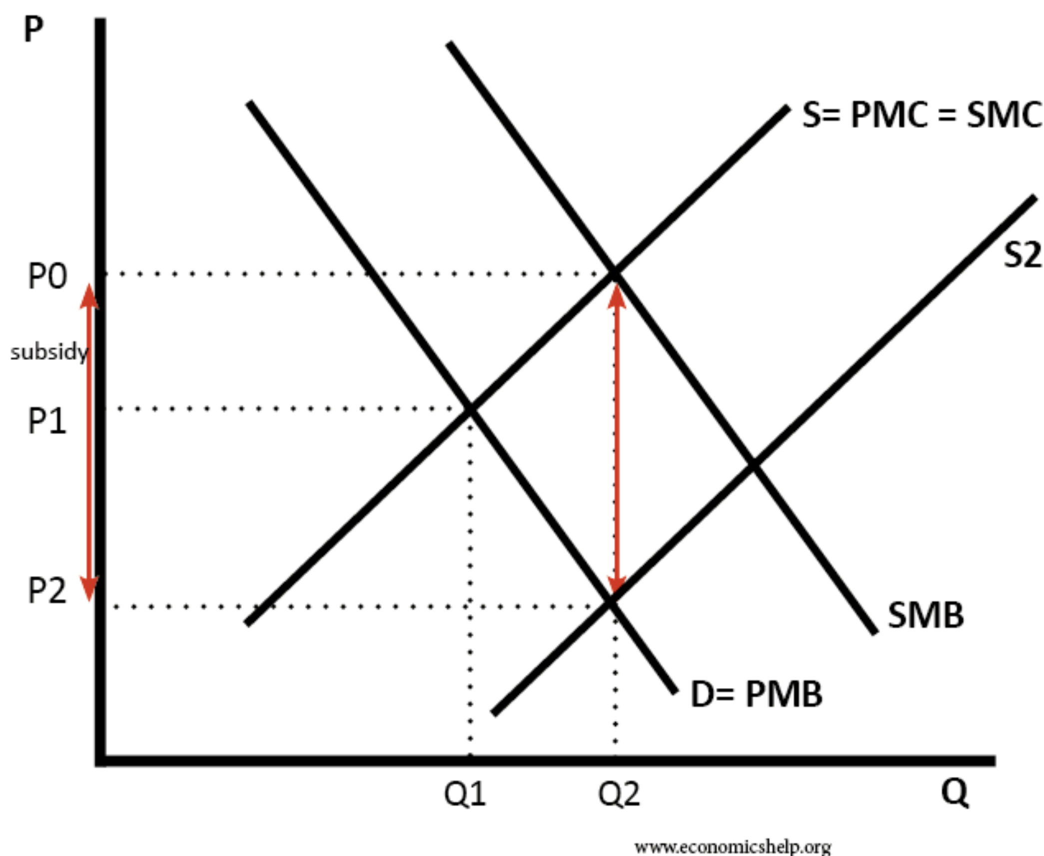
Subsidy to overcome market failure



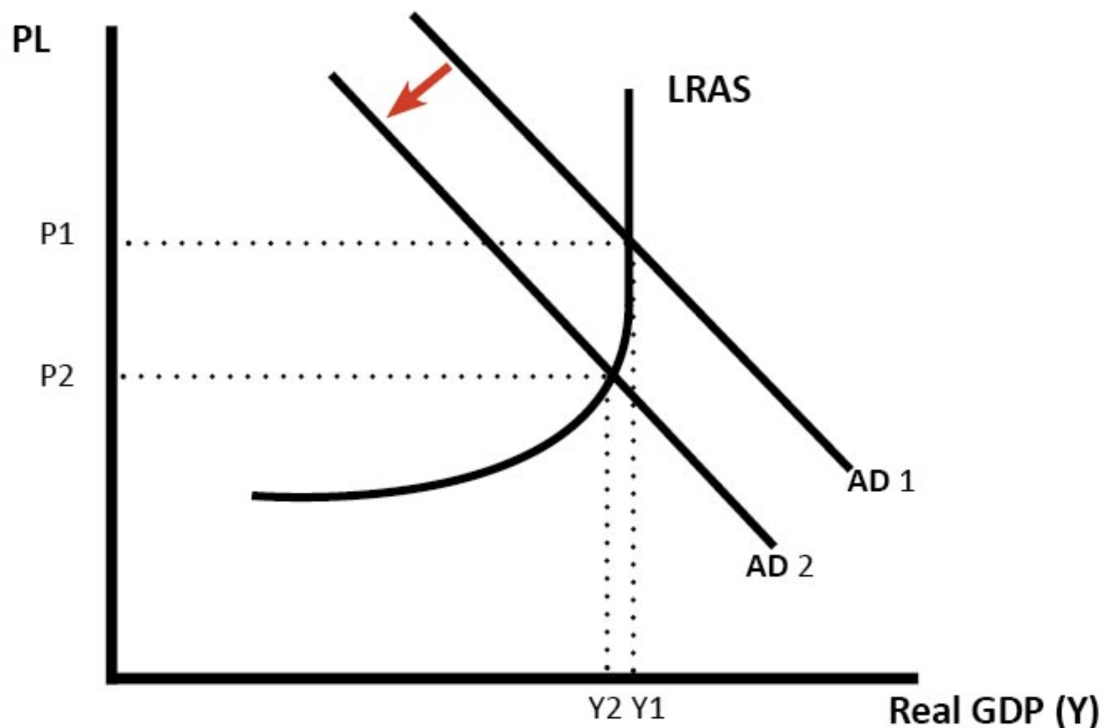
- In this example, the free market equilibrium is at Q1, P1 (S=D).
- A subsidy of P0-P2 shifts the supply curve to S2 and reduces price to P2. At this price, the quantity demanded is Q2. This is a socially efficient level because at Q2, SMB=SMC.

Evaluation of subsidies

- Cost to the government. Subsidies will be expensive and will require higher taxes on other goods.
- If demand is inelastic, a subsidy will be ineffective in increasing demand. For example, a subsidy on train travel may be ineffective if it is a poor substitute to driving a car.
- A firm that receives a subsidy is more likely to be inefficient, as they become reliant on the government subsidy. Subsidies may keep inefficient firms in business.
- There may be government failure, e.g. the government has poor information about who to subsidise.
- Subsidies may be most effective if combined with other policies, e.g. tax on driving and using money to provide alternatives to driving into town, e.g. cheaper buses.

Deflationary fiscal policy **(tight fiscal policy)**

- This involves higher tax rates and/or lower government spending.
- The aim of deflationary fiscal policy is to decrease AD and inflation.
- Deflationary fiscal policy will also improve the budget deficit.



Evaluation of fiscal policy

1. **Poor information** may reduce the accuracy of forecasting future economic growth and inflation. Therefore, the government may be unsure whether they need to boost AD or reduce AD.
2. **It depends on other components of AD**. For example, if the government cut income tax to increase AD, it may be ineffective if consumer confidence is low and people just save the extra income.
3. **Disincentives to work**. Higher income tax to reduce inflation can create disincentives to work - reducing productivity and LRAS.
4. **Time lag** involved in influencing AD. If the government wanted to increase AD, they could commit to more government spending. But, there will be delays in actually implementing higher spending, and then delays in this spending affecting the wider economy.
5. **Budget deficits.** Expansionary fiscal policy (higher spending, lower tax) will increase government borrowing. This could lead to higher interest rates in the long term or even cause markets to lose confidence in government debt levels.
6. **Crowding out**. If the government spend more by borrowing from private sector – it may reduce the amount of money the private sector has to spend.

7. In practise, governments find it difficult to ‘fine tune’ the economy with fiscal policy. But, in major recession, they may try expansionary fiscal policy.