

Preface

This work is an updated version of the background study prepared for the discussion paper on *Government Subsidies in India*, brought out by the Ministry of Finance, Government of India in May, 1997. The main changes in this updated version relate to the use of accounts figures rather than revised estimates in the projections for 1994-95, and separate estimation of subsidies for four special category States which also necessitated some modification in the methodology for arriving at all-State estimates for a common year, for special as well as non-special category States. The revision does not lead to any noticeable change in the overall magnitudes, or subsidy figures taken as percentage of GDP, but the recovery rates turn out to be even lower than the earlier estimates. An abridged version of the foreword to the background study by Dr. P. Shome, the then Director of the Institute, is included here. The magnitudes referred to there have been updated since.

Dr. C. Bhujanga Rao and Mr. H.K. Amarnath have provided substantial help in preparing this updated version. Mr. R. S. Tyagi provided adept secretarial assistance. The camera-ready text for printing was designed and prepared by Mr. S. B. Maan.

Although the study was initially undertaken at the instance of the Ministry of Finance, Government of India, the views expressed here, and any errors, are solely the responsibility of the authors.

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Preface to Background Study

The National Institute of Public Finance and Policy is an autonomous non-profit organisation established for carrying out research, undertaking consultancy work, and imparting training in the field of public finance and policy.

It was at the instance of the Ministry of Finance, following a commitment made by Shri P. Chidambaram, Honourable Minister of Finance in his 1996-97 budget speech to provide a discussion paper on subsidies so as to highlight the visible and hidden subsidies in the system for the purpose of having an informed debate on the subject, that this study was authored by a research team at NIPFP comprising D. K. Srivastava, Tapas K. Sen, and H. Mukhopadhyay with a foreword by Parthasarathi Shome. Additional research inputs were provided by Charu C. Garg, T. S. Rangamannar and C. Bhujanga Rao, and research assistance came from H. K. Amarnath, Gita Bhatnagar and Jagdish Arya. Secretarial assistance was provided by R. S. Tyagi.

The study was completed under considerable pressure of time, in a period of about five months.

The Governing Body of the Institute does not take responsibility for the views expressed in this report. That responsibility belongs to the authors of the report.

Parthasarathi Shome
Director

March, 1997.

Foreword

Subsidies can be a powerful welfare augmenting instrument of fiscal policy. However, their beneficial potential is at its best when they are transparent, well targeted, and suitably designed for practical implementation. In India, although subsidies account for a significant share of government expenditures, only a small part of the subsidies is made explicit in the budget documents. Since substantial subsidies remain implicit in the provision for social and economic services, they easily grow out of control putting further pressure on the fiscal deficit. In addition to having become unduly large in volume, our subsidies are mainly input-based, and are generally inefficiently administered. As a result, it has been difficult to control or comprehend their impact fully, giving rise to concerns about their ramifications for the pattern of income distribution. Problems related to their effects, and the persistent pressure on fiscal deficit caused by them, in turn, undermine the quality of fiscal policy in the economy.

The proliferation of subsidies in India could perhaps be linked to the expanse and growth of governmental activities. Apart from the basic and traditional functions like defence and maintenance of law and order, the government has extended itself into producing a wide range of commodities in competition with the private sector. In many of these activities, the government is unable to recover its costs, giving rise to an undue proliferation of subsidies. A quantification of the extent of unrecovered costs, disaggregated across the spectrum of governmental activities is, therefore, necessary to reform the existing structure of subsidies. Herein lies the objective of this discussion paper. It is to provide an estimate of (i) the aggregate volume of governmental subsidies, (ii) its distribution across services provided by the government and (iii) the extent of subsidisation in different services. Some general observations on the incidence of the major subsidies, and their implications for efficiency, are also made.

In choosing its approach and methodology, the NIPFP research team considered it relevant to distinguish between subsidies on merit goods vis-à-vis other subsidies and to focus on budget-based subsidies. Subsidies flowing towards such vital areas as health, education and environment stand on a footing quite different from those going, for example, to agriculture, industry and transport. In the former case, the justification arises because the benefits of subsidies spread well beyond the immediate beneficiaries.

In general, subsidies are advocated when the social benefits of a particular commodity or service is greater than the sum of the private benefits of the consumers. For example, the private benefits of research and development for the firms involved may not justify a large expenditure by those firms, but the overall technological progress made in the process may have much larger benefits for the economy as a whole. This difference between the social benefits and the sum of private benefits arises due to what economists call "externalities". Other examples of activities involving substantial externalities include inoculation against infectious diseases, environmental protection and a minimum level of education. It should be clear that there would be a gap between the private valuation of the benefits from such goods or services and their true value to society. The normal market pricing will therefore not operate efficiently, and subsidies can provide the necessary corrective in such cases. Thus, the use of subsidies signals society's desire for greater production and/or consumption of the subsidised commodity. Besides, subsidies are often used to redistribute income as also to ensure provision of minimum needs for all.

However, in the context of certain services which do involve large externalities, it is not relevant to consider subsidies. These are known as public goods which are characterised by (a) the inability to exclude anyone from enjoying the benefits of the service and (b) any one person's consumption of the service not affecting the consumption of the same by others. In the case of public goods like national defence, it is difficult to assess the benefits as well as the demand for such services. As a result, normal market pricing mechanism breaks down completely in such cases. Government expenditures on such services are therefore entirely financed through taxes. Thus, the category of goods and services that ideally qualify for subsidies should have two important characteristics: (i) they should give rise to substantial externalities and (ii) it should be possible to price them, even if imperfectly. These are known as 'quasi-public goods' or 'merit goods'.

In practice, not all subsidised goods and services have large externalities. When such subsidies proliferate, they may actually have adverse implications for the efficiency of the overall economic system instead of promoting it. They are often justified on the grounds of being conducive to long run economic growth, or of being redistributive in nature, or as promoting the use of the subsidised commodity. Such claims need to be assessed carefully as they can be based on false or outdated premises and may even be originating from non-economic factors. Also, the costs and benefits of such subsidies need to be weighed against each other. Therefore, a periodic review of the subsidies is necessary to make a judicious selection of the subsidies that promote the maximum enhancement of welfare within the overall budgetary constraints of the government. Further, the method of providing subsidies may allow leakages, causing loss of social welfare and additional budgetary costs. Thus, the administration or delivery mechanisms for the provision of subsidies assumes significance.

A real dent on the fiscal deficit can be made by operating on the voluminous subsidies flowing towards services that should have a low priority for direct participation by the government. The economic cost of unjustifiable subsidies is evinced in their dependence on a high-level of fiscal deficit as a result of which interest-rates also remain high. Consequently, high priority investment and justifiable subsidies are crowded out from the government sector, and investment in general is crowded out from the private sector.

In the context of recovery rates, it may be noted that an increase in user charges would lead to several effects which jointly mitigate the pressure on the fiscal deficit. First, excessive demand for scarce resources would be curtailed, releasing resources for other sectors where their productivity may be higher. This would augment systemic efficiency. Second, the average cost of providing the service would fall in those cases where, because of the extended governmental operations, the costs have become very high. The relative shares in costs reflect a pattern which is almost similar to the pattern of relative shares of subsidies in total subsidies, except that for the economic services, the share of costs in total costs is higher than the share of corresponding subsidies in total subsidies. As such, it is the economic services, especially of the non-merit kind, where effective action towards raising the relevant user charges would have the largest impact in improving the average effective rate. The sectors that ought to be especially targeted for action are: agriculture, irrigation, industries, power, transport and higher education.

Unduly low user prices, reflected in correspondingly low recovery rates, lead to excessive demand for scarce resources. Thus, while power and water may be overused, or even wasted in some sectors, other sectors remain starved of such vital resources leading to supply side bottlenecks and a reduction in the overall efficiency of the system. Subsidies also cause distortions in relative prices leading to a misallocation of resources. Oversubsidisation of diesel and overuse of nitrogenous fertilisers and urea may be cited as examples of distortions in the relative use of a good in a given product range that are induced by subsidies.

In general, subsidies that are administered to final consumption or production are considered to be more desirable since they accrue to the target beneficiaries directly. Subsidies on inputs are easily dispersed to the non-target population, instead. In our subsidy regime, considerable subsidies are introduced through inputs, e.g., feedstock of fertiliser, fertiliser, electricity, diesel and irrigation. Such diffusion inhibits the performance of a subsidy regime. Further, even where subsidies are on final consumption such as food subsidy, targeting remains poor and leakages are extensive. Leakages as well as poor design of subsidy regimes tend to make it difficult to ensure equity objectives. For example, a significant portion of subsidies in higher education is probably appropriated by the middle to high income groups. Health subsidies also seem to exhibit a non-rural and pro-rich bias. Thus our subsidy regime cannot be said to be tangibly progressive and could in fact be regressive.

It is often not realised as to how far our fiscal system depends on 'indirect' intervention. Both indirect taxes and subsidies constitute indirect fiscal intervention. In both cases, the degree of indirectness is higher when it is the inputs that are taxed or subsidised. Together, indirect taxes and subsidies amounted to nearly 27 per cent of GDP in 1994-95. The quality of fiscal intervention is highly compromised with such a heavy dependence of indirect fiscal instruments. In such a context, an effective grip on distributional objectives is weakened and the productive efficiency of the system is compromised due to allocative distortions. A generic problem in our subsidy-regime is that subsidies are generally input-based. As such they diffuse out to final goods in a broad spectrum. The benefits of these subsidies are therefore apportioned among consumers according to their share in the purchases of final goods. Clearly, since the relatively better-off also have the larger shares in final purchases, they appropriate a relatively larger share of the subsidies.

The distributional pattern of the benefits of the subsidies does not appear to be consistent with the equity objectives. The predominant beneficiaries of the food subsidies are urban non-poor. A major portion of fertiliser subsidies accrues to the fertiliser industry. The per capita subsidy on power is much larger in richer States as compared to that for the poorer States. A large amount of subsidies is absorbed by public enterprises. The pattern of inter-State distribution of subsidies on social and economic services indicates much higher levels of per capita subsidies for high income States which progressively fall as we move to the middle and low income States.

Subsidies are inducing a wastage of scarce resources, and are promoting inefficiency. Extremely low recovery rates in sectors relating to irrigation water, electricity and diesel lead to their wasteful use, having been drawn away from other sectors in which their productivity would have been higher. The schemes of retention prices for the fertiliser and petroleum sectors are not designed to encourage efficiency. A significant and increasing portion of food subsidies does not filter through to the consumers but is absorbed in increasing costs of handling and storing foodgrains. Obviously, scrapping inefficiency-promoting subsidies and increasing user charges in the cases of oversubsidisation, would usher a leaner and yet, more effective subsidy regime.

Subsidies may be said to have suffered from three kinds of inefficiencies. First, there is global inefficiency because many subsidised inputs like water and electricity are wasted and sub-optimally utilised. Second, government, when acting as a producer often turns out to be an inefficient economic agent. It is able to produce or provide goods at costs that are usually much higher than the correspondings cost for a comparable private producer. Third, there is the inefficiency of administering subsidies itself. For example, food subsidies may be administered through a better mechanism (e.g., a coupon system) where inefficiencies in procurement, storage and distribution can be avoided.

The case of petroleum subsidies has been examined as an important regulatory subsidy which is not directly a part of the Central budget but arises due to an administered price regime for petroleum products. Petroleum subsidies ensue from an administered price regime governing the sale of petroleum products, and thus provide an important example of an off-budget regulatory subsidy. The interface between the government and the oil industry is managed by the Oil Coordination Committee (set up in July, 1975) which regulates and monitors the production of petroleum products in India,

prepares long term demand estimates, formulates new oil industry projects, assists in reviewing and implementing pricing policies concerning petroleum products, and manages the oil pool accounts. Expert committees appointed by the Central government periodically review the pricing structure. Apart from a huge volume of subsidy, estimated at Rs. 18,440 crore in 1996-97, differential rates of subsidy over the entire range of petroleum products also induce distortions in the relative use of different petroleum products having serious implications for allocative efficiency.

With fiscal deficit targets legitimately being in focus, and tax rates almost lowered into their long-term slots, expenditure levels need to be sustained and restructured, through revenue-buoyancy not only from a broader tax base but also from non-tax revenue, particularly, increased user charges. Increase in user charges will have efficiency effects as well as revenue effects. In particular, wastage of scarce resources like water and power will be discouraged, and they will be drawn into more productive sectors. Revenue will increase and in many cases, the average cost of providing governmental services would also fall.

The study concludes with the position that subsidy reforms should be directed towards (i) reduction of their size, (ii) making them of finite duration, (iii) using them for strict economic objectives, (iv) making them transparent and (v) administering them through final goods, with a view to maximising their reach towards the target population at minimum cost. Recovery rates, even for non-merit services, are very low. An increase in user charges would substantially mitigate pressures on the fiscal deficit. There is clear scope for increasing user charges in areas of education, agriculture, irrigation, industries, power and transport.

Parthasarathi Shome