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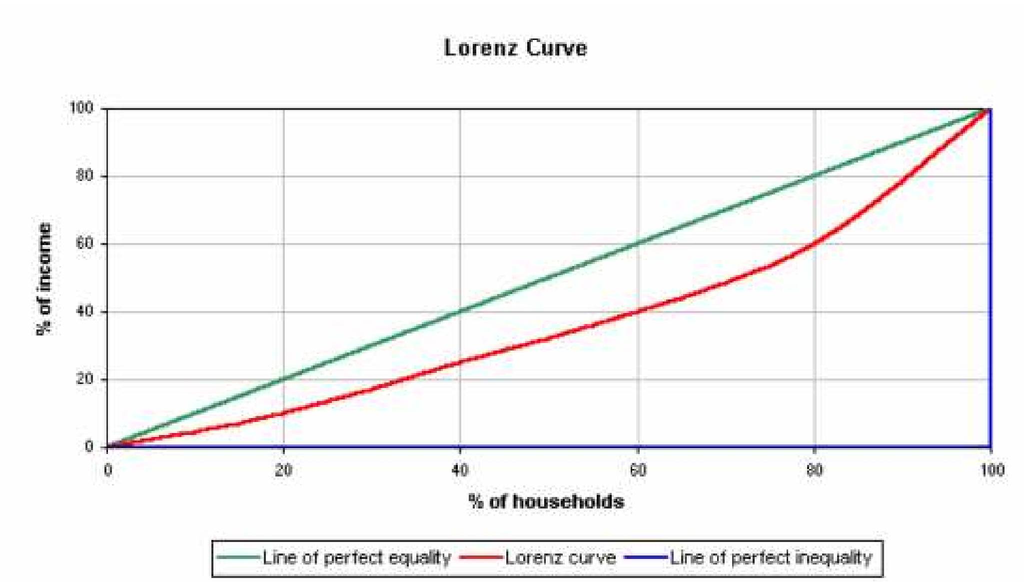
Economics Practice Essay – 2nd Question

3 (b) Evaluate the potential economic consequences if the UK government were to introduce a significant shift in the sources of its tax revenue from direct to indirect taxes. (30 marks).

To begin with, a tax can be defined as a compulsory levy charged by government or by a public authority to pay for its expenditure. The term can be categorised further; whereby direct taxes affect those who receive the benefits of income generated and who are therefore liable to pay the tax, a typical example in the UK being income tax. Whereas in contrast, most taxes on spending are indirect taxes, such as VAT, since it is the seller of the good and not the purchaser who is liable to pay the tax (although this does not mean to say that the seller will not pass on the incidence of the tax through a price rise at a later date).

One of the main effects of a shift in tax sources from direct to indirect would be a rise in the level of inequality. That is to say, direct taxes which were previously more dominant would give way to a larger quantity of indirect taxes that are regressive in nature – therefore hitting the poor the hardest as the proportion paid in tax falls as income rises. As a result, the effect of these changes can be illustrated on a Lorenz Curve in the diagram below:

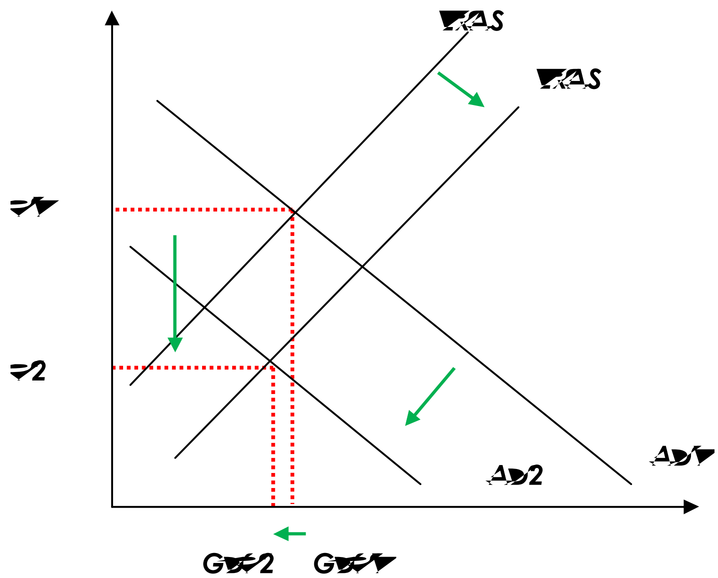


As the diagram reveals, the Lorenz Curve deviates by a considerable extent from the line of perfect inequality. With further analysis, indeed it would be possible to accurately determine the exact numerical figure which suggests just how unfair the income distribution is for a country/economy. The closer the figure produced is to 1 the more inequitable it is.

A major shift in the amount of tax previously coming from direct sources to indirect ones results in a tax liability, whereby more tax is passed on to the consumers rather than the producers of goods. Consequently if artificial inflation takes place once producers begin to pass on the tax rises on the goods they produce, then the prices will soon rise. Examples include: fuel, alcohol, and cigarettes where costs are comparatively expensive when stacked against other developed countries prices for these demerit goods. Subsequently leading to consumer demand falling, and therefore a drop in Consumption, which is the largest component of Aggregate Demand. This negative occurrence in addition to income and substitution effects (arising from changes in income tax as UK goods become relatively more expensive in comparison to other country's products) is then likely to prompt an increase in imports, i.e. a leakage from the circular flow of incoming, decreasing AD further.

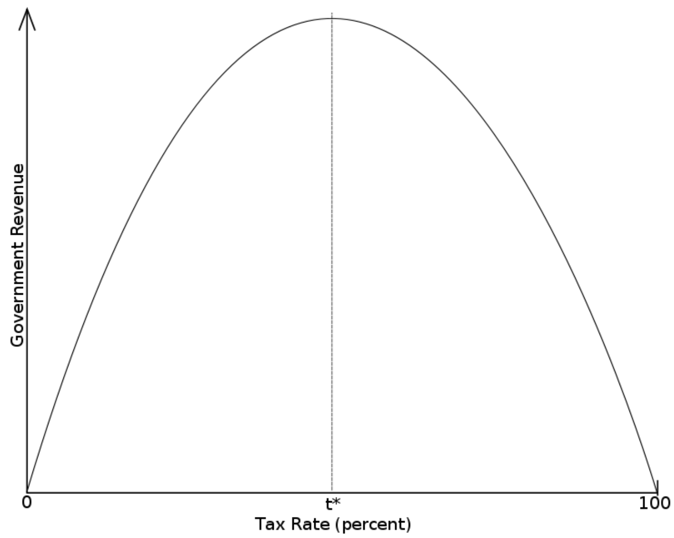
Although one possible benefit of a reduction in direct tax (although the money will have to be regained from alternative indirect tax sources) is that entrepreneurs/workers will feel more inspired to work longer hours in order to earn more money without being taxed quite as much. This will ultimately lead to a boost in productivity levels, and therefore a AS boost to the economy also, as labour is one of the key factors of production – which form the foundations of an efficient economy.

Therefore the AD/AS diagram included below can be used to show the effects of these contrasting conditions:



The diagram demonstrates how AD1 has shifted leftwards to AD2, and also how there has been a rightwards shift of AS1 to AS2. As a result, P1 has decreased from to P2 aster substantial deflation has occurred. And economic growth has stagnated from highs of GDP1 before shifting back to GDP2.

Finally in order to assess the macro consequences of a government switching from direct taxes to indirect taxes, "The Laffer Curve" may be an appropriate economic diagram to explore. The curve relates the rate of taxation in the economy to the total tax revenue received by the government. The diagram assumes that the amount of taxation received will be at zero at two points; when the rate is zero and also where it is 100%. The Laffer curve suggests there is an optimal tax rate at which at which tax revenue is maximized; the curve also argues that lower tax thresholds can increase the economic incentive to find employment, and subsequently the higher level of employment outweighs the lower tax yield per worker. The Curve is illustrated below, where the middle line shows the optimal level of taxation; where the most amount of taxation can be received.



There is quite a significant economic ramification for switching the UKs taxes to a more indirect system of charges on goods, and that is the consideration that the EU has a lower limit on VAT (15% minimum) and also a top limit (25%). Hence if the UK is looking to the long term and hoping of eventually joining the EU, then it essential that the government judges the tax changes in the context of EU tax harmonisation. As breaking the conditions set will be problematic for joining at a later date, especially once the population have become accustomed to the tax structure changes – and as we all know, people do not like change!

In conclusion, the economic theories behind such a decision to carry out a significant shift in the sources of tax revenue know doubt would initiate sincere economic consequences in terms of macro and micro changes. Moreover it is important to consider the fact (as previously touched upon) that polices such as these take time and effort to implement fully. Therefore if the government that put forward the proposals were to lose the following general election, then it is highly possible that the new government may simply abolish all of the plans and developments in favour of the original structure of the UK tax system.

One thing that is clear however is the fact that Taxes are an unpopular reality for many people; but they are also irrefutably necessary to redistribute the wealth of individuals and corporations to the needy members of society. Without a consistently positive budget deficit, essential public services such as healthcare defence and education would drop substantially in terms of the quality of the service provided (as huge borrowing is not a sustainable long term option for governments). Because all of the above are so fundamental to the health, quality of life and opportunities of the nation, the level of productivity would drop if the public services were not of a sufficient standard. Therefore, perhaps cost cutting measures in addition to considerable efficiency savings may be the better/more popular option. This school of economic thought can usually be attributed to pro free market, libertarian party of the Conservatives in Britain, in many recent election campaigns they have indeed focused upon cutting back on all the unnecessary and unprofitable parts of a large wasteful, interfering state and suggest additional methods of keeping the growing public finances in check.