Cutting Food Subsidies: Wrong for the Right Reasons?

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Can one be wrong inspite of right reasons? A case in point is the government's food policy. The BJP's coalition allies have demanded that the budget proposal to decrease food subsidies be withdrawn. At the moment of writing, it is not clear how the situation will resolve. Sadly, however, neither the budget proposal nor its withdrawal addresses the substantive issues of food policy.

India's food policy revolves around the public distribution system (PDS). The PDS sells subsidised grain (and sugar) through the ration shops. The PDS is supplied grain from government stocks and fresh purchases of grain. Storage and procurement are handled by the Food Corporation of India (FCI). Although the issue price (at which the grain is sold in the ration shops) is higher than the procurement price (at which the grain is purchased by FCI), the difference is inadequate to cover the costs of distribution, storage and transport. The difference between the economic cost of the FCI (which covers procurement, storage and distribution) and the sales realization by the PDS is the food subsidy.

The food subsidy bill is ballooning. In the early 1990s, it was Rs. 2500 crores. Today it towers around Rs. 9,000 crores. This is worrying. It seems right to prune it in the interests of fiscal stability. Furthermore, much evidence also suggests that excepting Kerala and perhaps Andhra Pradesh, the poor receive a very small fraction of the subsidy rupee. A majority of the poorest 20% of households in the northern and eastern states do not purchase any grain from the PDS. Even where significant numbers of the poor access the PDS, it is a very small minority that buys its entire requirement of grains from the PDS. The majority of the poor depend entirely or partly on the market to purchase foodgrains.

The food subsidy is large and does not seem to meet the interests of the bulk of India's poor. To contain the food subsidy, the finance minister's budget proposals seek to increase issue prices and to link them explicitly to the economic costs of the FCI. However, the proposals are alive to the need to target food subsidies to the poor. Hence while households below the poverty line will receive grain at 50% of FCI's economic cost, households above the poverty line will receive grain at 90% of FCI's economic cost. Ration quotas to households below the poverty line have also increased.

Critics of the government's move have complained about the attack on the PDS. Controlling the fiscal deficit is fine but why should it be at the expense of the poor? And how will the government go about distinguishing households that are below the poverty line from households that are above the poverty line? Already there are complaints that the system is used to exclude deserving poor households. Yet except for a couple of southern states where the PDS works tolerably well, the criticisms seem off the mark. If the PDS does not serve the poor, how can the reduction of subsidies hurt the poor?

Actually it does. Recent research shows that even the poor who buy little or nothing from the PDS are adversely affected by a reduction in food subsidies. True, the PDS is poorly targeted and is expensive. And these are right reasons for seeking reform of our food subsidy schemes. But increasing the issue price is not the solution. In fact, it is part of the problem.

From the consumption surveys of the National Sample Survey (NSS), it is well known that in most states, the poor depend more on the market rather than the PDS for the purchase of grain. Their economic well being depends more on the market price rather than the issue price. However, research has established that an increase in issue price does not leave the market price unchanged. In fact, the market price rises. So even a badly targeted PDS does not make the poor immune to a reduction in subsidies.

Why does the market price rise? From personal experience and anecdotal accounts, we are aware that grains sold in the ration shops have a reputation for lower quality and poor service. Queues, non-availability of supplies, adulterated grain and use of incorrect weights are some of the common complaints. For this reason, the cost of buying grain from ration shops exceeds their price. These costs are not the same for everybody. For some, however, these costs are high enough that they prefer to buy from the market even when the issue price is lower than the market price. And when the issue price increases, the numbers of such people, who switch demands from the PDS to the market, increases. The higher demand for market grain causes its price to rise. It has been estimated that nearly 6% of PDS offtake switches to the market when the issue price increases by 10%. As a result, it is likely that market prices rise between 30 to 50% of the percentage rise in issue price. Since the budget proposals contemplate issue price increases of the order of 50%, the consequences for market prices are not trivial.

This is not the end of the story. As offtake drops, grain stocks with FCI will increase. The costs of such storage will eat into the gains from higher issue price and the government's subsidy bill will not fall as much as expected. Over the year, higher market prices will lead the government to offer a higher procurement price. As the economic cost of the FCI goes up, the government will feel it necessary to raise the issue price once again.

These findings do not mean that we have to live with a dysfunctional food subsidy system. But for reforms, the government will have to look at options other than just increasing the issue price. The most obvious reform would be to address consumer perceptions of quality. It is not a deliberate policy of the government to procure lower quality grain. In the case of wheat, government purchases take place at market prices, which means that private traders acquire comparable quality grain at the same prices as the government. However, at the point of sale, consumers demand a discount on their purchases from the state marketing network, which represents their costs of transacting with the ration shops. The appearance of quality differences at the ration shops is due to inefficiencies in the marketing chain, such as bad purchase decisions, lack of care in storage and handling, and indifferent service at the ration shops.

A less obvious reform would be for the government to downsize the procurement of grain. If the government were to procure less, it can offer a lower procurement price and the market price would accordingly be lower as well as a result of larger supplies in the market. If the increase in issue prices is co-ordinated with procurement policy, it might not increase food prices. However, if historically achieved levels of procurement accompany the subsidy reduction, food prices will shoot up as a mountain of grain builds with the government.

Some see the opponents of food subsidy reduction as pandering to populist politics. Proponents of fiscally responsible policies must not, however, lose sight of the structural factors of the food policy regime that are responsible for rising food subsidies. Otherwise, an increase in issue price is populist as well – it panders to the financial community avoiding the hard reforms (of FCI and procurement policy). Opponents of food subsidy reduction must also realize that holding up reform of the PDS does disservice to the poor. We must consider alternative institutional arrangements for delivering food cheaply. These could include food stamps and greater involvement of private agencies in the procurement and distribution of subsidised grain.