Routledge
Taylor & Francis Group

Journal of Human Development and Capabilities
A Multi-Disciplinary Journal for People-Centered Development

ISSN: 1945-2829 (Print) 1945-2837 (Online) Journal homepage: http://www.tandfonline.com/loi/cjhd20

Group Identity, Productivity and Well-being Policy Implications for Promoting Development

Kaushik Basu

To cite this article: Kaushik Basu (2013) Group Identity, Productivity and Well-being Policy Implications for Promoting Development, Journal of Human Development and Capabilities, 14:3, 323-340, DOI: 10.1080/19452829.2013.764854

To link to this article: http://dx.doi.org/10.1080/19452829.2013.764854

Published online: 28 Mar 2013.

Journal of Human Development and Capabilities, 2013
Vol. 14, No. 3, 323–340, http://dx.doi.org/10.1080/19452829.2013.764854

Group Identity, Productivity and Well-being Policy Implications for Promoting Development

KAUSHIK BASU
Kaushik Basu is Senior Vice President and Chief Economist at The World Bank and Professor of Economics and C. Marks Professor at Cornell University, USA

Abstract The role of a person's group identity and sense of integration into society as a determinant of the person's productivity and capability has been vastly underestimated in the literature. We talk of policies to subsidize the poor and give direct support to alleviate poverty. These are important but, in the long run, it is critical that we instill in people a sense of belonging and having certain basic rights as citizens. This paper tries to advance this perspective by building a new model where a person's community identity matters, *ex post*, in determining whether he or she will be poor, even though all persons are identical *ex ante*. The paper also draws on data collected from a non-governmental organization-run school in Kolkata to illustrate the role of a school child's sense of 'belonging' in determining how the child performs academically. The theory and the empirical work are inputs into the larger and more general idea that when people feel marginalized in a society they tend to 'give up'. A substantial part of the paper is devoted to the policy implications of these analytical ideas and empirical results in the context of policy-making.

Key words: Poverty, Capabilities, Methodological individualism, Participatory equity, Community identity

JEL classification numbers: D20, D30, O12, D60, Z10

Social integration and economic development

In much of standard economics, when we consider a person's productivity we treat the person's social or community identity as inconsequential. Even when we venture into more unconventional domains of research, such as into questions of human capability and functionings, we tend to view this in individualistic terms. By extension, a person's sense of belongingness to a group or society as an instrument of enhancing capability or making economic progress has been vastly underestimated in the literature. We talk of policies to subsidize the poor and give a variety of direct support to alleviate poverty. These are important; but, in the long run, much depends on whether we can instill in people a sense of belonging and a sense of certain basic rights as citizens. I shall argue in this paper that what the poor and the marginalized in society lack is a sense of 'participatory equity'; namely, the sense that they belong to their society and also have rights like others. If this can be instilled in them, then economic development can be sustained much more effectively and without the use of permanent external crutches. The theme of 'participatory equity' and economic development is relatively new to economics. This paper will try to advance this perspective by building on a growing body of work in politics, sociology and, more recently and parsimoniously, economics. The aim will be to draw on this diverse literature, but to contribute to broadening the models that *economists* use to craft policy.

It has, for instance, been noted in some societies that development seems to bypass large segments of the population. In South Africa, the unemployment rate among Blacks is close to 50%, much higher than the unemployment rate of just over 10% among Whites, and the unemployment among Coloreds lies somewhere between these two rates.[1] In contemporary India, more than 50 years since untouchability was declared illegal, there are large sections of 'backward castes' that remain distinctly poorer than the rest of society. In the USA, if one looks at the life expectancy and morbidity of inner-city Blacks, so much worse are the numbers compared with the mainstream that it appears as though they belong to another nation.

The standard neoclassical model of economics is inadequate to understand these phenomena. How can it be that the Blacks in South Africa have such high unemployment rates so persistently? Surely a firm that employs Blacks can undercut the wages of other firms that employ Whites, earn higher profits and drive the other firms out of business. This should, in the long run, cause Black unemployment rates to converge towards White and Colored unemployment rates. There are models in economics that can explain the persistence of such differences, but I shall argue that the real reasons run deeper than what these models suggest. Once people are treated as marginal over a period of time, forces develop that erode their capability and productivity, and reinforce their marginalization. Such people learn not to participate in society and others learn to exclude them, and this becomes a part of the 'societal equilibrium.'

Once this happens, a variety of interesting policy questions arise. How can we disrupt such an equilibrium and take the economy towards an outcome where there is greater participatory equity? We can of course use taxes and subsidies but other novel kinds of policy instruments suggest themselves, once we properly understand why some groups are excluded and how poverty is often a consequence of a person's group identity. The odds of breaking out of poverty can be much lower for an Indian Dalit, an American Black and a South African Zulu, even if that person has the same education, intelligence and physical strength as another person belonging to a more advantaged group in the same country. It is often thought of as politically and morally correct behavior not to take account of a person's group or community identity. This is certainly as it should be for many different kinds of activities, such as when an examiner is evaluating answer scripts of different people. But, if *as researchers*, we ignore a person's identity markers, we risk missing out on a critical factor that may explain why a person is so poor, and this could handicap our effort to design good policy.

It will also be shown that some of this argument carries over to international policy-making. In today's globalized world, it is possible for *geographical* segments of the world and whole nationalities and religions to feel left out from the global boom. Hence, the idea of participatory equity has a global dimension that is important not to miss out on. This has policy implications. We may have to make an effort to deliberately draw sections of the world, which left to free market forces would be left out and marginalized, into the global marketplace, through planned interventions. This may require some sacrifice of short-run efficiency but it is necessary for our long-run well-being and political stability. This relates closely to the problem and tensions that are arising because of rapid *economic* globalization and much slower advance in global *political* institutions that I have written about elsewhere (Basu, 2006a). Since global interventions lie beyond the purview of any single nation, this gives rise to special responsibilities on the part of international organizations such as the World Bank, the ILO and the United Nations and raises difficult questions of global governance.

It is worth digressing briefly here to talk about the role of identity, which is a relatively new topic in economics (Akerlof and Kranton, 2000, 2003; Deshpande, 2000; Loury, 2002; Fryer and Jackson, 2003; Sen, 2006), although among sociologists and social psychologists its significance has long been recognized (see, for instance, Goffman, 1959; Tajfel, 1974). Usually, when we think of identity in economics or more broadly the social sciences, we think in terms of conflict and competition, the communal clustering of behavior and mutual support (and often aggression towards the other side), and the persistence of certain cultural practices (Varshney, 2002; Basu, 2005, 2006b). Identity is, for instance, central to the study of rebellion and war. The literature has debated whether the prime impetus to rebel collectively comes from a group's sense of deprivation and grievance or from its perception of the possibility of making large gains. Based on cross-country data on wars from 1960 to 1999, Collier and Hoeffler (2004) suggest that the latter is the dominant cause. No matter how one resolves this quandary, there is the additional question of how a group manages to resolve the innate 'public goods' problem involved in a group's rising up to war or rebellion.

In the present paper, I draw on these new perspectives but my aim is to understand why some people remain poor and disempowered and some do well, and the role of one's group identity in these outcomes. We have conducted too much of our analysis of poverty and capabilities overlooking this role of collective identity. Wedded, as so much of economics is, to methodological individualism, social identity is a difficult concept to accommodate in our thinking, even in unconventional lines of enquiry such as those based on functionings and capabilities (Basu, 2008; Basu and Lopez-Calva, 2011).[2] Hence, the convenient presumption was that identity either did not matter, or, if it did, it did so only as a surrogate for deeper factors. If we could understand those factors, we could do so without having to refer to identity. The argument in this paper is that this is not possible, at least not for the world as it exists now. Identity matters fundamentally. It may be conceivable that in some future world a person's community or other group identity will cease to be important. But for now, that is not the case.

Group identity, poverty and market forces: a new approach

We do observe around us correlations between a person's performance and his or her community identity—the group with which this person is associated—including identity markers, which seem to be unconnected to the person's 'fundamentals,' such as education, or largely innate qualities, such as IQ. Men earn higher incomes than women; Native Americans do worse than the latecomers in terms of economic well-being; members of backward Indian castes get lower wages than the more favored castes.[3]

Traditional economics tries to explain people's earnings differentials and other performance gaps in terms of differentials in fundamentals. Thus in mainstream neoclassical economics we encounter statements like: '*i* earns more than *j* because *i* has greater innate productivity or because *j* has a stronger preference for leisure than *i* has.' And traditional economics is uncomfortable with a theory that concludes: '*i* earns more than *j because i* is White and *j* is Black.' A free market would no longer be viewed as a fair mechanism for delivering greater income to whoever works harder or is more innately productive or is willing to take risks, and so on.

Of course, we may find even a mechanism that rewards the innately more productive (instead of the more needy) not so attractive. But we reconcile to the fact that, in practice, there may be no escape from this. For the economy to do well and progress, we may need such a reward mechanism. But what is being claimed here is that the market mechanism may not have even this minimal quality of rewarding the more productive. Its system of rewards may be more spurious and vindictive. A free market can reward a person of race X or religion Y simply for being of race X or religion Y. In short, identities, which have nothing to do with innate qualities, may matter.

The view that once markets are properly freed from government intervention, racist practices and caste-based rewards will wilt under competitive pressure and ultimately wither away is wrong. In the case of caste practices, we know that these rose to prominence in India at a time when there was very little government, and the logic of this note shows that they can flourish very well in the absence of government. Indeed, once we try to understand markets, cutting ourselves free from the chord of methodological individualism, this is not difficult to see.

To demonstrate this, I will here develop an algebraic model that was merely hinted at in Basu (2011). It should be clarified that it is not as if the literature is devoid of such models. There are important works by Akerlof, Arrow, Spence, Stiglitz and others, which make similar points, although in their models, unlike in mine, productivity can differ across individuals (even though they have the same profile over racial groups). There is a small empirical literature in economics that highlights what at an intuitive level we all know; that in different markets, people from certain communities do well and tend to corner a disproportionate amount of the market. Fafchamps (2000) has described how in East Africa Europeans and Indians manage to get loans and credit to start and expand business, whereas Africans are left devoid of funding. More recently, Banerjee and Munshi (2004), in their study of the garment industry in Tirupur, Tamil Nadu, India, find that the Gounders—an elite cultivator caste that has had a history of being prominent in business and finance—controls a disproportionate amount of capital. The Gounders are a close-knit community, and when they go into business they do so with a greater abundance of capital than do the non-Gounders, who comprise 42% of the exporters of Tirupur in the sample that Banerjee and Munshi study.

What these authors manage to demonstrate is that capital in the hands of the non-Gounders is as productive or even slightly more productive than capital in the hands of the Gounders. Output is smaller in a new non-Gounder firm compared with a new Gounder firm but the former typically cross over the Gounder firm in five years time.

Why then are the Gounder firms flush with capital? Banerjee and Munshi conclude, rightly, that this suggests the presence of 'community effects.' Clearly, community identity matters *per se*. They, however, go on to suggest that *this contrasts* with a model 'where the allocation of capital is guided entirely by its marginal product in alternative uses' (2004, p. 41). I will, however, argue here that community identity effects are entirely consistent with capital being guided by the market principle of seeking higher productivity. Except in a tautological sense, a community even without having any innate capital cost advantage can corner more capital. In brief, not only are markets no guarantee against community or race-based discrimination, they can actually nurture it. It follows that allowing free markets to flourish may have other advantages but should not be treated as a cure against group discrimination.

The basic idea is simple. Barring those involved in completely unskilled work, human beings go through life-exchanging assurances, making promises and signing contracts. A person starting a business raises start-up capital by implicitly promising to the investor that he will use the money productively, and pay it back with interest or profit-share at a later date. The same man may then go to someone to raise working capital. He may get raw material from some supplier and promise her that he will sell his final product to her at a cut price. He will, in the course of time, also try to get into contracts with customers.

Now suppose that you are one of the persons offering the above person a contract (for instance, providing him working capital). Before doing so, you will try to find out how productive and efficient he is (to make sure your money is safe and will yield a return). So you may look at his educational attainment, size up his penchant for hard work and promptness at returning calls, and so on. But his productivity may depend not just on all these characteristics *of his*. A large part of what he does depends on what others, who offer contracts to him, do. If consumers do not sign contracts with him, he will not be able to pay you back. If the provider of raw material refuses to sign a raw material supply contract, he will not be able to pay you back.

The same is true of the consumer and the raw material supplier. Before signing a contract, each of them will wonder about his productivity and efficiency. In each case, this will depend in part on his own characteristics, but also on how others view him, since whether he will be able to serve consumers well or pay back his raw material supplier within the stipulated time, will depend on whether he has enough working capital.

In most developing countries, there may not be much occasion for formal contract signing, but there will be surrogates for this—such as making verbal promises, shaking hands over an agreement, and talking in the presence of a villager senior, who can later count as witness. But the essence of the problem is the same. How much compliance you can expect from a person depends on how successful he or she is getting others to do business with him or her.

And here lies the nub. Assume that a person's community or religion or race identity has no bearing on his productivity. So whether a person is a Christian, a Brahmin, Black, White, a Jew, a Gounder or Dalit makes no difference to his business or work acumen or to his preference for leisure and work. But if a belief forms that a person from community C is more productive, then this may turn out to be true *ex post*. A person's community identity could begin to matter in determining how effective a life he can lead, even though it has no innate significance and it may also involve no special behavior or choice on the part of the person involved. This explanation opens the way for important government interventions, like affirmative action. Hence, it is useful to try to understand the argument more closely by formalizing it.

This is not necessary, but for simplicity suppose there are two kinds of people in society—entrepreneurs and investors. Investors offer contracts to entrepreneurs. Investors can be those with start-up capital to offer, working capital to lend or lawns that need mowing and upkeep. In reality, an entrepreneur is not just a person running an enterprise, but anyone with responsibilities. It can be a manager of a firm who signs contracts and produces some crucial input for a firm; a poor farmer who wants to start a poultry business; a peasant who wants to grow vegetables on his plot of land and sell the surplus in the village market; or someone running a lawn-maintenance company. In a more realistic model, I would treat every person as a bit of both—an investor and an entrepreneur, as indeed we all are. But to keep the algebra simple let us go along with this bifurcation.

Each entrepreneur *i* signs contracts (or deals) and produces output. Each person can sign up to *n* contracts (it is not humanly possible to handle more) and the output, y_i, he produces depends on his innate productivity, e_i, and the number of contracts, *m*, he manages to sign. Hence, we can write this as follows:

$$y_i = F(e_i, m) \tag{1}$$

where F is a function that, given the values of e_i and m, tells us what the output will be. It is assumed that if e_i is larger or m is larger, then output y_i will be larger.

For simplicity, let me assume that a person's innate productivity depends only on his IQ score and this is easy to test. So e_i is a number between zero and one that denotes *i*'s IQ score. Alternatively, we could think of e_i as *i*'s educational achievement.

In reality, a person's output depends on how many contracts he is able to sign or deals he is able to make but in a more complex way than Equation (1) suggests. Clearly, it is not simply the *number* of deals or contracts that matter but which ones. If *E*, in the above example, gets lots of working capital but very few home-owners asking for his service, his production will be different from having lots of home-owners but little working capital. But again, for simplicity and also because in the present context it is harmless, I am making the assumption that what matters is simply the *number* of deals or contracts entrepreneur *i* gets.

To make life even easier I will assume that the 'production function' (Equation (1)) takes the following special form:

$$y_i = (1 + e_i)f(m) \tag{2}$$

where $f(0) = 0$ and $m'' > m'$ imply $f(m'') > f(m')$.

Next, I will make an assumption that I will call 'the supermodularity assumption.' This says that $[f(m + 1) - f(m)]$ increases as m increases. In words, this means that, of two identical entrepreneurs, if one has more contracts and an additional contract is offered, then the returns to this *additional* contract will be greater from the entrepreneur who has more contracts. In other words, your lawn will be better maintained by an entrepreneur who has more working capital. And, likewise, your working capital has a higher expected return from an entrepreneur who has more lawn maintenance contracts.[4]

I will here take contract cost to be fixed and constant. Each contract has a cost of *c*. So if an investor offers start-up capital, the entrepreneur is supposed to pay the investor *c*. Treat *c* as the opportunity cost to the investor. If he gets less than *c*, it is not worthwhile for him to sign a contract with the contractor. In a more elaborate model I would allow for the fact that the investor's return would be higher the greater the profit of the entrepreneur (i.e. there is some equity income for the investor). But nothing essential is lost here by the simplicity and hence I stay with it.

If i signs m contracts, his profit, π_i, is given by:

$$\pi_i = (1 + e_i)f(m) - mc \tag{3}$$

But what the entrepreneur actually gets is not always π_i because, if π_i is negative, he simply goes bankrupt and earns zero. That is, there is an effective limited liability clause underlying these contracts. There is at times a presumption among economists that limited liability clauses are special to advanced market economies. But that is simply not true. There is enough evidence that when famines cause crop failures, landlords and moneylenders are expected to forego at least a part of their claims on the peasant. Not only is this simply a matter of informal custom, but a finding of a cache of old share tenancy contracts in South India shows that these limited liability clauses were often written into the contracts (Atchi Reddy, 1996).

Hence, for those offering contracts, this is a risk that has to be kept in mind. If π_i is negative, each of them receives less than c. If they knew this in advance, of course, they would not have signed the contract; that is, they would not have got into an agreement with the entrepreneur in the first place. This is exactly the problem that each contractor has to solve in taking a decision whether or not to invest in entrepreneur i. Suppose i has two visible characteristics e_i and z_i, where e_i is his IQ and z_i is his racial or caste identity. Assume z_i can be W or B, meaning White or Black. Since z_i does not appear in Equation (2), it has no effect on a person's ability to produce. So at first sight it seems that it will not matter at all.

Now define e^* and e^o as follows:

$$(1 + e^*)f(1) \equiv c. \tag{4}$$

$$(1 + e^o)\big[f(n) - f(n-1)\big] \equiv c \tag{5}$$

It is easy to see that $e^* > e^o$. This follows from the supermodularity assumption and the fact that Equation (4) can be written as:

$$(1 + e^*)\big[f(1) - f(0)\big] = c.$$

The meaning of these two critical values is as follows. If someone's innate productivity exceeds e^*, every contractor will want to offer him contracts, no matter how few other contracts he is expected to have. If $e < e^o$, then no matter how many contracts such a person receives, it is not worthwhile for you to offer him a contract. It is easy to verify the above claims. Hence, individuals with $e > e^*$ will get all the capital they need and all the customers they need, whereas individuals with $e < e^o$ will get no contracts.

The interesting case is that of an individual with e such that $e^o < e < e^*$. What will happen to such an entrepreneur? With such an entrepreneur, a contractor faces a dilemma. The entrepreneur's enterprise may or may not be productive. Now suppose that people use race or caste to form conjectures about how productive such an entrepreneur will be. Suppose it is generally believed that for any entrepreneur, i, with $e_i \in (e^o, e^*)$, he will be able to generate positive profit, π_i if and only if $z_i = W$; that is, i is White. Interestingly, if everyone believes in this, then this will be true. It is a self-fulfilling conjecture and it does not depend on anything that the entrepreneur does. In that case, White entrepreneurs will run profitable enterprises and Black entrepreneurs will fail, if they try. If one was to look for an explanation of Bertrand and Mullainathan's (2004) celebrated finding on how employers in the USA prefer to call for job interview those applicants who have 'White' names instead of 'Black' that is not based on innate racism, then this is a possible model. The use of racial categories is justifiable for each individual but not for the collectivity of those individuals.

A simple diagram can illustrate the workings of this model. Choose an $e \in (e^o, e^*)$. Fixing $e_i = e$, draw the production function of Equation (2) as shown in Figure 1. Given the supermodularity assumption, it is convex.

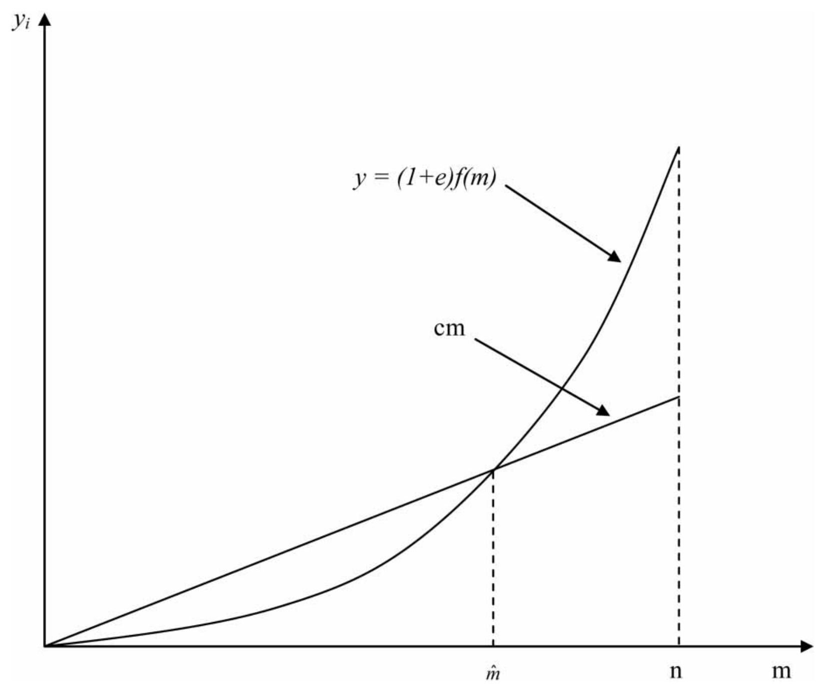

FIGURE 1. Identity and productivity.

Superimpose on it the line cm. By Equation (5) we know at $m = n$, $(1 + e)f(m) > cm$ (as shown), and by Equation (4) we know $(1 + e)f(1) < c$ (as shown). Hence, (ignoring the discreteness problem) there exists $\hat{m}$ such that $(1 + e)f(\hat{m}) = c\hat{m}$, with $1 < \hat{m} < n$. Hence, with such an entrepreneur if you expect more than $\hat{m}$ contractors to sign deals with him, it is worthwhile for you to sign a deal. And if you expect fewer than $\hat{m}$ people to sign deals, you will not sign a deal.

It is actually not necessary that people form conjectures on m. They may simply form conjectures on whether a person will create (weakly) positive profits, $\pi \geq 0$, or negative profits ($\pi < 0$). In the case of an entrepreneur of the kind illustrated in Figure 1, if all contractors share the same conjecture, then either all will offer him contracts or no one will and the conjecture will be self-fulfilling. So if race, color or religion is treated as focal information by all, then race, color or religion will turn out to have actual information, *ex post*.

This model has one similarity with Spence's (1974) model of job-market signaling and Coate and Loury's (1993) model of affirmative action (also, Arrow, 1973; Stiglitz, 1974). Racial prejudices, even when they have no actual basis, get borne out in equilibrium. But the similarity ends there. In that model, innate productivity varies across people and people use schooling to signal their productivity. In my model, entrepreneurs, across races, are not only *ex ante* the same, but they may not even choose different actions.

In fact, in the above model it is entirely possible to have all entrepreneurs having the same innate ability. If for instance $e_i = \hat{e}$, for all i, and $e^o < \hat{e} < e^*$, even then it is possible to have an equilibrium where community identity matters and people of one race get all the contracts and earn more. In other words, the market exhibits racism and the racism is entirely a product of the free market. Hence, freeing the market should not be treated as a cure for ending discrimination.

Thus far I have treated e_i, for every individual i, as an exogenously given variable such as the person's innate intelligence. It is easy to modify the above model so that e_i is something that is chosen by the agent. It could be the amount of education or simply the amount of effort she is willing to put into her entrepreneurial activity. Let us here treat it as the latter and assume that $e_i \in [0, 1]$. Let the cost of each unit of effort be k. Then entrepreneur i's profit is given by:

$$\pi_i = (1 + e_i)f(m) - mc - ke_i. \tag{6}$$

Now, unlike in the above model and somewhat akin to the model of Spence (1974), the individual also has to make a decision—how much effort to put in. It is easy to see from Equation (6) that if $f(m) - k > 0$, then it is worthwhile setting effort equal to one. Otherwise she should set e_i equal to zero. Let us suppose that, for some m, $f(m) - k > 0$; and, for some m, $f(m) - k < 0$. Then how the entrepreneur will behave will depend on her expectation of m; that is, on her expectation of how much business others will give her. If it is commonly known that investors give business to those of a certain race or caste group, then the individual i will put in a high effort if and only if she is of that group. In other words, the individual's own behavior will further reinforce the stereotypes of society. In other words, the person's expectation that others will 'discriminate' against her may make her perform less efficiently.

The way to correct the unfairness of the market is determined government action. Different kinds of affirmative actions can correct this. For instance, subsidizing the education of disadvantaged groups or providing subsidized capital to such groups can help. Of course, in reality failure can be habit forming. Persistent discrimination can lead to habits of tardiness and sloth and it can take time to break out of these habits. Hence, unlike in the model, where a subsidy can cause an instantaneous switch in equilibrium, in reality the change can take a long time and may need sustained effort and some financing for some length of time. I shall return to some of these policy questions later.

The way to correct the unfairness of the market is determined collective action. Different kinds of affirmative actions can correct this. For instance, subsidizing the education of disadvantaged groups or providing subsidized capital to such groups can help. Of course, in reality failure can be habit forming. Persistent discrimination can lead to habits of tardiness and sloth and it can take time to break out of these habits. Hence, unlike in the model, where a subsidy can cause an instantaneous switch in equilibrium, in reality the change can take a long time and may need sustained effort and some financing for some length of time.

Social context, performance and productivity

This model links up interestingly to some recent experimental work on identity and performance. Through a set of experiments in India's Uttar Pradesh, Hoff and Pandey (2004a, 2004b) demonstrated a remarkable result. Low-caste children solve mazes (an indicator of intelligence and analytical skill) with as much dexterity as upper-caste children. But if before the same kind of test each child's caste is publicly announced, then the lower-caste children perform worse. The public proclamation of a person's caste has a withering effect on the psyche of those belonging to historically disadvantaged groups.[5]

These results—following in the tradition of earlier work in psychology, such as Steele and Aronson (1995) and Ambady *et al.* (2001)—highlight the connection between social context and performance, and make the general point that a person's productivity depends not just on the obvious variables, such as how much she has studied or how well-off her family is,[6] but on her social situation. This opens up a whole new set of policy options for enhancing human capital and productivity.

This general point receives reinforcement in some data that I recently acquired from a non-governmental organization-run teaching institute for slum children in Kolkata called Anandan. Anandan is a teaching institute that is meant to supplement teaching for slum children. Children are taught basic numeracy, logic, English; they are made to be aware of world affairs. The idea is to take the poorest children and spark their curiosity and intellectual interests. Anandan collects basic information about the children's background—their household income; whether their households have radios, bicycles, watches; their number of siblings; and of course basic information about each child, such as age, sex and mother-tongue. In addition, they also have with them answers from questions directly administered to the children, about social conditions in the household, such as if the parents beat each other, if the parents talk to each other and if so how much, and if the parents talk to the children.

Furthermore, the school had earlier this year given 60 children, of ages from nine to 16 years, some basic IQ, arithmetic and general knowledge questions.[7] The data were not collected with special statistical care; the caveat is meant to warn the reader not to over-interpret these results and treat them instead as merely indicative.

What turns out to be most important for a child's aptitude is not income, or the possession of radios, watches and bicycles, but whether the parents talk to each other and whether the child lives with her family.

The reason for reporting on this result, although this will need more investigation in the future, is the suggestion that a child's *social* conditions matter significantly in how he or she performs in school; and, in this case, they seem to matter more than the economic conditions of the child's household. One suggestion is that a person's citizenship status matters. If a person feels a proper 'citizen of the household' with the rights and prerogatives that come with that, it bolsters his or her self-confidence and this again results in intelligence[8] and human capital. If the parents talk to the child, it bolsters his or her status in the household, and that citizenship status aids intellectual performance.[9] This is further reinforced by the fact that children who live with their parents do better, on average, in aptitude tests. In fact, on average they get 6.76 marks more; that is, marks one standard deviation higher. Clearly, children have a more secure status at home when they reside with their parents. These are somewhat similar to the results *á la* Hoff and Pandey, and Field and Nolen, on children's performance when they are reminded of their marginalized status in society.

Poverty, identity and policy

The above analysis belongs to a larger class of ideas, which claim that to understand an individual's economic well-being it is essential to know about the larger *social* status of the individual—the community to which he belongs, the kin system of which she is a member, the neighborhood where she has been raised, and so on. There is now a growing literature that recognizes the role of an individual's social 'membership' and institutional location as vital factors that explain whether he or she will be poor (Durlauf, 2001, 2006; Hoff and Sen, 2006; Plotnick and Hoffman, 1999).

Much of traditional economics viewed poverty as the fault or, more forgivingly, the choice of the poor. What is good about the membership-based or identity-based theories is that they eschew this extreme individualistic precept. And, with that, new policy options open up. But before going to that, I want to locate the above models in an even larger idea that has been around for a while in sociology and social psychology, but is relatively new to economics; namely, the recognition of the importance of identity. Whether or not one views this as a challenge to the very axiom of methodological individualism, on which economics is, allegedly, founded,[10] the recognition of identity clearly alters the way we reason in economics. This recognition of the significance of identity raises numerous research questions, which will no doubt keep our hands full for a long time to come. Is identity something that enters directly into a person's sense of well-being or, to put it in the language of economics, should identity be thought of as an argument in a person's utility function? Or is it something that matters instrumentally? Of the many identity markers that each of us carry, which ones are socially salient? Is (or to what extent is) identity a matter of choice and/or an unalterable attribute of a person? Can identity explain economic performance? Can it be a cause of a person's poverty?

The two latter questions have been answered in this paper, and in the affirmative. The other questions have found partial answers in the literature and will no doubt inspire future research. Clearly, identity can enter directly into a person's 'utility function' (see Akerlof and Kranton, 2000, 2003). But it is also possible that identity is of negligible (or no) direct concern to individuals, but of great significance *ex post*. This is suggested in the works of Varshney (2002) and also in the model constructed in Basu (2005).

This kind of analysis suggests many possible policy initiatives and provides justification for some standard initiatives. The most important is affirmative action. These models stress the importance of affirmative action—not just any affirmative action but ones that are designed in particular ways. A poorly-designed affirmative action plan can lead to greater stereotyping of the disadvantaged groups.

In designing an affirmative action plan well, we have to first determine which groups to target. Suppose poverty in a society coincides with lower intelligence, race, gender and age. Which ones should be the target of affirmative action? What the above model suggests is that it must be a trait *vis-à-vis* which there is an element of the self-fulfilling prophecy. If everybody takes the person of this trait to be unproductive then she will be unproductive, and if everybody takes her to be productive then she will be productive. Clearly, intelligence will not have this property, because it is likely to have a direct positive bearing on productivity. So while there may be a case (and I believe there is) to help all poor people, *for the purpose of affirmative action*, the unintelligent is not the right category to focus on.

Likewise, we may want to ignore age since we know that everybody will typically experience all ages. Hence, over a person's lifetime there will be equity. But race and gender have little innate connection with a person's productivity and they are traits that a person can do little to alter. Hence, in a society where one racial group or sex does badly, there may be a case for bolstering the group's position by using subsidies or direct legal provisions. What is interesting and different about the line taken in this paper is that such policies can be justified purely on grounds of efficiency.[11] These interventions tend to deflect the economy from a bad equilibrium to a good equilibrium.

Policy interventions in models with multiple equilibria have an interesting trait. The interventions need not be persistent. After a certain period, the intervention can be revoked without having the economy slide back to the earlier, inferior equilibrium. I have elsewhere called such an intervention a 'benign intervention.' An example of this is a nation's child labor laws. Take, for instance, the USA, where child labor has been banned either by state laws or by the nationwide Fair Labor Standards Act, 1938. When these laws were first initiated they had a lot of bite, but it is arguable that now, even if the law was to be revoked, children would not go back to work. The economy has simply shifted to a better equilibrium.

One practical matter concerning affirmative action is worth bringing up here. There is often a tendency to impose educational and job quotas in step with the relevant population percentages. This has been explicitly used in India. If x% of the population belongs to a backward caste that one is trying to help through affirmative action, the tendency is to require that x% of school seats or jobs in some sector should be reserved for this group. But of course that need not be. I would typically set a reservation percentage at y, where y is less than x. After all, a reservation means setting floor to the percentage. Clearly, if there are more good candidates of the relevant caste group, there is no bar on admitting them. The model developed in this paper can potentially be used to determine what the y should be, keeping in mind that the aim of this policy is to snap the economy out of the bad equilibrium and set it on course towards the good equilibrium.

The paper also suggests the importance of education, government activism and the building up of role-models to stress to people of various religions, caste-groups and races that they are equal citizens with prospects as good as anybody else. Since this policy does not entail 'hard acts' like new laws or new fiscal initiatives, we often play down the role of this. But repeated emphasis that all minorities have equal rights and steps to integrate disadvantaged groups into the mainstream by deliberately bringing people in to various walks of life—politics, business, science, and so on—can have a huge impact on people's sense of self-respect and, through that, on their intelligence and productivity.

Globalization, identity and marginalization

Many of the topics that I have discussed thus far in the context of particular nations carry over to inter-country relations, especially in this age of globalization. First, let us see how the logic of the model carries over to a nation. How well a nation does clearly depends in part on how much foreign direct investment and other forms of international contracts the nation receives. Given that the productivity of one foreign direct investment (FDI) depends positively on how many other FDIs it receives, it is entirely possible to have multiple equilibria *vis-à-vis* nations. Each may receive very little or plenty of FDIs and other kinds of international offers. One reason China is a good bet for investment is that so many nations and multinational corporations think that China is a good bet. In the case of India, it is almost possible to see the shift from one equilibrium to another. Until the late 1980s, nations and corporations were wary of India, whether it be on matters of trade, FDIs or portfolio investment. This began to change in the early 1990s and suddenly money and contracts are flowing into the country.

This should alert us to two important policy wisdoms. First, countries that are currently poor and doing badly may need a deliberate nudge. Secondly, after a phase of nudging, many nations will begin to move on auto-pilot with no further intervention from industrialized country governments and international agencies being required, because it will then be in the self-interest of nations and multinational corporations to invest in the country. Hence, the fiscal strain of enabling a poor nation to escape poverty may not be as big as may appear at first sight. What is needed is the effort to take the country beyond a threshold.

Let me now turn to the subject of inter-country policy coordination. In today's globalized world with volatile capital, it is important for nations at similar levels of development to coordinate on certain policies in order not to drive away capital. This is true, for instance, in the matter of labor laws and regulation. One nation trying to unilaterally uphold its labor standards, by pushing up wages or enforcing strictly laws about workplace safety or giving workers greater right to bargain collectively, could easily have corporations shift their business to other more lax nations. This can give rise to the need for coordinated labor market polices across nations.

But there is another matter requiring coordination that has gone unnoticed. Often when a nation has a lot of poverty or inequality, we blame the nation or its government for this. But just as we now recognize (as discussed above) that the blame for a person's poverty does not lie solely with the person, but could lie partly with the collectivity to which the person belongs, a single nation may not be able to do much about its inequality and poverty in today's globalized world. It is therefore not be surprising at all that within-country inequality is rising sharply in most developing countries, most notably China (see Kanbur and Zhang, 2005) and India (see Basu, 2004).

Effecting transfers from the rich to the poor become very different activities in closed and open economies. In today's world, an attempt to transfer money to the poor from the rich can therefore be met with flight of capital and flight of professional labor. And given that most poor countries cannot afford such flights, this puts a natural brake on what a single nation can do about its poverty and inequality and explains some of the rise in intra-country inequality in tandem with globalization.

I have argued elsewhere (Basu, 2006a) that this calls for global coordination of policies for curbing poverty and inequality. Institutional arrangements for doing this are notable by their absence. We have the World Trade Organization to coordinate on trade policies, the ILO to coordinate on labor policies and various organizations for coordinating environmental policies, but nothing to orchestrate global anti-poverty and inequality control policies. This is something that needs urgent attention.

Acknowledgements

This paper is based on my keynote address to the HDCA International Conference in Jakarta on 6 September 2012. The paper had been work in progress for quite some time before the address and continued to be written and revised after it. As a consequence, I have accumulated a large amount of debt to various scholars who have commented on it. I am grateful, in particular, to Talia Bar, David Crocker, Supriyo De, Rohini Kohli, Hyejin Ku, Ortrud Lessman, Eleonora Mavroeidi, Priya Mukherjee, Siddiq Osmani, Nupur Ray, Ranjan Ray, Frances Stewart, Ashutosh Varshney, Maria Monica Wihardja and, especially, Sudarno Sumarto who, as a discussant for my lecture, commented extensively on it.

Notes

1 These figures are from the Labour Force Survey 2003, conducted by Statistics South Africa.
2 Although I pose this paper as a critique of methodological individualism, some may consider a broader definition of methodological individualism, which allows group identity to matter in the description of what a person can do and the well-being a person has. For instance, in Amartya Sen's work on famines, the so-called entitlement mapping takes us from an individual's endowment to what the person is entitled to (see Osmani, 1995). I would argue that this mapping must also allow for the group identity in determining the person's entitlement. If someone's definition of methodological individualism allows for such group influences, with such a person my difference will be simply a semantic one.
3 Which castes are the favored ones can vary from region to region. Also, while caste hierarchies are fairly stable, it is not as if they do not change. Social processes, like *sanskritization* and the garnering of political power, can cause caste groups to gain or lose over time.
4 I am using the more bombastic term 'supermodularity' instead of the (in this context) equally good term 'convexity', to clarify that I could have worked with a more general model where each contract may have a different effect on output. Such a model would use a production function, g, as follows: $y_i = g(e_i, x_1, \ldots x_n)$, where x_j is an indicator variable, which takes a value of one if the jth contract is signed and zero if it is not signed. The general assumption I want to use says that if, for some j, x_j is changed from zero to one, the increase in output that occurs with this is greater if the value of $(x_1 + \ldots + x_{j-1} + x_{j+1} + \ldots + x_n)$ is higher, with e_i being held constant.
5 A similar set of experiments recently conducted by Field and Nolen (2005) with South African children—Blacks, Whites and Coloreds—finds similar results, especially with boys. Of course, race, unlike caste, is visible. So an announcement of race is not as revelatory as the announcement of caste. What Field and Nolen do, therefore, is to consider situations where no mention is made of race and situations where the atmosphere is 'charged' by giving questionnaires on race.
6 Between these two, education seems to be overwhelmingly the more important cause (Glick and Sahn, 2006).
7 The full test question is reproduced in the Appendix to Chapter 2 in Basu (2010).

8 The connection between a person's status and poverty, on the one hand, and his or her cognitive abilities and intelligence, on the other, is being increasingly observed in empirical studies. These are discussed persuasively in Esther Duflo's Tanner Lectures earlier this year (Duflo, 2012).

9 It remains a bit of a puzzle why this does not happen for children who live with their guardians, instead of the parents. It is possible that when asked whether their parents talk to each other, since their parents do not live with them, they gave erratic answers to the question.

10 For a discussion, see Bhargava (1993), Arrow (1994) and Basu (2008).

11 I am personally in favor of using affirmative action, including job quotas, even when there may be no efficiency gain to be made, purely to build up role-models within communities that have faced discrimination over long periods of time. (This has to be used in limited measures keeping in mind that this may involve efficiency tradeoffs.) This is a purely normative stance of mine that does not have anything to do with the argument developed in this paper. What is different about the argument being presented here is that it points to why there may be a case for affirmative action even if one had no normative commitment to correct intertemporal inequities.

References

Akerlof, G. and Kranton, R. (2000) 'Economics and identity', *Quarterly Journal of Economics*, 115, pp. 715–753.

Akerlof, G. and Kranton, R. (2003) 'A model of poverty and oppositional culture', in K. Basu, P. B. Nayak and R. Ray (Eds), *Markets and Governments*,Oxford University Press, New Delhi, pp. 25–37.

Ambady, N., Shih, M., Kim, A. and Pittinsky, T. L (2001) 'Stereotype susceptibility in children: Effects of identity activation on quantitative performance', *Psychological Science*, 12, pp. 385–390.

Arrow, K. (1973) 'The theory of discrimination', in O. Ashenfelter and A. Rees (Eds), *Discrimination in Labor Markets*,Princeton University Press, Princeton, N.J, pp. 3–33.

Arrow, K. (1994) 'Methodological individualism and social knowledge', *American Economic Review*, 84, pp. 1–10.

Atchi Reddy, M. (1996) *Lands and Tenants in South India: A Study of Nellore District 1850–1990*, Oxford University Press, New Delhi.

Banerjee, A. V. and Munshi, K. (2004) 'How efficiently is capital allocated? Evidence from the knitted garmet industry in Tirupur', *Review of Economic Studies*, 71, pp. 19–42.

Basu, K. (2004) 'The Indian economy: Up to 1991 and since', in K. Basu (Ed.), *India's Emerging Economy: Performance and Prsopects in the 1990s and Beyond*,MIT Press, Cambridge, and Oxford University Press, New Delhi, pp. 3–32.

Basu, K. (2005) 'Racial conflict and the malignancy of identity', *Journal of Economic Inequality*, 3, pp. 221–241.

Basu, K. (2006a) 'Globalization, poverty and inequality: What is the relationship? What can be done?', *World Development*, 34(8), pp. 1361–1373.

Basu, K. (2006b) 'Gender and say: A model of household behavior with endogenously-determined balance of power', *Economic Journal*, 116(511), pp. 558–580.

Basu, K. (2008) 'Methodological individualism', in L. Blume and S. Durlauf (Eds), *The New Palgrave Dictionary of Economics*, Palgrave, Macmillan, Basingstoke and New York.

Basu, K. (2010) 'The moral basis of prosperity: Altruism, other-regarding behavior and identity', *Economics and Philosophy*, 26(2), pp. 189–216.

Basu, K. (2011) *Beyond the Invisible Hand: Groundwork for a New Economics*, Princeton University Press, Princeton, N.J., and Penguin, New Delhi.

Basu, K. and Lopez-Calva, L. F. (2011) 'Functionings and capabilities', in K. Arrow, A. Sen and K. Suzumura (Eds), *Handbook of Social Choice and Welfare,* Vol. 2, Elsevier Science Publishers, North-Holland, Amsterdam, pp. 153–187.

Bertrand, M. and Mullainathan, S. (2004) 'Are Emily and Greg more employable than Lakisha and Jamal?', *American Economic Review*, 94, pp. 991–1013.

Bhargava, R. (1993) *Individualism in the Social Sciences: Forms and Limits of Methodology*, Oxford University Press, Oxford.

Coate, S. and Loury, G. (1993) 'Will affirmative action policies eliminate negative stereotypes?', *American Economic Review*, 83, pp. 1220–1240.

Collier, P. and Hoeffler, A. (2004) 'Greed and grievance in civil war', *Oxford Economic Papers*, 56, pp. 563–595.

Deshpande, A. (2000) 'Does caste still define disparity? A look at inequality in Kerala, India', *American Economic Review*, 90, pp. 322–325.

Duflo, E. (2012) 'Human values and the design of the fight against poverty', Tanner Lectures, presented at Harvard University, Cambridge, MA, 2–4 May, to be published.

Durlauf, S. (2001) 'The membership theory of poverty: The role of group affiliations in determining socioeconomic outcomes', in S. Danziger and R. Haveman (Eds), *Understanding Poverty in America*,Harvard University Press, Cambridge, MA, pp. 392–416.

Durlauf, S. N. (2006) 'Groups, social influences, and inequality', in S. Bowles, S. N. Durlauf and K. Hoff (Eds), *Poverty Traps*,Princeton University Press, Princeton, N.J, pp. 141–175.

Fafchamps, M. (2000) 'Ethnicity and credit in African manufacturing', *Journal of Development Economics*, 61, pp. 205–235.

Field, E. and Nolen, P. (2005) *Race and Performance in Post-Apartheid South Africa*, mimeo, Cornell University, Ithaca, N.Y.

Fryer, R. G. and Jackson, M. O. (2003) *Categorical Cognition: A Psychological Model of Categories and Identification in Decision Making*, mimeo, Harvard University and Caltech, Cambridge, MA and Pasadena, CA.

Glick, P. and Sahn, D. (2006) *Cognitive Skills Among Children in Senegal: Disentangling the Roles of Schooling and Family Background*, mimeo, Cornell University, Ithaca, N.Y.

Goffman, E. (1959) *The Presentation of Self in Everyday Life*, Double Day, New York.

Hoff, K. and Pandey, P. (2004a) 'Belief systems and durable inequalities: An experimental investigation of Indian caste', *World Bank Policy Research Paper # 0-2875*, The World Bank, Washington, D.C.

Hoff, K. and Pandey, P. (2004b) *Expected Injustice: Belief Systems as a Vehicle for Maintaining Group Inequality*, mimeo, The World Bank, Washington, D.C.

Hoff, K. and Sen, A. (2006) 'The Kin system as a poverty trap', in S. Bowles, S. N. Durlauf and K. Hoff (Eds), *Poverty Traps*,Princeton University Press, Princeton, N.J, pp. 95–115.

Kanbur, R. and Zhang, X. (2005) 'Fifty years of regional inequality in China: A journey through revolution, reform and openness', *Review of Development Economics*, 9(1), pp. 87–106.

Loury, G. (2002) *The Anatomy of Racial Inequality*, Harvard University Press, Cambridge, MA.

Osmani, S. (1995) 'The entitlement approach to famine: An assessment', in K. Basu, P. K Pattanaik and K. Suzumura (Eds), *Choice, Welfare and Development: A Festschrift in Honour of Amartya Sen*,Oxford University Press, Oxford, pp. 253–294.

Plotnick, R. and Hoffman, S. (1999) 'The effect of neighborhood characteristics on young adults: Alternative estimates', *Social Science Quarterly*, 80, pp. 1–18.

Sen, A. (2006) *Identity and Violence*, W. W. Norton and Co., New York.

Spence, A. M. (1974) *Market Signaling: Information Transfer in Hiring and Related Screening Processes*, Harvard University Press, Cambridge, Mass.

Steele, C. and Aronson, J. (1995) 'Stereotype threat and the intellectual test performance of African Americans', *Journal of Personality and Social Psychology*, 69, pp. 797–811.

Stiglitz, J. (1974) 'Theories of discrimination and economic policy', in G. von Furstenberg *et al.* (Eds), *Patterns of Racial Discrimination*, D. C. Heath and Co.

Tajfel, H. (1974) 'Social identity and intergroup behavior', *Social Science Information*, 13, pp. 65–93.

Varshney, A. (2002) *Ethnic Conflict and Civic Life: Hindus and Muslims in India*, Yale University Press, New Haven, CT.