

# How do U.S. taxes work?

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Throughout history, every organized society has had some form of government. In free societies, the goals of government have been to protect individual freedoms and to promote the well-being of society.

To meet those goals, the U.S. government spends trillions of dollars each year. To get that money, the government needs income, called "revenue," which it raises through taxes. In the United States, there are several different types of taxes on individuals and businesses.

## The Free-Enterprise Model

The American economy is based on a system of free enterprise, which means that consumers are free to decide how to spend their money. The goal of producers is to make profits by selling what customers want.

The free-enterprise system does not produce all the services needed by society – some services are more efficiently provided when government agencies plan and manage them. Two good examples are national defense (the military) and state or local police. Everyone benefits from these services and the most practical way to pay for them is through taxes.

For public protection, government agencies enforce regulations. There are regulations to cover the quality and safety of such things as home construction, automobiles and appliances. There are also regulations for financial services provided by banks, insurance companies and stock brokers. Another important form of consumer protection is the use of licenses to prevent unqualified people from working in certain job fields, such as medicine or construction.

City and county governments are responsible for funding public elementary and secondary schools, and most states support public colleges and universities. The federal government supports education through grants that go to schools.

## We All Pay For "Free" Government Services

Since the 1930s, the federal government has been providing services, often called a "safety net," for those in need. Major programs include health services for the elderly, known as Medicare, and financial aid for the disabled and unemployed, all of which are funded by taxes.

Governments pay for these services through revenue obtained by taxing three economic bases: income, consumption (purchases) and wealth.

The federal government relies mainly on income taxes for its revenue. The earnings of both individuals and corporations are subject to income taxes. The personal income tax produces about five times as much revenue as the corporate income tax.

Taxes taken from people's paychecks are called payroll taxes. These payroll taxes go toward Medicare, Social Security (which provides people with money when they retire) and unemployment compensation. Both employers and employees pay these. The tax is taken out of the employee's paycheck each week or two and sent to the government.

## Excise and Property Taxes

State governments depend on both income and sales taxes, which usually get paid on such things as cars, household items and movie tickets. The tax rate and the list of taxable goods vary from state to state. There are also taxes on some "luxury" goods, called excise taxes.

Excise taxes can pay for specific things. For example, a tax on gasoline is used to build and maintain highways and bridges. Only people who purchase gasoline – who use the highways – pay the tax. Some items get taxed to discourage their use. This applies to taxes on alcohol, tobacco and gambling – and sometimes unhealthy food, such as soda or candy.

Property tax, which is usually paid quarterly, is local government's main source of revenue. Most localities tax private homes, land and business property based on the property's value.

Some state and local governments also impose taxes on the value of certain types of "personal" property, including cars, boats, recreational vehicles and livestock.

Other taxes imposed on wealth include inheritances and taxes on large gifts individuals make to other people.

## **"Ability to Pay"**

A basic principle underlying the income tax laws of the United States is that people should be taxed according to their "ability to pay." Taxpayers with the same total income might not have the same ability to pay. For example, people with high medical bills and home mortgage interest payments have less money to spend on taxes. They can subtract these amounts as "itemized deductions," and can get exemptions. These reduce the amount of money the government can tax – also called taxable income.

Those with high taxable incomes pay a larger percentage of that income in taxes. This percentage is the "tax rate." Those with higher taxable incomes pay a higher percentage, called a "progressive" tax.

Sales and excise taxes are considered "regressive," meaning that everyone pays the same taxes on the same goods. This means that people with lower incomes pay a larger percentage of their income in sales and excise taxes. Some people think this is unfair.

Federal taxes are spent on many programs. Among the largest are Social Security and Medicare. Another large portion of federal spending is for national defense.

Veterans also receive benefits from the federal government. They receive medical services and education training. Veterans also receive a pension that pays them money when they get older and cannot work, and life insurance, which pays money to someone's family when they die.

## **Federal Government's Laundry List of Support**

The federal government supports transportation by giving money to states and local governments for constructing highways, train systems and airports. Also included in this category are the costs of operating the U.S. Coast Guard, regulation of the airways, and assistance to railroads and shipping.

There are many other federal government services and activities, including protection of natural resources, environmental protection, and maintenance of recreation areas and public lands. In addition, there is assistance to foreign countries, disaster relief, and community development.

Other government services are energy research, development and conservation, and space exploration and other scientific research. The government must pay for its administrative activities, along with federal law enforcement and federal prisons, payments to the U.S. Postal Service and more. The government also provides funds for agricultural research and conservation of farmland.