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National Institute of Advanced Studies

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A Note on the Inflationary Potential of Cash Transfers

The Government of India has initiated a series of moves to replace the current system of subsidies embodied in the price of essential commodities sold in the Public Distribution System with one of cash transfers to the poor. The Finance Minister announced the step in this direction in his Budget Speech in February 2011 and pilot projects are being launched in selected districts. The case for this fundamental transformation is built around the widespread belief that corruption has eroded the Public Distribution System (PDS). It is argued that a major portion of current subsidies is wasted as the subsidized commodities don't reach the poor. It would then be more efficient if, instead of subsidizing the commodity, money was directly transferred to the bank accounts of the poor. The simplicity of this argument makes its conclusion appear obvious. But this very simplicity hides a number of assumptions. Once these assumptions are made explicit it is clear that they are not quite realistic. And when they are dropped, it is no longer certain that the cash transfers will be better than the present system. On the contrary, once the assumptions are dropped it becomes evident that such a change in the way subsidies are distributed brings with it major risks of inflation as well as a worsening in the already serious problem of malnutrition.

In order to remove the veil over the assumptions in the cash transfer argument

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this note states the problem in formal terms. Each step in this formulation is first stated verbally and then repeated in the form of elementary algebra. Those with an aversion to algebra at any level can follow the argument by simply ignoring the equations. The note goes on to analyze the macroeconomic consequences of dropping the hidden assumptions. And finally, it returns to the realm of the household to list the impact of cash transfers on different types of households. In the process it highlights the possibility of the severely disadvantaged households, who cannot afford the transaction costs of getting a Below Poverty Line ration card, being more vulnerable to the risks of cash transfers, leaving them worse off than the current situation with all its leakages.

Towards a Formal Statement

In the system that exists before the move to cash transfers a household that is entitled to subsidies receives them in the form of lower prices for the subsidized commodities. Going along with the common perception that there is large scale corruption in the Public Distribution System, that household will buy what it can get from the public distribution system and will be forced to go to the open market for the rest of its needs of that commodity. The average cost the household bears for a unit of the commodity is then the weighted average of the open market price and the PDS price of that commodity, with the weight being the proportion of the commodity that the household buys from the two markets.

Formally, let

p = market price per unit of the commodity.

c_e = average cost per unit of the commodity to the consuming household in a system where the subsidies are embodied in the price of the commodity.

s = subsidy per unit of the commodity.

l_e = the proportion of that household's consumption of the commodity that it has to buy in the open market.

Then

$c_e = (1 - l_e)(p - s) + l_e p$

$c_e = p - s - l_e p + l_e s + l_e p$

$c_e = p - s + l_e s$

We can now move from a system where the subsidy is embodied in a commodity to one where the household buys its entire requirement of the commodity from the open market and the subsidy is given as a cash transfer to its bank account. The popular statement of this argument is that the leakages now disappear so that the household gets the entire subsidy in the form of cash and is hence better off to the extent of the earlier leakages. This argument has three rather critical assumptions.

The first, and most obvious, assumption is that leakages are impossible when cash is directly transferred to the accounts of those entitled to subsidies. It is, arguably, true that the scope for leakage between the government's account and the bank account of those entitled to the subsidy is limited as the transaction occurs within the banking system. But it is quite possible that in the list of those entitled to the subsidy there are many who are not. This would be a leakage in the subsidy. And that is the more benign case. The more malignant example is that of household names being used to create separate entitlements and corresponding bank accounts without their knowledge. The subsidy can then be diverted into these alternative bank accounts. And this is not some fanciful example. In the case of the Mahatma Gandhi National Rural Employment Guarantee Scheme each household with members seeking to do unskilled labour is entitled to one job card. In reality, in a state like Karnataka there are a number of households who have a job card but on whose names there are also other job cards with other bank account numbers. This makes it possible to list fictional works carried out by fictional workers who are paid into these alternative bank accounts. The official estimate of job cards with a different number but the same name of the head of household in the state is over 25 lakhs.[1] Any assumption of there being no leakages in a system of cash transfers simply because the money is put directly into a bank account is clearly much too facile and underestimates the creativity that has been noticed in corruption in India. It would be more realistic to acknowledge that a certain proportion of the subsidy due to a household may not reach the bank account of that household.

The second assumption relates to the proportion of the cash transfer that will be spent on the commodity that was originally subsidized. A shift from a subsidy embodied in the price of a commodity to a cash transfer is, strictly speaking, a shift from a subsidy for a commodity consumed by the poor to a subsidy to poor households as a whole. The cash transfers then need not go back into buying the commodity that was originally subsidized. In the simple formulation of the cash transfer being no more than a corruption-free replacement of subsidies on the price of a commodity it is assumed that the cash transfers would be entirely spent on the commodity that was originally subsidized. It could, of course, be argued that even if this does not happen it is a positive development as it shifts the decision on what is to be subsidized from the government to the household. And if we

[1] Pani, Narendar and Chidambaran G Iyer (2011) *Evaluation of the Impact of Processes in the Mahatma Gandhi National Rural Employment Guarantee Scheme in Karnataka.* Bangalore, National Institute of Advanced Studies, p 37.

see development as freedom, giving households the freedom to use their subsidies as they please is an advance. This difference is particularly significant as there is now growing evidence that the demand patterns of the poor do not necessarily follow norms economists or governments would like.[2] While this argument can be appealing, especially in the abstract, in reality there are two further, and somewhat less convincing, assumptions being made. First, it is assumed that the freedom of the person who receives the cash subsidy into his or her bank account is completely consistent with the freedom of individuals within that household. This ignores all scope for differences within the household. These differences are known to be quite significant, especially on issues related to gender. And the shift from a subsidy embodied in the price of a commodity to a cash subsidy can have a distinct gender dimension. When a subsidy on kerosene is replaced by a cash transfer that is spent on, say, a shirt for the male head of the household, the subsidy moves away from the kitchen. Even if the woman thinks that is not the right choice, gender relations within the household may not allow her sentiment to be taken into account. Second, it is also assumed that the shift from commodity specific subsidies to a cash transfer, that can be spent on any commodity, does not in any way weaken the case for the subsidy itself. That is to say, a moral case that can be made for a subsidy on basic food for the poor is just as valid for a subsidy on a packet of cigarettes consumed by the poor. It is then not inconceivable that the shift to cash transfers will lead to situations where the effective subsidy for food goes down while increasing the effective subsidy for other items including those like cigarettes. It is then important that we take into account the proportion of the cash transfer, that replaces a commodity specific subsidy, that is not spent on that commodity.

The third, and arguably the most significant, assumption relates to the inflationary pressure generated by cash transfers. It is assumed that the open market price of the commodity will not be affected by the shift from commodity specific subsidies to cash transfers. Thus the cost of the commodity to the poor household will be the same, since the difference between the earlier subsidized price and the market price will be met through the cash transfer. This assumption completely ignores what economists call the multiplier effect. Put simply, when a certain amount is spent to, say, buy a commodity it becomes income to the seller of that commodity. A part of this income may be saved and the rest spent on other goods and services. This becomes income to the seller of those other goods and services, and so on. The overall increase

[2] See for instance, Duflo, Esther (2007) "Poor but Rational?" in Abhijit Vinayak Banerji, Roland Bénabou and Diliip Mukherjee (eds), *Understanding Poverty*, Oxford University Press, New Delhi.

in income then is a multiple of the original expenditure.

In the current system the subsidy is embodied in the price of the subsidized commodity. That is to say, it is the difference between the market price and the subsidized price at which it is given to the consumer. One part of this subsidy will be spent on distribution with the consequent multiplier effects. The effects of the other part of the subsidy however exist only in the transaction where the government procures the commodity at a higher price and sells it at a lower price. Once the commodity is consumed the effect of this part of the subsidy ceases.

In the case of cash transfers, however, the effects of no part of the subsidy end with the consumption of the commodity. The entire cash subsidy that is used to buy the commodity is income for the seller of that commodity. When she saves a part of that income and spends the rest, what is spent becomes income for those who receive it, and so on. The overall impact on income would then be the subsidy times the multiplier. Thus while in the current system the multiplier effect is confined to that part of the subsidy that is spent on distribution, in the case of cash transfers the entire subsidy is subject to the multiplier effect. It is possible that this entire increase in demand can be absorbed by additional supply so that there is no effect on prices. It is even conceivable that there is a glut of the commodity at the time when the increase in demand is created so that the overall impact on prices is 0 or even negative. But, if all other factors including supply remain constant, the increase in demand can only generate an upward pressure on price. This additional multiplier-generated increase in demand is then an inflationary pressure.

Formally,

Let

S = total subsidy for the commodity.

S_{ye} = income generated from the total subsidy in the current form.

S_{yt} = income generated from the total subsidy as a cash transfser.

S_{yd} = additional income generated from the shift to cash transfsers.

d = Increase in the market price of the subsidized commodity due to S_{yd}.

r = the proportion of the total subsidy that goes to meet distribution costs.

m = multiplier.

b = proportion of the last unit of income that goes for consumption (the marginal propensity to consume).

where

$$m = 1 + b + b2 + b3 + \ldots + bn + \ldots = \frac{1}{1-b},$$

that is, $m \geq 1$

Then,

$$S = (1-r)S + rS$$

In the current system since only the distribution costs are subjected to the multiplier, the overall effect of the subsidy on income would be

$$S_{ye} = (1-r)S + rSm$$

When the subsidy is converted into a cash transfer both the distribution and non-distribution components are affected by the multiplier,

$$S_{yt} = (1-r)Sm + rSm$$

the additional income generated through a shift to cash transfers is then

$$S_{yd} = (1-r)Sm - (1-r)S$$

Since $m \geq 1$, $S_{yd} \geq 0$. As long as the income effect on the demand for the subsidized commodity is positive and supply remains the same,

$$d \geq 0$$

Within this general inflationary pressure, there will be an impact on the open market price of the commodity that was originally being subsidized. A portion of the increased income would be consumed at each stage of the multiplier. And a portion of that consumption could be on the commodity that had the subsidy. All other conditions being the same, the increase in demand will generate an upward pressure on the price of the commodity. The extent of the rise in the price of the commodity, everything else being the same, would depend on two factors. First, the additional demand for the originally subsidized commodity would be determined by proportion of the additional multiplier generated income that is spent on that commodity. And, second the impact of that expenditure on the market price of that commodity would be determined by the ability of the market to absorb this additional demand. In a situation where the entire additional demand can be absorbed, there will be no increase in price. But if some part of this additional demand cannot be met at the existing price, it will lead to an increase in price. There is then a need to take into account the difference in the open market price of the originally subsidized commodity before the shift to cash transfers and after.

Formally, let

c_t = cost to the household of the commodity that was originally subsidized, after the subsidy is replaced by a cash transfer.

l_t = proportion of the cash subsidy that does not reach the household entitled to the subsidy.

n = proportion of the cash subsidy per unit of the commodity that is not spent on the commodity.

The simple case as it is popularly portrayed along with the implicit assumptions would then be

$c_t = p - s$

Taking into account the possibility that in an economy marked by corruption the entire cash subsidy may not reach the household, we have,

$c_t = p - s + l_t s$

Taking on board the proportion of the cash subsidy that is not spent on the commodity, we have

$c_t = p - s + l_t s + ns$

Adding the impact on the market price of that commodity that results from the additional multiplier effect, we have,

$c_t = p - s + l_t s + ns + d$

If the cash transfers are to be preferred to the system of commodity embodied subsidies,

$c_t < c_e$

that is

$p - s + l_t s + ns + d < p - s + l_e s$

or

$l_t s + ns + d < l_e s$

In non-algebraic terms, for cash transfers to be preferred by a household to the current system of subsidies embodied in the price of a commodity, the sum of the leakages in the cash transfers, share of the subsidy that is diverted to commodities other than the one originally subsidized, and the increase in the price due to the additional multiplier effect of cash subsidies, must be less than the leakages in the current system of delivering subsidized commodities through the Public Distribution System.

Macroeconomic Impact of the Shift to Cash Subsidies

While the formal statement of the situation before cash subsidies and after has been made on the basis of the cost to the individual household it is important to explore the macro economic implications of the shift to cash transfers. There are at least three significant macroeconomic implications that demand our attention: the possibility of inflation, the implications for agriculture in the specific case of food subsidies, and the consequences of a shift in expenditure away from the commodity that was seen to be requiring a subsidy.

It is important not to underestimate the inflationary pressures that can be generated by the conversion of subsidies embodied in the prices of commodities into cash transfers. The addition to money supply as a result of the shift to cash transfers is a multiple of the transfers. And the amount that would be involved in cash transfers if all major subsidies were converted into cash is very substantial. The major subsidies were as high as Rs 1,53,962 crores in the revised estimates for 2010-11.[3] Even if the government were to restrict the movement from embodied subsidies to cash transfers only to food subsidies the numbers remain large. The revised estimate for food subsidies in 2010-11 was Rs 60,600 crores. No matter how conservative we are in estimating the multiplier, cash transfers of this magnitude would generate significant inflationary pressures.

These inflationary pressures will reduce the effect of the subsidy on the product, since it is likely to raise the price of the commodity that was being subsidized. The cash equivalent of the earlier subsidy will now account for a lower proportion of the higher price of that commodity. And if the government chooses to offset this effective reduction in the subsidy by increasing the amount of cash transferred to the households, this will further increase the upward pressure generated on income and prices.

It could be argued that the inflationary impact can be controlled through monetary policy. The Reserve Bank of India could be asked to adjust money supply in a way that offsets the additional demand generated by the shift to cash subsidies from subsidies embodied in the price of a commodity. But this only increases the pressures on monetary policy. The government's dependence on monetary policy to control prices has already had its impact on its growth strategy. A crucial component of the liberalization exercise was to move towards a regime of low interest rates. A regime where interest rates fluctuate within a band that is lower than what existed before liberalization was essential to encourage private investment. And in the first decade after liberalization there was an effective movement in this direction. But the government has not been able to sustain this regime. Its focus on monetary policy has led it to raise interest rates in an effort to curb inflation. Indeed, stubborn food inflation has seen the Reserve Bank raising interest rates even as there are signs of a slowdown in the economy. To ask monetary policy to take on the additional burden of managing inflationary pressures generated by a shift to cash transfers would place further constraints on growth. At a time when food inflation has been stubborn even after the economy has sacrificed some of its growth, shifting over to cash subsidies could be playing with inflationary fire.

The impact of a shift to cash transfers on the procurement of rice and wheat will also have a significant, and politically sensitive, impact on agriculture. As is widely

[3] The revised estimates of major subsidies and its food subsidy component are rounded off from the figures in the Expenditure Budget 2011-12.

known, food subsidies in India are not merely a subsidy to the household consuming the subsidized food grains. They are a part of an elaborate mechanism which begins by first procuring foodgrains at a remunerative price from farmers and then selling it at a subsidized price through the Public Distribution System. This mechanism aims not just to subsidize food to the consumer but to simultaneously protect the interests of farmers. The guaranteed procurement at a predetermined remunerative price ensures the farmer has no reason to sell in the market at a lower price. The procurement price then acts as a floor price for foodgrains. Without that price we could have a crash in prices in years of surplus production. With the share of agriculture already declining to around a sixth of GDP[4] the possibility of a dramatic fall in prices, after inflation has raised expectations, would add to the risk farmers have to take at a time when farmers' suicides are demanding national attention.

It is no doubt true that the current procurement and subsidy system may have outlived its utility. The mechanism of procuring at a remunerative price and selling at a subsidized one can be controlled as long as all that is procured can be sold. The government in such a situation knows the precise amount the subsidy will cost. But when the entire procured stocks cannot be sold the cost of procuring and holding unsold stocks becomes an addition to the subsidy without a corresponding benefit to the consumer. There is clearly a case for the current mechanism to be reformed. It is possible to come up with an alternative mechanism that meets the dual requirements of protecting the farmers' interests as well as ensuring the availability of grain to consumers without the burden of huge unsold stocks. We cannot digress to that debate here. But what is clear is that merely abandoning the procurement system by moving to cash transfers is not an alternative. It would place a huge burden on an already ignored agricultural sector. And by simply dismantling a rural infrastructure that has served the country well in the past would amount to throwing the baby out with the bath water.

The third major macroeconomic dimension of the shift from food subsidies embodied in the price of commodities to one of cash transfers is in the realm of the possibility of spending being diverted to items that do not deserve a subsidy. Whatever the merits of granting unbridled freedom to spend subsidies to the individual in the household who receives the cash transfers, it is important to remember that this is being advocated at a time when the country faces a serious crisis of undernutrition. It has been noted "that anthropometric indicators of nutrition in India, for both adults and children, are among the worst in the world. Furthermore,

[4] Agriculture accounts for 16.93 percent of GDP as per the Quick Estimates for GDP in 2009-10 provided in Economic Survey 2010-11.

the improvement of these measures of nutrition appears to be slow relative to what might be expected in the light of international experience and of India's recent high rates of economic growth . . . Undernutrition levels in India remain higher than for most countries of sub-Saharan Africa, even though these countries are currently much poorer than India, have grown much more slowly, and have much higher levels of infant and child mortality."[5] Any movement of the poor away from food towards other items will worsen this situation. And the idea that government subsidies may contribute to such a shift is very difficult to justify.

The macroeconomic impact of the shift from embodied subsidies to cash transfers, especially in the specific situation the Indian economy finds itself in, is therefore not insignificant. It will generate inflationary pressures that could reduce the effective quantum of the subsidy. If the government chooses not to let this happen, it would have to increase the amount of the cash subsidy. The additional cash transfers will only add further to the inflationary pressures. Any effort by the government to control these pressures through monetary policy would make it that much more difficult to achieve the aim of liberalization to move steadily towards a lower interest rate regime. In addition, the dismantling of the procurement system implicit in a shift to cash transfers of the food subsidy will add to the crisis in agriculture. And to make matters worse, the diversion of the cash subsidy for food at the household level to items other than food will add to the already serious problem of undernutrition.

The Impact on the Household

Against this macroeconomic backdrop we can now get back to the initial question of whether the shift from subsidies embodied in the price of commodities to a system of direct cash transfers provides a solution that is better than the current one based on a public distribution system that is widely believed to be ridden with corruption. When we get back to the level of the household it is quite evident that the effect of several of the factors we have discussed will vary from household to household. The extent to which subsidies will be diverted to the consumption of items that were not intended to be subsidized will not be the same across households. The ability to get a household's entitlement of subsidized foodgrains from the Public Distribution System in a system that is widely believed to be ridden with corruption will also vary depending on the influence of individual households. In tracking the effect of the shift from embodied subsidies to cash transfers we would be better off not focusing on some

[5] Deaton, Angus and Jean Dreze (2009) 'Food and Nutrition in India: Facts and Interpretations' *Economic and Political Weekly,* Vol XLIV No 7, February 14, 2009, p 42.

average household, but recognizing at least some different sets of households. In the context of general perceptions of corruption within which the debate on cash transfers is based, it would be useful to consider three broad types of households. First, we can consider those poor households that have been completely bypassed when Below Poverty Line or Antyodaya cards were given. These households have not got the benefit the current system is supposed to provide the poor and equally significantly, they will also not be able to claim cash subsidies. And the number of such households need not be very low. A recent survey in Karnataka first classified as chronic poor those who did not have any of a set of seven assets, including land, a cycle or a television. In three of the five regions of the state around a fifth of the chronic poor did not have either a BPL card or an Antyodaya card.[6]

At the other extreme we can take households where the current system is working well and the poor have full access to the subsidized commodities they are entitled to. It is important to note that while there is talk of large scale corruption there is no claim that the system does not work anywhere. Even if we accept without question estimates that put the leakage in the Public Distribution System at 40 percent, this leakage need not be evenly distributed across every shop in the Public Distribution System and all the households each shop covers. It is then quite possible that the remaining 60 percent covers a number of households that receive their entire entitlements.

The third type of household will be the one the case for cash transfers assumes to be universal across the country. This household does not get any of the subsidized commodities it is entitled to in the current system, but will get the entire benefit of the cash transfer when it happens.

The first set of households has no access to subsidies whether they are embodied in the price of the commodity or as cash transferred directly into their bank accounts. As they get no subsidies their entire entitlement becomes a leakage and there is no question of there being any diversion of the subsidy to other commodities by the household. They have been buying entirely in the open market and will continue to do so. They will however be affected by any increase in the market price of the commodity caused by the additional multiplier effect of cash transfers. These households are therefore likely to be worse off after the shift from embodied subsidies to cash subsidies. And the extent to which they will be worse off will be determined by the extent of inflation that results from the shift to cash transfers.

[6] Pani, Narendar and Chidambaran G Iyer (2011) *Evaluation of the Impact of Processes in the Mahatma Gandhi National Rural Employment Guarantee Scheme in Karnataka.* Bangalore, National Institute of Advanced Studies, p 69.

Formally,

The situation for this set of households after the shift from embodied subsidies to cash subsidies will be better if

$p - s + l_t s + ns + d < p - s + l_e s$

Since s = 0

$p + d < p$

Since $d \geq 0$, the household will be either worse off or, at best, in the same situation.

The second set of households is those where the current system is working well. They are able to get the subsidized commodities from the Public Distribution System as per their entitlement. They stand to shift to a new system which might well develop leakages. At the level of the individual commodity that can be subsidized there can be a diversion of the cash subsidy to other items and they also have to face any increase in the price of the commodity due to the shift to cash transfers. In the best case scenario where the household gets the entire benefit of cash transfers without any increase in the price of commodity, it will be left in the same situation where it was when it got the entire benefit of the subsidy embodied in the price of the commodity. But if, as is likely, the additional multiplier effect due to cash transfers raises the price of the commodity the household would be worse off. And the situation would be worse if there are leakages in cash transfers or if the subsidy is diverted to wasteful items.

Formally,

The situation for this set of households after the shift from embodied subsidies to cash transfers will be better if

$p - s + l_t s + ns + d < p - s + l_e s$

Since the current system is working well, $l_e s = 0$

$p - s + l_t s + ns + d < p - s$

If $l_t s + ns + d > 0$, the household will be worse off.

The third type of household is one where the existing system is working badly and the new one will work well. As this household gets no benefit from the existing system, it is paying the market price for the commodity. In this case there will also be no leakage in the cash transfers. The only pressures here will be from the diversion of the subsidy to other items and the increase in the price of the commodity due to inflation generated by the shift to cash transfers. If what is left of the subsidy after a part is diverted to other items is not greater than the increase in the price of the commodity the household will be worse off as far as the consumption of that commodity is concerned.

Formally,

The situation for this set of households after the shift from embodied subsidies to cash transfers will be better if

$p - s + l_t s + ns + d < p - s + l_e s$

Since the entire embodied subsidy is leaked, $l_e s = s$.

Also since the new system is working perfectly, $l_t s = 0$

Or

$p - s + ns + d < p$

that is
$ns + d < s$

The proposed conversion of the cash subsidy embodied in the price of a commodity to cash transfers to the poor thus raises a number of concerns both at the macroeconomic level and at the level of the household. At the macroeconomic level it risks higher inflation and a worsening of the problem of malnutrition. And at the household level its effects are far from promising. The poorest households that cannot afford the transaction costs involved in getting a BPL or Antyodaya card are likely to be worse off as they would have to bear the burden of any inflation generated by the shift to cash transfers. The shift to cash transfers would move households in areas where the current system is working well to a system of greater uncertainties. Even among the households in areas where the old system is at its worst and the new one of cash transfers works perfectly, its beneficial effect could be jeopardized by a portion of the subsidy being diverted to other commodities and the inflation generated through the shift to cash transfers wiping out atleast a part of the remaining subsidy.

The differential impact across different types of households also has implications for the targeting of the subsidy. The process of getting the subsidy across to the poor has two stages: the identification of the poor, and ensuring the identified households have access to their entitlements. The argument for cash transfers is that it will do better at ensuring that those who are identified as the poor get the full benefit of the subsidy. It is assumed that those among the poor who are not identified as poor will be in the same situation whether they are under the current system of subsidies embodied in the price of the commodity or in the system of cash transfers. But once we take on board the inflationary impact of the shift to cash transfers, those who cannot afford the transaction costs of being officially recognized as poor will be clearly worse off. It is quite possible, even likely, that those among the poor who cannot afford the transaction costs of being recognized as poor are likely to be the poorest. Thus even if the shift to cash transfers does better at targeting those who are identified as the poor, the inflationary pressure it generates will ensure it does so at the cost of the poorest.