The pros and cons of subsidies through direct benefit transfer

Direct benefit transfer can cut clean from all the abuses of the public distribution system, but it creates a new, and problematic, dependence on the banking system Photo: Pradeep Gaur/Mint

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The main takeaway is that PAHAL is potentially a much better alternative compared to PDS

With the National Democratic Alliance (NDA) government completing its second year in office later this month, there are numerous assessments of how the government has performed. This article assesses a particular reform initiative that has great potential to emerge as global best practice in benefit transfers to poor households. The initiative is PAHAL—the direct benefit transfer scheme for liquefied petroleum gas (LPG).

In mature democracies such as India, it is normal that a new government that comes to power continues to implement promising schemes launched by its predecessor. Direct benefit transfer (DBT) is one such United Progressive Alliance (UPA)-2 initiative that has been vigorously pursued by NDA-2. UPA-2 had introduced the DBT approach for some income transfers such as widows' pensions and scholarships. It also experimented with a scheme to use DBT for LPG subsidies, which it later withdrew. PAHAL is the first actual roll-out of a scheme using the DBT approach for providing subsidies.

A clarification is necessary here about the distinction between subsidies and income transfers, which are also sometimes loosely described as subsidies. When a government meets a part of the cost of providing a good or service to a beneficiary, this is a subsidy. When a government provides income support to a beneficiary, this is a pure transfer payment unrelated to the cost of providing any good or service.

PAHAL is the first major programme in India that provides subsidies through DBT. With nearly 150 million registered beneficiaries, it is probably the world's largest DBT programme ever. Yet, it accounts for only about 3.5% of the total annual flow of government subsidies. The provision of around ₹ 20,000 crore for the scheme is about 8% of the total provision of ₹ 250,433 crore for subsidies in the 2016-17 Union budget. And Union subsidies in turn account for only about a third of total subsidies provided by the Union and state governments taken together. Thus, DBT under PAHAL is just a beginning in using DBT as the medium for providing subsidies. There is still a long way to go. However, as the first pilot for this approach, the lessons learned from PAHAL have far-reaching implications for the whole approach of benefit transfers to poor households.

In summarizing these lessons, this article has drawn on the analyses provided in the Economic Survey for 2015-16 and the report on DBTL (direct benefit transfer of LPG) Performance Evaluation published last month by the Council for Energy, Environment and Water (CEEW).

The main positive lesson has to do with targeting. The goal of the government in subsidy reform is not doing away with subsidies, but targeting them effectively so that they flow only to the intended beneficiaries. Such targeting of subsidies is extremely problematic when the subsidy is embedded in the physical delivery of a product at a price that is below the open market price. This price gap distorts the market, providing opportunities for arbitrage, diversion of supplies and profiteering in the black market. An elaborate administrative apparatus has to be maintained at huge cost to manage the rationing of subsidized commodities. Despite this, problems of product adulteration, leakages, ghost ration cards and harassment of beneficiaries by the rationing bureaucracy remain endemic.

This is the experience with the public distribution system (PDS) presently in use to exclude non-poor consumers, a relatively small segment of the consumer base, from access to subsidized foodgrains, kerosene, sugar, etc. It has been argued, for instance, that the cost of maintaining this elaborate PDS bureaucracy is much higher than the amount of subsidy it is supposed to save by enforcing, unsuccessfully, the exclusion of this small group of non-poor consumers from access to subsidized commodities. Switching to the DBT system would cleanly cut away from all these problems. In time, it could enable dismantling of the elaborate PDS, with consequent saving of huge costs. However, DBT generates a new, and problematic, dependence on the banking system as discussed below.

Beneficiaries often complain about the PDS problems cited above. In contrast, the feedback from those who have access to PAHAL has been quite positive. That does not imply that providing subsidies through DBT has no problems. On the contrary, this new approach faces several challenges. Some of these are specific to LPG delivery and are discussed further below. But the most important challenge is generic for the DBT approach. It relates to the banking network, which is the backbone of the DBT system. In this system, subsidies are transferred to beneficiaries directly through their bank accounts. Hence, the system cannot work if the beneficiary does not have a bank account. Unfortunately, the Jan Dhan Yojana programme notwithstanding, banking penetration among the target beneficiaries is still quite limited, especially in rural areas.

Though it is not viable to have a commercial bank branch in every village, all villages can be served through the new payments banks and banking correspondents. However, it is widely reported that bank staff are reluctant to cooperate in opening accounts, especially unprofitable 'zero balance' accounts, for poor customers. These customers are quite unfamiliar with opening and operating bank accounts and they are often seen as supplicants rather than clients. Standard excuses are used such as spellings of names not matching, signatures not matching, address inaccuracy, etc., to avoid opening an account or making a payment. An important step in cracking this problem is the linking of Jan Dhan Yojana with Aadhaar, the unique biometric identification system. Aadhaar is now backed by an Act of Parliament and is reported to have covered virtually the entire population. Linking of the two systems is also being actively pursued. However, this is a work in progress and there is still a long way to go.

Thus, the main takeaway from PAHAL for the generic DBT approach is that it is potentially a much better alternative compared to the PDS. DBT can cut clean from all the abuses of

PDS. It has also proved to be popular with those beneficiaries who have had access to PAHAL. However, to scale up the DBT approach to all target beneficiaries, not just for LPG but eventually for kerosene, foodgrains, sugar, etc., it is necessary to overcome the roadblock that currently exists in the banking system, especially in rural areas.

In addition to integration of the Jan Dhan Yojana database with the Aadhaar database, DBT will require an aggressive awareness campaign. Such a campaign is urgent not just for beneficiaries but even more so for front-line commercial bank staff. They need to be made aware that the humble act of opening an account for poor beneficiaries is, in fact, a critical link in what could become best practice for the largest welfare delivery system in the world.

Apart from these generic lessons in providing subsidies through DBT, there are also lessons from PAHAL specific for the delivery of LPG. One key lesson is the importance of a consumer-friendly delivery system. Urban LPG consumers take for granted the home delivery of LPG cylinders. In rural areas, consumers have to fetch the LPG cylinders for long distances, often from delivery outlets located in other villages. This remains a major disincentive for adopting LPG as the cooking fuel of choice. An awareness campaign is also necessary about the subsidy scheme in place for low-income households, and how the DBT system works.

The initial outlay required for getting an LPG connection, by way of deposit, cost of a burner, regulator, etc., is another disincentive for low-income households. To overcome this constraint, the Ujjwala Yojana scheme has been initiated to provide free or subsidized connections to some 50 million poor households over the next four years at a total cost of about ₹ 8,000 crore. Switching from 15kg cylinders to 5kg cylinders in rural areas will also help ease the cash-flow constraint for these households by reducing the outlay required for each refill. Despite all this, LPG will remain an uncompetitive fuel alternative for about 50% of such households who continue to depend on firewood, cow-dung patties and other biomass that are essentially free. Thus, the adverse health and ecological consequences of traditional fuels notwithstanding, LPG penetration among this consumer group will remain a challenge.

A final, disappointing lesson is the failure of exhortations to induce rich households to voluntarily surrender their subsidy claims. The CEEW study estimates that the richest 15% of the population account for about 25% of the LPG consumer base. However, despite the much hyped 'Give It Up' campaign, only 3.6% of consumers actually gave up their subsidy claim. In other words, only 14% of the rich consumers actually 'gave it up'. This is a sad commentary on the attitude of the rich, and implies that their exclusion from subsidy has to be enforced, not voluntary. That is a pity.

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