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IMPLICIT SUBSIDIES: AN INDISPENSABLE MODULE OF BUDGETARY SUBSIDIES?

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ABSTRACT

The objective of this paper is to bring out the importance of implicit subsidies which have been neglected in the area of subsidies. Since implicit subsidies are derived from budgetary subsidies, the methodology of budgetary subsidies as unrecovered cost of public provision of non-public goods is also discussed. The rationale behind the classification of goods under budgetary subsidies approach is also deliberated upon. The aim of this paper is to discuss the theoretical arguments in acknowledging the seriousness and significance of implicit subsidies, discussing in the background the costs associated with the excessive government intervention. The paper concludes that there is a serious need of reducing government provision of non-public goods by rationalizing subsidies.

I. INTRODUCTION

One can solve a problem only if the problem is identified. Problem identification is the very first step towards the solution of the problem but in this case the problem is itself unrecognized. There are very few studies on the magnitude of implicit subsidies. Hence, the fact that available literature on subsidies is predominantly biased towards explicit subsidies becomes the first argument for the need for discussion on implicit subsidies. The debate on subsidies mainly revolves around explicit subsidies, that too provided by the central government and not much has been said on the issue of implicit subsidies provided by the state governments which are three to four times of explicit subsides. It has been observed that while a number of subsidies are explicitly stated in the central budget, the state budgets show very few subsidies explicitly. Thus measuring subsidies as explicit subsidies for the state governments only understate the overall volume of subsidies; hence implicit subsidies become even more important for the state governments.

There is no direct method to calculate implicit subsidies. It is calculated as a residual of budgetary subsidies after deducting explicit subsidies from it. . Budgetary subsidies are measured as the excess of costs over receipts on relevant budgetary heads in social and economic services. The costs are

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calculated as the sum of current costs and annualized capital costs. The receipts comprise interest receipts, dividends and other revenue receipts from user charges.The exercise is rigorous and detailing in the sense that it has to be calculated in terms of unrecovered cost of each head and sub head of social and economic services according to functional classification of the budget.One of the reasons behind lack of attention and attempts in recognizing the problem of implicit subsidies is that it is an economically sensitive subject. Also Subsidies are instruments of government intervention. One can use the magnitude of subsidies as a tool to measure the size of the govt. Various studies have revealed how subsidies in India have proliferated as a result of undue expansion of government activities in the provision of goods and services that are not pure public goods.

II. COSTS OF EXCESSIVE GOVERNMENT INTERVENTION

Recently economists have been brainstorming on how to attain the ideal size of government because there are various costs associated with the government intervention. Extraction cost, displacement cost, negative multiplier cost, behavioral subsidy cost, market distortion cost, inefficiency cost and stagnation cost or lack of innovation cost are some examples.

Extraction cost: government spending is met through some source which is not government's own. The source can be tax/non-tax revenues or borrowing which can be domestic or foreign. The financing choices are costly and have a dubious effect on economic growth, regardless of how it is financed.

Displacement cost: Government expenditure displaces private-sector activity. Every rupee that the government spends means one less rupee available in the private sector of the economy which is more productive than the public sector because here economic forces determine the resource allocation whereas in the government sector, political forces dominate. This dampens the overall economic growth.

Negative multiplier cost: sometimes the government finances harmful intervention by multinational bureaucracies which acts as a negative multiplier cost because of the anti-growth policies advocated by these regulatory agencies.

Behavioral subsidy cost: subsidy provided in a certain good/service encourages a behavior among individuals that they get used to the persistent subsidies so and so that removal or even considering their decrease becomes a tough challenge for the government. Providing free water and electricity serve as a classic example here. Even if Punjab government wants to reduce it or charge for it now not just because of the monetary debt implications it has but also of the detrimental effects it has on soil erosion and coz of wastefulness of scarce resources. It still cant. Hence subsidity imposes not just monetary cost but also the behavioural cost to the govt in the form of lack of productivity among individuals and increased dependence on the govt .

Market distortion cost: Government spending distorts resource allocation. Competitive markets ensure the most efficient allocation of resources, but some government programs interfere with the markets. In both health care and education, government subsidies to reduce out-of-pocket expenses have created a "third-party payer" problem. This weakens the critical role of competitive markets, causing significant inefficiency.

Inefficiency cost: Government spending is a less efficient way to deliver services. The gap between the recovery from services and their cost has been widening over the years. This observation strengthens the argument of reducing the size of government and allowing private sector to operate wherever is feasible. There is evidence that the private sector could provide services at a higher quality and lower cost. Government can limit its role to that of regulator and a watch dog as compared to that of a provider.

Stagnation cost: Government spending slows up innovation. Due to competition and the desire to augment income and wealth, those in the private sector constantly search for new alternatives and opportunities which enhances economic growth. Government programs, however, are intrinsically inflexible because of centralization and red-tapism. Reducing the government intervention or devolving central programs to the state and local levels can eliminate or diminish this effect.

Rationalisation of government subsidies has been prominent on the public policy agenda in India, since 1990, when the first comprehensive estimate of budgetary subsidies as unrecovered costs was made by Mundle and Rao (1991). During his budget speech for the year 1996-97, the Union Finance Minister promised to place before parliament a discussion paper on visible and hidden subsidies so that there could be an informed debate and a consensus on the overall level of subsidies as a percentage of GDP and their appropriate targeting. In response to this commitment, the central government brought out a white paper on central budgetary subsidies in May 1997. The study brought to the fore the massive magnitude of budgetary subsidies in the provision of economic and social services by the governments and stressed that the reform of the present regime of subsidies should focus on a number of actions such as reducing the overall level of subsidies, bringing transparency in the system and using subsidies for definite economic objectives.

The paper took a broad view of subsidies considering these as unrecovered costs of public provision of non-public goods and services financed by the budget for year 1994-95. The subsidy estimates pertained to the centre as well as for 19 major states. The idea was to provide an all India perspective on the extent and composition of total budgetary subsidies. It criticized the subsidy regime as being unduly large, non-transparent, largely input-based and poorly targeted, generally regressive in its incidence, and inducing misallocation of resources. Estimates for the centre were updated with some methodological changes for 1995-96 and 1996-97 in a later study by Srivastava and Amarnath, (2001). In the latest report on subsidies brought out by the Government of India (2004) the need for rationalization of this significant component of government's revenue expenditure was emphasized.

Although extensive discussion took place following these studies, hardly any effective policy measure was taken either to contain or to target the subsidies, except the modification of the then existing food subsidies to build in some amount of targeting.

III. BUDGETARY SUBSIDIES APPROACH: CLASSIFICATION OF GOODS AND METHODOLOGY

Over the years, it has been observed that most of the governments provide not only the pure public goods but also private and quasi-public goods. Therefore, in budgetary context, it is useful to distinguish between three sets of goods provided by the government, *viz*., pure public goods, pure private goods and club goods. Public goods are identified by the twin characteristics of non-rivalry (consumption by one user does not reduce the quantity available for another) and non-excludability (consumption by one cannot be distinguished from consumption by another). Non-excludability in consumption implies that true consumer preferences will not be revealed. Since these services cannot be easily priced, their costs have to be met out of the general budget. It is a general practice to exclude pure public goods from the calculation of implicit subsidies as the consumers can't be identified and hence the extent of consumption can't be measured for such goods.

In the case of private goods, the consumer is identifiable, and the extent of his consumption is measurable. There are many goods/services that do not clearly fall into the exclusive categories of purely public or purely private goods. Both the characteristics of rivalry and excludability are matters of degree, and often there are some goods which can be seen as characterised by different degrees of

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'publicness' and, therefore, fall in an intermediate category. A conceptual category is that of club goods like roads which are goods that are non-rival for small groups but become rival when the group of users becomes large. In the case of congestible goods, user charges are leviable, although these may be varied according to groups of consumers rather than individual consumers.

Government expenditures in India are broadly classified with respect to three service categories: general, social, and economic. In the general services, expenditure on fiscal and administrative services is included. These services are in the nature of public goods. These are not supplied by the market although sometimes services can be individualised. In most cases, individuals cannot be charged for services according to the extent of their consumption. In such cases, these are appropriately paid for by taxation. Although some services within the category of general services may be individually chargeable, it is difficult to separate public and private services and affect corresponding recoveries in this group of services.

Governments in India, both at the centre and in the state level, actively participate in the provision of a range of private goods or congestible goods under the head of social and economic services where users or groups of users are identifiable and user charges can be levied. Budgetary subsidies arise when the budgetary cost of providing the good/service is more than the recovery made from the user/beneficiary of the service, the difference being financed by the taxpayer.

The methodology takes into account only those goods which are mix of pure public and pure private i.e. club goods. Hence the subject matter of subsidies which are defined as the unrecovered cost in the public provision of non-public goods includes those non-public goods and services which are essentially excludable in nature so that you can exclude those who are not paying for the good/service to avoid the problem of free riding. These goods are semi-private and semi-public. Semi private refers to the fact that they are excludable and their consumption is rival in nature. At the same time they have certain degree of publicness too in the sense that their benefits are not limited to a person but extended to a group of persons. So they have varying degrees of externality in them. This feature requires public provision of such goods. This calls for/requires the public provision of such goods.

Hence subsidies for public provision of non-public goods/services. We call them non-public as they are not pure public. Had they been so, they would have been purely financed out of tax revenues and it would have been impossible to identify the users/beneficiaries of such goods as they would have been non-excludable and non-rival. We can only take those goods which need to be provided by the

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government (public provision) because of the innate externality or publicness in them but at the same time those goods which can be charged for, a price which doesn't cover the cost of production entirely but some part of it.

The criterion of positive externality determines the presence and extent of subsidization in a particular service. The discussion paper of 1997, classified the services into merit and non-merit categories. While the merit goods category deserves subsidization, there is no case for subsidizing non-merit goods. However, within merit goods, one still needs to determine the desirable degree of subsidization. In Srivastave and Amar Nath (2001) and Srivastava et al. (2003), budgetary subsidies on goods and services provided by governments were classified into three categories, viz.; (I) Merit I; (ii) Merit II; and (iii) Non-Merit. These broadly refer to categories of services with the desired high, intermediate and low (or zero) degrees of subsidization respectively. The difference between these is made on the basis of the extent of externality associated with the good/service.

IV. DEBATE ON SUBSIDIES

The economic reforms of 1991 laid emphasis on the re-assessment of role of government, limiting the size of government intervention in the economy and containing and targeting subsidies.

Although there is still resistance to limiting the role of government to those areas where it works best, the consensus is, nevertheless, on the view that the government should confine itself to the areas of public goods and possibly some merit goods. That's why the subsidies given in non-merit goods strongly needs to be revisited and shifted from merit goods to non-merit goods. If the government enters into provision of economic services like irrigation and power; an area which is traditionally profit making, and spends the taxpayer resources on subsidising loss-making units in such areas, as for example, in Haryana and Orissa, this leads to questions regarding the rationale behind government's expenditure policy stance. When the receipts are not sufficient to meet the expenditures, one has to focus on prioritizing expenditures.

Most of the studies done on implicit subsidies have been misunderstood. Studies were aimed at finding the magnitude and composition of budgetary subsidies across various heads and sub-heads of social and economic services and hence formulating sector specific policies. More often than not, it was found that the subsidies were greater in economic services like irrigation and power as compared to social services like health and education. Free water and free electricity that were popularised as a farmer-friendly policy, was neither yielding the promised benefit to the majority of farmers nor laying the basis of higher and sustained growth. On the contrary, inefficient and wasteful use of water led to erosion in soil quality. Therefore, the aim was to redirect it towards social services from economic services or towards merit goods from non-merit goods. The aim was not to take these subsidies away but to reduce them from the lesser deserving areas and shift them to those areas where the degree of positive externality is higher and where there is less scope of higher recovery.

The aim was to right-size the role of government in the provision of goods and services, through rationalisation of subsidies by improving cost recovery either by increasing the revenues or limiting the role of government to limited services with higher degree of externality or merit goods and services. The objective was to identify those areas where the users were identifiable and very well can pay for the services. Hence policy measures such as raising revenues from user charges and improving the recovery rates of the non-public services provided by the government were suggested. Share of user charges or non-tax revenue has been continuously declining while the revenue expenditure on provision of services by the government has been increasing, together resulting in an increase of un-recovered costs.

The methodology is so detailed and comprehensive that not only it covers the implicit but also the explicit. Budgetary subsidies give the total amount of subsidies arising out of the budget. It’s the budget based subsidies.

There is an obvious connection of deficit with subsidies. One can confirm this by calculating the subsidies as a proportion of deficits. The likelihood of higher deficits increases with increasing amount of subsidies. If the cost of subsidized goods or services is not met by the revenues generated by the goods or services the government is left with no option than deficit financing. Most economists have agreed upon a negative relationship between economic growth and subsidies. The positive nexus between subsidies and inflation can also not be ignored in this direction.

V.CONCLUSION

Reducing government control is not free from criticism. However, the possibility of "government failure", similar to the "market failure" argument, is now being taken seriously. It is recognized that the government itself may become too bulky and unwieldy. The establishment cost of government activity has risen and to provide the same or even a lower level of actual service, rising amounts of real resources seem to be needed to be spent. Increasing expenditure and declining revenues pose challenge to the scarce public resources. This is now recognised both at the Central and the State levels. As a result, there is some attempt to withdraw/reduce government controls from areas where it does not enjoy a comparative advantage. Acknowledging that implicit subsidies are an important component of subsidy reforms and hence calculating the magnitude of it, analyzing its composition across various heads and sub-heads is just one step towards it. After all, it is the quality of government intervention rather than the quantity that is important for economic growth (Tanzi and Shome, 1992).

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