

“Government Plans Cigarette Tax Raise”

Cigarettes are a very popular demerit consumer good. *A de-merit good is one which is undesirable, likely to be over-consumed, and have negative externalities.* As this good is a habit or even a necessity to the smokers, it then has an inelastic demand curve. *Inelastic demand is where quantity demanded or supply changes proportionately less than the price.* The diagram below shows that an increase in the price of cigarettes is inelastic and as the price rises, the total revenue will also rise. *Total revenue is the quantity sold at a given price; it is also the sales revenue or the income from sales.* The quantity demanded changes by a smaller percentage to the increase in price. *Demand is the amount of some goods or services, which a consumer is willing and able to buy per period of time.* This shows that the total revenue will increase.

Assume

$$P_1 = \$1.25$$

$$P_2 = \$2.00$$

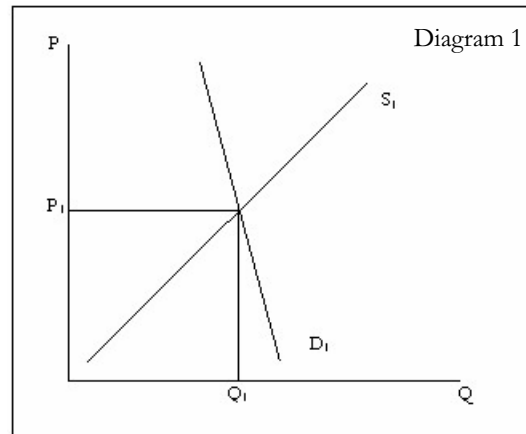
$$Q_1 = 50$$

$$Q_2 = 40$$

$$\underline{T.R. = Qty\ sold \times P}$$

$$T.R._1 = \$62.50$$

$$T.R._2 = \$80.00$$



To cut down on the purchase of the demerit good by the American public, the government has intervened for various reasons. In order to have less consumption of cigarettes, the government has imposed indirect taxes. These taxes may have been added to raise the tax revenue to fund the government funding. Also to discourage the consumption of demerit goods such as alcohol, gambling, tobacco, as in this case it has been done for tobacco. Another reason the taxes may have been imposed could be for environmental benefits to lower pollution (passive smokers). There are not several other methods the government can use to reduce consumption such as advertising against cigarette smoking, however the author does not provide these options, nor does the author justify why increasing taxes is the best option.

The diagram below shows how the specific tax imposed on the cigarettes has an effect on the market. *Specific tax is an indirect tax of a fixed sum of unit sold.* As this tax is imposed, the supply will decrease. The tax on the cigarettes has increased even more than before; from \$.75 to \$1.25 in August 2002.

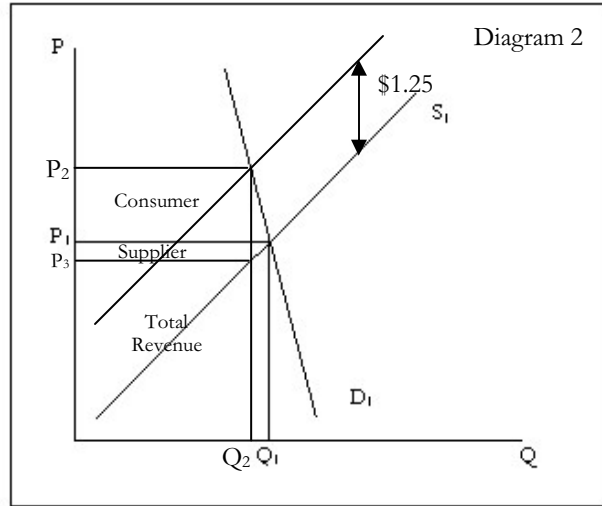
$$T.R. = Qty\ Sold \times P$$

$P_1 = \$2.00$
 Indirect Tax = \$1.25
 $P_2 = \$3.05$
 $P_3 = \$1.80$

Assume

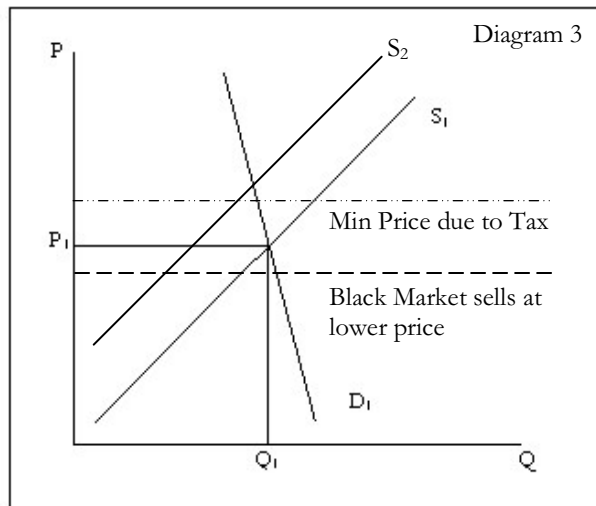
$Q_1 = 50$
 $Q_2 = 40$

Tax paid by consumer = \$42
 Tax paid by supplier = \$8
 Total Revenue for supplier = \$72

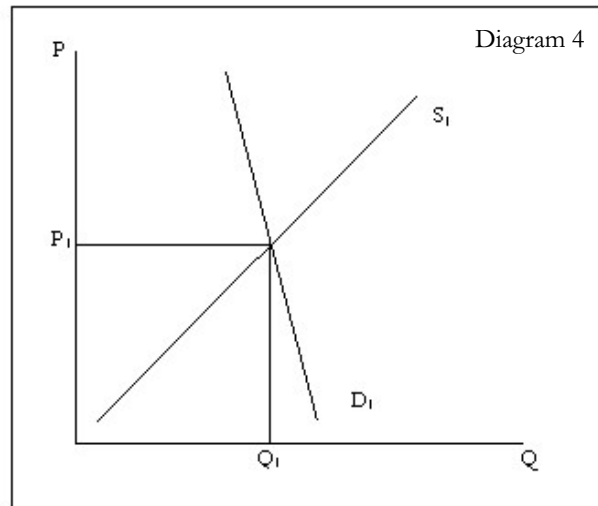


These high prices in the market will create alternative means to obtain the cigarettes such as the internet, “*Philosophy senior Brad Jackson purchases his cigarettes from Europe via the internet*”. Since the tax is only applicable in the state of Michigan, it is easy for consumers to evade the tax by purchasing cigarettes in other states or by other means. So the main aim of the increase in tax is to reduce the consumption of the demerit good so that the government has to spend less on health care and medical facilities.

As the price in a good is increased other means to overcome the high price such as a black market arises. *A black market is where people ignore the government’s price and quantity controls and sell at whatever the prices equates illegal demand and supply.* Certain websites allow the purchase of cigarettes without tax as Brad has done by ordering from abroad. This shows that the companies in USA have more substitutes. *Substitutes are a pair of goods, which are considered alternative to one another.* A rise in the price of the cigarettes due to the taxes can also cause counterfeit cigarettes to be produced.



Michigan is incurring a budget deficit of \$1.3million; this increase in tax will help to fund the budget deficit. *Budget deficit is the amount by which a government, company, or individual's spending exceeds its income over a particular period of time.* The budget deficit in this case is through government expenditure exceeding tax revenue. This creates a shortage of funds, and therefore the government can either reduce expenditure or increase revenue through taxes.



In this article, it is said that the businesses will have to close; *“We’re going to pretty much be shut out of business”*. This will mean that local merchants which are afraid that the increase in tax will drive consumers away is a false claim since the good is inelastic and so the tax revenue will not decrease and people will keep buying cigarettes. However on the other hand, the total revenue they receive will fall and their profit may not be enough to cover all costs. A cost is a payment for factors of production such as land, labor, capital, enterprise.

““We know that fewer people smoke as the result of a (price) increase”” is a wrong comment. This is based upon the fact that cigarettes are an inelastic good. An increase in price will only decrease the quantity demanded by a very small percent, so in reality the total revenue will actually rise and not fall. It can thus be concluded that an increase in tax on cigarettes will have some effect of reducing the consumption of cigarettes while at the same time increase revenue for the government. However this may be a long-term process since consumers have an addiction to cigarettes and thus will have to quit.

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