Chapter 16: Public Finance: Expenditures and Taxes

The American market economy relies primarily on the actions of private sector firms and consumers. Now that we have fully explored the role of the private sector in providing and consuming products, we turn to a discussion of the role of government in affecting the economic decisions of producers and consumers. Chapter 16 introduces government to the circular flow model, explaining how taxes and government spending affect private sector firms and individuals.

The government is a significant participant in the circular flow model, purchasing resources from households, buying products from firms, providing public goods, extracting tax revenues from firms and households, and redistributing income among firms and households. Federal budget deficits are important because they increase the national debt. Increased government demand for funds in the loanable funds market pushes up interest rates, crowding out private investment and reducing potential economic growth.

While the AP Economics exams to date have not focused on state/local taxes or spending, or on federal categories of spending, it is important to distinguish the types of taxes and the effects of each kind of tax. With progressive taxes, those with higher incomes pay a higher percentage of their income in taxes; with regressive taxes, those with lower incomes pay a higher percentage of their income in taxes. Proportional taxes collect the same percentage of income in taxes, regardless of income level. The type of tax implemented has important ramifications for the purchasing power of consumers at various income levels and the mix of goods that will be produced.

Tax incidence, the person who actually pays the final tax, is also an important consideration for policymakers. Because some taxes can be shifted (e.g., from producers to consumers, or from rental property owners to renters), it is important to understand who will actually pay the tax. If an excise tax is placed on a product with relatively elastic demand, consumers will be sensitive to the price change; therefore, the firm must absorb most of the cost of the tax to avoid losing very many customers. If an excise tax is instead placed on a product with relatively inelastic demand, most consumers will continue to buy the product at the higher price, and the producer can successfully shift most of the tax to the consumer. The tax, however, creates a deadweight loss, a loss of producer and consumer surplus as a result of the lower output.

Material from Chapter 16 consistently appears in a few multiple-choice questions and infrequently a free-response question on the AP Microeconomics Exam. It is important to be able to graph the effects of the tax (changing supply) and identify the area of deadweight loss.