

The Incidence of Taxes

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

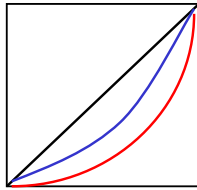
To exempt the following amount of income	Its tax rate must be
\$20,000,000	25%
\$30,000,000	28%
\$40,000,000	33%
\$50,000,000	40%

Whom Should We Tax?

- Two major questions
 - Incidence
 - Efficiency

Incidence

- Who pays the cost of running the government



Progressive Taxes

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- **\$10,000 = \$0**
- **\$20,000 = \$2,000 (10%)**
- **\$100,000 = \$18,000 (18%)**

The US Tax Code

- A tax is progressive if the tax bill rises faster than your income.
- It is regressive if the tax bill rises slower than your income
- **First tax bracket is 10%.**
- **Next tax bracket is 15%**
- **Then 25% (eventually)**

The Sales Tax

- A tax is progressive if the tax bill rises faster than your income.
- It is regressive if the tax bill rises slower than your income
- **Sales tax is generally thought to be regressive.**

Some Problems

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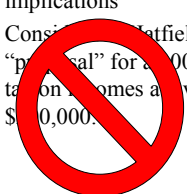
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- Consider the Hatfield "proposal" for a 100% tax on incomes above \$200,000.

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

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$$\tau = \frac{\$20,000,000}{\$100,000,000 - \$20,000,000} = 25\%$$

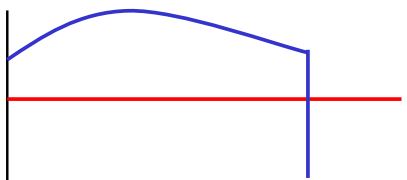
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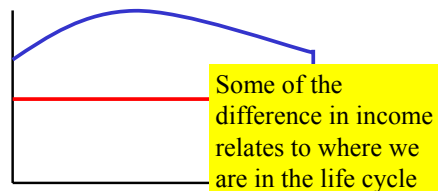
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The higher the exemption (the greater the progression) the higher the marginal rate.

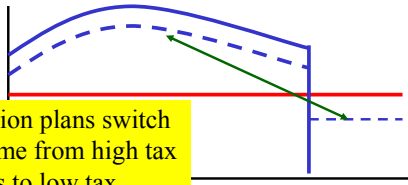
Consumption and Income over the Life Cycle



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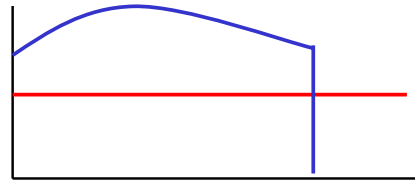


Consumption and Income over the Life Cycle

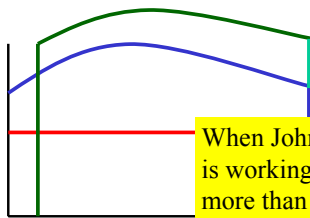


Pension plans switch income from high tax years to low tax years.

Consumption and Income over the Life Cycle

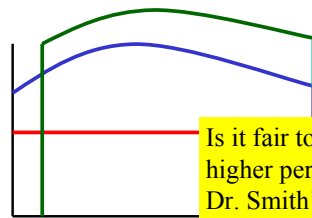


Consumption and Income over the Life Cycle



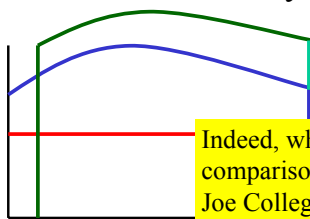
When John Smith, MD is working, he makes more than Joe College, BA, but then he spend years in Med School and years in residency.

Consumption and Income over the Life Cycle



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

Consumption and Income over the Life Cycle



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.

End

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