Chapter 35

Taxation

Key terms

1. Direct tax: a tax levied directly on an individual or organisation
2. Indirect tax: a tax on good and service
3. Laffer curve: a curve which shows that at low levels of taxation, tax revenue will increase if tax rates are increased. However, if tax rates are high, then a further rise in rates will reduce total tax
4. Progressive tax: a tax where the proportion of income paid in tax rises as income rises
5. Regressive tax: a tax where the proportion of income paid in tax falls as income rises
6. Proportional tax: a tax where the proportion of income paid in tax remains the same while income changes

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1. Reasons for taxation

1. Tax on income to redistribute income from rich to poor
2. Tax on demerit goods to discourage the consumption
3. Tax on pollution to raise cost to firm
4. Tax on imports to encourage the consumption of domestic goods

2. The distinction between direct and indirect taxes

2.1 Direct tax : is a tax on income and wealth.

2.2 Indirect tax : is a tax levied on goods and services

	Direct tax	Indirect tax
Definition	Tax on income and wealth	Tax on spending
Example	Income tax Corporate tax Capital gain tax Inheritance tax	Tax on petrol VAT 7%

3. The distinction between progressive, proportional and regressive taxes

Another way of classifying taxes is to make the distinction between progressive, proportional and regressive taxes.

	Progressive tax	Proportional tax	Regressive tax
Definition	When income rises, the rate of tax also rises.	When income rises or falls, the percentage paid in tax stays the same.	When income rises, the percentage paid in tax falls.
Example	e.g. income tax and corporate tax		e.g. tax on petrol

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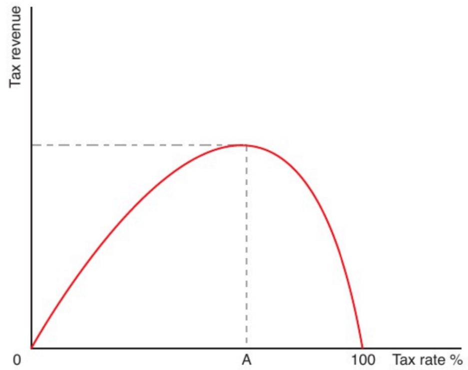
4. The economic effects of changes in direct and indirect tax rates

4.1 Incentives to work

- High marginal rates of tax discourage people to work.
- High income tax also reduce incentive to work.

4.2 Tax revenues and Laffer curve analysis

- Laffer curve: a curve which shows that at low levels of taxation, tax revenue will increase if tax rates are increased.
- However, if tax rates are high, then a further rise in rates will reduce total tax revenue.



4.3 Income distribution

- Indirect tax is regressive tax, then it can widen income inequality.
- Direct tax is progressive tax, then it can reduce income inequality.

4.4 Real output, the price level and employment

- A change in tax rates is likely to have an effect on real output, the price level and employment.
- Some tax changes affect aggregate demand while others affect aggregate supply.
- E.g. an increase in income tax reduces consumption and reduce AD.
- E.g. an increase in indirect tax leads to a fall in short run aggregate supply

4.4 The trade balance

- A n increase in income tax reduces spending on imports.

4.5 FDI flows

- A cut in corporate tax can increase FDI in the country.

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