Economics focus

On deaf ears

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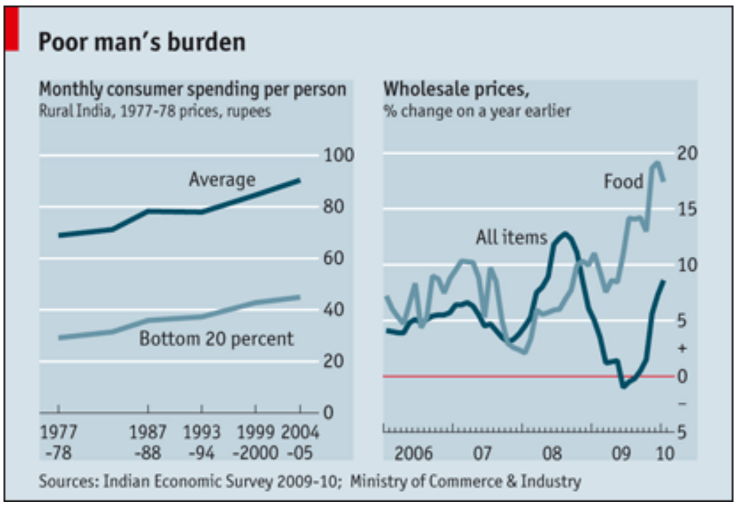
Does India's government pay any heed to its economic advisers?



ECONOMISTS like nothing better than giving advice to governments. But why do they, of all people, imagine that anyone listens? In their models economists assume that governments, like other actors in the economy, have objectives of their own, which they seek to advance as best they can. They are not disinterested servants of the public good. So governments will ignore a recommendation from their advisers unless it suits them, in which case they would have done it anyway.

In his book "Prelude to Political Economy", published in 2000, Kaushik Basu of Cornell University wrestled with this paradox. "If, seeing high unemployment in an economy, a person… advises entrepreneurs to employ more labourers, or consumers to demand more goods, this typically causes economists to share a laugh." And yet economists routinely advise governments to act in the economy's interests rather than their own.

Mr Basu is now living the conundrum he theorised about. In December he became the chief economic adviser to India's finance ministry, occupying an office amid the sandstone domes and colonnades of Sir Herbert Baker's Secretariat buildings in Delhi. On February 25th he released the ministry's annual economic survey, a day before the minister, Pranab Mukherjee, presented the budget. What advice did Mr Basu give? And did his boss upstairs pay him any heed?

Quintessential

The survey welcomes India's remarkable escape from both the financial crisis and a disappointing monsoon. The economy is expected to grow by 7.2% in the fiscal year ending on March 31st and it should return to growth of about 9% in the medium term, the survey argues. This government, however, will not settle for any old growth. It has committed itself to "inclusive growth". The phrase is often invoked, but rarely defined precisely. In the survey Mr Basu offers a "statistical summing up" of what inclusive growth might actually entail.

He proposes that the nation should measure its progress by the growth in per-capita income of the bottom quintile, or 20%, of the population. This simple yardstick gives due weight to both the poor and to growth. Mr Basu cites some figures crunched by S. Subramanian of the Madras Institute of Development Studies (see left-hand chart). They show India's poor making what Mr Subramanian describes as "a modestly plodding climb out of considerable income deprivation".

For growth to be inclusive, Mr Basu suggests, it is not enough that the income of the bottom 20% rise at the same percentage rate as the average. Instead, they should get an equal absolute share of the income the economy adds. If the economy grows by $100 billion in a year, the poorest fifth should get $20 billion. That is a high bar indeed. Certainly, it would be impolitic for the government to hold itself to such a demanding standard. But as Mr Basu noted in his book, the adviser's objectives are not always quite the same as the government's.

To help the poor plod a bit faster out of deprivation, the government will spend almost 1.9 trillion rupees ($41 billion) this year on social services and rural development—including education, health and a workfare scheme for the rural poor—by the end of this fiscal year. That some of this money has reached the poor, Mr Basu argues, is demonstrated by the rising price of the foods they buy. Indeed, inflation (or "skewflation", as Mr Basu calls the lopsided rise in prices) is now the government's biggest political headache (see right-hand chart).

One puzzle is why the government has not quashed food prices by releasing more grain from its overflowing stockpiles. There is, after all, little point holding a buffer stock if you never run it down. "If there are certain minimal amounts of grain that we are committed to holding at all times," Mr Basu points out, "then it is the same as not holding them." When the government has released grain, it has also made the mistake of doling it out in hefty batches to a handful of suppliers, who can then corner the market between them. In January the government sold smaller batches of grain to a larger number of traders, with far greater effect on prices. In this case, economic logic revealed a more effective means to the government's chosen end.

Another way the government purports to help the poor is to subsidise grain and fuel, selling them at controlled prices through "ration shops" to the poor. Some propositions, Mr Basu writes, seem obvious with a little thought, but far from obvious with a lot of thought. Price controls are one of them. It seems clear at first blush that one can cushion the poor from the vagaries of the market by regulating the prices of basic necessities, like food, fuel and fertiliser. But a good economic adviser knows better. Mr Basu points out that ration-shopkeepers divert much of the subsidised grain on to the open market, adulterating the remaining grain with gravel. Reetika Khera of the Centre for Development Economics in Delhi has found that in some states, when market prices rise the poor paradoxically get less subsidised grain, because so much is diverted. It would be better, Mr Basu argues, to give the money to the poor directly, through food, fertiliser or fuel coupons, which they could spend anywhere they please.

Has his boss heeded any of this advice? The government recently decided to raise the price of urea, a fertiliser. Mr Mukherjee also increased import duties and production taxes on fuel. This will help him reduce the central government's fiscal deficit to 5.5% in the next fiscal year, down from 6.7% this year. It also prompted the opposition and some of the ruling coalition's own allies to walk out in the middle of his speech. Thanks to these measures, fuel prices will be higher—but no freer. Shortly before the budget an expert committee headed by another economist urged Mr Mukherjee to liberalise the prices of petrol and diesel. In his budget Mr Mukherjee left that decision to his cabinet colleague at the petroleum ministry. The government's economic advisers, both in the finance ministry and outside it, may not be pleased by this dodge. But at least one of them should not be surprised by it.