ADMINISTERED PRICE POLICY

A DISCUSSION PAPER

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
(Department of Economic Affairs)

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Contents

I. INTRODUCTION

In the 1986 Budget Speech it was stated that:

> *"There has been a healthy debate in the country regarding the impact of administered prices on the inflationary situation. When all other prices are changing, some changes in administered prices are necessary and inevitable. But the Government accepts the view that as far as possible there is need to stabilise the prices of critical commodities. In order to clarify the issues involved, and to initiate an open debate on the appropriate approach, the Government will present a policy paper on administered prices to Parliament."*

In accordance with this commitment, this paper presents the facts and considers the issues involved in determining a policy on administered prices. The purpose of the paper is to generate a discussion on this important subject and initiate a more open approach to price setting by the Government.

The Role of Administered Prices

2. The Government formally or informally controls the prices of a large number of commodities in the Indian economy. These commodities are either vital raw material inputs to industry or are items that are essential for final consumers. The prices of these commodities, therefore, have a pervasive influence on the growth and development of the economy and on the welfare of a broad cross-section of consumers. The poorer sections, in particular, are greatly dependent on a progressive pricing policy with regard to commodities essential for everyday life. A clear policy on administered prices leads to a more stable economic environment for effective planning and investment decisions both in the public and the private sector.

3. This paper sets out the issues involved in reconciling the need for providing intermediate inputs at low prices with the equally imperative goal of ensuring that adequate internal resources are generated in public sector enterprises. These objectives can only be achieved if price policy is linked to improvements in efficiency, both in the allocation of resources and the performance of public sector enterprises. Administered prices can play an important role in generating a constant pressure on every enterprise to improve efficiency, productivity and overall performance.

4. The Government intervenes in the determination of prices of final goods which are basic necessities (such as rice, wheat, sugar, edible oils, cloth, etc.) and which form an essential part of the consumption basket of the poor. In the wider interests of equity and social justice, prices of these items cannot be allowed to be fixed wholly by market forces.

5. For a number of essential commodities the Government has established an elaborate network of retail outlets - such as Fair Price Shops which form part of the wider Public Distribution System - in order to ensure the availability of these items to the lower income groups at reasonable prices.

For some basic commodities (such as sugar and cement) the 'dual pricing' mechanism ensures that a certain proportion of the available supply is provided to target groups in the economy at fixed prices while the remainder is supplied in the open market. Through these direct measures of intervention, the Government plays an important part in improving the distribution of real incomes in the economy and ensuring a much greater degree of equity in society. The Government reiterates its determination to provide the basic necessities of life to the poorest sections at subsidised prices as an integral part of its pricing strategy.

6. The Government administers the prices of most commodities produced by public sector enterprises. The public sector is the mainstay of our economy and plays a vital part in our economic development. In line with its importance, the size of the public sector has grown substantially over the last decade and a half. Its share of total Gross Domestic Product has risen from 14.9 per cent in 1970-71 to 25.4 per cent in 1984-85. It now accounts for over half (51.3 per cent in 1984-85) of the investment in the economy compared to only 37.8 per cent in 1970-71.

7. Since the public sector dominates the strategic sectors of the economy - infrastructure, energy and raw materials - it not only provides basic inputs to the economy but it is also the major customer for a number of enterprises. Consequently, the impact of its pricing policies on the economy as a whole is of much wider significance than its share in production.

8. It is important to ensure that public sector enterprises are run in an efficient manner and that there is a reasonable return to the public's capital invested in them. In so far as it is important for internal resource generation, public sector pricing will play a crucial role in the fulfilment of the targets in the Seventh Five Year Plan. Table 1 shows that a striking

Table 1

The Contribution of Public Sector Enterprises*

		Centre	States	(Rs. Crore) Total
Total Plan outlay				
-Sixth Plan	Target	48,900	48,600	97,500
	Actual	60,689	50,132	110,821
-Seventh Plan	Target	99,302	80,698	180,000
Public sector contribution				
-Sixth Plan	Target	13,811	4,362	18,173
	Actual	18,118	516	18,634
-Seventh Plan	Target	51,694	7,243	58,937
Public sector contribution as percentage of total		%	%	%
-Sixth Plan	Target	28.2	9.0	18.6
	Actual	29.9	1.0	16.8
-Seventh Plan	Target	52.1	9.0	32.7

**Targets are at 1979-80 prices for the Sixth Plan and 1984-85 prices for the Seventh Plan. Actuals are latest estimates and are in current prices. 'Centre' includes Union Territories.*

feature of the Seventh Plan is the greater reliance, compared to the Sixth Plan, on the contribution from public sector undertakings. Over 50 per cent of the Centre's Seventh Plan outlay is to be funded by contributions of the public sector as against less than 30 per cent in the Sixth Plan.

9. It is imperative that the public sector rises to the challenge of the Seventh Plan. It must not only meet the wider social objectives assigned to it but it must also improve its capacity for surplus generation. In a situation where all other prices in the economy are changing, it is both unreasonable and counterproductive to delay price revisions in the public sector. This would only have the effect of the public sector subsidising the private sector. However, a greater effort is required to ensure that all possible avenues are explored for absorbing cost increases before finally deciding on any price

revisions. In particular, concerted action is required to reduce excessive administrative and overhead costs.

10. It must also be appreciated that administered prices constitute only a part of the overall price situation. Most prices in the economy are not administered. The policy for administered prices must be accompanied with appropriate measures for managing the overall price situation. In this regard, efforts must be made to bolster voluntary self-discipline by the government, by the representatives of consumers and by associations of trade and industry in respect of price decisions. Ways must also be found to harness the strength of consumers in checking inflation, particularly at the retail level. In addition to such voluntary measures and measures to strengthen Public Distribution System, vigorous action must also be taken to curb hoarding and other anti-social practices, which aggravate inflation.

The Scope of the Paper

11. In the broadest sense of the term, administered prices cover a wide range of products, services, wages and salaries, financial instruments (such as interest rates) and other items. The scope of this paper is, however, limited to only a subset of these items. The focus is essentially on the prices of major commodities produced by the public sector and a range of other important commodities whose prices are administered by the Government.

12. One of two important areas which is excluded from the scope of this paper is the pricing of agricultural commodities and their associated inputs. This will be dealt with in another policy paper specifically on agricultural prices. The other aspect of administered pricing not separately considered in this paper, although some of the principles discussed here may be applicable, is the pricing of railway freight and passenger services.

II. ADMINISTERED PRICES AND INFLATION

General

13. The determinants of the price level in the Indian economy are complex and interact with each other. The Committee on the Working of the Monetary System (the Chakravarty Committee), which submitted its report to the Reserve Bank of India last year, has analysed the behaviour of prices in the Indian economy over the past three decades. Broadly speaking, it is possible to distinguish between factors which influence the aggregate demand for goods and services from those which influence aggregate supply. It is the joint interaction of aggregate supply and aggregate demand which determines the level and structure of prices in the economy at any given point of time. As noted by the Chakravarty Committee, the management of the aggregate demand and supply balance has assumed increasing importance over the years in the context of the Plan objective of growth with reasonable price stability.

14. The level of aggregate demand in the economy is strongly influenced by the level of liquidity, that is, the amount of money, broadly defined, in the economy. Correspondingly, increases in the level of aggregate demand are substantially determined by increases in money supply. As the Chakravarty Committee has emphasised, it is necessary for the Government to evolve a framework to ensure that the increases in money supply are not too far out of line with year to year growth in output.

15. However, increases in prices cannot be attributed solely to changes in demand conditions. As noted by the Committee, the Indian experience in regard to price behaviour

shows that inflationary pressures are generated by a simultaneous operation of several forces. Factors on the supply side also play an important role in determining the level and rate of change of prices. The prices of agricultural commodities rose sharply in years when unfavourable weather conditions brought about a steep fall in agricultural output. Because of the large share of the agricultural sector in national output and income, failures in agricultural production have been associated with sharp increases in not only agricultural prices, but the price level in general. The Committee goes on to observe that prices have not, however, exhibited any significant downward flexibility in years of good harvests. There is, therefore, an inbuilt upward pressure on prices in India.

16. "Imported inflation " has also contributed to increases in the general price level, especially in the 1970's. The two successive oil shocks of 1974 and 1979 fuelled sharp bursts of inflation in India, essentially because of hikes in the prices of internationally traded commodities. It is, therefore, necessary to recognise the importance of supply factors in causing inflation and in framing any policy aimed at checking the growth of prices.

17. In evolving an effective set of policies for controlling inflation, it is necessary to appreciate that the policy for administered prices is only one part of an overall strategy. The control of inflationary pressures requires effective action in controlling aggregate demand and managing the supply of key commodities. In this context, the Chakravarty Committee has recommended the introduction of monetary targets to ensure that increases in money supply are not too far out of alignment with year to year growth in output. The Government has accepted this recommendation and is introducing monetary targets on an experimental basis this year. On the supply side, the Government has built up large buffer stocks of food and developed an extensive Public Distribution System, which constitute important instruments

for combating sudden bursts of inflationary pressure which may arise because of failures in agricultural production. At the same time, in the case of some key commodities, such as edible oils and sugar, the Government has resorted to imports to manage the supply of these essential goods and thus check inflationary pressures. In view of the need to conserve foreign exchange, it is necessary to explore the possibilities for encouraging higher indigenous production of these imported items. This, inter alia, involves the adoption of an appropriate price policy for encouraging production of crops which are in short supply. This is a subject of another paper on Agricultural Pricing, being prepared by the Ministry of Agriculture.

18. To the extent that inflationary pressures arise from the external environment, it has to be recognised that the underlying causes are outside our control. Nevertheless, in situations where external events, such as oil price hikes, aggravate domestic inflation, there is no alternative but to adjust to the changed external environment through efficient import substitution, stronger programme for exports and effective measures for reducing the demand for oil.

19. Apart from the macro-economic considerations mentioned above, there are a number of other factors which influence the behaviour of prices in our country. In addition to commodity taxation, including State levies, important factors such as high distribution margins, under-utilisation of capacity, uneconomic scales of production, lack of competition and technological obsolesence, affect the prices of industrial products. For example, under-utilised capacity and uneconomic scales of production raise unit costs. If indigenous production costs are high, it also becomes necessary to provide adequate protection to the domestic industry through tariffs or physical controls. In many industries, technology continues to be outdated with the result that cost economies arising from technological changes have not been fully exploited. In highly protected markets, there is

also a tendency to postpone investments in modernisation and cost-reducing innovations. In respect of commodities where demand is strong, middle-men are quick to exploit the situation by raising retail prices. In any analysis of price behaviour, due note has to be taken of these and similar factors.

20. An appropriate policy for administered prices has to be formulated in the context of the overall macro-economic and production factors which affect the behaviour of prices in the economy as a whole. The Government controls some prices but it cannot control all prices. Nor can it insulate the price behaviour of individual commodities from the effects of external factors, droughts, or changes in money supply. The past behaviour of administered prices and the impact of these prices on the general price level has to be viewed against this background. A change in the price of other commodities affects the cost structure of items under price control, and sooner or later, the increase in costs has to be passed on. Similarly, any autonomous change in administered prices is bound to affect prices in the rest of the economy. This Chapter analyses the contribution of administered prices to the general inflationary situation in the country since 1970-71.

Commodity Groups

21. While there are a number of alternative methods of analysing the effect of administered prices on the overall price situation in the economy, the impact on the Wholesale Price Index (WPI) is perhaps the most reliable and simplest to monitor on a regular basis. The WPI consists of a total of 360 commodities of which there are 55 major items whose prices are either fully administered, partially administered or subjected to different forms of voluntary and other mechanisms of control (see Table 2). The total weight of these items in the WPI is 30.85 per cent.

22. The 55 administered items form a heterogeneous group both in terms of their significance in the economy and

the precise method of price control under which they operate. Some of the items are subjected to such specific economic forces that including them in a single overall index may be misleading. Prices of petroleum and petroleum products (with a weight of 5.51 per cent) have been historically almost wholly determined by world prices and undoubtedly form a category of their own.

23. Administered commodities other than petroleum can be conveniently sub-divided into three categories :-

(i) **A1- Core Items** which represent basic goods with a total weight of 8.27 per cent in the WPI. The prices of all these items are fully administered. The items include coal, electricity, fertilisers and iron and steel products.

(ii) **A2- Other Fully Administered Items** with a total weight of 3.23 per cent and which are mainly intermediate goods and some important final goods. They include iron ore, non ferrous metals, drugs and medicines, paper, newsprint and insecticides.

(iii) **A3- Partially Administered Items** which have a total weight of 13.84 per cent and represent mainly agro-based items and commodities under the 'dual pricing' scheme. Items included are rice, wheat, sugar, vanaspati and cement. **

The remaining 305 commodities in the WPI whose prices are not administered have a total weight of 69.15 per cent.

Direct and Indirect Effects

24. There are three basic channels through which a rise in administered prices affects the overall inflation rate:

(i) Since administered items constitute a component of the WPI (with a total weight of 25.34) any rise in an

** *In the case of wheat there are 7 controlled price quotations out of a total of 23 quotations, and 8 out of 49 for rice. Vanaspati had a voluntary price agreement for most but not all of the period.*

individual item's price directly affects the WPI to the extent of its weight in the WPI.

(ii) Whenever the price of a basic or intermediate good is changed it affects the input costs of a large number of commodities. These indirect effects on the general price level can be measured by an input-output table which contains all the various commodity interactions in the economy. After incorporating these indirect effects, the impact on the general price level would normally be greater than the weight of the particular item in the WPI.

(iii) In most circumstances an increase in administered prices implies either an increase in revenues or a decrease in budgetary subsidies. This has an overall deflationary effect on the economy as it tends to reduce the rate of growth in money supply.

Table 2
Average Annual Rates of Growth of Administered and Non-Administered Prices between 1970-71 and 1985-86

Category	WPI Weight	% Increase
Overall Inflation	100.000	9.12
1. Non-Administered Prices	69.149	8.49
2. Administered Prices	25.337	9.07
- A1 : Core Items	8.272	11.50
- A2 : Other Fully Administered	3.229	8.57
- A3 : Partially Administered	13.836	7.36
3. Petroleum and Products	5.514	15.91

Based on figures available up to 31st March 1986.

25. The price trends in Table 3 essentially measure the direct impact on inflation of administered and non-administered commodity prices and not the indirect interactive effects. However, since the deflationary impact of a rise in administered prices works in the opposite direction to the

indirect effects, the use of WPI weights may not, in fact, provide any substantial underestimate of the contribution of each group to inflation.

Table 3

The Direct Contribution of Administered and Non-Administered Prices to Inflation

Period	Average Annual Inflation Rate *(wt.=100.00)*	Average Annual contribution of: Admin. Prices *(25.337)*	Non-Admin. Prices *(69.149)*	Fuel Prices *(5.514)*
1970-71 to 1985-86	**9.12**	**2.16**	**5.68**	**1.27**
1970-71 to 1975-76	11.99	2.83	7.45	1.71
1976-77 to 1980-81	8.53	1.47	5.50	1.56
1981-82 to 1985-86	6.84	2.19	4.10	0.55

Price Trends

26. Figure 1 shows the annual movements in administered and non-administered prices during the last decade and a half. From Figure 1, and from the average growth rates in Table 2, it is clear that while over the period as a whole both the price series have moved more or less together, in the post-1980 period non-administered prices decelerated slightly relative to administered prices.

27. For the period as a whole non-administered prices increased at an average annual rate of 8.49 per cent compared to a 9.07 per cent rate for administered prices. This marginally higher growth rate was mainly a result of the price of core items increasing at a relatively high rate of 11.50 per cent. However, many of these core items are energy related (particularly coal, electricity, and fertilisers).The faster increase in these items is not surprising since their prices had to be raised either because of an increase in energy

Figure – 1

ADMINISTERED PRICES AND NON-ADMINISTERED PRICES

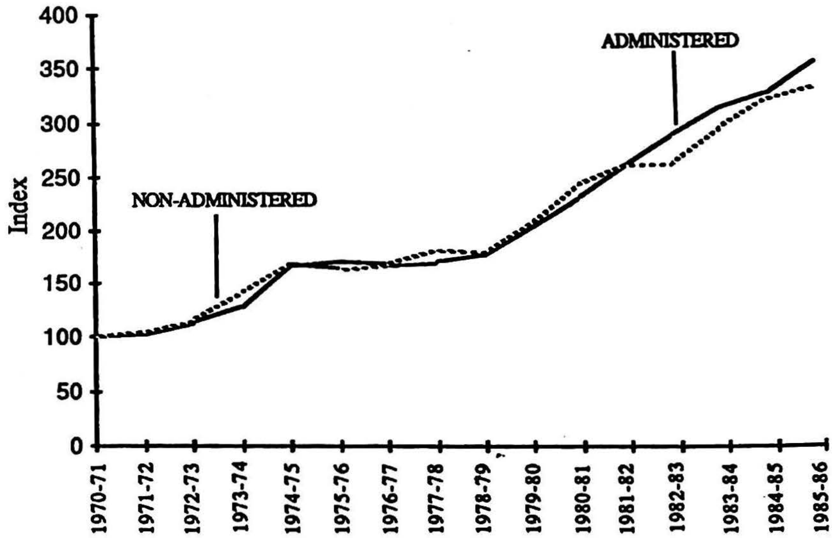
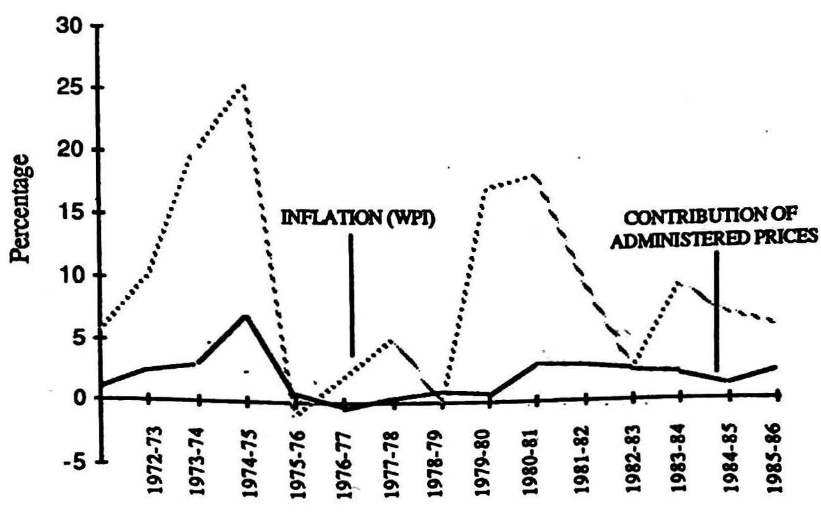


Figure – 2

INFLATION AND THE CONTRIBUTION OF ADMINISTERED PRICES



input costs or owing to the need to maintain a degree of relative price parity with petroleum.

28. Prices of other fully administered items (A2 in Table 2) have risen at almost exactly the same rate as the non-administered group. Between the administered price sub-groups, partially administered items have shown a much greater degree of price stability than other commodities. This sub-group has increased at 7.36 per cent per annum - over a percentage point lower rate than the non-administered group.

29. The trends in Table 3 and Figure 2 indicate that while increases in administered prices undoubtedly contribute towards overall inflation, there is no direct or simple relation. Stable administered prices do not necessarily guarantee that there will be no overall inflation. Nor is it always the case that an increase in administered prices leads to an unusually high rate of inflation in the economy. This conclusion is not surprising in view of the fact that a number of other important factors - particularly the demand and supply situation in respect of individual commodities, technological changes, other industrial costs and world prices - affect the overall behaviour of prices in the economy.

30. Over a fifteen year period since 1970-71, the direct contribution of administered prices to inflation has averaged 2.16 per cent per annum while for non-administered prices it has averaged 5.68 per cent per annum. The contribution of the non-administered price group can, of course, be expected to be higher because of its greater weightage in the WPI. In sum, therefore, the performance of administered prices, though far from ideal, has tended to be much less de-stabilising than is generally believed.

31. It has also to be recognised that the policy on administered prices has an important bearing on the development of the public sector. The public sector today controls the commanding heights of the economy and acts against the concentration of private wealth and monopoly power. It is essential that through an appropriate pricing

policy and efficient operations, the economic viability of the public sector is strengthened. The public sector produces many of the basic goods used in the economy. It is particularly important to reduce the costs of production of such basic goods, so as to promote growth and employment in downstream industries.

32. To bring about improvement in the efficiency of public sector units it is necessary that the policy of administered prices builds pressures for reducing costs and increasing productivity. Improvements in productivity must also be secured through better project evaluation, avoidance of time over-runs in project implementation and better overall management of ongoing units. It is also desirable to avoid overmanning of public sector units. Overmanning not only raises costs and prices today, but also reduces the surplus available for productive investment, which is necessary to expand future output and employment.

Figure – 3

COAL SECTOR

INDEX NUMBERS OF WAGE BILL, EARNINGS PER EMPLOYEE AND CONSUMER PRICE INDEX *

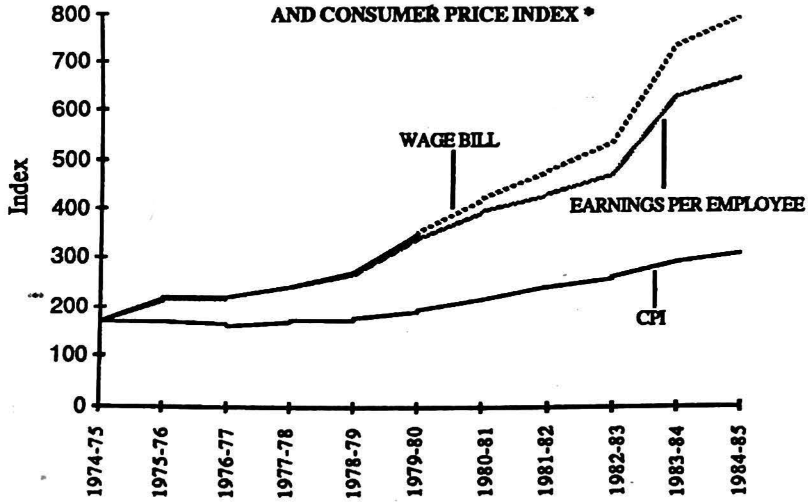
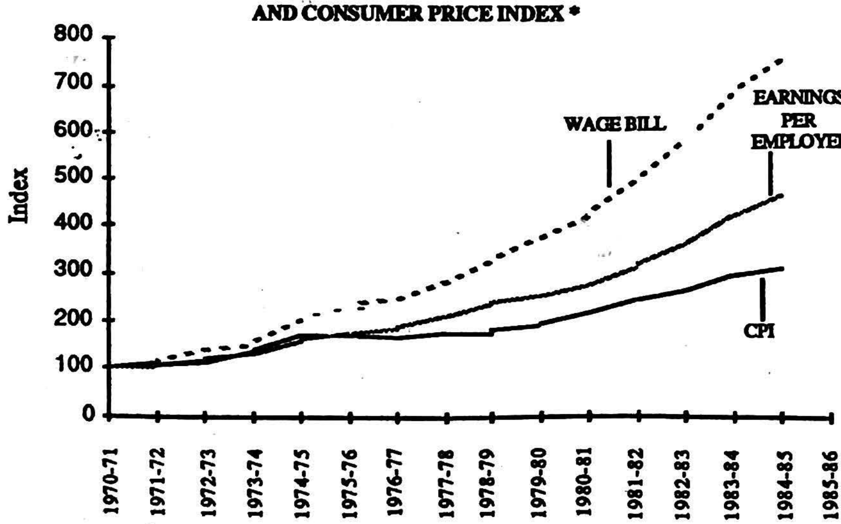


Figure – 4

STEEL SECTOR

INDEX NUMBERS OF WAGE BILL, EARNINGS PER EMPLOYEE AND CONSUMER PRICE INDEX *



* CPI (Base 1960=100), base converted to 1970=100 for comparison purposes

Figures 3 and 4 show the movements over a period of time in the wage rate per employee and the total wage bill. In both cases wage rates have risen at a much faster rate than the Consumer Price Index for Industrial Workers indicating that the standard of living of each worker has improved considerably in the 10 years since 1974-75 in each sector. At the same time, however, the number of employees has risen sharply, which accounts for the even higher increase in the total wage bill.

III - POLICY ISSUES

33. Government intervention in pricing decisions has wider social goals than merely profit making. Public sector enterprises, in particular, must share the responsibility for ensuring that the allocation of resources is to the benefit of the whole community. Subject to these important social objectives, which form the *raison d'etre* of the public sector, the Government expects these units to perform as economically sound, commercial enterprises. The price regime under which a public sector unit functions must, therefore, reward efficiency and make transparent any areas of waste. More generally, the policy on administered prices must help to build up pressures for reducing costs. This is an integral part of a programme for transition to a lower cost economy. The Government is taking steps to achieve a reduction in operating and other real costs of public sector enterprises.

Alternative Approaches

34. There is a widespread and legitimate concern over the impact of raising administered prices on the overall rate of inflation in the economy. Since a large proportion of the output of basic items produced in the public sector is used by other public sector units, raising prices leads to other price adjustments which eventually spread to the rest of the economy. It is important, however, to evaluate the various policy options available whenever there is an unavoidable increase in the operating costs of public sector units (Figure 5)

35. The first and most preferred option is to make every possible effort not to pass on the burden of the cost increase. This can only be achieved by improving the productivity and efficiency of the enterprises. The extent to which an increase

in costs can be absorbed in each case depends, of course, on the existing level of efficiency of the enterprise. In units which are already working efficiently at close to full capacity utilisation, the scope for substantial improvements in efficiency may be limited. On the other hand, for those units in which there is considerable room for improvement in productivity or capacity utilisation levels, there is less justification to pass on cost increases.

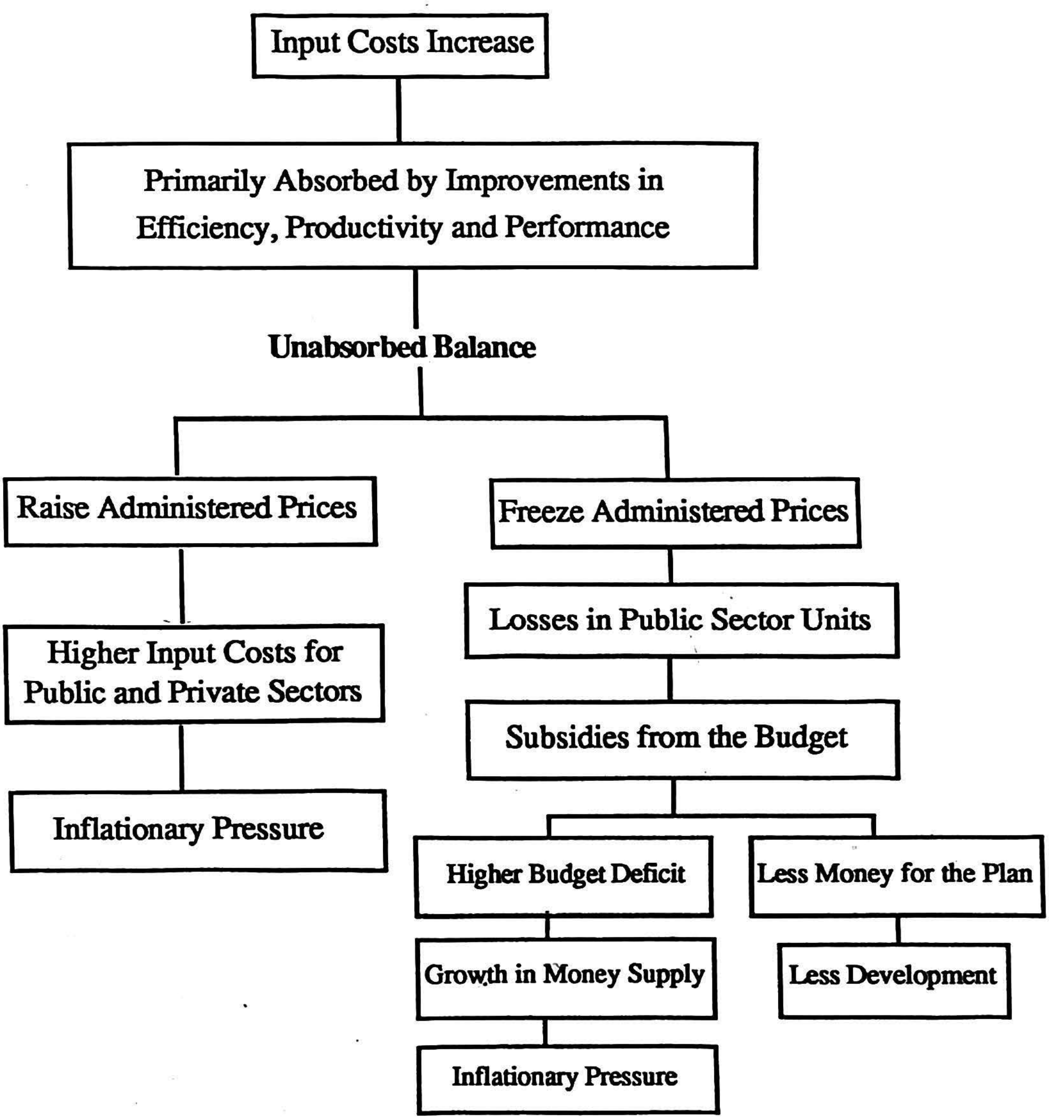
36. By this principle the justification for revising output prices in response to cost increases is closely related to the efficiency of the enterprise. Pricing policy should require inefficient units to absorb a higher proportion of any cost increase by showing greater improvements in performance. As long as the targeted increase in efficiency is reasonable within a given time frame – and unrealistic standards are not set to be achieved overnight – price setting can act as one instrument, amongst others, for encouraging greater efficiency.

37. Costs can increase due to a variety of reasons such as a rise in international prices. To the extent that these unavoidable cost increases are not wholly absorbed, the Government faces the dilemma of: (i) raising administered prices and thereby causing other prices to be revised, or (ii) suppressing the output price which forces public sector units into losses. Such losses, in certain circumstances, represent a subsidy to the private sector and, in any case, can lead to an increase in the budgetary deficit. These alternatives eventually lead to inflationary pressures in the economy and cannot be long term substitutes to improvements in efficiency. Nevertheless, it is unrealistic to expect all cost increases to be totally absorbed by immediate improvements in efficiency.

38. It is important to dispel the notion that since the public sector is a major buyer of the public sector's own output, increases in these administered prices need not affect the average consumer in the rest of the economy. Even in the case where prices of only basic items (e.g., coal, iron ore) are

Figure - 5

THE IMPACT OF ALTERNATIVE PRICING POLICIES ON INFLATION



revised, these must eventually reach the consumer through successive revisions of the prices of intermediate goods (e.g., electricity, steel, railway freight) and subsequently final goods (e.g., bicycles, passenger rail fares). This chain of price revisions generally has a high level of visibility and tends to occur in a short span of time. This leads to public reaction which, in turn, generates inflationary expectations that are often in excess of the underlying inflationary potential.

39. On the other hand the route of freezing administered prices, while costs increase, may contain at least as much, if not more, inflationary potential. The budgetary subsidies necessary to finance public sector losses either result in : (i) a reduction in the size of the Plan, or (ii) an increase in the size of the budget deficit (Figure 5).

40. The detrimental impact on economic growth and development of a cut in Plan investment, in order to finance public sector losses, is more obvious. The alternative of increasing the budget deficit implies that the Government must print additional money to finance the subsidies. This leads to an increase in the overall liquidity in the economy through a growth in money supply which eventually generates inflationary pressures. The budget deficit route is in some ways more harmful not only because its impact on prices is not immediately obvious but also because it must be repeated each year resulting in an annual increase in money supply. Its effects are, therefore, spread over an extended period of time and not just a once and for all adjustment as in the case of raising administered prices.

41. It may be argued that subsidies can also be financed by raising tax revenues rather than allowing the deficit to increase. There is obviously a limit to which the route of raising taxes in order to cover losses can be pursued. Beyond a point, the tax system itself is likely to become inelastic and there may also be other adverse effects on the economy (e.g., increase in prices due to increase in taxes on commodities). The Government is committed to maximise tax revenues, and

considerable success has been achieved in 1985-86 in increasing both direct and indirect tax revenues. It is desirable that increases in tax revenues are used for financing development rather than for financing losses.

Issues for Consideration

42. Keeping these broad objectives in view, it is necessary to consider pricing policy issues in the following three basic situations:

A. Pricing to cover normative costs - the normal context.
B. When actual costs exceed norms and units incur losses.
C. Pricing to raise resources for economic development.

A. Pricing to cover Normative Costs

43. Normally, it may be argued that any productive enterprise should price its products and services to cover Long Run Marginal Cost of production (LRMC). The basic idea is that prices should cover capital and current costs of efficient production in a new plant. While the determination of the LRMC (or the 'normative price') is sometimes difficult, the Bureau of Industrial Costs and Prices (BICP) has successfully demonstrated that in the majority of industries the computation of LRMC is eminently practicable.

44. In the case of commodities produced in industries where the public sector has to compete with other producers, there is a strong case for allowing enterprises to set their own prices as far as possible. However, in other cases, an appropriate procedure has to be developed which takes into account the interests of producers as well as consumers.

45. First of all it is important to distinguish between fixing the normative price level for an industry at one point in time and providing for justifiable changes in costs over time. In order to bring about an orderly adjustment of prices, a two-step approach may be desirable. First, the base level of prices

in an industry should be fixed after carrying out detailed studies of costs at normative levels of efficiency. Once the base level prices have been fixed according to normative considerations, changes arising from unavoidable increases in input costs could thereafter be made much more automatically.

46. In recent years, while fixing administered prices, an attempt has been made to take normative costs into account. Usually, however, these normative costs have been determined on the basis of historical costs of plant and equipment, and costs of inputs actually prevailing in the industry. In most cases it has not been possible to take fully into account the most efficient norms of input use. This has reduced the incentive for a more economical use of scarce resources, particularly energy. Public sector plants have also suffered from an inadequate level of internal resource generation for the replacement of capital.

47. It has, therefore, been suggested that the level of administered prices should be determined on the basis of Long Run Marginal Cost (LRMC) of production. The objective of LRMC pricing is that public sector prices should only cover capital and current costs of efficient production in a new plant. For important industries a detailed study to determine the LRMC should be carried out every five years in order to fix the base level prices. In industries with rapid technological changes, the frequency of detailed studies could be every three years. It should be emphasised that the use of normative capital costs will also put pressure to minimize time overruns in project implementation and reliance on inadequate Detailed Project Reports (DPRs), factors which increase capital costs of operating plants. In any case, there must be close monitoring of project implementation to avoid cost and time overruns. In fixing normative costs and prices, the BICP should also be guided by prevailing levels and trends in international costs and prices as discussed further below.

48. In the interim period between these detailed studies, changes in base level prices to reflect unavoidable changes in input costs could be made in a more simplified manner. The data base of the detailed studies can be used to construct a weighted index of input costs for each industry. This index would be based on normative costs and could be used to compute the justifiable impact on output prices caused by any change in the prices of inputs. It stands to reason that any unavoidable increase in prices of raw materials and energy inputs should be allowed to be entirely passed on. With regard to wages, a suggestion which needs to be considered is whether prices should be adjusted only to the extent of the rise in the CPI (Consumer Price Index) or the actual increase in wages, whichever is lower. The rationale for this is that in cases where the wage increase in any industry is excessive, the cost of such increase should not lead to higher costs all round.

49. Another issue which needs consideration is the frequency of price revisions in response to changes in input costs. It may be argued that these changes should take place infrequently so that administered prices remain stable for a longer period of time. This would inevitably imply that changes, when they occur eventually, would be relatively large. If sharp changes in administered prices have to be avoided, an alternative is to have more frequent but smaller changes in prices. When prices are not adjusted for prolonged periods, this may lead to unwarranted inflationary expectations as well as the emergence of a black market and hoarding in anticipation of a price change.

50. In order to ensure the effective implementation of a normative approach to administered prices, an organisation such as the BICP may be charged with the responsibility of undertaking the comprehensive industry-specific studies of cost-price structure every three to five years. The BICP may also compile cost escalation data from various industries and maintain the cost indices for each industry in order to ascertain the index-based price increases to be permitted in the interim.

For this purpose it may be necessary and desirable to establish a separate wing for 'Infrastructure Pricing' in the BICP to execute these tasks for the pricing of public utilities and basic infrastructural items.

51. In the determination of price and cost norms for each industry the BICP would take into account the real ground level problems and set standards that are realistic. Realistic norms should distinguish between cost increases that are due to factors within the management's control (avoidable) and those that are beyond the control of the management (unavoidable). The latter would include, for example, the non-availability or poor quality of certain inputs.

52. In the natural course of computing normative costs, the BICP would specify the costs directly attributable to factors such as management problems or overmanning in each enterprise. This will better identify the reasons for financial losses and a more informed decision can be taken on the social costs that need to be borne by society at large.

53. It is important that the viewpoint of consumers be taken into account by the BICP in its determination of prices. In appropriate cases, consumers may be requested by the BICP to represent their case in order to ensure that their interests are considered in the setting of administered prices.

54. It is unrealistic to suppose that any economy - no matter how self reliant - can remain insulated from world markets over any length of time. Even the traditionally isolated socialist nations are increasingly turning to the world markets for pricing information. International prices certainly have an important role to play in providing signals for the domestic economy. The long term trend of world prices is a useful yardstick for determining the level towards which domestic prices should be approaching.

55. There are, nevertheless, a number of qualifications that must be applied to prices in the world market before they are meaningful for the Indian economy. Since international exchange rates are constantly changing in a floating rate

regime it is difficult to estimate the true value of commodities at a particular point of time in a single currency.

56. Perhaps the most difficult factor to estimate is the true long run price of a commodity on the world market. Prices in international commodity markets are highly volatile and are unreliable indicators of the long run position. Under these circumstances, the best approximation to long run world prices is, perhaps, the average cost of production in the major producing countries. It would be important for the BICP to begin collecting this information, so that costs of production prevailing in other countries can be regularly compared with our costs. The current practice of linking the price of a number of mineral products to the London Metal Exchange (LME) price suffers from the problems of volatility and instability referred to above. It would be desirable to work out an alternative scheme which more closely reflects a longer run stable economic price.

B. When Costs are above Normative Levels

57. In practice, if costs of production in a public sector unit are above normative levels the policy with regard to prices would depend upon the nature of the commodity. Where costs are too high the first step is to introduce measures to improve efficiency. However, since these would not have an instantaneous affect, in the period of transition a realistic and rational price policy must be devised based on the item being produced. A useful approach is to make a basic distinction between final products and commodities that are inputs (raw materials, components, etc.).

58. In principle, prices of inputs in the economy should not be raised above their normative levels as: (i) it leads to distortions in the structure of production in the industrial sector of the economy, and (ii) it makes it difficult to discern the equity and distributional implications of price policy. On

the other hand, keeping the price of inputs at their normative levels forms the basis for a low cost economy and provides a stimulus to exports. Similar considerations led to the introduction of a Modified Value Added Tax proposed in the Long Term Fiscal Policy which allows taxes on inputs to be offset. The pricing of final products above or below their normative levels follows principles that are similar to the taxation of end products.

59. While commodity inputs must not be overpriced, the suppression of administered prices below their minimum economic levels results in severe distortions in the structure of relative prices in the economy . This upsets the pattern of consumption at the national level leading to waste and inefficiency. It is important, therefore, to maintain a structure of relative prices that is in line with the demand pattern and the resource position in the country.

60. In certain cases the normative price arrived at by the BICP may be well below the price currently being charged. In such cases, an attempt should be made to introduce the normative price in a phased manner within a specified period. For example, in certain cases such as steel, which is a basic intermediate input with virtually universal applications in the economy, a rapid move towards normative prices is desirable. For all inputs whose costs are above normative levels, a transition to normative prices can be achieved either by holding prices stable or by allowing smaller increases than implied by changes in costs. The success of this transition to normative costs would, however, crucially depend on an improvement in efficiency and productivity levels as well as the overcoming of a large number of technological and structural problems inherent in Indian industry. Otherwise, public sector losses would tend to increase.

61. There is some validity in the view that when an inefficient unit is prevented from raising its price above normative levels and as a result makes regular losses, there is an overall demoralisation of the workforce. Moreover, cost-

cutting exercises and improvements in efficiency are more difficult in a loss-making environment. While this view merits some attention, the option of raising prices to cover inefficiencies tends to reduce the pressure to improve performance. In order, therefore, to overcome these motivational problems it should be mandatory for every public sector unit to set more efficient work norms, with clearly set quarterly targets - along with the back up of appropriate incentive schemes.

C. Raising Resources for Development

62. The Seventh Five Year Plan envisages a substantial contribution of resources from the public sector to meet the investment requirements (see Chapter 1, Table 1). To meet this requirement with the minimum distortion to the economy, public sector enterprises producing basic inputs will need to generate extra resources primarily by cutting costs rather than increasing prices.

63. In principle, the prices of inputs should not be raised above normative levels. There are, however, certain situations in which a case can be made for raising such prices in order to raise resources which can be used for development. Among such situations are:

(i) Where there is an unofficial premium and a black market operates in a shortage situation. An increase in prices would tend to equate demand and supply, and undermine the basis of the profits made by the unscrupulous sections. The funds raised thereby would be used for further investment in the sector.

(ii) Where the commodity is used as an input for a large number of final products which are administratively difficult to tax directly.

(iii) Where there is a need to reduce the consumption of an exhaustible resource for conservation purposes.

64. Temporary shortages are inevitable in any developing economy where certain prices are administered. Under these

circumstances, the Government faces the choice of:

(i) Rationing the item – in which case those who are fortunate enough to be allocated the item receive a hidden surplus or premium.

(ii) Raising the price of the commodity temporarily – for the period of the shortage – either by imposing a short term excise duty or by increasing the administered price.

(iii) A combination of (i) and (ii) by introducing 'dual pricing' or multi-part tariffs.

65. There is a view that quantity rationing is more economical than raising prices. It is argued that those users who are allocated the item under a rationing scheme receive it at a low price and can, therefore, keep their own prices down. The problem with this, however, is that for those who are not allocated adequate quantities, capacity utilisation levels fall and costs go up, or they must resort to alternative more expensive production processes. Rationing, therefore, does not necessarily reduce the net cost to the economy. In such situations, the principle of differential pricing rather than quotas can be an effective method of protecting the interests of the poorer sections. This principle is in consonance with the findings of several committees on other sectors of the economy.

66. Dual pricing schemes aim at a combination of (a) improving equity through rationing a part of the output, with (b) charging a market determined price to those consumers or sectors which can bear it. For those items for which dual pricing has been in operation, the scheme has been functioning in a satisfactory manner. However, close monitoring is required to prevent the misuse of concessional pricing.

67. In terms of its impact on the prices of final products, petroleum affects a wide array of commodities. However, it is also an item that is in short supply; it affects the prices of a number of final products outside the tax net, and it is an exhaustible resource that must be conserved. Our known

reserves of petroleum crude at current levels of production are expected to be exhausted in less than twenty years. There is also a strong balance of payments reason for curbing the growth in consumption of petroleum products. Nevertheless, it has to be recognised that any increase in petroleum prices does require major adjustments throughout the economy and leads to some degree of instability. In taking a view on petroleum prices, the weighted average cost of crude (domestic and imported) is the relevant measure, since the average cost depends on domestic and international prices as well as the relevant proportion of imported crude in our total requirement. Looking ahead at the next two or three years, and taking into account the prevailing low level of international prices, it should be possible to ensure some stability in prices of petroleum products. A suggestion that merits discussion is whether the Government should keep present prices stable for a period of two or three years so long as the average weighted cost of crude (domestic and imported) remains below the 1986 levels.

Related Pricing Practices

68. In view of the above principles, it is necessary to review certain practices related to administered pricing policy. The increasing complexities of the Indian economy and the growing industrial base demand the simplification and rationalisation of existing pricing systems. Some of these are considered below.

69. Peak-Load Pricing: The tendency to favour uniform prices has also led to the neglect of efficiency considerations in the pricing of electric power. At present our electricity tariffs do not, generally, vary with time of day or season, yet the present pattern of demand for electric power is characterised by systematic variations according to the time of day. This leads to the need for heavy investment in capacity to meet peak demand, even though such capacity remains largely underutilised at off-peak periods. The introduction of peak -

load pricing (under which electricity at off-peak hours is provided at a much lower price than at peak times) will induce a more even pattern of demand over the day and thus reduce the need for fresh investment in capacity. Of course, the shift to peak-load pricing of electricity will require one-time investments in new meters. But this additional expenditure will be far outweighed by the savings in investment that may be expected as a result of a more even pattern of electricity demand. It may be desirable to set up a high level committee on the pricing of power which will study the action necessary to introduce peak-load pricing, multi-part tariffs and related issues.

70. Retention Pricing: In certain industries, where there are a variety of production processes and capital of different vintages, some units are likely to have an inherent cost advantage over others. In these circumstances retention pricing is commonly used to protect the high cost units. Under this scheme each unit in the industry is guaranteed a price equal to its costs plus a specified return: the low cost units receiving a lower price and the high cost units a higher price. The product is sold at a single price which is fixed at the average level for the entire industry. The low cost units pay the difference between their retention price and the average price into a 'pool' and, in turn, the high cost units receive a cross-subsidy equal to the difference between their price and the average price.

71. In practice, over the years retention pricing has tended to become a 'cost-plus' pricing system which may have worked against improvements in efficiency. There has been little incentive for units to invest in cost-saving technologies as their retention price would be lowered in proportion to the reduction in costs. A move to group-wise retention pricing and thereafter to a uniform price for each industry may also lead to a reduction in average prices for the consumer. This deserves consideration.

IV. SUMMING UP

72. Administered prices have a pervasive influence on the growth and development of the economy and on the welfare of a broad cross-section of consumers. The aim of this discussion paper is to identify principles which may be used in the determination of the level of administered prices. While increases in administered prices cannot always be avoided, such increases should be undertaken after measures for improving efficiency and reducing costs have been introduced.

73. In our economy, through direct measures of intervention, the Government plays an important role in improving the distribution of real incomes and ensuring a much greater degree of equity in the society. The Public Distribution System has a particularly vital role in ensuring the availability of essential commodities to the lower income groups at reasonable prices. The Government reiterates its determination to provide the basic necessities to the poorest sections, and to strengthen the Public Distribution System, as integral parts of its pricing strategy.

74. It is necessary to face squarely the issues involved in the determination of administered prices. When there is an increase in costs, the options are limited:

(i) The most preferred option is to absorb, to the extent possible, the burden of the cost increase by improving the productivity and efficiency of the concerned enterprises.

To the extent that unavoidable cost increases cannot be so absorbed, the other options available to Government are:

(ii) Raising administered prices and thereby causing other prices to also increase;

(iii) Holding the administered prices unchanged, leading to higher losses (or lower profits), which may be met by higher subsidies from the Budget. This, in turn, can be sustained by either:

(a) tolerating a higher Budget deficit, which may have at least as much inflationary impact as raising administered prices;

(b) reducing Plan expenditure, at the expense of development.

75. The importance of increasing the surpluses of public sector undertakings, through increases in efficiency, cannot be overestimated. However, if such improvements are not forthcoming and there is a shortfall in resources available for financing the Plan, the issue arises as to what action Government should take to protect the Plan.

76. The issues involved are complex, and the Government hopes that a wider discussion of these issues will lead to the introduction of policies, which will help in reducing inflationary pressures on the economy while at the same time generating sufficient resources for development. The Government will welcome a discussion and open debate on the issues raised in this Paper.