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The pathologies of redistributive resource transfers

The evidence suggests that all the pathologies associated with foreign aid appear to manifest in the context of intra-country transfers too

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worked on this year's Economic Survey

In Aravind Adiga's *The White Tiger*, the narrator makes an insightful comment about the role of geography in development. "Please understand, Your Excellency, that India is two countries: an India of light, and an India of darkness. The ocean brings light to my country. Every place on the map of India near the ocean is well-off. But the river brings darkness to India."
The Indian growth take-off since 1980 is associated with Peninsular India, the states that the narrator is astutely associated with better geography—being close to the ocean—which development experience has long confirmed as conferring special advantages. These states—Gujarat, Maharashtra, Tamil Nadu, Karnataka, Kerala and Andhra Pradesh—have indeed grown faster and advanced more rapidly economically vis-à-vis others.

As a result, they have also been a greater focus of research attention in comparison to other states—the "Other Indias", the India of forests, of natural resources, and of "special category" status. They are interesting in their own right because they have conformed to other models of development. One such is the model based on "aid", most applicable to the "special category" states in the North-East, Jammu and Kashmir, Himachal Pradesh and Uttarakhand.
In the international context, foreign "aid" has been shown to create a number of adverse effects. Aid perpetuates resource dependency, in the sense that since revenues are being provided from outside, recipient countries may fail or have little incentive to develop their own tax bases or their institutions. And it is institutions that have been found to be critical for growth, much more than overall resource availability.
Another potential downside of aid is that it could trigger the "Dutch disease", named after the impact that discovery of natural gas in the North Sea had on the domestic economy in the Netherlands. This windfall caused the real exchange rate to appreciate as the extra income was spent domestically, pushing up the price of non-tradables, such as services geared to the local economy. The higher prices for services then eroded profitability in export and import-competing industries, de-industrializing the economy, with the share of manufacturing in the economy falling. Do we see similar consequences within India?

To attempt an answer, the first task is to define a concept akin to "aid" in the Indian context. State governments have received funds from the Centre—"gross devolution" which is the sum of: (i) share of Central taxes, as stipulated by finance commissions; (ii) Plan and non-Plan grants; and (iii) Plan and non-Plan loans and advances of course, the Plan/non-Plan distinction has now been abolished.

Devolution is not all "aid" but embodies a strong redistributive element. We isolate this element—"Redistributive Resource Transfers" (RRT)—as gross devolution adjusted for some benchmark for the normal resources a state can

expect to receive, which we define as the state's share in aggregate gross domestic product or alternatively as a state's share in own tax revenues. Thus, RRT are transfers over and above states' contribution to GDP (or taxes) and serve as useful, if imperfect, measure of "aid".
There are two key differences between RRT and traditional foreign aid. RRT are intra-country transfers and do not augment overall national disposable income like foreign aid does; second, the donor-recipient relationship is also very different because states benefiting from transfers are part of the national governance structures that determine them.

Figure 1 shows the ranking of states, in 2015, in the descending order of RRT received in per capita terms. The top 10 recipients are: Sikkim, Arunachal Pradesh, Mizoram, Nagaland, Manipur, Meghalaya, Tripura, Jammu and Kashmir, Himachal Pradesh, Assam.
The yellow and green dotted lines in Figure 1 show, respectively, the all-India urban and rural annualized per capita poverty lines for 2015. Annual per capita RRT flows for all the North-Eastern states (except Assam) and Jammu and Kashmir have exceeded the annual per capita consumption expenditure that defines the all-India poverty lines, especially the rural one. In other words, RRT are substantial in magnitude.

We then correlate a state's RRT with a number of outcomes. The results are striking. Higher RRT seem to be associated with:
• Lower per capita consumption
• Lower gross state domestic product (GSDP) growth
• Lower fiscal effort (defined as the share of own tax revenue in GSDP)
• Smaller share of manufacturing in GSDP, and
• Weaker governance.

Figures 2-5 depict these findings. The results turn out to be quite robust to alternative definitions of RRT and there is suggestive evidence of causality from RRT to economic outcomes and governance. There are a few states which are exceptions (for example, Tripura with respect to per capita GSDP growth or Mizoram with regard to governance). The details of the methodology (including the index used to proxy overall governance) are outlined in Chapter E3 of the Economic Survey 2016-17. These results indicate that all the pathologies associated with foreign "aid" appear to manifest in the context of intra-country transfers too.

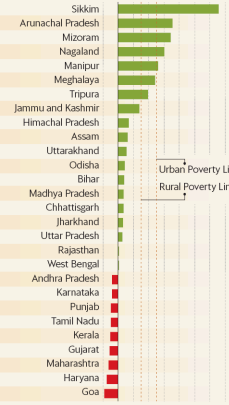
If the evidence suggests an "RRT curse", what are the policy implications?

Clearly, the "solution" cannot be to dispense with RRT altogether, since in a federal system the Centre must play a redistributive role because it will always have to redirect resources to under-developed states. Rather, the Centre will need to ensure that the resources it redistributes are used more productively.

Of course, it is possible that the "RRT curse" originates from poor connectivity and poor infrastructure—physical, financial and digital—

Negative outcomes of redistributive resource transfers

Figure 1: RRT per capita (Rs thousand, 2015)



Graphic by Vipul Sharma/Mint

Figure 2: Per capita consumption (MPCE) and per capita RRT

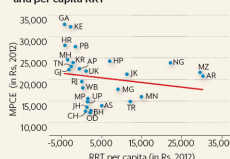


Figure 3: Per capita growth and RRT#

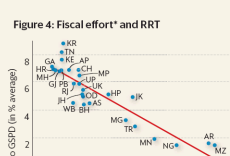
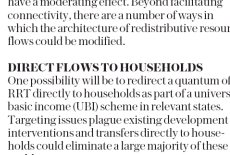


Figure 4: Fiscal effort* and RRT



Figure 5: Governance* and RRT



Enhancing connectivity on a war footing (as the government has attempted for financial inclusion) will have a moderating effect

that most of these states, and certainly the North-Eastern states, suffer from. Enhancing connectivity on a war footing (as the government has attempted for financial inclusion with the Pradhan Mantri Jan Dhan Yojana, or PMJDY, expediting the optical fibre network, etc.) will have a moderating effect. Beyond facilitating connectivity, there are a number of ways in which the architecture of redistributive resource flows could be modified.

DIRECT FLOWS TO HOUSEHOLDS
One possibility will be to direct a quantum of RRT directly to households as part of a universal basic income (UBI) scheme in relevant states. Targeting issues plague existing development interventions and transfers directly to households could eliminate a large majority of these problems.

PERFORMANCE-CONTINGENT TRANSFERS
Another possibility would be to find ways to offset the tendency of states receiving high RRT to relax their own tax effort. Perhaps future Finance Commissions could revert to the prac-

tice of the 13th Finance Commission of explicitly conditioning transfers on the tax effort of states, and perhaps to an even greater extent.

GOVERNANCE-CONTINGENT TRANSFERS

Given that some high RRT recipient states have performed better than others, the capacity of states to utilize funds efficiently plays an important role. To encourage better governance, the fund transfer mechanism could explicitly include a few monitorable institutional indicators as criteria for resource transfers.

In sum, large bounties—in the form of redistributive resources—can create surprising pathologies, even in democratic India. Recognizing and responding to them creatively will be important to learn the lessons of development experience in India and around the world.

The article is an abridged version of chapter E3 of *The Economic Survey, 2016-17*.

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myview

Trump's choice: Ukraine or Putin?

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Perhaps inevitably, North Korea's ballistic-missile test last Sunday was characterized by many analysts as Donald Trump's first foreign-policy challenge, or at least the first not caused by his own blundering. But this is to overstate both the threat presented by Pyongyang, and the options available to the White House. There is no realistic scenario in which Kim Jong-un, North Korea's dictator, launches a war against South Korea or Japan. And so long as he doesn't cross that line, Washington has no influence over his behaviour. The only challenge Kim presents is to Trump's claim as the planet's most egotistical leader.

In reality, the first foreign-policy crisis of the Trump presidency has been unfolding since the end of January, 7,000 km west of Pyongyang. In Ukraine, Russian President Vladimir Putin and his proxy militias have resumed in earnest their programme of destabilization and annexation. The campaign had been paused during the US presidential election, and started up again within hours of Putin's 28 January phone call with Trump. With his biggest American fan safely

ensconced in the White House, Putin seems to have decided to return to his plans to expand Russia's territorial outlines in the west, while pushing the envelope with his foes in the North Atlantic Treaty Organization. Violence flared up in the Donbas region of Ukraine, where Moscow's proxies as well as regular Russian forces have been competing with the government in Kiev for control. Observers for the Organization for Security and Cooperation in Europe reported that the number of explosions in eastern Ukraine shot up from 420 on 26 January to over 10,000 on 31 January. Attacks on civilian infrastructure by Russian and separatist forces killed 13 Ukrainian soldiers, and left the town of Avdiivka without electricity for a week, in the middle of the winter freeze.

How would the Trump administration respond? The first auguries were mixed. On 2 February, Nikki Haley, the US ambassador to the UN, slammed Russia for its continued occupation of the Crimean peninsula—snatched from Ukraine in 2014. "The United States continues to condemn and call for an immediate end to the Russian occupation of Crimea," said Haley. "Crimea is a part of Ukraine. Our Crimea-related sanctions will remain in place until Russia returns control over the peninsula to Ukraine."
But that same day, the US treasury department issued a notification easing one of the sanctions the Obama administration put in place against Moscow's Federal Security Service, better known by its Russian acronym as the FSB. CNS quoted a top-state department official as saying it was technical fix, to avoid "unintended consequences" of US government business with Russia. It was certainly not, as some American media outlets portrayed it, a peace offering by Trump to Putin—but the timing of the announcement was ill-judged. Ukrainians could be forgiven for seeing it as a sign that the new occu-

part of the White House didn't much care if bits of their country were seized by his counterpart in the Kremlin.
The uncertainty about Washington's intentions on sanctions against Russia continued on 5 February, when vice-president Mike Pence hinted that the US might consider lifting them if Putin proved valuably ally in the fight against the so-called Islamic State. But that same day, Trump himself spoke with Ukrainian President Petro Poroshenko, and promised to negotiate a peace between Kiev and Moscow.

It's hard to see Trump playing the honest broker in any such negotiations. Ukrainians would be right to be sceptical, given mind the President's man-crush on Putin. Never mind the Ukrainians, many in the US intelligence community worry that

Trump's admiration for the Russian leader makes him unreliable—so much so, they are reported to be keeping some sensitive Russia-related information out of his briefings, for fear that he might blab about it in his next call with Putin.
But keeping Trump in the dark won't help keep Russia at bay: Ukrainians need the American president to see the light. Unlike the kabuki-theatre confrontation played out along the demilitarized zone between the forces, the prospect of an all-out war in eastern Ukraine, where over 10,000 people have been killed since 2014, is frighteningly real.

Why is it in American interests to protect Ukraine? There are many reasons—political, military and economic. But the simplest is this: The US owes Ukraine. Washington led the effort, after the fall of the Soviet Union, to persuade Kiev to give up its stockpile of nuclear weapons, in exchange for guarantees of protection from Russia. To President Barack Obama's eternal shame, he betrayed Ukraine in 2014, allowing Russia to grab Crimea. Trump has an opportunity to redeem America's honour, as well as to

pressure other former Soviet states that Washington will not allow them to go the way of Crimea.

It will be hard for Trump to undo the damage done by Obama, and immediately restore Crimea to Ukraine. That will likely take years of difficult negotiations. But the President can immediately signal to Putin that Russia's territorial expansion must stop right now, on pain of even harsher sanctions. He can demand that Moscow's troops return to its own side of the border, and its surrogates give up their weapons and make peace with Kiev. If they don't, the US and NATO should supply Ukraine the firepower it needs to protect itself. While talking tough with Putin, Trump must also pressure Poroshenko to give the Donbas separatists not only amnesty, but a fairer share of political power.

That's what a real foreign-policy challenge looks like.

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