

# chapter:

# 7

## >> **Taxes**

**Krugman/Wells  
Economics**

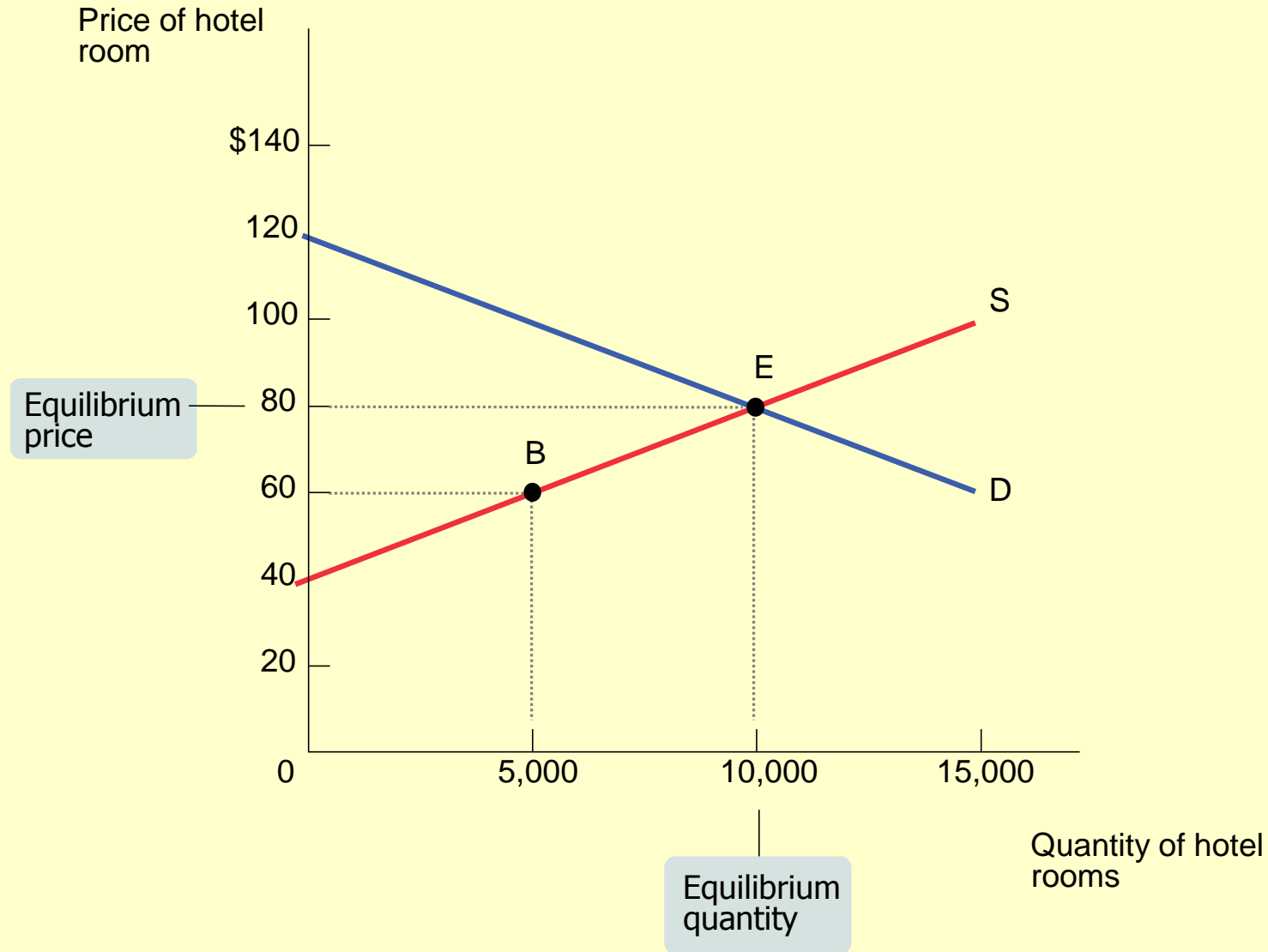
# WHAT YOU WILL LEARN IN THIS CHAPTER

- The effects of taxes on supply and demand
- What determines who really bears the burden of a tax
- The costs and benefits of taxes, and why taxes impose a cost that is larger than the tax revenue they raise

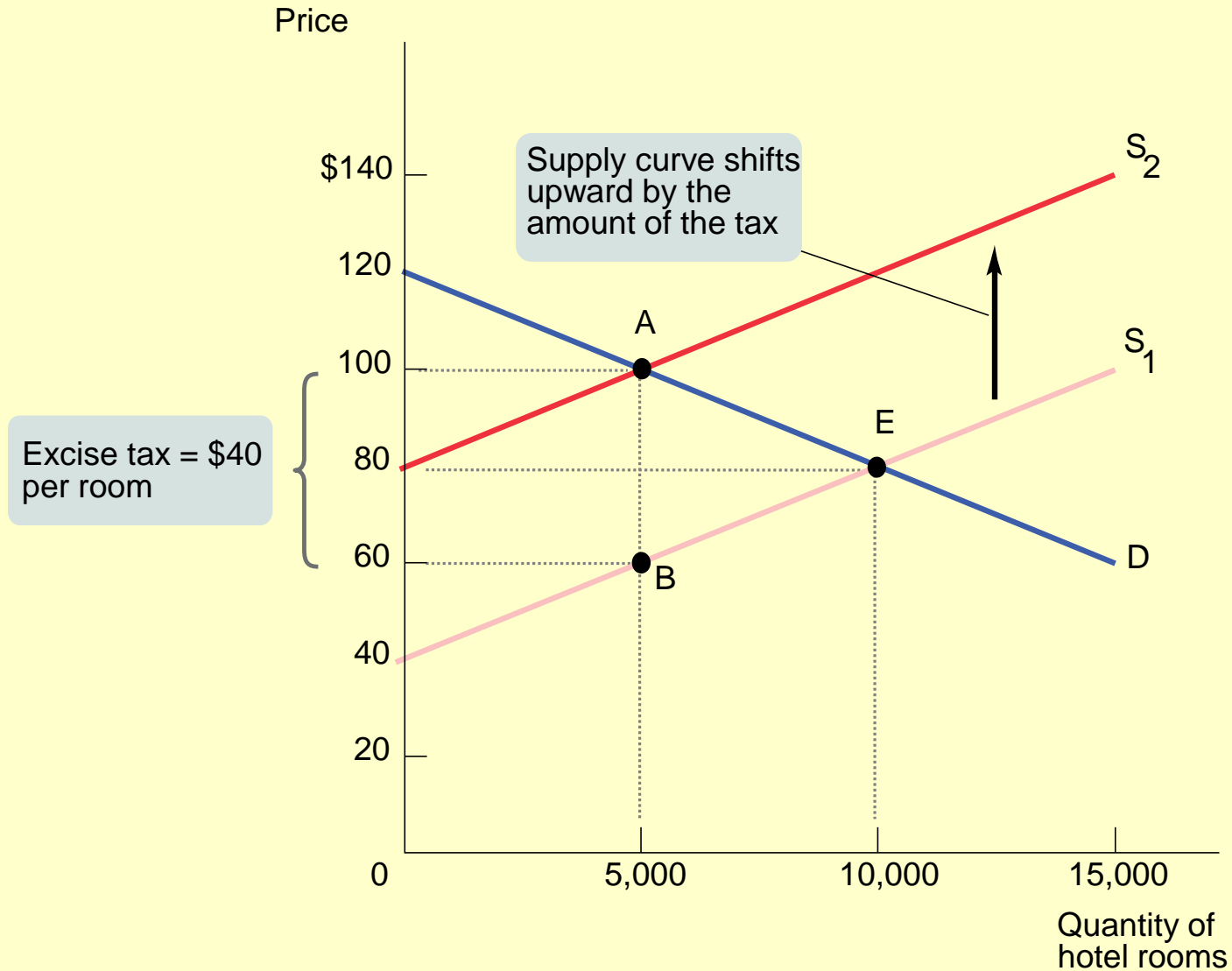
# The Economics of Taxes: A Preliminary View

- An **excise tax** is a tax on sales of a good or service.
- Excise taxes:
  - raise the price paid by buyers and
  - reduce the price received by sellers
- Excise taxes also drive a **wedge** between the two.  
Examples: Excise tax levied on sales of taxi rides and excise tax levied on purchases of taxi rides.

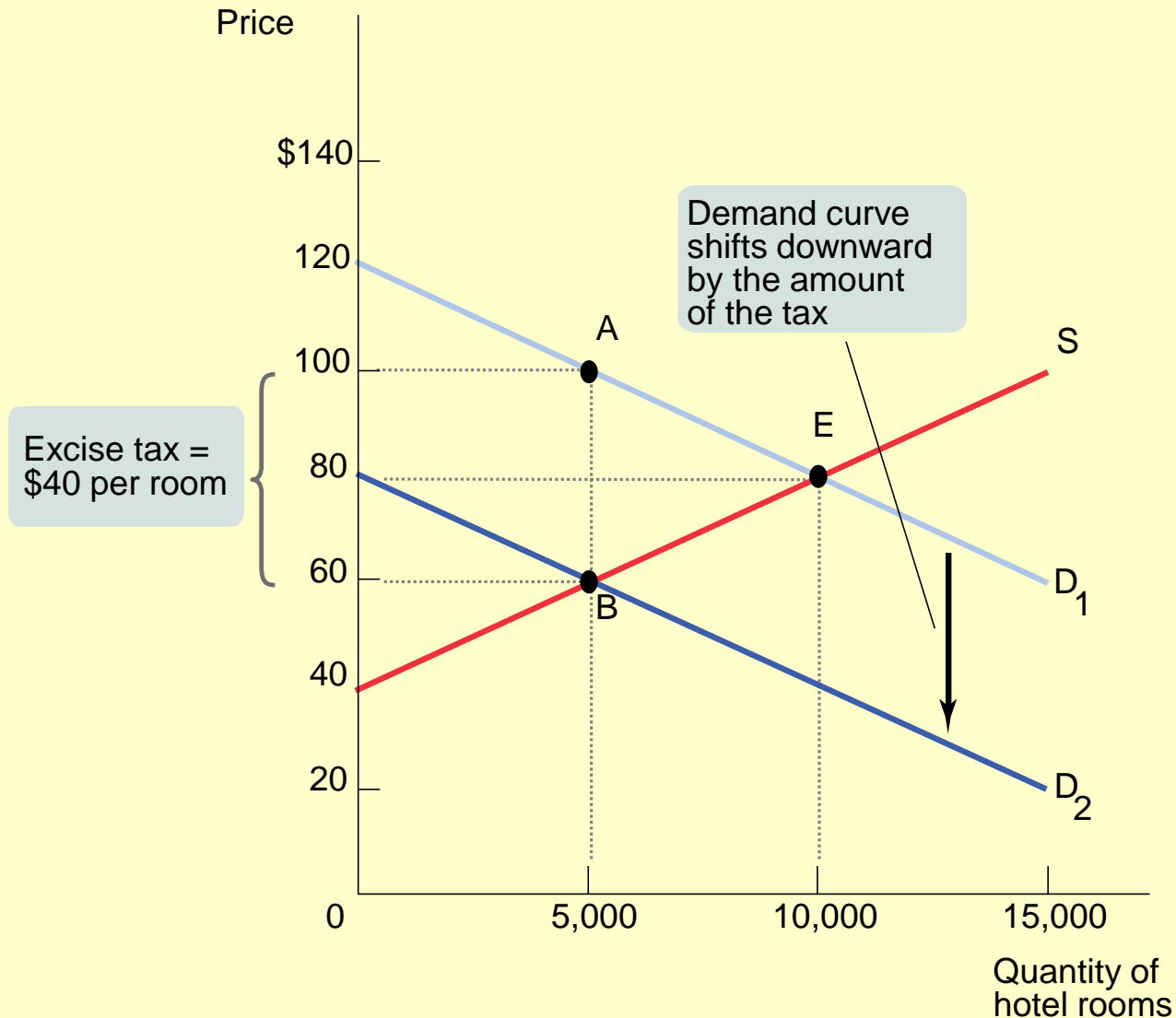
# The Supply and Demand for Hotel Rooms in Potterville



# An Excise Tax Imposed on Hotel Owners



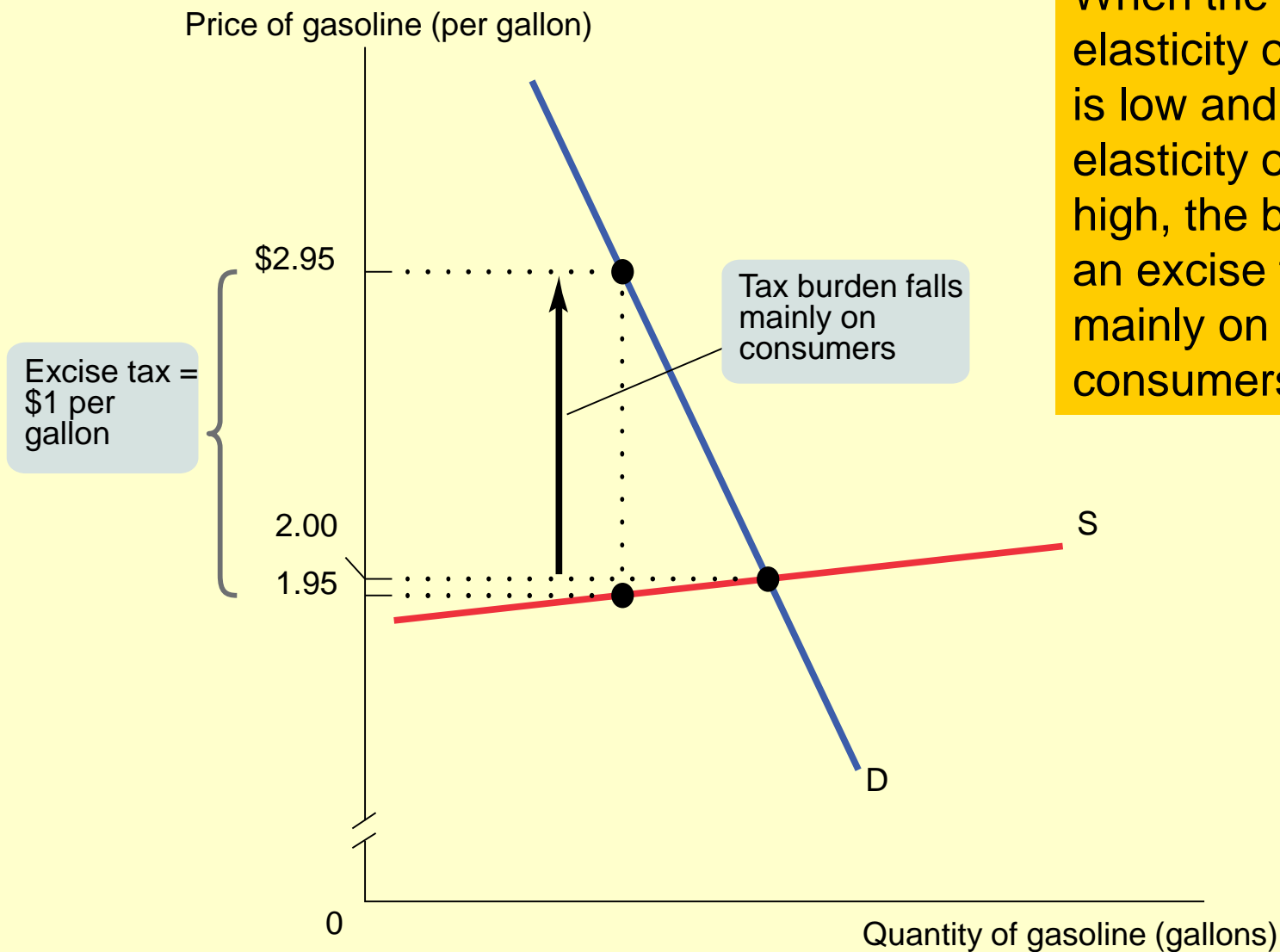
# An Excise Tax Imposed on Hotel Guests



# Tax Incidence

- The **incidence** of a tax is a measure of who really pays it.
- Who really bears the tax burden (in the form of higher prices to consumers and lower prices to sellers) does not depend on who officially pays the tax. Depending on the shapes of supply and demand curves, the incidence of an excise tax may be divided differently.
- The wedge between the demand price and supply price becomes the government's "***tax revenue.***"

# An Excise Tax Paid Mainly By Consumers

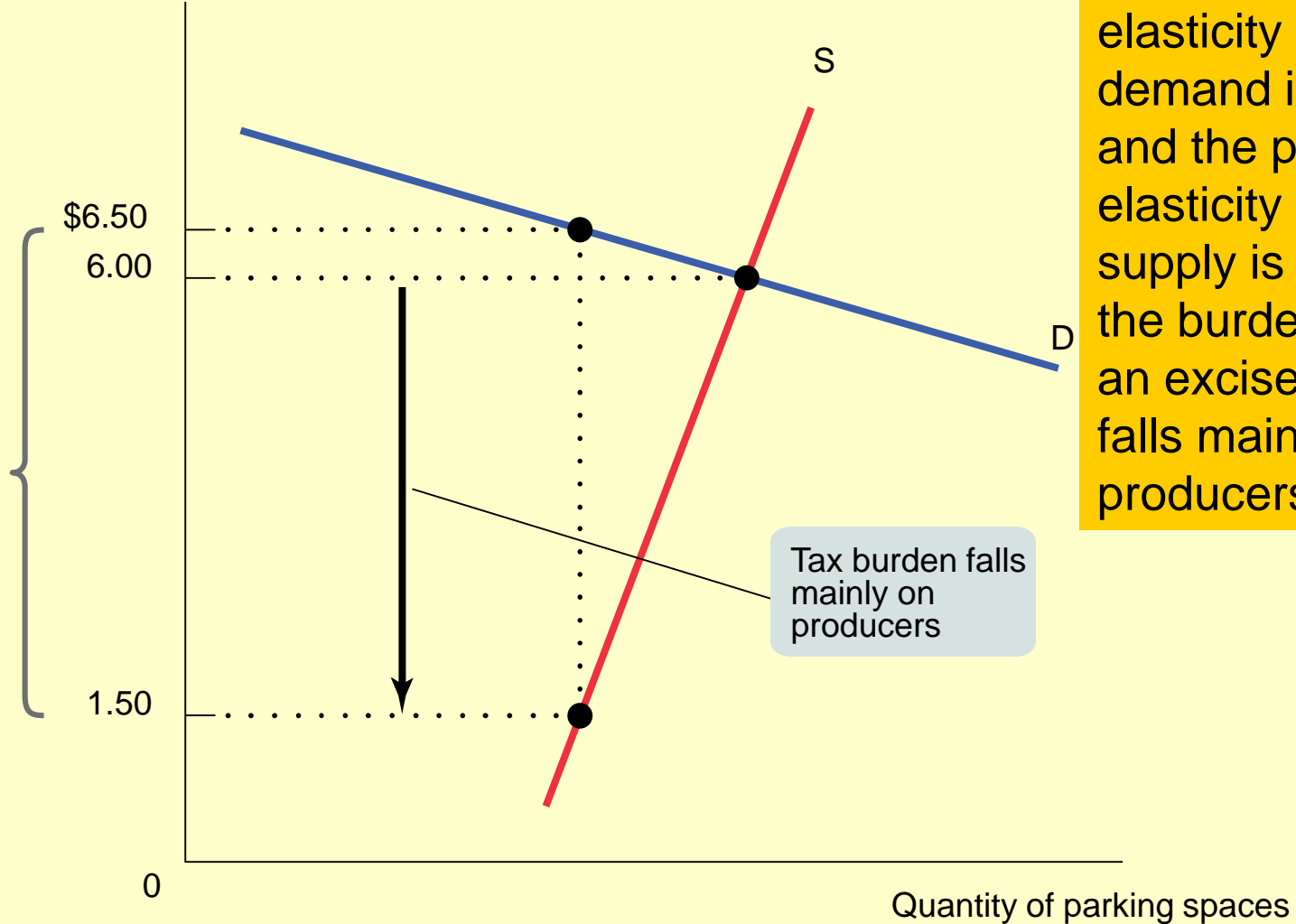


When the price elasticity of demand is low and the price elasticity of supply is high, the burden of an excise tax falls mainly on consumers.



# An Excise Tax Paid Mainly by Producers

Price of parking space

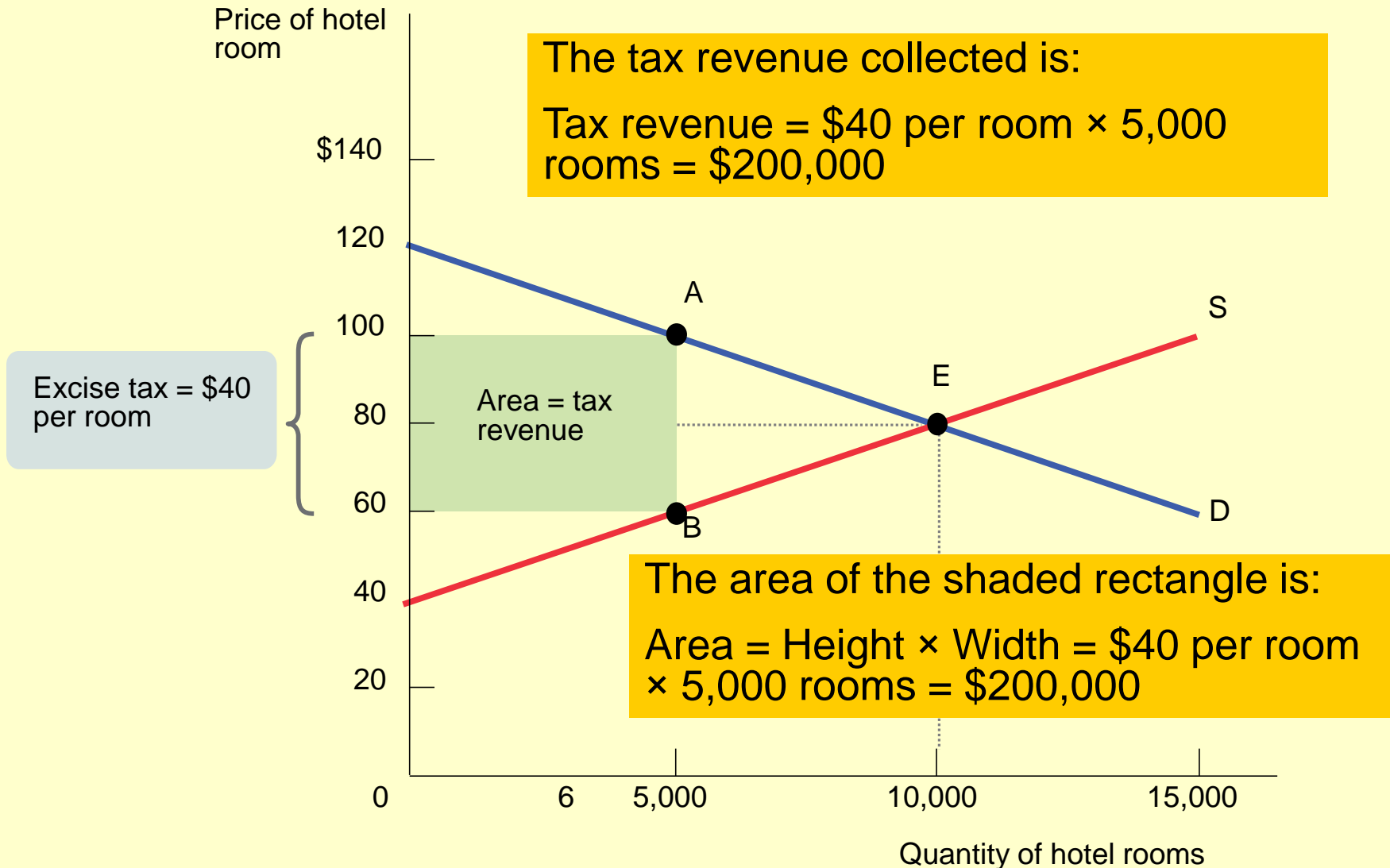


When the price elasticity of demand is high and the price elasticity of supply is low, the burden of an excise tax falls mainly on producers.

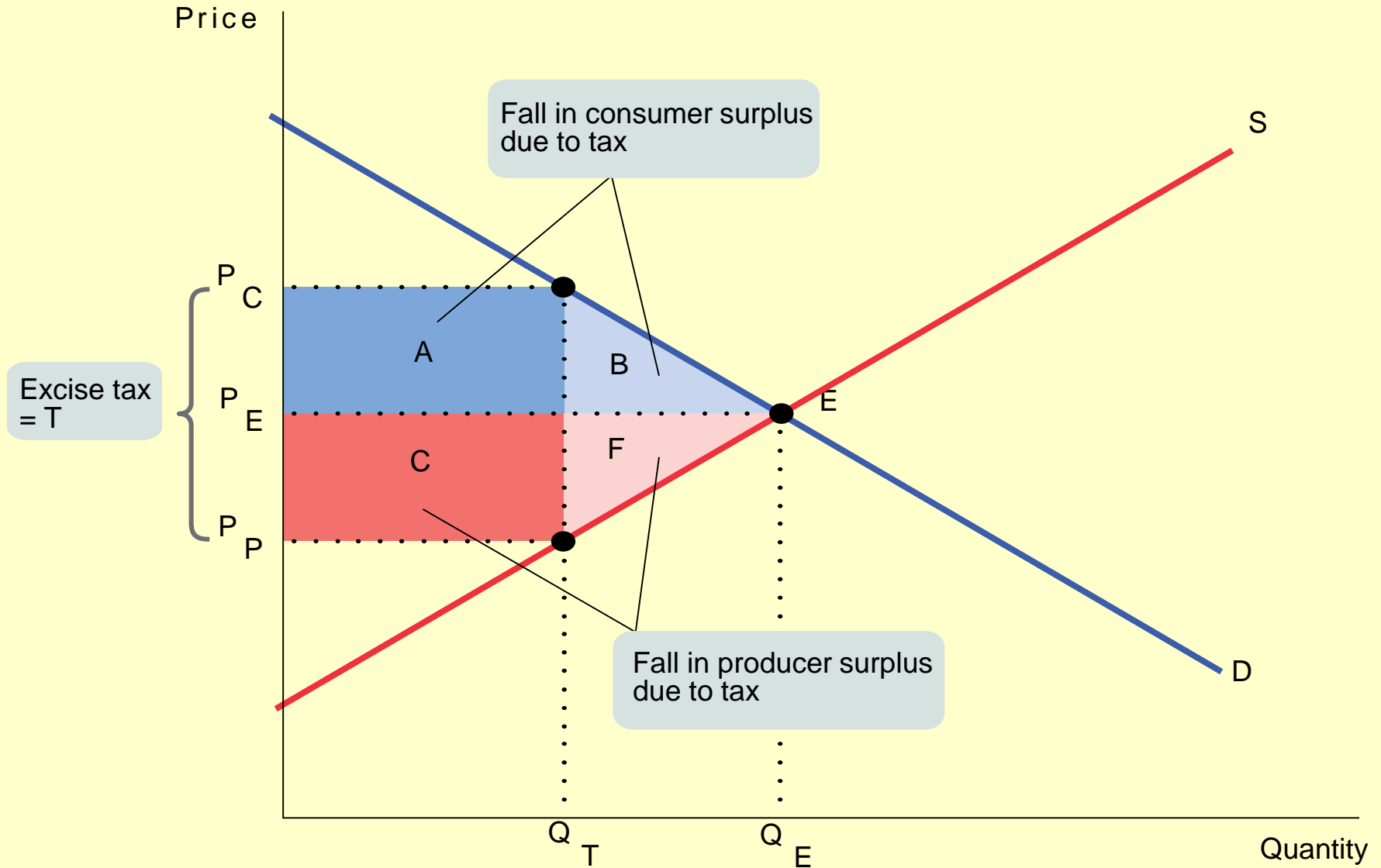
Excise tax = \$5 per parking space

Tax burden falls mainly on producers

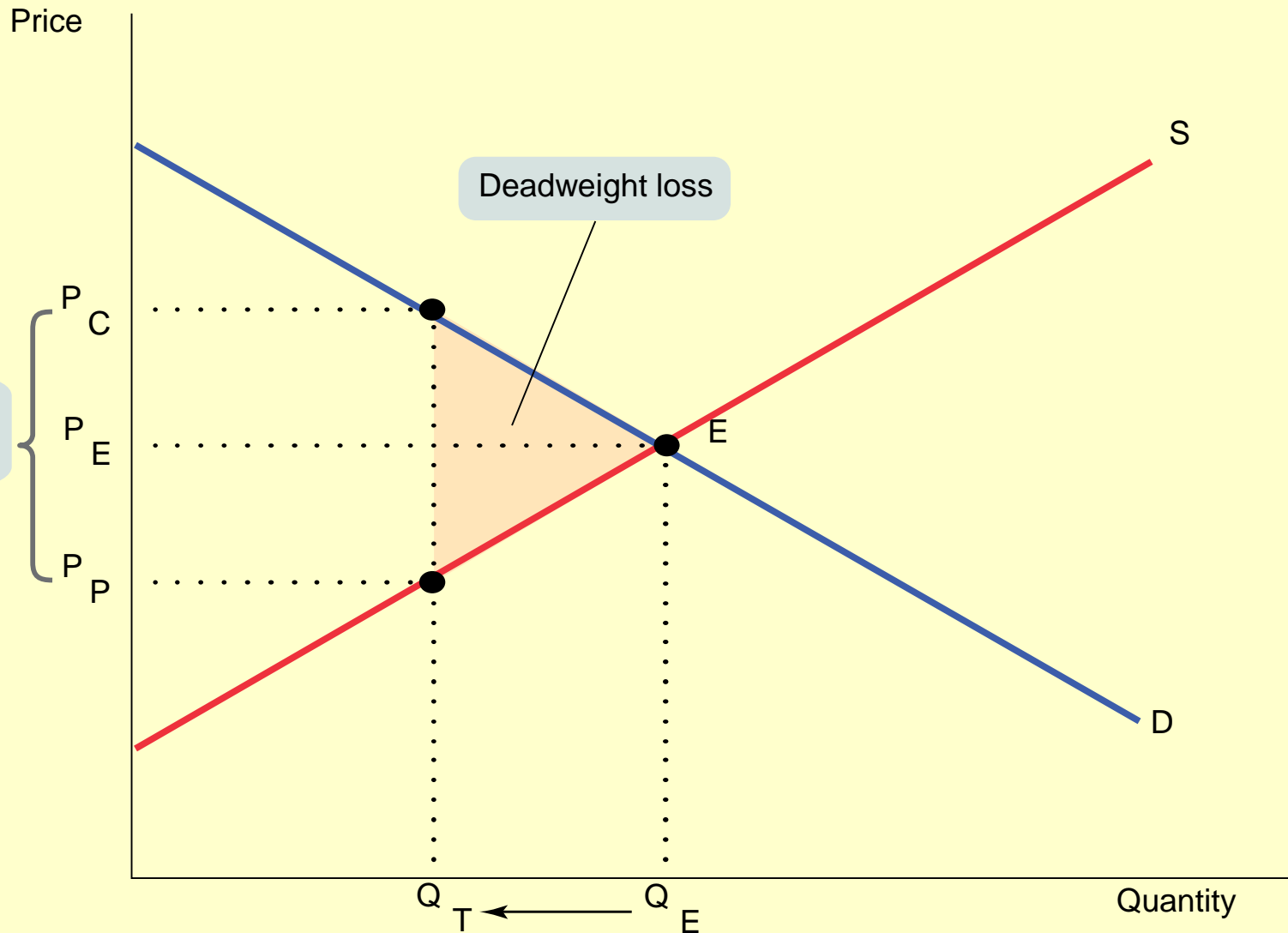
# The Revenue from an Excise Tax



# A Tax Reduces Consumer and Producer Surplus



# The Deadweight Loss of a Tax

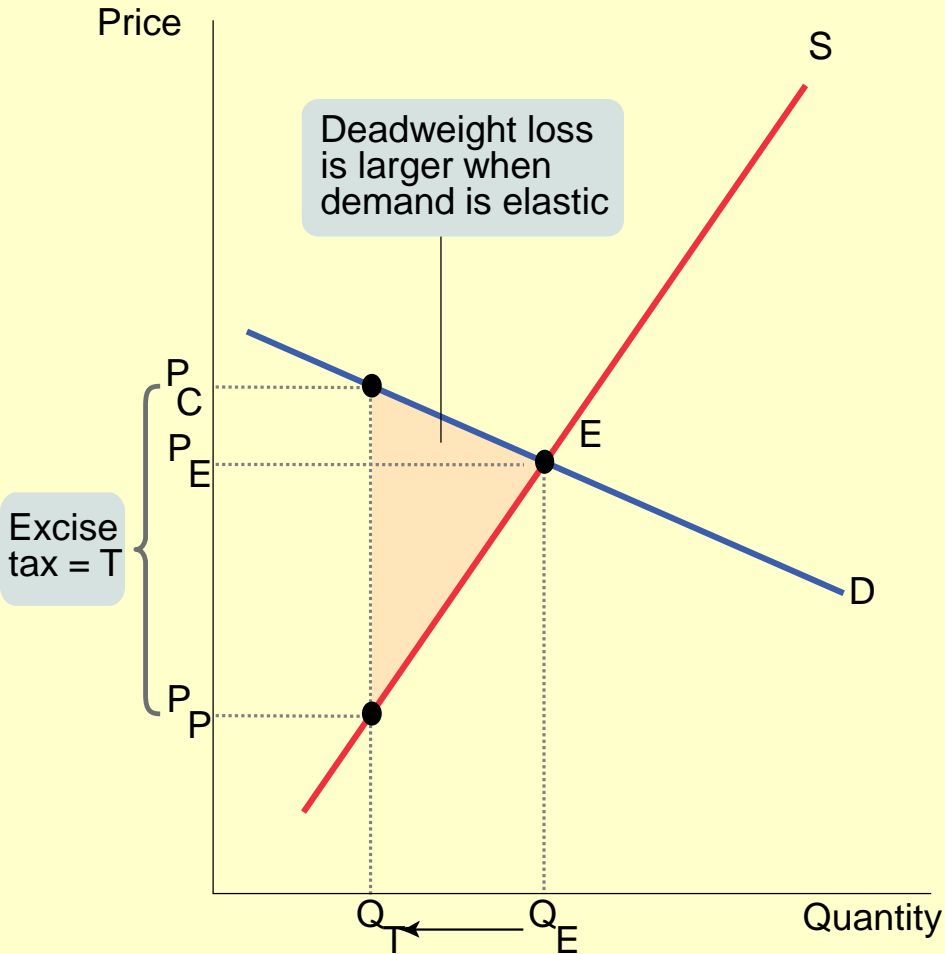


Excise tax = T

Deadweight loss

# Deadweight Loss and Elasticities

(a) Elastic Demand

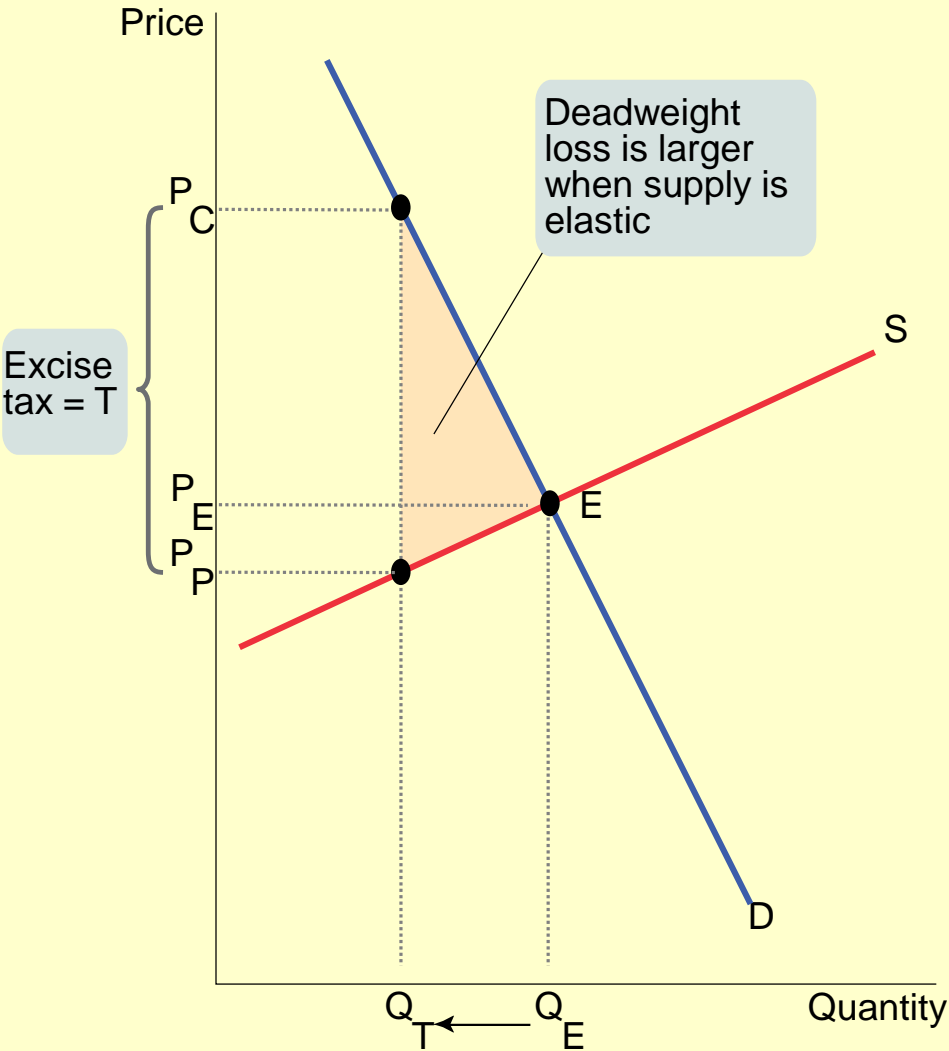


(b) Inelastic Demand

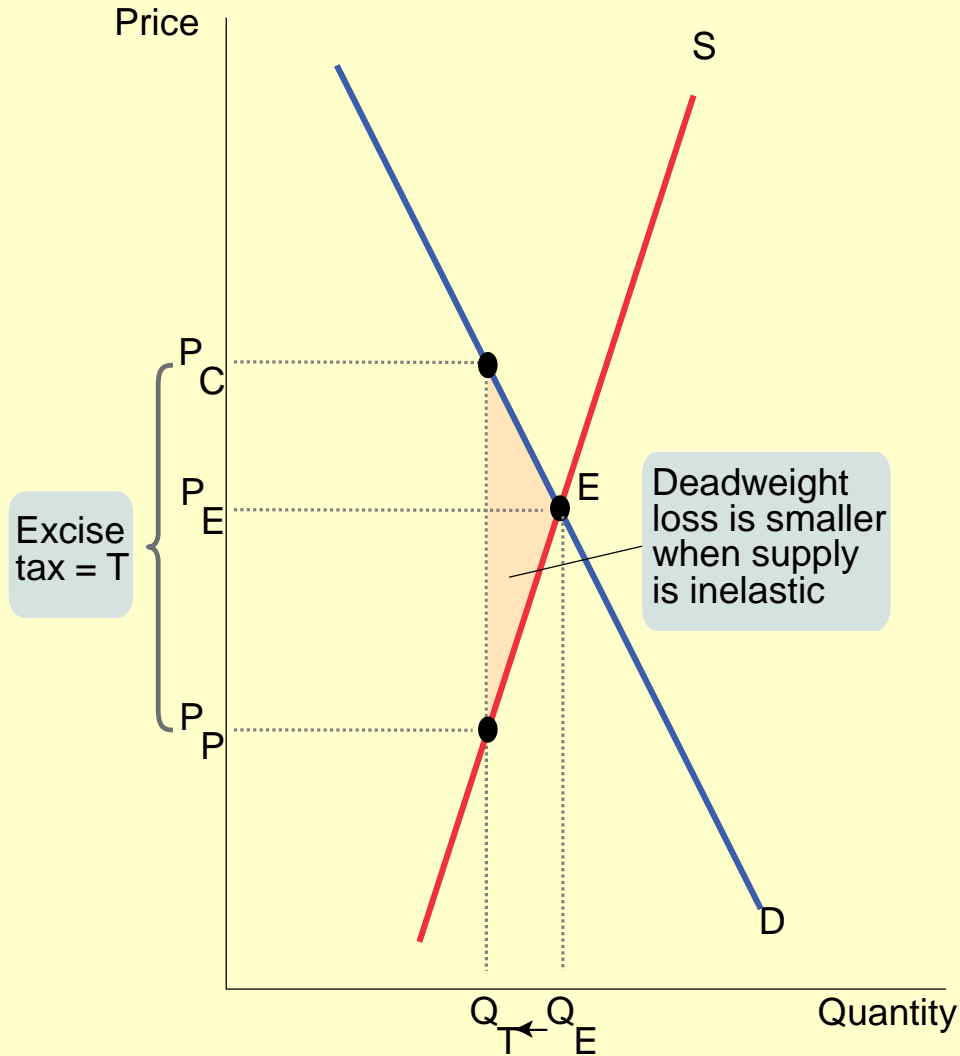


# Deadweight Loss and Elasticities

(c) Elastic Supply



(d) Inelastic Supply



# The End of Chapter 7

Coming attraction  
**Chapter 10:**  
**The Rational Consumer**