Government Subsidy Policy and its Impact on Efficiency and Economic Growth

Many governments in developing countries adopt price controls for basic consumer goods. They may counter the shortfall in the availability of such goods with direct subsidies to producers of these commodities. In Egypt, Iran, Mexico, and other developing countries the prices of staple items such as bread, sugar, and cooking oil have been under government control. As a specific example, in Venezuela the price of gasoline has been kept very low and well below the world price. At the official exchange rate, a gallon of premium gasoline in Venezuela is 5.8 U.S. cents! It is even lower at the unofficial exchange rate: only 1.5 U.S. cents per gallon!

One consequence of artificially cheap gasoline in Venezuela is the smuggling of gasoline from that country to Colombia, a neighboring state where gasoline is not subsidized. Every day thousands of cars, motorcycles, and buses in Venezuela load on gasoline and head into Colombia. There they sell their gasoline in small containers --or siphon it out of their cars-- for a profit.

The subsidy policy is part of a populist strategy of the former president of Venezuela, Hugo Chavez. By instituting government subsidies on basic goods like gasoline, Mr. Chavez made himself enormously popular. However the long term effects of this policy are questionable. For one thing, Venezuela, a major oil exporter is chronically short of cash. The network of refineries in Venezuela is in a state of disrepair. A major crude oil exporter, Venezuela depends on the imports of gasoline for its domestic consumption.

One aspect of the gasoline subsidy policy is that while it is designed to help the poor, everyone including the rich, who do not need the subsidy, benefit from it. The International Energy Agency calculates that energy subsidies cost the Venezuelan government some $27 billion in 2011, revenues it could have earned by selling gasoline at market prices. The lost energy revenues represent a significant 8.6% of the gross domestic product of Venezuela.

Since the government spends a sizeable amount of its budget on gasoline subsidy, it is unable to spend on important investment projects such as building new infrastructures or repairing the existing ones. The government also has to limit its expenditures on essential services such as crime control.

This distortionary measure is unlikely to change. Many Venezuelans have grown accustomed to the long running policy of artificially cheap gasoline and consider it their fair share of their economy's oil wealth.

This essay is based on the article, *Cheap Gas in Venezuela Comes at a Heavy Cost,* from The Wall Street Journal.

ESSAY – Why do governments adopt subsidy and price control policies? State the main points this article makes and articulate a pro or con argument (related to this article)

Essay 1- Sample 1- Score 6 or 5 (Very Strong)

Governments adopt price controls on basic goods to allow the poor urban consumers afford those goods. This policy is more common in the developing countries where there are large numbers of workers whose incomes are low. Given free market prices for basic goods, many of the urban poor may not be able to afford basic goods like bread, cooking oil, sugar, etc. The government therefore adopts a price control to keep prices low enough so the low income consumers can afford those goods. The effect of price control is a shortage. The government may also provide a subsidy to the producer in order to increase the quantity of this good available to consumers at low price.

As the article mentions, in the case of Venezuelan gasoline, one effect of the subsidy is that it may create a large difference between the domestic price and the price of this commodity in another region or country. There is an incentive to buy the gasoline at the artificially cheap price at home and smuggle it out of the country and sell it there at a higher price.

The article also points out that government spends large sums on this type of subsidy. This contributes to government budget deficits. In addition, due to low revenues from sale of low priced goods the producers may opt not to invest in their businesses. In the case of cheap gasoline in Venezuela, the refineries are unable to invest adequately in repair and expansion of their operations.

I would argue that price control and subsidy policies on basic goods are harmful to economic growth and efficient allocation of resources. The artificially low price leads to over consumption and waste. Additionally in the case of Venezuelan gasoline, the large difference between the price in Venezuela and Colombia has led to the rise of petty traders who illegally smuggle gasoline out of that country and into Colombia. These people could have used their time and effort actually producing other goods and services, increasing the national output.

I would also argue that the burden of large subsidies on government budgets harms economic growth. Governments of developing countries could best use their tax revenues on investment type projects such building of roads, schools, hospitals and promoting education instead of augmenting consumption of food or gas by the public.

Essay 1- Example 2- Score 6 or 5 (Very Strong)

In many developing countries, the government sets (controls) the prices of necessary goods to make these goods affordable to the poorer members of society. However price controls trigger shortages as producers are not willing to sell these goods at such low prices as this would result in losses. To induce producers to make these goods available at the price set by the government, their production must be subsidized. Another reason why governments might want to set low prices for widely-demanded goods is plain demagoguery: a leader might boost his popularity by doing so. For example, the former president of Venezuela subsidized gasoline resulting in ridiculously low prices.

The article describes the consequence of these policies in Venezuela, thus unveiling the general economic impact of price controls. The subsidies were very costly for the government, which was always short of revenues and as a result could not maintain the state-owned refineries in good working order. This was a vicious circle for Venezuela: the main export is crude oil, a substantial source of income for the country, but since the country is not able to refine its own oil, it has to import its gasoline that is then sold at a ridiculously low subsidized price to the Venezuelans, rich or poor. In addition, this policy gave rise to a thriving black market with Venezuelans smuggling oil into neighboring countries where oil prices were not subsidized.

It is hard to make much of a case in favor of price controls as a permanent scheme. Their impact helping the poor is limited. From an economic point of view, they distort prices, the fundamental signals determining the efficient allocation of resources in an economy. For the government, these policies are costly and they cannot be easily repealed. As a result, price controls and subsidies will have an adverse impact on growth and on welfare as well as inciting corruption.

Essay 2- Score 4 or 3 (Acceptable)

In some developing countries, governments help the poor and give them subsidies for some goods like food and gas. On effect of this policy is that people consume a lot of these goods and the government needs to spend a lot to provide them to the public. Therefore the government run budget deficit.

In Venezuela, gasoline is also smuggled out of the country. Consumers of this good buy it very cheap and can sell it at higher prices across the border in Colombia. While this activity is illegal, it helps a lot of people earn additional income by trading their goods at higher prices outside of Venezuela.

The Subsidy policy make the government or its president very popular. However from the standpoint of economic efficiency it is not desirable. The government spends on food and gas for the people and is short of funds to invest in infrastructure projects that help the economy in the long run. For example, the refineries in Venezuela could use some investment for repair but the government does not have funds.

One of the problems with this policy is that many poor people in the country are used to low prices and the government find it hard to remove the subsidies. Therefore economic inefficiency will continue and this is undesirable effect for the long term economic growth.

Essay 3- Score 2 or 1 (Not acceptable)

The government in developing countries make price controls and subsidies that helps everyone buy goods at cheap price. This helps the people and the government is very popular. In Venezuela, some people take gasoline to the border to Colombia and earn more money. This is good business and the poor is better off.

The policy of subsidy and price control show how prices are the opportunity cost of goods and how government will not remove them since people like it. It will be worse if government remove this policy and people protest. In Venezuela the government is short of cash and people make money. Low price keep people alive and this is very important. Such prices are important for efficiency.

Some of the distorted effect is that the government may compromise the economy in the long run. This is because people buy many goods and the government does not have money to educate them or build roads and hospitals. Also smuggling is illegal. I think we compromise our prospects in the long run.