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CRISIL Insight



Cascading cash, catalysing consumption
DBT will rewrite India's food subsidy script for good

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Cascading cash, catalysing consumption

Direct benefit transfer will rewrite India's food subsidy script for good

Executive Summary

Direct benefit transfer, or DBT, will likely prove to be a game changer in food subsidy. With the National Food Security Act, 2013 targeting expansion of coverage to 67% of the population, DBT could help the government save as much as 20% (or Rs 25,000 crore) in food subsidy expenditure by eliminating costs associated with procuring, distributing and storing foodgrains.

These incidentals are so high that they raise the economic cost under the PDS above the market price of similar quality foodgrains. Direct transfer of the difference between the market price and the subsidised price as cash to the intended beneficiaries thus will result in significant savings for the government. At the same time it will reduce losses due to pilferage and wastage and ensure better targeting of food subsidies.

Today, millions of households eligible for food subsidy do not have access to the public distribution system (PDS). With DBT, they will for the first time receive cash transfers into their Aadhar-linked bank accounts. We estimate that at fiscal 2016 prices, the cash transfers will amount to almost Rs 5,800 per year for a family of five, which will implicitly raise their disposable income. At first glance, Rs 5,800 may seem small, but it is higher than the reported total annual expenditure (food +non-food) of the poorest 5% of the rural households and more than half the annual expenditure of the poorest 10% of urban households.

Given the high marginal propensity to consume at lower income levels, such a significant unconditional cash transfer will undoubtedly raise discretionary spending of the recipient households, providing a consumption boost the economy.

Moreover, households have the choice on how to use the cash – whether to buy food grains or something else and thus maximise their utility. We find that while households in the lowest income bracket, particularly in rural India, will purchase foodgrains, those with slightly higher income levels are likely to spend the additional 'income' on protein-rich food (milk, egg, fish and meat), clothing & footwear, rent & conveyance, medical and education expenses. This will not only result in a consumption boost for the economy, but also go a long way towards raising social welfare through better nutritional intake and higher spending on health and education.

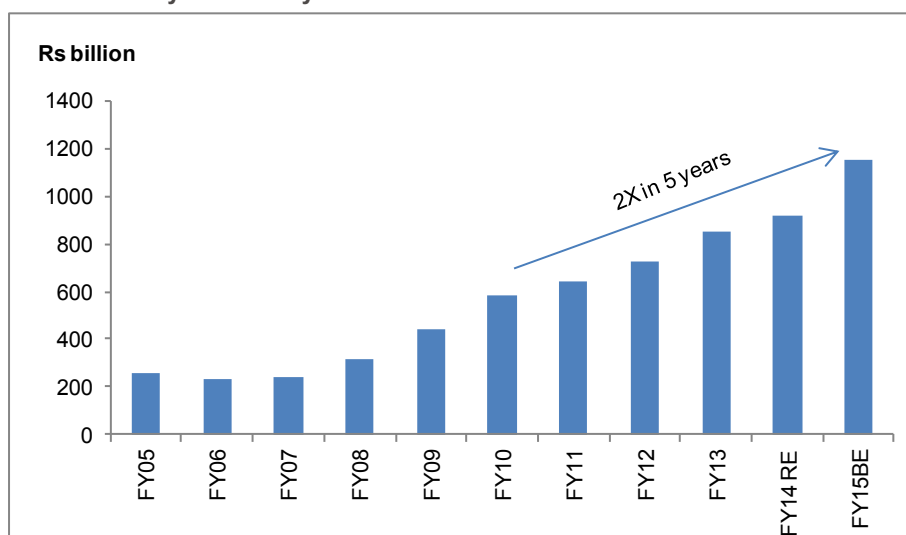
In our view DBT also fits snugly into the concept of Pareto improvement, a development that hurts none and helps at least one person – and many over time – in the economy.

The actual success of the scheme and its consumption impact on the economy will, however, depend on the progress in identifying all those eligible and the speed of its implementation.

Food security target a steep climb

The food subsidy bill, budgeted at Rs 115,000 crore for 2014-15 – up 25% over the last fiscal and 100% in the last five years - is expected to rise further with full implementation of the National Food Security Act (NFSA), 2013.

Food subsidy over the years



Source: Budget documents, CRISIL Research

The NFSA entitles 67% of India’s population (75% rural and 50% urban) to 5 kg per person per month of subsidised foodgrains at Rs 3 per kg for rice, Rs 2 per kg for wheat and Re 1 per kg for millets.

The targeted coverage under the Act is a significant increase from current levels. Today, only 37% of India’s population purchases subsidised rice from the public distribution system (PDS), while 28% buy wheat.

% of population	Rural	urban	All-India
Existing PDS			
Purchase PDS rice	42%	27%	37%
Purchase PDS wheat	30%	24%	28%
NFSA – full implementation			
Foodgrains	75%	50%	67%

Source: NSS 66th round January 2013, NSS 68th round February 2014, RBI, CRISIL Research

Direct cash transfer can ease government’s subsidy burden by Rs 25,000 crore in 2015-16

Extending the NFSA to 67% of India’s population in 2015-16 will entail provision of subsidised foodgrains to 850 million Indians.

Under the existing PDS, the increased coverage will drive up the food subsidy bill further to Rs 122,000 crore in 2015-16, even if one assumes an increase of just 3-4% in foodgrain minimum support prices (MSPs) in 2015, similar to 2014.

This is because:

- While MSPs are expected to increase – at least moderately – each year, subsidised prices of foodgrains are mandated to remain fixed until 2016 under the NFSA, thus increasing the subsidy per kg of foodgrains.
- Moreover, under the PDS, there are additional costs besides MSPs, in the form of procurement incidentals and distribution costs, which add to the government’s food subsidy burden. In the past, as a result of these incidentals, the total economic cost (per quintal) of foodgrains sold through PDS - has been nearly twice the MSP in case of rice and almost 1.5 times the MSP for wheat. (For details, see Annexure).
- The government also has to incur certain fixed costs for carrying/ storing foodgrains required under PDS. Recent trends suggest that the stock of foodgrains has far exceeded buffer and strategic norms - adding to costs and wastages.

In fact, as a result of these incidentals, the economic cost for the government under the PDS is higher than the market price for similar quality foodgrains. Direct transfer of the difference between the market price and the subsidised price as cash to the intended beneficiaries thus appears to be far more efficient option.

PDS subsidy/kg = [MSP+ procurement incidentals + distribution cost] - subsidised price > (market price – subsidised price)

This is exactly what is proposed under the Direct Benefit Transfer (DBT) scheme. Under this, the government will save on the cost of procuring, storing and distributing foodgrains (except for maintaining emergency stocks). Cash equivalent to the difference between the market price and subsidised price will be transferred every month into the Aadhar-linked bank account of the beneficiary who can then purchase foodgrains from the market at the market price.

DBT subsidy/kg = Market price- subsidised price

We estimate DBT to reduce the government’s food subsidy burden by Rs 25,000 crore in 2015-16, or around 20%, assuming full implementation of the NFSA.

The actual reduction in subsidy burden, however, will depend on the progress in identifying eligible households and the speed of implementation of the scheme. We have, therefore, simulated the food subsidy outgo for different penetration levels under the DBT in 2015-16. Incidentally, a January 2015 report by the High Level Committee (HLC) on restructuring the Food Corporation of India has recommended that the entitlement for food subsidies be reduced to 40% of the population from 67% mandated in the NFSA. (For details on estimation, see Annexure).

Food subsidy estimates (Rs crore)

Penetration level	2014-15	
	PDS	DBT
67% (75% Rural, 50% Urban)	1,15,484	89,821
2015-16		
67% (75% Rural, 50% Urban) – Full implementation of NFSA	1,21,908	97,180
50% (60% Rural, 30% Urban)		72,645
40% (50% Rural, 20% Urban)		57,986
Only BPL (25.7% Rural, 13.7% Urban)		31,550

Source: NSS 66th round January 2013, NSS 68th round February 2014, RBI, CRISIL Research

Better targeting, lower pilferage a huge tick for social welfare

The existing PDS is fraught with mistargeting and pilferage. Though all below poverty line (BPL) households are eligible for subsidised foodgrains even under the existing PDS etc, only 51% of the BPL population reports purchase of subsidised rice and only 40% takes subsidised wheat from the PDS. The rest are currently being denied their entitlement for various reasons such as lack of ration cards, pervasive pilferage etc.

In contrast, several households with a relatively high purchasing power report access to subsidised foodgrains in the existing PDS even though they are not eligible for food subsidy as per the NFSA. Of the richest quartile (richest 25%) of rural population, 33% and 22% currently purchase subsidised rice and wheat, respectively. In urban areas, nearly 1 in every 10 of the richest 25% reports purchasing subsidised rice from PDS. Even with the expanded coverage under the NFSA, these households are not entitled to subsidised foodgrains.

% of BPL population reporting consumption from PDS

	Rural	Urban	All-India
Rice	53.5%	40.6%	51%
Wheat	39.6%	41.0%	40%

Source: NSS 66th round January 2013, NSS 68th round February 2014, RBI, CRISIL Research

DBT can correct this anomaly to a large extent. The benefits of the NFSA will be two-fold:

Reduced pilferage: Currently, a large part of the food subsidy does not reach intended beneficiaries because the subsidised grains are either pilfered through ghost accounts or diverted for sale in the open market.

The HLC report suggests that leakages range from 40-50% and in some states to as high as 60-70% in others. Thus, at an all-India level, the pilferage comes to 46.7%. A separate study by Jean Dreze-Reetika Khara puts this number at 41.7%.

Under DBT, there will be no scope for such pilferage. Foodgrains will not be sold at subsidised prices through PDS, leaving no incentive for diversion. The subsidy will reach the intended beneficiaries through a direct cash transfer to their bank accounts.

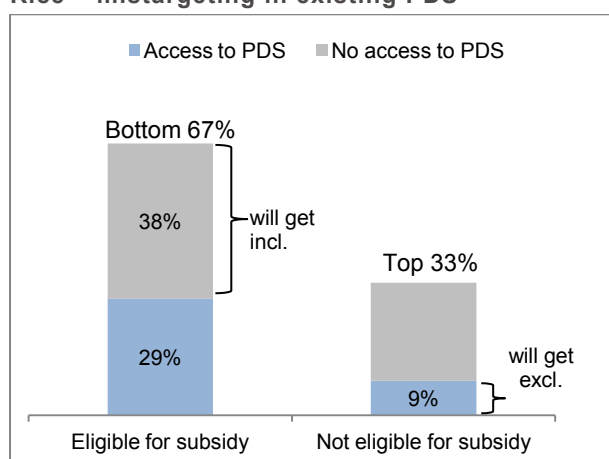
Improved targeting: As the NFSA will be gradually implemented in full scale, the government will have to first identify the 67% of the population eligible for food subsidies. Poor households that are entitled to subsidised food but currently do not have access to it can then, for the first time, receive cash subsidy in their bank accounts for purchase of foodgrains.

A January 2013 NSSO report ('PDS and Other Sources of Household Consumption') updated for latest data on household size and population shows that of the 67% eligible for food subsidy, around 38% do not report purchase of subsidised rice while 45% do not report purchase of subsidised wheat from PDS.

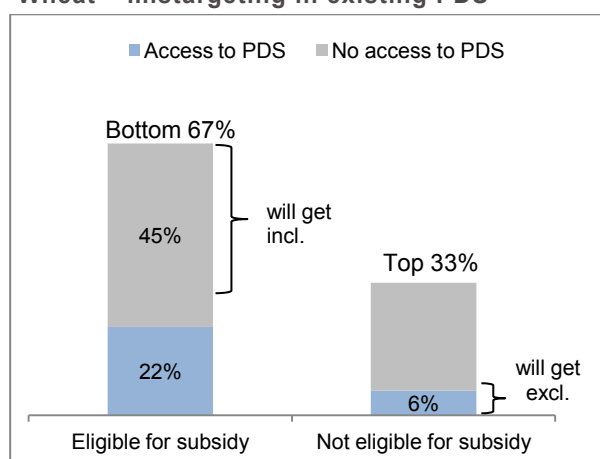
At the same time, there are a large number of relatively wealthy households that are currently purchasing subsidised food from PDS, even though they do not fall within the poorest 75% of rural or poorest 50% of urban population – as required by the NFSA. Of the richest 33% of the population that are actually not eligible for receiving subsidised foodgrains, 9% purchase subsidised rice while 6% purchase subsidised wheat from the existing PDS. With proper identification, such households will stand excluded from the food subsidy net (see chart below).

Even as per the HCL report, so far only 11 states have implemented the NFSA. These are: Haryana, Delhi, Himachal Pradesh, Rajasthan, Punjab, Karnataka, Chhattisgarh, Maharashtra, Chandigarh, Bihar and Madhya Pradesh. For full implementation of the NFSA, the other states must hasten their process of identifying the intended beneficiaries.

Rice – mistargeting in existing PDS



Wheat – mistargeting in existing PDS



Source: NSS 66th round January 2013, NSS 68th round February 2014, RBI, CRISIL Research

Win-win for all – DBT a pareto improvement

With proper identification, more people will be brought into the food subsidy ambit than will get excluded. The intended beneficiaries will receive cash subsidies directly into their bank accounts leaving no scope for loss of their entitlement owing to pilferage. Improved targeting and wider coverage will raise social welfare.

At the same time, despite the wider coverage, under DBT the government will save as much as Rs 25,000 crore or 20% on its food subsidy bill as it will no longer incur the costs of procuring and distributing the foodgrains which raise the economic cost for the government above the market price. The DBT is therefore a win-win for all. Under the PDS, the government incurs these additional costs while there is no additional gain for the beneficiary.

If the cash comes, can consumption be far behind?

With DBT, households that are eligible for food subsidy but currently do not have access to PDS, will be able to purchase subsidised foodgrains using the cash transferred directly into their bank accounts. As a result, they will now have to shell out only the subsidised price for foodgrains instead of the full market price as before. The additional cash – estimated at Rs 5,800 for 2015-16 for a family of five - would thus raise the disposable income of such households.

However, as the subsidy per kg of rice and wheat is different, the eventual subsidy will depend on (1) market prices of rice and wheat in 2015-16 (subsidised prices are fixed till 2016 as per the NFSA) and (2) the ratio in which the entitled 5kg is split into rice and wheat. Given the higher market price for rice, the subsidy per kg (market price – subsidised price) is currently higher for rice than for wheat.

Market price and subsidised price of foodgrains

	Market price (Rs per kg)		Subsidised price as per NFSA (Rs per kg)
	2014-15	2015-16F	Until 2016
Rice	23-24	25-26	3
Wheat	15-16	15.5-16	2

Note: Market price for 2014-15 is based on mandi price of similar quality foodgrains as distributed through PDS. Market price for 2015-16 is forecast (F) assuming the same WPI inflation rate for rice and wheat as 2014-15.

Source: agmarknet , CRISIL Research

Given that cash transfer under the DBT will be unconditional (similar to the LPG subsidy) and will be done ex-ante (prior to purchase), the government will have to assume a certain split of rice and wheat in calculating the subsidy that must be transferred.

Our estimate of Rs 5,800 for 2015-16 has been made using the existing ratio in which households split their foodgrains consumption between rice and wheat at an all-India level. This is 1.44 times for a rural household

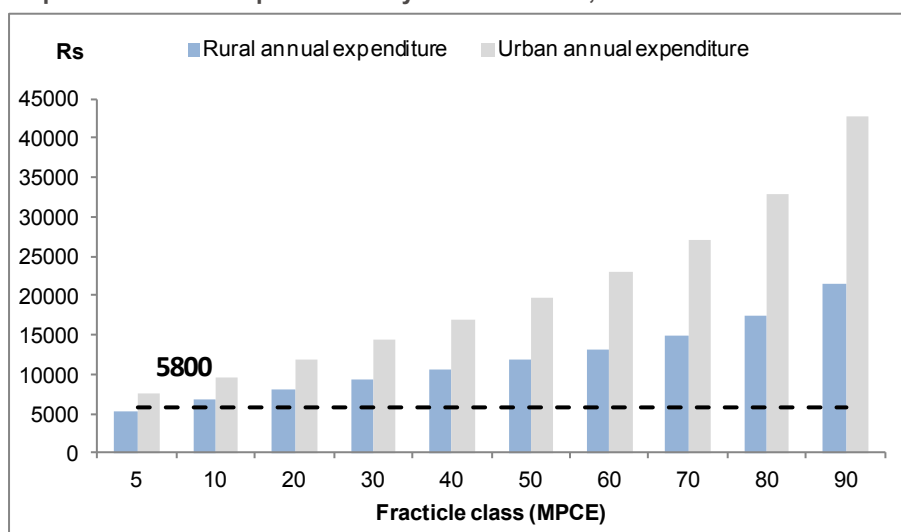
and 1.10 times for an urban household. For projecting market prices of rice and wheat in 2015-16, we have assumed a similar inflation rate (WPI inflation for rice and wheat) as in the current fiscal. *For more details on assumptions see annexure.*

Cash subsidy = $(w/5 \text{ kg}) \times (\text{Wholesale price rice} - \text{Rs } 3/\text{kg}) + [(5 \text{ kg}-w)/5 \text{ kg}] \times (\text{wholesale price wheat} - \text{Rs } 2/\text{kg})$

Where w = ratio of rice and wheat consumption observed in the NSSO data for the poorest 67% of India's population that is eligible for food subsidies under the NFSA, 2013.

At first glance, Rs 5,800 may seem small but it is higher than the reported total annual expenditure (food + non-food) of the poorest 5% of the rural households. For the poorest 10% of urban households, Rs 5,800 is more than half of their total annual expenditure.

Reported annual expenditure by fractile class, 2011-12



Note: Fractile class is as per the NSS report. The last two classes (95 and 100) have not been shown here.

Source: NSS 68th round February 2014, RBI, CRISIL Research

To put this in perspective, the reported medical expenditure for a family of 5 in the poorest 10% of the population in 2011-12 was Rs 1,338 in rural India and Rs 1,750 in urban India. For the poorest 10% of households, Rs 5,800 is twice the reported annual expenditure on protein-rich food (milk, egg, fish and meat) and three times that on household consumables. For a poor urban household, it is equal to 1.5 times the expenditure on household consumables and conveyance for a year.

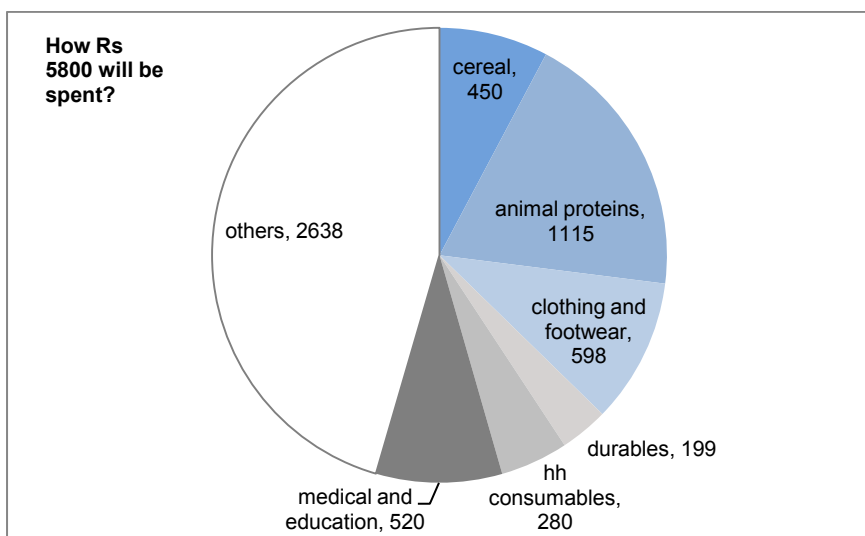
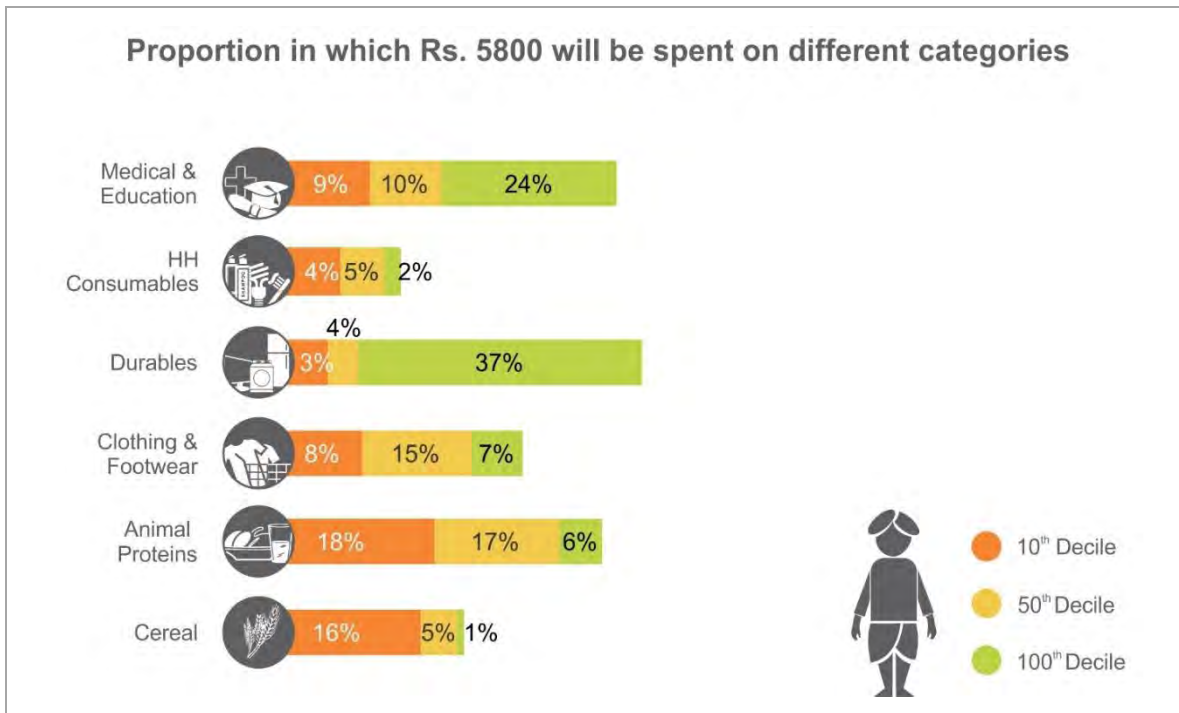
Given the high marginal propensity to consume at lower income levels, such an unconditional cash transfer will undoubtedly raise the discretionary spending of these households, providing a consumption boost to the economy. As beneficiaries will have a choice in spending this money, they may partially substitute their consumption of wheat, rice with protein-rich food due to its higher nutritional content, or use the cash to spend on discretionary items such as household consumables, leading to an increase in demand for the latter.



What items could see higher demand due to the unconditional cash transfer?

An analysis of incremental expenditure across different categories as a household moves up the income bracket throws some light on where this additional money is likely to be spent. As income data is not available, data on total household expenditure is used as an indicator for household income.

Share of Incremental expenditure as RURAL households move up the income bracket



Note: The split of Rs 5800 is based on data upto the 70th decile, for capturing the consumption pattern of only those rural households that will be eligible for food subsidies.

Source: NSS 68th round February 2014, RBI, CRISIL Research

We find that, only the poorest rural households spend a significant proportion of their incremental income on cereals – as much as Rs 16 of every Rs 100 increase in income - as they move up from the 5th decile

(poorest 5% of population by consumption expenditure) to the 10th decile. However, at income levels above this threshold, households allocate less than 10% of their incremental earnings on purchasing more cereals and instead spend more of the incremental income on other items such as protein-rich food, clothing & footwear, medical and education expenses.

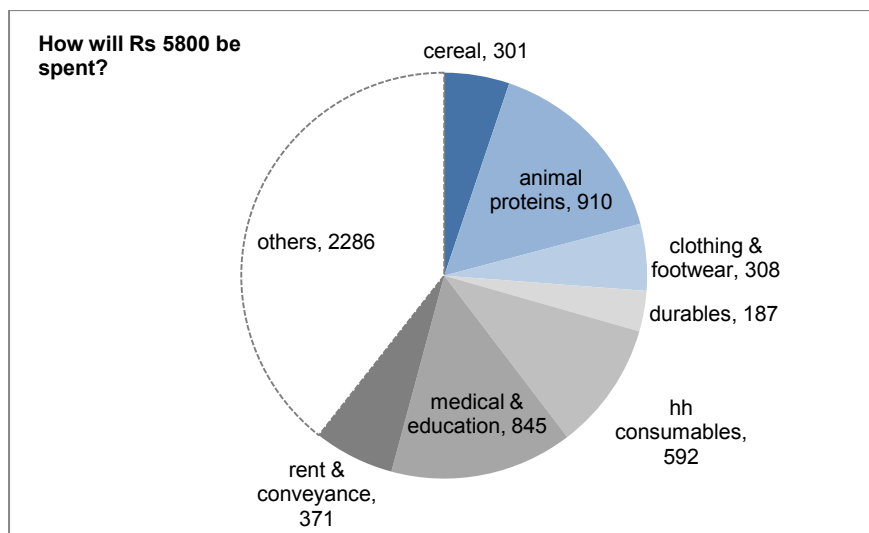
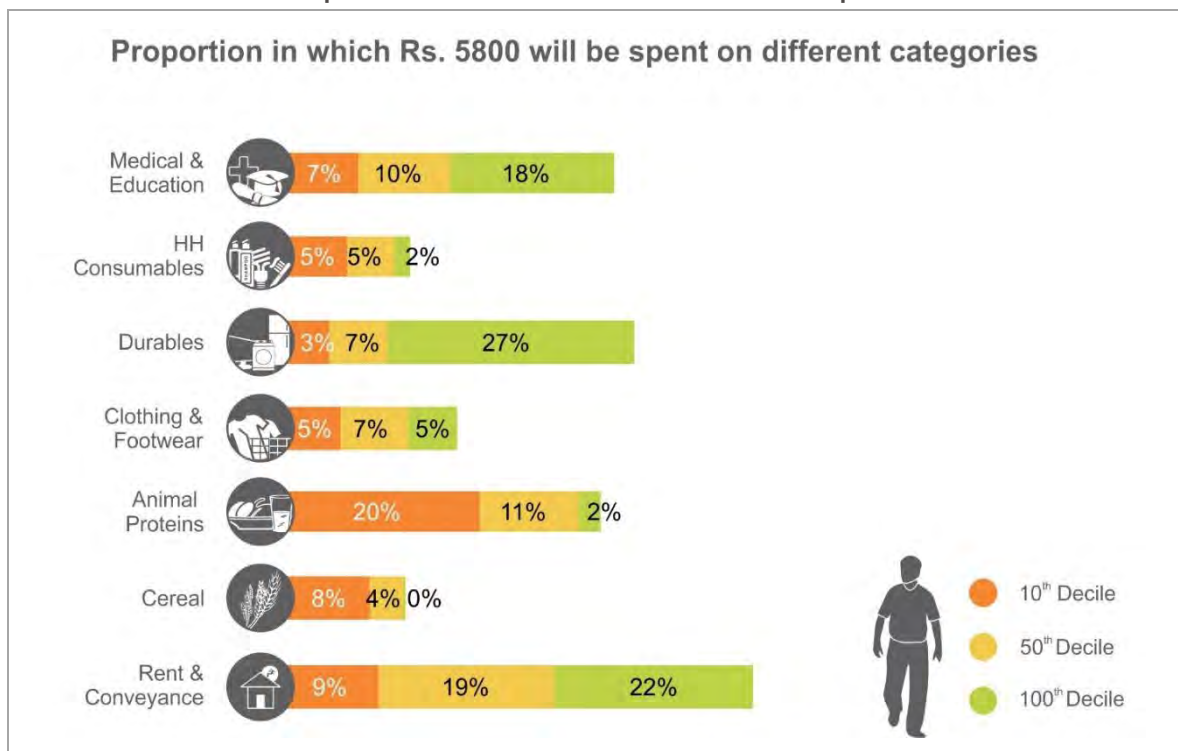
We also find that across all income brackets (except the richest decile), animal proteins such as milk, egg, fish and meat as a category see a sharp increase in spending as household income rises. Around 18% of total incremental income goes into animal proteins, mostly milk, as household income rises for the poorest of the rural households. For the richest household, this ratio is only 6%. The other categories where the incremental income gets spent by lowest and middle income households are medical & education and clothing & footwear. The richest rural households, on the other hand, spend the most on durables – Rs. 37 of additional Rs. 100 income gets spent on this. Using these trends of changes in household consumption expenditure, we estimate that of Rs 5,800, rural households eligible for food subsidies are likely to spend only Rs 450 on purchasing foodgrains; the rest will be spent on other items – Rs 1,115 on animal protein food, Rs 598 on clothing and footwear, Rs 520 on medical and education related expenses, to mention a few.

A similar analysis for **urban** households shows that even households in the lowest income bracket (5th decile by consumption expenditure) prefer to increase spending on animal proteins rather than cereals as income rises. For every Rs 100 increase in income, the poorest urban households hike their spending on animal proteins by Rs 20, but on cereals by only Rs 8. At middle income levels, households raise their incremental expenditure on rent & conveyance – Rs 19 for every Rs 100 increase in income - and medical and education expenses – Rs 10 for every Rs 100 increase in income.

Using these trends of changes in household consumption expenditure, we estimate that of the Rs 5,800, urban households eligible for food subsidies are likely to spend only Rs 300 on purchasing foodgrains. They will spend the rest on other items – Rs 910 on animal proteins, Rs 592 on household consumables, Rs 845 on medical and education related expenses and Rs 371 on rent and conveyance, to mention a few.

Overall, our findings suggest that in the lowest income bracket, particularly in rural India, households will use the subsidy transferred to purchase foodgrains, but at slightly higher income levels, a large proportion of the cash is likely to spent on other categories such as animal proteins, medical and education, household consumables, clothing and rent and conveyance. This will not only result in a consumption boost for the economy, but also go a long way towards raising social welfare through better nutritional intake and higher spending on health and education. DBT will not only help bring millions of poor households that currently do not have access to PDS into the food subsidy net, but also allow them to maximise their utility by giving them a choice on using this cash for purchasing foodgrains or any other item. At the same time, it will help reduce the government's subsidy burden.

Share of incremental expenditure as URBAN households move up the income bracket



Note: The split of Rs 5,800 is based on data upto the 50th decile, for capturing the consumption pattern of only those urban households that will be eligible for food subsidies.

Source: NSS 68th round February 2014, RBI, CRISIL Research

One trend that warrants caution is the sharp increase in spending on animal proteins for both low-income rural and urban households as their income rises. As the NFSA is gradually expanded to cover the 67% eligible population using DBT, there is likely to be a significant increase in demand for animal proteins, building up inflationary pressures in this category, unless matched with a commensurate increase in supply. Inflation in animal proteins has remained consistently around 10% in the last 8 years (FY08-FY14). Even with the recent sharp disinflation in the economy, animal proteins inflation continues to persist over 8% - much above the inflation in other food categories.

Implementation challenges

Identification of eligible households: Direct cash transfer can improve targeting of food subsidies, only if all eligible households are correctly identified. However, while the NFSA entitles 67% of India's households to food subsidy, it does not throw much light on how these households will be identified. The government has already begun direct cash transfer for LPG subsidies from January 1, 2015. In the case of food subsidies, however, the challenge will be much higher as a large section of the eligible households are currently out of the food subsidy net in the existing PDS. The government will have to work with state governments to identify such households.

Financial inclusion: Successful implementation of DBT requires that (1) every beneficiary is enrolled in Aadhar and (2) has a bank account that is linked to his/her Aadhar identification number. As of December 2014, Aadhar enrolment was at 730 million, or 60% of India's population. Aadhar enrolment will have to be accelerated so that beneficiaries are not denied their entitlement under the DBT scheme. Moreover, it is critical that all beneficiaries have access to banks/ATMs, or the business correspondent model is scaled up sufficiently so that beneficiaries, even in remote villages, can receive the transferred cash.

Subsidy transfer must be indexed to market prices: As market prices change constantly, the amount of subsidy will have to be indexed to inflation and regularly updated to ensure that the beneficiaries are not impacted when prices rise.

Annexure: Subsidy calculation

- Population estimates until FY14 are from RBI. For 2014-15 and 2015-16, we have assumed the population to grow at the average rate of the previous 3 years (FY12-FY14)

DBT subsidy/kg = market price – subsidised price under NFSA

- Subsidised prices are Rs 3/kg for rice; Rs 2/kg for wheat
- For market prices of PDS quality of foodgrains, we have used the mandi prices of less superior varieties of rice and wheat (from agmarknet). Alternatively, NSSO data on expenditure and quantity of foodgrains consumed from non-PDS sources by the poorest 30% of households gives similar estimates of market prices. (price= expenditure/ quantity consumed)
- For 2015-16, market prices of 2014-15 for rice and wheat have been assumed to grow at the same (WPI) inflation rate as observed in these foodgrains in 2014-15 (April-November).
- The cash subsidy – difference between the market price and subsidised price - is different for rice and wheat. For our estimates, we have assumed that the cash transferred to each beneficiaries bank account each month will be based on the existing ratio of rice and wheat consumption for eligible households
- No procuring, carrying/ storing or distribution costs under the DBT as beneficiaries will buy directly from the market.

Cash subsidy=(w/5)*(Wholesale price rice-3)+ [(5-w)/5]* (Wholesale price wheat-2);

Where w= average ratio of rice and wheat consumption observed in the NSSO data for bottom 75% rural households and bottom 50% of urban households (~eligible population under the NFSA)

PDS subsidy/kg= [MSP+ procurement incidentals + distribution cost]- subsidised price

- For 2015-16, we have assumed that MSP hikes will remain capped at 3-4%, similar to this year.
- The % increase in cost over the MSP, on account of procurement and distribution has been assumed to be similar to the last 5 year average. Storage costs have been assumed to rise at inflation rate.
- Carrying/ storage costs are treated as fixed costs. Average carrying cost for FY12 and FY13 has been assumed to rise as headline CPI inflation rate, to estimate the carrying cost for 2015-16.

Rs./quintal	MSP		Procurement Incidentals		Distribution Costs		Economic Cost		Additional cost over MSP	
	Wheat	Paddy	Wheat	Rice	Wheat	Rice	Wheat	Rice	wheat	rice
2008-09	1000	900	179.6	226.9	245.4	280.8	1380.6	1740.7	38.1%	93.4%
2009-10	1080	1000	206.9	288.6	200.4	184.9	1424.6	1820.1	31.9%	82.0%
2010-11	1100	1000	212.4	313.1	217.7	223.5	1494.3	1983.1	35.8%	98.3%
2011-12 (RE)	1170	1080	271.8	366.9	252.5	291.3	1651.9	2184.2	41.2%	102.2%
2012-13 (BE)	1285	1250	305.2	383.3	296.3	397.1	1822.2	2418.7	41.8%	93.5%

Annexure: Mistargeting

Our estimates for mistargeting are based on a January 2013 NSSO report ('PDS and Other Sources of Household Consumption') updated for latest data on household size and population. BPL definition used in our analysis is as per the planning commission report July 2013, using the Tendulkar methodology. According to this report, 25.7% of India's rural population and 13.7% of India's urban population (21.9%: All India) were below poverty line in 2011-12.

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