

The '3-3-3' puzzle and what to do about it

That we are in the midst of an unprecedented and alarming widening of income gaps amongst Indian states is becoming accepted as conventional wisdom. My co-author Praveen Chakravarty and I have been documenting this point for the past year, and our research at the IDFC Institute finds mention in last week's *The Economist* in a very useful report on the topic.

The facts are stark and simply illustrated (*see chart*). The ratio of per capita state income levels as between the richest three and the poorest three of the 12 largest states has been skyrocketing for the past quarter-century, and today stands at well over 300%. We have dubbed this the "3-3-3" puzzle: The three richest states are three times as rich as the three poorest states. It is a puzzle because orthodox economic theory predicts that contiguous economic units which are knitted together by movements of trade and people ought to exhibit convergence, not divergence.

The puzzle deepens because India's states constitute a federal economic union characterized by—finally, after the goods and services tax (GST)—harmonized taxes and free trade among states. Apart from this, there is suggestive evidence presented in this past year's Economic Survey that inter-state movement of people is more robust than we had thought. Finally, let us not forget that India's states constitute not only a customs union and a fiscal union, but a monetary union as well. These are strong forces for convergence that are, evidently, being counteracted by even stronger forces of divergence, leading to widening divergence overall.

The reality of rising regional inequality can no longer be swept under the carpet of rising average incomes across all states. But while the facts are not in dispute, there is little agreement on the causes of, and possible cures for, the 3-3-3 puzzle. Chief economic adviser Arvind Subramanian posits "governance" as a possible explanation, but this theory is unpersuasive. As we document, the data show not only widening income gaps amongst major states, but within those same states: The dubious ascription of state-level governance differences cannot account for this. After all, attributing what one cannot explain to a vague catch-all concept such as governance is little better than providing a label for one's ignorance.

By contrast, Chakravarty and I have argued that much the most plausible explanation for this pattern of widening divergence is the model of economic development itself, characterized by initial income gaps becoming locked in through economies of scale, network externalities, and agglomeration economies. Our hypothesis is consistent with the fact that, as the chart shows, inequality really began taking off only after the 1991 economic liberalization, suggesting that the move from a state-oriented to a market-oriented development paradigm may indeed be the driver. This is not at all to denigrate economic liberalization—quite the contrary—but to observe that the fruits of liberalization may be unevenly spread, as market-driven differences in opportunities and outcomes overcome the flattening effects of decades of socialist Central planning.

The existence of wide regional income gaps which are not going to go away anytime soon, and which, indeed, are integral to the texture of how our development paradigm has evolved, forces us to think creatively about ameliorative economic policy interventions, forming part of what economists have come to call "place-based" economic policy. These will require, in the first instance, a body of evidence which is lacking at present across a range of policy-relevant domains, even including monetary policy. For instance, computing reliable state-level consumer price indices, using local weights in the basket and local prices, rather than relying solely on a national average and broad aggregates such as urban and rural, would be a very good starting point for exploring the differential regional impacts of pursuing a national inflation target mandate.

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