Types of taxes

Peter Smith guides you through different types of tax, and provides diagrams on the effects of taxation

Why tax?

Governments impose taxation for various reasons:

- to raise revenue to enable government expenditure
  - Spending needs to be financed.
- to redistribute income between groups in society
  - Vulnerable groups (e.g. the unemployed) need to be protected.
  - Society may want a more equitable distribution of income.
- to correct market failure
  - Taxes are one way of dealing with externalities or other forms of market failure.

Direct taxes

These are taxes imposed on various forms of income:

- Personal **income tax**, as its name suggests, is levied on the income earned by individuals.
- **Social security contributions** may also be considered to be taxes, although they are not labelled as such. In the UK, national insurance contributions are paid by both employers and employees.
- **Council tax** is a direct tax related to property values.
- **Corporation tax** is levied on the profits made by firms.
- **Capital gains tax** is payable in the UK when assets are sold.
- **Wealth taxes** are payable on assets held by individuals. An example is death duties.

Characteristics of taxes

A **progressive tax** is one where the proportion of income that is taxed rises as income rises.

- An example is the personal income tax, where the rate at which tax is payable increases at higher incomes.
- This is one way in which income is redistributed from high-income earners to those on low incomes.

A **regressive tax** is one where the proportion of income that is taxed falls as income rises.

- Many indirect taxes tend to be regressive, as low-income households may spend a higher proportion of their income.

A **hypothecated tax** is one where the revenues are designated for particular uses. Examples include the following:

- National insurance contributions are used to fund social security benefits.
- The TV licence fee in the UK supports the BBC.
- Council taxes (which are imposed by local authorities) are used to provide local services.
- Road tolls may be used to maintain the roads.

Indirect taxes

These are taxes levied on expenditure rather than income.

- Value-added tax (VAT) is an example, payable on a wide range of goods and services in the UK at a rate of 20%.
- Other examples in the UK include excise duty, payable on alcohol, tobacco, motor fuel, betting and vehicles.
- A subsidy can be seen as a sort of negative indirect tax.

Specific taxes

A **specific tax** is an indirect tax charged at a fixed rate on sales of a good or service.

- In Figure 1, the effect of the tax is to shift the supply curve upwards by the amount of the tax.
- Without the tax, the equilibrium price would be at P_0 with quantity traded at Q_0.
- With the tax, price would be P_1 and quantity Q_1.
- Revenue from the tax is the shaded area.

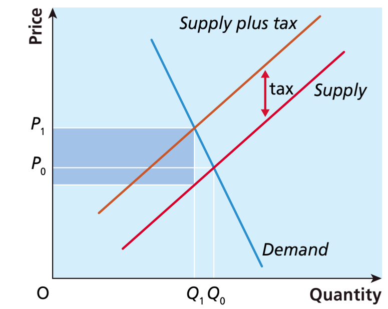

Figure 1 A specific tax

Ad valorem taxes

An ***ad valorem* tax** is an indirect tax charged as a percentage of the price of a good or service.

- In Figure 2, the effect of the tax is to shift the supply curve upwards by the amount of the tax.
- In this case, the supply curve becomes steeper.
- Without the tax, the equilibrium price would be at P_0 with quantity traded at Q_0.
- With the tax, price would be P_1 and quantity Q_1.

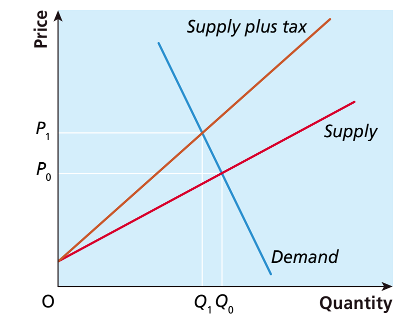

Figure 2 An *ad valorem* tax

The incidence of a tax

Figure 3 shows the effect of a specific tax on the market equilibrium.

- Price is higher with the tax, being P_1 rather than P_0, but the difference is less than the amount of the tax.
- In this example, the burden of the tax falls most heavily on the buyers, shown by area **A**.
- Sellers pay area **B**.
- This is known as the **incidence** of the tax, and the relative burden of the tax met by buyers and sellers depends on the elasticity of demand.

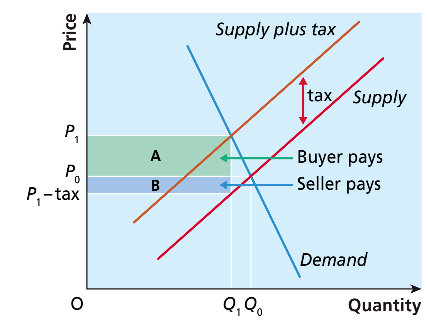

Figure 3 The incidence of a specific tax

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