

Applications on Demand, Supply, and Government Policies

Part II

EE211

Taxes

- ▶ The government levies taxes on many goods & services to raise revenue to pay for national defense, public schools, etc.
- ▶ The government can make buyers or sellers pay the tax.
- ▶ The tax can be a % of the good's price, or a specific amount for each unit sold.
 - For simplicity, we analyze per-unit taxes only.

The Economics of Taxes: A Preliminary View

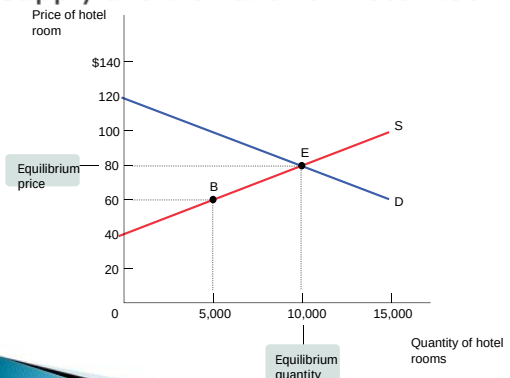
▶ An **excise tax** is a tax on sales of a good or service.

Excise taxes:

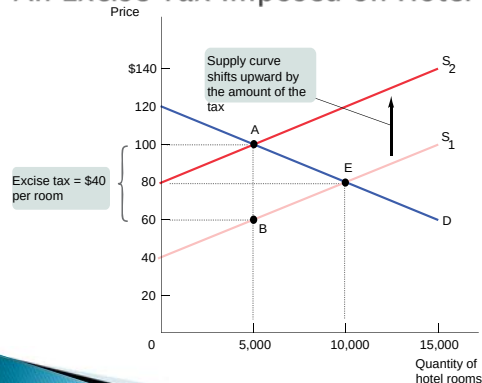
- raise the price paid by buyers and
- reduce the price received by sellers and drive a **wedge** between the two.

Ex.: For example, there are excise taxes on gasoline, cigarettes, and foreign-made trucks, and many local governments impose excise taxes on services such as hotel room rentals.

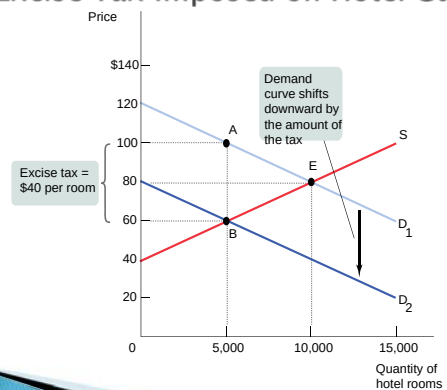
Supply and Demand for Hotel Rooms



An Excise Tax Imposed on Hotel Owners



An Excise Tax Imposed on Hotel Guests



Tax Incidence

The **incidence** of a tax is a measure of who really pays it.

Who really bears the tax burden (higher prices to consumers and lower prices to sellers) does not depend on who officially pays the tax. ***Depending on the shapes of supply and demand curves, the incidence of an excise tax may be divided differently.***

The wedge between the demand price and supply price becomes the government's "**tax revenue**".



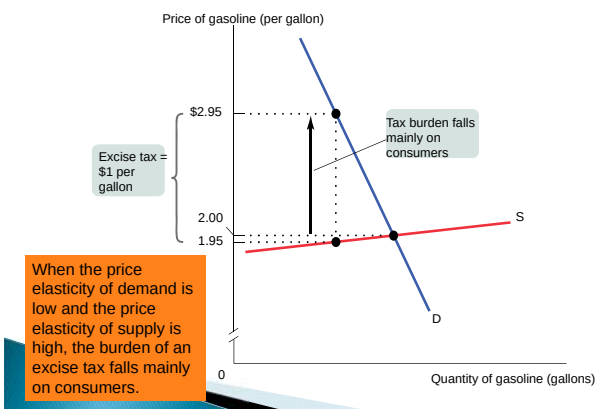
When an Excise Tax is paid mainly by consumers

Two key assumptions are reflected in the shapes of the supply and demand curves in the example:

- ▶ The price elasticity of demand for gasoline is assumed to be very low, so the demand curve is relatively steep
- ▶ The price elasticity of supply for gasoline is assumed to be very high, so the supply curve is relatively flat



An Excise Tax Paid Mainly By Consumers



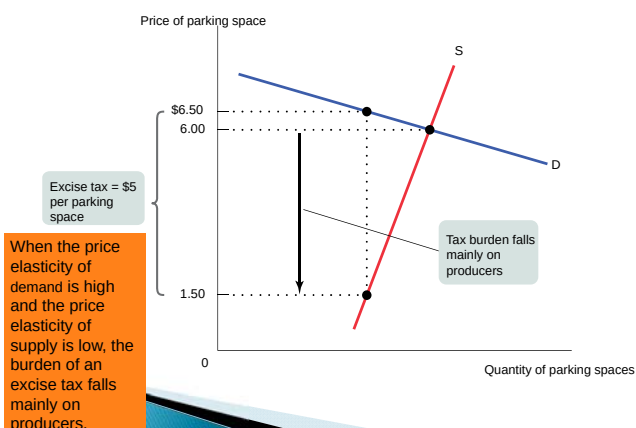
When an Excise Tax is paid mainly by producers

Two key assumptions are reflected in the shapes of the supply and demand curves in the example:

- ▶ The price elasticity of supply for parking is assumed to be very low, so the supply curve is relatively steep
- ▶ The price elasticity of demand for parking is assumed to be very high, so the demand curve is relatively flat



An Excise Tax Paid Mainly by Producers



Tax Incidence - Putting it together

When the price elasticity of demand is higher than the price elasticity of supply, an excise tax falls mainly on producers.

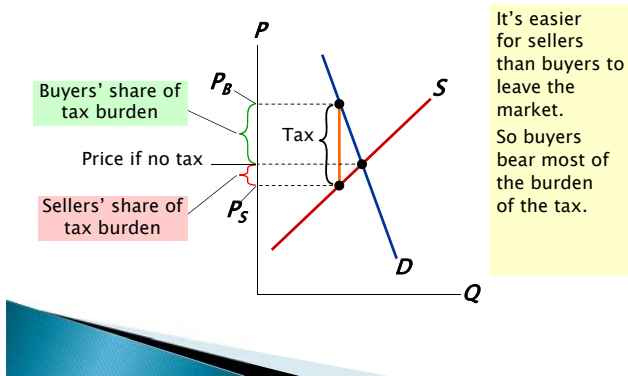
When the price elasticity of supply is higher than the price elasticity of demand, an excise tax falls mainly on consumers.

So elasticity—not who officially pays the tax—determines the incidence of an excise tax.



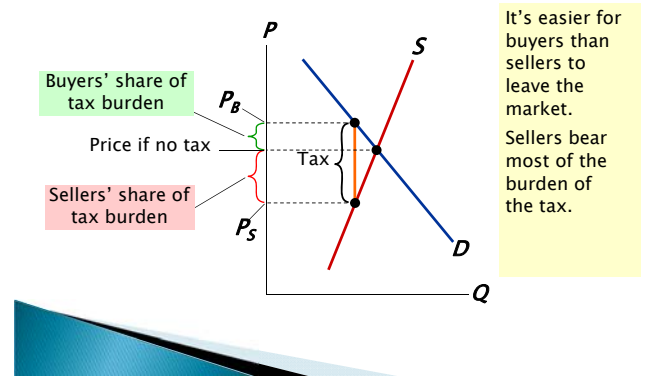
Elasticity and Tax Incidence

CASE 1: Supply is more elastic than demand

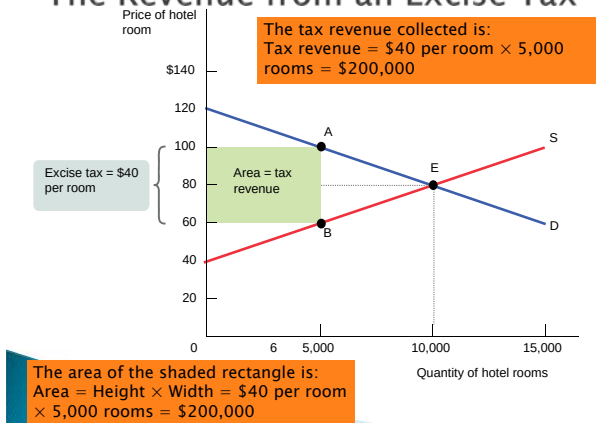


Elasticity and Tax Incidence

CASE 2: Demand is more elastic than supply



The Revenue from an Excise Tax

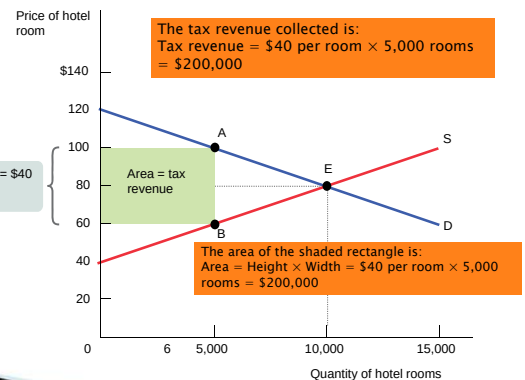


The Benefits and Costs of Taxation

The Revenue from an Excise Tax

The general principle is:

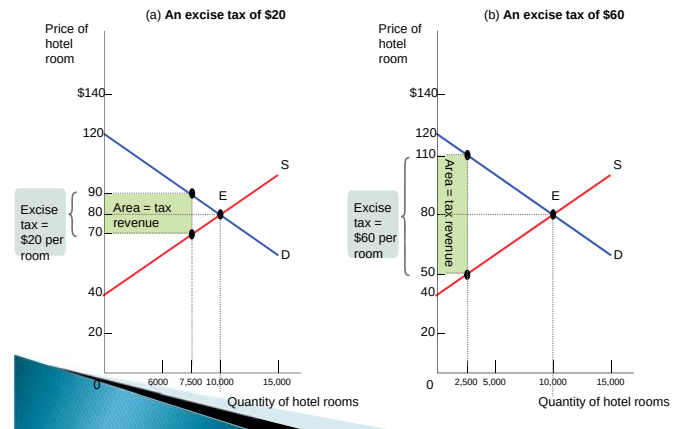
- ▶ The revenue collected by an excise tax is equal to the area of the rectangle whose height is the tax wedge between the supply and demand curves and whose width is the quantity transacted under the tax.



Tax Rates and Revenue

- ▶ A **tax rate** is the amount of tax people are required to pay per unit of whatever is being taxed.

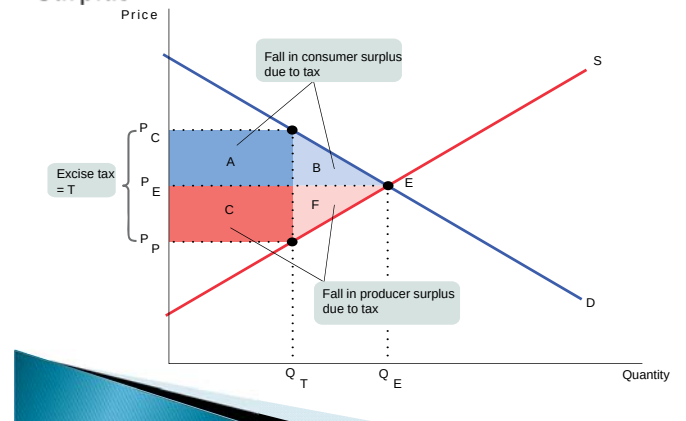
Tax Rates and Revenue



A Tax Reduces Consumer and Producer Surplus

- ▶ A fall in the price of a good generates a gain in consumer surplus.
 - ▶ Similarly, a price increase causes a loss to consumers.
 - ▶ So it's not surprising that in the case of an excise tax, the rise in the price paid by consumers causes a loss.
 - ▶ Meanwhile, the fall in the price received by producers leads to a fall in producer surplus.
- A tax reduces both, the CS and the PS

A Tax Reduces Consumer and Producer Surplus



The Deadweight Loss of a Tax

- ▶ The deadweight loss caused by the tax represents the total surplus lost to society because of the tax—that is, the amount of surplus that would have been generated by transactions that now do not take place because of the tax.

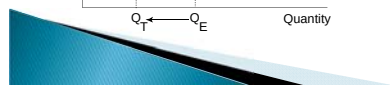
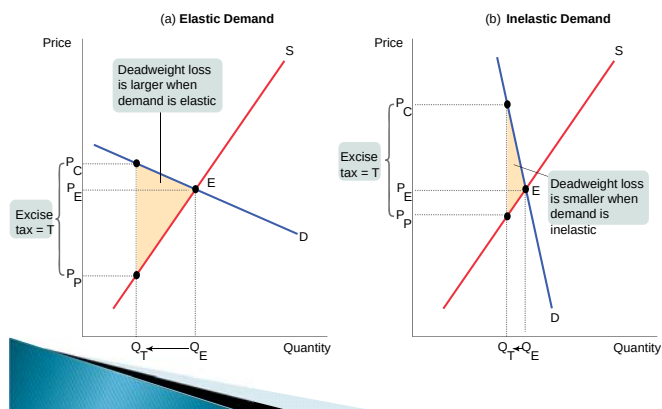
Cost of Collecting Taxes

- ▶ The **administrative costs** of a tax are the resources used by government to collect the tax, and by taxpayers to pay it, over and above the amount of the tax, as well as to evade it.
- ▶ The total inefficiency caused by a tax is the **sum of its deadweight loss and its administrative costs**. The general rule for economic policy is that, other things equal, a tax system should be designed to minimize the total inefficiency it imposes on society.

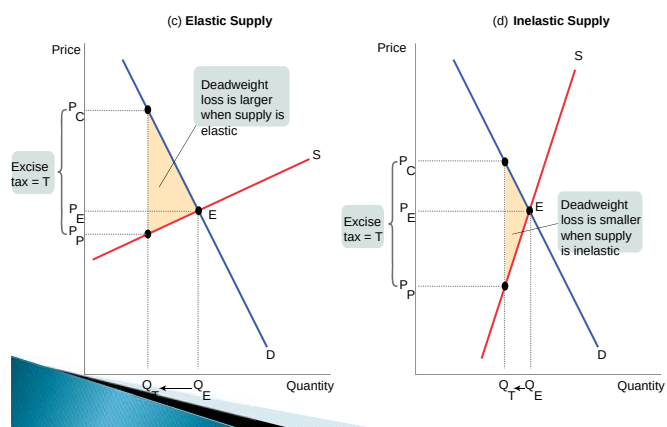
Elasticities and the Deadweight loss of a Tax



Deadweight Loss and Elasticities



Deadweight Loss and Elasticities



Deadweight Loss and Elasticities

- ▶ To minimize the efficiency costs of taxation, one should **choose to tax only those goods for which demand or supply, or both, is relatively inelastic.**
- ▶ For such goods, a tax has little effect on behavior because behavior is relatively unresponsive to changes in the price.



Deadweight Loss and Elasticities

- ▶ In the extreme case in which demand is perfectly inelastic (a vertical demand curve), the quantity demanded is unchanged by the imposition of the tax. As a result, the tax imposes no deadweight loss.
- ▶ Similarly, if supply is perfectly inelastic (a vertical supply curve), the quantity supplied is unchanged by the tax and there is also no deadweight loss.



Deadweight Loss and Elasticities

- ▶ If the goal in choosing whom to tax is to **minimize deadweight loss**, then taxes should be imposed on goods and services that have **the most inelastic response**—that is, goods and services for which consumers or producers will change their behavior the least in response to the tax.



Tax Fairness and Tax Efficiency

Two principles:

- ▶ According to the **benefits principle** of tax fairness, those who benefit from public spending should bear the burden of the tax that pays for that spending.
 - ▶ According to the **ability-to-pay principle** of tax fairness, those with greater ability to pay a tax should pay more tax.
- A **lump-sum tax** is the same for everyone, regardless of any actions people take.



Tax Fairness and Tax Efficiency

The fairest taxes in terms of the ability-to-pay principle, distort incentives the most and perform badly on efficiency grounds.

- ▶ In a well-designed tax system, there is a **trade-off between equity and efficiency**: the system can be made more efficient only by making it less fair, and vice versa.



Understanding the Tax System

- ▶ The **tax base** is the measure or value, such as income or property value, that determines how much tax an individual or firm pays.
- ▶ The **tax structure** specifies how the tax depends on the tax base.
- ▶ Once the tax base has been defined, the next question is how the tax depends on the base. The simplest tax structure is a **proportional tax**, also sometimes called a *flat tax*, which is the same percentage of the base regardless of the taxpayer's income or wealth.



Sources:

- ▶ Krugman, P. and Robin Wells (2008)
- ▶ Lipsey, Ragan, and Storer (2008)

