

# Why India's subsidies are inflationary

Instead of rationalising the harmful ones, policymakers compensate with more subsidies, each with its own unintended consequences



RAJIV SHASTRI

On January 1, 2014, Malaysia initiated measures to dismantle legacy non-merit subsidies because they are no longer sustainable. These energy and food subsidies, put in place a few decades ago, are being cut to reduce the country's public debt, which is around 53 per cent of gross domestic product (GDP). Prime Minister Najib Razak said the country's "commitment to development expenditure has grown and we have to manage our fiscal position to ensure the stability of our economy".

Now consider India. Despite having a few legacy subsidies ourselves, we have introduced new non-merit subsidies in the past few years. Our subsidy burden, at more than six per cent of GDP in FY13, is now the highest in recorded history. Our public debt is over 66 per cent of GDP, and our commitment to development expenses has only reduced to accommodate this additional burden. Is it any wonder that the outlook for the economy has only worsened steadily?

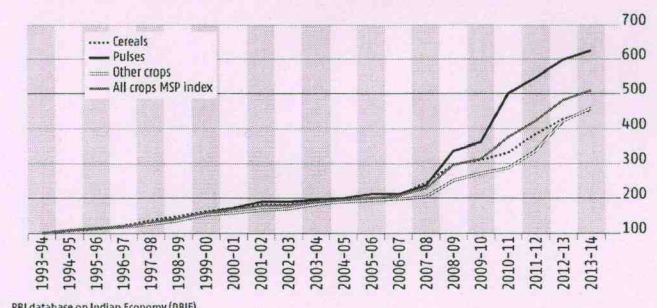
In dealing with existing subsidies, let's take government intervention in agricultural products as an example. For many years now, the government specifies Minimum Support Prices (MSPs) for 26 crops including cereals, pulses and others such as sugarcane, cotton, sunflower seeds and so on to support farmers. *Chart 1* displays the trajectory of the MSPs for various crop groups.

It is immediately apparent that something changed dramatically in the past few years. While it took about 14 years for the indices to move from 100 to 200, MSPs have more than doubled in the last seven years alone. For pulses, MSPs have more than tripled in this time.

The procurement of foodgrain by the government almost doubled as well (*chart 2*). In effect, we are now buying close to double the quantity at roughly 2.5 times the price compared to seven years ago.

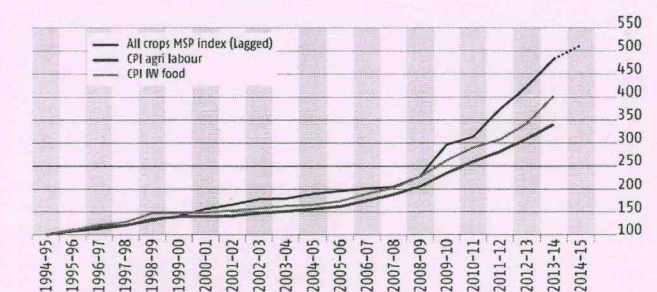
All market intervention has consequences, some intended and some unin-

CHART 1: MINIMUM SUPPORT PRICE INDICES (1993/94 = 100)



RBI database on Indian Economy (DBIE)

CHART 3: LAGGED IMPACT ON INFLATION



RBI database on Indian Economy (DBIE)

tended. This particular intervention has a lagged impact on inflation, especially since the food group occupies a large part of our low-income consumption basket. *Chart 3* plots two consumer price indices against the MSP index for all crops with a one-year lag.

Clearly, increasing MSPs lead to higher rural costs and food prices. It is, however, only farmers large enough to sell a substantial portion of their produce, who benefit. The rural poor, who really deserve support, are only hurt as costs rise.

When subsidies harm intended beneficiaries, it's apparent that they are either badly thought out or badly implemented. A normal reaction to such evidence would be to rethink the subsidy itself and rationalise it. Instead, we compensated for the unintended consequences by introducing more subsidies, each with its own unintended consequences.

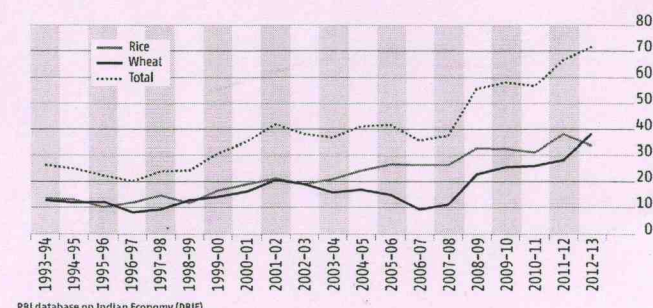
The livelihood subsidy under the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), which guarantees income but not work, imparted a one-time inflationary shock to rural and urban wages.

Moreover, the MGNREGA's inflation-indexed wages initiated a vicious cycle with higher inflation raising wages and higher wages raising inflation further. Our new food subsidy system simply allows the government to buy foodgrain at ever-increasing prices, and give it away at to two-thirds of our population at prices that don't even cover distribution costs.

As things stand, our crop mix responds to MSPs rather than demand, and demand responds to the manner in which food is distributed rather than need. In this scenario, achieving efficiency is virtually impossible. MGNREGA distorts the labour market by creating labour demand where none exists, driving up costs for an already struggling manufacturing sector and making it uncompetitive.

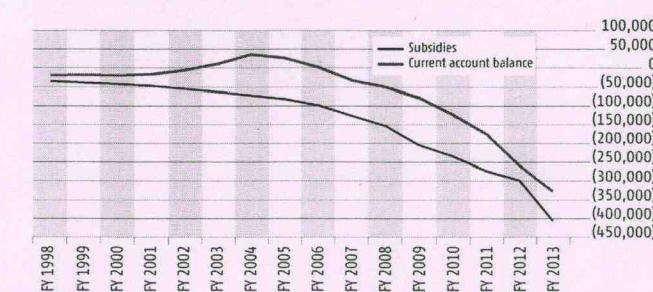
As is apparent, subsidies distort markets many times the size of the subsidy itself. For example, a ₹14 to 15 per litre subsidy on diesel distorts market

CHART 2: FOODGRAIN PROCUREMENT (MN TONNES)



RBI database on Indian Economy (DBIE)

CHART 4: SUBSIDIES AND CURRENT ACCOUNT BALANCE (₹ CR)



RBI and Mospi. Figures in () are in negative

All calculations by Pramerica Asset Managers

**We increase subsidies at a time when our peers have the good sense to reduce them. We pay for these subsidies through borrowings because government revenues are just not enough**

economy become "uneconomic", the consequences acquire omnipresence. Changes in our current account balance offer a glimpse. *Chart 4* plots a three-year moving average of subsidies (inverted) and the current account balance.

As one market after another is distorted and large sections of the economy rendered uncompetitive, domestic income falls short of consumption and investment demand. Looking at *chart 4*, one can almost visualise higher subsidies and an increasingly uncompetitive economy dragging the current account balance down as we import more goods and capital to meet our needs.

To believe this is acceptable because we seem to have insulated the poor from

dynamics for the entire litre of diesel, an impact roughly five times the size of the subsidy. With a subsidy burden of more than six per cent of GDP, the portion of GDP rendered similarly uncompetitive can only be dreaded.

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it is to live in denial. An uncompetitive economy doesn't benefit anybody, least of all the poor. The resulting lack of opportunity condemns them to a life of marginal subsistence provided by subsidies.

As a nation, we seem to have got it wrong. We increase subsidies at a time when our peers have the good sense to reduce them. We pay for these subsidies through borrowings because government revenues are just not enough to fund these extravaganzas. And with the inflationary impact of subsidies already imposing an informal tax of nearly the same magnitude as our official central taxes, our ability to raise additional taxes is virtually non-existent.

Pleading helplessness and portraying ourselves as a victim of international developments cuts ice only after we have done everything to help ourselves. From the evidence, it is clear that there is a lot we need to do, and undo. It's time we get down to it.

The writer is Director & Business Head Portfolio Management Services & Product, Pramerica Asset Managers. These views are personal