

Subsidies

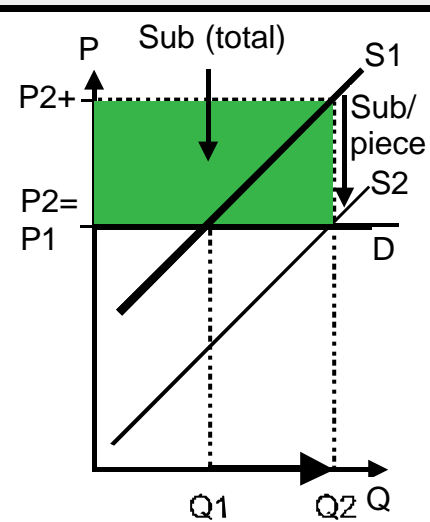
1 Example

A Government introduces a subsidy in favour of an infant industry, for example \$ 1 per piece, payable to the suppliers. Who profits from such a subsidy?

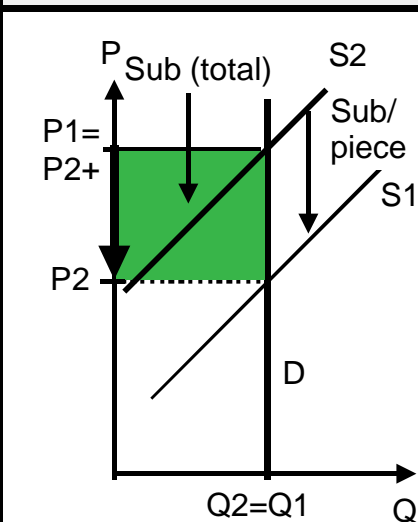
2 Effects of a subsidy (Sub)

The answer depends on the price elasticity of demand (e). Three different cases can be distinguished.

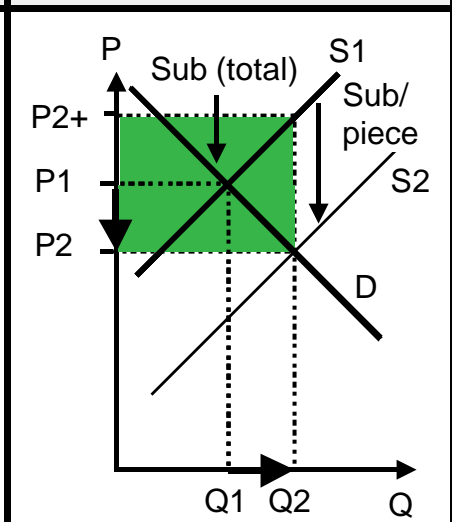
21 $e = \text{infinite}$



22 $e = 0$



23 $0 < e < \text{infinite}$



Abbreviations

P = Price Q = Quantity

D = Demand

S = Supply

+ = subsidy included

Situation for the buyers:

Old price P1

New price P2

Situation for the sellers:

Old revenue per piece = P1

New revenue per piece = P2+

→ total revenue = P1 * Q1

→ total revenue = P2+ * Q2

Result

- Price remains the same ($P2=P1$); Q rises from Q1 to Q2.
- For the sellers, average revenue rises by the subsidy per piece, total revenue rises for 2 reasons: subsidy **and** increase in Q from Q1 to Q2. **Sellers profit from subsidy.**

Result

- Price falls from P1 to P2 (by the amount of subsidy per piece). Quantity remains unchanged.
- **Buyers profit from subsidy.**
- For the sellers, both average revenue and total revenue remain the same ($P1 * Q1 = P2+ * Q2$).

Result

- Price falls from P1 to P2, quantity rises from Q1 to Q2. The decrease in prices is less than the subsidy per piece.
- For the sellers, average revenue rises from P1 to P2+. The increase is less than the subsidy per piece. Total revenue rises from $P1 * Q1$ to $P2+ * Q2$.
- **Sellers and buyers profit from subsidy.**