12 Taxing and Spending

This unit considers government and money: how government gets money and how government spends it. We look at the budget process, typical government expenditures, sources of revenue for government, and what government tax policies can and should do.

Lessons in This Unit

Lesson 56—Government Budgets
Lesson 57—Sample Government Budgets
Lesson 58—Sources of Federal Revenue
Lesson 59—State and Local Taxes
Lesson 60—Tax Policy Issues

Activity Idea

Should property ownership play any role in who has a voice in government? In the early days of the republic, voting rights and qualifications for holding office were based on property ownership. It was believed that those who owned property had a vested interest in doing what was best for society and that only they were responsible enough to be trusted with the right to vote and to hold office. Those who did not own property could be too immature or too irresponsible to have an interest in the well-being of society. Daniel Webster warned that if non-propertied citizens could vote, they might think that they ought to get a share of what the propertied people had and might vote accordingly. Is there any truth to this idea? How might this principle of responsibility in government be maintained when the only significant requirement for voting is that a person be eighteen years old? Write a two-page response.

If you are using the optional *Quiz and Exam Book*, answer the questions for each lesson after you have completed the lesson and read any assigned readings in *We Hold These Truths*. After you have completed Lesson 60, take the quiz for Unit 12.

Lesson 56—Government Budgets

Republics are created by the virtue, public spirit, and intelligence of the citizens. They fall, when the wise are banished from the public councils, because they dare to be honest, and the profligate are rewarded, because they flatter the people, in order to betray them.
—Supreme Court Justice Joseph Story (1833)

Budgets, Income, and Expenses

A budget is a plan of income and expenses, usually for a year's time. Responsible families plan their income and expenses. If an individual family's expenses exceed their income, they have to borrow money, find other sources of income, or reduce their spending.

A government budget is in many ways the same as a family budget. Every government entity, from the smallest agency to the entire Federal government, operates on the basis of a budget. The government tries to anticipate the revenues it expects to receive in the coming year. It also makes an estimate of the expenses it will have for salaries, equipment, and programs. Generally speaking, a government, like a family, should try to make its expenses about equal to its revenues. If revenues far exceed expenditures, the government is collecting too much money that could be staying in the pockets of its citizens. If expenses far exceed revenue, the government is spending beyond its means and should reassess its priorities to bring expenses in line with revenue or find additional sources of revenue.

A family has necessary expenses and discretionary or optional expenses. Most families find it necessary to spend money to provide housing, utilities, food, clothes, and medical care. Examples of optional expenses might include a new car, a vacation, or a new computer. Admittedly, sometimes the line between necessary and optional is hard to determine. If the old family car is constantly breaking down, buying a newer car might be the wiser choice. Internet service can be seen as optional; but if the family operates an Internet business, then Internet service is essential for what the family wants to do. This illustrates how family priorities are reflected in the family budget.

A government makes choices about how it spends its revenue. Spending for defense is the most essential expense, since without a defense budget the country might cease to exist. Law enforcement is essential for state and local governments, since a society must have peace and order to be able to function. Many Federal programs involve what is called mandatory spending because the government chose at some point to guarantee that those programs would be available. This is a choice or a priority that government makes which is reflected in its budget. The government also has discretionary expenses, meaning budget priorities that are not mandated by law but are reconsidered to some extent every year, at least in terms of how much money will be allocated for those programs.

Many people want the government to spend money on them or on their favorite projects; and since government does not have unlimited revenue, government decision-makers have to decide which ones it will approve. This too is like what a family experiences. A family receives advertisements from companies that want to sell them things and requests from people or groups who want the family to donate to them. The family has to decide what they can and want to do. In the same way, governments receive hundreds of requests each year, from day care centers, schools, universities, the military, the space program, farmers, veterans, the poor, the elderly—and the list goes on and on. Elected government officials often sincerely believe that the government should spend money on what they believe to be high and valid priorities. At the same time, these office holders also usually want to be re-elected; and so they do not want to tell people, "The government cannot or should not pay for your request. You will have to find another source of money or do without." Government programs are often enacted so that elected officials can say to the voters, "See what I did for you? This is why you should re-elect me."

However, the government cannot say yes to every request for funding without exceeding its revenues. When a family spends more than it receives, it experiences a deficit and has to borrow money. The amount that a family owes is called debt. When a deficit occurs month after month, the debt grows. The family has to develop a plan to pay off the debt, which might include generating more income and/or cutting expenses. If the family does not do this, it will be overcome by debt. More and more of the family's income will have to be allocated to paying off the debt, which usually involves paying interest on the debt. In the worst case scenario, the family is unable to pay its debts and must declare bankruptcy. It must then go through a process to decide what debts can be canceled or reduced and what long-term plan will enable them to pay off the remaining debts. Those to whom the family owes money may receive less than the amount they have loaned the family. These creditors will want to regain what they have lost by forcing the family to sell off some assets, such as a car or other valuables. Another way that a creditor might compensate for his loss is by increasing interest charges to other debtors.

Government finds it difficult to say no to requests or perceived needs. As a result, it is easy for a government to go into debt. It is possible for cities, states, and countries to default on indebtedness and go bankrupt; but this is an extreme case. What is more likely is that the government will try to raise taxes or borrow money. If it borrows a great deal of money, its budget can become increasingly dominated by payments on the debt. Either way, the economy of the state or nation becomes increasingly influenced by the demands made by the government for more revenue.

Department or agency budgets are estimates of what they think they will need in the coming year. Sometimes the agency does not spend as much as it had anticipated before the budget year started. However, government agencies want to spend all of what has been appropriated for them this year lest they lose some of their appropriation next year. This means that government workers sometimes look around for something to buy or a conference to attend—even thought they don't strictly need it—just so they will spend all of their appropriation.

The Budget Process

The process for developing and adopting a budget by a government is roughly the same whether it is the local, state, or Federal government. First, the various executive departments and agencies prepare their estimates for expenses for the coming year. Many times this will include what the department sees as a minimum essential budget as well as a wish list for what the department would like to have. Second, the estimates are collected and reviewed by a central budget office. This office compares desired expenditures with expected revenues and comes up with a final budget proposal. Third, the executive (the president, governor, county executive, mayor, or city manager) presents the budget to the legislative body (Congress, legislature, county commission, or city council). The president submits his budget proposal to Congress in February, and most other governmental budgets are also submitted in the spring for the upcoming fiscal year. The Federal budget year or fiscal year runs from October 1 of one calendar year to September 30 of the following year. Some states and localities use a July 1 to June 30 fiscal year.

The legislative body then considers the budget, usually by breaking it down for review by various committees. Congress makes a distinction between the budget resolution (the overall plan) and specific appropriations, through which money is actually committed to programs. Governments on lower levels do not necessarily make this distinction. As the proposed budget is being considered, the committees and other members of the legislative body will probably have their own ideas about department budgets and programs they would like to see implemented, so the figures in the executive's budget proposal will likely be changed before final passage.

Budget considerations in the legislative branch usually bring forth the same debates year after year. For instance, conservatives almost always say that we need more money for defense and point out the waste and fraud that occur in social programs. On the other hand, liberals almost always say that we need to spend more on social programs and point out the waste and fraud that occur in defense spending. What happens too often is that both defense and social programs receive more funding and little is done to stop the waste and fraud anywhere.

After the budget is adopted, procedures are followed to oversee the accurate expenditure of and accounting for government funds.

State government budgets are formulated under stricter guidelines than the Federal budget. The national government does not ever have to balance its budget, but forty-nine states have balanced budget requirements. These state requirements take different forms. Thirty-five state constitutions require a balanced budget, while the other states only have a law or resolution that can be easily amended from year to year to allow deficit spending. Another variation in state budgeting is that fifteen of them pass budgets for two years at a time. Some prepare a two-year budget, while others pass two separate annual budgets for the two-year cycle.

You can see that budget planning is a major part of what government departments do. In the next lesson we will look at sample budgets from various levels of government.

Sunshine, Sunset

It is easier to get a government program started than it is to get one stopped. Some states and localities have adopted what are called sunset laws for certain programs. This means that authorization for the program will end at a stated point in the future. The program must be reconsidered for it to continue. The sunset provision is intended to make programs have accountability. If an agency or program is not accomplishing what it was created to do, it needs to be changed or abolished.

Sunset provisions are not the same as sunshine laws. Sunshine laws require government bodies to hold their meetings in public, especially when votes are taken. They also require freedom of access to most government documents. This prevents secret or backroom deals that are attempts to avoid accountability.

I give my opinion in this matter,
for this is to your advantage,
who were the first to begin a year ago not only to do this,
but also to desire to do it.
2 Corinthians 8:10

Lesson 57—Sample Government Budgets

A billion here, a billion there, and pretty soon you're talking about real money.
—Attributed to twentieth century Republican Senator Everett Dirksen of Illinois
(The statement reflects his attitude toward government spending,
though many doubt that he ever actually said it.)

The elements of a family budget are usually easy to identify. Income is recorded on the W-2 form (or equivalent) issued by the employer or by careful record keeping if the family's income is from self-employment. Expenses can be fairly accurately recorded as well. The family spends so much on the house payment, so much on utilities, so much on food, so much on clothes, so much on medical care, and so forth. Some purchases might be difficult to classify. For example, do cleaning supplies come out of household expenses or out of groceries? Does eating with another family at a restaurant count as food or as entertainment? Nevertheless, most families can determine the best way to break down their spending accurately.

Government budgets, by contrast, are terribly difficult to nail down. They involve huge amounts of money in a large number of categories. The information is not easy to find or to break down line by line. This is exactly what many government officials want. They have less accountability this way.

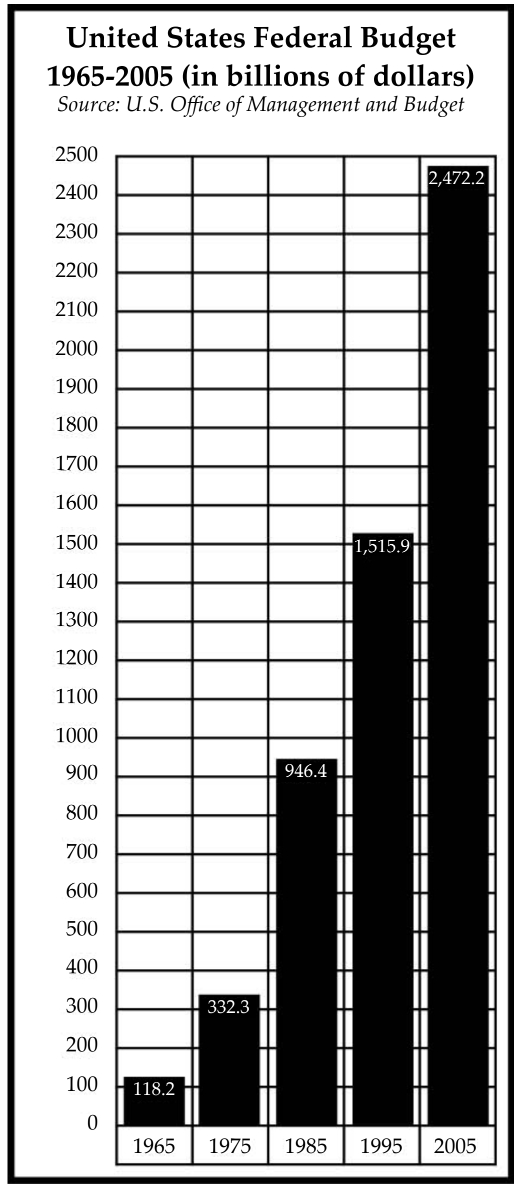
- For instance, do Social Security payments come out of the regular budget or are they a separate item? Are benefits paid to veterans to be considered military expenditures or social program expenditures?

- In addition, government budgets are difficult to examine. You may have a hard time finding a copy, and budgets are such huge and complicated documents that studying them is a frustrating experience. The budget and tax levy document for a rural county, for example, might contain 50 pages with many lines of figures in small print. The budget for the Federal government runs to hundreds of pages.

- Finally, state and local governments have become so dependent on Federal funding for much of what they do that it is difficult to determine what is actually state or local revenue and what is provided by Federal grants. State officials like to talk about how much they are spending on certain programs, but they might not mention that much of what they are spending comes from the Federal government.

In the 2000 election, candidates George W. Bush and Al Gore argued about the Social Security "lock box," meaning a guarantee that Social Security taxes will only be spent on Social Security expenses. However, there is no such lock box. There is a trust fund of excess Social Security tax collections from the past. The trust fund is used to buy government bonds as investments to increase the funds available for Social Security payments. Social Security contributions by individuals and employers are taxes, and payments to recipients come out of the Federal budget. If Social Security payments ever exceed Social Security revenue, the trust fund will have to be used to help make Social Security payments.

In addition, government budgets rarely decrease. Governments do not usually spend less one year in actual dollars than they did the previous year. A major part of the increase in the Federal budget is because of entitlement programs that are automatically increased year by year with at least a cost of living adjustment if not an actual increase in appropriations. When elected officials talk about budget cuts, they are often talking about a smaller increase than had been proposed, not a truly lower dollar amount from the previous year.



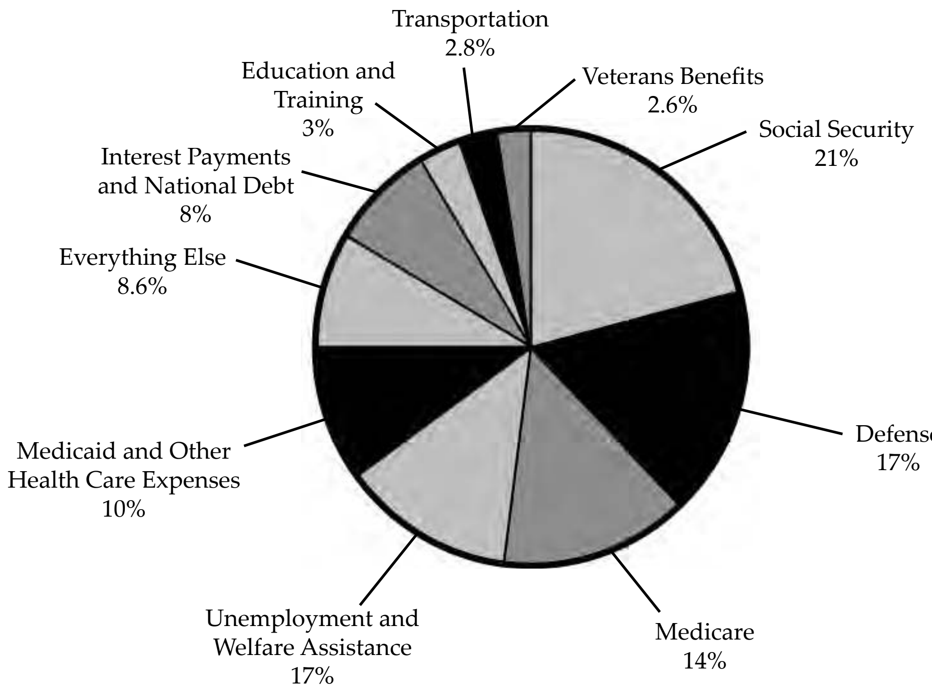
The chart shows the growth of the Federal budget from the 1960s. Major increases took place with Lyndon Johnson's Great Society programs in the 1960s and at other times. Even though Republicans have often complained about runaway government spending, the Federal budget continued to increase under Republican presidents and a Republican-controlled Congress.

The Federal Budget

The Federal budget for fiscal year 2007 that President Bush submitted to Congress in February 2006 called for $2,770,000,000,000.00 (that's $2.77 trillion) in spending. The general categories were as follows:

- Social Security: $586 billion or 21%
- Defense: $466 billion or 17%
- Medicare: $394.5 billion or 14%
- Unemployment and welfare assistance: $367 billion or 13%
- Medicaid and other health expenses: $276.4 billion or 10%
- Interest payments on the national debt: $244 billion or 8%
- Education and Training: $90 billion or 3%
- Transportation: $77 billion or 2.8%
- Veterans benefits: $72.6 billion or 2.6%
- Everything else (including justice, environment, agriculture, community development, energy, and governmental expenses—a $20.1 billion budget line in itself): the remaining 8.6%

All categories were increased over the previous budget except foreign affairs and energy.



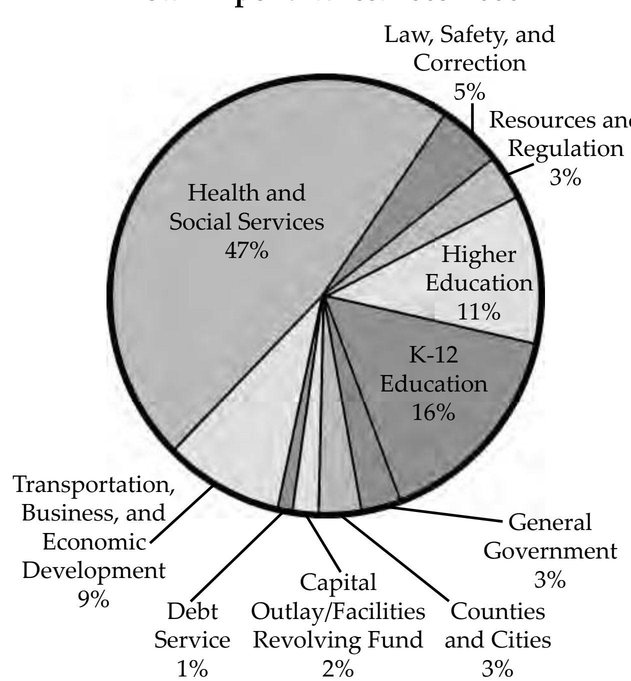
Within these general categories lie expenses for an almost endless list of programs. Here is one example. The community of Mt. Pleasant, Tennessee saw the construction of a community center that cost $1.2 million and was funded by the U.S. Department of Agriculture Rural Development Agency (*The [Columbia] Daily Herald*, February 10, 2006, page 1). If the Federal government is spending over a million dollars for one project in one small town in one county in Tennessee, we can begin to see why the entire Federal budget amounts to over two and three-quarters trillion dollars.

State Budgets

The budgets for state governments vary widely. The state government of New York planned to spend $110.7 billion in fiscal 2007. California's proposed 2007 budget called for almost $98 billion in spending. The Wyoming state budget, by contrast, was about $2.4 billion. Once again, we will consider the Tennessee state government's budget in more detail as our example.

The 2005-2006 budget for the state of Tennessee called for $25,927,600,600 in spending. Of this amount, 47% was on health and social services. The major part of this category, over $8 billion, was for the TennCare health care program (Tennessee's form of Medicaid) that provides health coverage for the poor and many others who do not have

Tennessee State Budget
Total Expenditures: 2005-2006

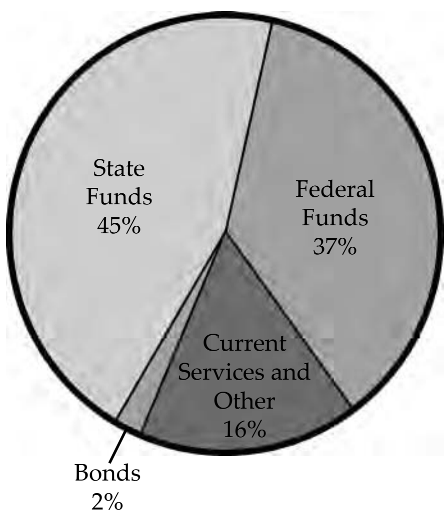


Source: Tennessee State Legislature

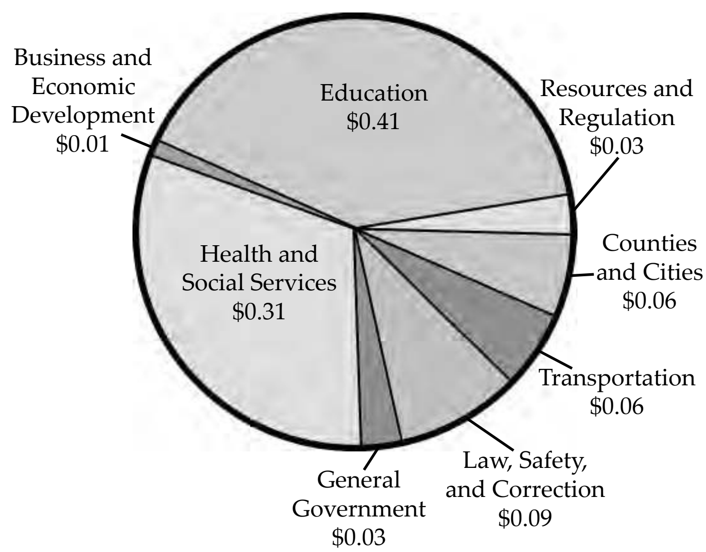
traditional health insurance. Another 27% (almost $7 billion) was allocated to education, from kindergarten through college. Transportation, business, and economic development received a total of 9% of the state's expenditures. Law, safety, and correction accounted for 5% of the state's spending. The expenses of operating state government totaled 3% of the budget. Another 3% was money sent to county and city governments.

The state's expenditure picture was a bit more complicated than this, however, because of the money provided by the Federal government. Of the $25.9 billion state outlay, a little less than $9.8 billion or about 37% came from the Federal government. Tennessee collects 45% of its funds through state taxes. The rest of its funds come from fee-based services and sale of long-term bonds. Of the Tennessee tax dollar, 41% is spent on education; 31% on health and social services; and 9% on law, safety, and correction. Since Tennessee receives significant Federal funds to help pay for the TennCare health program, proportionally more of the tax revenues generated by the state goes to education.

Tennessee State Budget: Total Revenues: 2005-2006



Where a Tennessee State Tax Dollar Goes



Source: Tennessee State Legislature

Some of the revenue that a state receives from the Federal government is called "pass through" money, because it enters the state treasury but is earmarked for specific purposes and passes through directly to that expense. The state has no discretion on how it spends this money.

County Budgets

Jackson County, Tennessee is a rural area. The county population is about 11,000 people. The largest community is Gainesboro, which has a population under 1,000. For the period July 1, 2005 to June 30, 2006, Jackson County government planned to spend just over $18 million. Of this amount:

- $10.6 million was for schools and another $903,000 was for cafeteria services.
- $3.3 million was earmarked for the broad category of general services, which includes county offices, the sheriff's department, and most other county expenses.

- $2.1 million funded the county's roads and public works departments.

- $577,000 was designated for the county's debts (such as school construction bonds)

- $354,000 paid for the county's solid waste and sanitation programs.

As with the state, an examination of the county's expenditures has to take into account funding from other sources. Fifty-nine percent ($9.4 million) of the county's revenue came from the state. Direct Federal grants accounted for just under one million dollars. Only 35%, or just over one-third of expenditures ($5.7 million), came from the county itself. Of the county's portion, over half was provided by the county property tax, while the rest came from the county's general fund that had $6.5 million in reserve (expenditures exceeded income in this budget by about $2 million). Thus, some of the state budget was included in the Federal budget, and some of the county budget was included in the state budget. These figures came from the Jackson County 2005-2006 budget document.

City Budgets

Finally, we look briefly at budget averages for municipalities. According to the National League of Cities, across the country cities spend:

- 21% of their budgets for safety (including police and fire protection)

- 21% for housing, waste disposal, and other environmental issues

- 14% for transportation (such as street repair and subsidizing city bus service)

- 12% for education (a lower figure than in a typical county since many cities depend on county or special district school systems)

- 11% for health, hospitals, and welfare

- 7% for administration costs.

The other 14% covers various smaller programs which might vary from city to city.

As with a family, a government's budget reflects its needs and priorities. To spend money, a government has to receive money. In the next lesson, we will analyze from where government revenues are derived.

Those deputies provided for King Solomon and all who came to King Solomon's table,
each in his month; they left nothing lacking.
They also brought barley and straw for the horses
and swift steeds to the place where it should be, each according to his charge.
1 Kings 4:27-28

Lesson 58—Sources of Federal Revenue

Our Constitution is in actual operation; everything appears to promise that it will last; but in this world nothing is certain but death and taxes.

—Benjamin Franklin (1789)

When a family needs more money, the father might change jobs to one that pays better, or he might take on a part-time job. Other family members might go to work or produce things in the home to sell. When a government needs more money, however, it cannot go out and govern more. Governments obtain more revenue by increasing taxes, enacting new taxes, or finding new sources of revenue such as imposing fees for certain services or creating a state lottery.

Filing Income Taxes, c. 1920

The sharp increase in government spending in recent years has meant that more and more money earned by Americans is being taken for government revenues. Americans have not always shouldered this heavy tax burden. In the early years of the country, the Federal government collected domestic taxes only on the production and sale of certain items such as alcoholic beverages, tobacco, carriages, and slaves. The War of 1812 was partly financed by a national sales tax on certain luxury items such as silverware, jewelry, and watches. In 1817, Congress ended internal taxes and financed the Federal government with tariffs imposed on imported goods. Since 1913, the Federal government has collected taxes on personal and corporate incomes.

The Tax Foundation computes what the average American pays in all taxes each year, including income tax, Social Security tax, sales tax, corporate taxes that are passed on to the consumer, and so forth. Based on the average American's income, the foundation annually announces Tax Freedom Day, the day when the average American has earned enough to pay all of his taxes based on a five-day work week. In 2005, Tax Freedom Day was April 17. Everything that the average American worker earned from January 1 to April 17 went to pay his taxes for the year. After that, he was able to work for himself.

The Federal Income Tax

The greatest single source of revenue for the Federal government is the income tax. It provides about sixty percent of Federal revenue.

The income tax is collected on the honor system. For most Americans, payment of the income tax begins with the process called withholding. Workers tell their employers at what rate they want their taxes withheld from their paychecks. The employer saves that money and sends that amount to the U.S. Treasury on behalf of the employee every three months. After the year ends, the employer gives the employee a statement, called the W-2 form. The W-2 tells how much the employee has earned and how much has been withheld and sent to the government.

Each individual is responsible to file a tax return by April 15. The return reports the individual's income, amounts that can be deducted from taxable income, and how much he owes in taxes. If too much has been withheld, the taxpayer is entitled to a refund. If too little has been withheld, he must pay the government the difference.

Withholding eases the burden on taxpayers by letting them pay their taxes throughout the year instead of forcing them to come up with the entire amount at tax filing time. It also lets the government be sure that it will in fact receive the taxes that are due. The government does not pay interest on the taxpayer's money that it holds until the tax returns are filed.

Self-employed persons have to maintain their own records and must make their own quarterly estimated tax payments to the government. Corporations file profit and loss statements with the government showing their income or loss for the year. On the basis of that information, corporations pay corporate income taxes.

The government assumes that a business honestly reports its profit or loss and the salaries that it pays to workers. The government also assumes that self-employed persons report all of their income and that hourly and salaried workers report all of their outside income that is not subject to withholding (such as tips received by restaurant servers and income from craft fairs and mowing lawns). Employers must send copies of the W-2 to the Internal Revenue Service (IRS). Banks and investment companies send copies of earnings statements both to investors and to the IRS. The information reported by employers is matched with the information reported by employees on their tax returns. When someone does not tell the truth to the IRS, they are subject to fines, the payment of back taxes with interest, and in some cases prison terms.

Members of the U.S. Air Force Work on an Income Tax Return at a Military Base in Germany, 2001

The Federal tax code is a dizzying assemblage of forms, requirements, exemptions, percentages, and loopholes. When an individual taxpayer reports his earnings, he does so on the IRS Form 1040 (or variations of it) with accompanying forms that provide relevant information such as interest income, self-employment income, rental income, and legitimate deductions. The taxpayer is entitled to a personal exemption of a certain amount of income each year on which he does not have to pay income tax. He or she can also claim an exemption for his dependents, the people for whom he provides most of the financial support. This most often refers to a taxpayer's children. The taxpayer can also claim certain deductions to be subtracted from his income before his tax is calculated. Deductions include medical expenses paid during the year, property taxes, interest on a home mortgage, and charitable contributions. He can take the standard deduction that the government offers or he can itemize (list) his deductions if the itemized total is higher.

When all of the exemptions and deductions have been subtracted from a person's gross income, what remains is taxable income. The tax rate is greater on higher incomes. This policy is called a progressive tax. It is based on the assumption that those with greater incomes can afford to pay a greater percentage in taxes and still be able to live comfortably.

This philosophy has been carried to an extreme in the past. The highest tax rate in the early 1960s was 91%. After a series of reductions, the top rate is now 28%. Still, the wealthiest Americans pay the majority of income taxes and the poorest pay no income taxes at all.

Social Security and Medicare Taxes

As we showed in an earlier lesson, Social Security and Medicare are a major part of what the Federal government does. Taxes to support these programs are listed separately but are withheld along with income tax. Social Security and Medicare taxes are paid by both the employee and the employer. The worker and the employer each pays 6.2% of the employee's income, up to an income of $94,200 per year, in Social Security (or FICA, Federal Insurance Contribution Act) taxes. Each also pays 1.45% in Medicare tax on all income (there is no income ceiling with Medicare as there is with Social Security). The employer portion is the government's way to make businesses contribute to retirement benefits for its workers and for all Americans. Thus a total of 15.3% of a person's income is paid to the government for Social Security and Medicare taxes (6.2% plus 1.45% of the worker's salary sent in by the employer; and 6.2% plus 1.45%—plus what he owes in income taxes—withheld from the employee's paycheck and sent to the government).

Keeping Individual Old-Age Insurance (Social Security) Records, 1930s

Self-employed persons must also pay Social Security and Medicare taxes, in accordance with the Self-Employment Contributions Act (SECA). At one time, self-employed persons paid a lower rate, but now a self-employed person is responsible for the entire 15.3% rate that covers both Social Security and Medicare. However, to ease the burden on self-employed persons, they pay this 15.3% rate on only 92.35% of their income, and they can subtract one-half of their self-employment tax as a deduction from their income before they figure their income taxes. I told you the Federal tax code was complicated!

Excise or luxury taxes are as close as we have come to a national sales tax. Countries such as the United Kingdom and Canada have a national sales tax called the Value Added Tax or VAT that can be as high as 18% of the purchase price. Supporters of a U.S. national sales tax (the rate of 23% has been suggested) to replace the income tax system say that it would be simpler than the complicated system we now have. A sales tax taxes consumption, not income. The more you buy, the more you pay. Most plans provide for poorer families to receive a rebate of the national sales taxes they pay. It would also be a way to tax the underground economy. No income tax is collected on illegal drug transactions, for instance; but when the persons involved in such activity make purchases, they would pay their fair share of taxes. One problem with creating a new avenue for the government to collect taxes is that the old avenues are still there. At some point both old and new will likely be used to generate revenue.

Other Sources of Federal Revenue

The Federal income tax provides most of the national government's revenue. The other 40% is generated by a wide array of sources.

- The government collects taxes on the sale of certain items, such as alcoholic beverages and tobacco products, gasoline, furs, jewelry, and guns.

- Customs or tariff duties are collected on items being imported into the country for sale.

- The capital gains tax is collected on the increased value that long-term investments acquire for the investor. This applies primarily to things like stocks and real estate owned for investment purposes. For many years, the increased value of a family home was taxed as a capital gain when the home was sold. This was quite a burden for the average American until the capital gains tax on the sale of residences under $500,000 for a married couple (under $250,000 for a single person) was repealed in 1997. The capital gains tax is seen by many as a way to generate tax revenue from people who have excess income to invest. Opponents of the tax say that it discourages investment.

- Estate or inheritance taxes are collected when an heir receives an inheritance from a deceased person in excess of $2 million. Most inheritances are below this amount. The rate on taxable estates is about 45%. Supporters of this tax say that a person who receives income in this way should be taxed for it. Opponents say that the estate has already had taxes paid on it as the deceased person built his wealth over his lifetime and therefore it should not be taxed again when someone inherits it.

- A gift tax is to be paid by the giver when he or she gives someone over $10,000 in one year. This tax is intended to prevent a person from shifting his wealth to someone else in order to avoid paying taxes on it or to avoid having it used to pay for such things as nursing home expenses. Some gifts are protected from taxes by certain laws, such as those governing education funds established by parents or grandparents.

- A Federal tax is charged on telephone service to help pay for Internet connections in public schools.

- A major source of Federal revenue is borrowing. For fiscal 2007, the government expected to spend $354 billion more than it would receive in revenues. This money was mostly borrowed by the sale of government bonds. This policy provides money for the short term, but it pushes the Federal government deeper in debt over the long term.

The rich rules over the poor,
and the borrower becomes the lender's slave.
Proverbs 22:7

Reading

- "The Moral Case for the Flat Tax" by Steve Forbes (*WHTT*, p. 158)

Aerial View of Washington, D.C., Showing the
Old Executive Office Building, the White House, and the U.S. Treasury

Lesson 59—State and Local Taxes

The truth is that all men having power ought to be mistrusted.
—James Madison

State and local governments need revenue to carry out the services that they render to the public. To raise this revenue, these governmental units employ a wide variety of taxes and fees.

State Income Tax

Forty-one states have imposed a state income tax on the regular earned income of residents and corporations. Two states, New Hampshire and Tennessee, only tax dividend and interest income above a certain amount. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming—do not have a personal state income tax.

Just as with the Federal income tax, state income tax is withheld from paychecks and self-employed persons are required to make quarterly estimated payments of their tax liability. Residents (and others who earn income in the state, such as those who own rental property in one state but live in another state) send to the state department of revenue tax returns that are due the same time that Federal returns are due. States have lower income tax rates than the Federal income tax rate, and state returns are generally simpler to complete than the Federal forms. Montana's progressive rate runs between 2% and 11% of taxable income. California collects from 1% to 9.3% depending on the amount of income. Rates of 2% to 6% are common.

Prudhoe Bay at the Northern End of the Trans-Alaska Pipeline

The state of Alaska receives substantial revenue from the sale of minerals exported from the state. The largest portion of this revenue comes from the oil sent through the Trans-Alaska Pipeline. A permanent fund has been created to invest and manage this income. Each year, the state gives a dividend from the fund's profits to every adult who has lived in the state for at least one year. In 2005 the dividend was about $845.00 each. The highest dividend so far was $1,963.86, which was the dividend paid for 2000.

State Sales Tax

Taken as a whole, the fifty states collect about as much from personal income taxes as they do through state sales taxes. States that do not have a personal income tax rely more heavily on the sales tax for revenue. Sales taxes are collected at the time of purchase by the seller, and the seller sends payments to the state revenue department once a month or once a quarter. Thus, those who conduct business in a state do the bulk of the work of collecting sales tax on behalf of the state government.

In most states, the state legislature sets a statewide rate but allows counties and cities to add an additional amount on sales occurring within their borders. Colorado collects only a 2.9% state sales tax, but localities can add up to 7% additional sales tax. Oklahoma's state rate is 4.5%. Local communities can add up to 6%, making a total possible tax rate of 10.5%. The Arkansas rate is 5.125% state and up to 5.5% local, giving a maximum combined sales tax of 10.625%. Counties receive all of the local sales tax plus a portion of the state sales tax collections. Hawaii has the lowest sales tax rate, charging a flat 4% statewide. The rate in Maine, Maryland, and Massachusetts is a flat 5% statewide. Alaska does not have a state sales tax, but localities may impose up to a 7% sales tax.

Grocery Store in Lincoln, Nebraska, 1942

Several exemptions to the sales tax are provided by the states. Churches and other charitable organizations are not generally charged sales tax on purchases they make. Some items, such as food and prescriptions, are in some states exempted from the sales tax or taxed at a lower rate. Professional services (doctor visits, plumbing calls, and so forth) are not taxed in all states, however some states do collect tax on certain services. Wholesale purchases (when a retail company buys something from a manufacturer or distributor to sell to the public) are not subject to sales tax, since sales tax will be paid by the retail customer.

Sales made in interstate commerce (a company in one state selling to someone who lives in another state) have traditionally not had to include sales tax, but this is changing. The practice of not charging sales tax on interstate sales has caused states to lose significant revenue from interstate sales made on the Internet. Because of this, some states have made an agreement to collect sales taxes on interstate Internet sales between participating states. Businesses will have to collect the sales tax for the customer's state of residence and send those revenues to the respective states on a regular basis.

The sales tax is often considered a regressive tax because it is not based on the person's ability to pay. Wealthy people pay the same sales tax on a loaf of bread or compact disc that poor people pay, but the sales taxes paid by a poor person make up a larger portion of their income than they do for wealthy people. This is why some states have exempted food and prescriptions from sales tax.

Other State Taxes

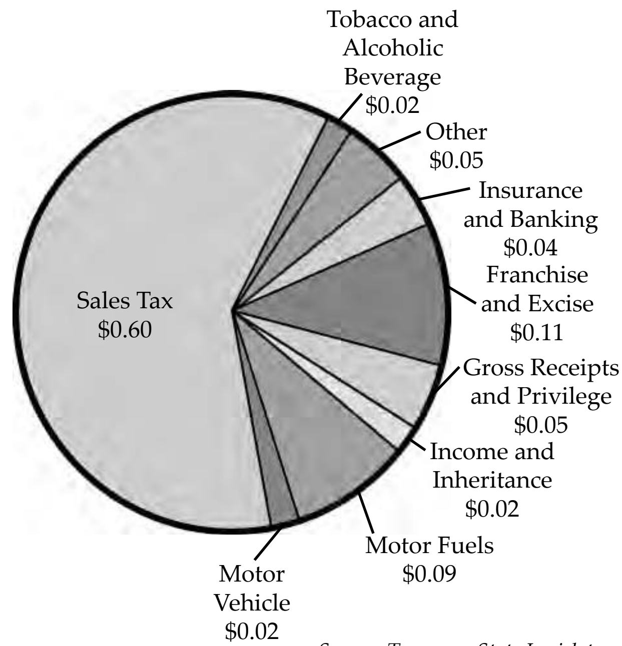
The next largest source of state revenue, after income tax and sales taxes, has to do with automobiles. Since vehicles play a big part of American life, and since they are such major purchases, states give special attention to how they can generate revenue from the sale, ownership, and use of vehicles.

States may impose their own sales tax on gasoline on top of the Federal gasoline tax. These revenues are generally used to help pay for road maintenance and construction. In addition, states charge a fee for registering vehicles and obtaining license plates. States assume that if you can afford to buy a car, you must be able to afford to register it with the state. This process not only raises revenue for the state, but it also gives the state a record of the vehicle in case it is stolen or is involved in an accident or traffic violation.

State governments can be quite creative when it comes to generating revenue through their citizens' ownership of cars. For instance, in Mississippi, the cost of license plates or annual renewal stickers is based on the value of the car. This is called an ad valorem tax (from the Latin for "to the value"). Thus, owners of newer and more expensive cars can expect to pay several hundred dollars for their license plates. The ad valorem tax that a car owner pays each year decreases over time as the value of the car decreases.

Other taxes that generate a significant amount of revenue for states include taxes on the sale of alcohol and tobacco and taxes paid by utilities and insurance companies to do business in the state. Taxes that have become popular with state and local governments in recent years are an amusement tax that is charged at theme parks and restaurants and a hotel/motel tax that is added to the price of a motel room. In some cases the taxes for staying in a motel room can add 15-18% to the basic rate. Some cities impose these taxes whether the state does or not. These taxes are attractive to governments because they are often collected from tourists who come from out of state or from business persons who have expense accounts and therefore do not feel the tax personally. Thus, a government can benefit from visitors without having to impose another tax on its residents.

Where a Tennessee State Tax Dollar Comes From



Source: Tennessee State Legislature

County and Municipality Revenues

The major portion of a county's revenue comes from the property tax (some states charge property taxes also). Real property is a community's most valuable asset, and since it is protected by the local government it is taxed according to its value. The property assessor must consider every parcel of land and determine a value for it. Usually this assessed evaluation is somewhat less than the fair market value of the property (the price for which the property could be expected to sell). If a property owner believes the assessment is too high, he can request a hearing before the board of equalization, which will reconsider the assessor's decision.

A portion of the property's assessed worth, perhaps 25%, is taxed at the rate set by the county government for each hundred dollars of taxable assessed value. For instance, the property tax rate for a rural county might be \$2.61 for each \$100 of taxable assessed value. A person who owns a home assessed at \$100,000 would pay \$652.50 in property taxes for the year (\$100,000 x 25%= \$25,000, then \$2.61 x 250 = \$652.50). This rate is low compared to many counties in the country. Property tax rates in some places are three or four times this much.

Property taxes are always collected in arrears, or at the end of the period in question. In other words, the 2005 property tax was paid at the end of 2005 or the beginning of 2006.

Many home mortgages include an amount for property tax in each month's payment, and the lending institution pays the property tax on behalf of the property owner when it comes due.

Business property is also taxed. A store owner pays a higher property tax than a residence since the property is used to generate income. Business equipment (such as computers and printers) is taxed as real business property. Counties and cities might also collect a business tax, which is a small percentage of the total sales a business has during the year. Cities and counties can charge for a business license or a professional license, which is a fee for the right to conduct business in the locality.

Cities and counties can be imaginative in how they collect taxes. For example, several years ago in Lexington, Kentucky, the city could not impose a city income tax (the state already had a state income tax). However, to generate more revenue, the city imposed what was called a licensing fee, which was a fee of 2% of a person's income for the privilege of having a job in the city. It wasn't an income tax, they said, but it taxed a person's income.

According to the National League of Cities, the average municipality in the U.S. receives 29% of its revenue from charges and fees, 21% from property taxes, 21% from the state government, 5% from the Federal government, and the rest from other taxes and fees.

For the love of money is a root of all sorts of evil, and some by longing for it have wandered away from the faith and pierced themselves with many griefs.
1 Timothy 6:10

Harrisburg, Pennsylvania

Lesson 60—Tax Policy Issues

> *When more of the people's sustenance is exacted through the form of taxation than is necessary to meet the just obligations of government and expenses of its economical administration, such exaction becomes ruthless extortion and a violation of the fundamental principles of free government.*
>
> *—President Grover Cleveland, 1886*

It is generally assumed that a government will collect taxes and provide services. In this lesson, we will take a second look at what might be the best taxing and spending policies for a government to pursue.

What Should the Government Do?

It seems like the faint echo of a distant day and time to suggest that the Federal government was intended to be limited in its scope and powers and that it cannot do whatever Congress and the president might want to do. A few facts give us some historical perspective:

- A program of "internal improvements" (Federally-funded roads and canals) was hotly debated in the early nineteenth century as to whether it was an appropriate and constitutional undertaking by the Federal government.

- The establishment of a national bank was repeatedly a matter of political conflict during the same period. Its opponents (including President Andrew Jackson) believed that such a bank was unconstitutional since it was not specifically mentioned in the Constitution.

President Grover Cleveland

- President Grover Cleveland vetoed an appropriation of $10,000 in 1887 to help farmers in Texas who were suffering from a drought. In his veto message he said,

> I can find no warrant for such an appropriation in the Constitution; and I do not believe that the power and duty of the General Government ought to be extended to the relief of individual suffering which is in no manner properly related to the public service or benefit. A prevalent tendency to disregard the limited mission of this power and duty should, I think, be steadily resisted, to the end that the lesson should be constantly enforced that, though the people support the Government, the Government should not support the people.

- Cleveland believed that private charities should and would assist the struggling farmers. He was right. The farmers received ten times more financial assistance from private sources than they would have received through this Federal appropriation. Perhaps the charitable impulse has been squelched today because many people believe the government will take care of everyone.

- When the Great Depression hit in 1929, the Federal government under Herbert Hoover provided assistance to states but not to individuals because Republicans did not believe such individual assistance to be an appropriate function of the Federal government.

President Herbert Hoover
Signing the Farm Relief Bill, 1929

Today, few question whether a government should undertake the programs that it does. With this outlook, it is no wonder that our taxes are getting higher and higher.

What Is a Taxable Event?

Here again, it seems that government generally will try to tax anything it is not specifically prevented from taxing (for example, states are not permitted to tax Federal lands, and export tariffs are specifically prohibited in the Constitution). The earning of income by private citizens is accepted as a taxable event. The purchase of most retail items is seen as a taxable event. The inheritance of a large estate is seen as a taxable event. The increase in capital worth (as in stocks and, until recently, the rise in property value of a home) is seen as a taxable event.

Does Lowering Taxes Help the Economy?

When President John Kennedy proposed cutting taxes to stimulate the economy, he justified the proposal by saying that a rising tide lifts all boats. Cutting taxes would seem to hurt the government's ability to generate revenue, but in fact cutting taxes has been shown to stimulate the economy so much that the government actually receives more revenue. This was demonstrated with the tax cuts enacted under Presidents Reagan and George W. Bush.

The answer to economic problems and personal difficulties is not always more government spending. Many times more government spending means more government bureaucrats but little help reaching those in need. What will help most is less government spending, which enables people to save, invest, and spend more of their own money as they see fit.

What Should Be the Goal of Tax Policy?

The government's collection of taxes should be undertaken to provide revenue for government to render necessary services: military defense, police and fire protection, and so forth. However, governments often use taxing and spending policies to regulate the economy and to accomplish other goals. For instance, high import tariffs do not just raise revenue. They provide protection for domestic companies against cheaper imported goods. This appears to be a good thing, but the result can be that domestic companies might not be motivated to produce goods economically or of high quality if they have no fear of foreign competition.

Tax policies should not attempt to reward or punish certain segments of the economy. The tax code is huge and complex because so many special provisions have been enacted that reward certain businesses and those with a certain level of income. What those businesses and individuals don't pay, average Americans (who don't have a strong lobby in Congress or luxury resorts to offer Congressmen) wind up paying. Sometimes attempts to punish by taxes backfire. As part of the tax increases enacted under President Clinton, a luxury tax was added to the price of yachts. This would seem a fair enough tax to the average American, but the added tax severely hurt the yacht-building industry and caused layoffs that wound up costing the government because it had to pay unemployment benefits.

Sometimes states, counties, and cities offer tax breaks to big companies in an effort to attract them to a particular location. The county government might offer to waive the business property tax for ten years, for instance. In return for this, the county hopes that having the business or industry there will create jobs and generate revenue in other ways. Places that are competing for businesses to come can get into bidding wars to see how attractive they can make the package offered to a prospective business. Some large companies have been known to demand such concessions and tax abatements before they will consider building in a locality. Of course, smaller businesses and local property owners do not get offers of tax cuts. In fact, they have to pay more for the services that the big company uses. Some companies make payments in lieu of taxes, and the Federal government makes payments if a large amount of county land is owned by the Federal government (such as a military base) and thus cannot be taxed by the local authority.

Fort Gillem Military Base near Atlanta, Georgia

When the policy is complicated and is used to accomplish purposes other than generating needed revenue, it can adversely affect many people.

How Big Should Government Spending (and Deficits) Be?

Indebtedness can be a heavy weight for a family to bear. It can come to dominate the thinking of the family and make a calm, peaceful life almost impossible. The debt of a home mortgage can be less of a problem, since most homes increase in value. However, buying too much house, being saddled with a huge mortgage payment, or having a long-term mortgage that requires paying the purchase price two or three times in interest can be financially paralyzing situations.

Yearly budget deficits and a constantly increasing debt would be indicators of fiscal irresponsibility for a family. It is no different with the government. We all should be willing to get by with less so that the government can regain fiscal soundness. Our government should not consistently spend more than it takes in. This means that hard choices have to be made and not every government program might be able to continue, but government action is not the only way to get things done. Some other countries, such as Ireland, New Zealand, and Slovakia, have found that cutting government spending greatly helps the economy.

President Warren Harding
Addressing Budget Committee, 1923

On the other hand, Federal spending in the U.S. is about one-fifth of the gross domestic economy, and the deficit is an even smaller percentage. Government spending in the U.S. is a much smaller part of the economy than is the case in European countries. The situation in the U.S. is not as dire as it could be, but the trend is not favorable.

Should Churches Be Tax-Exempt?

The exemption that churches receive from paying most taxes has been an element of the freedom of religion that we enjoy in this country. As John Marshall pointed out, the power to tax involves the power to destroy. However, the tax-exemption of churches has allowed certain individuals to build huge financial empires from which they derive enormous personal gain (which is usually taxed). Some religious groups own valuable pieces of property and pay no taxes on them. To have churches pay their fair share of property taxes and sales taxes might help spread the burden of taxation more evenly among the populace, but admittedly it might also cause a strain on smaller congregations. As difficult as having to pay taxes might be for churches, it is worth noting that the church has grown most in times and places where it was not privileged but in fact was persecuted.

These questions invite us to look again at the underlying assumptions of our system of taxing and spending. To change the direction that government has been going for decades would mean a major change in our thinking, our expectations of government, and our personal initiative and responsibility. However, if we want the direction of government to change, the change has to start somewhere. If we keep doing what we are doing now, we will continue getting what we already have.

He who is faithful in a very little thing
is faithful also in much;
and he who is unrighteous in a very little thing
is unrighteous also in much.
Therefore if you have not been faithful in the use of unrighteous wealth,
who will entrust the true riches to you?
Luke 16:10-11