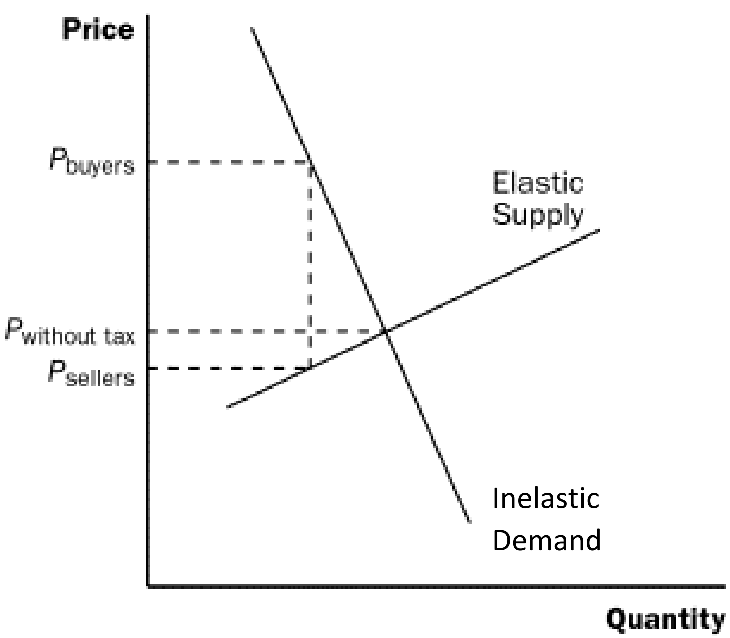
TAX INCIDENCE AND ELASTICITY

How does a tax affect buyers and sellers when elasticity comes into play?

Recall what we have talked about in class. If a product is demand inelastic, it means higher prices do not scare off that many buyers, or we could say most buyers may be willing to pay the higher price. So think of a tax added to a product as a higher price. Therefore, inelastic demand for buyers (see graph #1 below) means buyers would be willing to bear the burden of a tax on a product more than the sellers with an elastic response.

But what if the supply curve is inelastic? That would mean sellers would be willing to soak up most of the tax themselves so buyers would still purchase their product. Or in other words, If supply is inelastic and demand is elastic (like graph #2 below), sellers would be hesitant to pass too much of the tax onto their buyers, because buyers would be willing to stop purchasing the good to avoid the higher price caused by the tax.

GRAPH #1



GRAPH #2