

## **PIGOUVIAN TAXES: LIQUOR PRICE HIKE ON CARDS IN KERALA**

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### **ABSTRACT**

The following research paper includes a definition, analysis and evaluation of an article from an Indian national newspaper- The Times of India. The article provides a detailed insight into the possible implementation of a Pigouvian tax by the government of Kerala. The research paper uses this information to assess these measures and give a technical and theoretical perspective behind this government intervention.

**Keywords** - Economic well-being, government intervention, negative externality

### **Introduction**

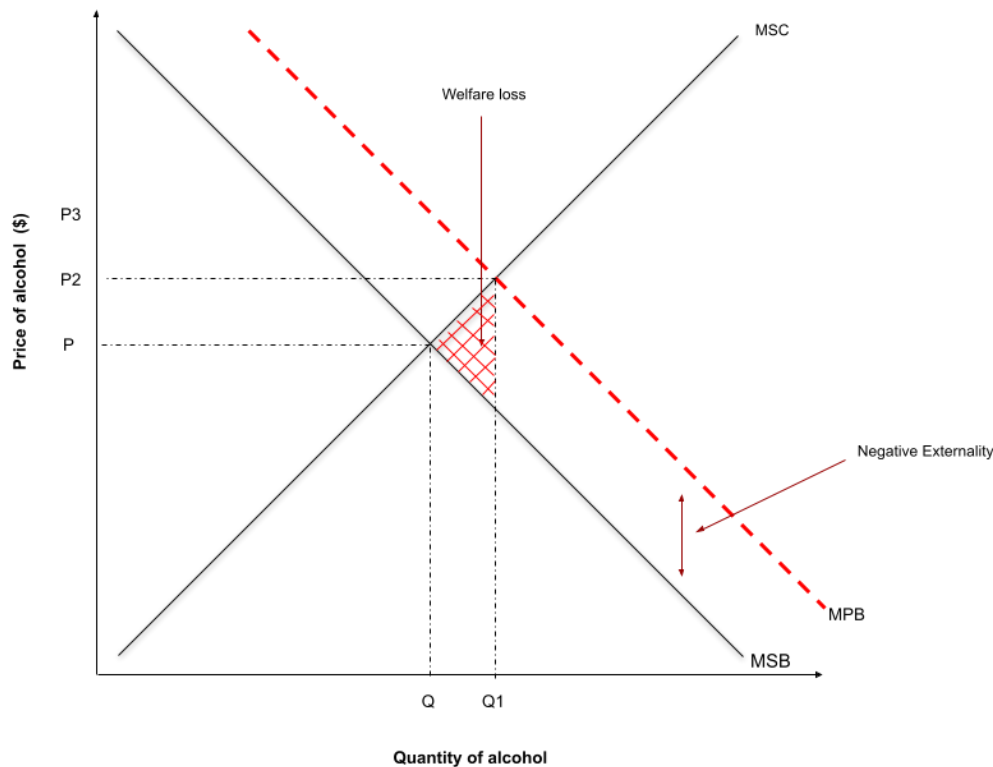
The article discusses a 7% increase in the purchasing cost of IMFL (Indian made foreign liquor) beverages in Kerala, India. There will be an increase in excise and sales tax issued by the government to reduce consumption of the demerit good, alcohol. The excise tax faced by the producers and the sales tax by the consumers will be increased in order to discourage the consumption of alcohol. Alcohol is considered to be a demerit good – goods that are harmful to consumer. Therefore, through this move the government will be looking after the **economic** wellbeing of its citizens.

### **Reason for government intervention**

**Negative externalities** are a cost suffered by a third party as a consequence of an economic transaction. The producer and consumers could be considered as the first and second party while the third party could anyone individual or group of people in the society. Some examples of negative externalities could be, air pollution from factories and vehicles, second-hand smoking, noise pollution from airports, etc.

**Negative externalities of consumption** are those that cause harm to health of those who consume it and others around them. A demerit good are those that are harmful to the consumers and people who consume such goods may do so due to lack of information (imperfect information) or the consumer may choose to ignore the risks. Therefore, when demerit goods are

consumed, they tend to cause negative externalities. In the case of alcohol, its overconsumption may cause problems such as, liver failure, high blood pressure, etc.

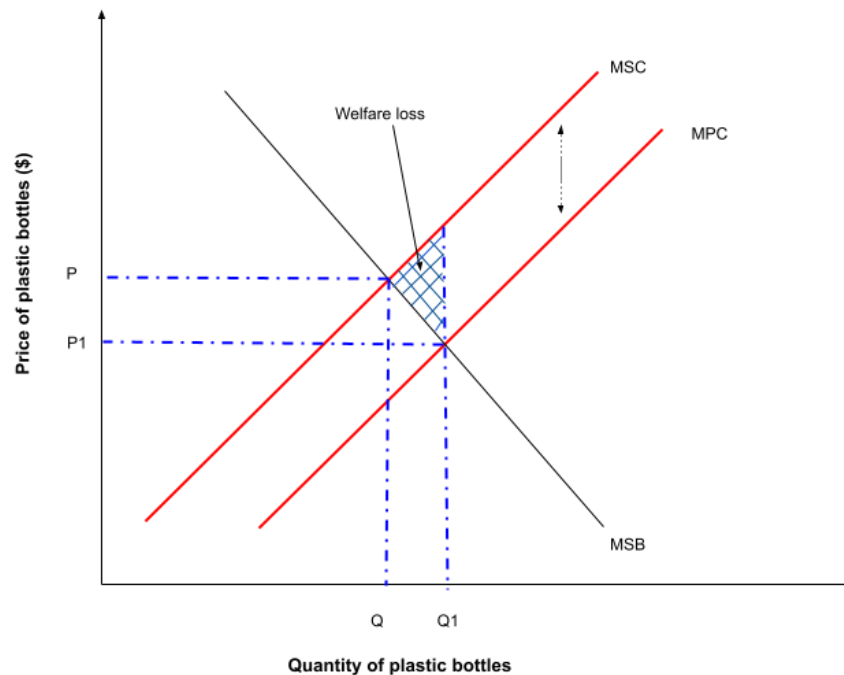


**Figure 1: Negative Externality**

As shown above in Figure 1, the marginal personal benefit (MPB) of the consumption of alcohol is greater than the marginal social benefit (MSB) as the consumption of alcohol only brings the private benefit of consumption to the person consuming the alcohol and mainly only brings harm to society - (traffic accidents, violence, misbehaviour)- therefore the difference between the MSB and MPB is known as the **negative externality** (shown by the arrows between MPB and MSB). The issue of second-hand smoking<sup>2</sup> an issue that the general public faces worldwide, it can cause issues from a little discomfort in breathing to lung cancer, bronchitis or asthma attacks, due to constant exposure to the smoke.

As the consumers of alcohol only consider the private benefits of its consumption the free-market equilibrium is placed at P1 and Q1 where the difference between Q and Q1 is the quantity by which alcohol is over consumed. This shows evidence of over allocation of resources

in the production of alcohol and that society would be better off if output is produced at Q or less. The graph shows a welfare loss to society (red shaded region) which leads to market failure.

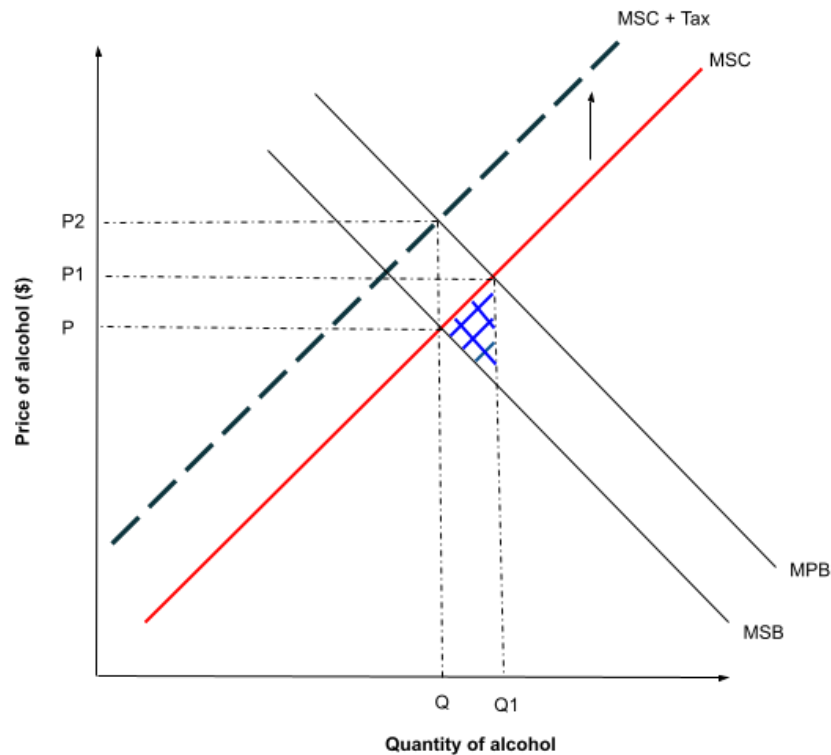


**Figure 2: The negative externality of production from production of plastic bottles**

A **negative externality of production** occurs when a good or service creates an external cost which damages a third party. Here there is a market failure as due to the lack of government intervention the profit maximizing producers are taken any measure that are able to reduce their cost of production without considering the cost to society and its future.

The cost to the community is greater than the cost to the producing firm, therefore the MSC (Marginal Social Cost) curve is above the MPC (Marginal Private Cost) curve. There is an extra cost to the society by the pollution created by the plastic bottles. The firm continues to produce at Q1 not concerned about the cost to society. If produced at Q it would be producing the allocatively efficient level. The difference between the MSC and MPC curve is the negative externality created. The area of the triangle between the curves is the welfare loss to the society (shown by the shaded blue triangle).

### **Government's Approach**



**Figure 3 – Market based approach (Pigouvian tax)**

When the 7% tax is levied on the alcohol the marginal social cost (MPC) curve shifts upwards to MSC + tax. Government does this in order to eliminate the negative externality by reducing consumption of alcohol. This attempt helps bring the output to a socially efficient output at Q where the price has increased from P to P2. The gain in price makes the good more expensive and reduces the disposable income even further of those who purchase the good, this makes the good unattractive and could help reduce consumption. When the demand for the good is lower the producers react by reducing the output, supply comes down to Q from Q1.

Hence with the use of taxation the government has made an effort towards betterment of the **economic well-being** of its citizens and has come closer to achieving allocative efficiency.

**Conclusion**

Alcohol is an addictive good, for those who consume it frequently it is hard for them to live without as there are not many substitute goods for it either, therefore the demand for alcohol is quite inelastic - inelastic demand is when the quantity demanded changes less than the change in

price. The price elasticity of demand (PED) is here is less than the price elasticity of supply (PES) therefore the tax burden is more on the consumers than the producers.

When the taxes are raised beyond the flexibility of a consumer's income it may lead to them finding other sources of supply where, this may lead to a rise in demand for imports and fall in demand for domestic goods.

Indirect taxes can also be considered to be regressive as they might have a higher impact on people with lower incomes than ones with a higher income. As taxes raise prices, purchasing the taxed good might take up a larger percentage of a person with a low income than one with a higher income.

Since the taxes reduce the demand for goods, the firms react by reducing supply and therefore may also layoff staff in order to reduce their cost of production. Hence, the unemployment in the economy rises.

Due to the taxation the government revenue is increased, the increase in funds can be used to invest in goods and services for the public, they can pay private sectors for development of infrastructure which also provides employment opportunities. In the long run these taxations will help reduce the demand for alcohol and will benefit the society as a whole as people will be healthier.

The article also discusses the requested switch from using plastic bottles to glass bottles<sup>3</sup> in order to reduce negative externalities of production as glass is a material that is fully recyclable and can be recycled endless times unlike plastic. The cost of recycling glass is also a lot lower than compared to plastic.

The choice to improving their health most certainly depends the most on the consumers themselves, they have been given an opportunity for their betterment it is their choice to utilize it or not. Finally, taking into consideration the difficulties that may occur while applying these taxes the government's approach to improve the **economic well-being** will certainly show favourable results in the long run.

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