

# Why do governments provide subsidies?

Subsidies can be paid to producers towards their costs of production

But why do governments want to increase the supply and reduce the prices of some products?

- to make products more affordable for those on the lowest incomes, e.g. basic foodstuffs
- to encourage their consumption because it can be beneficial e.g. medicines
- to encourage their development and production because it is beneficial and creates employment,
- e.g. wind turbines and solar energy panels



# Justifications for Subsidies for Producers

Subsidies are a form of government intervention. They are introduced for a variety of **economic, social & political reasons**



Help poorer families  
e.g. food and child  
care costs



Encourage output  
and investment in  
fledgling sectors



Protect jobs in loss-  
making industries



Make some health  
care treatments  
more affordable



Reduce the cost of  
training & employing  
workers



Achieve a more  
equitable income  
distribution



Reduce external  
costs of transport



Encourage arts and  
other cultural  
services

# Different forms of subsidies

- direct cash payments.
- low-interest or interest-free loans (to college students for example).
- tax relief (paying lower or no tax).
- provision of goods and services at below market prices

In this section of the syllabus, we consider only amounts of money paid by the government to a firm, per unit of output. A subsidy is an amount of money granted by the government to encourage/increase output.



# Merit goods vs. Demerit goods

Merit goods are good or services that are beneficial to society, because they are sources of positive externalities (increase society welfare)

E.g. ....

Demerit goods are the opposite of merit goods. They are goods or services which consumption is considered harmful to society, and therefore decrease society's welfare

E.g. ....



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Merit goods are those goods and services that the **government** feels that people will under-consume, and which ought to be **subsidised** or provided free at the point of **use** so that **consumption** does not depend primarily on the ability to **pay** for the good or **service**.



Health programmes



Early years education e.g. nursery provision



Subsidised Bike Schemes



Public libraries / community spaces



Museums and Galleries



Free school meals / nutritional advice



De-merit goods are thought to be 'bad' for you - this statement implies that a value judgement is being made. Examples include the external costs arising from consumption of alcohol, fast-food, cigarettes and drugs together with the social effects of addiction to gambling.



**High Caffeine Energy Drinks**



**High-fat, high-sugar & high-salt foods**



**Violent films and games**



**Hands-free mobile phones in vehicles**



**Alcohol fraud and binge drinking**



**Tobacco products**

Improve **resource allocation** and correct for positive externalities

**Increase revenues** and incomes of producers

Encourage the **export** of certain goods

Reasons why governments grant subsidies

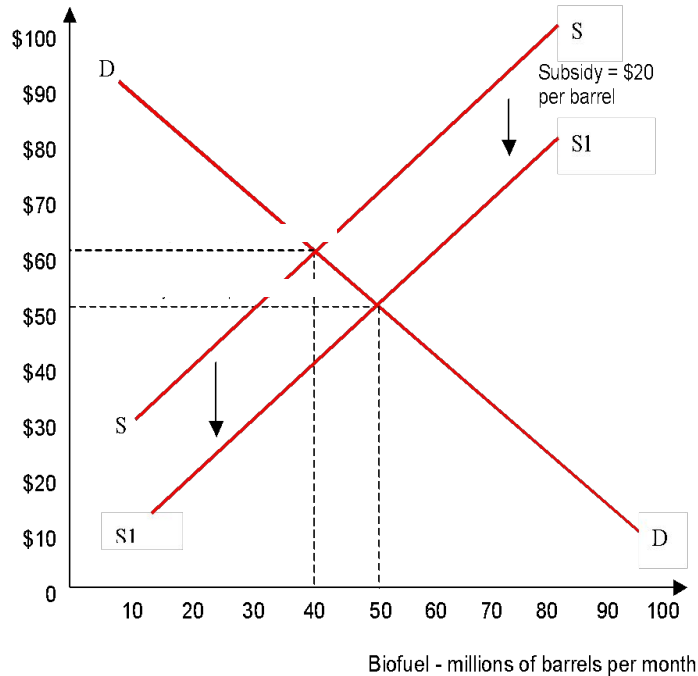
Make certain goods and services **affordable** to households on low-incomes

Support the **growth** of certain industries

Encourage the production and consumption of **merit goods**



# The effect of a subsidy diagram



**Objective:** to encourage the production and consumption of biofuel

**Before a subsidy of \$20 per barrel:** 40 million barrels of biofuel are supplied and traded each month at the market price of \$61 per barrel

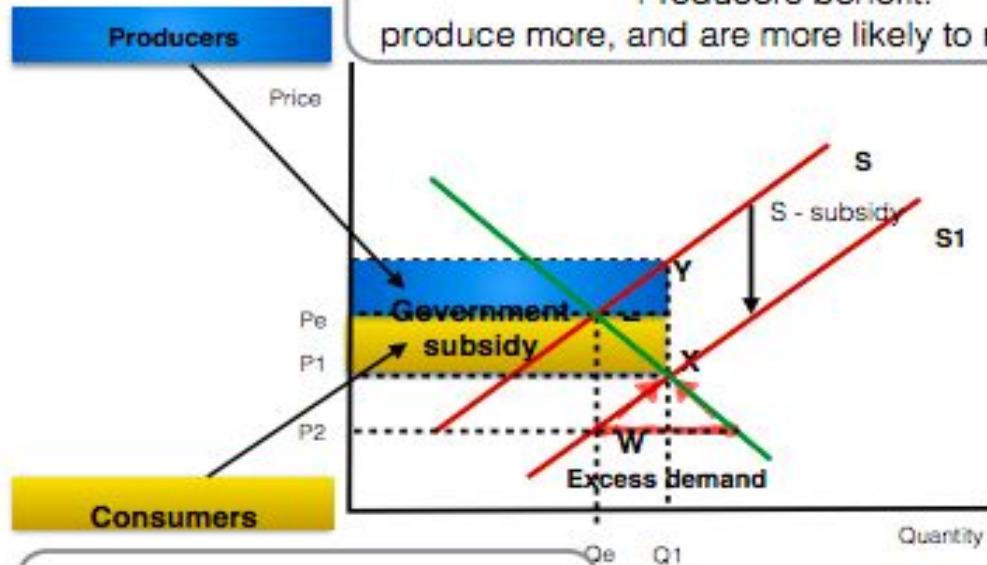
**After a subsidy of \$20 per barrel:** 50 million barrels of biofuel are supplied and traded each month at a new market price of \$51 per barrel

**But why doesn't the market price fall from \$61 to \$41 per barrel?**

Because at \$40 there is an Excess of Demand and remember that producers are driven by a profit motive and so will raise the price rather than pass the full \$20 production cost onto the consumer.

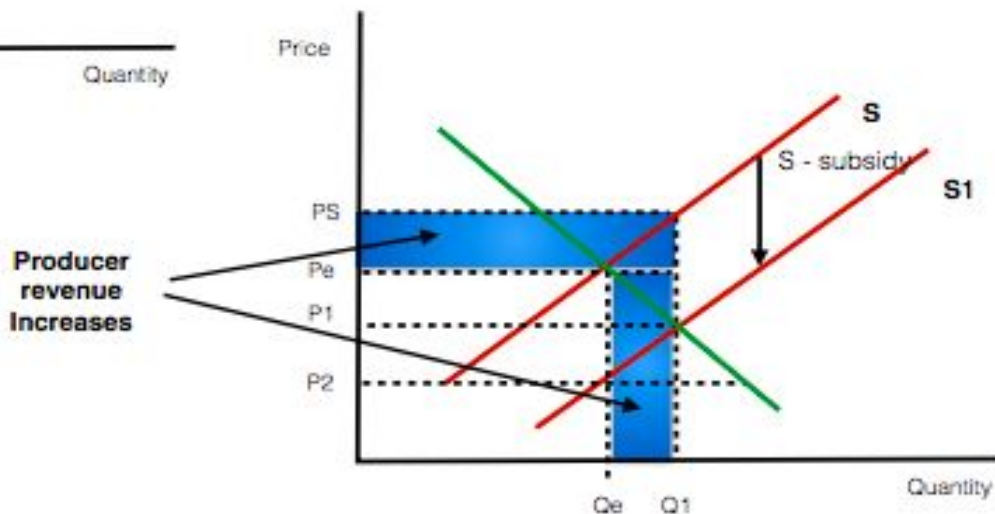


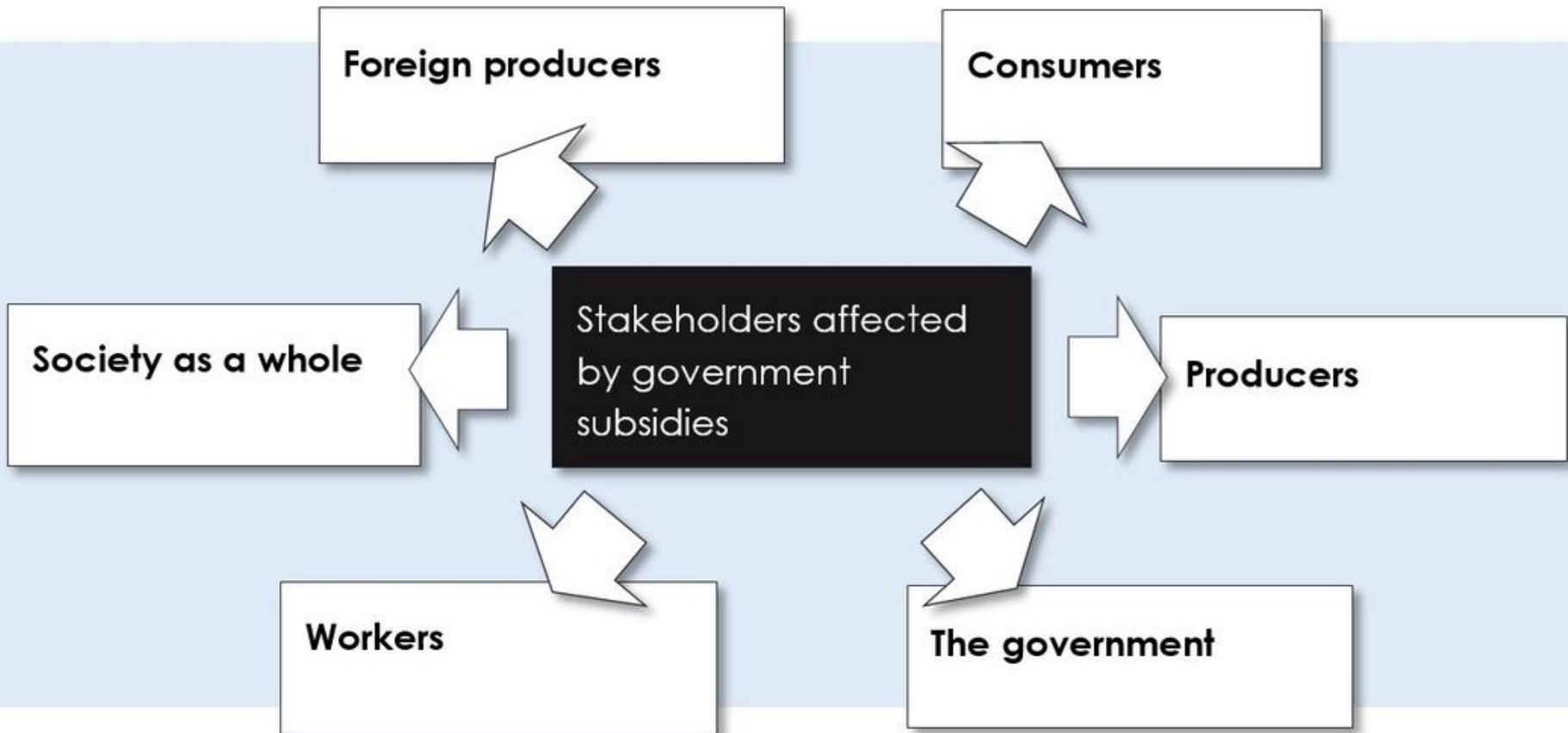
Producers benefit:  
produce more, and are more likely to make profits.



Consumers are better off:  
they pay lower prices ( $P_e$  to  $P_1$ ),  
and receive more ( $Q_e$  to  $Q_1$ ).  
Consumer surplus expands.

At the equilibrium price  $P_e$ ,  $Q_e$  is demanded.  
If the government grants a subsidy equivalent to  $XY$ ,  
the supply curve shifts downwards from  $S$  to  $S_1$   
(the subsidy is equivalent to a reduction of costs).  
The producer could pass on this reduction and lower  
the price to  $P_2$ .  
At  $P_2$ , there is excess demand, and a pressure for  
price to go up, to a new equilibrium price  $P_1$ ,  
where  $Q_1$  is demanded and supplied.





# Workpoint 5.4

Cotton producers hope to benefit from Brazil's subsidy battle with the US. The article was written in March 2010.

Research the current situation with regard to US cotton subsidies. Have the C4 countries in Africa experienced a positive change in their circumstances?

# Take home assessment

Discuss the consequences of the introduction of an indirect tax on gasoline for consumers, producers and the government (15 marks)