

India's Post-Liberalisation Blues

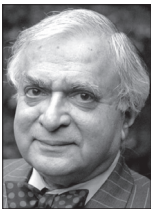
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Introduction

In this paper I want to reflect on three major themes arising from recent Indian experience after its partial adoption of the classical liberal economic package in 1991. The first concerns new forms of rent seeking, which are to be found not only in India but also in China and Russia after they moved, however imperfectly, from the Plan to the Market. The second concerns the rising tide of populism – reminiscent of the past and current policies of many Latin American countries – and the dangers this poses for sustainable growth in India. Finally, linking the two is the general theme of the growth and *dénouement* of ‘entitlement economies’ – the social democratic ideal – in the fiscal and debt crises now enveloping Europe and the United States. These correspond to the following three sections of the paper.

Post-liberalisation rent seeking

There is a new form of rent seeking that has arisen in India, China and Russia, after their various degrees of movement from the Plan to the Market. These economic liberalisations would have been expected to have shown a decline in rent seeking. The daily revelation recently of various scams suggests that rent seeking is alive and well in India. In fact one of the puzzles about its economic liberalisation was how it could occur in



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a country that, for nearly four decades, had created an equilibrium state of rent-seeking interests that had mired the economy in the dismal 'Hindu' rate of growth. Many observers saw little hope of a seemingly dysfunctional Indian democracy being able to deliver economic liberalisation. In an important book, Rob Jenkins (1999) showed how the political players, particularly at the Centre, used both a rearrangement of the previous spoils system, and the various conflicts of interest within the numerous rent-seekers, to both institute and consolidate economic reforms. In terms of my predatory state model (Lal 2005, Ch. 13.2), the improved productivity of the economy resulting from economic liberalisation provided larger rents to the predators. They got an unchanged share of a larger pie. It is these new forms of rent seeking that are the source of all these scams. But this raises its own puzzle: whereas the earlier pre-1991 form of rent

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seeking had led to growth rates well below potential, the new forms of rent seeking have been accompanied by phenomenal growth rates. What explains these differences in

outcome, and is this new corruption likely to damage growth like the old?

To answer this question it is useful to outline the sources of economic 'rent'. Armen Alchian provides a succinct discussion in *The New Palgrave Dictionary of Economics*. Economic 'rent' is the payment for any resource 'the supply of which is indestructible (maintainable for ever at no cost) and non-augmentable, and hence invariant to its price. In the jargon of economics, the quantity of present and future supply is completely inelastic with respect to price, a situation graphically represented by a vertical supply line in the usual 'Marshallian price-quantity graphs'. Land, distinguished by its location, provides one such resource. As at all prices the supply is constant, a tax on land rents does not affect any marginal decision by economic agents, and hence does not affect economic efficiency. It is a lump sum tax.

If in the future the aggregate supply of such indestructible resources can be increased in response to a higher price, even though the short-term supply is inelastic, there would be 'quasi rents' accruing to the resource. An important form of 'quasi rents' are what Marshall called 'composite quasi-rent'. 'When two separately owned resources are so specific to each other that the joint rent exceeds the sum of what each would receive if not

used together, then that joint rent to the pair was called “composite quasi-rent”.¹ This is important when the ‘resources that have been made specific to each other in the sense that the service value of each depends on the other’s presence, the joint value of composite quasi-rent might become the object of attempted expropriation by one of the parties, especially by the one owning the resource with controllable flow of high alternative use value’. Various institutional and contractual arrangements can be devised for the distribution of these ‘composite quasi-rents’. As with pure economic rent, given the short-term run inelasticity in the supply curve of at least the specific resource that does not have ‘a controllable flow of high alternative use-value’, the ‘taxing’ of this specific resource will not affect the efficiency of the economy. The arrangement for the division of the ‘composite quasi-rents’ will represent a purely distributive outcome.

We can now see why the recent scams have not affected the productivity of the economy. Most of the scams involving pure ‘economic rent’, as in the allocation of housing perpetrated by the armed forces in the Adarsh scandal,¹ have no efficiency consequences. Though there may be social losses from the expenditures undertaken by ‘rent seekers’ to acquire these rents through political or administrative means.

Similarly, the scams involving the allocation of the 2G spectrum, the various mining-related scams, and those involving infrastructure projects like roads, all relate to the distribution of ‘composite quasi rents’. These will again affect the distribution of income but have no effect on the productive efficiency of the economy, again with the proviso of the consideration of the social losses involved with the expenditure on ‘rent seeking’.

There is a third category of rents: ‘monopoly rent’. These are created by artificial restrictions on other potential competitors in order to favour some economic agents. The Indian licence-permit raj (during the ‘planning’ era), with its import quotas, industrial licensing, price controls, etc., created these ‘monopoly rents’. As the government interventions creating these rents affect the marginal decisions of consumers and producers, they lead to substantial efficiency losses, in addition to any of the deadweight losses associated with the ‘rent seeking’. They are equivalent to the levying of distortionary taxes cum subsidies, unlike the lump sum taxation

¹ This was a project for cooperative housing in a high-rise apartment on some of the most valuable land in Mumbai, meant for war widows. In practice numerous senior Army and Naval personnel and their relatives and friends appropriated these apartments for themselves.

associated with various forms of rent seeking to obtain pure ‘economic’ or ‘composite quasi’ rents.

Economic liberalisation in former highly controlled economies like India (but also China and Russia) reduces or eliminates these monopoly rents. With the boost given to economy-wide productivity by the liberalisation, the value of ‘economic’ and ‘composite quasi’ rents will rise. This allows the polity to substitute an even more highly valued source of rents to compensate the losers from the abolition of monopoly rents, but without any damage to the productive efficiency of the economy. This explains the paradox that post-liberalisation rent seeking has been accompanied by high growth rates in these predatory states, and an increase in the rents garnered, while the pre-liberalisation rent seeking had led to growth rates well below their potential.

There is, however, one continuing major source of ‘monopoly rents’. These are the colonial labour laws creating ‘monopoly rents’ for the small aristocracy of organised labour. By limiting entry and exit, and artificially raising the price of India’s most abundant resource, they have damaged labour intensive industrialisation in India. This situation will be made worse by the minimum wage and other purported labour rights being implemented in the unorganised sector. Much worse, the proposal to introduce minimum wages in the Rural Employment Guarantee Scheme will remove the main reason for the efficiency of this poverty-redressing policy: self-targeting.² Though the immorality of rent seeking associated with pure ‘economic’ and ‘composite quasi’ rents may be reprehensible, it is less damaging to growth than the continuing ‘monopoly rents’ generated in the labour market.

The wages of populism

One of the surprises in the comparative study of 21 developing countries in *The Political Economy of Poverty, Equity and Growth*, which I co-directed with Hla Myint for the World Bank (Lal & Myint 1996), was that two of our largest countries – Brazil and Mexico – which had had nearly three decades of spectacular growth, suffered prolonged ‘growth collapses’ in the 1980s. Thus, from 1950–1980, Brazil’s GDP grew at 6.8% and Mexico’s

² This is an extension of a scheme first introduced in Maharashtra to provide poor unemployed labourers work on public works at a wage just below the market wage.

at 6.4% p.a., as compared with Korea's at 7.4% p.a. This was followed by 'growth collapses', with Brazil's GDP growth rate falling to 2.4%, Mexico's to 1.0%, and per capita growth rates declining to -0.1% in Brazil and -1.2% in Mexico between 1980 and 1987 (see Maddison & Associates 1992). The lessons they provide for India's current political economy, as a corrective to the hubris flowing from recent Indian growth performance, is the subject of this section.

In both the Brazilian and Mexican cases, the proximate cause of the growth collapse was severe macroeconomic imbalances leading to hyperinflation and debt crises. But, the deeper causes were numerous micro-economic distortions and unsustainable fiscal expenditures on politically determined income streams.

We begin with Mexico. It had followed a policy of relatively balanced development with macroeconomic prudence until about 1970. This changed with the 1968 suppression of the protest movement before the Olympic Games. Luis Echeverría assumed the Presidency in 1970, and announced his new policy of 'shared development' – reminiscent of Indira Gandhi's '*garibi hatao*' ('remove poverty') slogan of the 1970s and the current Congress Party-led United Progressive Alliance's slogan of development for the '*aam admi*' ('common man') – in contrast with the 'stabilising development' economic policy since 1958. Echeverría thought that, even though poverty had declined as a result of the rise of per capita incomes in the 1960s, the stubborn inequalities in income distribution could be tackled by increasing public expenditure and expanding the public sector. This led in the short term to mounting inflationary pressures, a rising current account deficit, an overvalued exchange rate and increased foreign borrowing. The hitherto conservative Bank of Mexico 'became a printing press to finance rising budget deficits and public sector enterprises' (Maddison & Associates 1992, p. 133). Echeverría's aim to improve income distribution was belied as 'the 1977 family expenditure and income survey showed no noticeable improvement over conditions existing in 1973, in 1963, and as far back as 1950' (Maddison & Associates 1992, p. 135). The discovery of large oil deposits in 1972–73 provided a temporary bailout. But Echeverría's successor, López Portillo, took the oil price rise of 1978 as a permanent rise in Mexican income and began a further expansion of Echeverría's populist economic policies. A mild boom resulted, fuelled in part by foreign borrowing based on the new-found

oil reserves. When oil prices collapsed with Volcker's tightening of US monetary policy, the unsustainability of the Echeverría–López Portillo populist policies of *desarrollo compartido* were exposed, as the macroeconomic imbalances they had created led to the debt crisis of 1982, and the Mexican 'growth collapse'.

There are eerie similarities with India's current economic policies. Believing that, because of its 'demographic dividend', India is now on a permanent 9% growth path, a vast network of fiscal entitlements have been enacted, and are planned from the burgeoning tax revenues that are assumed to automatically accrue. If these assumptions are belied because of terms of trade shocks related to the currently projected trends in world food and oil prices, India might – like Mexico – find that these politically determined entitlements become unsustainable. Moreover, as Surjit Bhalla has documented, the 'leakage' from these entitlement schemes remains as great as Rajiv Gandhi's 1980s estimate: that only 15% of the expenditure reaches the poor. Much faith is put in the IT giant INFOSYS's former boss Nilkani's government-sponsored electronic ID cards, for accessing entitlements. But this may be premature, given the 'arms race' that is likely to develop with the counterfeiters. Nor do I believe – despite the rhetoric – that there is a demand for 'equality of outcomes' as opposed to 'equality of opportunity' in the Indian polity. As discussed in my *Unintended*

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Consequences (Lal 1998), there is a profound difference in the cosmological beliefs of the Semitic egalitarian religions and the hierarchical 'religions' of Asia. It is this profound cultural misunderstanding of the Nehruvian wing of Macaulay's

children³ that accounts for their current endorsement of the populist policies that could lead, as in Mexico, to a growth collapse.

³ The Indian political elites were all beneficiaries of Lord Macaulay's famous 19th-century Minute creating an English medium higher education system to educate the 'natives', during the heyday of the British Raj. There were however two wings of these Macaulay's children: one represented by Nehru for whom English became their mother tongue; the other one was the adherents of Gandhi, for whom English was a purely instrumental second language to their traditional vernacular. As I have argued in *Unintended Consequences* (1998), cosmological beliefs depend upon the mother tongue. The Nehruvian wing's cosmological beliefs, thus, have much in common with their English-speaking 'Semitic' cousins. The Gandhian wing by contrast adheres to the old hierarchical Hindu beliefs, where belief in reincarnation means one's current status in life is based on the just deserts of one's past life. To change this status by political whim would be a serious infringement of Vishnu's will!

The lessons from Brazil, and its growth collapse, for India are somewhat different. In a 1970s study of effective protection in Brazilian industry, Joel Bergsman was puzzled that Brazil could produce highly capital-intensive private jets competitively (at 'world prices') when labour-intensive industries like textiles required heavy protection to be sustained domestically against imports. The Lal–Myint comparative study, by distinguishing between the different development paths of countries with abundant labour and scarce land (including natural resources), and those that were land abundant but labour scarce, argued that, as the wage levels in the latter would necessarily be higher compared to their labour-abundant cousins, their comparative advantage would necessarily lie in the capital-intensive end of the manufacturing sector. As capital was also scarce in these land-abundant developing countries, with growing labour forces they would, over time, be forced on to a lower wage path, if capital did not grow as fast as population. To prevent this politically disastrous outcome, and to validate the high-wage capital-intensive development path, they needed to see the capital stock growing faster than the population. As domestic savings were insufficient, they sought to garner forced savings through inflation, supplemented by foreign borrowing to continue the high wage development path. These countries are thus likely to indulge in 'big pushes' of investment based on foreign borrowing and inflation.

Brazil has periodically followed this route. An innovative package, which included widespread wage indexation and relatively conservative macroeconomic policies, was initiated by Roberto Campos as planning minister, and Octavio Gouveia de Bulhos as finance minister in Castelo Branco's 1967 administration. The 'big push' initiated by Delfin Netto in 1979, after the second oil shock, sabotaged this strategy. The terms of trade shock was accommodated by changing the indexation formula to current rather than forecast inflation and higher adjustments for lower-paid workers. The resulting macroeconomic imbalances led to the Brazilian growth collapse of the 1980s.

India's similarity with Brazil is not in its factor endowments. Rather, because of labour laws going back to the Raj, India has created an artificial industrial sector reminiscent of Brazil. India too has high-tech, capital-intensive industries, which can be internationally competitive given the artificially inflated wages in the organised sector. Meanwhile the labour-intensive unorganised sector languishes, as it cannot grow to a sufficient

scale (as in China) if it is to avoid these labour laws. This is going to make a mockery of India's projected 'demographic dividend' as the millions of ill-educated youth flood the unorganised sector. Meanwhile palliatives like wage indexation, which are now being introduced for the 'poor', could – as in Brazil – lead to serious macroeconomic imbalances, making them unsustainable in the face of likely future terms of trade shocks.

For all these reasons, India today needs urgently to rescind its colonial-era labour laws and reappraise its populist economic path. For the wages of populism as in Mexico or Brazil are likely to turn its much hyped 'economic miracle' into a 'growth collapse'.

The entitlement economies

When I went up to Oxford in October 1960, I took a slow boat from Bombay on which were a number of young Australians, also going to British universities. One memory stands out. It was the amazement of the young Australians at the 'cradle to grave' welfare state that they had read Britain had set up, with bipartisan support.

As the dust settles on the first year of the new Con-Lib UK government, the *dénouement* of this major trend in the subsequent history of Britain is now apparent. The expansion of the welfare state, and its complications, particularly during the last 13 years of Labour rule, has led to the creation of a broken society with a large underclass: work-shy, feckless, sometimes criminal and entirely dependent on public handouts. Successive governments trying to massage the unemployment figures colluded with work-shy 'able-bodied' claimants, putting them on incapacity benefits. These 2.6 million, costing about 12.6 billion pounds a year 'on the sick', are either a sad indictment of the state of the nation's health under its self-proclaimed national treasure, the NHS, or else the current system of subsidising unemployment, while creating disincentives for this underclass to work, is to blame.

There are now 250,000 households where no one has *ever* worked. There are nearly 100,000 households receiving benefits that are more than the average wage. Someone on benefits who decides to work faces a marginal tax rate of 90%. They prefer to remain unemployed on benefits, while joining the black economy if they want to work. It is the fiscal crisis accompanying the vast expansion of a dysfunctional welfare

state that is leading the coalition to consider, and hopefully undertake, its radical overhaul – something even the Iron Lady shied away from. This *dénouement* (and the even more drastic one facing the Club Med countries of the Eurozone) should give the social democrats in the Indian coalition government, seeking to establish a European-style welfare state, cause to pause.

This reflects the well-documented dynamics of the creation of an entitlement society and its effects (see Lal 1993; Lal & Myint 1996). As with medical experiments, these dynamics are best seen in microcosm in the small, natural resource-rich open economies of the Third World, like Jamaica, Sri Lanka, Tanzania or Peru. Reliant on commodity exports for their prosperity, they are subject to the volatility of their terms of trade linked to the cycles in world commodity prices. The export sectors also provide the main source of public revenues, which also then fluctuate with world commodity prices. During the boom, with public coffers flush, ‘rent seekers’ flock to obtain politically determined entitlements. Governments keen to expand their clientele find it expedient to succumb. With the turn in the commodity cycle, expenditures inflexible because of the entitlements granted in the boom, and revenues falling, there is an actual or incipient fiscal crisis.

This is met, in successive cycles, by ratcheting up export taxes. Eventually this rising tax burden on the productive sector leads to a permanent fall in output and revenues, and a full-blown fiscal crisis. This is sought to be met by borrowing (usually from abroad). When its limits are reached, as lenders react to the fall in output by taking fright, the monetary spigots are turned on to raise the inflation tax. As the inflation tax rises, the populace escapes it, by limiting holdings of domestic money, and the revenues from the inflation tax actually start declining. The government is then faced with a fiscal-cum-debt-cum-foreign exchange-cum-inflationary crisis.

Often in this downward spiral, the government finds its revenues insufficient to even pay its functionaries providing public goods, like the police, defence and utilities. It seems to be faced with the un-Marxian ‘withering away of the state’. It is only when they are staring at such an abyss that governments undertake the rescinding of the politically determined entitlements to income streams, which are the ultimate cause of the multifaceted crisis they face.

The origins of the recent global financial crisis in the US, as in the 1980s Latin American debt crisis, lay in unsustainable entitlements – in the US case in housing, health and social security (see Lal 2010a, 2010b; Reinhart & Rogoff 2009; Rajan 2010). The US is still a long way from the final *dénouement* of these entitlement crises. But as the current travails of California show, it is not unimaginable, and the current debt crises in Greece, Ireland and Portugal, and the incipient ones in the UK and other European welfare states, show that, once the primrose path of the entitlement economy is trodden, it is politically very difficult to get off until close to the abyss.

What, then, of the emerging Asian powers that, in the future, could conceivably challenge the US? China under Mao had, in keeping with its Communist ideology, sought to create the ultimate entitlement economy. The recognition of its economic failure with Deng Tsiao Ping's economic liberalisation programme in the late 1980s, also led to smashing of the 'iron rice bowl', and the creation of the freest labour market in the world. Being once bitten, twice shy, the Chinese remain reluctant to create a new entitlement economy, despite the advice from many welfare state proponents from the West, who want China to raise domestic consumption by expanding entitlements. Instead, the Chinese are rightly following the classical liberal advice of raising the demand for labour in productive enterprises, which, by raising labour incomes (unlike entitlements), ensures sustainable alleviation of poverty. Its future prospects, however, are clouded by its increasing adherence to the state-led capitalist model since Tiananmen labelled 'the Beijing Consensus' (see Huang 2008, 2011).⁴

India, by contrast, which seemed to have turned its back on Nehruvian *dirigisme*, with the liberalisation following the economic crisis that its past *dirigisme* had caused, appears to have begun to seriously tread the primrose path of the entitlement economy. After the 2004 elections, the economic reformers responsible for the 1991 liberalisation, who once again came to power, were forced to trim their sails by their Communist coalition partners, particularly in rescinding the colonial labour laws that still hamper the labour-intensive industrialisation that India needs to alleviate

⁴ Some recent pronouncements by the new Brazilian President, on the need for industrial policy to promote 'national champions' in Brazilian public enterprises, suggest this virus might now be about to infect Brazil. For a critique of the supposed efficacy of 'industrial policy' in generating the 'miracles' in the East Asian countries, see my *Poverty and Progress* (in press).

its ancient poverty. With the Congress Party's victory in the 2009 election and the decimation of its previous Communist allies, it seemed that the government could now speak with a unified voice and undertake the so-called second generation economic reforms. Instead, the reformers are again being hamstrung. The *dirigiste* Opposition is now present within the Congress, particularly in the wholly constitutionally unaccountable National Advisory Council set up by the latest Nehru–Gandhi dynasty, Sonia Gandhi, who is the President of the Congress Party but not the Prime Minister. A vast expansion of the entitlement economy and the 'quotacracy'⁵ has begun, under the aegis of a leader who in effect wields power without responsibility. Though – as in the small, boom-time, resource-rich open economies – these may seem to be easily financed by the rapid growth the initial economic liberalisation of 1991 has engendered, the damage they can do to India's productive potential, once this primrose path is trodden, makes me wonder about India's ability to achieve the high potential growth rates and the concomitant great power status it craves. It might find, like Argentina in the early part of the 20th century, that its seemingly unstoppable economic rise, to rival the US or China, turns to ashes.

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⁵ This refers to the unique form of affirmative action India has embraced with quotas for the so-called backward castes in public employment and higher education, which populist politicians are now threatening to be spread to the private sector.

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