Whether taxation is the most effective solution to market failures

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? Discuss whether taxation is the most effective solution to market failures arising from negative externalities Marketfailureis when the free market fails to provide an efficient allocation of resources. Negative externalities are the costs to a third party of a particular action, and it is where the social cost is greater than the private cost. Taxation is a solution to correct market failure which is arising from negative externalities. Introducing an indirect tax, (a tax levied on goods and services), can generate a reduction in consumption of the good which produce the negative externalities.

An indirect tax can internalise the cost of the negative externality by discouraging its production. The government places a tax on producers, which will increase their costs of production. This can be shown in a diagram. The increase in costs of production will reduce supply and therefore shift the supply curve in from S to S1 which results in an increase in price from P to P1 and a decrease in quantity from Q to Q1. The tax is indicated on the graph as the difference between S and S1. However, the effectiveness of this tax depends on the price elasticity of demand for the product.

If the PED is inelastic, consumers will be unresponsive to a change in price, so producers may pass on most of the tax burden to consumers, who will continue to buy the product. The tax set by the government must be equal to the size of the external costs associated with the product, and this is difficult to set especially if the effect is not quantifiable. If the tax was set too low, it would be ineffective, and if it was set too high, the consumers may stop purchasing it altogether, which may have other undesirable outcomes. The amount of tax paid by the consumer is shown by area A, and the amount paid by producers is shown by area B.

Ideally, producers should bear the full cost of the tax, but goods with inelastic demand may mean that they shift this on to consumers. Where consumers pay more, this is a situation where taxation is ineffective at reducing market failure as it has not reduced consumption of goods causing negative externalities. A reason why indirect taxation may be effective in correcting market failure is that the policy will generate revenue for the government. The revenue collected will be greater if the tax is set on inelastic goods because this means that consumers will pay for them regardless of an increase in price.

Also, the revenue gathered from the tax can be used to fund schemes to reduce consumption of the product, for example, educating the younger people on the negative effects of an action. The revenue could also be used to correct the market failure by minimising the effect on the third parties. Another way of dealing with negative externalities is government legislation to correct the market failure. Placing restrictions on demerit goods, (their consumption is more harmful than realised), can help to reduce market failure as it is their use that often leads to negative externalities arising.

Legislation can be effective, but it takes a long time to enforce and can also be costly. Overall, introduction of an indirect tax can reduce market failure which arises from negative externalities. The reduction in supply that results from the tax increases the price and decreases the quantity, which causes a shift along the demand curve. This increase in price may deter consumers from purchasing the good. However, it is difficult to set the correct amount of tax on the good, because often, the negative effects are not quantifiable, and their value must be judged.

It is important that the level of tax is just right, because if it is set too low, it will be ineffective, and if set too high, consumers may completely stop purchasing it, which may have other undesirable effects. The producer must pay the greater proportion of the tax, but if the demand for the product is inelastic, they may shift this on to consumers, who will pay for it regardless of the price. On its own, taxation may not be the most effective way of correcting market failure arising from negative externalities, but together with legislation, may provide to be more effective..