Intro to Taxation

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Taxes are an **involuntary** fee levied on individuals or corporations that is enforced by a government entity, whether local, regional or national in order to finance government activities. Unlike most transfers of money, which are entered into voluntarily, taxation is compulsory. In previous classes we showed that government must intervene in order to provide adequate amount of public goods. We also showed that contributions to support public services need to compulsory to avoid the free rider problem.

Is Taxation theft?

Such forced transfers have been likened to theft. However there is a major difference: transfers through the government wear the mantle of legality and respectability conferred upon them by the political process. When the political process in a country becomes detached from the citizenry and its used to transfer resources to the groups in power, the distinction between taxation and theft becomes blurred at best.

Principles of Taxation

Adam Smith's four principles for taxation

1. Equality: taxes should equally burden all individuals or entities in similar economic circumstances.
    - Equality of sacrifice: the burden of taxation should involve an equal sacrifice for every individual.
    - Ability to pay: taxes should be levied according a taxpayer's ability to pay.
2. Economic Efficiency: tax collection efforts should not cost an inordinately high percentage of tax revenues.
3. Convenience: taxes should be enforced in a manner that facilitates voluntary compliance to the maximum extent possible.

4. Certainty/Predictability: collection of taxes should reinforce their inevitability and regularity.

More principles of Taxation

Adequacy: taxes should be just-enough to generate revenue required for provision of public services.

Broad Basing: taxes should be spread over as wide as possible section of the population, or sectors of economy, to minimize the individual tax burden.

Neutrality: taxes should not favour one group or sector over another, and should not be designed to interfere-with or influence individual decisions-making.

Simplicity: tax assessment and determination should be easy to understand by an average taxpayer

Effects of Taxation

- Behavioral Effects
- Financial Effects
- Organizational Effects
- General Equilibrium Effects

Announcement effects

Economy does not adjust automatically to a tax. Often the long term distortions are bigger than the short term distortions, as the economy is able to respond more fully to the new circumstances. However, in some cases the effects of a tax may be felt even before the tax is imposed, simply upon announcement. We call those effect announcement effects. For example, the announcement of a future increase in property tax, will impact the construction industry even before tax is imposed.

Distortionary and Non-distortionary Taxation

A tax is *nondistortionary* if, and only if, there is nothing an individual or firm can do to alter the tax liability. Economists call taxes that are *nondistortionary* lump-sum taxes.An example would be a head-tax, a tax one has to pay regardless of income, consumption or wealth. However, most taxes are *distortionary.* If a tax is imposed on income, an individual can reduce his/her liability by simply working less hours. If a tax is imposed on consumption of a product, an individual can reduce his/her liability by simply purchasing less units.

Types of Taxation

In 1696 in England, was introduced the Window tax. Houses with more than ten windows had to pay a steep ten shillings. Many houses bricked up their windows to reduce the number which caused health problems. After 156 years, it was repealed in 1851 following campaigners branded it a "tax on health" and "tax on light and air".In 1698, Russia instituted a beard tax to bring Russian society in line with Western European models. Police could forcibly and publicly shave those who refused to pay the tax.If you're in a hot air balloon in Kansas but it's tethered to the ground, the experience is taxed at a rate of 6.5%. But if the balloon is set free, it means you're traveling from one place to another (technically considered "air commerce") and therefore the ride is tax-free.In New York, a bagel by itself is exempt from tax. But if you slice a bagel or smear anything on it, then it's a "prepared food"

Direct and Indirect Taxes

There are two broad categories of taxes: direct taxes on individuals and corporations and indirect taxes on goods and services. **Direct taxes include:** - Taxes on income: personal income tax, payroll tax, social security contributions, capital gains tax, corporate tax - Taxes on wealth: estate tax, inheritance tax, solidarity tax **Indirect taxes include:** - Taxes on Consumption/sales: VAT, sales tax, excise taxes (tobacco, alcohol etc.) - Taxes on Imports/Exports: tariffs/duties

Per unit or *Ad Valorem* Taxes

A per unit taxis a set amount of tax per unit sold, such as a 10p tax on packets of cigarettes. In contrast, an *ad valorem* tax is a percentage tax based on the value added by the producer, such as a 20% VAT.

Tax revenues in the world

Taxation Terms

Tax evasion and avoidance

Both aim to reduce tax liability. Tax Evasion is illegal. Breaking the letter and the spirit of the law. Tax Avoidance is Legal. Breaking the spirit, not the letter of the law.

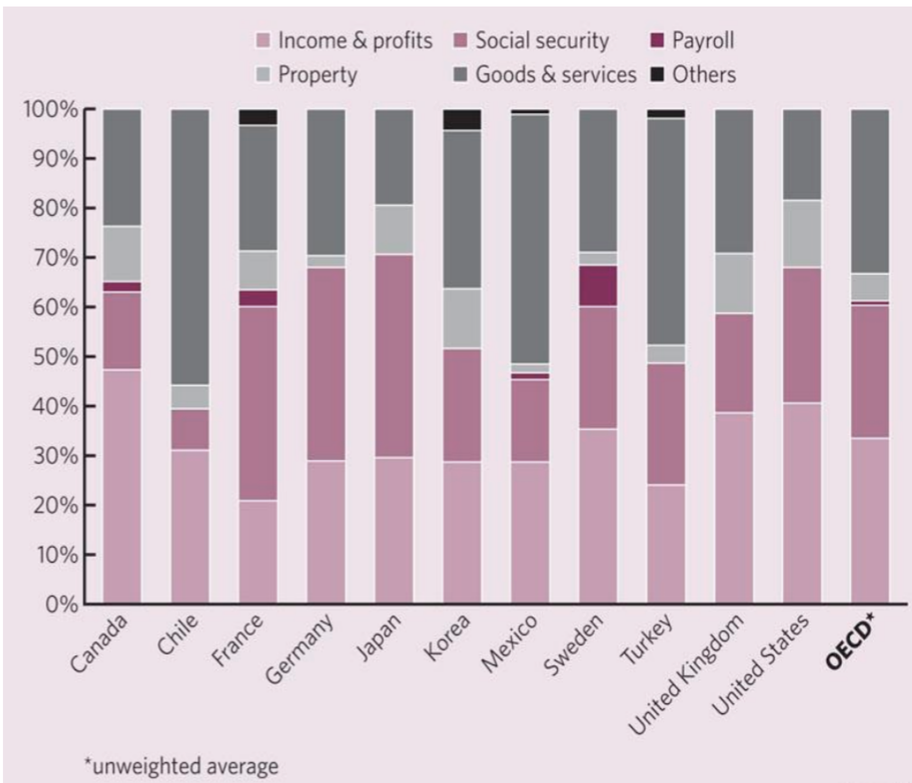

Figure 1: Taxes around the World

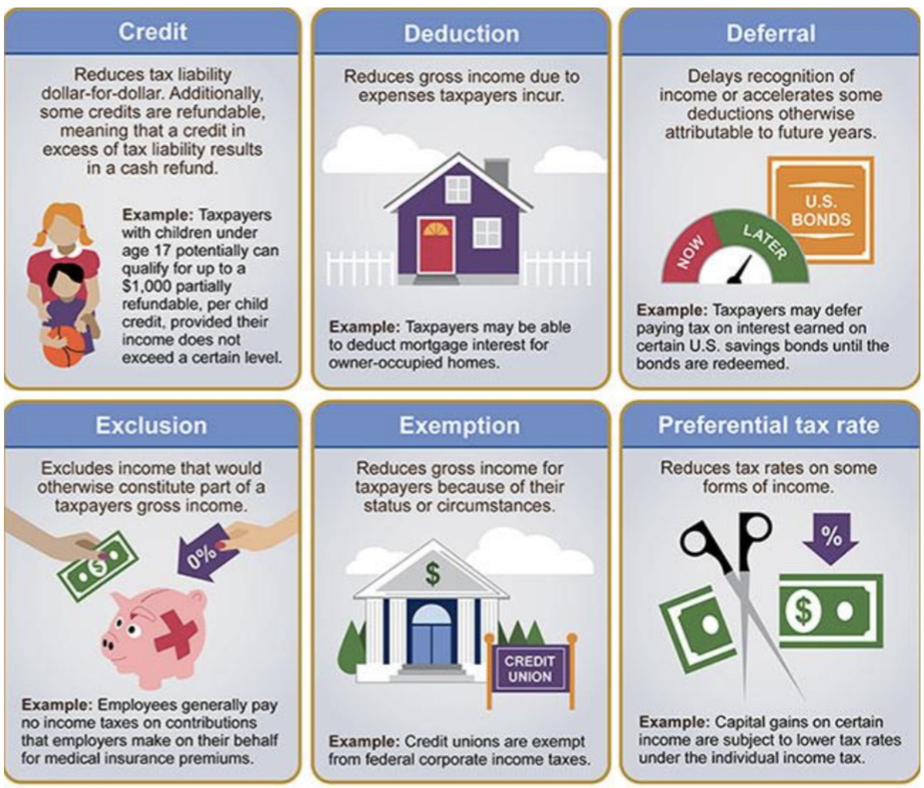

Figure 2: Terms around Taxation

Income Tax

An income taxis a tax imposed on individuals or entities (taxpayers) that varies with their respective income or profits (taxable income).Income can be taxed at source (payment of income is done after the deduction of tax) or can be taxed after receipt of income. E.g. Pay as you Earn (PAYE) vs Self Assessment.

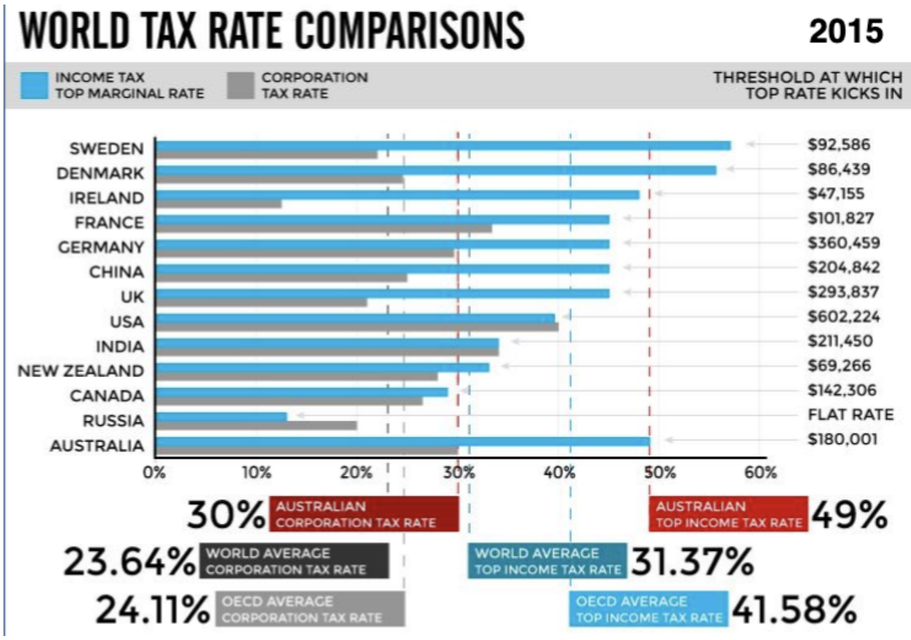

Figure 3: Income Tax Rates around the world

Sales Tax

A value-added tax (VAT), also known in some countries as goods and services tax (GST), is a type of general consumption tax that is collected incrementally, based on the increase in value of a product or service at each stage of production or distribution.

Sales Tax Vs. VAT

VAT (Value-Added Tax) is collected by all sellers in each stage of the supply chain. Suppliers, manufacturers, distributors and retailers all collect the value added tax on taxable sales. All pay the VAT on their purchases. Businesses must track and document the VAT they pay on purchases that will be resold in order to receive a credit for the VAT paid on their tax return. Tax jurisdictions receive the tax revenue throughout the entire supply chain as opposed to at the sale to the final consumer chain.In United States there is no VAT (the only OECD country without one). Instead a sales tax is collected by the retailer when the final sale in the supply chain is reached via a sale to the end consumer. End consumers pay the sales tax on their purchases. Unlike VAT, sales tax is levied on the total value of goods and services purchased.