LESSON 10 – GOVERNMENT INTERVENTION: INDIRECT TAXES

And Who Really Pays

Slide 1 – Introduction

Good morning everyone.

So far, we've analyzed markets assuming they operate freely through demand and supply. But in reality, governments rarely leave markets completely untouched. They intervene — and one of the most common forms of intervention is taxation.

Today, we focus on indirect taxes — taxes on spending rather than income — and who actually bears the burden of these taxes.

Slide 2 – Why Governments Intervene

Governments intervene in markets for several reasons. Markets may not always produce outcomes that are:

- Efficient
- Fair
- Socially desirable

So governments step in to influence outcomes. Taxation is one of the key tools used to do this.

Slide 3 – Direct vs Indirect Taxes

Before going further, we distinguish between:

- Direct Taxes
- These are taxes on income or wealth.
- Examples include:
- Income tax
- Corporation tax

Indirect Taxes

These are taxes on spending.

Examples include:

VAT

Excise duties on fuel, alcohol, and tobacco

Today's focus is on indirect taxes, because they directly affect prices in markets.

Slide 4 – Why Governments Use Indirect Taxes

Governments use indirect taxes for several reasons.

1. Generate predictable revenue

Because consumption is relatively stable, tax revenue is reliable.

2. Influence behavior

Taxes can discourage certain activities.

3. Discourage harmful consumption

For example: Smoking, Alcohol consumption

4. Fund public services

Revenue can be used for: Healthcare, Education, Infrastructure

However, taxation involves trade-offs. Taxes raise prices and reduce consumption. So policymakers must balance benefits against costs.

Slide 5 – Taxation on a Supply and Demand Diagram

Let's now analyze taxation using a diagram.

When an indirect tax is introduced:

- The supply curve shifts upwards by the size of the tax
- This reflects an increase in firms' costs of production

As a result:

- The new equilibrium price rises
- The quantity traded falls
- The vertical distance between the original and new supply curves represents the tax per unit.

Slide 6 – Tax Incidence: Who Bears the Burden?

Now we move to the key concept: Tax incidence.

Tax incidence refers to how the burden of a tax is shared between: Consumers and Producers. And crucially, it depends on elasticity.

If demand is inelastic, consumers bear most of the tax, because they cannot easily reduce consumption.

If supply is inelastic, producers bear most of the taxes, because they cannot easily reduce production.

The key rule is: The less responsive side of the market bears the greater burden.

Slide 7 – Worked Example

Let's apply for this.

Suppose demand is highly inelastic, and a tax is introduced.

What happens?

- Firms raise prices
- Consumers continue to buy similar quantities

So most of the tax is passed onto consumers. This explains why governments tax goods like:

- Fuel
- Tobacco

Because demand is inelastic, revenue remains high.

Slide 8 – Case Study: Private School Fees

Let’s connect this directly to your research.

Consider a tax on private school fees.

In the short run:

- Demand is relatively inelastic.
- Parents are already committed.
- Switching schools is difficult.

So:

- Fees rise
- Parents bear most of the burden

In the long run:

- Demand becomes more elastic.
- Families adjust behavior.

So:

- Enrolment may fall
- The burden becomes more shared

This shows how elasticity changes tax outcomes over time.

Slide 9 – Welfare Effects of Taxation

Taxes do more than change prices. They also affect economic welfare. Taxes reduce total surplus — meaning the total benefit to consumers and producers. This creates a deadweight loss.

Deadweight loss represents:

- Lost trades that would have benefited both buyers and sellers
- A reduction in overall economic efficiency

However, this loss may be justified if the tax generates important social benefits.

Slide 10 – Evaluation: Advantages and Disadvantages

To evaluate taxation, we must consider trade-offs.

Advantages:

- Raises government revenue
- Can correct harmful behaviours
- Funds essential public services

Disadvantages:

- Raises prices
- Reduces output
- Creates deadweight loss
- May disproportionately affect certain groups

Tax incidence depends on elasticity.

So understanding elasticity is essential for evaluating policy.

Slide 11 – Summary

Let's summarize:

Indirect taxes shift the supply curve upward.

They increase prices and reduce quantity.

Tax incidence depends on elasticity.

The less responsive side bears more of the burden.

Taxes create welfare effects, including deadweight loss.

Slide 12 – Conclusion & Forward Look

The key takeaway is this: Taxes do not just affect prices. They redistribute burden between consumers and producers. And they create trade-offs between revenue, efficiency, and equity.

Understanding taxation requires combining:

- Demand
- Supply
- Elasticity

In the next unit, we will explore: Market failure — situations where markets alone do not produce socially optimal outcomes.

Thank you.