2-2 Unearned Income and Payments

GOALS

- Name private and governmental sources of unearned income.
- List the types of taxes levied against individuals and businesses.
- Discuss the benefits of paying taxes, both direct and indirect.

KEY TERMS

- unearned income, p. 51
- interest, p. 51
- dividends, p. 51
- transfer payments, p. 52
- in-cash payments, p. 54
- in-kind payments, p. 54
- use taxes, p. 55
- excise taxes, p. 55
- sales taxes, p. 55
- property taxes, p. 56
- public goods, p. 58

What Is Unearned Income?

Unearned income is money received from sources other than working in a job, either for yourself or for someone else. There are several sources of unearned income for individuals.

unearned income money received from sources other than working

PRIVATE SOURCES

One form of unearned income is **interest**, which is money earned on savings accounts and other funds. It is unearned because the owner does not work to receive it. A bank will pay you interest on funds you deposit into a savings account with the bank. The bank will use the deposited funds to make loans and investments and will pay you interest for the use of your money. When you put your money aside in a certificate of deposit (CD), it also accumulates interest. You can also loan money to the government by purchasing U.S. Savings Bonds. Once again, you will receive interest on this money.

interest money earned on savings accounts and other funds

Another form of unearned income is **dividends**, which are a portion of a corporation's profits distributed to stockholders. *Stockholders* are the people who buy stocks in a corporation. A *cash dividend* payment is money shared with stockholders when a corporation makes profits. Dividends may also be in the form of stock, known as *stock dividends*. While you do not receive actual cash, the added shares of stock increase your wealth.

dividends a portion of a corporation's profits distributed to stockholders

Retired people may receive pension payments or other forms of retirement benefits from employer pension funds or individual retirement accounts. Some people may receive winnings or prizes from the lottery or other contests. These are other examples of unearned income. That is, you are receiving income from sources other than working.

The Internal Revenue Service (IRS) lists some types of income as variable income. *Variable income* refers to money received from some type of activity other than from working under the direct control of another person or company. The income may be earned or unearned, depending on the situation in which it is received. *Royalties* (payments for the use of copyrighted material, such as books or songs) and rent are examples of variable income. Variable income is often unpredictable from year to year and depends on general economic conditions. Figure 2-2.1 shows different types of income as listed by the IRS.

Figure 2-2.1 Types of Income

Earned Income	Unearned Income	Variable Income
Salaries and wages	Interest	Business profits
Tips	Dividends	Rents
Commissions	Capital gains	Royalties
Bonuses	Gambling winnings	Farm income
Professional fees	Alimony	
	Social security benefits	
	Pensions	
	Annuities	
	Unemployment compensation	

Like earned income, most forms of unearned income and variable income are fully taxable. However, the tax rates may be lower than income tax rates on earned income. Because this income is not earned, it is not subject to employment taxes. Some forms of variable income are subject to employment taxes (business profits and farm income) while other forms (rents and royalties) are not subject to employment taxes.

GOVERNMENT TRANSFER PAYMENTS

transfer payments money and benefits received from local, state, or federal governments

Money and benefits received from local, state, or federal governments are called **transfer payments**. Transfer payments are made from many different programs. They increase the disposable income of those who receive them. Examples of transfer payments provided from state and federal governments are shown in Figure 2-2.2.

Figure 2-2.2 Transfer Payments

Type of Benefit:	Paid to:
Temporary assistance for needy families (TANF)	Needy families with children; varies by state
Medicaid	Low-income families
Veterans' benefits	Veterans and their families
Supplemental security income (SSI)	Low-income elderly and disabled
State-provided medical plans	Low-income residents
Social security	Retirees, disabled workers, dependents
Medicare	Retired people with social security
Unemployment compensation	Laid-off workers; varies by state
Workers' compensation	Workers injured on the job

Building Communications Skills

CRITICAL LISTENING

Critical listening involves evaluating the information you hear. The goal is to consider only the important or relevant information. Unneeded, untrue, or conflicting information is unnecessary. When you listen critically, you are able to make good decisions based on what is accurate and useful.

For example, pretend you are buying a used car. The seller is telling you about the car and its features. He tells you that the car runs great and will run for years to come. It is the best car he ever had. These statements are not useful for making a decision about whether to buy the car. Next, the seller tells you that the car was serviced regularly (and shows you the receipts), has traveled 34,000 miles, and was kept in a garage every night. Using this information can help you make a good decision.

Try It Out

1. Pair up with another student. Take turns telling each other about an experience you recently had completing a project, such as baking a cake or completing a science experiment. Detail all the steps you took from the time you started until you finished. Listen carefully to the speaker and summarize aloud in one sentence, ten words or less, what the person accomplished.
2. How can critical listening help you make good decisions?

Some transfer payments provide income to retirees. Although they have stopped working, their needs continue. Other government transfer programs provide benefits to help low-income families with medical needs or living expenses. For example, Medicaid is a program of medical aid designed for those unable to afford medical service.

In the United States, transfer payments are a "safety net" so that workers who lose their jobs, become injured, or fall victim to natural disaster will have a place to turn. Many of these benefits (other than social security and Medicare) are not intended as handouts but rather as "handups." This means they are intended as temporary help to get people back on their feet again. With social security and Medicare, which are often referred to as ***entitlement programs***, retirees have paid into the programs through payroll tax deductions during their working years.

How do government transfer payments help victims of natural disasters?

Focus On...
SOCIAL SECURITY BENEFITS

Most workers in the United States pay into the social security fund. A social security number is assigned to each person's account. Payments are made into the account through payroll deductions. These payments are matched by employers. Based on the amount paid into the account and other factors, the worker will receive monthly benefit checks when he or she retires.

Each year while paying into the fund, workers should receive a social security statement. The statement allows workers to see that earnings are being posted properly to their accounts. If you are a worker and do not receive a statement, you should request one. A statement can be requested at a local Social Security Office or at the Social Security Administration's website (www.ssa.gov).

Think Critically

1. Social security was created by law in 1938. Research the Social Security Act on the Internet. Why do you think such a program was needed? (Hint: The Great Depression started in 1929.)
2. Social security was never intended to meet the full retirement needs of someone unable to work. Rather, it is intended as supplemental income. What do you need to do to avoid depending on social security as your only form of retirement income?

in-cash payments money in the form of check, debit card, or other direct payment given to a person needing assistance

In-Cash Payments

In-cash payments are money in the form of a check, debit card, or other direct payment given to a person needing assistance. For example, after Hurricane Katrina, flood victims were given debit cards worth $1,000. They used the cards to buy food, clothing, and other items. Social security payments, unemployment benefits, and workers' compensation payments are also examples of in-cash payments. People receive checks or have direct deposits made to their checking accounts.

To receive in-cash transfer payments from the federal or state government, you must fill out an application and show need. In most cases, your need must be verified by the government agency. People who try to hide income or assets are committing fraud and may face criminal charges.

in-kind payments payments made indirectly on a person's behalf or in a form other than money

In-Kind Payments

In-kind payments are made indirectly on a person's behalf or paid in a form other than money to those in need. Examples include food stamps, rent subsidies, and vouchers that can be exchanged for goods and services.

The U.S. federal government and state governments make in-kind transfer payments. For example, Medicaid is a program in which payments are made to medical providers on behalf of those unable to afford medical services. Many people age 65 or older qualify for Medicare hospital insurance based on their own or their spouse's work record. Some people under age 65 who are disabled may also qualify.

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How are in-kind payments different from in-cash payments?

What Types of Taxes Do You Pay?

Taxes are collected from many sources. Taxes are based on consumption, income, and wealth. They may be assessed by the federal and state government, and in some cases, by county, city, and local governments as well. Some of these taxes are *direct taxes*, which means consumers pay them directly to the government. Other taxes are *indirect*, which means they are charged on goods or services bought by the consumer. In such cases, the selling business sends the collected taxes to the government.

use taxes taxes based on the use of goods and services provided by the government

TAXES BASED ON CONSUMPTION

The first type of tax is based on what consumers use or buy. Only those who purchase certain goods and services are charged these taxes. These forms of tax are considered indirect—you may not pay it directly to the government, but it is collected from you and the business sends it later. Some items, such as gasoline, may be subject to more than one type of consumption tax.

Why do states levy gasoline taxes?

Use Taxes

Use taxes are paid by people who use certain goods or services provided by the government. Those who do not use the good or service do not pay the tax. For example, people who visit a state or national park may be charged a use tax. This money is used to help pay for operation of the park. Drivers may have to pay a toll to be able to cross a bridge. This use tax helps to pay for the bridge maintenance and operation. A *gasoline tax* is another type of use tax that helps to keep the roads and highways repaired.

Excise Taxes

Another type of consumption tax is the excise tax. **Excise taxes** are charged on the purchase of specific goods, such as gasoline, cigarettes, and alcoholic beverages. They are also charged on services, such as phone service, utilities, and garbage collection. Excise taxes are usually included in the price of the product or service. They help pay for government goods and services. An excise tax on a product that is not considered essential for a normal standard of living, such as an expensive car or yacht, is called a *luxury tax*.

excise taxes taxes charged on the purchase of specific goods and services

sales taxes taxes levied on consumer purchases of goods and services

Sales Taxes

Sales taxes are charged in most states. **Sales taxes** are added to the purchase price of consumer goods and services. The sales tax is a percentage of the cost of the purchase price. If you purchase a refrigerator, clothing, or other goods subject to sales tax, the tax is added to the cost of your purchase. The retailer will collect the sales tax from the consumer and send it to the state's department of revenue. Typically, most states that have sales taxes do not tax medical services, prescriptions, and food that you prepare at home. If you eat out at a restaurant, however, the sales tax will be added to your purchase.

Sales taxes are known as *regressive taxes* because they take a larger percentage of income from lower-income people than from higher-income


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How do sales taxes affect consumers' income?

people. Because the price of a product is the same regardless of income level, the sales tax paid is also the same and is a bigger burden on lower-income people.

TAXES BASED ON INCOME

The federal government requires *income taxes* to be paid on earned and unearned income. An income tax is a direct tax paid directly to the government. It is called a *progressive tax* because the more you earn, the more you pay in tax. For example, someone with low income may pay 15 percent of their income as taxes while someone with higher income may pay 28 percent.

Businesses also pay taxes based on income. In some states, they also pay business license taxes, occupancy taxes, and various other fees to help pay for public transportation and other services. Generally, these taxes are based on income generated by the business or on the size of the business.

Most states also levy a tax based on income, and cities and counties often do too. The state and local income taxes are in addition to the federal income tax you pay. You will learn more about individual income taxes later in the chapter.

TAXES BASED ON WEALTH

property taxes wealth taxes based on the assessed value of owned real estate

Wealth taxes are another form of direct tax. They are levied against the value of the property and assets that you own. **Property taxes** are paid by those who own real estate. The tax is based on the property's *assessed value*, which is determined by the county or other taxing authority. Assessed value may not be the same as *market value*, which is the highest price for which the property would sell to a willing buyer.

In some states, businesses pay a *business personal property tax*. This tax is levied against property other than real estate, such as equipment, that is used by the business to generate income.

Figure 2-2.3 Partial List of U.S. Taxes

Alternative minimum tax	State and local income tax
Capital gains tax	Luxury tax
Corporate income tax	Property tax
U.S. estate tax	Hotel occupancy tax
U.S. excise tax	Rental car tax
Federal income tax	Recreational vehicle tax
Federal unemployment tax (FUTA)	Road usage tax (commercial trucks)
FICA (social security and Medicare tax)	Sales tax
Gasoline tax (federal and state)	State unemployment tax (SUTA)
Gift tax	Tariffs
Vehicle sales tax	Workers compensation tax
Cell phone tax (911 and other)	IRS penalties
Use tax	

Another type of wealth tax is the federal *estate tax* or the state *inheritance tax*. These taxes are levied against the estate of a person who has died or the person who inherits the deceased's money or property. In most cases, the estate must exceed $3.5 million to be subject to the tax. The estate tax laws could be reformed. Find out about recent changes by searching online.

In addition, a *gift tax* is levied by the federal government. It is paid by those who give more than $13,000 to any person within a tax year. This amount is adjusted periodically.

The U.S. government collects money through a number of taxes. Figure 2-2.3 is a partial list of those taxes.

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How are consumption taxes different from income and property taxes?

How Do You Benefit from Paying Taxes?

Paying taxes reduces the disposable income of an individual. The more taxes a person pays, the less money he or she has available to save or spend. When people have less money to spend, the economy may be affected. When people spend less on goods and services, businesses have lower sales. Lower sales may lead to lower profits. Workers may have to be laid off or dismissed from their jobs. Charitable groups may receive less money from donations. Having less money means these groups are unable to help more people in need. These are all disadvantages of paying taxes, but there are some benefits.

How do you use public goods provided by taxes collected?

DIRECT BENEFITS

Paying taxes can benefit the person making the payments and others who do not make payments. For example, social security tax provides a system of old-age, survivors, and disability insurance. Workers pay social security tax during their working years. When they retire, workers receive payments from the social security fund. This is an example of a direct benefit from paying taxes.

Taxes also provide overall benefits. **Public goods** are the goods and services provided by government. Examples include national defense, public education, police protection, national parks, and roads and highways. You benefit from the security provided by our armed forces. Taxes collected pay for military members' wages and benefits and the equipment needed to protect us. Police protection is available when you need it. Because there are various policing agencies enforcing the laws, you are able to enjoy relative peace and security.

public goods government-provided goods and services paid for by taxes

Public goods have three unique qualities:

- Everyone benefits from them (they raise the overall standard of living in a country).
- No one can be excluded from the benefits.
- People do not benefit in direct proportion to taxes paid; those who benefit the most often pay less.

INDIRECT BENEFITS

Even if you do not benefit directly, you benefit indireclty when others receive government assistance. For example, government transfer payments are funded with taxes. Because others receive a free vaccination, you are protected from the spread of illness. Providing public education to citizens produces a higher-quality workforce, giving you the benefit of better products and services.

Most individuals could not afford to pay for the government services they receive. These goods and services increase our overall standard of living. Not everyone benefits directly from every type of tax. For example, some people may never visit a state or national park. However, everyone benefits from some government services.

You must consider that taxes paid benefit society as a whole. Without the benefit of the goods and services provided because of taxes, citizens would be worse off.

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How are the direct benefits of paying taxes different from the indirect benefits?