

Burden of Tax



7-3

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.

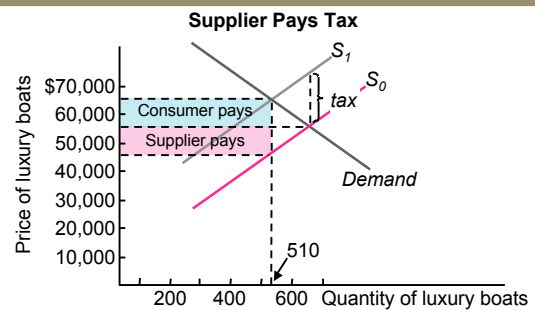


Burden Depends on Relative Elasticity

- 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.



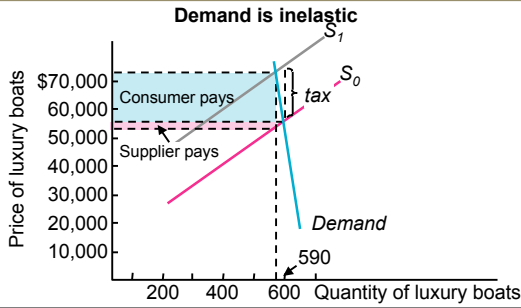
Who Bears the Burden of a Tax?



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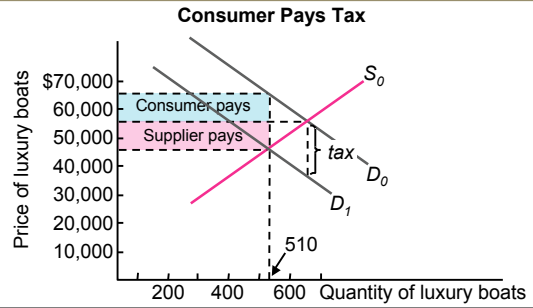
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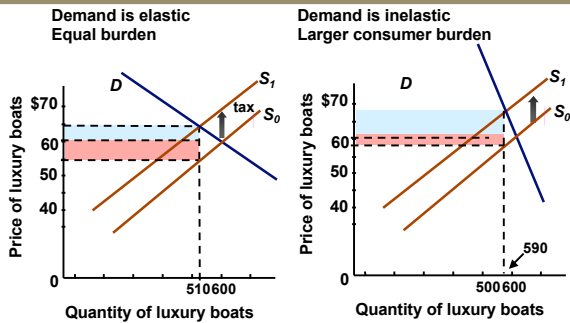
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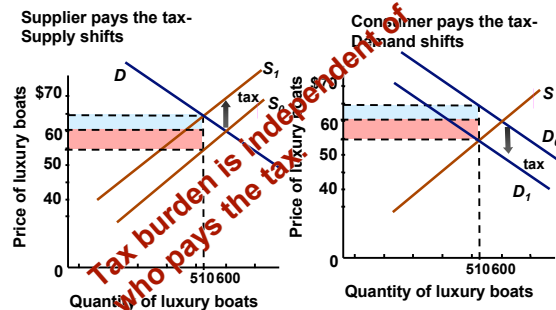
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Who Bears the Tax Burden?



Who Bears the Tax Burden?





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.