Position Paper No.1 from the IMG on Inflation

Preamble

The Inter-Ministerial Group (IMG) on inflation constituted on 2nd February, 2011, has had four meetings of the full Group and has been addressed to by the Finance Minister and the Governor of the Reserve Bank of India, and it had interactions with several others who it was felt could be of value in terms of offering advice and data. We are also working actively to set up a small office for monitoring data pertaining to inflation and there are several research projects in the Economic Division of the Ministry of Finance currently in progress. A brief report from the Chair of IMG based on the first two meetings of the IMG especially on matters pertaining to Agricultural Produce Market Committees (APMC) Act has already been sent to the Cabinet Secretary on 05.04.2011. In addition, we want to put out occasional "Position Papers from the IMG". This is our first such paper and pertains to food inflation and in particular to matters of marketing and retail prices.

On the basis of the deliberations that the IMG on inflation has had since its first meeting held at the Ministry of Finance on 15th February, 2011, and the research being conducted in the Ministry of Finance under the supervision of the Chairman of IMG, we would recommend that the government consider two important steps to cut down the margin between farm gate prices and retail price or, in other words, between the price that farmers get and price that consumers pay. Correcting this is not going to solve the problem of inflation for all times to come but it can have a sharp desirable effect in the short run of bringing inflation down in food and increase the efficiency of our food markets. This can be of great value to Indian farmers as well as to Indian consumers.

The gap between farm gate price and retail price is exceedingly high in India. We clearly need policy measures to bring this down. However, in designing such a policy it needs to be kept in mind that in a vast and complex country like ours it is impossible for Government to directly deliver on all needs of society. It is also not reasonable to try to create another layer of bureaucracy that can monitor the price in mandies and stores. This will lead to higher transaction costs and could even fuel corruption. Consequently, the strategy that the Government has to think of is to make a few pivotal changes which facilitate competition, narrow the price margins and enable and incentivize private citizens and firms to engage in nation building activities. Several studies point to the fact that there are severe impediments to competition at the local level. In order to promote competition at the local level and prevent cartelization action needs to be taken on multiple fronts such as reforming APMC into an enabling Act and a facilitator of efficient markets. It is in this spirit that the IMG recommends two pivotal policy changes that can have multiplier effects and yield large benefits:

I. APMC Reform

We believe that the APMC Act ought to be amended so as to enable farmers to bring their products to retail outlets and also allow retailers to directly purchase from the farmers, without facing blockades by incumbent traders. It is often the case that tomatoes are Rs. 3/- per kg at farm gate and around Rs.15/- per kg in the hands of consumers. This applies to other agricultural commodities also with some variations here and there. There is a perception that currently the traders in some markets engage in cartel like behavior, preventing small farmers and new traders from bringing their products into the city mandies. This explains why during the onion price spike last December there were huge gaps not only between farm gate and retail outlets but also between neighboring cities. There were days on which the price of onion in Delhi was double the price of onion in Agra. Likewise for Nagpur and Mumbai. For small traders and farmers such price differences create scope for making profit by buying where it is cheap and selling it where it is expensive. Such arbitrage activity is actually desirable from the consumer's point of view because it evens out prices and curtails price spikes. The reason why this did not happen is that new comers face many hurdles to bring products into the market. APMCs were established to protect the interest of farmers. However, in reality, the APMC system has abetted monopolistic behaviour and reduced the choices available to small farmers. Moreover, APMC at many places, instead of collecting service charges for services delivered has acted more as a 'tax collector'.

Unwittingly, it is our well intentioned APMC law that has contributed to cartelization and collusion amongst incumbent traders. The need, therefore, is to re-visit the APMC Act with this in mind. There is a model APMC Act that has not yet been implemented. Our view is that the model Act from 2003, when our inflation was low, may already be somewhat dated. We, therefore, recommend that the government review and revise the model Act keeping in mind the need to keep inflationary pressures down.

In this connection, it is worth also mentioning that there is need to put an end to systems of taxation which entail stopping the flow of food and other perishable items from one region to another enroute. Even if we cannot put an end to octroi and such charges we should try to have a system where all such charges are implemented at a single point, such as mandi in case the mandi services are utilized or additional taxes at the organized retail level. The flow of goods between cities and States should not be stopped for the collection of such taxes. This slows down the speed of food movement and can also become an avenue for harassing farmers and small traders.

In this connection, we also believe that a more effective use of our competition laws can play a role in bringing down retail prices. There are critical issues regarding competition in implementing the APMC Act such as:

a. **Limitation on number of markets:** Agricultural markets are heavily regulated in India through APMC Acts, which allow only Governments to set up the mandis, thus creating a very strong entry barrier even in setting up of market.

b. **Structure:** Some of the Acts like APMC Act of Delhi allow only registered traders/commission agents in the markets with little scope for new comers to enter the market, again creating strong entry barriers for participation in the marketing processes. This results in market being dominated by a limited number of players.

c. **Behavior:** Such restrictive markets inherently encourage anti-competitive practices such as formation of cartels to fix up prices or to control supply (U/s3 of Competition Act, 2002) as well as abuse of dominance by trader's associations (u/s 4 of the Competition Act, 2002).

II. Multi-Product Retail Reform

The IMG deems that it is time for India to allow foreign direct investment (FDI) in multi product retail and proposes that the Government considers this at the earliest. India's retail sector continues to be primitive and there is evidence that there are large losses that occur as products pass through the supply chain from farm to the retail customer. Because of dated technology and managerial methods used to move products from one part to another there is excessive value erosion that occurs all the way. This, in turn, raises the price that consumers have to pay. The IMG believes that reform in this sector can be an effective inflation busting measure.

The share of organized retail in the total retail trade happens to be just over 4 per cent in India. This compares unfavourably not only with the 66 per cent figure for Japan but also with China's 20 per cent, Malaysia's 55 per cent and Indonesia's 30 per cent. China allowed FDI in multiproduct retail since 2004 and the benefits have been palpable. Clearly there is scope for huge change and modernization on this front, especially in the case of fruits and vegetables. In the case of rice and wheat and to a certain extent coarse cereals we do have reasonably good systems in place. For government to try to achieve modernization in retail through hands-on intervention at every stage and for every product is to court failure. One way of playing an enabling role is to allow FDI into multi product retail.

This is also a way to get new technology to come into the country and expand organized retail. While this policy alone may not achieve all the results, it can be an important step in serving the interests of both the consumers and farmers in the long run. This could provide remunerative prices for farmers and fair prices for consumers especially during the peak marketing season. However, it is important to allow the entry of FDI into this sector in a properly regulated fashion. We must guard against the risk of these new corporations becoming monopolistic and charging high prices.

Government will have to work out an appropriate regulatory framework for FDI in multi-product retail. In the absence of a regulatory framework, an increased FDI may not necessarily ensure a good price to the farmer. There is no single policy panacea and the issues confronting retail sector need to be addressed on multiple fronts. Specific mention may be made regarding suitable facilities for sorting and grading at the farm gate, incentivizing retailers to purchase directly from farmers, increasing competition through large number of players and export benefits to the farmers. Regarding setting up of large retail outlets, what we would suggest is that broad parameters/ norms need to be firmed up as to where the corporations can set these up. The norms may be linked to access to land, population size and the city's zoning plans. This will ensure that there is space enough for our small retailers to continue to sell their products. By pitting the small retailers and the large corporations in competitive mode against one another in the retail market, we can make sure that prices remain low.

There is another important advantage to opening up the retail sector. Once these large corporations begin to source their products from Indian outlets it is very likely that they will gradually take these products to sell in their outlets in other countries. In other words, this can have the beneficial effect of opening up the world of exports to lots of small Indian producers. The potential benefit from this can be enormous.

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