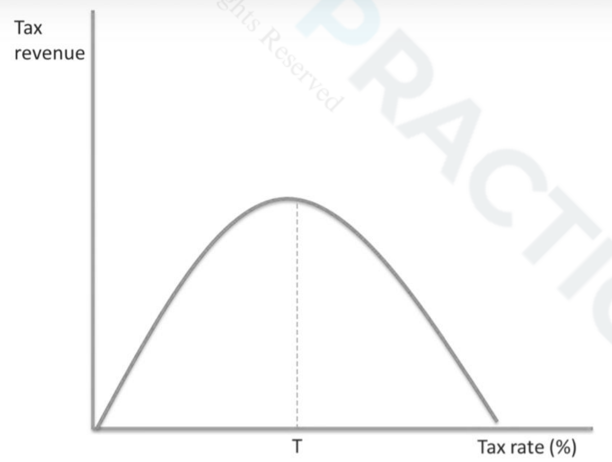
4.5.2 Taxation

a) *Distinction between progressive, proportional and regressive taxes*
b) *The economic effects of changes in direct and indirect tax rates on other variables:*
   - *Productivity and growth*
   - *Living standards*
   - *Crowding out*
   - *Level of taxation*
   - *Equality*

- Progressive taxation: where an individual's taxes rise as a percentage of their income as their income rises. A government can use these policies to redistribute income. It achieves vertical equity.
- Regressive taxation: where an individual's taxes fall as a percentage of their income. A government might use these policies to achieve supply-side effects such as a trickle down effect. It increases inequality
- Proportional taxation ('flat tax'): where everybody pays the same proportion of tax regardless of their income level. It achieves horizontal equity.
- Adam Smith's characteristics of a good tax:
  - Equality
  - Certainty
  - Simplicity
  - Convenience
- Horizontal equity: people who have similar incomes pay the same amount
- Vertical equity: people have higher incomes and a greater ability to pay taxes should pay more than those on lower incomes
- Impact of changes in taxes:
  - **Incentives to work:** higher tax rates may discourage people from working as they will gain less of what they have earned
  - **Tax revenues: the Laffer curve**



  - Up until the peak, tax revenue rises as the average tax rate increases. After the peak the incentives to work are lower so tax revenue falls
  - **Income distribution:** inheritance tax reduces wealth inequality and progressive taxes will reduce income inequality
  - **Real output and employment:** a fall in direct taxes will cause a rise in AD because it increases real incomes. Indirect taxes affect SRAS.

- **The price level:** Indirect taxes could cause cost push inflation because they increase costs of production for consumers
- **Trade balance:** tariffs make it more expensive to import imports which should improve the trade balance
- **FDI flows:** lower corporate taxes attract FDI because firms are likely to earn higher profits from FDI. However, tax rates must be consistent and predictable