Financial Express - June 14, 1997

Subsidies are not that high

by UTTAM GUPTA

THE discussion paper on subsidies says that non-merit goods like milk, transport, irrigation, agriculture and allied activities are subsidised 90 per cent. Prima facie, this makes little sense.

Subsidy, the excess of reasonable cost of supply and distribution of the product, is controlled by the central and state governments. For food and fertilisers, the difference is met by the government through explicit subsidies. For other items like power, road transport etc, the shortfall in realisation by selling cheaper is not directly reimbursed, but is reflected in balance sheets of state-owned and controlled agencies as losses. This is categorised by the central government or the states as non-plan support.

POL products and concessional supplies of naphtha, fuel oil, LSHS to fertiliser industry are cross-subsidised by higher prices on petrol, ATF, motor spirit, naphtha and fuel oil/LSHS to non-fertiliser users. Although the oil pool account (OPA) has to be self-sustaining, (indeed until the end of the '80s, it was in surplus), during the 1990s it has been in deficit. The extent of subsidisation should be noted. In case of urea, the farmer pays Rs 3,660 per tonne (excluding local tax) against the production and distribution cost of about Rs 6,500 per tonne on a weighted average basis. The subsidy on domestic supplies is thus Rs 2,840 per tonne, which about 44 per cent of the cost. For imported urea, the cost of supply works out to about Rs 8,000 per tonne. The subsidy is Rs 4,340 per tonne, ie., 54 per cent of the cost.

Among decontrolled P and K fertilisers, for DAP, against the current selling price of about Rs 8,300 per tonne, supply from domestic production costs about Rs 12,000 per tonne, entailing Rs 3,700 per tonne as subsidy or about 30 per cent of the cost. The farmgate cost of supplying imported DAP is about Rs 10,500 per tonne yielding a subsidy of Rs 2,200 per tonne, that is, 21 per cent of the cost.

In the food sector, against the issue price of Rs 4 per kg - for people above the poverty line (APL) - wheat costs about Rs 7.25 per kg. The latter is on the basis of Rs 4.75 per kg as the procurement price (for current marketing season) and about Rs 2.50 per kg towards handling and distribution cost and the subsidy is Rs 3.25 per kg, ie., 45 per cent of the cost. Thus, contrary to the sweeping claims made in the Discussion Paper, that 90 per cent of supply cost is being subsidised, in the case of food and fertilisers subsidization ranges from 20-54 per cent. The application of the 90 per cent subsidisation assumption to other less data-friendly areas leads to absurd conclusions on likely supply cost. Supplies to agriculture are charged at about 25 paise per unit in a majority of the states.

Contrary to the sweeping claims made in the Discussion Paper, that 90 per cent of supply cost is being subsidised, in the case of food and fertilisers, subsidization ranges from 20-54 per cent

If this is 10 per cent of the actual cost, then, the supply cost should be Rs 2.50 per unit. This may make some sense, but the figure is still higher than the likely actual.

The recommendation that consumers should be made to pay 50 per cent of the cost and, after subsequent two years, 75 per cent, would lead to major price impact. At the end of three years, they will be required to pay Rs 18,300 per tonne for urea, Rs 55 per kg for milk and Rs 7.5 per unit for power (house-hold use). This is absurd. Items are heavily subsidised, but realistic numbers should be arrived at to avoid distortions in perceptions regarding the extent of subsidy.

Why do subsidies increase? On any product, subsidy per tonne being the difference between the reasonable cost of production and distribution, on the one hand, and selling price, on the other. It can increase under three scenarios: cost remaining unchanged, decrease in selling price and increase of cost while selling price remains unchanged. The first situation rarely happens; examples are the urea selling price reduced by 10 per cent in August 1992 or recently, power made free in Punjab. The second scenario is not uncommon; this holds for urea, kerosene and foodgrain. The last situation is the most commonly found situation.

A glaring example is the concessional price of feedstock supplies to the fertiliser industry. Since 1990, the ex-refinery price of naphtha has increased by 145 per cent, fuel oil by 177 per cent and LSHS by 175 per net. And yet, according to the petroleum ministry, there is a heavy subsidy of Rs 1,500 crore on such supplies. The increase in the cost of supply has been much more. Mostly, cost increase has been due to the government's own actions. On POL products, domestic crude output fall and increase in POL demand have led to higher imports at increasing prices. Domestic crude production has fallen due to absence of a policy in exploration and development of oil fields.

Bad BOP management has depreciated the Rupee, pushing up import cost and , the subsidy bill. The government cites it as an "extraneous factor". When there is a heavy flow of dollars, it loses no time to intervene and keep the rupee undervalued. There is a customs duty on imported crude at the rate of 25 per cent ad valorem. While giving revenue to the government, this increases the POL production cost. It has become the policymakers' pastime to treat the ever-increasing gap between supply cost and the price paid by the consumer. Consumers should indeed be charged a reasonable price, but to effectively solve subsidy problems, cost-push factors must be addressed. ◆

Regd. No: DL-26002/97 R.N.I. No. 26750/74 Printed and published for the proprietors, Indian Express Newspapers (Bombay) Limited by Sushil
Managing Editor: Vivek Goenka Executive Editor: