

Outline for lecture 7

ECON 1a, Fall 2008, Warren Gibson

The burden of taxation and deadweight loss.

- Recall burden of taxation, pp. 125, 127
- Recall consumer & producer surplus, p. 149
- Recall how elasticity determines how the burden is shared, p. 166
- Combine these to see the effects of taxation
 - Definition of deadweight loss: a loss that is no one's gain. Example: I steal your car stereo: stereo is your loss, my gain; broken window no one's gain
- Loss of consumer & producer surplus to gov't revenue
- Show deadweight loss of consumer & producer surplus.
 - Marginal buyers leave the market after tax
 - Marginal sellers leave the market after tax
 - Both lose their surpluses and there is no offsetting gain
- P. 168 shows these effects at various tax rates
- As tax rate rises
 - Tax revenue rises at first, reaches a maximum, then falls, and when the tax is high enough to drive out all buyers and sellers, revenue goes to zero.
 - Deadweight loss rises faster and faster.

- In many cases, people will evade the taxes. Example: marijuana tax 1937-1970. Based on testimony that MJ causes “murder, insanity & death.” Ruled unconstitutional on account of self-incrimination.
- Comments on taxation.
 - Correlation of high income tax rate with less work, p. 171
 - In general, you get less of what you tax; more of what you subsidize.
 - Deadweight loss of higher federal income tax rate est. 70%.
 - Costs of compliance are very high.
- International trade
 - Closed economy: one with no imports or exports. A starting point for thought experiments, not realistic (except maybe North Korea, Burma).
 - Assume closed economy opens up.
 - * World price higher than domestic price: p. 180. Gains and losses in consumer & producer surplus. Domestic producers are better off, domestic consumers worse off, net gain
 - * World price lower than domestic price: p. 182. Gains and losses in consumer & producer surplus. Domestic producers are worse off, domestic consumers better off, net gain
 - Tariff: tax imposed on imported goods. Effects shown on p. 185.
 - * Loss in consumer surplus

- * Gain in producer surplus
- * Gain in government revenue
- * Deadweight loss