Smoking is a negative externality of consumption; an economic activity which imposes costs on third parties for which the consumer does not pay. Smoking not only creates health problems for the smokers but such as illness, these are private costs. Also the passive smokers which will rise the costs of health care in the community, these are social costs. Negative externalities are one of the types of market failure because they are caused because of the overprovision of de-merit goods, for example, goods that are harmful not only for the consumer himself but for the society as a whole.

Diagram 1: Cigarette Market in China

The diagram above represents negative externality of consumption within the cigarette market. The marginal social costs (MSC) is greater than the marginal social benefit (MSB) since the damage to the society and community is ignored by the smokers, where the MSB curve is below the MPB curve, the cigarettes are overconsumed at P*Q*. The pareto optimal
of cigarette consumption is at $P^*Q^*$, where $MSC=MSB$ and the market is in equilibrium. However, a larger quantity of cigarette, $Q_1$ is consumed, leading to a welfare loss to the society which represented by the triangle. Pareto optimal is a state of allocation of resources in which it is impossible to make any one individual better off without making at least one individual worse off.

One way to reduce the negative externality of consumption is to impose an indirect tax which is a tax levied on goods and services rather than on income or profits. The diagram below shows how an indirect tax will impact the cigarette market.

Assuming the tax pull the price up to $P_2$ and pull the consumption down to $Q^*$. Tax cigarette seems to be an easy and effective way for the governments to generate revenue since it is taxing on a de-merit good which harms people which can be more acceptable by the public than tax on merit goods. This gives the government tax revenue which allow them to spend more on other things such as the infrastructures which is a positive externality that affect the society positively. Although this looks really nice on the surface, there are still some problems. Since it is hard to quit smoke, cigarettes have become inelastic especially for the “experienced” smokers which means even the price go up, the sale will not fall much as the price go up.

On the one hand, increase the tax can be a good thing that it stops young people from smoking or start smoking, the increase in price makes them harder to access cigarettes since they don’t have any income rather than pocket money. There is also reduced negative externality that since the price are up, there will potentially be less smokers, as a result, there will be less second-hand smoke which will reduce the welfare loss in the society. Less
people smoking will also means less illness, smoke will cause lang and heart disease, if people have these disease, they will not be able to work and they will go to hospital and use the resources and subsidy from the government, increase the tax will help improve the quality of the work force which helps improve the quality of factors of production, it will also make government spend less on health care which enable them to spend on infrastructure more.

On the other hand, however, the low income family seem to be ore addicted to the cigatrttes since most of them were not educated and do not really understand the harm of the tobacco to themselves and others, therefore, they become the major tax payer which they have to given up other things to balance up. Additionally, in developing countries, it is also very difficult to educate the public the danger of smoking, government does not have the money to do this while it is impossible for people to pay to listen to this, therefore people won’t realize the harm of it and will keep smoking. There could also have the resistence of tobacco company and smokers since this will have a negative impact on their benefit, the government could potentially receive less vote on the election.

Although increase taxes can have negative impacts such as losing votes, it is still highly recommended since it will improve the quality of work force, stop youth from smoking and reduce welfare loss in the society. Therefore, such regulation is beneficial, not only for the smokers but the society.

Word count: 745.