by the employer. However, if a state has an approved unemployment compensation system (and all 50 do), then up to 5.4 percent of the state rate is a full credit against the federal liability, leaving a net federal rate of 0.8 percent. States may have a taxable wage base higher than the federal limit (41 do). States also can levy rates on employers that differ from the 5.4 percent standard based on the unemployment experience rating of the firm: those with fewer layoffs pay lower tax than do those with more layoffs.[52] The idea is to encourage employers to stabilize their labor force while financing the unemployment compensation system.

Finally, the federal and state payroll taxes are all earmarked. That is, their revenues are dedicated to finance only particular social insurance benefits. Because these benefits tend to be more valuable to lower-income individuals, the public generally accepts the unusual features of these taxes that make their burdens regressive. Nevertheless, they do contribute to labor market incentive effects by adding to the wedge between what employers pay and what employees retain. Any surpluses in these funds are invested in U.S. government bonds, thus helping support those markets.

Conclusion

The income tax has been the heart of the federal revenue system from the early years of the twentieth century, providing sizable revenue for global responsibilities and domestic programs. For more than 60 years, the individual income tax has been the dominant source, although the payroll taxes for social insurance have become almost as significant in overall finance. Corporate income taxes now play only a small role in finances. Individual income taxes also make a major contribution to the finances of state governments. While achieving progressivity, the income taxes do have problems of economic inefficiency, horizontal inequity, expensive collection, and failure of transparency. Corporate and payroll taxes raise considerable revenue, but they offer difficult challenges of equity and efficiency. There are enough preferences inserted in the income tax system to raise the belief that lawmakers have lost sight of the fact that the fundamental purpose of the system is to raise money to support government operations.

QUESTIONS AND EXERCISES

1. Identify the important elements of the income tax in your state. What governments levy the tax, does the tax apply to individuals and corporations, how is the tax linked to federal income taxes, are the rates graduated, and is the tax indexed?
2. A midwestern state aids its institutions of higher education by giving a credit against its income tax equal to 50 percent of any gift to such institutions (subject

[52] Rates can range from zero (16 states) up to 10 percent (three states). Three states also tax the employee. A number of state unemployment compensation funds ran out of money during the recession that started in December 2007 and were forced to borrow from the federal government to maintain benefit payments.

to a limit of $50 credit per person). Two residents of that state, Mr. Blue (in the 15-percent federal tax bracket) and Ms. Jones (in the 35-percent federal tax bracket), each contribute $100 to an eligible state university.

a. How much will state tax liabilities of each change as a result of their gifts?
b. State income tax payments and contributions to charitable organizations (such as universities) are both currently deductible from the base used to compute federal tax liability. How much will federal tax liability change for Mr. Blue and Ms. Jones as a result of their contributions?
c. Considering both changes in federal and state tax liability, what is the net after-tax cost of Mr. Blue's and Ms. Jones's gifts? (*Hint:* Subtract the changes in state and federal liability from $100.)
d. Suppose the state program changed from a credit to a deduction. If the state tax rate were a flat 3 percent, how much would state liability for Mr. Blue and Ms. Jones change?
e. From the previous computations, which approach (credit or deduction) do you suppose universities in the state would favor? Why?

3. Mr. Brown is in the 10-percent federal income tax bracket and wants to invest $8,000 in interest-earning assets. Mr. Black is in the 35-percent bracket and wants to invest $15,000. The current rate on a typical high-quality tax-exempt municipal bond is 5 percent and on a similar quality corporate bond is 6.5 percent. You are the financial adviser to both. Which investment would you recommend to each individual?

4. The Millers, a family of three filing joint returns, have the following information to prepare their federal income tax. Use the current federal tax forms (available at the local IRS office or from the IRS website) to make your computation.

Salaries	65,000
Interest income, corporate bonds	1,000
Interest income, municipal bonds (issued in 1984)	1,500
State and local income taxes	800
Real estate taxes	750
General sales taxes	750
Home mortgage interest	3,350
Credit card interest	500
Cash contributions to charities	250
Interest on education loans	500
Hospital and doctor expenses	1,500

Compute the following:

a. Adjusted gross income
b. Taxable income
c. Tax
d. Average tax rate
e. Average effective-tax rate
f. Marginal tax rate