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Answers

Exam-style questions

Questions on income tax

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This resource provides answers to the questions posed in the Exam-Style Questions column, in the February 2024 issue of ECONOMIC REVIEW.

Question 1

Using only data from Table 1, calculate how much tax would be paid by someone who earns £40,000 in one year. (2 marks)

Answer

$£40,000 - £12,000 = £28,000 \times 25\% = £7,000$

Question 2

Using evidence from Table 2, to what extent do the data show that the budget balance is mainly cyclical rather than structural? (4 marks)

Answer

- A cyclical budget balance is one where the budget balance is largely affected by the rate of economic growth.
- Biggest fall in budget deficit — in 2018 and 2020 the deficit fell from 5.1% to 3.5% and 2.1% to 1.2%. This coincided with the two highest years of economic growth (2.2% in 2018, and 2.9% in 2020).
- Biggest increase in deficit was in 2021 (from 1.2% to 2.5%). This coincided with lowest growth rate (-0.1% in 2021).
- This indicates the budget deficit could be judged as being mainly cyclical.

Question 3

With the help of a diagram, explain how changes in income tax rates affect economic growth. (9 marks)

Answer

Diagram: AD/AS model with either:

- increased AD (as a result of increased disposable income leading to increased consumption)
- or
- increased LRAS (as a result of supply-side effects from improved incentives to work)

Diagram: Laffer curve with explanation of incentives and effective on labour participation and potential growth in economy.

Multiplier effect: increased consumer spending leading to further increases in spending and incomes.

Question 4

Evaluate the extent to which decreases in income tax are always good for the economy. (25 marks)

Answer

Decreases in income tax are always good for the economy:

- should increase economic growth
- should lead to lower unemployment (cyclical)
- multiplier effects will lead to further increases in economic growth
- creates incentives to work, set up businesses, etc.

Decreases in income tax are not always good for the economy:

- could be inflationary
- may lead to increased spending on imports and worsening of current account balance
- depends on consumer confidence
- increased disposable income may be saved
- could increase budget deficit (structural deficit?)
- may lose 'confidence' of financial markets
- credit rating may be affected

Issues for evaluation:

- depends on size of tax cut (and duration)
- cutting higher tax rates may not lead to big increases in deficit due to high earners already taking steps to avoid tax.
- likely to lead to improvements in achievement of some objectives but worsening of achievement other objectives
- depends on what stage of economic cycle economy is currently in
- depends on current budget balance
- always is quite a strong term — would be unlikely to be always a good idea

- depends on whether consumers think it is a 'permanent' tax cut or not — linked to permanent income hypothesis