

3

Checklist of Economic Considerations in Price-Subsidy Reform⁹

17. Based on the above discussion, policymakers should do the following to the extent information is available:¹⁰

18. *Assess the nature of existing subsidies*—their objectives, beneficiaries, administrative mechanisms, and costs. The analysis of current subsidies should be the starting point and should include an assessment of their economic rationale and efficiency in achieving their objectives. Special attention should be given to identifying the extent of implicit subsidies, which in contrast to explicit subsidies, cannot be easily gleaned from the budget. In the case of *producer subsidies*, design considerations are different. The goal of producer subsidy policy is to protect incomes of producers and support employment. In such cases, as noted in Appendix 2, output prices are set above market-clearing levels. Compensatory measures should then be targeted at smaller, less wealthy, producers and those rendered unemployed by reforms.

19. *Assess the socioeconomic and demographic characteristics of the population affected by higher consumer prices, particularly the poor.* The poor may be clustered in certain socioeconomic groups or regions. For instance, in Europe and Central Asia, single mothers, families with many children, pensioners living alone, and workers with little or outdated education are very often poor (Grootaert and Braithwaite, 1998); much of the poverty in Africa, on the other hand, is concentrated in rural areas (Demery, 1999). Such information is typically available from the World Bank's Poverty Assessments and household surveys. The poverty line is crucial for assessing the characteristics of the poor. In the design of social safety nets, the usual practice has been to use country-specific

⁹In practice, the design of price-subsidy reforms will be the outcome of a collaborative process involving the country authorities, the IMF, the World Bank, and other stakeholders, particularly if such reforms are part of a poverty reduction strategy paper.

¹⁰If full information from existing sources is lacking, substantial resources would be required to take into account all relevant considerations set forth in the guide.

poverty lines, rather than international poverty lines defined in terms of daily consumption measured in U.S. dollars in purchasing-power-parity terms.

20. *Assess the gains from price-subsidy reform.* These would include improved resource allocation (e.g., improved availability of price-controlled items), resource savings that could finance critical public services, or reduce the deficit or taxes, and the beneficial impact on real incomes of some households (see below).

21. *Examine the short-term impact of increasing prices of consumer items on real household incomes, particularly the incomes of the poor.* Both the direct and indirect effects of changes in the price of subsidized items must be considered by following these steps:¹¹

- *Assess the direct impact of a reduction in subsidies on real household incomes.* A pragmatic approach to estimating this impact is provided in Appendix 3. Such estimation requires information on the share of subsidized spending in total household expenditure. These data can usually be obtained from household surveys, but are often available only with a substantial lag or with less detail than desired for these purposes (see Deaton, 1997). For example, in Poland in 1993, an increase in household tariffs for heating, electricity, and natural gas to market levels (an increase of about 80 percent) would have resulted in an immediate 5.9 percent fall in real income of the households in the bottom 20 percent of the income distribution (Freund and Wallich, 1997). In Indonesia, in the aftermath of the 1997–98 financial crisis, food price increases had an immediate and significant impact on the level of real consumption of low-income households. This was attributable to the high share of food (over 70 percent) in total expenditures of low-income households and the high increase (over 75 percent) in food prices during 1998 (Gupta and others, 1999).

Not all poor households lose from price-subsidy reform. For example, households that produce more food than they consume may gain from the liberalization of food prices. Those employed in the traded-goods sector may also benefit from the elimination of implicit exchange rate subsidies.

¹¹For a number of countries, World Bank staff carries out analyses of the impact of price subsidies in the context of the Poverty Assessments and Public Expenditure Reviews.

- *If possible, assess second-round effects.* Increases in subsidized commodity prices may trigger price increases in other items, such as locally produced foods (e.g., in Jordan, elimination of the wheat subsidy in 1996 prompted producers of poultry and dairy products to raise their prices sharply; see Footnote 1). Reducing the subsidies on energy products will increase the production cost of a broad range of items. Although such effects on the production cost of nonsubsidized items are typically difficult to assess *ex ante*, an initial, tentative estimate can be made by using the input share of subsidized items in the production of other major goods and services consumed by households. Data on such input shares can be obtained from social accounting matrices (e.g., see Thorbecke, 1998).
- *The impact of price-subsidy reform on real household income (particularly of the poor) should be monitored.* With the support of the World Bank, units have been established in a few countries to continuously monitor social outcomes during the implementation of reforms (e.g., the Social Monitoring and Early Response Unit in Indonesia, in 1998).

22. *Examine the macroeconomic stance.* Typically, price-subsidy reform is undertaken at a time of fiscal consolidation to help achieve macroeconomic stability. The scope of the compensation scheme and the speed and extent of the reform must be consistent with these overall policy targets. Macroeconomic policy should also take into account the impact of price-subsidy reform. The reduction of consumer-price subsidies will be reflected in a one-time increase in prices. Monetary and fiscal policies should prevent these price adjustments from triggering a period of sustained higher inflation through, for example, a price-wage spiral.

23. *Examine the capacity to use, on a temporary basis, existing social protection instruments to compensate the poor.* These instruments may include formal social security arrangements, including social insurance (such as public pensions and unemployment insurance), family allowances, and social assistance. In cases where speed is of the essence, the administrative structure of existing social security programs can, in principle, be used to transfer benefits quickly to those poor individuals and households affected by the price-subsidy reform. It will be important, though, to ensure that such use of existing social security programs is temporary and that any additional cost is funded separately. Since these

instruments—particularly social insurance programs—do not have poverty reduction as their principal aim, they may need to be adapted, a process that has often encountered political resistance, especially in transition economies. Finally, although some countries—particularly many transition economies—have a variety of such instruments, others—notably in Africa—may lack them.

24. *Assess the interaction with other elements of the adjustment program.* The adverse impact of price-subsidy reform can be exacerbated by other adjustment measures (e.g., an exchange rate devaluation and civil service reform). Specific measures, though not designed to compensate for price-subsidy reform, may help to ameliorate its adverse impact on certain population groups (e.g., the provision of severance pay to assist those laid off from civil service and public enterprises). On the other hand, in a number of transition economies, enterprises provide in-kind subsidies to their workers (e.g., for housing, day care, school, health care, sports, and food) (Hu, 1998). Enterprise reform can deprive households of such in-kind benefits, and this fact should be reflected in the design of safety nets.

25. *Assess governance and administrative capacity.* In many countries, weak governance and administrative capacity hamper the targeting and delivery of benefits. Weak governance can divert and waste resources allocated for price subsidies. Weak administrative capacity reflects the lack of cost-effective mechanisms to channel income transfers or targeted price subsidies to the designated population groups, and can be rooted in such factors as insufficient information on the poor and lack of equipment. Even where administrative capacity exists, targeting and delivery can be difficult. Determining eligibility on the basis of income may lead to mis-targeting benefits if the administrative capacity is weak. Furthermore, incomes change over time and frequent updates of income data are costly (Van de Walle, 1998). For example, the cost of administering a means-tested rice-subsidy program in India's Andhra Pradesh state in 1996 was Rs 1.75 for every rupee reaching the poor, and another Rs 3.6 were lost in leakage to the nonpoor (Radhakrishna and others, 1997).

26. *Take account of available financing.* The reform of explicit subsidies is usually undertaken to achieve, inter alia, budgetary savings. Depending on the size of required fiscal adjustment, part of those savings can be used for targeted programs. On occasion, access to foreign funds and commodity assistance may provide additional resources for compensatory measures.

27. *Assess the impact on the environment.* Price-subsidy reform is usually, but not always, beneficial for the environment (Gupta, Miranda, and Parry, 1995). Input subsidies for pesticides, fertilizers, and irrigation can be harmful for the environment. They also provide incentives for land clearance, which can lead to soil erosion. Subsidies for energy may contribute to global warming, acid rain, and respiratory and other health problems. On the other hand, subsidies for kerosene have been defended because they tend to benefit the poor and they can reduce reliance on firewood and protect forests.¹² However, the most efficient way to internalize environmental costs and benefits is to penalize behavior that harms the environment, as with a carbon tax, rather than subsidize alternatives to this harmful behavior.

¹²However, Pitt (1985) found that kerosene subsidies in Indonesia disproportionately benefited the nonpoor and that the elasticity of substitution between firewood and kerosene was very small.