Edexcel Economics A-level

Unit 4: The Global Economy

Topic 5: The Role of the State in the Macroeconomy

5.2 Taxation

Notes

Progressive, proportional and regressive taxes

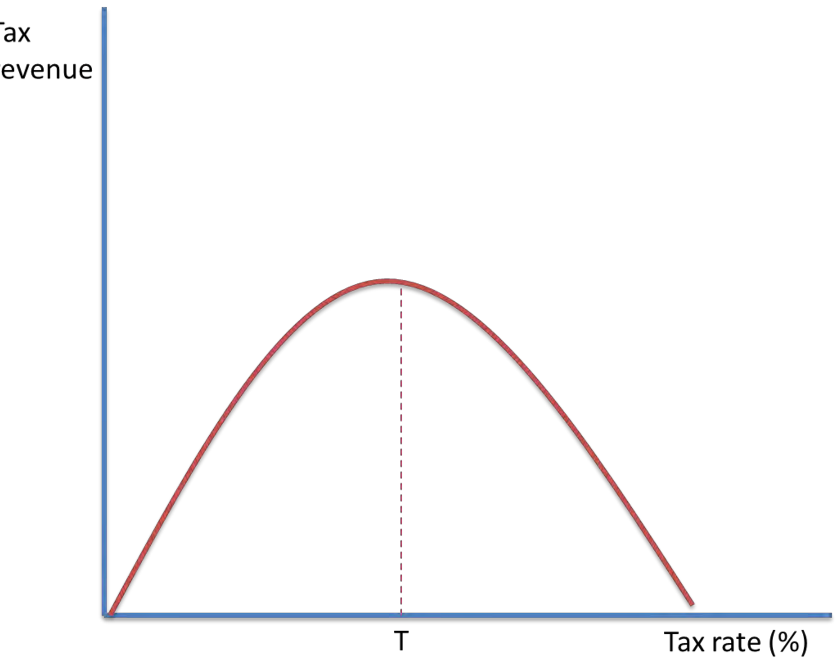
A proportional tax has a fixed rate for all tax payers, regardless of income. It is also called a flat tax. For example, all tax payers might have to pay 20% income tax rate. The incidence of taxes is equal, regardless of the ability of the taxpayer to pay. It could encourage people to earn higher incomes, because the rate of tax paid does not increase.

A progressive tax has an increase in the average rate of tax as income increases. As income increases, the proportion of income taxed increases. For example, in the UK income tax is progressive. People have a personal allowance of £10,600 where tax is not paid. For incomes below £31,785, people only pay the basic rate of 20%. For incomes between £31,786 and £150,000, people pay the higher rate of 40%. Above this, a 45% rate is paid. This should help reduce inequality, because those on lower incomes pay less tax. The tax is based on the payer's ability to pay. Higher income households are more able to pay higher rates of tax than lower income households. Generally, direct taxes are more progressive.

A regressive tax does not relate to income, but means those on lowest incomes have a higher average rate of tax. In other words, the proportion of income paid as tax is higher for those on lower incomes than those on higher incomes. For example, as a percentage of income, the London Congestion Charge and Council Taxes are higher for those on lower incomes. This leads to a less equitable distribution of income. Generally, indirect taxes are more regressive.

The economic effects of changes in direct and indirect tax rates on other variables

Incentives to work and tax revenues: the Laffer curve



The Laffer curve shows how much tax revenue the government receives at each level of tax. Up until the point 'T', as tax rates increase, government tax revenue increases. After point 'T', people do not think it is as worthwhile working, and the lack of incentive to work leads to falling tax revenue. 'T' is the optimum tax rate where the government can maximise their revenue. Laffer argued that tax rates are too high, so they provide a disincentive to work. To encourage people to work harder, Laffer argued, tax rates should be reduced.

Income redistribution

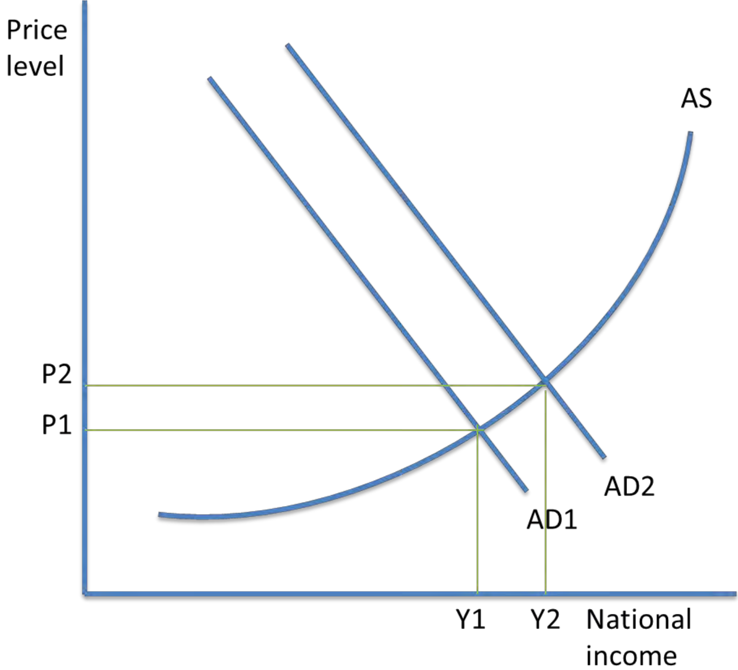
There can be income redistribution and wage equality through government intervention. For example, inheritance tax means rich families cannot keep their entire wealth.

Over the last 2-3 decades, the UK has switched towards indirect taxes, which tend to be more regressive than direct taxes. The top income tax rate fell from 83% in 1979 to 40% in 1988, and it is still at this rate today.

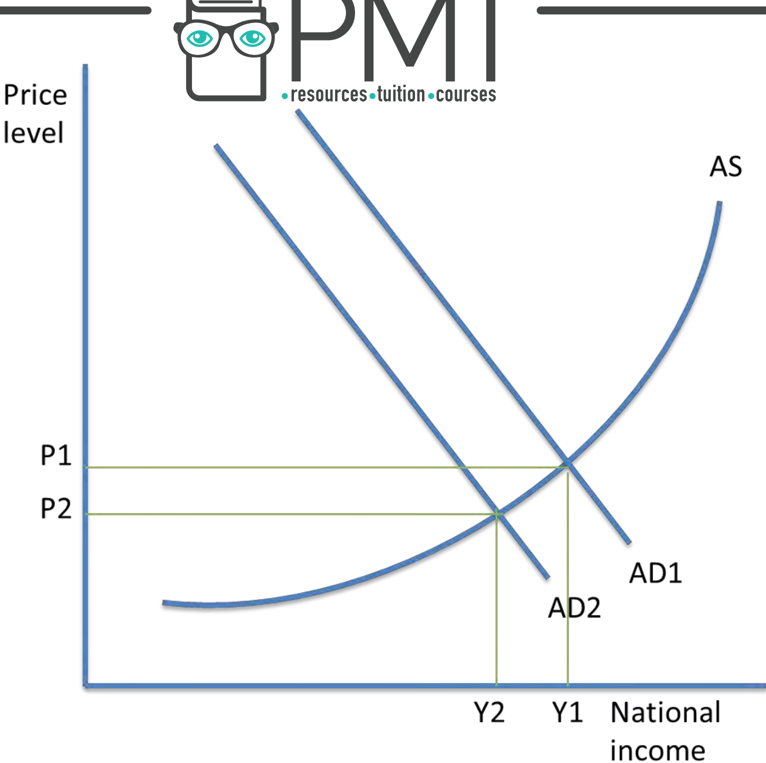
The basic income tax rate fell from 33% to 22%, which helps workers keep more income. However, the benefits of this disproportionately favour the richest households. This has led to a worsening of the income distribution.

Real output and employment

Expansionary fiscal policy aims to increase AD. Governments increase spending or reduce taxes to do this. It leads to a worsening of the government budget deficit, and it may mean governments have to borrow more to finance this.



Deflationary fiscal policy aims to decrease AD. Governments cut spending or raise taxes, which reduces consumer spending. It leads to an improvement of the government budget deficit.



The price level

Indirect taxes could cause cost push inflation. Indirect taxes could increase the cost of goods such as cigarettes or fuel, if producers choose to pass the costs onto the consumer. Since the demand for cigarettes and fuel is relatively price inelastic, producers are likely to pass the cost of the tax onto consumers.

The trade balance

Taxes could be imposed on imports into a country. These are tariffs and they make it more expensive to import goods, which should, in theory, improve the trade balance. However, other countries might retaliate, so exports might decrease as well.

FDI flows

Governments can provide a competitive tax environment to encourage FDI, so that the market is profitable, fair and has macroeconomic stability. Taxes should also be consistent and predictable, so they are business friendly. This would encourage FDI flows. High, fickle taxes are likely to discourage FDI flows, since investors will choose to invest elsewhere.