

Essay 9: The UK Income Tax Personal Allowance is set to rise to £12,500 by 2020-2021. The government also now allows people to earn up to £1000 per year tax-free through internet auction sites (such as eBay) and other internet-based services, for example, which allow you to rent out rooms in your home.

Evaluate the impact of a more progressive tax system on the UK economy.

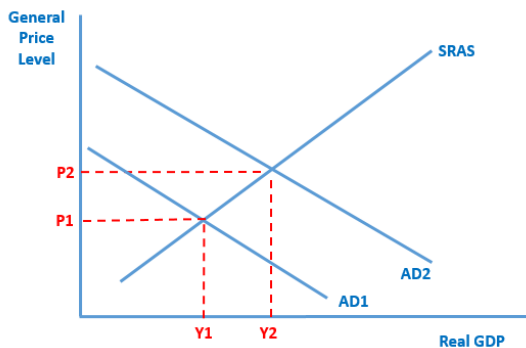
A progressive tax is one where the proportion of income paid in tax rises as income increases. Income tax in the UK is a progressive tax. A more progressive tax system means that there is a bigger difference between the high income and low income tax rates, which could be caused by an increase in the higher level of tax rates, a reduction in the lower levels of tax rates or both. A more progressive tax system will have an impact on the economy through its effect on the main macroeconomic objectives of sustainable economic growth, low and stable inflation, low unemployment, a satisfactory balance of payments position and the distribution of income and wealth. This essay will evaluate the impact of a more progressive tax system on the UK economy with regards to these objectives, arguing that there will be both positive and negative effects depending on several factors.

*Good definitions, and clear evidence that the candidate is focusing on the **discriminator** word in the question i.e. a **more** progressive tax system, rather than merely just the pros and cons of progressive tax systems.*

Firstly, a more progressive tax system can lead to an increase in aggregate demand (AD). If the government raises the highest rate of income tax and redistributes this money to the lowest income workers, it will raise their disposable income and thus increase their living standards. Since high-income workers tend to have a higher marginal propensity to save than low-income workers, due to surplus income, the redistribution can result in a reduction of withdrawals from the circular flow of income. Furthermore, the high marginal propensity to consume of low-income households means that their spending will rise resulting in a higher consumption level in the economy. Since

The paragraph starts with a succinct statement of the key point of the paragraph.

The reference to the different marginal propensities to save/consume for different income groups helps to shift this essay from AS standard to A level standard.



consumption is a component of AD ($AD = C + I + G + (X - M)$), this will result in an increase of AD from AD_1 to AD_2 as shown in the diagram to the left. The increase in consumption will raise output within the economy from Y_1 to Y_2 , leading to an increase in actual economic growth. More workers will be needed to produce this output, as labour is a derived demand, leading to an increase in demand for

workers and therefore a fall in cyclical unemployment. This will further raise disposable incomes within the economy, leading to higher consumption and could result in a positive multiplier effect, causing an even further rise in economic growth.

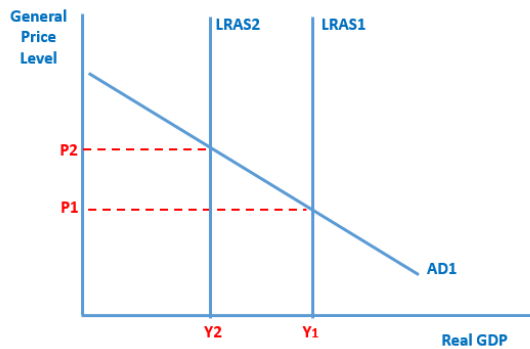
*Consideration of which **type** of unemployment is reduced allows greater depth of analysis.*

However, the increase in AD may lead to a rise in demand-pull inflation, if aggregate supply is not able to increase at the same rate as aggregate demand. This could lead to instability and uncertainty within the economy, and a need for contractionary monetary and fiscal policies to be used to keep inflation within its target. This could lead to adverse effects on the economy cancelling out the increase in AD explained above. In addition, as low-income households gain higher disposable incomes they may increase their demand for imports (UK households have a high marginal propensity to import), which could worsen the trade balance on the current account, requiring greater inflows to the financial account to balance this e.g. via FDI. Also, high-income earners would argue that a more progressive tax system would reduce the opportunity to exploit the trickle-down effect, which states that high-income earners will benefit all of society as their income and wealth will filter through to all areas of society. Therefore, whilst the income redistribution may have short-term benefits, it will mean that society is unable to exploit the long-term increase in everyone's income and wealth that could have been achieved through the trickle-down effect.

*Likewise, reference to the specific **type** of inflation also adds depth.*

An understanding of the overall structure of the BOP indicates that the essay is at A level rather than AS standard; the same is true of the inclusion of the trickle-down effect.

The second impact of a more progressive tax system in the UK is that it can lead to a decrease in long-run aggregate supply (LRAS). If corporation tax is made more progressive high earning firms will face higher tax rates. This will further reduce their retained profit and therefore reduce their ability to invest. In the long-term this lack of investment could lead to a slowdown in the rate of increase of LRAS or even a decrease, as shown in the diagram below (LRAS₁ to LRAS₂). A decrease in LRAS causes



a reduction in the productive capacity of the economy and a fall in potential economic growth. This raises the price level from P_1 to P_2 , making UK goods less internationally competitive. This could lead to a fall in the demand for UK exports and a rise in imports, worsening the current account deficit. If the increase in the highest corporation tax rates is significant, then some firms may be incentivised to move abroad in search of lower

tax rates e.g. to Ireland. The impact on investment, though, really depends on alternative sources of finance available to the firm, perhaps via share issue, corporate bond issue or even borrowing from a bank.

However, the increase in the rate of corporation tax for the highest earning firms is likely to raise the government tax revenue, assuming that the original rate of tax is below the optimal tax rate according to the economy's Laffer curve. This revenue could be used to support the provision of merit goods and goods with positive externalities, such as education and health care, and also public goods such as libraries and flood defences, which can have a positive effect on the productive capacity of the economy. This may therefore balance out the effects from lower private sector investment so that overall there is no impact on the LRAS and the economy. In other words, private sector investment may be replaced by public sector investment. Whether the overall impact is more efficient really depends on one's political perspective regarding state provision of goods and services.

Overall, the impact of a more progressive tax system on the UK economy will depend on several factors. First it will depend on the extent of the change in the tax systems. A small change in the degree of progressiveness of any direct tax may not be big enough to cause a significant change in behaviour and therefore there may be negligible impact on AD and LRAS. Behavioural economics tells us that with bounded rationality, economic agents struggle to compute marginal gains. Secondly, the overall impact will depend on which taxes the government changes and how the revenue is used. For example, a lowering of the bottom rates of income tax and corporation will reduce tax revenue, so government spending may have to be reduced, decreasing AD, cancelling out the effects of higher consumption or investment. Likewise, if the government raises the top rate of income tax but then uses the increases in tax revenue to pay off some of the national debt, the money will be withdrawn from the circular flow of income and the benefits to the economy will not occur. Finally, the impact on the economy will depend on the current economic state of the economy and consumer and business confidence levels. During a recession consumer and business confidence is likely to be low. Therefore, even if low-income earners have higher disposable income they may choose to save this extra income rather than spend it, thus not raising consumption levels or AD within the economy.

Overall, the impact of a more progressive tax system will have a mixed impact on the UK economy depending on which taxes are changed and to what degree.

It is helpful to structure essays by using "firstly", "secondly" and so on – it helps to indicate a clear chain of thought and structure.

The first part of this paragraph focuses on issues that could be discussed by a student at AS standard, but by considering global tax rates and alternative sources of finance, the student is providing more A level content.

This is a nice synoptic link with market failures that then links nicely with macro analysis.

This is a sound evaluative paragraph containing three 'it depends on' statements, each of which are developed with further explanation and examples where relevant. This then supports the final sentence that forms the conclusion.