Internal Assessment: Exemplar

Commentary 1

Title of the article: Indiana Lawmakers Discuss 1st Cigarette Tax Hike Since 2007

Source of the article: CBS Chicago
https://chicago.cbslocal.com/2021/02/02/indiana-lawmakers-discuss-1st-cigarette-tax-hike-since-2007/

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Date the commentary was written: 30th March 2021

Word count of the commentary: 794

Unit of the syllabus to which the article relates: Microeconomics

Key concept: Efficiency

ARTICLE

Indiana Lawmakers Discuss 1st Cigarette Tax Hike Since 2007
February 2, 2021 at 6:51 pm
Filed Under:cigarettes, Indiana, Tax, Vaping

(CBS/AP) — Indiana could increase its cigarette tax for the first time in more than a decade and impose a new state tax on vaping liquids under a proposal taken up Monday by state lawmakers.

The proposal would add $1 to the state's current 99.5 cents per pack cigarette tax and has the backing of many health organizations and business groups as a way to discourage smoking and reduce Indiana's high smoking rate.

It also would charge a 39% tax on the liquids used in e-cigarettes, which bill sponsor Republican Rep. Julie Olthoff, of Crown Point, said would be roughly equivalent to the cigarette tax.

Bryan Hannon, an American Cancer Society lobbyist, told the Indiana House Public Health Committee that increasing the cost for vaping was needed so that it didn't become more appealing to cigarette smokers.

"The importance of tobacco tax parity in public health is to make sure when you raise the price on one tobacco product, you're raising the price on other tobacco products so as not to encourage switching," Hannon said.

Some supporters want an even greater increase of $2 per pack in the cigarette tax.

Indiana Chamber of Commerce President Kevin Brinegar argued the state's high smoking rates increased health care costs for businesses and hurt Indiana's economic competitiveness.

Indiana's 21.1% smoking rate among adults was the 4th highest in the country for 2018, according to the federal Centers for Disease Control and Prevention. Nationwide tracking by the Campaign for Tobacco-Free Kids lists Indiana's current cigarette tax as the country's 39th highest, falling below all neighboring states.

The Indiana House last backed a $1 per pack increase in 2017, only to see the move fail as the state Senate as Republican Gov. Eric Holcomb also opposed it. Previous attempts to implement a vaping products tax have also failed in the Republican-dominated Legislature.

Donald Rainwater, who was the Libertarian candidate for governor last year, urged lawmakers to consider the "adverse economic outcomes" for business that have struggled during the COVID-19 pandemic if the tax hike was to cut their sales of cigarettes and vaping products.

No one from the Holcomb administration spoke during Monday's committee hearing, but the governor's top health adviser said during the state health department's budget hearing last week that lawmakers should make any cigarette tax increase large enough to be "worthwhile" and noted Indiana's status with the region's lowest tax.

Indiana saw a 20% decrease in the consumption of cigarettes following its 2007 tax increase of 44 cents per pack, state Health Commissioner Dr. Kristina Box said.

"Most importantly, what we saw was a decrease in new starts in our most vulnerable population, like our pregnant patients," Box said.

Some Democrats on the House health committee questioned why more of the nearly $290 million in estimated revenue from the cigarette and vaping taxes wasn't being directed to health programs. A legislative report projected that more than 60% of the money would go to the state's general fund and pension programs, with much of the remainder split between several health programs.

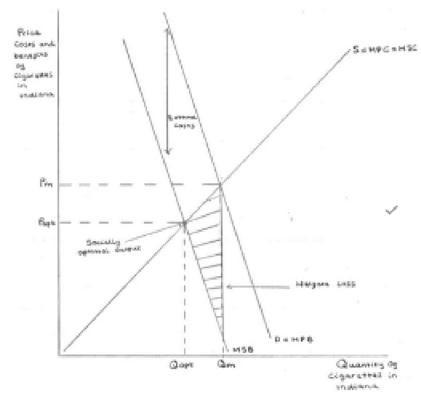
Republic Rep Brad Barrett of Richmond, the health committee chairman, said he agreed the committee should weigh in on possible uses for the tax revenue and that he expected it would consider amendments to the proposal next week.

COMMENTARY

Indiana has one of the USA's highest smoking rates and there are increasing concerns that this negatively impacts their economy. This article discusses a proposed legislation, which would increase the present tax of 99.5 cents per cigarette pack by $1, and ideally decrease the consumption of cigarettes within the state. This relates to the key concept of **efficiency.** An increase in Indiana's cigarette tax could decrease the negative consumption externalities of cigarettes, reduce **inefficiencies** and move closer to achieving **allocative efficiency,** and hence the Socially Optimal Output (SOO). This is where Marginal Social Costs (MSC) equals Marginal Social Benefits (MSB).

Cigarettes are demerit goods, where the benefits are overestimated, and have unfavourable effects on consumers. This overconsumption causes market failure. When individuals smoke cigarettes, this usually imposes negative effects on third parties e.g passive smoking. Cigarettes can also amplify the prevalence of diseases, and as a result Indiana has experienced "increased healthcare costs", which are negative consumption externalities.

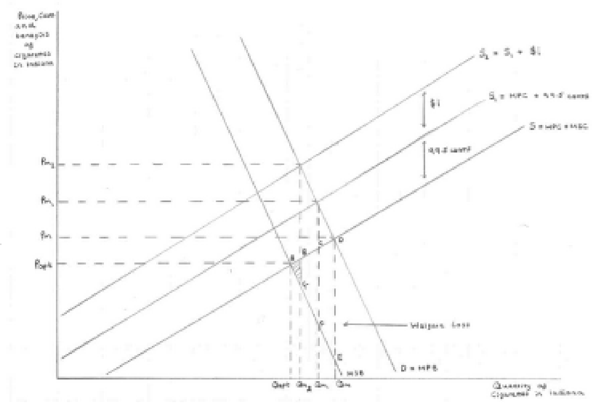
Figure (1): The negative consumption externalities of cigarettes before any indirect tax



In figure (1), the marginal private benefits curve (MPB), represents the benefit of consuming an additional cigarette. The MSB lies beneath the MPB, as smoking creates external costs for Indiana's population, portrayed by the gap between the two curves. The intersection of the MPB and Marginal Private Costs (MPC), provides the market equilibrium price and quantity, 'Pm, Qm'. However, the **allocatively efficient** output is 'Popt, Qopt', hence an excessive consumption of Qopt-Qm. This results in market failure, as there is an overallocation of resources to cigarette production. Furthermore, as shown, a welfare loss occurs as the MSC exceeds the MSB.

An increase in Indiana's excise tax per cigarette pack can decrease **inefficiency**. The excise tax is an indirect tax on expenditure on goods and services.[1] It increases the costs of production and the price of cigarettes, meaning that producers and consumers are made to pay the external costs. Consequently, consumers may be less willing/able to purchase cigarettes, reducing the quantity demanded, hence decreasing Indiana's high rate of smoking.

<u>Figure (2): Effect of initial and subsequent indirect tax on Indiana's cigarette consumption</u>



The effect of an excise tax can be seen in figure (2) above. The previous tax imposed on cigarettes was 99.5 cents; shown by 'S1 = MPC+99.5 cents'. This led to a contraction in demand from 'Qm' to 'Qm1', whilst the price increased from 'Pm' to 'Pm1'. Consequently, the overconsumption of cigarettes reduces to 'Qopt-Qm1'. There is a reduction in the size of the welfare loss from ADE to ACF.

[1] Tragakes, E., 2020. *Economics for the IB Diploma*. 3rd ed. Cambridge University Press, p.372

A further $1 increase in cigarette tax could cause the supply curve to shift leftwards to 'S2 = S1+$1'. The quantity of cigarettes demanded contracts from 'Qm1' to 'Qm2', with price increasing from 'Pm1' to 'Pm2'. Overconsumption decreases and the welfare loss is reduced to ABG, therefore moving closer to **allocative efficiency**. This should be beneficial in reducing market failure.

This proposal also suggests the introduction of a "39% tax on liquids" used in vaping products, which are substitutes for cigarettes. Increasing their price can discourage consumers from purchasing them as an alternative. Indiana's Senate, aside from considering the need for **efficiency**, should also consider the potential tax revenues for Indiana's government, estimated to be around $290 million. This could be utilised to fund healthcare institutions, or advertising campaigns to educate society on the dangers of smoking and vaping.

According to Donald Rainwater, an Indiana politician, this proposal could have detrimental consequences for firms. Higher production prices, combined with a reduction in sales, results in smaller revenue and profit. This may cause businesses to shut down, as it adds to the multitude of economic hardships caused by the pandemic. This could increase unemployment and worsen Indiana's economy, and is one of the main concerns regarding the proposal.

Additionally, cigarettes are highly addictive, and so have a price inelastic demand, as shown in the diagrams above. An increase in price will result in a proportionately larger decrease in consumption. Therefore it is plausible that an increase in taxation may only slightly decrease cigarette consumption. Despite these concerns, an increase in cigarette tax proved to be successful in 2007 where Indiana "saw a 20% decrease in the consumption of cigarettes". Due to the likely success of a further tax hike, the government could further increase the tax above the proposed $1, but this could be highly regressive. Indiana smokers pay the same amount of tax per pack, irrespective of their income, thus taking up a larger proportion of low-income earners' incomes.

The 2007 tax increase is likely to have decreased the consumption of cigarettes, moving closer to **allocative efficiency**. In light of the price inelastic demand of cigarettes and regressive nature of the tax, it may be advisable for Indiana to support the proposed tax rise by implementing additional measures such as negative advertising, or extending restrictions on smoking, to move closer towards **allocative efficiency.**

Bibliography

1. Tragakes, E., 2020. Economics for the IB Diploma. 3rd ed. Cambridge University Press, p.372

Commentary 2

Title of the article: RBA to pump $100bn into Australia's economy by extending quantitative easing

Source of the article: The Guardian
https://www.theguardian.com/business/2021/feb/02/rba-to-pump-100bn-into-australias-economy-by-extending-quantitative-easing

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ARTICLE

RBA to pump $100bn into Australia's economy by extending quantitative easing

This article is more than 4 months old

Reserve bank's decision to print more money shows recovery remains fragile, experts say

The reserve bank has extended quantitative easing and left interest rates unchanged at 0.1%.

Ben Butler

Tue 2 Feb 2021 07.03 GMT

The Reserve Bank of Australia will continue printing money through its quantitative easing program until September, pumping an additional $100bn into the economy, despite saying that recovery from the coronavirus crisis was stronger than expected.

Economists say the decision shows that the economy remains fragile, with unemployment remaining high and inflation stuck below the RBA's target of between 2% and 3%.

In a speech on Monday Scott Morrison talked up the recovery, while at the same time preparing to remove support from businesses by ending the jobkeeper employment subsidy program at the end of March.

At its meeting on Tuesday, the RBA board also left official interest rates unchanged at the record low level of 0.1%.

"In Australia, the economic recovery is well under way and has been stronger than was earlier expected," said the bank's governor, Philip Lowe.

He said the RBA would not increase rates until wages growth, which has been less than 3% for almost seven years, was "materially higher than it is currently".

"This will require significant gains in employment and a return to a tight labour market," he said. "The board does not expect these conditions to be met until 2024 at the earliest."

He said at 6.6% the unemployment rate was the highest it had been for 20 years and would probably still be 5.5% by the end of next year.

Lowe said the RBA had bought about $52bn worth of government bonds from banks and other financial institutions as part of the quantitative easing program, which began in March. The program was due to expire in April but the bank has extended it to September.

The chief economist at BIS Oxford Economics, Sarah Hunter, said although the move seemed at odds with the RBA's sunnier economic outlook, "to achieve the RBA's inflation target the economy needs economic activity to be significantly higher than its pre-Covid peak".

"Australia's economy entered the Covid downturn with capacity to spare, and notwithstanding the hit to migration the population and so productive potential of the country has increased since then."

Brendan Rynne, the chief economist at the accounting firm KPMG, said he expected the RBA to maintain its position for the foreseeable future.

"The RBA has set out to do all it can to boost economic activity and, with business investment still fragile, and some weakness in the labour market in the new year, it will keep on its current course," he said.

He said one risk was the soaring price of houses and other assets, which "will further exacerbate the difference between the haves and have-nots in society".

This was mitigated by "ensuring lending standards are maintained to protect borrowers from over-extending themselves – including maintaining serviceability stringency and enforcing loan to-value ratio limits," he said.

The government has announced it wants to ditch responsible lending laws designed to stop banks pushing unaffordable loans on to borrowers, although the change may be rejected by sceptical crossbench senators.

The banking analyst Grant Halverson said the RBA would have been worried by an "extraordinary" 6.9% fall in consumer, government and business payments in January.

"These payments show the business, import/export and government payment daily volume average fell by $8bn per day," he said.

"Combine this with the record massive consumer savings and the decline in December retail sales and it spells trouble for banks, lenders and consumer spending."

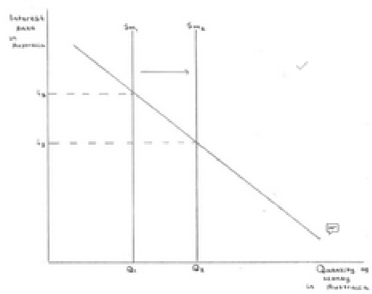
COMMENTARY

This article discusses the decision of the Reserve Bank of Australia (RBA) to further inject $100bn into Australia's economy through quantitative easing (QE). They made this decision as Australia is in a recessionary gap; where real GDP is below potential GDP and unemployment is above the natural rate of unemployment.[1] This is due to reduced Aggregate Demand (AD) resulting from the "6.9% decrease in consumer, government and business spending." AD refers to the total amount of goods and services demanded by an economy, over a certain period of time at varying price levels.

This use of Monetary Policy (MP) relates to the concept of **intervention**, as the RBA has **intervened** on the government's behalf, using MP to stimulate economic activity and thus achieve the societal goal of economic well-being.

To stimulate the economy when it is in a recession, the RBA would typically employ expansionary MP, whereby they increase the MS, as shown in Figure (1). The demand and supply of money determines the equilibrium rate of interest. In this diagram, the money supply (MS) is perfectly inelastic, depicted by 'Sm1'. When the RBA increases the MS, the Sm curve shifts from 'Sm1' to 'Sm2', reducing the interest rate from 'i1' to 'i2'.

<u>**Figure (1): Increasing the supply of money in Australia**</u>



One method of increasing the MS is QE, which increases the funds available for commercial bank lending. Here the RBA buys government bonds from commercial banks to increase bank liquidity. To fund the purchase of the government bonds the

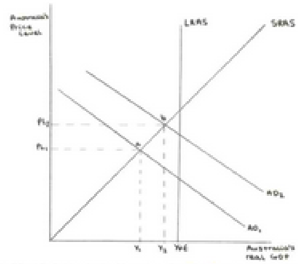
[1] Tragakes, E., 2020. *Economics for the IB Diploma*. 3rd ed. Cambridge University Press, p.659

RBA electronically creates money, which commercial banks can use for lending. Moreover, as bond prices are bid up the yield will fall. Investors are now encouraged to invest in riskier financial assets, such as shares and property. Hence their prices will rise, resulting in the wealth effect. The wealth effect refers to the idea that as the value of an individual's assets increases, their perceived wealth rises[2], which increases consumption, and thus raises AD.

Additionally, with interest rates at the "record low level of 0.1%", borrowing costs decline. Consequently, consumers and investors have more incentive to borrow and spend, increasing consumption, investment, and AD. Furthermore, reduced interest rates in Australia limit the returns on savings from overseas, resulting in a fall in the demand of the Australian dollar, thus decreasing its value. This improves Australia's international price competitiveness, increasing exports and decreasing imports, and boosting AD. This may be fairly significant in aiding Australia's economy, particularly as their "business, import/export and government payment daily volume average fell by $8bn per day." However, a depreciation may not lead to export growth due to the decline in world trade resulting from COVID.

The possible effects of QE and the record low interest rate, can be seen in Figure (2). Before **intervention**, the Australian economy is at point 'a'. QE increases the MS, adds to liquidity and enhances the wealth effect. Increased spending by consumers and firms, and an improved (X-M), will ideally boost AD. This shifts the AD curve rightwards from AD1 to AD2. The new equilibrium point will be at point b; whilst the price level increases from 'PL1' to 'PL2' and Real GDP increases 'Y1' to 'Y2'. It is unlikely this **intervention** will completely eliminate the recessionary gap, as it is expected that unemployment in Australia will be around 5.5% next year, which is likely to be above Australia's full employment level.

Figure (2): ADAS diagram showing the possible effects of Australia's expansionary MP



[2] Liberto, D., 2021. *The Wealth Effect Definition*. [online] Investopedia. https://www.investopedia.com/terms/w/wealtheffect.asp [Accessed 1 March 2021].

Whilst this **intervention** may have benefits for economic well-being, it may have potential limitations. The chief economist at KPMG, stated that QE could lead to the "soaring price of houses and other assets." This could increase economic inequality. Cheaper borrowing and lower interest rates increase the demand for assets, such as property and shares. Wealthier people are disproportionately likely to own these assets, and so will benefit most from price rises.

A further limitation is that the RBA cannot force consumers and firms to borrow more, or banks to lend more. In Australia, where unemployment is at a 20 year high of 6.6%, consumers and firms likely lack confidence surrounding their economic future, and may be hesitant to borrow and spend. Likewise, banks may be reluctant to increase lending, due to the augmented risks of society's inability to service loans. Therefore AD may only be minimally impacted.

Furthermore, the RBA started their QE program in March 2020, where they purchased "$52bn worth of government bonds" to stimulate the economy, and planned to cease their use of QE in April 2020. However, the RBA is now considering extending this programme until September to further inject "$100 billion into the economy". This suggests that the initial QE was not enough and that QE may not be an automatic solution to their problems. Thus this **intervention** may not work in the way the RBA intended, and highlights the need for a direct fiscal stimulus.

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1. Liberto, D., 2021. *The Wealth Effect Definition.* [online] Investopedia. Available at: https://www.investopedia.com/terms/w/wealtheffect.asp [Accessed 1 March 2021].

2. Tragakes, E., 2020. Economics for the IB Diploma. 3rd ed. Cambridge University Press, p.659

Commentary 3

Title of the article: Australia trade deal: Ministers discuss British farmers' concerns

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Australia trade deal: Ministers discuss British farmers' concerns

Published 20 May

Senior ministers have met to discuss concerns about how a zero-tariffs free-trade deal with Australia would affect UK farmers.

International Trade Secretary Liz Truss said on Wednesday that negotiators were "in a sprint" to secure an agreement in principle by early June. But a farming union has warned of "irreversible damage" from a bad deal and the cabinet is reportedly split. There are fears huge Australian cow and sheep farms could undercut UK rivals.

The UK government is keen to strike trade deals following Brexit and has indicated that the agricultural sector may have to prepare for the lowering of tariffs on imports.

In **2019-20, trade in goods and services between Australia and the UK was valued at £20.1bn**, and both sides are hoping to expand this amount considerably. Currently, trade in meat between the two countries is very small. Approximately only 0.15% of all Australian beef exports go to the UK. Last year, 14% of sheep meat imports to the UK came from Australia.

The Financial Times has reported that Environment Secretary George Eustice and Cabinet Office minister Michael Gove strongly disagree with Ms Truss and Brexit minister Lord Frost over granting tariff-free access to Australian, and possibly New Zealand, farmers.

Ministers met earlier on Thursday to discuss the issues.

The BBC's Laura Kuenssberg said a source had given her a "flavour" of how the meeting went, tweeting: "Liz [Truss] left the room happier than [George] Eustice". Our political editor said while it was "not quite white smoke on what was actually decided" we "should have a better indication" by the end of the day about what was discussed.

Chancellor Rishi Sunak has said that any trade deal signed by the UK government will include "the appropriate safeguards and protections" for farming and standards. In an interview with BBC Newsbeat he said: "The government is keen to try and conclude a trade deal with Australia that's good for British businesses and good for British shoppers."

The National Farmers' Union has urged ministers to "make sure concessions to our hugely valuable home market are not given away lightly", while the Scottish and Welsh governments have also raised concerns.

Scottish Rural Affairs Secretary Mairi Gougeon has written to Ms Truss, arguing that "a trade deal that liberalises tariffs for Australian farmers, to put it bluntly, will put UK farmers out of business".

She also suggested imposing quotas to control imports of lamb and beef, which must be "duly maintained and not eroded over time".

'How can we compete?'

And Welsh First Minister Mark Drakeford told BBC Radio 4's Today programme he wanted a "level playing field". "How can our hill farmers compete with Australian climate?" he asked. "How can our hill farmers compete with the space that is available for the huge farms that they have in Australia?" Mr Drakeford said UK animal welfare standards were "higher" than those in Australia, making two-way trade more difficult.

The Conservative MP, Dehenna Davison, told BBC Radio 5 Live that cheaper meat imports from Australia "could bring down the price of a weekly shop" and "that can be seen as a good thing". But she said poor quality food would not be brought in to the country and the government "would not let" the UK be "flooded" with an influx of cheap meat to undercut British farmers.

The prime minister's official spokesman said the UK was seeking deals "tailored so that they can best meet the needs of the British people".

"We want to secure an ambitious deal that benefits businesses and consumers across the UK, and of course any agreement will include protection for the agriculture industry," he added.

Fiona Simpson, president of Australia's National Farmers' Federation, told BBC Today programme on Radio Four, she wanted to "re-establish a very strong trade relationship with the UK, which we had before the UK joined the EU".

She added that some UK consumers had a desire to "eat some Aussie beef". But Australian farmers were "just not able to ship our produce in any sort of a quantity to the UK", Ms Simpson said, adding: "It's just way too expensive and way too far."

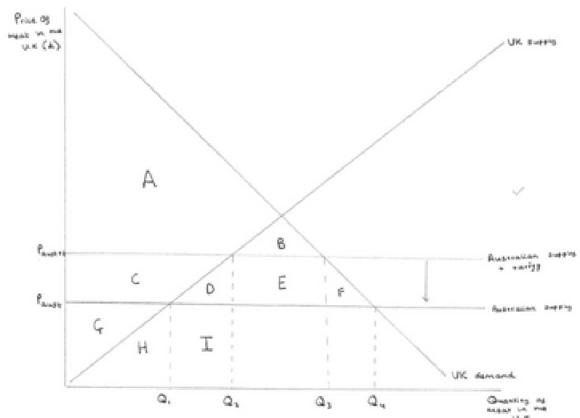
Commentary

Following their withdrawal from the EU, the UK has arranged their first free-trade deal. This article discusses the concerns that have been raised surrounding the livelihoods of British farmers following this trade deal with Australia. This relates to the key concept of **economic-well being.** The reduction of quotas and tariffs on imported goods may increase the volume of meat imported from Australia into the UK, making it difficult for British farmers to compete. This could threaten their job security, income and wealth, and thus their **economic-well being.**

This bilateral trade agreement encourages trade liberalisation and minimises trade protectionism, which are methods undertaken by countries to decrease imports.

Tariffs are taxes on imported goods[1], reducing their price competitiveness whilst simultaneously raising government revenue. This agreement would reduce and/or remove tariffs on imports from Australia. According to the article, "In 2020, only 14% of sheep meat imports were from Australia." The tariff reduction is likely to significantly increase this figure, causing disquiet amongst British farmers' regarding their **economic well-being.**

Figure (1): Removal of the UK's tariff on imported meat from Australia.



[1] Tragakes, E., 2020. *Economics for the IB Diploma*. 3rd ed. Cambridge University Press, p.444

The removal of the tariff on imported meat from Australia is shown in Figure (1). The existing tariff on Australian meat raises the price to Paust+t where the quantity of meat supplied by British farmers is Q2, domestic demand is Q3, and the quantity of imports is Q2-Q3. Removing the tariff decreases the meat price to Paust. Consequently, domestic supply decreases to Q1, whilst domestic demand increases to Q4, and imports from Australia increase to Q1-Q4. Due to increased consumer consumption and production by more efficient Australian farmers, the welfare loss (DF) is eliminated, thus improving resource allocation. As a result of the tariff removal, the social surplus (consumer surplus+producer surplus) increases from 'ABCG' to 'ABCDEFG'.

Meat from Australia is now likely to be relatively more price competitive. British consumers benefit due to lower priced meat, and have access to more choice. Contrastingly, this could negatively impact the **economic well-being** of British farmers, as they receive a lower price, Paust, and sell a smaller quantity, Q1, resulting in a revenue reduction from 'CDGHI' to 'GH'.

Moreover, due to Australia's warm climate and large farms, Australian farmers are likely to have a comparative advantage over British farmers. A country has a comparative advantage when they can produce goods at a lower opportunity cost.[2] Additionally, animal welfare standards are deemed to be higher in the UK than in Australia. This suggests that British farmers face higher costs of production, making their produce more expensive than Australia's, thus further limiting British farmers' ability to compete.

However, it is unlikely that Australian farmers will significantly increase their exports of meat to the UK. High costs of transportation, combined with shipment distances, mean that Australian farmers may not greatly increase exports to the UK. Additionally, Australia may not have the capacity to increase exports.

To limit the oversupply of meat from Australia, it has been recommended to maintain quotas. A quota is a restriction on the quantity of a good that is legally allowed to be imported over a period of time.[3]

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[2] Tragakes, E., 2020. *Economics for the IB Diploma*. 3rd ed. Cambridge University Press, p.441
[3] Tragakes, E., 2020. *Economics for the IB Diploma*. 3rd ed. Cambridge University Press, p.448

<u>Figure (2): The impact of an import quota on UK meat prices</u>

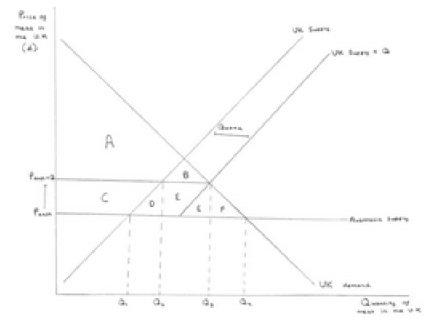

Figure (2) portrays the UK's economy with quotas. Before quotas, the quantity of meat supplied by British farmers is Q1, the quantity demanded by British consumers is Q4 and imports from Australia are Q1-Q4. The introduction of a quota shifts the domestic supply curve rightwards from 'UK Supply' to 'UK Supply+Q'. This results in the new price, Paust+Q. At this price, British farmers' production increases to Q2, whilst the quantity of meat demanded by British consumers falls to Q3 and imports decrease to Q2-Q3. This portrays how a quota can aid **economic well-being** by enabling British farmers to sell a larger quantity of meat at a higher price.

However, the quota results in a welfare loss, represented by 'DEF'. DF highlights inefficient production and a fall in consumption, whilst E portrays the quota revenue that is passed over to Australia. The welfare loss from this quota is greater than that of the tariff.

Despite this, some argue that free trade should be encouraged. Between 2019 and 2020, trade between the UK and Australia was estimated to be "£20 billion". Free trade is likely to substantially increase this value, by providing a wider variety of price competitive goods and services to UK businesses and consumers.

This deal is viewed to be particularly beneficial for the UK. Following Brexit, it has been imperative for the UK to arrange their own trade agreements and to establish their trade sovereignty. This deal provides British businesses with increased access to markets and greater opportunities, thus potentially enhancing **economic well-being** for exporters and the country in the long term. The question of whether the benefits of the trade deal override the possible negatives, will ultimately determine if this deal will enhance the UK's **economic well-being**.

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