

Learning activity 8

True/False answers

1. The existence of externalities prevents the attainment of a socially efficient allocation of resources in the economy.

1. True
2. False

Externalities are not reflected in the market price. E.g. to ensure a socially efficient allocation of resources the cost of fighting air pollution (an externality) should actually be included in the cost of power generation by means of coal.

2. Government could use the budget to try to influence variables such as total production, income and employment and to redistribute income in the economy.

1. True
2. False

The government uses fiscal policy (changes in government expenditure and taxes) to try to attain macro-economic objectives such as full employment, economic growth, stable prices, external equilibrium and equal distribution of income. The government budget is the result of decisions regarding government expenditure and the way in which this expenditure will be financed, and will therefore affect total production, income and employment.

3. Government should implement restrictive fiscal policy measures during a recession.

1. True
2. False

Restrictive fiscal policy will inhibit growth and employment, therefore this is not the appropriate policy during a recession. When a recession is experienced expansionary policy should be implemented to try to increase economic activity.

4. The budget deficit is usually financed through taxation.

- 1. True
- 2. False

The budget deficit is the difference between government expenditure and taxes, and will be financed by government borrowing

5. Direct taxes are levied directly on goods and services.

- 1. True
- 2. False
- 3.

Direct taxes are levied on income. Indirect taxes are levied on goods and services.

6. A tax is progressive if lower income groups pay a smaller percentage of their taxable income in the form of tax than higher income groups pay.

- 1. True
- 2. False

In a country where the income distribution is unequal, the tax system should strive to be progressive in order to redistribute income from higher income earners to the poor. If higher income earners pay a higher percentage of their income towards taxes, the tax system is progressive.

7. VAT is a regressive tax.

- 1. True
- 2. False

Low income earners usually spend a larger percentage of their total income, and will therefore pay a higher percentage of their total income towards VAT. Therefore VAT is regressive

8. Government can always specify precisely who will ultimately bear the burden of a tax.

- 1. True
- 2. False

This is not always possible to predict exactly. For example, in some cases producers may be able to defer taxes to consumers who will pay the full amount of the tax included in the market price. Sometimes this is not possible and the producer may have to carry some of the cost themselves, i.e. accept a lower profit margin.

9. An increase in the excise tax on beer will affect only the consumers and producers of beer.

- 1. True
- 2. False

The consumers and producers of beer will definitely be affected by an increase in the excise tax on beer. However, other members of society can also be affected. for example, if there is not excise tax on wine and wine is regarded as a close substitute for beer, the wine market will also be affected, and thus the consumers and producers of wine will also be affected. Restaurants that serve mainly beer may also be affected.

10. An increase in the excise tax on wine could affect workers in the wine industry.

- 1. True
- 2. False

Since an increase in the excise tax on wine will affect the price at which wine can be sold in the market, it will also affect the quantity demanded on wine. The quantity at which market clearing will take place, will therefore change and thus suppliers will have to adjust production. This will therefore affect the workers in the wine industry.

Review answers

1. If you are a merchant in medical equipment, you will definitely prefer **(not to be)** exempted from VAT.

Let's explain using an example: A supplier of medical equipment would probably use a number of inputs to produce or distribute such equipment. VAT is levied on all these inputs and if the supplier is exempted from VAT, he/she may not claim back the input tax. The tax is then a cost to the supplier, reducing profits. Therefore, the supplier would prefer not to be exempted from VAT.

2. If individuals are taxed at a fixed rate of 25 per cent and all taxpayers are eligible for a tax rebate of R7 200, personal income taxation is **(progressive)** to income.

Let us compare three individuals earning R6 000, R8 000 and R10 000 respectively:

Persons earning less than R7 200 will pay no tax. Persons earning more than R7 200 will pay 25% of the amount higher than R7 200 that they earn to tax.

The person earning R6 000 will pay no tax as the first R7 200 is not tax, thus 0% of his/her total income will go towards tax.

The person earning R8 000 will pay R200 (25% of R800) to tax, thus 2,5% of his/her total income will go towards tax.

The person earning R10 000 will pay R625 (25% of R2 500) to tax, thus 6,25% of his/her total income will go towards tax.

Persons earning higher income therefore pay a higher percentage of their income towards tax, and therefore this tax is progressive.

3. An efficient tax does not affect **relative** prices at all.

A tax is efficient if it does not affect decisions of consumers and suppliers. If the relative prices of goods are not affected, e.g. if all goods are taxed at the same rate, the tax will not affect decisions of consumers and suppliers, and will therefore be efficient.

4. Explain each of the following:

- 4.1 Progressive tax
- 4.2 Proportional tax
- 4.3 Regressive tax

4.1 A tax is **progressive** if the average tax rate *increases* as income increases.

4.2 A tax is **proportional** if the average tax rate is *constant* as income increases, that is, the percentage tax that an individual pays stays the same, regardless of the income level.

4.3 A tax is **regressive** if the average tax rate *decreases* as income increases.

5. Government functions can be classified according to the following categories:

- 5.1 Allocation
- 5.2 Regulation
- 5.3 Distribution
- 5.4 Stabilisation

Describe each category briefly.

5.1 Allocation: Refers to the role government plays to assure the efficient allocation of resources. Non-excludability, free riding and non-rivalness lead to some goods not being provided by the private sector, and the government must ensure that these are provided. Externalities not reflected in market prices may lead to inefficient allocation of goods – government can attempt to correct this through taxes (in the case of negative externalities) or subsidies (in the case of positive externalities) or other measures such as production quotas.

5.2 Regulation: Refers to the function of government to promote efficiency by implementing legislation to ensure certain minimum standards. Examples of these are measures to ensure healthy competition and minimum standards set for banks and other financial institutions regarding risk management.

5.3 Distribution: Refers to the function of the government to promote a more equitable distribution of income, by using a progressive tax system and paying

subsidies to low income earners.

- 5.4 Stabilisation:** Refers to monetary and fiscal policy a government applies to promote macroeconomic stability, i.e. to use certain measures to even out the economic cycle. A decision by the fiscal authorities to decrease the general tax rate during a recessionary period to try to stimulate demand is an example of a counter-cyclical policy measure.