Webnote 132

SYLLABUS REFERENCE Taxes[1] + Subsidies 1.3

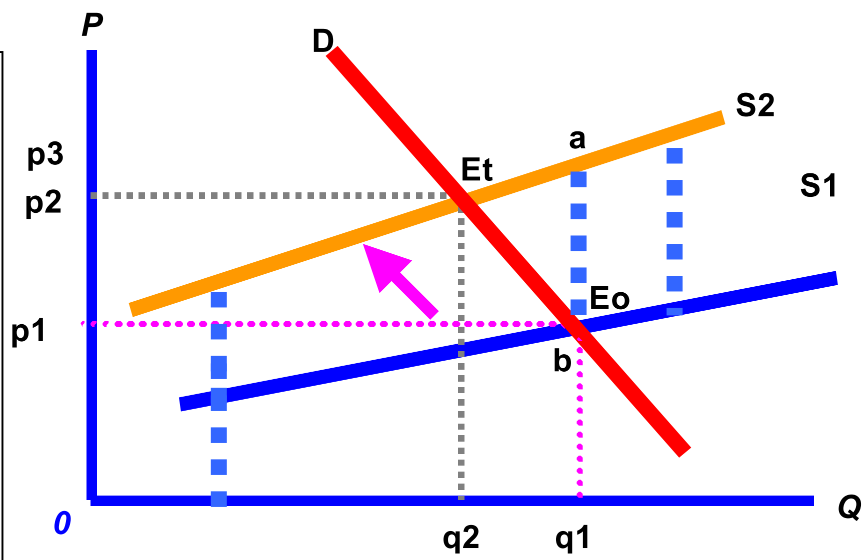
- **Main Course theme: Government intervention in the economy**[2]

Note: After you have studied elasticity you will notice that the slope of the curve will be significant here:

(1) the more inelastic demand is the more effect a tax or subsidy will have on price. The more elastic it is the less effect on price.
(2) The more inelastic demand is the less effect on quantity and the more elastic demand is the greater the effect on quantity. We will look at this concept when we study syllabus 1.2
(3) Taxes and subsidies are a significant interference/ **intervention** in the market system
(4) When using the diagrams remember the issue is the effect on price and quantity. How much do price and quantity change and this is therefore related to resource allocation. If taxes are too high resources may leave the industry and if subsidies are high resources may flow into the industry.
(5) Read Blink chapter 6, pp 64-70.

Fig 1: Resource Allocation: Effects of a tax on goods / services Interference in the market by government

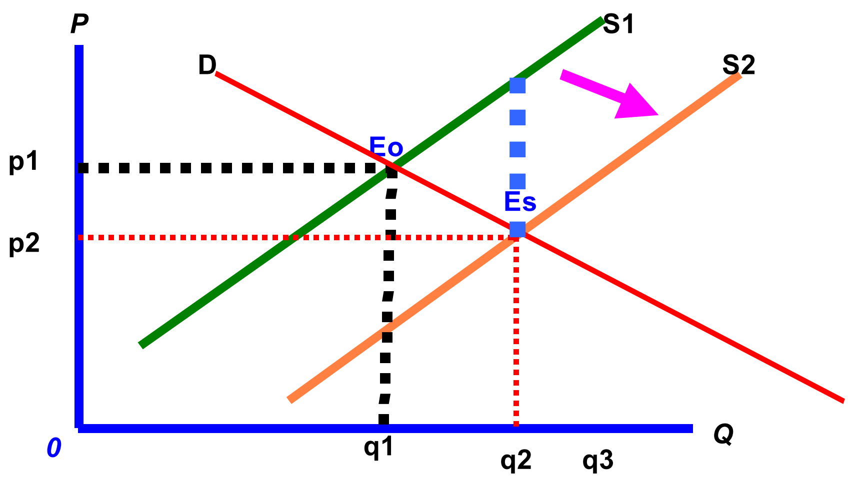
Note: The value of the tax or subsidy = vertical disance between the two lines shown by the line ab



Reading: See Blink p. 65

Fig 2: Resource Allocation: Effects of a subsidy on goods/services Interference in the market by government

Reading: See Blink p. 66



[1] **Examples include VAT, SALES TAXES, MVST. Note that The term *ad valorem* is also used for this i.e. indirect tax is a % of price of the good. Eg in Germany it is 19%.**

[2] This theme of ‘ intervention’ in markets is a main theme in the course. Consider using it in your evaluation.