the ability-to-pay principle.Most federal taxes, including the federal income tax, are progressive.

The main argument in favor of progressive taxation is the equity argument. A progressive tax gets larger as income increases. Thus it places a greater tax burden on the wealthy—where advocates believe it should be—than on the poor. Critics of progressive taxation, however, believe that placing an unequal burden on the rich is fundamentally unfair. In effect, they argue, such a tax punishes people for accumulating wealth and may create a disincentive to work, save, and invest. They also complain that creating different rates for different income levels leads to a more complex, and therefore less efficient, tax system.

Regressive taxes. The third tax structure, the **regressive tax**, is a tax that takes a smaller share of income as income increases. Governments do not set out to impose higher tax rates as incomes fall. But a tax that is proportional—that applies a single rate to everyone—can effectively function as a regressive tax if it takes a bigger bite out of the incomes of poor people than those of wealthy people.

Sales taxes, for example, are regressive. To understand why, consider a low-income person who earns $20,000 a year and spends $10,000 of it on taxable goods and services. If the sales tax rate is 5 percent, that person pays $500 in sales tax a year. This amount represents 2.5 percent of the low earner's income.

Compare that with the tax burden of a person who earns $100,000 a year and spends $30,000 on taxable goods and services. At the same tax rate, the high earner pays three times as much sales tax, or $1,500. But that figure represents only 1.5 percent of the high earner's income. When the percentage of income claimed by a proportional tax goes down as income goes up, the tax is considered regressive.

Critics of taxes that tend to be regressive argue that they turn the ability-to-pay principle on its head. Instead of taxing most heavily those who are most able to pay, such taxes place the greatest burden on those least able to pay.

Advocates of proportional taxes, however, argue that they need not be regressive. High earners, they point out, may choose to spend the same percentage of their income on taxable goods and services as people with lower incomes. In such cases, the tax is flat, not regressive, with high earners paying more as they consume more.

Individual Income Taxes

The largest share of tax revenue taken in by the federal government comes from individual income taxes. The majority of states also impose an income tax on their residents. The federal income tax and most state income taxes are progressive taxes.

The federal income tax applies to all U.S. citizens and residents with income above a certain minimum level. For example, a single adult who earned less than $8,750 in the year 2007 was not required to file a federal income tax form.

The Internal Revenue Service is responsible for issuing federal income tax forms and processing tax returns. The IRS also works to ensure compliance with the **tax code**, the set of laws that govern federal taxes. Over time, these laws have grown in size and complexity. Between 1954 and 2005, for example, Congress enacted 35 significant changes to the income tax code. These changes have increased the volume of income tax regulations by a whopping 648 percent—to more than 1.2 million words.

The IRS collects taxes from workers using a "pay as you earn" system. Under this system, also known as **withholding**, employers take out a certain amount of tax from each paycheck. At the beginning of each year, most workers receive a **W-2 form**, which lists their wages for the previous year and the amount of tax that was withheld.

Taxpayers submit tax returns between January 1 and April 15. They are required to declare all their income for the previous year, including wages, investment earnings, business profits, and other types of income. If the IRS questions the accuracy of a tax-payer's return, it may order an **audit**, or formal review of the return.Taxpayers who fail to comply with tax laws may face fines or, like Al Capone, imprisonment.

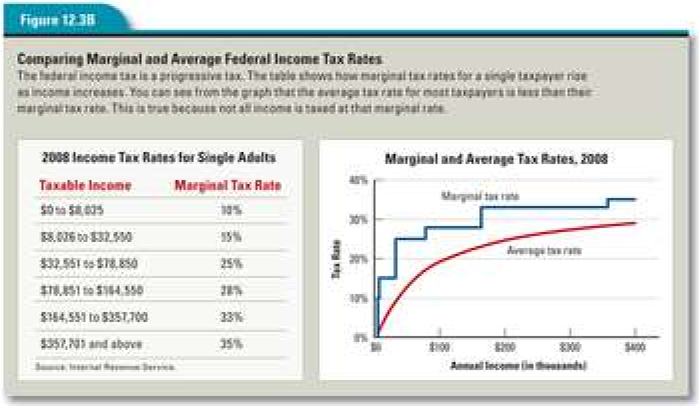


Figure 12.3B shows the federal income tax rates for single adults in various income brackets for 2008. As income rises, the marginal tax rate rises as well. The **marginal tax rate** is the rate at which the last dollar a person earns in a given year is taxed. The table in Figure 12.3B shows six marginal tax rates for single adults in 2008, ranging from 10 to 35 percent. These rising rates make the income tax a progressive tax.

Suppose you earned $15,075 in 2008. The first $8,025 of your income would be taxed at the lowest rate of 10 percent. The remaining $7,050 would be taxed at the next highest rate of 15 percent. This rate—15 percent—would be your marginal tax rate, because it is the rate you would pay on the last dollar earned that year.

Because your income is taxed at two different rates, your average tax rate will be lower than your marginal tax rate. In this case, your average tax rate in 2008 would be just over 12 percent. The graph in Figure 12.3B shows both marginal and average tax rates at different income levels.

Payroll Taxes

The second-largest share of federal tax revenue comes from payroll taxes. A **payroll tax** is a tax on the wages a company pays its employees. Of the several kinds of payroll taxes, the two most important are the Social Security tax and the Medicare tax. Both are used to fund large federal social insurance programs.

The **Social Security tax** is set at a fixed rate, which is paid half by the employer and half by the employee. People who are self-employed pay the entire tax themselves. In 2008, the total Social Security tax rate was 12.4 percent.

Because its rate is fixed, the Social Security tax appears, at first glance, to be a proportional tax. But it is actually regressive, for two reasons. First, the Social Security tax applies only to wages, salaries, and self-employment income. It does not apply to income from investments. Second, only earnings up to a specified maximum amount, or cap, are taxed. In 2008, that cap was $102,000. Earnings over that amount are not taxed. Thus Social Security claims a smaller share of income as income rises.

The **Medicare tax** is also split evenly between employer and employee. In 2008, the total Medicare tax rate was 2.9 percent, half of which—1.45 percent—was withheld from employees' earnings. The Medicare tax is not capped. It applies the same rate to all tax-payers at all income levels, making it a true proportional tax.

Many states also levy payroll taxes. An **unemployment tax** is a state payroll tax that is used to assist workers who lose their jobs. Some states also levy a **state disability tax**, which funds state programs to help workers who are injured on the job.

Property Taxes

Taxes on property are a major source of revenue for many state and local governments. **Property taxes** are commonly levied on real property, which consists of land and buildings. Some governments also tax personal property, such as cars and boats.

Property taxes are proportional taxes that charge a fixed percentage of the value of a property. That value is calculated by an assessor, a public official who determines the value of a property for taxation purposes. If the **assessed value** of a property changes—a common occurrence in the real estate market—property taxes change, too.

In many communities, property taxes are a major source of revenue for public schools. However, the practice of funding public schools with property taxes has many critics. Some charge that it is unfair to require all property owners to pay such taxes when not all of them use the public schools. Others question the equity of basing school funding on property taxes. These critics point to the fact that lower-income school districts with low property values cannot raise as much revenue as higher-income school districts can. Funding schools in this way puts lower-income students at an educational disadvantage.

Sales Taxes

Another important source of state and local revenue is the **sales tax**. Such a tax levies a percent charge on the purchase of a wide variety of goods and services, from manufactured items to meals served in restaurants.

Sales taxes are relatively easy to collect and provide critical funding for state and local governments. But as you read earlier, sales taxes tend to be regressive, because people with high incomes typically spend less on goods and services as a share of their income than do lower-income individuals. To limit the regressive effects of a sales tax, many cities and states do not tax necessities, such as food and medicine.

Corporate Income Taxes

Governments at all levels levy various types of business taxes. The largest business tax is the federal **corporate income tax**, which is applied to the profits of corporations. Like individual income taxes, corporate taxes are progressive, applying a higher tax rate to higher levels of corporate income.

It might seem that placing high taxes on corporations and other businesses would help relieve the tax burden on ordinary citizens. In reality, the cost of corporate taxes is passed along to individuals—to customers in the form of higher prices, to employees in the form of lower wages, and to shareholders in the form of smaller dividend checks. As one economist put it, “Purely and simply, business taxes, like all other taxes, . . . are paid for by people.”

Excise and Luxury Taxes

Federal, state, and local governments also earn revenue from excise and luxury taxes, both of which tax consumption of certain goods and services.

Excise taxes are typically levied on goods and services a government wants to regulate. For example, alcohol and cigarettes are taxed to discourage their use.Because of their association with alcohol and cigarettes, excise taxes are sometimes called **sin taxes**. Like other sales taxes, excise taxes are generally regressive.

Luxury taxes, as the name implies, are levied on the sale of luxury goods, such as fur coats and private jets. Luxury taxes are progressive, because the consumption of luxury goods increases as income increases. The theory behind such taxes is that a person who can afford to buy a fur coat or a private jet can easily afford to pay an extra tax on it.

In practice, however, luxury taxes have not always worked the way lawmakers intended. In 1990, for example, Congress passed a luxury tax on expensive furs, jewelry, cars, private airplanes, and yachts. Because of the tax, wealthy people who might have purchased such products decided not to.

As demand for the luxury goods dropped, the firms that supplied them laid off workers. Within a year, according to a government study, the tax had destroyed 330 jewelry industry jobs, 1,470 aircraft industry jobs, and 7,600 jobs in the boat-building industry. In 1991, these job losses cost the federal government more than $24 million in lost income tax revenue and unemployment benefits paid to laid-off workers. This amount was more than all of the revenue generated by the luxury tax that same year.

The 1990 luxury tax illustrates the unintended consequences of poorly thought-out tax legislation. In this case, lawmakers failed to realize that the demand for luxury goods is actually quite elastic. In 1993, Congress repealed the luxury tax on everything except cars costing more than $30,000. The luxury car tax expired in 2003.

User Fees and Tolls

Have you ever paid an entrance fee to a national park or a toll on a bridge? Like charges to park in public lots, swim in public pools, or use public highways, these are examples of user fees and tolls.**User fees** and tolls are fixed charges levied on the use of a public service or facility. Fees and tolls are based on the benefits-received principle, because those who use a facility pay the tax.

User fees and tolls are proportional taxes in that everyone pays the same rate, regardless of income.They become regressive or progressive only when a given fee tends to fall more heavily on low-income or high-income taxpayers.

Estate and Inheritance Taxes

The federal government imposes an **estate tax** on assets left to heirs by someone who dies. The heirs, or inheritors of such assets, pay the tax. Many states also levy an estate tax, sometimes called an **inheritance tax**, on top of the federal tax.

Estate taxes are progressive, because larger estates are taxed at a higher rate. Some critics argue, however, that estate taxes are unfair because they impose an additional tax on property and wealth that may already have been taxed during a person's lifetime. Estate taxes may also discourage saving. Critics who oppose the estate tax sometimes call it a "death tax." "Death and taxes may be inevitable," one critic has said, "but they shouldn't be related."