Rein in farm subsidies

Uttam Gupta

ACCORDING TO an estimate, aggregate measurement support (AMS) to agriculture in India - expressed as percentage of value of agricultural production - is a whopping minus 38 per cent. After setting off subsidy on agricultural inputs estimated at about 7 per cent, on a net basis, AMS would be minus 31 per cent. Against this, under WTA, the prescribed floor limit of AMS to agriculture for developing countries is 10 per cent.

This has led to some complacency in regard to the need for pruning subsidies on agricultural inputs. In view of already existing substantial margin, it is felt that even if the quantum of subsidy increases, it would not undermine India's obligations under WTA. This is in sharp contrast to the situation in early 1990s when, under pressure from the IMF/World Bank, major subsidies, namely, on fertilizers, etc, were the target of reduction.

The above is a dangerous approach. In this context in a recent conference jointly organized by NCAER/IEG/World Bank in New Delhi, in view of the prevailing depressed international prices of agricultural products and the resultant narrowing of gap vis-a-vis prices received by Indian farmers on their sales (primarily in the domestic market), some of our economists questioned the negative protection to agriculture.

The developed countries (DCs) could take advantage of the unfolding scenario and insist on reworking of the AMS in the forthcoming review of the Agreement on Agriculture at Seattle, Washington in November, 1999. In case this exercise leads to higher levels of AMS exceeding the floor limit of 10 per cent, India could come under pressure. The DCs would then train their guns forcing India to undertake reduction in subsidies sooner than later.

Generally, actions taken under pressure are sudden and ill-conceived/planned, thus leaving a serious debilitating impact on the economy. This is not just theoretical. India had a taste of it when, under pressure from the IMF, the government suddenly decided to decontrol all P and K fertilizers and dismantled the retention pricing/subsidy scheme in August, 1992. In turn this resulted in their reduced consumption and increasing imbalance in fertilizer use. India is still not out of the woods.

In view of the above there is an urgent need for a proactive approach. It is possible to deal with subsidies effectively provided these are understood well, prime factors properly identified and the precise contribution of each quantified. Unfortunately this is not happening, even as in the ongoing debate on the subject there is more of rhetoric and less emphasis on substance.

Take the case of subsidies on fertilizers. In 1990-91 it was Rs 4,400 crore. This was perceived to be too high and the government vowed to prune it drastically. In 1991-92, it even committed to the IMF that fertilizer subsidies will be removed in three years. However, by 1998-99 the payout had already increased 2.6 times to Rs 11,388 crore. The budget allocation for 1999-2000 at Rs 13,250 crore is three times the 1990-91 level. Clearly, the fundamental causes leading to growth in subsidy have hardly received any attention.

Subsidy expressed in rupees per tonne represents the excess of reasonable cost of production (including a fair margin of profit) - based on prescribed efficiency norms in regard to capacity utilization and consumption of raw materials and utilities - over netback from sales at the controlled price. This is reimbursed to producers under the retention pricing scheme (RPS). The changes in subsidy amount depend on the relative movements in reasonable cost vis-a-vis selling price.

At the root of ballooning fertilizer subsidies is a sustained increase in prices of feedstocks on the one hand and reluctance to hike urea selling prices even by small amounts on the other

In the 90s the ex-refinery price of naphtha increased from Rs 1,982 per tonne to about Rs 9,100 per tonne (for supplies to port based units) currently, i.e., by Rs 7,118 per tonne. The increase in production cost due to this alone was thus about Rs 5,000 per tonne (based on 0.7 tonnes naphtha for one tonne urea). The overall increase in cost would be much higher due to increase in conversion cost, viz, wages/salaries, other overheads, chemicals and catalysts, repairs and maintenance, cost of bags, marketing and selling expenses, etc.

In sharp contrast, the selling price of urea increased from Rs 2,350 per tonne to Rs 4,000 per tonne. Thus the hike was only Rs 1,650 per tonne leaving an uncovered gap of Rs 3,350 per tonne towards increase in feedstock cost alone (5,000-1,650). Necessarily, this was plugged by a corresponding increase in subsidy. The scenario for units based on other feedstocks, i.e., gas, fuel oil/LSHS, etc, would be broadly similar.

In view of the above, at the root of ballooning fertilizer subsidies is a sustained and steep increase in prices of feedstocks on the one hand and reluctance to increase the selling price of urea even by small amounts on the other. Interestingly, the former represents a corresponding additional income in the hands of public sector units in the oil/gas sector - Indian Oil, ONGC, GAIL, Hindustan Petroleum, Oil India, etc. This is nothing but intraeconomy transfer, i.e., from budget head to PSUs.

The above leads to an anomalous situation. Even though, the net outgo from the exchequer - after setting off intraeconomy transfer - is low, for the purpose of AMS calculation the higher gross payments (that is, subsidy as reported in the budget) are considered. This makes us potentially vulnerable. Even as the increase in feedstock prices continues unabated, the situation will only worsen.

To prevent this the Indian government should endeavor to rein in the cost of feedstocks. This will not only contain the subsidy outgo - and, in turn, AMS - but also make the exchequer better off on a net basis; savings being to the extent of interest on incremental working capital on higher feedstock price and local taxes levied on ad valorem basis. It should also increase urea prices in steps to bring them reasonably closer to cost of production.

A gradual action plan needs to be implemented to bring down subsidies on irrigation, credit, power, etc. While farmers should be made to pay a reasonable price for all these inputs, sincere efforts are also needed to reduce the cost of supply. For instance, the cost of power can be lowered by reducing the price of fuel, namely, gas, fuel oil, coal, etc, on the one hand and improving efficiency of state electricity boards on the other.

(Uttam Gupta is chief economist at the Ferilizer Association of India, New Delhi)