Economics

The significance of price of elasti of demand in decisions relating to an increase in the tax on tobacco The role of taxation is not only the generation of more revenues to the government, but to discourage the consumption of certain goods among the population as well. However, since the imposition of a tax is reflected in the high price of the respective item, it might result to a fall in consumption to a large extent and hence, does not result to a hike in government revenues. But there are certain commodities, especially those meant for addiction purposes, whose prices have a very low impact on the decision making of the consumers, since people keep on consuming them till they are in a position of not being able to afford them or need some other external causes to prevent their usage; sometimes people might even go beyond their capacity to get hold of the commodities. In such cases, the government has to impose a very high tax on the particular item for the welfare of the society (George & Wilding, 1984). Thus, the main reason operating behind the imposition of high taxes on addiction items is the price inelasticity of demand (Baumol & Blinder, 2008). One such item of addiction is tobacco that is often considered as being one of the most harmful and hazardous elements of consumption as well and this is the reason why the government of all concerned nations have decided to impose a high tax on the same.

When tax is imposed on a commodity, it results to an upward shift in the supply curve of the commodity but the demand curve remains unchanged. This is because, the tax in such cases are imposed in the form of higher prices and thus are sales tax (Aronson, Hilley & Maxwell, 1986). So these taxes are indirect in the sense that they are transferred from the seller to the buyer. In case of a sales tax, the retailers will buy lower quantity of a product from the wholesalers which subsequently lead to a fall in the supply of the commodity – this factor is reflected through an upward shift in the supply curve. For a commodity like tobacco having a very low price elasticity of demand, an upward shift in the supply curve with demand remaining constant, leads to a rise in the position of the equilibrium point and consequently, a fall in the equilibrium quantity and a rise in the equilibrium price. However, the fall in quantity is not in proportion to the rise in the final price (Lipsey & Harbury, 1992).

Thus, it is found that the imposition of taxes on items like tobacco, which have a very low price elasticity of demand, is that, they serve a two-fold purpose. Firstly, it leads to a fall in aggregate consumption so as to cause social welfare to some extent, and secondly, since the fall in consumption is much lower in proportion to the hike in prices, it results to a rise in the total government revenue generated from imposition of tax on tobacco, where revenue is defined as the product of total quantity and market price (Chaloupka, Wakefield & Czart, 2001; Mankiw, 2008).

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