Does Economic Theory Inform Government Policy?

Kaushik Basu

IEG Distinguished Lecture 2

सत्यमेव परमो धर्मः

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Twelfth Dharm Narain Memorial Lecture

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Institute of Economic Growth

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INSTITUTE OF ECONOMIC GROWTH

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Founded in 1952 by eminent economist V.K.R.V. Rao, IEG’s faculty, Board of Directors and Trustees have included a wide range of distinguished intellectuals and policy makers, including V.T. Krishnamachari, C.D. Deshmukh, P.N. Dhar, A.M. Khusro, Dharm Narain, C. Rangarajan, C.H. Hanumantha Rao, Arjun K. Sengupta, P.C. Joshi and Bimal Jalan. Several former faculty members have served as members of the Planning Commission or on the Prime Minister’s Panel of Economic Advisors. Prime Minister Manmohan Singh has had a long association with the Institute, initially as Chairman of the Board (1977-1982) and since 1992 as President of the IEG Society. Nitin Desai is the current Chairman of the Board of Governors and Bina Agarwal is the Director of the IEG.

A NEW IEG LECTURE SERIES

This is the second of a new series of occasional papers that lEG has begun under its ‘lEG Distinguished Lectures’. The series includes both periodic named lectures, such as the VT. Krishnamachari Memorial Lecture and the Dharm Narain Memorial Lecture, as well as invited lectures by distinguished intellectuals under the broad theme ‘Distinguished Lectures in Economy, Polity and Society’.

This paper is based on Professor Kaushik Basu’s Dharm Narain Memorial lecture, delivered on 4 September 2010. The first Dharm Narain lecture was given by John Mellor in 1981. Subsequent speakers included K.N. Raj, Amartya Sen, S.R. Sen, Pranab Bardhan, B.S. Minhas, Ashok Rudra, C.H. Hanumantha Rao, Arjun Sengupta, Y.K. Alagh, and Nicholas Stern. The lecture is co-hosted by the Delhi School of Economics.

Dr. Dharm Narain (1925-1980) is remembered as an outstanding agricultural economist and policy-maker, widely respected for his painstaking research and insights, and as a man of rich human qualities. He taught at Hans Raj college at Delhi University for several years, and was also a research scholar with the Delhi School of Economics. The major part of his career, however, was spent at the Institute of Economic Growth which he joined in 1959 as senior fellow. He stayed with the IEG till 1970, when he became chairman of the Agricultural Prices Commission. He was also a visiting professor at Cornell University, and in 1978 joined the International Food Policy Research Institute in Washington DC.

Dr. Dharm Narain wrote extensively on various aspects of agricultural economics, including his widely cited IEG paper on “Distribution of Marketed Surplus of Agricultural Produce by Size Level of Holdings in India 1950-51” in which he demonstrated that a substantial part of marketed surplus came from distress sales by small and marginal farmers. His book, *Impact of Price Movements on Areas under Selected Crops in India,* published in 1965 by Cambridge University Press, also had a substantial impact. His work received extensive attention from eminent scholars even after his death. A collection of his writings was published posthumously in 1988 in *Studies on Indian Agriculture*, edited by K.N. Raj, Amartya Sen, and C.H. Hanumantha Rao. Also, John Mellor and Gunvant Desai edited a volume *Agricultural Change and Rural Poverty,* with papers by renowned academics and policy makers, including Montek Singh Ahluwalia, Pranab Bardhan, Hanumantha Rao and Amartya Sen, who commented on and extended unfinished aspects of Dharm Narain’s work on rural poverty.

In his writings, Dr. Narain was especially concerned with the impact of agricultural prices on agricultural growth and poverty—aspects which continue to concern us today. Crop productivity, he argued, could be enhanced not only by shifts in technology but also by shifts in cropping patterns toward higher value crops, or toward ecological regions more hospitable to particular crops. At the same time, he recognized the double-edged role of a rise in agricultural prices: on the one hand this provides an incentive to farmers, but on the other hand it adversely affects net buyers of foodgrains. This divergent role of prices continues to be a conundrum of economic policy.

Dharm Narain's work traversed both economic theory and policy. This was well recognized by scholars such as Michael Lipton who reviewed his book, *The Impact of Price Movements,* and wrote: 'This is very much a book by and for the economic theorist, though its conclusion… has wider policy implications.' It is therefore entirely appropriate that this year's Dharm Narain Memorial lecture focuses on the potential bridge between economic theory and policy. And it is also appropriate that the lecture was delivered by Kaushik Basu who, as a professor of Economics at Cornell University and currently Chief Economic Advisor to the Ministry of Finance, Government of India, wears both hats—that of economic theorist and that of a policy maker.

We hope the paper will provoke further debate on an issue that is of great topical interest.

Bina Agarwal, Director IEG
December 2010

Kaushik Basu

Kaushik Basu is currently the Chief Economic Advisor to the Ministry of Finance, Government of India. He studied economics at St. Stephen's College, University of Delhi, and the London School of Economics. After teaching for several years at the Delhi School of Economics he joined Cornell University, where he is Professor of Economics and the C. Marks Professor of International Studies. He has also served as Cornell's Director of the Program of Comparative Economic Development (2000-09) and Director of the Center for Analytic Economics (2006-09). Among the several distinguished positions he holds at present is the Presidentship of the Human Development and Capabilities Association (2010-12). He is also on the editorial board of a number of international academic journals.

An unconventional economist and eclectic thinker, Professor Basu has contributed both to theory and to applied economics, and has written extensively on issues such as social choice, globalization, the limits of the market and child labour, in journals such as the *American Economic Review, Econometrica, Social Choice and Welfare*, *Man and Society, The Journal of Economic Perspectives* and the *Journal of Development Economics*. His many books include: *The Retreat of Democracy and Other Itinerant Essays on Globalization, Economics and India* (Permanent Black, 2007); *Prelude to Political Economy: A Study of the Social and Political Foundations of Economics* (Oxford University Press, 2000); and the forthcoming *Beyond the Invisible Hand: Groundwork for a New Economics* (Princeton University Press and Penguin Books India). For several years Basu also wrote a witty fortnightly column for *The Hindustan Times*, a regular column for BBC News Online, and occasional pieces for *The New York Times* and several leading Indian newspapers and magazines.

In 1989 Kaushik Basu received the National Mahalanobis Memorial Medal, and in 1990 the UGC-Prabhavananda Award, for his many contributions to Economics. In 2008 the President of India honoured him with the Padma Bhushan.

Does Economic Theory Inform Government Policy? [1]

This lecture addresses the interconnections between two seemingly disparate worlds—the world of abstract economic analysis and the world of policy and politics, drawing on the author's personal experience in both worlds. A fundamental premise underlying the analysis is that it is a society's ideas and beliefs that are ultimately responsible for its development. The absence of good, scientific ideas prove to be the biggest stumbling block in crafting good policies. Keynes was right when he wrote that 'the power of vested interest is vastly exaggerated compared to the gradual encroachment of ideas'. So was Nehru when, in 1929, in a speech in New Delhi, he urged his young audience: 'The world is moved by ideas.'

India today stands on the cusp of a major economic take-off. It is up to us to seize the moment. To do so, however, we need to bring the best ideas from the world of scientific enquiry into the humdrum world of politics and policy. The aim of this lecture is to illustrate, by drawing on real-life examples, that it is possible to do so. The lecture uses this dictum about 'ideas' to investigate several topics, ranging from the management of inflation and the scope for monetary and fiscal policy interventions to microeconomic topics, such as labour regulatory reforms and the economics of foodgrain production and distribution.

Inflation has been a topic of much concern, debate and acrimony in recent times. Yet it remains ill-understood. Hence, managing inflation is a good example of an area where we have to make policy by using a combination of scientific knowledge and practical intuition. Labour regulatory reforms have been a taboo topic in India, since any mention quickly leads to ideological polarization. From a few cue words people quickly decide whether the person writing or speaking is pro-worker or anti-worker, and then decide whether or not to switch off. It is time to break this taboo. The paper argues that elementary economic theory can be used to help us take an intelligent position on this politically-sensitive topic. The lecture also comments on the economics of India's foodgrain policy, including the charged topic of foodgrains wastage in government granaries. Quick-fixes and piecemeal interventions may look good but are unlikely to solve the problem.

Keywords: foodgrains, inflation, food procurement, public distribution system, India

JEL codes: O12, L13, Q11

1 I am grateful to Bina Agarwal and B. L. Pandit for inviting me to deliver the Dharm Narain Memorial Lecture and to Bimal Jalan for chairing the event. I would like to thank all three of them, as well as Alaka Basu and Supriyo De for numerous valuable comments and suggestions.

Policy and Academe

I am honoured to have been invited to deliver the Dharm Narain Memorial lecture this year. Dharm Narain was a legendary figure in the field of agricultural economics. He had left the Delhi School of Economics and the Institute of Economic Growth by the time I joined the Delhi School. Nor did we overlap at Cornell University, where he was a Visiting Professor in the Agricultural Economics Department. Indeed, three years after I completed my PhD and returned to India, Dharm Narain met a very untimely death. But his legend followed him and I would hear plenty of stories from his erstwhile colleagues of his quiet, sophisticated charm and his deep commitment to economic analysis and policy. I am glad to have this opportunity to pay my respect to him by this lecture.

The title of my lecture is ‘Does Economic Theory Inform Government Policy?’ If you are expecting a one-word answer to this question, I have to warn you that you will not get it. The title question is a rhetorical one. I want to use it to speak about the inter-connections between two seemingly disparate worlds—the world of abstract economic theory and the world of policy and politics. What I hope to convey to you by the end of this lecture is the importance of bringing these two worlds closer to each other; and how each stands to gain from an awareness of and interaction with the other. I have now had an association with both these worlds and in speaking to you today I plan to liberally draw on my own experience.

Until last year my association with the world of politics and policy was minimal. I had been writing columns for newspapers and magazines for quite some time and that meant of course that I had to take an interest in the world of politics. I have done that consistently from the early 1990s, ever since India undertook major reforms in the wake of the first Gulf War.

My only other association with politics was an inadvertent one. My mother is now 91 years old and living in Calcutta. She is in reasonably good shape. The only problem is that she tends to confuse the terms 'economist' and 'communist'. So every now and then I hear her tell friends and relatives how she is proud that I am such a good communist. And once when I was headed to an international research conference, she let it be known widely that I was going to a conference where leading communists from all over the world were going to discuss how to save the world. That and faint memories of my father's brief involvement in Bengal politics in the late 1950s and early 1960s were the sum total of my engagement.[2]

The serious break came last year when I was invited to be Chief Economic Adviser. After a short period of agonizing over the offer, I said yes; but the decision was not an easy one. Research is a bit like competitive sport. It is at the same time exciting and totally absorbing. At one level it is a selfless activity—you want new ideas to be developed, new theorems to be discovered. But at another level it is a selfish activity—because *you* want to be the one to develop those new ideas and, while you want the theorem to be discovered, ideally, you want it to be you who discovers it. And in *frontline* research one is pitted against some of the best minds in the world. It is a sport that, once tasted, is difficult to give up.

My first weeks in government were disorienting ones. I had to tell myself that if Malinowski could spend months on end in the Trobriand Islands, I could last it out in the North Block. If nothing else, I could think of myself as an anthropologist who had come to observe and some day write on the tribes of the North Block. But once I had tuned into the rhythm of this life amidst the chaos and bustle of policy and politics, I started enjoying it.

The reason I have enjoyed my work thus far is largely luck. The three or four senior politicians I interact with most closely are remarkable

2 In revising the paper, which was first written in August and September, I have left this paragraph and the tenses of the verbs used here unchanged. My mother passed away on October 7, 2010, a few weeks after the lecture was delivered. The paper may be viewed as dedicated to her.

people with vision and commitment. The group of secretaries and my junior advisers with whom I interact almost daily are also a remarkable lot, with deep professional involvement as well as a sense of fun. I am not foolish enough to believe that this is everybody's lot. Because of our own good fortune we must not forget that politics can be murky and the bureaucracy grim.

Another reason for the pleasure in my work is my belief that India is on the cusp of a major, sustained take-off which can enable the nation to take its seat among the industrialized nations of the world by as early as the 2030s. This is not certain but looks possible in a way that it never did in the last 60 years. In a recent cover story discussing China and India, the *Economist* magazine says that 'India's long-term prospects now look stronger'. I think the *Economist* is right. I have argued this before and I believe that India can overtake China's growth rate within the next four years.

Let me put this comment in perspective. China's phenomenal rise has been one of the big stories of the last thirty years. This deserves celebration. But competition among nations, as long as it is played within the rules of the game, is a healthy activity that can boost productivity and bring about progress and advancement. China's success is the outcome of intelligent and hugely powerful government. The Indian government can make no such claim and that is India's strength. Its growth is coming from multiple sources. Moreover, many of India's corporations are showing a maturity and sense of social responsibility which are impressive by any standard. This was not the case before.

However, with all these good signs, there are no guarantees. The business of crafting economic policy is remarkably complex. The economy is one of those strange machines which no one fully understands. It is like driving a car, where you are never totally sure if the accelerator pedal will speed up the car or bring it to a halt, whether a right turn of the wheel will turn the car right or lurch it left. One has to use a combination of daring, intuition and, above all, the large body of imprecise but nevertheless scientific knowledge that has been accumulated from the time of Adam Smith to the present. It is fine for a politician not to know. But it is essential for a good politician to know that he or she does not know. It is this realization that makes room for professional knowledge and allows us to bring the best of science into decision-making.

The problem with *economic* policymaking is that, unlike engineering or physics, everybody feels that everybody knows it all. Try the following mental experiment. Suppose a new aeroplane is being built and we decide to take everybody's opinion into account in designing it—a shorter wingspan because a majority of people want it that way; nose turned upwards because people feel that that will enable it to climb quickly. The chances are, this plane will not fly. At least some of our economic policies have faltered for this reason. While of course in terms of ultimate objectives a democratic society has to be driven by the preferences of its people, in the actual design of how we deliver those objectives, we have to use the best scientific opinion that is available.

When someone asks me, and several have, what is the one big thing that I have learned in the three quarters of the year that I have spent in government, I have a clear answer: the importance of ideas and beliefs. Vested interests do thwart good policy but they are way less important than false beliefs and wrong ideas that keep us wedded to doing things the way we have always done them, refusing to admit new knowledge and shutting our minds to good deductive reasoning.

The problem with the academic researcher is very different. Cutting edge research, whether it be in mathematics, physics, economics or biology has one driving force: the pursuit of aesthetics. It is the same as what Satish Gujral, trying to explain the artist's drive, called the 'disease of creativity.' Finding order where, on the face of it, there is chaos, is what drives the scientist. The social benefit that accrues from research is an unintended consequence of this drive of the researcher. Pythagoras did not set out to find the beautiful relation that occurs between the three sides of right-angled triangles in order to create a better world. But it is nevertheless true that we would be living in a much poorer world if that connection had not been discovered. We would almost certainly be taking longer to travel from one place to another, and we would be having less food and poorer shelter.

It is therefore important not to stymie research by telling researchers that they must direct all their effort to socially useful projects, but to let them pursue what their peers consider valuable. This means that a lot of research will end up creating things of beauty which have little social value. But among the thousands of papers written and patents registered, every now and then there will be something that can transform our lives.

The problem with many researchers is that, having spent years in the laboratory or the classroom, they forget that not every idea that they develop is meant to be put to use. Many of those are patently unrealistic. That is where commonsense comes in. Commonsense is what informs us about which ideas have relevance to the world and which do not. Unfortunately, commonsense is not that common among hardcore researchers. It is this that makes it so difficult to bring together the world of practical policy making and the world of research. It is not surprising that there are very few people who have been successful in both. Keynes and Ricardo are, for this very reason, rare.

As for the economics researcher, there is another problem. Her tendency is to treat economic variables as the key to development. She will argue that to have development and efficiency in society it is essential to get the fiscal policy right, to set right our monetary controls—the repo, the reverse repo, the cash reserve ratio; and that to choose projects we have to do cost-benefit analysis, calculate present values and internal rate of return properly. While there is some truth in all this, I am also convinced that, maybe somewhat paradoxically, economic development and growth does not depend on economic variables alone. Much depends on social norms, culture and the human qualities of integrity and trustworthiness in the citizenry. At the end of the lecture I will comment on this, although this is not my focus today.

I have taken long with the preamble. Let me now use some examples to illustrate how we can bring together abstract academic reasoning and practical policy making and get value out of the endeavour. I have chosen three topics to illustrate this: Inflation, labour laws, and the economics of foodgrain management.

Inflation

To manage inflation successfully one needs to be armed with the first rule of science, which is to recognize that what we do not know far exceeds what we do know, and so be prepared to admit ignorance. The skeptical philosophers, led by the Greeks, Anaxarchus of Abdera and Pyrrho of Elis, are traditionally treated as the leaders of this school of thought. For those who are chauvinistic enough not to like ideas simply because they may have come from another land, I should point out that Anaxarchus had travelled to India some three hundred years before Christ, and by his own admission was deeply influenced by the Indian practitioners of this same philosophy.

Inflation is such a contentious subject because of our innate tendency to assume that whenever we see a phenomenon or an object it has to have a cognizant creator. Popularly, government is viewed as the creator of inflation. We find protestors castigating the government for the persistence of inflation and this is often put on an equal footing with corruption. Corruption is a matter of shame and I believe it is incumbent on us, including those like me who are part of the government, to openly criticize this. Our loyalty to our government or even the nation must never override our personal morality.

To hold government responsible for inflation in the same way as for corruption is, however, meaningless. This is so for four reasons. First, the causes of inflation are not fully understood. This is not a comment on our government or for that matter on any government, but on the state of economic theory. We understand many facets of inflation but not its full details. Second, from the little we know about inflation, one thing is clear. Inflation does not arise solely from the actions of the government and the central bank (in our case the Reserve Bank of India—the RBI), but also from the actions of thousands of firms and millions of individual citizens. Third, unlike corruption from which some people gain and so there are vested interests that keep it going, inflation is a phenomenon which almost no democratic government wishes to see persist. Fourth, despite not understanding the full causes of what gives rise to inflation, economists now have a fairly good grasp of how to bring it down. The trouble is that the measures to stall inflation come with negative side effects, such as escalating unemployment. Hence, these measures cannot be used recklessly as some critics of current policy expect.

In this context, it may be useful to place some facts and simple principles on the table. Since inflation is reported by comparing spot prices today with spot prices one year ago, a one-time increase in price will continue to register as an elevated inflation rate for a full year. If the price of a certain product is raised on a certain date, once and for all, with no further increase for a full year from the date of increase, the inflation figure will be elevated, since we will compare the prevailing price with the price one year ago.

A good example is the current food inflation. The food price index rose from June 2009 to the end of November, peaking on the 27th. After that, the average index has held virtually steady. It was 296 in end-November 2009 and it was 298 in mid-August. Food inflation is still reported to be around 10 per cent per annum because we are comparing prices today with prices in August. Unless some new shocks come into play, the food price inflation should vanish altogether by the end of

November. However, even as I write this, there is news coming in of increases in global prices of commodities, particularly wheat and iron ore, and this is beginning to fuel a fresh round of inflation.

Let me now illustrate the claim that there are multiple sources of inflation. We all know that human beings hold some of their savings in cash. That is, in lockers and under the pillow. A recent study by NCAER and CMCR done by Rajesh Shukla (2010) documents that as much as 41 per cent of rural savings are held in this form. This has an interesting implication. It gives government the leeway to create money supply equal to this amount that people keep under the pillow, without causing inflation. To elaborate further, it is basically a case where the assurance that person i will not put into circulation x rupees gives person j or the government the freedom to inject x rupees into the economy without this causing inflation.

Experience suggests that developing country governments can run slightly larger deficits than can industrialized nations. One likely reason for this is precisely the fact that, in emerging economies, ordinary citizens are more likely to save a part of their money as cash and so hold back from putting it into circulation. There is no hard formula about how much money supply a central bank can create, and how much deficit the finance ministry can notch up, without causing inflation. These are things that we learn from experience. This is the reason why both monetary policy and fiscal policy are part science, part intuition.

Let us assume that through experience we have learnt that fixing the repo rate at 6 per cent, the reverse repo at 4.75 per cent and the fiscal deficit at 4 per cent causes no inflation. Now suppose that ordinary citizens develop a taste for holding their savings not as cash but in bank accounts, postal savings and mutual funds. With absolutely no change in government behavior or the behavior of the RBI, we will begin to see inflation rearing its head. This inflation is sparked by changes in the behavior of millions of individuals taking small actions to put more money into circulation. Yes, this inflation can be brought under control by lowering the fiscal deficit and tightening the money supply. But since there is no exact science of how much this correction should be, it will again have to arrived at through trial and error.

This is just one example. There are numerous other ways in which the actions of individuals and firms can cause inflation. It is true that these can be countered through the actions of the state. But, as just explained, there is no magic formula. A sudden draining of the economy would bring inflation to a halt but in all likelihood that would also bring the economy to a halt, causing unemployment to mount and production to collapse. If you do not want this to happen, you have to tread carefully.

While I am ashamed of corruption in government, our inflation management in this difficult time is not something I am ashamed of. In fact, I believe that the government and the RBI have done a remarkably good job. There are serious flaws in our foodgrain management policy, which I have written about elsewhere (Basu, 2010), and will comment on briefly later. These ought to be corrected so as to have more abundant food and to ensure that this reaches the poor. But, contrary to an opinion held by some, this is unconnected to the present round of inflation.

Labour

I now want to discuss two topics where the crux of the mistake we often make is in failing to appreciate other people's rationality. Full of good intentions we have crafted laws to help our labour markets function efficiently and to help workers do better. But if we look at the level of poverty that prevails in India and the abysmally low wages that most of our workers receive, it is evident that we have not been very successful with this policy.

A similar criticism can be leveled against our foodgrains policy. With our large system of foodgrain procurement and disbursement through nearly 500,000 ration shops we have tried to design a policy to ensure that the poorest households get a minimal amount of food. But there is evidence that malnutrition continues to be high and that the food meant to reach the poor often does not. By some estimates two-thirds of our wheat targeted at poor households misses the target (Khera, 2010). Moreover, foodgrain is stocked beyond our stocking capacity, and a part of it rots away and gets eaten by rats.

Why have these policies fared so poorly? The popular explanation is 'vested interests'. However, during these past nine months I have become convinced that while there are people with an interest in a malfunctioning system because they can profit from it, our failure here is, more importantly, a failure of ideas. We have fared poorly in these areas because we have tried to design systems not by using the best available scientific analysis and statistical information but through popular political consensus. Just as an aeroplane designed by majority opinion or purely political compulsion is unlikely to fly, our policies have often faltered.

There is a lot of existing knowledge and information that we need to draw on to develop a good system. At the heart of this is the importance of appreciating other people's rationality. A well-designed system has to be compatible with individual incentives. This is a central tenet of modern game theory. In deciding how to intervene it is just not good enough to be rational. It is essential that we take into account the rationality of ordinary citizens, ration shop owners, and even the bureaucrats meant to enforce the law.

A fundamental flaw in our thinking is to disregard the fact that the policeman, the PDS shopkeeper, the worker, and the trade union leader are all rational. If you design a policy assuming full honesty on everybody's part and assuming that everybody will carry out his or her duty like a robot, it is likely that the policy will fail. This is the crux of game-theoretic reasoning.

Let me add one word of caution. When I assert that human beings are rational I am not making the common assumption among economists that they are all selfish. Human beings are all endowed, in lesser or greater extent, with morality, norms and integrity. They are selfish within the limits of these moral constraints (Basu, 2010a). So what I am asserting here is that in designing policy in India we will have to make realistic assumptions about how honest the PDS shopkeeper is, how professional the Indian policeman is. To design a system by assuming them to be robotically correct is to doom the system to failure.

Labour market regulation is a taboo topic in India. That is exactly why I have chosen to talk about this. Anybody who talks about the need for reforming our labour laws is viewed as a neo-liberal and those who are against labour market reform are assumed to be progressive and pro-worker. I want to argue that such thinking is fundamentally flawed. We need to reform our labour laws not to help the nation grow faster, or for big business to flourish, but because we want our workers to do better. Our laws, well-meaning though they may be, have ended up hurting our workers, both in the unorganized and organized sectors.

Minimally, we need to drag this topic out of the closet into public space for discussion. Once the issues are properly understood, my expectation is that it will be workers and the trade unions that will be championing the need for reform. We must not allow this important topic to be hijacked by ideologues.

There are debates in which the position one takes reveals ones ideology. But there are also debates where this is not the case. When two persons argue whether or not there is intelligent extra-terrestrial life, to try to deduce from one's position on this debate whether he is left-wing or right-wing is hopeless. I am arguing that the position one takes on labour market reform is like the debate on the existence of extra-terrestrial life. It says nothing about a person's ideology. One can be left-wing and still argue that workers should not have an exogenously-determined right of job tenure. The current left-wing argument is that such a law, after various economic agents have responded to it, ends up creating a world where workers are worse off.

The kind of legislation that is of central interest to me here is India's *Industrial Disputes Act*, 1947. This Act, along with the amendments of 1976 and 1984, places restrictions on layoffs and dismissal by large firms. What is important is that these restrictions are exogenous in the sense that they override any contract between the employer and workers. For firms employing more than 100 workers the Act requires the employer to take prior permission from the government for layoffs and retrenchment of labour and for closing down the firm.

Actually, government intervention in labour markets goes much deeper than would appear through studying the labour laws. The Industrial Disputes Act, 1947, allows the Labour Departments of the Centre and State governments to intervene not only in labour disputes but also in *anticipated* labour disputes. In addition there is the problem of political and ministerial intervention. Also, the judiciary often takes a custodial attitude to labour. In 1992, in a case involving a bankrupt private firm, a judge of the Calcutta High Court, Mr. Justice Hazari, argued that, if another private firm took over the firm, there would be no guaranteeing that that firm would not, in turn, go bankrupt and cause workers to be laid off. He therefore directed the Government of West Bengal to take over the firm and run it with the existing workers. Finally, the effect of a law often goes beyond the actual words of the legislation. Legal philosophers have written about the 'expressionist function of law', which refers to the effect that a law has by altering human preference and behavior, over and above that which is dictated by the actual letter of the law.

Such laws and practices hurt not only workers who are not protected by the law (because, for instance, they work in small firms), but also the workers who are allegedly protected by law. Many observers have pointed out that protective labour legislation may have hurt India's overall growth and efficiency (see, eg., Ahluwalia, 1991; Papola, 1994; Besley and Burgess, 2004). They are probably right but my argument here is distinct because I am claiming that such legislation may have hurt the very constituency that it was meant to protect, to wit, labour.

Suppose some workers in a large firm ask their employer to pay them a higher wage and, in turn, they promise to go away without compensation whenever the employer wishes to sack them. Even if both the workers and the employer benefit by such a contract, it is unlikely in contemporary India that an employer will agree to such a contract. This is because if, after paying a higher wage for some time, the employer actually gives notice to his workers (perhaps because demand for the product has fallen off), the workers can appeal to the government and the government is very likely to cite the *Industrial Disputes Act* and declare such a dismissal illegal *no matter what the prior agreement between workers and employer*. Indeed there are few credible ways for workers to give up their *right* not to be dismissed. Over here we must distinguish between 'not resisting dismissal' and 'giving up the right not to be dismissed'. A worker can of course choose not to resist dismissal; but what is interesting is that he or she may not waive, and, in the case of India, is not *able* to waive the right not to be dismissed.

The above paragraphs draw on an earlier paper of mine (Basu, 2006). Let me veer from that and construct an intuitive argument to illustrate my point. Consider the market for domestic help—cooks, drivers, and so on. Suppose the government enacts a new law (or equivalently a new custom comes to prevail) whereby one cannot fire a domestic servant, or before one fires someone one has to get some cumbersome government clearance. At first sight this *looks* like a progressive legislation, especially given that our treatment of domestic servants is far from exemplary. But the effect of this law is not difficult to see. People will immediately cut back on hiring domestic help. The demand for washing machines, clothes dryers, microwave ovens and vacuum cleaners would go up.

The biggest loser of this seemingly good policy would be the workers. Their demand having plummeted, unemployment would rise and wages would drop.

My claim is that this is what has happened to our industrial sector workers. They have received a raw deal. But what I am arguing for is not to change the laws, but something more minimal, to bring this discussion into the public domain. My hope is that once this is properly understood, the demand for change will not have to come from corporations and newspaper columnists, it will come from the workers themselves. A decision can be taken only after that.

The Market for Foodgrains

The Indian Government has been subject to a good deal of adverse press regarding the management of foodgrains. Critics have pointed out that alongside high food prices, foodgrain stocks have been piling up and going waste. Further, it has been pointed out that the subsidized foodgrains that the government is supposed to distribute among the poor and vulnerable households frequently do not reach them and, when they do, they are often adulterated.

These are serious criticisms. But the persistence of the problem, despite the government's best intentions, suggests that there may be more to the problem than is commonly acknowledged. Some of the more popular recommendations are fraught with risks. Take the suggestion that the government should build more warehouses and stock the grain properly so that there is no rotting and wastage. This, in itself, is a desirable objective. However, it has to be understood that this policy will not lower the price of food since the shortage of grain will not be alleviated by virtue of the grain being stored.

Consider another policy intervention that is being talked about widely, namely that the government should sell the stockpiled foodgrains at zero or near zero prices. If this policy is followed without complementary changes in other policies, we will encounter another problem. Traders will buy up the grain at zero or near zero prices and sell it back to the Food Corporation of India at the minimum support price declared by the government. In other words, there will be round-tripping—the same foodgrain will be bought from the government and sold to the government repeatedly, with traders making huge profits in the process.

One can react to this by arguing that this kind of profiteering by traders is immoral and they should not be doing so. The mistake that we make is precisely the one of confusing 'should' with 'is'. To make effective policy, we have to assume what rational traders will realistically do and not pretend that traders are moral creatures or robots that will carry out the government's order. Some people may argue that we should place officers and policemen to monitor the behavior of traders, but here again we encounter the same problem. Policemen and bureaucrats entrusted with this job will, in all likelihood, end up creating another layer of bureaucracy and corruption. To say that they should not do so is a nice moral sentiment, but not a practical one.

Economic theory teaches us that in designing a good policy we have to take account of the incentives of those involved and affected by the intervention. If they are prone to cheat we have to take that into account in designing our policy. Further, in the above case, we have to look at our entire foodgrain policy—from production and procurement to release and distribution—in a holistic fashion. To try to repair just one part and leave everything else unchanged may do more harm than good.

One flaw in our MSP policy has been the tendency to procure foodgrains at a fairly even pace from one year to another. Good economic theory tells us that, in order to stabilize markets, we should be procuring foodgrains when production is plentiful and prices low, and releasing food when production is short and prices are high. This will tend to cut down the risk of traders buying up grain and selling it back to the government. It will also stabilize the price of foodgrains from one year to another. It could help dampen the well-known cobweb price cycle that basic economic textbooks teach us. I have, in a recent paper, described at length a holistic package of reforms for the better management of foodgrains in India (Basu, 2010).

Let me turn to another problem of foodgrain management. A long standing practice in India has been to supply foodgrains at a low price to the poor and vulnerable households. This is as it should be in any responsible country. The rich and the middle classes have a responsibility toward the marginalized. The recent initiative to make this more comprehensive in the form of the new food security bill is thus commendable. But to make sure that we do this successfully, it is essential to review the mechanics of how we reach the food to the poor. And for this we have to begin by asking why our existing system has performed poorly.

Note that currently the Food Corporation of India hands over subsidized food to the PDS shops and the PDS shopkeepers are asked to supply this cheap food at below-market prices to the poor households. If the PDS shopkeepers were totally honest or mere robots, this would be a faultless scheme. But they are neither. The temptation that these shopkeepers face is too big for many of them to resist. So they sell off a lot of the subsidized grain they receive from the government at the high open-market price and send away the poor on the pretext that they do not have any grain available, or they adulterate the grain that they sell to the poor. Once we recognize this chink in the distribution architecture, the need to get the subsidy directly to the poor households becomes evident.

One way to do this is to hand over the subsidy not to the PDS store owner but to the poor households directly. This can be done by handing out food coupons or (better) smart cards, or even via transfers effected through cell phone messaging. The households are then given the freedom to buy food from any store using this direct subsidy from the government. Notice that the shopkeeper now has no reason to prefer a rich customer over a poor one, since both pay the full price. Also, a shopkeeper who adulterates food now faces the risk that the buyer will walk over to another store and buy her supplies there. This is not a flawless system but unequivocally better than the existing one. It has some of the flaws of the existing system but not all, and it has no serious additional flaw.

One problem that is mentioned is that of people using fake coupons. This is no doubt a matter of concern, but it is of no greater concern than that of fake rupee notes being used in everyday financial transactions. Just as we do not stop using currency because there is some counterfeiting, so this risk is not enough reason to not use coupons. We should simply manufacture the coupons using some of the same technology currently used for printing currency notes, which has lots of safeguards.

There is a small risk that the coupons or the smart cards will be traded off by the male head of the household and used to buy other products. This can, however, be largely warded off by giving the coupons or the smart cards to the senior women in the household. There are enough studies to show that this can make a huge difference in terms of the quality of household spending (Sen, 1990; Desai and Jain, 1994; Agarwal, 1997; Basu, 2006).

Social Norms and Personal Integrity: A Closing Comment

The analysis in this paper takes a rather grim view of how human beings behave and commends the design of policy that takes this into account. Economists usually leave it at this. This is unfortunate, there is enough evidence that a successful economy relies not just on good economic policy but on citizens' social qualities. Honesty, integrity and trustworthiness may not get enough mention in standard economics texts, but there is a growing body of research that shows that societies endowed with these qualities tend to do better even in economic terms.

The relationship between the presence of these qualities in a community of individuals and the economic well-being of that community is not a simple one, nor is it always uni-directional. I discuss these at length in Basu (2010a). But complex or not, the relation is there, and by promoting it we can enable an economy to be more efficient and develop faster.

Very simply, the argument is this. To help an economy do well and grow faster it is essential that we can rely on contracts ('I will supply you oil today, you will pay me tomorrow'. 'I will give you a loan to buy a house, you will pay this back to me with interest over the next 30 years'). But contracts and agreements are ubiquitous in life and there is a limit to what can be enforced by the government and the law courts. If human beings have basic honesty and trustworthiness, then most small agreements can be relied on without expensive formal contracts. For this reason, a society that manages to inculcate these qualities in its citizenry tends to do better.

Mainstream economics has paid too little attention to these social and cultural prerequisites of development. We need to correct this in the world of research, and, at the same time, try to inculcate these values in our people, through education and through our leaders setting a better example. This is a vast topic on which volumes can be written, but I would be amiss if I did not draw attention to it, however briefly.

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