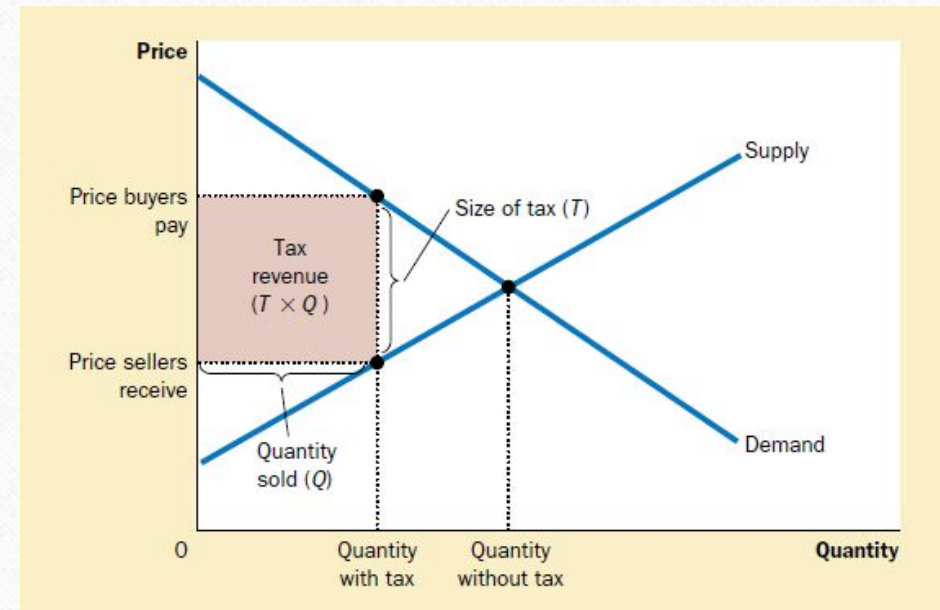
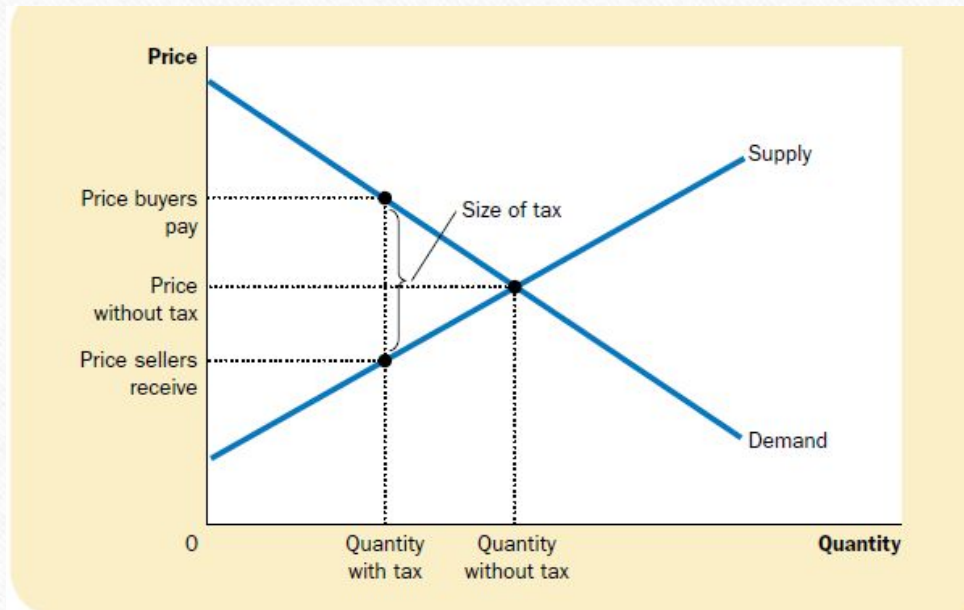


Chapter 8

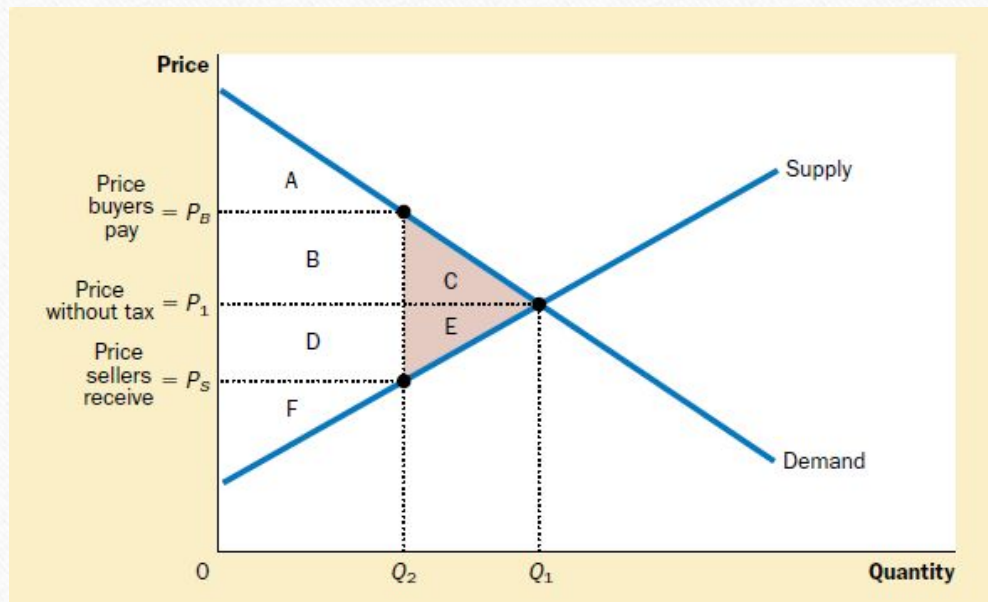
Application: Cost of taxation

Introduction

- Tax is one of the key determinants of politics



Deadweight Loss



	WITHOUT TAX	WITH TAX	CHANGE
Consumer Surplus	$A + B + C$	A	$-(B + C)$
Producer Surplus	$D + E + F$	F	$-(D + E)$
Tax Revenue	None	$B + D$	$+(B + D)$
Total Surplus	$A + B + C + D + E + F$	$A + B + D + F$	$-(C + E)$

The area $C + E$ shows the fall in total surplus and is the deadweight loss of the tax.

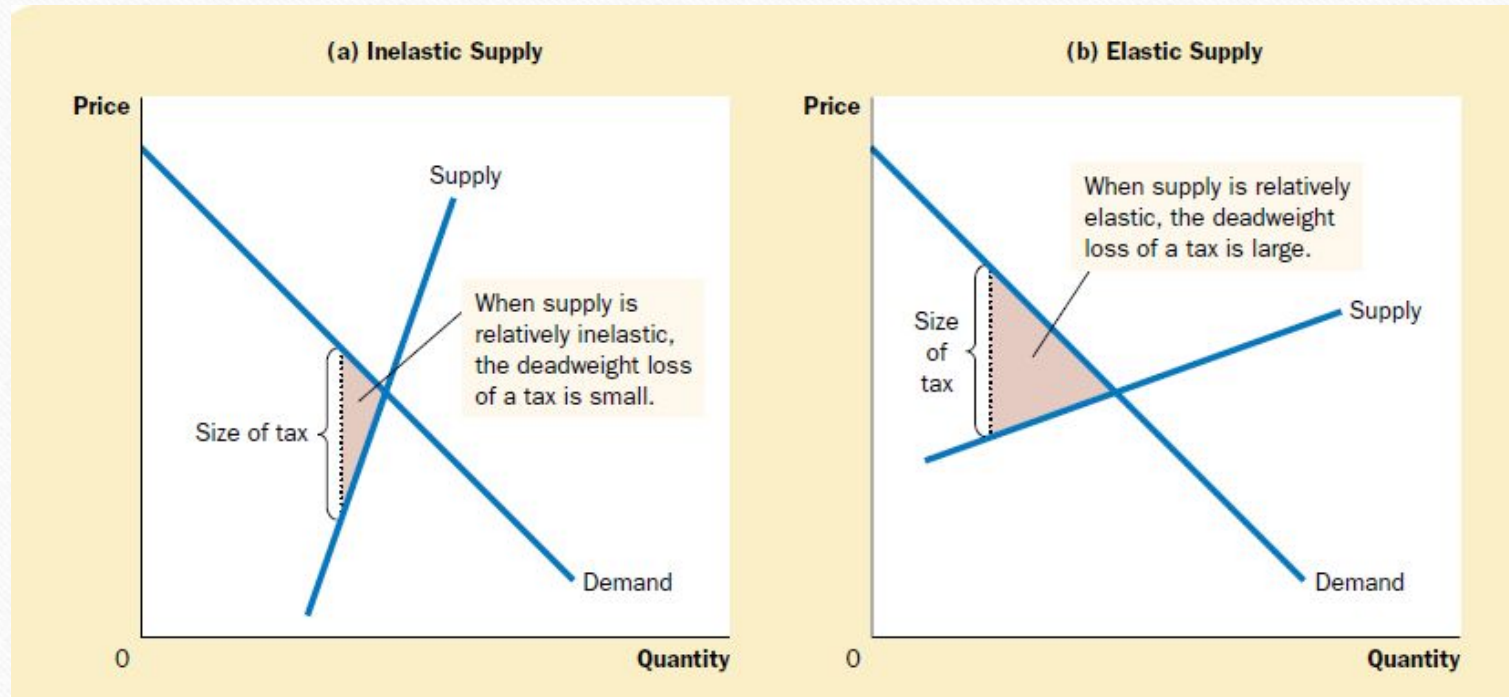
Example

- Joe cleans Jane's house at \$100
- Joe is benefitted by \$20 as his opportunity cost is \$80
- Jane is benefitted by \$20 because the valuation of cleaning house is \$120
- Total surplus is \$40 with gains from trade

Cont...

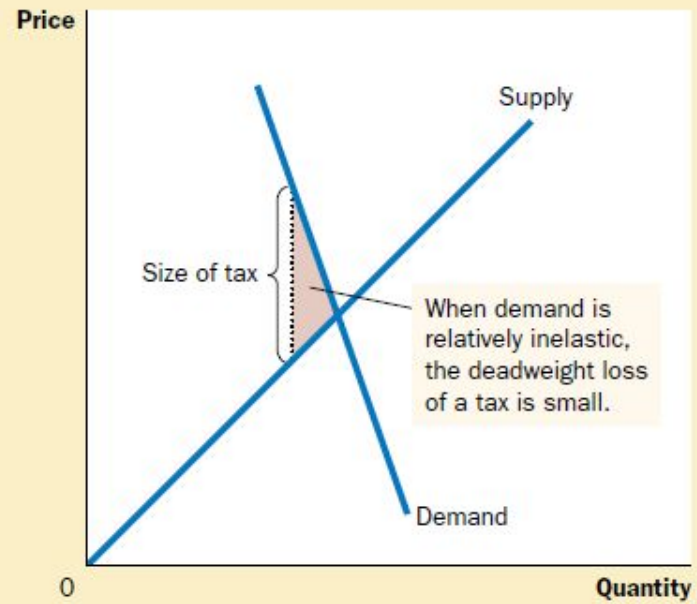
- A tax of \$50 is levied
- Jane will pay \$120 maximum to Joe but after paying the tax Joe will have \$70
- To cover his opportunity cost he has to get \$130 now that Jane wouldn't pay
- Ended up with no contract: Joe goes without income and Jane lives in a dirty house
- Deadweight loss of \$40

The Determinants of Deadweight Loss

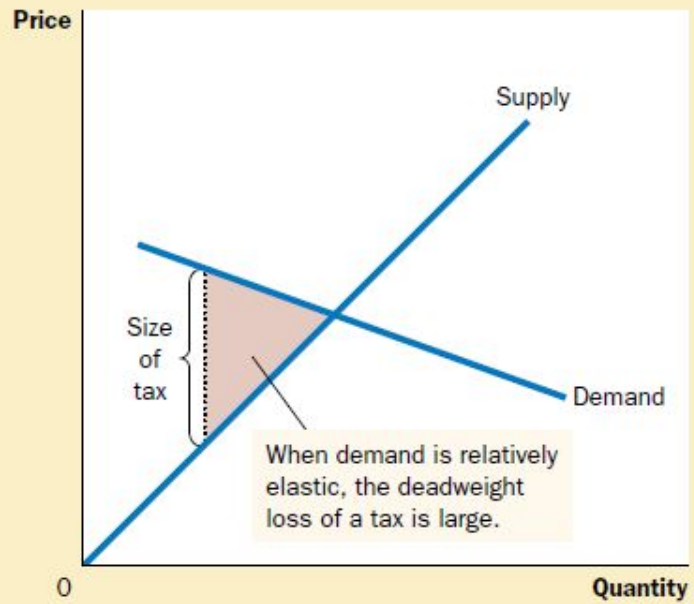


Cont...

(c) Inelastic Demand



(d) Elastic Demand



Deadweight Loss Debate



"LET ME TELL YOU WHAT I THINK ABOUT THE ELASTICITY OF LABOR SUPPLY."

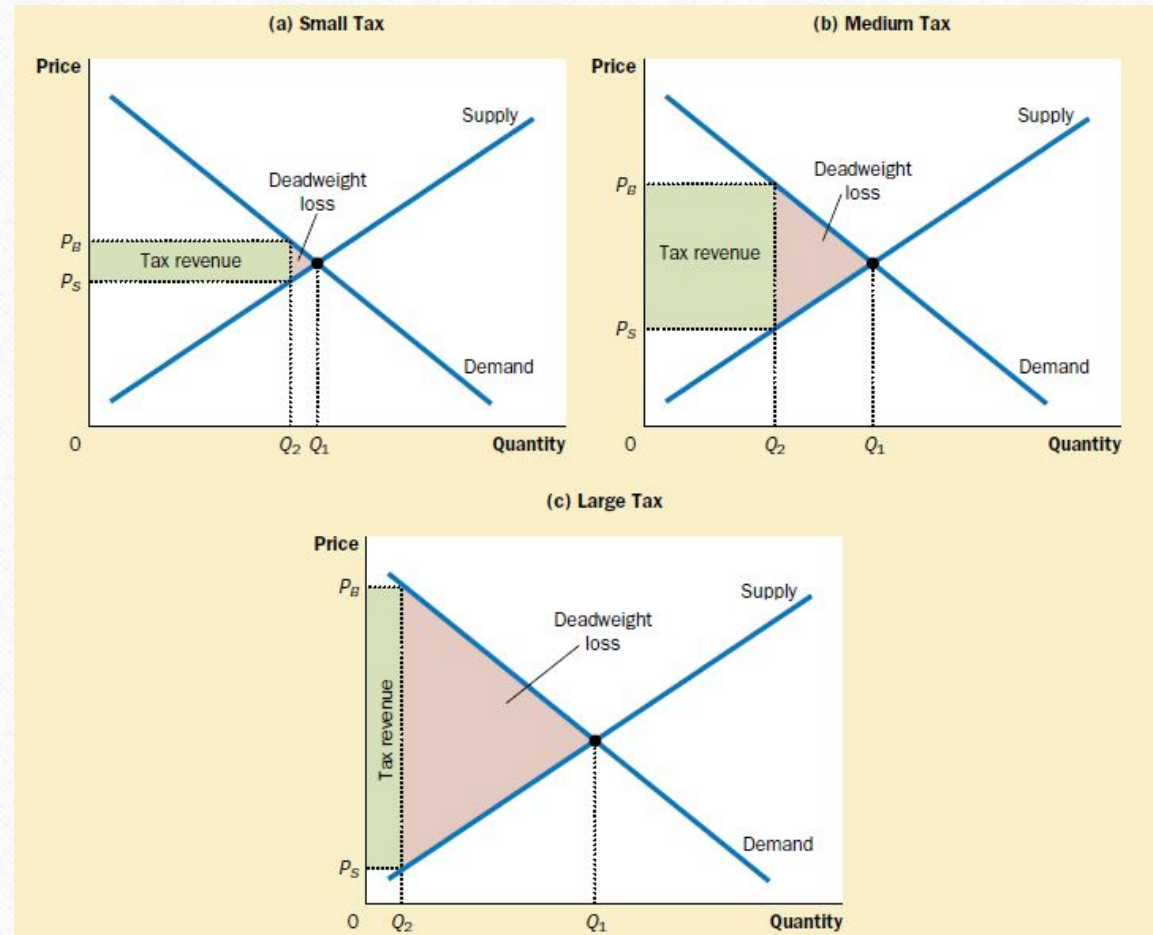
Cont..

- Cases for disagreement
 - Overtime work's incentive comes down
 - Discouraging women
 - Voluntary retirement and part-time work
 - Illegal activities
- The above cases are a few examples that discourages work

Level of Taxes and Deadweight Loss

Higher the tax rate, higher will be the deadweight loss

With higher tax base, total revenue initially rises, and it falls thereafter



Laffer Curve

Shows the relationship between tax base and revenue

The idea was previously encouraged by Reagan

Incentivizing supply side

Empirical findings are heterogeneous

