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## Subsidies and Basic Needs

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Many governments use subsidies as part of their social welfare policies. In this note I consider the effectiveness of subsidies as a means of meeting basic needs, and in particular I examine the case for food subsidies.

For the purposes of this paper, a subsidy is defined as a negative consumption tax designed to lower the market price—and presumably increase the consumption—of some good or service. The total impact of subsidies can be adequately considered only in the context of the whole fiscal system, but I shall assume that governments have the choice between the payment of income supplements to those unable to afford a minimum level of basic needs, while leaving their provision to the market, and the subsidisation (including the free provision) of the goods and services which it includes in the list of basic needs. In this comparison, I take the fiscal system as given.

The case for subsidies as compared with direct financial subventions can be summarised as follows:

—The social cost of the additional consumption made possible by the subsidy may be less than the benefit derived from the additional consumption which it makes possible. Thus the cost of admitting more patients to an underutilised hospital may be very small. This is of course the principle behind marginal cost pricing, and is especially applicable to ‘lumpy’ types of investment.

—Markets for the provision of basic needs may not work well. Potential consumers may be badly informed. Thus a system of relying on the market for the provision of education or health services will favour middle-class families—who will have the information required to choose between various types of provision—over poor families—who may not. Because of monopoly or other market imperfections, the supply of basic commodities may be inadequate or expensive. If the problem is one of monopoly, however, governments could in principle provide the goods or services concerned at less than the market price but without any subsidy. Monopoly or imperfect competition may justify government intervention; they do not necessarily justify subsidies.

—External benefits may arise from greater consumption of the good or service concerned than would occur at market prices. Thus the whole community may stand to gain if individual ill-health is reduced. The elimination of malnutrition may increase output, and the benefit of at least part of this increase will

accrue to the community (e.g. through the fiscal system).

—A system of direct financial aids to people below some basic minimum would necessitate arrangements for selecting those entitled to benefit, and deciding on its extent. A selective system of this kind involves problems of access—and may indeed yield greater benefits to those involved in administering the system than to the intended beneficiaries. Subsidies, however, could be non-selective, and may therefore not involve questions of access. They could thus be more cost-effective than direct income supplements.

—Income supplements may involve problems of the distribution of consumption within families. If additional income is made available to the head of the family, it may not go to increase the consumption of those in most need—e.g. pregnant or nursing women, or pre-school children. Through the subsidisation and distribution of commodities (especially foodstuffs) it may be possible to direct aid to those in most need. This argument is, however, inconsistent with the case against direct income supplements.

—Poor people would spend additional income on the ‘wrong’ things—‘unnecessary’ consumption (weddings, drink, non-nutritious food) rather than ‘basic needs’—i.e. poor people have a high income elasticity of demand for ‘non-basic’ goods and services. Alternatively, it is argued that, in a capitalist system, poor consumers are persuaded to buy things that they do not really ‘need’. Government can correct these distortions by subsidising or freely distributing those goods and services which enter into basic needs.

This last argument assumes that ‘officials’, ‘politicians’ or ‘experts’ are better informed about poor people’s basic needs than are the poor themselves. Indeed it calls into question the whole concept of basic needs. Are basic needs definable by experts, or by the poor themselves? If we accept that wants are socially determined, is determination by government ‘better’ than determination through the market? In Pigou’s words (1952:759) “it is a very delicate matter for the State to determine authoritatively in what way poor people shall distribute scanty resources among various competing needs”.

These arguments (which are familiar from the public finance literature) clearly have different weights. Many who would accept the case based on monopoly, external benefits, or lack of appropriate information, might doubt that the poor are more stupid than experts or bureaucrats. But even if not entirely

accepted, these arguments clearly have some force. We need, however, to consider in rather more detail who are likely to be the actual beneficiaries of subsidies. To illustrate the problems, I shall consider subsidies on basic foodstuffs.

Food subsidies take many forms. They may be subsidies to farmers; most of their benefit accrues to growers who obtain higher prices for their products than they would without subsidies, consumer prices being little affected. We shall assume that the immediate benefit of the subsidy accrues to consumers—consumer prices are lowered by the full amount of the subsidy. This will clearly be so where the subsidised food is distributed free or where it is imported and the importing country is too small to influence world prices. The distribution of benefit will depend on three factors—the identity of the purchasers or recipients of the subsidised foodstuffs, the effect of the subsidy on wage rates, and the effects on employment.

Food subsidies may be selective or general—that is, subsidised food may be made available to particular groups (as in food aid projects) or may be generally on sale. Thus there may be schemes to distribute free or cheap food to 'vulnerable groups', or for free school meals to be provided. Again, food subsidies may be associated with a rationing scheme so as to ensure that large or industrial consumers do not benefit unduly. Again, the types of food being *subsidised may be those mainly consumed by the poor*. Thus subsidised rice in Mauritius is normally of a quality which is not bought by the rich.

In principle, food subsidies should be selective if they are to be of direct help to the poor. But there are several qualifications to this simple formula.

First, the proportion of total expenditure on basic food (e.g. cereals) by poor people is greater than that by rich people. A non-selective subsidy on such foods will therefore be of far greater relative benefit to the poor than to the rich. Moreover, since by far the greater part of the population in most developing countries is poor and (above a certain income level) the price and income elasticity of demand for basic foodstuffs is low, most of the increased food consumption stimulated by a general subsidy on such foods will be by the poor. For middle class families such a non-selective subsidy will amount to a general income supplement—it will release purchasing power for additional expenditure elsewhere.

Second, a deliberately selective system will involve some means of identifying beneficiaries. Such systems involve similar problems of access and exclusion to those already referred to as affecting minimum income support schemes.

In addition, some types of selective system may be inherently biased against the poorest people. Thus school meals benefit only children in school: if children from the poorest families or areas do not go to school they will not benefit. This is not to argue against school meals: they may have various favourable external effects—encouraging more children to come to school, or increasing the alertness of children in their studies. But one should be aware of such unintended bias.

So far I have argued that although, in principle, food subsidies to the poor should be selective, even a non-selective system of subsidies on basic foodstuffs may help them. But a subsidy of less than 100 per cent will be of help only to those who have some cash income. Below a certain income level, the subsidy will be regressive, and the actual direct impact then will depend on the extent of the subsidy and the distribution of income.

The principal potential indirect effect of food subsidies is on the wage level. If wages are at subsistence level, lowering the cost of subsistence may reduce the level of wages. As far as unorganised, marginal workers are concerned, food subsidies could lower the wage rate at which they would begin to accept employment. But in many developing countries, wages in the formal sector are substantially above subsistence level, and the factors determining the distribution of income between wages and profits will vary from sector to sector. Thus governments may enact *minimum wage regulations* (which in practice will exclude people in many low-wage occupations); trade unions in certain industries may be successful in increasing wage rates, through the limitation of entry into the industry or other means; employers may increase the capital intensity of their operations and thus increase the share of profits in output. The effect may be (and frequently is) to create a privileged group of employees earning wages which are high by local standards, and a large number of people who, when they are employed, have a weak bargaining position and correspondingly low wages. To this must be added the effect of inflation. Where wage bargaining is centrally concerned with changes in price levels, measures to reduce the rate of increase of prices (e.g. through food subsidies) will tend to reduce the rate of increase of wages.

The impact of food subsidies on wage rates is therefore likely to be complex. In certain circumstances food subsidies could reduce wages—or at least act as a brake on increases. Thus such subsidies *could* accrue to employers rather than to wage-earners. In practice, however, subsidies are only one of many factors affecting the distribution of income as between wages and profits, and their effects are likely to be difficult to predict *a priori*.

In so far as food subsidies reduce wages, what effect do they have on employment? The case for the use of food subsidies to promote employment was put in the Meade Report (Meade *et al*, 1968) on Mauritius:

“ . . . wage rates should be kept stable, so that automatically in the search for low costs . . . producers and employers (governmental as well as private) will have an incentive, whenever there is a choice, to introduce new products and processes which involve the use of labour rather than the use of capital and land . . . But a policy involving wage restraint does not mean that there can be *no* measures taken over the coming years to improve standards of living . . . The subsidisation of the cost of living is a . . . way in which the standard of living of the worker can be supported without any direct raising of labour costs”.

One issue here, as the report recognised, is how far food subsidies actually do act as a restraint on increases in money wage levels, and if they do, what the impact of such wage reductions is on employment. It would be simplistic to suggest that there is a clear and direct relation between wage levels and employment. The structure of wages and salaries (e.g. as between urban and rural occupations, white collar and other jobs) may be as important as their overall level.

Again, where output and employment are heavily dependent on local incomes and expenditure, and supply constraints are of minor importance (the classical Keynesian situation) wage restraint could have a negative effect on employment. But in comparatively open economies, where the level of demand depends mainly on external factors, wage restraint could help employment.

The choice of techniques argument used in the Meade Report may however have only a limited application; in many activities techniques appear to be virtually given by the equipment and machinery available on world markets. But in many countries the cost of imported capital equipment is undoubtedly lowered by the existence of cheap foreign exchange, tax treatment of investment, and cheap loans. In so far as such practices favour capital-intensive operations and products, a policy of wage restraint could do something to correct the resulting distortions.

All this suggests that, in certain circumstances, food subsidies *could* help employment. The relation between the two is, however, uncertain. Indeed, if a government wishes to subsidise employment, it might do so more effectively through direct wage subsidies than by the indirect means of food subsidies.

Can the argument based on food subsidies be extended to other, widely used types of subsidy on such basic needs as housing, water and education? How effective are such subsidies in the meeting of

these needs—and in particular the needs of the poorest citizens?

Such subsidies may raise problems of a different kind from those involved in food subsidies. For example, the income elasticity of demand for many of these other services—notably education and housing—is far greater than that for basic foodstuffs. Even with a service such as water, we may assume that rich people have more appliances than poor people, and will therefore consume more.

Moreover, if loans for house building or purchase are subsidised through the tax system, the beneficiaries will be those at the top end of the income tax scale, buying or building the most expensive houses. Middle class families may be able to gain access to the best schools for their children—even in a system where access to such schools is in theory through competitive examinations. Thus unselective subsidies on such goods and services are likely to be regressive and their cost-effectiveness in terms of meeting basic needs will be poor.

What strategies are available for the use of subsidies in such situations? First, subsidies can be made selective. But this entails the sacrifice of one of the main potential advantages of subsidies over income supplementation. Selectively subsidised housing implies the creation of a privileged group who benefit from the subsidy as against the mass of the people who do not. Access to the subsidised service becomes a tradeable commodity—and has value in the hands of those who control its supply.

Secondly, selection can be effected implicitly by the provision or subsidisation of goods and services consciously intended to be ‘inferior’ in some sense to those demanded by the rich. Thus schools, medical services and so on may be provided on a ‘pauper’ level for the poor, the rich being encouraged to make their own provision. This is a common strategy, but there are clear social objections to it.

Thirdly, pricing systems may provide for a measure of cross-subsidisation between rich and poor. Thus water charges may allow for an initial supply of free or cheap water for small consumers, with rising marginal charges for large consumers. Such systems are practicable (and indeed used) only where the measurement of consumption is simple. Moreover, they do not solve the problem of access; those who have no supply will not be subsidised, and at the lower end of the scale, such a system may be regressive.

There is thus no completely satisfactory system for subsidising goods and services with a high income elasticity of demand. In the last resort, any fair system would involve means tests. And in many countries such tests have the effect of excluding those in most need.

The regressive impact of certain subsidies has drawn attention to the possibility of using income supplements as an alternative means of providing basic needs. If the 'basic needs' of the poor could be provided if only they had sufficient income to pay for them, direct income supplements would have several advantages over subsidies. They would permit a greater range of choice to their recipients; they would deliberately exclude all but the neediest; they may avoid many of the administrative problems involved in selective subsidies. But they raise their own type of access problems. Even highly sophisticated social welfare systems (as in the UK) find difficulty in identifying those in most need and meeting their needs. Whatever the rules governing such systems, they may have the effect of excluding the poorest and

neediest, and of providing as much benefit to those administering the arrangements as to their clients.

If, then, the choice lies between the selective subsidisation of basic needs, unselective subsidies and general income support, unselective subsidies have a clear advantage in terms of access, but will be appropriate for only a limited range of goods and services. Over a wide area of social provision there is no clear general advantage (or disadvantage) in subsidies over income support.

#### **References**

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