

formal rate of interest and paying a wage rate or output price that is lower than the market rates.

In order to tackle these constraints, policies should be implemented in the right direction. SHGs should be induced to enter matured levels of enterprise and factor in livelihood diversification in order to ensure that their members are not dependent on informal sources of credit for their financial and non financial needs. There is a scope of increasing credit disbursements on the part of the public lending institutions through policies, innovations and techniques that enable correct identification of viable borrowers. Effective policy interventions in other markets can increase the size of asset holdings with borrowers, thus increasing their access to formal credit sources. As of now, RBI's actions have been effective to a very large extent in purveying credit in the rural sector through regulations pertaining to priority sector lending and opening branches in rural areas. However, Co-operative banks and credit societies as well as RRBs need to shift their focus primarily towards the poorest of the poor rather than just looking broadly at the rural sector. Policies should be initiated in order to incentivise lending to the marginal and small farmers to a greater extent by formal institutions. At the same time, policies like concessional credit rates should be reconsidered since they distort socially optimal loan decisions. Microfinance Institutions developed on the lines of Grameen Bank, which promote group lending can be another possible solution. Credit rationing theory implies that under a policy of no restrictions on interest rates and in a competitive environment, credit will be rationed. Thus any intervention in the market other than to alleviate informational constraints will do more harm than good. A new theory of incentives and monitoring embedded within the actual

operational framework of India's lending institutions might be more appropriate for analysing and designing corrective mechanisms.

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A Tale of Two Transfers

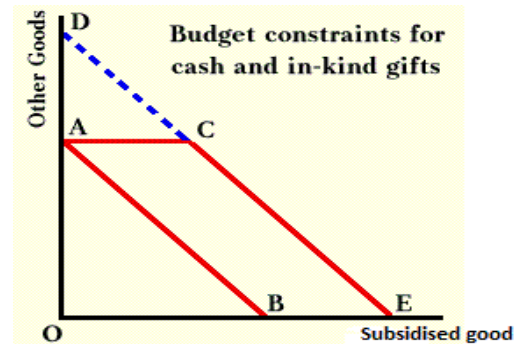
Parnika Dar and Upasana Majumdar

A transfer payment (or government transfer) is a redistribution of income in the market system. These payments are considered to be exhaustive because they do not directly absorb resources or create output. Examples of certain transfer payments include those for welfare (financial aid), social security, and subsidies given by the government.

Recent months have witnessed a spurt in discussions on cash transfers as an instrument for delivering social security in India. The dominant view is advocating a transition to cash transfers from existing regimes, be it as a replacement for the public distribution system (PDS) or administered pricing for select fertilisers. This transition to cash transfers is plagued by financial inclusion and availability of information technology infrastructure constraints. Also, it would be imprudent to ignore the success of in-kind transfer scheme like PDS in Tamil Nadu and Chattisgarh.

Transfer programmes in developing countries are constrained by three factors: financial resources, institutional capacity and ideology. Governments in poor countries are highly limited in the amount they can invest in transfers and the money required to ensure that the programmes are effective. The amount invested is influenced by 'value for money or the commodity in question' considerations, as well as by political and ideological concerns regarding 'free handouts' and 'creating dependency'.

A central question in anti-poverty policy is whether transfers should be made in kind or cash. The potential benefits of in-kind transfers are weighed against the fact that cash transfers typically have lower administrative costs and give recipients greater freedom over their consumption. Simple economics clearly states cash is better for welfare. Cash raises the budget constraint leading to higher indifference curves (as shown in the figure). With an in-kind transfer, however, you (potentially) impose a constraint on the basket of goods, thus (potentially) reducing the utility compared to the cash case.



Another potentially important but less discussed aspect of this policy trade-off is the effect that In-kind and cash transfers have on local prices. Cash transfers increase the demand for normal goods, and if supply is not perfectly elastic, prices of these goods should rise. In-kind transfers have a corresponding cash value, so they similarly shift demand through an income effect. But, in addition, an in-kind transfer program increases local supply. If the government injects supply into a partially-closed economy (e.g., a village), then relative to cash transfers, local prices should fall when transfers are provided in-kind.

Price effects of transfer programs are likely to be most pronounced when, first, the size of the individual transfer is large; second, there is high program enrolment within a community; and third, the economy is not fully integrated with the outside economy so local supply and demand determine prices.

Price effect of cash transfers should be positive for normal goods since the income effect shifts the demand curve outward. The supply effect of an in-kind transfer is the change in prices caused by the influx of goods into the local economy. This supply effect should cause a decline in prices. Goods that are not part of the transfer program are also subject to pecuniary effects. The supply influx from the in-kind transfer should lower the demand and prices for goods that are substitutes of the in-kind items.

In the empirical application, an economy is an Indian village, and the main goods that are examined are food grains. The local suppliers are shopkeepers in the village, and they procure the items from outside the village. A positively sloped supply curve implies increasing marginal costs.

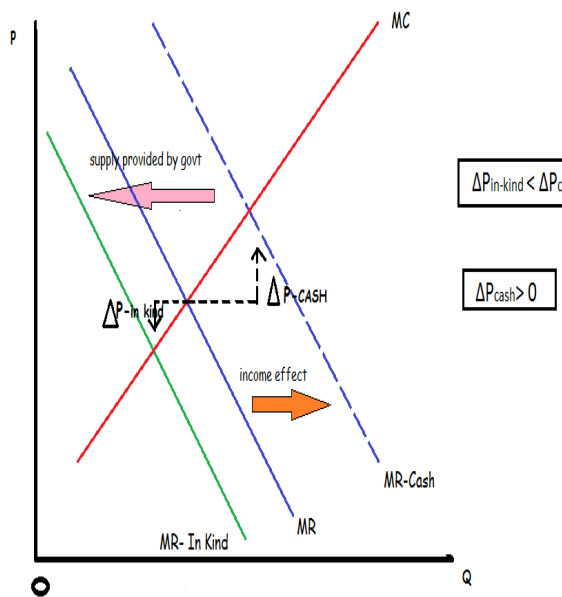
In effect, we assume that for local suppliers, procuring more supply entails increasing marginal costs, at least in the short-run. A high transportation cost to other markets is one reason that inventory in local stores is unlikely to adjust instantaneously. To meet higher demand, a shopkeeper in a remote village might need to travel to a neighbouring village to buy supply from a shop there. In the long run, one might expect the supply curve to be flatter.

Figure 1 depicts the market for a normal good in a village. The demand curve represents the aggregate demand faced by local suppliers. The figure shows, first, the effect of a cash transfer. The demand curve shifts to the right via an income effect, and the equilibrium price, p , increases. Denoting the amount of money transferred in cash by X cash, our first prediction is that a cash transfer will cause prices to rise. In-kind transfers also generate an income effect, so demand will again shift to the right. Here, the in-kind transfer amount X -In Kind is defined in terms of its equivalent cash value. Thus the demand shift caused by a transfer amount X is by definition the same for either form of transfer.

With an in-kind transfer, however, some of consumers' demand is now provided to them for free by the government, so the residual demand facing local suppliers shifts to the left by the amount provided in kind. While the net price effect of an in-kind transfer relative to the original market equilibrium is, in general, theoretically ambiguous, one can sign the price effect of

in-kind transfers relative to cash transfers. For transferred goods, the price should be lower under in-kind transfers. Government transfer programmes often inject a large quantity of goods or services or cash into a community. Through these shifts in supply and demand, transfer programs could have quantitatively important price effects.

Here, two main predictions are tested; first, that cash transfers should lead to price inflation and second, that prices should fall under in-kind transfers relative to cash transfers. There is no strong evidence for the first hypothesis, though the point estimates generally match the prediction. There is robust evidence in support of the second hypothesis. Prices are significantly lower with in-kind transfers than cash transfers. The transfer programme injects a large quantity of food or cash into these villages. This finding suggests that in most settings, price effects will have quite negligible consequences for policy decisions. The hypothesis is that price effects are bigger in more physically remote areas, where the markets are less tied to world prices and there is less product market competition. Moreover, in remote villages, the price effects estimated are economically significant. While these explanations cannot be tested decisively, there is suggestive evidence that imperfect competition is part of the explanation. Even if marginal costs are flat in the long run, with imperfect competition there could be long-run price effects of in-kind transfers since the residual demand facing local suppliers would be permanently lower.



The dearth of supply-side competition in remote markets suggests then when the government acts as a supplier and provides in-kind transfers; it may not only be creating a monetary externality but also reducing the inefficiency associated with imperfect competition.

An In-kind transfer leads to an increase in the demand facing the local suppliers, due to the income effect of the transfer, which is offset by an increase in supply due to an injection on the government's part. The net effect is that the marginal revenue curve shifts from MR to MR - in kind. A cash transfer has only the income effect, and the marginal revenue curve shifts to MR - cash. Social programs are often targeted, and in the presence of imperfect information for recipient identification, offering in-kind transfers leads to self-selection. For example, only needy people will show up at a soup kitchen or health clinic providing free services. Of course, some needy people may be erroneously screened out. Note, however, that targeting does not necessarily imply overprovision of in-kind goods like paternalism does.

Cash transfers do not encourage poor people to do something about their future, as future cash payment depend on them being poor. Providing in-kind transfers takes care of this problem by forcing them into consuming goods that will help them out (education, health screening, etc.). Moreover, the voters prefer to bestow on the poor, benefits-in-kind rather than cash transfers. For example, a coronary artery bypass graft (CABG) can easily cost the equivalent of a fully loaded Mercedes Benz E- 350 with GPS and a six-deck CD player. Taxpayers do buy such medical procedures for fellow countrymen in countries like USA with few questions asked. Can we imagine taxpayers voting for handing out the equivalent amount in cash to the stricken poor?

Another important consideration is how efficiently the government can provide supply. Reforms; like taking away the ownership of all the PDS shops from private businessmen and giving it to local community-owned bodies like forest co-operatives employing tribals, gram panchayats (village councils) and women self-help groups, increasing the commission to PDS shop owners, online monitoring of PDS operations as implemented successfully in Chattisgarh; are helpful. Also, cash transfers are obviously less effective in periods of rising prices of essential goods and services. In situations of volatile and rising prices in the deregulated markets, the real value of cash transfers can get quickly eroded, and the systems of price indexation of such transfers are typically slow, insensitive and inadequate to cover the price increases.

The cash transfers cannot be a solution to the problem of persistent poverty, simply because they do not in any way address the basic causes of poverty. The poor are defined not just by low income but more fundamentally by their lack of assets, which in turn is related to the concentration of assets somewhere else in the same society.

The bank account is the most important criterion for the cash transfers to work. But only 40% of India's population has bank accounts. The other pillar that the cash transfer scheme leans heavily on is the UID. The implementation of UID has been cumbersome - getting banks to rural areas and sensitizing administrators working at the grassroots level have been some of the challenges. So far, about 21 crore Aadhaar numbers have been created. This is less than a third of the number of people targeted under the cash transfer scheme. Thus, financial inclusion and availability of information technology infrastructure are preconditions to cash transfer and there are substantial problems in the state on both accounts.

To sum up, we see that in-kind transfers do not raise prices like cash transfers, and are also expected to be compatible with the social security expectations of tax-payers, as illustrated by the heart operation and Mercedes example cited above. Cash transfers cannot and should not replace the public provision of essential goods and services, but rather only supplement them. They cannot be considered as panacea for evils like poverty, low incomes etc. In other words, cash transfers are desirable and can play a positive redistributive role if they are additional to other basic goods and services, provided in-kind to the needy.

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Indirect taxation in India: GST- a must needed switch

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There is a saying in Kautilya's Arthshastra, one of the earliest books on economics in the world, that the best taxation regime is the one which is "liberal in assessment and ruthless in collection". The proposed GST (Goods and Service Tax) seems to be based on this very principle. Although there has been a lot of hype about the much needed change in the Indian indirect taxation system with an introduction of GST, its true relevance and salient features have not yet been highlighted.

In recent years, the Indian government has undertaken significant reforms in the indirect taxation system. This includes the initiation of a region-based and state-level VAT on goods. However, in order to remove barriers to inter-state trading and to attain a secured market for the activities related to services and goods, more reforms are needed. Some of the reforms that can be