FINANCIAL EXPRESS

“Pricing Issues for Government and Regulatory Decision” BY S L RAO

February 2 2013

 Much of the public discussion on public finance has been on macro issues relating to the size of the deficit, tax to GDP ratio and recently, taxing the very wealthy at higher rates. But there are more specific issues that have needed attention for long. They have in some cases become more important, as economic growth has accelerated, and inequalities increased.

 One of them that predate liberalization by many years is the differential taxation of the same products when made in India and when imported as finished products. Within India, the goods and services tax was to bring about uniform tax rates between states. It was to make the Indian Union into a true common market. But the g.s.t is yet to become law. The same product made in India has very different rates of sales and other indirect taxes between states. However if the product were to be imported, it is subject to an import duty, which with liberalization, has become modest. This is grossly unfair on the Indian producer whose product costs more.

 Another unfairness is in the differential rates of import duty on raw materials and finished products. If poly vinyl chloride is imported it is subject to one rate of duty. However, the raw materials for pvc are not fully available in India and a part has to be imported. The import duty on raw materials is higher than the import duty on the import of pvc as finished product. The same applies to vehicle tyres. This makes the locally manufactured product more expensive.

 Government has in the last few years moved aggressively with infrastructure projects funded and executed on public-private partnerships. This has enabled marginal government funding and substantial private funding for projects. The return on the private funding is through tolls, property rights, advertising entitlements, etc. It requires good forecasting of future revenues through these means. If the bidder in a competitive situation bids aggressively, he might over estimate the prospective revenues and find that the project is unviable since the revenues are inadequate to cover costs. There are an increasing number of instances in which the bidders have dropped the project after its being awarded to them, and even when they have initiated work because the revenues are likely to be grossly inadequate. A prominent instance was of the Hyderabad Metro for which Maytas (a Satyam company) made a successful bid and then withdrew. This delayed the project.

 There is one possible solution for such ppp projects where government awards the project to the bidder who asks for the lowest “viability gap funding” from government. Government should have a floor for the viability gap funding, below which it will not consider a bid. If this is done, there is bound to raise an outcry and audit objections as well. In its absence, bidders will make bids that are not viable and may dump the project. A way has to be found to deal with this problem if an innovative idea, namely, ppp with viability gap funding is not to fall into disuse. Perhaps one way is for government is to make income projections within a range and ask bidders to pick income projections from within the range and play with other costs and margins, in estimating their requirement of viability funding.

 Another problem that has arisen in recent years is that of whole sectors that have become unviable because of mindless price cuts by operators. Two examples come to mind. One is the way in which airline fares went below cost as a so-called low cost carrier, Deccan Airways, offered fares that were actually below cost. Deccan Air became unviable. Other operators had to follow suit with lower fares so as not to lose passengers. They also got into financial trouble. The airline industry has yet to recover from the losses that Deccan imposed on the industry because of unviable low fares.

The same thing happened with telephone calls on mobile phones. Price competition became so vicious that margins got severely eroded and all operators suffered, some more grievously than others.

 The Competition Commission is very effective in dealing with cartels that join to keep prices high and exploit the consumer. It has the power to investigate “predatory pricing” where the operator prices low to eliminate competition and get a desired market share, after which he raises prices. But there is no agency that watches to prevent price cutting that makes a whole industry unviable. To regulate this will open a Pandora ’s Box of difficult issues. These include timing (how long after such price cuts should the agency intervene), what is viable for different operators, why not leave the sector to suffer and solve the problem for themselves through the exit of some operators and the dawning of good sense on others? There may be no solution to the problem but it merits careful study.

 Another issue in pricing decisions is when government offers raw materials at free or subsidized rates. A good example is that of coal to mega and ultra mega power projects. In the first place, this was born out of the pressure by politicians to keep power tariffs low. In the process they gave away national natural resources like coal at no cost and left it to the power generator to exploit the mines and use the coal. It might have been better if the coal or coal mines were actually sold or leased, and government gave a subsidy to the generator in order to keep tariffs low. The electricity experience suggests that government should not interfere in market and cost based pricing decisions. It could come in subsequently to support the vulnerable groups with direct subsidies. (963)