

Tashkent State University of Economics

Prof. Obid Baratov

Treasure system of Uzbekistan

Lecture#4: Application of tax theory to tax policy

Tashkent

The Economics of Taxation

- ▶ The primary vehicle that the government uses to finance itself is taxation.
- ▶ Taxes may be imposed on transactions, institutions, property, meals, and other things, but in the final analysis they are paid by individuals or households.

Taxes: Basic Concepts

- ▶ The *tax base* is the measure or value upon which a tax is levied.
- ▶ The *tax rate structure* is the percentage of a tax base that must be paid in taxes—25% of income, for example.

Proportional, Progressive, and Regressive Taxes

- ▶ A *proportional tax* is a tax whose burden is the same proportion of income for all households.

Proportional, Progressive, and Regressive Taxes

- ▶ A *progressive tax* is a tax whose burden, expressed as a percentage of income, increases as income increases.

Proportional, Progressive, and Regressive Taxes

- ▶ A *regressive tax* is a tax whose burden, expressed as a percentage of income, falls as income increases.
- ▶ *Excise taxes* (taxes on specific commodities) are regressive. The retail sales tax is also regressive.

Proportional, Progressive, and Regressive Taxes

The Burden of a Hypothetical 5% Sales Tax Imposed on Three Households with Different Incomes

HOUSEHOLD	INCOME	SAVING RATE, %	SAVING	CONSUMPTION	5% TAX ON CONSUMPTION	TAX AS A % OF INCOME
A	\$ 10,000	20	\$ 2,000	\$ 8,000	\$ 400	4.0
B	20,000	40	8,000	12,000	600	3.0
C	50,000	50	25,000	25,000	1,250	2.5

Marginal versus Average Tax Rates

- ▶ The *average tax rate* is the total amount of tax you pay divided by your total income.
- ▶ The *marginal tax rate* is the tax rate you pay on any additional income you earn.

Marginal versus Average Tax Rates

Individual Income Tax Rates, 2003

MARRIED FILING JOINTLY

TAXABLE INCOME	TAX RATE
\$0 - 14,000	10%
\$14,001 – 56,800	15%
\$56,801 – 114,650	25%
\$114,651 – 174,700	28%
\$174,701 – 311,950	33%
More than \$311,950	35%

Individual Income Tax Rates, 2003

SINGLE

TAXABLE INCOME	TAX RATE
\$0 – 7,000	10%
\$7,001 – 28,400	15%
\$28,401 – 68,800	25%
\$68,801 – 143,500	28%
\$143,501 – 311,950	33%
More than \$311,950	35%

Marginal versus Average Tax Rates

- ▶ All taxpayers can subtract the *personal exemption* (\$3,050 in 2003), and the *standard deduction* (\$4,750 in 2003).
- ▶ Income is taxed in slices according to the income tax rates established by the government.

Marginal versus Average Tax Rates

- ▶ Marginal tax rates influence behavior. Decisions about how much to work and how much to invest depends in part on the after-tax return.

Tax Equity

- ▶ One theory of fairness is called the *benefits-received principle*, which holds that taxpayers should contribute to government (in the form of taxes) in proportion to the benefits that they receive from public expenditures.

Tax Equity

- ▶ Another theory of fairness is called the *ability-to-pay principle*, which holds that citizens should bear tax burdens in line with their ability to pay taxes.
- ▶ Two principles follow: *horizontal equity* and *vertical equity*.

Horizontal and Vertical Equity

- ▶ **Horizontal equity** holds that those with equal ability to pay should bear equal tax burdens.
- ▶ **Vertical equity** holds that those with greater ability to pay should pay more.

What is the “Best” Tax Base?

- ▶ The three leading candidates for best tax base are:
 - ▶ Income,
 - ▶ Consumption, and
 - ▶ Wealth

What is the “Best” Tax Base?

- ▶ Income—to be precise, *economic income*—is anything that enhances your ability to command resources.

Economic Income = Consumption + Change in Net Worth

- In economic terms, income is income, regardless of source and use.

What is the “Best” Tax Base?

- ▶ Consumption is the total value of things that a household consumes in a given period.
- ▶ Wealth, or net worth, is the value of all the things you own after your liabilities are subtracted.

$$\text{Net Worth} = \text{Assets} - \text{Liabilities}$$

Consumption as the Best Tax Base

- ▶ If we want to redistribute well-being, the tax base should be consumption because consumption is the best measure of well-being.

Consumption as the Best Tax Base

- ▶ Supporters of consumption as the tax base argue that a tax on income discourages saving by taxing savings twice. It also distorts the choice between consumption and saving.
- ▶ Double taxing also reduces the saving rate and the rate of investment—and ultimately the rate of economic growth.

Income as the Best Tax Base

- ▶ Supporters of the use of income as the tax base argue that your ability to pay is your ability to command resources.
- ▶ It is your income that enables you to save or consume, and it is income that should be taxed regardless of its sources and uses.

Wealth as the Best Tax Base

- ▶ Supporters of the use of wealth as the tax base argue that the real power to command resources comes not from income but from accumulated wealth.