

# Understanding Taxes



Theme 4: What Is Taxed and Why





#### Theme 4: What Is Taxed and Why

Few of us ever test our powers  
of deduction, except when  
filling out an income tax form.

— Laurence J. Peter

Understanding  
Taxes 

- Taxes are used to generate needed revenue to pay for government goods and services.
- Creating tax legislation involves a compromise of what can be conflicting goals.
- Tax credits, exemptions, and deductions have been added to the tax code to ease our tax liability.
- What are the two meanings of deduction used in this quote? (Deduction is used both as a means of drawing conclusions and as an expense that can be subtracted before determining one's taxable income.)



## Theme 4: What Is Taxed and Why

### The U.S. Constitution Divides Government Powers



Federal Responsibilities

State Responsibilities

Local Responsibilities



Understanding  
Taxes

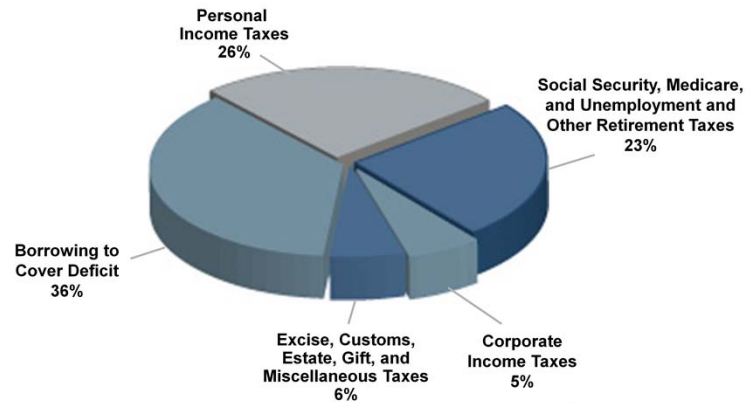


- The U.S. Constitution divides its powers and responsibilities among the federal, state, and local governments.
  - Federal responsibilities:** defense, currency, foreign relations, health, education, welfare, transportation, housing and urban development
  - State responsibilities:** state criminal codes, working conditions, internal communication, regulation of property, industry, business, public utilities
  - Local responsibilities:** police, fire, health regulations, education, public transportation, housing
- Each level raises money through taxation.



#### Theme 4: What Is Taxed and Why

### The Federal Government Dollar – Where It Comes From



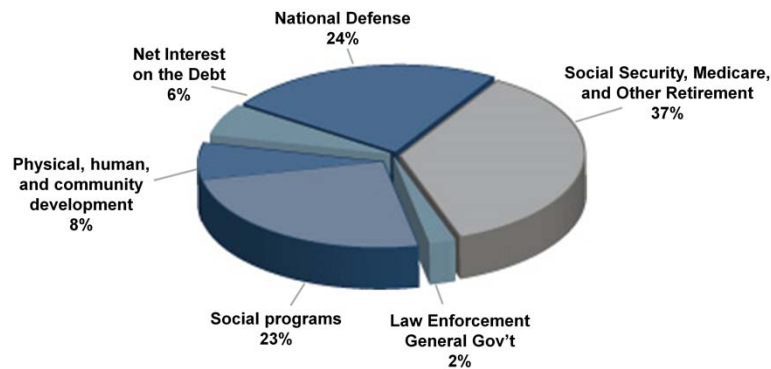
*Understanding  
Taxes* 

- The federal government raises needed revenue through taxation.
- Personal income taxes and Social Security/Medicare/unemployment/other retirement taxes are primary sources of tax revenue.
- The federal government also relies on monies collected from corporate income taxes and from excise, customs, estate, gift, and other miscellaneous taxes.
- Money is also borrowed to cover our nation's deficit.



#### Theme 4: What Is Taxed and Why

### The Federal Government Dollar – Where It Goes



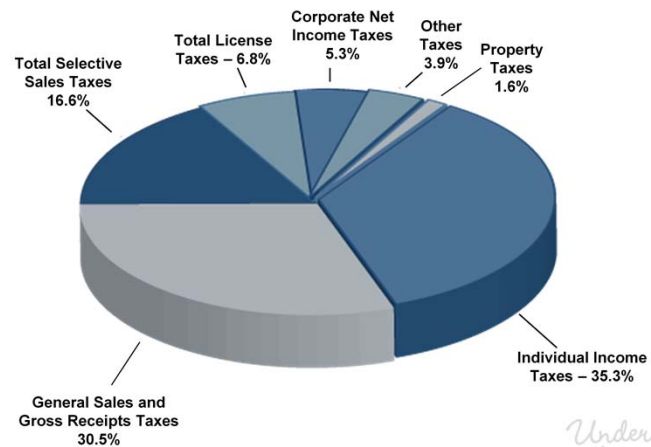
Understanding  
Taxes 

- Federal services supported through taxation include:
  - National defense, veterans, and foreign affairs
  - Social Security, Medicare, and other retirement services
  - Health and medical
  - Education and social services
  - Commerce and transportation
  - Energy and environment
  - Physical, human and community development
  - Law enforcement and general government
  - Social programs (Medicaid, food stamps, unemployment compensation, assisted housing)
  - Net interest on the debt



#### Theme 4: What Is Taxed and Why

### The State Dollar – Where It Comes From



Understanding  
Taxes

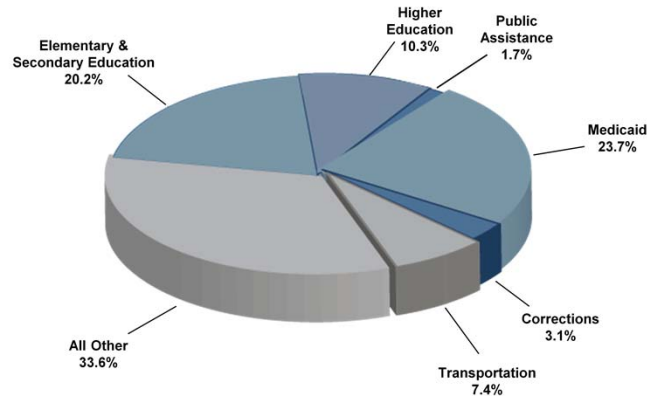


- States have the power to make, collect, and spend their own taxes.
- Each state is unique, its laws are made by the state legislatures and governors.
- There are 51 different tax programs (one for each of the 50 states and one for the District of Columbia).
- Sources of state tax revenue:
  - Sales taxes
  - Income taxes
  - Excise taxes
- States cannot make any laws that interfere with interstate commerce.
- Some states do not have individual income taxes on wages.
- Some do not have sales tax.
- Individual donations from private citizens often provide a significant source of revenue for many hospitals, schools, and libraries.
- Local taxes are under the authority of the state and may vary from city to city.
- The federal government often gives local governments additional tax revenue for schools and highways, among other services.



#### Theme 4: What Is Taxed and Why

### The State Dollar – Where It Goes



Understanding  
Taxes 

- State highways and transportation projects, such as building bridges, are supported through tax dollars.
- Universities and schools also get state funding.
- State monies pay for the state law enforcement system, including state courts, prisons and the police.
- States fund state parks and recreation and pay for welfare and special services.
- Tax revenue is also used to oversee professional license programs given to such groups as drivers, doctors, lawyers, and barbers to ensure that proper standards of conduct and safety are maintained.
- Local tax dollars are used in many different ways.
- Local services supported by tax dollars include
  - Schools and local libraries
  - Maintenance of local roads and city streets
  - Streetlights, garbage collection, and recycling
  - Local police and fire protection
  - City and county jails; local courts
  - Enforcement of zoning laws
  - Local parks and recreation



## Transaction Taxes



- Levied on economic transactions
- Set on percentages or physical quantities
- Support state and local services

*Understanding  
Taxes* 

- Transaction taxes are levied on economic transactions, such as the sale of goods and services.
- These taxes can be based on a set percentage of the sales value (sales tax) or on physical quantities (per unit, such as gasoline tax)
- Revenue collected from transaction taxes supports state and local services such as education, police, Medicaid, employment services.





## State Income Taxes

- Come from earned and unearned income
- Levied on individuals and corporations
- Support state expenses, education programs, and welfare



Understanding  
Taxes



- Income taxes come from income, both earned (salaries, wages, tips, commissions) and unearned (interest, dividends).
- Income taxes can be levied on both individuals (personal income tax) and corporations (business and corporate income taxes).
- Income taxes support state expenses, education programs, and welfare programs.



## Property Taxes



- Levied on property, especially real estate
- Can also be levied on boats, RVs, business inventories
- Fund schools, local services, welfare programs

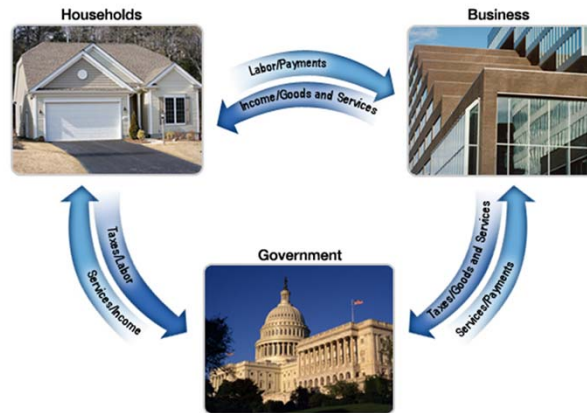
*Understanding  
Taxes* 

- Taxes are levied on property, especially real estate.
- Property taxes may be assessed on other assets such as boats, recreational vehicles, and business inventories.
- Local property tax on assessed valuation of land, home, business, or other structures is the traditional and most common kind of local tax.
- Property taxes are a traditional source of funding for schools, local services (police, fire, libraries, parks, water, and sanitation), and welfare programs.



## Theme 4: What Is Taxed and Why

### Market Economy



Understanding  
Taxes 

- In a market economy, businesses, households, and the government are closely linked.
- Households provide the economy with consumers and employees. Employees supply businesses with needed labor; in turn, businesses provide an income to their employees.
- Employee wages or income supports government services through taxation. Consumers who buy goods that support businesses also use wages.
- Businesses provide income and goods and services to households.
- Businesses pay taxes, which help support government goods and services.
- The government pays for the services offered by businesses and also provides services to aid businesses.
- Households pay taxes, which fund government services.



## Conflicting Goals of Taxation

- Fairness
- Productivity
- Economic prosperity
- Promoting well-educated citizens and strong families
- Limiting government burden



Understanding  
Taxes 

- Taxation represents a compromise of conflicting goals.
- Goals in conflict:
  - Fairness
  - Productivity
  - Economic prosperity
  - Promoting well-educated citizens and strong families
  - Limiting government burden
- The goal of raising revenue conflicts with the goal of reducing taxes to encourage certain activities.
- For a given level of government services, lower taxes for some groups (or activities) implies higher taxes for other groups or activities.
- As a result of special tax treatment of certain activities and different sources of income, people with the same income may pay different amounts of taxes.



## Taxes and Equity



- Horizontal Equity: “Equals should be taxed equally.”
- Vertical Equity: “Unequals should be taxed unequally.”

Understanding  
Taxes 

- The concept of horizontal equity is that people in the same income group should pay the same amount of taxes.
- “Equals should be taxed equally.”
- The concept of vertical equity is that people in different income groups should pay different amounts of taxes or different percentages of their income as taxes.
- “Unequals should be taxed unequally.”
- What factors can cause people with equal incomes to be taxed differently? (Deductions, Tax Credits, Tax Exemptions)



## Factors Affecting Tax Liability

- **Deductions:** Expenses that can be deducted before determining taxable income
- **Tax Credits:** Amounts that can be deducted from taxes owed
- **Tax Exemptions:** A part of income on which no tax is imposed



Understanding  
Taxes 

- Deductions, Tax Credits, and Tax Exemptions can affect one's tax liability
- Deductions: A person's or a business's expenses that can be deducted before determining taxable income, which is always less than total income and is figured according to IRS rules
- Tax Credits: Amounts, based on certain expenditures, that a taxpayer can deduct from taxes owed
- Tax Exemptions: A part of a person's total income on which no tax is imposed



## Theme 4: What Is Taxed and Why

### Payroll Taxes

EARNINGS	HOURS	AMOUNT	DEDUCTION	CURRENT	YEAR TO DATE
Regular	70.00	846.16	FICA Tax	69.06	494.17
Overtime	14.75	267.57	Medicare Tax	16.15	115.58
Total	84.75	1,113.73	Federal Tax	116.17	880.89
			NY State Tax	52.40	347.98
			NY City Tax	27.05	183.34
			Disability	1.20	9.60
			LTD	1.00	
Year to Date Gross		\$7,970.53	Total	\$283.03	
			Net Pay	\$830.70	

Understanding  
Taxes 

- Everyone with income from a job or from savings may be subject to federal personal income tax and may be subject to state and local income tax as well.
- Nearly everyone has some tax liability, or total tax bill. The system of withholding was developed so that taxpayers could pay as they earned rather than having to pay a substantial sum at one time.
- FICA tax funds Social Security. FICA stands for Federal Insurance Contributions Act.
- Medicare tax funds the federal health programs for those over age 65.
- FICA and Medicare taxes are required by federal statute. Other deductions involve voluntary compliance whereby taxpayers take responsibility for reporting income, calculating tax liability, and providing information for appropriate amounts to be withheld.



## Direct and Indirect Taxes

### **Direct Tax:**

- Tax paid directly to the government
- Cannot be shifted to another
- Includes personal income tax or property tax on a residence



Understanding  
Taxes 

- Taxes can be either direct or indirect.
- A direct tax is a tax that the taxpayer pays directly to the government.
- Direct taxes cannot be shifted to any other person or group.
  - Personal Income tax
  - Property tax on a homeowner's own residence





## Direct and Indirect Taxes

### Indirect Tax:

- Can be shifted by a person or business
- Can be recovered by charging higher prices or paying lower wages
- Sales tax, business property tax, and payroll tax can be shifted



Understanding  
Taxes 

- An indirect tax can be passed on or shifted by the person or business that owes it to another person or group.
- Businesses may recover the cost of the taxes they pay by charging higher prices to consumers, paying lower wages and salaries, accepting lower profits, or paying lower dividends to shareholders.
- Taxes that can be shifted:
  - Sales tax (customers pay; businesses collect them but may absorb a portion of them by lowering costs and payroll expenses)
  - Business property tax (businesses may charge higher prices, pay lower wages, or suffer lower profits to cover the cost of these taxes)
  - Payroll taxes (businesses may pay lower wages and salaries than they would if there were no taxes)