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Introduction

The purpose of our research - to characterize US tax system. First we shall tell about main principles of US tax system. In chapter 1 we cover principles of federalism in tax system.

In chapter 2 we shall discuss the basic federal taxes and intergovernmental revenues. Also chapter 2 covers main US tax reforms and their influences on a tax policy as a whole. After examining some basic facts about the tax system, the remainder of tile chapter turns to matters dealing with tax policy.

One issue that has surfaced with regard to individuals taxes is the degree of progressivity of particular taxes, but a more relevant consideration is the degree of progressive of the tax system as a whole. It is a subject of chapter 3. If some taxes are regressive while others are progressive, their effects can offset one another, and a very regressive tax might be acceptable, or even desirable, within the context of the entire, tax system. After all we shall tell about political influences on the tax system.

Chapter 1

Federalism & the Tax System

Let's tell some words about a tax policy all over again. One important aspect of tax policy is that the optimal provisions for one type of tax will often depend on the way in which other taxes are levied. A tax should be efficient and equitable when analyzed on its own, but often the efficiency and equity of a tax depend upon how it fits in with the whole system of taxes. So, taxes must be viewed as individual components of an overall tax system to really understand their effects.

The United States has a federal system of government, and, followings that model, the tax system can be divided into the three major categories of federal, state, and local taxes. Federal, taxes make up about 56 percent of total taxes, although federal expenditures are: only about half of total expenditures. The difference occurs because a substantial fraction of state and local government expenditures are, financed by federal government grants. Intergovernmental grants make up nearly one-third of local government revenues. One of the goals of this chapter is to examine how the various levels of government raise revenues to finance their expenditures.

The federal government collects more in revenues than all other governments in the United States combined. Table 1 lists the percentage breakdown of all government own-source revenues and own-source revenues from major tax bases. Own-source revenues excludes intergovernmental grants, which are discussed in a separate section later, but includes revenues collected from fees and user charges, which might ordinarily not be considered as tax revenue. As table 1 shows, the federal Government collects 56.4 percent of total government revenues, with states collecting 24.3 percent and local 19.3 percent. [1, p.305]

Although all levels of government tend to collect revenues from a variety of sources, more taxes than all table 1 shows that the different levels of government rely on different tax bases to state and local different degrees. Most income taxes are collected by the federal government, which collects 81 percent of all individual income taxes and 81.5 percent of all corporate income taxes. States collect about 17 percent of both individual and corporate income tax payments, and local governments collect less than 2 percent. Thus, while states rely to a significant degree on income tax collections, the income tax is primarily a federal tax. When considering the income tax from an equity standpoint, this is even more true because most states base their income tax structures on the federal income tax structure, so changes in federal tax laws can have a significant effect on state income tax collections, both in terms of the amount of tax collected and in terms of the distribution of income tax payments among taxpayers.

The tax that is most clearly assigned to one level of Government is the property tax. More than 96 percent of property taxes are collected by local governments. Sales and gross receipts taxes, taxes are collected primarily by state governments. Although 62.9 percent of sales and gross receipts taxes are collected by states, both the federal government and local governments collect a significant amount. The federal government collects 24 local governments 24 percent of sales and gross receipts taxes, mostly through federal excise taxes on motor fuel, alcohol, and tobacco. [1, p.307] Local governments collect 13. 1 percent of sates and gross receipts taxes, coming from a combination of local general sales taxes, excise taxes on gasoline, and other less significant excise taxes.

Stepping back to examine the overall tax system, we see that the federal government relies primarily on income taxes, state governments on sales taxes, and local governments on property taxes. This division makes some sense when one considers the mobility of tax bases.

Although the property tax has remained a local tax, the income tax is becoming, increasingly important at the state level, as will be discussed later, so states might be viewed as encroaching on a traditionally federal tax base. Likewise, the federal government collects a significant amount of sales and gross receipts taxes, primarily as excise taxes, which might be viewed as taxing a state tax base. One factor relevant to the discussion of a federal value added tax is that, as a consumption tax, it would be placed on a tax base that has traditionally been used by state governments. This was less of an issue when the value added tax was adopted by European governments because tax systems in Europe tend to be more centralized than the tax system in the United States.

So, we can divide US tax system into the three major categories of federal, state, and local taxes. Intergovernmental grants make up nearly one-third of local government revenues. The federal government collects more in revenues than all other governments in the United States combined.

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Chapter 2

Federal Taxes and Intergovernmental Revenues. Tax Reform

The federal government relies on income and payroll taxes for the vast majority of its revenues. Table 2 shows the percentage breakdown for four categories of federal tax revenues and shows that the personal income tax is by far the most significant source of federal government revenue. Social insurance payroll taxes, which consist mostly of Social Security and Medicare taxes, make up the second-largest category, and this category is the only one that increased its percentage contribution from 1990 to 1999. Both corporate income taxes and excise taxes have fallen slightly in importance over that period.

The increased importance of Social Security taxes is worth considering from an equity standpoint. Although the income tax structure is designed to be progressive, the Social Security tax structure is regressive because it taxes income at a flat rate up to t maximum amount and is not collected on income above the maximum. [2, p.122]

When Social Security taxes were relatively low, the regressive nature of the tax might not have been much of an issue, but with rising Social Security tax rates and uncertain future benefits, the issue is worth considering. The progressivity of the tax system is reduced when social insurance taxes replace income taxes. Although the expected future benefits are a relevant and offsetting factor, normally the progressivity of the tax structure is analyzed independently of the distribution of tax benefits.

One of the important points to note from the numbers in table 2 is that income and payroll taxes make up about 90 percent of federal government revenues. The bulk of those taxes are levied on individuals in the form of the individual income tax and social insurance taxes. [1, p.320]

One of the major sources of revenues for lower-level governments is intergovernmental revenue. Revenues collected by the federal government are distributed through grants to state and local governments, and state governments also provide financial assistance to local governments. Intergovernmental revenues make up about 22 percent of total state government revenues and 33 percent of local government revenues. [1, p.320] There is some double counting here because the federal government can provide revenues to states, who then distribute revenues to localities. Also, local governments sometimes borrow from state governments and repay loans, so intergovernmental revenues to state governments can come from both federal and local governments. However, the most significant intergovernmental revenues consist of federal aid to state and local governments.

As a percent of state and local government spending, federal aid peaked in the late 1980s at about 24 percent of state and local government expenditures and has since declined to about 17 percent. Although they have been declining slowly in importance, intergovernmental revenues are still large and can have significant effects on government finance.

Although each individual intergovernmental transfer program will have its own motivation, there are three basic reasons why intergovernmental transfer programs might be established: (1) higher-level governments provide money to encourage certain types of programs by lower-level governments; (2) taxation for lower-level governments can be shifted to higher-level governments, where taxes are harder to avoid; and (3) programs are established for equity reasons, to give poorer states or localities parity with richer states or localities in funding government programs. [2, p.158]

But state governments rely mainly on sales and income taxes for their revenues, while local governments rely mainly on property taxes.

Now we shall tell about tax reforms. Tax laws are continually being modified at all levels of government. Indeed, most changes in tax law tend to be small changes that directly affect only a few taxpayers, and with good reason. Changes in any laws tend to be initiated as a result of a demand for the change, and special interests will consistently demand changes that will benefit them, while the general public will remain on the sidelines of most policy debates. Thus, the tax laws change as one small provision after another is added to the tax code as a result of requests from special interests.

Although each change by itself may have a plausible rationale, changes in the tax code tend to be in the form of loopholes that allow some taxpayers to reduce their tax payments. This was the general idea that drove the federal income tax reform in 1996. The tax code had so many loopholes in it that much income was escaping taxation, making everyone’s tax rates higher. If all the loopholes and special interest benefits could be done away with, everyone could have lower tax rates but the tax system could still raise the same amount of revenue.

Thus, the idea of that tax reform was to broaden the tax base by closing loopholes and making more income subject to taxation and lowering rates to raise the same amount of revenue. That effort at reform was mostly successful for two reasons. It considered the tax system as a whole rather than piecemeal, and the reform proposals were revenue neutral, which meant that they all proposed a more efficient tax structure that would raise the same amount of revenue. [1, p.356]

When tax reform takes place by examining one small tax issue after another, special interests can have undue influence over the reform process, and the resulting reform will tend to favor special interests rather than the general public interest. Small changes to the tax code will not affect most people very much one way or the other, so it will not pay them to get involved in the debate, whereas special interests can benefit substantially from small changes in the tax code. Thus, when the tax code is changed a little at a time, special interests will tend to benefit, and the tax code will become increasingly complex as loopholes are added to the tax system one at a time.

This problem of an overly complex tax code ridden with loopholes may be overcome by proposing a complete overhaul of the tax system that does away with all the loopholes in exchange for lower tax rates for everyone. Everyone tends to lose some special interest benefits with such a reform, but, overall, the more efficient tax code with lower rates can more than make up for the loss of these special interest benefits. Thus, a comprehensive tax reform has the potential to be a Pareto superior move, and all citizens can agree to give up their loopholes in exchange for a more efficient tax system that improves the welfare of all. This was the philosophy underlying federal tax reform in 1996.

Since the 1996 tax reform, changes in the tax code have been small ones, and this type of change is likely to benefit special interests rather than further the general public interest. Cynics might even suggest that by 1996, Congress had created just about all the special interest loopholes that it could fit into the tax code and that to create any more would have required taking away someone else’s. Therefore, Congress moved to eliminate as many of the special interest provisions as it could so that it could start giving them out again, one at a time, in exchange for renewed political support from the favored special interests. An optimist can hope that once a better tax system has been enacted, Congress and the general public will resist tampering and might even improve upon it.

For special interests in the private sector, the tax code provides a method by which they might be able to produce benefits for themselves. For governments, the tax system is a method of raising revenues. With the federal government running a substantial deficit and states and localities also finding themselves strapped for revenues, many people see tax reform as an opportunity to generate more revenues for cash-strapped governments. This view is not universal, however, and others think that governments spend too much and that taxes should be cut. Inevitably, when tax matters enter the political debate, there will be tension between those who think the government needs to increase taxes and those who think taxes need to be cut.

Both groups should agree that however much revenue the government raises, it should do so as efficiently as possible. Thus, there is a possibility to get agreement among all parties to create a more efficient tax structure if they can lay aside differences regarding whether the government should increase or decrease its revenues.

Agreeing to adhere to the principle of revenue neutrality when changing the tax structure partitions the policy debate so that issues regarding how much revenue the government should raise can be considered separately from efficiency and equity issues. On one side of the partition, legislators can debate how to create a fair and efficient tax structure, leaving the amount of revenues unchanged, and, on the other side of the partition, they can debate whether tax rates should be raised or lowered to collect the right amount of revenue.

So, the federal government relies on income and payroll taxes for the vast majority of its revenues. Social insurance payroll taxes, which consist mostly of Social Security and Medicare taxes, make up the second-largest category. When Social Security taxes were relatively low, the regressive nature of the tax might not have been much of an issue, but with rising Social Security tax rates and uncertain future benefits, the issue is worth considering.

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Chapter 3

The Progressivity of the Tax System. Political Influences on the Tax System

One of the important issues in the analysis of individual taxes in the previous chapters was the progressivity of taxes. The progressivity of individual taxes is of minor importance, however, when compared with the progressivity of the tax system as a whole. For example, taxes on cigarettes are widely viewed as regressive taxes because lower-income people spend a larger percentage of their incomes on tobacco than do higher-income people. In general, regressive taxes are viewed as inequitable, yet there is minimal resistance to increases in this regressive tax because it is a sumptuary tax on a product that is increasingly viewed as harmful to consume. There is not necessarily an inconsistency in calling for an increase in a regressive tax and favoring a proportional or progressive tax system if that one tax is a small part of the total system. Thus, the progressivity of the tax system as a whole is more important than the progressivity of any particular tax. [2, p.165]

Analyzing the entire tax system is not an easy task, for several reasons. If one simply examines the amount of taxes paid in one year when compared with people’s incomes for that year, the degree of regressivity of the tax system is sure to be overstated. Many people at the low and high ends of the income distribution in a particular year are there because of temporary circumstances. People who are temporarily unemployed, or college students who expect to have higher-paying jobs in a few years, will have relatively high consumption and taxes when compared with their incomes, and, at the other end of the income distribution, some people have annual income may be especially high incomes in a year because they have realized capital gains, such as might occur if one sold a business or even a house that one has owned a long time. Thus, it may be more reasonable to look at the progressivity of the tax system compared with lifetime income rather than with income in a particular year.

It is very progressive at the extreme ends of the income distribution, with the lower 2 percent of individuals paying much less in taxes as a percentage of their incomes and the upper 2 percent paying much more, relative to the rest of the population. But, for most people, the tax system works out to be roughly proportional with respect to income.

The most progressive tax in the tax system is the income tax. [1, p.309] This should not be surprising because it is designed to be progressive with respect to income. But sales and excise taxes are consistently regressive with respect to income, which partially offsets the progressivity of the income tax. States that do not tax food or rent remove a substantial amount of the general sales tax burden from low-income individuals, but included in excise taxes are taxes on gasoline, tobacco and alcohol products, electricity, and phone service that obviously take a larger percentage of income from lower-income individuals.

The overall progressivity of the tax system is driven mainly by income taxes and by sales and excise taxes, which make up the biggest share of the total tax burden. Sales and excise taxes are slightly regressive overall, while income taxes are progressive enough to more than offset the regressive effects of other taxes, making the tax system progressive as a whole. This suggests that if the tax system were to start relying more on consumption taxes, such as a value added tax, the progressivity of the tax system might be reduced, and this is a concern for policymakers who are examining such alternatives. A consumption tax structured like the current income tax, on the other hand, could be designed to retain the current progressivity of the tax system, so it would be less controversial from a policy standpoint.

One can draw some general conclusions about the progressivity of the tax system by looking at the lifetime tax burden in this way, but the approach still has some possible problems. Most obvious is accurately estimating who actually is paying taxes, but there may be deeper problems with this way of looking at things as well. For one thing, people do not have their entire lifetime incomes available for them to pay taxes at any point in their lives. Someone who will have a much higher income in twenty, years cannot use that future income to pay today’s taxes, so, for purposes of fairness, we should be concerned about taxing people with low incomes heavily now even if their incomes will be substantially higher in the future. This has led some economists to back away from the concept of lifetime income and instead examine the burden of taxes over a shorter period, such as five years.By examining a period like five years, a temporary spell of unemployment would have a smaller effect than if annual income were used as a benchmark, but, at the same time, one would not place heavy tax burdens on people with low incomes today who might have high lifetime incomes.

Another reason for examining the progressivity of the tax system over a shorter period of time than an entire lifetime is that the tax structure can change substantially over time, and any estimate made now of a young person’s lifetime tax burden is sure to be in error because of unforeseen changes in the future tax structure. From an academic standpoint, it is interesting to estimate what the lifetime tax burdens of various groups of people would be under the current tax structure, but, if one is really interested in designing an equitable tax structure, there is a great deal of uncertainty involved in forecasting future taxes. The Social Security payroll tax provides a good example of a tax that had to rise faster than originally forecast to provide sufficient revenues to maintain the program. [2, p.183]

Yet another problem with this approach is that it does not consider how the tax money is spent. If taxes are the price we pay for government goods and services, then we should be concerned with how well the burden of taxation matches up with the flow of government services rather than just looking at taxes in isolation. The Social Security payroll tax was explicitly designed to have some (but not complete) correspondence with the expected benefits received. Although other taxes do not match up so exactly with benefits received, a complete accounting from an equity standpoint should include both government taxes and government benefits.

It is still worthwhile to examine the issue of the progressivity of the tax structure, these caveats notwithstanding. But, at the same time, we must recognize that any measure of the progressivity of the tax system will be imperfect and must be considered in the context of what it does and does not measure.

One can analyze the tax system at length in an academic framework, yet real-world tax policy is made through the political process rather than as a result of economic analysis. Thus, the actual tax system will be the product of compromise among various interests in the political arena. In this setting, economic analysis serves two roles. First, it provides arguments that both sides use in the political debate on taxes. No one says that he favors a particular tax, or a particular tax reduction, because it will make him richer. Rather, political interests argue that the tax changes they favor are in the public interest for a variety of reasons. They argue that changes will make the tax system more fair or more efficient, but, to make such arguments, they need to know enough about the economics of the situation that they can use economic analysis to present their cases in the most favorable light. But economic analysis is also used to estimate what the effects of tax changes will be so that interests actually will know which changes will benefit them, and by about how much. There is no sense arguing for a change if it will provide little in the way of real benefits.

If the democratic political system truly were representative, everyone’s interests would be given equal weight in designing the tax system. In reality, special interests tend to dominate political debate because they are the ones who have the most to gain, and interests with more wealth will be in a better position to use their resources to steer the course of political decision making. This has the potential for pushing the tax system toward a complex set of special interest benefits giving loopholes to those who have political influence, while leaving those who do not have much influence to bear increased tax burdens.

One problem is that when special interests seek tax advantages, they will care little whether those advantages enhance overall efficiency as long as they benefit the special interests. Tax reforms that actually do enhance economic efficiency probably will have a better chance of passing through Congress because they will have less opposition than inefficient tax reforms, but this may not be enough to produce an efficient tax system. [1, p.387] This is especially true when one considers the tax system as a whole. One change in the tax laws may have a plausible rationale but may be counterproductive when considered within the context of the rest of the tax system.

Conclusion

The tax system in the United States is a composite of federal, state, and local taxes. The federal government raises more than half the tax revenues in the United States, with state governments raising about a quarter, and local governments a little less than that. Although there is not an absolute division among tax bases used by the various levels of government, the federal government relies mostly on income taxes, state governments rely most heavily on sales taxes (but also get significant revenues from income taxation), and local governments rely most heavily on property taxes.

Intergovernmental revenues make up a substantial amount of state and local government revenues, mostly in the form of federal government grants. The use of intergovernmental revenues helps equalize expenditures across the nation, so that lower-income areas are not as disadvantaged because of smaller tax bases. These revenues also have the effect of lowering the state or local government tax price for government spending, which encourages more state and local spending. This is often the intention, as federal grants are made to entice lower-level governments to spend more in certain areas. Because federal government programs spread across the nation, intergovernmental revenues also make different jurisdictions more similar and therefore lower intergovernmental competition.

One of the significant issues with regard to any tax, and especially with regard to the overall tax system, is its degree of progressivity. The tax system in the United States is, overall, progressive, with people at the extreme lower end of the income distribution paying much less in taxes as a percentage of their incomes, and people at the extreme upper end paying much more, than average. For people who are not at the extremes of the income distribution, however, the tax system is roughly proportional. Income taxes are the most progressive taxes as a group, while sales and excise taxes are the most regressive, but the progressivity of income taxes more than offsets the regressivity of sales taxes.

With regard to both equity and efficiency issues, taxes are best considered within the context of the overall tax system. Some taxes, such as cigarette taxes, may be very regressive, yet they are a small part of the total tax payments of any group and therefore are not viewed as unfair because of their regressiveness. Similarly, the efficient tax treatment of dividends, capital gains, inheritances, and most kinds of property depends upon how related tax bases are treated throughout the tax system, so one cannot get a complete understanding of any individual tax without seeing how it works as a part of the entire system of taxes.

#### Ultimately, the tax structure is a product of the political system, so understanding the political forces involved in changing the tax laws goes a long way toward understanding the nature of the actual tax system, especially when the actual system seems to deviate from what appears to be fair and efficient. Special interests tend to have an undue influence over tax changes, as they do over legislation in general, with the result that if tax reform takes place on a piecemeal basis, the tax structure is likely to be increasingly riddled with special interest benefits that erode the tax base and make the tax code inefficient. More comprehensive tax reform has the chance of creating greater potential gains for the general public, which increases the likelihood that reform will take place in the general public interest rather than for the benefit of special interests. The federal tax reform of 1996 serves as a model in this regard.

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