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# Insights from Behavioral Economics on Current Policy Issues

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**Abstract**

*The paper examines behavioral constraints in policy-making and in achieving coordination across policies. First it applies psychological concepts to understand policy inadequacies, and next examines how general reforms or better coordination can be achieved using psychological trigger strategies.*



**Keywords: Indian policy; Behavioural constraints; Psychological trigger strategies**

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## Introduction

A long day of intense and enthusiastic debate among a Panchayat of wise elders has generated valuable insights. One of the learning points repeatedly touched on through the day is the importance of coordination across regulators, government departments and policies. Moreover, Bibek Debroy in his talk extended it to the citizen—how can the citizen help the government achieve its tasks.

Criticisms made, however, point to the question of why policy has not been able to deliver—why is it India has under-performed in so many dimensions? From the macroeconomic perspective, higher growth and some reduction in poverty has been associated with a lot of volatility. Growth has not yet crossed the threshold above which it becomes self-sustaining.

Participants of this symposium were long associated with policy. There is an old saying that India has good economists but poor policy. Post liberalization, however, there is more optimism—it is agreed India has excellent potential but the question is when is it going to be realized?

It may be helpful to try a fresh approach. This year the Nobel Prize was given for behavioral economics[1]. It is useful to examine behavioral constraints in policy making, and in achieving the required coordination. First we will apply psychological concepts to understand policy inadequacies, and then go on to see how general reforms or better coordination can be achieved using psychological trigger strategies.

## Behavioral constraints in policy

*Over-reaction*: After the global financial crisis (GFC) excess macroeconomic stimulus led to overheating of the economy. As a result there was an over-reaction. We bound ourselves tightly in monetary-fiscal rules. This was a valuable strengthening of institutions bringing in a long-run perspective. But even flexibilities and space available within the rules was not utilized, although demand stimulus was required since export demand was slowing and there was clear excess capacity in industry. Overreaction was the psychological trap policy was caught in.

The post GFC fiscal stimulus was very large. The fiscal deficit rose by 4 per cent. The increase then went largely into rural construction at a time when food inflation was high. That stimulated a rise in wages and further inflation. But that should not be taken to conclude that all rise in government spending will have this effect. If spending is on social or physical infrastructure that reduces bottlenecks and costs in the economy it could reduce inflation. Pay

[1] The 2017 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2017 was awarded to Richard H. Thaler "for his contributions to behavioural economics," and in 2002 to Daniel Kahneman “for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty.”

commission awards that increase demand for consumer goods when industry has excess capacity would not be inflationary. Fiscal rules are being tightened to ensure the most the fiscal deficit can increase even in adverse times would be 0.5. But there is a reluctance to reverse consolidation by even this minor amount. Markets take a rise in fiscal deficit as a negative signal.

*Once bitten twice shy*: After the post GFC demand stimulus and the overheating it caused only structural reform has taken place since 2011, despite the importance of domestic demand for countering the collapse in export demand. The experience of over-heating made policy-makers extra cautious. Once bitten tends to be twice shy. After too much of it macroeconomics stimulus got a bad name. Structural reform was regarded as a pre-condition for increasing spending or decreasing interest rates. Another psychological concept limited policy.

*The best as the enemy of the possible*: The best became the enemy of the possible. This psychological trap wants all problems to be resolved before growth can be allowed to rise since such growth can be expected to be sustainable. But it is never possible to resolve all problems. So it is better to follow simple principles such as if there is unutilized capacity spending should increase. We did not do that and the result was 2 per cent per annum slower growth over 2011-2017 compared to the previous period of 2003-2011. This implies a loss 400USD per capita, which and further growth based on it, cannot be recovered.

*Others have done it, so:* Copying something seems safer—others have done it so we may also be able to do it. This principal seems to have guided the application of rules adopted. Inflation targeting was applied without modification in the Indian context—where fiscal supply-side policies affect inflation more and monetary policy has a larger and more immediate effect on output. In such a context monetary policy has the space to compensate for demand shocks, if adequate supply-side reforms are restraining inflation.

*Interpreting rules rigidly*: Taking rules as sacrosanct and interpreting them with too much rigidly helps policy makers feel virtuous or safer. But it is said the young know the rules—while those with more experience understand the importance of exceptions and of flexibility. The job of a lower-level bureaucrat is to implement rules but high-level policy-makers must be able to take a nuanced overview. The inflation targeting India has adopted is flexible, but it has been implemented too strictly. Rules perform a valuable function in constraining discretion, but some discretion is important. The reason why you have people there to interpret rules is they are expected to have the wisdom to able to asses when it is necessary to be very strict and when it is possible to be a bit relaxed.

*Narrow vision*: The other psychological problem is narrow vision or thinking in siloes. Whether it is an industrialist or a policymaker or a government department they tend to see only their business and their department but not the whole. For example, when asked in meetings at the Reserve Bank of India (RBI) industrialists often say a fall in interest rates will not help investment. But estimates show the interest elasticity of consumption demand in India is as high as it is abroad (-0.21). If there is excess capacity in durable goods, as industrialists are able to sell more so their capacity is more fully utilized, they will invest. So interest rates affect their investment in a circular way not directly. But they do not see that loop. Consumer durables, which are often purchased on loan, specially tend to be interest sensitive. Their weight in the new IIP is now 12.84. Despite the evidence, the ability of the interest rate to induce investment was not fully internalized.

The Reserve Bank talks to corporates and hears interest rates will not materially affect investment. But partly they are telling the Reserve Bank what they think it wants to hear. So what is said has to be taken with a pinch of salt, and moderated by knowledge of the economy as a whole.

Another example is lack of coordination between macroeconomic and macro prudential policy. An overview is missing with regulators bogged down in sectoral details. There does not seem to be any discussion of macro prudential measures for current Indian stock market exuberance—although household savings are going in through mutual funds at peak values.

*Excess weight to foreign reputation and to external risks*: Since foreign outflows can be a very public and concentrated event there is a fear of such outflows, and a bias towards conservative policies that satisfy foreign capital despite the high unemployment costs they may impose internally. This happens even though India's less than complete capital account convertibility gives policy degrees of freedom. Debt inflows have been rising in absolute amounts but are still capped at 5 percent of the domestic market. Moreover, international investors say Indian interest rates were too high in the post Euro debt crisis period. Debt inflows earned excess returns. In the longer-run inflows also value higher growth, which reduces country risk premium.

*Pessimism:* Another psychological trap is pessimism. This encourages status-quoism—the view it is no use acting since nothing will happen. An international analyst wrote in the 2000s of his optimism about India and belief it will do better than China in the long-term, even after a visit to Delhi, where he interacted with many pessimistic government economists. The views of Delhi economists tend to be more pessimistic than those in Mumbai. When you constantly interact with slow moving governments and problems persist for long you tend to think it is very difficult to do anything.

*Do not perceive changes taking place:* Pessimism makes it difficult to perceive changes taking place and to admit things may be improving. In the West in the 2000s Chindia was a popular term after Nail Ferguson coined it. Growth in Chindia was the big story. It was a culture shock if you came from India where everybody was talking about how nothing works. In 2017 the big story was a slowdown in productivity growth worldwide. But the IMF (2017)[2] reported India to be an exception. CSO (2017)[3] shows that compound annual productivity growth over 2011-2016 was higher in the unorganized sector (7.2 per cent)

[2] IMF (International Monetary Fund). 2017. Regional Economic Outlook for Asia and the Pacific. Available at http://www.imf.org/en/Publications/REO/APAC/Issues/2017/04/28/areo0517. Last accessed on 15th May, 2017.

[3] CSO (Central Statistical Organization). 2017. NSS 73rd round: Unincorporated Non Agricultural Enterprises (excluding construction) in India for July 2015 – June 2016, June.

compared to the organized sector (3.2 per cent). Yet in India itself this was barely noticed because of a focus on the growth slowdown.

*Optimism:* But the opposite psychological trap is optimism where there can be hype without substantive foundation, detail, or action plans. We fell into that also during high growth in the 2000s—India was widely expected to grow at 9 per cent indefinitely into the future. This leads to excessive risk-taking, neglect of risks building-up and of persistent problems that need to be addressed. Growth is regarded as bound to occur actions and reforms required to achieve it are not undertaken.

*Persistent problems*: These include poor public services, congestion and pollution, failures of market integration in agriculture and in industry, poor health, nutrition and poor quality education, failures in land, labour and financial markets, and of fiscal federalism that give heterogeneous quality of life in the States. It is a long road to overcome these and much effort and intelligent policy is required.

Particularly pressing is the inadequate pace of employment creation. Figures for employment elasticity of manufacturing output in the 2000s estimate it to be only 0.09 compared to world levels of 0.3. It is really amazing that in a country with 1 billion plus people with a working force of 500 million our employment elasticity is lower than it is in most places in the world. What is going on? One hint is from the incremental capital output ratio, which went up from 3.7 an early 1990s to 4.8 in the 2000s. Our labor laws could be responsible, together with a general absence of encouragement of labour intensive industry and difficulties in doing and financing business.

*Discouragement:* Our labour participation rate of around 50 is one of the lowest in the world—the world average is 63. For women our rate is just 25. A psychological factor which can perhaps explain this is just discouragement. For women it remains unsafe to travel at late hours. We need think of how we can improve the quality of jobs, provide a better working environment, and better security in our cities to change this.

But just as there are behavioral constraints on policy-making, psychology can also suggest strategies to trigger change.

**Behavioural strategies for reform**

*Reform by stealth*: One such strategy is reform by stealth. Political constraints make land and labor laws very difficult to change. But if it is possible to trigger competition among states, some reforms can be left to them. As a few states start doing better than others and NITI Aayog rankings make this public, it will aid convergence to best practices. Informative websites can help the process, such as designed for the smart cities program.

One of the problems in finance commission attempts to devolve money to the third tier was the severe lack of capacity. So when the Vijay Kelkar chaired 13$^{th}$ Finance Commission made part of devolution conditional on performance many local governments could not even take it up. They did not have proper accounts and conditionality was not sufficient to make them start. As a result the Y. V. Reddy chaired 14$^{th}$ Finance Commission decreased the conditional component. But now when they compete for a smart city project they have to give their accounts. So there is a motivation for them to develop these. Since it is all put up on the website it is easier to learn what other cities are doing, and adopt specific accounting details, technical projects, or governance arrangements. That the Inter-State Council has been activated and the goods and service tax (GST) Council successfully and relatively quickly evolved consensus in a difficult area, and showed the ability to resolve teething problems fast, promises well for fiscal federalism and convergence.

*Opportunistic reform*: Improving governance and bureaucratic ways of functioning is one of the most urgent and most difficult. It involves changing organizations consisting of people with entrenched mindsets. India's rise to 100 in the World Bank's ease of doing business index can be used to push government departments into undertaking the further changes required to continue to improve rankings. Opportunistic reform therefore would use the ease of doing business index as a focus and trigger.

The presence of Constitutional, as well as Central, State, Plan, and local bodies are one reason for multiple government departments. This creates a lack of accountability. A clear allocation of responsibilities; competition among departments; or merging them; or imposing a hierarchy among institutions with priority to constitutional institutions are all possible reforms. For example, Mumbai has so many problems with transport because there are multiple government agencies with poor coordination.

Another set of opportunistic reform revolves around the use of rapidly developing new technologies. India has already benefitted considerably from these, as outsourcing created new industries and jobs. At the turn of the Century when outsourcing started as correcting the Y2K configuration in computers it was regarded as just body shopping. But that initial entry gradually led to more complex activities and now has resulted in a lot of value addition. For example, Koramangala in Bangalore specializes in start-ups developing new products. So we should not try to stop technology for fear of automation and job loss. Robotics may automate mechanical jobs but new complex tasks are created. It has always been so in waves of technological innovation. As a result productivity and income levels rise.

Digitalization can be used to develop and share databases on land titles, thus improving the functioning of land markets, and the use of property as collateral for loans, while reducing litigation.

Collecting user charges for public services has long been a major problem in India. This is the reason electricity distribution companies are always in trouble. It is thought that politicians strategically want to provide free electricity and look the other way when there is theft. Some research shows, however, that once consumption is metered collection becomes feasible. It is the absence and high cost of metering that leads to underpayment and leakages in last mile distribution. A big innovation, therefore, is e-metering through mobile phones.

India has a large potential market size for the mass consumer goods relevant for lower-income groups. And today they can be high tech goods like mobiles that are subject to continuous innovation and improvement. The large market size induces innovation in affordable technologies that leverage youthful skills and reduce prices for mass goods. Public goods enable entry of the poor into types of consumer goods market where innovation is happening, thus creating active inclusion, which raises their productivity. Aadhar-based technology can itself improve the provision of public services.

Another example is Non-Banking Financial Companies (NBFCs) lending to the informal sector using high frequency big data. This is FinTech—non collateralized lending based on cash flow. These innovations aid formalization of the informal sector. One of the biggest factors encouraging innovation is diversity and in India there is a lot of that. The other advantage India has is catch-up—from about 45 if the US frontier is 100—which is faster in a more open economy. Productivity growth has slowed in most countries while continuing here. As a 'happening' high growth country, India should be able to attract adequate foreign inflows and other help from abroad.

*Identify trigger sectors for employment expansion*: Numbers available for the 2000s show employment elasticity in Indian manufacturing was only 0.09 compared to a world average of 0.3. This is unacceptable for a populous country. In order to change this, labour laws that induce industry to substitute towards capital need to be modified. Second, relatively low-skill labour intensive industries could be encouraged. These include textiles, electronics, chemicals and food processing. Third, skill programs must better match industry requirements, and their delivery improved by easing certification requirements for government skilling programs and imposing more standardization in industry training.

Apart from manufacturing, construction has a higher employment elasticity of 0.19. Stimulus to low income housing, and signs of revival of construction in general, will improve job creation.

Service industry will continue to be a major employer. Health and education services are severely under-provided in India. Their expansion at all levels will improve the capability of the work-force even while providing jobs. The Indian Medical Council that creates entry barriers and chokes the expansion in the supply of doctors and nurses needs to be reformed. New teaching facilities should be judged on the basis of accreditation and outcomes rather than infrastructure, and competition encouraged.

In exports it should be possible to identify and focus on measures to compete with Bangladesh in textiles.

*From helping industrialists to helping industry, but avoid overreaction:*

In India corruption is regarded as deeply entrenched. Recent developments, however, suggest that society is willing to shift away from a norm where corruption and gaming the system was accepted. Demonetization showed people were willing to undertake sacrifices to ensure that the tax base increases, and there is a shift from a norm where nobody paid taxes to one where everyone pays a fair share.

Helping industrialists for a hidden payment was the earlier political mantra. Now there is a shift to helping industry as a whole through reducing business obstacles. For the first time, serious action has been taken against industrialists accused of wrong-doing. The earlier infrastructure cycle involved largely debt finance using the public sector banks with very little equity.  Under delays, a slowdown and a high interest rate regime, debt grew and became non-performing. Earlier tax payer bailouts were the norm in the absence of a resolution regime, but now under the Insolvency and Bankruptcy Code (IBC) industrialists stand to lose their assets giving them an incentive to repay.

But there were also external and systemic shocks. The climate of suspicion and allegations of corruption may have been overdone. This started with the telecom scam of 2008 where the minister was accused of selling bandwidth cheaply with kickbacks. But a special court acquitted all the accused in December 2017. Excessive witch-hunting can also become an obstacle to business. Improvements in governance, corporate governance and regulation are the best way to reduce corruption.

*From delay and drift to deadlines*: IBC deadlines plus bank recapitalization conditional on decisiveness will induce major changes in behavior. Borrowers will become more serious about repaying loans since they stand to lose their assets; bankers will make faster decisions on haircuts required for resolution because if the asset goes into liquidation they are not likely to get much.

*Dialogue as a means of escaping the comfort zone and confirmation bias:* Taking forward ideas from a symposium such as this that bring policy-makers, academics and industry together has to struggle against participants comfort zones and confirmation bias. The instant reaction is to reject an opposing view, in favour of one's own view.  Debate is healthy since countering another's position forces a strengthening and deepening of arguments. But ultimately talking to each other, listening and identifying where there is agreement is necessary for progress. Civilized dialogue can be a strength of democracy. But some rules of engagement and openness of mind are required.

A major aim of the symposium is to encourage the public and private sector to learn from each other and work together, because both are essential parts of the economy. Constructive dialogue is the way forward.

The two are learning from each other. A wonderful innovation from the last government was compulsory corporate social responsibility (CSR). If municipalities keep a ready list of projects firms can take this up in the CSR, and contribute to improving civic governance and facilities. This nonprofit activity is making them a little like the public sector. As their governance standards improve public sector banks are learning that market discipline is useful and can help them do better.

So there are possibilities of convergence from identifying what works better in each system. Symposia such as this can perform a valuable function in helping us extract what we can agree on to implement so that systems improve.