tutor2u

Producer Subsidies

What are the main justifications for subsidy? How does a subsidy affect market price and output? What are the consequences for economic welfare? Should governments subsidise particular industries or should free market forces allocated scarce resources

Government subsidies

- Subsidies represent payments by the government to suppliers that have the effect of reducing their costs and encouraging them to increase output
- The effect of a subsidy is to increase supply and therefore reduce the market equilibrium price
- The subsidy causes the firm's supply curve to shift to the right
- The total amount spent on the subsidy is equal to the subsidy per unit multiplied by total output

What is a Subsidy?

- There are many different types of subsidies in the UK
  - Some affect specific industries (e.g. farming and tourism)
  - Others form part of the general tax and benefit system
  - Other subsidies relate to the operation of the labour market –e.g. employment subsidies paid to businesses participating on New Deal
- There is a long running debate about whether government subsidies actually enhance or worsen economic and social welfare
- The key in each case is to consider as part of your evaluation the potential impact on any subsidy on
  - Economic Efficiency
  - Equity

Different Types of Government Subsidy

- Producer subsidy
  - A guaranteed payment on the factor cost of a product e.g. payments for farmers under the EU CAP
  - An input subsidy which subsidises the cost of certain inputs used in production
  - Financial support – such as a grant or block payment to cover losses made by a business (e.g. the annual operating subsidy given to train operating companies)
- Consumer subsidy
  - A government payment to consumers designed to allow them to purchase more of a good or service
  - Might take the form of
    - Interest free loans (an effective subsidy)
    - Direct grants

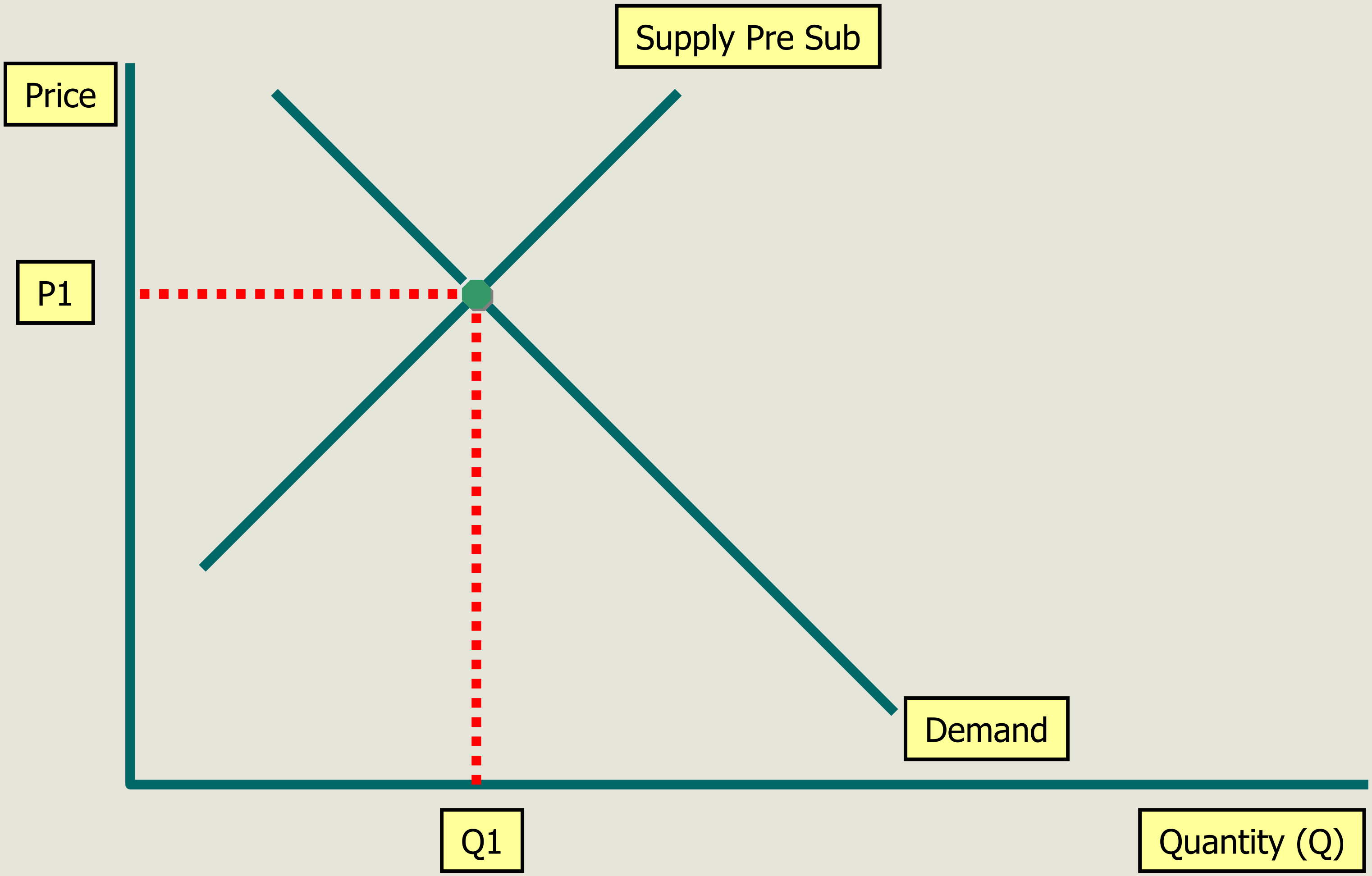
The Main Economic and Social Aims of Subsidies

- Keep market prices down (i.e. to raise real incomes of buyers)
- Boost market demand for certain goods and services (in particular encourage consumption of merit goods)
- Maintain or increase the revenues (incomes) of producers
- Reduce the cost of capital investment projects – which might help to stimulate long-term economic development in a country
- Help to smooth the process of long term structural change/decline in an industry (for example in farming, fishing, steel)
- Maintain a service that is thought to bring positive externalities / social benefits (i.e. the merit good argument)
- Protect employment in particular markets / industries or boost employment potential for certain groups of workers
- In some industries, subsidies are an alternative to tariffs (taxes) placed on imported products – designed to improve a country's balance of payments against other countries

Subsidies – in the News

- British Farming – compensation payments and guaranteed prices
- EU Aviation – compensation subsidies in the aftermath of September 11th
- Steel and Coal– facing subsidised output from overseas
- Employment subsidies under the New Deal programme
- External subsidies for Train Operating Companies and London Underground
- Business recovery programme for the UK tourist industry and rural areas
- Government subsidies for the cost of child care
- Subsidies for public sector workers in the south east unable to afford housing
- Rescue packages for the British car industry
- Subsidies for the Arts (theatre, film etc)
- Subsidies of life prolonging drugs or for people taking out private medical insurance
- Subsidies for specific environmental projects such as research into low-carbon technology

The Effect of a Producer Subsidy



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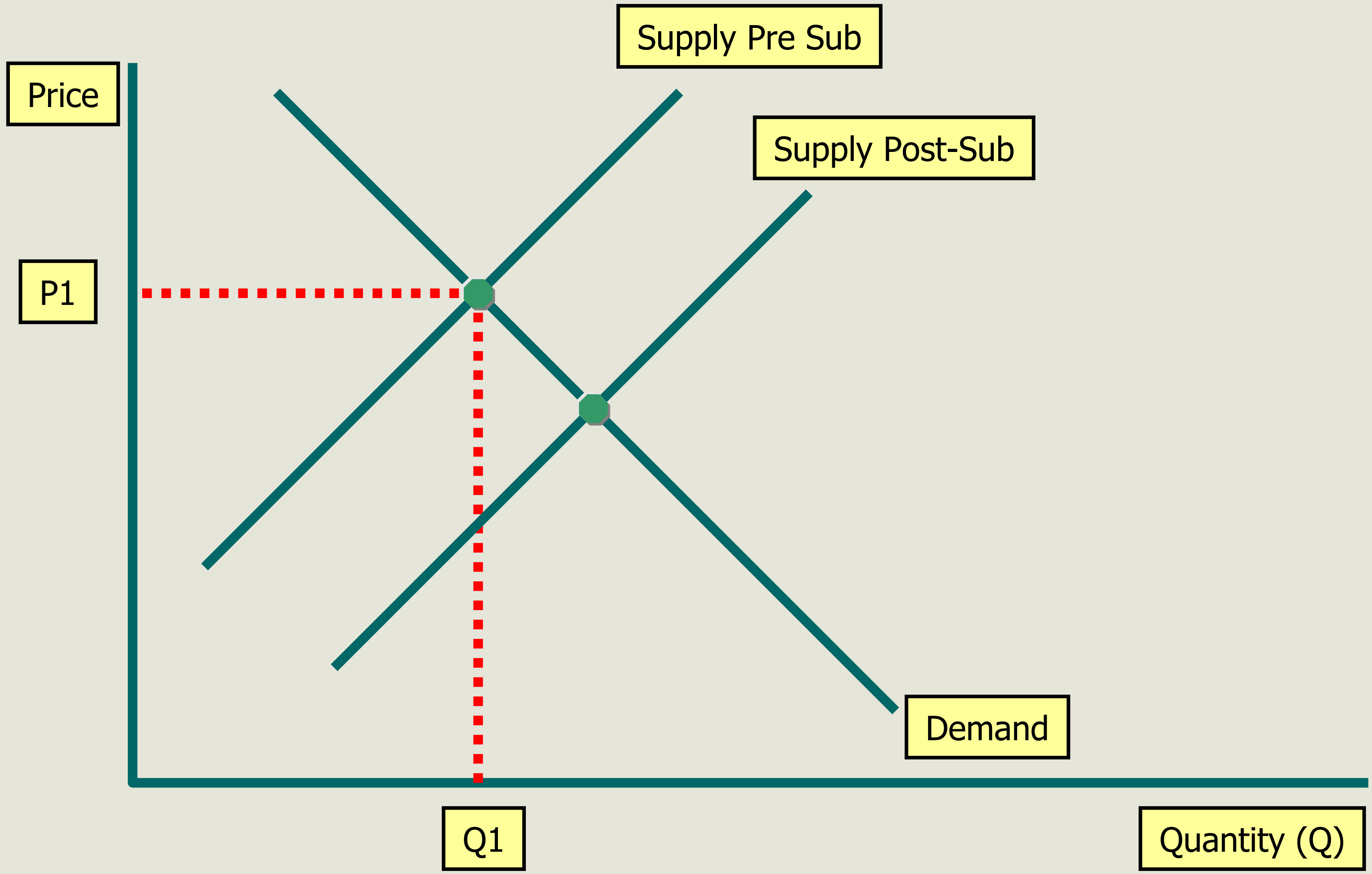

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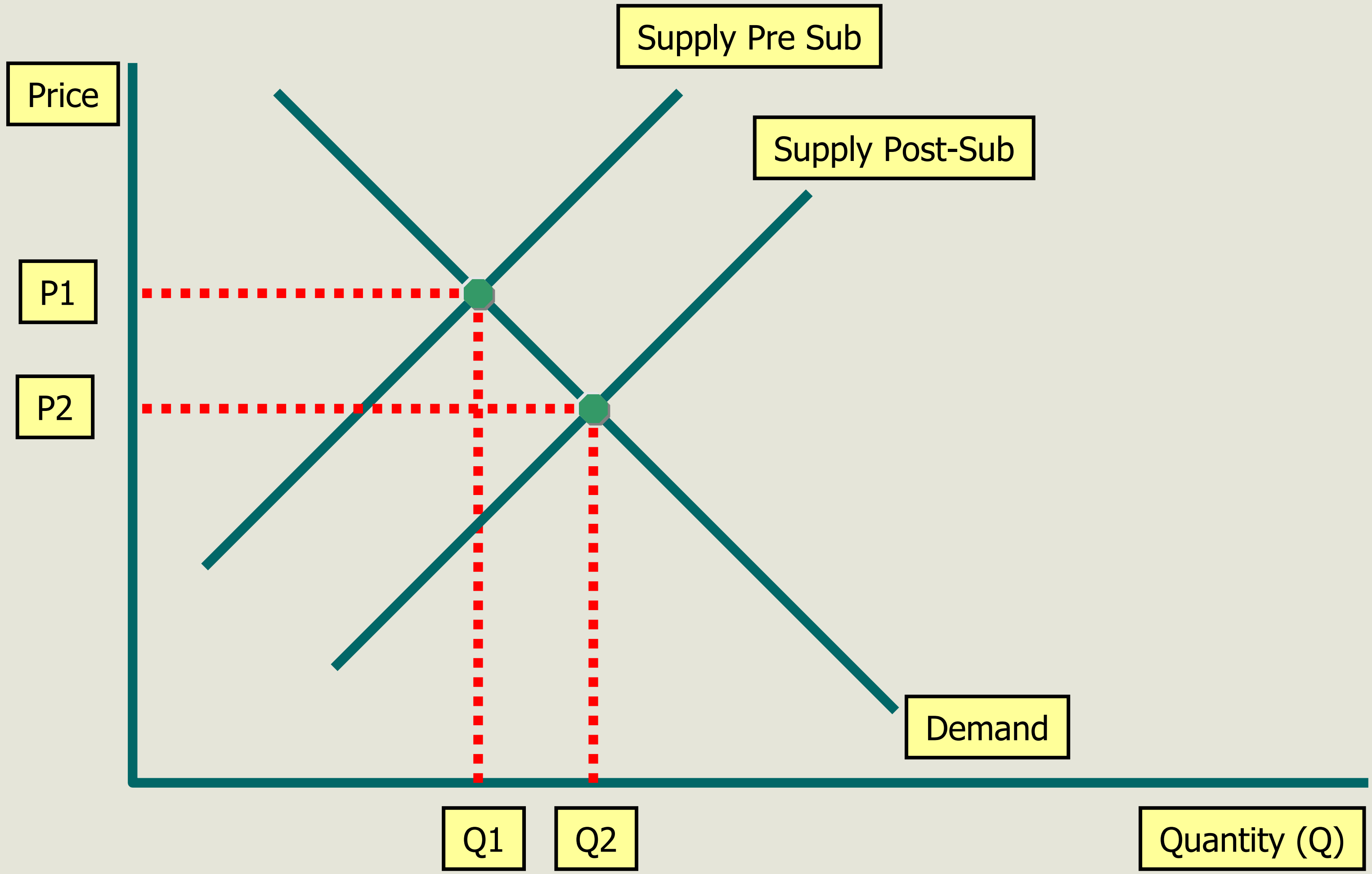

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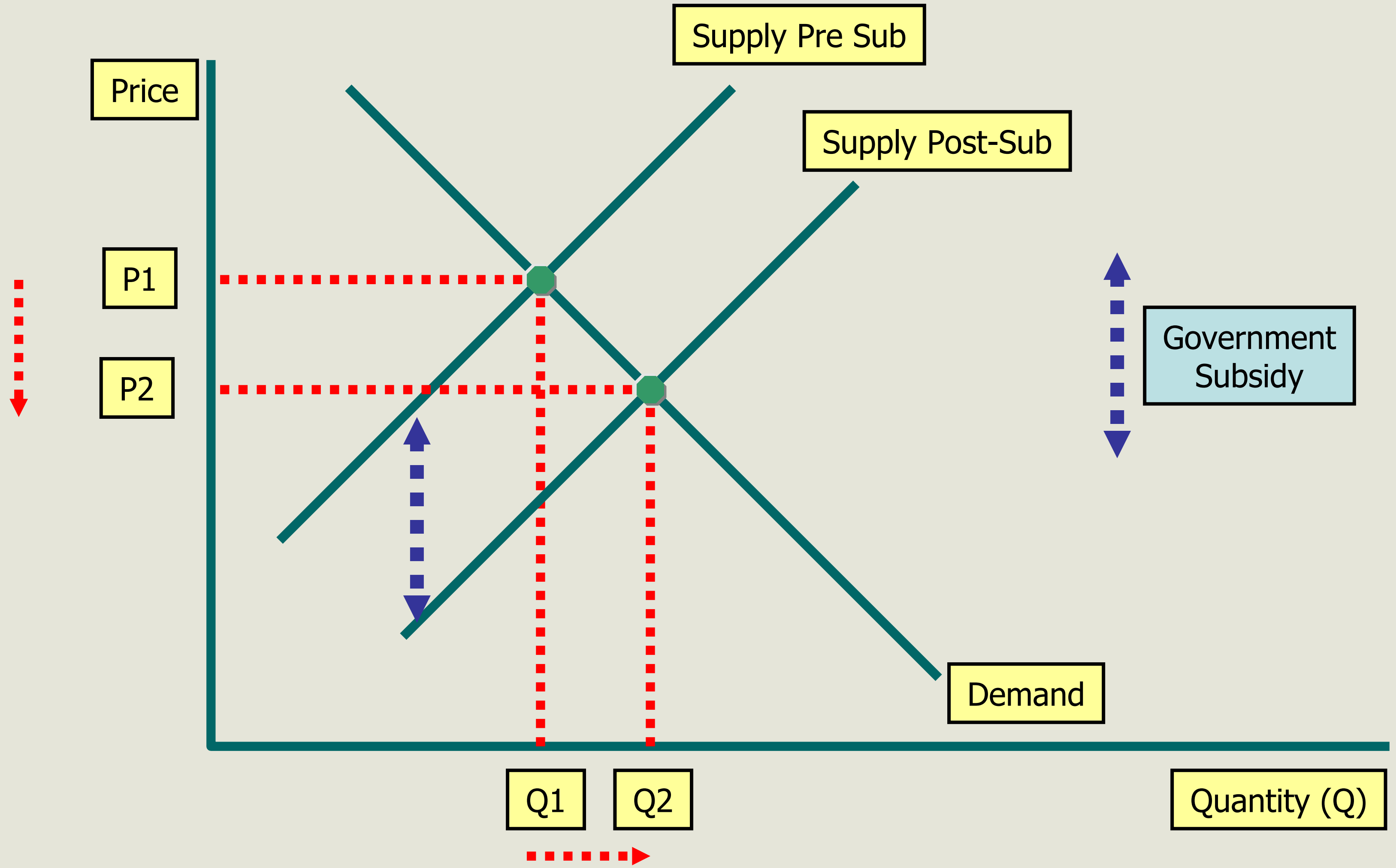
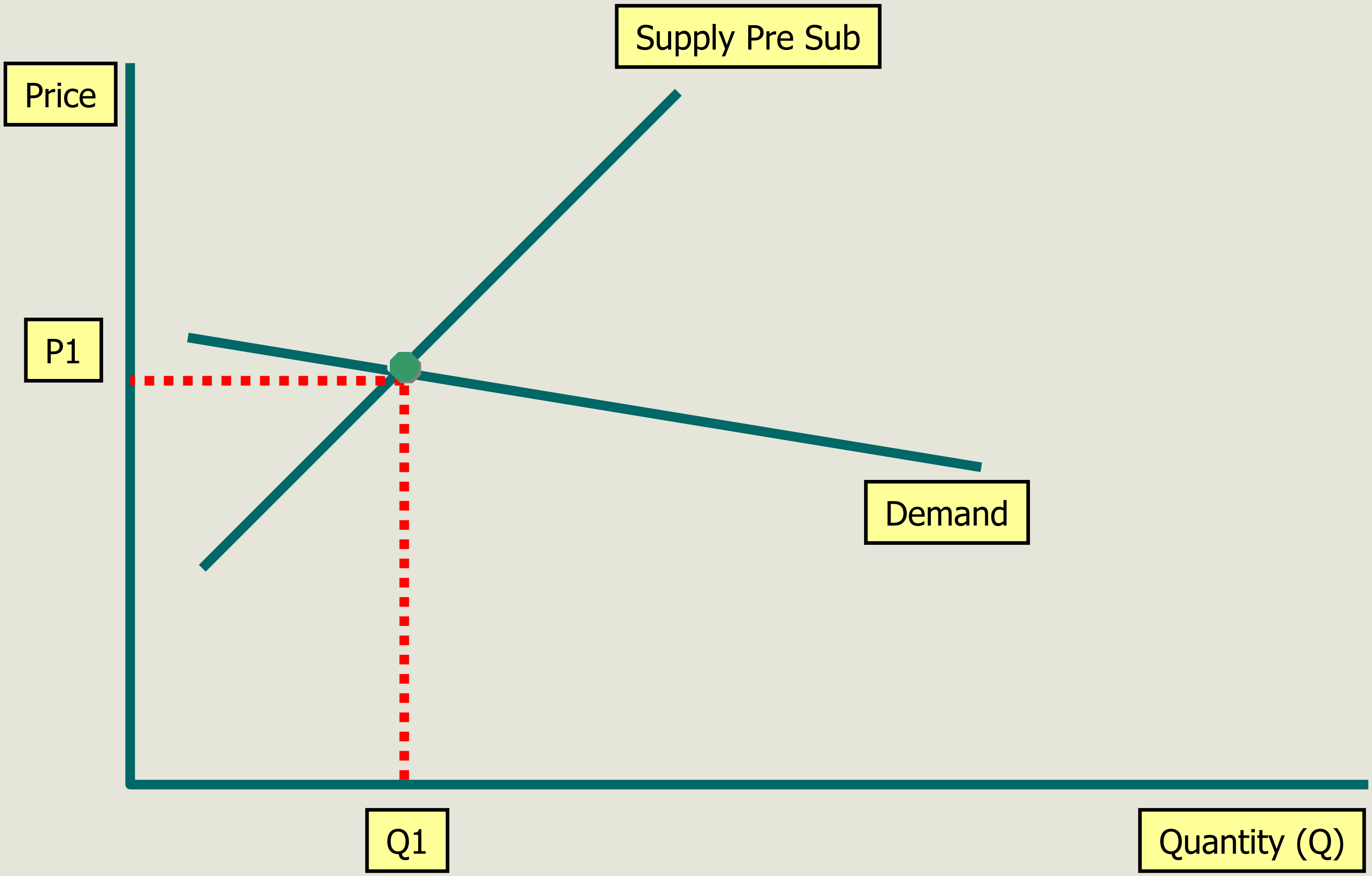


Producer Subsidy and Elasticity of Demand



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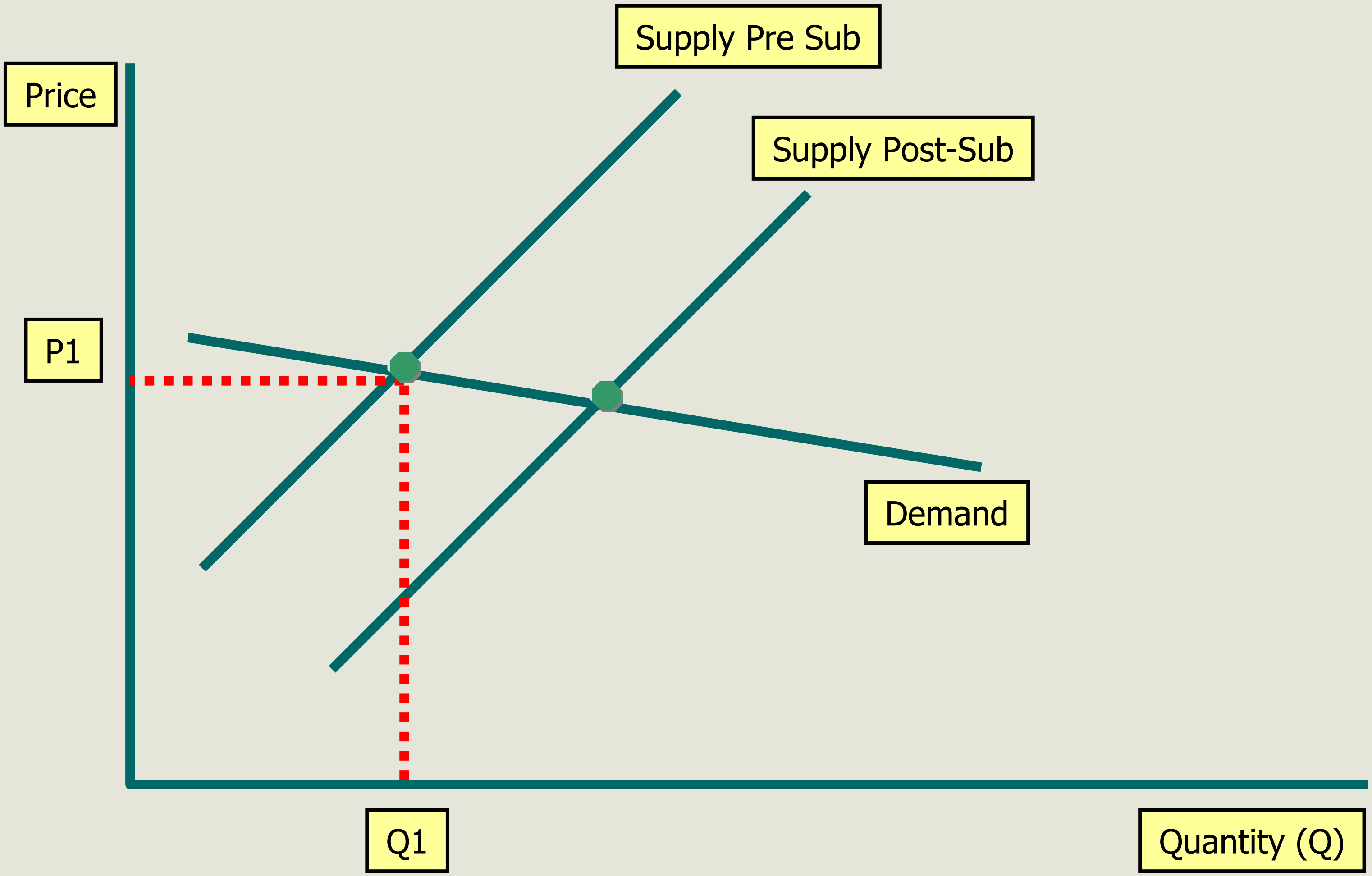

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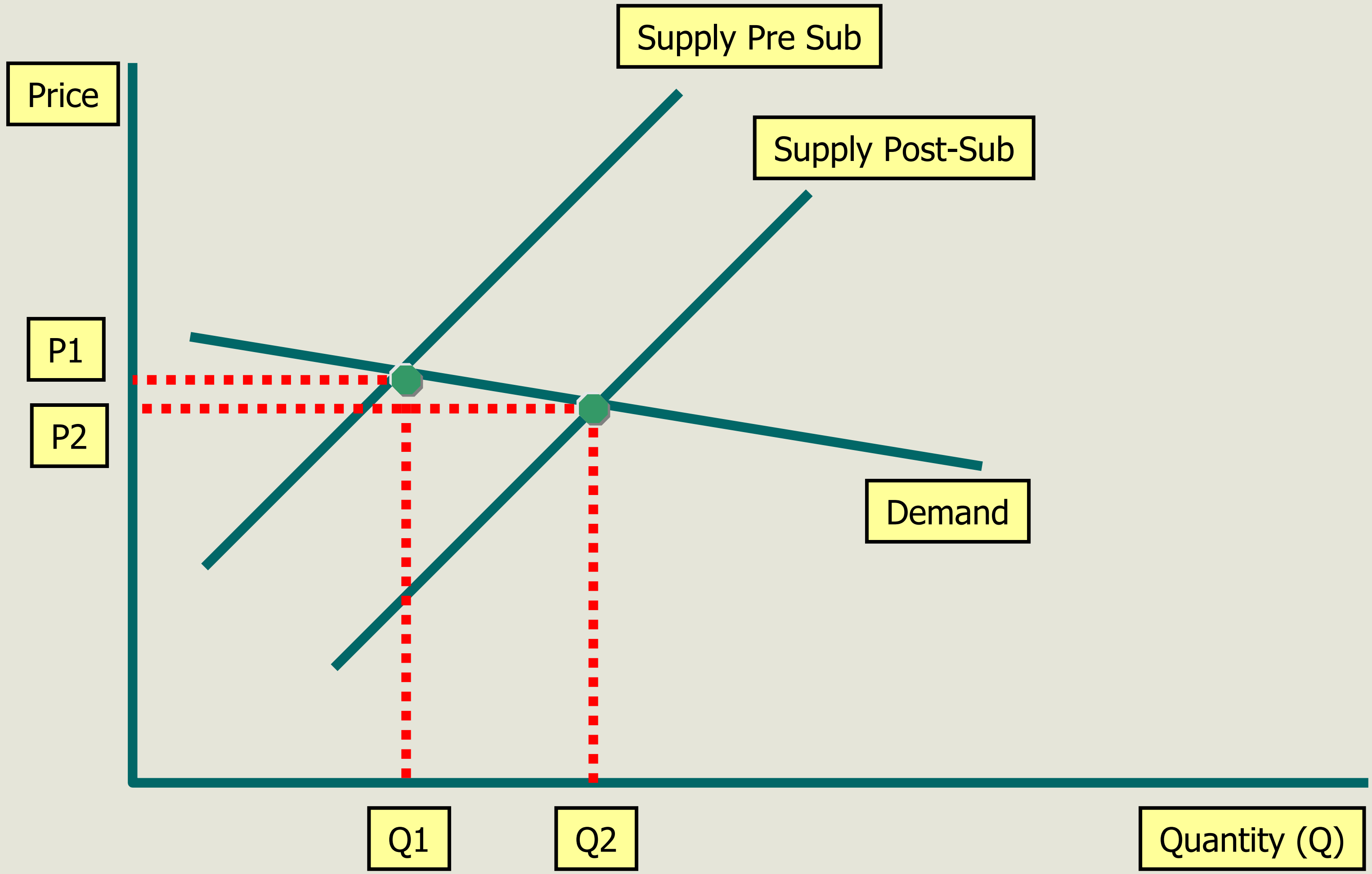

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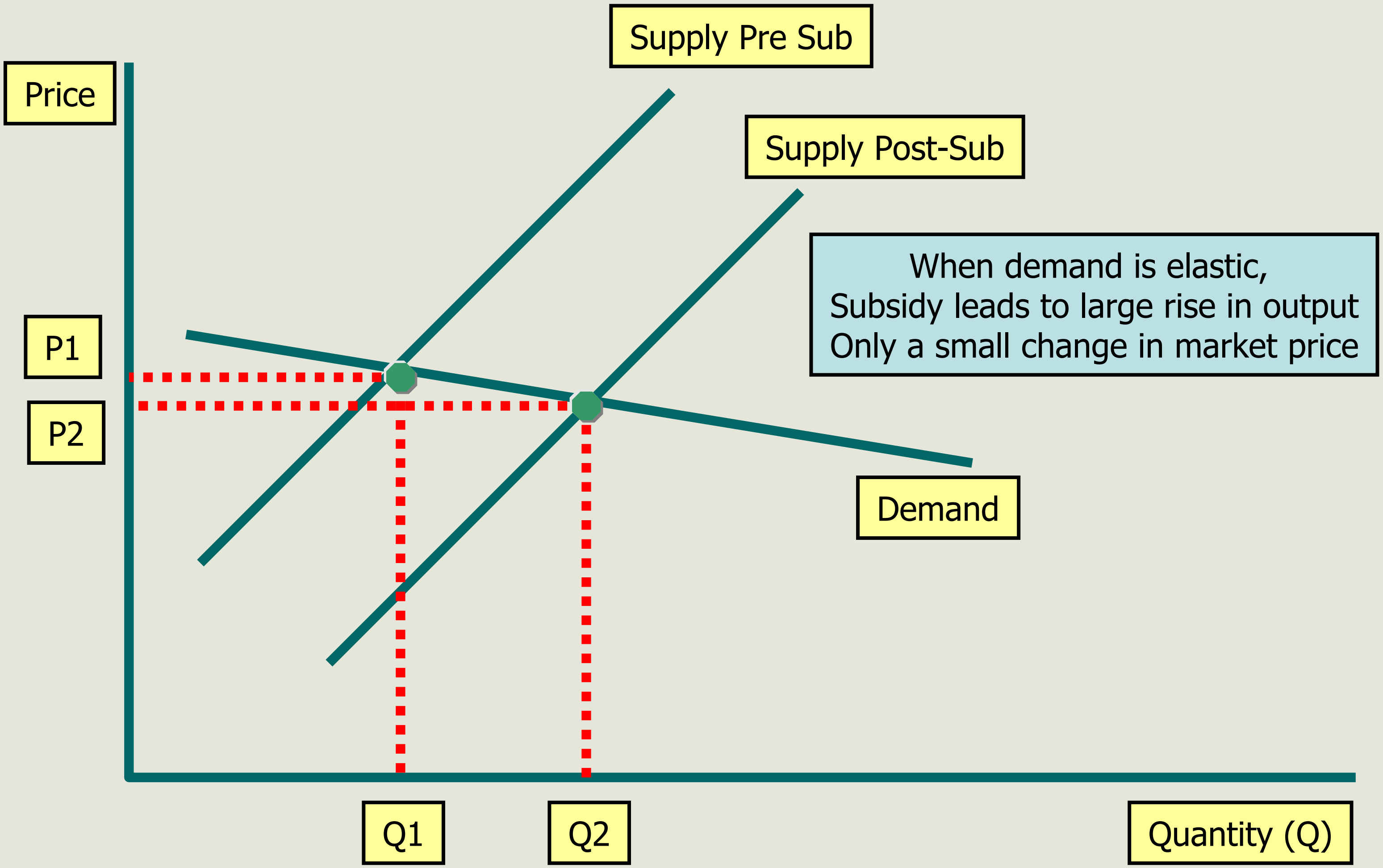
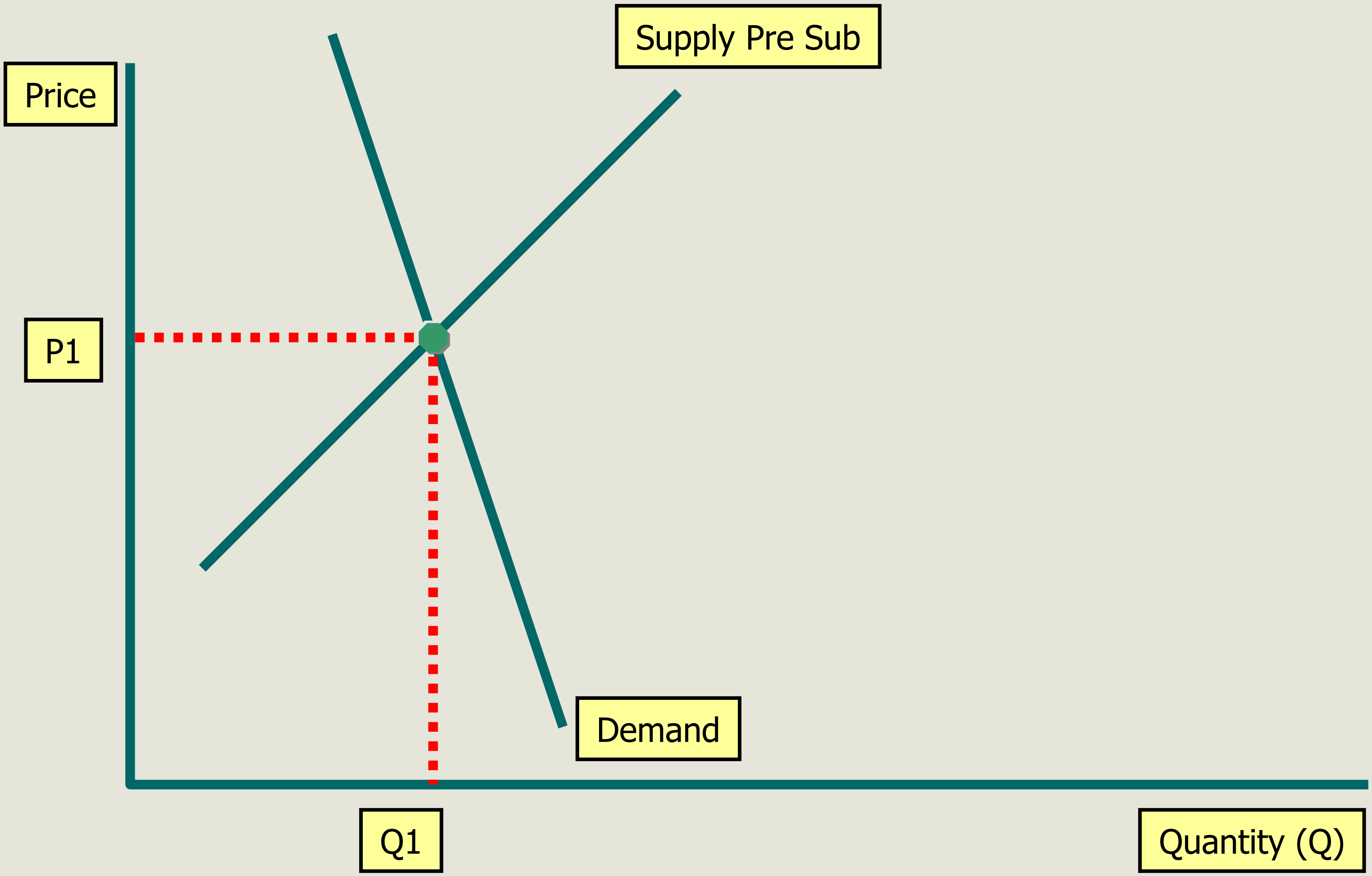


Producer Subsidy and an Inelastic Demand



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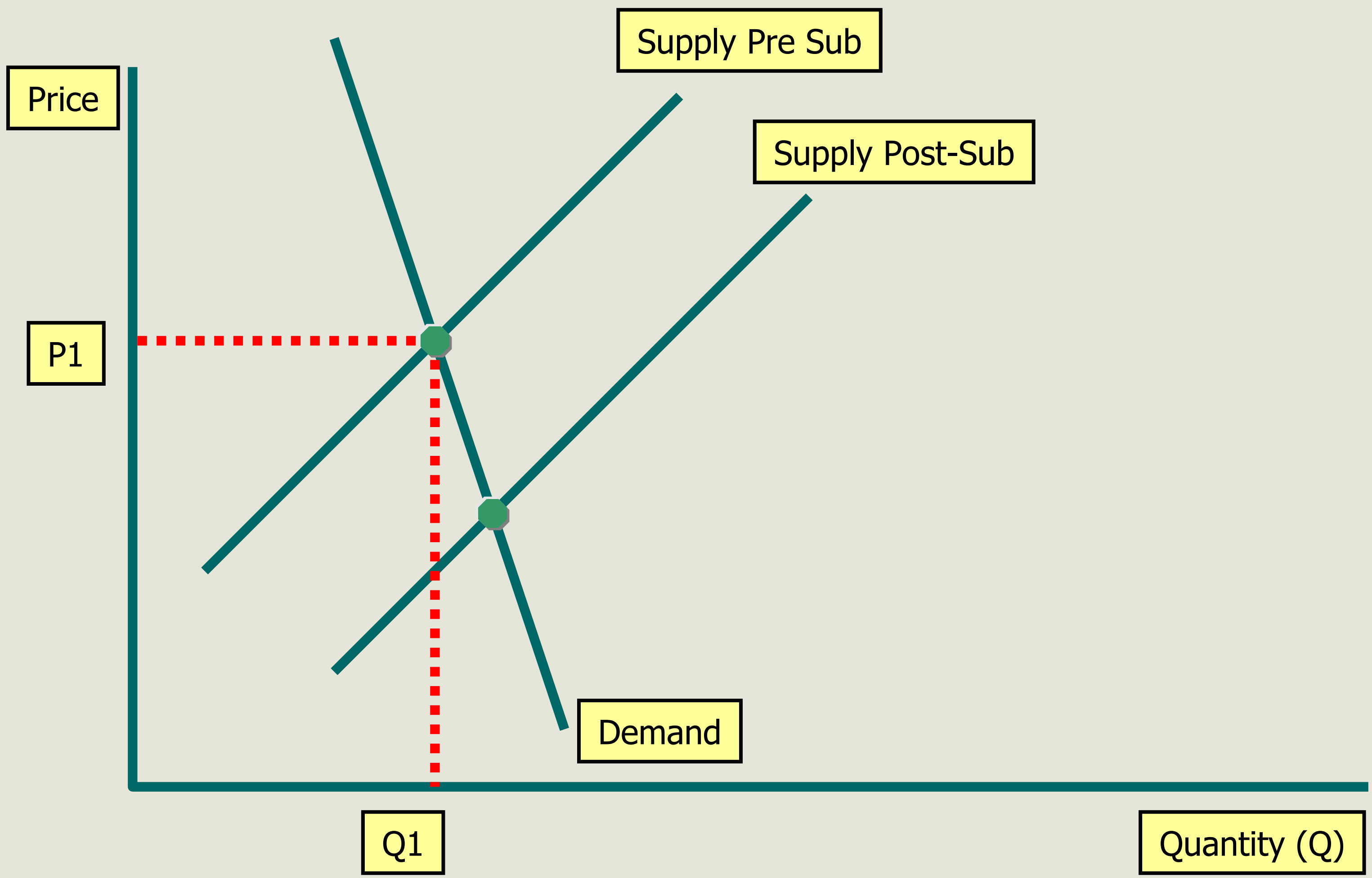

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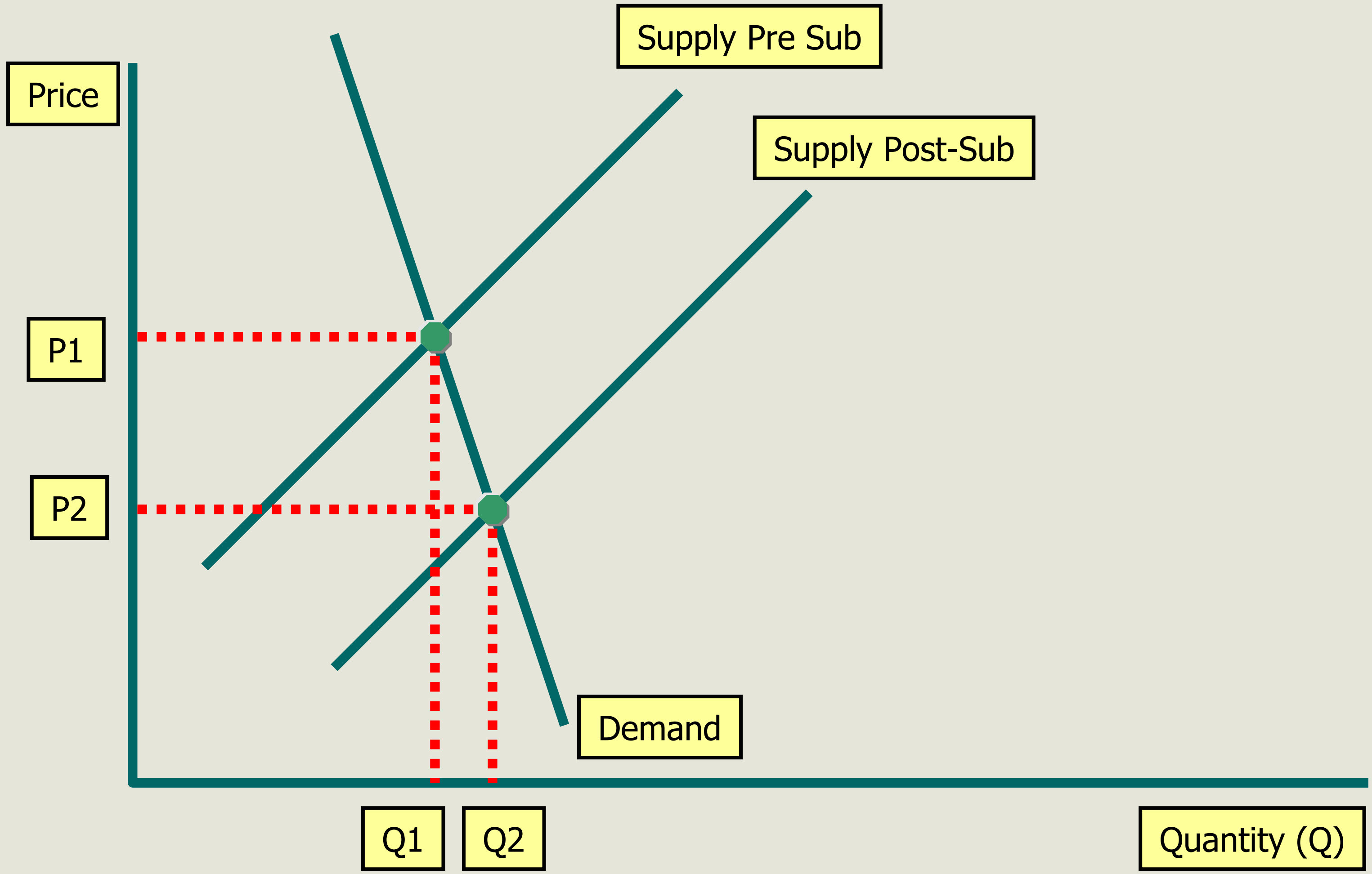

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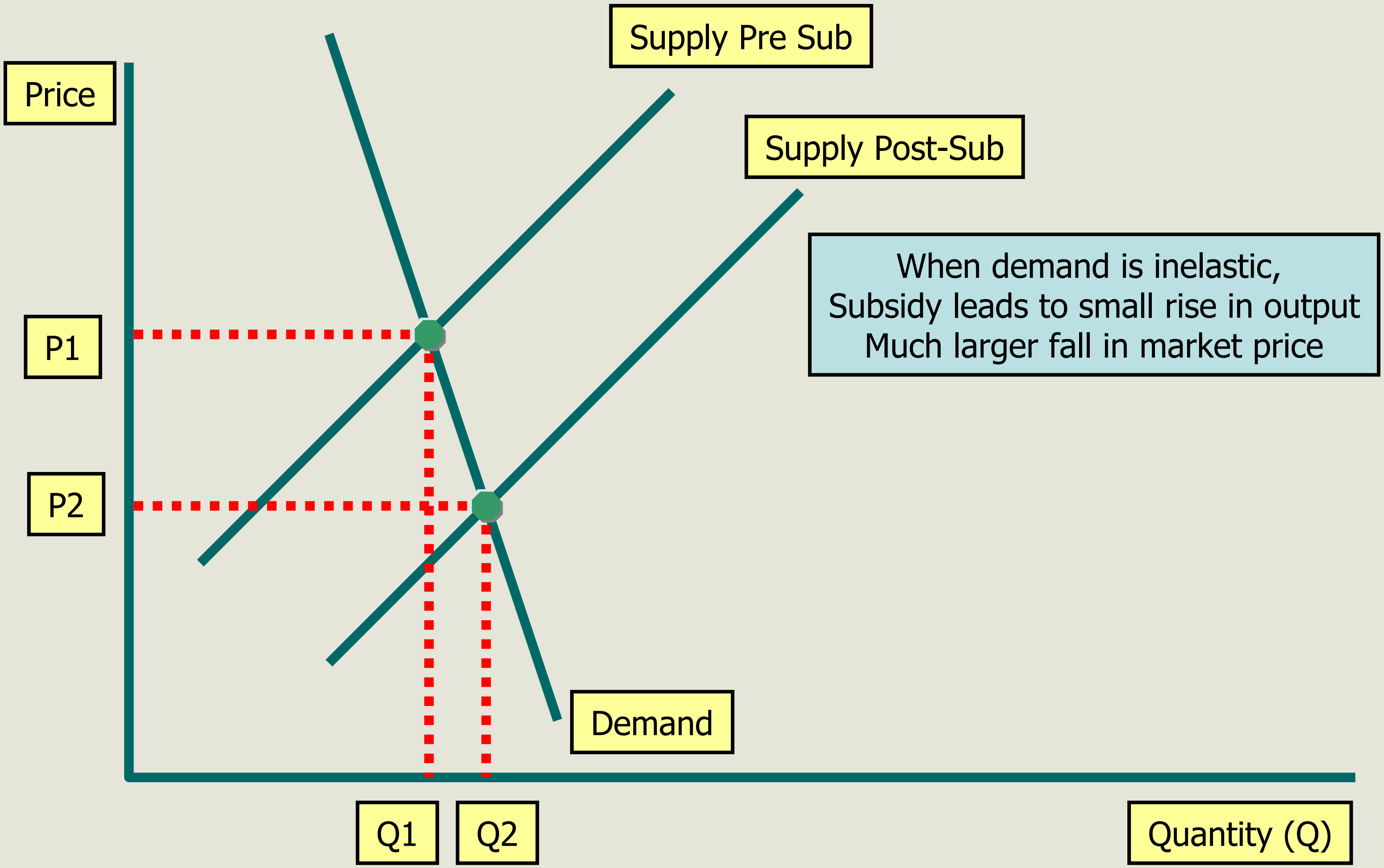
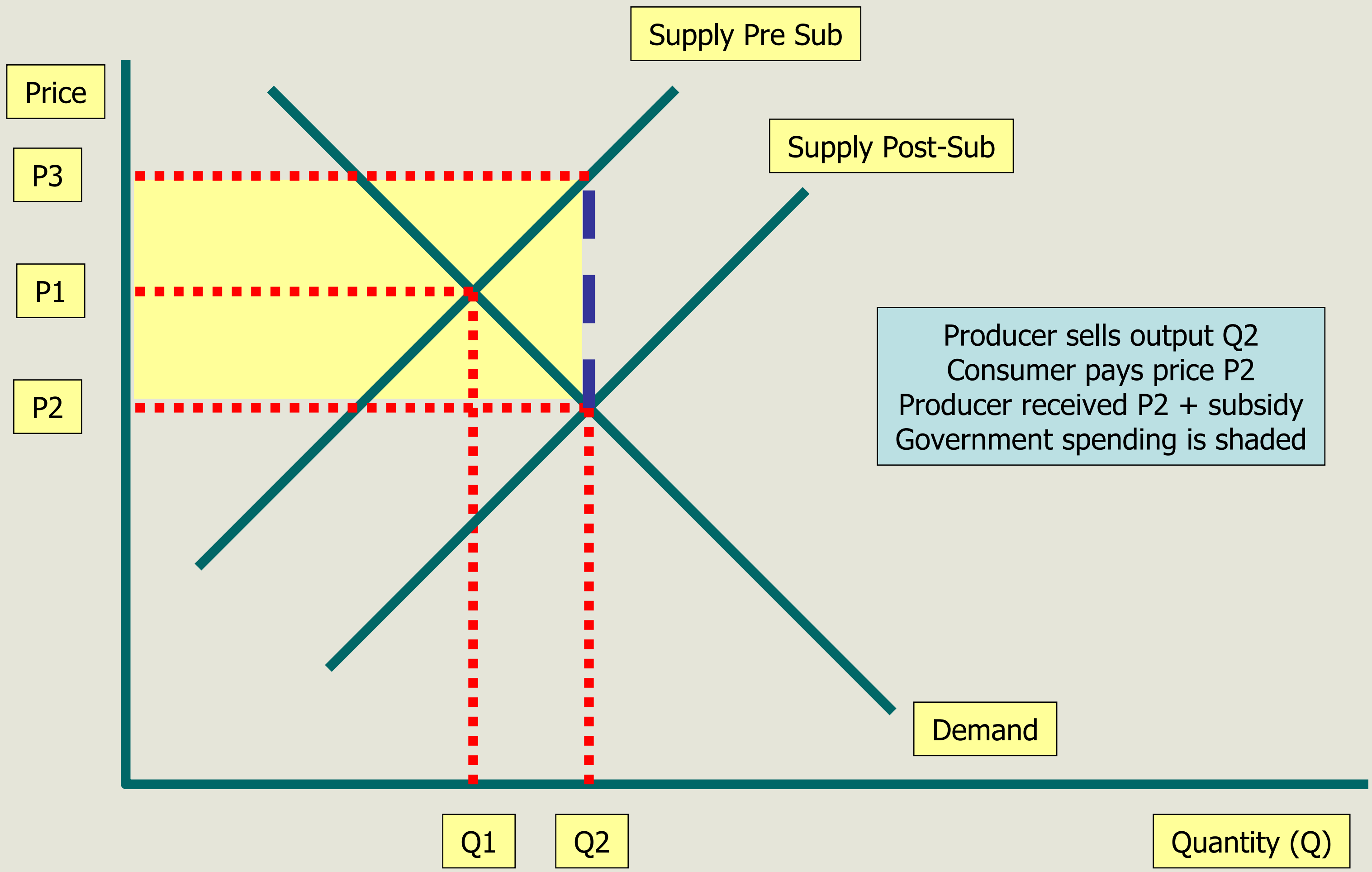
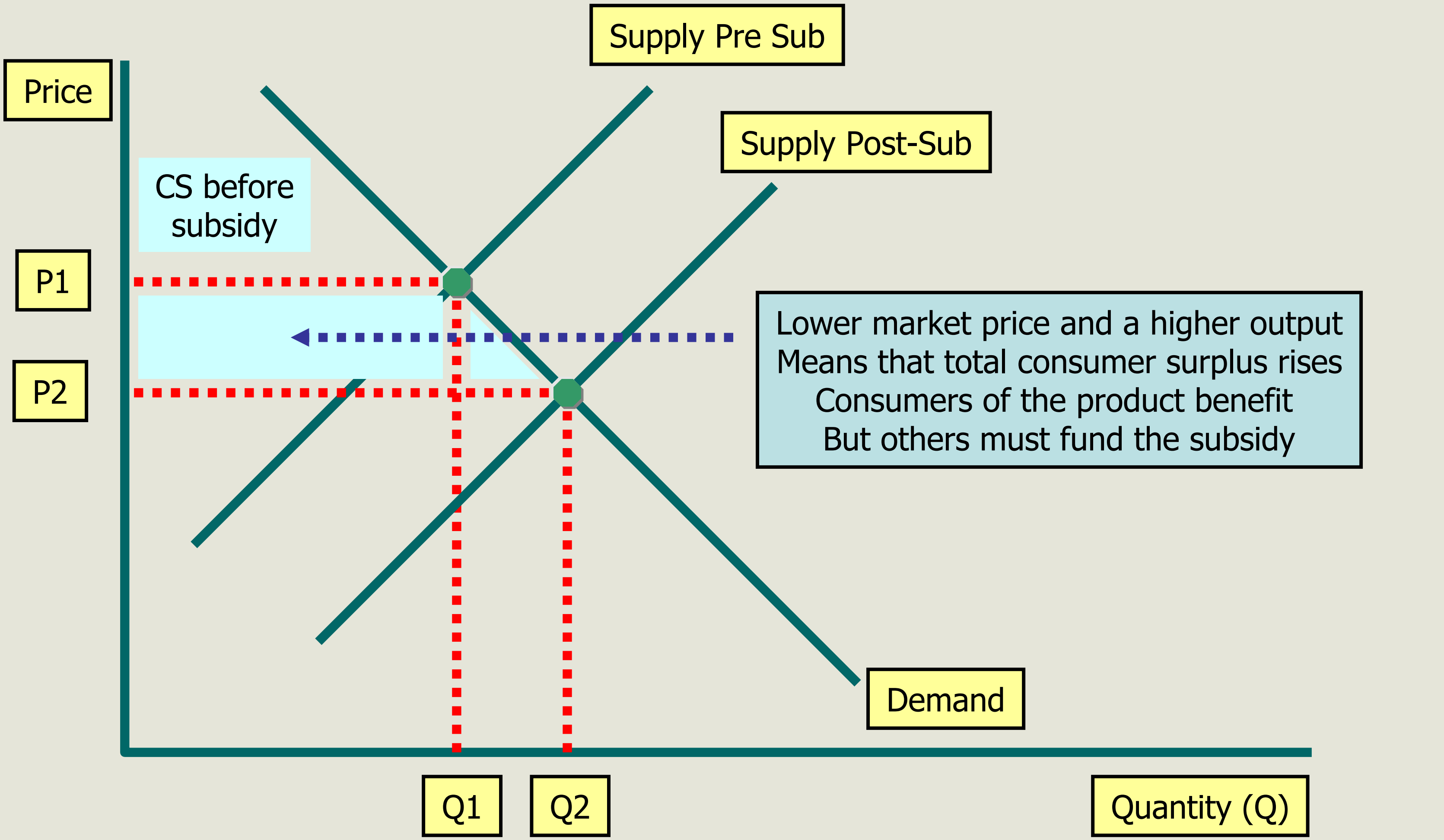
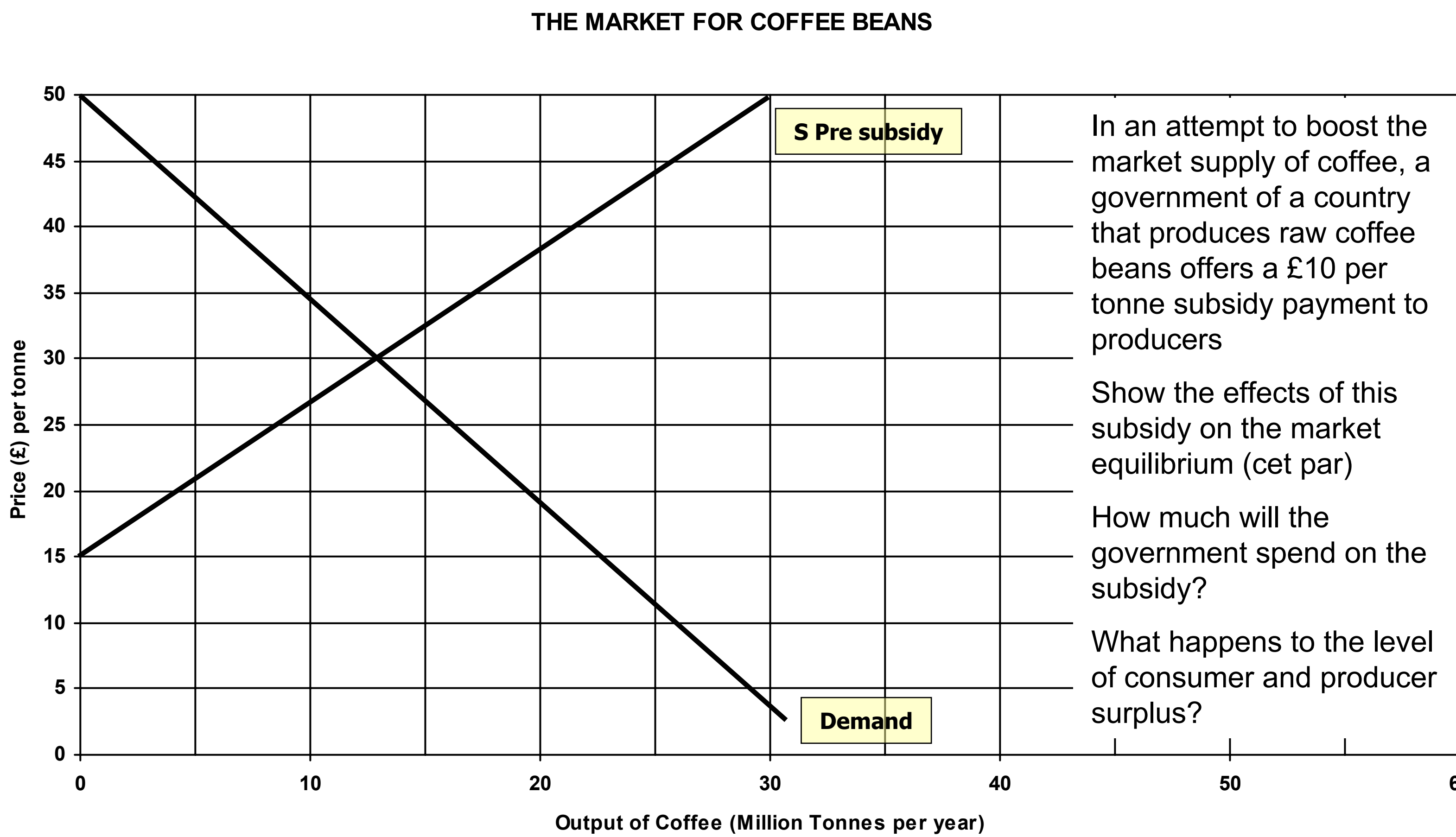


Government Spending on the Subsidy



Government Subsidy and Consumer Surplus



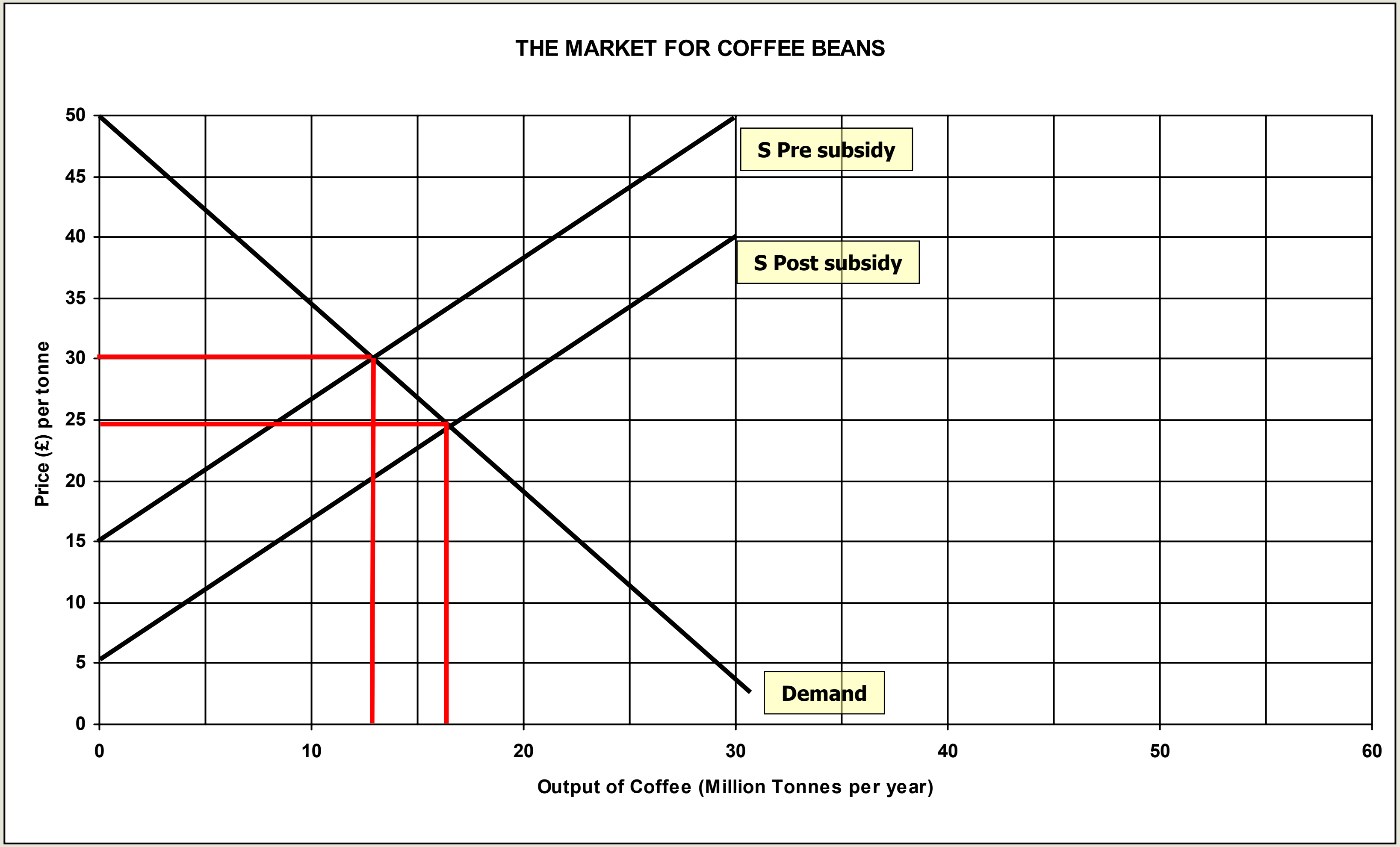


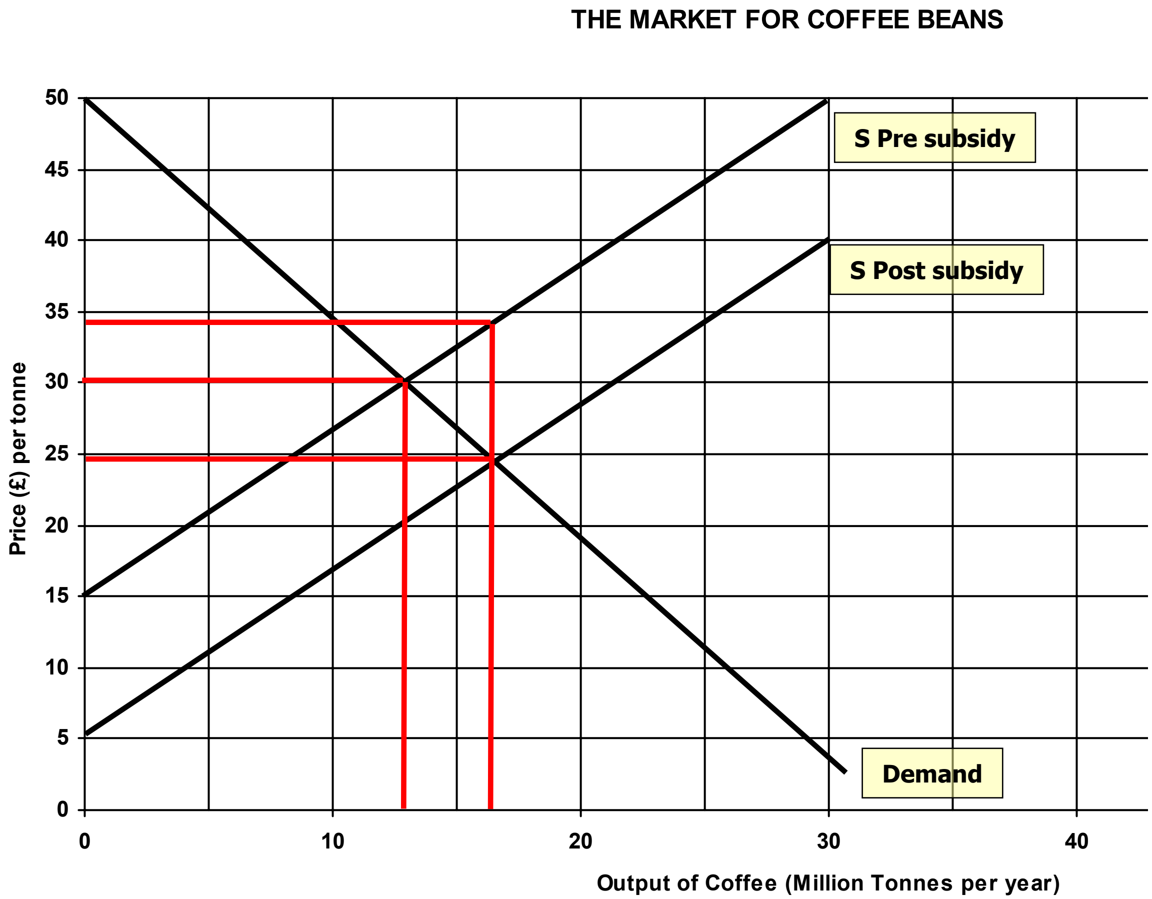
In an attempt to boost the market supply of coffee, a government of a country that produces raw coffee beans offers a £10 per tonne subsidy payment to producers

Show the effects of this subsidy on the market equilibrium (cet par)

How much will the government spend on the subsidy?

What happens to the level of consumer and producer surplus?


THE MARKET FOR COFFEE BEANS
S Pre subsidy
S Post subsidy
Demand
Price (£) per tonne
Output of Coffee (Million Tonnes per year)
0
5
10
15
20
25
30
35
40
45
50
0
10
20
30
40
50
60



Show the effects of this subsidy on the market equilibrium: price falls to just under £25 per tonne

How much will the government spend on the subsidy? = subsidy (£10per tonne) x new output (approx 17 million tonnes)

What happens to the level of consumer and producer surplus? Consumer and producer surplus both increase

Welfare Effects of a Government Subsidy

- Gainers
- Consumers who are able to purchase a product at a lower market price (an increase in consumer surplus)
- Consumers who are the direct recipient of subsidies I.e. payments for child care etc
- Producers – their net revenue is higher (leading to an increase in producer surplus)
- Is there a positive social rate of return to a particular subsidy? I.e higher social benefits from consuming more of a product?

Losers from government subsidies

- General taxpayers – who must fund subsidies (long term rise in taxation)
- Other producers not in receipt of a subsidy
- Higher government spending – involves an opportunity cost – the money could be spent in alternative ways
- Subsidies may lead to inefficiencies in production – due to the lack of competition – producers are “cushioned” by the subsidy

The Economic Case Against Subsidies

- Subsidies distort market prices - this can lead to a misallocation of resources – many economists believe that the free-market mechanism works best
- Decisions about which groups or industries receive a subsidy can be arbitrary – if tourism is supported, why not British manufacturing?
- Subsidies can become expensive – and there is an opportunity cost
- The financial cost of a subsidy often falls on consumers (tax-payers) who themselves may have derived no benefit from the subsidy
- Subsidy can artificially protect inefficient firms who need to restructure (leading to higher costs and prices in the long run) – i.e. it delays much needed economic reforms (EU farm policy?)
- Ever-present risk of fraud when allocating subsidy payments
- It may be possible to achieve the objectives of subsidies by alternative means which have less distorting effects, for example by direct income support through the tax and benefit system