

INDIANOMICS

How to put the Indian economy On the development track

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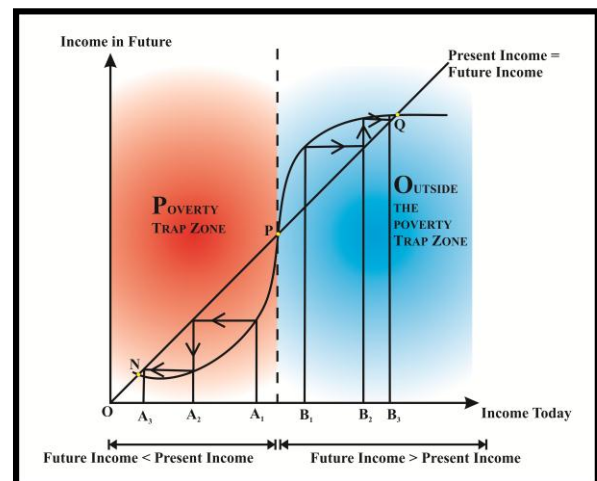
It can be naturally expected from a country like India that is experiencing growing per capita income rates, to raise unprecedented fiscal resources to finance the pro-poor developmental missions. However, despite well-intentioned and targeted pro-poor developmental strategies taken up by the Government of India, it seems that the Indian social milieu is not quite responding to such stimuli. The only possibility of why there is no significant improvement in the living standards of the Indian poor seems to be corruption. Most people would argue that it is because of extensive corruption that benefits do not actually reach the needy. But why can we not be honest, if we are the ones who are suffering from corruption? Moreover, we must also acknowledge that there are other factors pulling the reins of India's success, apart from corruption. In fact, the most basic question to

be asked is that whether government policies like subsidies, have any significant meaning to the poor, and even if they do, are they helpful in the long run?

Why does a poor farmer not use new output-enhancing agricultural techniques? Why are poor people eating less with more income? Why are government hospitals rendered non-functional in rural areas? Why building schools (even with proper infrastructure) is not enough for the spread of rural education?

This essay will throw light on all the above questions, as well as how government pro-poor policies should be designed along with corruption-fighting mechanisms. For all these analyses, I need to establish the concept of a Poverty Trap.

Figure No.: 1



The above multiple equilibria scenario is typical of the economic condition of most of the people in the developing world. **This model assumes that what you have today determines how much you eat, how much you have to spend on medicine or on the education of your children, whether or not you can buy fertilizer**

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or improved seeds for your farm, and all this determines what you will have tomorrow.

The S-shape of the curve is the source of the poverty trap. On the diagonal line, income today is equal to income tomorrow. For those who are in the *poverty trapzone*, income in the future is lower than income today: the curve is below the diagonal line. This means that over time, those in this zone become poorer and poorer, and they will eventually end up trapped in poverty, at point N. Similarly, for those who start outside of the poverty trap zone, income tomorrow is higher than income today: over time, they become richer, at least up to the point Q.

To understand the situation in a poverty trap, we consider a story revolving around the experiences of a small Indian farmer. Suppose he was given free fertilizer and as a result, the harvest from his field was 20 times what it had been in the previous years. With the savings from that harvest, it is expected that he would be able to support himself forever. The implicit argument is that the farmer was in a poverty trap in which he could not afford fertilizer: the gift of fertilizer was his only escape route from the trap. But skeptics of such subsidies would object that if fertilizer is really so profitable, why could the farmer not have bought just a little bit of it and put it on the most suitable part of it. This would have raised the yield and with the extra money generated, he could have bought more fertilizer the following year and so on.

However, adoption of such policy depends on whether the strategy is feasible: buy just a little to start with, make a little extra money, and then reinvest the proceeds, to make even more

money, and repeat. But maybe fertilizer is not easy to buy in small quantities. Or perhaps it takes several tries before one can get it to work. Or there are problems with reinvesting the gains. Or something makes it hard to save between planting seasons, so that even if the farmer can make money in one season, he cannot turn it into further investment. One could think of many reasons why a farmer might find it difficult to get started on his own.

Now we see the application of the above poverty trap multiple equilibria scenario in the context of nutrition, health and education.

Nutrition Trap

A nutrition trap implicitly assumes that low nutrition is capable of creating low incomes. This is the functional aspect of undernutrition: apart from being of social and ethical concern in its own right, it has an impact on the ability to earn. Thus, it is not difficult to imagine a vicious circle of poverty in many low-income countries, in which low incomes are responsible for undernutrition, which in turn perpetuates those low incomes. The whole point is that of a biological relationship between nutrition and work capacity. However, if work capacity affects future work output, why do not employers wish to offer nutrition-enhancing long-run contracts that take advantage of this? Because there is no guarantee that the employee will work for him, perhaps he might migrate to another village. Second, if a person in good health can be identified by other employers, the market will bid up the wage rate for such an employee. This means essentially that the employee will reap the entire benefit of the employer-financed investment in the form of a higher wage. Therefore, it is evident why there is no incentive

for the employer to increase his employee's work capacity.

This leads us to tend to believe that if there was any chance that by eating a bit more, the poor could start doing meaningful work and get out of the poverty trap zone, then they should eat as much as possible. Yet, this is not what we see. Food represents from 36% to 79% of consumption among the rural extremely poor, and 53% to 74% among their urban counterparts. In other words, the food budget does not go up proportionately faster than total spending. In the Indian state of Maharashtra, in 1983, even for the very poorest group, a 1% increase in overall expenditure translated into a 0.67% increase in the total food expenditure. Moreover, when poor people get a chance to spend a little bit more on food, they buy better-tasting, *more expensive* calories. This "flight to quality" in food consumption is a completely psychological phenomenon.

Angus Deaton and Jean Dreze have shown that despite rapid economic growth, there has been a sustained decline in per capita calorie consumption in India. It is still that richer people eat more than poorer people do. But, at all levels of income, the share of the budget devoted to food has declined. Moreover, the consumption of the food basket has changed, so that the same amount of money is now spent on more expensive edibles. Fortunately, in India, the percentage of people who consider that they do not have enough food has dropped dramatically over time: from 17% in 1983 to 2% in 2004. So, perhaps people eat less because they are less hungry.

Thus, we can conclude that whether or not a nutrition-based poverty trap exists depends on

the poor people themselves and not on some pre-fixed minimum metabolic requirement. What is important from the policy perspective is that provision of ever-increasing amounts of food grain for subsidized public distribution is not the solution to alleviating malnutrition. This philosophy renders the Food Security Bill functionally redundant.

Health Trap

It is typical of a poor family to lose any hope of escaping from the classic poverty trap --- the expensive (often debt-financed) treatment of father's illness made them poor, which is why the undernourished child stayed sick, and because he was too sick to get proper education, poverty loomed in his future. Even if the family was not in the poverty trap previously, it can be entrapped because of the ballooning debt obligations.

Thus, expensive private health facility has the potential to be a source of poverty trap. However, militating against our common sense, if the poor people are provided cheap medical facilities, especially preventive ones, then people do not take advantage of these cheap preventive technologies to improve their health. This is invariably because of the typical psychology that whatever is "free" is "worthless". Thus, if the government wants to provide cheap health services then it must invariably carry on a campaign on educating people about the positive effects of cheap but effective, preventive medication.

As far as public health services are concerned, instead of heavy subsidies in medical expenses, the government should channelize its funds to the poor in the form of easy availability of low-

interest health loans and publicly provided health insurance. This would not only increase the worth of public healthcare facilities in the eyes of the poor, but also reduce the incentive for rent-seeking activities for getting admission in the overcrowded government hospitals. Moreover, the poor people will have lesser chances of being thrown into the poverty trap by a negative shock of sudden medical expenses, if the interest rates on health loans are administered to be low by the government. It has been calculated by the distinguished economist Arvind Panagariya that such a policy of health loans and insurance will require only one-tenth of the present State-expenditure on health subsidies.

Education Trap

If the younger generation of a poor family does not receive education then the hope of achieving higher and more formal income becomes dimmer. However, making available primary or secondary education in a poor society may not always produce the desired effect of achieving higher human capital to be used for tapping the gains from growth and globalization. This is because, if the economic environment of the poor people dictate to them that returns from education are typically low (particularly, when there are rampant opportunities of informal employment) then there may not be enough demand for education. Thus, the problem of education trap cannot be solved through a unilateral treatment of the supply side. The demand side shortage needs to be addressed in a poor society.

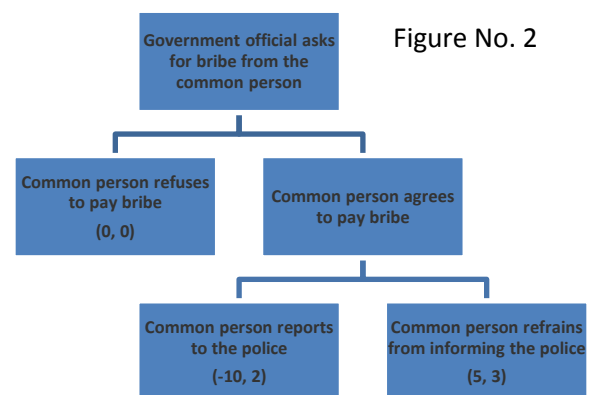
From the ongoing discussion, we have understood how a common Indian villager lives in an air of despondency due to useless public

services. Even when the public services are somewhat useful, they scarcely reach the actual poor due to massive corruption and pilferage. Although the problem of corruption is mostly tried to be solved through moral or ethical value judgements, economists have long realized that so long as there remains private incentives for corruption and rent-seeking activities, no amount of ethical deliberation will make the economy corruption-free.

Game-theoretic Approach to Corruption

Suppose a layman approaches a government official to get his routine job done. However, the corrupt official, as usual, asks for a bribe, saying that if he does not pay the bribe his job will be delayed. At this juncture, the common man can decide not to pay the bribe and remain content with a delayed completion of his job. Alternatively, he could have agreed to pay the bribe. Nevertheless, once his job is done, he always has the option to report this corrupt action of the official to the police.

The payoffs of the government official and the common person are shown in the sequential game-tree of Figure No. 2, in the form of ordered pairs.

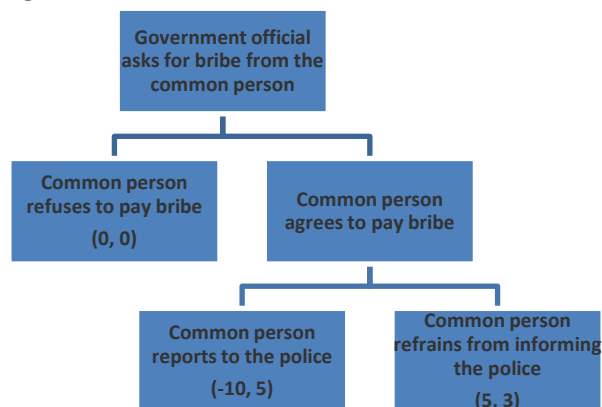


Note that since the payoff of the layman is less

if he reports to the police than if he does not, therefore the corrupt official gets away and corruption persists in the economy.

This gloomy scenario can be changed quite easily, if there is some legal reward provision for the common person (whistleblower) who reports about an act of action. In this way, his payoff can be increased in case of reporting and then the official's payoff falls to -10, thereby rendering bribe-seeking non-profitable. In this way, protection and reward of the whistleblower in the society can help reduce corruption. This case is shown in Figure No.: 3 below.

Figure No.: 3



Economics through Alphabets

Gaganjyot Kaur Narwal

On an early winter morning, 4 a.m: the villages and cities sleep soundly. A young girl, studying in 11th grade and belonging to a poor laborer's family in a small village in north Rajasthan, is wide awake. The cause of her early rise is to read a book titled "Time management". She must finish as much as possible because when the day light spreads she will get busy in tending to the cows and goats and help her mother to take milk to the milk collection center of the village. After that, on her bicycle she will go to school in a nearby town. Her family, asleep, is completely unaware of her daily conferences with the books at this hour.

Her story is no different from that of a few others in the same village. The concept is, to wake up early morning and read books borrowed from the village library which was inaugurated a few years ago. Later in the day the farm and household work will dominate the schedule of all village residents. The evenings and nights will suffer from electricity cuts making it impossible to read books, thus, the time snatched from the busy day and early morning electricity blessed hours are put effectively to gain knowledge.

A few years ago this was not the case- there was no library. The post green revolution era was marked with prosperity- increased use of machinery reduced man hours. A survey of four