© Anforme Limited www.economics.ac Text: Mark Jewell

TAX Cuts

The case for

1. less distortion (when reducing indirect taxes):
   - welfare gains associated with lower prices
2. increased incentives to work (when reducing income tax):
   - boosts aggregate supply, causing non-inflationary growth for those below the 'backward bend' on their supply curve of labour
3. boost to net disposable income (when reducing income tax):
   - raises aggregate demand, stimulating growth via the Multiplier
   - reduced unemployment
   - politically popular
4. encourages foreign direct investment (when reducing corporation tax)
5. encourages efficient international trade (when reducing tariffs)
   - cheaper imports
   - pressure to move into sectors with comparative advantage

Taxes on incomes	**e.g. income tax**
Taxes on wealth	**e.g. capital gains tax**
Taxes on spending	**e.g. V.A.T.**

The case against

1. may encourage increased spending on demerit goods (cigarettes) or those with external costs (petrol): social welfare losses
2. reduced incentives to work for those on 'backward bending' supply curve of labour
3. Other problems with reducing taxes on incomes:
   - creates inflationary pressure (if there is a positive output gap) and pressure on Monetary Policy Committee to raise base rates
   - increases spending on imports (Balance of Payments current account worsens)
   - any short term demand-driven growth is reversed if inflation reduces competitiveness (if unemployment falls below the NAIRU)
   - pressure to reduce public spending on public services and/or welfare payments to avoid public debt…
   - …budget deficits tend to cause rising interest rates ('crowding out') and/or inflation ('printing money')
   - administrative costs
4. destabilises economies within trading blocs, creating pressure for governments to compete for FDI inflows by reducing business taxes
5. costs domestic jobs (especially if tariffs are maintained by competitors)