The difference between direct and indirect taxes

Externalities occur when there is a divergent between social and private costs/benefits. Externalities on spillover effects are the differences between social cost/benefits and private costs/benefits. They exist when the action of producers and consumers affect not only themselves but also top parties and no compensation is made by those who generate those externalities. Externalities can be seen as positive or negative.

According to Economic Fundamental Finance (2010), Negative Externalities " occurs when an individual or firm making a decision does not have to pay the full cost of the decision". When markets are left to themselves too many goods will produce third party harmful effects rather than produce goods that give beneficial third party effects. Many companies pay little or no attention to the effects of their activities on the society. Examples include Air pollution from road and traffic congestion, the social cost of drugs and alcohol abuse etc. Firms base their prices on the private costs and benefits. They don't consider the social costs and benefits of their actions. An example could be a car driven by an individual; the car causes air pollution on the society because he/she doesn't take into consideration the effects of driving the car. The air pollution from the car is the negative externality.

Here is a graph showing Negative Externalities:

A

B

MPC represents cost of production, MSC represents the additional external cost therefore private cost plus external cost equals to social cost that is the full cost of production. No government intervention means that equilibrium will be at point A where P1 and Q1 will be the price and quantity sold. Consumers pay higher prices when external costs are added to the private cost so P1 will increase to P* and Q1 will reduce to Q*. Negative externality increases prices and reduces quantity resulting to the market failing to allocate their resources efficiently.

According to Economics Fundamental Finance (2010), Positive Externalities " exists when an individual or firm making a decision does not receive the full benefit of the decision. The benefit to the individual or firm is less than the benefit to society". They generate more beneficial third party effects such as education and training. Firms do not take into consideration of the positive external effects of their actions and so they produce very little. This graph below shows positive externalities:

C

D

Equilibrium is at point C with the price of P* and the output of Q*. The equilibrium will be at point D where the output and price are Pe and Qe when additional benefits are taken into consideration so more goods and services are expected to be produced. Positive externalities exist when the MSB of production and or consumption exceeds the MPC.

The impositions of taxes are based on what the government thinks they should protect. Reasons for this include are to provide the government with money it needs to pay for many services it provides. Taxes made are used to control the amount of spending in an economy which means that if there is an increase in tax, it will reduce an individual's ability to spend. Another reason for imposing tax is to create equality in the distribution of income closing the gaps between the rich and the poor. They also impose tax so they can keep track of what comes inside their countries and so they can discourage the consumption of commodities like tobacco and alcohol.

Indirect taxes have many drawbacks such as prices which add to the goods and services causing inflation. It leads to uncertainty because the governments aren't really sure of how many people will spend on goods and services so they are uncertain of the revenue indirect tax will raise. Indirect taxes are regressive meaning they fall most heavily on people that have very low incomes. Advantages of indirect taxes include cost of collection meaning they are very cheap to collect and the burden of collecting these taxes are fall on the manufacturers, wholesalers and retailers collecting VAT. Indirect taxes have a wider tax base where taxes are paid by young, old, employed and the unemployed and not just by those who have earned incomes. Indirect taxes are used to achieve some certain aims. These aims include putting taxes on harmful goods such as alcohol and cigarette.

Taxation is a way of the government controlling such negative externalities such as air pollution. They have a wide range of policies to use to bring about efficient allocation of resources where externalities exist. These policies include Regulation, Common property rights and Extending property rights.

Regulation is a way in which the government can monitor the pollution levels in an area or might decide to ban pollution. Regulation is easy to understand

and very cheap to enforce. However, it is often difficult for government to fix the right level of regulation to ensure efficiency.

The problem of externalities exists when there is lack of property rights. For instance no one has the right over the air they breathe. If gas emission from one country affects the forest from another country, the government of the country affected can pay the other country to stop its economic activity.

There should be direct transfer of resources from those who create pollution to those who suffer for instance workers can sue for compensation if they suffer from any kind of injury as a result of working in that company. An advantage of using this method is that the government doesn't have to assess the cost of production. A problem with this method is that it is often difficult even for the owners of the property rights to assess the value of the rights. Property owners may put higher values on their property to gain more compensation.

According to Tutor2u (n. d), Indirect taxes " are imposed by the government on producers – but the burden of the tax can be passed onto consumers depending on the price elasticity of demand and elasticity of supply for the product". The graph below shows the effect of a specific tax which causes a shift in the supply curve.

According to Tutor2u (n. d), " A specific tax will cause a parallel shift in the supply curve. The vertical distance between the supply curves shows the amount of tax per unit. When demand is inelastic, most of the tax is passed onto the consumer. When demand is elastic, the producer must carry most of the burden of the tax. " The effect of indirect taxes on goods and services also depend on the degree of competition between producers in a market. In some industries – particularly those for luxury goods where the demand is relatively elastic – intense price competition between producers may limit the extent to which a firm is prepared to pass on any extra taxes to consumers".

Indirect tax is a satisfying way to tackle a negative externality such as air pollution because the government can regulate the use of some commodities increasing the amount of tax on those goods that are considered harmful to the society. As said before government can place policies on such commodities such as common property rights and extending property rights. Increasing the price and raising taxes controls the negative externality.