Chapter 2. Easing Subsidy Reform for Producers, Consumers and Communities

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Introduction

The subject of subsidy reform has received considerable attention in recent years. However, much of this attention is focused on the end points or goals of reform and less attention has been paid to the actual process of reform. It is generally recognised that appropriately targeted subsidy reform will result in improved overall economic efficiency and will increase social welfare. But not everyone will gain in the short run and some individuals and communities may be adversely affected by the policy change, prompting governments to seek ways to cushion the impacts of reform on individuals and communities.

This paper provides a review of the key issues involved in the provision of transitional support as part of the process of subsidy reform. The potential social consequences of reform for individuals include reduced incomes, unemployment, relocation and retraining, while affected communities may experience flow-on effects from income redistribution, economic structural change and changes in social capital. The paper reviews the rationales for transitional support, arguing that such support may be necessary to reduce the opposition to reform, reduce the negative impacts of reform, and to reinforce policy reform.

Governments have a range of options for helping individuals and communities in the transition: different types of support, primarily involving compensation payments, and active labour market programmes. The paper reviews some OECD experiences with these policy tools in agriculture, fisheries and trade and provides some insights for the design and implementation of transitional measures. The major lesson from this experience is that transitional supports need to be truly temporary and well-targeted if they are to be effective and help to maintain policy credibility for the government. Other key insights relate to the timing and sequencing of reforms, concerns over equity versus fairness, and the need to ensure coherence between transitional programmes and the broader policy settings of economies.

The context of reform

In the late 19th century, an American political commentator, John Jay Chapman, remarked that "*[p]eople who love soft methods and hate inequity, forget this – that reform consists in taking a bone from a dog. Philosophy will not do it*". Just because a particular reform is a good idea and is judged to be beneficial, this does not mean that it will be easy. Rational arguments, economic findings, reason, or philosophy will not be enough to get the reform done. Much more is required.

Reforming policies by reducing or removing subsidies improves economic efficiency as a whole through a better allocation of resources. Society as a whole will be better off. However, this does not mean that everyone will be better off. In most cases, subsidy reform in a sector will have adverse effects on some individuals, households and communities engaged in the sector, in particular in the short-term. There may also be negative impacts on upstream and downstream sectors. Regional economies that rely on commodities whose prices and production levels fall with reductions in support may also be affected.

Such adverse impacts, or just the threat or prospect of adverse impacts, is one of the major reasons why governments find it difficult to make progress on subsidy reform. And this is despite significant and arguably growing pressures for reform to meet multilateral and bilateral trade commitments and to respond to budgetary constraints.

Social issues in subsidy reform

The process of subsidy reform must take into account a number of key social issues. The most obvious and immediate impact of subsidy reform is that there will be a change in the income distribution between individuals. While there will be an overall gain in welfare, some individuals will be made worse off and some better off as a result of changes in income or wealth. This is effectively the driving force behind the political economy of subsidy reform. Those who stand to gain from the *status quo* or who lose from the reform have the greatest incentive to lobby for the retention of the existing regime or modification of the proposed reform to lessen the impact on their individual or group welfare.

There will also be impacts at the level of the community(ies) in which the affected individuals live. This will vary with the dependence of the community on the subsidised industry, which in the case of some fishing, agriculture and resource dependent areas, can be quite high. There may be a lack of immediate alternative opportunities for employment or economic diversification, reflected in a low resilience in the community to handling change. And there will be effects on activities and communities both upstream and downstream from the formerly subsidised sector.

At the same time, however, it must be remembered that reform can generate new economic opportunities over the medium to longer-term. A more efficient allocation of resources will create a stronger enabling environment in which economic activity can flourish. In the case of the beef liberalisation in Japan, farmers responded to trade liberalisation by shifting to more value-added products and decreasing costs by expanding farm size. When subsidies on grain transportation in Canada were removed, farmers responded to market signals by diversifying crop patterns, increasing livestock production and increasing value-added processing. The underlying goal of transitional support should therefore be to help individuals and communities to increase their resilience and flexibility and to improve the sustainability of the industry.

Rationale for transition support

The reform of an existing policy situation does not by itself justify the provision of transition support. Modern economies are constantly changing as they evolve in the face of technical progress and other external influences, creating winners and losers in the process. It is impossible and arguably undesirable to indemnify all members of society from harms caused by economic change. One of the primary risks in offering support is that the market signals that lead to improved efficiency and productivity may be muted or silenced entirely, adversely impacting the long-term growth and viability of the sector. So care is needed in designing transitional support measures.

Nevertheless, transition support may be an attractive policy option in many cases. The motivation for this may come from reasons of social choice and preferences, political economy, some legal obligations or a sense of moral duty. These different rationales are of interest because different motivations and objectives lead to different reform approaches to obtain them.

Social choice: Social preferences may be expressed for relative income distributions across individuals, communities or sectors. If the underlying preferences have not changed despite the subsidy reform, then it can be argued that transition support will help keep actual income distribution in line with the preferred one. Community concepts of fairness and equity are central to these preferences and how they are manifested in policy.

Political economy: Policies are chosen in order to maximise social welfare according to economic and political constraints. In addition, pressure groups can have influence on policy reform and the distribution of benefits. Transition support, either in the form of compensation or some other policy concession, may well then be the equilibrium outcome of a political process where some stakeholder group or groups apply sufficient political pressure to obtain favourable treatment. The amount of the policy concession is more a function of the influence of the pressure group than the amount of harm that might be incurred.

Legal obligation: the idea of a government "taking" – a reduction in the value of property as a result of government action – is best developed in the United States, although this clearly depends on the laws and constitution of different countries. A central criterion in determining whether a taking has occurred is "reasonable investment-backed expectations".

Moral duty: Finally, there may be a sense of moral duty on the part of the government to offer transitional support. Governments may feel a responsibility to offer compensation subsequent to a policy reform that changes an economic landscape that they had a hand in creating. Governments may also be motivated by genuine concern for less advantaged groups.

Types of transition support

Different reform strategies are possible, depending on the duration of implementation and the level of compensation (**Figure 1**). Gradual reform without compensation reduces interventions over time, significant enough to yield benefits but slow enough to avoid resistance (*squeeze-out*). When reforms are offered with compensation, typically the old policy is terminated and replaced with a series of cash payments (*cash-out*). When these payments are of unlimited duration, this is termed “re-instrumentation”. Rapid reform terminates a policy completely without a phase-out period, either associated with a compensation payment (*buy-out*) or not (*cut-out*).

Figure 1. Alternative subsidy reform strategies

Compensation?	Duration of implementation	
	Long	Short
Yes	Cash-out	Buy-out
No	Squeeze-out	Cut-out

There are several types of or approaches to transition supports in the context of subsidy reform which are discussed below: 1) reliance on existing social assistance, 2) “fiddling” with the reform, 3) economic diversification, 4) compensation, and 5) packaging reforms.

Existing social assistance

Basing transition supports on the generally available social security system, retirement and retraining schemes, or upskilling and training could be regarded as the “do nothing” option or the “cut-out” option. This approach has been used in many countries, particularly for minor reforms where the political weight of the affected groups was not sufficient to create a groundswell of support for extensive new assistance.

This has several advantages in that the support system is already in place and functioning or could be easily adapted, and it is low cost and administratively simple. An example is the additional social security available to fishers in countries such as France and Norway when direct fisheries supports are modified or withdrawn.

However, the existing social security or training schemes may not be sufficiently targeted or easily tailored to the sector affected by subsidy reform. Owing to regional and other disparities, one size does not necessarily fit all. For example, a small coastal French fishing village will not face the same adjustment challenges as a steel town in the heart of the Ruhr valley. In addition, there may be poor political acceptability by the public as well as the industry and workers. Doing nothing does not always sit well with the voters and may be difficult with flagship sectors or sectors with some attachment to society’s heritage (such as fishing and farming).

"Fiddling" with the reform

The "fiddling" approach involves longer phase-in periods for reforming harmful subsidies, just as international trade rules generally allow for longer phase-in periods for special and differential treatment reasons. This may include exemptions or carve-outs for specific groups – a good example being the exemption wrought by taxi drivers from the Central London traffic charge (which was not given to other groups such as nurses).

The advantages of this selective approach include the ability to target the reform to specific groups or sectors, the extended time allowed for adaptation, and general political acceptability. However, the extension of the transition period and the temporary exemptions from the reform can become entrenched and permanent. Once governments provide exemptions, there may be doubts about the direction, timing and political commitment to reform. Judgements about equitable treatment are also required. As a result, overall policy credibility may suffer.

Governments who try to minimise social dislocation by delaying adjustment also run the risk of creating a situation requiring greater and more difficult adjustment later on. In the chemicals industry, for example, countries such as the United States which left adjustment to market forces experienced some declines in employment but recovered relatively quickly. In contrast, some countries who delayed adjustment experienced longer periods of turmoil with greater declines in employment in the end.

Economic diversification

Subsidy reform programmes oriented towards increasing economic diversification include the use of active labour market programmes (unemployment insurance, early retirement payouts, counseling and training), regional supports, and aid to industry and infrastructure development. These aids are generally targeted towards individuals and communities. An example is the *Farm Family Restart Scheme* in Australia designed to assist exit of farmers from the industry by giving them access to professional advice on the future viability of their business and other employment opportunities. Over the 7 years up to 2004, 8 700 farmers have accessed the scheme, 7 400 have received professional advice, 1 000 have received re-establishment grants, and 200 have accessed training grants.

There are several advantages to this approach, including enhanced political as well as individual and community acceptance of reform. Individual capabilities and social capital can be deepened, the resilience and flexibility of communities and regions can be strengthened, and the economy can be diversified away from supported sectors. In general, active labour market programmes have proven to be largely successful.

There is some evidence that decentralisation of adjustment policies may be beneficial because different regional effects can be taken into account. It may be possible to base transitional support packages on local information and may allow more targeted actions and policies to be undertaken. For example, fishing industry adjustment in France was assisted by local policies, and some support payments in US tobacco industry case were devolved to the local level.

However, care must be taken to not shift subsidies and support to new industries or to diversify resources into sectors or activities that are themselves still the subject of significant support. There can be other unintentional side effects of the diversification strategy. For example, regional subsidies provided to some companies in the European chemicals industry were part of the reason for the excess capacity in the 1980s. The subsidies allowed inefficient producers to survive and numbed the ability of efficient producers to sense impending change and adjust to changing market conditions.

Compensation

There are many examples of compensation packages being put in place to assist subsidy reform, including payments for loss in asset value, reductions in prices, elimination of quotas, etc. In the EU and US tobacco industries, for example, compensation was provided to assist individuals whose wealth was in part based on quota holdings. In the Australian dairy industry, an adjustment package was provided to help farmers adapt to the elimination of a price support scheme for manufacturing milk. Two components of the adjustment package were directed to farmers (one for all dairy producers and one to assist those who wished to exit the industry) and a third component was directed to communities in which dairying was an important contributor to the local economy.

Over- and under-compensation are both potentially optimal strategies to overcoming opposition to subsidy reform, where the relative influence of pressure groups is the determinant factor. Policy reform and compensation provide an opportunity to bring the distributional impacts of agricultural policies more in line with current social preferences, implying in some cases a pattern of compensation payments different from that of the reformed policy. Compensation should in every case minimise market distortions. Programmes that are temporary, targeted and tailored will minimise costs and allow beneficial market adjustments to occur.

However, there are also certain disadvantages to this approach. Compensation can itself become entrenched and difficult to remove, as is the case with all types of transitional supports. The credibility of governments with regard to the true commitment to reform can be questioned, while they may also be accused of “picking winners” and making bad selections of industry segments to support. In addition, compensation linked to subsidy reform can itself have high budget costs.

Packaging reforms

Subsidy reduction can be packaged with other fundamental policy changes or combined with other changes to the regulatory environment governing an industry to ease the adjustment process. In the case of fisheries in New Zealand, for example, the early 1990s saw a major shift in policy towards the sector. Subsidies were eliminated virtually overnight, a major change in management philosophy was introduced in the form of rights-based management and individual transferable quotas, and there was a minimum buy-out of existing rights. Subsidy reduction alone would not have been sufficient to create a sustainable fishing sector and would have caused substantial financial and social distress. It would also have an impact on fish stocks due to overfishing when fishers increase effort in order to try and cover marginal costs. In New Zealand, subsidy reduction went hand in hand with a shift to a management regime (individual transferable quotas) which helped give those remaining in the fisheries sector a good chance at creating a profitable business environment, while allowing those who wished to leave to be bought out by those who wish to remain.

Devising a roadmap for reform which packages together several offsetting measures may reduce political opposition to policy changes as well as increase transparency.

Reducing subsidies while also changing regulatory and management regimes can improve the overall functioning of the economy. However, correct policy sequencing can be difficult and "big" reform packages are often politically difficult to sell unless there are external driving circumstances.

Ensuring successful reforms

In summary, a successful subsidy reform process which includes transition supports depends on a number of factors:

1) a good enabling environment – including macroeconomic settings, the social security system, labour market programmes, and a well-funded education system;

2) a clear exit strategy – where programmes are time bound from the outset. If not, they risk preventing the adjustment they were designed to facilitate. For example, a programme that compensates farmers for the fall in prices or revenues resulting from reform or liberalisation beyond the short-term may have exactly the opposite impact to that intended. Moreover, such programmes are extremely difficult to terminate. If they continue in place for a long time they may create new distortions;

3) clear and agreed objectives – where adjustment policies are well targeted to specific adjustment aims and intended beneficiaries. Consideration needs to be given to whether up or downstream industries should also be included in adjustment measures or whether economy-wide measures relating to reconversion or redeployment of resources tied up in affected industries are sufficient. More generally, from a political economy point of view, the equity issues relating to who gets assistance and who pays, needs careful consideration in the design of any transition package;

4) policy coherence – when designing several programmes for adjustment, these should be mutually consistent and integrated. A well designed subsidy reform scheme would include coordinated and consistent entry and exit elements, and coherence with existing policies such as the general safety net.

Conclusions

In conclusion, there is no one true and tried formula for designing and implementing transition support policies in the context of subsidy reform. This varies from country to country and from sector to sector. Transition support should help producers who want to leave the industry to do so with dignity and financial standing or to diversify into other activities. Here, financial grants and job training for other activities, buyouts and early retirement plans are useful. Transition supports should also aim to raise the stock and quality of the human, material and social capital of the sector in question in order to improve the competitiveness or viability of those who stay in the sector, both individually and from a community perspective.

Political economy considerations have tended to dominate the design of transition support programmes. The use of compensation payments as a means of reducing opposition to reform is pragmatic but can set the sector and government up for unintended effects. Careful design is therefore needed.

For any adjustment process to be successful it is important for those affected to believe in the irreversibility of the policy changes being made and in the time-limited nature of the assistance measures being offered. Clearly, one-off measures or multi-year schemes with provisions known in advance will be more plausible than year by year decisions. Governments therefore need to be clear and transparent about their intentions and, in so far as political processes allow, should hold firm to the reform and adjustment measures as originally announced. The prior planning and consultation process should be managed so as to limit the risk of moral hazard or adverse selection.

The reluctance of governments to undertake reform suggests that they may have underestimated the adjustment potential of industry. Reduction of subsidies presents severe challenges to industry and governments alike, but it also generates new opportunities. We have seen this in many cases where the potential of producers to transform changing conditions into new opportunities has been demonstrated. For example, this has been accomplished by shifting to more value-added products, by expanding firm size, by consolidating companies, and by developing export opportunities. Adjustment packages associated with subsidy reform need to be designed to unleash the potential of the private sector to create new opportunities in response to changing conditions.

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