

* *Teacher's version P.141-147*

(Activity 1: To examine the effect of tax on working incentive)

This is an alternative exercise which focuses on the change of tax rate on working incentive excluding the effect of the change of tax allowance on working incentive.

Worksheet 2: The effects of the change of tax rate on working incentive

Suppose a country changes its income tax structure as follows:

<u>Old tax system</u>		<u>New tax system</u>	
Tax allowance*	\$100,000	Tax allowance*	\$100,000
Taxable Income#	Tax rate	Taxable Income#	Tax rate
1st \$100,000	5%	1st \$100,000	10%
2nd \$100,000	10%	2nd \$100,000	25%
Remainder	15%	Remainder	45%

* *Tax allowance is part of income that is not subject to tax.*

Taxable income = Gross income – Tax allowance

Consider the following three persons (you may interpret A as a low-income worker, B as a middle-class member and C as a millionaire) and show the effects of the changes in the tax system on the disposable income by completing the following tables. How would their working incentive be affected?

Under the old tax system

Person	Gross income	Taxable income	Tax payment	Disposable income	Disposable income / Gross Income
A	\$120,000				
B	\$300,000				
C	\$1,000,000				

Under the new tax system

Person	Gross income	Taxable income	Tax payment	Disposable income	Disposable income / Gross Income
A	\$120,000				
B	\$300,000				
C	\$1,000,000				

Questions

Q.1 If we assume that the three individuals have no change in income under the new tax system. Who is affected most under the new system? Why?

Q.2 However, it is not realistic to assume that their earnings remain unchanged when the tax system changes, because people will respond to tax incentive or disincentive. Based on the above data, Who is/are less willing to work under the new system? Explain your answer.

Q.3 What conclusion(s) can be drawn from the above questions?
(Hints: what factors will affect the working incentive in response to a rise in (marginal) tax rate?)
