

Chapter 11: Tax Incidence: Who Really Pays

"I agree perfectly... that we should tax the rich. But the trouble is that when we try to do it, the rich don't pay it. The poor pay it. We can't tax the rich because the rich can quit." —

Attributed to Calvin Coolidge (summarising Andrew Mellon's tax philosophy, 1924)

The tax debate is conducted in the language of morality and settled, if at all, by the arithmetic of headlines. A levy is proposed. A villain is named. A sum is announced. And then, with the satisfied air of having performed justice, the public is invited to imagine that the person who writes the cheque is the person who bears the cost.

This is a child's understanding of taxation.

Taxation is not merely the act of collecting money. It is the act of changing incentives. Incentives change behaviour. Behaviour changes prices, wages, investment, location, and production. Those changes determine who *actually* pays. The bearer of the burden is not necessarily the party whose name appears on the assessment notice. The cheque writer is a visible target. The true payer is often an invisible one.

This is what economists mean by *tax incidence*: the distribution of a tax's real economic burden across people who may never receive a bill. Incidence is the question that turns political theatre into analysis. It is also the question most political arguments are designed to avoid, because it dissolves the comforting idea that one can punish a disliked group without consequences for everyone else.

Tax incidence is the discipline of second effects applied to revenue.

It insists on four inconvenient facts. First, taxes on firms can become taxes on workers through lower wages or slower wage growth. Second, taxes on transactions can become taxes on consumers through higher prices. Third, taxes on capital can become taxes on savers through lower asset values and lower future returns. Fourth, taxes on "the rich" often become taxes on the mobile—meaning taxes on the immobile, because mobile capital and high-skill labour do not sit politely while governments experiment.

In what follows, the aim is not to argue that taxes should never be raised, or that governments should never spend, or that social obligations do not exist. The aim is to show that the moral language of taxation is usually detached from the mechanics of taxation, and that this detachment reliably produces policies that hurt the very people they claim to help.

If you do not understand incidence, you do not understand taxation. You understand slogans.

I. The first error: confusing the payer with the payee

The first error is conceptual. It is the belief that a tax is “paid” by the entity that remits it.

A business remits corporate tax. Therefore the business “pays.”

A landlord remits property tax. Therefore the landlord “pays.”

A shareholder remits capital gains tax. Therefore the shareholder “pays.”

A firm remits payroll taxes. Therefore the firm “pays.”

This is not analysis. It is accounting.

In each case, the remitter is merely the point of collection. The question is whether the remitter can adjust behaviour—prices, wages, investment, location—to shift the burden elsewhere. If it can, incidence moves.

The deeper point is that tax incidence is determined not by law but by market conditions. The legal incidence is who must send the money. The economic incidence is who must bear the reduced purchasing power.

The distinction is as old as serious political economy and as ignored as ever.

II. Incidence is governed by elasticity: who can move, who cannot

The central driver of incidence is *elasticity*—how responsive buyers and sellers are to changes in price.

If consumers are highly sensitive to price (elastic demand), firms cannot raise prices much without losing customers. In that case, a tax on the firm may be borne more by the firm’s owners (lower profits) or by workers (lower wages), because price pass-through is limited.

If consumers are not very sensitive to price (inelastic demand), firms can raise prices without losing much business. In that case, a tax on the firm may be borne mostly by consumers.

On the supply side, if producers can easily relocate or reduce production (elastic supply), taxes drive activity elsewhere, and those who cannot move bear the burden.⁴⁵

A simple rule emerges: the side of the market that is least able to adjust bears more of the tax.

The political significance is brutal. Wealth and high-skill labour are often more mobile than low-skill labour and local consumers. Therefore a large share of the burden of “taxing the rich” can fall on those who cannot relocate: ordinary workers, renters, and local consumers.

Coolidge’s attributed line captures this in vernacular form: the rich can quit. The poor cannot.

III. Four channels of tax pass-through

Taxes can be shifted through multiple mechanisms. The public debate tends to recognise only one: price increases. But incidence can also show up as wage suppression, reduced investment, and asset repricing. These channels interact.

A. Price effects: the consumer pays

If a firm faces a new tax and can raise prices, it will attempt to do so. The extent depends on demand elasticity and competitive conditions.

This is the most visible form of pass-through. People notice higher prices. Yet they often misattribute them: “greed,” “price gouging,” “corporate malice.” Sometimes opportunism exists. But price increases after taxes are often simply arithmetic: a cost has been imposed; it is passed on where possible.

A tax on fuel raises transport costs. Transport costs raise the delivered price of everything. A tax on energy raises the cost of production and heating. A tax on imports raises consumer prices directly.

This is incidence as inflation-by-policy: a price-level increase driven not by monetary expansion but by imposed costs. For households, the distinction is academic. The grocery bill rises either way.

B. Wage effects: the worker pays

When prices cannot rise enough, businesses seek other adjustments. The most common is labour cost adjustment—often not through nominal wage cuts (which are politically and

⁴⁵ **Marion & Muehlegger (2011)**, “Fuel Tax Incidence and Supply Conditions,” *Journal of Public Economics*. Empirically demonstrated that fuel taxes are almost entirely passed through to consumers when supply is elastic (refineries can adjust) and demand is inelastic (drivers need fuel).

psychologically difficult) but through slower wage growth, reduced hours, fewer hires, weaker benefits, or postponed promotions.

This is why taxes on employers can fall on employees even if the legal obligation is on the firm. Over time, wages adjust to productivity and to the demand for labour. A tax that reduces the after-tax return to operating a business reduces investment and expansion. Less expansion reduces demand for labour. Reduced demand weakens bargaining power. Wages are lower than they otherwise would have been.

The worker does not receive a bill. The worker simply receives a smaller future.

The cruelty is that this burden is invisible. It shows up as the job that was never created, the raise that never came, the training budget that was cut, the expansion that was postponed.

The public rarely riots over “the raise that didn’t happen.” It riots over visible cuts. This is why wage incidence is politically convenient and economically devastating.

C. Asset-value effects: the saver pays

Taxes on capital—corporate taxes, wealth taxes, capital gains taxes, transaction taxes—often reduce asset values.

This seems counterintuitive to those who imagine assets as fixed piles of wealth. But asset values are present values of expected future cash flows. If taxes reduce future cash flows, expected returns, or growth prospects, valuations adjust downward.

A corporate tax reduces net profits. Lower net profits reduce dividends or reinvestment. Reduced reinvestment reduces growth. Reduced growth reduces expected future cash flows. Prices fall.

A transaction tax reduces liquidity. Reduced liquidity raises the required return to compensate for trading frictions. Higher required return lowers present value. Prices fall.

A wealth tax forces periodic liquidation or leverage, increasing sell pressure and reducing the attractiveness of holding concentrated equity. Prices fall.

When prices fall, the burden is not borne only by “billionaires.” Public equities are held by pension funds, retirement accounts, endowments, and insurance pools. Asset repricing hits the middle class through retirement balances and institutional funding. The incidence spreads through the financial system.

This is why capital taxation is never as neatly targeted as political rhetoric suggests. The wealthy may have larger exposures, but they also have more diversification and more access to planning. Those with retirement accounts bear real losses and cannot easily restructure.

D. Location effects: the immobile pays

Some taxes do not merely shift prices or wages. They shift geography.

When a jurisdiction raises taxes on mobile factors—capital and high-skill labour—it can change where investment occurs, where businesses expand, where innovators locate, where headquarters sit, where production is placed. The effect may be slow, but it is real.

As mobile activity moves, the tax base shrinks. The jurisdiction then responds by raising rates further or broadening the base to less mobile factors. The burden shifts toward land, consumption, and labour—things that cannot quit.

This is how tax policy can become a machine for punishing the local. The rich who can leave do leave, or at least adjust. The community remains and pays in weaker job growth and higher local taxes.

IV. Corporate tax: the moral favourite, the economic mirage

Corporate tax is politically popular because it appears to target “corporations,” a term that functions as a moral category in popular debate. But a corporation is not a person. It is a legal structure linking owners, workers, customers, and suppliers.

Therefore corporate tax must fall on people.

The incidence question is: which people? Owners, workers, or customers?

In competitive markets with mobile capital, a substantial portion can fall on workers over time. If after-tax returns fall, investment declines. Lower investment reduces productivity growth. Lower productivity growth lowers wages. The effect is gradual, diffuse, and difficult to attribute. Which makes it politically safe.⁴⁶

This does not mean owners bear nothing. They can bear part through lower profits. But the popular belief that corporate tax is “paid by corporations” is incoherent. It is paid by human beings through some combination of lower wages, higher prices, and lower returns.

⁴⁶ **Fuest et al. (2018)**, “Higher Corporate Taxes Reduce Wages of Low-Skilled Workers,” *American Economic Review*. Using data from German municipalities, this study found that workers bear about 51% of the total tax burden from corporate tax increases, with low-skilled workers and women bearing a disproportionate share.

The corporate tax debate is often a morality play staged over a mechanism.

V. Wealth taxes and “paper wealth”: incidence through forced liquidity

A wealth tax is often defended with a slogan: “it’s only a small percentage; it won’t affect lifestyles.” This is not the point.

The point is liquidity.

Most large fortunes are not piles of cash. They are illiquid claims on productive assets: founder equity, private holdings, control blocks, real estate, intellectual property. A recurring tax bill requires cash. If cash flows are insufficient, the taxpayer must sell assets or borrow against them. Both actions have incidence effects beyond the taxpayer.

Forced sales create persistent sell pressure, especially in concentrated positions. Markets clear at the margin. Price is set by the next buyer and seller, not by the average holder’s comfort. Price-insensitive selling widens spreads and can depress valuations. Depressed valuations reduce wealth across all holders, including pension funds and index investors.

Borrowing against assets to pay wealth taxes increases leverage. Increased leverage increases fragility. Fragility increases systemic risk. Systemic risk raises risk premia. Higher risk premia lower valuations. Again, the incidence spreads.

A wealth tax can therefore operate as a valuation tax, not merely a revenue tax. It reduces the capital base from which future production and wages arise. The burden appears as lower future output and lower future returns, not merely as a redistribution of current consumption.

This is why “tax the rich” rhetoric often misfires. It targets symbols, not mechanisms.

VI. Property taxes, rents, and the myth of landlord-only incidence

Property taxes are legally levied on property owners. Yet in many contexts, especially housing markets with constrained supply, the burden can be shifted onto renters through higher rents.

The mechanism is simple. If housing supply is inelastic—because zoning and planning restrict building—landlords face relatively stable demand. They can raise rents. The tax becomes part of the rental price. Renters pay.

Where supply is more elastic and competition stronger, landlords may bear more of the burden through lower net returns or lower property values. Again, incidence depends on market conditions, not moral intention.

This is why housing policy and tax policy cannot be separated. A city that restricts supply and raises property taxes often ends up taxing renters while claiming to tax owners.

The renter becomes the hidden payer.

VII. Payroll taxes: incidence hidden in the labour contract

Payroll taxes are often split between employer and employee on paper. Economically, much of the burden can fall on workers through lower wages over time, especially when labour supply is relatively inelastic.

The worker sees the deduction and believes it is the worker paying. The employer sees its portion and believes it is the employer paying. In practice, the total cost affects the wage bargain. If the cost of employing a worker rises, the firm offers a lower wage than it otherwise would. The incidence is shared depending on labour market conditions.⁴⁷

Payroll taxes therefore function as a wedge between what the employer pays and what the employee receives. The wedge can reduce employment, especially for low-skill workers whose productivity is closer to the minimum wage floor. This can trap people at the bottom: the tax intended to fund social support can reduce entry-level opportunities.

Incidence here shows up as exclusion.

VIII. Sin taxes and moral taxation: punishing demand, punishing the poor

“Sin taxes” are often defended as public health tools: taxes on tobacco, alcohol, sugary drinks, gambling. Their incidence is often regressive because consumption of these goods is disproportionately concentrated among lower-income groups, and because demand can be relatively inelastic for addictive products.

The moral theatre is intense: the tax is framed as discouraging vice. The fiscal reality is also intense: governments become dependent on the revenue from the very behaviour they claim to discourage.

⁴⁷ **Gruber (1997)**, “The Incidence of Payroll Taxation: Evidence from Chile,” *Journal of Labor Economics*. Found that when payroll taxes were privatized (reduced for firms), wages rose almost dollar-for-dollar, confirming that firms view payroll taxes as part of the total compensation package; reducing the tax benefits the worker, raising it hurts the worker.

The poor pay both ways: through the higher prices and through the social costs that persist.

This does not mean such taxes are never justified. It means they are not morally clean. They are behavioural policy disguised as revenue policy.

IX. The politics of visible cheques and invisible burdens

Tax debates are designed to emphasise visibility: who receives the bill. Visibility produces moral satisfaction. The trouble is that visibility is a political variable, not an economic one.

The greatest political advantage of incidence shifting is that it creates plausible deniability. Legislators can claim to punish a disliked group while the costs disperse through prices, wages, and asset values. The public sees the bill sent to “them” and does not see the smaller pay packets, higher prices, and weaker pension returns.

This is why incidence analysis is politically unwelcome. It ruins the story.

But the story is not what people eat. The second effects are.

X. A simple framework for readers: four questions to ask of any tax

To cut through rhetoric, ask four questions.

1. Who can change behaviour?

The more mobile party shifts burden.

2. How elastic is demand and supply?

The less elastic party bears more cost.

3. Where will the adjustment occur: prices, wages, or investment?

If prices cannot rise, wages or investment will often fall.

4. What assets reprice?

If expected future returns fall, asset values fall—hitting savers.

These questions do not give a slogan. They give a discipline.

XI. The lesson: taxation is incidence, not intention

The moral impulse to tax “the rich” is often sincere. The economic result is often different from the intention. This is not because the rich are magically immune. It is because economies are systems of adjustment. The rich have more adjustment options. The poor have fewer.

If you want to tax a thing, you must first ask whether that thing can move. If it can, you will tax what cannot.

This is not cynicism. It is mechanics.

The Lesson Line

The cheque writer is easy to name; the bearer is harder to see—so politics targets the visible and bills the invisible.

Chapter 11 Notes:

[1] Corporate Tax Incidence (Workers Pay) Fuest et al., "Higher Corporate Taxes Reduce Wages of Low-Skilled Workers," *American Economic Review* (2018). Using high-quality administrative data from Germany, this study found that workers bear approximately 51% of the total tax burden from corporate tax increases, with low-skilled workers bearing a disproportionate share through suppressed wages.

[2] Elasticity and Pass-Through Marion & Muehlegger, "Fuel Tax Incidence and Supply Conditions," *Journal of Public Economics* (2011). Empirically demonstrated that taxes are passed through to consumers almost entirely when supply is elastic (producers can adjust) and demand is inelastic (consumers need the product), confirming the standard incidence model.

[3] Migration of the "Rich" Kleven et al., "Taxation and Migration of Superstars," *American Economic Review* (2013). Showed that high-income "superstars" (top athletes, inventors) are highly responsive to top marginal tax rates and will migrate to jurisdictions where they can keep more of their income, shrinking the tax base of high-tax states.

[4] Payroll Taxes and Wages Gruber, "The Incidence of Payroll Taxation: Evidence from Chile," *Journal of Labor Economics* (1997). Analyzed the privatization of social security in Chile (which lowered payroll taxes for firms). Found that the cost reduction was passed through to workers as higher wages almost dollar-for-dollar, confirming that firms view payroll taxes as a direct deduction from potential wages.

Governing Claim Taxation is not merely the collection of revenue; it is the alteration of incentives. The person who writes the cheque (statutory incidence) is rarely the person who bears the cost (economic incidence). Because capital and high-skill labour are mobile ("elastic"), taxes aimed at them often shift burdens onto those who cannot move: workers (lower wages), consumers (higher prices), and savers (lower returns).

The "Hazlitt" Examples (Primary)

1. Corporate Tax (The Wage Illusion):

- o *Claim:* Taxing corporations is a painless way to fund the state because "companies" pay, not people.
- o *Hidden Assumption:* Corporations are wealth hoards that cannot adjust wages, prices, or investment.
- o *Mechanism:* Corporations respond to lower after-tax returns by reducing investment. Lower investment slows productivity growth. Lower productivity growth depresses wages.
- o *Lesson:* The worker doesn't receive a tax bill; they simply receive a smaller future.

2. Payroll Taxes (The Shared Wedge):

- o *Claim:* Splitting the tax between employer and employee makes it fair.
- o *Hidden Assumption:* The employer's contribution comes from profits, not the total compensation budget.
- o *Mechanism:* Employers view the tax as part of the cost of labor. If the tax rises, the cash wage offered falls (or grows slower) to keep the total cost constant.
- o *Lesson:* A tax on the job is a wedge that lowers the take-home pay, regardless of who legally remits it.

3. Property Taxes & Renters (The Pass-Through):

- o *Claim:* Property taxes target landlords and asset owners.

- o *Hidden Assumption:* Housing supply is perfectly elastic and landlords cannot pass costs on.
- o *Mechanism:* In supply-constrained cities (inelastic supply), landlords can pass tax increases almost entirely to renters.
- o *Lesson:* A city that restricts building while raising property taxes ends up taxing its poorest residents while claiming to tax assets.

4. **Capital Flight (The Exit Option):**

- o *Claim:* "Tax the rich because they have the money."
- o *Hidden Assumption:* The tax base is a fixed pie that will sit still while being sliced.
- o *Mechanism:* Mobile capital and talent relocate to lower-tax jurisdictions. The tax base shrinks, forcing the state to raise taxes on immobile factors (land, consumption, labour) to make up the shortfall.
- o *Lesson:* If you try to tax what can move, you end up taxing what cannot.