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Subir Gokarn: You can't kill two birds ...

A fundamental policy rule is that there must be as many instruments as there are objectives

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The economic parallel of the popular aphorism about the limitations of using one stone is the assignment rule, usually attributed to Jan Tinbergen, who was (along with Ragnar Frisch) the first Nobel laureate in economics in 1969. This essentially says that when multiple objectives are to be met and there are many instruments to do this with, it is efficient to assign a specific objective to each instrument.

This has a very significant policy implication: there must be at least as many instruments as there are objectives. For many governments, such matching is often difficult to achieve, so it is tempting and perhaps even a compulsion to piggyback multiple objectives on a single instrument. The rule predicts that the consequences of this can be adverse.

India's development narrative is replete with instances of this. Let me focus on two instances, all of which are situations in which the objective of social protection is overlaid on to the underlying transaction. Both these are central issues in the current policy debate and I think that looking at them from the perspective of the assignment rule might add some value to the thinking on how to design appropriate reforms.

The first is the issue of job security and the regulatory framework that has been built up around it. The government of Rajasthan has amended some critical elements of this framework, changes that are viewed by many observers, including myself, as being a breakthrough. But let's take a step back and look at the piggybacking aspect of the original arrangement. Essentially, by giving workers job security, the arrangement attempted to simultaneously achieve both job creation and unemployment insurance. In effect, the entire cost of unemployment insurance was borne by the employer, since he had to keep workers on the payroll even if business conditions did not justify this.

Well-intentioned, without a doubt. But what were the consequences? The overwhelming majority of employers were small and medium enterprises, who could not bear the implicit cost of unemployment insurance built into a formal employment contract. The two direct consequences of this were extreme fragmentation of enterprises and a complete informalisation of labour contracts, which, let alone job security, did not even provide workers any rights or protections. The first completely undermined the competitiveness of Indian manufacturing, which has resulted in a stagnation of its share of gross domestic product over the past two decades. The second has effectively denied the vast majority of the workforce the very unemployment insurance that was the intent of the piggybacking.

The second illustration of the hazards of violating the assignment rule is the procurement framework for rice and wheat. The original intent of the strategy was, unambiguously, to ensure adequate availability of these staples, with some control over prices. The role of the government as a procurer, a stocker and a distributor of these products seemed like a reasonable institutional innovation to achieve these objectives.

As the scheme evolved, though, a second objective was introduced. This was the preservation, perhaps even the enhancement, of farmers' incomes. The scheme effectively became a "double guarantee" model, in which the government offer to the farmers was that it would buy up the entire quantity that they wanted to sell at an assured price. Yes, this approach did allow the government to accumulate a large enough stock to guarantee food security. But there were unintended consequences.

Effectively, in the market for food, the government supplanted and displaced the consumer as a source of demand. The double guarantee induced farmers into producing more and more rice and wheat, completely insulated from the significant shifts that were taking place in aggregate Indian dietary patterns. Rising incomes were contributing to greater diversification, resulting in higher demand for proteins, vegetables and fruit. But since farmers were deriving their price signals from the government, their supply responses to these changes were muted. The seven-year long episode of high food inflation, which was for much of that period, driven by protein and vegetable prices, is testimony to this causal sequence.

In sum, a scheme that started out with the intention of providing food security, piggybacked livelihood security for farmers along the way and, as a consequence, introduced a significant distortion in the relative prices of different food groups. If food security is somewhat more broadly understood as nutrition security, accommodating farmers' needs has evidently come at the cost of meeting consumer needs. Proteins, vegetables and fruit have become less affordable and more out of reach for a larger number of consumers

What are the implications of the assignment rule for policy reform in both these domains? On the labour market front, we have to start with the premise that the objective of providing unemployment insurance is completely legitimate, but the financial load cannot be imposed entirely on to the employer. So even as job security regulations are being amended, which is a good thing, efforts need to be put into devising a financially viable unemployment insurance programme. This would require the cost being distributed between the employee (in the form of an insurance premium), the employer (as a tax) and the government (guarantees and gap funding).

Essentially, the labour market reform strategy must be framed in terms of two objectives - employment growth and viable safety nets - and two instruments - flexibility in hiring and firing, and an unemployment-insurance scheme with distributed funding.

On the food procurement issue, the reform strategy must be based on moving from the double guarantee to a single guarantee. Either the price is guaranteed, in which case the quantity procured is uncertain, or vice versa. The stocking level must be enough to ensure food security, but no more. The element of uncertainty that the transition from double to single guarantee introduces into the farmers' calculations will contribute to a greater diversification of cropping patterns, which will ultimately ease the price pressures on a whole range of agricultural products.

Bringing consumers back on centre stage is of the essence. Livelihood security for farmers is unquestionably a legitimate objective, but, like unemployment insurance, it needs a separate mechanism involving financial provisions and direct transfers.

To sum up, as the government charts out its reform strategy, its chances of success will increase if keeps the assignment rule firmly in mind. Either objectives need to be reduced, or instruments need to be increased.

The writer is director of research, Brookings India, and former deputy governor, RBI. These views are his own