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# Demystifying Minimum Support Prices

Based on the recommendations provided by the Commission of Agricultural Costs and Prices (CACP), the Government of India declares the Minimum Support Price for 25 principal crops before their sowing season as to protect the farmers from price fluctuations in the market – especially during bumper production years. The intent of such a scheme is to give farmers assurance of a market and a guaranteed price, generally well above the market rate during times of distress. MSP is supposed to act as a mechanism to protect farmers from selling their produce at a loss as government agencies procure the entire quantity offered by the farmer at the announced rate. Such a scheme is also expected to encourage investments in new market technology by ensuring remunerative prices for production.

The effectiveness of MSP, however, has been under debate due to factors such as inefficiency, narrow range of crops that are covered under the scheme as well as the system of calculation. The storage facilities maintained by the government to hold this produce have also been deemed inefficient due to the losses of stored food grains observed over the years. These elements will be further discussed in this report.

## Minimum Support Prices – Historical Perspective

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The rather underdeveloped nature of our agricultural sector due to their over dependence on monsoon coupled with a disaggregated market place populated with middlemen, has made Indian farmers vulnerable to price shocks. This led to the emergence of Agricultural Price Policy which was directed towards ensuring reasonable food prices to consumers by providing food grains through Public Distribution System (PDS) and inducing adoption of new technology for increasing yield by providing a price support mechanism. Minimum Support Price (MSP) was first introduced in the 1960s in order to battle the gap between rising cost of living post rapid industrialization and monsoon dependent agricultural produce. Initially, two different prices were published:

1) Minimum Support Price
2) Procurement Price

MSPs served as a floor price that was fixed by the government as a long-term guarantee for investment decisions of producers. Prices in the market would not be allowed to fall below this price point, even in the case of a bumper crop. Procurement prices, on the other hand, were the rate at which public agencies like Food Corporation of India would procure from the farmers. These were generally lower than the market price but higher than the minimum support price. This form of price control was discontinued after 1973-74, post which the present system of minimum support prices acting as an indicative pricing measure for buffer stock operations was implemented.

With a bountiful harvest, sometimes, the prices of crops see a drop, well below the cost of production, adversely affecting the indebted farmers. Such minimum support prices are meant to be fixed at incentive level, so as to induce the farmers to make capital investment for the improvement of their farm and to motivate them to adopt improved crop production technologies to step up their production and thereby their net income. In the absence of such a guaranteed price, there is a concern that farmers may shift to cash crops causing shortage in essential commodities.

## Methodology and formulation

To formulate the level at which minimum support prices are determined, the Commission of Agricultural Costs and Prices (CACP) is expected to utilize various price and non-price measures to take into account the comprehensive view of the economic structure for a commodity. These factors include cost of production, changes in input prices, input-output price parity, trends in market prices, demand and supply, inter-crop price parity, effect on industrial cost structure, effect on cost of living, effect on general price level, international price situation, parity between prices paid and prices received by the farmers and effect on issue prices and implications for subsidy.

During the budget speech on February 1st 2018, the Finance Minister Mr Arun Jaitley announced the Government's intention to hike the Minimum Support Prices for *Kharif* crops by one and half times of their production cost. However, the very determination of support prices has faced harsh criticism as it suffers from deep-rooted systemic flaws that need to be mitigated for the benefits of this scheme to be transferred to agriculture producers.

The contentions begin from the very determination of cost principles. There are several cost concepts that the CACP considers while recommending MSP of 25 crops:

1) Cost A2 – These are the costs that the farmer incurs for buying various inputs such as seeds, fertilizers, fertilizers, hired/owned labour, hired/owned machinery and rent paid for leased land.
2) Cost A2 + FL – Actual costs incurred plus imputed value of family labour in producing a crop (i.e. the opportunity cost of working on the field)
3) Cost C2 – This is a more comprehensive cost structure which includes imputed rent of owned land and imputed interest on owned capital

The CACP recommends MSP for 25 commodities, which comprise seven cereals (Paddy, Jowar, Bajra, Maize, Ragi, Wheat, Barley), five pulses (Arhar/tur, Moong, Urad, Gram, Masur), eight oilseeds (Groundnut, Sunflower seed, Soya bean, Sesamum, Nigerseed, Mustard, Safflower, Toria), and five commercial crops (Cotton, Copra, Coconut, Raw jute and Sugarcane). Data for crop yields is collected from the Comprehensive Survey (CS) estimates, which has repeatedly been accused of being inadequate and unreliable due to inefficiencies in data collection. For instance, in 2011, cotton farmers of Maharashtra's Vidarbha region agitated over the low MSPs pegged at Rs 3,300 per quintal compared to the cost of production of Rs 5,700 per quintal.

The Commission uses the cost estimates provided by the Directorate of Economics and Statistics (DES) and Ministry of Agriculture and Farmers Welfare, which is generally available with a time lag of three years in case of *Kharif* crops and therefore needs to be projected for the ensuing season. These projected cost estimates are based on actual estimates of the latest three years viz. 2013-14 to 2015-16; however, actual estimates during the block period are unavailable for some states due to a change in sample selection. Using the available data for latest input prices like human labour, bullock labour, machine labour, etc. a Composite Input Price Index (CIPI) is constructed and used for MSP calculation. According to a study conducted by Ashok Vishandass and B. Lukka in 2013, an ex-post facto analysis of the projected and actual costs for the decade of 2000s revealed that, sometimes, actual costs have risen considerably higher than projected costs.

With the background of farmer suicides and agrarian distress, the National Commission of Farmers submitted five reports to the government entailing recommendations for widening the scope and benefit accrued from the Minimum Support Price Scheme. They detailed that MSP prices should be fixed at least 50% more than the weighted average cost of production (C2), to make the "net take-home income" of farmers comparable to those of civil servants. However, this recommendation has not been accepted by the government, offering the economic rationale that C2 cost includes the rental value of own land but is not incurred by 88% of farmers in India, rendering the A2+FL method of cost calculation more appropriate. Nonetheless, the Government has faced harsh criticism as MSP for *Kharif* crops has been above A2+FL costs for the last 10 years while not giving farmers enough or reasonable returns over the cost incurred.

Another factor that could have led to this decision is the inflationary impact of raising costs above the C2 costs. It should be noted that cost C2 is normally 35-40% higher than cost A2+FL. A 50% margin over C2 would lead to an upward revision of commodity prices such as paddy by 46%. Additionally, the cost burden would land on the

Government, which would lead to worsening fiscal conditions for the rest of the financial year. Regardless of the kind of cost plus methodology being used to determine MSP, be it A2+FL or C2, it is fraught with dangers as it completely ignores the demand side. The CACP is required to consider all aspects of the economy before recommending MSP; however, if MSP is to be determined by merely adding a margin to A2+FL, it is unsurprising that farmer distress has not been mitigated.

## The Procurement Hurdle

Procurement is the essential next step in the assurance to the farmer from supply shocks and price risk. The weakest link in the transfer of benefit of MSP lies in the inadequate procurement by public sector agencies at the price promised by the government. Problems include delay in procurement activity leading to distress sales, lack of storage capacity limiting procurement ability and lack of awareness in rural areas. Unequal access to this scheme has rendered many remote/inaccessible regions with lack of support, necessitating improvement in the implementation of this scheme. An example of the impact of these inefficiencies can be observed in recent history. Incentivised by high growth in selling prices and significant increases in MSPs of pulses in the last couple of years, farmers increased the area sown under pulses to a high of 18 lakh hectares in 2017-18, which is a 44% expansion over the previous year. Good monsoons further led to a record production of 24.51 Million tonnes; a growth of 6.0% (y-o-y). Unfavourable trade policies restricting export of the bumper stock and attractive international commodity prices leading to additional import of pulses further augmented the sustained fall of domestic commodity prices. Inability of the government procurement agencies to buy commodities from farmers led to distress sales and a sustained unprecedented fall in prices of pulses. Resultantly, even in the years of good yields, farmers actually faced losses.

In order to rectify the issues surrounding procurement, three schemes have been under consideration:

1) Market Assurance Scheme (MAS): State agencies will procure farmer produce and state government would ensure direct payment of MSP into Aadhaar linked farmers' account.
2) Price Deficiency Payment Scheme (PDPS): This would not involve physical procurement; however, farmers would be paid the difference between MSP and market prices.
3) Private Procurement and Stockiest Scheme (PPSS): Empanelled and authorized private agencies would get incentives to procure commodity at MSP.

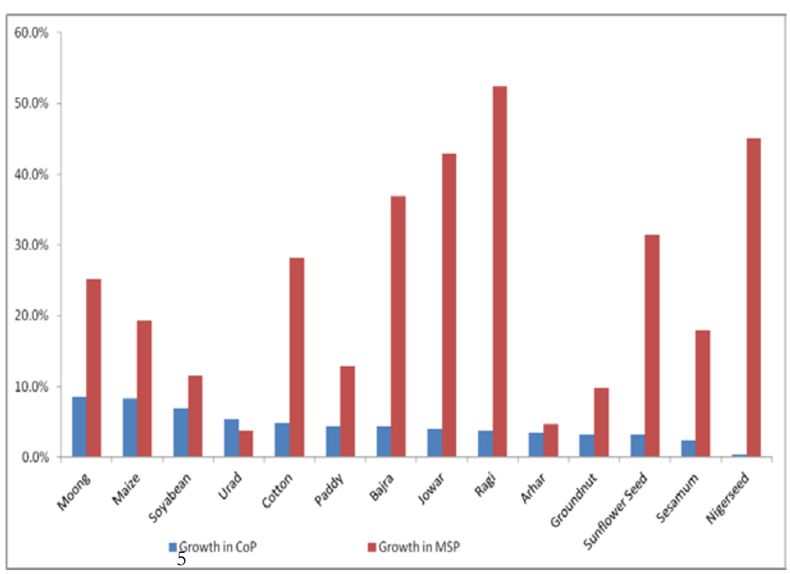
The first scheme proposes procurement by States and compensation of losses up to a certain extent after price realisation out of sale of the procured produce. In the second scheme, if the sale price is below a modal price then the farmers are to be compensated the difference between MSP and actual price subject to a ceiling, which may not exceed 25% of the MSP. No compensation would be due if modal price in neighbouring States is above the MSP. Third option related to Private Procurement and Stockiest Scheme, which relates to procurement by private entrepreneurs at MSP and Government providing some policy and tax incentives and a commission to such private entities, decided based on transparent criteria and bidding for the empanelment.

The government has faced heavy criticism over the implications of the second scheme as it can be prone to manipulation by traders and middlemen. The PDP scheme would merely fill the price gap and not ensure the growth of farmer income. The Bhavantar Bhugtan Yojana (BBY) was a PDP scheme introduced by the Madhya Pradesh State Government with the intention to provide a better alternative than procurement procedures while reducing costs to the Government. However, challenges such as lack of necessary digital connectivity to Aadhaar linked bank accounts disadvantaged remote regions and lack of transparency in the function of *mandis* led this scheme to be rescinded abruptly in March 2018.

The Food Corporation of India (FCI) and other designated State Agencies are expected to continue to provide price support to the farmers in the case of cereals. National Agricultural Cooperative Marketing Federation of India Limited (NAFED), FCI, Small Farmers Agri-Business Consortium (SFAC) and other designated Central Agencies would continue to undertake procurement of pulses and oilseeds. Cotton Corporation of India (CCI) will be the central nodal agency for undertaking price support operations for Cotton.

## Impact on Inflation

Prima facie, the much-awaited release of minimum support price for Kharif crops shows an overall increase of 22%, compared to 6% last year. This has been the highest increase since FY 2012-13 when MSPs had been hiked by an



average of 29%. From the information available, it would appear that there is a lack of correlation between the rise in cost of production and the hike in MSP. In fact, some of the commodities with the only a marginal increase in Cost of Production have received a substantial hike in MSP.

Nonetheless, to understand the impact this hike would have on inflation, three main factors would need examining:

### 1) Market Prices:

A preliminary analysis estimates that eliminating crops whose current market price is higher than MSP price, the impact on retail inflation (CPI) could be to the tune of ~40 bps. The following table portrays the expected impact of this hike on retail inflation based on their individual weights in the CPI index.

| Crops | MSP in 2017-18 | MSP in 2018-19 | Growth in MSP | Wholesale Prices: June 2018 Average | Weight in CPI | Inflation in bps |
|---|---|---|---|---|---|---|
| Paddy | 1550 | 1750 | 12.9% | 2711 | 4.38% | - |
| Jowar | 1700 | 2430 | 42.9% | 1710 | 0.23% | 0.10 |
| Bajra | 1425 | 1950 | 36.8% | 1260 | 0.11% | 0.06 |
| Maize | 1425 | 1700 | 19.3% | 1425 | 0.05% | 0.01 |
| Ragi | 1900 | 2897 | 52.5% | 2000 | 0.04% | 0.02 |
| Arhar | 5420 | 5675 | 4.7% | 6000 | 0.79% | - |
| Moong | 5575 | 6975 | 25.1% | 5100 | 0.34% | 0.13 |
| Urad | 5400 | 5600 | 3.7% | 5000 | 0.27% | 0.03 |
| Groundnut | 4450 | 4890 | 9.9% | 3934 | 0.28% | 0.07 |
| | | | | | | **0.42** |

Though wholesale prices are a better indicator for prevailing market prices, MSP is applied to the raw crop that is brought to the *mandis* for procurement. In many instances, the price for the raw crop is below the MSP even though the wholesale price is higher than this rate. The disaggregated *mandi* system and the lack of transparency hinder the farmers from acquiring benefits from this scheme. Likewise, the actual impact on domestic inflation will depend on how much of the crop produce is eventually procured at the higher MSPs and that will determine how much this policy successfully pushes up market prices to the new levels.

### 2) Procurement

Historically, the government has been a large procurer of paddy during the summer harvest season. However, for other crops, the government’s ability to influence market prices has been weak. With the election year coming up, the Government can be expected to diverge from past practices and introduce a procurement strategy that is a combination of the Market Assurance Scheme, Price Deficiency Scheme and Private Procurement and Stockiest Scheme. The weightage given to the different schemes would directly affect the fiscal costs that the Government would have to incur. Though various reports suggest that this is expected to be in the range of 0.1-0.2% of GDP (Rs 15,000 Cr to Rs 33,500 Cr), the use of different schemes could wildly alter cost projections. Large procurement via the price deficiency scheme could increase costs and would eventually prove to be a burden on the fiscal front. Nevertheless, without a pickup in GST collections to fill the revenue gap, government finances by the end of the financial year could be under stress.

### 3) International commodity prices

One of the factors that distressed farmers in FY17 was a sharp fall in international commodity prices for pulses that made imports attractive and caused domestic prices to further fall. If the price of pulses continues to fall in the international market, without adequate measures to protect domestic producers, the production of pulses would suffer. However, according to the Food and Agriculture Organisation of United Nations, international prices for rice in the first five months of 2018 were 16.3% above their levels in the corresponding period in 2017. In conjunction with the depreciation in the domestic unit, rice exports from India would receive a competitive edge.

## Outlook

The Reserve Bank of India has been highlighting risks on inflation from MSPs, pegging H1FY19 inflation at 4.8-4.9% and H2FY19 at 4.7% (including HRA). Now that MSPs are known, RBI may increase its inflation projection marginally. However, it should be noted that with a strong favourable base in the coming months, the upside risk to the headline inflation could be minimized. Clarity on the procurement strategy and efficacy would shed more light on the future domestic inflation trajectory. However, the Monetary Policy Committee might take a more hawkish stance in its August policy decision but refrain from hiking rates until the October policy, awaiting further developments.

There are no short-term solutions for resolving farmer distress. India has to solve its procurement, storage and marketing problems for agriculture and rural India to prosper. In the current release, the government has mentioned the formulation of a new Agricultural Produce and Livestock Marketing (Promotion and Facilitation) Act, 2017 which is expected to allow direct buying from Farmer Producer Organisations (FPO), bypassing the *mandi* system and giving farmers new avenues to sell their produce. Political analysts have found that misunderstanding regarding the Minimum Support Price being the maximum sale price has caused distress in some areas. Adequate measures to disseminate knowledge need to be ensured to meet the objective of boosting farmer income by 2022.

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