

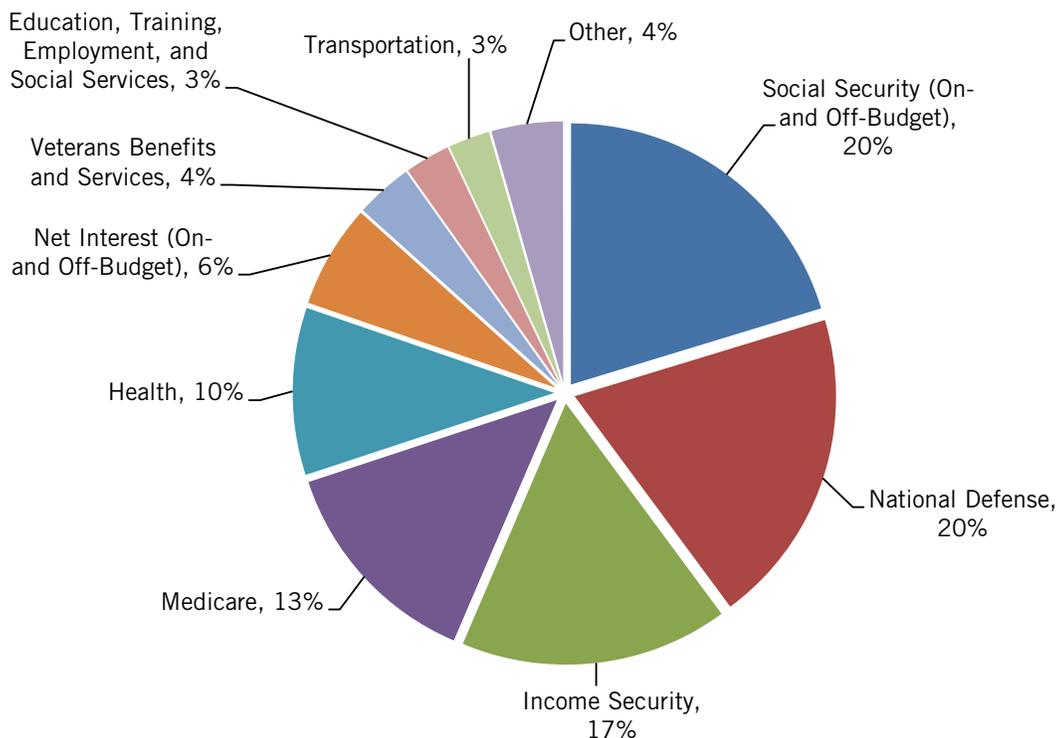
# Overview of Federal Taxes

**Many Types of Taxes:** Three activities are commonly taxed: earning income, spending money/engaging in transactions, and owning or transferring wealth or property. These activities can be taxed in various ways, usually expressed as a percentage, but also occasionally as a flat fee, leading to the many types of taxes we have today. For example, the tax on the income that taxpayers earn is progressive. That means the tax takes a larger percentage of income from high-income groups than from low-income groups and is based on the concept of ability to pay. Similarly, corporations pay taxes on their profits

as corporate income tax. See the online glossary entries on *capital gains tax*, *duty*, *estate tax*, *excise and gift taxes*, *income tax*, *payroll taxes (FICA)*, *property tax*, and *user tax (user fee)* for details about specific types of taxes.

**Where Federal Tax Dollars Go:** Nearly everyone benefits from some government service paid for by federal taxes, even if he or she is unaware of it. Figure 1 shows where federal tax dollars go, according to the major expenditure categories established by the Office of Management and Budget (2012).

**Federal Expenditures by Function, Fiscal Year 2011**



Source: Office of Management and Budget. (2012). Table 3.2—Outlays by function and subfunction: 1962–2017. Retrieved from <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist03z2.xls>

**Figure 1.**

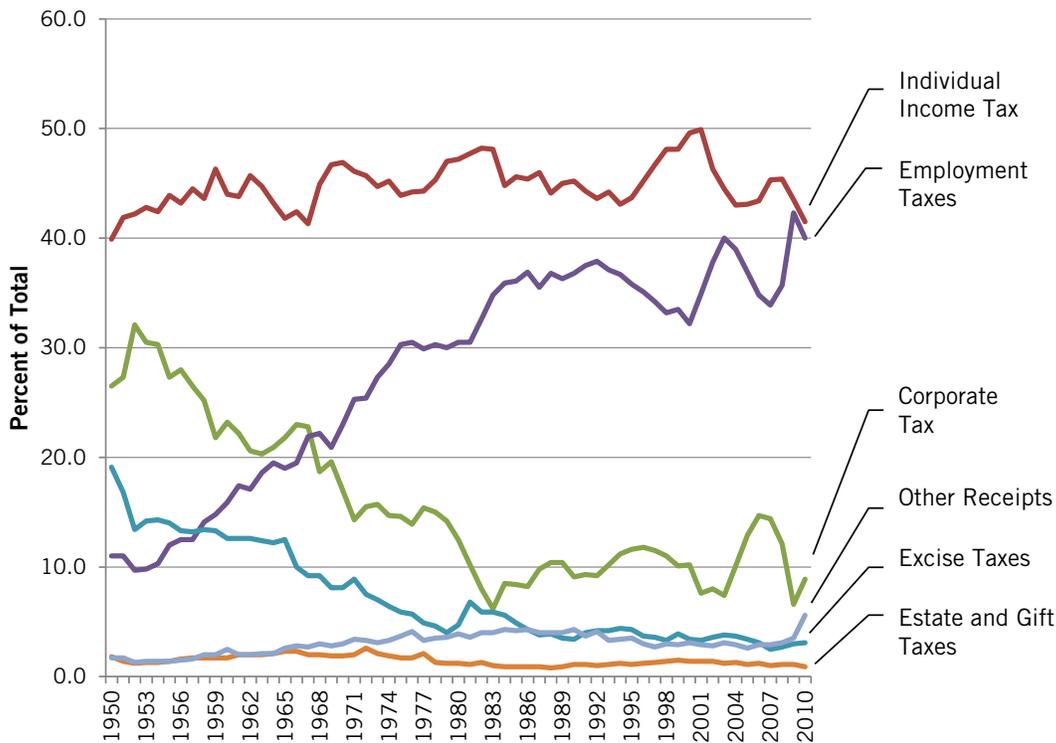
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**Where the Money Comes From:** Figure 2 shows how the distribution of sources of federal revenue has changed over the past 60 years. These five types of taxes are the major sources of revenue for the federal government, in addition to customs duties and fees and income from the Federal Reserve system.

**Who Pays Taxes:** A common criticism of the tax system is that nearly half of Americans pay no income tax (Bluey, 2012; Weisman, 2011). In a narrow sense, this is true; the Tax Policy Center reports that, in 2011, 46 percent of U.S. households paid no federal income tax (Johnson et al., 2011). In order to make fair judgments about any proposed changes to tax policy, however, that number needs to be placed

in context. When other types of federal taxes are taken into account, especially the payroll tax that all workers pay to fund Social Security and Medicare, the number of households who pay no taxes drops to 17 percent. Furthermore, as a result of the recession of 2008–2009, an unusually large percentage of Americans were unemployed or in poverty in 2011, and thus did not make enough income to owe any income taxes. Tax cuts enacted by Congress and Presidents Bush and Obama to stimulate the economy temporarily lowered income taxes to zero or below for many Americans. (These provisions have expired.) Finally, a large percentage of people who pay no income tax are elderly, have disabilities and thus are unable to work, or are students (Marr & Huang, 2012).

### Federal Receipts by Source, as a Percentage of Total, 1950–2010



Source: Joint Committee on Taxation. (2011, September 22). Table A-8. Federal receipts by source, as a percentage of total revenues, 1950–2010. Retrieved from <https://www.jct.gov/publications.html?func=startdown&id=4363>

Figure 2.

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**How Taxes Change Based on Income:** The design of the income tax system in the United States takes into account ability to pay; higher income is taxed at a higher percentage, or rate. This is known as a *progressive* tax system. If all income were taxed at the same percentage, the system would be *proportional*. Many other types of taxes are regressive in relation to income, meaning that people with lower incomes pay a higher share of their incomes in taxes than people with higher incomes pay. For example, if everyone must pay \$100 in taxes to register a car, that tax is regressive. That \$100 is a larger share of a poor person's income than a rich person's income. Even if a tax is a flat percentage (for example, a sales tax of 8 percent on all purchases), the tax would be regressive because poorer people must spend a larger share of their money, whereas wealthier people are able to save more. For more information, see *flat tax rate*, *proportional tax*, *progressive tax*, and *regressive tax* in the online glossary.

**Marginal Tax Rates:** Even though the income tax system is progressive and higher incomes are taxed at higher rates, that does not mean people should avoid getting raises at work because they think they actually lose money due to higher taxes. The system is designed so that higher rates only kick in on the higher income itself; for example, if a system has just two rates, 10 percent for income below \$10,000 and 20 percent for income above, and a person makes \$10,001, then the first \$10,000 would be taxed at 10 percent and only the \$1 above \$10,000 would be taxed at 20 percent, leading to a tax bill of \$1,000.20. In the online glossary, see *marginal tax rate*.

**Tax Expenditures:** Many economists, political commentators, and the Simpson-Bowles commission (a commission created by President Obama in 2010 to recommend medium- and long-term policies that would improve the U.S.

fiscal situation) have recommended reducing or eliminating “tax expenditures” and using the savings to cut the main marginal tax rates. Tax expenditures are what taxpayers commonly call deductions and credits, because they use them to reduce their taxable income. (They are *expenditures* because, from the government's point of view, they cost money to grant them.) Proponents say this will make the tax system more efficient. In essence, these people want to eliminate the deductions and credits (typically for interest paid on mortgages and for charitable contributions) that provide a patchwork of ways to lower existing rates of taxation and instead lower tax rates. Some economists argue that when there are many tax expenditures (deductions and credits) available to taxpayers, the government must raise marginal tax rates to offset those losses and, in so doing, discourages productive employment and investment. They believe that deductions are protected because they are politically popular, not because they make economic sense.

**The Bottom Line:** Tax formulas matter because the nation faces a basic long-term dilemma: for the past several years and for the foreseeable future, federal government spending has surpassed tax revenue. Although economists and policy makers debate the urgency of this problem, its consequences, and the best way to solve it, few disagree that some changes are necessary to ensure long-term fiscal sustainability. The real challenge is solving the problem while preserving many of the important functions and government services shown in Figure 1, as well as many of the features of the tax system that people like, including relatively low income tax rates with many generous credits and deductions. (See Figure 3 for a comparison of today's top tax rates with previous top rates.) The design of a tax system that is fair and efficient, promotes growth, and provides sufficient revenue to fund the services people expect from the government

### Top Marginal Tax Rates in the United States, 1913–2012



**Note:** A thorough analysis of the the tax code over time would be considerably more complex than this and would take other policy changes into account, including, for example, changes to both the amount of income and the percentage of taxpayers subject to the top rate.

**Source:** Urban Institute & Brookings Institution. (2011, April 11). Historical capital gains and taxes. Retrieved from <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=161&Topic2id=30&Topic3id=39>; Urban Institute & Brookings Institution. (2012, April 13). Historical top tax rate. Retrieved from <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=213>

**Figure 3.**

is not esoteric or wonky. Everyone must be concerned with it because it raises questions that have critical implications for our economy and society: What level of services do we want? Who should pay? What do we mean by a “fair” tax system? How do taxes encourage or discourage productive activities?

**What to Do:** Opinions vary widely on the answers to these broad questions and on the specifics of the design of the tax system. Some argue for deep cuts to government spending and scaling back of public services, accompanied by tax cuts. They believe that this will stimulate and sustain economic growth. Others believe in basically maintaining the current level of government services and expenditures, but

disagree on how to collect sufficient revenue to fund them. In addition to those who would cut tax expenditures (deductions) and lower marginal rates to simplify the system, there are those who would raise top marginal tax rates on the wealthiest earners and others who would raise taxes across the board to broaden the base of those who pay. These issues require careful attention to the assumptions and values underlying any proposal, as well as an analysis of the most likely consequences.

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