Syllabus weight = 3

Webnote 134

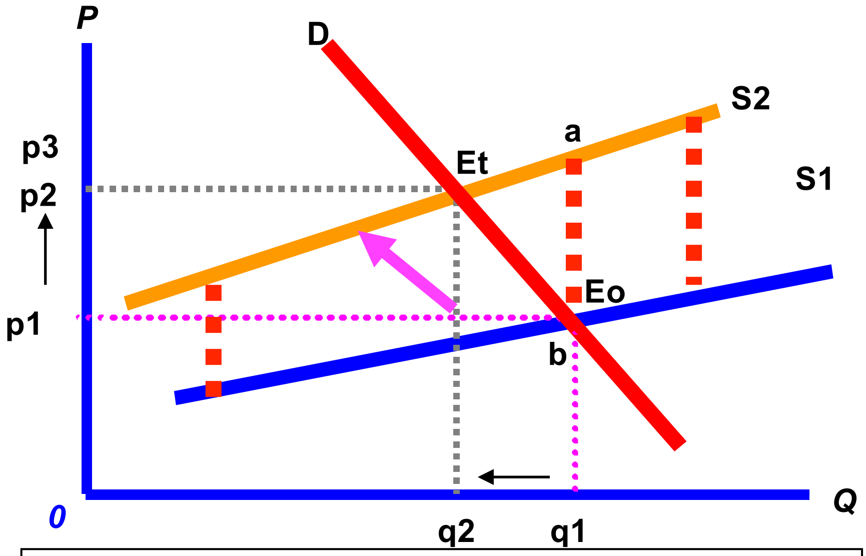
[1]SYLLABUS REFERENCE Taxes[2] + Subsidies + Elasticity (2.1 and 2.2)

- Main Course theme: Government intervention in the economy[3]

Indirect tax: Ad Valorem Tax

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

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

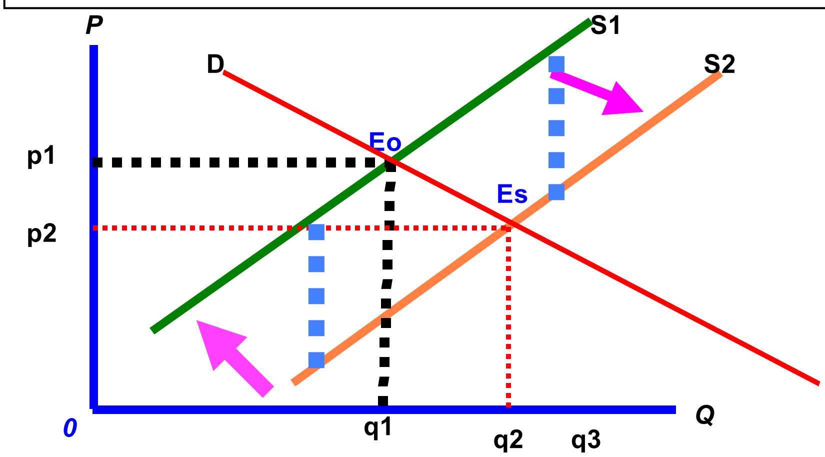


Indirect tax: Flat Rate Tax/subsidv

Fig 2: Resource Allocation: Effects of a tax or subsidy on goods/services. Example of intervention in the market by government

Reading: See Blink p. 65

Reading: See Blink p. 66



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 2.2
(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 is 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.

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[2] **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%.**

[3] This theme of ' intervention' in markets is a main theme in the course. Consider using it in your evaluation.

Webnote: 134

Taxes, subsidies slope and elasticitity: Stakeholder view

Elastic = Q responds strongly to changes in price
Inelastic = Q does not respond strongly to changes in price

Task1: Draw a detailed diagram to show the effect of an indirect tax on the Firm when demand is very 'elastic'

Reading: See Blink p. 65

Task 2: Using the diagram from Task 1 show the revenue Area of firm before + after the tax is applied.

Answer:
before

after

Task 3: Using the diagram from task 1 show the revenue loss Area for the firm because of the tax.

Answer:

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1a Explain the importance of price elasticity of demand and cross elasticity demand for business decision making. 10/25

Task4: Draw a detailed diagram to show the effect of an indirect tax on the Firm when demand is 'inelastic'

Readin: Blink p. 66

Task 7:
What tax burden /impact do you notice between the two diagrams for the
1) consumer?
2) Firm?

Task 5: Using the diagram from Task 4 show the revenue Area of government after the tax is applied.

Task 6: Using the diagram from Task 4 show the revenue Area of firm after the tax.