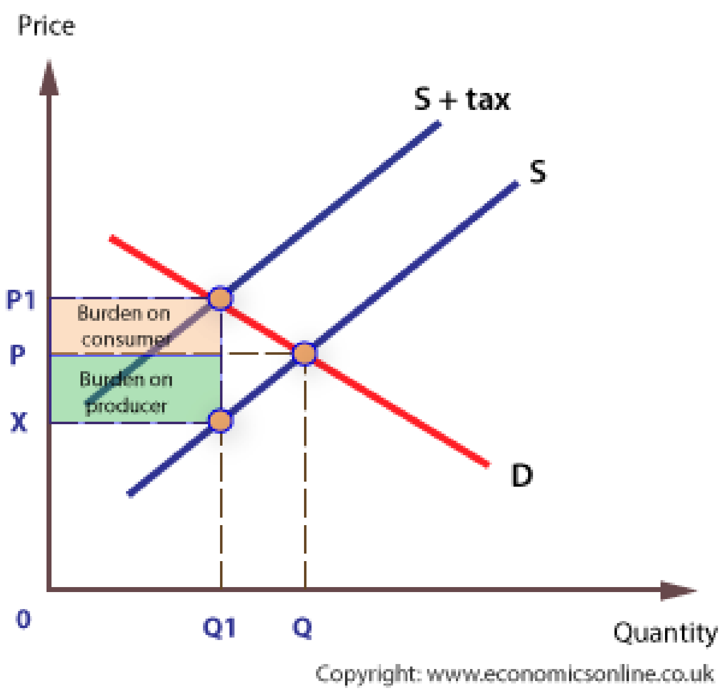
Government Intervention

Indirect taxes

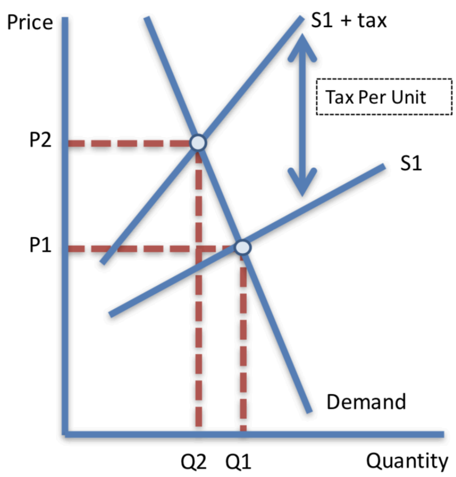
- An indirect tax is a tax imposed by the government that increases the supply costs faced by producers. (S- S+tax)
- The amount of the tax is always shown by the vertical distance between the two supply curves.P1-X)
- Because of the tax, less can be supplied at each price level.
- The result is an increase in the market price (P-P1) and a reduction in quantity demanded (Q-Q1) to a new equilibrium output.



Specific and ad valorem indirect taxes

- A specific tax is a set tax per unit e.g. a £5 tax per unit sold.
- An ad valorem tax is a percentage tax e.g. 20% on the unit price.

Value added tax (standard rate in the UK is 20%) is an example of an ad valorem tax.



- The effect of an ad valorem tax is to cause a pivotal shift in the supply curve
- This is because the tax is a percentage of the unit cost of supplying the product.
- So a good that could be supplied for a cost of £50 will now cost £60 when VAT of 20% is applied
- A different good that costs £400 to supply will now cost £470 when the same rate of VAT is applied
- The absolute amount of the tax will go up as the market price increases

The Effects on Stakeholders (Firms; Government and consumers)

Effect of a tax depends in part on price elasticity of demand

Problems in setting the tax rate at the right level to achieve aims

How much tax revenue is raised? How is it used?

What is the impact on businesses / competitiveness?

Might there be a possible loss of jobs and/or capital investment?

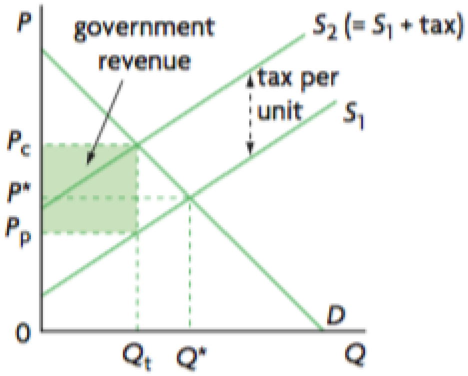
Will an indirect tax negatively affect competitiveness and trade?

Consequences for equity / the distribution of income

Does a tax have a regressive effect on lower income groups?

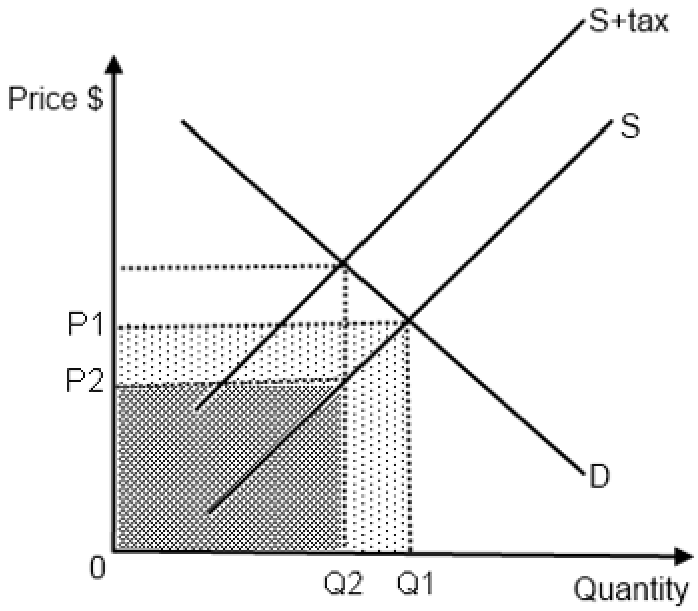
Key Diagrams

Government revenue



Producer Revenue

Falls from P1q1 to p2q2



Consumers and indirect taxes
Here consumers see the price rise significantly and they suffer as most of the tax is passed onto them by the firm. This is because PED is highly inelastic.

Tax per unit is p2-p3
Price increase is p1-p2