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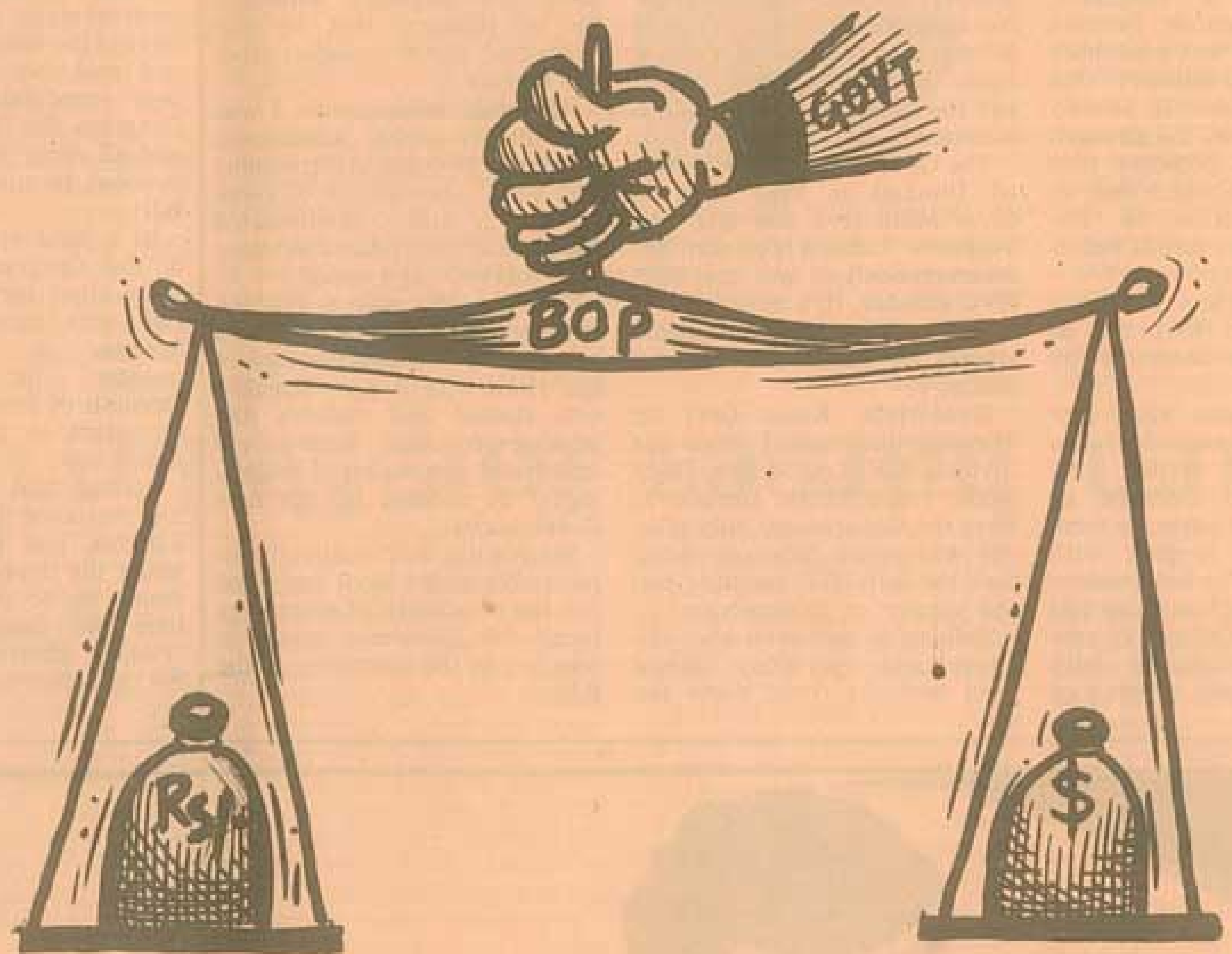
Flawed approach to subsidy reduction

There is a need for undertaking an objective analysis of the phenomenon of increasing subsidy, says **Uttam Gupta**



RECENTLY, the Government of India reduced the concession on imported DAP and domestic DAP and Rs 250 per tonne each (proportionate basis) for other complex phosphatic fertilisers retrospectively w e f 1. 10. 1997 with respect to sales during 1.10.1997 to 31.3.1998.

The cuts have seriously eroded the bottomline of manufacturers/importers, including a number of companies in the public/cooperative sector e g, MFL, PPL, IFFCO, FACT etc and impaired their capability to maintain production at an optimum level. This in turn could affect supplies in the ensuing Kharif 1998 and even thereafter.

Why did the government take recourse to this step? Was it with a view to lower the subsidy burden on the exchequer? In the Budget for 1997-98, a provision of Rs 2,000 crore was made towards concession on all decontrolled P and K fertilisers, including DAP and other complexes. Against this, reduction in rates yielded a meagre savings of less than Rs 100 crore. Clearly, there is a need for undertaking an objective and dispassionate analysis of the phenomenon of increasing subsidy.

Subsidy arises because the government directs the manufacturer/importer to sell the product to farmers at a certain target price — affordable to farmers, which is lower than the reasonable cost of production. Prior to decontrol, in August 1992, this was being done by the government under its retention pricing and subsidy (RPS) scheme.

Under the RPS, the government fixed a fair ex-factory price, commonly known as retention price, based on the prescribed norms of capacity utilisation and consumption of raw materials/intermediates and utilities. The excess of this over net realisation from sales at controlled price (consumer price minus distribution margin) was reimbursed as subsidy to the manufacturer. The transportation cost from the factory to the consumption point was separately reimbursed on a normative basis.

At the time of decontrol, reasonable farmgate cost of supplying indigenous DAP was about Rs 9,400 per tonne against a selling price of Rs 4,680 per tonne. Based on JPC recommendations, the government removed customs duty on imported phos acid, reduced railway freight on movement of all P and K fertilisers including DAP by bringing them at par with other essential commodities viz. foodgrains, salt etc in Tariff Classification, and allowed import of raw materials and intermediates at a lower official rate of exchange under the dual exchange regime.

While these measures enabled reduction in cost to about Rs 8,000 per tonne, concurrently, the government should have increased the selling price of DAP, in small steps, say, about 10-15 per cent per annum (proportionate basis for other complexes). This would have automatically brought about a gradual reduction in subsidy and even satisfied the IMF, which wanted us to eliminate fertiliser subsidy in a three-year time frame as one of the preconditions for the bail out package offered by it.

But, the government was more than eager to demonstrate to the IMF that subsidy could be eliminated much earlier than even the deadline set by latter. Hence, sudden decontrol of all P and K fertilisers w e f 25th August, 1992. Consequent to this and in the absence of subsidy support, selling price increased steeply to Rs 8,000 per tonne to reflect the full reasonable farmgate cost. Fearing that this could adversely affect consumption, within just one month of decontrol, the government reintroduced the subsidy in a new shape — as ad hoc concession.

Initially, the concession amount was kept low at Rs 1,000 per tonne which could restrict the selling price to about Rs 7,000 per tonne during October 1992-March 1993. Thereafter, even as concession remained unchanged, reasonable farmgate cost rose sharply to about Rs 11,000 per tonne during the second half of 1995-96. Correspondingly, the selling price reached a peak of about Rs 10,000 per tonne and DAP consumption slided from 4.5 million tonnes in '91-92 to 3.3 million tonnes during '95-96.

To salvage the situation, the concession amount was raised in July 1996 to Rs 3,000 per tonne and further at the beginning of the current year, to Rs 3,750 per tonne. With this, and reasonable farmgate cost escalating to Rs 12,050 per tonne, during Kharif 1997, the selling price was Rs 8,300 per tonne. This enabled recovery in consumption i.e., about 2.9 million tonnes against only 1.6 million tonnes during Kharif 1996.

During Rabi 1997-98, even as the selling price was kept unchanged at Rs 8,300 per tonne, concession amount was reduced to Rs 3,500 per tonne despite further increase in farmgate cost to about Rs 12,425 per tonne. As a result, the manufacturers had to take a knocking of Rs 625 per tonne.

During Kharif 1998, even as the reasonable farmgate cost is expected to increase further to about Rs 13,000 per tonne, the Government is reportedly contemplating to freeze concession at the same level as during Rabi 1997-98. And, if the selling price is also maintained at Rs 8,300 per tonne, this would be at the cost of affecting viability of production/imports. This, in turn, is bound to affect consumption putting the clock back with regard to promoting balanced fertiliser use.

The only viable way to reduce subsidy is to control cost push factors. Consider the following facts. In October 1992, C&F cost of phos acid was $340 per tonne and ammonia $112 per tonne. In one tonne DAP, their cost was $188 per tonne. At the prevailing official exchange rate i.e., $1 Rs 25, this translated to Rs 4,700 per tonne. Currently, the C&F cost are phos acid, $432.5 per tonne, and ammonia, $180 per tonne, which gives about $248 per tonne DAP. At US $1 Rs 41 (including premium for forward cover), this works out to about Rs 10,168 per tonne i.e., a whopping increase of Rs 5,468 per tonne over the October 1992 level. Of this, increase on account of rupee depreciation alone is about Rs 4,000 per tonne.

A number of plants use indigenously produced ammonia based on hydrocarbon feedstock. Since October 1992, cost of naphtha delivered factory gate has gone up from about Rs 4,500 per tonne to Rs 8,500 per tonne. This, in turn, has resulted in higher production cost of DAP from these plants by about Rs 900 per tonne. Along with an increase on account of phos acid — largely imported, the overall cost hike is more or less similar to that for units using imported ammonia.

Thus, if the government is really serious about reducing subsidy, it should improve BOP management to substantially enhance the value of the rupee vis-a-vis the dollar, refrain from further increasing prices of hydrocarbons and exempt all fertilisers from an increase in railway freight. Besides, the state governments should be prevailed upon not to levy taxes and duties.