Misleading stylised facts

PUBLIC INTEREST

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The 2008 global financial crisis shattered many myths about how economies work. These myths were part of an economist's toolkit, professionally made respectable by calling them "stylised facts" i.e. things that are so well known that they need not be questioned. The evolution of policy thinking in India has also burdened us with a number of such "stylised facts" about the Indian economy. I think this is the right time to question these. Of the many such accumulated across 68 years of our economic history, I shall pick four egregious examples.

Capital/Plan expenditure is not superior to revenue/non-plan expenditure: In my interactions with policy officials and economists, I often hear assertions about the "quality of public expenditure," based on a summary statistic: The ratio of Plan/capital to total expenditure. This is strange. The Non-Plan expenditure is not unplanned expenditure; spending on regular government business, rather than on so-called Plan "schemes," is vitally important for the state to perform its basic administrative functions effectively. Equally, capital expenditure only delivers results when there is adequate provisioning for human and maintenance inputs, which are revenue expenditure. Schools need teachers, textbooks and other teaching materials; hospitals need doctors, medicines and nurses, to achieve desired outcomes. To speak, *sui generis*, of one input as productive versus another is simply meaningless, and our health and education systems have suffered terribly as a consequence of this lazy judgement about the "quality" of public expenditure.

This has nothing to do with the proposition that states should not run revenue deficits. That governments should finance revenue expenditure entirely out of current revenues and not borrowings is the same principle that we apply in our daily lives — do not borrow for consumption. But just as we would starve, or fall ill, if we did not earn enough to consume, squeezing revenue expenditure throttles the productivity of public service delivery, as it is doing across the country.

Most Indians do not pay taxes: There is a common perception among the middle class that they bear a disproportionate share of the tax burden. Not true. First, it is well known that India's personal income tax collections fall far short of what one would expect from the fastest growing major economy in the world. India's average income tax rates (net of exemptions) are among the lowest in the G-20. Second[1], the bottom 40 per cent pay taxes on footwear, medicine, clothing, bedding, electricity, education and healthcare services. Other than footwear and electricity, the average tax rates faced by the bottom 40 per cent are about the same as paid by the rest. Customs duties also impact the poor especially when they seek to consume cheap Chinese products.

India has too many civil servants: As a member of the 7th Pay Commission, I was struck by the common perception that the government of India had too many civil servants. Not true. India has 1,622 civil servants per 100,000 citizens, the US has 7,680. At the state level, Bihar has just 457 civil servants per 100,000 citizens, Gujarat has 826 and Punjab has 1,260. So what is the pay bill being spent on? According to the 7th Pay Commission, between 2006 and 2014, every major civilian ministry of the central government witnessed a decline in personnel with the exception of home affairs, which grew by 32 per cent because of a sizeable increase in paramilitary strength. The share of defence pay and allowances in defence expenditure also grew from 27.5 per cent to 41 per cent between 2007 and 2012. But I do not see anyone arguing for a reduction in the size of armed or paramilitary forces.

The Indian "business cycle": Many Indian economists speak airily of "cyclical downturns," and the need to make macro-policy "countercyclical". For three years, I have been searching for a credible business cycle in India, and have failed to find one. I am not surprised. This is because India typically grows as fast as it can with exogenous shocks and institutional barriers impacting its trend growth, a point brought out generically in an excellent paper by Mark Aguiar and Gita Gopinath[2]. They show that in emerging markets, shocks to trend growth are the primary sources of fluctuations, rather than business cycles, which involve transitory fluctuations around a stable trend. Clearly policy prescriptions to deal with such fluctuations (countercyclical policy) would be different analytically from those that would address shocks impacting a trend. The myth of Indian business cycles and the consequent lazy recourse to textbook prescriptions to make policy countercyclical is, therefore, misplaced.

The consequences of relying on incorrect stylised facts are more damaging than incorrect analysis or wrong empirical evidence. Indian society has long suffered from "stylised facts" about caste divisions, and gender views that result in discrimination against women. Our founding fathers had the courage to challenge these. It is important for economic policy makers to learn from this. Stylised facts are the enemy of good policy making, and must be constantly challenged and reviewed, taking account of the specifics of the contemporary Indian context.

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1. Report on the Revenue Neutral Rate and Structure of Rates for the Goods and Services Tax (GST), 2015.
2. Aguiar, Mark and Gita Gopinath (2007): Emerging Market Business Cycles: The Cycle is the Trend, Journal of Political Economy, *Vol 115, No. 1, February, pp 69-102.*

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