Good and bad freebies

Three questions arise: What goods and services should be selected for such programmes? What should be their ideal mode of delivery? What should be a prudent fiscal limit for their funding?

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The newly elected Punjab government's announcement of providing up to 300 units of free power to every household has raised questions: What constitutes "freebies"? Should they be encouraged? There is, in fact, no consensus on the definition of a "freebie". It is almost a pejorative term. They constitute a sub-set of goods and services distributed by the government.

In India, policymakers have drawn on budgetary resources for providing support to low-income households for augmenting their consumption of selected goods and services, and also offering incentives to support selected categories of investors and producers. The economic objectives in these two categories are quite different. The first category would include the free or subsidised provision of foodgrains and services such as health and education. The Punjab government's announcement of free power falls in this category. Sometimes, these are also referred to as "freebies", depending on the type of commodity provided. These may be distinguished from budgetary support for incentivising investment or production. Examples of the latter group include the central government's recent initiative for production-linked incentives to various sectors and tax concessions. In the past, incentives in the form of reduction of corporate taxes have been offered to promote investment in general, or in certain regions such as backward areas.

Given the proliferation of these schemes in recent times, three important questions arise. First, what goods and services should be selected for such programmes? Second, what should be their ideal mode of delivery? Third, what should be a prudent fiscal limit for funding such programmes?

The practice of providing certain goods or services free or at highly subsidised prices has been common in budgets. Foodgrains, particularly wheat and rice, are supplied to target groups at a highly subsidised price through the public distribution system. The subsidy is the difference between the price at which they are procured and the price at which they are sold. In the central budget, the food subsidy amounts to Rs. 2.06 lakh crore. The provision of foodgrains at a heavily subsidised price to target groups has found general acceptance, particularly among political parties, even though there are some critics of the measure. The key question is to decide what commodities should be distributed free or at a subsidised level and what the level of subsidy should be. So what is a "freebie" depends on the nature of the commodity or the services distributed.

As mentioned earlier, the distribution of commodities which are considered "essential", primarily foodgrains, faces no criticism. In fact, there is enough evidence that such a distribution has helped to reduce poverty. There is also a category of goods which are called "merit" goods where significant positive externalities are associated with their consumption — for instance, health and education-related provisions, including mid-day meals and breakfast. In these cases, the benefit of the use of such goods extends beyond the immediate consumer to the wider community. In such cases, subsidisation is justified: If only market prices prevail, the community will consume less than what is socially desirable.

Thus, while subsidisation or the free provision of essential and merit goods can be justified on the grounds of meeting social objectives when the list of commodities expands to include such items as TV sets, serious doubts arise. For example, one unintended consequence of free power up to 300 units is likely to be an undue increase in the power consumption of households which use less than 300 units. Perhaps it is advisable to limit the distribution of commodities and services at highly subsidised levels to essential and merit goods. Any distribution beyond these two categories must be treated as "freebies". The words "essential" and "merit" should not be made so elastic as to lose their meaning.

The question of a suitable model for providing budgetary support arises in the context of both consumption and production-supporting initiatives. In the first case, budgetary support to a targeted segment of the population for augmenting their consumption of essential items may be provided either through direct income support or by a free or highly subsidised provision. Both involve fiscal costs. In the former, income is raised for the targeted households which will support an increase in consumption according to the household preferences. In the latter, the consumption of the selected goods and services will increase. When the provision of subsidised goods is involved, there may, in general, be a requirement of a procurement set-up and a public distribution system. Managing procurement and distribution by government agencies involves additional costs which tend to be higher than the corresponding supply through the market because of leakages and avoidable administrative costs.

In the case of production-related incentives, alternative methods include direct budgetary support and indirect support through tax concessions. Both have a differential impact. These schemes also require to be carefully designed to avoid their misuse and minimise their costs. The provision of free power to farmers was often misused — it's a common practice, for instance, to leave the pump sets running for long hours. In the case of tax concessions, there have not been any convincing studies as to whether the stated initial objectives were achieved in line with the large budgetary costs. The Government of India comes out with a statement of forgone revenues in the context of tax concessions. The magnitudes involved amounted to 1.9 per cent and 2.5 per cent of the GDP in 2018-19 and 2019-20 respectively. Some argue that production may be incentivised more effectively by other methods such as infrastructure expansion. Therefore, in respect of production-related incentives also, greater care is required for determining the total quantum of support as well as the specific forms of such support.

It is also important to consider a limit to the fiscal cost of undertaking such initiatives. We consider here only the case of distribution of commodities that are meant to support consumption. This question should be considered in light of our limited budgetary resources. In India, the revenue to GDP ratio has been stagnating over a long period of time. During 2010-11 to 2019-20, combined revenue receipts of central and state governments, relative to GDP, have languished in the narrow range of 18.4 per cent to 20.3 per cent. In contrast, in many developed and emerging market economies, this ratio tends to be much higher. In 2019, these ratios were 36 per cent and 30.1 per cent for the UK and USA, 48.6 per cent and 43.6 per cent for Sweden and Netherlands, and 31.5 per cent for Brazil. Considering these trends, it would be prudent to limit overall fiscal support to such schemes to less than 10 per cent of the total expenditure of the central government and state governments until their revenue GDP or GSDP ratios are successfully increased in a sustained way. Governments that do not pay adequate attention to the strength of their fisc eventually become exposed to the cost of the choices that they make.

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