EE441 Economics of Public Expenditure

14. Taxation and Income Distribution

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Vocabulary

- Tax Analysis – use of economic theory to analyze impact of taxes
- Equity and Efficiency – how do taxes affect the distribution of income, how do taxes affect economic efficiency
- Statutory Incidence - who is legally responsible for tax (who writes the check)
- Economic Incidence – whose purchasing power is reduced by the tax
- Tax Shifting – extent that *statutory* and *economic* incidence differ
- Partial Equilibrium Models- look at a *single* market, appropriate when market for commodity is small relative to economy

Tax Incidence: General Remarks

- Only people can bear taxes
  - *Functional distribution of income* - the way income is distributed among people when they are classified according to the inputs they supply to the production process (eg., landlords, capitalists, laborers).
  - *Size distribution of income* – They way that total income is distributed across income classes.
- Both sources (inputs) and uses (consumption) of income should be considered
  - Eg., a tax on wine. Suppose that poor people spend a relatively large proportion of their incomes on wine, but the vineyards tend to be owned by the rich. Then on the uses of income side, the tax redistributes income away from the poor, but on the sources side, it redistributes income away from the rich. The overall incidence depends on how both the sources and uses of income are affected
- Market structure
- Elasticities of supply and demand
- Mobility of factors of production
- Tax salience/visibility

Tax Progressiveness Can Be Measured in Several Ways

- Proportional tax system
  - A tax system under which an individual's average tax rate is the same at each level of income.
- Progressive tax system
  - A tax system under which an individual's average tax rate increases with income.
- Regressive tax system
  - A tax system under which an individual's average tax rate decreases with income.