Taxation in the United States

Published: November 1, 2006, 5:53 pm
Edited: November 1, 2006, 5:53 pm

Lead Author: Brian Roach

This article has been reviewed by the following Topic Editor: Cutler Cleveland

Table of Contents

Introduction

Taxes are complicated. The U.S. federal tax code contains over three million words – about 6,000 pages. A casual browsing of the tax code's table of contents offers a glimpse into the vast complexity of federal taxation. Entire sections of the tax code apply specifically to such topics as the taxation of vaccines, shipowners' mutual protection and indemnity associations, specially sweetened natural wines, and life insurance companies. Annual changes to the tax code imply that taxes will continue to become more complex even as politicians tout tax simplification. Taxes levied by other jurisdictions, such as states and cities, add further layers of complexity. Americans spend billions of hours each year working on their taxes, not to mention the costs of accountants and tax preparers.

Fortunately, one needn't comprehend the imposing complexity of the tax code to understand the crucial role of taxes in American society. Taxation is an important, but commonly neglected, topic for students of economics, political science, and other social sciences. Tax policy has important economic consequences, both for the national economy and for particular groups within the economy. Tax policies are often designed with the intention of stimulating [economic growth](#) – although economists differ drastically about which policies are most effective at fostering growth. Taxes can create incentives promoting desirable behavior and disincentives for unwanted behavior. Taxation provides a means to redistribute economic resources towards those with low incomes or special needs. Taxes provide the revenue needed for critical public services such as social security, health care, national defense, and education.

Taxation is as much a political issue as an economic issue. Political leaders have used tax policy to promote their agendas by initiating various tax reforms: decreasing (or increasing) tax rates, changing the definition of taxable income, creating new taxes on specific products, etc. Of course, no one particularly wants to pay taxes. Specific groups, such as small-business owners, farmers, or retired individuals, exert significant political effort to reduce their share of the tax burden. The voluminous tax code is packed with rules that benefit a certain group of taxpayers while inevitably shifting more of the burden to others. Tax policy clearly reflects the expression of power in the U.S. – those without power or favor are left paying more in taxes while others reap the benefits of lower taxes because of their political influence. Broad attempts to reform the tax system have produced dramatic and sudden shifts in tax policy, generally motivated by political factors rather than sound economic theory. For example, the top marginal federal tax bracket on individual income in the U.S. dropped precipitously from 70% to 28% during the 1980s. Tax policy has clearly been used to promote political, as well as economic, agendas.

The Structure of Taxation in the United States

Tax Progressivity

The overall system of taxation in the United States is progressive. By a progressive tax system, we mean that the percentage of income an individual (or household) pays in taxes tends to increase with increasing income. Not only do those with higher incomes pay more in total taxes, they pay a higher rate of taxes. For example, a person making $100,000 in a year might pay 25% of their income in taxes ($25,000 in taxes), while someone with an income of $30,000 might only pay a 10% tax rate ($3,000 in taxes).

A tax system may also be regressive or proportional. A regressive tax system is one where the proportion of income paid in taxes tends to decrease as one’s income increases. A proportional tax system simply means that everyone pays the same tax rate regardless of income. A given tax system may display elements of more than one approach. Consider a hypothetical tax system where one pays a proportional, or flat, rate on income below a certain dollar amount and then progressively increasing rates above that dollar amount. Also, within an overall tax system, some particular taxes might be progressive while other taxes are regressive. We’ll see later on that this is the case in the United States.

Reasons for Progressive Taxation

The overall tax system of the United States, and in most other countries, is progressive for a number of reasons. A progressive tax embodies the concept that those with high incomes should pay more of their income in taxes because of their greater ability to pay without critical sacrifices. By paying a tax, any household must forego an equivalent amount of spending on goods, services, or investments. For a high-income household, these foregone opportunities might include a second home, an expensive vehicle, or a purchase of corporate stock. A low-income household, by comparison, might have to forego basic medical care, post-secondary education, or vehicle safety repairs. As income increases, the opportunity costs of paying taxes tend to be associated more with luxuries rather than basic necessities. The ability-to-pay principle recognizes that a flat (or regressive) tax rate would impose a larger burden, in terms of foregone necessities, on low-income households as compared to high-income households.

A progressive tax system is also a way to address economic inequalities in a society. A high degree of inequality can be lessened by taxing high-income households at a relatively higher rate than low-income households. But we also need to consider who receives the benefits derived from tax revenues to fully evaluate a tax system's impact on inequality. If the benefits of programs funded by taxation primarily accrue to low-income households while high-income households pay the majority of taxes, then the tax system effectively operates as a transfer mechanism. Increasing the progressivity of the tax system or altering the distribution of benefits allows redistribution of economic resources. We'll mainly focus on tax payments in this article but you should also be aware that the benefits of public expenditures are not evenly distributed throughout society.

There is also an economic argument for a progressive tax system – it may yield a given level of public revenue with the least economic impact. To see why, consider how households with different levels of income would respond to a $100 tax cut. A low-income household would tend to quickly spend the entire amount on needed goods and services – injecting $100 of increased demand into the economy. By comparison, a high-income household might only spend a fraction on goods and services, choosing to save or invest a portion of the money. The money that a high-income household saves or invests does not add to the level of demand for goods and services in an economy. In economic terms, we say that the marginal propensity to consume tends to decrease as income increases. So, by collecting proportionally more taxes from high-income households we tend to maintain a higher level of effective demand and more economic activity.

Of course, one can posit that a tax system can become too progressive. Extremely high tax rates at high-income levels might create a significant disincentive that reduces the productive capacity of society. Very high taxes might limit the risks taken by entrepreneurs, stifling innovations and technological advances. The desire to "soak the rich" through an extremely progressive tax system might be viewed as unfair, and not just by the rich. In fact, this was a concern of the Constitutional framers – that in a democratic system, the majority could impose unduly burdensome taxes on the wealthy minority. We'll see that their concerns have proved groundless. Many critics of the current tax system point to the contrary position – that a powerful minority have used their might to shift the tax burden away from themselves onto an immobilized and misinformed majority.

Even if one could devise a tax system that is economically optimal (i.e., producing the highest overall level of economic growth), the topic of taxation encompasses ideals about equity and fairness. A society may be willing to sacrifice some degree of economic growth in exchange for a more equitable distribution of economic resources. This is not to say that economic growth must always be sacrificed with redistribution. In fact, analysis of the U.S. historical data finds that high levels of economic growth tend to be associated with periods of relatively equitable distribution of economic resources.

We now turn to differentiating between the different types of taxes levied in the U.S. We'll first discuss several forms of federal taxation, roughly in order of the revenue they generate, and then consider taxation at the state and local levels. A final section will consider taxes that are generally not used in the U.S. but are important in other nations.

Federal Income Taxes

The federal income tax is the most visible, complicated, and debated tax in the U.S. The federal income tax was established with the ratification of the 16th Amendment to the U.S. Constitution in 1913. It is levied on wages and salaries as well as income from many other sources including interest, dividends, capital gains, self-employment income, alimony, and prizes. To understand the basic workings of federal income taxes, you need to comprehend only two major issues. First, all income is not taxable – there are important differences among "total income," "adjusted gross income," and "taxable income." Second, you need to know the distinction between a person's "effective tax rate" and "marginal tax rate."

Total income is simply the sum of income an individual or couple receives from all sources. For most people, the largest portion of total income comes from wages or salaries. Many people receive investment income from three standard sources: interest, capital gains, and dividends. Self-employment income is also included in total income, along with other types of income such as alimony, farm income, and gambling winnings.

The amount of federal taxes a person owes is not calculated based on total income. Instead, once total income is calculated, tax filers subtract some expenses as non-taxable. To obtain adjusted gross income (AGI), certain out-of-pocket expenses are subtracted from total income. These expenses include individual retirement account contributions, moving expenses, student loan interest, tuition, and a few other expenses. AGI is important because much of the tax data presented by the Internal Revenue Service (IRS) are sorted by AGI. However, taxes are not calculated based on AGI either. Taxable income is basically AGI less deductions and exemptions. Deductions are either standard or itemized. The standard deduction is a fixed amount excluded from taxation – in 2003 the standard deduction was $4,750 for single individuals and $9,500 for married couples. Tax filers have the option of itemizing their deductions. To itemize, a tax filer adds up certain expenses made during the year including state taxes, real estate taxes, mortgage interest, gifts to charity, and major medical expenses. If the itemized deductions exceed the standard deduction, then the itemized total is deducted instead. Exemptions are calculated based on the number of tax filers and dependents. A single tax filer with no dependent children can claim one exemption. A married couple with no children can claim two exemptions. Each dependent child counts as one more exemption. Additional exemptions are given for being age 65 or over or blind. In 2003, each exemption excluded a further $3,050 from taxation.

Taxable income is obtained by subtracting the deduction and exemption amounts from AGI. This is the amount a taxpayer actually pays taxes on. However, the amount of tax owed is not simply a multiple of taxable income and a single tax rate. The federal income tax system in the U.S. uses increasing marginal tax rates. This means that different tax rates apply on different portions of a person's income. The concept can be illustrated with an example using the 2003 tax rates. For a single filer, the first $7,000 of taxable income (not total income or AGI) is taxed at a rate of 10%. Taxable income above $7,000 but less than $28,400 is taxed at a rate of 15%. Taxable income above $28,400 but less than $68,800 is taxed at a rate of 25%. Income above $68,800 is taxed at higher marginal rates – 28%, 33%, and 35%.

Not all income, however, is taxed at the same marginal rates. Investment income from capital gains has generally been taxed at a lower rate than income from labor. Dividend income used to be taxed at the same marginal rate as labor income but the Jobs and Growth Act of 2003 also taxes dividends at the lower capital gains rate. While the top marginal rate on labor income in 2003 was 35%, the top rate on capital gains and dividend income was only 15%. Given that the vast majority of investment income is earned by wealthy taxpayers, the lower rates on investment income has important implications for the progressivity of the federal income tax.

Social Insurance Taxes

Taxes for federal social insurance programs, including Social Security, Medicaid, and Medicare, are taxed separately from income. Social insurance taxes are levied on salaries and wages, as well as income from self-employment. For those employed by others, these taxes are generally deducted directly from their paycheck. These deductions commonly appear as "FICA" taxes – a reference to the Federal Insurance Contributions Act. Self-employed individuals must pay their social insurance taxes when they file their federal income tax returns.

Social insurance taxes are actually two separate taxes. The first is a tax of 12.4% of wages, which is primarily used to fund Social Security. Half of this tax is deducted from an employee's paycheck while the employer is responsible for matching this contribution. The other is a tax of 2.9% for the Medicare program. Again, the employee and employer each pay half. Thus, social insurance taxes normally amount to a 7.65% deduction from an employee's wage (6.2% + 1.45%). Self-employed individuals are responsible for paying the entire share, 15.3%, themselves.

There is a very important difference between these two taxes. The Social Security tax is due only on the first $84,900 (in 2002) of income. On income above $84,900, no additional Social Security tax is paid. In other words, the maximum Social Security tax in 2002 that would be deducted from total wages is $5,264 ($84,900 × 0.062). The Medicare tax, however, is paid on all wages. Thus, the Medicare tax is truly a flat tax while the Social Security tax is a flat tax on the first $84,900 of income but then becomes a regressive tax when we consider income above this limit.

Consider the impact of social insurance taxes on two individuals, one making a salary of $30,000 and another making $300,000. The typical worker would pay 7.65% on all income, or $2,295, in federal social insurance taxes. The high-income worker would pay the maximum Social Security contribution of $5,264 plus $4,350 for Medicare (1.45% of $300,000) for a total social insurance tax bill of $9,614. Note that this works out to a 3.2% overall tax rate, or less than half the tax rate paid by the typical worker. As the high-income individual pays a lower rate of taxation, we see that social insurance taxes are regressive.

Federal Corporate Taxes

Corporations must file federal tax forms that are in many ways similar to the forms individuals complete. Corporate taxable income is defined as total revenues minus the cost of goods sold, wages and salaries, depreciation, repairs, interest paid, and other deductions. Thus corporations, like individuals, can take advantage of many deductions to reduce their taxable income. In fact, a corporation may have so many deductions that it actually ends up paying no tax at all or even receives a rebate check from the federal government.

Corporate tax rates, like personal income tax rates, are progressive and calculated on a marginal basis. In 2002, the lowest corporate tax rate, applied to profits lower than $50,000 was 15%. The highest corporate tax rate, applied to profits over $10 million was 35%. As with individuals, the effective tax rate corporations pay is lower than their marginal tax rate.

Federal Excise Taxes

An excise tax is a tax on the production, sale, or use of a particular commodity. The federal government collects excise taxes from manufacturers and retailers for the production or sale of a surprising number of products including tires, telephone services, air travel, fossil fuels (including gasoline, diesel fuel, and aviation fuel), alcohol, tobacco, and firearms.

Unlike a sales tax, which is evident as an addition to the selling price of a product, excise taxes are normally incorporated into the price of a product. In most cases, consumers are not directly aware of the federal excise taxes they pay. However, every time you buy gas, make a phone call, fly in a commercial plane, or buy tobacco products, you are paying a federal excise tax. For example, the federal excise tax on gasoline as of 2003 was about 18 cents per gallon.

Federal excise taxes initially may appear to be an example of proportional taxation – everyone pays the same tax rate on goods subject to excise taxes. However, in practice excise taxes turn out to be regressive because lower-income households tend to spend a greater portion of their income on goods that are subject to federal excise taxes. This is particularly true for gasoline, tobacco, and alcohol products.

Federal Estate and Gift Taxes

The vast majority of Americans will never be affected by the federal estate or gift taxes. These taxes apply only to the wealthiest Americans. The estate tax is applied to transfers of large estates to beneficiaries. Currently, estates valued at less than $1 million ($2 million for couples) are totally exempt from the tax. The top marginal estate tax rate is 55% but, as with individual and corporate taxes, the effective tax rates on estate tend to be lower. Provisions of the estate tax laws reduce the tax burden for the transfer of small businesses and farms.

The estate tax exemption amount is scheduled to increase over the next several years to $3.5 million ($7 million for couples) in 2009. In 2010, the estate tax is scheduled to expire but this expiration is only temporary – under current law the estate tax would be reinstated in 2011.

The transfer of large gifts is also subject to federal taxation. The estate tax and gift tax are complementary because the gift tax essentially prevents people from giving away their estate to beneficiaries tax-free while they are still alive. In 2002, gifts under $11,000 were excluded from the tax. Similar to the federal income tax, the gift tax rates are marginal and progressive, with a maximum tax rate of 50%. The gift tax is also scheduled for temporary expiration in 2010.

The estate and gift taxes are the most progressive element of federal taxation, paid exclusively by those with considerable assets. The majority of estate taxes are paid by a very small number of wealthy taxpayers. In 2000 over half of estate taxes were collected from estates worth more than $5 million, about 0.15% of all estates.

State and Local Taxes

Like the federal government, state governments also rely on tax revenues to fund public expenditures and transfer programs. Like the federal government, state governments rely on several different tax mechanisms including income taxes, excise taxes, and [[corporate tax]es. Thus, much of the above discussion applies to the tax structures in place in most states. However, there are some important differences that deserve mention.

Table 1. 1999 U.S. Tax Receipts, by Source

Source	Amount (Millions $)	Percent of All Taxes
Federal Taxes		
Income Taxes	879,500	34.5%
Social Insurance Taxes	611,800	24.0%
Corporate Taxes	184,700	7.2%
Excise Taxes	70,400	2.8%
Estate Taxes	22,900	0.9%

Total, Federal Taxes	1,769,300	69.4%
State Taxes		
Sales Taxes	200,600	7.9%
Property Taxes	240,100	9.4%
Income Taxes	189,300	7.4%
Corporate Taxes	33,900	1.3%
Excise and Other Taxes	114,500	4.5%
Total, State Taxes	778,400	30.6%
Total, All Taxes	2,547,700	100.0%
Source: U.S. Census Bureau (2002), except for federal estate tax data from Johnson and Mikow (2002).		

First, nearly all states (45 as of 2003) have instituted some type of general sales tax. State sales tax rates range from 2.9% (Colorado) to 7.25% (California). A few states reduce the tax rate on certain goods considered to be necessities, such as food and prescription drugs. For example, the general sales tax in Illinois is 6.25% but food and drug sales are taxed at only 1%. Other states with sales taxes exempt some necessities from taxation entirely. In most states, localities can charge a separate sales tax. While local sales taxes are generally lower than state sales taxes, there are exceptions. In New York the state sales tax is 4% but local sales taxes are often higher than 4%. Unlike income taxes, sales taxes tend to be regressive. The reason is that low-income households tend to spend a larger share of their income on taxable items than high-income households. Consider gasoline – which tends to be a declining share of total expenditures as income rises. An increase in gas taxes impacts low-income households more than high-income households. Some states, such as Idaho and Kansas, offer low-income households a tax credit on their state income taxes to compensate for their regressive state sales taxes.

Forty-one states levy an income tax. Most of these states have several progressive tax brackets (up to 10 rates) similar to the federal income tax. However, state income taxes tend to be much less progressive than the federal income tax. Six states have only one income tax rate, meaning that their income tax approaches a flat tax. Several more states have what is effectively a single tax rate because the top rate applies at a very low income. For example, Maryland's top rate of 4.75% kicks in at only $3,000 of income.

Another important distinction between the federal system of taxation and the taxes levied at state and local levels is use of property taxes. In fact, property taxes tend to be the largest revenue source for state and local governments. The primary property tax levied in the U.S. is a tax on real estate, including land, private residences, and commercial properties. Generally, the tax is an annual assessment calculated as a proportion of the value of the property, although the formulas used by localities differ significantly. Property taxes are commonly collected at a local level, but a share of property taxes is allocated for state purposes. Property taxes tend to be regressive, although less regressive than excise and sales taxes. The reason is that high-income households tend to have a lower proportion of their assets subjected to property taxes. While renters do not directly pay property taxes, most economists conclude that the costs of property taxes are largely passed on to renters in the form of higher rents.

Composition of Tax Collections in the U.S.

Table 1 presents government tax receipts, by tax source, for 1999 (the most recent year for which complete data were available). The table shows that federal taxes dominate the nation's tax system with nearly 70% of all receipts. The largest federal tax is the income tax, followed closely by social insurance taxes. State and local tax systems are primarily dependent on sales, income, and property taxation. The data in Table 1 cover the major taxes utilized in the United States.

Further Reading

- Global Development And Environment Institute, Tufts University

Citation

Brian Roach (Lead Author);Cutler Cleveland (Topic Editor) "Taxation in the United States". In: Encyclopedia of Earth. Eds. Cutler J. Cleveland (Washington, D.C.: Environmental Information Coalition, National Council for Science and the Environment). [First published in the Encyclopedia of Earth November 1, 2006; Last revised Date November 1, 2006; Retrieved January 12, 2011 <http://www.eoearth.org/article/Taxation_in_the_United_States>

The Author

Brian Roach received a Ph.D. in environmental policy analysis from the University of California, Davis in 1995 and an M.S. in agricultural economics from The Pennsylvania State University in 1990. From 1997-2001, he worked at the University of Maine, Orono as a researcher and teacher. His research background has focused on non-market valuation of natural resources, including drinking water quality, water-based recreation, wildlife, and subsistence activities. As a teacher, he has taught courses ... (Full Bio)