

## THE US TAXES ON INCOME

**Bazarova Mamlakat Supiyevna**  
Asian International University, Bukhara

**Annotation.** *The income tax is the largest but one of the newest sources of federal revenue. In the early years, the new nation funded its federal government largely with land sales and tariff revenue. The two largest sources of federal revenue today, the individual income tax and the Social Security payroll tax, are twentieth-century innovations.*

**Key words:** *individual income tax, payroll taxes, the Social Security tax, corporate income tax*

The term income tax registers in most people's minds as the federal individual income tax. But there are several other kinds of taxes that are also based directly on income. The Social Security tax and other payroll taxes are also income taxes, as is the corporate income tax. Many local business license taxes are income taxes because they are based on the firm's gross receipts, or income.

Unlike most other countries, the United States relies almost exclusively on income taxes to fund its central government. In addition, 41 states and more than 4,000 local governments also depend on individual income taxes as a source of revenue. Table 1 summarizes the role of individual and corporate income taxes and Social Security taxes as revenue sources at the federal, state and local levels. The United States is exceptional among Western industrial nations in the degree of reliance on income taxes of various kinds as the primary federal revenue source.

To those people who have lived with the income tax for most of the twentieth century, this question may sound strange. But income is notoriously tricky to discover, track, and/or define. It is easier to hide from the tax collector than many other kinds of tax bases. For most of human history, taxes have been collected where "tax handles" can be found—a visible asset, a transaction, a border crossing.

**Table 1 Share of income and payroll taxes in US public finance**

	Percentage of revenue (unified budget)	Percentage of own source revenue
Federal (2021)		State and local (2021–22)
Individual income tax	43.5	15.5
Corporate income tax	6.6	3.3
Social Security payroll tax	42.3	
<b>All Federal income taxes</b>	<b>92.4</b>	

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Property taxes, poll taxes, sales and excise taxes, and tariffs or tolls have a much longer history than income taxes. Even today, the United States is unique among modern industrial nations in its high dependence on income and payroll taxes as a source of both central government and regional government revenues.

In many countries, sales taxes play a much bigger revenue role. Often the choice of sales rather than income tax as the primary revenue source reflected an actual or expected high degree of noncompliance with the income tax. Income taxes depend heavily on the voluntary cooperation of taxpayers and employers, backed by threats of audit and penalties for at least some tax cheaters.

If it is possible for the government to generate the paper trail necessary to administer an income tax, however, this tax has certain significant advantages. It can be a highly productive revenue source. Progressive income taxes are the only major federal or state revenue source with an elasticity greater than one, meaning that a 1 percent increase in income leads to more than a 1 percent increase in tax revenue. This tax lends itself to fine-tuning both in terms of equity and in terms of achieving social goals of encouraging desirable activities. It generates a regular flow of revenue to the government through withholding, unlike the property tax which comes in all at once for most local governments. And it even provides information that enables tax collectors to do a better job of enforcement on other taxes.

Although there are a number of taxes that fall under the heading of income tax, most of this chapter is devoted to the US federal income tax and its counterparts at the state and local level. Corporate income taxes also get some attention here, although they are a much more modest and declining source of public revenue, especially at the state level. The area of compliance and collection cost is the most contentious one in income taxation.

Creating a broad tax base for efficiency reasons requires more effort by both tax collectors and taxpayers to keep track of a variety of income flows, increasing both collection and compliance costs. On the other hand, making adjustments in the tax base to accommodate horizontal equity concerns makes the tax law more difficult to administer and more confusing for the taxpayer to comply with. A progressive rate structure, which was put in place in the interest of vertical equity, makes the tax liability somewhat harder to compute, although the use of tax tables and tax software has largely resolved that problem.

The expense of administering the federal income tax is fairly low as a percentage of revenue collected. However, the low collection cost is somewhat offset by shifting much of the cost to the taxpayer and the taxpayer's employer, who must maintain records and fill out various forms in order to comply with the tax.

Other forms of income taxes, such as payroll taxes and many state and local income taxes, are simpler to administer and to comply with for a variety of reasons. In some cases, particularly local income taxes and Social Security taxes, there is a single flat rate and most of the collection is through payroll withholding, often without a need to file a

return. In the case of many (but not all) state income taxes, once the federal return is complete, the additional effort required to file a state return is very small.

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