Taxes and subsidies

Taxes and subsidies are terms that are very commonly used in economics that have a large impact on the country's economy, trade, production, and growth. Taxes and subsidies are complete opposites of one another; taxes are a cost and a subsidy in an inflow. Taxes are levied to discourage certain activities, to grow local domestic industries, and also one of the major forms of government income. Subsidies are given to encourage certain activities, improve growth and reduce cost levels. The following article explores both these terms in greater detail and offers a clear explanation of their similarities and differences.

Tax

Taxes are financial levies imposed on an individual or corporation by the government. Taxes are not paid voluntarily and are not considered to be 'donations' to the government; rather a tax is a compulsory contribution imposed on the individual/corporation. Failing to pay taxes can result in the taking of legislative action.

Taxes exist in our everyday lives even though they are called by different names such as toll, duty, excise, custom, etc. The best way to identify payments that are taxes is to understand which of the day to day payments we make are imposed by the country's government. Taxes are levied by governments for a number of purposes such as, spending on a country's infrastructure, nation's security, development, funding public services, law enforcement, pay for public utilities, pay off debt and the general running of a country's government, among others. There are a number of different taxes such as income tax, capital gains tax, corporate tax, inheritance tax, property tax, VAT, sales tax, etc.

Subsidy

Subsidies are benefits that the government will provide to corporations and individuals and can be in the form of a cash inflow, or a tax reduction. A subsidy is given to reduce the burden on the individual or the corporation, and subsidies are generally considered to be beneficial to corporations and individuals as it reduces costs and improves business profitability. There are a number of different types of subsidies such as grants and direct payments, tax holidays/concessions, in-kind subsidies, cross subsidies, credit subsidies, derivative subsides, government subsidies, etc.

Subsidies are also treated as a trade barrier since it results in lower costs of production thereby making locally produced goods more competitive than imports. Subsidies can, however, result in market inefficiencies and can result in economic costs as a subsidy can artificially and unfairly change the playing field in a free market place.

Subsidy vs Tax

Subsidies and taxes are complete opposites to one another. The only similarity between the two is that the government is responsible for imposing taxes and providing subsidies. A tax is seen negatively as a cost to individuals and corporations as it increases levels of cost. Subsidies, on the other hand, are considered to be positive as it improves competitiveness and reduces the cost for local producers, and can encourage more investment and higher levels of production. Taxes, however, are for the greater good of the country as it is spent on the country's development, etc.

Taxes and Subsidies - Key takeaways

- Governments steer markets through taxes and subsidies, which change consumer and producer behavior, which can be seen as shifts in the supply and demand graph.
- Taxes and subsidies majorly impact a government's budget; an increase in taxes raises their money supply. However, an increase in subsidies lowers the government's budget.
- When a market is at equilibrium, it maximizes efficiency; implementing a tax or subsidy will disrupt and lower the overall efficiency.
- The deadweight loss represents the lost efficiency felt by consumers and producers; this loss is created by implementing taxes and subsidies.
- The government decides to put the tax on is usually determined by the elasticity of the supply and demand curve, the more inelastic, the better to tax.

INTERTEMPORAL CONSUMPTION

Economic theories of **intertemporal consumption** seek to explain people's preferences in relation to consumption and saving over the course of their lives. The earliest work on the subject was by Irving Fisher and Roy Harrod, who described 'hump saving', hypothesizing that savings would be highest in the middle years of a person's life as they saved for retirement.

The life-cycle model of consumption suggests that consumption is based on average lifetime income instead of income at any given age. First, young people borrow to consume more than their income, next, as their income rises through the years, their consumption rises slowly and they begin to save more. Lastly, during their retirement these individuals live off of their savings. Furthermore this theory implies that consumption is smoothed out relative to a person's income which is the reason economists set consumption proportional to potential income rather than actual income.

Behavioural economists have proposed an alternate description of intertemporal consumption, the behavioural life cycle hypothesis. They propose that people mentally divide their assets into non-fungible mental accounts – current income, current assets (savings) and future income. The marginal propensity to consume (MPC) out of each of these accounts is different. Drawing upon empirical studies of consumption, superannuation and windfall gains they hypothesize that the MPC is close to one out of current income, close to zero for future income and somewhere in between with respect to current assets. These differing MPCs explain why people 'overconsume' during their highest earning years, why increasing superannuation contributions does not cause current savings to be reduced (as the life-cycle model implies) and why small windfall gains (which are coded as current income) are consumed at a high rate but a higher proportion of larger gains is saved.

Many of the choices we make have consequences for the future. For instance, deciding how much money to spend in the present and how much to squirrel away can greatly impact our quality of life both now and in the years ahead.

For companies, various investment decisions involve intertemporal choice. For individuals, on the other hand, decisions made in the near-term that can affect future financial opportunities relate mostly to saving and retirement.

An individual who saves today consumes less, causing their current utility to decline. Over time, the savings grow, increasing the number of goods the individual can consume and, therefore, the person's future utility.

Most individuals tend to be limited by budget constraints that prevent them from consuming to the extent of their desires. Nevertheless, behavioral finance theorists generally find that present bias is common, suggesting that people prefer to spend now, regardless of the impact it might have in later years.

It is common for people to make intertemporal choices that accommodate near-term needs and wants over long-term objectives.

Intertemporal Choice Example

If an individual makes an exorbitant purchase, such as paying for an around-the-world vacation that exceeds their usual budget and requires additional financing to cover, this could have a substantial impact on the person’s long-term wealth. The individual might take out a personal loan, max out credit cards, or, when possible, even withdraw funds from retirement accounts in order to cover the expense.

Making such a choice would reduce the assets the individual has available to continue to save for retirement. The person may have to fund supplemental forms of income to augment their salary to compensate for the decline in assets.

This could be further exacerbated if unforeseen events affect current income. A sudden loss of employment, for example, would make it difficult to recoup recent expenses and set aside funds for retirement. If a consumer made a sizable purchase and then was laid off, their intertemporal choices combined with those external factors stand to change their future opportunities.

Perhaps the individual planned to retire by a certain age or was on track to finish paying off a mortgage. The shortfall in assets could mean postponing retirement or taking out a second mortgage to help deal with the more immediate issues.

Other Types of Intertemporal Choice

Decisions on employment can also factor into intertemporal choices. A professional might be presented with two job opportunities with salaries that vary depending on the intensity and demands of the role.

One position may be high-stress with long hours required. The compensation might also be higher than what is standard for such a position.

As an intertemporal choice, taking such a job might allow for more options on later pension plans. Conversely, taking the job that offers a lower salary but a better work-life balance may mean having fewer retirement options with less funding available.

INCOME EFFECT & SUBSTITUTION EFFECT

The substitution effect is an idea that shows how price shifts may lead consumers to seek substitute items. A consumer's propensity to spend money on goods and services rises with other economic indicators, such as their disposable income and level of material comfort. When wages rise, demand drops for certain products, typically poorer or inferior items, though consumers can still buy costly goods when their prices decrease. Using substitution ideas and the income effect, economists and businesspeople may get an insight into customers' motivations for engaging in these actions.

What is the income effect?

The income effect is a concept that illustrates how a shift in discretionary income affects consumers' spending patterns. The income effect can be direct or indirect. When the effect is direct, such as when a consumer's income drops and they decide to reduce nonessential spending like eating out, then the income shift has altered consumers' spending habits. When a change in income, not their actual income, affects consumers' spending habits, it shows indirect effects. This may mean they're being less impulsive with their spending because of the price increases they've seen in certain products.

Substitution effect vs. income effect

The substitution effect and the income effect are two economic ideas that explain how customers' spending habits change because of changes in the market. There are significant distinctions between the two, including:

The price of a product

The income effect may have a greater effect when prices rise with few substitutions in the market and may cause consumers to stop buying the product. Where the price of a product increases with multiple substitution options available in the market, the substitution effect may have a greater effect, as consumers can buy a more affordable product. A decrease in the price of a product makes it more affordable than its substitutes and increases the consumer's spending power.

The type of good

These changes may affect some products and services more than others. The substitution effect may involve both normal and inferior goods. The income effect typically works on normal goods more than it does on inferior goods.

The availability of products

The substitution effect differs from the income effect because it occurs only in the presence of substitutes. The substitution effect doesn't affect products with no substitutes, such as gasoline, since buyers can't switch to an alternative product. In contrast, the income effect works when a similar product has more quantity available for purchase.

The cause

The income effect shows the effect of increased purchasing power on consumption, while the substitution effect shows how relative income and prices affect consumption. A change in price affects the consumer's purchasing power. You can determine the substitution effect on a product when you analyze consumers' buying behavior toward changes in the price of that product with similar products.

The result

The results of the substitution effect and income effect also differ. Consumers choose to replace products with higher prices with similar, lower-priced ones. When prices fall, the income effect results in consumers buying more quantity of a product, as they can get more with the same amount of money.

How the substitution effect works

The substitution effect tries to explain how a price increase in goods and services might cause customers to look for cheaper alternatives as substitutes. The substitution effect may benefit retailers who sell products and services at more affordable prices than their rivals. It may also work when prices or income increase. For instance, a customer might decide to purchase a more costly version of a product or service after experiencing an increase in their disposable income.

How the income effect works

The income effect analyzes consumer spending patterns in response to a change in income. An increase in disposable income typically results in a shopper's decision to spend money on pricier or better-quality goods. Spending tends to drop with a decrease in earnings, though you can't use this effect to predict what individuals are going to purchase. Consumers' tastes and preferences can also affect their spending patterns. For instance, they may decide to buy cheaper items in bulk rather than fewer expensive ones, or they might buy a few costly items rather than many inexpensive items.

Which effect has more influence over consumers?

Customers may react in various ways depending on their income and the substitution effect. When there's little opportunity for price discounting, an increase in prices might change the income effect significantly. For example, some areas might have only one internet service provider. This may force consumers to choose between canceling their service or reducing their standard of living if the provider raises fees. An increase in disposable income has a larger effect on the demand for services in this context.

The substitution effect may have more influence on customers in settings where there are several viable alternatives. A customer looking to buy a product like a car may select the less expensive model. Determining which available products provide the best value can save you time and money. In highly competitive markets, the substitution effect may also help businesses set prices. It can persuade customers who believe the alternative to be excessively costly to try a product at a lower price.