Where Does the US Government Get Its Money?

Debt 101

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The US Constitution can be vague at times, but when it comes to taxes, there is little question about the government's power. "The Congress," James Madison writes, "shall have Power to lay and collect Taxes, Duties, Imposts and Excises." In modern language, the government can tax its citizens, and it does. But just because the government has the power to do something doesn't mean it should. Despite the Constitution's clear mandate that the federal government may tax its citizens, taxes are a very complicated and often problematic part of American life. The US tax code is around 2,600 pages long. And there are additional tens of thousands of pages about the tax code: IRS regulations, revenue rulings, and case law covering court proceedings around the code. But a few fundamental questions can get to the root of how American taxes relate to the US debt.

What Is the Structure of the US Tax System?

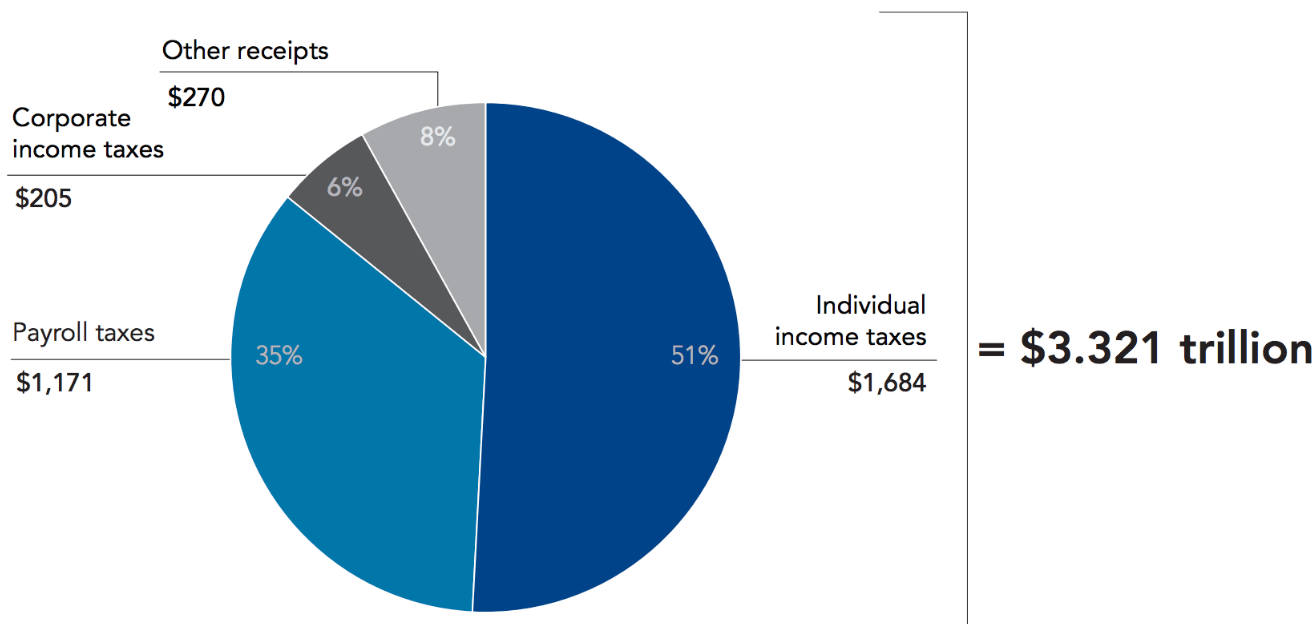
Just as individuals earn wages, so does the government. Over the course of the 2018 fiscal year, the US government took in $3.329 trillion. This number reflects the amount of money the government earned from revenue, both taxes and miscellaneous sources (or nontax revenue, an insignificant source).

As we have said over the course of this series, the federal government provides services to its citizens, such as military protection, interstate regulation, and, of course, health care. These services come at a cost to those who live within the borders of the nation and benefit from government help. That cost is taxes.[1]

Figure 1

Government revenue in billions of dollars

(Fiscal year 2018)



Source: Congressional Budget Office (2018)

The federal government levies three main types of taxes: individual income taxes, payroll taxes, and corporate income taxes. Let's look at each of these tax types individually to see what goes into them.

1. **Individual income tax**
   The individual income tax is applied to the wages, salaries, dividends, interest, and any other income a person earns throughout a year. The US income tax system is progressive, meaning that the more you earn, the more you pay as a percentage of your income. Importantly, it is never the case that the more you earn, the less you will take home after taxes (the "moving into a higher tax bracket" story is often exaggerated and misunderstood). The federal government does *not* want taxes to disincentivize citizens from making money.

   The marginal tax rates (the rates that apply to each additional dollar of income) as of 2017—the latest year for which people have already filed—range from 10 percent at the lowest end of the spectrum to 39.6 percent at the highest end. A family earning $40,000 annually can expect to pay about 15 percent of its income in federal taxes; a household earning $10,000,000 annually can expect to pay about 39.6 percent of its income in federal taxes (effective tax rate). If you'd like to play around with these numbers to see how the marginal tax rate changes with income, use this easy tax calculator.

2. **Payroll taxes**
   Payroll taxes differ from income taxes in three key ways. First, payroll taxes are paid only on the wages and salaries of employees (not on, for example, bank interest or dividends on corporate stock). Second, these taxes are used only to finance social insurance programs such as Social Security and Medicare. These taxes make up the second greatest share of federal revenue of the US government. Look for payroll taxes on your pay stub under FICA (Federal Insurance Contributions Act).

   Third, payroll taxes, unlike income taxes, are regressive. This means that, as opposed to income taxes, payroll taxes become proportionately smaller compared to income as income rises. The more one earns, the smaller the share of one's income that goes into payroll taxes. This is because only the first $118,500 of wages is subject to

payroll tax. If you looked at the tax calculator (above), you may have noticed this trend. A worker making $50,000 annually in wages will pay about 7.65 percent in payroll taxes, while a worker making $250,000 a year will pay just 2.35 percent in payroll taxes (importantly, though, the lower-wage worker will get a much higher rate of return on his taxes when he collects benefits). In 2018, the Congressional Budget Office provided an estimate of an increased $1 trillion in revenue over 10 years if the government were to increase the taxable maximum from $118,500 to $250,000—although, depending on the details, this change also could increase future benefits.

In general, the theory behind these taxes holds that you will get your payroll tax money back when you retire and cash in Social Security and Medicare. However, as we discussed in earlier Debt 101 pieces, this guarantee is perhaps not as certain as it used to be, as the funds are quickly being depleted. However, increasing the payroll cap is controversial and, some believe, possibly detrimental.

3. **Corporate income tax**
   The corporate income tax is imposed by the US government on the income of corporations. Corporate taxes at the federal level are imposed on all US corporations and on foreign corporations that have income or activities within the United States. A new law passed on 22 December 2017 reduced the federal income tax on corporations to a flat rate of 21 percent. Prior to the passage of The Tax Cuts and Jobs Act, corporations making more than $18,333,333 were taxed at 35 percent, while corporations making less than $25,000 were taxed at 15 percent of income (with incremental increases in between).

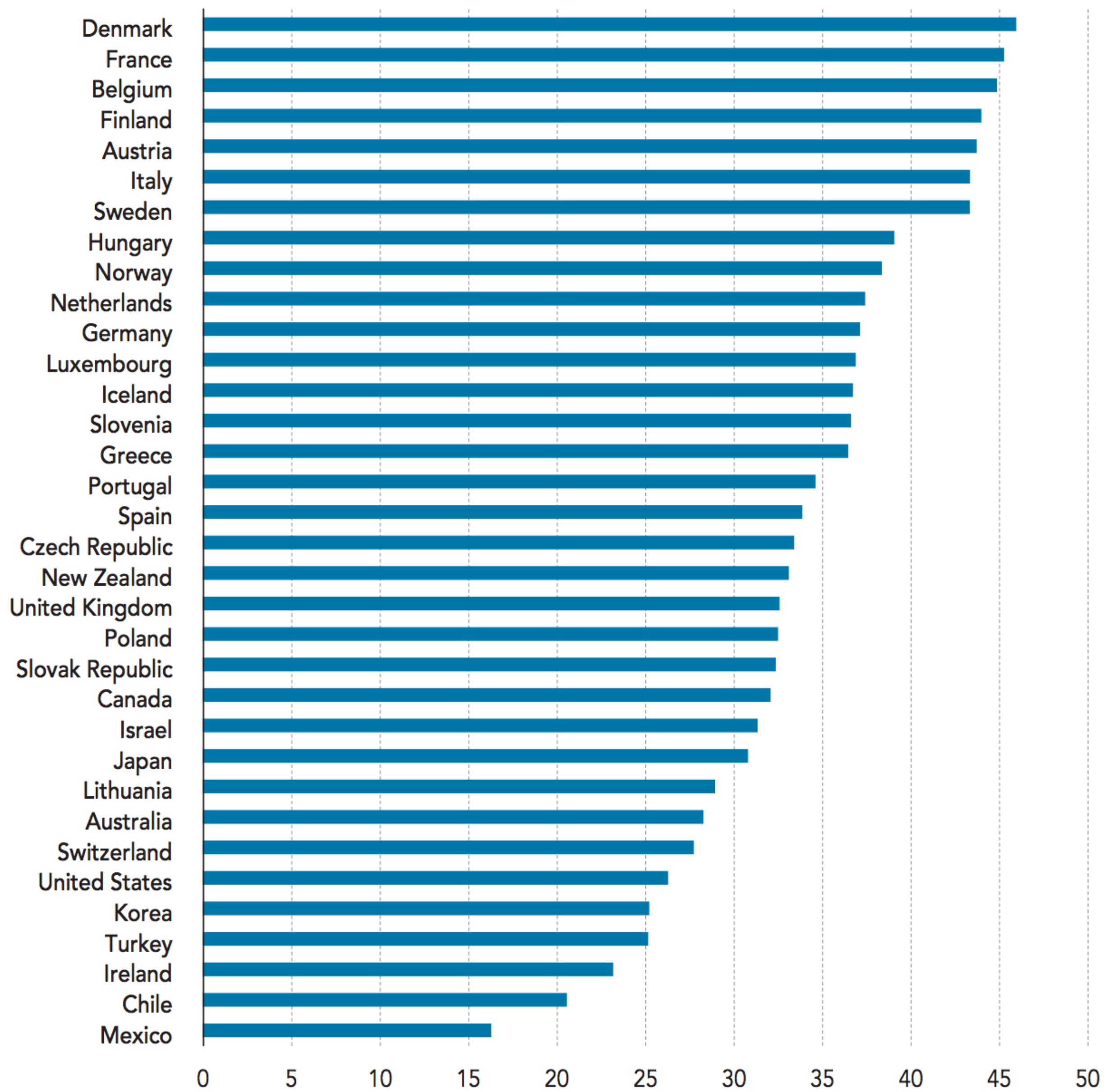
   This new flat tax came with controversy. Many on the left believe it is a feeble attempt at "trickle-down economics," while more conservative Americans believe it will incentivize businesses to return to the United States and thus will pay for itself while stimulating economic growth.
4. **Other revenue sources**
   A fourth type of revenue, often agglomerated simply into "Other," accounts for a relatively small percentage of total government revenue from taxes (8 percent or $278 billion in 2018). Within "Other" are mainly excise taxes and estate and gift taxes. In brief, excise taxes are taxes on certain goods and services, often items that are perceived as luxuries or as imposing costs on society—such as tobacco, alcohol, and tanning salons. Excises are imposed at the point of sale of those goods and services. Estate taxes are levied on assets bequeathed to beneficiaries after a person dies. Only assets or estates valued over a certain level are subject to this tax. Gift taxes, on the other hand, are taxes levied on recipients of donations or "gifts" by a living person of more than a certain amount ($14,000 per year currently) to other persons.

How Does US Taxation Compare to That of Other Nations?

In Fiscal Year 2018—which ended in early October of 2018—the United States raked in what seems like an astounding $3.329 trillion in just 12 months. The federal government received most of this through taxation (Figure 1). Surprisingly, however, despite the huge fundraising campaign that is the US tax system, the United States ranks low among Organization of Economic Co-operation and Development (OECD) member countries with respect to tax revenues as a percentage of each nation's total collected income (or GDP) (Figure 2). In other words, despite our large economy, US effective tax rates are quite low compared to the other 33 countries within the OECD.

Figure 2

OECD countries tax revenues as a percentage of GDP



Source: Congressional Budget Office (2018)

Denmark, the OECD country that taxes the most in terms of percentage of GDP, brought in just $135.585 billion USD in 2018. However, Denmark's total GDP is tiny compared to the US, at just $301.3 billion USD versus the US's whopping $19.39 trillion. So, while the US gross figures are large compared to Denmark's, the US is a significantly larger country with a larger economy (GDP). But, as Hillary Clinton noted in 2015, "We are not Denmark." Denmark provides social welfare programs with its tax revenue that the US does not (See Debt 101 Part III on the US health care system for one example).

Very real differences exist among national tax systems and thus among welfare systems (or perhaps it is welfare systems that create the tax systems!). While we cannot explore individual countries' priorities in this primer, we suggest readers take a look at different systems and see if some seem more or less desirable than others.

What Does This Have to Do with The Debt?

Not surprisingly, federal government revenue has a lot to do with US debt. In fact, it gives us about half of the picture. Debt is the accumulation of total federal government revenue minus total federal government spending. If the US is not bringing in enough money, primarily through taxes, then our deficits, and ultimately our debt, will be large and will grow. This is currently the case. The US federal government does not tax citizens or entities nearly enough to offset its total expenses. Again, what the nation does about that is a matter of preference. The choices are: spend less, tax more, grow the economy, or use a combination of the three. The choice is up to voters (and to the economy's ability to grow). The one option that we cannot choose, assuming we want to avoid the "Whimper" or "Bang" situations described in Part I, is complacency.

Notes

1. To note, we are focusing on the federal government. State and local governments have their own unique ways of earning revenue that do not affect the national debt, but rather affect individual state debts and, of course, your take-home pay.