

Question: Could you briefly explain how income tax affects aspects of markets/business.

Remember how the excise tax effects the product market, it effects the demand or the supply and changes equilibrium driving a wedge between price or product paid and amount kept by the firm. The result of a tax in the product market is less product sold, more costly to the buyer (consumer), less rewarding to the seller (the producer) and leads to a deadweight efficiency loss.

The key to understanding income taxed is to recognize the concept of derived demand, that the amount of labor demanded is derived from the product demand. If no one wants the item produced, no one will get jobs to make it...

The income tax effects the demand or the supply OF LABOR and changes equilibrium EMPLOYMENT driving a wedge between the cost of hiring a worker and the amount received by the employee. The result of an income tax in the factor or labor market is less employees hired (and less product produced), more costly to the buyer (employer), less rewarding to the seller (the worker) and leads to a deadweight efficiency loss in the labor market. If I use less labor and it is a complement to capital, I will have less capital as well. Since product output is a function of both labor and capital there is going to be less output and that will drive up prices to consumers.

It gets more complicated as capital gets substituted for labor (avoiding the higher cost labor), as consumers substitute to non income taxed produced items (foreign goods), and as technology is employed again to avoid old capital and labor.

There is proof in the market (ala Kennedy, Reagan and Bush II) that cutting taxes (when they are too high) leads to greater growth in the overall economy. It stands to reason that higher income taxes stifle the growth of the economy.

In all these tradeoffs you have to also determine what society wants, that is how valuable is it for the government to have our money for the collective good.

That is as brief as I can be....

Dr. Myers