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Maximizing the Economic Impact of Cash Transfers: why Complementary Investment Matters

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Providing safety nets to the poor is part of the agenda of most developing countries. When poverty incidence is high, providing a significant share of the population with social transfers implies substantial mobilization of resources for the government. It also implies that a large injection of funds will flow into the economy and reach a population that will mostly consume the transfers they receive. This increase in households' consumption will increase demand for all sorts of goods and services and will have varying economic impacts depending on whether it reaches markets that have the elasticity needed to respond efficiently and rapidly enough to prevent prices from increasing.

Lack of market integration, which is characteristic of remote areas and rural villages where social protection programs are especially needed, implies that such a rise in household demand for goods and services could generate price increases and hence compromise the benefit of the measure for both recipients, whose real income might not increase as expected, and non-recipients who will also see their purchasing power affected. Rising prices may also induce increased imports, thereby lessening the potential benefit to domestic producers, which has been noted in relation to the economic impact of social transfers (Barrientos 2012). Such risks could affect the efficiency of cash transfer policies.

Since pilot projects were implemented in the early 2000's, research on social protection has mainly focused on its impact at the level of households, through their behavior and decision making. Very few studies (Alderman and Yemtsov 2013) have analyzed or tested empirically the impact that social transfers are likely to have on the local economy.

We have developed a macroeconomic model of the Cambodian economy that was tailored specifically to simulate a large range of social policies and household targeting strategies. This simulation tool allows us to analyze the potential economic impact that social protection policies might have in a small economy with market imperfections and weak market integration between rural and urban areas. This study (Levy and Robinson 2014) illustrates why cash transfers might induce price increases that could reduce the efficiency of the policy and calls for complementary measures to benefit both recipients and the domestic economy.

Price effects and impact on local markets

When cash transfer policies are simulated alone, we find no increase in real GDP, even when up to 2 per cent of the gross domestic product is distributed to households and even when the policy is fully funded by aid or by the Cambodian oil and gas revenue–and so does not increase the tax burden that could slow down the domestic economy. This result holds whatever household targeting strategy is used: cash transfers appear insufficient to promote economic growth when implemented alone. Why?

The rapid introduction of a relatively large scale cash transfer programme could give rise to distortions on local markets, agricultural markets in particular, where supply fails to adjust rapidly enough to the increase in household demand through production, and even, for parts of the country, through trade. Our results show a potential increase in some domestic prices, agricultural commodities' in particular. This outcome would be bad news for both direct beneficiaries and non-beneficiaries of the measure. Even if many targeted households decide to invest part of the transfer they receive into productive activities and assets (such as cattle, tools, seeds), the benefit of this investment on the domestic economy seems insufficient to overcome the distortion on domestic markets.

Combining cash transfers with productive investment

So what role can social transfers play in an economic growth strategy? Our results show a strong complementarity between cash transfers and productive investment in agriculture (i.e. rural infrastructure, irrigation and productivity-enhancing inputs). For example, we find that it would be economically more efficient to share public spending between such productive investment and cash transfer, than dedicating it to any of these measures alone. Such an association of policies creates strong synergies and would be conducive of a beneficial combination of economy-wide impact and poverty reduction among all Cambodian households, compared to social transfers or investment measure alone.

By stimulating domestic supply and allowing it respond to the increase in demand without increasing prices, public investment appears to be an ideal complement to social protection, and the combination of the two provides a robust engine for growth. This means that combining cash transfers with such targeted public investment is likely (i) to significantly stimulate the domestic economy and (ii) generate better outcomes in terms of poverty reduction than each measure separately.

In our results, poverty reduction among all households becomes then greater than when CTs are implemented alone. This means that safety nets are likely to have better poverty impact when integrated in larger investment and rural development programmes that enhances productivity in economic sectors that are key for the poor. Such policies should be designed in conjunction rather than in parallel.

Policy makers have limited, typically scarce, funding capacity. They demand realistic assessment about what social protection can achieve. Our results suggest that the efficiency of these policies could be improved by taking into account and supporting, at an early stage of policy design, the capacity of local production to respond to a sustained increase in domestic demand.

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