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Structural issues in inflation

Customs and excise duty cuts are inadequate to contain the price rise, says **Uttam Gupta**

A key feature of the Union budget for 1995-96 has been the reduction and rationalisation of the customs and excise duty structure. While making the proposals, the finance minister was upbeat that the significant lowering of duty rates would lead to increased competition and generate pressures to reduce selling price across a wide range of commodities.

Later, top officials in the finance ministry expressed optimism that these measures would help in lowering the rate of inflation to about 8 per cent by the year end. This optimism is certainly not warranted by underlying fundamentals.

At the outset, we must recognise that there is nothing new in this strategy. It is only a continuation of the exercise undertaken in the previous budgets. The peak rate of duty was brought down to a low of 65 per cent in 1994-95. Import duties on a variety of goods were slashed drastically. And yet, the prices did not come down. On the contrary, these have only increased.

An immediate explanation may be that the manufacturers have not passed on the duty concessions, either in full or in part, to the consumer. The warnings issued by the Government from time to time have gone unheeded. For the current year, most of the manufacturers maintain that they have passed on the benefits at the wholesale level (see CII's recent survey). But, this is of no consequence to the consumers as the concessions are yet to be reflected at the retail level. This, however, is only part of the problem.

To know where things really go wrong, it is necessary to scrutinise all major factors which influence the selling price. For the imported products, these are the prevailing international prices, ocean freight, exchange rate, port handling charges and internal handling and distribution cost. The customs duty/ countervailing duty is only one amongst these several elements. During the last four years or so, these 'other' factors were working in a direction opposite to that of the customs duty. The depreciation of the rupee — by almost 60 per cent since July 1991 — alone has more than offset the contemplated benefit of duty reduction.

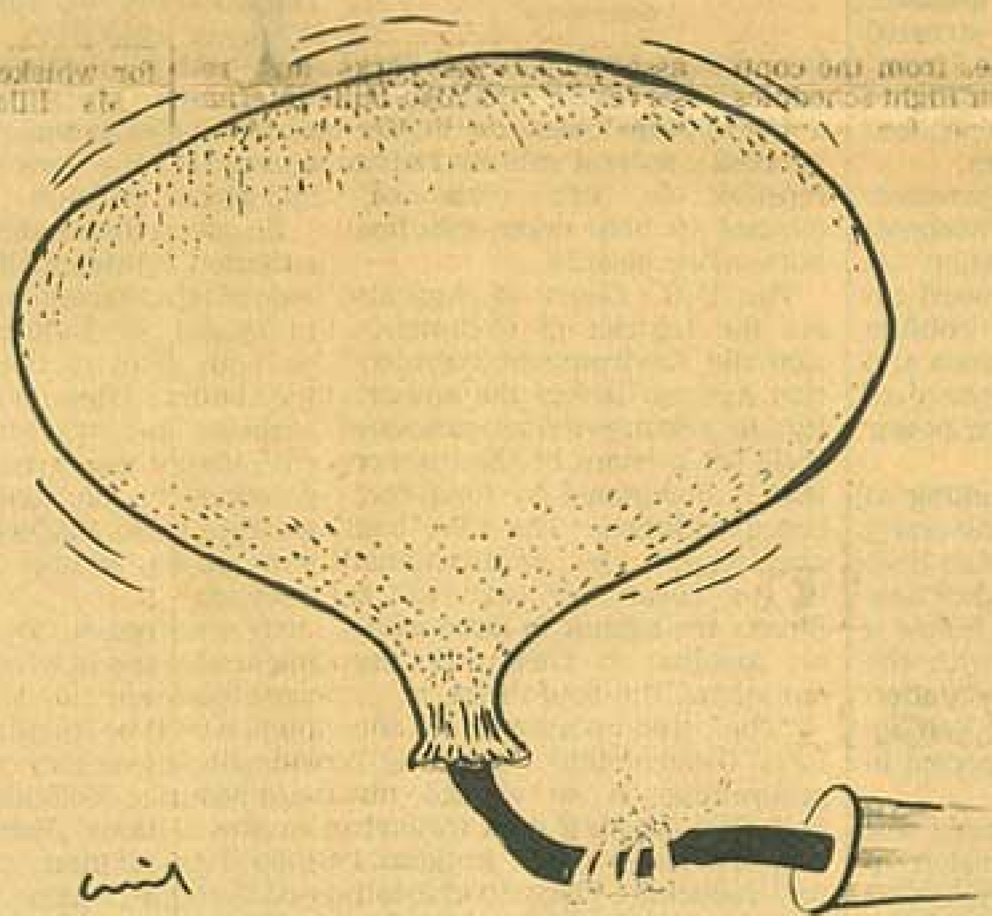
The domestic producers, therefore, continue to be protected and there is no pressure to reduce costs and consequently the selling prices. In such a situation, it is also unlikely that they would pass on the benefit of excise duty reduction to the consumers. No doubt the domestic manufacturers too have handicaps on account of high interest rates, local taxes and duties and higher administered prices like power tariffs etc. But, despite all these, the cost of imports would turn out to be more in a majority of the cases.

That the underlying cost push factor has not changed is evident from the price trends for a variety of items in respect of which customs duty rates have been cut. At the prevailing international price, the c&f landed cost of imported molasses is about Rs 1,920 per tonne. Even at the reduced customs duty of only 10 per cent, the cost to the importer, inclusive of duty at the port, will be Rs 2,112 per tonne. Add port handling charges and internal distribution costs, and the cost to the consumer will be significantly higher than the prevailing domestic price, which is in the Rs 1500-2300 per tonne range.

In the case of caustic soda, even after the duty reduction from 65 per cent to 45 per cent, the landed cost of import will be about Rs 23,000 per tonne as against the prevailing domestic price of Rs 18,000 per tonne.

Likewise, in respect of sponge iron, the landed cost, even with the reduced duty of 20 per cent, will be about Rs 7,000 per mt as against the domestic price of about Rs 6,000 per mt.

The lowering of the customs duty on DMT/PTA/MEG from 60 per cent to 35 per cent will also not be a major worry to the domestic producers because of the ruling high international prices of these intermediates on the one hand and inherent protection available through high exchange rate on the other. The c&f landed cost of imported DMT, for instance, is about $1,250 per tonne. Even with the reduced duty of 35 per cent, the cost to the importer at the port would be about Rs 54,000 per tonne as against the domestic manufacturers' selling price of Rs 48,000 per tonne.



Consider LPG, in respect of which the Government has reduced the effective customs duty (including CVD) from 26.5 per cent earlier to 21 per cent. Notwithstanding this cut, the selling price of the 14 kg cylinder is being sought to be raised from the existing Rs 82 to about Rs 119 within a span of just about 2 years on the grounds that consumers are at present enjoying a subsidy of about Rs 37.

In respect of food and related items which have played a major role in exacerbating inflation, the rationale for fiscal concession induced reduction in prices is even weaker. Import duty cuts on agricultural machinery, pesticides etc, pale into insignificance when compared to the substantial increase in the cost of production resulting from steep increases in fertiliser prices. Even so, the hefty increases in the procurement prices of major cereals allowed by the government were not quite warranted by escalations in cost of agricultural inputs.

When we talk of controlling inflation, other structural aspects cannot be ignored either. Steep increases in administered prices of basic inputs, utilities and services are in the nature of several mini-budgets presented by the government almost throughout the year. These mobilise resources in a subtle manner and, at the same time, produce a cascading effect on the overall price level.

Important items in this category are petroleum products, gas, coal, power, railway freight, post and telecom. These are all supplied by state monopolies and their prices have been increased with impunity during the reform years. More of such increases may be in the offing. The petroleum ministry has already hinted at such a possibility under the contemplated market determined pricing mechanism.

The unprecedented time and cost overruns in a majority of the core sector projects are also very important to be ignored. The increase in investment cost is recovered only by charging higher prices from the users. Considering that these new projects have a major share in total supplies, the impact of delays in their commissioning on the overall inflation rate is substantial.

Finally, how can the highly inflationary effect of the persistently high fiscal deficit be ignored? The government has not made any worthwhile attempt to bring it down. The decision to put a cap on the monetised deficit may have prevented some additional currency notes from entering the market, but, in doing so, it has drawn excessive funds from the banking system, fuelling interest rates and in turn, inflation.

On their own, the moves on the customs and excise front are welcome. Indeed, there is need to consolidate on these trends. But, the consumers are unlikely to get relief from the raging fires of inflation until major structural issues are addressed.