Budget 2018's pivot to agriculture: What will it cost?

Union Budget 2018 has received much attention for its pivot to agriculture and rural development. With parliamentary elections approaching next year and continuing reports of rural distress, the attention to the rural sector was expected.

The proposal that has received the most attention is the promise that minimum support prices (MSP) will be fixed so that they are 50% higher than the unit cost of production. Over the past couple of years, the National Democratic Alliance government has warmed up to the idea of increasing MSP for rice and wheat. Last year, it extended the procurement model to pulses. The stupendous response caught the government off-guard and the government was unable to guarantee MSP for all purchases even after purchasing about 1.5 million tons in 2017. Much of that stock remains with the government and hangs over the market, depressing prices.

The pulse fiasco is emblematic of the procurement model. Unless the government steps in with a commitment to buy whatever is offered to it, there is no assurance that prices can be supported. Open-ended procurement needs elastic fiscal resources, and the presence of purchase agents and associated infrastructure. Even in foodgrains, where the commitment is firm, the model has worked well only in some parts of the country.

Saner voices in successive governments (including this one) have seen the procurement and storage model as a political trap with costs that extend to wasteful subsidies, food inflation, distortions to cropping patterns and unsustainable groundwater extraction. It is these practical considerations that have led governments to not implement support prices (except for rice and wheat) despite announcing them for 26 kharif and rabi crops. So how can the circle be squared?

MSPs will be fixed with reference to A2+FL cost (which is paid-out costs plus the imputed value of family labour) rather than the C2 costs (which also includes the imputed value of interest on value of land and machines). Since support prices already satisfy the 50% mark-up over A2+FL, this gets the government out of the jam.

However, this is not so. Even if based on A2+FL, the MSPs have to be implemented. As the pulse procurement experience shows, this is sure to be demanding—logistically as well as financially. This is acknowledged indirectly in the budget speech when the finance minister said "….Government should purchase either at MSP or work in a manner to provide MSP for the farmers through some other mechanism." What could that other mechanism be?

The only alternative that is at work is the Bhavantar initiative of the Madhya Pradesh government where the government compensates farmers for the difference between the MSP and market price. The principal merit of deficiency payments is that the government does not need to procure any more and can therefore be scaled easily without the inefficiencies of physical handling. Price deficiency payment schemes have long been a mainstay of farm support in rich countries. These countries switched to deficiency payments after their procurement-based price supports accumulated massive stocks. Their experience in this regard was no different from that of rice and wheat supports in India.

The initial run of the Bhavantar scheme threw up some challenges in terms of coverage of eligible farmers and more seriously in terms of suspected collusion among traders that suppressed market prices. These problems apart, the history of price deficiency supports in the developed countries offers some lessons.

Farmers typically respond to price supports by allocating more land and resources to the

supported crops. Market prices drop and the subsidy payout quickly becomes much larger than anticipated. To curtail prices, countries resort to production controls or/and import curbs. For oilseeds and pulses that are not internationally competitive, these curbs will increase prices domestically.

It is relevant to recall that WTO negotiations are at this moment stalled because India's subsidies to rice and wheat have breached the allowable limits. The current budget proposal will make this problem acute and it is hard to see how other nations can agree to a 'peace' clause that allows India to offer subsidies to such a broad range of commodities.

A deficiency payments form of price support improves on procurement but is expensive and wasteful as well. It is also a political trap as evident from the experience of rich countries. Yet, the pressures for redistribution are strong. Rural incomes are far behind average urban incomes.

Rather than deficiency payments, the government ought to boldly consider direct transfers. Administratively, it will call for the same information as deficiency payments. The economic distortions will be far less—in particular, governments have no incentive to curb supplies.

While it is an economist's dream, direct transfers will not come cheap. India's gross cropped area is about 190 million hectares. If Rs10,000 is offered per hectare to all farmers, the subsidy will cost close to Rs2 trillion. These are upfront costs.

Price supports, whether based on procurement or deficiency payments will have lower upfront costs but complex dynamic effects on markets, politics and rest of the economy. It would be a mistake to assume that deficiency payments (unlike procurement driven supports) are inherently sustainable. If anything, the available evidence from the rich countries suggests otherwise. If the government is not to sleepwalk into a disaster, it should seriously consider direct transfers as the way forward.

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