

Indirect Taxes

AS economics revision presentation on the effects of indirect taxes on market equilibrium price and quantity. And it considers the impact of a tax on economic welfare using concepts such as consumer and producer surplus

What Are Indirect Taxes?

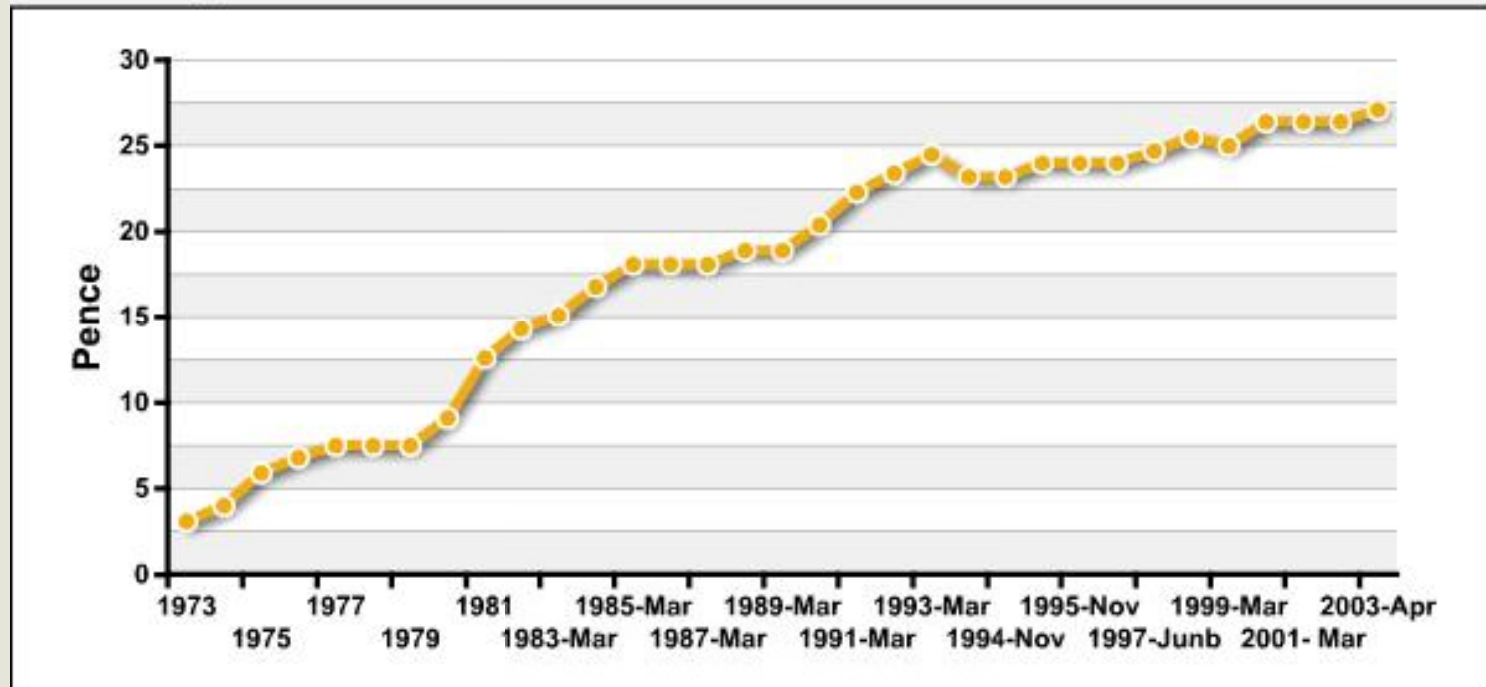
- **Indirect taxes** are taxes on
 - Suppliers in a market which affect their costs of production and therefore affect market supply at each price
 - Taxes on specific items of consumer spending
- Indirect taxes can be
 - **Ad Valorem**
 - A tax levied as a percentage (%) of the unit cost of a good
 - E.g. value added tax (VAT) and insurance premium tax
 - **Specific**
 - A fixed tax per unit of the good or service produced
- Who pays an indirect tax?
 - The **burden of an indirect tax** can be passed on by the producer to the consumer
 - This depends on the price elasticity of demand and supply

Specific taxes

- A specific tax is where the tax per unit is a fixed amount
- For example the duty on a pint of beer is 27.1 pence or 194p per packet of twenty cigarettes
- Another example is the air passenger duty which imposes a standard tax of £10 for flights within the European Economic Area (EEA) and £40 for flights outside of the EEA

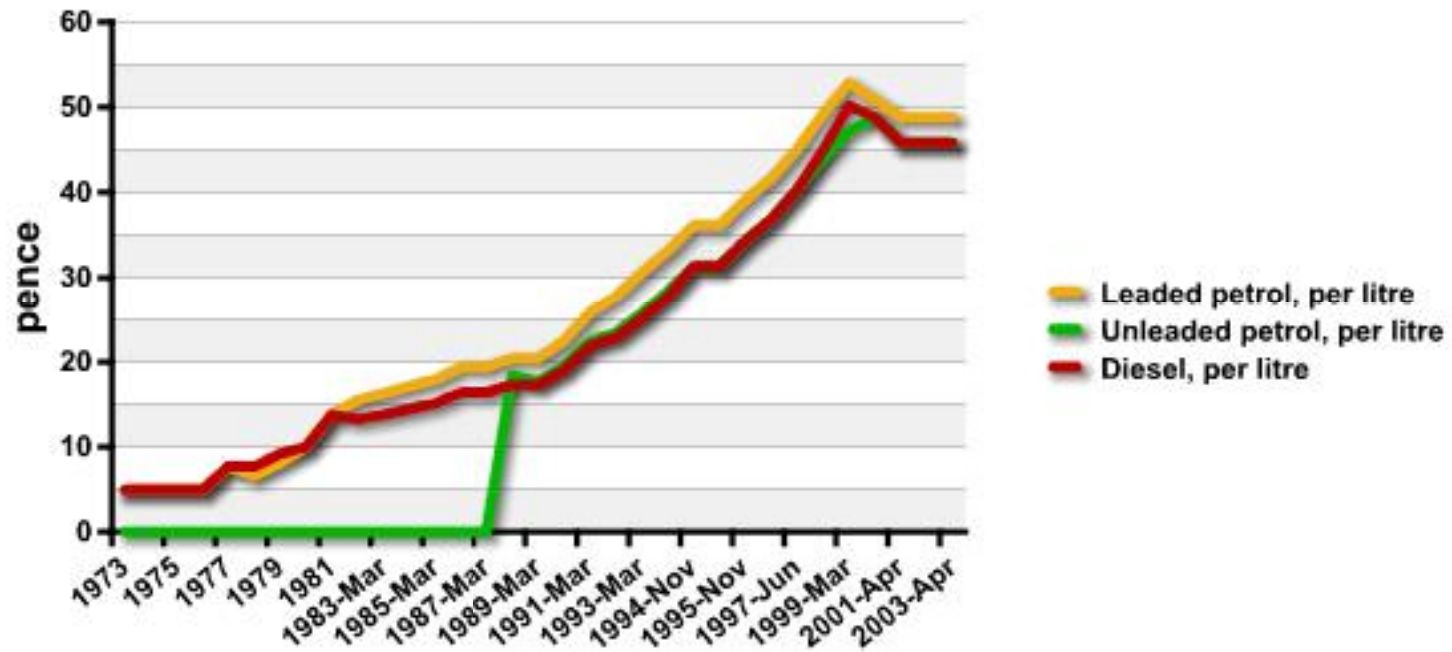
Beer duty

Excise Duty on a Pint of Beer



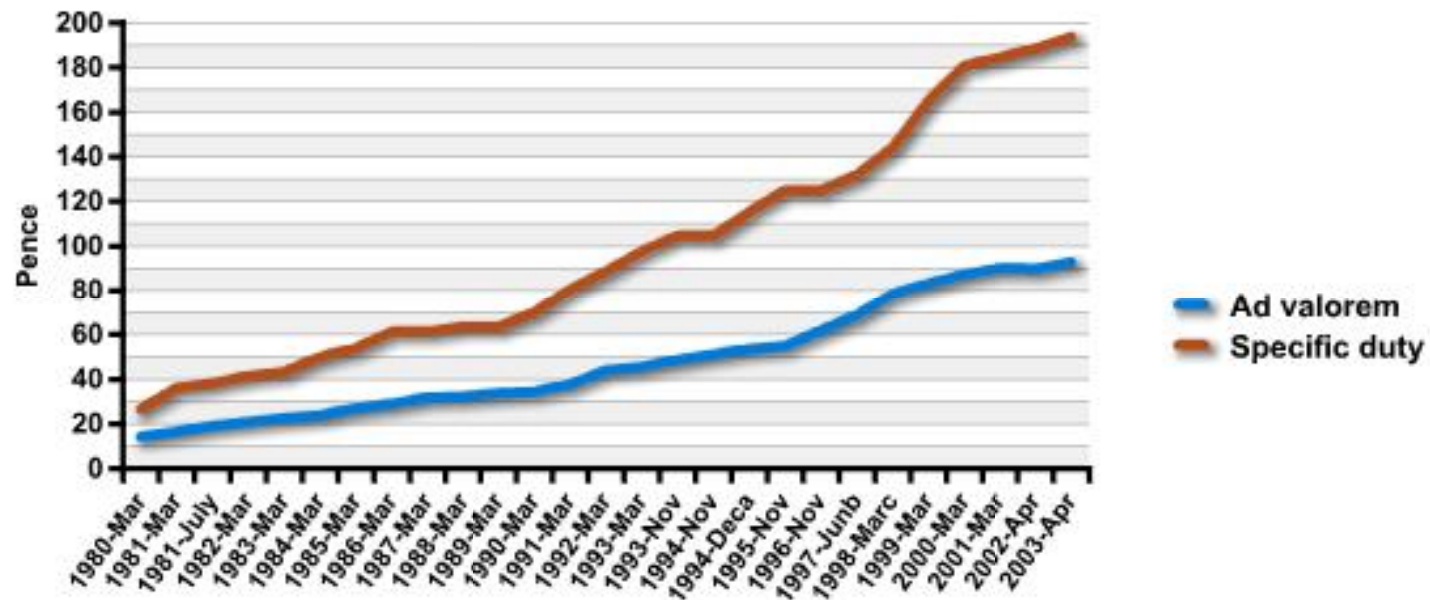
Petrol duties

Excise duties, hydrocarbon oil



Tobacco duty

Excise duties, tobacco (20 king-size cigarettes)



Source: HM Treasury and Institute for Fiscal Studies

Indirect Taxes in the UK

Value added tax

VAT standard rate	17.5%
VAT domestic fuel rate	5%
Insurance Premium Tax	5%

Excise duties

Beer (pint)	27.1p
Wine (75cl bottle)	119p
Spirits (70cl bottle)	548p
20 cigarettes	Specific duty 194p
	Ad valorem (22% of retail price) 93
Unleaded petrol (litre)	48.82p
Unleaded petrol (litre) for ultra-low sulphur	45.82p

Air passenger duty

Low rate (for destinations within the EU)	£10
High rate (for destinations outside the EU)	£40

Source: Institute for Fiscal Studies “Fiscal Facts” for 2003-04

Value Added Tax

- Standard rate = 17.5%
- Zero-rated Goods and Services
 - Food
 - Construction of new dwellings
 - Domestic passenger transport
 - International passenger transport
 - Books, newspapers and magazines
 - Children's clothing
 - Water and sewerage services
 - Drugs and medicines on prescription
 - Supplies to charities
 - Vehicles and other supplies to people with disabilities
- Reduced-rated
 - Domestic fuel and power
 - Women's sanitary products
 - Children's car seats
- VAT-exempt
 - Rent on domestic dwellings
 - Rent on commercial properties
 - Private education
 - Health services
 - Postal services
 - Burial and cremation
 - Finance and insurance
 - Betting, gaming and lottery
 - Businesses with low turnover
- 56% of consumers' expenditure is taxable at the standard rate and 3% is taxable at the reduced rate. The remaining expenditure is on zero-rated and VAT-exempt items

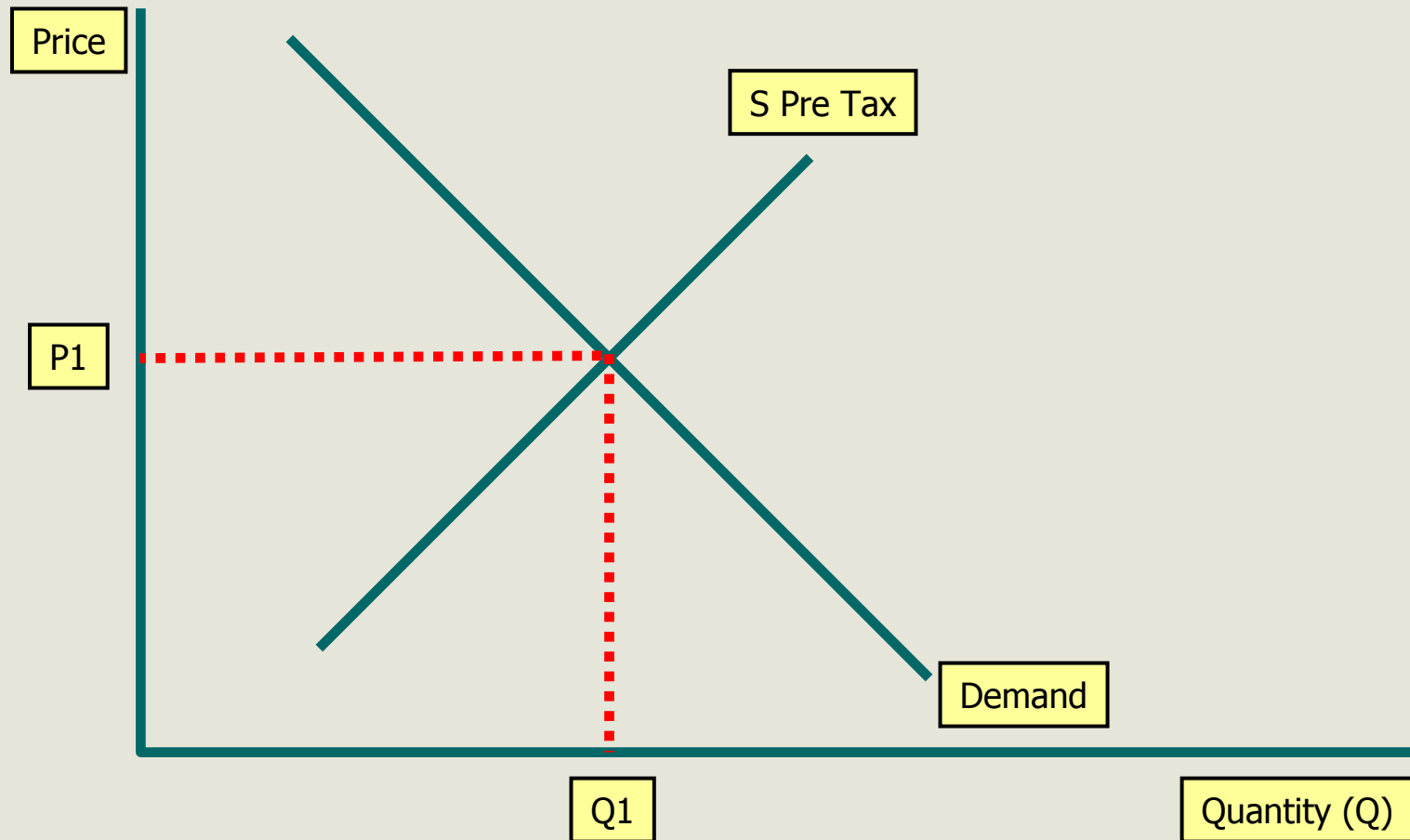
Why Does the Government Impose Indirect Taxes?

- (1) To raise tax revenue to fund government spending
- (2) Indirect taxes are perceived by some to be preferable to taxing income and wealth (a normative judgement!)
- (3) To change the level of demand and also the pattern of demand for different goods and services
 - (a) To deter consumption of goods considered to be harmful
 - (e.g. tobacco, alcohol)
 - These are known as de-merit goods which create negative externalities (*additional social costs*)
 - (b) To encourage the conservation of scarce economic resources (e.g. petroleum)
- Indirect taxes affect supply decisions of producers and (indirectly) the behaviour / choices of consumers

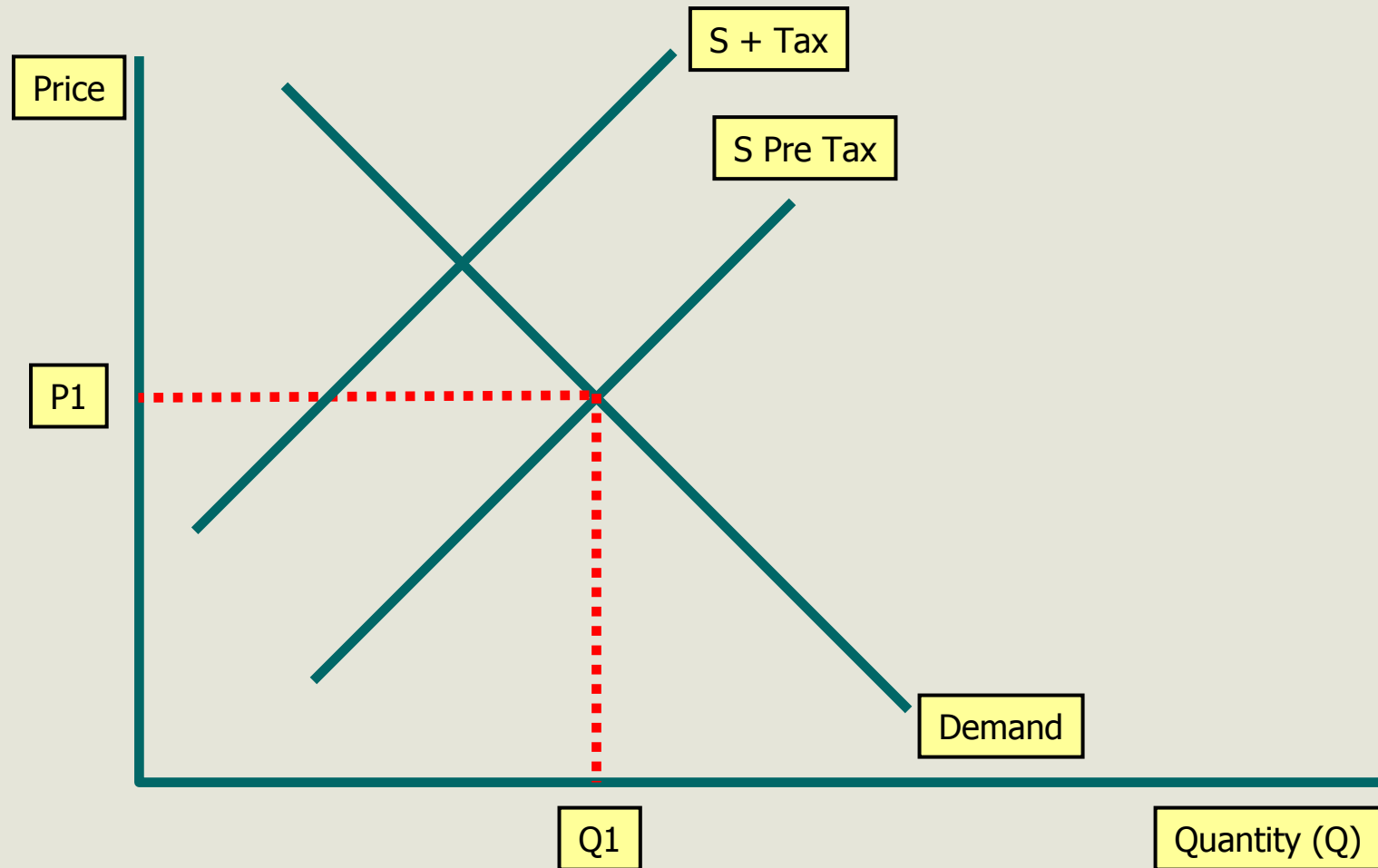
The Arguments Against Reliance on Indirect Taxes

- (1) Many indirect taxes have regressive effects on low-income consumers. This makes the distribution of income more unequal – examples of such taxes?
- (2) Higher indirect taxes can cause “cost-push” inflation (i.e. suppliers passing on a tax by raising prices)
- (3) If indirect taxes are too high – this creates an incentive to avoid taxes through “boot-legging” – examples?
- (4) When demand is inelastic, indirect taxes have little effect on people’s spending behaviour (therefore an inefficient policy)
- (5) The government revenue from indirect taxes can be uncertain particularly when inflation is low or there is a recession / downturn
- (6) Loss of economic welfare because of higher prices and reduced output (shown by a loss of consumer and producer surplus)

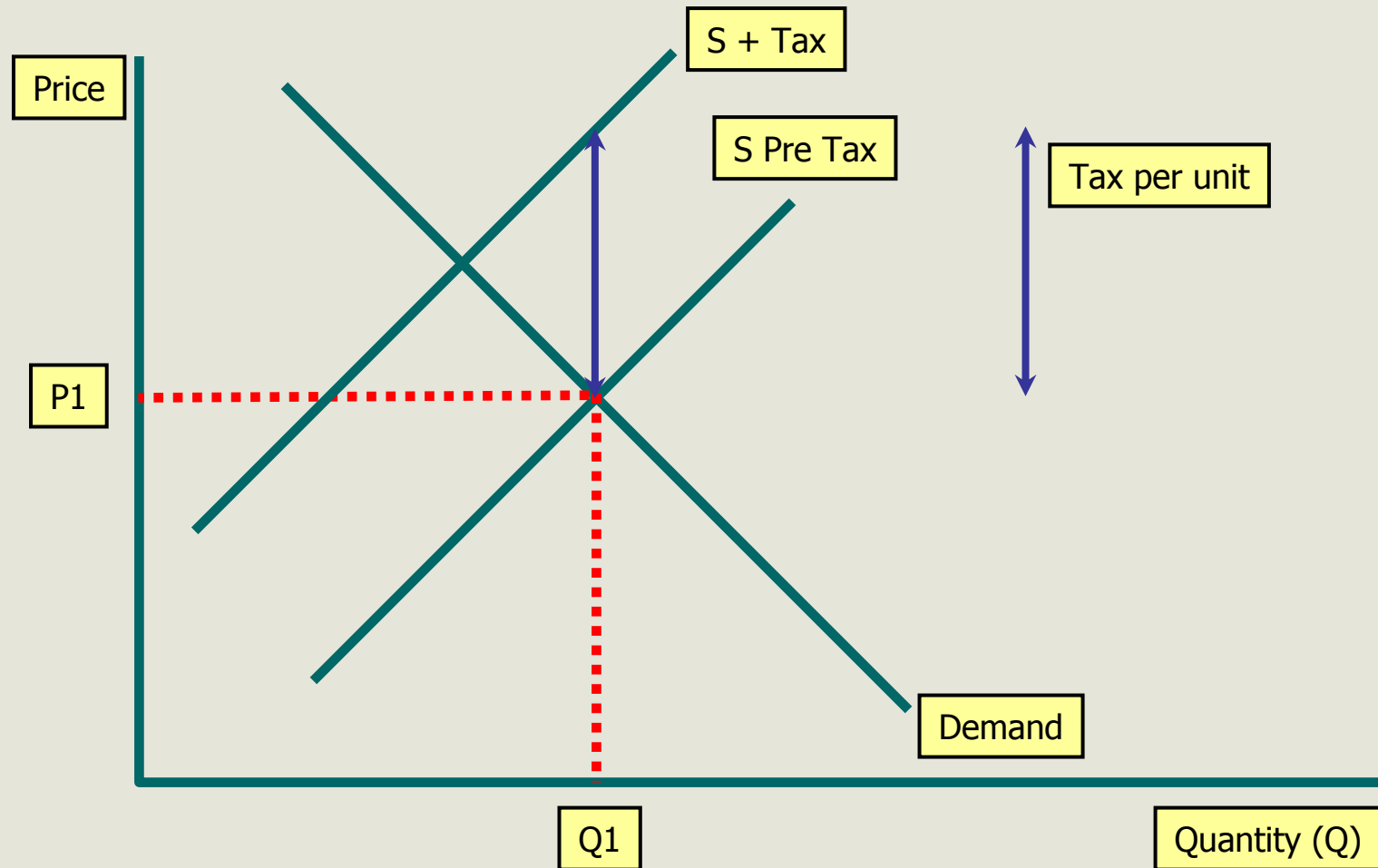
The Effect of an Indirect Tax on Producers



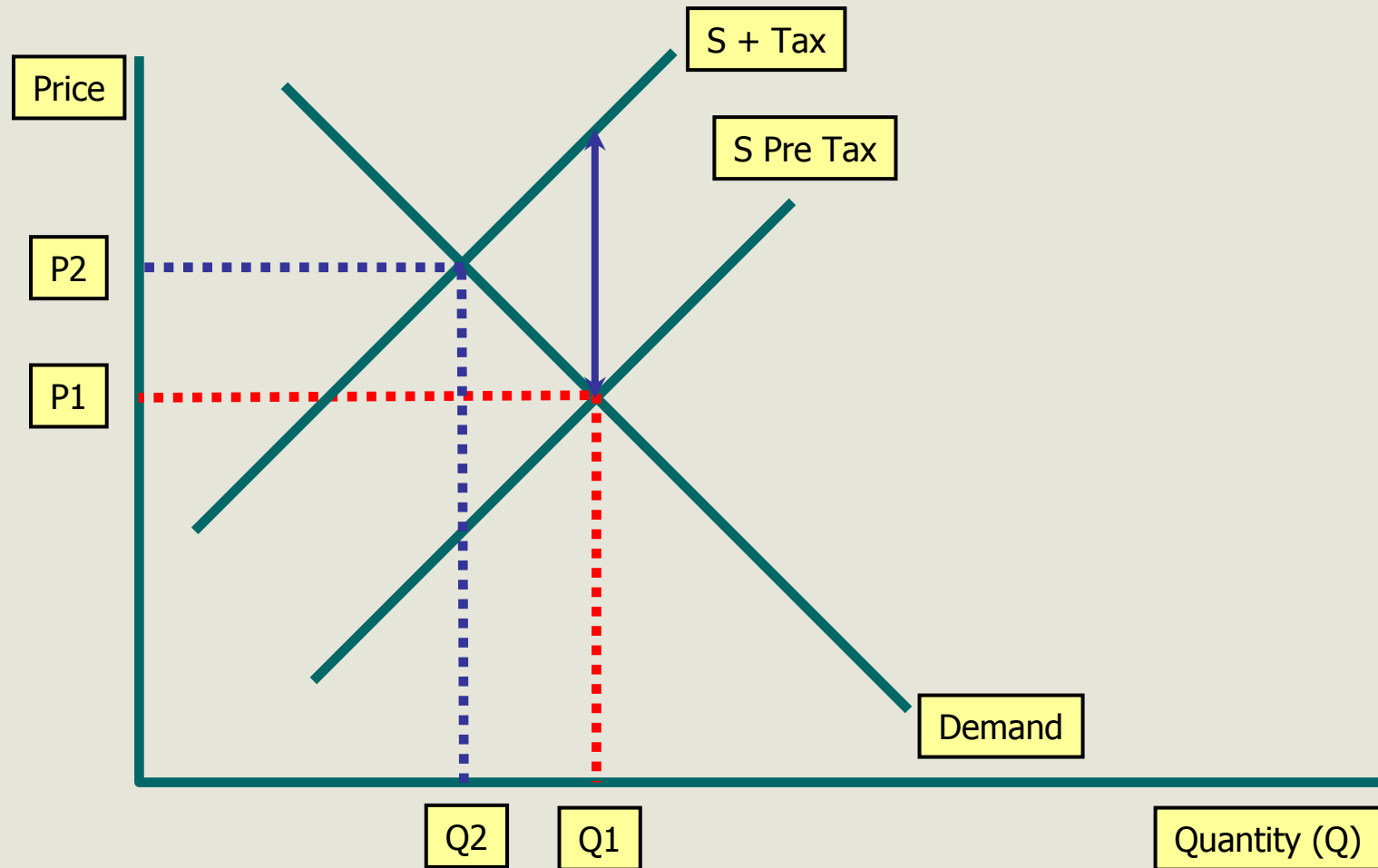
A Tax Raises the Costs of a Producer



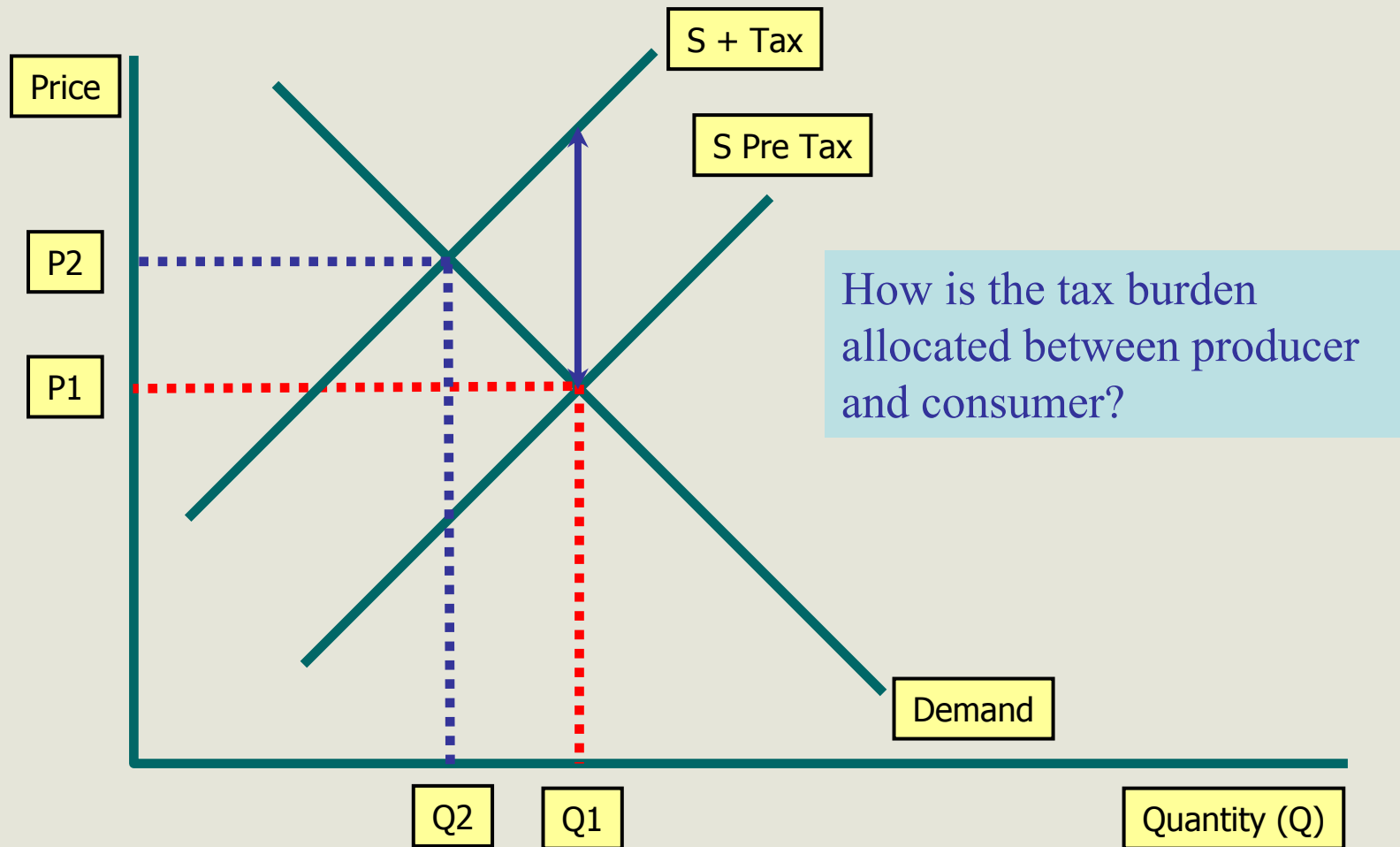
Tax Shown by Vertical Distance Between Supply Curves



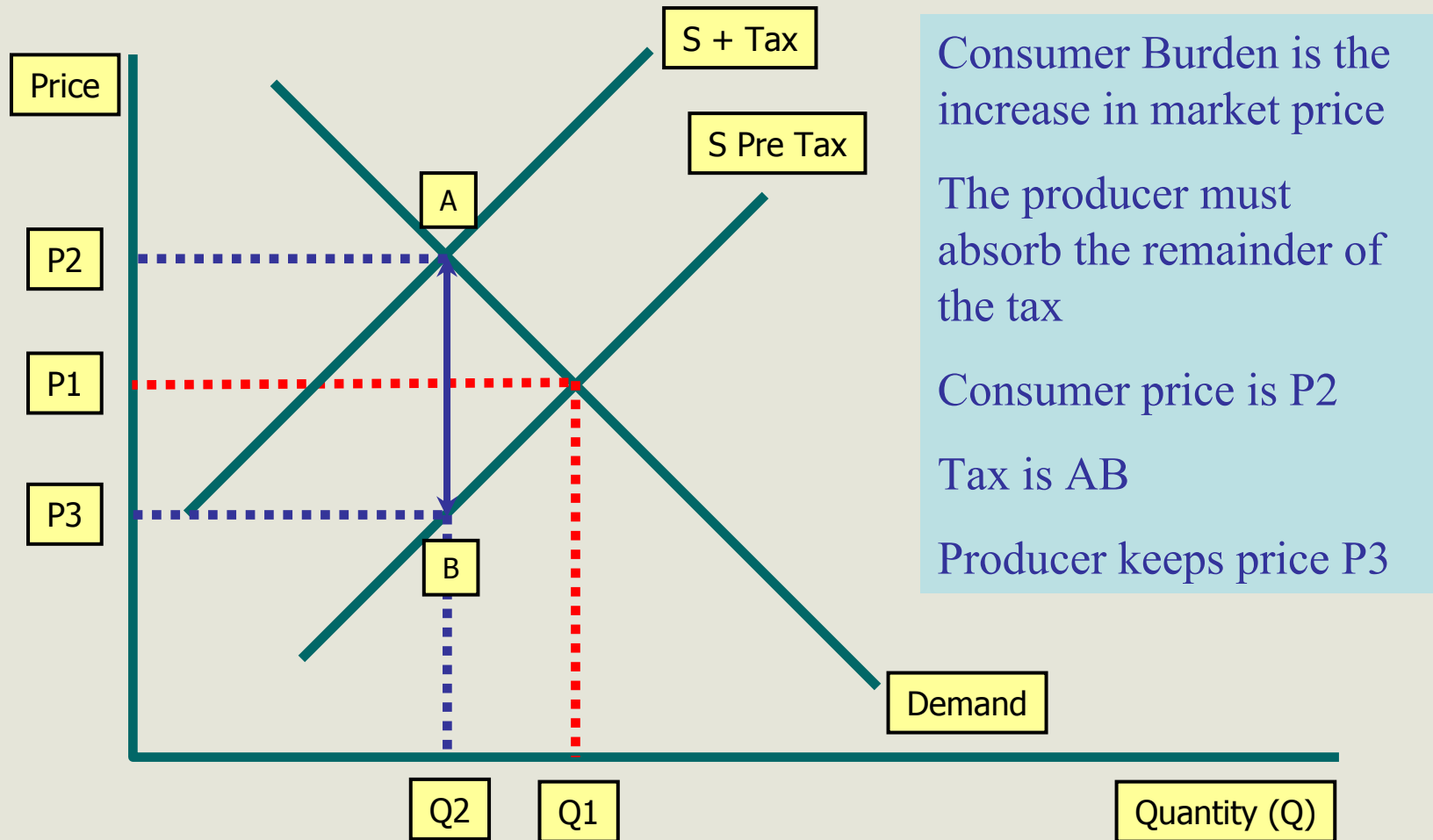
Equilibrium price rises, equilibrium quantity falls



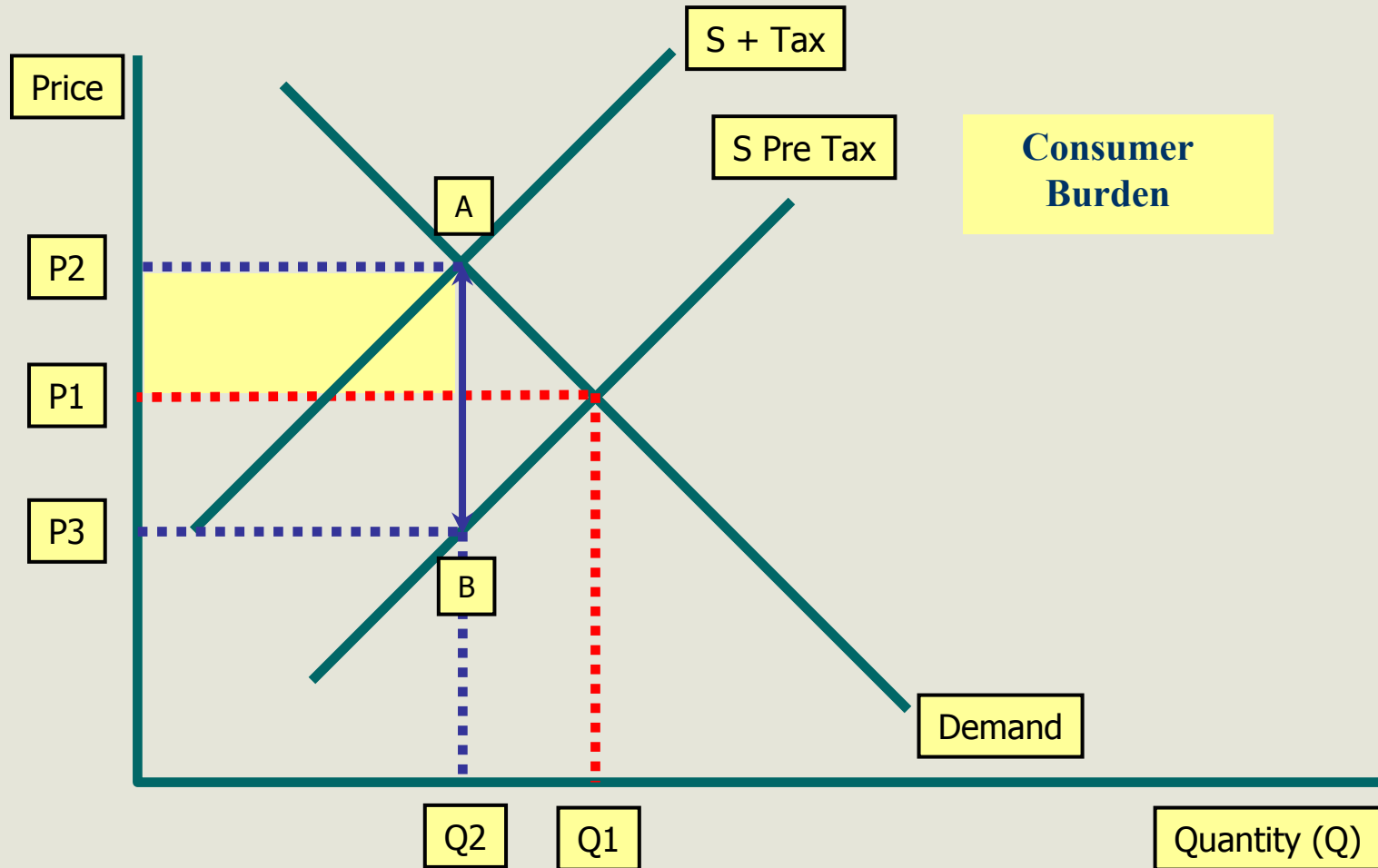
Who Pays The Tax?



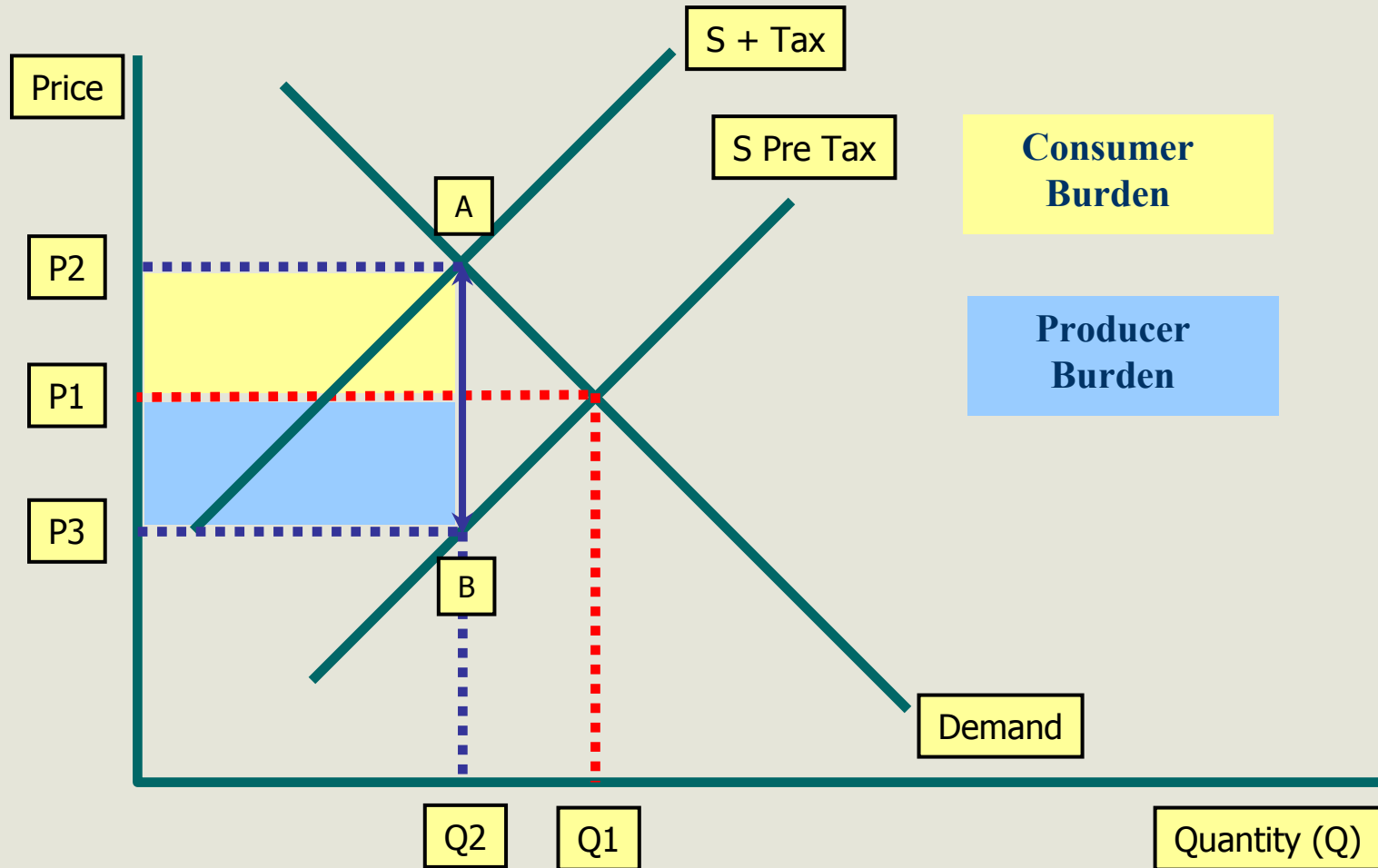
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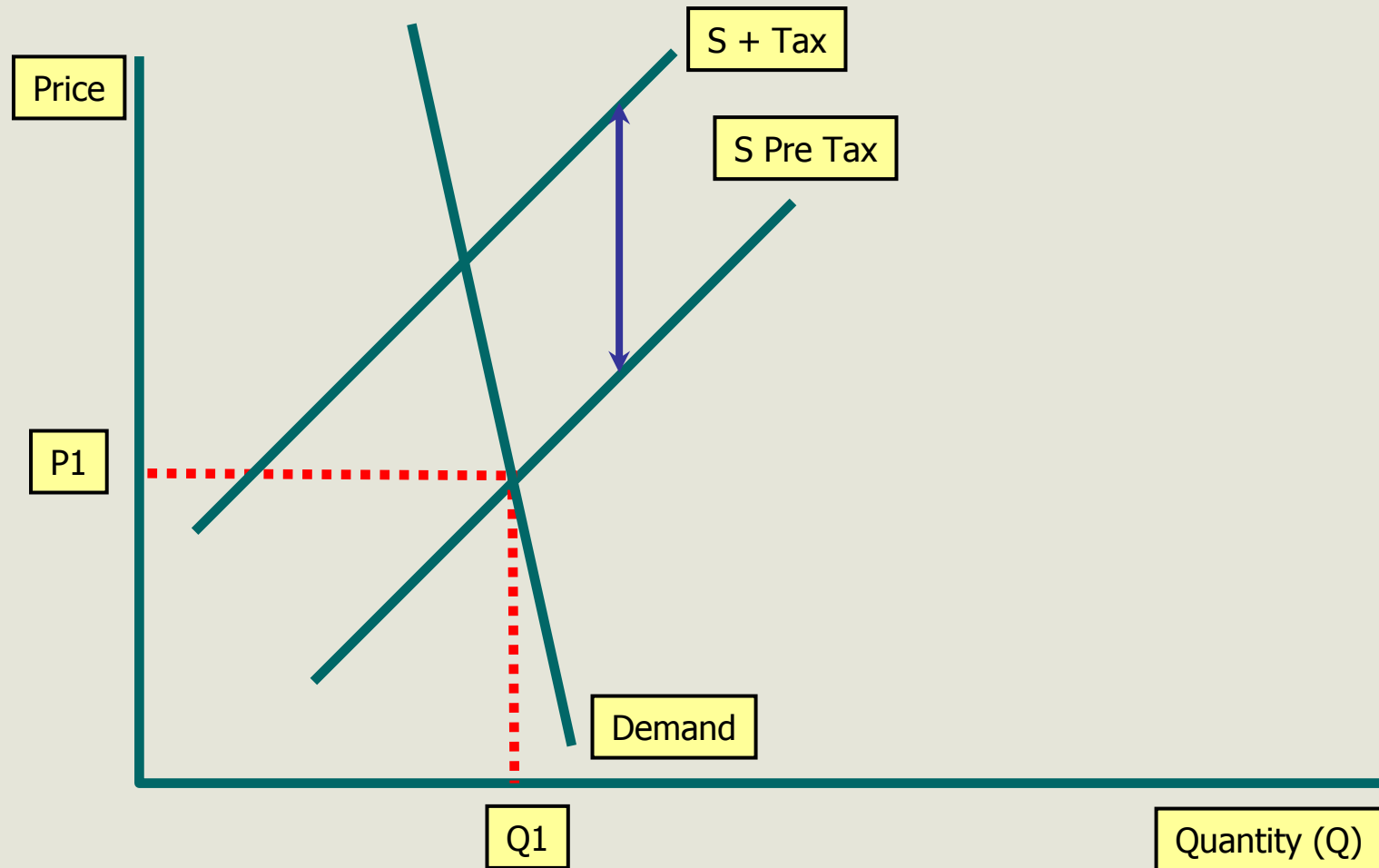
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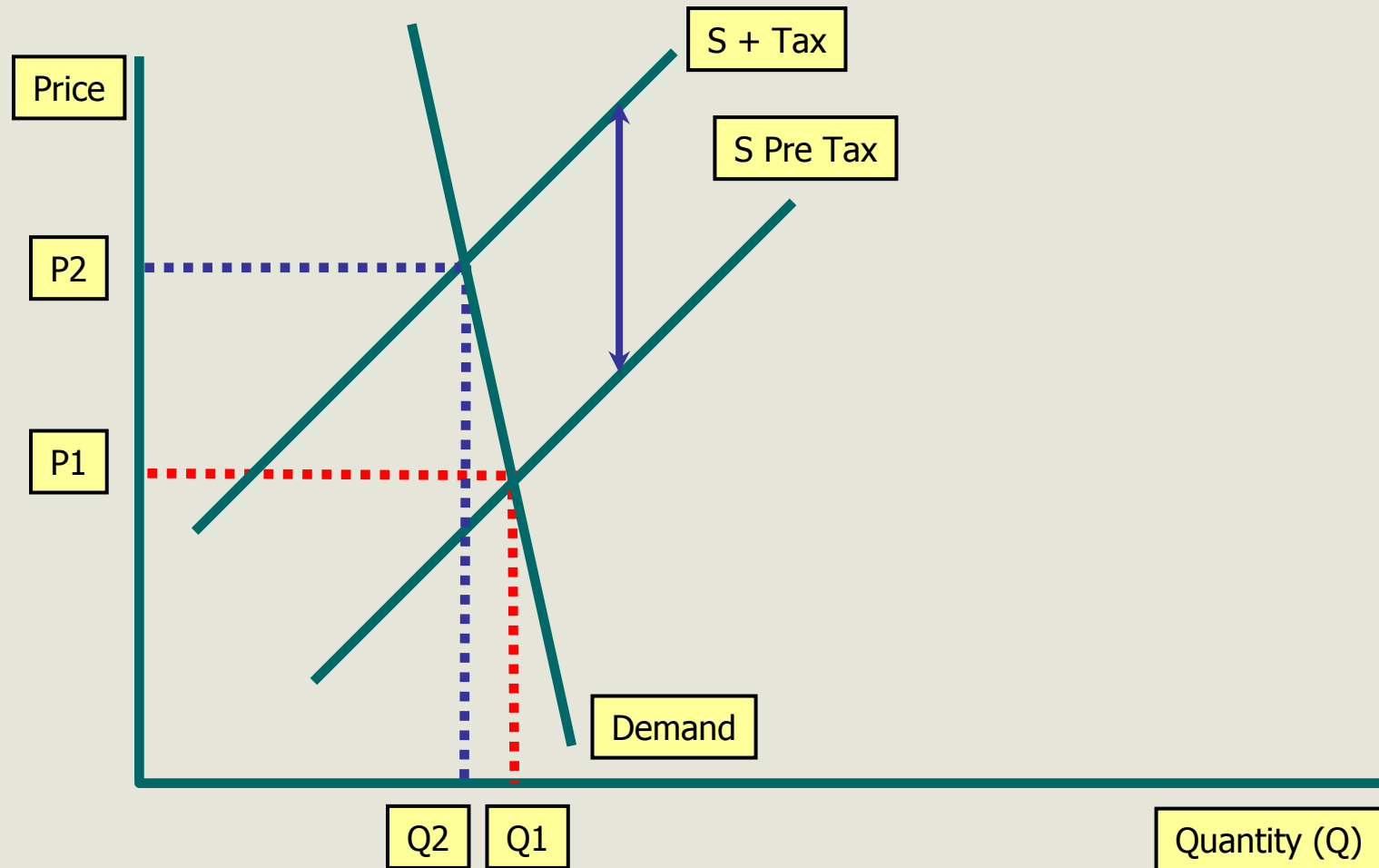
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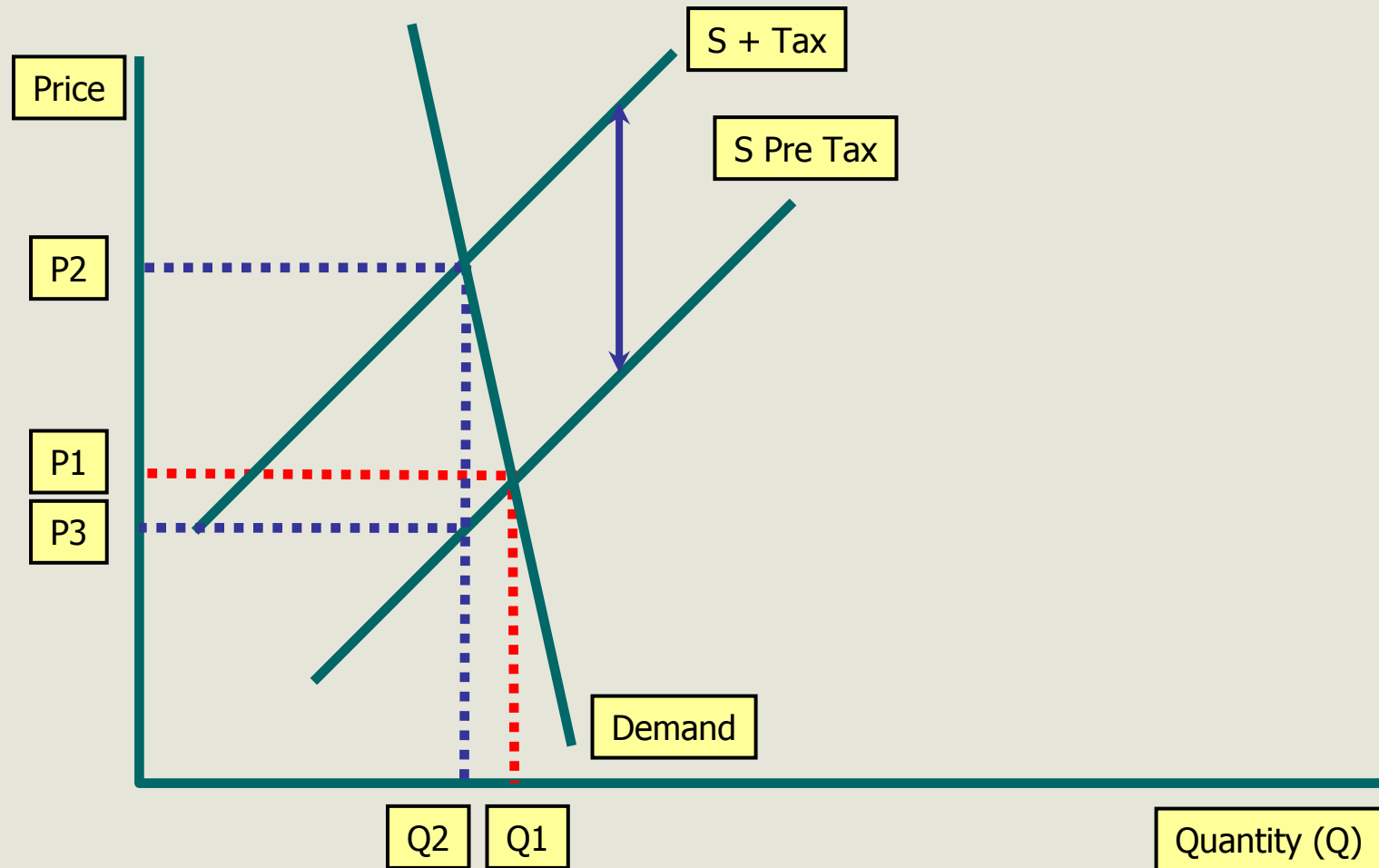
The Tax Burden When Demand is Inelastic



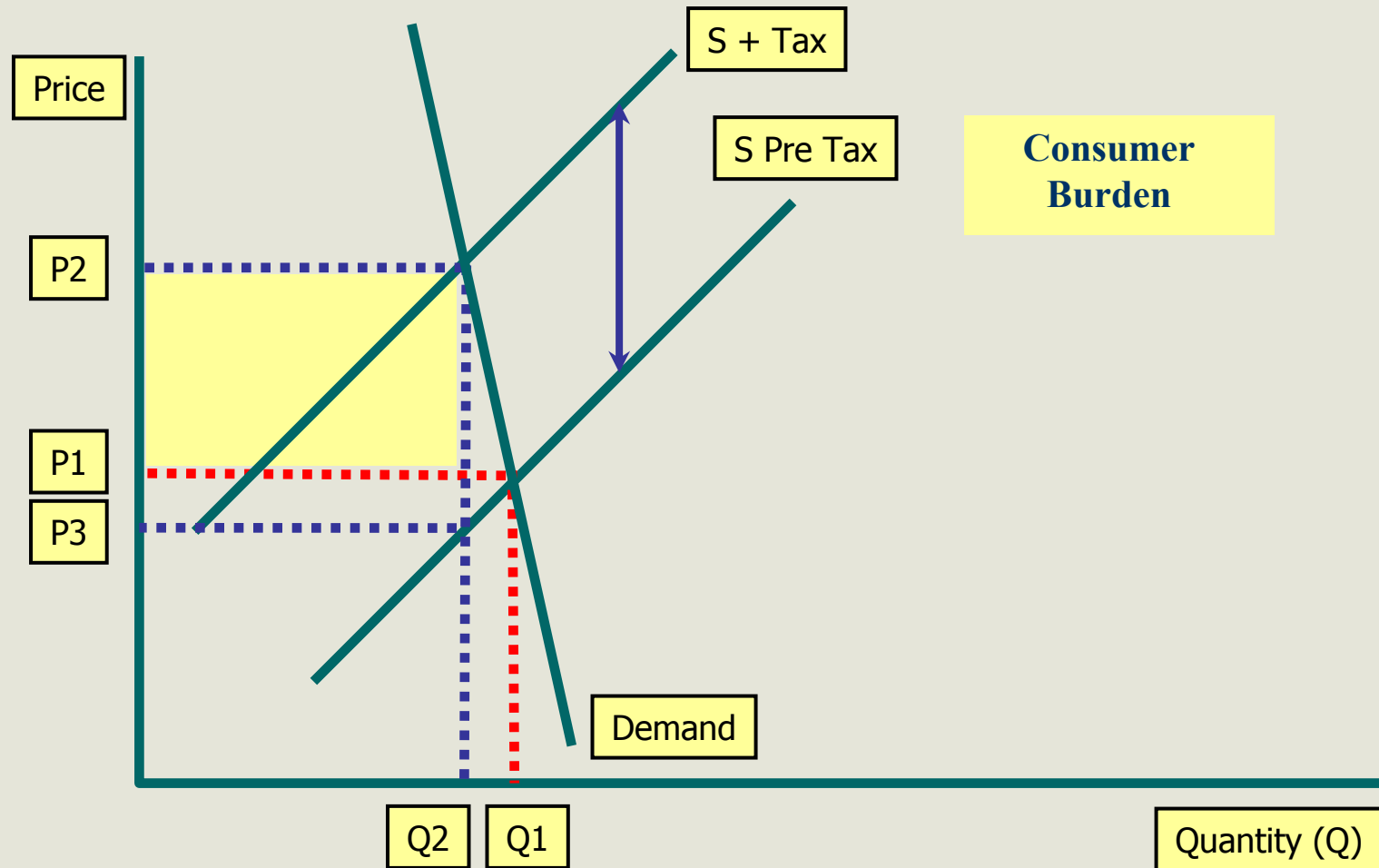
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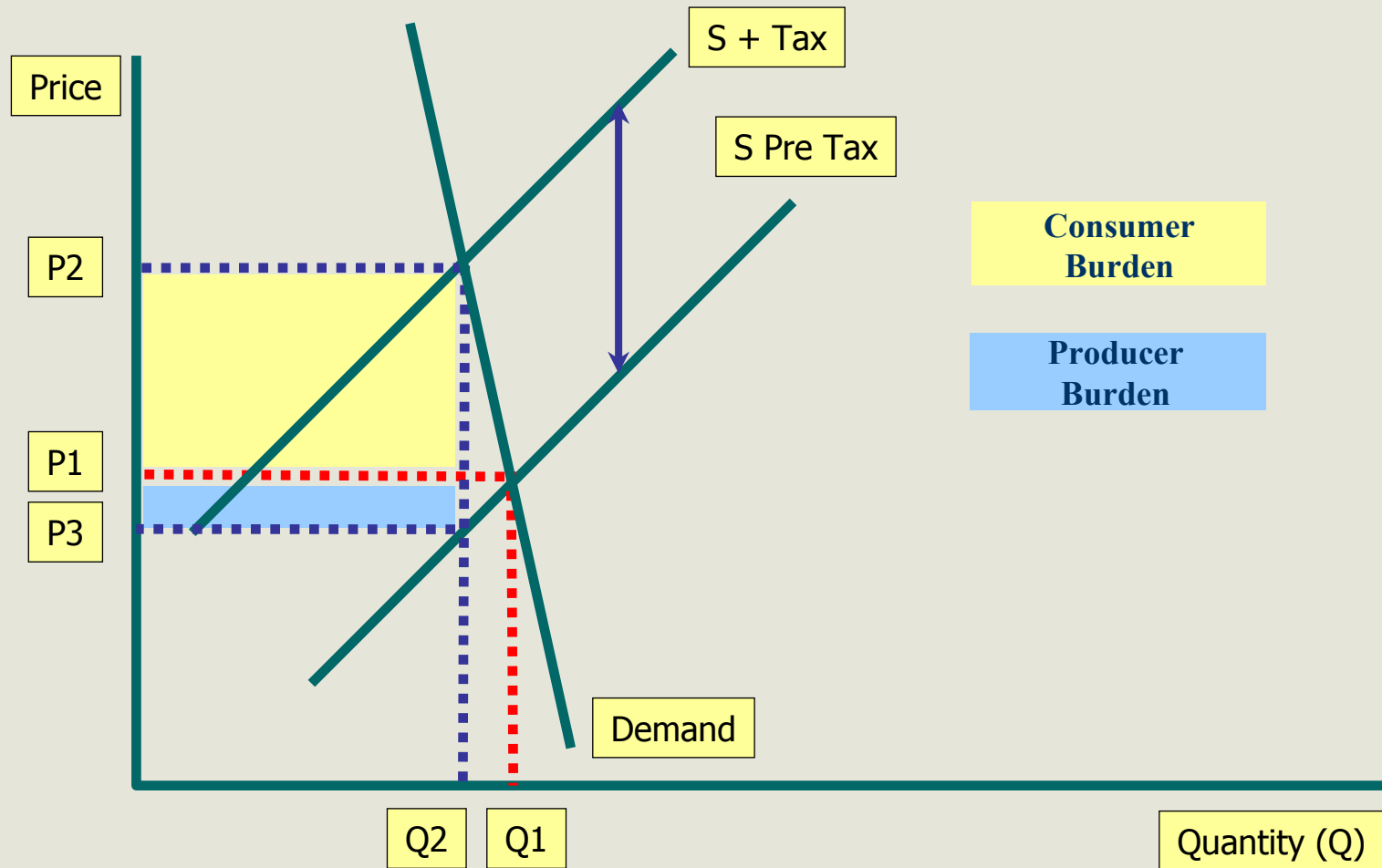
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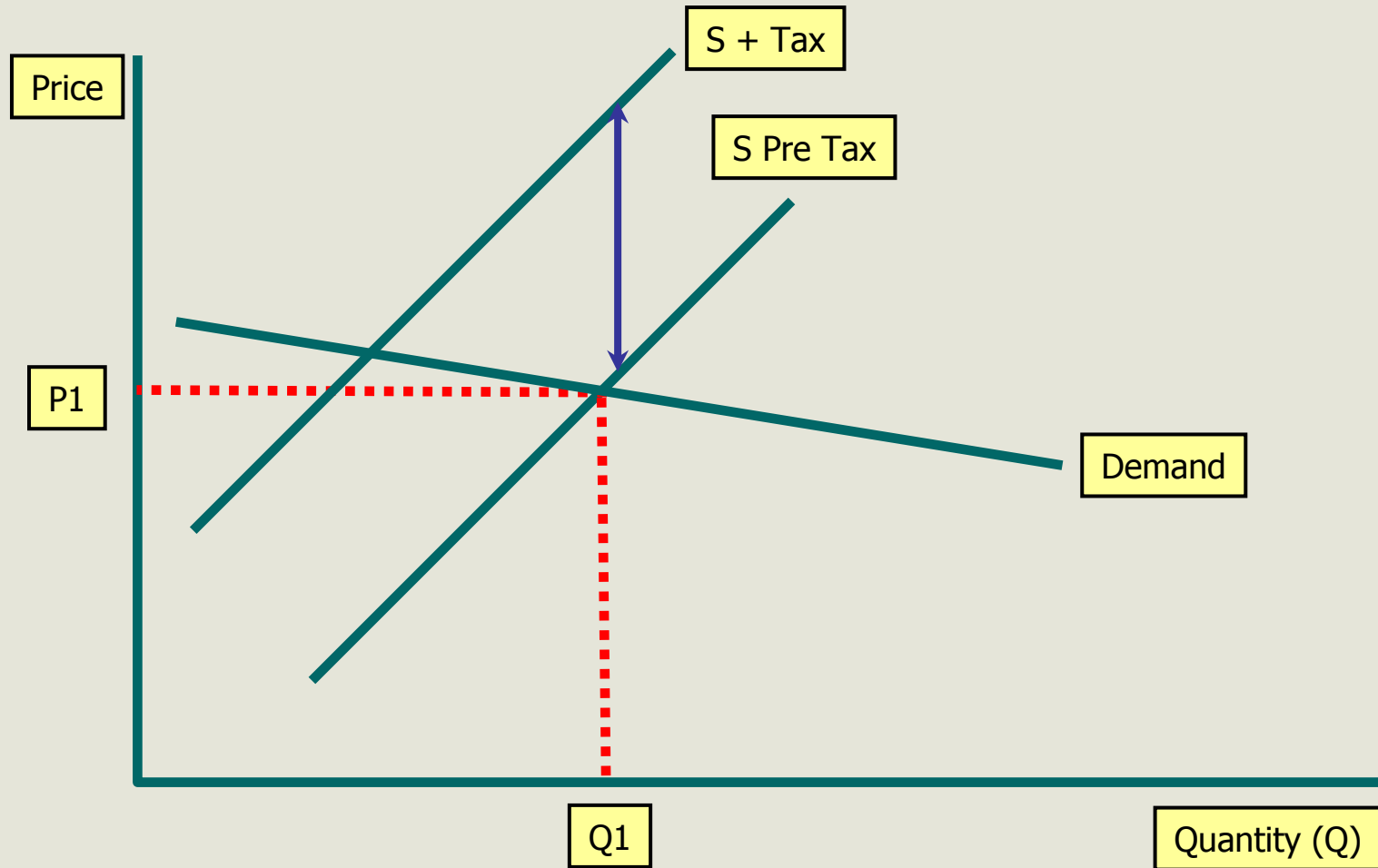
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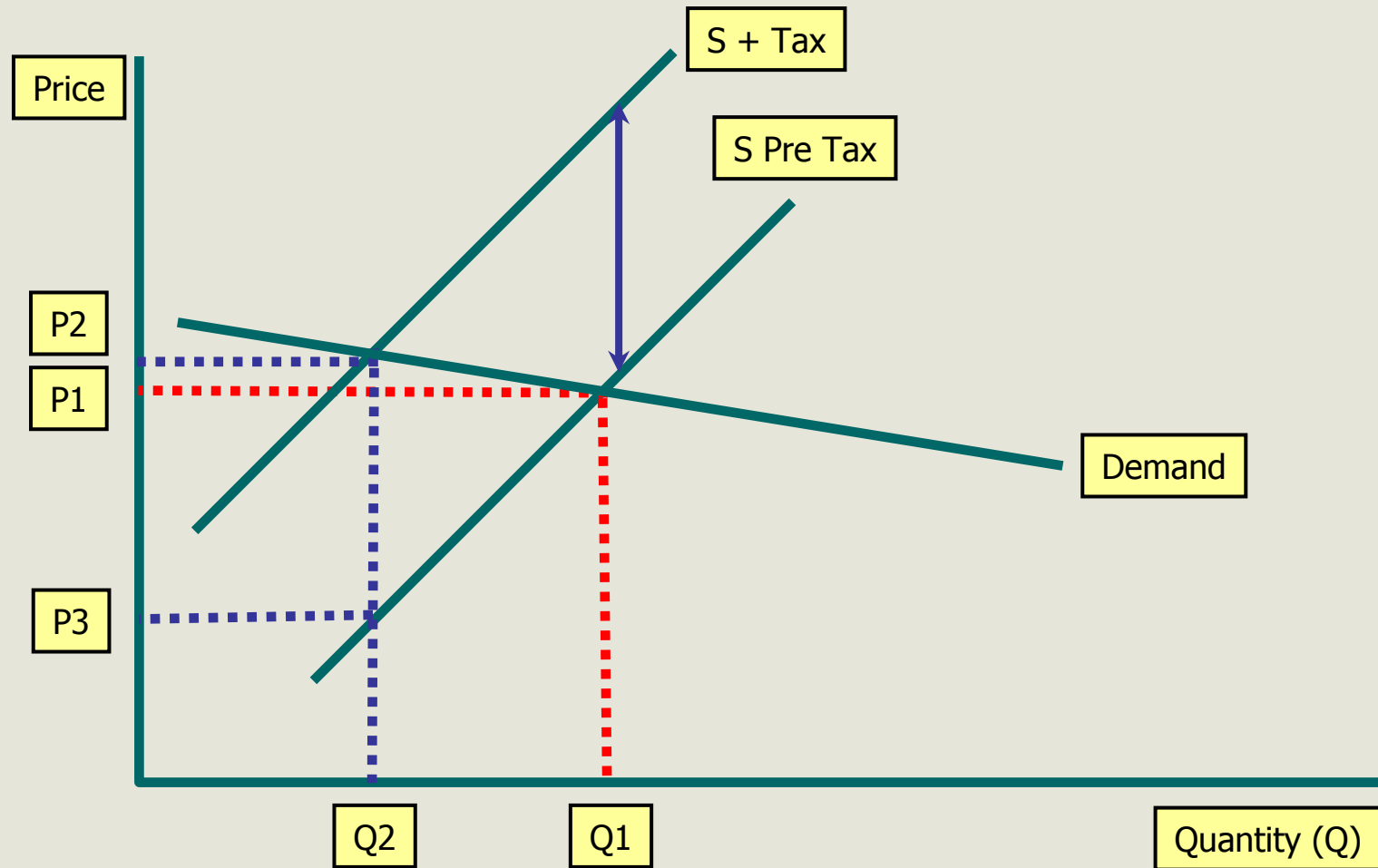
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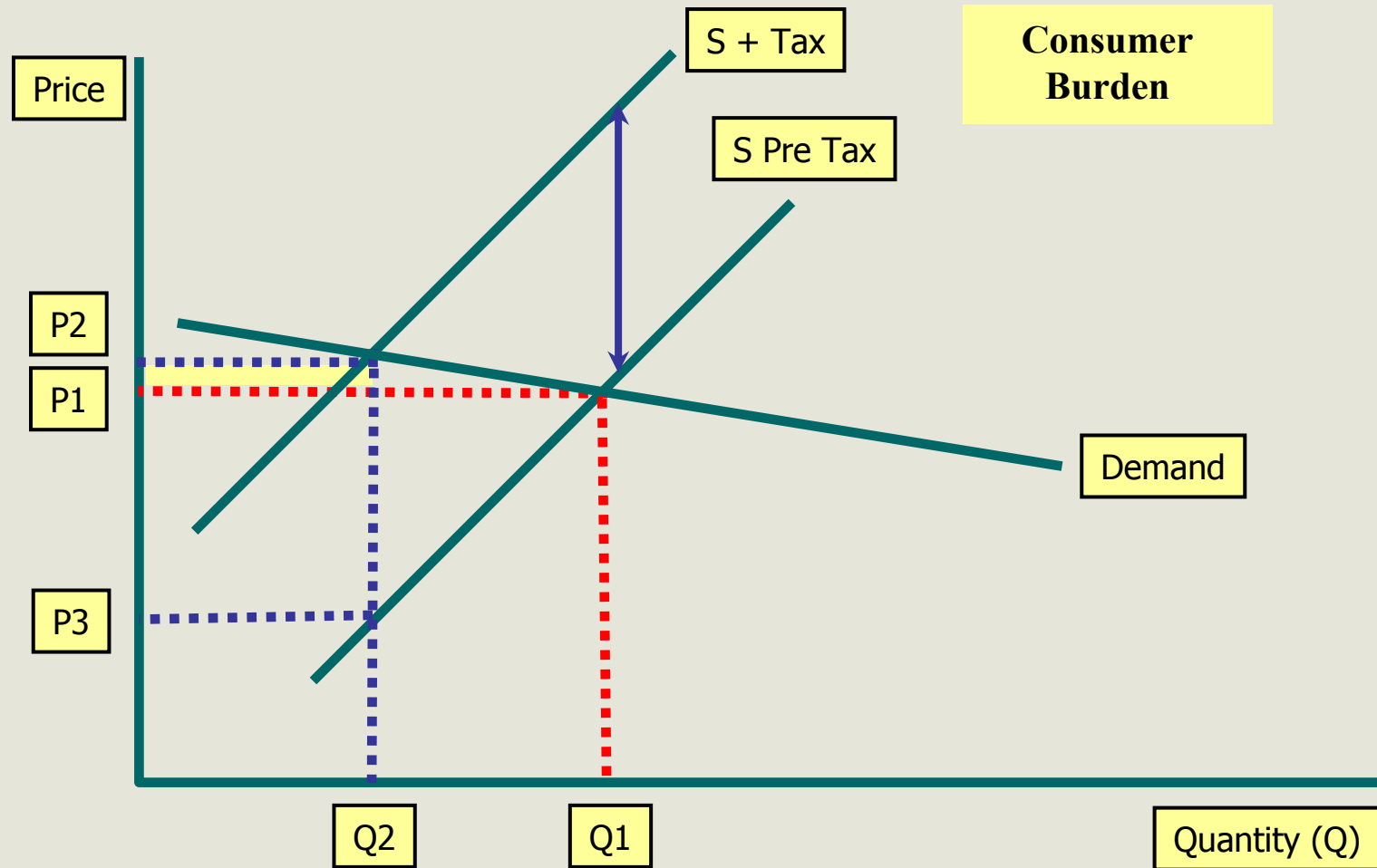
The Tax Burden When Demand is Highly Elastic



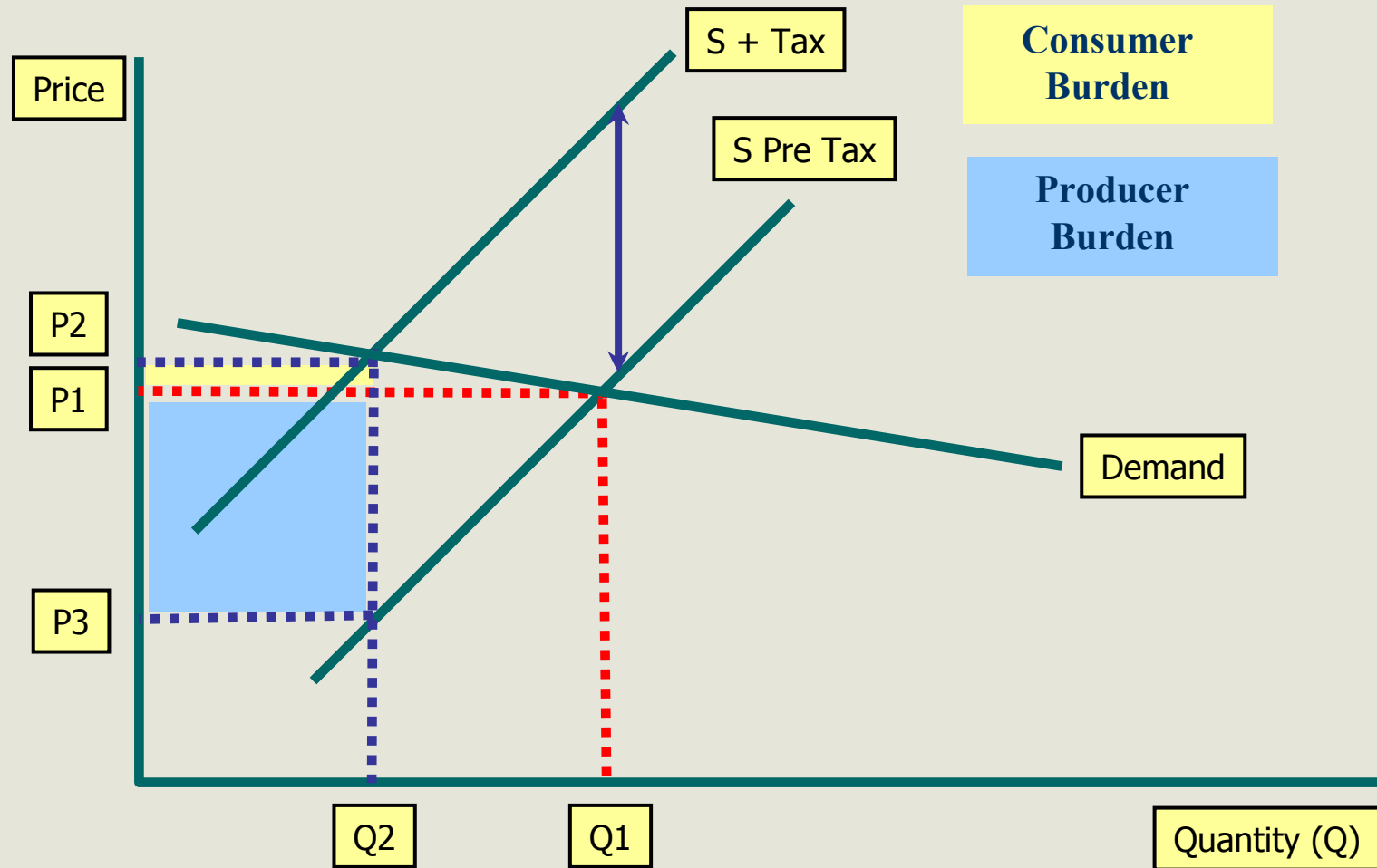
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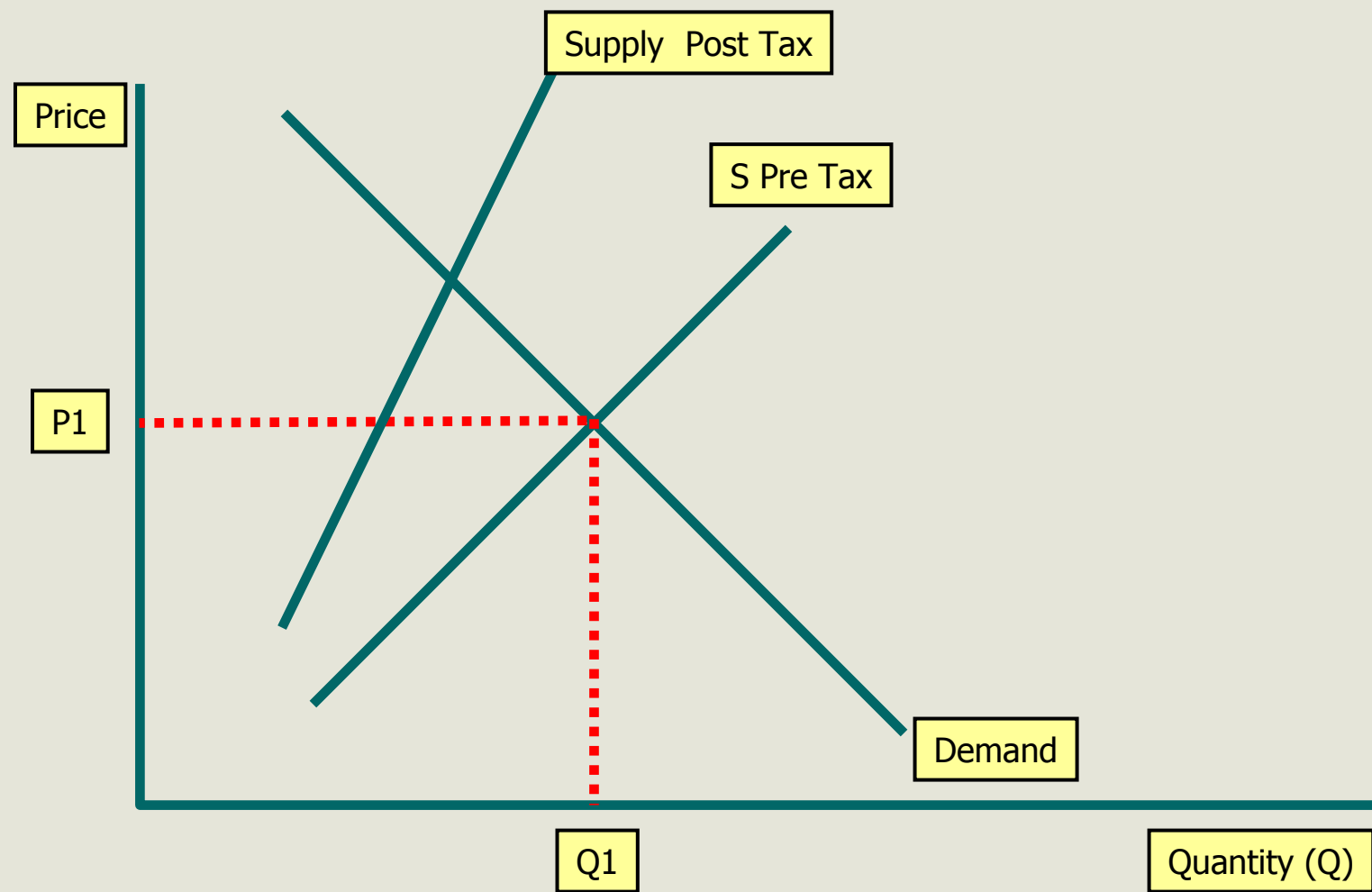
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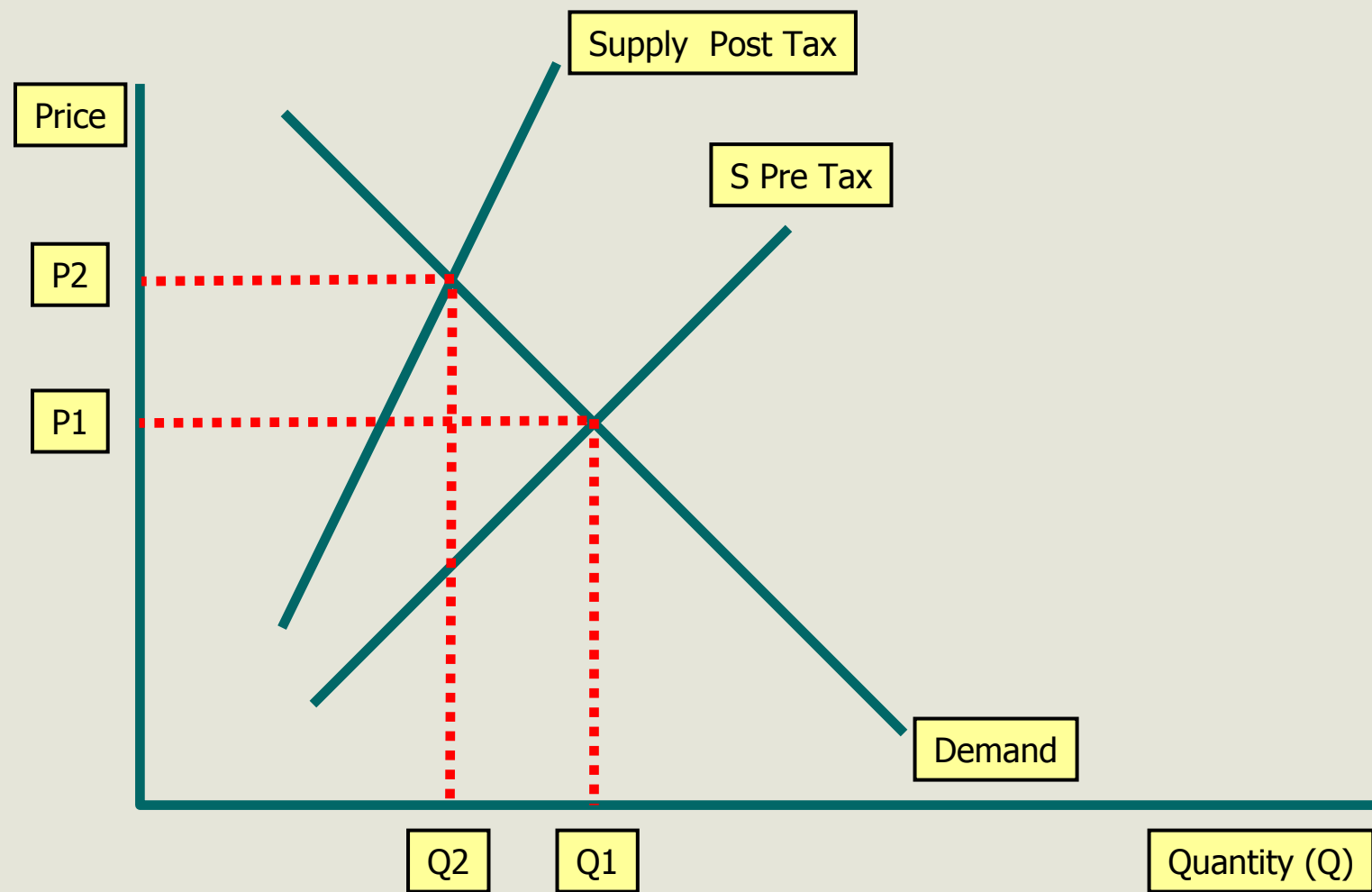
The Tax Burden When Demand is Highly Elastic



An Ad Valorem Tax on Producers

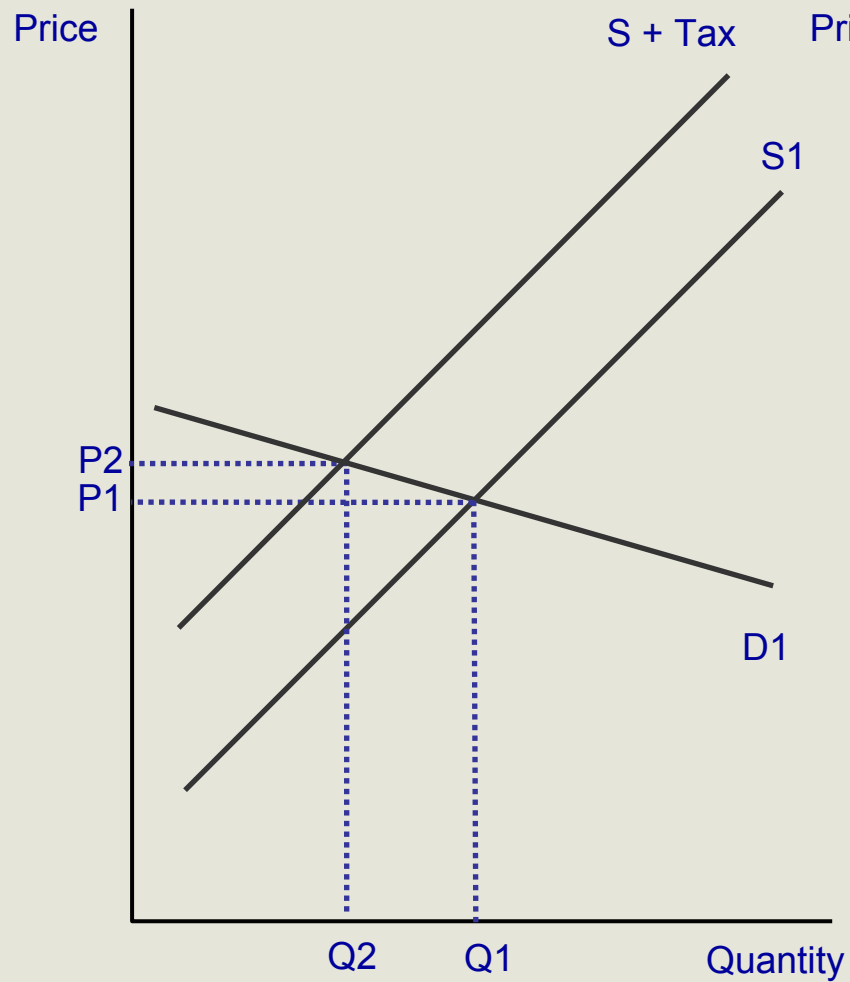


An Ad Valorem Tax on Producers

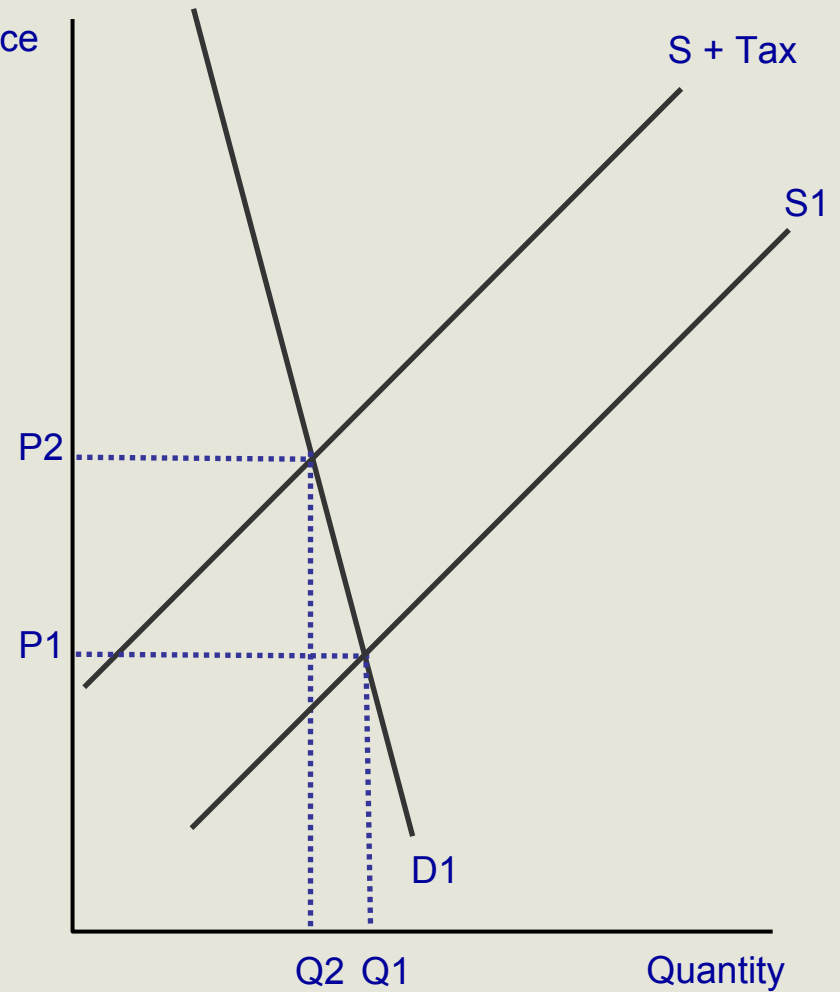


Summary of the effects

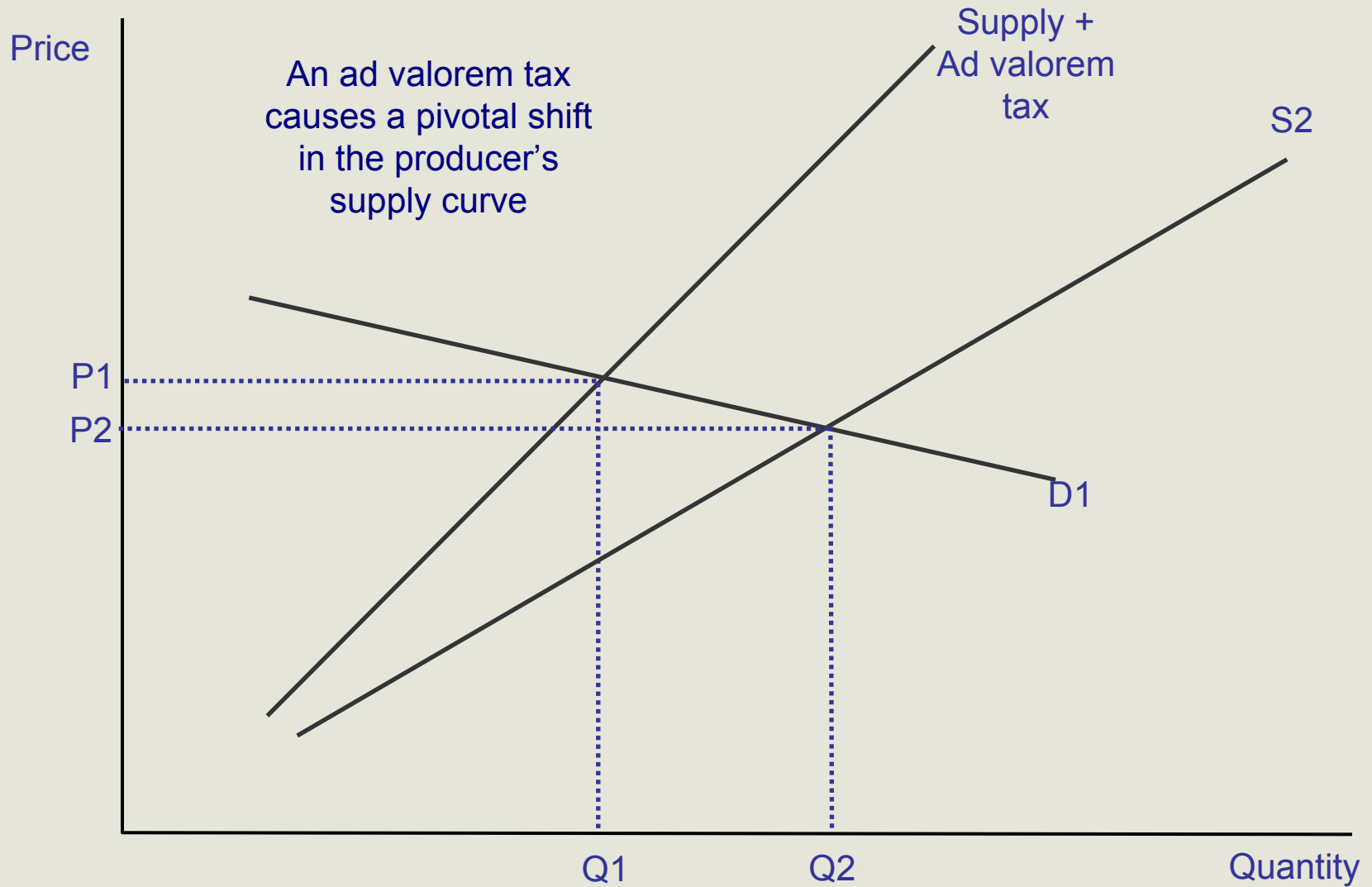
A Tax When Demand is Price Elastic



A Tax when Demand is Price Inelastic



Ad valorem taxes



Economic arguments for indirect taxes

- Indirect taxes effective in **changing the pattern of demand** for particular goods and services
- Useful way of **correcting for the effects of externalities**
- **Less likely to distort the choice between work and leisure** and possibly undermine work incentives
- Easier to change than direct taxes – a flexible tool for the government
- Less easy to avoid (in part because the tax is “hidden”)
- Indirect taxes provide an increased incentive to save