

Tashkent State University of Economics

Prof. Obid Baratov

Treasure system of Uzbekistan

Lecture#8: Tax theory and tax policy

Tashkent

The Gift and Estate Tax

- ▶ A person's *estate* is the property that a person owns at his or her death.
- ▶ An *estate tax* is a tax on the total value of a person's estate regardless of how it is distributed.

Tax Incidence: Who Pays?

- ▶ ***Tax incidence*** refers to the ultimate distribution of a tax's burden.
- ▶ ***Sources side/uses side***: The impact of a tax may be felt on one or the other or on both sides of the income equation. Either income falls or the prices of goods and services rise.

Tax Incidence: Who Pays?

- ▶ ***Tax shifting*** occurs when households can alter their behavior and do something to avoid paying the tax.
- ▶ Final price changes in input and output markets determine the ultimate burden of the tax.

Tax Incidence: Who Pays?

- ▶ A tax such as the retail sales tax, which is levied at the same rate on all consumer goods, is harder to avoid, and therefore to be shifted.
- ▶ Broad-based taxes are less likely to be shifted and more likely to “stick” where they are levied than “partial taxes” are.

The Incidence of Payroll Taxes

- ▶ In 2003, 40 percent of federal revenues came from social security taxes, also called “payroll taxes.”
- ▶ The payroll tax may lead firms to substitute capital for labor, and perhaps to cut production due to higher labor costs.

The Incidence of Payroll Taxes

- ▶ If the payroll tax reduces the demand for labor, wages will decrease, and part of the tax is thus passed on to the workers.

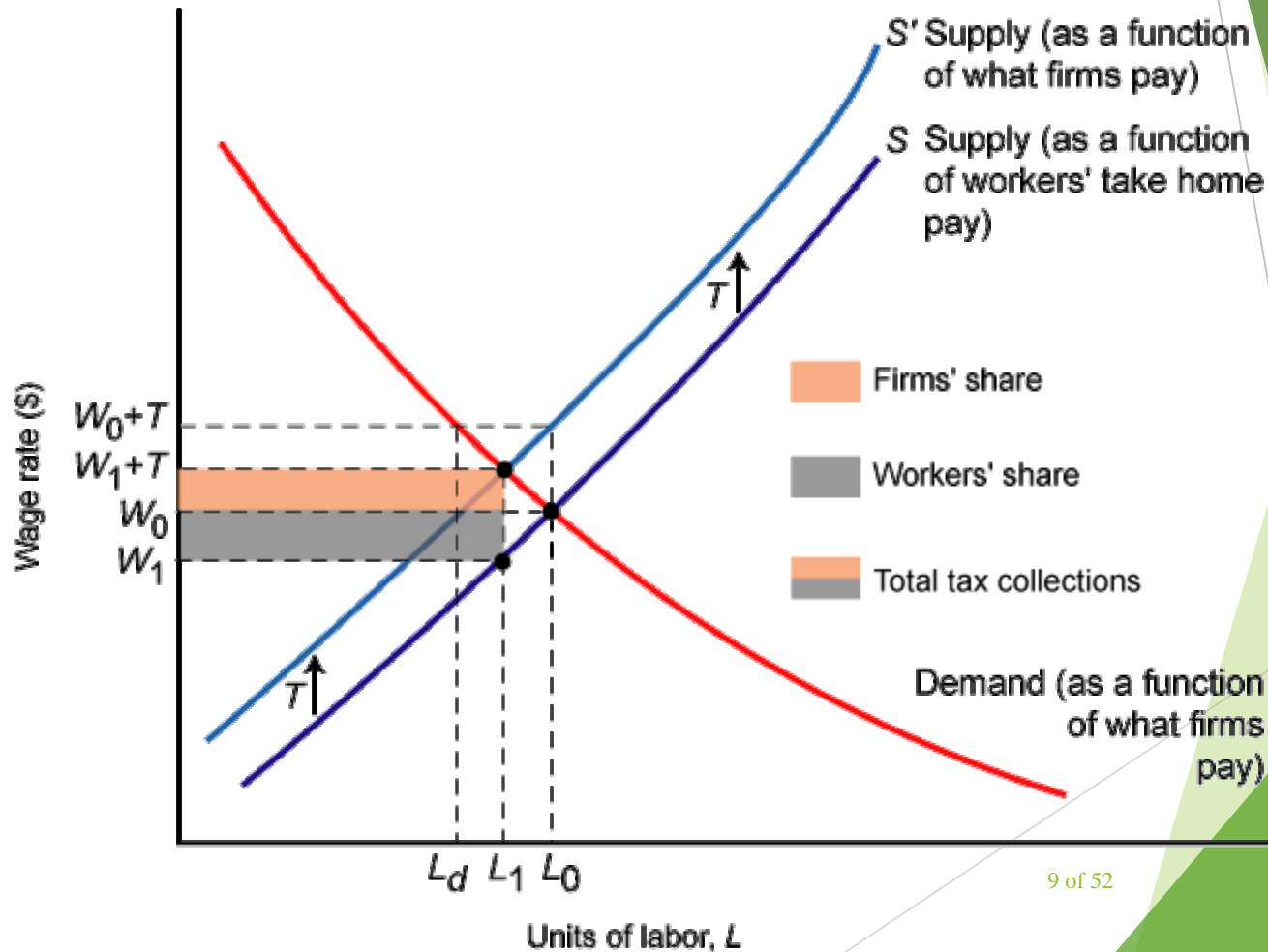
Labor Supply and Labor Demand Curves in Perfect Competition



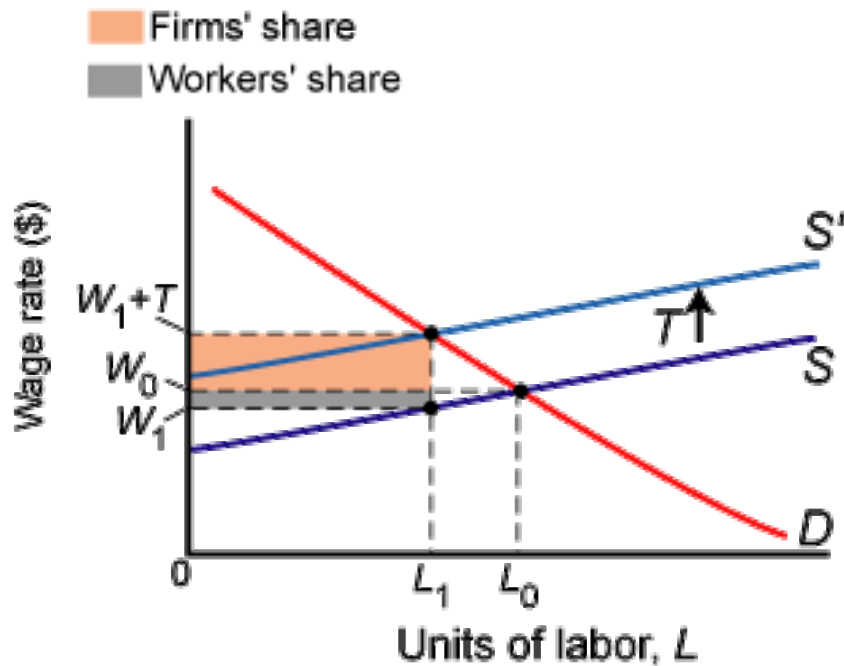
- ▶ The demand for labor depends on its productivity ($W = MRP_L$). Its shape depends on how responsive firms are to wage changes.
- ▶ The shape of the labor supply curve depends on the relative strengths of income and substitution effects.

Imposing a Payroll Tax: Who Pays?

Incidence of a Per Unit Payroll Tax in a Competitive Labor Market



Imposing a Payroll Tax: Who Pays?



- ▶ If labor supply is relatively elastic, the burden of the tax falls largely on employers.

The Incidence of Corporate Profits Taxes

- ▶ **Corporations** are firms granted limited liability status by the government.
- ▶ **Partnerships** and **proprietorships** do not enjoy limited liability and do not pay this tax; rather, they report their firms' income directly on their individual income tax returns.

The Incidence of Corporate Profits Taxes

- ▶ We can think of the corporate tax as a tax on *capital income*.
- ▶ If the corporate sector becomes less profitable as a result of the tax, capital investment begins to favor the nontaxed sector. The taxed sector contracts, and the nontaxed sector expands.

The Incidence of Corporate Profits Taxes

- ▶ As capital flows to the to nontaxed sector, competition springs up and prices are driven down.
- ▶ Some of the tax shifts to capital income earners in the noncorporate sector.
- ▶ Eventually, the after-tax profit rates in the two sectors are equal.

The Incidence of Corporate Profits Taxes

- ▶ Taxed firms will have an incentive to substitute labor for capital. This could benefit labor by driving up wages.
- ▶ Owners of corporations, proprietorships, and partnerships all bear the burden of the corporate tax in rough proportion to profits, even though it is directly levied only on corporations.

The Burden of the Corporate Tax

- ▶ The ultimate burden of the corporate tax depends on:
 1. The relative capital/labor intensity of the two sectors.
 2. The ease with which capital and labor can be substituted in the two sectors.
 3. The elasticities of demand for the products of each sector.

Excess Burdens and the Principle of Neutrality

- ▶ The *total burden* of a tax is the sum of the revenue collected from the tax and the excess burden created by the tax.
- ▶ An *excess burden* is the amount by which the burden of a tax exceeds the total revenue collected. Also called the *dead weight loss*.

Excess Burdens and the Principle of Neutrality

- ▶ The *principle of neutrality* states that, all else equal, taxes that are neutral with respect to economic decisions are generally preferable to taxes that distort economic decisions.
- ▶ Taxes that are not neutral impose excess burdens.

How Do Excess Burdens Arise?

Technology	Input requirements per unit of output X		Per unit cost of X $= K(P_K) + L(P_L)$	
	K	L	$P_K = \$2$ $P_L = \$2$	
A	7	3	\$20	Least cost
B	4	7	\$22	

- ▶ If the industry is competitive, long-run equilibrium price will be \$20 per unit of X. If 1,000 units of X are sold, consumers will pay a total of \$20,000 for X.

How Do Excess Burdens Arise?

Technology	Input requirements per unit of output X			Per unit cost of X $= K(P_K) + L(P_L)$	
	K	L			
A	7	3	→	\$27	→ Least cost
B	4	7	→	\$26	

$P_K = \$2 + \$1 \text{ tax} = \$3$
 $P_L = \$2$

- ▶ If the industry is competitive, price will be \$26 per unit of X when a tax of \$1 per unit of capital is imposed. If technology B is used, and sales remain at 1,000 units, total tax collections will be \$4,000, but consumers will pay \$26,000, or \$6,000 more than before the tax.

How Do Excess Burdens Arise?

- ▶ The larger the distortion that a tax causes in behavior, the larger the excess burden of the tax. Taxes levied on broad bases tend to distort choices less and impose smaller excess burdens than taxes on more sharply defined bases.