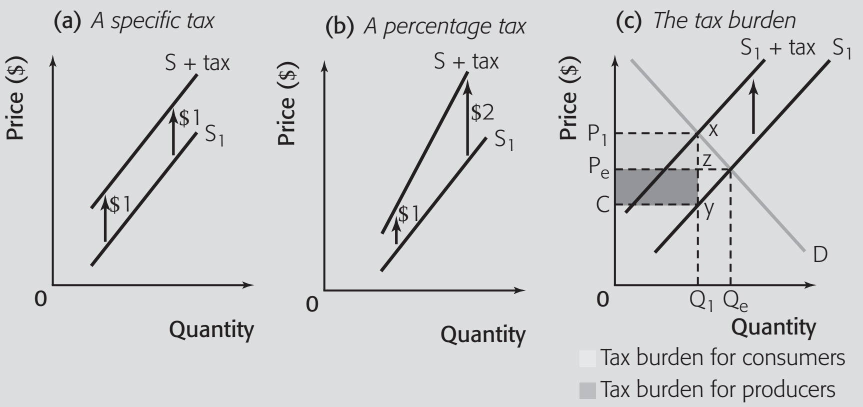
13 Revision – Taxation

Indirect tax: Expenditure tax on goods and services, e.g. the Mehrwertsteuer in Austria. It is shown as a decrease in supply. (*Microeconomics*)

Ad valorem tax: An indirect percentage tax. It is shown as a divergent shift of a supply curve, with a higher tax paid at higher prices of the product. (*Microeconomics*)



Flat rate (specific tax): A fixed amount indirect tax, where the tax is the same regardless of the price of the product. It is shown as a parallel shift of the supply curve. (*Microeconomics*)

Incidence of tax: This refers to the 'burden' of an indirect tax – i.e. who pays more of an indirect tax, producers or consumers. (*Microeconomics*)

Direct tax: Tax paid on income. Households pay income tax, businesses pay corporate tax. (*Macroeconomics*)

Progressive tax: A system of taxation where the higher the income, the higher the marginal and average rate of tax paid. Most countries have a progressive direct tax system as a means of redistributing income from high-income earners to lower-income earners. (*Macroeconomics*)

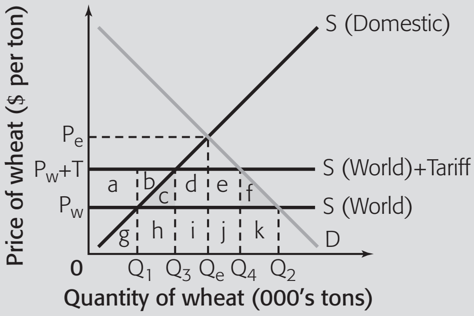
Regressive tax: The higher the income, the lower the average rate of tax paid. All indirect taxes are regressive. For example, a 1 euro tax on a package of cigarettes will make up a lower proportion of income for a high-income person than for a lower-income person. Direct taxes are never regressive. (*Macroeconomics*)

Proportionate tax: A system of direct taxation where people at all income levels pay the same average tax, e.g. all people pay 15% of income. (*Macroeconomics*)

Fiscal policy: The set of government policies regarding taxation and government spending. Fiscal policy is used to manage aggregate demand (AD) in the economy. (*Macroeconomics*)

Expansionary fiscal policy: Government policy to raise AD in the economy by lowering taxes and increasing government spending. (*Macroeconomics*)

Contractionary fiscal policy: Government policy to lower AD in the economy by raising taxes and decreasing government spending. (*Macroeconomics*)



Transfer payments: Payments from the government for no economic output, in order to redistribute income, e.g. unemployment benefits, pensions. (*Macroeconomics*)

Tariffs: A tax on imports to protect domestic producers. The diagram is drawn differently from a normal tax diagram as we assume that there are two different supply curves – a normal supply curve representing the amount that domestic producers are willing and able to supply, and a perfectly elastic world supply curve indicating that there is an infinite supply of the good from global suppliers. (*International trade*)

Why do governments tax?

You need to know all four items in this list, not just three!

1. To reduce the quantity of products the production or consumption of which causes negative externalities (i.e. to correct market failure).
2. To raise money for government spending.
3. To manage the level of AD in the economy. (Keynesian demand management.)
4. To redistribute income.

1. To correct market failure

Goods called de-merit goods, e.g. cigarettes, alcohol and petrol, create negative externalities of consumption. According to the law of demand, an increase in their prices due to a tax will cause a reduction in quantity demanded.

Since the demand for such goods tends to be inelastic due to their necessity or consumers' addiction, the burden of tax will fall mainly on the consumers.

This is good in the sense that it doesn't penalize the producers overly. On the negative side, because the demand is inelastic, the fall in quantity demanded will be proportionately smaller than the change in price and so the attempt to reduce consumption considerably may be unsuccessful, particularly in the short run where demand is known to be less elastic. However, such indirect taxes may be useful in preventing new consumers, e.g. young people, from starting to consume such goods. Their demand is likely to be more elastic, as they have not yet developed addictions, and such products would consume a larger share of their income. In the longer run, then, the quantity demanded would fall as fewer new consumers take up the habits.

Another concern is that if governments raise taxes too much, it is likely that black markets will develop as consumers seek to avoid paying taxes.

It is arguable as to how much governments actually do want to reduce consumption of such goods. Taxes on de-merit goods create a large amount of government revenue, which can be used for necessary government spending on infrastructure, health and education, and it can also be used to fund campaigns to reduce consumption of such goods. Sadly, the government revenue may not be helpful to third parties who have already had to pay the external costs.

2. To raise money for government spending

In order to finance government spending on infrastructure, health care, education, transfer payments, defence, etc., taxes must be paid.

3. To manage the level of AD

Governments who adopt a Keynesian demand management approach use the tool of taxation (part of fiscal policy) to manage the level of AD in the economy.

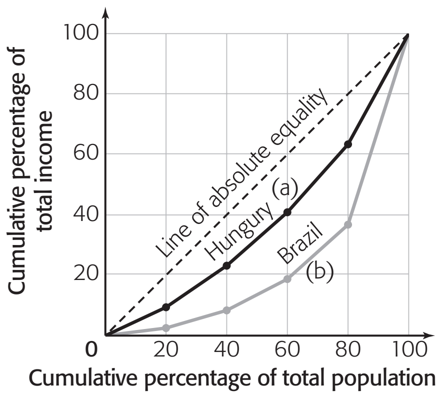
This involves:

- lower taxes to encourage spending and investment when the economy is below the full employment level of income and there is demand-deficient unemployment
- higher taxes to reduce spending when there is demand pull inflationary pressure.

The key issue here is that it is very difficult to change taxes (there are huge legislative steps to go through), and it is most unpopular to raise taxes! This means that monetary policy is more effective at managing AD than fiscal policy. Monetary policy is also considered to be more effective because as long as the central bank of a country is independent, it will make decisions based on the economy, not based on political objectives.

4. To redistribute income

Market systems result in some degree of inequality – demand and supply in labour markets mean different levels of income. The degree of inequality may be measured using the Gini index and Lorenz curve.



A fifth macroeconomic goal is said to be the achievement of equity (not equality) in the economy. This is a very normative (subjective) area of economics. Redistribution of income is achieved through the tax system where government revenue is used to finance transfer payments such as child allowances, unemployment insurance, pensions and other benefits.

Here are some arguments against higher taxes.

- A key feature of the market system is **incentives**. Higher taxes may create a disincentive effect because if people know that higher income means that they have to pay higher marginal rates of taxes, then they may not be motivated to work harder and get better-paying jobs.
- There is likely to be less entrepreneurial activity without the incentive of higher incomes. Since entrepreneurship is one of the factors of production, then this will have negative supply-side effects on the economy.
- If businesses earn higher profits and this puts them into a higher tax bracket, then they have less incentive to invest to increase capacity.
- There might be a brain drain as high-skilled people leave the economy to go to work in places where they don't pay such high taxes.

It may be difficult for the country to attract foreign direct investment, since multinationals will prefer to work in countries where taxes are lower.

Therefore these all have significant negative supply-side effects on the economy and therefore the growth of potential output. *(Remember that cutting taxes is a supply-side policy to increase aggregate supply (AS); therefore higher taxes might reduce AS).*

This may be referred to as the 'efficiency versus equity' argument. Higher taxes may result in greater equity, but the negative consequence might be a less efficient allocation of resources.