Chapter 7  
Findings and Policy Imperatives

Budgetary subsidies arise when the government fails to recover the cost of providing the services from the user charges by such means as fees, tariffs, and user charges. Subsidies also arise when government procures a commodity from sellers, and then sells it at prices that do not cover the procurement prices and cost of storage, handling, transmission, etc. such is the case of food subsidies in India. Apart from being costly and cumbersome, widespread, intervention by the government in the market impedes to respond to changing situations.

Although the issue of equity and efficiency has to be considered keeping in view the impact of entire fiscal and regulatory system (taxes, subsidies, fiscal deficit, government expenditures, administered prices), subsidies in India have a significant impact on equity and efficiency of fiscal regime because of their size and spread. If excess subsidisation is financed through distortionary taxation, efficiency of the system is doubly compromised. An appropriate degree of subsidisation may lead to better alignment of market prices to the structure of social demands; but excessive subsidisation would distort their alignment leading to waste of scarce resources, and regressive outcomes. Achieving the right balance is, therefore, the key question in achieving the equity and efficiency objectives of fiscal interventions.

Misguided sectoral policies particularly weak cost recovery, and, a policy and regulatory framework, which have been not conducive to private sector participation, has contributed to fiscal imbalances and poor provision of infrastructure. The subsidies both implicit and explicit have important sources of pressure on budget that has lead to inefficient use of critical inputs and inefficiencies in the public sector.

Uttar Pradesh, is the largest State of the India and populous enough to be the fifth largest country in the world. As per population census 2001, Uttar Pradesh, with its 16,605 crore strong population, continued to be the most populous State in the country and accounts for 16.17 per cent of India’s 102.70 crore population. Resource-wise Uttar Pradesh is rich region with its fertile soils, good climate, plenty of surface and ground water and diverse flora and fauna and thus State presents highly favourable conditions for agricultural development. However, the economic performance of the State over the years has fallen behind the rest of the country. The result of poor overall economic activity and high population growth is reflected
in extremely slow growth in per capita income as compared to all-India growth figure. The structure of State income shows that the contribution of primary sector has declined to 41 per cent of the State income though the sector still sustain 73 per cent of the total working force. This shows the continued pressure of working population in the primary sector. The share of secondary sector, on the other hand, has gone up to 20 per cent of the total State income which now employ 9 per cent of the total workers in the State.

Uttar Pradesh is at the tail end when compared to major States in terms of fiscal indicators. Expenditure allocation strategy is directed more towards welfare schemes and committed expenditure (on both interest payments and salaries) than operation and maintenance expenditure. This has also resulted Utter Pradesh being behind other major States in terms of growth of income and certain socio-economic indicators.

Though contribution of tax revenues has shown slight improvement but the contribution of non-tax revenues in revenue receipts of the State are continuously decaling during the study period. Shortage in revenues from time-to-time has resulted in cut down of expenditure on socio-economic infrastructure.

The present chapter, concluding in nature, summerises major findings in this exercise, raises certain issues in administration of subsidies and suggests certain policy issues. The chapter is organised into three sections. First section summanses the finding of the study. The second section raises issues in the policy of subsidies and the third section discusses about certain policy suggestions and explores the areas for further research.

**Main Findings**

It is clear that Central budgetary subsidies both implicit and explicit have increased during last two decades. Food subsidies are around 40 per cent of total explicit subsidies followed by fertiliser. Subsidies have not only increased in current prices but also in real terms. Ratio of subsidies to fiscal deficit is also significantly high. There is an increasing trend with some fluctuations in different years. Increasing subsidies at alarming rate have generated burden on fiscal condition of the country. Per capita subsidies have also increased during last one and half decade.
• In nominal term, aggregate explicit subsidies of the Central government have increased from Rs. 10728 crore in 1990-91 to Rs. 60181 crore in 2006-07 (RE).

• Explicit subsidies of Central government as a percentage of GDP have declined from 2.08 per cent in 1990-91 to 1.59 per cent in 2006-07 (RE).

• The growth of subsidy was much higher between 1990-91 and 1999-00 compared to the period of 2000-01 to 2006-07 (RE).

• Per capita explicit subsidies have increased from Rs. 12.79 in 1990-91 to Rs. 53.64 in 2006-07 (RE).

• Over the period, the relative importance of major subsidies given by the Central government like food, fertiliser, agriculture, power, and petroleum have changed.

• The per capita food subsidy has increased around ten times from Rs. 2.92 to Rs. 21.57, which is a significant increase in last 15 years.

• The burden of fertiliser subsidies is growing and the RPS has generally been the main cause of ballooning fertiliser subsidy bill.

• At constant prices, agriculture subsidies of the Centre have risen from Rs. 164 crore in 1990-91 to Rs. 362 crore in 2006-07(RE) with an annual growth of about five per cent in real term.

• Because of transmission and distribution to rural electrifications, power subsidies increased tremendously after 2004-05.

• There are two reasons, why explicit petroleum subsidies are decreasing sharply; i) decontrolled of the prices; ii) losses are shown outside of the budgets.

• Fiscal indicators of major States are showing that Utter Pradesh is at the tail end.

• The share of revenue deficit in fiscal deficit, which is indicative of the quality of fiscal deficit, has also sharply deteriorated. In 1990-91, nearly 40 per cent of fiscal deficit was claimed by revenue deficit.

• Average primary deficit as a percentage of GSDP is more than the difference between real growth and the real interest rate. The primary deficit continued to be positive.
• The debt in Uttar Pradesh is relatively expensive with higher interest rates as compared to other States.

• From 1990-91 to the period prior to reorganisation, the TGR of total own tax revenues was 12.78 per cent and over the period 2000-01 to 2007-08 was 14.55 per cent.

• There is also considerable volatility in the year-to-year growth in almost all taxes.

• For the period from 1990-91 to 2006-07 Uttar Pradesh’s buoyancy of own tax revenues is more than unity and highest among all major States

• Share of interest receipts in non-tax revenues has declined significantly from 50.92 per cent in 1987-88 to 12.69 per cent in 2006-07.

• The structure of revenue expenditure has undergone a significant change during 1987-88 to 2007-08.

• Social sector covers only about one third of total revenue expenditure and a major part is going to other services. In the case of capital expenditure share of social services cover only a little portion of total capital expenditure and it varies between 3.53 per cent and 16.52 per cent.

• There is sharp increase in the ratio of interest payments to total revenue expenditure in post-division years.

• In Utter Pradesh, Grants-in-aid have increased more than four times from Rs. 1941.32 crore in 1990-91 to Rs. 7842.28 crore in 2005-06. More than 90 per cent of these grants-in-aids are provided under social services, while a little amount goes in economic services.

• Transfer to individuals, which constitute direct income to the recipients and like a negative tax.

• Implicit budgetary subsidies in nominal term have gone up from Rs. 4486.07 crore in 1990-91 to Rs. 15928.39 crore in 2005-06 with 8.81 per cent annual growth rate. Economic Services absorbed major part of these subsidies.

• In social services, it has increased from Rs. 1285.28 crore in 1990-91 to Rs. 4989.88 crore in 2005-06 with an annual growth rate of 9.46 per cent. Major part of the subsidies in social services absorbed by Health and Family Welfare followed by Education, ‘Water Supply and Sanitation’ and Social Welfare.
In Economic Services, subsidies increased from Rs. 3200.78 crore to Rs. 10938.50 crore over the same period with an annual growth of 8.54 per cent. Major part, approximately 33 per cent of subsidies in economic services is covered by Irrigation and Flood Control followed by Energy, Rural Development, and Agriculture and Allied services.

The overall recovery rate has decreased from 4.78 per cent to 3.19 per cent during the period.

In Social Services, recovery rate decreased from 3.70 per cent in 1990-91 to 3.02 per cent in 2005-06. Most of the recoveries are made in Education, Sports, Art and Culture sector.

Economic Services also show decreasing trend in recoveries. These have decreased from 5.21 per cent in 1990-01 to 3.28 per cent in 2005-06. Other Economic Services, Agriculture and Allied Services, and Irrigation cover major recoveries. Energy sector shows least recoveries from cost of providing services.

On an average only 27 per cent of total budgetary subsidies is give under Social Services and rest 73 per cent under Economic Services.

As a per cent of GSDP, total implicit budgetary subsidies have increased from 7.01 per cent in 1990-91 to 5.82 per cent in 2005-06.

In Social Services, ratio of subsidies to the GSDP has decreased from 2.01 per cent in 1990-91 to 1.82 per cent in 2005-06.

In economic services, subsidies as a percentage of GSDP decreased from 5.00 per cent in 1990-91 to 4.00 per cent in 2005-06.

The Per Capita Subsidies in the State are continuously increasing from Rs. 343.79 to Rs. 873.80 during the period from 1990-91 to 2005-06. In Social Services, it is much lesser than Economic Services.

In social services, per capita budgetary subsidies increased from Rs. 98.50 in 1990-91 to Rs. 273.742005-06 to.

In Economic Services, per Capita Budgetary Subsidies are at higher side with 6.15 per cent growth of per annum. They have increases from Rs. 245.30 in 1990-91 to Rs. 600.07 in 2005-06.

In real term, per capita subsidies in the State have decreased from Rs. 731.48 in 1990-91 to Rs. 699.04 in 2005-06.
• In Social Services, per capita implicit subsidies at constant prices increased marginally from Rs. 209.57 in 1990-91 to Rs. 218.99 in 2005-06.

• In Economic Services, per capita subsidies in real term rose from Rs. 521.90 in 1990-91 to Rs. 571.67 in 2003-04 and then decreased to Rs. 480.05 in 2005-06.

• The total surplus generated is Rs. 7.77 crore in 1990-91 and increased to Rs. 345.76 crore in 2005-06.

• As a per cent of GSDP, surplus sector covers a negligible part.

• Too much concentration of government expenditure is in health services (rural and urban), water supply, medical education (training and research) under social services and roads and bridges, rural development programmes, commercial irrigation and, power under economic services are caused neglecting other sectors will no longer result in overall development of the State.

• The present study makes it clear that there is an overestimation of implicit budgetary subsidies by the earlier studies. Over estimation of subsidies by the earlier studies is due to overestimation of costs by not converting the capital stock into real terms and inclusion of grants-in-aid to local bodies in the cost of provision of services.

Increasing burden of subsidies both implicit and explicit subsidies need to be revised in view of the State facing disturbing and fluctuating finances. An inter-State comparison shows that Uttar Pradesh is at the tail end in terms of growth of State’s income and in many other development indicators. The State should reorient itself in modifying and directing its policies towards higher growth injecting sectors. Identifying the right sectors is itself a challenging task in the situation of weak finances. For the justification of the subsidies, goods and services are categorized into five categories Impure Public, Merit I, Merit II, Merit with Distributive Justice, and Private Goods. It is quite possible that categorisation of these governmental services and goods, not commonly agreeable, at least form the basis for a debate on prioritisation of the services.

• In social services only Merit II goods and Merit goods with distributive justice (mainly consists welfare programmes) have shown a substantial increase. The share of Impure public goods (which result into building social infrastructure) in total implicit subsidies have declined. In economic services,
the share of Merit goods with distributive justice has increased. While the share of other categories have declined.

**Broad Issues in Subsidies**

Subsidies are justified for all those goods and services, which have positive externalities, as the benefit to the society is more than the sum of individual benefit and welfare is improved by inducing a higher level of demand through subsidies, which lower the relative prices.\(^{11}\)

Subsidies are justifiable on the argument of infant industry and distributional objectives. The example of distributional objective is the public distributional system. Infant industry argument is given for small-scale industries. But these subsidies could only be valid for temporary periods and should be well administered\(^{12}\).

Subsidies can have a major impact in augmenting welfare of the society provided these are designed and administered efficiently to serve a clearly stated set of objectives. However, subsidies can also be very costly if they are poorly designed and inefficiently administered. Subsidies in areas such as education, health and environment are advocated on grounds that their benefits are spread well beyond the immediate recipients, and are shared by the population at large, present and future. Subsidies are also used with redistributive objectives, particularly for ensuring minimum consumption levels of food and other basic needs\(^{13}\).

There are some subsidies like incentives given to employees in addition to usual pay and inflationary adjustment in pay without any valid reason. Some examples of such subsidies are free travel concession given to employees in the transport sectors like railways and road transport.

There are many subsidies, which, cannot be justified on the grounds of insignificant externalities.

“Subsidies can be detrimental to environment, efficiency, and growth. Excessive subsidization harm growth prospects in both micro and macro terms, by affecting relative prices as well as by putting pressure on interest rates.” Srivastava and Rao (2001).

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\(^{11}\) Srivastava and Amar Nath (2001)

\(^{12}\) Srivastava and Rao (2003)

\(^{13}\) Srivastava and Rao (2003)
In some service minded sectors like health and education, the degree of subsidisation (rate of recovery) may be high but volume of subsidisation is low. This situation arises due to low priority given for these sectors in spending priorities of the governments. If the services in these sectors is bad, the recovery may fall. Therefore, there is a need for increasing allocation on operation and maintenance of the services in such sectors in addition to investment as per changing technologies.

Subsidies should be more transparent and explicitly stated.

Some specific sectors should be identified, where without an additional burden to the State exchequer, subsidies can be financed through cross subsidisation. It is often possible to distinguish between different classes of consumers for a good or a range of goods, such as domestic and commercial or agricultural use of electricity. Similarly, within the broad group of petroleum products distinction can be made between kerosene and diesel vis-à-vis petrol and turbine fuel. If a particular sector with one or more products is subjected to an administered price regime, it is possible to charge some consumers (product-wise) or use wise) a price, which is more than cost so as to finance a subsidy given to other consumers, by charging them a lower prices, which is less than cost. Such intra-sectoral financing of a subsidy involves cross subsidisation. In such cases, if a net subsidy is still left after cross-subsidisation, it will be charged on the general budget. Some instances of important cross-subsidisation in Utter Pradesh relate to power sector. But, over a period of time, cross-subsidisation results in to captive generation by the high price paying consumers and entire subsidy burden falling on the exchequer of the government.

Better targeting is the key to lowering the volume of subsidy, while continuing to satisfy the objectives of subsidisation. Examination of alternative delivery mechanisms is therefore very important. The delivery mechanism should be cost-efficient, and should maximize the quality of delivery to the intended beneficiaries. An alternative delivery mechanism in the case of both food and power could be coupon system.

The discussions point out the need for grater transparency in subsidy regime. This requires making subsidies as explicit as possible that are generated through administered price regimes and those that are kept off the budget. Targeting assumes utmost importance, while subsidies are made explicit, and their budgetary burden is kept under control.
One more aspect which requires consideration is that subsidies should be treated as short-term measures. They cannot be considered as an all-time phenomenon. Their operation as well as utility should be frequently reviewed and those outlived or misused should be weeded out. An important principle to be kept in mind is that consumers do not hesitate to pay for the good quality service provided the quality of services is good, supply is regular and dependable.

Budgetary subsidies provide the interface between the two sides of the budget, viz., expenditures and non-tax revenues. Policy reforms affecting subsidies will have to address both these budgetary dimensions. The main objectives that should guide the formulation of a subsidy reform strategy may be listed as: lower volume, higher recoveries, better service focus, improved targeting, removal of inefficiencies, and promoting budgetary transparency.

The case of justified subsidisation through budgetary support is limited to Merit goods and services. These services are characterised by positive externalities where social benefits are more than private benefits. Among these, the Merit I services like elementary education and primary health deserve a high degree of subsidisation because of large positive externalities. Merit II services like secondary and higher education, other health services, and water supply and sanitation would also require budgetary subsidisation albeit of a lower order. Although in different cases, the extent of subsidisation relative to costs may differ, a subsidisation of 90 percent or above may be justified for Merit I and 40 to 60 percent for Merit II services.

Suggestions

Subsidy reforms should aim at (i) reducing their volume relative to revenue receipts of the Central and the State governments, (ii) administering subsidies more directly to the targeted beneficiaries, thereby eliminating input-subsidies and focusing more on transfers as compared to price subsidies, (iii) making these subsidies transparent by showing them explicitly in the budget, and (iv) avoiding multiple subsidies to serve the same policy objective.

Costs of service provision and/or low negligible recoveries through user charges are the two critical sides of subsidisation. Unit costs need to be reduced, wherever desirable and viable. Surplus employment and other operational inefficiencies must be reduced.
Subsidy reforms, in the first instance, need to focus on selected sectors, which would yield maximum results and for those services for which there is considerable scope for higher recovery in the non-Merit category. In the case of Centre, the immediate focus of reform should be on food and fertiliser subsidies, and for State, it is important to attend to power and irrigation subsidies, while reforming the overall subsidy regime. The following are the sectors, where subsidy reforms, should focus in the first instance.

Power Subsidies - Power subsidies largely subsidies inefficiencies. There is a need to reduce T&D losses, make subsidies more explicit, overhaul the Electricity Act and drastically prune staff strength in the SEBs. The power subsidy should be administered explicitly by making the farmers pay the regular tariff and claim the subsidy from State’s Department of Agriculture. A change of this nature in Kerala has reduced not only the subsidy bill but also the wastage of power, as farmers become conscious of payments made by them to the Electricity Authority.

Subsidies for only impure public goods, Merit I and Merit II categories are justified. Elementary education, primary and preventive health care are deserving cases, and even in these cases, subsidies should be administered to the intended beneficiary as far as possible.

Users cannot be persuaded to pay higher costs unless they are assured of reasonable quality of services provided by the public authorities. The term quality can be used in a broad sense covering multiple attributes of services: accessibility, reasonable waiting period, regularity, and adequacy. For example, quality provision of power means regular supply of electricity without frequent breakdowns or stoppages, and without undue voltage fluctuations. In health services, quality means access of service with minimum waiting time, availability of medicines, cleanliness of hospitals, etc. Cost recovery is closely linked to the quality of services. On the other hand, quality deteriorates without adequate finances. This creates a vicious circle. Unless adequate quality is assured, people would not be willing to pay and unless they pay, quality cannot be maintained.

The rigidity leading to non-revision of user charges comes from the absence of suitable institutional mechanisms which could deal with the related issues of quality, inefficiency, increase in costs, and extent of subsidisation according to service categories. Any increase in user charges requires explicit public decision by legislative/executive authorities who are very reluctant to increase user charges.
Necessary institutional mechanism would involve setting up of autonomous bodies who can undertake objective and independent deliberations and make recommendations to the government with regular periodicity with a view to protecting both the consumers’ interest and the need to cover costs. These bodies should also evaluate the quality of service, and quantify the inefficiencies in the public provision of private goods.

Untargeted subsidies waste scarce resources and distort the incidence profile of fiscal intervention which consists both of tax and subsidy policies. Properly targeted subsidies economise on budgetary resources. Since, the beneficiary of a subsidy is reached through a commodity market, the incidence of the benefit of a subsidy becomes difficult to control. The problem is further accentuated, if these are administered through inputs. Many subsidies in India are administered through inputs like fertilisers, power, and irrigation water. Even when a final good like food is involved, the subsidy regime remains poorly targeted. The same is true of educational and medical subsidies. It is because of these reasons that the distributional pattern of subsidies shows a regressive pattern. The benefits of many subsidies in agriculture, industries, and other sectors are distributed according to the pattern of consumption of the concerned products which reflects the pattern of income. Thus, segments of population with a higher purchasing power are able to get relatively larger benefits. Subsidies lead to lower prices and price reduction has a substitution effect (increasing the demand for the subsidised good, the price of which has gone down, relative to others) and an income effect (increasing the demand for the concerned good as also that of others). It is because of the income effect, that the targeting of subsidies becomes absolutely essential. If the demand of a subsidised good is inelastic with respect to price/income, any income effect through subsidisation would lead to an increase in demand for goods other than the subsidised good.

Subsidy as a budgetary instrument of promoting social welfare has been overused, and sometimes abused, leading to inefficiencies. The cost of subsidies has generally been underestimated because most subsidies are hidden or implicit. In State budgets, only a very small fraction of subsidies is shown explicitly as subsidies. The State government should explicitly show its subsidies in the budget as much as possible, so that their volumes and continued validity may be discussed each year in the legislature. Many subsidies arise because the government may be participating in the provision of purely private goods where its presence is not
warranted either economically or technologically. In the few areas like health and education, where subsidies are justified because of large externalities, government should rationalise the subsidy structure, so that subsidies are given more to the economically poorer sections. Subsidies should have specific time span, after which its utility should be reassessed, and the duration revised; it should be withdrawn in stages. Subsidy reforms should be approached from both the expenditure and revenue sides. On the expenditure side, reducing costs of providing services by reducing operational inefficiency could reduce subsidies without affecting service levels. On the receipt side, one has to target higher recovery rates by linking prices (user charges) to costs. At first, these linkages may be fixed with reference to current costs. Input-linked use charges, partial privatisation of generation and distribution (in electricity), proper metering, setting up bodies for autonomous tariff revisions in power and transport, fees for health and education, should lead to better cost recoveries, and lower implicit subsidies. The subsidy regime should lead to better cost recoveries, and lower implicit subsidies. The subsidy regime should be limited, transparent, and poorly targeted.

**Issues before the State Government**

- To enable a debate on categorisation of services as per the externalities involved in consumption of goods and services.

- To reduce the cost of provision of service by improving efficiency.

- To revise the user charges regularly on the basis of inflation.

- To specify the duration for which subsidy is given.

- Subsidies to be limited to the intended beneficiaries and targeted groups.

- Independent authorities to be set up to periodically review the quality of services and the user charges in various services.

- More transparency in stating the burden of subsidies to the exchequer of the State.

- If not reducing the subsidies, at least reorient them towards creating socio-economic infrastructure and proper maintenance than high salary component in the cost of provision of services.
• A mere concentration in to sectors like social welfare, power, irrigation, roads and bridges can help the government in generating and directing surpluses towards income and employment generating sectors.

• Higher allocation for non-salary maintenance expenditure.

**Conclusions**

The comprehensive analysis of the estimated values of the subsidies clearly shows that there is an increasing trend in the volume of subsidies in Utter Pradesh. Implicit budgetary subsidies have increased from Rs. 4486.07 crore in 1990-91 to Rs. 15928.39 crore in 2005-06. Per capita subsidies in Utter Pradesh have also increased from Rs. 343.79 in 1990-91 to Rs. 873.80 in 2005-06. Recoveries have declined and costs have increased that shows inefficiency on the part of the government. Economic Services absorbed major parts, around 73 per cent of total subsidies in the State. Social Services are given much lesser subsidies, which is more welfare generating sector. Most of the subsidies are implicit, whereas explicit subsidies are negligible. This shows that subsidies in Utter Pradesh are not transparent and poorly targeted.

Therefore, hypothesis formulated in this study is rejected here. As the result shows that, there are no serious efforts as a part of fiscal correction measures by the Government of Uttar Pradesh to rationalise the subsidies.

**Agenda for Further Research**

In this study we have constructed a discrete time series of estimated values of implicit subsidies for Utter Pradesh only. There is a need to compute the subsidies for other major State in India to analyse the inter-State variations in the volume of subsidies and policies of their rationalisation.

There are certain expenditures, which are completely or partially borne by the Union government in the form of Central and Centrally sponsored schemes. In such schemes sum part of the expenditure is shared by the State. Therefore, there is a need to take into account the State’s share.

For the justification of subsidies, services are classified into broad categories as per the relative degree of externalities involved in their provision. But the main problem with the externalities is how to measure it. Therefore, there is a need to develop a suitable methodology for the measurement of the extent of externalities.
There should be a debate among the intelligentsia, policy makers and stakeholders on what to subsidise, how to subsidise and how much to subsidise! The present classification of goods and services at least forms the basis for such debate.