VIEWPOINT

Cash Subsidies for Food and the Fallacy of Composition

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The shift to cash transfers thus provides us with a near textbook case of the fallacy of composition. But with its consequences being far from trivial the lessons to be learnt cannot be confined to the classroom

THE CASE that has been made out for the direct cash transfer of subsidies is so striking in its simplicity that it appears self-evident. When a subsidy is transferred directly into a bank account there is very little scope for leakage between the transferring authority and the bank account. From there it appears easy to argue that if we have the identification numbers of all individuals in the country and the technology to transfer funds into their accounts we immediately have a leakage-proof system of transferring subsidies. But it has not taken very long for it to become evident that things are not quite so simple. The pilot projects have pointed to the myriad problems in scaling up cash transfers of subsidies to a national level. The problems of implementation have been serious enough for the government to decide to be more cautious in launching the pilot phase of the scheme. The focus on implementation has however ensured that the more serious problems inherent in some forms of cash transfers, especially when they replace the system of providing cheap food grains to the poor, have received much less attention. In particular, little attention has been paid to the fallacy of composition in the case that has been made out for cash subsidies replacing subsidised grains in the PDS: what is true of the individual case is not true for the system as a whole.

In order to understand the fallacy of composition in this argument it is useful to first remove some popular misconceptions about the scheme of direct transfer of benefits. First, there is the view that it will do away with all leakages. But a part of the leakage is due to the non-poor getting the benefits meant for the poor. And the Aadhar number that will be used in the scheme only identifies an individual, it does not tell us whether she belongs to a poor household or not. It is believed that the Business Correspondents that are now to be appointed will help identify the poor and also ensure that the illiterate poor will get the benefit at their doorsteps. But this only falsifies the second popular misconception of the scheme, that it eliminates the middlemen. All that the scheme does is introduce a new set of middlemen under the control of the banks. And it is to be seen whether bank-controlled middlemen are less corrupt than

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the panchayat-controlled ones. The urban policy maker may tend to lean towards the choice of the banks, since she has at least dealt regularly with these institutions. But as the continuing use of non-banking financial institutions in the rural areas, including money lenders, tells us, there is a large part of the country where this faith in banks is not yet as complete. These are also the areas where the local panchayat is not the remote hotbed of corruption that urban policy makers believe it to be. Those more familiar, and comfortable, with the rural panchayats than the urban policy maker, could argue against putting so much faith in banks that have run up Non-Performing Assets of hundreds of thousands of crores. The scaling up of the system of cash transfers from the individual to the society as a whole thus has a variety of issues that could cripple it at the stage of implementation.

Let us however assume, for the sake of argument, that all these problems involved in the implementation of the scheme are overcome. The government is able to accurately identify the poor households and the Business Correspondents do not fall for any temptation to take a slice of the cake when the opportunity presents itself. We can go a step further and also assume that the process is so uncharacteristically efficient that the poorest and the illiterate in the most remote areas all find a way to access their bank accounts without any transaction costs. It is in such a perfectly implemented system that the fallacy of composition will become quite evident.

The first sign that what is true for the individual is not true for the whole will probably emerge in the effect on food subsidies. If and when the cash transfers replace the subsidised food in the Public Distribution System, the shops in this system will provide food grains at non-subsidised prices and the subsidies will be transferred into the bank account of the beneficiaries. As the price at which the grain is available in the PDS does not involve a subsidy there would ideally be no scope for leakage through the sale of subsidised grain at open market prices. Seen as a set of individual cases the absence of leakage should imply that the subsidies will come down. When seen in its macroeconomic totality, though, this need not be the case. The food subsidy is in essence the difference between the costs of procurement of food grains and receipts from the distribution of these grains in the Public Distribution System. The three main variables influencing the subsidy are then the procurement price, the cost of holding and distributing stocks, and the receipts from the sale in the Public Distribution System. When the subsidy is transformed from food to cash the beneficiary is no longer required to purchase the grain from the PDS. As the unsubsidised price in the PDS could well be comparable to the open market price, at least some of the beneficiaries would prefer to use their cash subsidy in the open market. This would lead to a reduction in the off-take from the Public Distribution System thereby leaving the government with greater unsold stocks. In cases where the costs of holding additional stocks is greater than the leakage that has been plugged, the overall subsidy will increase, rather than decrease, due to a shift to cash transfers.

It could be argued that the government could overcome this problem by quite simply reducing procurement. The government could argue that it would instead fall back on a system of only intervening in the open market when prices are too high or too low. But governments in India do not have a reputation for responding quickly enough to changes in market prices. As the experience with sugar tells us the interventions are usually preceded by aggressive lobbying on behalf of the producers and the consumers. And there is no telling how the farmers will react to increased uncertainties in the demand for rice and wheat. Even if the increased risk does not lead them to occasional disasters and suicides, they may well decide they are better off with other crops. Shifting the burden of a move to cash transfers on to farmers would then have serious implications for food security.

The tendency for food prices to move in a wider range would be accentuated by another macroeconomic consequence of the move to cash transfers: its inflationary potential. This potential arises from two sources. First, the shift to food subsidies is likely to have a greater multiplier effect. When the subsidy is given in terms of food grains its effects on income end when it is consumed. But when it is given in the form of cash, the recipient spends that money to buy some commodities, thereby creating income for the person she buys it from. To the extent that that person then spends her income, it becomes additional income for someone else and so on. It could be argued that all the additional rounds of the multiplier would not exist if the beneficiary of the subsidy simply goes back and spends the entire amount on food grains in the PDS so that she simply returns the cash subsidy to the government.

But this would only be a special case. In all other cases there would be an increase in liquidity and hence an inflationary pressure. It is of course true that the government can address this additional liquidity through its monetary policy. But in situations of slow growth monetary policy measures to absorb extra liquidity will hurt growth further.

The second source of inflationary pressure in the shift to cash transfers is hidden under the tendency to see this change as an ethical rather than an economic issue. When seen in purely economic terms any leakage of food grains from the PDS can only be realized if it is sold in the open market. High leakages therefore imply higher supplies in the open market, thereby acting as a dampener on inflation in food prices. This dampener is particularly important as leakages are not constant. Studies that have tried to estimate leakages show a wide variation in the quantum of leakage across both years and crops. This is easily explained as the leakage would depend on open market prices. When the difference between the open market prices and the PDS price is low there is little to be gained by diverting PDS stocks to the open market. But when open market prices are much higher there would be a greater tendency to divert stocks. And these additional supplies would have a dampening effect on the prices in the open market. If leakages are reduced to zero this dampening effect in times of inflation would no longer be available. It could once again be argued that the government could intervene in such situations and use its stocks of food grains to calm inflationary pressures. But if experience is any guide, and for reasons that this paper may not be the best place to go into, the government's ability to use its food stocks to calm market prices is severely constrained.

Managing the effects of any inflation that arises from the shift to cash transfers would strike at the very roots of the subsidy. If the higher prices are not to eat into the effective subsidy for the poor, the cash transfers would have to be indexed for inflation. Such a system of indexation would be less than perfect. As the inflation would have to first exist before the subsidies are raised, there would be a lag between the increase in prices and the compensatory increase in cash transfers. Such a time lag can have great humanitarian consequences for those who are close to hunger. Moreover, indexation is typically based on the average of prices over a large area, if not the country as a whole. In regions where the food inflation is greater than the national average, the increase in transfers due to indexation would not fully compensate for the reduction in the effective subsidy. From the point of view of the government too indexation would build an automatic element of an increase in food subsidy. To the extent that cash transfers contribute to inflation they can contribute to an increase rather than a decrease in the food subsidy bill of the government.

The consequences of this fallacy of composition are accentuated by the tendency to see the problem of leakages in terms of government finances alone. From this state-centric perspective the problem is entirely one of only a fraction of every rupee of the subsidy actually reaching the targeted beneficiary. But from the point of view of the beneficiary that is not the only possible source of leakage. There could also be leakages between the point the cash is received and it being spent on the purpose for which it has been given. For a member of a family close to hunger what matters is whether there is additional food available at home. Any leakage that reduces the availability of food hurts her interests. It is only of secondary interest to her whether the reduction is due to leakage at the PDS or because the cash received for the purpose is spent on something else.

It is tempting to sweep such concerns under the carpet of the freedom of choice. We could argue with all righteousness that it is better that the household has the choice rather than the government. But such a view makes a set of choices of its own. It chooses to ignore conflicts of interests within a family. In the crudest statement of this problem it would be a choice between liquor over food. The problem is however not one of such dramatic extremes alone. It is quite conceivable that a mother in a poor household believes that once her child has overcome basic hunger she should begin to emphasise aspects other than food; she should give her child an English education rather than a nutritious diet. We can decide such decisions are not a matter for the state. But then we should be comfortable with the fact that even as we claim to be one of the fastest growing economies in the world we have rates of malnourishment that place us below some of the world's poorest economies.

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