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Economics Revision Focus: 2004

A2 Economics

Direct and Indirect Taxation

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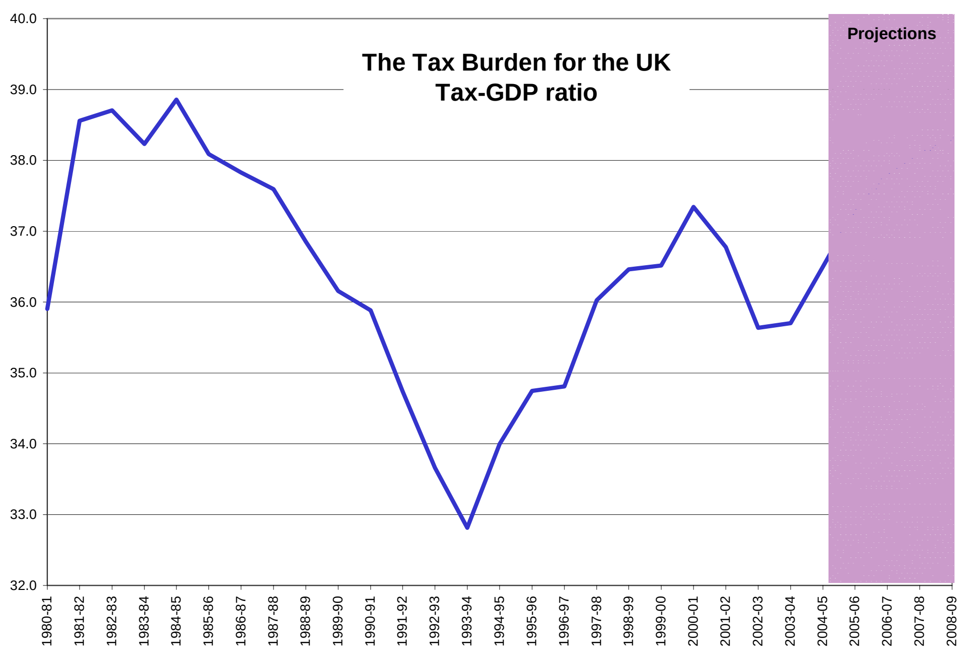
Revision Focus on Direct and Indirect Taxation (A2)

A2 Syllabus Requirements

Candidates should be able to evaluate the **relative merits of different taxes**. When considering **equity** candidates should be aware of the **ability to pay and benefit principles.** Candidates should be aware of the **effects of taxation on the distribution of income**

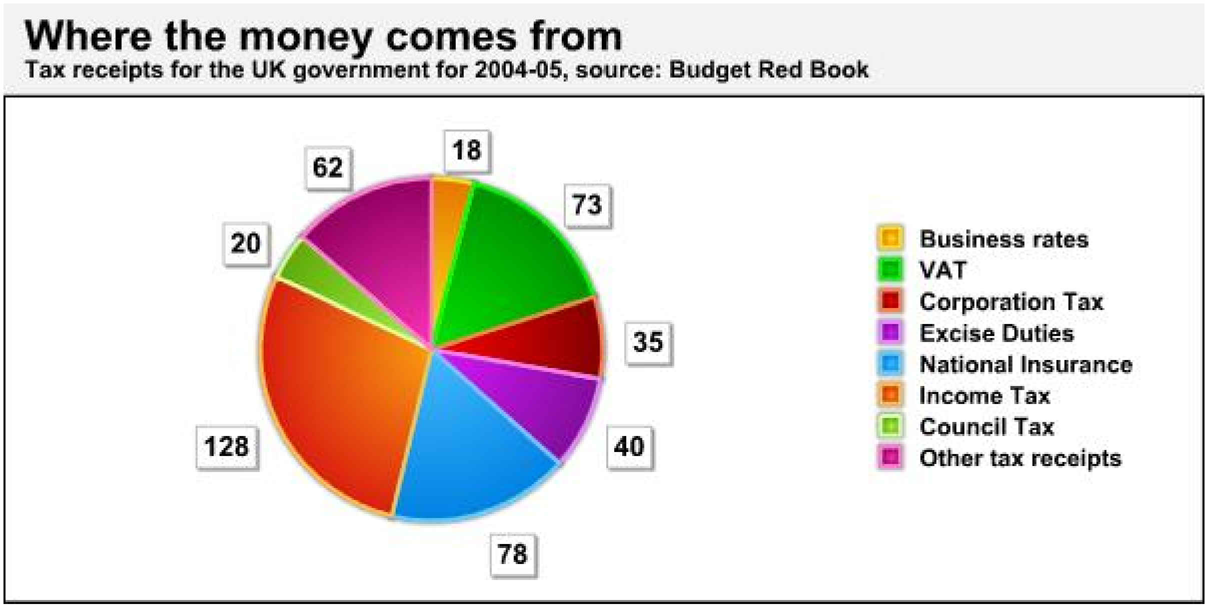
The main objectives of the UK tax system

The current government's objectives for the British tax system are broadly as follows:



1. **The burden of tax:** To keep the tax burden as low as possible (the burden of tax for a country can be measured by the % of GDP taken in taxes and is shown in the chart above)
2. **To improve incentives:** The government believes that reducing tax rates on income and business profits helps to sharpen incentives to work and create wealth in the economy as a strategy to enhance long-run economic growth (this links in the use of the tax system to improve the functioning of the labour market and as a supply-side strategy to increase trend GDP growth)
3. **Tax spending rather than income:** To shift the balance of taxation away from taxes on income towards taxes on spending – this is because it is thought that taxes on income have a greater effect on work incentives
4. **Equitable taxes:** To ensure taxes are applied **equally** and **fairly** to everyone. Equality is not always the same as fairness – see the notes below on the canons of taxation
5. **Correct for market failure:** As with many other governments in other countries, the UK government believes in the use of taxes to make markets work better (including taking account of externalities) – this is an important microeconomic objective. The government is committed to using the tax system as an instrument of correcting for market failures.

The pie chart below shows the main sources of direct and indirect tax revenues for the UK projected for the 2004-05 financial year. **Income tax** and **national insurance** contributions together account for over £200 billion of government tax revenues each year. **VAT** is the biggest single source of indirect tax revenue although over £40 billion of revenue comes each year from **excise duties.**



What are the principles of a good tax system?

These principles were established as the **canons of taxation** developed by Adam Smith in his famous work on the 'Wealth of Nations'. When you are asked to discuss the justification for different forms of taxation, it is often worth coming back to these principles when evaluating the relative merits and de-merits of alternative forms of taxation

1. **Efficiency** - an efficient tax system raises sufficient revenue to pay for government spending, without creating negative distortions such as reducing work-incentives for individuals and investment incentives for companies
2. **Equity** – the principle of equity is that taxes should be fair and based on people's **'ability to pay'**. Income tax satisfies this condition because it is a progressive tax system, the marginal and average rate of tax rises with income – but some indirect taxes may not – for example the duty on cigarettes is said to have a regressive effect on the overall distribution of income
3. **The 'benefit principle of taxation'** – this principle is that taxes paid by people have a link with the benefit that the person paying the tax actually receives from government spending. However, there are some problems with too much emphasis on the benefit principle. Firstly if ignores the **redistributive aims of taxation**. For example, the government might introduce a new tax or raise an existing one with purely redistributive aims in mind i.e. a desire to reduce **relative poverty**. The benefit principle is mainly concerned with **allocative efficiency** rather than equity. A second problem is that the benefit principle assumes correct revelation of preferences by consumers – whereas in reality many consumers do not have to pay for the public goods and services provided for them (consider the 'free rider problem'). It is also difficult for the government to assess individual benefits from public goods.
4. **Transparency and certainty** - taxpayers should understand how the system works and should be able to plan their tax affairs with a reasonably degree of certainty. Taxes should also be difficult

to evade – we know that in many countries there is a fast-growing industry that provides information to people on how to reduce their tax liabilities. Collection costs should be kept to an acceptable level so that the costs of collection are very low relative to the total tax revenues collected.

Direct versus Indirect Taxation

- **Direct taxes** – paid directly to the Exchequer by the individual taxpayer – usually through "pay as you earn". The same is true of corporation tax. Tax liability cannot be passed onto someone else

- **Indirect taxes** – including VAT, a range of excise duties on oil, tobacco, alcohol. Burden of an indirect tax can be passed on by the supplier to the final consumer – depending on the price elasticity of demand and supply for the product.

In the last twenty years there has been a shift towards indirect taxation – economists differ in their views about what is the **optimum mix** of taxation between indirect and direct taxes

Arguments For Using Indirect Taxation	**Arguments Against Using Indirect Taxation**
Changes in indirect taxes are more effective in changing the overall **pattern of demand** for particular goods and services i.e. in changing **relative prices** and thereby affecting consumer demand (e.g. an increase in the real duty on petrol)	Many indirect taxes make the **distribution of income** more unequal (less equitable) because indirect taxes are more **regressive** than direct taxes
They are a useful instrument in controlling and correcting for **externalities** – all governments have moved towards a more frequent use of indirect taxes as a means of making the polluter pay and "internalizing the external costs" of production and consumption	Higher indirect taxes can cause **cost-push inflation** which can lead to a rise in inflation expectations
Indirect taxes are **less likely to distort the choices that people have to between work and leisure** and therefore have less of a negative effect on work incentives. Higher indirect taxes allow a reduction in direct tax rates (e.g. lower starting rates of income tax)	There is no hard evidence that cutting direct tax rates has much of an incentive effect on people's decisions about whether or not to work If indirect taxes are too high – this creates an incentive to avoid taxes through **"boot-legging"** – a good example of this would be attempts to evade the high levels of duty on cigarettes
Indirect taxes can be changed more easily than direct taxes – this gives economic policy-makers more **flexibility** when setting fiscal policy. Direct taxes can only be changed once a year at Budget time	Revenue from indirect taxes can be uncertain particularly when inflation is low or there is a recession causing a fall in consume spending
Indirect taxes are **less easy to avoid** by the final tax-payer who might be unaware of how much indirect tax they are paying	There is a **potential loss of economic welfare** (taxes can create a deadweight loss of consumer and producers surplus)
Indirect taxes provide **an incentive to save** (and	Higher indirect taxes affect households on lower

Arguments For Using Indirect Taxation	**Arguments Against Using Indirect Taxation**
thereby avoid the tax)- a higher level of savings might be used by the economy to finance a higher level of capital investment	incomes who are least able to save in the first place
Indirect taxes **leave people free to make a choice** whereas direct taxes leave people with less of their gross income in their pockets	Many people are unaware of how much they are paying in indirect taxes – this goes against one of the basic principles of a good tax system – namely that taxes should be **transparent**

The effect of direct and indirect taxation on the distribution of income

What are the effects of the tax and benefit system on the final distribution of income in the UK? This summary table is published each year by the Government and gives us an idea of the **progressiveness** of the tax and benefits system for households in different income bands

Redistribution of income through taxes and benefits, 2001-02

United Kingdom £ per year

	Quintile group of households					
	Bottom fifth	Next fifth	Middle fifth	Next fifth	Top fifth	All house-holds
Total original income	**3,410**	**9,140**	**19,240**	**32,000**	**62,080**	**25,180**
plus Welfare benefits in cash						
Contributory	2,590	2,880	2,040	1,280	720	1,900
Non-contributory	2,900	2,810	1,970	950	420	1,810
Gross income	**8,910**	**14,820**	**23,260**	**34,230**	**63,230**	**28,890**
less Income tax and National Insurance	390	1,380	3,320	6,280	14,070	5,090
less Local taxes (e.g. council tax)	650	710	890	1,010	1,130	880
Direct tax as a % of gross income	**4.4**	**9.3**	**14.3**	**18.3**	**22.3**	
Disposable income	**7,870**	**12,730**	**19,050**	**26,950**	**48,030**	**22,930**
less Indirect taxes	2,710	2,940	4,150	5,200	6,660	4,330
Indirect taxes as a % of disposable income	**34.4**	**23.1**	**21.8**	**19.3**	**13.9**	
Post-tax income	5,160	9,790	14,910	21,750	41,370	18,600
plus Benefits in kind						
Education	2,250	1,630	1,650	1,410	770	1,540
National Health Service	2,770	2,740	2,330	2,150	1,790	2,360
Housing subsidy	80	80	40	20	10	50
Travel subsidies	60	60	50	60	80	60
School meals and welfare milk	70	30	10	-	-	20
Final income	**10,410**	**14,320**	**18,990**	**25,390**	**44,020**	**22,620**

Source: Social Trends 34 (2003) www.statistics.gov.uk

This table is worth working through in careful detail. Original income comes from wages and salaries in work, self-employment income, investment incomes et al. To which we add entitlements to welfare benefits in cash – not that the lowest income households are those most entitled to these benefits, some of which are **means-tested**. The ratio of the original income of the richest fifth of households to the poorest fifth is 18. By the time that welfare benefits have been included, that ratio falls to 7.1.

Then we include the effects of direct taxation – mainly income tax and national insurance – which acts as a progressive tax – a higher income group pays a higher % of their incomes in tax. This gives us disposable income - the ratio of the disposable income of the richest fifth of households to the poorest fifth is 6.1. Our final transfer is to include the effects of indirect taxes and estimated benefits in kind from state provision of education, the NHS and housing subsidies. The final result is that our ratio between richest and poorest quintiles falls further to 4.2.

Note that indirect taxes fall most heavily on poorest households. In 2001-02, they accounted for 34% of disposable income whereas for the highest income quintile, the percentage was just 14%.