

ECONOMIC BRIEF NO. 11

When Are Taxes Shifted? It Depends!

This series of economic briefs explores fundamental concepts in economics and community and economic development.

Proposals are afloat for a national value-added tax (VAT), increases in so-called "sin" taxes on tobacco and alcohol, and perhaps elimination of some exemptions to the state sales tax. For any tax change, an important concern centers on who, in the end, will bear the increased tax burden.

Many citizens understand that taxes get passed on to consumers by businesses. But not all taxes get passed on. Businesses absorb some taxes rather than passing them on to consumers by raising the price of a product. So

relatively small changes in the amount of food purchased. So it is relatively easy to shift taxes by simply adding them to the prices of food and other necessities. Almost all of a retail sales tax on food is passed on to consumers.

Shifting a tax is more of a problem when it comes to luxury goods. Adding a tax to the price can mean a substantial loss of sales. If sales fall sharply when a tax is passed on, producers and merchants will effectively pay at least some of the tax because their profits fall as a result of lost sales. For this reason, airlines often absorb part of the taxes on tickets.

A general VAT, therefore, will have its greatest effect on consumers in the form of higher prices of basic necessities. Its effect on suppliers of such necessities is apt to be very small. The same tax, on the other hand, will have a significant effect on businesses providing non-essential goods and services, or luxuries. These firms could reduce profits or see reduced sales (or both).

Some taxes are more easily shifted to buyers than others. There is considerable debate, for example, over who really pays the property tax. Undoubtedly,

homeowners pay since they have no one to whom they can shift the tax. But do landlords shift higher property taxes to renters? Do businesses pass along higher property taxes to customers? The evidence is mixed, suggesting that the answer depends upon local and industry circumstances.

There is also debate over who pays the corporate income tax. In some cases, it may be passed on, at least in part, to consumers. In many other cases, however, taxes have the effect of lowering return on stockholders' equity and actually represent a tax on savings and investments. Such a tax may lead to slower long-term economic growth.

What about so-called "sin" taxes? If tobacco and alcohol are truly addictive, taxes through price increases can easily be passed on to consumers in the short run. In the long term, higher prices, however, may discourage people from developing these habits. Thus higher sin taxes could have adverse impacts for tobacco growers, breweries, distilleries, and tobacco manufacturers, but beneficial effects by discouraging the use of harmful products.

Taxes are a necessary cost of having government services. When we design them, however, we need to be sure who is ultimately bearing the tax burden.

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how much tax is passed on and how much is absorbed? Basically, the firm bases its decision on the effect that raising prices will have on sales.

First of all, economists know that if it is possible to increase the price of a product without losing many sales, it is highly likely a tax will be shifted to the consumer. The ability to shift a tax, however, depends upon the nature of the product being sold and upon the type of tax.

For necessities like basic food-stuffs, relatively large changes in prices usually bring forth only