

The New Export Subsidy Scheme

A Note

Mirnal Datta-Chaudhuri

The new cash subsidy scheme for exports may, in the short run, increase the exports of the commodities concerned.

But it will also raise their domestic prices, lead to little or no expansion in their outputs, reduce the exports of certain other commodities by raising adverse expectations and, in the long run, put inflationary pressure on the economy to necessitate more subsidies, with or without proportionately larger investments flowing into these industries.

A NEW SCHEME of providing cash subsidies for the export of a wide variety of industrial products was announced by the Government on August 16. This scheme is claimed to be the result of "exhaustive calculation and taking into account the full benefit of devaluation". Most of the economic issues connected with promoting our exports were rather fully discussed at the time of devaluation. This provides a good framework for analysing the merits of the new scheme.

Let us begin with the economic rationale behind the devaluation of the rupee. It is true that if a properly worked out scheme of taxes and subsidies can be implemented efficiently throughout the entire economy, any pegged rate of exchange is consistent with the desired balance of trade, at least on merchandise account. But taxes and subsidies are very poor policy instruments, because, among other things, the economic agents do not consider these measures as permanent inducements, which are necessary for formulating their long-run policies.

Two Premises

The prospect of higher export earnings after devaluation were based on two premises:

- some of our exportables, which currently account for a relatively small fraction of our total export earnings, face elastic demands and as a result of the permanent inducement provided by devaluation their sales abroad will expand; and
- the Government will take appropriate policy measures to check the inflationary pressures within the economy, which may otherwise nullify the advantages offered to the exporters by the new exchange rate.

The new subsidy scheme covers sugar, woollen carpet, iron and steel and 165 different products of engineering industries. In the earlier calculations regarding devaluation, the long-run prospects of higher export earnings were based on expectations regarding these goods. So, it is relevant at this stage to ask the following questions.

- If these goods are always to need subsidies at the current exchange rate to compete in world market, does the new exchange rate help their export promotion at all?
- What are the likely effects of the new subsidy scheme on the exports of the other products, which ceased to get assistance after devaluation?
- Is subsidy the best means to expand the sales of our products abroad?
- Does any error on the side of over-subsidization set in motion the right type of dynamic adjustment mechanism so that the benefit of doubt goes in favour of higher subsidies?

The answer to the first question is clearly in the negative. If the uncertainties associated with subsidies were to be avoided, there is no reason whatsoever to believe that uncertainty should decrease with the quantum of subsidy. If any inducement is necessary for promoting these exports, the extent of devaluation should have been different to make the measure really effective¹.

It would be rather naive to assume that the new subsidy scheme will have no effect on other items in our export trade. The rupee was devalued to end the multitude of subsidies. The new scheme will arouse expectations of fresh subsidies and a rational exporter should be expected to withhold his supplies. Such

speculations tend to be self-vindicating, because any decline in these exports, in the absence of precise information regarding costs, is likely to be taken as evidence of need for subsidy. If one adds to this another bit of rational behaviour on the part of a typical exporter faced with such uncertainties, namely, making higher allocation of efforts to lobbying, then the probability of the outcome further improves.

The export of a commodity can be increased if the domestic demand decreases and/or the output increases. The success of any measure using price mechanism depends on the price elasticities of the demand and the supply functions. If both the supply and the domestic demand are inelastic, no amount of price incentive is going to increase exports.

Supply and Demand Elasticities

Let us assume for the sake of simplicity, that the domestic demand curve is downward sloping, whereas the foreign demand curve is perfectly elastic². If the commodity is already being exported in small quantities, then subsidy will raise the domestic price by the same percentage. This price-increase will cut domestic demand and more supplies will be available for exports. Now if the supply is inelastic in the short run³, exactly the same result could have been achieved by an indirect tax on domestic sales. If, on the other hand, the short run supply curve has an upward slope, the price increase is also accompanied by an expansion of output. But the assumption of a gently upward-sloping industry supply curve (or similarly shaped short-run marginal cost curve of a firm) does not appear to be very plausible.⁴

If, on the other hand, the short-run supply curve is perfectly elastic (presumably, an excess capacity case), the subsidy brings the average

cost in line with the average revenue received from sales abroad. Now, if this is the typical picture of these industries, then it can make a good case for appropriate devaluation. One cannot consistently hold the position that

- these goods are the ones with "sizeable export potential",
- subsidies are very poor inducements to export, but
- one should devalue up to a point where these goods would need some subsidies anyway.

Taxes VS Subsidies

In most discussions regarding the choice between taxing domestic consumption and subsidizing exports with a view to diverting supplies from the domestic to the foreign market, one rather elementary point is lost sight of; i.e., subsidies are inflationary whereas taxes are deflationary. In our earlier example with inelastic supply, we found that both taxes and subsidies raise domestic price equally and divert equal quantities to the foreign market; but subsidies pump in more purchasing power to the disposable income stream and consequently put pressure on the general price level; whereas taxation, by reducing disposable income, acts in the opposite direction. The success of the devaluation, and the associated foreign trade policies depends on keeping the inflationary pressure in check. And if one has to characterise Indian inflation in the recent past as belonging to either of the two rather imprecise categories. — cost-pushed and demand-pulled. — most observers will choose the latter diagnosis. So, the instruments of policy should be such as to affect the demands side of the market also. The role of taxation in this context has not been properly recognised, and far less the role of subsidies.

Effect on Investment

Another argument often made in favour of subsidies is based on long run considerations: subsidies transfer income to the producers of these exportables as higher profits; higher profits attract more investments into the industry and consequently lead to the proper allocation of resources in the economy. This is a correct conclusion from the analytics of comparative statics. When investment-output lags can go up to four or five years, any policy conclusion based

on the *ceteris paribus* of comparative statics becomes quite unrealistic¹. A proper dynamic analysis should take into account the response of prices to higher profit-incomes, the behaviour of price expectations etc.

On balance one can say that the new subsidy scheme may, in the short run, increase the exports of these commodities, raise their domestic prices, lead to a little or no expansion in their outputs, reduce the exports of certain other commodities by raising adverse expectations, and in the long run, put inflationary pressure on the economy to necessitate more subsidies, with or without proportionately larger investments flowing into these industries.

- The differential rates of subsidies seem to reflect the current (direct) import-content in the manufacture of these products. The subsidies work out to be about 20 per cent of the net export earnings on all these goods. This implies a valuation of foreign exchange at Rs 9 per US Dollar.
- A more general assumption of a downward-sloping foreign demand curve will not alter the qualitative nature of the argument.
- The short-run supply function is the relevant one for our ana-

lysis. The long-run analysis should take into account the various dynamic adjustment mechanisms to be of use, relevance for policy-making. This will be discussed in greater detail later.

- Arguments for possible output expansion are often based on the belief that a large number of firms in these industries have excess capacities. Idle capacity implies constant or diminishing average costs if specific supply bottlenecks or limitations due to demand are removed. This only provides arguments for removing the supply bottlenecks. Incidentally, if the industry is on a downward sloping (static) average-cost curve, then price-incentive is redundant; it may, however, be useful to provide better information about markets and costs to the industries. Infant industry subsidy, on the other hand, is applicable only to the cases involving learning-by-doing process in newly established industries. A look at the list of the products coming under the new scheme can convince anyone that most of these industries do not qualify for infant industry protection.
- The observed phenomenon of a wide divergence among the profit rates prevailing in the sectoral cross section of our economy cannot but shake one's faith in the mechanism of the rate of profit being equalised by the mobility of investment funds.

Sharp Rise in Handicraft Exports

HANDICRAFT EXPORTS rose sharply in the Third Plan. In 1965-66 export earnings from handicrafts stood at a record figure of Rs 28 crores. In the first two Plan periods, handicraft exports per annum averaged at Rs 8 crores compared to Rs 24 crores in the Third Plan. Between 1961-62 and 1965-66 exports increased from Rs 19 crores to Rs 28 crores, or by 44 per cent. With 1961-62 as the base year (100), exports increased to 111, 124, 131 and 144 in 1962-63, 1963-64, 1964-65 and 1965-66 respectively.

Analysing the growth of exports by 12 major groups, exports of 8 groups (precious, semi-precious and synthetic stones; imitation jewellery; woollen carpets, rugs and druggets including namdabs; art metalwares; handprinted textiles; woodwares; shawls and scarves as artwares, woollen shawls; and 'other handicrafts') have gone up, while those of 4 groups (jewellery; gold jewellery; ivory pro-

ducts; and zari) have contracted. Exports of imitation jewellery expanded 14-fold; shawls and scarves as artwares and woollen shawls rose nearly 4-fold; woodwares 2-fold; precious, semi-precious and synthetic stones by 84 per cent; art metalwares by 44 per cent and 'other handicrafts' by 30 per cent. There was a moderate increase in the exports of woollen carpets, rugs and druggets and handprinted textiles. The most substantial increase, Rs 7 crores in absolute terms, was recorded under precious, semi-precious and synthetic stones accounting for a little less than 80 per cent of the total increase in handicraft exports between 1961-62 and 1965-66. The trend in carpet exports has been uneven. With a marginal increase of 2 per cent in 1962-63, exports during the next two years expanded by about 25 per cent. But the following year saw a big fall of Rs 48 lakhs though exports were still marginally higher as compared to 1961-62.