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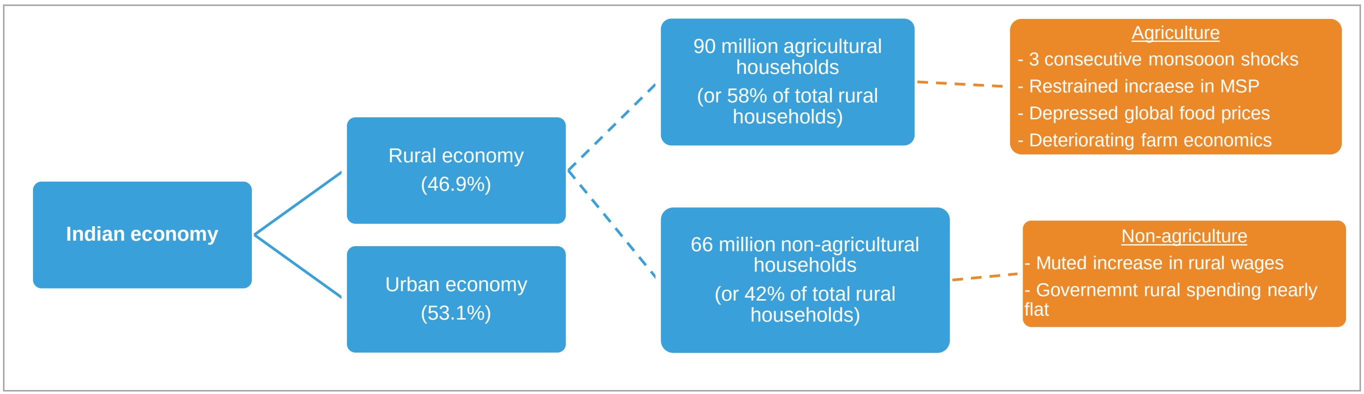
CRISIL Opinion

Rural India in distress. Will the Budget take notice?

This year, one of the loudest calls for attention in the Budget will be from the rural sector, specifically agriculture, which has been reeling after three consecutive weather shocks and policy inattention for even longer. That is not to say that governments -- both at the Centre and the state level -- have failed to provide budgetary support. The point is, India's farm economy has been crying for a holistic, structural approach for long, where resources, reforms and implementation go hand in hand to ensure long-term rural prosperity.

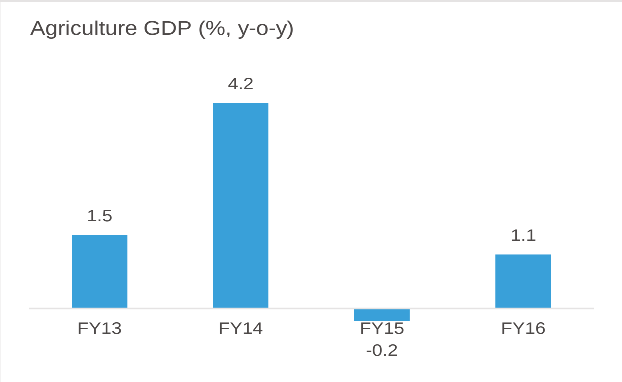


Source: NSSO, CSO, CRISIL Research

Why is rural economy distressed?

- **Inclement weather stress:** Rising frequency of weather shocks amid higher vulnerabilities has compounded the stress in agriculture, slashing cultivation income and farm profitability[1]. This, even as half of India's GDP comes from the rural areas. About 58% of rural households engage in agriculture and within this, two-thirds are heavily reliant on it. Last fiscal, agriculture growth was at -0.2% and in fiscal 2016 is estimates at 1.1% *(Figure 1)*. As agriculture suffers, the biggest impact is on rural demand.

Figure 1: Slipping agriculture growth



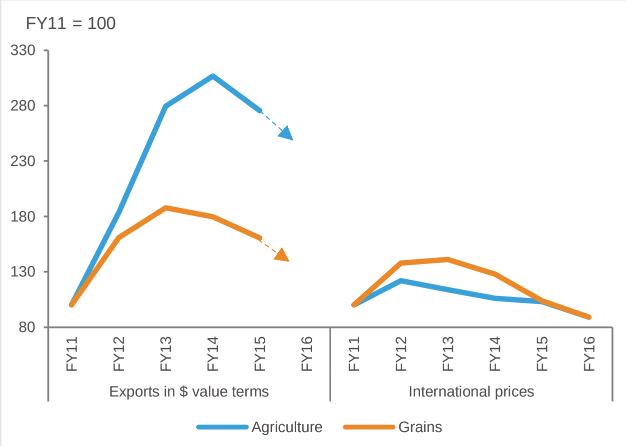
Note: FY16 are advance estimates

Source: CSO, CRISIL Research

[1] Read CRISIL Research report on Angsty Farms, August 2015 for further indept study into Agriculture sector stress in India, including state-level vulnerabilities.

- **Small fry bears the brunt:** The continued fall in rural wage growth has hurt those on the fringes. Small and marginal farmers constitute about 70% of India's agricultural households and they depend more on wage income than big farmers who enjoy cultivation income. What's worse, the other 42% of rural households -- or 66 million -- who are heavily reliant on non-agricultural income are also in pain. That's because in recent years, a slowdown in mining and manufacturing output - more than half of which is produced in rural areas – has reduced employment opportunities and brought down wage growth. All this underscores the magnitude of rural stress.

Figure 2: Agriculture exports hurt as global prices dip



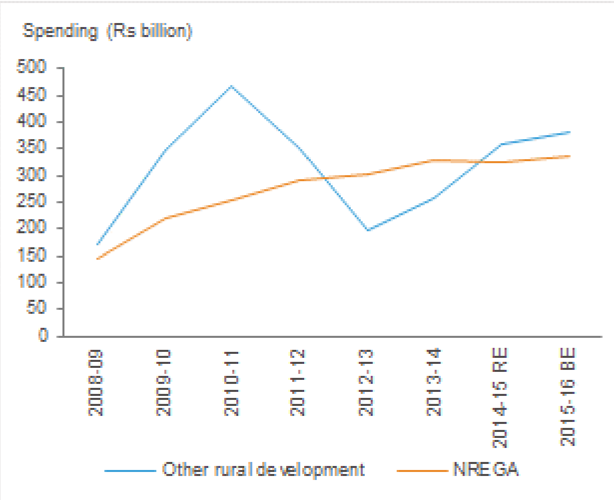
Source: Ministry of Commerce, World Bank, CRISIL Research

- **Depressed by global prices:** While monsoons have been unkind to agriculture, falling global food prices have come as another fell blow hurting agricultural export income. India's agricultural exports stood at $24 billion in fiscal 2015 – or 8% of the country's total exports. That's up from 6% in fiscal 2010. But with international food prices falling sharply – by almost 3% in 2014 and 14% in 2015 following a supply glut, income from exports declined (*Figure* 2). In fiscal 2015, agriculture exports fell 11%, and in April to December of fiscal 2016, it has plunged 23%. Grain exports, which are almost 40% of agriculture exports, have fallen 35% so far this fiscal, as international grain prices slipped 15%.

- **Constrained spending on safety net schemes:** For long, policy support has allowed the non-farm sector to provide offset to farm sector stress. During the monsoon failure in 2002, the government's ongoing focus on the National Highway Development Project helped create rural jobs in the construction of roads and highways. Again during the drought-hit 2009, the expansion of the National Rural Employment Guarantee Scheme (NREGA) ensured rural jobs were aplenty. In 2012, too, when rains were delayed and ill-distributed causing drought-like situation in certain states, NREGA employment came to the rescue. But, the scale of NREGA expansion has thereafter been limited, as there is increased focus on other rural development spending as well, such as roads and social assistance.

  In fiscals 2015 and 2016, budgetary allocation for NREGA only saw small increases (*Figure 3*).

Figure 3: Shift in rural spending focus



Source: Ministry of Commerce, World Bank, CRISIL Research

Incidentally, in these years, number of jobs created under NREGA has also appears to have come down. Given the duress in the farm sector, there is, therefore, a need to scale up employment creation – either through direct spending on employment generation or by pushing up spending on sectors with high employment potential. The key, however, is not only to design policies and increase allocation to social safety net schemes but to ensure they are effective in sustainable job creation. Committing additional resources to employment generation and creating assets for rainwater harvesting and storage on a war footing for instance, will go a long way in drought-proofing the economy and also providing support to fledging rural demand.

The government has promised to revive the NREGA scheme to include works that are more productive and asset creating. But latest data[2] show that employment generation under the scheme has slowed. In fiscal 2015, at an all-India level, only 23 million households were provided employment compared with nearly 50 million in each of the preceding 5 years. And in the first four months of fiscal 2016, average employment days per household halved. Reduced employment generation under the scheme coupled with the three monsoon shocks – deficient rains in 2014 and 2015 and unseasonal rains in early 2015 – together have hurt incomes, accentuating rural stress. However, there are some positive developments. The current government has sharpened focus on rural road construction. A budgetary allocation of Rs 150 billion for fiscal 2016 has been expanded by another Rs 50 billion, and is now 21% more than in fiscal 2015. To some extent, this is likely to cushion non-farm rural income through job creation.

Pain points the Budget must address to support rural India

The Budget needs to outline measures to restore the health of the rural economy without increasing unproductive subsidy spend. We highlight six broad areas that require innovative policy solutions:

1. **Expand irrigation cover:** In India, poor irrigation cover exposes agriculture to shocks from uneven rainfall patterns. At the all-India level, irrigation covers only 46.9% of the total cropped area, exposing the rest to monsoon shocks. Around 84% of pulses, 80% of horticulture, 72% of oil seeds, 64% of cotton and 42% of cereals are cultivated in unirrigated conditions. The combined spending of Centre and states on irrigation has been a mere 2% per year of their total spending in the last five years. This is also less than the 3% per year spent in the 5 years preceding. In the fiscal 2016 Budget, the government allocated Rs 50 billion to support micro-irrigation, watershed development and the Pradhan Mantri Krishi Sinchai Yojana (PMKSY) that extends crop insurance. Such spending needs to be encouraged more and linked to employment generation. Focus on irrigation will require the government to deploy sustainable micro-irrigation schemes and creation of assets for rainwater harvesting and storage. This will go a long way in drought-proofing the economy.

2. **Big push to crop insurance:** One way to mitigate the pain from crop losses due to weather shocks is through crop insurance. But in India, coverage remains low. For example, the Universal National Crop Insurance Scheme, which merges all existing schemes, only covers 25% of all farmers and 20% of the area. An Assocham-Skymet survey (April 2015) found that crop insurance is not a natural choice for farmers. Only 19% of respondents have their crops insured, exposing the rest to the vagaries of monsoon. Of the uninsured, 46% were aware but not interested, 24% said the facility was not available to them, while the rest (11%) could not afford to pay the insurance premium. A report by National Sample Survey Organisation (December 2014) confirms the low crop insurance cover, with the crop with the highest insurance coverage being cotton. But the adequacy of this insurance cover is also suspect. For crops such as paddy and wheat, few households have insurance. As the frequency of weather-related shocks rises, so must insurance coverage.

[2] As reported by Indiastat.com

The government has recently launched the Pradhan Mantri Fasal Bima Yojana, a crop insurance scheme which promises to contribute a larger share of the premium. The scheme will be operational from fiscal 2017. Here effective implementation will be a key to meeting the target of 50% coverage in the first two years. At the same time, adequacy of coverage per farmer per crop will be critical to ensure the usefulness of the scheme. This however, will need a sharp increase in Budget allocation compared with the current dismal amount of Rs 26 billion in fiscal 2016. Other challenges include ensuring transparent assessment of crop-damage within a specified time following weather shocks, and the ability to adequately compensate for the losses within the shortest possible time.

3. **Encourage production by making agriculture profitable:** Profitability at the farm is low and declining as cost of inputs continues to soar. And if that weren't enough, input and output cost dynamics have been turning unfavourable year after year, reducing the farmer's profit margin. Pulses is one such crop where such disparities are high and rising. Within pulses, the largest disparity between cost of cultivation and output prices is in *urad*, *gram* and *tur*. In *urad*, while output prices in the last decade have risen by 12%, cost of cultivation in major producer-states have risen in the range of 12-26%. Similarly, in *gram* and *tur*, output prices grew about 10%, but cost of cultivation rose 12-18%. The Bharatiya Janata Party (BJP) had in its 2014 general elections manifesto, announced its intention to take steps to enhance profitability in agriculture by ensuring a minimum 50% profit over the cost of cultivation. This will require, among other things, ensuring availability of high variety seeds at reasonable costs, reducing cost of transportation, effective market pricing of agricultural produce, drought-proofing the sector on by expanding irrigation cover and introducing latest technologies for farming.

4. **Farm investment versus farm subsidy:** After coming to power, the National Democratic Alliance (NDA) government promised a technology-driven second Green Revolution in India. Crucial to this objective is investment, but public sector investment in agriculture is low and poor, while private investors don't have enough incentives. Of the government's total government spending on agriculture, less than 10% is towards public outlay on capital formation, while the rest is in the form of subsidies for food and fertilisers. Therefore, for investments in agriculture to increase, the government will have to take the first step forward. And to make room for spending, it will have to reorient expenditure from subsidies to public sector investment in agriculture. For instance, during fiscals 2013 and 2014, while public sector gross capital formation in agriculture grew by an average 4.7%, spending on food subsidy rose nearly three times faster.

5. **Extend direct benefits transfer (DBT) scheme to food and fertiliser subsidy:** A critical step to funnelling resources into agriculture will require plugging leakages in the existing public distribution system (PDS). As per a 2015 study by Gulati and Saini[3], 46.7% of the off-taken grain is leaked from PDS. This is the gap between the grains off-taken by each state and consumption by the targeted consumer for the year 2011-12. Extending the DBT scheme to include food subsidy in addition to LPG transfers will help curb losses due to leakages and 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. Moreover, this will give households a choice on how to use the cash – whether to buy food grains or other items of consumption. A CRISIL Study[4] finds that while households in the lowest income bracket, particularly in rural India, might 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

[3] 2015, Gulati A. and Saini S., 'Leakages from Public Distribution System (PDS) and the Way Forward', Working Paper 294, Indian Council for Research On International Economic Relations

[4] Read our report, Cascading cash, catalysing consumption, February 2015 for a detailed study on impact of DBT on consumption

for the economy, but also go a long way towards raising social welfare through better nutritional intake and higher spending on health and education.

6. **Generate non-farm employment:** Typically, policy support to the non-farm sector of the rural economy can aim at two outcomes; (i) create a *safety net* to mitigate losses to the farm sector in case of a weather shock, and (ii) provide a *long-term solution to impart skills training and create employment*. As in the past, a push to non-farm income tends to create a demand-pull in the economy and improves welfare. Construction, trade and transport have historically acted as engines of rural non-farm employment growth. But these sectors, though labour-intensive, contribute just about a fourth to GDP at the aggregate India level, and therefore may not be able to solely drive rural employment. In addition, in recent years, a slowdown in mining and manufacturing output - more than half of which is produced in rural areas – is likely to have brought down wage growth. Policy focus, therefore, needs to sharpen on other rural non-farm sectors such as food processing and even tourism. A focussed push to initiatives such as Skilling India and labour-intensive manufacturing can go a low way towards creating sustainable employment and livelihoods.

In fiscals 2015 and 2016, India managed to put a lid on food inflation despite monsoon failure because of the steep fall in global food prices and proactive steps taken by the government such as showing fiscal restraint, offering muted increase in minimum support price, deploying food stocks, and cracking down on hoarding. But repeating this feat every year is not possible without structural improvements in agriculture. More reason why investing in agriculture's future make eminent economic and political sense. And that's where we believe, the government needs to change the game – and quickly so.

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