Tax Incidence 1: Introduction

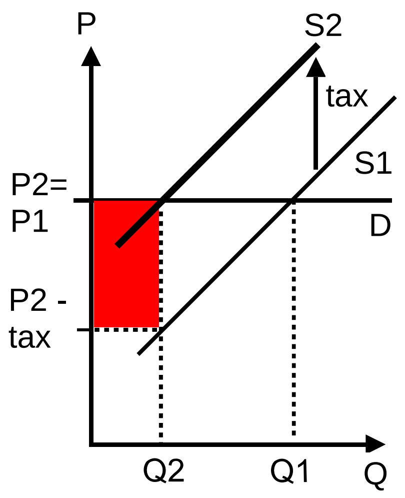
1 Example

A government introduces a new sales tax, for example $ 1 per piece, payable by the seller. Who bears such a new tax at the end of the day?

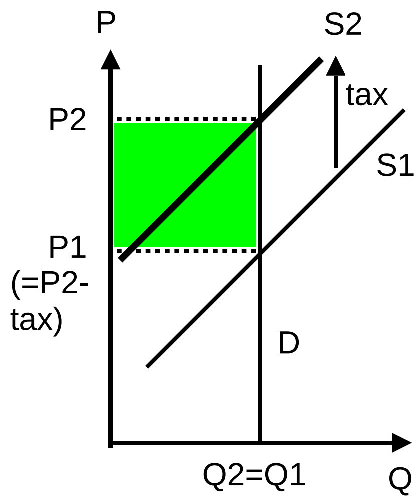
2 Tax incidence at work

The price elasticity of demand (e) plays an important role. Three different cases can be distinguished.

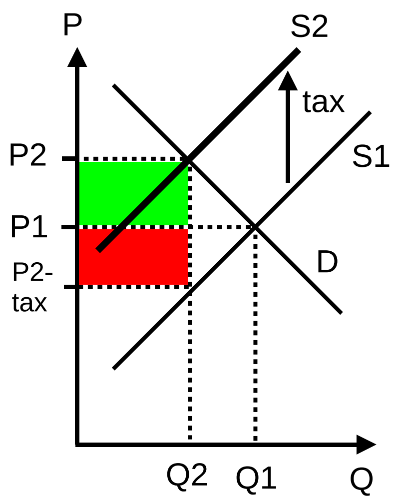
21 e = infinite



22 e = 0



23 0 < e < infinite



Abbreviations

P = Price Q = Quantity D = Demand S = Supply

Case 21 (e = infinite)

Buyer	
Old price	P1
New price	P2
	(but P2 = P1)
Seller	
Old net revenue	P1
New net revenue	P2 - tax
or	P1 - tax

Result

Tax is borne completely by the **seller**. For the buyer, P does not change.

Case 22 (e = 0)

Buyer	
Old price	P1
New price	P2
Seller	
Old net revenue	P1
New net revenue	P2 - tax
or	P1

Result

Tax is borne completely by the **buyer**. For the seller, net revenue does not change.

Case 23 (0 < e < infinite)

Buyer	
Old price	P1
New price	P2
	P2 **<** (P1 + tax)
Seller	
Old net revenue	P1
New net revenue	P2 - tax
	(P2 - tax) **<** P1

Result

Tax is borne **partially** by the buyer and partially by the seller. The **distribution** depends on the **price elasticity of demand and** on the **price elasticity of supply**.