#5, 15 February 1999

A Publication of the International Centre for Policy Studies

ICPS newsletter

Indirect Taxes Versus Direct Taxes

Indirect taxes encourage economic growth more than direct ones, states RAND Senior Economist John Thissen. Dr. Thissen is RAND Project Manager of the ICPS/RAND Centre of Policy Excellence Programme. The following text comprises an abridged lecture presented by John Thissen at the macroeconomics seminar held at the International Centre for Policy Studies on 9 February.

The main objective of taxation is to finance state expenditure. All other objectives, such as structural policies or income redistribution, are secondary.

Any government has three ways of raising money for its expenditure:
· tax income by means of income tax or corporate profit tax, i. e. direct taxes;
· tax consumption by means of value added tax, excise tax, receipts tax, i. e. indirect taxes;
· print money.

If we do not consider printing money an adequate way to finance state expenditure, then the government has either to tax income (use direct taxes) or tax consumption (levy indirect taxes). Should the government choose to levy both direct and indirect taxes, it must decide which taxes will contribute a bigger share of revenue to the state budget.

A simple model suggests that indirect taxes encourage economic growth in the long-run better than direct ones do.

The model assumes the following:
· the government can use either direct or indirect taxes;
· consumption at any given period of time equals consumption financed from income received at this period plus consumption financed from income earned and saved during the previous period;
· savings are converted into domestic investments;
· increased investments mean increased production capacities and economic growth.

Let us suppose that there is an economy which consists of only one household and earns an income of UAH10. Further assume that if there are no taxes, this household will spend UAH5 on consumption and save the remaining UAH5.

Now, we shall introduce a government which has decided to spend UAH1. For this reason it has to raise UAH1 by taxing the economy. Let us consider two instances:
1. The governments decides to tax the household's income. In this case, UAH1 will enter the budget by taxes from the household's total income of UAH10. The household's disposable income will then equal UAH9, out of which UAH4.5 it will consume and UAH4.5 it will save.
2. The government opts to tax consumption, i.e by means of receipts tax at the rate of 10%. In this case, the household will be able to use its income as if there were no taxation: UAH5 will be consumed and UAH5 will be saved. However the government will receive UAH0.5 in tax revenues from the amount spent by the household on consumption, and the remaining UAH0.5 will come from from the tax on UAH5 saved during the previous period of time and consumed in this period.

If we compare these two cases, we come to the following conclusion: the use of indirect taxes maintained the level of savings, which are a source of investment. Unlike direct taxes, indirect taxes allow part of an income (in the form of savings) to be postponed for taxation in the future, thus providing a basis for investments and economic growth.

To make sustained economic growth possible in Ukraine, the government has to determine the most important items of expenditure and finance them through a larger proportion of indirect taxes which will allow economic agents to save a larger share of their income and facilitate growth in investments, production capacities and GDP.

Last week

ICPS Director to participate in an international conference of democracy activists. ICPS Director Vira Nanivska has left for India, where she will participate in the Inaugural Assembly of the new World Alliance for Democracy. The Assembly will be held in New Delhi on 14–17 February.

Mrs. Nanivska will also deliver a speech at a special seminar in Bangalore. The subject of her presentation will be "Legacy of the Soviet Union: Impact on the State and Civil Society". The seminar will be attended by government officials, representatives of NGOs, media and scholars (about 40 people). Mrs. Nanivska's speech will be published in upcoming issues of the ICPS Newsletter.

This week

Local Budget Revenues: a solution for Ukraine. The next ICPS Macroeconomic Seminar to be held this Tuesday will be devoted to the subject "Local taxes and fees: options and guidelines in Ukraine". The main speaker will be Dr. Wayne Thirsk, Fiscal Economist at Barents Group.

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies delivered by electronic mail.
To be included into the distribution list, mail to: marketing@icps.kiev.ua.
ICPS Newsletter is published by the Publications Group of the International Centre for Policy Studies.
Publications Director Hlib Vyshlinsky (qp@icps.kiev.ua)
Editor Yuri Yasmo (Yasmo@icps.kiev.ua)

The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the development process of Ukrainian policy. This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of policy.