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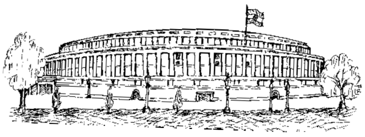

Parliamentarians' Forum on Economic Policy Issues (PAR-FORE)

Need to Take a Re-look at Central Non-merit Subsidies

INTRODUCTION

The governments (both Central and State) provide private goods and services in addition to public goods. Subsidies arise when the cost of providing private goods and services exceeds the price recovered from the users of these goods and services. Thus subsidies are the unrecovered costs of publicly provided private goods and services.

Subsidies have a tendency to self-perpetuate and create political vested interests. By diverting economic resources away from areas (like infrastructure) where their marginal productivity would have been higher to lower productivity areas, subsidies result in inefficient resource allocation and unintended economic effects. Generalised subsidies waste resources. Further, they may have perverse distributional effects endowing greater benefits on the better off people. The Subsidies Report of 2003[1] categorised subsidies in terms of their desirability as follows:

Merit I: These subsidies are characterised by a greater excess of social benefit over personal benefit. These include subsidies pertaining to elementary education, primary health care, prevention and control of diseases, social welfare and nutrition, soil and water conservation, ecology, and environment.

Merit II: Examples of these subsidies are those relating to non-elementary education, urban development, small and cottage industries, roads and bridges etc.

Non Merit: These subsidies do not provide any social benefit over and above personal benefit. Examples of these are irrigation, electricity, industry, transport subsidies.

It is the last group of subsidies which are the focus of this paper, as these subsidies provide benefits to consumers who generally do not need them. Therefore, these subsidies can be termed as inefficient expenditure.

Subsidies claim a significant portion of resources, but remain hidden as only a small portion of them is explicitly shown in the budget document. In addition to subsidised charges for various services, hidden subsidies also include bonds issued by the Government to the Food Corporation of India, Fertiliser Companies, Oil Marketing Companies etc. The estimated off budget liability of the Government is around two percent of the gross domestic product (GDP).

Box 1: Subsidies Act As a Hurdle

"We need to address the problem of mounting subsidies in food, fertilisers and now, in petroleum which is a recent phenomenon. Over Rs 1 lakh crore are going to be spent this year alone on these three items. I would like my cabinet colleagues and the Planning Commission to reflect on what these mean for our development options and what development options these subsidies are shutting out. Do they mean fewer schools, fewer hospitals, fewer scholarships, slower public investment in agriculture and poorer infrastructure? It is important that we restructure subsidies so that only the really needy and the poor benefit from them and all leakages are plugged". *Prime Minister Dr Manmohan Singh at the full Planning Commission meeting, in November 2007.*

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1 "Central Government Subsidies in India – A Report", Ministry of Finance, Government of India, March, 2003

Box 2: Subsidies vs Resources

The soft budget syndrome and the need to adhere to the Fiscal Responsibility and Budget Management (FRBM) Act have resulted in the postponement of the payment of food, fertiliser and petroleum subsidies. The total subsidy burden in the year 2007-08 is expected to be Rs 1 lakh crore out of which almost half is going to be off budget. The Government can take credit for containing the fiscal deficit, but, in the long run such accumulation may be counter-productive.

JUSTIFICATION FOR PROVIDING SUBSIDIES

In India, we find subsidy support for various goods and services like food, fertiliser, petroleum, energy, irrigation, education, drinking water, etc. The simple justification for such support is that the cost of providing these goods and services is so high that the common man cannot afford them. Politicians who oppose a cut in subsidies always argue that, in a welfare state, the maximisation of aggregate consumer welfare is facilitated through the subsidisation of goods and services which benefit the poor. But unfortunately, the majority of subsidy benefits go to the rich and non-deserving instead of the poor. In addition to this, subsidies in agriculture are also supported on the grounds that Indian products need to compete in the international market with the heavily subsidised products from the US and the European Union (EU).

It cannot be argued that subsidisation of goods and services is necessary for the maximisation of social welfare and providing an impetus to economic growth. Disadvantaged people, areas and sectors certainly need government support and subsidies have some economic justification. Thus, we cannot do away with subsidies altogether in a welfare state like India. What is worrying is that their share in government expenditure has been increasing over time. Even when the original reason for putting a subsidy in place no longer exists the government simply does not have the courage to remove/reduce it for fear of losing political support. It is essential to select products to be subsidised with caution. Subsidies should also be time-bound and reviewed periodically. Instead of trying to subsidise the majority of the population which leads to a thin spread of limited resources a better targeting of subsidies is important to ensure that benefits reach the really needy and the resources are available for essential services such as universal primary education, rural health, water and sanitation.

In India, much of the subsidy expenditure is on food, fertiliser and petroleum products. Various initiatives have been taken to rationalise subsidies in these sectors, including the phasing-out of subsidies, but the results are not encouraging. The issues related to these sectors are discussed below:

FOOD SUBSIDY

Food subsidy has been a highly sensitive issue and therefore reducing or removing it constitutes a tough challenge for any government. There are distortions and inefficiencies in the delivery of food which lead to huge subsidy bills without benefits reaching the target beneficiaries. Food subsidies (only budgeted) have gone up from Rs 9100 crores in 1998-99 to Rs 24,204 crore in 2006-07 and Rs 25,696 crore in 2007-08 (almost half of the total budgeted subsidy).[2]

Food subsidies fall in two classes: production subsidies which relate to minimum support pricing (MSP) and consumption subsidies which are provided through the public distribution system (PDS) for food grains. Given that the burden of these subsidies on the exchequer has been increasing it might be advisable to try and achieve the welfare objectives of these subsidies by an alternative route – that provided by the introduction of competition in agricultural markets. Presently, the food subsidy policy uses MSP-PDS operations to serve the conflicting objectives of ensuring remunerative price to farmers and providing food grains to the poor at affordable prices. This entails a huge gap between the purchase price and the issue price, and consequently, a very large subsidy burden. In future, this burden might rise as a rising MSP is not going to be accompanied by an increase in the issue price in the same proportion.

2 Expenditure Budget Vol. 1, 2007-2008, Government of India.

The procurement of food grains was introduced with the objectives of maintaining a buffer stock against price fluctuations and meeting the requirements of the PDS. In the globalised world where required quantities of food grains can be arranged at short notice keeping a huge buffer stock is not an efficient solution. This is where the government could use competition, i.e. government can procure foodgrains on the basis of competitive bidding, and thereby maximise the amounts it gets for a given amount of financial resources. In this manner, it can reduce the budgetary burden caused by food subsidies.

To improve the inefficient system of delivery of food grains to the poor and thereby reduce the government's budgetary burden, food vouchers/stamps can be employed. Such vouchers/stamps can be issued to Below Poverty Line (BPL) families through the *Panchayati Raj* system/ local government bodies for use in the open market. This would also improve consumer choice.

Support pricing as it exists today is bereft of utility to the nation as it not only imposes a heavy burden on the exchequer but also creates regional imbalances as the major portion of associated subsidy goes to foodgrain (wheat and paddy) producing states. Moreover, the subsidy goes to the middle and large farmers who produce for the market and distorts the income distribution against small and marginal farmers who produce only to meet part of their subsistence consumption. For such farmers, support pricing and related procurement only serves to create an artificial shortage of food grains in the open market which, in turn, implies that they have to face higher prices in the open market. As the coverage of the PDS in rural areas is poor these small and marginal farmers have to meet the gap between their subsistence consumption and their own production through purchases in the open market at these high prices.

The entire system of support pricing needs a rethink, i.e. from the point of economic theory, support pricing should exist only in cases where the market does not lead to the production and consumption of the socially optimal amount. This happens when there are positive externalities associated with consumption. As a means of ensuring income distribution, support pricing has proved to be a failure; coupled with the poor rural coverage of the PDS it has led to regressive changes in the income distribution.

In India, the Government has not been successful in developing free and transparent markets. The absence of a link between the farmer and consumer provides opportunities to intermediaries to dominate the market and exploit the farmer as well as the consumer. Much of the justification for support pricing of food grains would weaken if the government can bring the farmer closer to the ultimate consumer through better communication and transport facilities. This would enable the farmer to get a higher price for his produce.

Box 3: How the Poor Benefit from PDS?

The PDS is beyond the reach of the poor as it suffers from considerable leakage and management inefficiencies such as poor forecasting capabilities, outdated storage facilities, cost inefficiencies, poor quality of foodgrains, harassment of customers, corruption and poor rural coverage. Thus, benefits derived by the poor are negligible. Moreover, administrative efficiency is so poor that the administrative costs amount to almost 85 percent of the total expenditure.

FERTILISER SUBSIDY

"These subsidies are larger than necessary as domestic manufacturers of urea are given a cost plus price under the Retention Price Scheme (RPS). This provides very little incentive to domestic manufacturers to cut costs".[3]

The share of fertiliser cost in the total cost of inputs in agriculture being high, only large farmers get significant benefits from subsidies as they are the ones who incur a large expenditure on agricultural inputs. Fertilisers are not used in large quantities by poor farmers due to their low purchasing power. Out of a total of 11 crore farmers in India, 8 crores are small and marginal farmers who benefit very little from fertiliser subsidies.

The budgeted subsidy is continuously rising and doubled between 2002-03 and 2006-07. The budgeted subsidy at Rs 22,451 crores for 2007-08 is a grossly

3 Expenditure Reforms Commission 2000

Table 1: Budgetary Subsides on Fertiliser [4] (in *Rs crores*)						
Item	***2002-03***	***2003-04***	***2004-05***	***2005-06***	***2006-07 (Revised)***	***2007-08 (Budget)***
Indigenous (Urea)	7790	8521	10243	10653	11400	11400
Imported (Urea)	-	-	494	1211	2704	2704
Sale of decontrolled farmers with concession to farmers	3225	3326	5142	6596	8348	8347
Total	**11015**	**11847**	**15879**	**18460**	**22442**	**22451**

underestimated and the actual amount is estimated to be around Rs 50,000 crores. So far, Rs 36000 crores, including bonds worth Rs 7500 crores have been released by the Government.The fertiliser subsidy is further expected to increase to Rs 70,000 crores in 2008-09. The major part of the subsidy is provided to urea which is being sold at Rs 4830 per tonne, much lower than the imported price of Rs 16000 per tonne. The Table 1 shows the details of rising fertiliser subsidy (only budgetary):

The main argument for justifying fertiliser subsidy is that it ensures an increase in agricultural productivity, the benefits of which are shared between consumers and producers. However, recent data demonstrate that productivity growth has been declining and the real prices of foodgrains are rising faster than the overall Consumer Price Index (CPI). The major portion of the subsidy goes to the fertiliser industry and encourages it to be inefficient. A good sign is that the government is slowly increasing the price of urea and trying to reduce the subsidy burden.

Box 4: Fertiliser Subsidy Issue

One of the claims made by the government is that fertilisers cannot be afforded by small and marginal farmers and hence need to be subsidised. However, the fertiliser subsidy is indirect and a majority of benefits accrue to the industry and large farmers rather than small and marginal farmers.The Finance Minister in his Budget of 2007 promised to provide the subsidy directly to farmers but nothing has happened in this direction.

However, no steps have been taken to make the fertiliser industry competitive and self-reliant. This can be another means of reducing the required per unit fertiliser subsidy which is the difference between industry price and the price paid by farmers. Another step which would lead to a reduction in the budgetary burden caused by such subsidy as well as more social equity is to provide direct subsidy only to small and marginal farmers.

PETROLEUM

The petroleum subsidy has become a political issue. Liquefied petroleum gas (LPG) and kerosene continue to be heavily subsidised.This subsidy benefits largely the higher income groups and proves to be regressive. Diesel subsidy can be considered to be an exception because of its use in agriculture and public transport but increasingly the higher income groups in urban areas are consuming diesel for the operation of passenger cars and gensets.

At present diesel sales are four and a half times that of petrol. Diesel sales have risen by 6.37 million tonnes during 2002-2006, while petrol sales have increased by only 1.74 million tonnes.

As a matter of policy, the Government has authorised the Oil Marketing Companies (OMCs) – Indian Oil Corporation (IOC), Bharat Petroleum Corporation Ltd. (BPCL) and Hindustan Petroleum Corporation Ltd. (HPCL) to change the price of oil when international prices change, keeping only LPG and kerosene on the sensitive list. However, this policy directive is not being implemented in practice as whenever there is a price rise in the international oil market the government requests the OMCs not to increase the price for social reasons. In fact there are strong political reasons hidden behind these so called social reasons. Our consumer prices have been fixed ever since the international price of oil reached US$60 a barrel. The OMCs have been absorbing the burden of a sudden spurt in the global oil price, which has now reached around US$100 a barrel (January 02, 2008).

Thus, companies are selling petrol at a loss of Rs 9.20/litre, diesel at a loss of Rs 10.95/litre and kerosene and LPG at losses of Rs 19.90/litre and Rs 331.25/

4 Expenditure Budget Vol. 1, 2007-2008, Government of India.

cylinder respectively. Therefore, it is being estimated that OMCs will lose around Rs 69,753 crores in 2008.[5] This loss has gone up by almost three and half times in the last three years (Rs 20,146 in 2004-05). The highest loss has been due to sale of diesel followed by kerosene, LPG and petrol in declining order of magnitude.

The Government, to compensate these losses, issues oil bonds to the OMCs. This act might provide relief to OMCs but it is a further off-budget liability for the Government. By doing this Government is just postponing the liability and it will create problems in the future. The postponement of the issue of increasing domestic petroleum prices implies an additional interest cost. The fact is that this cost is to be borne by the future generation who will not derive benefits from the current subsidy.

In West Bengal, petrol at the refinery gate costs Rs 20.39 per litre while the price at the pump is Rs 46.86 per litre. This includes Rs 14.70 per litre as excise duty and education cess levied by Central Government and Rs 9.97 per litre as sales tax and cess levied by the State Government[6]. The only way to come out of this paradox is to take tough decisions of allowing the OMCs to increase the price in phases and reduce the tax burden on them.

Box 5: Tax Paradox

It is a paradox that on one hand petroleum products are highly taxed, while on the other hand they are highly subsidised. Taxes constitute up to 58 percent of the total price of the petroleum products – the highest in the world.

ISSUES FOR DISCUSSION

- Our subsidies such as petroleum, food and fertiliser subsidies do not help the poor. What should be the policy to help the poor directly?
- Only the merit subsidies, which are transparent, well targeted and implemented, can benefit the poor. But due to leakage and wastage these hardly reach the deserving needy people. What should be the mechanism to ensure that subsidies reach the needy?
- What measures should be taken to reduce the subsidy burden? Can reducing the cost of the service on one hand and increasing the recovery charges (at least variable cost should be recovered) from the user of the service on the other hand work?
- Fertiliser subsidy is indirect and the majority of benefits accrue to the industry and large farmers rather than small and marginal farmers. Can full decontrol of the fertiliser industry coupled with direct subsidy to small and marginal farmers be a viable solution?
- It is a paradox that petroleum products are highly taxed on the one hand while on the other hand they are highly subsidised. How is this paradox helping the Government and what is the justification for this?
- One way of reducing the subsidy burden is to abolish or at least reduce their magnitudes across the board and let the market do the rest. The long run solution lies in proper targeting of subsidies to make them equitable and efficient. We should move away from indirect subsidies to direct income support. Can providing vouchers/stamps (for food, education, kerosene etc.) to the needy be a better option as it is a targeted intervention which increases the choice of the consumer and hence consumer welfare?
- The concept of vouchers/stamps may not be well understood by the legislatures at the state level. How can awareness be generated among state leaders?
- Given the political situation and general elections due in 2009, can we expect the Government to reduce subsidies or attempt to cater to the really needy?
- The Government has developed a practice of postponing the payment of food, fertiliser and petroleum subsidies through off budget subsidies which may be counter-productive in the long run. How is it helping the Government?
- Can the opposition to reduce subsidies be blunted by explicitly mentioning in the budget that the resources saved would be used to raise public investment in the social and infra sectors?

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5 *The Hindu Business Line, January 03, 2008*
6 *The Financial Express, January 06, 2008*