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AS Economics

Producer Subsidies

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AS Economics: Government Intervention in the Price Mechanism

Revision Focus on Producer Subsidies

Should government money be used in the form of subsidies to help businesses in financial trouble? The age-old issue of the arguments for and against subsidy has resurfaced in recent years as several sectors of the economy have experienced difficulties. They range from farming to coal mining to steel production and the aviation industry. The consensus is probably that government subsidies may create more problems than they solve. And, that an existing market failure that might be used as part justification for a subsidy can serve to deepen the problem, giving rise to the existence of government failure arising from intervention in the price mechanism. Subsidies can have the effect of distorting the allocating of scarce resources and damage the competitiveness of markets.

State subsidies are certainly an important issue within the European Union. The EU Competition Commission is concerned to gradually reduce the scale of state aid given to businesses operating within the EU. The aim is to provide more of a level playing field between competing suppliers. There remain loop-holes in the system because state aid is permitted if it is part of a restructuring process for industries in long-term decline or where there is substantial excess capacity.

The subsidy issue is also important as the European Union expands to twenty five nations in May 2004. The majority of the new entrants to the EU are transition economies, still in the process of making the adjustment from state-owned and state-financed production to the position of a largely private-owned economy having to compete in European markets.

(I) what is a Government Subsidy?

- A subsidy is a payment by the government to suppliers that reduce their costs and encourage them to increase output.
- The effect of a government subsidy is to increase supply and (ceteris paribus) reduce the market equilibrium price. 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

(II) Different Types of Producer Subsidy:

(1) **A guaranteed payment on the factor cost of a product**

a. Example

(2) **An input subsidy** which subsidises the cost of certain inputs used in production

a. Example

(3) **Government grants to cover losses made by a business**

a. Example

(4) **Financial assistance (loans and grants)** for businesses setting up in areas of high unemployment

a. Example

(III) Consumer subsidies

A government payment to consumers designed to allow them to purchase more of a good or service. Might take the form of

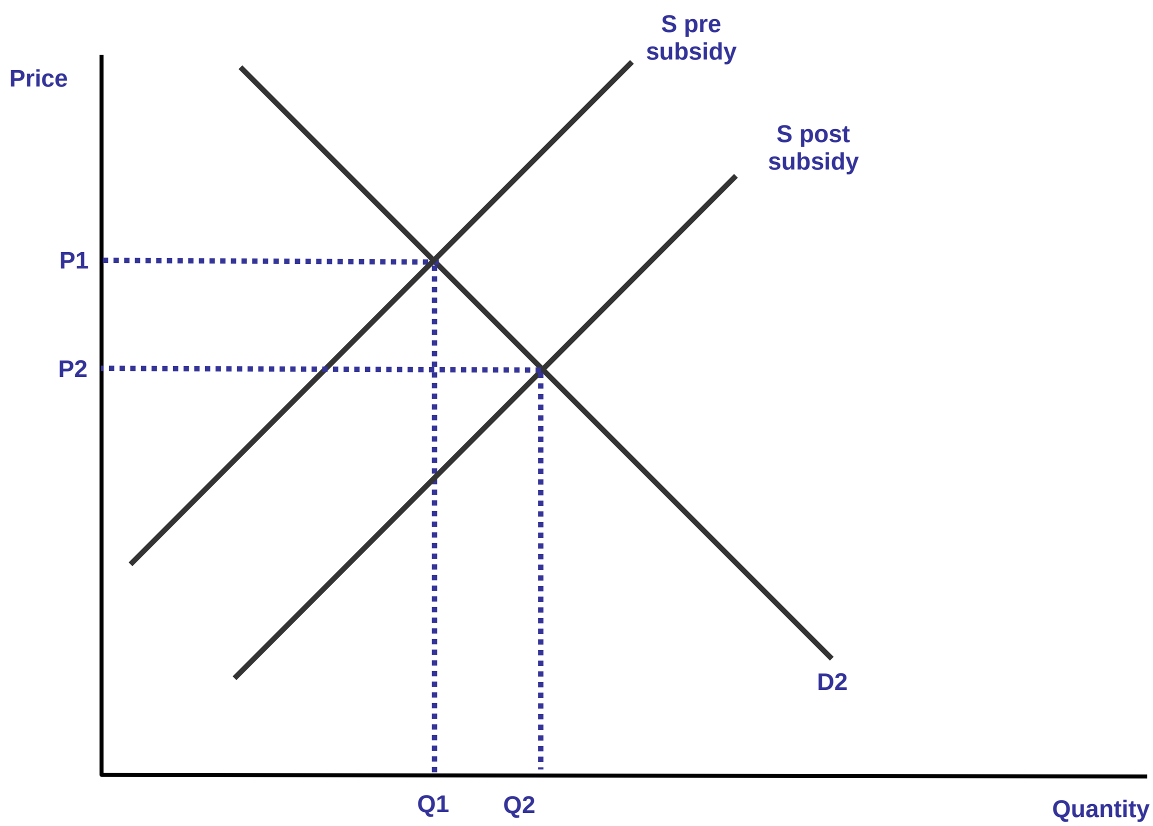
(a) Interest free loans (an effective subsidy)

a. Example:

(b) Direct grants to consumers

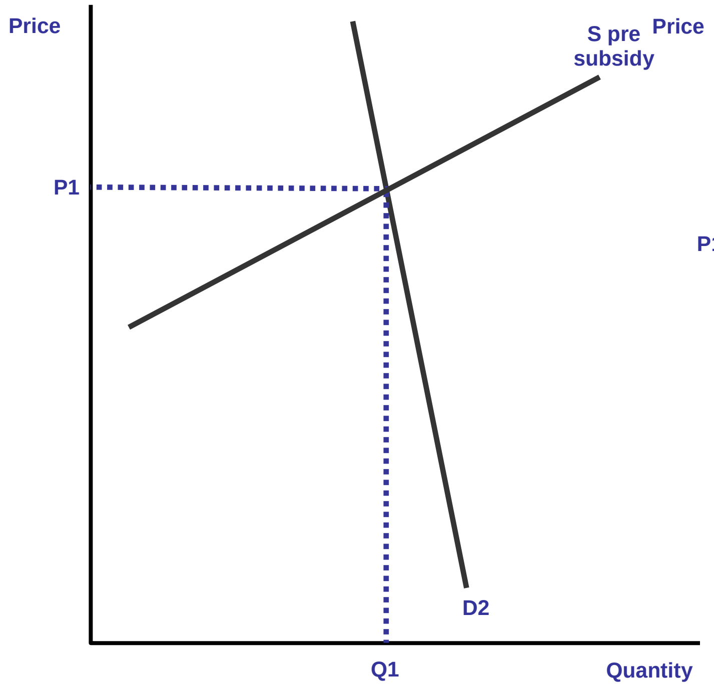
a. Example

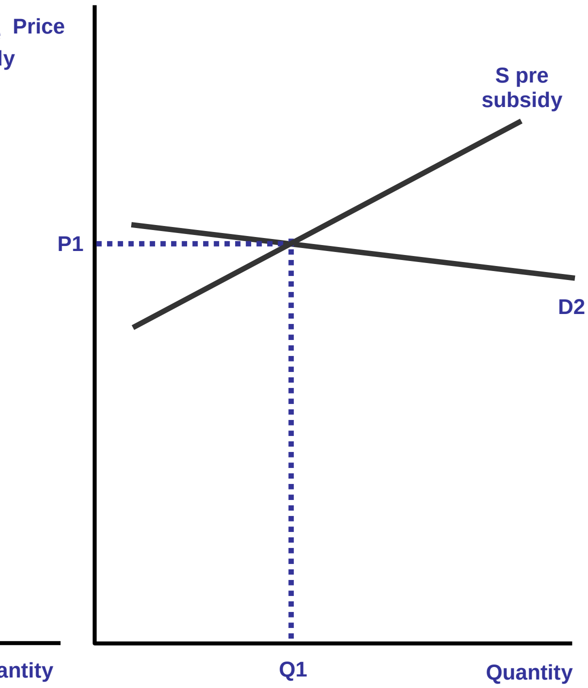
Showing the effect of a subsidy to producers

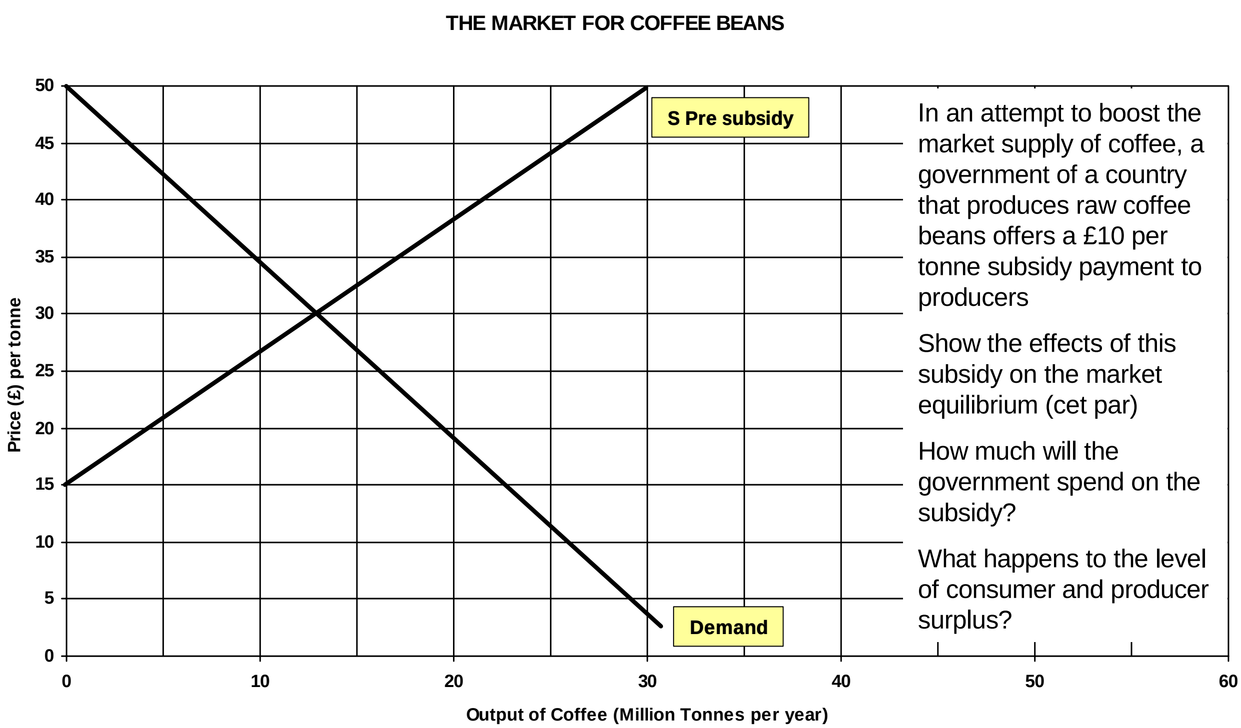


To what extent will a subsidy feed through to lower prices for consumers?

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.







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 Economic and Social Justifications for Government 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 **control the rate of inflation** and boost the real living standards of some groups of consumers

(2) To encourage the provision and consumption of **merit goods and services** which are said to generate **positive externalities** (increased social benefits). Under-consumption or provision of merit goods can lead to market failure

(3) **Maintain or increase the revenues (incomes) of producers** during times of special difficulties in markets

(4) **Reduce the cost of capital investment projects –** which might help to stimulate economic growth

(5) **Subsidies to smooth or slow-down the process of long term structural change/decline in an industry** (for example in farming, coal, fishing and steel)

(6) **Boost employment for certain groups of workers** e.g. the long term unemployed

Subsidies in the News

Current issues regarding subsidies

(1) The railways:

Government financial help to the ailing railway industry in the UK has accelerated since 2000 the year of the Hatfield rail disaster. In 2001 total state aid to the UK railway sector was Euro 6.8 billion, over twice the level of 1997 and nearly two-thirds of total UK government financial assistance. Much of the extra state funding is required to over-haul the track infrastructure and meet requirements for improving passenger safety. Network Rail is the successor the Railtrack which was forced into administration in October 2001. Network Rail is run on a not-for-profit basis whose funding for rail maintenance comes from the Strategic Rail Authority (SRA) and from access charges to the train operating companies. The SRA also offers subsidies to the majority of the train operating companies to ensure the provision of loss-making services.

(2) The coal industry:

There has been a huge decline in the scale of coal production in the UK over the last twenty years. Much of our demand for coal now comes from cheaper imports from countries such as South Africa and demand has also been affected by the switch towards gas partly on grounds of the environmental effects of using sulphur-rich coal. Is there a case for continued subsidy of what remains of our coal industry? Thousands of jobs still depend directly or indirectly on keeping the few remaining pits open even if, on purely economic grounds, there is little justification in maintaining production. On grounds of equity, the government may decide that further financial assistance is required to prevent structural unemployment and poverty in areas where coal mining is still an important source of employment. There may also be a strategic motivation behind subsidies - to give the UK an alternative fuel supply if gas and oil are cut off.

(3) Agriculture:

Farm subsidies invariably give rise to strong opinions and controversy. All countries subsidise their agricultural sectors to one degree or another. Farmers in the UK currently receive around £2 billion worth of subsidy under the Common Agricultural Policy (CAP). The Fischler Reforms to the CAP are now being implemented and seem certain to have a significant effect on the farming industry in the years to come. At the heart of the reforms is the concept of de-coupling - removing the direct link between how much farmers produce and the subsidy that they can claim. There will be a switching of CAP funds away from production incentives towards rural economic development and diversification. Farmers will be paid an income to reflect their contribution to maintaining the rural environment and subject to them meeting tough standards for good farming practice. Inevitably the reduction in production subsidies will affect some farmers more than others.

Evaluation: The Economic Arguments against Producer Subsidies

Many economists believe that subsidies have a damaging effect on the way in which the free market mechanism allocates scarce resources.

(i) **Distortion of the Market:**

a. Subsidies distort market prices - this can lead to a misallocation of resources – many economists believe that the free-market mechanism works best

b. **Export subsidies** distort the free trade in goods and services and can severely curtail the ability of ELDCs to compete in the markets of industrialised countries

(ii) **Arbitrary Assistance**: Decisions about which groups or industries receive a subsidy can be arbitrary – if tourism is supported, why not the British steel industry?

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

a. **Example:** The financial cost of the EU Common Agricultural Policy

(iv) **Who pays? Who benefits?:** The final cost of a subsidy usually falls on consumers (tax-payers) who themselves may have derived no benefit from the subsidy

(v) **Encouraging inefficiency:** 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

(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, for example by direct income support through the tax and benefit system

Adapted from BBC News Online, April 2002