

**Standard 2:** The student will identify and describe the impact of local, state, and federal taxes upon income and standard of living.

## Taxes: Somebody Has To Pay



Mario received \$20 for his birthday. He wants to buy a new video game at Aim Videos. His friend Sonny bought one there, and said the price was only \$19.95. That \$20 bill was just perfect.

Once at Aim, Mario heads to the game aisle. Sure enough, it is there, and the price is \$19.95.

With a big smile, he heads to the cashier, who rings it up and says, "That will be \$21.60."

Mario is shocked. The price on the label says \$19.95, and he only has \$20 in his pocket. The cashier explains he has to pay the sales tax to get the game. And Mario starts to complain.

"Why do I have to pay taxes? It is not fair. 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 Objectives

- ⇒ Differentiate between "ability to pay" and "benefits received" tax theories.
- ⇒ Explain the differences between progressive and regressive taxes.
- ⇒ Identify the role of public goods and services.
- ⇒ Evaluate the costs and benefits 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. The U.S. individual income tax is based on this principle.

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

**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; the U.S. federal income tax is an example.

**Regressive tax:** A tax that takes a larger percentage of income from people in lower-income groups than from higher-income ones. Sales taxes and excise taxes are examples.

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

## Introduction



People have been paying taxes to the government almost since the beginning of time. The money collected supported the empires of kings and provided revenue for military efforts. While most people complain about paying taxes, they still enjoy the goods and services paid for by the government.

Today, we pay several different kinds of taxes to local, state, and federal governments and receive many goods and services in return. The tax structure of the United States is based on two basic theories, and we have two basic forms of taxation policy. Even so, it does not make paying taxes any less controversial.

## Lesson

**A**ny time you buy something or get a paycheck, you pay some form of taxes. Some taxes are more obvious than others, but you can be certain that no one escapes paying taxes.

Local, state, and federal governments use tax dollars to provide many goods and services to its citizens. Those goods and services include public schools, roads and highways, national defense, fire and police protection, safe drinking water, and public welfare programs—to name a few. Some of these programs are paid for only at one level of government while others are partnerships between two or more levels.

Regardless of who provides the service, someone has to pay for it. And that “someone” is the taxpayers.

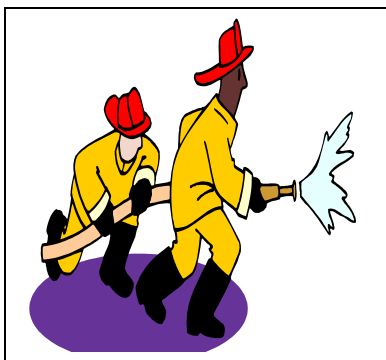
The overall goal of tax policy in the United States is to ensure that taxes are “fair.” Other words similar to fair include unbiased, just, equitable, objective, and impartial. The idea of a “fair tax” is based on the notion that no one segment of society should be treated differently in the eyes of 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.

### Tax Theories

Policymakers tend to rely on two theories of taxation – ability to pay and benefits received – to help bring about some degree of fairness.

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 does not sound fair to those with higher levels of income. 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 **benefits received** theory 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 toll roads 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, there is only one problem: people with limited income often benefit more from programs such as unemployment compensation or public welfare such as food stamps and housing subsidies. How can people with little income pay enough taxes to provide the services they receive? 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?



In the box below, use your own words to explain the differences between the ability to pay and the benefits received tax theories.

Ability to pay means:	Benefits received means:

What have you learned about these two theories?

What are the costs and benefits of each theory?

**Progressive and Regressive Taxes**

The problems with these two theories have led to the implementation of 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.

The federal income tax is an example of a progressive tax. As income increases, tax rates increase. As income decreases, tax rates decrease. Most states, including Oklahoma, also have a progressive income tax.



Oklahoma currently has a 4.5% state sales tax rate. When making a purchase in our state, you pay the state sales tax plus the sales tax rate for the city and/or county in which you make the purchase. Do you know the local tax rate in your town?



Sales taxes, however, are classified as regressive. Sales tax is the tax paid on certain goods and services at the point in time they are purchased. Sales tax rates vary from city to city and from state to state. The rate is a percentage set by the government levying the tax. While everyone pays the same amount of sales tax, lower income households spend more of their earnings to purchase goods and services than people with higher incomes. Therefore, the tax burden is greater for those with lower incomes.

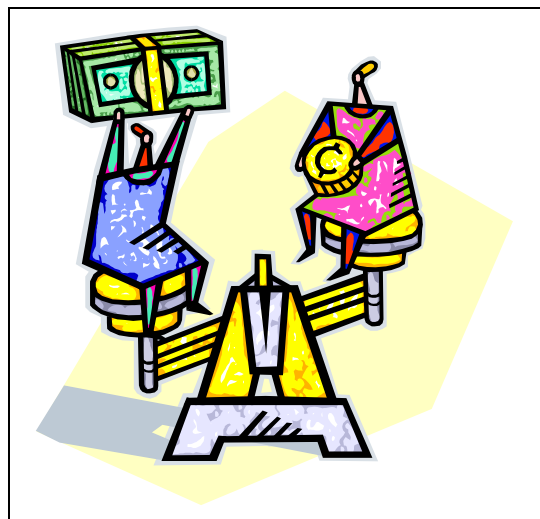
The overall tax system in the United States is progressive. Why? Because the amount of money paid in income tax exceeds the amount of money paid in sales tax and other regressive taxes.

### Public Goods and Services

One of the biggest debates 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 level.

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. If we do not have to pay or only pay a small share, there is little incentive to control our demand for those goods or services. Those who are paying will need to pay more to meet our demands. In addition, public goods and services provide benefits to more than one person at a time, and it is difficult 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. Nevertheless, without the goods and services, we would not live in the kind of society to which we have become accustomed.



### Progressive Tax Bucket

Below is a bucket with different federal tax bracket percentages and income levels of single individuals in 2007. This exercise will show you how you pay taxes at different levels. Remember that you must fill each level of the bucket before you move to the next level. Draw a line on the bucket indicating where the person’s income falls within the bucket. Then, calculate the total amount of tax due by the individual.

For example, suppose Bill makes \$35,000. The first \$7,825 is taxed at 10%, the next \$24,025 (\$7,825 to \$31,850) is taxed at 15%, and the last \$3,150 (\$31,850 to \$35,000) is taxed at 25%.

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

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

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

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

Now, try the same exercise assuming that Julia earns \$80,000. How much is her total tax bill?

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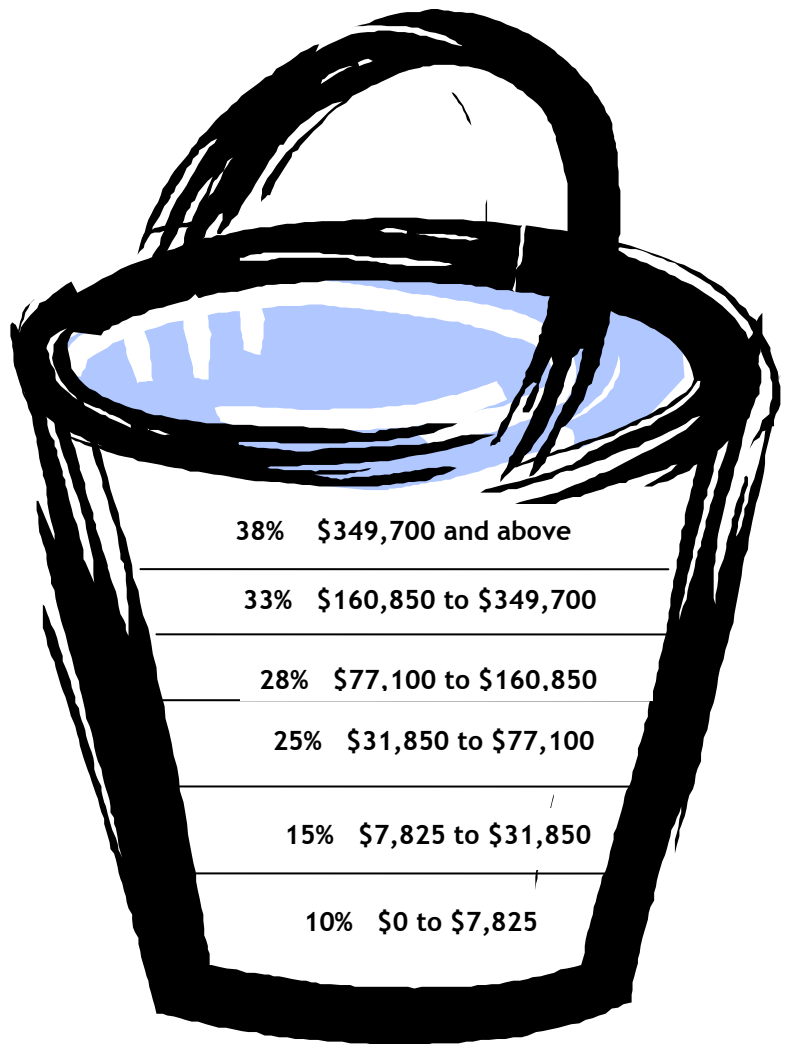
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**Ask your teacher to review your answers before continuing with this lesson.**

What did you learn from completing this activity?

Answer:

## 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.

*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 revenue generated from the city's sales tax at stores like Aim.*

*You might also tell Mario how 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.*

Name: \_\_\_\_\_ Class Period: \_\_\_\_\_

## Taxes: Somebody Has To Pay Review Lesson 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. A “free rider” is defined as a person who
  - a. sneaks onto trains without paying taxes.
  - b. benefits from services without paying for them.
  - c. pays extra tax so someone else doesn’t have to pay.
  - d. receives a voucher to help them pay for transportation costs.
  
3. 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	