

**IF YOU PAY THE TAX,DO YOU
BEAR THE BURDEN OF THE TAX
... OR CAN YOU PASS IT ON?**

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Taxes

- Efficient governments levy taxes to raise revenue to pay for public goods.
- Public goods cannot be supplied by private firms in competitive markets, as people who do not pay for a public good can still consume it. Lots of nonpayers
 → firm revenue ↓ → firm profit ↓
 → too few public goods produced and consumed.

Are Taxes Necessary?

- Absolutely!
- Without taxes—no government.
- Examples are Justice, Defense, Public Health Services, Roads, and Education.

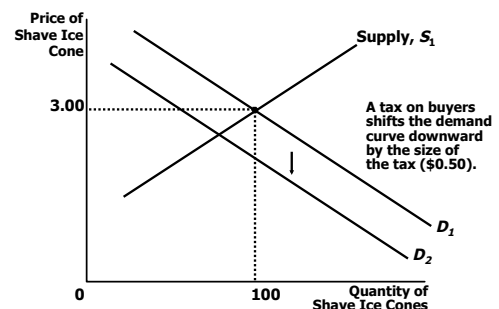
What are some potential impacts of taxes?

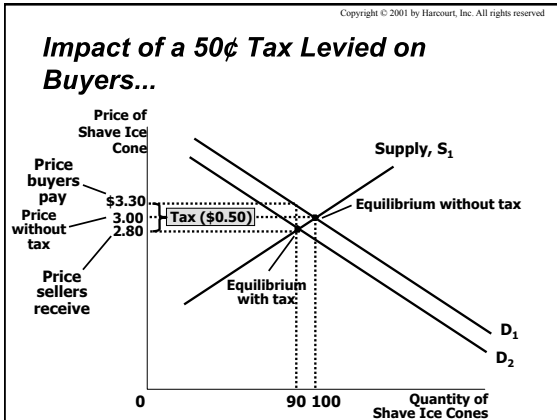
- ◆ Taxes are a drag on market activity.
- ◆ Taxes increase the total price of a good. The Law of Demand tells us that the quantity demanded falls as the price increases.
- ◆ Buyers and sellers share the tax burden.

Taxes

- ◆ Tax incidence is the study of who “bears the burden” of a tax.
- ◆ Taxes induce a change in equilibrium in competitive markets.
- ◆ Buyers pay a higher price and sellers receive a lower net price, regardless of whom the tax is levied on.

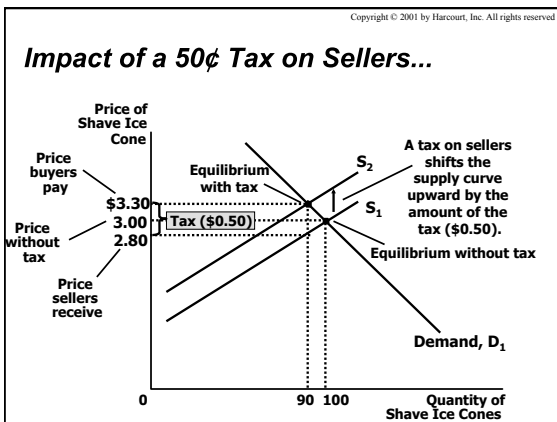
Impact of a 50¢ Tax Levied on Buyers...





What is the impact of a tax?

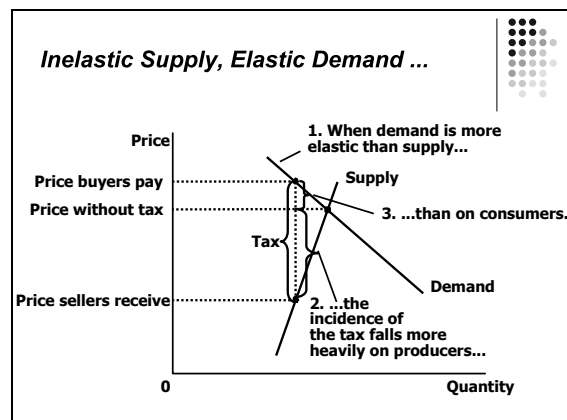
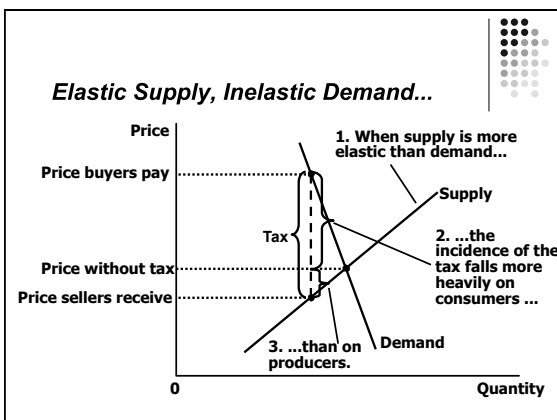
- ◆ Taxes discourage market activity.
- ◆ When a good is taxed, the price paid by buyers increases and the quantity sold falls.
- ◆ Buyers and sellers usually SHARE the tax burden.



The Incidence of a Tax

- ◆ In what proportions is the burden of the tax divided?
- ◆ How do the effects of taxes levied on sellers compare to those levied on buyers?

The answers to these questions depend on the elasticity of demand and the elasticity of supply.



So, how is the burden of the tax divided?

The burden of a tax falls more heavily on the side of the market that is less elastic.

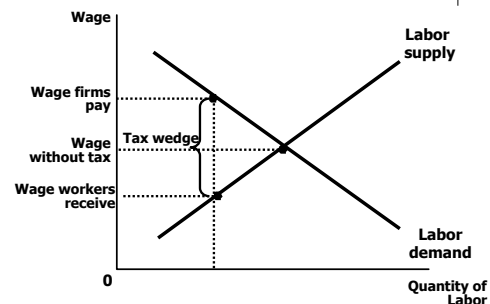
Federal Payroll Taxes

- Social Security and Medicare spending are funded by payroll taxes.
- Employee “pays” 7.65% of paycheck.
- Employer “pays” 7.65% of paycheck.
- SS tax (6.2%) is levied up to \$102,000 of labor income and Medicare (1.45%) on ALL labor income—no upper limit.
- So each party “pays” 50% of the overall tax.
- BUT: Who really “bears the burden” for Social Security and Medicare???

Incidence of Payroll Tax??

- Labor Supply for a single parent with two young children: Inelastic.
- Labor Demand: Much more elastic.
- Workers “bear the burden” of over 90 percent of the Social Security Tax even though they directly “pay” only 50 percent of it.
- Why the difference? The presence of SS-Medicare tax leads to a decline in the equilibrium wage rate.

A Payroll Tax



Summary

- ◆ Taxes are needed to raise revenue to pay for public goods.
- ◆ When the government levies a tax on a good, the equilibrium quantity of the good transacted falls.
- ◆ A tax on a good places a wedge between the price paid by buyers and the price received by sellers.

Summary

- ◆ The incidence of a tax refers to who bears the burden of a tax.
- ◆ The incidence of a tax does not depend on who actually pays the tax to the government.
- ◆ The incidence of the tax depends on the relative price elasticities of supply and demand in the market.