ADDRESS POLICY-RELATED DISTORTIONS TO REALISE FULL POTENTIAL OF ECONOMIC REFORMS

*(Memorandum to the Hon'ble Finance Minister for Budget 2006-07)**

Key Issues

* Pradeep S Mehta, Secretary General, CUTS International, Jaipur. Email: sg-cuts@cuts.org; psm@cuts.org

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The thrust of economic reforms undertaken since early 1990s has been to allow for more competition and for the government to play the role of a facilitator of economic activity. These efforts towards ensuring a competitive economy got a further impetus with the Government making 'competition' a serious policy issue. The National Common Minimum Programme (NCMP) inter alia, states: "*Indian industry will be given every support to become productive and competitive.The government will not support the emergence of any monopoly that only restricts competition. All regulatory institutions will be strengthened to ensure that competition is free and fair. These institutions will be run professionally*". In spite of this kind of speak, government policies continue to be framed and implemented in a manner that thwarts the market process. There is a need to address the various policy-related distortions to realise the full potential of economic reforms by undertaking a 'competition audit' of all government policies and by ensuring that the budget takes progressive decisions to promote competition and fair markets. A few issues are flagged below:

I. Policy-related distortions addressable in the General Budget

Key Issues	**Current Status and Impact on Economy**	**Could Mention in Budget Speech**
Inverted duty structure	For several product lines, the existing tariff regime results in higher import duty on raw materials/ intermediates vis-à-vis that on finished products. This adversely affects domestic manufacturers of finished products and encourages suppliers of raw materials/ intermediates, denting value addition in industries concerned. Some examples are: • *Tyre industry*: import duty on natural rubber is 20 percent as against 10 percent duty on imported finished tyres. • *Vegetable Oil sector*: crude palm oil, a raw material for manufacture of vanaspati, attracts customs duty of 65 percent; while import of vanaspati attracts much lower duty of 30 percent.	• My government is committed to avoiding creation of inverted duty structures that renders the domestic manufacturing process uncompetitive. • The government will list all product lines which face inverted duty structure and rationalise the tariff regime to address this anomaly.

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	• *Petrochemical sector*: suppliers of feed-stock like naphtha, natural gas and basic polymer have a tariff protection advantage over producers of finished products like plastics and synthetic fibres.	
Anti-dumping duty	• The reduction of trade barriers since early 1990s has been accompanied by a proliferation of anti-dumping (AD) measures. • As per Annual Report (2003-04) of the Directorate General of Anti-dumping and Allied Duties (DGAAD), in 81 percent of cases (135 out of 167 cases initiated), provisional or final AD was recommended or imposed. In several of these cases, the authority accepted an increase in foreign firms' market share (which was only to be expected in a period of trade liberalisation) as evidence of injury, even though the Indian industry's sales and profits were increasing! • In almost all cases AD remedies have been used to protect Indian industries, and not to preserve competition. • Moreover, AD measures have inflicted higher import costs on user industries, as it is mainly intermediate goods industries in the chemicals sector that have succeeded in obtaining protection.	• My government will ensure that anti-dumping remedy is used cautiously, and not merely to restrict competition.

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Central Government Subsidies	<u>Food Subsidies</u> • Food subsidy bill has gone up by 10.5 times from Rs.2450 crore in 1990-91 to Rs.25,800 crore in 2003-04. • Cost of transferring a rupee to the poor through the PDS is Rs.6.68 and administrative costs account for 85 percent of the total expenditure. • Studies suggest that only 25 percent of the grains actually reach the poor (*Food Stamps: A Model for India*, Discussion Paper, Centre for Civil Society, November 2004). • There are distortions and inefficiencies in the way food subsidies are delivered, leading to mounting food subsidy bills, without commensurate benefits to target beneficiaries. • At present, the food subsidy policy uses the MSP-PDS operations to serve the 'conflicting' objectives of ensuring remunerative price to farmers and providing foodgrains so procured, to the poor at affordable prices. By implication, this entails a huge gap between the purchase price and issue price, and consequently a larger subsidy bill! • The government is tinkering with issue price and quantity of foodgrains to reduce its food subsidy bill, rather than address this systemic distortion.	• The govenrment will take measures to separate the MSP-PDS operations. Already some states have taken this initiative. Other states would be encouraged to follow suit. • MSP operations will be undertaken to provide support to small and marginal farmers and the foodgrains so procured will be used to create buffer stock to maintain price stability. The procurement process will be decentralised with Food Corporation of India being the main coordinating agency. MSP operations will primarily be undertaken in agriculturally underdeveloped regions, which have a vast unexploited potential for agricultural growth. • Procurement of foodgrains for distribution to poor through PDS will be done through competitive bidding for delivery at target locations. Since these foodgrains are to be distributed to the poor at affordable price, competitive bidding will minimise the cost of procuring the foodgrains. • As an alternative, cash transfers through Post Office network will be undertaken on a pilot basis to provide direct support to needy families to cover the subsidy differential.

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	<u>Petroleum Subsidies</u> • The Government's share of petro subsidies is estimated at Rs.3553 crores in 2004-05. • However, the method of calculating subsides is based on import based parity pricing of petroleum products and not on the basis of unrecovered costs. The subsidy amount is therefore unduely inflated. • The calculation of subsidy on petroleum products goes against economic logic. The government first adds taxes to arrive at a notional market price. Subsequently, products are sold at a price, which is lower than this notional market price, and the difference is termed as the 'subsidy' burden! In the process, the government mops up a part of the inflated price as taxes and at the same time claims to provide subsidy on petroleum products! • Concerns are expressed over inflation, and the impact of rise in petro-products prices on prices of other commodities is also acknowledged. However, a large share of the petro-product prices comprises of taxes. As per the Petroleum Minister, more than half of the retail selling price of petrol and one-third of the selling price of diesel is made up of central and state duties. Thus, by imposing taxes and duties on petro-products, government is actually fuelling inflation!	• My government will overhaul the prevailing tax structure related to petroleum products. The current *ad valorem* duty structure will be replaced with a specific one. This will remove the cascading effect of a rise in oil prices and contain inflationary pressures. • A price stabilisation fund will be created to check high volatility of crude prices. The fund will be sourced from the cess collected under the Oil Industry Development Act. • Oil companies will be allowed to charge market-determined prices. • The government will take measures to directly support the needy people, rather than canalise subsidies through oil PSUs, which distorts the market process. • The Petroleum and Natural Gas Regulatory Board will be established to foster competition and ensure transparency in the determination of prices of petroleum products.

II. Systemic Measures Suggested to address Policy-related distortions

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Competition Audit of Government Policies	• Even after liberalisation and economic reforms, government policies are often framed and implemented in a manner to protect the welfare of some market players rather than promote competition. Distortions to the market process arise in various ways. Four distortionary policy instruments are already listed above. There are several other policies with similar outcomes. • These policies/practices result in either excessive expenditure or reduction in government revenue, constraining the already limited government resources. For example, bid rigging in civil works undertaken by the government results in huge bills, with the amount landing in the pockets of construction contractors.	• My government will launch a rolling programme for a 'competition audit'. Planning Commission will be asked to assess all govenrment policies and practices that are impeding the market process. • Measures would be identified to streamline government policies and regulations, so that government's intervention facilitates functioning of markets. • Planning Commission would be asked to assist the State governments in carrying out a similar exercise at their levels. • Rs 50 crores fund is set aside for carrying out 'competition audit'.
Autonomy to Regulatory Agencies	• Independent regulatory agencies have been established in various sectors, while in other sectors the process is on. • In order to ensure effective regulatory framework, regulatory agencies need to be given sufficient autonomy to implement their mandate. An appropriate mechanism to hold regulatory agencies accountable is equally vital. • Most regulatory bodies in India depend on the line-ministry for their budget. This is not a	• My government is committed to strengthening regulatory institutions. Measures would be taken to ensure there is no interference in the functioning of regulatory agencies. • A fixed percentage of the license fees or taxes collected by the government from regulated sectors will be earmarked for respective regulatory agencies to meet their operational expenditures.

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	desirable practice as such provisions limit regulatory autonomy. The number and nature of staff, appointing consultants, market investigation, etc are activities that can be controlled through budget allocations.	
Capacity Building of Stakeholders	• Globalisation and liberalisation has changed the approach towards economic management of the country, requiring different stakeholders to acquire necessary skills to perform their respective roles in the best manner. • However, there is lack of proper training programmes/facilities on subjects that are still evolving such as economic regulation, competition policy & law, trade negotiation skills, etc. • In a country where half the population is illiterate, it is imperative to build the capacity of our policy makers and other stakeholders such as agency personnel, civil society organisations and media so that they can participate effectively in the decision making process in the emerging economic order.	• The government is committed to improve governance at all levels including at the level of policy makers. • Research and training agencies will be asked to develop special capacity building programmes for our policy makers at national and sub-national levels. • A fund will be created for capacity building of policy makers and other stakeholders such as agency personnel, civil society organisations and media.

III. Other Issues

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Outcome Budget	• The Finance Ministry has taken a commendable step in bringing out an outcome budget in respect of Plan programmes/schemes implemented by administrative ministries. • There are also plans to come out with a Performance Budget, at the end of every fiscal year indicating if the identified physical targets proposed in the Outcome Budget have been actually achieved. • By linking government outlays with outcomes, this exercise would justify the expenditure incurred on achieving particular outcomes. • However, productivity level in government departments is quite low. The outcomes identified should reflect the efficiency with which money is spent to achieve them. Proper system for accountability needs to be in place.	• The government will introduce a performance-based system for all government functionaries and departments to make them performance-oriented and accountable for the outcomes. • Incentives will be given to good performers.
Utilisation of Education Cess	• An education cess of 2 percent was imposed on direct and indirect taxes with effect from April 2004. • However, reports suggest that there has been little utilisation of the cess amount. There are already complains that education cess is being used less for educating or feeding children and more for providing fiscal comfort to the Centre.	• The government will provide detailed information on the utilisation of education cess amount. The information will be available on the website of the Ministry of Finance and would be updated every quarter.