Problem Set 4

1. Suppose the government announced that in 5 years marginal tax rates for everyone would go up.

A. How would this change the tax prices people expected to face in 5 years?

B. If giving in 5 years and giving now are substitutes, what would happen to giving now?

C. What would happen to giving now if they are compliments?

2. Suppose that the demand for charitable giving can be expressed as follows:

$$g = m - m(1-t)\ ,$$

where g is giving, m is after-tax income, and $t > 0$ is the marginal tax rate.

A. Is giving a normal good?

B. What is the tax-price of giving? Does charitable giving obey the law of demand?

C. Suppose after-tax income is \$5,000 and the tax rate is 20% (so t is 0.2). How much will this person give to charity?

D. Using the values given in part C for m and t, figure out this individuals' tax-price elasticity of demand.

E. Again, consider the values given in part C. Suppose the government wanted to lower this person's taxes by \$500. Thus, after the government lowers tax payments after-tax income will be \$5,500. The government can lower taxes by \$500 two ways: send the person a refund check for \$500, or by lowering t. If the government decided to lower t so that taxes fell by \$500, what would the new t be? How would giving differ depending on whether the government sent a check or lowered t?