



Taxes: Somebody Has to Pay

Standard 2

The student will identify and describe the impact of local, state and federal taxes upon income and standard of living.

Lesson Objectives

- Differentiate between “ability to pay” and “benefits received” tax theories.
- Explain the differences between progressive and regressive taxes.
- Describe the role of public goods and services.

Personal Financial Literacy Vocabulary

Ability to pay: The belief that people should be taxed according to their ability to pay, regardless of the benefits they receive.

Benefits-received principle: The belief that people should be taxed according to the benefits they receive from the good or service the tax supports.

Free rider: One who enjoys the benefits of a good or service without paying for it.

Progressive tax: A tax that takes a larger percentage of income from people in higher-income groups than from people in lower-income ones.

Regressive tax: A tax that takes a larger percentage of income from people in lower income groups than from higher-income ones.

Taxes: Government fees on business and individual income, activities, or products to support government programs.

Introduction

Mario received \$20 for his 10th birthday. He asks his big brother Ben to take him to Aim Video to buy a new video game that costs \$19.95. When he gets to the cashier to pay for the game, she rings up and says, “That will be \$21.60.”

Mario is shocked. The price on the label says \$19.95, and he only has \$20. The cashier explains he has to pay the sales tax to get the game. “But, why do I have to pay taxes? I am just a little kid. Why does the government want my money for taxes?”

If Mario was your little brother, what would you tell him?

Lesson

People have been paying taxes almost since the beginning of time. The money collected in “the olden days” supported the empires of kings and provided revenue for their protection. Today, people pay several different kinds of taxes to local, state and federal governments. In return, receive a variety of goods and services in return, such as public schools, roads and highways, national defense, safe drinking water, fire and police protection, and public welfare programs. Some of these programs are supported with different types of taxes and provided by multiple levels of government. Others are supported by a single tax or fee and provided by only one level of government. Regardless of who provides the service or receives the benefits, someone has to pay for it. Taxes are the primary source of income for government, and no one escapes without paying them, one way or another.

Some taxes are more obvious than others. For example, your pay stub shows the amount of federal and state taxes you are required to pay. Also, your receipts from the grocery store, the fast food drive-thru, and the local clothing store all show the amount of taxes collected on those purchases.

The tax structure of the United States is somewhat more complex than the structure in other countries. Even so, most countries have regressive and progressive taxes and they build their tax theories around the same basic philosophies. Few people enjoy paying taxes, but all of us benefit from them in one way or another.

Tax Theories

The two basic theories behind taxes are “ability to pay” and “benefits received.” Most nations will have a combination of the two theories to provide a greater balance and sense of “fairness” to their overall tax policies. Other words similar to fair include unbiased, just, equitable, objective, and impartial.

The idea of a “fair tax” is based on the notion that no one segment of society should be treated differently in the eyes of the law. Of course, what seems fair to one group may seem unfair to another. As a result, the concept of fairness is generally difficult to achieve. Taxing one group more than another may decrease the incentive to earn more money, which creates problems for society as a whole and will eventually decrease the revenue gained from those taxes.

The ability to pay theory says that people who can afford to pay taxes should pay more than those with limited ability to pay. In other words, people with higher income should pay more taxes than people with lower levels of income. While this idea sounds great to those with low incomes, it may not sound as great to those at upper income levels. This theory is based solely on a person’s income, with no regard for what goods and services are received in return.

The benefits received theory is basically the opposite. It is based on the premise that the government should tax people who receive the goods and services provided by those taxes. Using this theory, only people who use the programs or receive the services would pay the taxes to support them. For example, people who drive on the toll roads and turnpikes in Oklahoma pay fees for those roads; people who do not drive on them are not required to pay for them. While this theory sounds like a great solution for all taxes and fees, there is one problem with it: people with limited income often benefit more from some of the programs, than people who are paying taxes to support the programs. For example, how can people with little income pay enough taxes to provide services they receive such as unemployment compensation, food stamps, or housing subsidies? And, how can the government determine exactly the per person benefits from services such as public education, police and fire protection, national defense, and other government programs?

Finding a way to balance those two theories helps increase the overall concept of “fairness” in a nation’s tax policy and can reduce the negative perceptions associated with paying taxes.

Progressive and Regressive Taxes

The problems with these two theories have provided an incentive to implement two different kinds of taxes: progressive and regressive. By definition, a tax is progressive if the proportion of income paid in taxes increases as income increases. A tax is regressive if the proportion of income paid in taxes decreases as income decreases. Basically, this means that people with higher income levels pay more in taxes overall than people with lower incomes.

Personal income tax in the United States is often called a marginal income tax. That means, everyone pays the same amount of tax on their lowest earnings but taxes get progressively higher as income increase.

For a better explanation, refer to the bucket on the left. In this example, you see that everyone is paying a 10 percent tax rate on the lowest of income (up to \$7,825). Notice how the tax rates increase as the income levels increase. Those who make \$30,000 would pay 10 percent on the first \$7,825 and 15 percent on the earnings between \$7825 and \$30,000.

The additional (or marginal) tax rates continue increasing as income levels increase.

The federal income tax is an example of a progressive tax. As your income increases, your tax rate increases. As you income decreases, your tax rates decrease. Most state with a state income tax, like Oklahoma, also have a progressive income tax structure.

Sales taxes, however, are classified as regressive. Sales tax is paid on numerous goods and services when you purchase them. Sales tax rates vary substantially from city to city, from county to county, and from state to state. They are called regressive because the tax burden on the person paying the tax is different even though everyone pays the same rate. With regressive taxes, lower income households have a greater tax burden that middle and upper income households. The tax is especially regressive on items such as food because lower income families spend a higher percentage of their monthly income on food and other basic expenses than do middle and upper income families.

The overall tax system in the United States is progressive. Why? Because the amount of money paid in income tax exceeds the amount of money paid in sales tax and other regressive taxes.

Progressive Income Tax

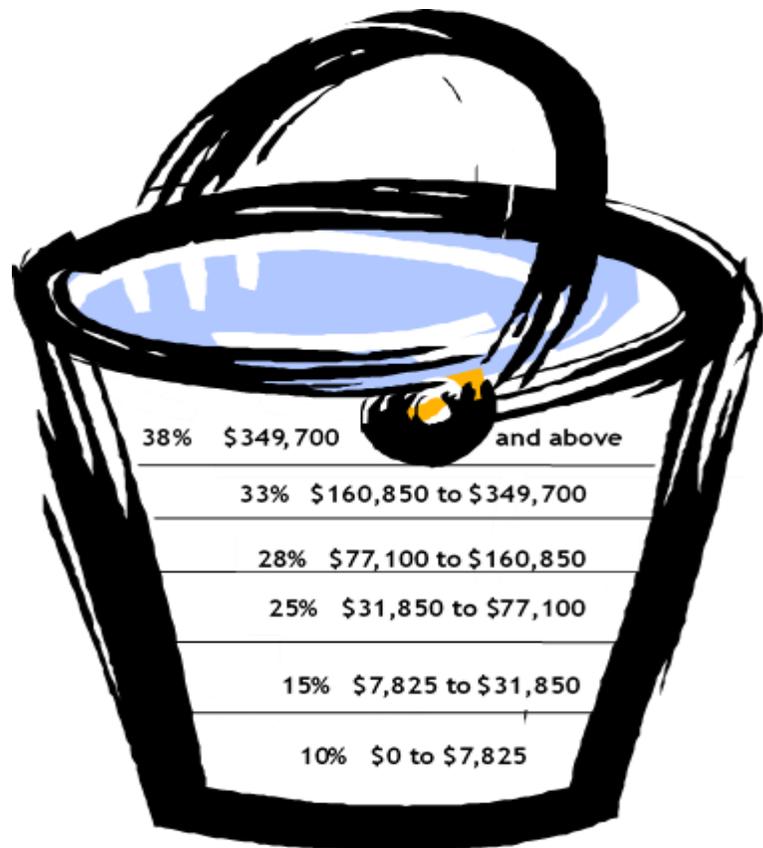
Using the information provided in this tax bucket, you can estimate the amount of taxes to pay at the various income levels. Suppose your gross income is \$35,000. You would be taxed 10 percent on the first \$7,825, 15 percent on the next \$24,025 (\$31,858 minus \$7,825) and 25 percent on the last \$3150 (\$35,000 minus \$31,850)

$$7825 \times .10 = \$782.50$$

$$24025 \times .15 = \$3,603.75$$

$$3150 \times .25 = \$787.50$$

$$\text{Total tax due} = \$5,173.75$$



These different levels of taxes are commonly called “tax brackets”. The tax rates for each bracket can vary from year to year. The most recent are posted on the IRS website, if you want to check them out. Just remember, in Oklahoma, you would need to repeat this process using the Oklahoma tax brackets to calculate your state income tax.

REMINDER

As your income increases, your tax rate increases. As your income decreases, your tax rate decreases. Sales tax vary from city to city, county to county, and state to state.

One of the biggest issues in our country today revolves around taxes and how they are used. Because the idea of “fairness” is subjective, it becomes a hot political topic at both the state and federal levels.

Part of the problem stems from an economic concept called free riders. The free rider problem happens when people benefit from using goods and services without paying for them. The theory says this: when people do not have to pay or only pay a small share for a good or a service, there is little incentive for them to control their demand for those goods or services. As a result, those who are paying the cost need to pay more to meet the demands of the free riders. Resolving this problem is even more complex because public goods and services provide benefits to more than one person at a time, and it is virtually impossible to limit their use to only those who pay for them.

Governments provide public goods and services for the good of society. Deciding what government should provide is much like any other decision: Government should provide goods and services as long as the benefits of providing them are greater than the costs associated with them. Measuring those costs and benefits is difficult because the benefits and costs are not necessarily shared by the same people. Not all individuals have the same benefits and not all individuals have the same costs. At the same time, public goods and services are an important part of our society.

Conclusion

Even though we may not enjoy giving part of our income to the government, everyone benefits in some way from the public goods and services provided with our tax dollars. The tax system in the United States is a combination of different tax theories and different kinds of taxes. How much we should pay in taxes is frequently debated by politicians and elected officials. The best answer to that debate is this: We should continue paying taxes as long as the benefits to society are greater than the costs.

FINAL NOTE: If you would tell Mario that paying sales tax is an important source of income for local government, you would have the right answer.

Mario and his friends like to play in the park, which is paid for with his tax dollars. You might also tell Mario that sales taxes provide bike paths, roads, police, and fire safety. Everyone who buys goods and services pays sales taxes, regardless of age or income—even little kids.

This lesson was written and created by
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Taxes: Somebody Has to Pay Review 2.1

Answer the following questions and give the completed lesson to your teacher to review.

1. Label the following tax scenarios as progressive or regressive.
 - a. Federal income tax _____
 - b. Sales tax _____
 - c. A tax where everyone pays the same percentage _____
 - d. Oklahoma state income tax _____
 - e. A tax where the amount of tax paid depends on income _____

2. Which of the following are public goods or services paid for by taxes? Circle your answers.

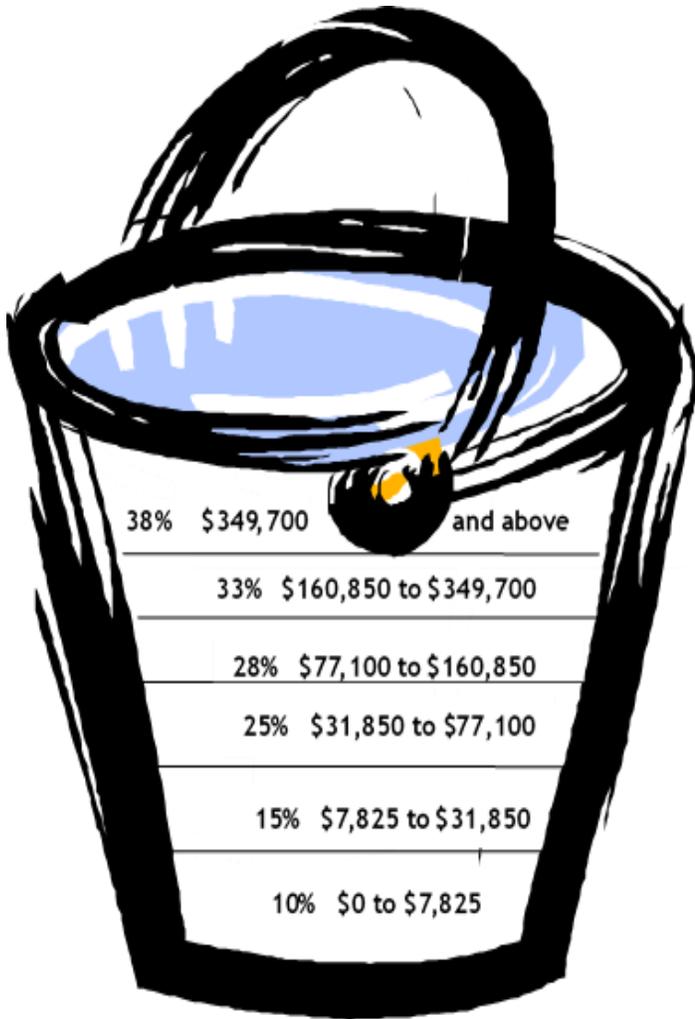
Roads and Highways	Military	Zoos
Fire Protection	Your House	Schools
Shopping Centers	Parks	Restaurants
Water/Sewer Service	Trash Pickup	

3. What is a free rider?

Name: _____ Class Period: _____

Calculating Taxes Activity 2.1

Use the bucket from the lesson to calculate the following tax problem. Show your work in the box provided and give the completed lesson to your teacher to review.



Julia has just gotten a new job paying \$80,000 a year. What would be her estimated federal taxes?