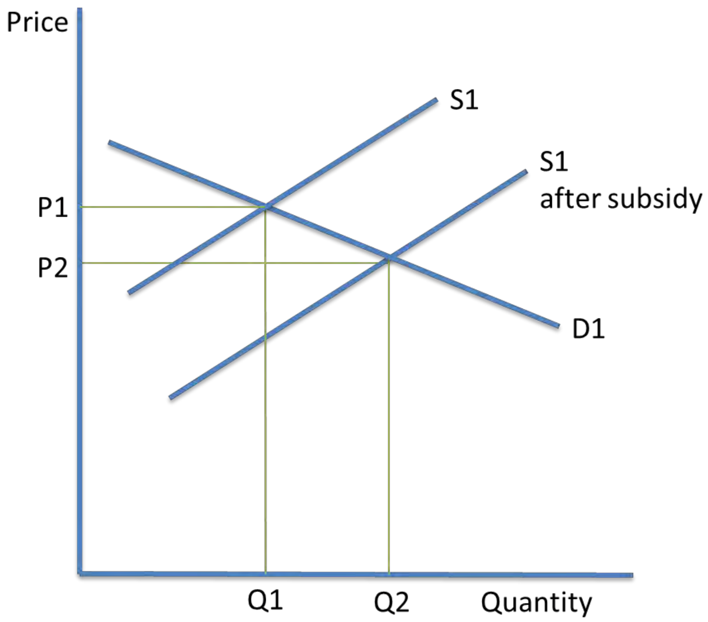
CIE Economics AS-level

Topic 3: Government Microeconomic Intervention

c) Subsidies

Notes

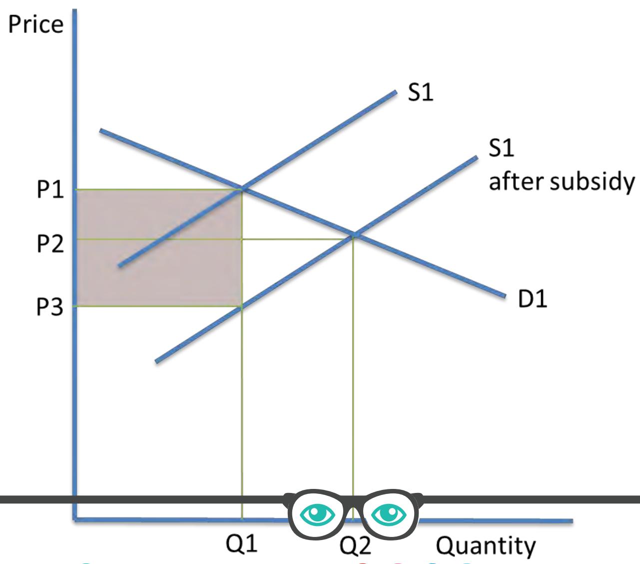
- A subsidy is a payment from the government to a producer to lower their costs of production and encourage them to produce more.
- For example, the government might provide apprenticeship schemes or help farmers by contributing towards their production costs.



- Subsidies shift the supply curve to the right, which lowers the market price.
- The vertical distance between the supply curves shows the value of the subsidy per unit.

- **Government spending on subsidy**

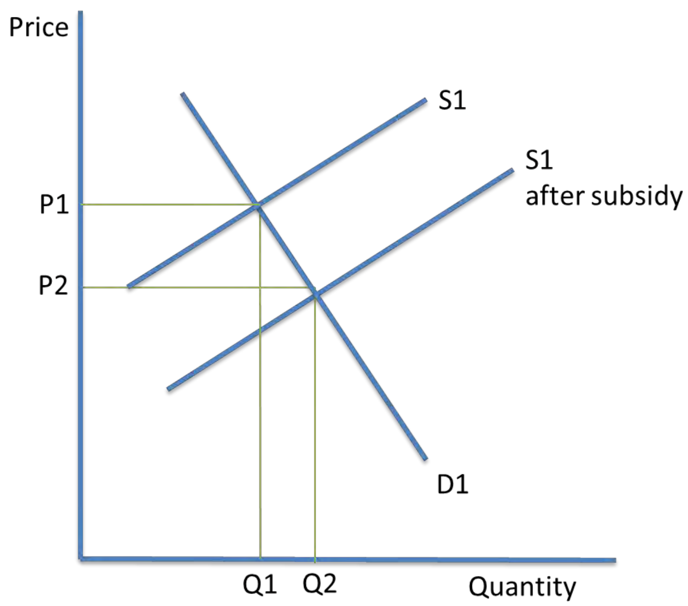
- This is shown by the shaded area and is calculated by the value of the subsidy per unit times the output.



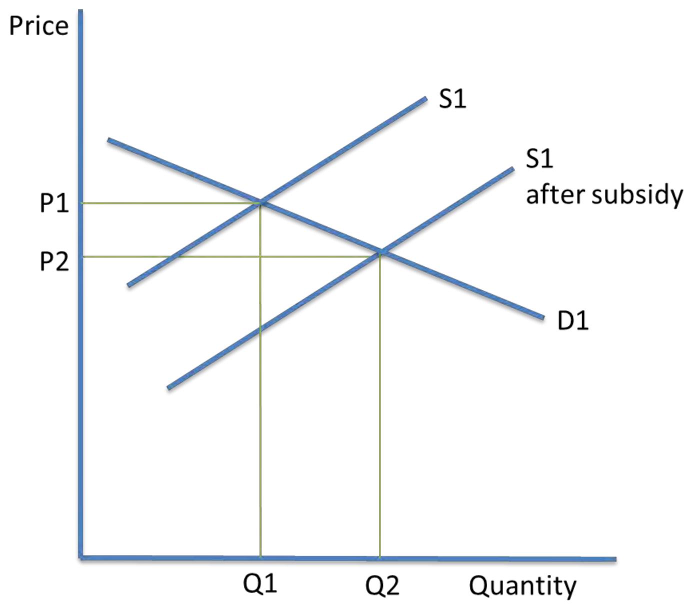
- The consumer pays P3 and the producer receives P1, which includes the subsidy.

- **Effects of subsidies**

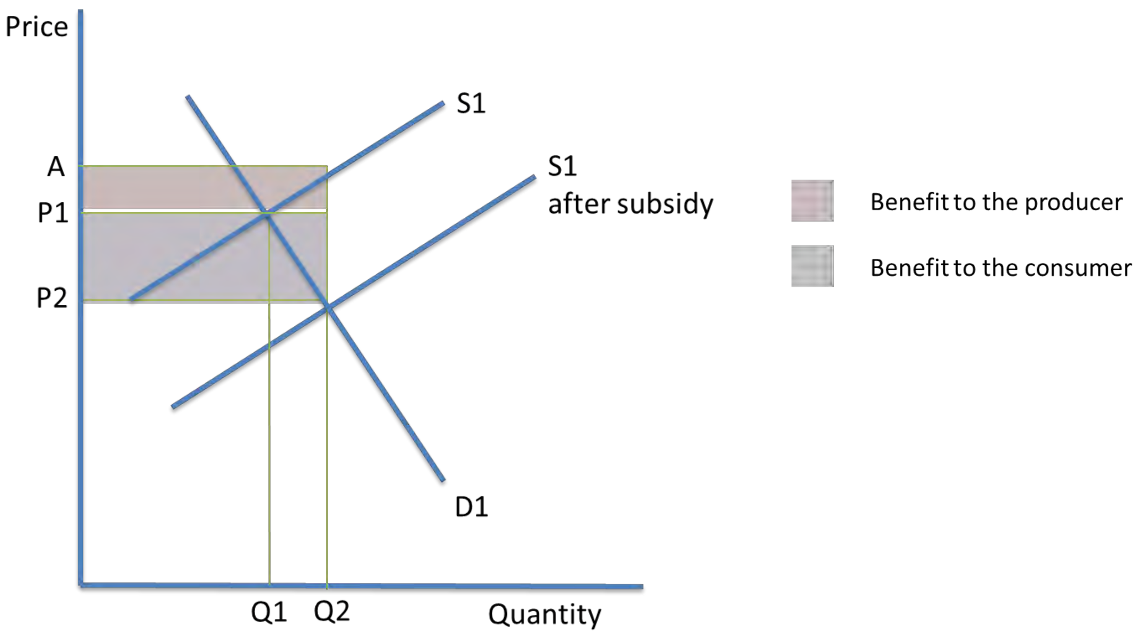
- Subsidies increase output and lower prices for consumers, which could help families on low and fixed incomes.
- They increase the employment rate, by making workers more skilled through apprenticeship schemes and lowering the cost of employing workers.
- They reduce inequality in society, if the subsidy is progressive.
- Subsidies could help control inflation, by keeping costs of production low.
- They could help boost demand during periods of economic decline.
- Subsidies could encourage the consumption of merit goods, which creates positive externalities.
- Long run aggregate supply could increase if the subsidy is aimed towards a capital project.
- There could be government failure, if the government provides an inefficient subsidy or if the subsidy distorts the market price.
- Government revenue could be better spent elsewhere. The opportunity cost of the subsidy should be considered.
- It is usually the tax payer who pays for the subsidy, and they might not receive any direct benefit from the subsidy.
- If demand is price inelastic, the subsidy will have a large effect on equilibrium price. This give a greater consumer gain than when demand is elastic.



- If demand is price elastic, the subsidy will have a large effect on quantity, and therefore benefit producers more.



- **Producer and Consumer Subsidies**



- A consumer subsidy encourages consumers to purchase more of a particular good or service. It could be a direct grant or a loan without interest, for example.
- Consumer subsidies affect demand and do not shift the supply curve.
- Producer subsidies lower the cost of production and shift the supply curve.