Subsidies: Some Work, Others Don’t

Some government subsidies make sense, but often there are downsides

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NORWAY EXEMPTS OWNERS of electric vehicles from paying highway tolls. In Australia, the government pays part of the wages when businesses hire young people, indigenous Australians, or older workers. Singapore offers tax breaks to companies that establish global or regional headquarters in the country. All these are examples of subsidies—fiscal tools governments use to encourage economic development, help disadvantaged groups, or advance other national objectives.

Subsidies take many forms. Governments sometimes keep prices artificially high, which is the case with subsidies intended to boost the incomes of farmers. They may offer services, such as a university education or a subway ride, at below cost. They may pay some of the interest on loans used to finance construction of a road or a power plant. Or they may grant relief from taxes on certain products or technologies.

When do subsidies make sense? They can be a good policy tool when used to correct so-called market imperfections; that is, when competitive, private markets fail to deliver socially desirable outcomes. For example, subsidies can encourage businesses to invest in research and development that benefits not only their firm, but the industry or society as well. They can also help start-ups survive an initial period of losses until they grow large enough to be profitable (although governments need enough information to determine whether firms will succeed when they grow larger).

Impact on inequality

But there are drawbacks. Consider energy subsidies, which are often intended to help low-income households. These can be a drain on government resources if they are available to everyone, including those who are relatively well-off. A targeted cash transfer aimed at poor households costs far less. Subsidies can also exacerbate inequality if they disproportionately benefit those producing or consuming the most. For example, across Africa, Asia, Latin America, and

the Middle East, the top 20 percent of households capture on average *seven times* as many of the benefits of energy subsidies as do the bottom 20 percent (Coady, Flamini, and Sears 2015).

Another drawback: subsidies that do not address market imperfections can distort prices, causing a misallocation of scarce labor and capital that undermines growth. Propping up petroleum prices, for example, may artificially keep firms afloat in energy-intensive sectors and damp investment in alternative energy. Producer subsidies in agriculture, which increase prices received by farmers above prices for imported food products, also reduce incentives for improving efficiency. In the European Union, these subsidies averaged 20 percent of gross farm receipts in 2014–16, according to a 2017 report by the Organisation for Economic Co-operation and Development.

Some subsidies can be harmful, such as those for fossil fuels. They are not only expensive but also at odds with environmental objectives, such as reducing deaths caused by local air pollution or meeting commitments under the 2015 Paris Climate Change Agreement to

ART: THE NOUN PROJECT / MASSUPA KAEWGAHYA reduce emissions of carbon dioxide and other heat-trapping gases. In a broad sense, energy can be considered subsidized whenever its price does not fully reflect not just production costs, but also the full range of environmental costs. Using this more expansive measure, global subsidies in 2015 are estimated at a whopping $5.3 trillion, or 6.5 percent of global GDP (Coady and others 2017)—more than governments spend on health care throughout the world. These subsidies are pervasive across both advanced and developing economies. Subsidies were largest in China, at $2.3 trillion, followed by the United States, at $700 billion, and Russia and India, at about $300 billion each.

Reform strategies

Subsidy reform can be a tough sell because it often involves raising the prices of goods, such as gasoline or food, which immediately hits consumer pocketbooks. Many attempts to scale back harmful subsidies have been reversed under pressure from interest groups and the public.

Governments therefore need a comprehensive and detailed reform strategy that specifies clear long-term objectives for future price paths and the use of revenues (Clements and others, 2013).

Subsidies that do not address market imperfections can distort prices.

A far-reaching communications strategy is also needed to show how subsidies crowd out more efficient and equitable public spending. A gradual approach to reform, allowing consumers and firms time to adjust, can help. Measures such as cash transfers to protect vulnerable households and retraining for displaced workers are often essential to overcome opposition.

Reforming subsidies isn't easy, but many (mostly energy-producing) countries have nevertheless managed to raise domestic prices in recent years, including Angola, Egypt, India, Mexico, and Saudi Arabia. Reforms need to go a lot further, however, particularly in reflecting environmental costs in fuel prices, which should be a key component of countries' strategies to implement the pledges made in 2015 under the Paris Climate Change agreement to reduce carbon emissions. FD

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