Optimal Subsidy Policy and Welfare

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Abstract
I develop a general equilibrium model with non-homothetic preferences and monopolistic competition. In this model, firms are heterogenous with respect to their productivity. A benevolent government collects proportional income tax and subsidizes the new entreprenuers who want to enter the market. Given this framework, this model investigates the optimal tax and subsidy policies which maximize the social welfare. I show that optimal subsidy policy has two main impacts on economy. First, this policy leads more operating firms (i.e. more entreprenuers) in the economy namley, extensive margin. Second, such policy yields an increase in the average productivity of the economy. In other words, each operating firm can produce more output at lower prices, namley intensive margin. The contribution of this paper is the non-homothetic set up of preferences which yields impact on both margins: intensive and extensive. These two impacts increase the social welfare compared to no tax and subsidy case. In contrast, standard CES preferences yields only one source of impact: intensive margin. Moreover, this model also analyzes the case with moral hazard in which the firms are using subsidies just for consumption goods instead of benefical expenses for firms.

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