• 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
  - 61
  - 3
  - 6
  - 10
  - 19

- Kerosene
  - 20
  - 21
  - 19
  - 20

- LPG
  - 54
  - 4
  - 8
  - 13

- Diesel
  - 42
  - 7
  - 12
  - 16
  - 23
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 $1 of such spending, \lambda)
Example 1: Cash transfers ($\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
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?