24 Some Microeconomic Policy Implications of Consumer-Oriented Food Subsidies

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Some of the most important macroeconomic policy implications derived from the studies and policy experience reported in this book were discussed in chapter 23. This chapter attempts to summarize the microeconomic policy implications, with emphasis on lessons useful for the choice, design, modifications, and implementation of future food policy measures, including food subsidies.

Worldwide recession plus severe foreign exchange problems in many developing countries, along with high fiscal costs of explicit subsidies and large economic costs of price distortions to producers, are putting pressure on governments to reduce or eliminate consumer-oriented food subsidies. However, many subsidies have significantly increased the purchasing power of the poor and have reduced the risk of food shortages and price fluctuations for poor households. Attempts to eliminate subsidies could result in severe hardships and are likely to be met with strong resistance. Such resistance is amplified because the economic costs of food subsidies and other price distortions—and thus the potential gains from eliminating them—are generally not fully perceived by the general population. Furthermore, the gains from removing the subsidies may not accrue to those who benefit from the subsidies.

The long-run net effect of food price subsidies on incomes of wage earners is less than the income transfer embodied in the subsidies, because wages tend to adjust to changing food prices. This is particularly pronounced in cases where minimum wage laws or labor unions are able to maintain at least a certain degree of indexing between prices and wages. Thus at least part of the transfer is passed on to other sectors of the economy. This implies that government savings from reduced food subsidies would be partly offset by increasing public sector wages. This occurred in Sri Lanka and would be likely to occur in Bangladesh, Egypt, and probably most other countries. In some countries, food subsidies are in fact viewed as partial wages to public sector employees, including military personnel, and may be designed with this in mind.

Government savings from reducing or removing explicit food subsidies may also be less than expected, because a large share of the subsidy cost is borne by donors of foreign food aid. In fact, some food subsidy programs based on foreign food aid have resulted in net gains to governments, as shown by Ahmed for Bangladesh (chapter 15), thus providing a source of government revenue that would disappear if both food aid and subsidies were discontinued. If on the other hand foreign food aid is maintained and subsidies are discontinued, domestic food demand will decrease, and strong downward pressures on domestic agricultural prices and associated increases in economic costs are likely to result unless commercial imports are reduced.

As illustrated by the above discussion, an assessment of the benefits and costs of consumer food subsidies is not straightforward and should be undertaken within the socioeconomic and political context of which they are part. While ideological convictions may lead to sweeping generalizations as to whether food subsidies are good or bad, such generalizations are of little value in pragmatic policymaking, because they ignore political realities and potential economic trade-offs among policy measures.

One of the key lessons learned from the research and policy experience reported here is that consumer food subsidies may be appropriate and cost-effective components of government policies to achieve growth and equity goals—or they may be inappropriate and cost ineffective. They clearly have a role to play for some countries during some periods in efforts to reach social, economic, and political objectives. However, in many cases this role has not been properly specified, and failure to design or modify subsidy programs to achieve the objectives in the most cost-effective manner and failure to discontinue or replace inappropriate programs have resulted in high fiscal and economic costs and misallocations of resources and transfers. Correcting inefficiencies in program design and implementation offer opportunities for reducing costs and increasing benefits to intended beneficiaries, thus improving overall cost effectiveness. Similarly, introducing appropriately designed subsidy programs when they offer the best option for achieving certain goals—for example, short-term compensation to population groups that lose from macroeconomic adjustments—could greatly improve the cost effectiveness of the overall policy package. The challenge is to identify conditions in which consumer food subsidies are appropriate policy measures and to improve their cost effectiveness.

When Are Consumer Food Subsidies Appropriate?

Consumer food subsidies are rarely, if ever, the most efficient measure to deal with long-term structural problems in the economy. On the contrary, they may contribute to such problems. Their proper role is to compensate for the effects of inappropriate development strategies, institutional changes, and policy measures. Thus the need for consumer food subsidies to enhance the purchasing power of the poor and to lower food prices should be decreased by a development strategy that emphasizes employment generation among the poor, by cost-saving technological change in food production, by investments in rural infrastructure, and by improvements in food marketing. Such institutional improvements may also reduce fluctuations in food prices and food availability. Last but not least, institutional changes and policy measures that provide the poor access to productive assets and skills could greatly reduce the need to enhance their incomes through food subsidies.

However, in societies where the development strategy is biased toward capital-intensive urban development rather than employment-intensive rural development, where too little emphasis is placed on expanding food production at lower unit costs and on reducing food marketing costs, where marketing institutions are not effective in dealing with price fluctuations, or where the poor do not have effective access to sufficient productive resources to assure a minimum living standard, consumer food subsidies may have an important role. Food subsidies frequently exist amidst other distortions in capital and product markets, including explicit subsidies on energy, transportation (mass transit as well as national airlines), telephones, and other goods and services. In such cases, it is not clear that priority should be placed on reducing or eliminating food subsidies over other distortions. In fact, food subsidies may be needed to compensate the poor for negative effects of regressive distortions.

Based on the evidence presented in this book, it may be concluded that consumer food subsidies, if properly designed and implemented, may be very effective in reducing the insecurity of access to food at the household level by making fixed rations available at predetermined prices. They may also be very effective in enhancing the short-run purchasing power of the poor. Whether this is achieved in a cost-effective manner depends on the design and implementation of the program. Furthermore, although few subsidy programs have attempted to create or enhance the income-generating ability of the poor in a self-sustained manner, such opportunities clearly exist if the programs are designed and implemented accordingly. Finally, the appropriateness of consumer food subsidies should be assessed in the light of other types of programs. Relative cost effectiveness offers an effective indicator for program choice as well as the most appropriate design and implementation of consumer food subsidies. Ways of assuring high cost-effectiveness are discussed in the next section.

Improving the Cost Effectiveness of Food Subsidies

Program Design and Implementation

The magnitudes of benefits and costs, the way they are distributed, and the extent to which goals are met vary among programs and are influenced by program design and implementation. Modifications of existing programs may improve their performance. However, for such modifications to be successful, program goals must be clearly specified. Pursuing rationing or price stabilization goals efficiently may require programs that are different from those needed to assure efficient income transfers. Similarly, if the goal is to improve nutrition rather than to transfer income, the most cost-effective program design may be different.

Many existing programs and policies have changed over time, from being primarily public distribution schemes aimed at assuring households access to certain rations of basic staples at fixed prices to much more costly food-linked income transfer programs. In some cases, the transition has been by default rather through a change in policy goals and has been caused by an inability to increase the prices of food rations at the same rate as the price increases in the open market.

Targeting

Household targeting is a key element in achieving income transfer or nutrition goals at reduced costs. Although targeting conflicts with rationing goals if these are interpreted to include all households, targeting is compatible with rationing goals that include only the poor. Modifications in food subsidy programs toward targeting would be likely to reduce fiscal and economic costs, but they would also result in economic losses for nontarget households and therefore incur political opposition. The design and implementation of programs to reach target households and to exclude nontarget households are extremely difficult. The difficulties are due to political and logistical factors as well as to insufficient information. Nontarget households will oppose successful targeting, in some cases to the point of threatening political and social stability. Furthermore, administrative costs of operating subsidy and transfer programs increase with increasing targeting. This is of particular concern in those developing countries where trained manpower is scarce.

Thus for the above reasons, perfect targeting should not be attempted. There is a point beyond which increases in administrative costs, including the cost of identification of target households, exceed the savings from further reducing benefit leakage to nontarget households. Furthermore, as a program gets more narrowly targeted, the risk of excluding target households increases due to insufficient information. Finally, a program narrowly targeted on the poor is likely to have little political support in all but the most enlightened societies and—if implemented—may have a short life, as exemplified by the Colombian food stamp program.

Ideally, household targeting would be based on incomes of households adjusted for size and composition. However, reliable estimates of household incomes are not usually available, and efforts to obtain and periodically update such estimates would be extremely expensive and often impossible. Furthermore, households may move in and out of poverty or may need support only during certain periods. Therefore, flexibility as well as an exit criterion may be needed. Nevertheless, income and assets may be used to exclude the highest income groups.

As further elaborated in chapter 8, a larger number of other targeting mechanisms have been tried, some with success and others not. These include geographical targeting, targeting by the nutritional status of household members or by employment status, targeting by subsidizing inferior commodities or inferior qualities, and targeting in certain periods of the year where seasonal fluctuations severely limit the ability to acquire sufficient food. The most appropriate choice among the various targeting approaches depends on the particular circumstances within which subsidies are introduced. As a general rule, however, targeting approaches that contradict household behavior the least—for example, subsidies on less preferred foods—are most likely to be successful. Lack of success in targeting or high costs of targeting are frequently due to the desire and ability of nontarget households to circumvent targeting efforts. Removing their desire to do so would cut targeting costs.

In some cases, targeting may result in a stigma on certain population groups. This may lead to societal divisions and social and political instability, particularly if the target group tends to belong primarily to a distinct ethnic group.

Governments may consider targeting subsidy costs as an alternative to targeting subsidy benefits. The generation of revenues to cover subsidy costs through excise taxes on luxury goods and services is one example of such an approach; progressive income taxes is another. However, it is not clear that targeting costs is easier than targeting benefits.

The cost of implicit food subsidies are usually targeted on producers. While, as discussed in chapter 6, efforts to maintain consumer subsidies through artificially low producer prices may entail high economic costs, selective procurement need not. Government procurement of food from farmers at prices below free-market prices need not reduce incomes to the producer sector if the lower prices are passed on to low-income consumers in the form of a highly targeted food price subsidy and if the procured quantity is a small part of the quantity produced by a particular farmer. This is so because the scheme will result in an overall demand increase and in compensation to producers through higher prices for the quantity sold in the free market.

If such procurement is limited to large producers, small ones would benefit from the price increases without having to contribute to the cost of the subsidies. In the absence of changes in foreign trade of the commodity, the net result would be a transfer from high-income (nontarget) consumers to low-income (target) consumers and small producers. Whether large producers would lose or gain would depend on the price response among consumers and producers. Studies of the Indian procurement scheme for foodgrains (chapter 16; Mellor, 1968; Dantwala, 1967, 1981; Hayami, Subbarao, and Otsuka, 1982; and George, 1985) indicate that producers as well as low-income consumers may gain, at least in the short run, and that significant improvements in income distribution may be obtained with only small losses in economic efficiency if the subsidy scheme is effectively targeted on the poor rather than on most urban consumers, as is currently the case.

Distribution

Results from the work reported in this book indicate that private sector distribution of subsidized food can be very cost effective, often more than public distribution. Food stamps that may be redeemed in private stores are an obvious example. Even when the subsidy is embodied in a lower price for a certain commodity ration, it is unlikely that a separate public distribution network can operate at a lower cost or a lower degree of corruption and program abuse. Private distribution has been successfully used in a number of countries, including the Philippines and Egypt, at a relatively low cost. Household food security goals may not be fully achieved through private distribution in countries where a strong competitive market is absent or where the risk of political or social instability is high, but in most countries, investing in marketing infrastructure and activities to improve competition among marketing agents appears to be a more efficient strategy than maintaining a public sector food distribution network. Promoting small-scale private sector retailing, improving transportation, and investing in other private sector marketing activities are particularly promising because, in addition to being cost effective and reducing concentration of food marketing in the hands of a few, such a strategy will accelerate entrepreneurship and income generation among the poor.

Program Choice

The cost effectiveness of food subsidy programs may also be improved by a careful choice of program type. The two most common types are food stamps and price subsidies for specific rations or for unlimited quantities. The transfer effects of price subsidies for inframarginal rations would not be expected to differ greatly from food stamps for a given household. However, the degree to which rationing goals are achieved may vary greatly between the two program types. The critical issue is whether the household is assured a certain physical quantity at a fixed price or a certain monetary transfer. In the former, recipient households are assured a constant transfer in real terms, whereas in the latter, price fluctuations and increases in open-market prices may erode the real purchasing power of the transfer (but will reduce real fiscal costs), as illustrated by the food stamp program in Sri Lanka. In theory, the difference between the two programs could be eliminated if the ration price or the nominal value of food stamps was increased as fast as the open-market price. However, inaction by the government would result in increasing fiscal costs and constant or increasing benefits to the recipients of the ration price but decreasing benefits and fiscal costs for food stamps users.

The issue of appropriate adjustments in subsidized food prices and the effect on rationing and income transfers is particularly important during periods of devaluation of the local currency or of rapid food price increases in the international market. Maintaining fixed nominal prices for food staples in the face of devaluation and rapidly increasing domestic prices may result in large and unsustainable increases in the cost of food subsidies. On the other hand, if sharp increases in domestic prices are fully reflected in the price of basic staples, the poor may experience hardships that are economically and politically unsustainable. Social unrest caused at least in part by increasing food prices in a number of countries during the recent past illustrates this point.

Recent efforts to solve foreign debt and deficit-spending problems have included devaluation, higher agricultural prices, and reductions in spending on food subsidies and social programs in a number of countries. In some cases, it appears that the poor have borne a disproportionally large share of the burden of economic adjustment. Although these measures may be necessary to solve immediate foreign exchange problems and may result in accelerated long-term economic growth and employment, short-term implications for the poor may be such that compensatory measures are needed. Targeted food subsidies may be a cost-effective means for providing such compensation. Before such measures are designed, it is important to clarify which consumer groups the government wishes to compensate and whether such compensation will meet the stated goals.

Food price subsidies are but one of many ways in which governments may increase the purchasing power of the poor and compensate for losses in real incomes caused by needed adjustments or by an inappropriate development strategy. Tied or untied cash transfers as well as food transfers are available policy measures. Untied cash transfers tend to be less palatable politically than transfers linked to food, such as food stamps, targeted food price subsidies, and food supplementation schemes. Political resistance to programs directly aimed at a reduction in starvation and malnutrition is likely to be much less severe than political resistance to cash transfers, even when the former results in transfer of real income that is partially or fully fungible, such as most food stamp programs. Cash transfer programs are also very difficult to implement, and the cost of the necessary control measures to avoid fraud and excessive leakage to nontarget groups is likely to be high. Self-targeting, which may be possible if food subsidies are aimed at less desired foods, is not possible for cash transfers. Another argument that favors food transfers over cash transfers is that food subsidy and direct feeding schemes reduce food prices relative to other commodity prices and thus contribute to a substitution of food for nonfoods, which would not occur as a result of a direct income transfer. This argument holds true only if food becomes cheaper at the margin.

There is some evidence that the marginal propensity to consume food is higher for real incomes originating from food subsidy programs or direct feeding schemes than from cash transfers. The reason is probably to be found in differing preferences of household members and the relation between source of income and household budget control.

Finally, in comparing cash and food transfer schemes, it should be recognized that food may be available from foreign aid at a cost to governments considerably below its market value, thus making food-related transfer less expensive. In some cases, such food aid can be monetized by the recipient governments, while in many others, donor restrictions prohibit monetization.

In attempts to reduce leakages to nontarget households and to focus more sharply on improved nutrition, some countries have opted for food supplements or direct feeding of individuals deficient in calories and protein, usually children and pregnant and lactating women. School lunch programs and feeding of preschool children in health and nutrition clinics are examples of direct feeding. Such programs may assure that leakages to nontargeted households are small. However, intrahousehold leakages will occur through reductions in the allocation of food to target individuals. Furthermore, households may reduce food acquisition from other sources.

If nutritional improvement is the sole goal of a food subsidy program, its cost effectiveness is likely to be highest if combined with an integrated primary health care program, which may include growth monitoring, nutrition education, vaccinations, and various preventive and curative health measures. Malnutrition is likely to be caused by a set of factors, only some of which will be affected by a food subsidy per se. Therefore, since the effect of changing one factor—for example, purchasing power—depends on changing other factors—for example, anorexia caused by diarrhea, or low budget allocation to food due to poor nutrition knowledge—a combined program is likely to be more cost effective than a food subsidy program per se. Such an approach may also be used to identify target households through, for example, growth monitoring at the health center or in the homes.

An integrated approach implies a risk of overloading the primary health care system. Therefore, it is important that a sufficient addition be made to the resources available to the system. Furthermore, private retailers rather than the primary health care system should be charged with distribution of the subsidized food. This may be implemented by distributing food stamps to target households at health centers. More detailed discussions of alternatives to consumer food subsidies are presented in chapter 9 and in Pinstrup-Andersen (1987).

Concluding Remarks

Subsidies are, of course, only one means of keeping food prices low to the consumer. Improvements in the efficiency of food production through technological change, improved rural infrastructure, and expanded input use, as well as improved marketing efficiency, offer great opportunities for reduced consumer prices without adverse effects on producers and without large government outlays. Enhanced capacity of the poor to generate sufficient incomes to meet nutritional requirements and other demands provide the long-term means to meet welfare goals. Consumer food subsidies or alternative transfer programs should be viewed as temporary but important means to assure that the poor are able to acquire sufficient food to meet nutritional requirements while such capacity is being created.

Opportunities for using food subsidies to create self-sustained income-generating capacity among the poor have not been fully exploited and should be pursued. Such opportunities include the formation of human capital through improved health, nutrition, and education, as well as the use of subsidized food to facilitate the development of small-scale enterprises and other self-help activities by the large portion of the poor who are self-employed. Public work schemes offer promise in this regard. Furthermore, access to food subsidies along with credit and technical assistance during the initial phases of new private sector activities may greatly facilitate and expand small-scale entrepreneurship, increase incomes among the poor, and reduce the needs for food subsidies in the future. Furthermore, food subsidies may be effectively used to support community efforts to create the infrastructure needed to support local economic development. Ideally, the poor would gain first from participating through public works programs that generate infrastructure and, subsequently, through increased employment and new opportunities for small-scale entrepreneurship made possible by the newly created infrastructure. These relations are discussed in chapter 10.

In conclusion, the most important lesson learned from the research and policy experience presented in this book is that consumer food subsidies can be a powerful and cost-effective policy tool to reach certain social, economic, and political goals, or they can be harmful to growth and equity. As with so many other policy tools, the question is not whether consumer food subsidies are good or bad but when and how they are applied.