ECO101H1S L101, L201: Principles of Microeconomics

Midterm 2, Winter 2022

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Short Answer Questions

1) Suppose the market for coffee is perfectly competitive with downward-sloping Market Demand and upward-sloping Market Supply. At the equilibrium price, Market Demand is inelastic and Market Supply is inelastic.
The government needs to raise money and so it imposes a per-unit coffee tax of $1.

1a) [7 points] If the government wants to minimize the impact of this tax on consumers, whom should the government collect this tax from–consumers or producers? Explain your reasoning. A diagram is not an explanation. Your explanation needs to be sufficient without a diagram.

Solution: Whom the government collects the tax from is statutory incidence. The only thing it affects is which price P_D or P_S is the market price. With the $1 tax, the **relative elasticities** of demand and supply determine who bears the burden of the tax. If demand is relatively more inelastic than supply, consumers will bear the larger burden of the tax regardless of statutory incidence.

1b) [7 points] Claim: Over time, government revenue from the coffee tax will fall.