The Incidence of Taxes

Whom Should We Tax?

- Two major questions
  - Incidence
  - Efficiency

Incidence

- Who pays the cost of running the government

Progressive Taxes

- A tax is progressive if the tax bill rises faster than your income.
- A tax is regressive if the tax bill rises slower than your income

Progressive Taxes

- Income Tax = 20% with $10,000 exemption
  - $10,000 = $0
  - $20,000 = $2,000 (10%)
  - $100,000 = $18,000 (18%)

The US Tax Code

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- First tax bracket is 10%.
- Next tax bracket is 15%
- Then 25% (eventually)
The Sales Tax

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- It is regressive if the tax bill rises slower than your income.

Sales tax is generally thought to be regressive.

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Taxes have behavioral implications
- Consider the Hatfield “proposal” for a 100% tax on incomes above $200,000.

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Yet another problem

**The Tradeoff between Progressive Taxation and economic efficiency**

Flatland has total income of $100,000,000. It must finance a government budget of $20,000,000.

The first $X of income will be exempt, and the rest will be taxed at a constant rate.

Flatland has total income of $100,000,000. It must finance a government budget of $20,000,000.

To exempt the following amount of income, its tax rate must be:

- $20,000,000: 25%  
- $30,000,000: 28%  
- $40,000,000: 33%  
- $50,000,000: 40%

The higher the exemption (the greater the progression), the higher the marginal rate.

**Consumption and Income over the Life Cycle**

Some of the difference in income relates to where we are in the life cycle.
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Consumption and Income over the Life Cycle

Pension plans switch income from high tax years to low tax years.

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Consumption and Income over the Life Cycle

When John Smith, MD is working, he makes more than Joe College, BA, but then he spends years in Med School and years in residency.

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Is it fair to take a higher percentage of Dr. Smith’s income than Joe College?

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Indeed, what about the comparison between Joe College and Hank High School Grad?

Another Query

• Who has the lower marginal tax rate, a typical college professor or Bill Gates?
• Probably Bill Gates, who pays capital gains rates of 15% on most of his “income”.
Payments in Kind

- There are other means of avoiding income taxes by taking your income *in kind* (perks).
- The CEO gets a fancy apartment in Manhattan, a country club membership, etc.