Producer Subsidies

A **subsidy** is a payment by the government to suppliers that reduce their costs of production and encourages them to increase output. The subsidy causes the firm's supply curve to shift to the right. The amount spent on the subsidy is equal to the subsidy per unit multiplied by total output. Occasionally the government can offer a direct subsidy to the consumer – which has the effect of boosting demand in a market

Different Types of Producer Subsidy

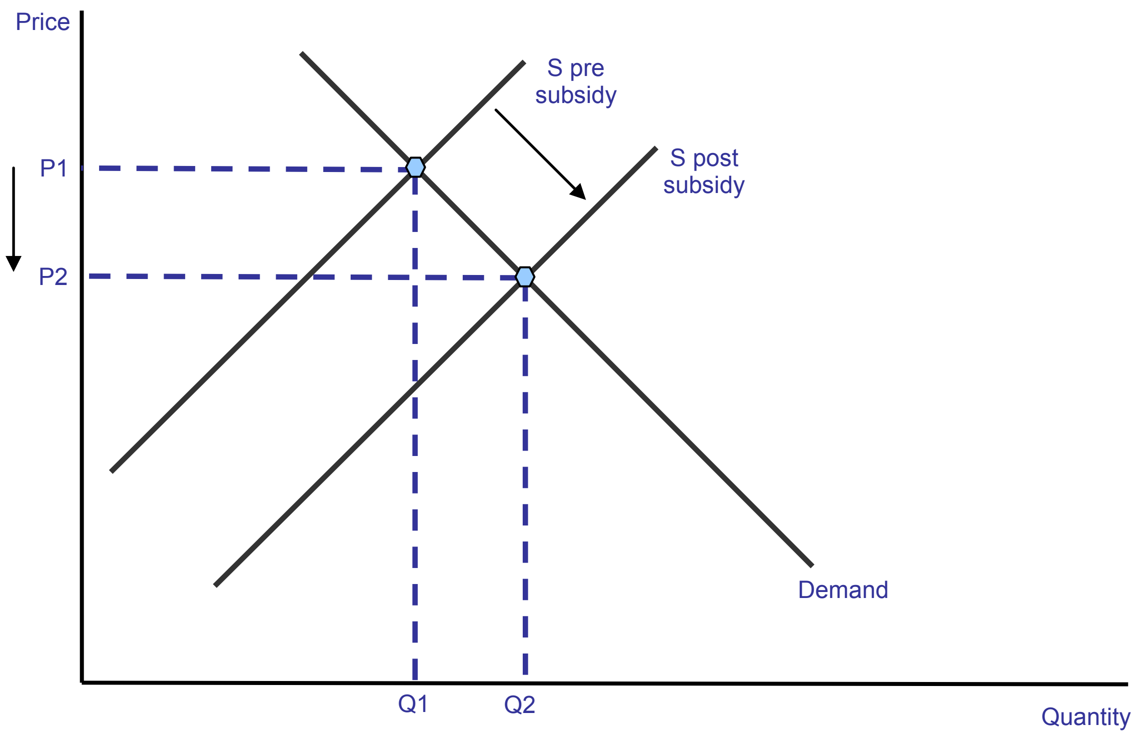
(1) **A guaranteed payment on the factor cost of a product** – e.g. a guaranteed minimum price offered to farmers such as under the old Common Agricultural Policy (CAP).

(2) **An input subsidy** which subsidises the cost of inputs used in production – e.g. an employment subsidy for taking on more workers.

(3) **Government grants to cover losses made by a business** – e.g. a grant given to cover losses in the railway industry or a loss-making airline.

(4) **Bail**-outs e.g. for financial organisations in the wake of the credit crunch

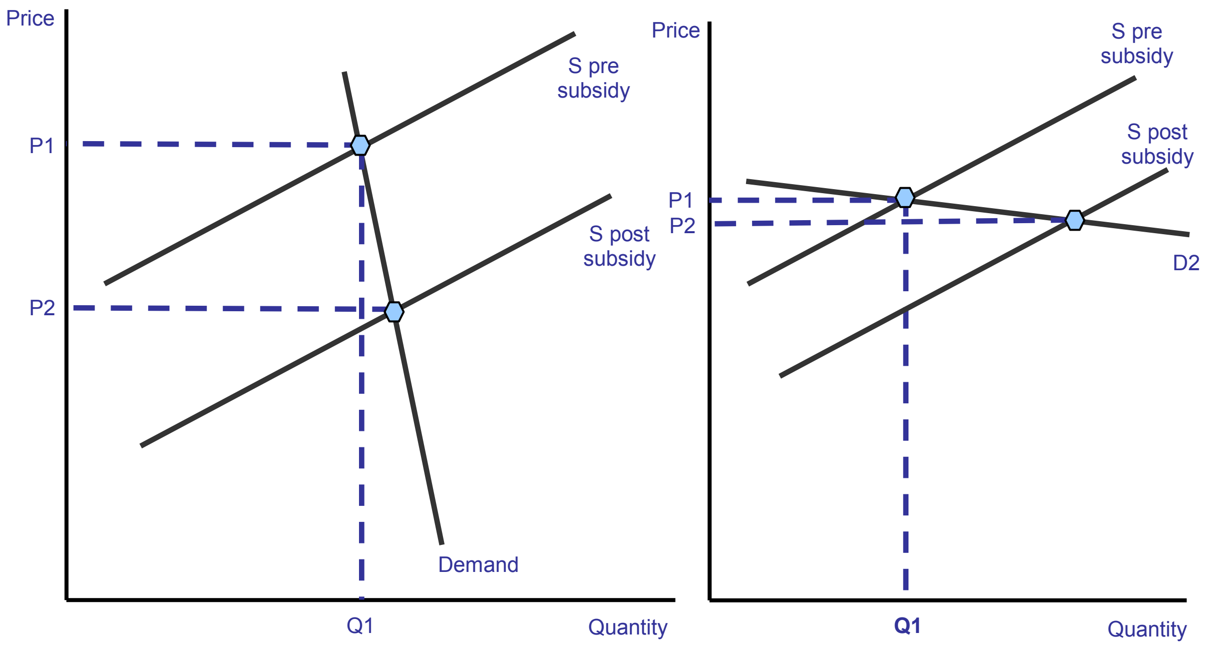
(5) **Financial assistance (loans and grants)** for businesses setting up in areas of high unemployment – e.g. as part of a regional policy designed to boost employment.



To what extent will a subsidy feed through to lower prices for consumers?

This depends on the **price elasticity of demand for the product**. The more inelastic the demand curve the greater the consumer's gain from a subsidy. Indeed when demand is perfectly inelastic the consumer gains most of the benefit from the subsidy since all the subsidy is passed onto the consumer through a lower price. When demand is relatively elastic, the main effect of the subsidy is to increase the equilibrium quantity traded rather than lead to a much lower market price.

The effect of a subsidy on the market price is greatest when demand is inelastic
When demand is price elastic, a subsidy will have more of an effect on quantity traded



Economic and Social Justifications for Subsidies

Why might the government be justified in providing financial assistance to producers in certain markets and industries? How valid are the arguments for government subsidies?

(1) To keep prices down and **control inflation** – in the last couple of years several countries have been offering fuel subsidies to consumers and businesses in the wake of the steep increase in world crude oil prices.

(2) To encourage consumption of **merit goods and services** which are said to generate **positive externalities** (increased social benefits). Examples might include subsidies for investment in environmental goods and services.

(3) **Reduce the cost of capital investment projects** – which might help to stimulate economic growth by increasing long-run aggregate supply.

(4) Subsidies to slow-down the process of long term decline in an industry e.g. fishing or mining

(5) Subsidies to **boost demand** for industries during a recession e.g. the car scrappage scheme

Economic Arguments against Subsidies

The economic and social case for a subsidy should be judged carefully on the grounds of **efficiency** and **fairness**. Might the money used up in subsidy payments be better spent elsewhere? Government subsidies inevitably carry an **opportunity cost** and in the long run there might be better ways of providing financial support to producers and workers in specific industries.

Free market economists argue that subsidies distort the working of the free market mechanism and can lead to **government failure** where intervention leads to a worse distribution of resources.

(i) **Distortion of the Market:** Subsidies distort market prices – for example, **export subsidies** distort the trade in goods and services and can curtail the ability of ELDCs to compete in the markets of rich nations.

(ii) **Arbitrary Assistance**: Decisions about who receives a subsidy can be arbitrary

(iii) **Financial Cost:** Subsidies can become expensive – note the opportunity cost!

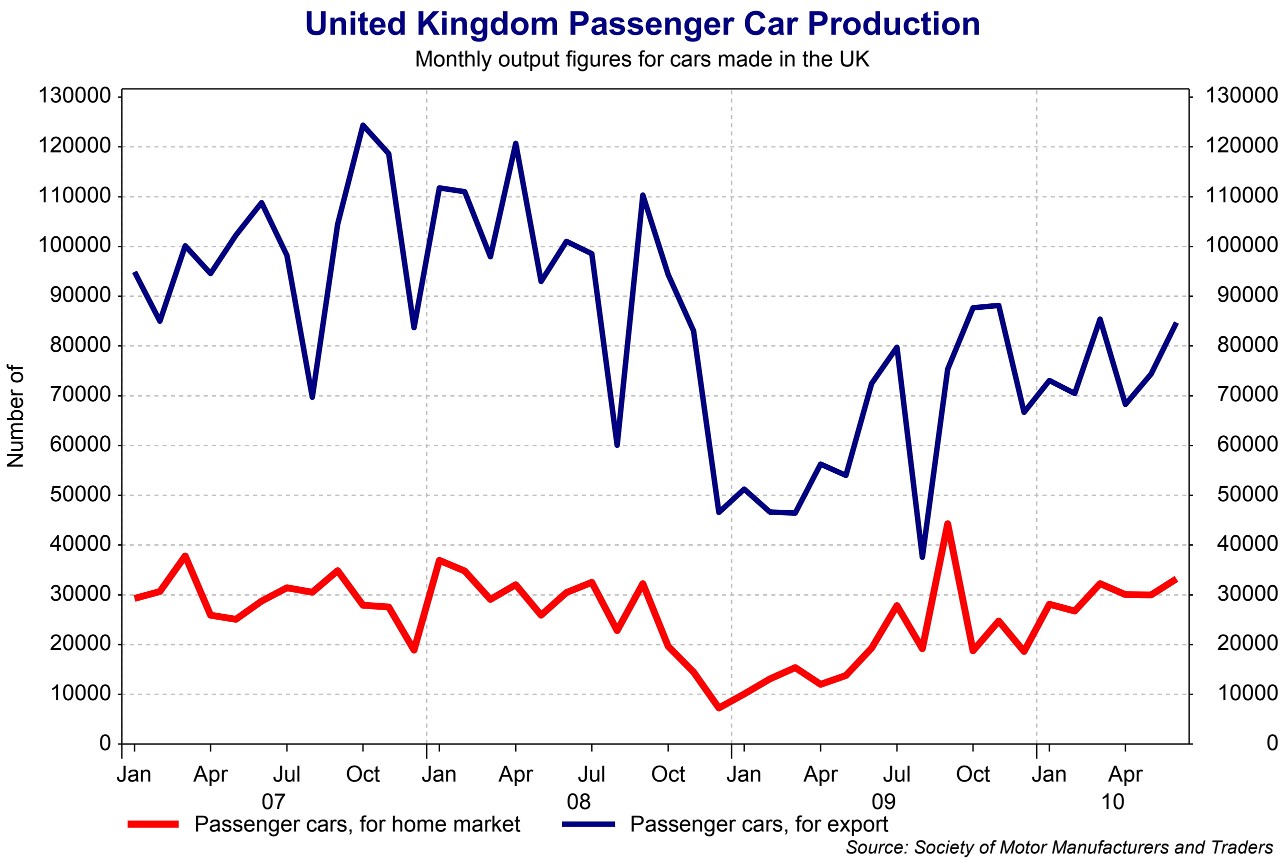
(iv) **Who pays and who benefits?** The final cost of a subsidy usually falls on consumers (or tax-payers) who themselves may have derived <u>no benefit</u> from the subsidy.

(v) **Encouraging inefficiency:** Subsidy can artificially protect inefficient firms who need to restructure – i.e. it delays much needed reforms.

(vi) **Risk of Fraud:** Ever-present risk of fraud when allocating subsidy payments.

(vii) **There are alternatives:** It may be possible to achieve the objectives of subsidies by alternative means which have less distorting effects.

Case Study: The Car Scrappage Scheme



A scrappage subsidy is a "pay-to-scrap" scheme where a government offers a financial incentive to car buyers if they scrap a car that has reached a specified age and in its place they are offered a payment towards the cost of a new vehicle.

Scrappage subsidies have become more popular during the 2009 recession. Germany offers a Euro 2,500 payment for cars more than nine years old and France offers a Euro 1,000 payment. In the United States, a ''Cash for clunkers' bill offers up to £3600 for US consumers to buy new, more fuel-efficient vehicle assembled in the US and up to £5400 for 100mpg or more plug-in hybrids. Customers buying cars built outside of the country will only receive a maximum of £2900. And in Slovakia where there has been huge foreign direct investment into their fledgling motor industry, incentives worth Euro 1,000 to Euro 1,500 are available. The UK launched its own scheme in April 2009 offering £2,000 towards the cost of a new car replacing nine year old vehicles.

Arguments for a scrappage subsidy

(1) It is a direct incentive for consumers to buy a new vehicle - a targeted subsidy
(2) Stimulating demand will help keep car plants open and producing vehicles at a time when the credit crunch and rising unemployment has caused a collapse in new vehicle demand and production
(3) There are environmental benefits if consumers swap older for newer - more fuel efficiency vehicles that emit less c02 per km travelled
(4) Crushing (and recycling) used cars reduce the risks of a sharp fall in second hand car prices caused by vast over-supply
(5) Some of the financial costs of the subsidy would be recouped by the revenue from the VAT charged on new car purchases

Arguments against a scrappage subsidy

(1) Distortion of market competition, why should the car industry be in receipt of a subsidy and other sectors miss out? If cars can be scrapped for a payment why not old televisions?
(2) The payment brings forward demand that might have occurred anyway and risks a sharp fall-off when incentives end. Economists call this a deadweight loss - a benefit is being given to people who would (eventually) have bought a new car anyway
(3) There are extra costs of crushing / disposing of vehicles that was still roadworthy and usable
(4) There is an opportunity cost to financing a scrappage scheme - the money might be better spent developing greener public transport alternatives
(5) Subsidies might be a catalyst for protectionism i.e. only giving subsidies for new vehicles produced within the domestic economy and not for importers. For example the Malaysian government finances 50% of their scrappage scheme, which pays owners of older vehicles to turn them in and purchase new cars from Malaysian produced Protons and Peroduas. In the UK, nearly 90 per cent of new cars are imported. UK made vehicles is exported to countries that may not have a similar pay to scrap scheme in place.
(6) We must also consider the C02 emissions created by the manufacturing of new cars

A scrappage scheme would be great news for recycling plants and car dealerships and perhaps just the fillip that our motor industry needs. But for many people such a scheme is a poorly judged scheme for a failing industry that already suffers from over-capacity.

Tutor2u blog articles on subsidies