ECONSTOR
Make Your Publications Visible.

A Service of

ZBW Leibniz-Informationszentrum Wirtschaft
Leibniz Information Centre for Economics

Oschinski, Matthias

Research Report

Financing for development series: Are cash transfers a suitable alternative to energy and food subsidies?

Briefing Paper, No. 11/2008

Provided in Cooperation with:
German Institute of Development and Sustainability (IDOS), Bonn

Suggested Citation: Oschinski, Matthias (2008) : Financing for development series: Are cash transfers a suitable alternative to energy and food subsidies?, Briefing Paper, No. 11/2008, Deutsches Institut für Entwicklungspolitik (DIE), Bonn

This Version is available at:
https://hdl.handle.net/10419/199628

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

WWW.ECONSTOR.EU

Mitglied der Leibniz-Gemeinschaft

Deutsches Institut für Entwicklungspolitik
German Development Institute
d·i·e

Briefing paper 11/2008

Financing for Development Series: Are Cash Transfers a Suitable Alternative to Energy and Food Subsidies?

As rising energy and food prices reached their peak, subsidies have come under increased scrutiny as a means of supporting the poor. Not only do they put a severe strain on government budgets, more often than not they miss their target owing to leakages, corruption and price distortions. An alternative to subsidies may consist in conditional cash transfers to the poor. Whether they are a more efficient option for financing development goals depends, however, on a number of factors. First, conditional cash transfers are appropriate when structural poverty is, at least in part, due to a lack of demand. Second, a country needs to have both the administrative capacity for proper targeting and the means to monitor conditionalities accurately and to enforce them. Third, a viable exit strategy must be established to prevent families from falling back into extreme poverty once they become ineligible to participate. Finally, political will and public acceptance are essential for successful implementation.

The massive increase in energy and food prices at the beginning of this year has prompted a number of governments to re-evaluate their approach to subsidies on these items. On June 4th India decided to raise retail fuel prices by about 10 per cent and the price of cooking gas by 17 per cent. In a similar move, Malaysia increased petrol prices by 41 per cent and announced it would apply global market rates for fuel from August. In May Indonesia had already increased energy prices by 29 per cent. Taiwan and Bangladesh also announced they would review subsidies.

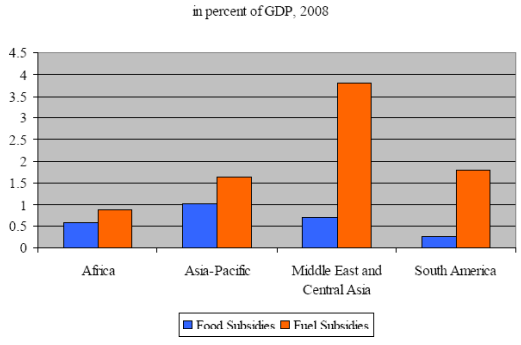
Overall, energy and food are, however, still quite heavily subsidised in developing countries and emerging markets. Global estimates put energy subsidies alone at US$ 300 billion p. a., equivalent to 0.7 per cent of world GDP (UNEP 2008). As subsidies are rather inefficient tools for fighting poverty, the question arises whether they can be used in a more efficient way to achieve development goals.

1. Rationales for subsidies

In general, a subsidy can be interpreted as a negative tax, i.e. it drives a wedge between consumer and producer prices so that the price paid by the consumer is lower than the price the producer receives. Where the form of financing is concerned, a distinction can be made between explicit subsidies and implicit subsidies. An explicit subsidy is financed through the government's budget. In the case of implicit subsidies producer prices are kept down by an overvalued exchange rate, quantitative restrictions on trade and price controls. An overvalued exchange rate leads to cheaper imports, which in turn benefits consumers. It also serves as a disincentive to domestic producers to sell their goods in the world market since an overvalued exchange rate makes their commodities less competitive.

The underlying objective of energy and food subsidies is to create greater equity among the population with the intended effect of increasing the real incomes of all households with access to the subsidies. A government may be willing to subsidise certain food items on the ground that improved nutrition contributes to overall better health, which, in turn, has a positive effect on labour productivity. In a similar vein, it can be argued that energy subsidies may enable children of poor households to study better at home – especially where households cannot afford unsubsidised electricity. Arguing along these lines, a government can claim that subsidy payments may contribute to better overall education figures. Furthermore, as lower prices of certain commodities or services increase the purchasing power of the poor, they can be interpreted as a way of redistributing income to the poorer segments of society.

Figure 1: Average energy and food subsidies by region



Source: IMF (2008)

2. The level of energy and food subsidisation

Figure 1 depicts average regional fuel and food subsidies in 72 developing countries and emerging markets. It shows that average fuel subsidies are consistently higher than food subsidies, reaching their highest level of around 3.8 per cent of GDP in the Middle East and Central Asia (IMF 2008).

The figures reveal that fuel subsidies are a fairly widespread policy tool in developing countries and emerging markets. In a situation where oil prices are rising, however, they put a strain on governments' budgets. In the first half of 2008, for example, Indonesia's fuel subsidies grew by 40 per cent owing to rising oil prices, finally totalling US$ 13.9 billion. India's fuel subsidies have also been sizable, amounting to around US$ 6.25 billion in 2007.

Besides fuel subsidies, many countries subsidise food items. As Figure 1 shows, they are, on average, highest in the Asia-Pacific region, where they exceed 1 per cent of GDP. Most of these subsidies are untargeted, i.e. they do not distinguish between poor consumers and wealthy consumers. The absolute extent to which food is subsidised can be rather substantial. In April this year, for instance, the government of Indonesia revised its 2008 budget, announcing an increase in food subsidies to a total of US$ 290 million. Egypt too has budgeted for US$ 4.01 billion in food subsidies for the next fiscal year, compared to US$ 2.8 billion in its previous budget.

3. The impact of subsidies

The main problem with subsidies is targeting inefficiencies and leakages, i.e. in many cases a subsidy does not fully reach the target population. In an evaluation of food subsidy programmes in India, for instance, it has been estimated that for every rupee's worth of food transferred to the poor the government spends around Rp 3.65, implying a leakage of about 70 per cent. Other calculations show that even in the most efficient systems leakage amounts to at least one third of total transfers (Alderman / Lindert 1998).

What is worse, there is a pro-rich bias in the case of energy subsidies since higher-income households generally consume larger quantities of petroleum products and electricity. In Mexico and Ecuador, for example, the top 10 per cent of households account for more than 30 per cent of domestic electricity consumption. In Venezuela, around 38 per cent of electricity subsidies accrue to the richest 20 per cent, whereas a mere 16 per cent is received by the bottom third. And, at more than US $100 million p.a., energy subsidies in Bangladesh exceed the government's expenditure on health care. The benefits of the subsidy go to those 16 per cent of households that have electricity. In India, government expenditure on fuel subsidies now amounts to as much as fiscal spending on education. Similarly, fuel subsidies in Nepal mean that its government has to cover losses corresponding to 30 per cent of budgeted spending on education and around 70 per cent of its planned expenditure on health care. As in other countries, however, fuel and energy subsidies mainly benefit the (relatively) better-off in society (Owen 2008).

A second problem in this context is efficiency, i.e. the effect of the subsidy on the performance of the economy. The costs arising from a subsidy are the benefits lost as a result of the same resources not being used in other ways. Additional costs occur when the subsidy creates negative incentives to consumers or producers. This is likely to be the case with energy and fuel subsidies where increased consumption has harmful environmental effects.

Box 1: Subsidy reform and political resistance

In many countries abolishing subsidies is likely to meet with strong resistance since subsidy schemes create vested interests. Some policy measures, however, can help to minimize opposition. First, governments need be very clear when communicating the benefits of cutting subsidies. Second, gradually phasing out a subsidy may be easier to achieve than a 'cold turkey' approach. Third, moderate tax cuts for certain segments of society can help to overcome resistance in some cases.

Further economic effects depend on how the subsidy is financed. If the government has to borrow money, the level of public debt will increase. Interest rates may then rise owing to the greater demand for credits. This, in turn, may dampen private investment. Higher interest rates also lead to upward pressure on the exchange rate, which has adverse effects on the country's export sector.

A second option for financing a subsidy is to increase the money supply. This policy will eventually raise the rate of inflation. A higher rate of inflation, then, can actually offset the positive effects of the subsidy for the target group if the rise in price levels is large enough. A higher overall price level also increases the need for higher subsidies and so exacerbates economic problems.

In the case of implicit subsidies the government applies an overvalued exchange rate and price controls. An overvalued exchange rate allows cheaper imports. A food subsidy, then, will lead to more food items being imported, while discouraging domestic production. An overvalued domestic currency thus works like an implicit tax on producers, who pay the immediate costs of implicit subsidies. Direct price controls, often used in addition to an overvalued domestic currency, exert downward pressure on wages. This, in turn, leads to lower incomes in the agricultural sector. As a consequence, the net effect of an implicit subsidy may be negative for the target group.

In summarizing, then, both equity and efficiency effects of food and energy subsidies are problematic. Targeting inefficiencies, leakages and corruption in many programmes has a rather detrimental effect. The overall welfare of a country may also be higher if a government chooses to spend the money on infrastructure, health care and education instead.

4. Cash transfers as an alternative?

In recent years, direct cash transfers have emerged as an alternative policy tool for combating poverty. In principle, a distinction can be made between unconditional and conditional cash transfers. Unconditional cash transfers are, in essence, a form of basic social security designed to support poor families and the elderly. Conditional cash transfers, on the other hand, contain a reciprocal element: the transfer occurs only if the poor engage in labour activities or, as is the case in cash-for-human-development schemes, the children of poor families are enrolled in schools. In addition, cash-for-human-development programmes often require household members to participate in health education courses or similar activities. There is thus an intrinsic paternalistic element coupled with the underlying premise that an existing poverty trap can be overcome by investment in human capital. In the past few years, around 15 developing countries have implemented such cash-for-human-development programmes, mainly on a regional basis. For many Mexico's country-wide *Oportunidades* programme has served as a role-model.

Why have conditional cash transfer programmes become so popular in recent years? Their general appeal is twofold. First, administrative costs are often lower than subsidy payments. Second, if targeted correctly, transfers can bridge the trade-off between equity and efficiency since they redistribute income to the poor without distorting market prices. In addition, the money paid to the poor has a multiplier effect on the rest of the economy. Moreover, the related conditionalities enhance investment in human capital.

Box 2: Mexico's *oportunidades* programme

Established in 1997, *Oportunidades* now covers 5 million extremely poor families. Eligible households are entitled to monetary assistance for a period of three years, with a possible extension of a further three years. Targeting is effected in two steps. First, the poorest regions in the country are identified. Second, the poorest families in those regions are selected by means of household surveys.

Two conditions are attached. Beneficiary households are obliged to send their children to school, and household members are required to attend health education courses and regular health check-ups. The overall cost of the programme is less than 1 per cent of GDP.

In theory, then, conditional cash transfers are designed to support the poor in the short run through direct cash transfer payments and to help break the cycle of poverty in the long-term by enabling the poor to gain access to health care and education. Whether conditional cash transfers can live up to these expectations and so constitute a policy measure superior to subsidies depends, however, on a number of factors.

If poverty is the result of social exclusion and low levels of education, it is necessary to establish whether these problems, e.g. poor school attendance, are due to supply- or demand-side factors. Inadequate health or education outcomes resulting from a lack of an adequate supply of schools and medical care, which also includes adequate supply in terms of the quality of education and health care, require different policy responses from demand-side problems. In situations where poverty is, in part at least, a consequence of low demand, conditional cash transfers can be used to offer short-term relief while fostering investment in human capital.

Box 3: Strengthening the supply side

In many countries the quality of supply will have to be improved in parallel with demand-side measures. In a pilot programme set up in 2007, the government of Indonesia is adopting a two-pronged approach. To compensate for increased food and fuel prices and give families better access to health and education services, poor households receive monetary assistance. At the same time, a conditional cash transfer system was set up at the village level. To this end, participating villages must commit themselves to improving infrastructure for health and education. In 2007, 1625 villages received US$ 8400 each to work towards this goal.

5. When do cash transfers work?

An important prerequisite in this context is a country's administrative capacity to identify beneficiaries accurately. Targeting can be conducted through either means testing or proxy means testing. Means testing requires the ability to investigate the incomes and assets of the potential target population. Countries lacking this capacity can resort to a form of proxy means testing. Eligibility is then determined by reference to specific household or geographical characteristics commonly associated with poverty, e.g. single parenthood. If targeting is not performed well, subsequent programmes will suffer from either errors of inclusion, i.e. payments will be made to people outside the target population, or errors of exclusion, i.e. some members of the target population will not receive the benefits. In addition to the ability correctly to identify beneficiaries, a country needs the institutional facilities to monitor and enforce the conditions associated with the programme.

A further precondition if conditional cash transfer programmes are to be successful is the existence of a basic infrastructure of health and education facilities. If the programme seeks to improve outcomes in health and education, demand must be met by adequate supply. Supply in this respect relates not only to the quantity of health and education facilities but also to their quality. This makes it necessary to establish whether initially low demand is due to a deficiency in the quality of supply or whether it is the consequence of a lack of financial resources. Only if the latter deficiency is overcome can the programme lead to the desired results. Finally, a proper exit strategy needs to be in place, i.e. the programme must ensure that former beneficiaries do not fall back into poverty once they become ineligible to participate. Studies in Mexico, for instance, have found that families leaving *Oportunidades* above the extreme poverty line have not necessarily managed to escape poverty altogether. Since Mexico does not provide an overall social protection system, these families are in

danger of falling back into extreme poverty, especially when labour market conditions are unfavourable.

6. How to obtain public support

It is also important to gain public acceptance of the programme. In this context, the conditionalities of the programme can play a vital role. Functioning as a kind of signalling device, they can demonstrate that the poor "earn" the financial support they receive. Besides conditionalities, an independent evaluation scheme enhances both the accountability and legitimation of a programme. This, in turn, can facilitate greater acceptance by the wider public. Moreover, for a programme to work effectively, the country needs to have adequate financial resources and institutional support. Financial resources can be released by cutting or abolishing subsidies. If additional means are required to launch the programme, as is likely to be the case in the least developed countries (LDCs), international aid may be a sensible form of support. As for institutional support, the political will needed to make any programme work is not restricted to the government. To increase overall acceptance, the authorities should aim to include civil, religious and tribal leaders and political parties. This calls for a sufficiently high level of transparency on the part of political decision-makers. The political will to implement a programme is also likely to be higher when the government assumes ownership – a point well worth considering in cases of donor-financed schemes.

It is obvious, however, that a government's reliance on the support of the urban middle classes, who benefit most from subsidy schemes, may prevent it from switching to more pro-poor expenditure policies.

7. Conclusion

In recent years the negative impacts of food and energy subsidies on governments' budgets have become very noticeable, especially at times of high oil and food prices. Moreover, as these subsidies distort market prices, are often poorly targeted and frequently have a pro-rich bias, they are an inappropriate policy instrument for assisting the poor. A more efficient way to finance development goals is the conditional cash transfer programme. If implemented correctly, it helps to break the vicious cycle of poverty. Technical knowledge on the introduction of pro-poor public expenditure policies has increased substantially in recent years. Many countries could gain tremendous fiscal space by using their financial resources more effectively for poverty alleviation.

Dr. Matthias Oschinski
Research Associate in the Department "World Economy and Development Financing"

Literature

Alderman, H. / K. Lindert (1998): The Potential and Limitations of Self-Targeted Food Subsidies, in: *The World Bank Research Observer* 1 (2), 213–29

IMF (International Monetary Fund) (2008): Food and Fuel Prices – Recent Developments, Macroeconomic Impact, and Policy Responses, Washington, DC

Owen, N. (2008): Subsidies take a toll on Nepal's economy, in: *International Herald Tribune* 30 June 2008

UNEP (United Nations Environment Programme) (2008): Reforming Energy Subsidies: Opportunities to Contribute to the Climate Change Agenda, Geneva: UNEP DTIE

Financing for Development Series:

8/2008	The Financial Crisis and Developing Countries
9/2008	Increasing Government Revenues from the Extractive Sector in Sub-Saharan Africa
10/2008	Development Finance by Regional Development Banks – Combining Regional Ownership with Multilateral Governance
11/2008	Are Cash Transfers a Suitable Alternative to Energy and Food Subsidies?
12/2008	Foreign Direct Investment – A Means to Foster Sustainable Development?
13/2008	Southern Non-DAC Actors in Development Cooperation
14/2008	Increasing Domestic Resource Mobilization by Tackling Tax Flight
15/2008	Leveraging Private Investments in Climate Change Mitigation

DEUTSCHES INSTITUT FÜR ENTWICKLUNGSPOLITIK · GERMAN DEVELOPMENT INSTITUTE gGmbH©
Tulpenfeld 6, 53113 Bonn ☎ +49 (0)228 94927-0 🖷 +49 (0)228 94927-130
E-Mail: die@die-gdi.de http://www.die-gdi.de
ISSN 1434-8934 (deutsch) ISSN 1615-5483 (englisch)