Introduction to Microeconomics

Effects of Tax

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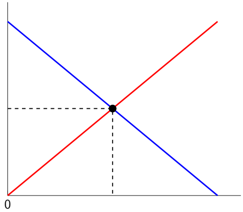
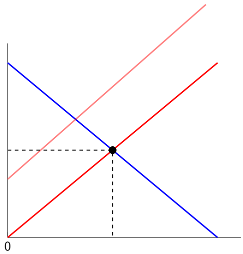
Concept of Tax

- Tax is imposed on a market: reduces the quantity that will be sold in the market
- Tax revenue is the monetary amount of tax collected.
- Tax can be imposed on buyers or sellers. Regardless of on whom it is imposed, both the buyers and sellers would be affected
- If tax is levied on buyers, demand curve shifts downwards; If tax is levied on sellers, supply curve shifts upwards/leftwards: Both adversely affected

Graphs



Tax Levied on Sellers



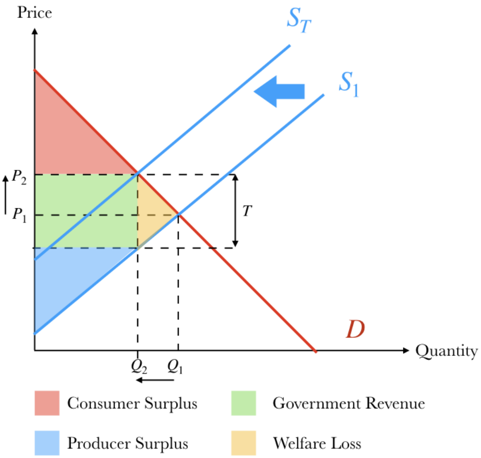
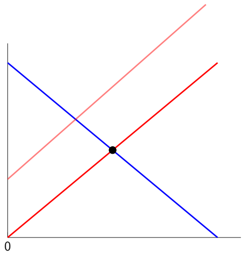


Figure: Caption

Price controls/Tax regulations lead to market inefficiency. There is a cost due to this which is called Deadweight Loss

- Price control (price ceiling and price floor)
- Tax Incidence: Share of the tax burden between sellers and buyers.
- The distribution of the burden depends on elasticity factor. Assume: Tax burden would be equally shared by the buyer and seller; Relative elasticity of demand supply would be same

Graphs - Tax on Sellers



Price Controls

- Price Ceiling: When the government imposed the maximum price at which the product can be sold at (Effective when price is set below the market price) $\longrightarrow$ Inefficiency (Shortage: Excess Demand)
- Price Floor: When the government imposed the minimum price at which the product must be sold at (Effective when price is set above the market price) $\longrightarrow$ Inefficiency (Excess Supply)

Example - Price Ceiling

Figure 1

A Market with a Price Ceiling

In panel (a), the government imposes a price ceiling of $4. Because the price ceiling is above the equilibrium price of $3, the price ceiling has no effect, and the market can reach the equilibrium of supply and demand. In this equilibrium, quantity supplied and quantity demanded both equal 100 cones. In panel (b), the government imposes a price ceiling of $2. Because the price ceiling is below the equilibrium price of $3, the market price equals $2. At this price, 125 cones are demanded and only 75 are supplied, so there is a shortage of 50 cones.