

Market failure essays

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2(a) Explain why governments impose indirect taxes

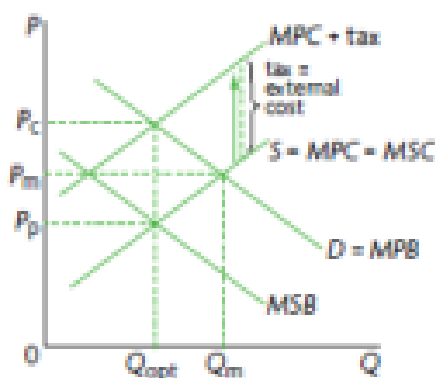
1. Define indirect taxes

Indirect taxes are taxes levied on the expenditure of goods and services, rather than on income and wealth. Indirect tax raises a firm's cost of production and shifts the supply upwards by the amount of tax levied. There are two kinds of indirect taxes, specific tax and ad valorem tax. Specific tax is a fixed amount of money taxed per unit produced of a good and is used to reduce consumption of a good, while ad valorem tax is a percentage taxed on price of the good sold and is used to gain government revenue

2. To correct market failure

To reduce the consumption of a good because of its negative externalities, governments place indirect taxes on the product to reduce consumption. A good example of this is the tax in Singapore on cigarettes. Singapore government places a high tax on cigarettes to curb consumption.

(b) Market-based: imposing an indirect tax



Above is a figure for the negative externalities of consumption of cigarettes, the negative externalities of individuals smoking such as second hand smoke and burden of air pollution is the reason for the divergence of marginal personal benefit and marginal social benefit. The socially optimum quantity of cigarette consumption is at Q_{opt} , however without any government intervention the market will produce at Q_m , thus causing market failure (the failure of a free market to allocate resources efficiently).

To correct this market failure the government imposes an indirect tax to increase the cost of production and shift the supply curve ($MSC = MPC$) upwards, the new market equilibrium quantity is at Q_{opt} , effectively reducing the consumption and minimising the deadweight welfare loss.

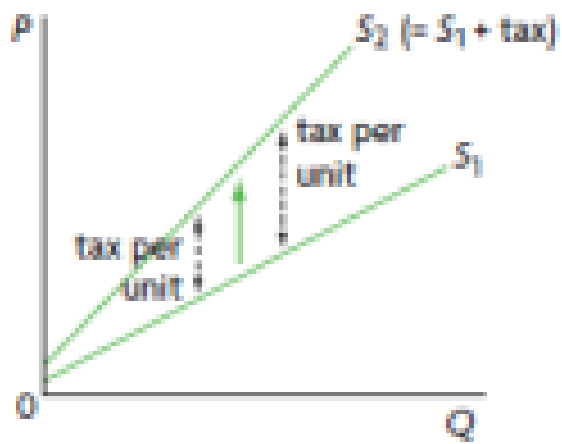
However, it is hard for the government to estimate exactly how much external cost the consumption of cigarettes incurs. Tax usually does not totally eliminate the deadweight welfare loss incurred by the divergence of MPB and MSB. Yet it still reduces consumption to a certain extent

3. Generate tax revenue for a government

Indirect taxes are also a way for the government to gain tax revenue and this is in the form of an ad valorem tax. As mentioned above it is a percentage tax on expenditure and it shifts the supply curve

upwards and makes it less price elastic.

(b) *Ad valorem tax*



2 (b) Discuss two possible government responses to threats to sustainability