

EQUITY OBJECTIVES AND PUZZLES IN LINKING TAX AND SPENDING POLICIES



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Views and errors are mine alone

- Whether the equity-efficiency frontier slopes up or down, we want to be on it
- For distributional impact, it is (only) the joint impact of taxes and spending that matters
 - ‘progressivity’ of individual items not in itself very informative
 - We are bad at taking this holistic view
- (Incidence—We know very little about even the simplest instruments let alone the more complex ones)

THE PUZZLE

Generalized price support can be a very badly targeted way to support the poor

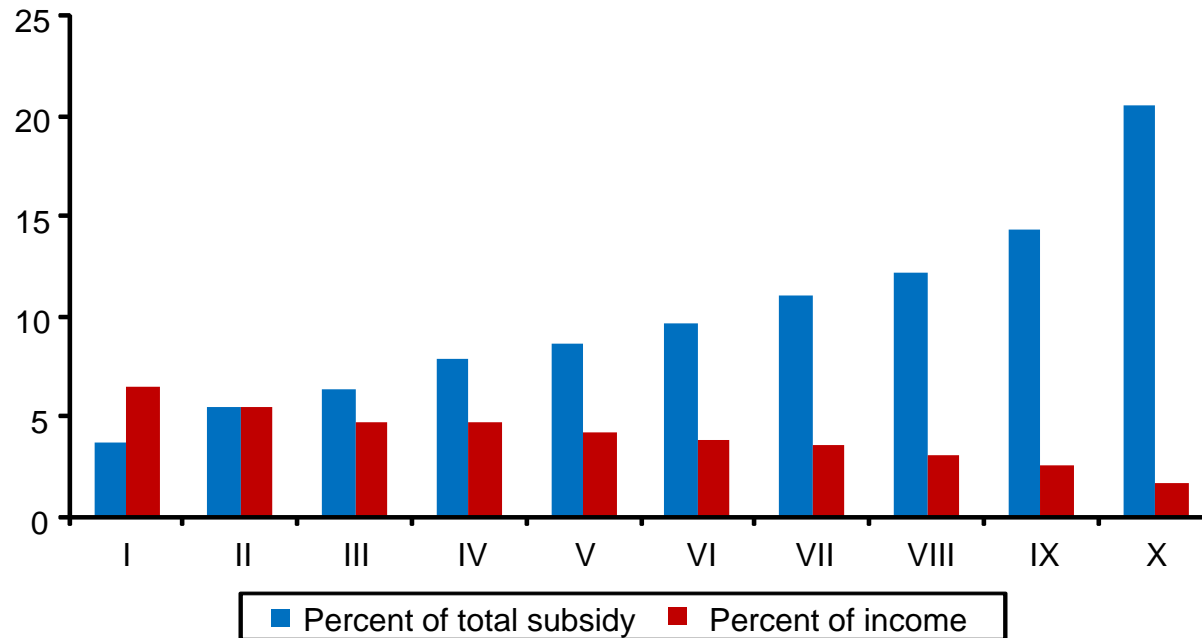
Because although the poor may spend a larger proportion of their income on, say, food or fuel, the rich spend absolutely more

—so most of the dollar benefit (revenue foregone) goes to them

Plenty of examples....

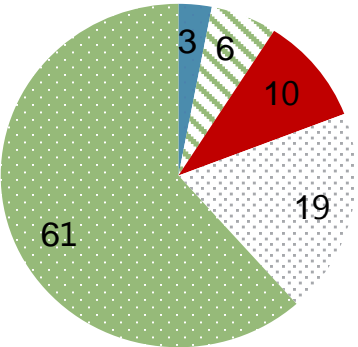
Example 1: Reduced rates of VAT

- Zero rate on food in Mexico:

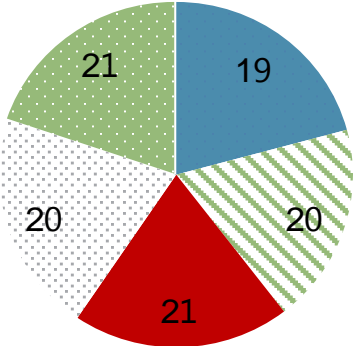


Example 2: Petroleum subsidies

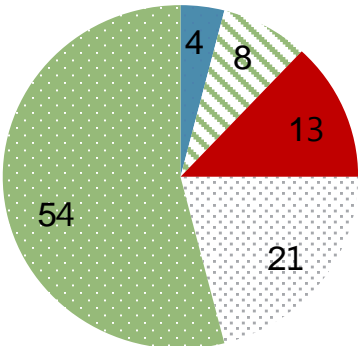
Gasoline



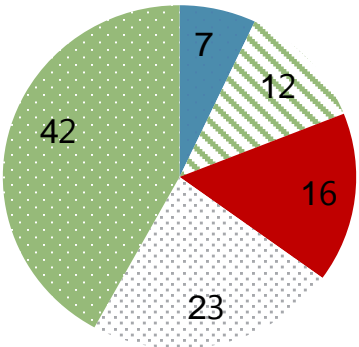
Kerosene



LPG



Diesel



But the question is:

Maybe these heavy costs are a price we have to pay for equity objectives? Real issue is:

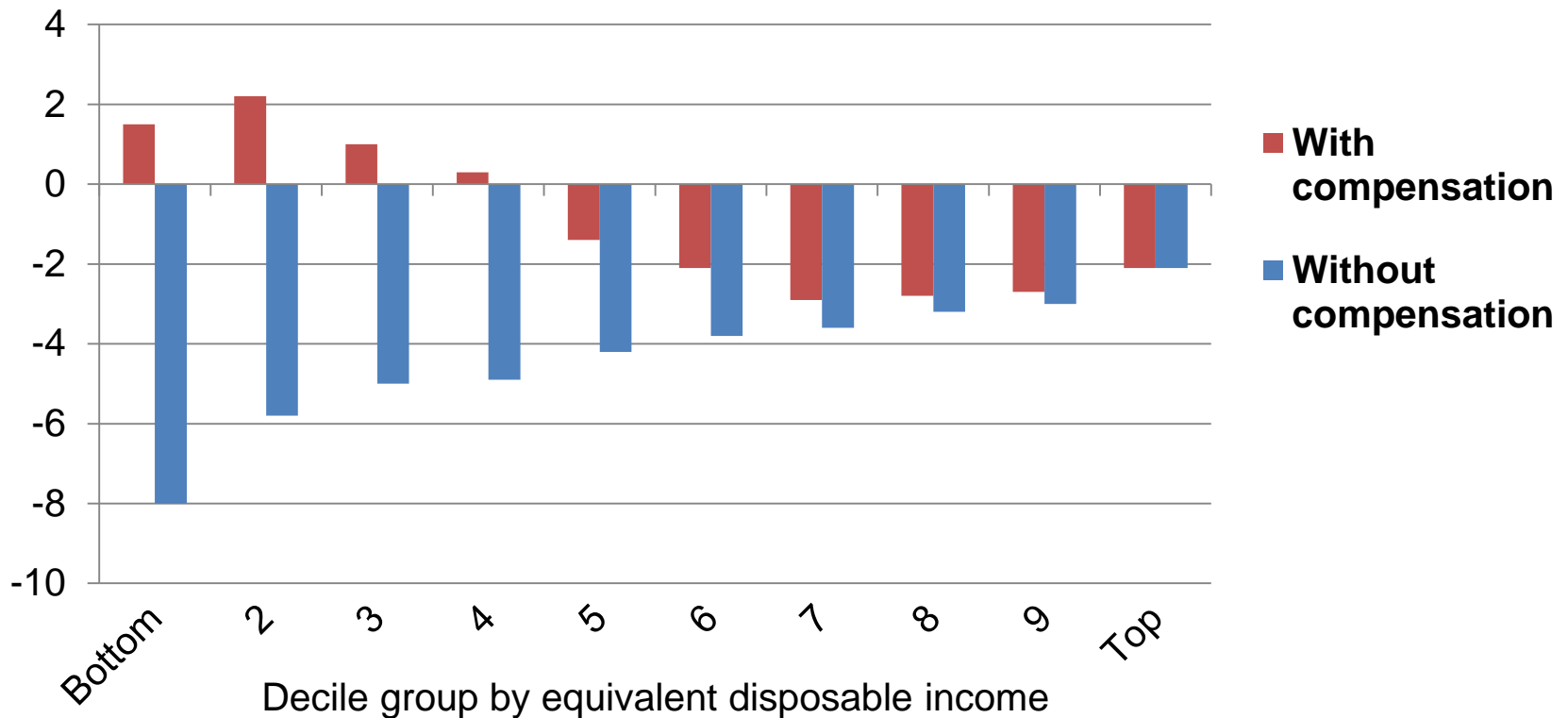
Are there better targeted ways to support the poor?

Benefit to poor from subsidies can be sizable:

- E.g. \$0.25 per liter increase in fuel prices can reduce real consumption of poorest 20 percent by 5.5 percent

For advanced economies, answer is/should be “Yes”

For zero rating of food in the U.K.:



...using up only about half of the revenue gain

What about emerging/developing?

Only blunter spending instruments available,
so policy case for rate differentiation stronger
—but how strong?

A condition

Suppose 'maximin' concern only with very poorest

Leaving aside behavioral effects, poorest gain from increasing rate on 'food' if and only if:

Proportion of all food they consume

Is less than

(Proportion of \$1 of public spending from which they benefit) \times (Their valuation \$1 of such spending, λ)

Example 1: Cash transfers ($\lambda=1$),

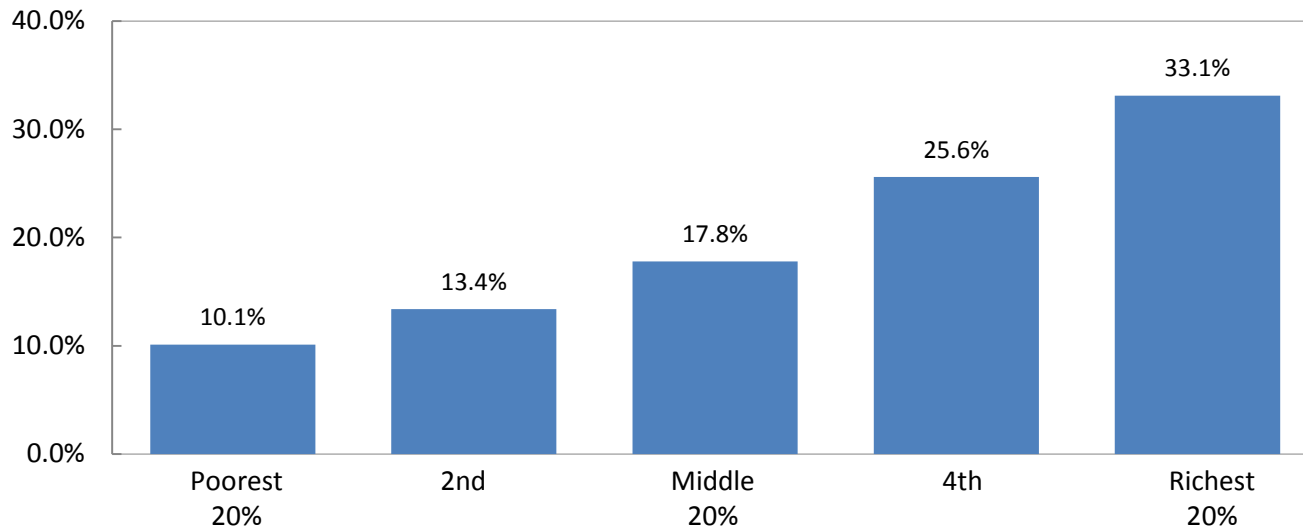
For a cash transfer, condition is simply that consumption share lower than share in total cash benefits

- For a poll subsidy, this must be the case if their consumption is below the average
 - Iran
- And even more likely to be case if some element of pro-poor element in cash transfers

Example 2: In-kind benefits (maybe $\lambda \geq 1$)

In India example below, bottom 20 percent benefit from increased spending on curative health care if they account for less than 10 percent of 'food' consumption even if $\lambda = 1$

—and a fortiori if $\lambda > 1$



The moral seems to be:

Price subsidies may be so badly targeted on poor that spending doesn't have to be very well targeted to be a better way to help them

—e.g. Ethiopia work (more needed!)

Many qualifications:

- Inferior goods
- Some price subsidies may be even more poorly targeted: e.g. role of VAT thresholds
- Always someone who can't be protected

**SO WHY DO AREN'T BETTER TARGETED
POLICIES ADOPTED?**

Efficiency considerations?

E..g. U.K. reform above would raise effective marginal tax rates over some range

- But in wider optimal tax context, question (for advanced economies) is whether low taxed goods are relatively strong substitutes for 'leisure'
 - not strong evidence
- Arguments for emerging/developing
 - little explored

Political economy to the fore...

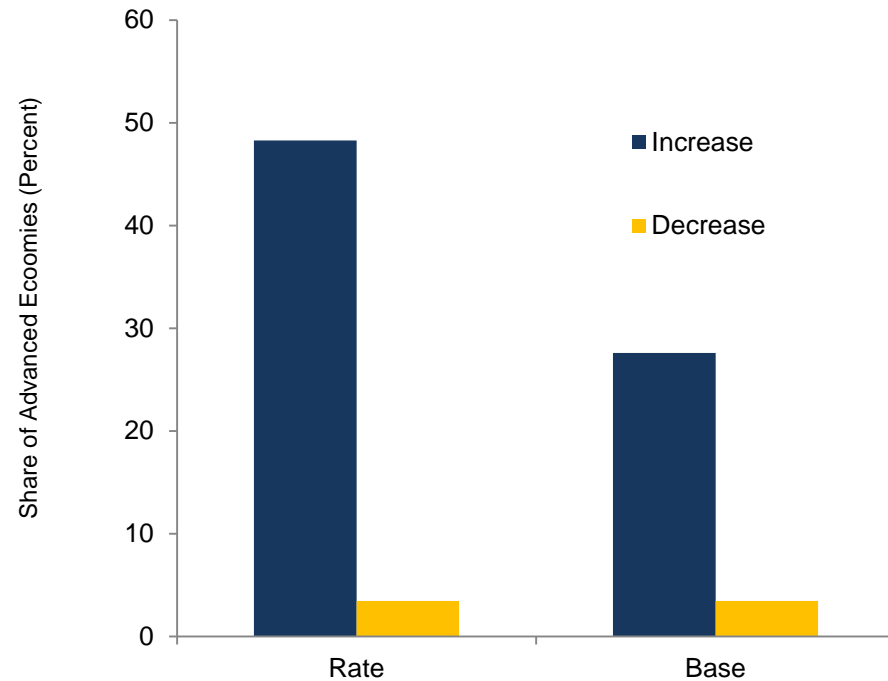
- The beneficiaries are powerful!
- Distrust that spending benefits will be sustained
- Cultural sensitivities
 - Sense that natural resources are ‘ours’
 - In UK, taxing food political death poison since the Corn Laws
- Inefficient policies as a signal of politician’s pro-poor preferences?
- Stigma of income testing

WAYS AHEAD?

Can crises help?

- Didn't in advanced economies (right)
- In other cases, support can become fiscally unsustainable:
—recent subsidy reduction in Egypt

Value-Added Tax Changes in Advanced Economies: 2010-13



Transparency

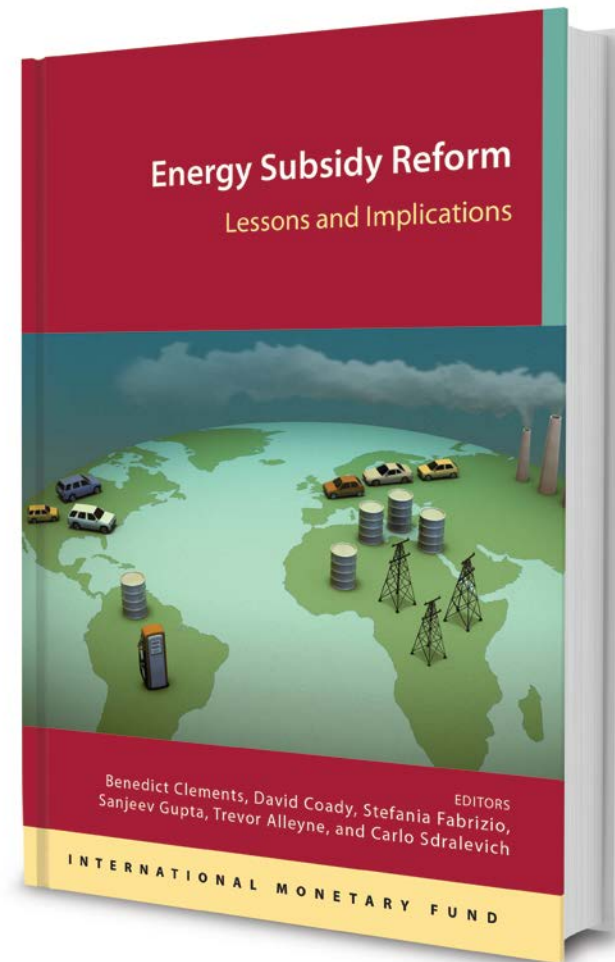
- Assessment of revenue foregone (tax expenditure analysis) and distributional impact necessary for informed discussion
 - And still much to do on this
- But clearly not sufficient for policy change
 - E.g. No mystery about zero-rating issue in U.K.

Earmarking?

- For example
 - Ghana raised VAT standard rate from 10 to 15 percent earmarked to education and health
- But either:
 - (a) Constrains spending or
 - (b) Is misleading and non-transparent
- Last resort?
- Links with PFM reform?

Lessons from subsidy reform?

- Comprehensive, detailed reform plan
- Far-reaching communications strategy
- Consider sequencing reform, to build up trust



The possibilities are changing

- Biometric cards in principle facilitate poll subsidies
- Targeting by income or cruder indicator of needs
 - SNAP ('food stamps') in US
 - Retailers prohibited from charging any tax
 - Becoming feasible elsewhere: Egypt experiment with income-tested limit (5 loaves per day) on access to subsidized bread; excess can be spent on other things

...as transition to removal?