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

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 trans-
fer program.

With many food subsidies, policymakers are con-
cerned 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 con-
sumption in a manner different than income
transfers. The reduced price will have a direct
influence on purchases of commodities with gen-
eral 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, pos-
sibly due to changes in the share of resources
controlled by women.

**Challenges**
The main challenge for a successful subsidy pro-
gram 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 con-
sider. Many subsidy programs require at least one
distribution network, and some systems may
require two: one for any coupons or ration certifi-
cation 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, technol-
ogy—in the form of cards suitable for scanning—
can provide cost-effective monitoring mecha-
nisms, 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 jus-
tified by the lack of a private market able to han-
dle the volume of trade that is needed for a
national subsidy program, but it may also limit
the development of an efficient private market-
egger 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 poli-
tics of subsidies and subsidy reform are fraught
with conflicting positions and diverse interests
involving international agencies, local communi-
ties, ministries of agriculture (which represent
farmers’ interests), ministries of food (which rep-
resent consumers’ interests), and finally minis-
tries 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.