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COMPETITION, STATE AIDS AND SUBSIDIES

Contribution from India

-- Session I --

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Contact: Hélène CHADZYNSKA, Programme Manager of the Global Forum on Competition
Tel: +33 1 45 24 91 05; email: helene.chadzynska@oecd.org

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COMPETITION, STATE AIDS AND SUBSIDIES

-- India --

1. State-Aid and Subsidies are the policy instruments which Sovereign Governments consider as vital development tools available with them to achieve various national goals. Although they may lead to certain unintended economic effects and inefficient allocation of resources in a competitive market and may fundamentally act against the functioning of open markets and liberalisation of international trade, State aid and Subsidies may also contribute to the correction of market failures or market imperfections. They often produce externalities[1] which may sufficiently achieve the objectives of prevention of distortion of competition; factors that ought to be considered in determining the compatibility of state aid measures and subsidies with the market.

2. This paper discusses subsidies as part of state-aid measures which have been undertaken in India in the recent years.

3. Generally, subsidy is considered as financial contribution that is paid by a government or an organisation to reduce the cost of services or cost of producing goods so that their prices can be kept low. On an international level, unfair trade practices such as subsidies were identified as a threat to open markets as early as 1947, when the first GATT agreement was signed. In framework of WTO, *Agreement on Subsidies and Countervailing measures has defined subsidy as*:

a) A financial contribution by a government or public body within the territory of the country where:

   - There is a direct transfer of funds (e.g. grants, loans and equity infusion) and potential of funds or liabilities (e.g. loan guarantees);

   - Government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits, income tax exemptions etc);

   - When a government provides goods and services at a preferential price other than general infrastructure;

   - A government makes payments to a funding mechanism, or entrusts or directs a private body to carry out, one or more of the type of functions which would normally be vested in the government.

b) Any form of income or price support;

1 Employment aid, environmental aid, aid for research and development, regional aid are some of the instruments which may be taken as positive externalities.

c) Any benefit given by a government to an exporter that provides an unfair advantage to the exporter in international markets.

4. Thus for a subsidy to exist there must be a financial contribution by the government and a benefit be conferred thereby.

5. Subsidies may have different forms. The various alternative modes of administering a subsidy may include grant of subsidy to producers and consumers, subsidy to producers of inputs, production/sales through public enterprises, cross-subsidisation etc. A cash payment to producers/ consumers is an easily recognisable form of a subsidy. However, it also has many invisible forms like reduced tax-liability, low interest government loans or government equity participation. Subsidies are implied if the government procures goods, such as food grains, at higher than market prices or if it sells as lower than market prices.

1. Subsidies in India and Competition Act, 2002

6. Although there is no specific mention of state aid measures or subsidies and their treatment under the competition law in India, the Competition Act, 2002, defines enterprise to include Govt. Departments except when engaged in the discharge of sovereign functions. Subsidies have proliferated in India due to several factors like spread of governmental activities, relatively weak determination of government to recover costs from the respective users etc. It has been recognised[2] that market mechanism often results in under consumption of goods and services by the vulnerable sections of essential commodities, either because of their high prices or because of the competing claims of other goods and services on their incomes and by reducing the price of the identified goods for identified sections of the society, subsidies increase affordability, improve access and correct the under consumption of these goods with positive externalities.

7. Studies[3] have shown that central government subsidies were at 4.25% of GDP in 2002-03 and 4.18% of GDP in 2003-04 accounting for 72.32% and 87.68% of fiscal deficit, respectively. Bulk of the Central Govt.'s subsidies in India arise on account of the provision of economic services with very low recovery rates with subsidies on non-merit goods exceeding those on merit goods. The most important explicit subsidies administered through the Central Government budget are food and fertiliser subsidies. In states, one-third of total subsidies are directed towards merit goods. Subsidies in social services and economic services constitute bulk of the total subsidies and the proportion of merit subsidies is much higher in social services vis-à-vis economic services. Subsidies to States' public enterprises are large but recovery in the form of interests and dividends is extremely low indicating general trend towards low recovery.

8. In the context of their economic effects, subsidies have been subjected to an intense debate in India in recent years. Apart from issues like magnitude and incidence of subsidies- both explicit and implicit, their burden on government finances, target group of such subsidies and their injurious effect on general economic growth of sectors have also been in the realm of discussion.

2. Recent Trends

9. The total Central Govt. expenditure on subsidies increased from Rs.47,522 crore in 2005-06 to Rs. 1,29,243 crore in 2008-09 as per revised estimates. Out of this, expenditure on major subsidies accounted for Rs. 44,480 crore in 2005-06 which has gone up to Rs.1,22,728 crore in 2008-09 as per

2 The Economic Survey, Ministry of Finance ,Govt. of India, Year 2008-09 , pp. 45-46.

3 Analysis provided by the Finance Ministry in its Report prepared with assistance from the National Institute of Public Finance and Policy ("Central government subsidies in India: A report", December 2004).

revised estimates and has been budgeted at Rs.1,06,004 crore in 2009-10. *Among the major subsidies, Food subsidy* is provided to meet the difference between economic cost of food grains and their sales realisation at Central Issue Prices fixed for Targeted Public Distribution System (TPDS) and other welfare schemes. In addition, the Central Government also procures food grains for meeting the requirements of buffer stock. Hence, part of the food subsidy also goes towards meeting the carrying cost of buffer stock. A retention price scheme for indigenous fertilisers is in operation since 1977. Under Indigenous (Urea) Fertiliser subsidy scheme it is intended to make fertilisers available to the farmers at reasonable prices and to give producers of fertilisers a reasonable return on their investment. The difference between the concession price so fixed, less distribution margin and the statutorily controlled consumers' price is allowed as subsidy. As indigenous production is not adequate to meet the demand for fertilisers, imports are arranged to make up the shortfall. Mainly three varieties of fertilisers, viz. Urea, Di-ammonium phosphate (DAP) and Muriate of Potash are imported. As only Nitrogenous fertilisers are under price control, the estimates of subsidy under imported subsidy are based on the likely imports of urea during the year. The provision of 'sale of decontrolled fertilisers with concession to farmers' relates to payments to manufacturers/importers of fertilisers/agencies. The scheme was introduced after the prices of phosphatic and potassic fertilisers were decontrolled, with a view to enable farmers to maintain a healthy N:P:K ratio and contain prices of fertilisers.

10. Interest on loans sanctioned by the Government is normally payable at the rates prescribed from time to time. In specific cases where a concession is allowed in the rate of interest or where exemption is given from payment of interest on the loans, subsidies are paid and an amount equal to the subsidy is taken as interest receipt of the Government.

11. Subsidies are also paid towards other items like support for Market Intervention/Price Support Scheme for agricultural produce, maintenance of buffer stock of Sugar (for meeting outstanding claims of sugar mills for maintenance of buffer stock of sugar), reimbursement of internal transport charges to sugar factories on export shipment of sugar, extending financial assistance to Sugar Undertakings, import of edible oils, import of Pulses, payment to Shipyards etc.

Table 1. Subsidy payments[4] during 2005-06 to 2008-09 at a glance are given as under

Details of subsidies	In Rs.crore				
	2005-06	2006-07	2007-08	2008-09 (RE)	2009-10 (BE)
A. Major subsidies	44480	53495	67498	122728	106004
1. Food	23077	24014	31328	43627	52490
2. Indigenous(Urea)Fertiliser	10653	12650	12950	16517	9780
3. Imported (Urea) Fertiliser	1211	3274	6606	10981	5948
4. Sale of decontrolled fertiliser with concession to farmers	6596	10298	12934	48351	34252
Total Fertiliser Subsidy	**18460**	**26222**	**32490**	**75849**	**49980**
5. Petroleum subsidy	2683	2699	2820	2877	3109
6. Grants to NAFED for MIS/PPS	260	560	860	375	425
B. Other Subsidies	3042	3630	3428	6515	5272
7. Import/Export of sugar Edible Oils etc.				540	200
8. Interest Subsidies	2177	2809	2311	4063	2601
9. Other Subsidies	865	821	1117	1912	2471
Total-Subsidies	**47522**	**57125**	**70926**	**129243**	**111276**

4 Budget Documents, Ministry of Finance, 2009-10.

3. Tax Concessions[5]

12. Subsidies to preferred taxpayers are given as tax preferences in budget. Such implicit payments are referred to as "tax expenditures".

13. The table given below gives details of revenue foregone for the year 2007-08 and 2008-09.

Table 2. Revenue Foregone in financial year 2007-08 and 2008-09 (in Rs. crore)

	Revenue Foregone in 2007-08	Revenue foregone as a percentage of Aggregate Tax Collection in 2007-08	Revenue Foregone in 2008-09	Revenue foregone as a per cent of Aggregate Tax Collection in 2008-09
Corporate Income-tax	62199	10.5	68914	11.36
Personal Income-tax	38057	6.43	39553	6.52
Excise Duty	87468	14.77	128293	21.16
Customs Duty	153593	25.95	225752	37.23
Total	341317	57.67	462512	76.28
Less export credit related	56265	9.5	44417	7.32
Grand Total	285052	48.16	418095	68.95

14. Revenue Foregone on account of Export Promotion Concessions was estimated to the tune of Rs. Rs. 44417 crore in the year 2008 -09 as against 56265 crore in the year 2007-08.

15. Subsidies have the potential to lead to perverse economic effects which would result in inefficient resource allocation where market imperfections do not justify a subsidy, by diverting economic resources away from areas where their marginal productivity would be higher. The unfair competition between subsidised goods of one country and similar non-subsidised goods of another country could arise in any of the markets; (i) the market of the subsidising country; (ii) market of the country importing the subsidised product; or (iii) a third country market. The WTO agreement covers within it framework mechanism to take action against such subsidies.

16. Subsidies are used to promote a wide variety of government policies and address a range of market failures. An unintended consequence of subsidies is that these can distort competition between firms undertaking similar activities, particularly when subsidies are large and only available to a select group of the firms that compete with each other. Efficient competitive markets are created by a process of rivalry and competition between firms. Competition, through efficient markets, delivers lower prices, greater choice and more popular products to consumers. The provision of subsidies to a recipient will impact on the recipient's costs and so will affect its decisions concerning what, how much and how to produce, and what to charge for it. If a subsidy recipient's actions are affected, competing firms may also adjust their behaviour. Giving some firms an advantage over their competitors may give rise to abusive behaviour since as a result of the subsidy the recipient increases its market share to a level at which it has power to behave independently of competitive pressures.

17. Subsidies that are closely targeted at the particular policy objective would be less likely to have a significant effect on competition. Characteristics like size of subsidy, target of subsidies, effects on costs, market concentration, level of product differentiation, barriers to entry and exit, effects on input markets are some of the factors that will enable the assessment of subsidy from the point of view of competition.

5 Statement on tax expenditure or revenue foregone was first laid before the Parliament during Budget 2006-07.

18. Concerns have also been raised about the widespread use of subsidies particularly domestic farm subsidies by developed countries. Farm subsidies distort the production structure of a country by raising crop prices in a country's internal market. Overproduction and stagnant demand for agricultural goods lead to surpluses in these countries which squeeze out imports in the already restricted domestic markets. The surplus is also dumped in the international market at a cheaper rate causing price suppression of that commodity in the international market. Export subsidies are eventually used to cover the price difference between high domestic prices and lower international prices.

19. Subsidies are an important policy tool that can bring about improvements in welfare. In particular, subsidies that address market failures can bring about economic growth. However, subsidies also place costs on the economy. Competition among firms helps markets to function effectively, rewarding efficient firms that direct resources to the use most valued by consumers. Changes in market outcomes could affect allocative efficiency since resources may not be employed in the most efficient way possible. It may affect productive efficiency since goods may not be produced as efficiently as they could be and finally it may also impact dynamic efficiency affecting innovations.

20. Competition, through efficient markets, delivers lower prices, wider choice and more popular products to consumers. In competitive markets, firms seek to bring products to market which are more valued by consumers than those of their competitors at a lower cost. Firms that consistently fail to deliver products that consumers want and at prices they are willing to pay, will be forced out of the market to be replaced by more proficient firms. In this way, competition encourages the economy to be efficient and to produce the goods most valued by consumers using the least possible resources.

21. Most of the Indian manufacturing sector depended on "subsidies" of a different kind for several decades up to the early 1990s. High tariffs and import controls protected manufacturing units from cheaper imports and the Indian consumer paid the subsidy through inflated prices for domestic manufactures. As trade protection was gradually and systematically reduced, these subsidies disappeared. Indian industry also reacted positively by becoming more efficient, resilient and dynamic.

22. The macroeconomic costs of unjustified subsidies are reflected at present in large fiscal deficits in India. Justification for overall cutbacks in subsidies, regardless of their effects on the poor and needy has been recognised as an important fiscal policy agenda. Realising this Economic Survey for the year 2008-09 brought out by the Ministry of Finance, Govt. of India has underlined the need for reforms in subsidies. Any agenda discussion on subsidy in India must focus at placing systems for periodic review of existing subsidies, setting clear limits on duration of any new subsidy schemes and ultimately reducing the overall scale of subsidies considering that it is competition in the market which will ensure survival of more efficient firms, delivering benefits to the consumers and ushering economic efficiencies in the markets place.