I Subsidies: Concepts and Issues

Introduction

Apart from the unduly large volume of subsidies (at more than 14 percent of GDP), the subsidy regime in India was critiqued in the Discussion Paper (DP) on *Government Subsidies in India* (May, 1997), as being non-transparent, inefficiently administered, poorly targeted, and regressive, leading to misallocation and waste of resources, while keeping government budgets in persistent imbalance. While the states accounted for the bulk of these subsidies (more than 2/3rds), the remaining subsidies emanated from the central budget. Although more than two and a half years have elapsed since the publication of DP 1997, attempts at reducing unwarranted subsidies have been few and far between.

A successful reform of the subsidy regime calls for evolving a consensus among policymakers. One write-up, among several that commented upon the DP 1997, had appropriately concluded by quoting Prof. Sukhamoy Chakravarty: "Societies which have grown fast during the recent period have done so not because the sum total of problem solving effort has been vastly greater in any measurable sense (than ours), but because they could succeed in evolving a broad consensus on priorities".[2]

The present paper revisits the subsidy issue but focuses on the central budgetary subsidies. In the context of subsidies, the three pertinent questions, *viz.*, **what** to subsidise; **how** to subsidise; and **how much** to subsidise; are addressed here. Its main features are: (i) reclassification of subsidies within the *merit* and *non-merit* categories using information on expenditure heads upto sub-major and minor heads, where necessary; (ii) modification in the methodology [3] of calculating depreciation costs;[4] (iii) estimation of implicit and explicit central budgetary subsidies for 1995-96 and 1996-97; estimation of `excess' subsidisation by grouping goods/services into three broad categories deserving high, intermediate, and low subsidisation; (iv) quantification of the scope of subsidy reduction under alternative assumptions; and (v) identification of the ways and means for subsidy reduction.

The main findings of the study are: subsidies explicit and implicit, emanating from the central budget are estimated at Rs. 43,000 crore in 1995-96, and Rs. 48,000 crore in 1996-97. This amounts to about 40 percent of centre's net revenue receipts. The recovery rates are as low as 8.36 percent of costs for social services and 16.58 percent for economic services. Of the total subsidies, nearly 60 percent are in the *non-merit* category deserving little subsidisation. The category where a high degree of subsidisation may be considered desirable account for only 4 to 6 percent of the total subsidies. Using a sensitivity analysis, making alternative assumptions about the average degree of subsidisation for different categories, it would appear that excess subsidisation is about 70 percent of total subsidies. Subsidies, can thus be cut down to nearly 30 percent of their present level while maintaining a desirable degree of subsidisation in the relevant categories.

The Case for Subsidies

To recapitulate, the issue of subsidy arises in the context of the provision of a service/good, where a user/beneficiary is identifiable, and the extent of his consumption, measurable. To the extent that the cost of providing a good, financed by the government budget, is not paid for by the user, it is paid for by the taxpayer. Such a subsidisation by the taxpayer may become justifiable when the benefit of the good/service is spread beyond the user or the direct beneficiary. Economists often refer to this phenomenon as positive externalities. For example, when an individual is educated, he may have benefited himself. But by his education, his neighbours, and the society at large would also benefit, if he turns out to be sociable and a law abiding citizen as a result of his education. In such circumstances, the market leads to a less than socially desirable level of consumption. This is because, individuals express their demand for a certain good taking into consideration their private benefits and their ability to pay. Their demand reflects benefits to themselves and not to the society as a whole. Since the benefits to the society are additional, the society may try to induce a higher level of demand through subsidies. Such extended benefits may relate both to consumption and production activities.

Budgetary subsidies arise when the government fails to recover the cost of providing the service from the users by such means as fees, tariffs, and user charges. Subsidies also arise when government procures a commodity from the sellers, and then sells it at prices that do not cover the procurement price and the cost of storage, handling, transmission, etc. Such is the case for food subsidies in India. Apart from being costly and cumbersome, widespread intervention by the government in the market impedes the ability of the market to respond to changing situations.

Although the issue of equity and efficiency has to be considered keeping in view the impact of the entire fiscal and regulatory system (taxes, subsidies, fiscal deficit, government expenditures, administered prices), subsidies in India have a significant impact on the equity and efficiency of the fiscal regime because of their size and spread. If excess subsidisation is financed through distortionary taxation, efficiency of the system is doubly compromised. An appropriate degree of subsidisation may lead to better alignment of market prices to the structure of social demands; but excessive subsidisation would distort their alignment leading to waste of scarce resources, and regressive outcomes. Achieving the right balance is, therefore, the key question in achieving the equity and efficiency objectives of fiscal intervention.

Considering the draft on account of subsidies on budgetary resources and also the effects of subsidies on the economy, there seems to be need for prescribing, even at the initial stage, a duration or time limit for the continuance of a subsidy. This may help in forewarning the consumers/beneficiaries so that they may look for suitable alternatives for their consumption profile.

Classifying Government Expenditures and Subsidies

Government expenditures in India are broadly classified into two categories: non-developmental and developmental. In the non-developmental category, expenditure heads like organs of state, fiscal and administrative services are included. These services are in the nature of public goods. They are not supplied by the market. Nor can they be charged to individuals according to the extent of their consumption. They are appropriately paid for by taxation. The issue of subsidisation is not relevant in these cases.

Public goods are identified by the twin characteristics of rivalry (consumption by one user reduces the quantity available for another) and excludability (consumption by one can be distinguished from consumption by another). In modern economies, there are many goods/services that do not clearly fall into the exclusive categories of purely public or purely private goods. Both the characteristics of rivalry and excludability are matters of degree, and often there are some goods which can be seen as characterised by different degrees of `publicness' and therefore fall in an intermediate category. One such category is that of `club' goods which relate to goods that are non-rival for small groups but become rival when the group of users becomes large. Examples are swimming pools and roads.

Governments in India, both central and of states, however, actively participate in the provision of a range of private goods under the head of social and economic services. Budgetary subsidies arise when the budgetary cost of providing the good/service is more than the recovery made by the user/beneficiary of the service, the difference being financed by taxpayers. Clearly, some subsidies are less justified than others. How far can a service be subsidised through taxation is the critical issue.

The criterion of `externality' determines whether the concerned service should also be subsidised and to what extent. In the earlier DP a classification of subsidies into merit and non-merit categories was proposed. Many goods fell into the non-merit side, and since budgetary subsidies have continued on these items for a long time, it has been difficult to reduce them. As part of the phasing out strategy, it may be desirable to have an intermediate category which can distinguish between such expenditure categories as elementary education and higher education. While both may require subsidisation, the degree of subsidisation may be much higher for elementary education. With more disaggregated information being used, subsidies and related service categories may be divided into three categories, *viz.* (i) *Merit 1;* (ii) *Merit 2* and (iii) *Non-Merit*. These broadly refer to categories of services with desired high, intermediate and low (or zero) degrees of subsidisation. The distinction between them may be made on the basis of the extent of externality associated with the service. The exact degree of subsidisation may ultimately need to be determined, service by service. Determining the right degree of subsidisation depends on the elasticities of social and private demand, the extent of externalities, the associated cost (supply) functions, and the relative preferences (weights) given by the society to distributional objectives. Since quantifying the relevant parameters often proves to be difficult, the society has to exercise a collective judgement. The desired degree of subsidisation may be broadly indicated as: *Merit 1* (80 to 100 percent), *Merit 2* (50 to 70 percent), and *Non-Merit* (0 to 10 percent). Services proposed to be included in the three categories (details in annex 1), respectively, are indicated below:

Merit 1: Elementary education, primary health centres, prevention and control of diseases, and ecology and environment.

Merit 2: Education (other than elementary), family welfare, sanitation services, welfare of SC, ST and OBCs, social welfare and nutrition, food for those below poverty line (BPL), plant protection, social and farm forestry, rural development, major and medium irrigation (non-commercial), non-conventional sources of energy (other than atomic energy), and village and small industries.

Non-Merit: Irrigation (commercial), energy (power), coal and lignite, iron and steel industries, cement and non-metallic industries, petrochemical industries, chemical and pharmaceutical industries, dairy development, engineering industries, transport equipment industries, telecommunications and electronic industries, consumer industries, shipping, civil aviation, road transport, and postal services, food for those above poverty line.

Here, the *Merit 1* category is limited to only four items. The implied judgement is that these are the heads of expenditures, where government participation is a priority and externalities are large enough to place them in the category deserving highest subsidisation. It needs to be further emphasised that the items listed are only accounting heads, and it is the actual activity within those heads, which should be deserving of subsidisation. In ecology and environment, for example, much of the task is to be attended to by market-based instruments other than subsidisation.The *Merit 2* category requires the judgement that although subsidisation may be provided for the time being, it need not be as high as 90 to 100 percent. Although the criterion on which this should be decided is the degree of associated externality, because of measurement difficulties, some broad judgement has to be exercised.

The decision to subsidise the provision of a private good by budgetary support can be considered in two stages. In the first instance, it should be decided whether government should participate in the provision of a private good/service at all. Apart from welfare related expenditures, the government is supposed to participate in developmental activities. However, not all developmental activities of the government need to be subsidised. In the second stage, these developmental activities may be divided into merit and non-merit categories so as to determine the appropriate extent of subsidisation.

There already exists a scheme of expenditure classification whereby government expenditures are divided into non-developmental and developmental categories. As indicated earlier, expenditure heads like organs of state, administrative, and fiscal services are classified under the non-development category. These goods and services are in the nature of public goods and do have a contribution to make in the development process. However, our main concern is with the government provision of private goods. These are all classified under development expenditures. The first task in launching a subsidy reform programme is to clearly delineate the sphere within which the governments should participate in the provision of private goods, either by directly producing them or supporting their production/supply through the private sector. This limit may be provided by considering only those goods/services which are truly developmental in character. The term developmental has been used with a variety of meanings by economists and can differ in scope depending on the context. In our present fiscal situation, within the developmental category may be included only activities which are characterised by strong vertical and horizontal linkages. The developmental effects of these should spread out to a wide range of sectors/individuals. Roads and railways are examples of such activities. Some of these activities, characterised by lumpy initial investment and connectivity, may not be forthcoming from the private sector initiative. But even here the presence of government may be limited to that of an activity initiator, a nodal facilitator, or a regulator. Even while the government participates only in the provision of developmental goods/services, it does not automatically imply that all these activities should be subsidised. That requires further consideration of the associated degree of externality.

Reforming Subsidies: Some Critical Issues

a. Inefficiency and Costs: Inefficiency leads to a higher cost of production. This creates a wedge between subsidies that are actually received by the user of the service, and subsidies that are borne by the budget. The difference between the two only subsidises inefficiency. government's participation in providing services is attended by several types of inefficiencies. Apart from direct costs like those due to overstaffing, poor maintenance of assets, procedural delays, delays in taking critical decisions, there are systemic inefficiencies. Subsidy interventions by the government distort market prices and often lead to sub-optimal use of inputs in the economy, thereby raising overall costs in the system. As a result of these and other inefficiencies, the costs associated with the governmental provision of services tend to be high. Who should pay for the inefficiencies — the taxpayer or the user? As argued in DP 1997, the taxpayer should be asked to pay for public goods or partially for goods with extended benefits to the society. Since inefficiency is neither a public good nor a merit good, cost-escalation due to inefficiency cannot be pushed on to the taxpayer. Nor is there a case for passing it on to the user. The user is entitled to supply of service/good at the lowest possible cost. However, inefficiency costs have become integral to the public provisioning of goods in India. Since, in effect, when the user does not pay enough to cover either the legitimate costs or the inefficiency costs, it is the taxpayer who subsidises both types of costs. While, it makes no difference to the estimated volume of budgetary subsidies, it does imply that the first target in subsidy reduction should be to lower the inefficiency costs, for in that case, subsidies can be reduced without either reducing the level of the service or increasing the user prices. The issue of inefficiency is equally relevant for the supply of public goods, i.e., organs of state, fiscal and administrative services, although these are not considered here.

b. Targeting Subsidies: Untargeted subsidies waste scarce resources. Properly targeted subsidies achieve the desired results with a limited draft on the budgetary resources. The beneficiary of a subsidy must ultimately be a person rather than a commodity or sector, although a subsidy, in contrast to a transfer, is administered through the market of a good or service. As such, even on first principles, the incidence of the benefit of a subsidy becomes difficult to control. The problem is further compounded, if they are administered through commodities that are inputs. Many subsidies in India, as highlighted in DP 1997, are administered through inputs like fertilisers, power, irrigation water, and diesel. Even when a final good like food is involved, the subsidy regime remains poorly targeted. The same is true of educational and medical subsidies. As a result, the distributional pattern of subsidies evinces a regressive pattern in many cases. Also, subsidies in agriculture, industries, and other sectors are distributed according to the pattern of consumption of the concerned products. Since, the pattern of consumption reflects the pattern of income, segments of population with a higher purchasing power are able to appropriate relatively larger benefits of subsidies. Subsidies imply provision of a good/service at a price lower than what would have prevailed without the subsidy intervention. Every price reduction has a substitution effect (increasing the demand for the good, the price of which has gone down, relative to others) and an income effect (increasing the demand for the concerned good as also that of others). It is because of the income effect, that the targeting of subsidies becomes absolutely essential. If the demand of a good is inelastic with respect to price/income, any income effect through subsidisation would lead to an increase in demand for goods other than the subsidised good.

c. Reversing the Dynamics of Subsidy Growth: From any given starting point, the degree and volume of subsidies have an inherent tendency to increase because of the different ways in which costs and receipts grow over time. Input costs, determined as a result of diffused and multiple market processes, increase in the normal course. User charges, on the other hand, being more exposed to public scrutiny, and upward revisions in them being processed through public bodies and authorities (executive and legislature), tend to remain glued to old nominal levels. The gap between costs and receipts associated with publicly provided goods thus keeps widening. The recognition and reversal of this process is vital for keeping the subsidy volume in check.

*d. **Dealing with Harmful Subsidies:*** Excess subsidisation is not just an unwarranted fiscal cost. It can do significant damage. For example, over-subsidisation of fertilisers, leads to excessive use of fertilisers, pesticides and other agricultural inputs that have environmentally detrimental effects leading to erosion, compaction, and denitrification of top soil. Similarly, excess subsidisation of water causes drying up of rivers, declining water tables and soil erosion. Excess subsidisation of diesel compounds environmental pollution. `Perverse' subsidies are, in fact, recognised to be a harmful global phenomenon. Myers, *et.al.* (1997) have estimated that perverse subsidies constitute about 80 percent of the total subsidies on a global scale, thus constituting about 5.3 percent of the global economy, where the total volume of subsidies is estimated to be 6.8 percent of the global economy.