DEVELOPMENT AID AND SUBSIDIES - AN ART

CONCEPTUAL FOUNDATIONS

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Swiss Agency for Development and Cooperation SDC

«There is, of course, nothing bad about subsidies. …They could encourage sustainable agricultural and industrial practices and greater equity. …But, for the most part, they have the opposite effect. They encourage practices that reduce growth and productivity, distort trade, undermine the environmental basis for development, and harm the poor».
– Jim MacNeill, Chairman of the World Bank's Independent Inspection Panel, in: van Beers, de Moor: Public Subsidies and Policy Failures

INTRODUCTION

This note is addressed to programme staff of the Swiss Agency for Development and Cooperation and other interested development professionals. Its aim is to help them to assess the effectiveness of their activities and their support especially with regard to the possible effects of subsidies. The paper consciously abstains from giving a comprehensive theoretical overview on the complex topic of subsidies, but focuses rather on common practical questions and concerns in development cooperation.

In Chapters 1 and 2, a short overview on the delimitation of subsidies is given, without going deeply into the theory of Economics and Social Welfare.

Chapter 3 lays out the rationale for subsidies especially with regard to governments and development agencies.

Chapter 4 provides an overview of the most common types of subsidies in development cooperation, with practical examples as illustrations.

Chapter 5 lists a series of important questions to be asked or looked into at the time of project and programme planning, implementation and monitoring.

Chapter 6 summarizes important lessons learnt with regard to objectives, policies and results. They build on the examples given in Chapter 4.

Chapter 7 draws attention to some readings on subsidies related to development work.

This paper was written by Ruth Egger of Intercooperation at the request and with the support of the Employment and Income Division of SDC. Professor Manfred Zeller from the University of Hohenheim, who has worked on subsidies for many years at the International Food Policy Research Institute, has commented the draft version. His valuable contribution assures that this paper reflects today's knowledge and state of the art. The final editing was done by Hansruedi Pfeiffer, taking into consideration the key points of a discussion in a thematic forum conducted at SDC.

It is our intention to enhance and complement this paper, not least with experiences, illustrative examples and action research findings from the field. SDC programme staff and other development professionals are invited to contribute! A contact point and roster for feedback examples are given as an attachment in the folder.

1. BACKGROUND / RATIONALE

In a broad sense, most or all of the support the Swiss Agency for Development and Cooperation (SDC) is providing to its partners in the South and the East can or should be considered as a subsidy. At the same time, we know that subsidies used inappropriately and without the necessary transparency and diligence have drawbacks, i.e., they may tend to cause or reinforce market distortions, favour non-optimal allocation of resources, create new dependencies, dampen self-help initiatives and the like, obstruct structural changes and long-term solutions in general, and facilitate the inclusion of freeriders and direct benefits to the "wrong" public.

The purpose of this note is:

a) to contribute to SDC's reflection and enhance clarity with regard to its objectives and results achieved;
b) to look for the best type of intervention or solutions in relation to the objectives to be reached in a given environment; and
c) to stress the importance to follow up and monitor the effectiveness and efficiency of the chosen intervention or policy.

A lot has been written about subsidies and their effects, but mostly with regard to agriculture, environment, energy and transport, and related to industrialized countries. In the light of globalisation, persistent poverty in the South, and continuing market imperfections combined with high transaction costs, the debate on subsidies and the distribution of roles between governments and the private sector has been revived.

2. DELIMITATION OF THE THEME – OUR UNDERSTANDING

A subsidy is a grant or monetary gift to certain producers or consumers in society. It may include some discretionary tax exemptions or reductions. Most often, subsidies are linked to the production or consumption of a specific commodity or service. In such cases, the subsidy reduces the cost of the product or service below the market price, and therefore alters the production and consumption pattern compared to a situation with an undistorted market. Governments may also choose to pay subsidies that are partially or fully divorced from production and/or consumption. These are paid to selected groups in society that fulfil certain socio-economic criteria (e.g. transfer payments to farmers, the elderly, or to parents with children). In these latter cases, the subsidies are mainly motivated by distributional objectives. Taxes levied by the government are, simply speaking, the opposite of subsidies. They may increase the market price of all or certain selected goods or services.

The most prominent actors in the use of subsidies are governments, but there are also private persons and civic and philanthropic organizations providing subsidies. In an ideal case, governments pursue a policy of general welfare, set prices (tariffs) for externalities (e.g. air pollution related to consumption or production), and clearly define their role and tasks with regard to public goods and access to services. Very often, however, subsidies are politically motivated (to satisfy lobbies and voter groups).

In the following, we are especially looking at donors and bilateral development aid (both project and programme aid, including policy dialogue). At the same time, we are aware that a radical change in certain detrimental subsidy policies of the industrialized countries could have a greater impact and more lasting effect than development aid[1].

Donor support is given either to governments or to non-profit and civic, as well as to profit-making organizations in developing and transition countries. In rare cases, donor support is directly channelled to selected groups of people in society (the target group).

[1] The agricultural subsidies of Europe and the United States alone amount to USD 350 billion a year, corresponding to about 7 times the money spent by them on development aid (USD 50 billion). Should these subsidies be dropped, the estimation is that worldwide food-trade would augment (+ 17 %), increasing income in developing countries by USD 60 billion. Subsequently, developing countries would become more autonomous and have more room for self-determination. However, with the benefit not being equally distributed between regions and within countries, the necessity for public action or state intervention would remain.

3. WHY SUBSIDIES ?

In principle, there are three goals a government wants to reach with a subsidy or a tax:

a) to align market prices closer to social prices (which include costs of production or consumption to society);
b) to finance/support the protection of a public (common) good like clean air or the general access to a service (e.g. basic education) based on a political decision; and
c) to bring about more equitable income distribution and reduce poverty.

Depending on the specific situation, there are various ways to do this. The changes and mechanism a donor wants to promote, and the objective a donor hopes to achieve through a subsidy are manifold. Therefore, it is crucial that the donor be clear and transparent with respect to the objectives he is aiming at, the results he is looking for, and the implications of a discontinuation of donor support (exit strategies).

We will consider some of the most frequent areas of activity pursued to achieve the goals mentioned above not only by donors, but also by governments in what follows below:

a) strengthen governments in their role to promote development and social welfare through budget aid, sector wide support, policy dialogue, writing off debts, capacity development, etc.;
b) reconstruction and building of infrastructure and institutions in remote or deprived areas, in transition periods, and after war situations;
c) promotion of an innovation, a technology, a measure, a political idea;
d) protection and preservation of structures and sectors of the economy: agriculture, textile industry and employment rate;
e) improving markets through the promotion of transparency, competition and linkages;
f) substitution for market forces or creation of new markets in the long term, especially with regard to «environmental goods» such as clean air, water on national and global levels, and externalities in general; and
g) access for all to basic services such as education, health services, security, information, etc. Preservation of cultural heritage.

In all these cases, subsidies are one instrument or intervention among others. In each case, it has to be clarified if it is the best one (and if it should be used in combination with complementary measures) to reach the set objective and to achieve social welfare efficiently and effectively. In some cases, taxation measures might be better indicated; in others, an active information policy, measures to reduce transaction costs, or a change of framework conditions such as legal action would have a more lasting effect or may be needed as a complementary measure. In still other cases, moral or social persuasion of people and governments may do the job, as illustrated in the examples below.

4. TYPES OF SUBSIDIES AND THEIR POSSIBLE IMPACT (EXAMPLES)

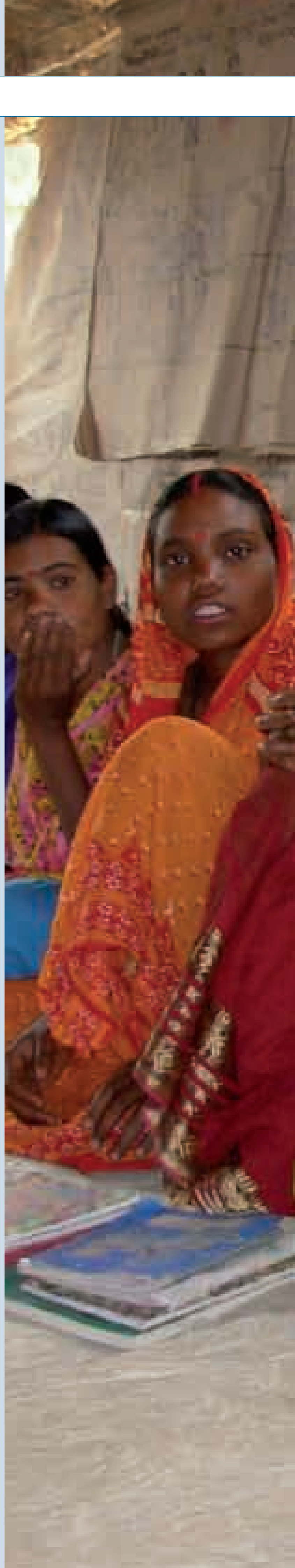
In the following, we are looking at the most often applied types of subsidies: price subsidies, payment to build infrastructure, direct or indirect financial incentives to promote activities, financing of public goods and access to basic services, and payments for environmental measures and benefits (externalities and spill-over effects).

a) Price subsidies are widely used by governments and donors e.g. for agricultural inputs, food, and financial and non-financial services (see examples below). They generally distort markets, are extremely costly and mostly unsustainable. They favour more or less arbitrarily one good over another good, thereby leading to losses in production and consumption efficiency. They are usually regressive and benefit the rich (at least in per capita absolute terms) more than poor people. They create dependencies and partly prevent necessary structural adjustments. They benefit certain producers or consumers (and sometimes bureaucrats and politicians). They induce the formation of special-interest lobbying groups and are therefore politically difficult to discontinue.

Food subsidies are provided through governments' either regulating the prices of certain commodities and keeping them below market prices, or by handing out food coupons at zero or minimal prices. The former benefit the poor, as well as the rich or middle classes. At the same time, they might affect salaries (entrepreneurs' reducing salaries of the workers as basic food prices go down) and production patterns negatively. They have a high budgetary cost and strong distortional effects. Food coupons (vouchers) have lower costs as they can be better targeted at a certain group of the population, have fewer effects on production, and can be more easily discontinued. But they demand a strong administrative system and are prone to misuse. Food price subsidies can be self-targeting with lower administrative transaction costs if inferior foods are chosen that are largely consumed by the poor. However, food price subsidies hurt (poor) rural producers. In general, there are more cost-efficient and equity-enhancing subsidies to favour the poor than food price subsidies (such as subsidizing primary education, school lunch provision for needy children, free food for the ultra-poor identified by efficient targeting methods, etc.).

Interest rate subsidies: Subsidizing either cost of money or administrative costs allows financial institutions to set interest rates below market and "real" costs. This can have a whole range of implications: people getting indebted above their real income earning capacity because of cheap money; crowding out of other credit providers who have to work without subsidies; disincentive to collect savings or to reduce costs while favouring the rich as they have more power to capture cheap credit. Sustainability, efficiency and outreach to the poor cannot be achieved. In a situation of building up an institution serving the poorer strata of the population, or that of developing services and a market e.g. in rural areas, certain initial grants/subsidies might be necessary but only to build up institutional and social capital and capacity, and not to offer services below market rates (see SDC's Financial Sector Policy and numerous studies).

Training and other services for free: How many of us have been sitting in training courses where people joined because of social prestige, because they had to, because there was free board, etc.? Content and learning had little or no relation to attendance. The introduction of a voucher system (partly or fully subsidized coupon) in places where there is a choice of courses or services offered has yielded positive results (even though misuse has been observed and voucher systems have an administrative cost). Where there is no market for such services, cost participation or a competitive entrance system might be a better option (Goldmark L. et al.).



b) **Financing of infrastructure** (roads, drinking water, communal buildings, etc.) often provides access to basic services, creates employment and income, allows for improvement of the living conditions, and increases the attractiveness of a region. Depending on population density and the poverty level of the target region as well as the technology chosen, the allocative and distributional effects can vary greatly. Care has to be taken that poor people participate in decision making already in the design, execution and later on in the management and maintenance of the infrastructure. Identification of long-term solutions for running and maintenance costs is crucial. If these aspects are not taken care of at the outset, continuity of service provision is at stake once donor support has been withdrawn.

Road construction: Road alignment, concerns of land ownership and linking poorer areas with others, especially also with regard to markets, are decisive if positive effects for poorer population groups and economic development for the region in general are to be expected. Further, the use of labour intensive technologies and employing local people have a positive impact on income in the area and on capacity building for future maintenance work. However, accompanying measures might be needed with regard to environmental concerns and the economy. In a food deficit area, part of the salary payment in food might be the right thing to do, while at the same time preparing people to produce for new markets or to compete with incoming goods and services. To minimize future costs, afforestation and slope retention measures might be necessary. If the benefits of the road are widely felt, maintenance can usually be resolved through self-help, taxation and the like (SDC Nepal and Tanzania).

c) **Promotional financing** in general allows the realisation of an activity with a more or less targeted population group. Promotional financing can be found for example in agriculture and forestry for experiments, demonstrations and innovations (risk participation), or for the promotion of technology, of service organisations and of environmental measures.
To be successful, the relevance of the result for the actors, the benefit - if any - that they and not just society get out of the undertaking, and the replicability of the activity without subsidies, are all decisive factors.

Subsidies for the adoption of ecological and other measures: Subsidies are paid either in the form of free inputs, food or cash for work. These subsidies usually form the basis (motivation) for people to adopt a certain technology or carry out a certain task or work. As in many cases it isn't their priority or their curiosity that has led them to do the task (nor does it always fit into their strategy), they will abandon the technology or undertaking if it doesn't prove beneficial to them and doesn't correspond to their priorities. Replication might even be more questionable especially when the subsidy is high. Promotional work or contractual payments on the basis of results might have a bigger impact and cost less (Gyger M.; Kerr et al.).

The promotion of latrines in Bangladesh is an excellent example: With the financing of latrines (free of cost), latrines were built, but hardly used. A campaign on the health implications of not using latrines later on, however, motivated many families to build latrines with their own means and to use them (IDS).

Grant or risk capital for institutional development (start-ups, markets and institutions):
For poor regions, risks are considered high and there are few or no individuals who are ready to invest in them. In such cases, risk capital or grants usually combined with technical assistance are needed to help to open a new business, to build up an institution, e.g. a bank, or to cover the risks of an innovation.

In many cases, it is a one-time input that allows for continuing services and growth and might attract other actors, especially if the subsidy is minor or if its benefit goes beyond just the one partner. The role of a donor in such cases might be limited to bringing the right partners together, attracting a private investor, or being a guarantor for certain risks due to the novelty of the venture or the client. Vital for the success of such partnerships are the congruence of objectives and a common understanding of each partner's motivation and responsibility in accordance with the reaping of benefits by all the partners.

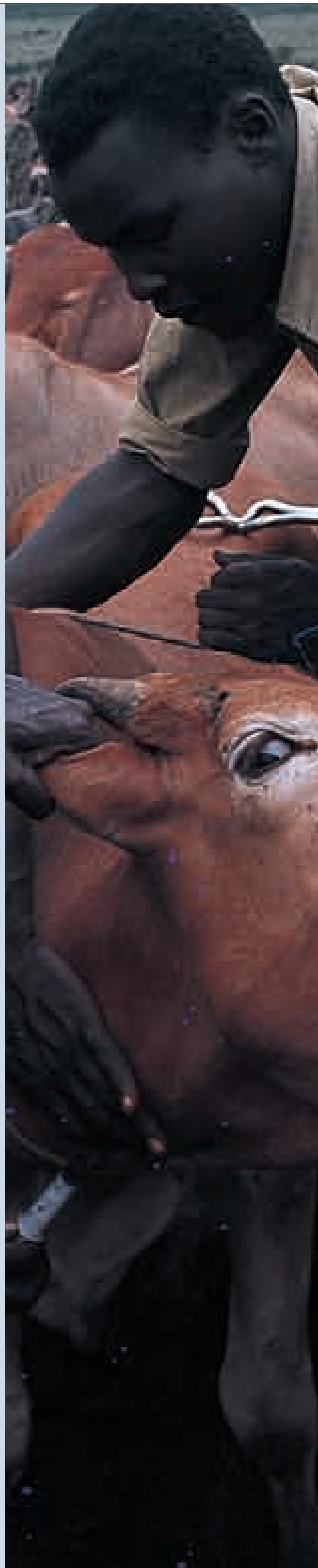
d) Payment for public goods and access to basic services: There is no universally accepted definition of public goods and basic (public) services. The latter is a question of political decision and design. Public (common) goods like clean air or certain categories of water usually have no price, they are not subject to rivalry (their use by one individual or firm does not exclude others from using them at the same time), and are consumable by all (they are non-excludable). Basic (public) services are of public interest (primary education, health, property rights and legal enforcement, research, dissemination of knowledge, security) and their provision is decided by society as a whole rather than by each individual.

The question then remains who should care for or offer public goods and basic (public) services. From an efficiency point of view, the provision of basic public services should be done by the lowest-cost provider. In some cases, this can be the government itself; in other cases, it may be the private sector or civic organizations. Governments can contract the private sector to do it.

Access to information and knowledge: Supporting (subsidizing) information services (radio, promotional campaigns), exposure visits and demonstrational activities (agriculture pilot tests, etc) may be vital to allow for information and knowledge to spread. Information and knowledge clearly have a dimension of power and are a basis for development. Being able to make your own (well-informed) decisions usually allows for efficient allocation of resources and shows lasting effects. It also allows for corrective measures when and where necessary.

Extension services: As financial means become scarce, the role of public and private sectors in agricultural extension have to be reconsidered in most countries. Ways and means have to be developed so that the remoter areas and the smaller farmers still get served and can diversify their production systems. Training of lead farmers or of paraprofessionals with subsidies, who then get paid by the community or through the sale of inputs, has been tried out in several places (Tuki system in Eastern Nepal and veterinary services in Tanzania). Training of farmers and keeping them up-to-date on the newest developments (access to research results) demand in general a combination of public inputs (subsidies), along with efforts from the private sector and the farmers.

As access to and use of public goods and basic public services differ according to socio-economic groups, their provision has allocative and distributional consequences.



e) Externalities and spill over effects: There are measures or activities which have positive or negative effects (also called diseconomies) on production, equity and/or welfare. Examples are CO2 production, water retention, noise, pollution etc. In such cases, governments have to take corrective measures to internalise these externalities, i.e. to compensate the providers of public goods and to transfer the social cost of public bads to those who produce them

CDM Carbon Trading: Carbon emission trading through the Clean Development Mechanism (CDM) is one of the means defined in the Kyoto Protocol of the United Nations Framework Convention on Climate Change to mitigate effects of climate change. CDM opens the access of developing countries to the various funds created by industrial countries and multilateral organizations for this purpose. A particular task of donors and other international and national institutions is to assure that it contributes to sustainable development, and to facilitate access of poor communities and poor people to carbon trading. Poor communities may need support in project prepartion, capacity building, and access to information, technology and markets. The challenge lies in the sustainable development goal, and the threat of perverse incentives that could derive through inadequate implementation procedures.

The aim of the initiative is to create a market and therewith a price for future carbon emission.

5. SUMMARY - SOME LESSONS LEARNT

STRATEGIC CHOICES AND CONSIDERATIONS TO BE MADE

a) To support government partners in the realization of their tasks with regard to general welfare is to be preferred over direct donor activities. However, lack of good governance or capacities often do not allow for, or result in, governments' taking the necessary measures. Therefore, fund those projects that catalyse domestic reforms (e.g. taxation, energy saving measures or promotion of property rights).

b) Favour solutions that promote structural adjustments over short-term benefits. E.g. invest in future technology instead of keeping an ailing industry alive.

c) Target subsidies at a certain population group (to subjects). They are usually more efficient than subsidies related to an object (e.g. credit) and can have a greater effect on empowerment if well introduced and managed.

POLICIES (DO'S, DON'TS AND PREFERENCES)

a) In general, favour government action or private sector development over project subsidies.

b) Prefer solutions with a one-time subsidy (e.g. institution building) over a regular long-term subsidy.

c) Refrain from price subsidies, and favour payments that increase efficiency as e.g. for capacity building, equipment.

d) Invest in information, knowledge and in increasing transparency instead of subsidising goods and services (e.g. latrines).

e) Always ask yourself if there are not other actors, the private sector for example, that could do the job with a similar or even better result.

f) Give preference to a contractual collaboration where benefits, time frame, results to be achieved, and exit strategy are fixed (innovations, risk participation, etc.).

g) Assure participation in design and in cost by the beneficiaries (e.g. water supply). Allow for choices and thereby for empowerment.

h) Be careful to not impede individual or joint action by creating expectations for outside help.

RESULTS AND SIDE-EFFECTS TO BE CONSIDERED

a) Subsidies can have the intended positive effects, but their results can also be unsatisfactory or even negative. It all depends on the environment in which they are applied, and on whether they achieve what they were meant to achieve. This requires accountability for results.

b) Effectiveness and efficiency are strongly influenced by the framework conditions in a country or region. Framework conditions as well as the approach chosen are at the root in explaining why in one case a (type of) subsidy may be the right intervention, and in another, the wrong.

c) However, there are types of subsidies which have in general shown better results than others (subsidising innovations or target groups – «subjects» – rather than the production or consumption of goods or services – «objects»).

d) A high level of outside (donor) subsidies takes away from a country some of its sovereignty and room for self-determination. However, while waiting for major policy changes at local and global level, subsidies at national level (budget support, etc.) allow states to fulfil their function and exercise their role.

e) Subsidies were in the past - and will also be in the future - instruments used to stay in power or to gain power and influence.

6. PRACTICAL IMPLICATIONS AND CRUCIAL QUESTIONS IN PLANNING AND IMPLEMENTATION WHEN WORKING WITH SUBSIDIES

IN THE PLANNING PHASE

Clarification of the objective and the right choice of measures / type of intervention are crucial for lasting success:

a) Be explicit and transparent on the objective you want to reach and on the values behind it. Does the objective contribute to the overall goal of poverty reduction, and how?

b) Could the subsidy prevent the authorities or others from taking different, more powerful or lasting measures and, if so, can such measures be promoted at the same time so that the subsidy could be ended once the other measures are in place? E.g. opening up of a remote area with a transport infrastructure; law enforcement or schooling in that very same place.

c) Do you know enough about the framework conditions, social and economic cohesion of your target group, power structures, and social values to be able to design the type of intervention and predict the outcome? Is the timeframe realistic?

d) Ask which groups in society (bureaucrats, parastatals, certain lobbying groups) benefit from current or planned subsidies or investment in certain public goods and services. Is the subsidy regressive? Does it distort production in comparison with that achieved if social prices had prevailed?

e) Check alternative measures and solutions for reaching the objective: laws correcting for negative externalities, taxation policy, tariffs and fees, property rights, decentralisation and cost-sharing of services, promotion of competition, etc. Analyse pro's and con's of the alternatives, especially with regard to foreseen cost and benefits, possible secondary effects, and sustainability. What are the financial and social costs if the subsidy is not granted?

f) Look for an internal solution instead of one coming from outside, i.e. one that is carried by forces in the country (e.g. taxation, information campaign, etc.).

g) Has the target group been involved in the development of the intervention, and do they foresee to participate in costs according to their possibilities?

DURING IMPLEMENTATION

Regular monitoring is needed to detect misuse, discover unexpected effects, and be ready to adapt or abandon the subsidy policy with changes in framework conditions and the environment:

a) Do the real benefits exceed the real costs, taking into consideration secondary effects and opportunity costs?

b) Do the intended beneficiaries outweigh the free riders (beneficiaries not belonging to the target group)?

c) Does the impact on poor people or the environment outweigh the effect of rent seekers (free riders) and of market distortions (which may undermine sustainability once donor support stops)? – From a pure profitability perspective, resource allocation might not be optimal; however, welfare or environmental benefits might outweigh such an unwelcome result, especially if long-term or global considerations are also taken into account.

d) Are corrections in the approach needed? Have exit strategies been planned? Is the handing over of an activity being prepared, or even better, is the activity no longer necessary?

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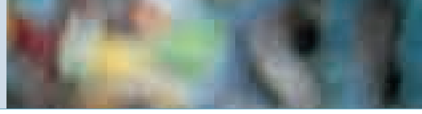

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