Conclusions

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Subsidies in the fiscal system would be considerably understated if one looked only at the explicit budgetary provisions of subsidies. The hidden subsidies are exposed by measuring subsidies as unrecovered costs of providing governmental services. It turns out that for the Central government, the proportion of implicit subsidies is about 70 per cent in the total budget-based subsidies for 1994-95. A similar indication cannot, however, be given for the States because of varying practices adopted by them in reporting the subsidy figures in their respective budgets. But, in general, the proportion of hidden subsidies in their case is larger. Below, we summarise the main empirical findings of this study, and indicate the basic tenets in designing subsidy reforms in India.

AGGREGATE SUBSIDIES

The Central subsidies are estimated at Rs. 43089 crore in 1994-95. For the States, the aggregate amount of subsidies, at Rs. 93754 crore, is more than twice that at the Centre in 1994-95. Together, these amount to Rs. 136844 crore constituting 14.35 per cent of GDP in 1994-95. If we take subsidies net of surplus (Centre and all States) it comes to 13.36 per cent of GDP in 1994-95. The estimates of subsidies in social and economic services are more or less in line with the division of expenditure responsibilities in this area. In the provision of social services, the Centre has had a limited role, and its subsidies in this sector are only a small fraction of the total subsidies given by the government as a whole. Nearly 90 per cent of the subsidies in social services and a little more than 55 per cent of subsidies in economic services are State government subsidies.

If only non-merit subsidies are taken into account, they amount to 10.93 per cent of GDP, which is composed of 3.94 and 6.99 per cent of GDP, pertaining to Central and State subsidies, respectively. The average all-India recovery rate for these non-merit subsidies is just 8.98 per cent, implying a subsidy rate of more than 90 per cent.

For merit goods, the largest subsidy is provided by States under social services amounting to Rs. 18837.47 crore. State subsidies on non-merit social services are also much higher than those provided by the Centre. As far as economic services are concerned, Central subsidies on non-merit services are almost as large as those for the States, the two figures being Rs. 33627.59 for Centre and Rs. 38837.37 for the States. In the aggregate, for non-merit economic services, the recovery rate is 11.17 per cent which is quite low, and the Centre and the States share responsibility for this poor performance almost in equal measure.

In social services, there are no surplus sectors in general; only in a few cases, individual States show some surplus, which are essentially non-recurrent in nature. While human development is legitimately a major concern of the welfare State, it may be necessary to reassess policies in this area at the micro level to temper this concern with the equally legitimate concern for the burgeoning public expenditures. This is particularly important if inadequate targeting and leakages are major problems with these subsidies.

The disaggregated picture shows large subsidies in the areas of agriculture, irrigation, industries, power (excluding petroleum), transport and higher education. In these cases, the services involved can be priced in varying degrees. There is scope for augmenting cost recovery in these areas. A substantial reduction in subsidies in the six sectors noted above would make a real dent on the problem of rising government expenditures. This would need to be done both by reducing expenditure in non-priority areas within these sectors and by ensuring better recoveries. Some of the subsidies, as discussed earlier, may need to be reduced for efficiency reasons also (e.g., irrigation and power).

It would be interesting to analyse the intertemporal changes in the overall magnitude and pattern of subsidies in India. The exercise undertaken here constructs a comprehensive picture but only for one year (1994-95). Exercises undertaken earlier for 1987-88 and 1992-93 can provide a basis for some comparison over time, but only in a limited way due to differences in the methodology and approach. Our estimates are expected to be larger, as compared to the previous two studies because in their case, surplus of some sectors were adjusted against subsidies of other sectors in calculating the aggregate subsidy, and because their estimates cover the Centre and 14 States only. In their cases, the aggregate subsidy amounted respectively to 14.38 per cent (1987-88) and 15.20 per cent (1992-93) of GDP. It would appear, therefore, that aggregate subsidies have fallen between 1992-93 and 1994-95.

Also, the share of subsidies as a percentage of GDP appear to have marginally fallen since 1987-88 and 1992-93, although the volume of subsidies still remains massive in size and as a proportion of GDP.

Recovery Rates

The degree of relative subsidisation between different services can be gauged by a comparison of the relevant recovery rates. The average recovery rate, considering the Centre and States together, for all services is just 7.21 per cent. In the case of non-merit economic services of the Centre and States, where the average recovery rates are expected to be relatively higher, the recovery rates are respectively, 11.73 and 7.35 per cent. There is a clear scope for improving these recovery rates by raising user charges, and reducing costs by locating and minimising sources of inefficiency in the provision of services.

For merit services, the recovery rates are all below 3 per cent. For most of the State level merit services, these rates are lower than corresponding rates for the Centre. While greater subsidisation of merit services has been justified on grounds of externalities, there is a scope for increasing the recovery rates even in these sectors by reducing inefficiencies and leakages. This would improve the quality and spread of the merit subsidies.

Subsidies and Fiscal Deficit

Aggregate subsidies (Centre and States) on non-merit social and economic services amount to 10.93 per cent of GDP at market prices in 1994-95. In the same year, the fiscal deficit of the Centre and States has been estimated to be 7.3 per cent of GDP. Any reduction in the quantum of non-merit subsidies would have a direct and immediate impact on fiscal deficit. By raising the relevant user charges in the non-merit services, our fiscal deficit profile can easily be improved. The all-India recovery rates on non-merit services are as low as 3.54 per cent for social services and 11.17 per cent for economic services. Any increase in the relevant user charges would lead to a more than proportionate increase in cost recovery due tc three distinct effects, *viz.*, (i) increase in user prices, (ii) reduction in quantity supplied and (iii) a fall in average costs. Apart from these first round effects, there would also be positive secondary effects on fiscal deficit, as the overall efficiency in the economy increases with an improved utilisation of scarce resources like water, power and petroleum. With an increase in efficiency, the consequent expansion of tax-bases and rise in tax-revenues would further reduce the fiscal deficit.

Structure and Distributional Implications

Subsidies are by definition indirect even if they pertained to final goods. If they are administered through inputs, the degree of indirectness increases. Taxes that fall on final goods, rather than inputs, are preferred among indirect taxes as they are least distortionary, and most amenable to controlling incidence. Similarly, subsidies that directly accrue to the target beneficiaries are more desirable than subsidies administered through inputs. The benefits of input subsidies are easily dispersed to non-target population. In our subsidy regime, considerable subsidies are introduced through inputs, e.g., feedstock of fertiliser, fertiliser, electricity, diesel and irrigation. Just as cascading is an undesirable feature of commodity taxation, diffusion inhibits the performance of a subsidy regime.

In the case of subsidy on a final good like food subsidy also, targeting is reported to be poor, and leakages extensive. Similarly, on average, nearly half of the fertiliser subsidies are estimated to accrue to the producers/ suppliers rather than the farmers. A significant portion of subsidies in higher education is appropriated by the middle to high income groups, because shortages of seats in this sector are cleared by a quality-based screening in the shape of entrance examinations, etc., where the poorer sections of society are easily competed out. Health subsidies exhibit a non-rural and pro-rich bias. Thus our subsidy regime is not tangibly progressive and could in fact be regressive.

Subsidies and Indirect Taxes

As noted earlier, subsidies are indirect taxes in reverse. In 1994-95 indirect taxes were 12.68 per cent of GDP. Government subsidies on merit and non-merit services amounted to 14.35 per cent in the same year. Together, indirect taxation and subsidies accounted for about 27 per cent of GDP. This represents the extent of indirect fiscal intervention in the economy. It is difficult to control the ultimate distributional impact in the case of indirect taxes as well as subsidies. As such, there is a *prima facie* case for examining the resultant progressivity/regressivity of the tax/subsidy configuration within the overall fiscal regime in India.

Subsidies and Efficiency

In addition, our subsidies are inducing a wastage of scarce resources, and 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 marginal productivity would have been higher. The scheme of retention prices for fertiliser and petroleum sectors are not designed to encourage efficiency. A significant and increasing portion of food subsidies do not filter through to the consumers but are absorbed in increasing costs of handling and storing foodgrains. Scrapping inefficiency-promoting subsidies and a tangible increase in user charges in the cases of oversubsidisation would usher a leaner but more effective subsidy regime.

At the Central level, the rates of return on investment in public enterprises are better than those at the State level. However, the return on equity investment is substantially lower as compared to that on loans. In the States, the loans to public enterprises fetch practically no return while the rate of return on equity investment is also negligible. This implies that disinvestment in public enterprises ought to receive priority at both levels. Further, at the State level, it is imperative to reduce government lending to public enterprises and cooperatives, and direct them to market sources, which should have a salutary influence on their financial discipline. At the least, the interest subsidies will become less opaque.

The incidence of the subsidy programmes could be better aligned towards economically weaker sections of the society and their magnitudes can be controlled by better targeting. In reforming the subsidy programmes, the Centre will have to take initiatives and lead by example.

Subsidy Reforms

Subsidy reforms should be directed towards:

- Reduction of their size on the basis of careful prior consideration of each specific case so as to identify the exact extent and duration for which a subsidy is proposed.

- Strict adherence to the principle that subsidies are used for economic reasons only and not for political reasons or as vote catching exercises. The greater is the transparency of a subsidy, the more likely would be the application of strict fiscal principles governing it.

- The mode of administering the subsidy should be such as to minimise its overall size and maximise its reach to the intended targets.

Transparency

In order to minimise costs of individual subsidy programmes and to subject a subsidy to constant scrutiny by legislators, researchers as well as the public at large, it is best to make subsidies as transparent as possible. In other words, for any given total amount of subsidy, the larger the proportion of transparent subsidies the better it would be. Transparency implies that subsidies are explicit and as far as possible budget-based. It is the hidden and the extra budgetary subsidies that usually grow beyond control.

Better Targeting

Subsidies may be designed for specific targeting, i.e., towards intended groups or sections. Since they usually operate through a market mechanism, there is little control on their final incidence. As different modes of administering subsidies are available, a choice among these modes should be made in a manner such that instead of giving generalised benefits in which intended as well as unintended groups are able to participate, sometimes with perverse results, the choice of the mode leads to a minimisation of the total cost of subsidy and maximisation of its reach.

As an example, instead of a generalised supply of staple food at controlled prices, alternative modes of administering subsidy such as food coupons or differentiated ration cards would reduce the total size of subsidy and increase the coverage of the target groups.

Time Profile of Subsidies

Once a subsidy programme gets initiated either in the budget or outside of it, there is a tendency for it to become a permanent feature. It is essential to work out the entire time profile of a subsidy before it is introduced. This may also require periodic studies of existing subsidies so as to evaluate the effects and incidence of the subsidies and for working out the remaining duration for which they may be continued. Subsidy programmes should not be allowed to be seen by their beneficiaries as permanent features because then they change their behaviour in a manner as to become dependent on the subsidies. These time profiles of subsidies are specially useful for protecting industries against foreign competition or absorbing sudden price shocks, etc.

Improving Cost Recovery

Since subsidies are unrecovered costs of government services, the most direct means of reducing their size would be to improve the recovery of costs. The goods in question are usually excludable goods and the consumers of the good/service in question can be identified and charged according to the extent of their consumption. It would lead to overall economic efficiency if they are charged according to the extent of their consumption. When they are charged at flat rates independent of the extent of their consumption (e.g., water and electricity rates in rural areas) they generate overconsumption and wastage of scarce resources.

Efficiency and Cost Minimisation

Several existing subsidies involve inefficiency costs in the provision of public services. If the same goods were to be supplied through private producers, the per unit cost is likely to go down considerably. The fiscal burden of the subsidies would be automatically reduced where the costs of provision of goods are minimised on the basis of standard efficiency principles. In the provision of services where partial or full participation of the private sector is possible (e.g., contracting out to private sector relevant production/ distribution activities), it ought to be considered. In general, the greater the efficiency of the government sector, the lower would be the burden of subsidy for achieving the same subsidy objective.

CONCLUDING OBSERVATIONS

The main objective of this work was to draw attention to the massive draft the government subsidies in India constitute on our budgetary resources. A significant reduction in the subsidy to GDP ratio can easily solve the basic fiscal malaise. For example, if a reduction of about five percentage points in the non-merit subsidy to GDP ratio is brought about, the fiscal deficit to GDP ratio would be brought to a level below 2 per cent.

A reduction in the subsidy levels can be achieved through (i) a reduction in level of provision of governmental services and (ii) by increasing the relevant user charges, fees, etc., i.e., by increasing the price of the service. In each case, there would be beneficial secondary effects if resource allocation becomes more efficient as a result of release of resources from pre-emptive claims by the government, or as a result of better alignment of prices of resources to their true opportunity costs.

The design of a suitable subsidy reform package needs to be carefully considered. This task calls for prioritisation and phasing. Sectors where the extent of subsidisation is extremely high, and not easily justified need to be targeted first. For the Centre, as well as for the States, a sustained programme of reducing and restructuring our subsidy regime can improve overall efficiency of the system, and make a significant positive impact on the fiscal profile of the country. In designing a subsidy reform programme, sector-level and State-specific studies should now be undertaken.