The Indian EXPRESS COLUMNISTS

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Sunday , February 06, 2005

FROM THE RINGSIDE

Getting cross with cross-subsidies

This is a season when it is fashionable for all and sundry to give even unsolicited advice to P Chidambaram. Finance Ministers are tolerant, fully conscious that the basic Budget story involves multiple inflexibilities. The arithmetic of accounting limits manoeuvrability. During the winter session of the Parliament, Chidamabram presented, for the second time, a White Paper on subsidies to promote discussion and share concerns on multiple hidden and explicit subsidies. Subsidy discussions have primarily centered around public distribution system, application of user charges for public utilities and pricing of farm inputs. Subsidy targeting has also been discussed with little tangible outcomes.

India is replete with cross-subsidies where one sector or segment bears an extra cost for subsidy within the segment. To say the least, the cost of such cross-subsidies are neither carefully calculated nor explicitly known and yet cross-subsidies span large segments of economic activity:

• **Railways**: Over-charging on freights to subsidise passenger traffic. Within the freight segment itself, uneconomic freight subsidising other categories of goods and differential subsidies between various classes of passengers.

• **Petroleum**: The well-known subsidy is by over-charging petrol to subsidise kerosene and LPG. Diesel prices fluctuate sometimes on and sometimes not on par with import parity price.

• **Civil Aviation**: Passengers on economic routes being penalised to pay for connectivity to uneconomic routes and the more profit-making airports subsidising the loss-making airports.

• **Telecom**: The Universal Service Obligation and Access Deficit Charge casting a burden on existing consumers, particularly long distance and international callers, for enabling rural connectivity.

• **Electricity**: Surcharges which penalise domestic and industrial consumers to pay for either free or less than economic cost from certain categories of users.

The list is long. Cross-subsidies are convenient for Finance Ministers. In the event of their elimination, if social and equity considerations necessitate their continuation, the Budget will have to directly bear their burden. The ever present fiscal compulsion makes this difficult. Continuation of such subsidies is therefore a convenient option. This masks the real incidence of fiscal distortion. Cross-subsidies may be appealing on equity considerations by making the rich pay for the poor. It is a kind of redistribution within sector, but is it the most efficient way to

effect redistribution?

It is not for atleast three reasons:

First, if we are going to have cross-subsidies, we should carefully consider who is subsidising whom and what is the effect of ‘‘tax’’ in a broader context. Cross-subsidies as implemented in India do not generally redistribute from rich to poor. Electricity cross-subsidies, for example, are not means-tested for wealthier consumers pay more. They are instead subsidies from industry to non-commercial users. The industries are not necessarily the ‘‘rich’’, and handicapping them only hurts the poor in the bigger picture since it makes investment in industry less attractive, reducing the number of jobs that are created. On the other hand extracting higher prices more directly from wealthier people has a lesser effect: additional taxes placed on the rich might reduce their current available income, but the elasticity of investment to income is probably less than one. They will go ahead and invest the same amount, or nearly the same amount, in creating jobs for the economy.

The advantages of means-tested cross-subsidies over the current rough industry-household method depends on the relative sizes of two effects: the ‘‘substitution effect’’ and the ‘‘wealth effect’’. When industry is taxed, then investment in Indian industry becomes less attractive, so entrepreneurs look elsewhere, such as other countries, or other forms of investment. This is a ‘‘substitution effect’’. When rich people are taxed, then investment is likely to be only slightly lower because while their overall pool of funds shrinks, their investment in industry stays the more or less same. This is the (loosely speaking) ‘‘wealth effect’’!

I argue that the ‘‘wealth effect’’ is smaller than the ‘‘substitution effect’’ for two reasons: (i) Substitution effect is significant: the market for attracting investment is global and pretty competitive. A small disadvantage is all it takes for Indian industry to lose a lot of investment on alter intersectional investment pattern. (ii) Wealth effect is small: The marginal utility of consumption is pretty low for rich people — there is a general consensus that consumption displays decreasing marginal utility and they are already consuming plenty. The marginal utility of investment, however, is not necessarily decreasing for an individual. So when their pool of discretionary income drops, and they have the choice of cutting investing or cutting consumption, they cut the one that affects their marginal utility less — which would be consumption. So investment may even stay the same.

Second, cross-subsidies are more distortionary than broader redistribution through the general government budget. They change the relative costs of consumption of various goods, leading people (especially the beneficiaries) to change their behavior and consume more of whatever is being subsidised than they would otherwise. Why not simply tax the population that is now subsidising services directly and give a ‘‘living grant’’ to poorer people that would cover a certain normatively desirable level of electricity, water, rail transport, etc.; price these things at market or cost-recovering levels for everyone, and let people spend their grant on these services as they see fit. The beneficiaries might well be happier — they have more freedom to choose what to spend on, and the subsidisers would be no worse off than before. Of course, as argued above, the pool of subsidisers would be changed too. But the main point is that broad-based redistribution is a ‘‘pareto improvement’’ over sector-specific redistribution — it makes some people better

off, while making no person worse off.

Third, cross-subsidies are a nightmare when considering public-private participation. Whatever their merits for completely government-run services, they really make it difficult to the kind of firm-specific accounting required for private participation. While the government might only care if the sector as a whole is making money, the private company cares if it is making money. Cross-subsidies are incompatible with the kinds of public-private partnerships that India is moving toward, both in rhetoric and in fact.

Chidambaram cannot be expected to do all things in one go. I also doubt the progress he can make on many of his ‘‘loud thinking’’ proposals contained in the White Paper on subsidies. Subsidies may in some cases be justified on social and equity consideration if targeted sensibly. However, cross-subsidies are distortionary to the economy, irrational in conception and clumsy in implementation. They deserve a ‘‘sunset clause’’ even if outright abolition is not feasible. The least we can expect from Chidambaram is a commitment to progressively eliminate these irrationalities. No expenditure management policy can be oblivious to these concerns. Coalition politics is no excuse to overlook these endemic and long-pending corrections. It is difficult to avoid not getting ‘‘cross with cross subsidies’’.

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