Cost of Taxation

Chapter 7-2

Taxation and Government

• For government to operate, it must tax.
• For the market to work, it needs the government.
• Tax rates depend on what goods and services government provides.

How Much Should Government Tax?

• To answer this, we must know the costs and benefits of taxation.
The Costs of Taxation

• The costs of taxation include:
  – The direct cost of the revenue paid to government
  – The loss of consumer and producer surplus caused by the tax
  – The cost of administering the tax codes.

The Costs of Taxation

• A tax paid by the supplier shifts the supply curve up by the amount of the tax.

The Costs of Taxation

• When government raises taxes, there is a loss of consumer and producer surplus that is not gained by government.
  This is known as deadweight loss.
The Costs of Taxation

• Graphically the deadweight loss is shown on a supply-demand curve as the welfare loss triangle.

The Costs of Taxation

• The welfare loss triangle – a geometric representation of the welfare loss in terms of misallocated resources caused by a deviation from a supply-demand equilibrium.
A per unit tax \( t \) paid by the suppliers shifts the supply curve from \( S_0 \) to \( S_1 \), and increases price to \( P_1 \) and decreases quantity to \( Q_1 \).

Consumer surplus is \( A+B+C \) before the tax and \( A \) after the tax.

Producer surplus is \( D+E+F \) before the tax and \( F \) after the tax.

Government revenue is \( B+D \)

Deadweight loss is \( C+E \)

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The Costs of Taxation

- The other costs of taxation are the administrative costs of compliance.
- Resources are used by the government to administer the tax code and by citizens and businesses to comply with it.