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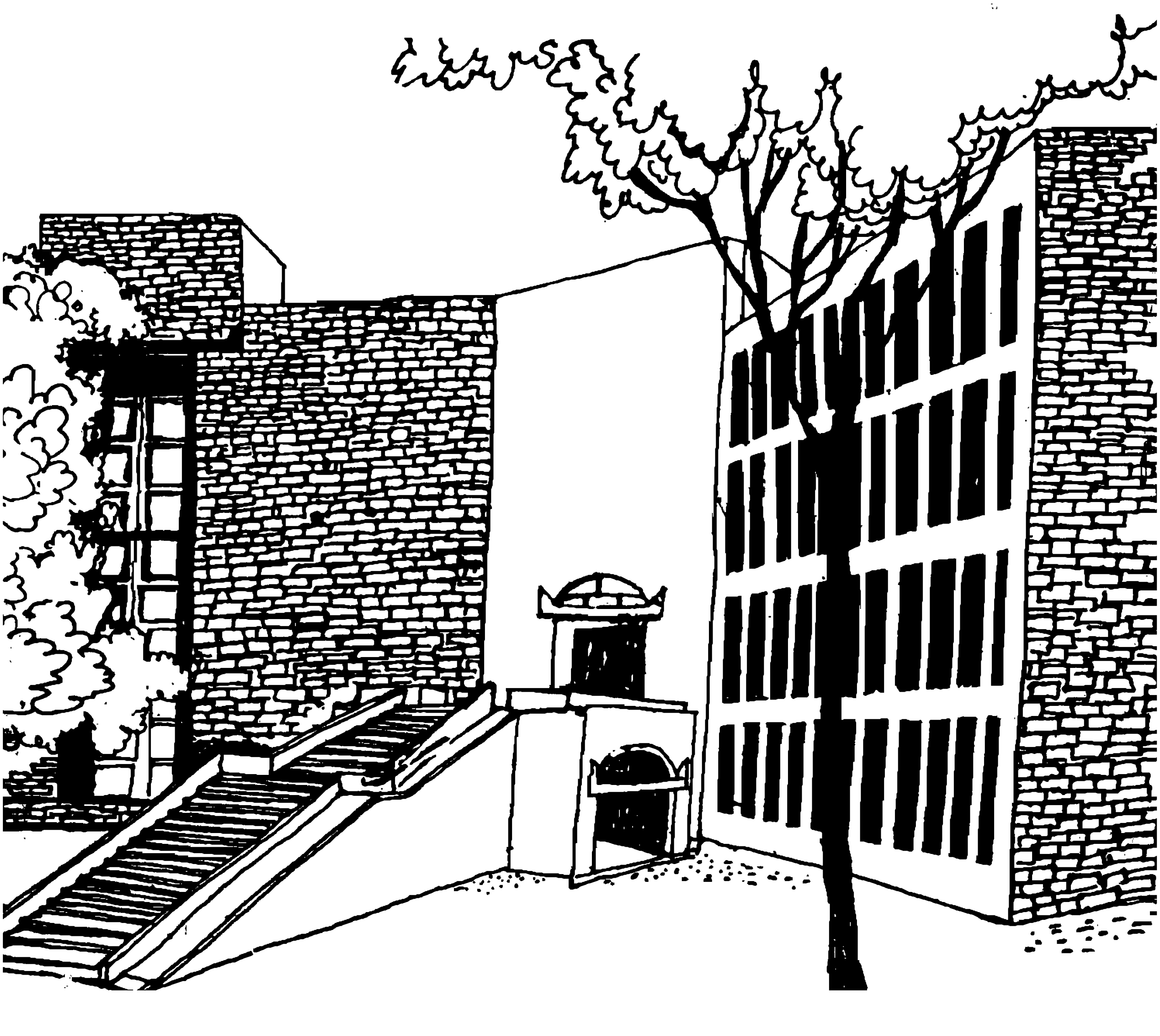

# DEFUNCT ECONOMISTS AND ECONOMIC POLICY: A COMMENT ON THE ECONOMIC POLICY REFORMS IN INDIA

By

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# Defunct Economists and Economic Policy: A Comment on the Economic Policy Reforms in India.

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Abstract:

In General Theory of Employment, Interest and Money, J.M.Keynes made the observation - "...the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

The approach of the present policy regime in India fails to see that a free market economy is sustainable only in the presence of minimum necessary institutions. This paper brings out a few issues in this respect.

# Defunct Economists and Economic Policy: A Comment on the Economic Policy Reforms in India

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Towards the end of The Theory of Employment, Interest and Money, J.M.Keynes made the following observation:

> "...the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist."

With these words of Keynes, The Economist magazine published a story in August 1993 about the consequences of the World Bank sponsored agricultural policy in some of the African nations. The agricultural sector in several African nations could not develop because the terms of trade have always been kept in favour of urban consumption much against agricultural production. Secondly, the World Bank sponsored policies do not provide for subsidies to farmers for use of fertilizers. Non-use or little use of fertilizers by the farmers leads to quick soil infertility and hence encouraging the farmers to go in for an extensive form of cultivation which means cutting down more forests and subsequent deforestation. This, in turn, is observed to cause high incidence of famines in these countries in a cumulative fashion.[1]

As one observes several aspects of the approach of the present policy regime in India, not necessarily in any great depth, it does appear the above words of Keynes are highly applicable to the present times.

The objective of this paper is to present a critique and bring out some implications for the way the market fundamentalism is being pushed in India without constructing minimum necessary conditions and a careful assessment of possible policy options. The critique of the present policy approach should not be interpreted as a defence for the previous policy regime of excessive policy intervention. Secondly, it is not the intention of this paper to attribute too much importance to the policy makers (or economists) for any major shifts in policy. In a democratic setting, as shown

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1. The agricultural policy of the previous policy regime in India can be observed to be relatively very successful compared to the industrial policy. By whatever little incentives that were directed towards it, since the late 1960s, the agricultural sector responded quite positively. Within a very short period, India became self-sufficient in food grains production. It is rather a dubious argument that the Indian agriculture sector had been highly subsidized. Major part of the fertilizer subsidy has been towards subsidizing inefficient industrial production of fertilizers. The procurement and output price policies kept the prices realized by farmers far below the world prices which means, as shown by a recent study by Gulati (1990), the agriculture sector paid a net tax. Dholakia and Dholakia (1993) observe that the total factor productivity growth (TFPG) in agriculture has contributed significantly to the acceleration of agricultural growth facilitating release of scarce resources from agriculture to other sectors in the economy which has been the driving force behind the acceleration of overall growth in the Indian economy in the eighties. It is observed that the main determinant of TFPG has been found to be in the use of inputs like HYV seeds and fertilizers and irrigation.

by the theories of political economy, the policies of government are circumscribed by the preferences of the dominant interest groups [Datta-Chaudhuri (1990)]. Any major shift in a policy that disturbs the interests of the dominant groups is rarely feasible, unless the coalition changes.2 But the importance of the role of policy makers in causing major shifts in policy might emerge or get enhanced in times of economic and political crisis. In this context, the role of policy makers in shifting a society to a higher or lower plane of development becomes germane.

The policy shift towards market fundamentalism, sponsored by the international agencies and adopted by the present policy regime in India, could be easily traced to the external and internal resource crisis engendered by the macro-policy mismanagement of the eighties [see Basu (1993)]. This is similar to the experience of several Latin American countries, which had to adopt the World Bank and IMF sponsored market reforms (the structural adjustment programs) after they plummeted into serious external debt trap caused by macro policy mismanagement.

The structural adjustment programs, which come as a package deal, are simply unleashing free market forces in most spheres of economic activity. The stabilization policies are supposed to reduce inflation and other macro economic instability so that free market price-mechanism can provide

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2. For example, the import liberalization and populist macro-economic policies towards catering to the consumerism of the eighties is attributed to the emergence of the Indian middle class as a politically viable group.

the right kind of price signals.3 In the following, we discuss some of the possible implications for the way these reforms are being pushed in India.

I

The historical experience of the western capitalist countries clearly shows that free market with sub-optimal institutions and in the absence of appropriate institutions could lead to disastrous consequences. One of the biggest lessons these countries learned from the great depression of the 1930s, when millions of people starved to death, was to build strong social security systems in terms of food stamps, unemployment insurance schemes, minimum wage regulations, etc.4 India never had any strong social security system. The public distribution system (PDS) of food might have served, to an extent, as a source of food security to the weaker sections. The bankruptcy of the present policy regime is that, instead of making PDS stronger and more targeted as a preparatory ground for a free market economy, it weakens it by slashing down the subsidies to it.5

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3. Structural adjustment and stabilization policies generally consist of devaluation of the currency, reduction in government subsidies and budjet deficit, reduction in anti-export bias, liberalization of labour markets to reduce real wages, etc,.

4. Despite the presence of strong social security systems, the recent prolonged recession in the U.S and the European countries has led to racial tensions and riots in these countries.

5. The irony of it is that the present finance minister appears to have succeeded in convincing the Indian middle class and its intellectuals that he has saved the Indian economy by pointing at the difference between the present and a few years ago's foreign exchange reserves. But, on the other

It is but plain commonsense to realize that a market economy is viable only when there are certain minimum efficiently functioning social, economic, and legal institutions. In the absence of these institutions, free market economy (especially with historically given arbitrary inequalities between agents) is akin to a boxing match between a well-fed boxer and a under-nourished one with a referee biased in favour of the former. Let us take the example of primary education. The role of primary education or literacy in the modern market economy is to reduce informational asymmetries and transaction costs so that every one can participate in the market economy effectively. Informational limitations and high transaction costs to certain sections of the population, as shown by the institutional economics, will be a source of mobility and entry barriers. In India, a major section of the population (34 per cent according to the 1981 census) never had access to any form of primary education. 6

A market economy is sustainable only in the presence of institutions that could effectively monitor and regulate the

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hand, a few recent studies show that there has been increase in unemployment and incidence of poverty as a result of the structural adjustment policies, which is all the more poignant in the absence of a social security net.

In recent times, one has to listen to a lot of cheap talk in the media that India should learn from China as the market reforms in China are a lot more bolder. But this ignores one striking difference between India and China that China has been able to provide basic material security to all its people. The Indian middle class intellectuals appear to have reduced India's economic problems to those of the Indian middle-class.

6. A minimum level of education can effectively enhance the ability of the poorer sections in utilizing the public good services like public health, ration cards, etc.

pursuit of individuals' (myopically) perceived self-interest will not cause high social costs. In the following, we provide a simple example. A colleague from South Africa told this author about one of the results of privatisation of the city bus service in Cape Town. The competition between the private city bus operators in Cape Town has become so intense that they have started to shoot at each others' buses with machine guns. Often, in the process, several commuters have to loose their lives in the cross fire. A milder form of this type of outcome must have been experienced by any commuter in Delhi who has to deal with the Red Line private city bus service. After the introduction of the Red line private city bus service in Delhi, it has been observed that there has been a significant increase in the number of fatal road accidents.7 Now, the commuters in Delhi have to assess the resultant increase or decrease in their welfare after the privatization of the city bus service - the trade off between the increase in consumer surplus owing to the increase in the bus service as against proportionately higher increase in the probability of getting killed on the roads.8

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7. Anyone who travels in these buses must have experienced these buses overtaking and blocking each other at super speeds and also getting into fist fights with each other if one of them happens arrive before his scheduled time or happens to undercut the stipulated price. The latter behaviour can be termed as a private competition policy that privately restrains the anti-competitive conduct of agents with fist fights.

8. The private bus operators in Delhi, as generally observed, can get away with this conduct because they could bribe the police. If one extends the argument of the rent seeking literature in economics, since the police and the judges are corruptible these institutions also may be privatised.

In this context, the other relevant issue is the importance of policy intervention in the presence of positive or negative externalities in industrialization. Let us take the example of leather industry exports. The leather industry throws out high levels of pollution because of the chemicals used in cleaning leather. For example, the expansion of the leather industry in pockets of Tamil Nadu state is observed to have caused irreparable damage to the cultivable land. An appropriate policy that calculates the social costs of these negative externalities will impose a heavy tax on leather exports. But the present policy regime appears to be blind to these outcomes in its desperation to boost exports.

The market economies of developed countries function on the basis of highly evolved institutions [Lerner (1972)]. The evolution and emergence of the necessary institutions might have been a time-consuming and painful process in which certain sections of society might have to pay a disproportionately higher price.9 The argument that the necessary institutions will emerge and evolve after we go in for a free market economy is rather incomplete because it implies our inability, as a society, to learn from our own and others' economic history. A minimum level of institutional support system does not have to evolve through experience. In other words, we do not have to experience something like the great depression and its consequences to think in terms of building a social security system.

9. For example, the people who starved to death during the great depression and the child labour employed in the coal mines in England during the industrial revolution.

II

This section discusses a few issues regarding the policy options at the present juncture towards achieving higher economic growth within a broad market economy framework.

While selective policy intervention, within a broad market economy frame, led to spectacular economic development in countries like Japan, South Korea and Taiwan, the policy intervention in some of the Latin American countries and India is generally observed to have not achieved similar results.10 The striking examples are India and South Korea which started with similar industrialization strategy which has been very successful in S.Korea but not so in India [see Patibandla (1993), Westphal et al (1985), Pack & Westphal (1986)]. The important question in this context is 'why' policy intervention is successful in some countries and not so in the others and whether the success or failure of policy has to do with institutional conditions!. This should enable us to assess the issue of whether we should jump into a crude form of free market economy in a haste or build up necessary

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10. But the green revolution in agriculture in India is a tremendous success story of policy intervention.

Stiglitz (1992, p.58) points out: ".....there were notable successes of government (Korea, Japan and Singapore) mixed with the failures; it often seems, at least within some circles, as if the failures have been given selective emphasis over the successes." In the same paper (p.60) he observes: "The call for less government was based partly on ideology- the selective drawing of lessons form certain cases - and partly on a theory of government which perhaps exaggerated the importance of rent seeking activities." Bardhan (1990,p.5) observes: " The rent seeking literature is better at explaining failures (of course, after the fact) than success stories, particularly of state-led industrialization, and there has been some dramatic cases of the latter in the history of last 100 years or more, starting with the classic case of Meiji Japan."

institutional requirements for selective policy intervention to succeed, if the latter option leads to a higher economic growth.

Within the mainstream Neo-classical economics, there is a large body of literature on the issue of market failure and the possible role of policy in correcting it [see Stiglitz (1989), Arrow (1962), Pack and Westphal (1986), Bardhan (1990)].11 The important contribution of the Arrow-Debreu general equilibrium models is that they specify the conditions under which markets can be efficient. Most conditions, for example, presence of futures markets, fail to prevail in less developed economies. With pervasive market failure, free market economy in less developed economies leads to a low level equilibrium trap.12 This is exactly one of the possible outcomes of the present policy approach in India.13

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11. In certain circles, policies like patent protection are justified on the basis of the argument of market failure- that in the absence of patent protection technological innovation may not take place because of the inappropriability of innovation. But the arguments for policy intervention for correcting other forms of market failure and towards generating and appropriating positive externalities for higher economic growth in developing economies are generally dismissed or ignored.

12. See Stiglitz (1989), for an exposition of why markets do not function in the way hypothesized by the Neo-classical theory.

13. It seems that in the relatively high levels of economic decision making in Indian government, in the recent times, when an important project comes up for discussion, some of these free-marketeers would say: "Don't worry, the market will take care of it". This reminds me of my grand mother who used to say that one should procreate as many children as possible as it is God who is giving them, He will take care of them. Therefore, any practice of family planning will be an intervention (or a distortion) into the natural selection process.

A seminal paper by Lucas (1988), which extensively discusses the issues of economic growth, shows that economic liberalization, internal and external, in developing countries might contribute to a one-shot gain in terms of improvement in static allocative efficiency, i.e. movement of resources across sectors depending on the prevailing prices (or opportunity costs). But economic liberalization is not consistent with economic growth. Let us take an example of the well known Neo-classical Heckscher & Ohlin (static) theory of comparative advantage which is used as the underlying logic for the propagation of trade liberalization. According to this theory, countries should specialize in production of those commodities in which they have comparative advantage dictated by the relative factor endowment conditions. Based on this theory, the Samuelson-Stopler theorem shows that free international trade would lead to equalization of factor rewards (incomes) across trading nations. In other words, if India has comparative advantage in producing fruits, exchange of fruits with computers made in the U.S, would lead to equalization of wages of a fruit picker in India to that of a computer maker in the U.S. The computer maker in the U.S must be irrational to spend five or six years of his life to learn the skills of making computers as the unskilled fruit picker can earn similar wages because of free trade. This is where, in a dynamic perspective, the importance of human and physical capital accumulation through selective policy intervention is relevant in shifting a less-developed economy from a low-wage to a higher wage economy.

The new growth theory (the endogenous growth models), which appears to have been inspired by the East Asian development experience, lays strong emphasis on human capital accumulation [see Romer (1986), Grossman & Helpman (1991)]. Human capital accumulation can take place because of - (1) the learning by doing economies [Arrow (1962)] and (2) systematic investment in higher education and high technology industries.14 As Stiglitz (1989, p.198) points out, "... a major difference between the more and less developed countries arises from learning by doing and limits on the ability to transfer what occurs across international boundaries. The less developed countries finding it impossible to acquire the learning of the more developed countries find it optimal (given their initial disadvantage) to specialize in technologies or products with lower learning potential." Let us take the example of the South Korean industrialization and development experience in this regard in very brief terms. South Korea (and Japan and as a matter fact, many other industrialized developed countries) industrialized under the

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14. These days one comes across many papers, both journalistic and academic, which say that multi-nationals are interested to bring in capital to India after the liberalization. The reasons for their interest in India are given as the availability of a large pool of inexpensive skilled labour and the large middle class market for consumer goods. One wonders whether these factors have dropped from the sky after the liberalization. The large pool of cheap skilled manpower has been generated by the public investment in higher education which might have been at the cost of primary education to the masses. Secondly, the large middle class in India has emerged because of the expansion of the government sector. The policy intervention, obviously, has played a role. The interest of the multi-nationals is to internalize the externalities generated by the public investment.

umbrella of a critical level of protection from imports. The policy identified and targeted certain high technology sectors in which dynamic gains (the learning effects and externalities) were perceived to be high by using the signals emanating from the world market. These sectors were promoted with a 'carrot and stick' policy mechanism by ensuring that infant industries would not turn into inefficient protection lobbies. The industries that were provided with preferential treatment were made to export right from the infant stage. The export market pressures were argued to have resulted in quick learning and dynamic gains. [Westphal et al (1985)]. This clearly shows the important role of selective policy intervention, within a broad market economy frame, towards accomplishing rapid economic growth.

The solution or remedy to the relative failure of the past industrial policy in India may not be in jumping into a crude form of free market. Several times, in certain circles in India, the move from one extreme to the other is being justified and pushed by dubious economic research and lopsided arguments. In the absence of a good historical perspective and theory, research in economics towards observing and explaining a complex economic phenomena is akin to blind men trying to figure out an elephant. In this context, it might be useful to remind ourselves of a story from Panchatantra which goes as follows. A man was so poor that the only thing he was left with was a healthy cow. He needed some cash very badly. He asked his son to take the cow to the market and sell it for a good 'price'. Three cheats observed the boy taking the cow to the market and decided to cheat him off the cow. As the boy was walking with the cow, one of the cheats joined him on the way and enquired as to where he was taking the old 'donkey' to, referring to the cow. The boy replied that it was a cow and not a donkey. The cheat insisted that it was a donkey, but left the boy after awhile. The second cheat joined the boy further along the route and did the similar talk insisting that the animal was a donkey, not a cow and left him after awhile. Although the boy stood by his ground, the seeds of doubt ware planted in him. After some time, the third cheat joined the boy and told him that he would not get much of a price for such an old donkey. By then, the boy was convinced that it was a donkey and not a cow, and sold off the cow to the cheat for a very poor 'price'.

Let us take the example of Ahluwalia (1985) and (1991) on growth and total factor productivity in Indian industry.15 Ahluwalia (1985) measures total factor productivity (TFP) and output growth in Indian industry and attributes the observed low levels of TFP and industrial stagnation in the sixties and seventies to the supply side bottlenecks caused by the import substitution policies, by negating the arguments regarding the demand constraint. Ahluwalia (1991) comes out with the slogan of 'turnaround' of the eighties that TFP and Industrial growth have turned around for good and attributes them to the liberalization policies. Leaving aside the questions regarding the validity of

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15. See Jain (1993) for an interesting critique of Ahluwalia (1991).

aggregate production function, economists, so far, have not come to terms with measurement of 'capital' which is a very complex task because of differences in vintage and expected life span of machinery and plant, lack of appropriate depreciation methods and also the importance of expectations of agents regarding interest rates and prices. Any slight improvement in the measurement of capital has significant implications on the measured levels of TFP in a production function framework. Even if we ignore this, by taking the basic framework and the data sets of Ahluwalia, Balakrishnan and Pushpangadan (1994) have shown that by accounting for changes in raw material prices in measuring value-added, Ahluwalia's claims about changes TFP in Indian industry are very suspicious. They have shown that TFPG in Indian industry in the seventies was higher than that in the eighties, on the contrary. If these results are more credible, then all the laborious explanations provided by Ahluwalia towards attributing low levels of TFP to the import substitution and high levels of TFP to liberalization policies are highly dubious. The ludicrous side of it is that when industrial growth stagnated in the late eighties and early nineties (despite wide spread liberalization), it is attributed to the labour policies and trade unions 16 which were very much in the operation in the early and mid eighties.17 The theories

16 It is not surprising that some of these economists try hard to ignore or negate the demand constraint because it involves issues like income distribution.

17. But Nagraj (1994) shows that the trade union (the bargaining) power of labour went down significantly in the

of 'learning by doing economies' show that changes or growth in total factor productivity in the industrial sector is a cumulative process [see Arrow (1962)]. It is rather absurd to break up time into small periods and attribute the observed levels of TFP in the particular periods to policies or environment of the specific time periods. This is because the policies that caused adoption of a particular technology and techniques of production in the seventies may have implications on the realized levels of TFP in the eighties because of learning by doing economies. Any approach that attempts to attribute any positive gain in industrial efficiency in recent times exclusively to the free market forces is dubious because the liberalization is undertaken after acquiring a certain level of industrial endowments on the basis of policy intervention of the last forty years at whatever costs it might have been. It is really not possible to delink the pure effects of liberalization on industrial productivity at the present juncture. The issue, here, is our ability to carefully assess the past failures and achievements and choose an appropriate course rather than let ourselves be swept away by the tide.

## III. Concluding Remarks.

It has to be reminded again that the critique of the approach of the present policy reforms in India, in this

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eighties.

The economic theories have not been able to shed clear light on the dynamics of labour markets. The neo-classical economics which is based on the 'hire and fire' approach is rather unable to explain the success of the 'life-time' employment approach of the Japanese model.

paper, should not be interpreted as a defence for the excessive intervention of the past policies. The remedy for the past failures may not lie in jumping from one extreme to the other. The main issue of this note is that the move towards a free market economy in India is made without constructing the minimum necessary institutional requirements in the absence of which the crude form of free market economy could lead to disastrous consequences. Secondly, there has been no careful assessment of the policy options towards realizing economic growth.

At the theoretical level, within mainstream Neo-classical economics, there has been a large body of literature on the issue of market failure and on the need for policy intervention in correcting it towards facilitating the efficient functioning of a market economy. The general equilibrium models of the Arrow-Debreu mould show the conditions required for markets to be efficient.18 Most of these conditions, like the existence of futures (contingent) markets (for efficient inter-temporal allocation of resources), perfect foresight of agents and information do not hold in less developed economies operating with sub-optimal markets and institutions. Free market in such a scenario could lead to low-level equilibrium trap - the less developed economies would specialize in low technology and low-wage

18 As Frank Hahn (1984 p.136) observes:" ...that a myriad of self seeking agents left to themselves will lead to a coherent disposition of economic resources, Arrow and Debreu show what the world would have to be like if the claim is to be true. In doing this they provide the most potent avenue to falsification of the claims."

sectors. At the empirical level, the industrialization experience of East Asian countries like Japan, S.Korea and Taiwan, clearly show the important role of selective policy intervention towards achieving rapid economic growth within a market economy frame.

The development experience of India over the last forty years presents a rather mixed picture. On one side, policy intervention in the agriculture sector led to spectacular results in the form of the green revolution and self-sufficiency in food grains production within a short period. On the other hand, policy intervention in the industrial sector, which started off with some very dramatic positive results, turned out to be a relative failure. Bardhan (1984) has explained the policy failure in terms of the collusive groups capturing the policy, which turned the organized industrial sector into inefficient protection lobbies. Unlike the agriculture sector which consists of atomistic producers, the organized industrial sector is dominated by a few dominant oligopoly producers.19 The domination of the market by a few oligopoly corporate houses facilitates collusion not only between the producers but also between the producers and policy makers. In due course, the pervasive policy intervention turned into a very profitable business for the coalition groups. This type of collusion can take place in a free market economy also, may be with a different group of

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19 As discussed by Hahn (1984), the presence of oligopolies and market power can be a significant source of market failure in a free market economy.

players, in the absence of appropriate institutions.

The major failure of the past policy formulation is that it failed to predict for these institutional failures and build necessary checks and balances which could have minimized these outcomes. The policy intervention succeeded in S.Korea (and also Japan) because the Korean government ensured that the industries that were provided with preferential policy treatment, in pursuit of the dynamic growth, performed accordingly by using both policy instruments and the market mechanism.

In the presence of a sound theoretical case and historical proof for the necessary role of policy intervention in achieving economic growth, perhaps we should carefully think in terms of institutional reforms and building up of necessary institutions to ensure the success of "selective" policy intervention. For example, one of the reasons for the success of the policy intervention in Taiwan is attributed to the rigorous system of recruitment of government servants and accountability imposed on the actions of the government servants. In such a scenario, the scope for government failure in the implementation of a policy may be minimized.

**Notes.**

(The author has benefitted from the informal discussions with Larry E. Westphal, and several friends. The author is solely responsible for the views expressed in this paper and these views do not, by any means, represent the institution and the individuals he is associated with).

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