Indirect taxes

Using the appropriate diagrams, explain why the relative burden (incidence) of an indirect tax on the producers & on the consumer varies depending on the price elasticity of demand for the good/product. Indirect Tax is a tax placed upon the selling price of a product, so it raises the firm’s cost and shifts the supply curve left or vertically upwards depending on the amount of tax. Because of this shift, less products will be supplied at every price. The diagram below shows the effect of imposing a tax and how the tax is being paid. There’re two types of indirect taxes, they are ‘ Specific Taxes’ and ‘ Ad Valorem’.

Specific Tax is a fixed amount of tax that is imposed on a product. For example, if the government imposes a tax of $2 per loaf of bread, it will shift the supply curve vertically upwards by the amount of tax, which is S2. This is shown by the diagram below. Ad Valorem, also known as ‘ percentage tax’, is a percentage of tax from the selling price of a good. In this case, the supply curve will not shift directly upwards because the gap between the ‘ price’ and the ‘ price + tax’ will get bigger as the price rises. For example, a packet of cigarette costs $10.

If the government imposes a 20% tax per packet, the tax on each packet of cigarette would be $2. This is shown by the diagram below. When the government puts a tax on a product, the product’s price will usually increase in order to achieve maximum profit. Which means that the quantity demanded for the product is likely to decrease. If the demand for a product is very elastic, then a price increase as a result of the imposition of a tax on the product will lead to a relatively large fall in the demand for the product. For example, Waitrose pasta and Tesco Value pasta both cost $5 per pack.

However the price of Waitrose pasta increases to $6 because of the rise in tax. This would result an immediate change in demand from Waitrose pasta to Tesco Value pasta instead. This means that the Tesco Value pasta consumers would carry on buying pasta from Tesco, whiles a lot of the Waitrose pasta consumers would switch to buy pasta from Tesco instead of Waitrose. This can be shown by the diagram below. On the other hand, if the government imposes a tax on a product where demand is relatively inelastic, the demand for product will not fall significantly despite the huge rise in price.

For example, coffee and tea both cost $5, but coffee has become an absolutely essential drink in the morning, whiles tea is just for people's interest. If the price of the coffee rises significantly to $10 and the price of tea stays the same, the coffee demanded will not change a lot because people still see it as a necessity good (a good that we can't live without, or won't likely to cut back on even when times are tough), and therefore the change in demand would only decrease by a little. This is shown by the diagram below.

As we can see from the two diagrams above, the share of the tax burden from consumers and producers varies. The reason for that is because the price elasticity of the demand and supply for the product costs a different shift towards the supply curve. Another reason is because there are other firms (different numbers of firms, the size of a firm) producing the same good, causing competition. Therefore, the relative burden of an indirect tax on the producers and consumers would vary depending on the price elasticity of demand for the good/product.