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Social Safety Nets Primer Notes

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Price and Tax Subsidies: Effectiveness and Challenges

Many governments use price and tax subsidization to meet social protection objectives. They endeavor to reduce the cost of living for their population—or for a subset of the population—by subsidizing the price of goods or services in lieu of, or in addition to, direct income transfers. While these subsidies may distort production incentives, subsidize the non-poor more than the poor, and limit consumer choice, there are reasons why a government may choose to use some forms of pricing policy rather than make income transfers to help the poor:

- Subsidies can be used to promote socially desirable policies, such as investment in education or healthy nutrition.
- Subsidies can be used to encourage at least a minimum level of consumption of certain goods—sometimes termed 'merit' goods—which are given extra weight in economic calculations.
- It is sometimes easier to obtain political support for commodity subsidies than for direct income transfers.
- Subsidies may be easier to administer than income transfers.
- Subsidies may be more effective than transfers when commodity markets are under-developed. For example, income support alone cannot counter a famine if there is no network for food distribution.

Forms of Subsidies

The most common form of price subsidy is a direct, untargeted subsidy. However, various other means may be used as well: untargeted indirect price subsidies, exemptions under value-added or other sales taxes, dual exchange rates, export taxes, producer quotas, subsidies on transport and storage, and domestic sales of a commodity below international opportunity cost. Subsidies on goods available in a rationed amount are a less costly alternative to open ended subsidies on the entire supply of a good.

Benefits and Effects

Price subsidies are most commonly assessed in terms of their incidence—that is, who benefits from the subsidy. In general, who gets the subsidy or who does not depends on a number of policy decisions regarding which commodities are chosen, what type of targeting, if any, is used, and what marketing channels are employed.

For many commodities, including most commonly consumed grains, wealthier households consume more and thus receive larger transfers in absolute terms, making the subsidies poorly targeted. Nonetheless, the amount of transfer that a poor household receives will be a larger share of its budget than for a non-poor household so that a reduction in subsidies will disproportionately hurt the poor. Some goods—meat is an example—are inappropriate vehicles for redistribution as subsidies on them will not only accrue mainly to the rich but will actually increase welfare inequality.

A few governments have been able to subsidize goods for which consumption declines as incomes increase. These 'self-targeted' subsidies avoid the problems of gathering information on each household to determine benefit eligibility, as with

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a means test, and yet can result in aid directed to the poorest households. Even so, the poorest 40 per cent of the population receives only a half to two-thirds of the benefits of the most successful self-targeted subsidies, compared to more than four-fifths of the benefits of a means-tested transfer program.

With many food subsidies, policymakers are concerned more with the impact on total nutrient consumption rather than with the level of the transfer. And there is substantial evidence that subsidies on specific foods do affect nutrient consumption in a manner different than income transfers. The reduced price will have a direct influence on purchases of commodities with general subsidies and for rations that exceed the amount normally purchased. But even in the case of quotas and food stamps there is evidence that the presence of food-related transfers encourages increased consumption of food, possibly due to changes in the share of resources controlled by women.

Challenges

The main challenge for a successful subsidy program is to select the right type of commodity that will not create distortions in the market and that will provide additional benefits to the intended consumers.

There are also administrative challenges to consider. Many subsidy programs require at least one distribution network, and some systems may require two: one for any coupons or ration certification and one for the commodities themselves. The costs of these systems may be appreciably higher than the costs of private marketing.

As well, appropriate control systems are needed to limit the sale of subsidized commodities in the higher priced general market through 'back-door' sales. To help control subsidy programs, technology—in the form of cards suitable for scanning—can provide cost-effective monitoring mechanisms, though this solution may be problematic in communities without sources of power for scanning devices.

Finally, government intervention may have adverse consequences. For example, public-sector transportation and storage of grain might be justified by the lack of a private market able to handle the volume of trade that is needed for a national subsidy program, but it may also limit the development of an efficient private marketing sector.

The Politics of Subsidies and Reforms

Few governments have introduced new general food price subsidies recently, and many have reformed existing systems of subsidies. The politics of subsidies and subsidy reform are fraught with conflicting positions and diverse interests involving international agencies, local communities, ministries of agriculture (which represent farmers' interests), ministries of food (which represent consumers' interests), and finally ministries of finance (which are in charge of the national budget).

The nature and timing of subsidy reforms depend on many factors, including the interplay of diverse interests expressed by local groups and international agencies. Balancing the different interests is not easy, but country experiences suggest that the public is more likely to accept a policy change if: a) they are told the rationale behind it in advance; b) credible policies and safety net programs are introduced when the inefficient program is reformed; c) coalitions of public support offset opposition from interest groups who benefit from the subsidies to be abolished; and d) targeted programs or income transfers are introduced when international prices rise.

The World Bank Social Safety Nets Primer series is intended to provide a practical resource for those engaged in the design and implementation of safety net programs around the world. Readers will find information on good practices for a variety of types of interventions, country contexts, themes and target groups, as well as current thinking on the role of social safety nets in the broader development agenda.

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