

Unit 5 Lesson 29**Can Taxes Be Incentives?****INTRODUCTION**

Economics Different levels of government impose several different types of taxes and fees. The purpose of imposing these taxes is to generate revenue to pay for goods and services provided by government. Federal, state, and local governments depend on different types of taxes and provide different types of government services. The different types of taxes have different advantages and disadvantages. Economists have attempted to identify criteria for a fair tax. Four criteria commonly noted are the ability to pay, efficiency, simplicity, and benefits derived.

Reasoning Governments depend on taxes for revenue. While most people agree that government is essential, most do not like to pay taxes. Two reasons are frequently cited. First, government has the authority to set the rules of the economic system. Within our system of laws, government is authorized to use coercion to enforce the rules. Since the exchange of taxes for government services is not voluntary, it may not be of equal benefit to all taxpayers. Second, the nature of taxation diminishes the link between payment and consumption. In some cases, individuals pay their taxes but do not see much direct benefit for their payment. In other words, the cost is obvious but the benefit is not.

Taxes are a cost. As such, they influence people's behavior in predictable ways. Changing the types of taxes or the tax level will encourage certain types of behavior and discourage others. For example, increasing or decreasing taxes influences people's behavior by encouraging or discouraging the use of substitutes for goods and services which are taxed.

CONCEPTS

- Incentives
- Substitutes
- Taxes

OBJECTIVES

Students will:

1. Recognize that governments impose many different types of taxes and fees in order to collect revenue.
2. Identify reasons why people might dislike paying taxes, including government coercion and the diminished link between payments and consumption.
3. Identify and apply criteria for judging what constitutes a fair tax, including ability to pay, efficiency, simplicity, and benefits received.

4. Recognize that taxes are incentives or disincentives that influence people's behavior.
5. Predict how people will respond when the incentive structure is changed by tax changes.

CONTENT STANDARDS

- People respond predictably to positive and negative incentives. (NCEE Content Standard 4)
- There is an economic role for government to play in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income. (NCEE Content Standard 16)

LESSON DESCRIPTION

Students examine different types of taxes and criteria for determining a fair tax. Students work in pairs to predict how changes in taxes will change people's behavior.

Time Required: 60 minutes

MATERIALS

- A transparency of Visuals 1, 2, 3, and 4
- Activities 1 and 2

PROCEDURE

1. Explain that the purpose of this lesson is to analyze the effects of taxes on individual behavior.
2. Remind the students that public goods are paid for by taxes. Display Visual 1 and Visual 2 to illustrate the categories of taxes and spending (federal, state, and local).
3. Ask: Why do you think that people often dislike paying taxes? List the students' ideas on the board. Accept any plausible answers.
4. Display Visual 3. Explain the two reasons why people might dislike paying taxes.
5. Refer the students to Activity 1. Ask them to read Part 1 and identify criteria for assessing a fair tax. Display Visual 4. Use it to review the criteria of ability to pay, efficiency, simplicity, and benefits received.

- Direct the student’s attention to Part 2 of Activity 1. Make sure that they understand the directions. Do the driver’s license example together. Then divide the class into small groups and ask them to complete Part 2. After the groups have completed their work, discuss the results.

Possible Answers to Activity 1, Part 2

| Tax/Fee | Criteria | | | |
|--------------------------------------------------------------------------------------|----------------|------------|------------|-------------------|
| | Ability to Pay | Efficiency | Simplicity | Benefits Received |
| 1. Driver’s license fee (a fixed amount for each driver) | - | + | + | + |
| 2. Personal income tax (a percentage of wages and salaries up to a limit) | + | + | - | - |
| 3. Social Security tax (a percentage of wages and salaries up to a limit) | - | + | + | + |
| 4. Sales tax (a percentage of the pre-tax retail price of covered goods or services) | - | + | + | - |
| 5. Property tax (a percentage of the property’s value) | + | - | - | + |

- Explain that governments have created many ways to raise revenue. The most common are taxes on sales, income, and property; fees and licenses also are important. Whenever government imposes a new tax or changes an old one, people may change their behavior.
- Refer the students to Activity 2. Read the introductory paragraphs to the students. Emphasize that taxes act as incentives and that changes in taxes may encourage people to substitute one action for another.
- Ask the students to predict how individuals might respond to Situation 1. Some possible responses appear below.

Situation 1: Congress increases the federal income tax by 25 percent for all income groups. How might individuals respond?

(People would be discouraged from earning income. They might begin to substitute more leisure time for work time. People would be encouraged to cheat on paying their taxes.)

- Ask the students to work in pairs and write predictions for each of the remaining four situations. The following are some sample predictions:

Situation 2: Your state raises the fee for a driver’s license to \$500 per person. How might individuals respond?

(People would be discouraged from driving. They might begin to substitute the use of mass transit or car pools. They might also substitute the use of other vehicles that do not require a car driver’s license. In some states, for example, there are special licenses for operating motorcycles. People would be encouraged to drive without a license. Young people would be discouraged from getting driver’s licenses.)

Situation 3: Complaints are increasing every year about tourists overcrowding the U.S. National Parks. The federal government increases the National Parks’ camping fee to \$50. How might individuals respond?

(People would be encouraged to substitute visits to private, state, or county parks for visits to National Parks. People would be encouraged to substitute overnight stays in motels for stays in National Parks. People would be encouraged to enter parks without permits and substitute the risk of being caught for paying the increased fee.)

Situation 4: Freeways are very busy and travel is slow during morning and evening rush hours. The state government decides to make the freeways tollways during the peak hours (from 7:00 a.m. until 8:30 a.m. and from 4:00 p.m. until 5:30 p.m.) by imposing a \$5.00 fee per car at each entrance ramp along the most-traveled 10-mile stretch of freeway. How might individuals respond?

(People would be encouraged to rearrange work schedules so they could travel during non-peak hours. People would be encouraged to substitute mass transit and car pools for the increased fee. People would be encouraged to enter the freeway outside the 10-mile toll zone.)

Situation 5: Congress changes federal law so that homeowners are no longer permitted to deduct home mortgage interest from their taxable income. How might individuals respond?

(People would be discouraged from keeping or purchasing homes. People would be encouraged to seek other ways to “shelter” their taxable income. People would be encouraged to seek rented apartments as substitutes for owned homes.)

- Discuss the students’ predictions in the whole group.

CLOSURE

- Why do people often dislike paying taxes?
(Government coercion; diminished link between payment and consumption: the cost is obvious but the benefit is not.)
- What taxes does the federal government charge?
(Individual income taxes, social insurance taxes, corporate income taxes, excise taxes, estate and gift taxes, customs duties.)
- What sorts of taxes do state and local governments charge?
(Sales taxes, property taxes, individual income taxes, corporate income taxes.)
- What do you think is the most important criterion for deciding what is a fair tax?
(Encourage the students to present reasons for any of the following: ability to pay, efficiency, simplicity, benefits received.)
- Remind the class that taxes are valuable sources of government revenue and that they also create incentives that influence behavior. Ask them to imagine that the student parking lot is overcrowded. The student council and the principal decide that a \$25 fee should be charged each semester to all students who want to park a car in the lot. How might some individuals respond?
(Some students might substitute riding the school bus or walking to school for the convenience of using a car. Some students might substitute car pools, rides with parents, bicycles, motorcycles, or the use of mass transit. Students who place a high value on the convenience of parking in the school lot, perhaps because of an after-school job, would probably pay the fee.)

MULTIPLE-CHOICE QUESTIONS

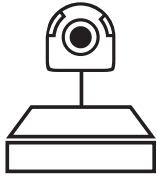
(CORRECT ANSWERS SHOWN IN BOLD)

1. A fee charged to campers for the use of state parks does not fulfill the principle of:
 - A. Ability to pay.**
 - B. Benefits received.
 - C. Simplicity.
 - D. Efficiency.
2. The first internal tax levied by the federal government was a tax on distilled spirits produced in the United States. This tax was justified not only as a source of revenue but also as a way to discourage the use of alcohol. This is a case of using a tax as:
 - A. An incentive.**
 - B. A device based on ability to pay.
 - C. A device based on simplicity.
 - D. A voluntary exchange.
3. A good or service that can be used in place of another good or service is a(n):
 - A. Inferior good.
 - B. Complement.
 - C. Substitute.**
 - D. Economic want.

ESSAY QUESTION

Officials in your school no longer want students to bring backpacks to school. Rather than impose a ban on backpacks, they have decided to impose a \$5.00 tax on each backpack students bring to school. What do you predict will happen?

(Students would be encouraged to leave books or notebooks in lockers or at home. They would be encouraged to substitute briefcases for backpacks.)



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Visual 1

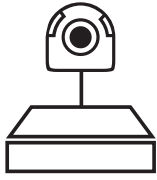
CATEGORIES OF FEDERAL TAXES AND SPENDING

FEDERAL TAXES

- Individual income taxes
- Social insurance taxes
- Corporate income taxes
- Excise taxes
- Estate and gift taxes
- Customs duties

FEDERAL SPENDING

- Social Security
- National defense
- Medicare
- Interest on the debt
- Health and human services
- Transportation
- Agriculture
- Education and training



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Visual 2

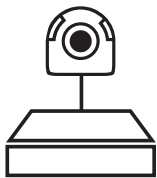
CATEGORIES OF STATE AND LOCAL TAXES AND SPENDING

STATE AND LOCAL TAXES

- Sales taxes
- Property taxes
- Individual income taxes
- Corporate income taxes

STATE AND LOCAL SPENDING

- Education
- Health and welfare
- Transportation
- Civilian safety

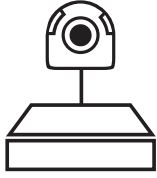


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Visual 3

WHY DO PEOPLE DISLIKE PAYING TAXES?

1. Government can coerce people.
 - Most economic transactions depend on voluntary exchange.
 - Government has the exclusive right to coerce individuals to pay taxes.
2. Costs are obvious; benefits are not.
 - Government spending of tax dollars diminishes the link between payment and individual consumption.
 - Usually, when consumers make a purchase, they see a direct benefit from the goods or services they receive.
 - When people pay taxes, the benefits (from national defense or cancer research, for example) are often delayed, indirect, or spread out so thinly that people may see little benefit from their payments.



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Visual 4

CRITERIA FOR A FAIR TAX

1. Ability to pay
 - Proportional (flat tax)
 - Progressive tax
 - Regressive tax
2. Efficiency
3. Simplicity
4. Benefits received

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Activity 1

What Is a Fair Tax?

PART 1: THE CRITERIA

1. **Ability to Pay:** A fair tax should equally tax individuals with equal ability to pay. People with different amounts of wealth or income should pay different amounts of taxes. A proportional tax (sometimes called a flat tax) takes the same percentage of income or wealth from all taxpayers. A progressive tax means that those with higher incomes or those who are wealthier pay a higher proportion of their income in taxes. A regressive tax means that poor people pay a higher proportion of their income in taxes than those with higher income or those who are wealthier. Income tax policy in the United States has generally reflected the idea that a progressive tax is fair. However, interest in proportional taxes is commonly expressed.
2. **Efficiency:** A fair tax should not inhibit productive activities. It should not discourage people from working or investing in new businesses. It should

not encourage individuals to be wasteful in buying goods because of their tax benefits rather than their value. A fair tax should not favor less productive businesses over more productive ones.

3. **Simplicity:** A fair tax should be simple. One frequent complaint about the federal income tax, often voiced around April 15, when taxes are due, is that the system is very complex, with forms that require many hours to complete. Increased complexity encourages people to make mistakes, promotes cheating, and builds resentment. Another example comes from residential property taxes. To figure a property tax, a government official must decide the value of a person's home. Formulas for assessing values vary widely, and the assessed values may or may not reflect the market values. This system can be very confusing to taxpayers.
4. **Benefits received:** A fair tax should tax individuals according to the benefits they receive from government services. Those who receive numerous benefits should pay more than those who receive few. For example, in some states, revenues generated from gasoline taxes are used to maintain and improve roads. Therefore, people who drive more pay more tax to support roads.

PART 2: APPLYING THE CRITERIA

Directions: Mark a plus or minus sign under each criterion to indicate whether the tax in question meets the criterion.

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Activity 2

The National Commission of Taxation Makes Its Annual Forecasts

WELCOME TO THE NCT

You have just been appointed by the President of the United States to the National Commission of Taxation (NCT). The purpose of the NCT is to forecast how changes in tax laws might change individual behavior. Every year, the NCT presents its forecasts to members of Congress and to the President for their consideration. And, every year, people are amazed at how well the NCT is able to predict changes in people’s behavior.

BACKGROUND FOR NCT MEMBERS

There is a simple rule that guides the work of NCT members. They understand that taxes act as incentives. Changing the types of taxes levied and tax levels can influence people’s behavior. Sometimes government deliberately raises or lowers taxes on particular goods and services to encourage or discourage certain types of behavior. For example, the first internal tax levied by the federal government was a tax on distilled spirits produced in the United States. This tax was justified not only as source of revenue but also as a way to discourage the use of alcohol. At other times, government leaders are not very certain about how changes in tax laws might change people’s behavior. Ill-considered tax laws often result in unintended consequences.

A second rule is that there are substitutes for everything. If, for example, government makes one type of activity more expensive by increasing the tax on it, people often make substitutions. Applying this understanding has helped the NCT to predict actions that other government leaders had not considered.

YOUR JOB

Your job is to read each of the following situations and forecast how people’s behavior might change. Form your response so that you identify what people might substitute in each case.

Situation 1: Congress increases the federal income tax by 25 percent for all income groups. How might individuals respond?

Situation 2: Your state raises the fee for a driver’s license to \$500 per person. How might individuals respond?

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