

Why do people not enter the formal sector?

This is mainly due to the difficult environment under which the formal sector operates, especially in developing countries. The Indian bureaucracy is plagued by red tapism, bribes, excessive taxes etc. The more popular reason is that the benefit of working in the formal sector is available only to the privileged ones. Strict market regulations are another force driving workers against entering the formal sector.

How to formalize the informal sector?

The government needs to bring in changes in different stages. It needs to create new jobs, enough to accommodate the young population. The huge barricades of costs and regulations need to be reduced to make the transition easy. The reason employers prefer hiring on contractual basis is that it is more affordable. Hence, labour laws should be made more flexible. The informal sector attracts many entrepreneurs because of the ease of starting a business, and the same needs to happen in the formal sector. The regulations governing the setting up of a business need to be mellowed down and made more accessible to everyone. It takes 71 days to register a business in India, compared with six in Singapore, and three years to close an insolvent business. The corporate tax code should be more business friendly to keep tax evasion in check and a strong administration brought in for its implementation. More tax amenities and tax based incentives should be introduced. A good example here is that of Spain, which reduced corporate taxes and streamlined labour laws. It managed to reduce unemployment by 40% and increase tax revenue by 75%. Until the informal sector is made less attractive, this web of the gray economy will continue to trap people and

the cycle of poverty will consume generations to come!

References:

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The Fascinating Realm of Behavioural Economics

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Why is it that we sometimes find ourselves excitedly buying things that we don't really need?

What about the 'FREE' extra helpings that we pile up on the plates at a buffet even though our stomach is full?

Have we not ever bought two of a product that we wouldn't have chosen in the first place just in order to get the third one free?

Trying to analyze one's daily behaviour using the tools of economics often presents various puzzling examples such as those listed above. As we delve a little deeper into these issues, one is introduced to the fascinating world of behavioural economics which tries to provide answers to these amusing puzzles and paradoxes by drawing upon the aspects of both psychology and economics.

But if all economics is meant to be about people's behaviour, then how exactly does behavioural economics differ from the rest of economics? In standard economics, we conceptualize a world of unemotional supermen like utility maximizers and rule out the cognitive and social aspects of human behaviour. And it seems logical to do so, since the models then become practically more relevant and much easier to formulate. But the test of any theory lies largely in its predictive power and crucial to any theory or branch of study are the central assumptions / traits on which the foundation is laid.

Standard economic model has three such traits/assumptions that behavioural economics finds to be flawed.

1. Unbounded rationality
2. Unbounded willpower
3. Unbounded selfishness

The ignorance of bounds on rationality and the limited information processing and problem solving capabilities of human beings in standard economics, often, is the reason why economic agents act in ways that seem irrational and these departures from rationality emerge both in their judgements and choices, and their suboptimal behaviour.

The second idea of unbounded will power is something that seems incredibly incredulous, especially to us, the students,

who keep procrastinating till the last day and never manage to submit assignments on time because we, as humans, lack complete self control. The diet plans that fail and the difficulty we have in saving for the rainy day - all are examples of our fallible human behaviour and bounded willpower.

As for the third basic tenet, i.e. people are unboundedly selfish, illustrated in standard economics with the help of issues such as problems of moral hazard and free riding, we have counter examples such as those of altruism and charity that behavioural economics deals with. In fact, several researches in behavioural economics solely deal with the connection between these two separate realms of market and social norms.

Rather than relying on these superhuman traits of standard economics, behavioural economics tends to provide a more realistic, psychological foundation and thus increases the explanatory power of economics.

While standard economics assumes that we independently know what we want and our preferences are fixed and we carry out a rational analysis every time we have to make a choice; behavioural economics, on the other hand, suggests that we are not guided only by rational analysis, rather at times we merely copy others and our actions are a result of social influences and not just any utility maximization process i.e. our preferences are not fixed or independent.

For instance, it is observed when policy makers devise mechanisms with immediate effect such as a fine for over speeding, it has a short term impact which may not last. Knowing that there's a fine for speeding and high likelihood of getting caught, I'll probably drive more slowly, but I will drive just as fast once I realize the chance of being

caught is low. However, if policy makers can change the social norm then much less enforcement will be needed after the change.

Moreover, neo-classical economics fails to recognize the existence of habits. Doing something out of habit such as choosing my normal cup of coffee when shopping, is outside the realm of neo-classical theory, in which I do a full analysis of all the available options. But in behavioural economics, the view that frequency of our past behaviour influences our current behaviour is an accepted norm. Once you pay a certain amount of money for a particular good, chances are high that the next time you buy the same good, the price you'll be willing to pay would be at least the same or more. You wouldn't bother to conduct an independent analysis again for making the choice. This is known as the anchoring effect in behavioural economics. The earlier price acts as an anchor and influences our future actions. The realm of behavioural economics is full of such realistic examples. One puzzling example that clearly highlights the inadequacy of standard economics to explain normal human behaviour is presented below.

"When small fines were imposed on the parents of all children at a day care centre in Israel, if they arrived late, it had a counter effect. Parents arrived late more often than before the fines were introduced."

This seems illogical in neo-classical economics since a standard neo-classical analysis would add up the financial costs and benefits, so financial rewards would always be expected to encourage and financial fines would always be expected to discourage. But the same example finds explanation in behavioural economics in which it is accepted that we have intrinsic motivations where we do activities for their

own inherent reward as well as extrinsic motivations (financial reasons) and example such as that given above show that it is possible that intrinsic motivations are crowded out by extrinsic ones and hence measures such as fines prove to be counterproductive. In the above example, by making a payment, the parents no longer felt guilty about arriving late and treated the situation as if they were paying for a service. Similar behaviour was observed when people were asked to volunteer for some social work. The average volunteering time was 14 hours per week but those who were paid did approximately 4 hours less volunteering work per week than unpaid volunteers.

Professor Dan Ariely presents another interesting example in his book 'Predictably Irrational' about the rationing of tickets for basketball matches at the Duke University Stadium. Since the number of seats available at the stadium is limited, a kind of lottery is used to distribute the tickets among the potential buyers. He asked the winners of the lottery the lowest price at which they would want to sell their tickets to the losers of the lottery and also inquired about the highest price that the losers of the lottery would be prepared to pay for buying the tickets. And the results showed that the average selling price (about \$2400) was separated by a factor of 14 from the average buyers offer (\$175).

Again, neo-classical economics, that expects people to have a preference on risk (risk loving or risk averse) but usually assumes them to be neutral to loss/gain, fails to explain the difference between someone's "willingness to pay" and their "willingness to sell" i.e. they wouldn't sell something they own for just about the same price as they would be willing to pay to buy it, if they didn't already own it. People are observed to show an 'endowment effect' i.e. once they

own the good, someone's selling price (willingness to accept) for the same good would be upto 20 times the buying price (willingness to pay).

Further, the standard neo-classical assumption of human beings being capable of making complex calculations to compute their optimum best choice with all necessary information at their disposal is a seriously flawed one. Psychologists have long established that people, rather than using any consumer theory, depend upon their internal biases and certain 'rules of thumb' to make decisions. In making a decision between any two actions, if one is presented to us as a loss and the other as a neutral or a gain, we avoid the apparent loss i.e. framing a question differently would yield different responses even if the two outcomes are mathematically identical, such as :

1. Would you agree to undergo a medical procedure if your doctor tells you "Of those who have this procedure, 10% are dead after 5 years"?
2. Would you agree to undergo a medical procedure if your doctor tells you "Of those who have this procedure, 90% are alive after 5 years"?

Positively framing the question leads to more number of people confirming in an affirmative quite predictably but also irrationally since both the outcomes are mathematically identical.

Similar to this is the tendency to jump to conclusions based on our intuitions. An example of a mathematical problem where our intuition is often wrong finds mention in Kanheman's paper.

"A bat and ball cost \$1.10 in total. The bat costs \$1 more than the ball. What is the cost of the ball?" Most people answer 10 cents including 50% of Princeton University students, which is wrong. All these are the different kinds of internal biases that may cloud the judgement of rational human beings while making decisions.

Examples such as this and the several ones that have been cited above clearly highlight the need for questioning the inherent irrationality of human behaviour, which is often left unexplained by standard economics. Under the telescope of behavioural economics, one finds that these apparent irrational acts are also systematic in a certain way and hence predictable and learning more about how the human mind ticks, requires that we modify conventional economics and try to have a new understanding of human nature and decision making using the forces of both economic rationality and psychological notions.

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Prepare for Judo Economics!!!

Aditi Singh III Year

Judo (meaning "gentle way") is a modern martial art created in Japan in 1882 by Jigoro Kano. A central principle of judo is that of *seiryoku zen'yō* (maximum