# *Preface*

This study was undertaken by the National Institute of Public Finance and Policy in consultation with the Ministry of Finance.

The study team consists of D.K.Srivastava and H.K.Amarnath. Opinions and analyses here are those of the authors. The members of the Governing Body of the National Institute of Public Finance and Policy are in no way responsible for these.

May 2001.
New Delhi

Ashok K. Lahiri
Director

# *Foreword*

The Discussion Paper on *Government Subsidies* brought out by the Ministry of Finance in May 1997 led to a countrywide discussion on subsidies in which academicians, parliamentarians, auditors and accountants, journalists, and public at large, participated at length. Among the various issues that caught the attention of the discussants in relation to the multi-faceted subject of subsidies in general, and the Discussion Paper in particular, were those that pertained to alternative definitions of subsidies, their classification into merit and non-merit categories, the methodology of estimating budgetary subsidies, and the implications of inefficiency costs that were embedded into the subsidy estimates. However, the seriousness and significance of the issues was acknowledged by all concerned.

In an analytical review, A. Vaidyanathan (*The Hindu*, September 1, 1997) observed: "These figures should dispel any doubt that a large and growing magnitude of the unrecovered cost of goods and services provided by the government is a major factor contributing to the deteriorating fiscal health of the governments at both levels". In a panel discussion organised by the PHD Chambers of Commerce and Industry (PHDCCI), it was reported (*Times of India*, July 4, 1997) that a consensus had emerged that government subsidies should be gradually phased out.

At the technical level, however, various methodological issues were discussed. In a commentary on the Discussion Paper, the *Economic and Political Weekly* (May 31, 1997) wrote that the paper failed to take cognizance of the significance of "dynamic externalities" in the entire range of social and economic services. The EPW write-up asserted that the "the incidence of subsidies is estimated to have gone up" because of "extraneous elements such as the average interest costs which have been arbitrarily pushed up by public policies". Other methodological issues related to estimation of depreciation rates. It was suggested that the capital expenditure on projects under construction should not include depreciation for the first few years as the assets had not yet begun to yield services.

A second dimension of the debate related to classification issues. Many people questioned whether a particular subsidy should be classified as "merit subsidy". Most cited the example of higher education. In the Discussion Paper, elementary education, however, had been counted on the side of merit subsidies. In this context as well A. Vaidyanathan (*The Hindu*, September 1, 1997) observed: "While in principle a society is free to decide this, its freedom is constrained by the availability of resources". Classification into merit and non-merit categories was bound to be disputed. A.C. Tiwari (*Financial Express*, June 4, 1997) wrote: "The classification of services into `merit' and `non-merit' can be highly subjective and reaching a consensus will be difficult".

There was hardly any disagreement as to the fact tnat most subsidies were poorly targeted. Kirit S. Parikh (*Economic Times*, June 23, 1997) suggested "If we and our politicians really care for the poor, we would drastically trim all non-targeted subsidies ... and of course, spend twice as much on elementary education and make it compulsory". G.K. Nair (June 17, 1997) observed "The purpose of subsidising merit goods/services would be served only when the benefits reach the targets and enhance their ability to earn and produce more for the economy".

Although, the paper had provided a blueprint for recasting the subsidy regime, it stopped short of providing a concrete action plan. In the May 19-June 1, 1997 issue of *Business India*, N. Chandramohan (p. 53) wrote: "A white paper on subsidies reveals the extent of the subsidy problem, but tiptoes around any solution". There was also the complaint: "The problem it skirts around however is getting the government, any government, to bell the cat".

While this debate continued, the Parliamentary Committee attached to the Ministry of Finance met twice to discuss the issues that were raised in the Discussion Paper. The present study arose primarily out of the concerns expressed in the meetings of the Parliamentary Committee that in classifying subsidies into merit and non-merit categories, it may sometimes be necessary to go to sub-major or minor heads rather than dealing with expenditures only at the level of major budgetary heads. The study updates subsidy estimates with reference to the Union Government Finances for

1995-96 and 1996-97, whereas the earlier estimates pertained to 1994-95 only. It examines the issue of classifying subsidies into *merit* or *non-merit* services at a more disaggregated level. Furthermore, the issue of excess subsidisation with reference to certain exogenous norms pertaining to the desired degree of subsidisation for different categories of services is examined.

The working out of excess subsidisation requires magnitudes of elasticities of demand with respect to private and social demand curves, and elasticities of supply. A general equilibrium framework also needs to take into account inter-sectoral elasticities. As information on these is not readily available, some broad norms with respect to the recovery rates, keeping in view a broad judgement regarding relevant externalities, needs to be taken. The study works out the scope of additional recoveries by applying average desirable or normative recovery rates on three categories of services, namely, *Merit I*, *Merit II*, and *Non-Merit*. While in the *Non-Merit* case, recoveries should be near hundred percent, at least of the current or variable cost, for *Merit I* category, a high degree of subsidisation may be justified.

The study was undertaken at the instance of the Ministry of Finance, Government of India. However, the opinions expressed here are those of the authors only.

In the completion of the study, we had the opportunity of discussing various issues with a number of officials in the Department of Economic Affairs, Ministry of Finance, and colleagues at NIPFP who contributed with important materials and views. We would especially like to acknowledge the help received from Shankar N. Acharya, Tarun Das, and Arvind Kumar from the Department of Economic Affairs, Ministry of Finance. At the NIPFP, Amaresh Bagchi, Emeritus Professor, and A. Lahiri, Director, helped with valuable suggestions and constant encouragement. We consulted Tapas K. Sen from time to time in view of his expertise in the matter. Bhujanga C. Rao and T.S. Rangamannar provided relevant materials and useful suggestions. We gratefully acknowledge their help and take the responsibility for any errors that may yet remain undetected.

R. S. Tyagi provided adept secretarial support. The editorial and production team at NIPFP comprising Rita Wadhwa, Jagmohan Singh Rawat, and Jagan Mohini have transformed the manuscript in its present format.