The Benefits of Taxation

- The benefits of taxation are the goods and services that government provides.
  - Provides a stable set of institutions and rules
  - Promotes effective and workable competition
  - Corrects for externalities
  - Creates an environment that fosters stability and growth
  - Provides public goods
  - Adjusts for undesirable market results

Two Principles of Taxation

- The benefits principle – the individuals who receive the benefit of the good or service should pay the tax necessary to supply the good.
- The ability-to-pay principle – individuals who are most able to bear the burden of the tax should pay.

Who Bears the Burden of a Tax?

- The supply and demand framework gives the answer to this question.
Burden Depends on Relative Elasticity

- The person who *physically* pays the tax is not necessarily the person who bears the burden of the tax.
- The burden of the tax is rarely shared equally since elasticities are rarely equal.

Burden Depends on Relative Elasticity

- The more inelastic one’s relative supply and demand, the larger the tax burden one will bear.

Who Bears the Burden of a Tax?

- If demand is more inelastic than supply, consumers will pay the higher share.
- If supply is more inelastic than demand, suppliers will pay the higher share.
Who Bears the Burden of a Tax?

Demand is inelastic

Supplier pays the tax

Demand shifts

Price of luxury boats

Quantity of luxury boats

Who Bears the Tax Burden?

Demand is elastic

Equal burden

Supplier pays the tax

Demand shifts

Price of luxury boats

Quantity of luxury boats

Who Bears the Tax Burden?

Demand is inelastic

Supplier pays the tax

Supply shifts

Price of luxury boats

Quantity of luxury boats

Who Bears the Tax Burden?

Consumer pays the tax

Demand shifts

Price of luxury boats

Quantity of luxury boats

Who Bears the Tax Burden?

Consumer pays the tax

Supply shifts

Price of luxury boats

Quantity of luxury boats
Who Pays Versus Who Bears the Burden of a Tax
• The burden of a tax is independent of who physically pays the tax.

Tax Incidence and Current Policy Debates
• The analysis of tax incidence is helpful when discussing current policy debates.

Social Security Taxes
• Both employer and employee contribute the same percentage of before-tax wages to the Social Security fund.

Social Security Taxes
• The fact that both the employer and employee contribute the same percentage does not mean they share the burden equally.
Social Security Taxes
- On average, labor supply tends to be less elastic than labor demand, so the Social Security tax burden is primarily on employees.

Sales Taxes
- Sales taxes are those paid by retailers on the basis of their sales revenue.
- Since sales taxes are broadly defined, consumers find it hard to substitute.
- Demand is inelastic so consumers bear the greater burden of the tax.

Sales Taxes
- As consumers increase purchases on the internet where sales are not taxed, retail stores will bear a greater burden of the sales tax.