

REFORMING THE SUBSIDY REGIME

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Abstract

Why should we, as a citizen, care about subsidies? Does it serve an important purpose in our lives? The answer to these questions varies from country to country. But because government expenditure has limitations, as we tend to oppose an increase in tax rates, citizens should care about subsidies as they serve the public interest and not merely a private one. We being a developing economy do depend on subsidies to ensure equitable utilization of the resources for the people. The word subsidy is derived from a Latin word 'Subsidium' which means support, assistance, aid, help and protection. According to WTO, a subsidy is a financial contribution by a government, or agent of a government, that confers a benefit on its recipients.

The need has arisen to reform the subsidy regime in the Indian economy. The existing government has tried to initiate this by moral suasion followed by up gradation and relying on technological solutions. There is a need to take few more concrete steps in this direction. One of the critical issues is wasteful subsidies that do not reach the poor, should be reduced. The resultant savings should be better spent and this might actually reach the poor. In this paper I have tried to analyze the distribution of subsidies under various heads and how this can be rationalized, specifically in case of fuel, fertilizers and food. An effort has been made to propose reform in subsidies and redirect the expenditure which can yield high returns. The study is based on secondary data compiled from various sources.

Keywords: Subsidy, Rationalization, Savings, Fuel

JEL classification: H23; H75

Introduction

Do we want the government to reduce tax rates? Yes, sure. We also want the government to pay higher taxes to us, that is, a subsidy. Subsidies are reverse of taxes. Just as a tax increases the price of the product taxed, subsidies reduce the price of the product subsidised. And just as taxes increase a government's income, subsidies reduce it. Hence, subsidies are sometimes called negative taxation.

Subsidies play a vital role in the economy of a country. They are a kind of incentive which plays an important role in economic development of developing countries. Subsidies bring out desired changes by effecting optimal allocation of resources, stabilizing the price of essential good & services, redistributing income in favor of poor people thus achieving the twin objective of growth & equity of nation (Shodhganga, 2010). It can be classified as public goods (like defense, police, general administration, etc.), merit goods (education, health, social sector, etc.) and non-merit goods.

The general rationale for providing subsidies is:

- Correcting market failures
- Protecting national production from competition
- Reducing import dependence
- Encouraging national employment
- Ensuring balanced regional development
- Enabling access to and affordability of basic services or goods by all
- Stimulation of economic growth (Mehra, Sinha, & Sahu, 2004)

The reforms programme initiated by the Government of India in 1991 aimed at reducing fiscal imbalances and improving allocative efficiency by minimizing the distortions in relative prices arising from budgetary and fiscal imprudence. Hence, containing and targeting subsidies is an important element of reforms. Subsidies are different from transfer payments, which are straight income supplements to individuals, who are normally the poor and the vulnerable. Providing minimum consumption entitlement to the poor by subsidizing the items consumed by them is an extremely important welfare dimension of fiscal policy. Subsidies can correct for the under-consumption of goods with positive externalities. However, the benefits can be maximized only when the subsidies are transparent, well targeted, and suitably designed for effective implementation without any leakages (Affairs, 2004).

Subsidies in India

Subsidies represent a sizeable item of the non-plan revenue expenditure. In India, food and fertilizers are the two main items subsidized by the government through budgetary support. No doubt a developing country like India needs subsidies due to various reasons. Providing minimum consumption entitlement to the poor by subsidizing the items consumed by them is extremely important for the welfare of the economy.

The size, incidence, allocation distortions, and recent upsurge in some subsidies are the key issues in the context of budgetary subsidies in India. The main issues pertaining to subsidies in India may be listed as: (i) are budgetary subsidies provided for the right reasons; (ii) are many wrong goods/services being subsidized; (iii) does over-subsidization lead to harmful effects; (iv) are subsidies too large relative to resources; (v) what are the implications of cross-subsidies and off-budget subsidies; (vi) has there been an upsurge in some subsidies

in recent years; (vii) what are the implications of subsidizing inputs; (viii) is the subsidy regime in India regressive; (ix) what is the interface of subsidies with inefficiencies; (x) is there a case for increasing subsidies in some sectors; and (xi) is there a need for distinguishing long-term subsidies from those that should have a limited life? (Pal, 2005)

Issues in Subsidy Distribution

In India, despite having a few legacy subsidies, government has introduced new non-merit subsidies in the past few years. Our subsidy burden, at more than six per cent of GDP in FY13, is now the highest in recorded history. Our public debt is over 66 per cent of GDP, and our commitment to development expenses has only reduced to accommodate this additional burden

(Shastri, 2014). In 2014-15, subsidies accounted for 2.1 per cent of GDP. Subsidies pre-empted 23.7 per cent of the entire revenue receipts of the central government. In terms of the opportunity cost, subsidies were 2.64 times the entire capital plan expenditure for 2014-15. Food, fertilizers, and fuel subsidies account for 95 per cent of all subsidies. Subsidies provided in India suffer from both inclusion error (wrong kind of people benefiting) and exclusion error (deserving people left out of subsidies). Efficient subsidies must be transparent, targeted and-in many cases temporary. These three Ts are missing from most subsidies in India (Jain, 2009).

Inflationary Tendencies of Subsidies

For many years now, the government specifies Minimum Support Prices (MSPs) for 26 crops including cereals, pulses and others such as sugarcane, cotton, sunflower seeds and so on to support farmers. *Chart 1* displays the trajectory of the MSPs for various crop groups.

It is apparent that it took about 14 years for the indices to rise from 100 to 200, but MSPs have more than doubled in the last seven years alone. In case of pulses, MSPs have more than tripled during this time. The procurement of food grain by the government almost doubled as well (*chart 2*). The effect of this has been that we are now buying close to double the quantity at roughly 2.5 times the price compared to seven years ago. *Chart 3* plots two consumer price indices against the MSP index for all crops with a one-year lag. Here, it can be seen that increasing MSPs lead to higher rural costs and food prices. It is, however, only farmers large enough to sell a substantial portion of their produce, who benefit. The rural poor, who really deserve support, are only hurt as costs rise. When subsidies harm intended beneficiaries, it's apparent that they are either badly thought out or badly implemented.

Chart 4 plots a three-year moving average of subsidies (inverted) and the current account balance. As one market after another is distorted and large sections of the economy rendered uncompetitive, domestic income falls short of consumption and investment demand. Looking at chart 4, one can almost visualize higher subsidies and an increasingly uncompetitive economy dragging the current account balance down as we import more goods and capital to meet our needs. We pay for these subsidies through borrowings because government revenues are just not enough to fund these extravagances. And with the inflationary impact of subsidies already imposing an informal tax of nearly the same magnitude as our official central taxes, our ability to raise additional taxes is virtually non-existent (Shastri, 2014).

Distortion in Fertilizer Subsidy

The fertilizer subsidy in India reveals the same dismal picture as it places another heavy burden on the central government. It is a very well known fact that only 60 per cent of fertilizer subsidy goes to farmers and rest to the fertilizer industry. The original purpose of the fertilizer subsidy was to encourage spread of green revolution technology to new areas and farmers but this reason and motive has lost its credibility in the recent years. Here regarding the fertilizer subsidy, one should also keep in mind that the availability of subsidized fertilizer should be restricted to farmers who grow staple food and cereals and those farmers, who produce cash crops, do extensive horticulture or produce farm goods for direct exports should be kept outside the purview of subsidy regime (Jain, 2009).

Increasing Food Subsidy

The food subsidy amounts to Rs. 1.25 lakh crore for the year 2015-16, which has doubled since 2010-11 because of the growing divergence between minimum support price (MSP) and central issue price (CIP), higher procurement linked costs and an expanded coverage. Presently, the CIP for below poverty line (BPL) households per quintal are Rs. 415 for wheat (Rs. 5.62 per kg) and Rs. 565 for rice (Rs. 7.64 per kg) and it's unchanged since 2002. On the other hand, the estimated economic costs per quintal for Food Corporation of India (FCI) are Rs. 3000 for rice and Rs. 2,200 for wheat. During 2002-2015, the MSP for wheat has increased from Rs. 620 to Rs. 1,400 (125 per cent) and rice from Rs. 530 to Rs. 1,410 (166 per cent). This subsidy accounts for 81 per cent of the total economic cost at present. The same subsidy was around 45 per cent and 48 per cent of total economic cost for wheat and rice respectively in 2002. For above poverty line (APL) households, the subsidy has tripled since 2002 and has risen from 34 per cent to 63 per cent of the economic cost (Khullar, 2015).

As far as the poverty is concerned, we have witnessed a substantial reduction since 2002. The question is, if 45 per cent subsidy was deemed sufficient in 2002 and the incidence of poverty has shown reduction, what is the

justification to raise it over 80 per cent? Secondly, the poor do not live on staples alone. Surveys show that the poorest of the poor spend only 35 per cent of their food expenditure on cereals. Also, the annual inflation on other food items has been in the range of 7-12 per cent. Hence, the question arises that why the CIPs have remained unchanged since so long. The National Food Security Act (NFSA) expands the coverage to two-thirds of the population, covering the APL households as well. The prices under NFSA have further declined to Rs 3, Rs 2 and Rs 1 for rice, wheat and cereals respectively. This has raised the subsidy burden to more than 1 lakh crore. Although, entitlements for the abject poor (Antyodaya) at very low prices are justified, but not for all BPL households and certainly not for APL households. The Shanta Kumar Committee report has correctly argued that the NFSA coverage needs urgent and immediate review because in the present form it's unjustifiable, fiscally unsustainable and administratively impractical.

Another issue is of capping the total procurement of FCI, as it is carrying larger stocks than necessary, and current levels are far in excess of buffer stock requirements. This leads to higher interest, storage, handling and transport costs as well as storage losses. The committee has highlighted that the procurement drive has primarily worked to the benefit of big farmers majorly in the north-western and few other states. They have also stated that a meager six per cent of all farmers sell their produce to FCI. It is therefore a myth that FCI procurement is benefitting all the farmers (Khullar, 2015).

Ways to Reduce Subsidy Burden

The central government is relying on technological solutions, like JAM trinity, and moral persuasions in order to reduce the subsidy burden. Technological solutions will reduce some losses due to unintended beneficiaries. But unless price distortions are addressed, no headway can be made to plug leakages in the system. Further, in case of food subsidy, technological solutions cannot address losses on the FCI's (Food Corporation of India) carrying cost, rotting stocks, or graft in procurement. Technological solutions offer virtually no relief on fertilizer subsidies. They cannot address the unintended beneficiary problem, and fertilizer overuse can only be tackled by reducing the price distortion. On kerosene, the argument is the same, no significant impact can result unless the price distortion is reduced (Khullar, Ways to Reduce Subsidy Burden, 2015).

A practical proposal has been proposed by Mr. Rahul Khullar, former TRAI chairman. According to him, the solution to this problem can be reduction in the wasteful subsidies that do not reach the poor and consequently the savings from this reduction would be better spent and might actually reach the poor. He emphasizes that his proposal will yield annual savings of Rs. 20,000 crore (2015-16), Rs. 60,000 crore (2016-17) and Rs. 1 lakh crore (2017-18). This redirection of expenditure on account of substantial savings can yield high returns.

The Case of LPG Subsidy

At present government is giving a total subsidy of Rs. 22,000 crore per annum, aimed at the poor section (BPL) of society which is largely dependent on kerosene. But, the benefit of this subsidy is largely consumed by the non-poor section (APL). Effectively, this comes out to be Rs. 2000-2500 for every household, and this would have been more than 80,000 crore if the oil prices had not plummeted. Presently, the cost per cylinder is Rs. 585, whereas the price is Rs. 418 per cylinder. The price was Rs. 345 in 2010 and had the prices been increased at 10 per cent per annum (inflation rate being 10 per cent since 2010) the price would have been Rs. 550 per cylinder today. In January 2014, the price was Rs. 414 and it hasn't changed much in last two years. But, an increase in price is due to come.

It's proposed here that the government should immediately increase the price to Rs.460 (approx 10 per cent increase). Thereafter, the price should be increased by Rs 5 per cylinder per month from April 1, 2016. Thus, by March 2018 this will almost entirely eliminate the subsidy, i.e. within two fiscal years. From April 2018 onwards government can decontrol the price of LPG cylinder as it has done in case of petrol and diesel, but continuing the subsidy for BPL households by targeting them through JAM trinity. This adjustment will yield annual savings of Rs. 5500 crore, Rs. 13,350 crore and Rs. 21,500 crore in the fiscal years up to 2017-18 (Khullar, Reform Subsidies and Redirect Expenditure, 2015).

The Case of Food Subsidy

The food subsidy has increased to Rs. 1.25 lakh crore for the year 2015-16, from Rs. 60,000 crore since 2010-11 because of the growing divergence between minimum support price (MSP) and central issue price (CIP), higher procurement linked costs and an expanded coverage. The major factor behind this steep rise is expanded coverage and reduced prices under NFSA. On one hand the government is boasting of reduction in poverty levels and on the other hand they have raised the coverage to two-thirds of the population.

It is proposed here that the CIP for wheat and rice should be increased to Rs. 7.25 and Rs. 9 per kg respectively with an immediate effect for BPL households. This amounts to an increase of four per cent per annum over 2002-15. From here on, the CIP should be increased by 25 paise per kg every month starting April 2016. For Antyodaya households there should be an increase of 20 paise per kg per month in the prices as under the act. For APL households, raise the CIP to Rs. 9 and Rs 10.50 per kg for wheat and rice respectively, which is to be followed by an increase of 50 paise per kg per month from April 2016. After this adjustment the subsidy for BPL households will be 55 per cent by the end of 2018, after taking into account MSP increase and other factors.

Other Measures

Few other steps which government should initiate includes no open-ended procurement, capping the procurement for buffer stock requirement and PDS (Public Distribution System) needs (from almost 70 mt to 50 mt per year), shifting the procurement to eastern regions along with an implicit ceiling on procurement from north-western states and other states like Andhra Pradesh, Madhya Pradesh, Chattisgarh, etc, and surplus states should move to decentralized procurement to meet their own PDS requirements.

Conclusion

A substantial amount of savings on subsidies would be generated by adopting the above mentioned proposal and the proper utilization of this fund will be a crucial issue. These subsidies should be better spent for poor class with an emphasis on employment generation, skill enhancement, housing, and improving rural infrastructure. From 2017 onwards this savings can be better utilized for increasing the outlays under various programs like – (i) MGNREGA by Rs. 15,000 crore (45 per cent increase); (ii) National Rural Livelihood Mission by Rs. 2,500 crore (100 per cent); (iii) Indira Awas Yojana by Rs. 9,500 crore (100 per cent); (iv) National Social Assistance Programme by Rs. 4,500 crore (50 per cent); (v) Scholarship for SC, ST, OBCs and minorities by Rs. 3,000 crore (63 per cent); (vi) Pradhan Mantri Gram Sadak Yojana by Rs. 10,000 crore (100 per cent); (vii) Pradhan Mantri Krishi Sinchai Yojana by Rs. 5,000 crore (100 per cent); and (viii) Rashtriya Krishi Vikas Yojana by Rs. 4,500 crore (100 per cent) (Khullar, 2015).

This increased spending by reducing the wasteful subsidies will be more effective in the overall growth and development of the poor section and eventually contributing towards the goal of inclusive and sustainable development. An increase in subsidies will make the population ineffective and uncompetitive in the long run. Hence, there is an urgent need to revamp the subsidy regime and to cap it for only those who actually need it, rather than increasing it indefinitely.

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APPENDIX

CHART 1: MINIMUM SUPPORT PRICE INDICES

(1993/94 = 100)

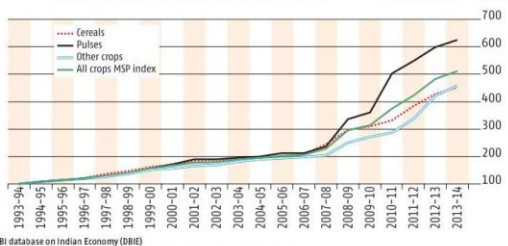


CHART 2: FOODGRAIN PROCUREMENT

(MN TONNES)

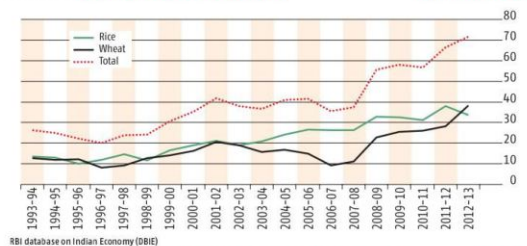


CHART 3: LAGGED IMPACT ON INFLATION

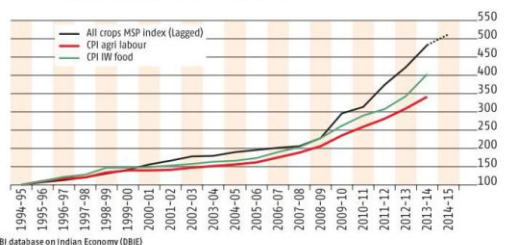


CHART 4: SUBSIDIES AND CURRENT ACCOUNT BALANCE

(₹ CR)

