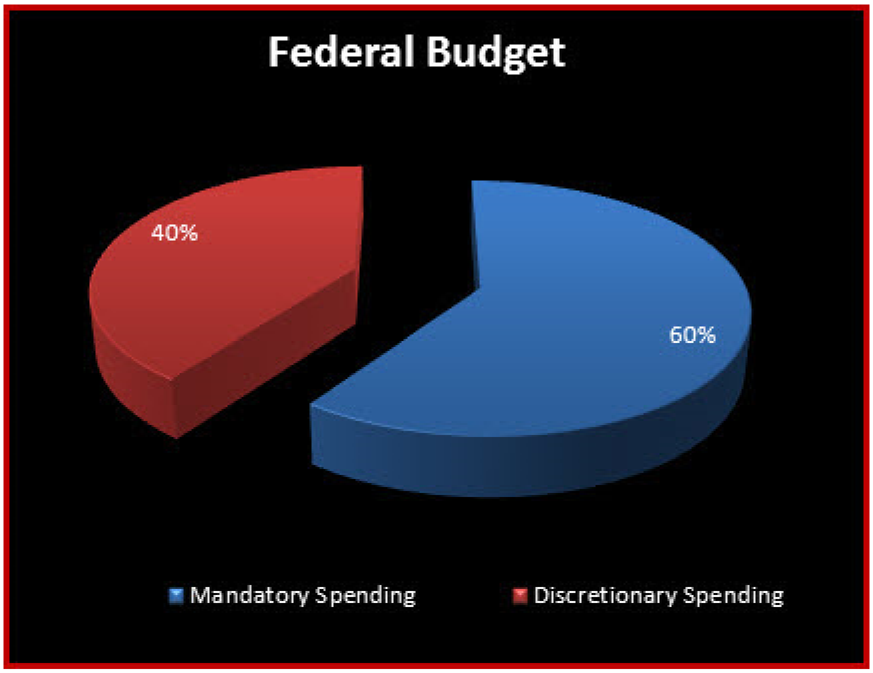
TAXING AND SPENDING



Unit Overview

Although no one likes to pay them, taxes are necessary because they generate the money to fund the goods and services that Americans have come to expect from their government. National defense, education, highways, help for people in need and law enforcement are just a few things that our tax dollars provide. Like households, the President and Congress share the responsibility for preparing a budget to allocate the nation's financial resources. This involves planning, analysis and, like all economic decisions, trade-offs. Let's see how it all happens.

The Power to Tax

To acquire the money that they need to operate, governments require citizens to pay **taxes**. Income from taxes and other non-tax sources, such as loans or government-owned enterprises, is called **revenue**. Without revenue, government would not be able to provide the services that Americans have come to expect. These include national defense, education, infrastructure and help for those in need. The Founding Fathers intensely debated the wisdom of giving the federal government the authority to tax. For this reason, the Constitution sets very specific limits on this power. It cannot be used to collect money that goes to individual interests, and federal taxes must be the same in every state. The Constitution also prohibits certain types of taxes. For example, since it violates the freedom of religion guaranteed by the First Amendment, Congress cannot tax church services. The Constitution, however, can also be amended. In 1913, the **Sixteenth Amendment** legalized the collection of federal income tax, which had been declared unconstitutional by the Supreme Court.

U.S. Constitution: Amendment 16
The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

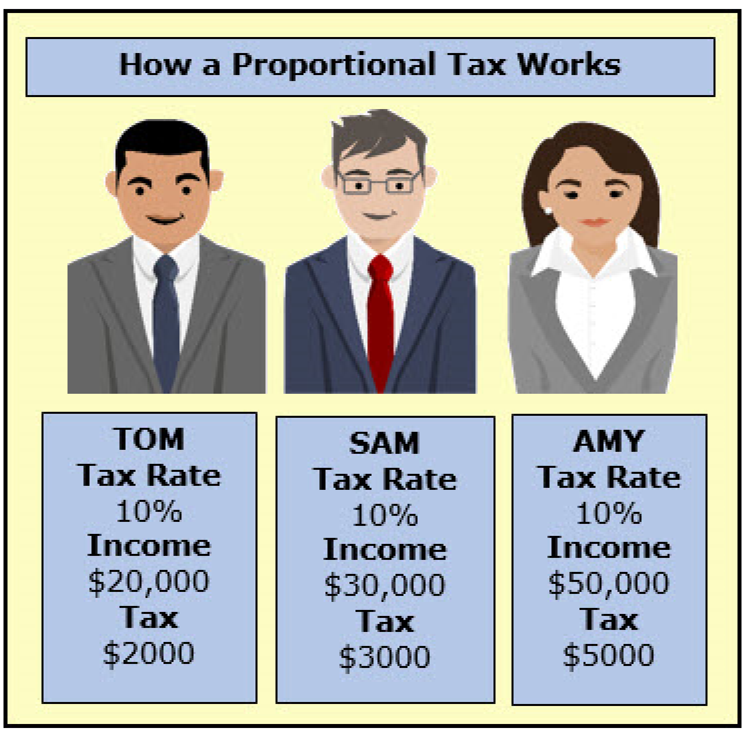
Although no one really wants to pay taxes, we will always need them. For this reason, it is important that taxes be equitable, reasonably simple to understand and easy to collect. Citizens and businesses should be able to prepare their own tax forms and to pay what they owe on a regular schedule. At the same time, government officials need to collect taxes without spending too much time and money. A tax must generate enough revenue to make the process worthwhile. Tax payers want a system that is fair and avoids loopholes. These are exceptions that permit some people to pay less than others.

Go to Questions 1 and 2.

Tax Structures

When adding new taxes, federal, state and local governments make two important decisions: exactly what is going to be taxed and how the tax is going to be structured. The property, income, good or service that is taxed is referred to as the tax base. After establishing a tax base, governments must then choose the best way to structure the tax. Economists divide tax structures into three categories: proportional, progressive and regressive. As with all decisions, each tax structure comes with benefits and trade-offs.

A **proportional tax**, sometimes called a **flat tax**, requires everyone to pay the same percentage regardless of their income. The more money an individual makes, the more he or she pays in proportional tax. For example, aside from federal income tax, some towns and cities also collect local income taxes from their residents. Unlike federal income tax, everyone usually pays the same percentage. Based on a tax rate of 2%, an architect with an income of $125,000 annually pays $2500. A nurse's aide, who earns $30,000 a year, also pays 2% for a total of $600. Proportional taxes have several advantages. They are simple to understand and easy to collect. On the other hand, opponents argue that proportional taxes are unfair because they demand more sacrifices from lower-income households that already spend most of their earnings on necessities.



Because it is based on a percentage that may increase or decrease depending on changes in income, a **progressive tax** structure is more complicated than a proportional system and requires the supervision of government agencies, such as the **Internal Revenue Service**. At the same time, progressive taxes generally produce the most revenue. Federal income tax is one example of a progressively structured tax. Under this system, people with large incomes pay more, while those with small incomes pay little or nothing. The federal income tax code consists of several levels called **brackets**. A tax payer may pay several different rates depending on his or her earnings. In other words, the government divides taxable incomes into pieces, and each piece is taxed at a corresponding rate.

Let's see how it all works by looking at a single taxpayer. Allen is an electrical technician and earns $53,000 annually. At first glance, you may think that Allen simply has to pay 25% of $53,000. Fortunately for our taxpayer, this is not the case. Allen pays 10% on $9,275 of his earnings. Moving to the next bracket, he owes 15% of $28,375. This leaves $15,350 for the third bracket at 25%. The graphic below illustrates Allen's tax calculations.

Single	
Taxable Income	**Tax Rate**
$0—$9,275	10%
$9,276—$37,650	$927.50 plus 15% of the amount over $9,275
$37,651—$91,150	$5,183.75 plus 25% of the amount over $37,650
$91,151—$190,150	$18,558.75 plus 28% of the amount over $91,150
$190,151—$ 413,350	$46,278.75 plus 33% of the amount over $190,150
$413,351—$415,050	$119,934.75 plus 35% of the amount over $413,350
$415,051 or more	$120,529.75 plus 39.6% of the amount over $415,050

Allen's Income Tax without Deductions

$9275 at 10% = $927.50
$28, 375 at 15% = $4256.25
$15,350 at 25% = $3837.50

Total income: 53,000.
Total Tax before Deductions: $9021.25

Governments also add to their revenue by collecting taxes based on the regressive structure. Under a **regressive tax**, the percentage of income paid in taxes goes down when income increases. This format is often criticized because it imposes a greater burden on low-income households. State sales tax qualifies as a regressive tax. Let's say someone who earns $20,000 annually spends $7,200 on clothing and food. At the same time, a person making $200,000 spends $20,000 on the same essentials. If the state sales tax is 5%, the individual earning $20,000 spends almost 2% of his or her annual income on state sales tax. Although the person earning $200,000 spends more money on food and clothing, the state sales tax on these items adds up to .5% of his or her total income. For this reason, opponents of the regressive tax structure argue that these taxes are unfair. At the same time, they are easy to understand and simple to collect. Therefore, they continue to be a valuable source of revenue.

Go to Questions 3 through 8.

Collecting Taxes

The federal government has several major sources of tax revenue. You can see how they contribute to the nation's financial status in the table below. Although the goal of taxes is to create operating money, sometimes the federal government also uses them to discourage the public from buying harmful products. Federal taxes on tobacco and alcohol, often referred to as **sin taxes,** fall into this category. In these cases, taxes not only provide money for goods and services but also serve as incentives to change behavior.

Taxes Used to Fund the Federal Government		
Tax	**Source**	**Amount Collected**
Income Tax	Income earned through employment, investments and interest	$1.1 trillion
Social Insurance Tax	Contributions paid into programs such as Social Security and Medicare	$934 billion
Corporate Tax	Profits earned by businesses and corporations	$297 billion
Excise Tax	Specific services or products, such as alcohol, gasoline and tobacco	$74 billion
Custom Duties and Tariffs	Products from foreign countries	$27 billion
Estate and Gift Taxes	Money or property received as an inheritance or gift	$25 billion

Individual income taxes are currently the country's main source of revenue. Because the amount that each person owes is determined annually, the government could collect this tax in one lump sum at the end of the year. It is likely, however, that this would create problems for taxpayers and government. A single, annual payment from everyone at once would make it difficult for the government to cover expenses, such as rent, salaries, supplies and services, throughout the year. Taxpayers, too, might have trouble budgeting the money for one, large tax bill. For these reasons, employers are responsible for collecting taxes on a pay-as-you-earn system.

Rally to Protest a Tax Increase

Under the **pay-as-you-earn system**, employers **withhold**, or take out, payments from workers' salaries before they receive them. Then, they forward this money to the federal government. At the end of the year, every employee receives a **W-2 form** from his or her employer. This report shows the total amount of income tax paid during the year. Workers use this information to complete tax return forms that determine whether the amount withheld covers the tax owed. If the total collected by the employer is lower than the actual amount due, the worker pays the difference. On the other hand, if the total collected by the employer is higher than the actual amount due, the worker receives a refund from the federal government. Midnight on **April 15** (or the first business day after April 15) is the deadline for submitting tax returns for the previous year to the Internal Revenue Service (IRS).

In addition to income taxes, employers also deduct funds for Social Security and Medicare, two well-known federal programs. **Social Security**, launched in 1935 in response to hardships encountered during the Great Depression, was established as a retirement fund that provided pensions for older Americans. Today, the fund also pays benefits to disabled workers and the surviving family members of wage earners. **Medicare** is the country's national health insurance program. It helps people over sixty-five pay for hospital care and medical services. It also assists people who suffer from certain diseases and disabilities.

Go to Questions 9 through 13.

Setting up the Federal Budget

Just as households plan the best way to utilize their financial resources, Congress and the President share the responsibility for establishing the **federal budget**. This plan lists the nation's expected income and shows exactly how the money will be spent. The federal government prepares a new budget for each fiscal year. A **fiscal year** is a twelve-month period that does not necessarily follow the traditional January-through-December format. Usually, the federal government's fiscal year runs from October 1 through September 30.

The process begins with the offices and agencies funded by the federal government. Each one prepares a detailed estimate of the money needed to operate during the upcoming fiscal year. The **Office of Management and Budget (OMB)**, an agency within the executive branch, reviews these proposals and works with the President's staff to combine them into a single document. The President presents this spending plan to Congress in January or February. At this point, the budget is nothing more than a request. Congress must approve the funds to make it a reality.

For the next few months, Congress studies, debates and modifies the President's proposed budget. Committees in the House of Representatives and the Senate hold hearings and listen as agency officials explain their funding requests. The **Congressional Budget Office (CBO)** assists in the process by collecting additional statistics concerning the economy. Before the end of the fiscal year, Congress must pass the revised budget and a series of appropriation, or spending, bills to pay for it. Once the President signs the **appropriation bills**, the budget becomes the official spending plan for the new fiscal year beginning on October 1. The President also has the option of vetoing these bills.

Shutdown Barricades at the Washington Monument: 2013

If the budget is not finalized by September 30, Congress approves **stop-gap funding**. This emergency legislation keeps the government running temporarily. If the President refuses to sign this measure, the government stops functioning. For example, in 2013, the government experienced a sixteen-day shutdown. For over two weeks, only essential services, such as the military, remained operational. The news clips listed below describe the events leading up to the federal **shutdown**. Nearly 800,000 federal employees experienced lay-offs; others were required to report for work but did not know when they would receive their next paychecks. National parks and monuments closed, and some benefit payments were delayed. Congress and President Obama eventually reached a compromise and agreed on a new bill to end the crisis.

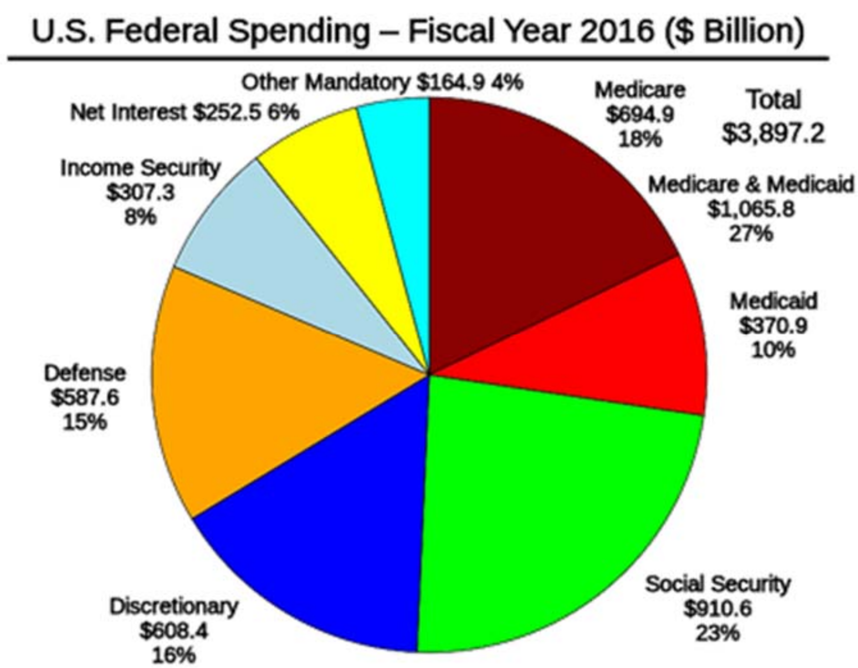
QuickTime The Budget Battle Begins

QuickTime Government Budget Standoff

STOP Go to Questions 14 through 16.

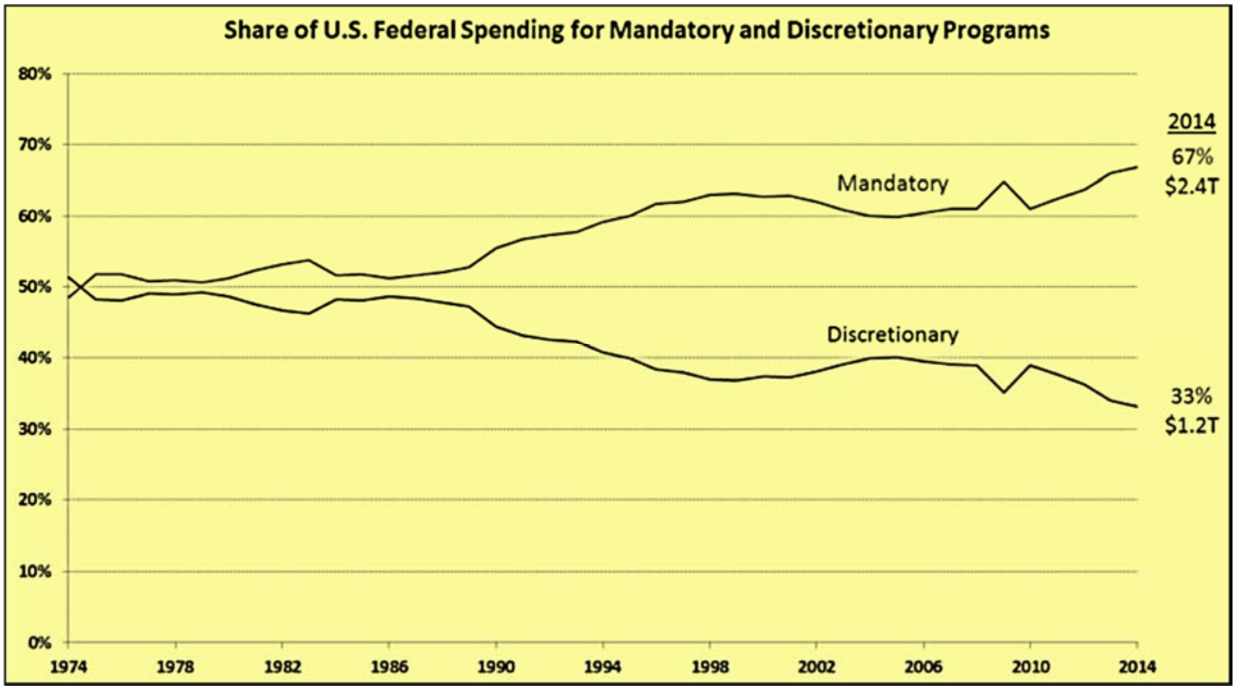
Where Does All the Money Go?

Federal spending is divided into two major categories, mandatory spending and discretionary spending. **Mandatory spending** consists of payments that the government is required by law to make. Along with interest fees on the national debt, this category includes a number of entitlement programs, such as Social Security, Medicare, Medicaid and the Supplemental Nutritional Assistance Program (SNAP). **Entitlement programs** pay benefits to U.S. citizens who meet certain eligibility requirements established by law. In other words, people qualify for, or are entitled to, these benefits because they meet certain legal standards. Unlike other areas of the federal budget, Congress does not annually approve dollar amounts to fund these programs. It may, however, pass new legislation that changes eligibility criteria or benefit formulas.



The remaining items in the federal budget make up what is known as **discretionary spending**. Discretionary spending covers defense, education, student loans, scientific research, national parks, disasters aid and many other federal programs. To fund these areas of the budget, Congress passes appropriation bills with specific dollar amounts attached. This means that Congress must make choices that result in trade-offs. Before the Great Depression, almost all government spending was discretionary. However, the creation of

Social Security in 1935 and Medicare in 1965 changed how the federal government spent its money. Today, almost 70% of the federal budget is devoted to mandatory spending. The graph below shows the changes in mandatory and discretionary spending over the course of several decades.



Go to Questions 17 through 19.

Deficit and Surplus

When federal spending equals federal revenue for a given fiscal year, the government's budget is **balanced**. The same amount of money is flowing into the Treasury as is flowing out of the Treasury. In reality, this almost never happens. Most of the time, the government operates at a deficit or a surplus. When a fiscal year's revenue is greater than its expenses, a **budget surplus** occurs. During the mid-1990s, tax increases, a strong economy and low unemployment resulted in several fiscal years of surpluses. These favorable circumstances did not last long. The stock market boom ended, tax cuts reduced the amount of money collected and terrorist attacks on September 11, 2001 disrupted the economy. All of these factors added up to a series of fiscal years with budget deficits.

A **budget deficit** is the result of the government spending more than it takes in. In this situation, printing more money is an option, but this causes inflation and lowers the value of the country's currency. Therefore, the government usually chooses to borrow the money to make up the shortfall. This action has its advantages. Borrowing money permits the government to undertake projects it could not otherwise afford. It also allows government to produce more goods and services. Unfortunately, each fiscal year of budget deficits increases the total amount of money owed. This accumulates and grows into what is called the national debt. The video listed below explains the history of the national debt. It also discusses its pros and cons.

QuickTime The Historic Struggle with the National Debt

Go to Questions 20 through 22.

What's next?

When planning the federal budget, Congress and the President deal with the basic economic problem of allocating scarce resources. Countries, like individuals, cannot produce all the goods and services they need or want. One way that nations deal with this problem is through trade. Is it cheaper for a country to import certain products rather than manufacture them? Should a country specialize in a few goods that it can export at a profit? Before moving on to answer these questions in the next unit, review the terms found in Unit 14; then, answer Questions 23 through 32.

Go to Questions 23 through 32.