

POLICY OF PRICES SUBSIDY AND CONSUMER'S

CHOICE : AN ALTERNATIVE

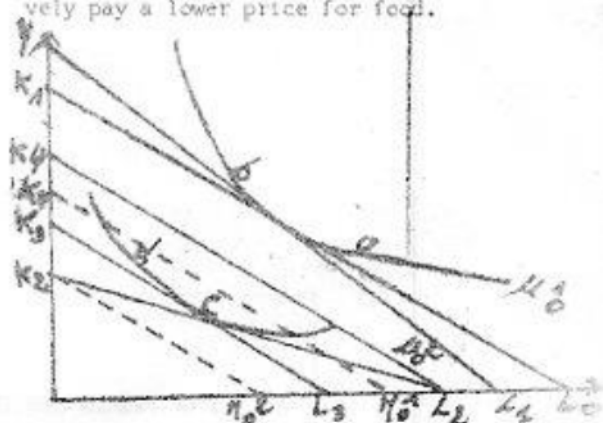
BY : FAROUK A. BENGHEZAL

In many developing countries there exists a policy of prices subsidy for food items (some times some industrial good are also concerned by such policy). This policy objective is to sell goods at a price below of what would be their market price in order to allow low income family to purchase these items considered as basic. However this policy of prices subsidy is not discriminatory in terms of income levels in the sense that every body can buy these goods at the same subsidized price.¹ The paper purpose is to present an alternative view where the funds used to implement the policy of prices subsidy are distributed among households whose incomes are below a given level. In this case households having an income more than a stated level (that will be defined) will pay the full (not subsidized) price.

The approach is based on the distribution of funds, previously allocated to prices subsidy, to households having incomes below a stated level that must be determined. For three classes of incomes are defined in relation to the income of a given household (called household 1) whose level of satisfaction should not change when a policy of funds allocation is substituted to a policy of funds allocation is substituted to a policy of prices subsidy (figure 1).

(1). During the 1970's, a welfare program was carried out by the department of agriculture in the United States: low

income families could buy food stamps that were used to purchase food in the market. The market value that can buy these food stamps is higher than their purchase cost allowing low income families to effectively pay a lower price for food.



Let in figure 1, X be goods whose prices are subsidized and Y all other goods. Let also $K_0^1 L_0^1$ be the budget line of household 1 in the case of prices subsidy and U_0^1 be the utility curve.

The consumer optimum is attained at point "a". If the prices of goods X are not subsidized the new budget line for household 1 becomes $K_0^1 M_0^1$. Since his level of satisfaction should not change when allocating funds, for prices subsidy among households, his new budget line becomes $K_1 L_1$ (which is parallel to $K_0^1 M_0^1$). In this case the consumer's optimum is b and is on the same utility curve namely U_0^1 . The allocation that must get household 1 is equal to $K_0 K_1$ times the price of Y.

Now, for all household whose original budget line (case of prices subsidy) is below $K_0 L_0$ are in class 1 of incomes. Let household 2 be in this class of incomes and let $K_2 L_2$ and U_0^2 be his original budget line and utility curve. To be on the same utility curve this household must have a new budget equal to $K_3 L_3$. The funds allocation policy

must seek to give household 2 the opportunity to be on a higher utility curve. This can be achieved if his budget line is greater than $K_3 L_3$. The proposal is to give this household as much income as budget line $K_4 L_2$. In this case if household 2 were at a corner solution in terms of X say at point " L_2 ", the new budget line $K_4 L_2$ still allow this kind of solution.

Now, let us consider the case of class II of incomes represented by household 3, whose budget line is higher than $N_0 L_0$ but does not cross $N_0 L_0$. For example let household 3's income and utility curve be $K_5 L_5$ and U_0^3 (figure 2).

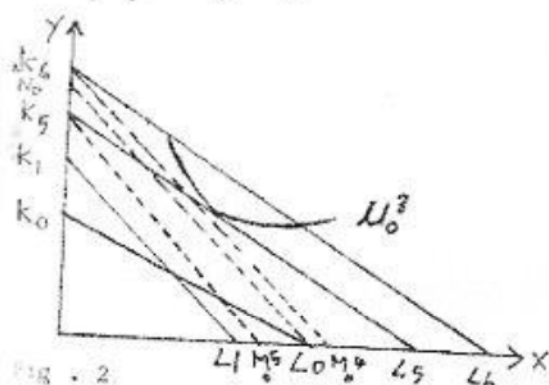


Fig. 2

For household 3 his budget line becomes $K_5 M_0^3$ after that prices subsidy has been suppressed for goods X. Once the allocation of funds has taken place he will have a new budget line equal to $N_0 L_0$ which is parallel to $K_1 L_1$ reflecting the new prices of goods X.

- Two kinds of situations may arise, depending on the position of the tangency point of the original budget line and utility curve.

- If the tangency point is to the right of the intersection of the original

budget line and $N_0 L_0$ as is the case in figure 2, household 3 will be worse off because he will be on a lower utility curve than U_0^3 .

- If the tangency point is the left of the intersection of the original budget line and $N_0 L_0$, household 3 will be better off.

Finally, let us consider class III of incomes represented by household 4 whose budget line does not cross $N_0 L_0$. Let his budget line be $K_6 L_6$. After the prices subsidy suppressed his new budget line becomes $K_6 M_0^4$. Since it is higher than $N_0 L_0$ this class of income will not benefit from any allocation of funds. Households in this class of incomes will be worse off.

The approach even though advocating the prices truth as suggested by the International Monetary Fund and the world Bank to Governments of Developing Countries is different in one respect : funds previously used for prices subsidy are distributed among households for four purposes.

- To increase welfare for those belonging to class I of incomes.

- To maintain the level of satisfaction for those whose incomes are equal to a stated level ($K_0 L_0$) used as a guideline to determine the limits of classes of incomes.

- To lessen the effects of the new prices of goods X on households in class II of incomes.

- To banish high income households from benefiting of low prices because of the prices subsidy policy.

On effect of this approach is to allow for changes in consumption patterns. The price change of goods X may induce a lower demand for these goods. The total demand for these goods (mostly agricultural products) will decrease overtime and may induce a relative price reduction since this kind of products is traded in a near perfect competition type of market.

Usually, food products (mainly agricultural) are concerned by the policy of prices subsidy. In developing countries a major part of these products are imported because local output is not sufficient to meet demand. In fact this policy aim is to subsidize import of food products. The effect of this situation is to discourage local producers from increasing their output because the market price is low (because of the subsidy) ; this situation does not allow local producers with higher marginal cost to enter the market. However if a part of the funds previously allocated to prices subsidy is used to enhance local output of agricultural products the result will be a substantial increase of local production and a probably a decrease of imports.

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