

# [Here is no economic case for having any targeted benefits essay sample](https://assignbuster.com/here-is-no-economic-case-for-having-any-targeted-benefits-essay-sample/)

[Economics](https://assignbuster.com/essay-subjects/economics/)

Throughout history, governments have suggested that individuals have invalid preferences over consumption. Whether governments justify this belief through the existence of externalities or through plain paternalism, action is taken to distort consumers’ choice in favour of the government’s projected preferences. One way governments achieve this is by choosing in kind transfers, or targeted benefits, over cash transfers. In doing so, Governments can theoretically insure that the targeted consumers spend a minimum amount on a certain good or service. In this essay, I hope to diagrammatically and intuitively support the theory behind carte blanche principle, before extending the principle to a real life example, more specifically, to the United States Supplemental Nutrition Assistance Program, commonly known as the Food Stamp Program. The carte blance principle implies that targeted benefit recipients would be weakly better off if they were given cash instead of an equivalent amount in targeted benefits.[1] Consumers are ‘ weakly’ better off because they would either be better off or indifferent with a cash transfer opposed to a targeted benefit.

Which category a consumer falls in depends on whether they are inframarginal or distorted. Inframarginal consumers are indifferent because they already spend at least the value on the targeted good then the targeted benefit allows. For these consumers, a targeted benefit would free up the money that was already being spent on the targeted good to increase expenditure on targeted and non targeted goods. Therefore inframarginal consumers are able to maximise their utility to the same level of utility subject to their budget constraint, regardless of whether the benefit was in kind or a transfer thus avoiding any dead weight loss. However the same cannot be said for distorted consumers, which is where targeted benefits has the most ‘ bite’. Distorted consumers are those that would otherwise spend less than the value of the targeted benefit on the targeted good. These are the people that the targeted benefit is designed for, because it is thought they aren’t consuming enough of the targeted good.

Figure 1 shows distorted consumers’ strong preferences for the non targeted goods. The diagram shows that before the targeted benefit, the consumer optimises her utility by choosing the bundle of goods in her budget set that is on her highest indifference curve. This occurs at e0, where the indifference curve u0 is tangential to her budget constraint. The in kind transfer in the targeted good horizontally shifts her budget constraint outwards, increasing her opportunity set and allowing her to consume q1 of the targeted good (the minimum amount) and more of the non targeted good. However this is a corner solution because the distorted consumer values the last pound spent on non targeted goods more than the last in kind transfer (with a cash equivalent of a pound) spent on targeted goods. Hence if the distorted consumer was given a cash equivalent transfer, as shown by the dotted budget constraint, then she would spend less on targeted goods (q2) and more on non targeted goods. This different bundle of goods (e2) attained from a cash transfer allows her to reach a higher indifference curve of u2 than if she received a targeted benefit. The difference in the indifference curves u1 and u2 show that targeted benefits are economically inefficient in maximising utility.

Firstly, there isn’t allocative efficiency because cash transfers are in higher demand than targeted benefits by distorted consumers. Secondly, there isn’t Pareto efficiency because the distorted consumers would be better off by receiving cash transfers, without making anyone else worse off. This loss of economic efficiency is also known as a dead weight loss and it is the reason why there isn’t an economic case for targeted benefits. So thus far, I have shown that targeted benefits create a dead weight loss to society, but to what extent? This depends on the size, nature and context of the targeted benefit. Size is important because it affects the proportion of consumers that are distorted. If the targeted benefit is large then it is more likely to exceed a consumer’s optimal consumption of the good if it had been a cash transfer. Therefore the larger the targeted benefit then the higher the concentration of distorted consumers and the larger the deadweight loss. In addition, the nature of the targeted benefit influences the proportion of consumers who are distorted, which in turn influences the size of the dead weight loss.

For instance, if there was a low demand for the good that that can be bought with the targeted benefit then there would be a large proportion of distorted consumers. For example, there would be more distorted consumers for a targeted benefit for rotting apples compared to a targeted benefit for chocolate. In addition the size of the targeted benefit relative to the price and expected consumption of the targeted good is also important. For example a targeted benefit for toothbrushes with a nominal value of £50 will have more distorted consumers for the same targeted benefit for cars; although both commodities may be in equal demand, their relative prices and expected consumption are very different. Finally the societal context of the targeted benefit refers to the existence of an underground market in the targeted benefit. As is often the case with targeted benefits, an underground market forms allowing distorted consumers to sell their ‘ extra’ targeted benefits to inframarginal consumers at a price below their nominal value.

This effectively turns the targeted benefit into a cash transfer and reduces the dead weight loss. The extent to which it is reduced will depend on the underground price for the targeted good: the closer the underground price to its nominal value then the smaller the dead weight loss. This in turn will depend on many factors such as: the punishment for being caught trading the targeted benefits; the ease at which sellers and buyers can meet to trade; whether the nature of the targeted makes it possible to trade. From an economic perspective, targeted benefits are generally seen as inefficient, this begs the question why they are still being used by governments across the globe today. Maybe it is because their purpose is to be ethically sound or politically viable and not necessarily to be economically efficient. For example the Food Stamp Program set up in 1939 in the USA has a mission to “ safeguard the health and well-being of the nation’s population by raising levels of nutrition among low-income households.”

Although economic efficiency may not be a top priority to policy makers it is always strived for. In the rest of this essay I hope to apply the carte blanche principle by looking at a current application of targeted benefits: the Food Stamp Program. The Food Stamp Program amounts to a significant proportion of U. S. government resources; in 2010 the program served 31. 3 million participants which is equivalent to 13. 4 percent of the U. S. population.[2] It allocates electronic food tokens to the poor which are then exchanged for non alcoholic drink and food. In 2002 the effectiveness of the program was evaluated in a study by Diane Whitmore. The study found that 18 to 21 percent of households who received food stamps were distorted suggesting the society suffered a large dead weight loss [4]. The paper calculated the loss to distorted households by subtracting the amount of utility in dollar terms they obtain from the food from the cost of extra food consumed. This was done by using the compensated demand elasticity for food which is defined as: [5]

This shows the sensitivity of the quantity of food demanded to a change in price whilst holding utility constant. It is important to use the compensated elasticity because the welfare loss is a measure of how to make the consumer as well of if the targeted benefit had been a cash transfer, hence, utility must be held constant. By using values from existing studies, Whitmore found the compensated demand elasticity for food to be in the range of -0. 16 to -0. 28, that is a 10 percent increase in food prices reduces demand by 2 to3 percent, in other words, it’s inelastic. Using linear approximation to the elasticity, Whitmore was then able to estimate the dead weight loss: $0. 23 of value is lost on each dollar of food consumption above what distorted consumers would already spend on food. This translates to an aggregate dead weight loss of $0. 91 billion. This supports the theory that there is no economic case for targeted benefits. If the U. S. were to cash out food stamps and keep benefit levels the same then the distorted recipients would be made $0. 91 better off.

However the presence of an underground market offsets some of this dead weight loss. One of Whitmore’s estimates suggests that distorted recipients should be willing to sell their extra food stamps for 43 percent of their face value. This low price might be due to the harsh consequences of being caught trading and the increased difficulty that the electric Furthermore there would be other savings that aren’t part of the dead weight loss, for example cashing out would reduce administrative costs which the paper estimated to be at $5. 9 billion in 2002. [6] To conclude, targeted benefits create a dead weight loss to society.

More specifically, they narrow the choice set for consumers which leads to distorted consumers choosing a bundle of goods that lies on a lower indifference curve compared to if the targeted benefit had been a cash transfer. The extent of the welfare loss is determined by the size, nature and context of the targeted benefit. A current example of a targeted benefit being used today is the Food Stamp Program in the U. S. which the Whitmore paper estimates to have a welfare loss of $17 billion of annual food stamp spending. Although a cash transfer may be a more economically efficient use of resources compared to the Food Stamp Program, this may not be a viable alternative. A cash transfer is unlikely to have the same political popularity. Although for the majority of consumers are inframarginal and are indifferent between the two, the fact that the benefit is labeled as a ‘ food stamp’ gives rise to its popularity. Therefore there appears to be a pay off between economic efficiency and political popularity.

References

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