Taxes are obviously necessary in order for a society to provide [public goods and services](http://economics.about.com/od/public-goods-etc/ss/Public-Goods-Common-Resources-And-Club-Goods.htm) to its citizens. Unfortunately, taxes also impose costs on citizens both directly (because if an individual gives money to the government, she doesn't have the money any more) and indirectly (because taxes introduce inefficiency, or [deadweight loss](http://economics.about.com/od/d/g/deadweight_loss.htm)) into markets. Because the inefficiency that taxes introduce grows more than proportional to the amount of a tax, it makes sense for the government to structure taxes so that a lot of markets get taxed a little bit rather than so that a few markets get taxed a lot. Therefore, a number of different taxes exist, and they can be categorized in a number of ways. Let's take a look at some of the common tax breakdowns.

**Business Taxes versus Personal Taxes**

Because businesses and households are the main players in the [circular flow of the economy](http://economics.about.com/od/economics-basics/ss/The-Circular-Flow-Model.htm), it makes sense that some taxes are levied on businesses and some on households. Taxes on businesses are usually calculated as a percentage of the [profits](http://economics.about.com/od/production/ss/Calculating-Profit.htm) of the businesses, or what's left after the company pays its suppliers, workers, etc. and also after it takes accounting deductions for things like depreciation of its assets. (In other words, the tax is a percentage of what's left over, not a percentage of what the company brings in in[revenue](http://economics.about.com/od/production/ss/Introduction-To-Revenue.htm).) This means that suppliers and workers are effectively paid with pre-tax dollars, but that the profits are taxed before they are distributed to shareholders or other owners. That said, corporations may end up indirectly paying other types of taxes during the course of their business activities. These taxes could include property taxes on land or buildings that a company owns, customs duties and tariffs that are charged on production inputs that come from foreign countries, payroll taxes on a company's employees, and so on.

Personal taxes, on the other hand, are levied on individuals or households. Unlike business taxes, personal taxes are generally not levied on the "profits" of a household (how much a household has left over after paying for what it buys) but rather on the revenue of a household, or what the household brings in in income. It's not surprising, then, the the most prevalent personal tax is an income tax. That said, personal taxes can also be levied on consumption, so let's take a look at income taxes versus consumption taxes.

An income tax, not surprisingly, is a tax on the money that an individual or household makes. This income can either come from labor income such as wages, salaries, and bonuses or from investment income such as interest, dividends, and capital gains. Income taxes are generally stated as a percentage of income, and this percentage can vary as the amount of a household's income varies. (Such taxes are referred to as regressive and progressive taxes, and we will discuss them shortly. Also, capital gains are generally taxed at a different rate than other income.) In addition, income taxes are often subject to what are known as tax deductions and tax credits.

A tax deduction is an amount that is subtracted from the amount that is counted as income for tax purposes. Common tax deductions are those for interest paid on home mortgages and donations to charity, for example. This doesn't mean that a household gets back the entire amount of the interest or the donation, however, since a tax deduction just means that those amounts aren't subject to the income tax. A tax credit, on the other hand, is an amount that is subtracted directly from a household's tax bill. To illustrate this difference, consider a household with an income tax rate of 20%. A $1 tax deduction means that the household's taxable income decreases by $1, or that the household's tax bill deceases by 20 cents. A $1 tax credit means that the household's tax bill decreases by $1.

Consumption taxes, on the other hand, are levied when an individual or household buys stuff. The most common consumption tax (in the U.S. at least) is a sales tax, which is levied as a percentage of the price of most items that are sold to consumers. Some common exceptions to the sales tax are grocery items and clothing, for reasons that we will discuss later. Sales taxes are usually levied by state governments, which means that rate differ from one state to the next. (Some states even have a sales tax of zero percent!) In some other countries, the sales tax is replaced by the quite similar value-added tax. (The main difference between a sales tax and a value-added tax is that the latter is levied at each stage of production and is thus levied on both businesses and households.)

Consumption taxes can also take the form of excise or luxury taxes, which are taxes on specific items (cars, alcohol, etc.) at rates that may differ from the overall sales tax rate. Many economists feel that consumption taxes are more efficient than income taxes in fostering economic growth

Taxes can also be categorized as either regressive, proportional, or progressive, and the distinction has to do with the behavior of the tax as the taxable base (such as a household's income or a business' profit) changes:

* A regressive tax is a tax where lower-income entities pay a higher fraction of their income in taxes than do higher-income entities. (Regressive taxes can also be thought of as taxes where the marginal tax rate is less than the average tax rate. This will be discussed in more detail later.)
* A proportional tax (sometimes called a flat tax) is a tax where everyone, regardless of income, pays the same fraction of income in taxes. (Proportional taxes can also be thought of as taxes where marginal and average tax rates are the same.)
* A progressive tax is a tax where lower-income entities pay a lower fraction of their income in taxes than do higher-income entities. (Progressive taxes can also be thought of as taxes where the marginal tax rate is higher than the average tax rate.)

In addition, a lump-sum tax is a tax where everyone pays the same dollar amount in taxes, regardless of income. A lump-sum tax is therefore a particular kind of regressive tax, since a fixed amount of money is going to be a higher fraction of income for lower-income entities and vice versa.

Most societies have progressive income-tax systems, since it is (rightly or not) viewed as fair for higher-income entities to contribute a higher fraction of their income in taxes, since they are spending a much lower fraction of their incomes on basic necessities. Progressive income-tax systems also partially balance out other tax systems that are likely to be regressive in nature. For example, an excise tax on cars is likely to be a regressive tax since lower-income households spend a greater fraction of their income on cars, and thus on the tax on cars. Lower-income households also tend to spend larger fractions of their incomes on necessities such as food and clothing, so a sales tax on such items would also be quite regressive. (This is why it's typical for unprepared foods to be exempt from sales taxes, and in some states clothing is exempt from sales tax as well.)

The main function of most taxes is to raise revenue that the government can use to provide goods and services to the public. Taxes that have this goal are referred to as "revenue taxes." Other taxes, however, are put in place not specifically to raise revenue but instead to correct for negative externalities, or "bad" behaviors where production and consumption has negative side effects for society. Such taxes are often referred to as "sin taxes," but in more precise economic terms are known as ["Pigovian taxes,"](http://economics.about.com/od/incometaxestaxcuts/a/pigouvian_tax.htm) named after economist Arthur Pigou.

Because of their differing objectives, revenue taxes and sin taxes differ in their desired behavioral responses from producers and consumers. Revenue taxes, on one hand, are viewed as best or most efficient when people don't change their work or consumption behavior very much and instead let the tax just act as a transfer to the government. (A revenue tax is said to have low deadweight loss in this case.) A sin tax, on the other hand, is viewed as best when it has a large effect on the behavior of producers and consumers, even if it doesn't raise very much money for the government.