Growth, Development Deficits and Sustainability

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Abstract:

This paper extends a conception of balance or sustainability to the Indian economy over the course of its evolution since the reforms initiated in 1991. An overview of the current juncture and the path leading to it points to mounting development deficits reflecting missed opportunities and skewed socioeconomic priorities. Much the most important of these imbalances fall to one side of the fault lines of conflict between the interests of haves and have-nots that a tumultuous year has exposed. Drawing on insights from economic theories of growth and of policy implementation, the analysis advances the notion of a sustainable economy in terms of the balancing of ends and means.

Keywords : *Growth, Socioeconomy, imbalance fall, current juncture, development, deficits, sustainability, Indian economy*

1. Introduction

The multiple crises that have beset the world over the past year have given serious cause to doubt the economic, environmental, social and political sustainability of long-prevalent patterns of economic growth, consumption and distribution in rich and poor countries alike. With varied causes and sites, these exigencies include the severe spike in food prices that burnt deep holes in poor people's budgets everywhere, the unprecedented linkage between the food and fuel economies that a misguided, heavily subsidized rush into fuel ethanol in the US and Europe produced, the bursting of the real estate and financial bubbles in the US and elsewhere that has laid low major parts of the world's financial system, a faltering real economy doubtless slipping into a prolonged recession, and the continuing fires of the war on terrorism and sundry geopolitical and ethnic battles reemerging with renewed ferocity. The dithering over global warming remains an unquiet backdrop to these quick-moving developments.

High skepticism has become the order of the day. Economic dogmas that reigned as unquestionable truths for over a quarter century seem to have bit the dust. The notion, always facile, that markets can do no wrong now looks a little ridiculous with financial icons felled like dominos and bailed out with a trillion dollar package. The shibboleth, everywhere dubious, that states can do no right now seems quite silly with economies in their intensive care and corporate chiefs effectively asking for nationalizations. But the newly recovered skepticism could succumb again to old habits and, as happened after the dot-com bust, let the reins pass almost absent-mindedly to the so-called invisible hand, paving the way for a new bout of unsustainable euphoria ending in breakdown. Else, it could reach for an understanding of what a sustainable path of growth entails. Such an understanding must identify sustainability in terms of the balancing of ends and means. Above all, it must recognize the profound fault lines of conflict between haves and have-nots that a turbulent year has exposed and that had lain dormant or taken to be part of the natural order. Absent such an understanding, no new social accord will materialize and no recovery seen to be assured or just.

India has hardly escaped the full force of the world-wide crises. The sharp surge in inflation hit the common man hard, particularly on the food front and via fuel prices. Contrary to optimistic pronouncements of the punditry as recently as the onset of the financial crisis in the heartland of capitalism, developing countries such as China and India have not become *decoupled* from the capitalist core. Rapid changes in liquidity, asset values, lending volumes, the current account and the economy itself have all reflected troubles both at home and abroad. Stock prices have nosedived, portfolio capital has fled and exports are slowing along with uncertainty about key sectors including information technology (IT) and IT-enabled services (ITeS). As the recession in the North worsens, sharp declines in the investment rate, corporate hiring and economic growth can all be expected. Meanwhile, South Asia is becoming a new epicenter of *the war on terror* while India joins China in the world league of big and growing contributors to global warming.

At any rate, whatever variations in impact the future may reveal, the crises have reinforced grave doubts about the social and political sustainability of India's economic growth paradigm. Already for a decade and a half, the rapidly growing contrast between *India Shining* (especially the corporate sector together with perhaps the top two or three urban income deciles) and the rest of India had been part of the consciousness of the excluded masses even if not of the ruling classes. The multiple crises of 2008 come in the wake of the ongoing sharpening of inequalities - between corporate and informal sectors, urban and rural areas, across geographical regions, between favored and disfavored industries and lobbies, and along ethnic, tribal and religious divides.

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The present juncture, therefore, is both challenge and opportunity for reassessing India's development path and re-balancing means and ends. At issue is precisely the sustainability of a strategy that dresses up socially concentrated income growth as the means to all ends. 'Sustainability' commonly refers to inter-temporal balance in the use of natural resources. According to the World Commission on Environment and Development, development is sustainable if it "meets the needs of the present without compromising the ability of future generations to meet their own needs." (UN, 1987). Imprecise though it may be, this definition draws attention to the potential for inter-generational conflicts of interest and the need for rules of inter-generational equity to guide resource use. But it is not practically possible to separate the potential for inter-generational conflict from the actuality of conflicts in meeting the "needs of the present". It seems utterly implausible that the social resolution of the former will not be influenced by how the latter conflicts are resolved; to the contrary, the impact can be expected to be profound. As Keynes pointed out, in the long run we are all dead: it is only through a series of short runs in which intra-generational conflicts play out that the long run, in which

inter-generational tradeoffs become manifest, is realized.

The still raging financial-economic debacle is illustrative. It has not only imposed gross inequities on the poor, the vulnerable, the retired and the working classes and exposed the duplicity and regulatory capture by which financial and corporate elites have been enriched since the social accords that supported the Golden Age of Capitalism broke down. It also threatens to compromise *the needs of the future* as the "needs of the present" are realigned via new political compromises. Both sets of compromises involve conflicts within, not just between, generations. In Europe, for example, the crises have heightened the readiness with which nations seem prepared to dilute if not jettison proposals for tough new agreements on global warming.

While much current thinking about environmental degradation in countries such as India finds fault with the poor both for unsustainable harvesting of fragile natural resources and for excessive population growth ('degradation from below'), the much higher levels and rates of growth of upper class consumption indicate high levels of degradation from above (Rao, 1995). This is not just a question of ex post accounting and apportioning of blame. It is surely impossible to arrive at reasonable tradeoffs and policies without agreeing on who will sow and who will reap, an agreement, in effect, on intra-generational equity. Much the same *class* lines of conflict appear on the global North/South axis over the buildup of green house gases.

The notion of a *sustainable* economy brings to mind the idea of a *balanced* economy in the sense of reconciling current rates of growth in our consumption and the future of an increasingly fragile planet. But achieving balance in the economic basis of our present social relations is equally important, indeed more urgent since it is a prerequisite to achieving a balanced relation with nature (or the future). Clearly, the parameters for a sustainable economy cannot be conceived in purely techno-managerial terms. Rather, when defined with a view to balancing ends and means both intra- and inter-temporally, they delimit the ethical, social and political context in which technical and managerial sustainability is to be achieved. They must not be reckoned merely in such terms as rates of environmental resource use, GDP growth, or even targets of poverty reduction and human capability advancement. A criterion of feasible justice within and across generations must be at the center of this understanding of sustainability.

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The aim of this paper is to extend the above conception of balance or sustainability to the economic juncture in India today. Section 2 is an overview of that juncture and the path leading to it. Section 3 presents a selective exegesis of key ideas in the economic theory of growth in order to identify a relevant basis for understanding the nature of imbalances outlined in Section 2. Section 4 complements that understanding with a dissection of core issues in coordination and cooperation that are central to governing a sustainable

economy. Section 5 concludes with some implications.

2. Growth Imbalances

The impact of the financial meltdown could have been appreciably worse for India but for safety barriers inherited from the past. Recently, the Congress president credited the nationalization of banks in 1969 for the fact that Indian financial institutions have withstood the meltdown (Times of India, 2008). But this outcome owes as much, if not more, to the non-dilution of equity in public sector banks (including the preclusion of foreign capital) and a relatively controlled capital account, safeguards that the Congress would have blithely overridden in the cause of "second generation" reforms but for the resistance of its erstwhile Left partners in government.

In a way, 2008 has been a second near hit ('near miss' in American coinage) for India. India escaped the brunt of the Asian financial tsunami of 1997 thanks to capital controls that providentially remained in place despite the clamor for opening up not just from interested lobbies but even from an RBI committee. This time around, India along with countries such as Italy and Japan has escaped the worst only because its (nationalized banks), deliberately or unconsciously, failed to "innovate" credit instruments, "securitize" debts or otherwise yield to the temptations of Ponzi schemes. Since old-fashioned retail banking continues to dominate, India has been mercifully spared. Its financial sector had also undergone a decade long program of stabilization aimed less at freeing the market than at enforcing prudential norms and regulations to rein in bad lending. None of this should divert attention from the fact that India remains vulnerable on the external front. Whereas China's mammoth reserves are the accretion from its export surpluses, India does not own the reserves accumulated on account of foreign loans and portfolio inflows, the latter being highly volatile.

Obviously, the jury is still out on the full range and force of the impacts that India will face. But in the court of intelligent public opinion, the 2008 crises have reinforced grave doubts about the social and political sustainability of India's economic growth paradigm. Already for a decade and a half, the growing rift between 'India Shining' and 'India Eclipsed' had been part of the consciousness of the excluded masses even if not of the ruling classes. The multiple crises of 2008 come in the wake of the ongoing sharpening of inequalities - between corporate and informal sectors, urban and rural areas, across geographical regions, between favored and disfavored industries and lobbies, and along ethnic, tribal and religious divides. What follows is but a brief sketch of the growth trajectory since the early 1990s and the accumulated social and democratic deficits that can be traced to the turn in India's political economy in 1991.

Although the reforms set in motion in 1991 proved eventually to define a decisive break with the past, their immediate provocation lay in the onset of the balance of payments crisis. A sharp exchange rate devaluation, partial liberalization of the domestic financial sector, and opening up of the external sector followed IMF strictures. But as events unfolded, the depth of the change in direction became apparent with major reductions in investment by public sector enterprises and their partial privatization, substantial retrenchment in public development expenditures, dismantling of the industrial licensing system as well as barriers to foreign direct investments and financial inflows, and a freeing up of important, previously administered, prices. The policy path was

firmly oriented toward establishing a neo-liberal policy regime by dismantling state direction and coordination whether in promoting growth or advancing distributive equity. Successive coalition governments, whether professing socialism or otherwise, have striven, by design or by compulsion, to consolidate and deepen the established policy path.

Steep cuts in tariff and income taxes benefitting the top income decile or two, fiscal downsizing in social sectors including health and education, grievous reductions in public investment for agriculture, a glacial pace of employment growth and a sharp deceleration in the rate of poverty reduction (as compared to the 1980s) sum up this picture of contrasts. The reformers made external openness the focal point of the policy changes while holding out great expectations for their impact on growth and globalization. In line with the world-wide influence of neo-liberalism, free trade and free domestic markets would not only deliver the most goods but they could also reliably be expected to alleviate mass poverty as well (*trickle down* growth). At the very least, the pursuit of public action for enhancing social opportunities can proceed on a track parallel with globalizing policies (Dreze and Sen, 1995). Thus, social progress and globalizing policies are at worst independent of each other and at best strongly complementary. Sensible critics, however, discounted the rosy promises on growth while predicting adverse social impacts on employment, income inequality, poverty and the quality of life for the majority of people (Bhaduri and Nayyar, 1996).

Predictably, there has been a large increase in the trade/GDP ratio although, barring the dramatic rise of IT and ITeS, not much change in export composition. Inflows of FDI and portfolio investments rose steadily and peaked in the years since 2004. Contrary to reformers' expectations, there was no break in trend growth as between the 1980s and the reform years through 2003, though the subsequent period saw the growth rate rising by about 1.5 percentage points coinciding with a rise in the domestic investment rate, the rise in capital inflows and an unprecedented urban-centered consumption boom partly financed by the growth of bank credit and ultimately fed by capital inflows. A goodly share of this growth gain is attributable to the rise of IT (and services closely connected with it such as communications, trade and transport followed by financial and business services). Contrary to accepted wisdom, however, the Indian offshoot of the IT boom is itself attributable to the big push in higher education during the much-maligned Nehruvian era of planned development, the colonial legacy of an anglicized middle class and, yes, the fact also that IT is fairly free of the infrastructural demands typical of the brick-and-mortar *old economy* rather than to neo-liberal policies per se.

Two other vital frustrations of reform expectations deserve mention. First, gross fixed capital formation rose notably faster in the reform period than in the 1980s belying the hope that external liberalization would reduce capital intensity – whatever be the influence of wage growth, foreign competition and technological up-gradation. Second, the hope that devaluation and trade liberalization would sharply raise farm incentives was not fulfilled, nor, therefore, was the prediction that agricultural growth would be a prime beneficiary of the reforms (see Rao and Dutt, 2006).

Perhaps the key change from the pre-reforms decade is that the divide now between the elite and the rest has scaled new heights. Though the 2004 election reversals reflected, in some

measure, the socioeconomic reversals of the reforms without noticeable gains in growth, the continuity of reforms in the large reflect the political commitment of the BJP and the Congress alike to uphold the economic interests of the vastly wealthier, more influential, better educated and socially dominant minority of at most a quarter of the population - a minority that has virtually monopolized the substance and symbols of power emanating from the markets, the media, and cultural and educational institutions as well as the gains from economic growth. *"India Shining"* has been, at best, a quarter truth. This minority has also progressively come to see one side of its bread to be buttered by foreign capital. Its effective (though not always electoral) command over the political realm is at once cause and consequence of this virtual monopoly.

While symbols of 'India Shining' in the form of high GDP growth rates, a booming stock market, skyrocketing real estate prices and a rising number of *dollar millionaires* commanded attention as the preferred metrics of success, they have lost their sheen from the developments of 2008. Poor agricultural growth has been a persistent source of concern throughout the reform era. Low output and employment growth in rural India, with two-thirds of the labor force, underlies widespread distress including mounting numbers of suicides by indebted peasants. Liberalization has reduced input subsidies while globalization has reduced output prices in important instances such as cotton. This is the dark cloud that the media and the elites it serves would rather forget while they celebrate the sliver of 'India Shining'. The stark fact is that 86% of Indians live on less than $2 a day, scarcely a generous standard, while 44% subsist on less than the far more stringent norm of $1 a day. No more than 9% of India's half-billion-strong labor force was employed in the formal sector including medium to large scale firms and all forms of government employment. About 40% of the population remains illiterate and there is tremendous educational inequality among the rest. Notwithstanding the boosterism surrounding the stock boom, listed companies accounted for no more than 5% of aggregate economic activity in the country while a bare 2% of all households have any money at all in the stock market.

The flip side of the rise in capital intensity noted above is a decline in the economy-wide labor intensity, again "unforeseen" by reformers. There has been a consequent rise (decline) in unemployment (employment). The faith in increasing external integration as the be-all of the development stratege has been upset by the reality of growing internal disintegration, in the form of increasing economic disparities across states and across the urban-rural divide. The desire to strengthen the fiscal situation through supply-side policies has been frustrated by an actual fall in the tax-GDP ratio and a continued rise in public debt. The urge to curb the food subsidy bill through reduced coverage and higher consumer prices only served to raise that bill through a phenomenal increase in food stocks. Unless one willingly reposes faith in the non-comparable evidence on poverty yielded by the National Sample Survey for 1999-2000, there is little reason to celebrate continued, let alone accelerated, progress on the poverty front. On the whole, the evidence shows increased inequality in the personal and functional distribution of real income within the rural and urban sectors, and a rising rural-urban income gap. Thus, neither direct nor indirect channels of growth-equity complementarity have been realized. And the record provides sufficient grounds to doubt even the weaker expectation that social ends and LPG means (liberalization-privatization-

globalization) can be pursued simultaneously without tradeoff or conflict.

3. Insights from Growth Theory

Most theories of economic growth postulate its key sources to be exogenous. Such factors as the rate of growth of the labor force, the speed of technical progress, the national rate of saving or the entrepreneurial appetite for investment are taken to be given outside the system. Yet, paradoxically, modern economics and growth theory began with Adam Smith (1776) who identified the degree of division of labor or specialization as the fundamental determinant of productivity. Smith's famous dictum that the "division of labor is limited by the size of the market" yields the inference that the major source of productivity growth lies within the system in an ever expanding process of dividing labor into tasks, firms, industries and sectors and, spatially, across regions and nations. It is an endogenous source of growth that is set in motion by sheer growth of the system itself. In his seminal paper published a century and a half after Smith, Allyn Young (1928) developed a clear description and analysis of this dynamic along with its remarkable implications. Though economists have rediscovered endogenous growth theory in the late twentieth century, there is still none simpler or more illuminating than what is quite properly termed the 'Smith-Young model'.

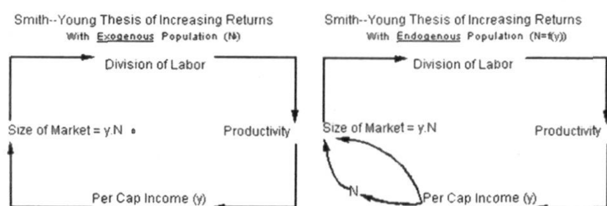
The Smith-Young model may be summed up by the thesis that the division of labor is determined by the division of labor and is shownin Figure 1. Smith argued that the extent of specialization (or division of labor) of workers to occupations and tasks determines the level of productivity. This is shown by the arrow in the northeast of both panels of the Figure. Productivity per worker, in turn, is the main determinant, of income per head, denoted by y (the southeast arrow). Smith's aforementioned dictum appears as the arrow in the northwest: the larger the market or demand for goods and services, the more detailed or refined the specialization of their suppliers. Now the size of the market (of the aggregate of all goods) is simply total income Ny, population *times* per capita income. In the left panel, population size is taken to be constant (at N_0) so the size of the market is proportional to income per head. For example, Bangalore has not just generalist lawyers but numerous specialists and sub-specialists in various aspects of civil, criminal, family and other laws. By contrast, with its much smaller population and level of per head income, Hassan can be expected to have only a fraction of the number of lawyers that Bangalore does and who, for that reason, will be called to work on a variety of disputes with only a rudimentary level of specialization.

The entire argument, as in the Figure, is a closed *circle*. Dynamic movement around the circle can go in either direction - in the forward/upward direction, it will be a virtuous circle while in the backward/ downward direction, it becomes a vicious circle. Once the movement gets going, say in the forward direction, then, in principle, it can keep going by its own momentum. The result will be self-sustaining growth: as specialization advances, so will the size of the market; and as market demand grows, so will specialization. All along this virtuous circle, productivity will be rising and so economic growth occurring. This explains why Smith's is an endogenous theory of growth. It also illustrates the idea of increasing returns: the larger the system (meaning the total demand for final goods as also the volume of inputs including labor and the total supply of final goods), the more productive it will be. Young ascertained important features of this growth process that are worth noting:

1. While increasing returns at firm or industry levels may be due to specific technological features tied to scale (such as a fixed factor), the scale of the economy-wide division of labor, considered at any given point in time, may be itself seen to be the *fixed factor* of the economy.
2. Moreover, this fixed factor grows dynamically by the momentum it imparts to both demand and supply in the Smith-Young process i.e., increasing returns arise only dynamically as specialization progresses with the main productivity advances coming from employing labor in roundabout or indirect ways.
3. The income gains from a growing division of labor are conceptually independent of and additional to the gains that arise from purely exogenous growth of knowledge. This does not mean, however, that the two sources of growth are easily distinguished empirically since growing roundaboutness will also engender new products, new processes and even new industries. Calling the two sources of new knowledge *discovery* and *invention* respectively is conceptually accurate but does nothing to resolve the empirical ambiguity.

Figure 1

Increasing Returns & Endogenous Growth



The model of growth just outlined can be extended to take account of the demographic transition that has invariably accompanied modern economic growth. Two centuries of world-wide experience shows that as economic growth (with rising y) proceeds, both death and birth rates decline but the death rate declines sooner and faster than does the birth rate. Consequently, population growth accelerates (witness the population explosion) until y rises to high levels at which death and birth rates decline to rough equality (and the size of the population becomes stationary). Disregarding the difference between the labor force and population, the left panel takes population to be exogenous while the right panel incorporates the observed endogeneity of population (N determined by y). The right panel shows that with N endogenous to the Smith-Young virtuous cycle, there is a second source of endogenous growth: per capita income rises not only because per capita income is rising (this being the specialization aspect) but also because population N rises as per capita income is rising (this being the demographic transition aspect). The latter source of growth is more than just the so-called *demographic dividend* arising from the lagged acceleration of labor force growth during the transition and a reduced dependency burden. The additional fillip owes to interaction between population and economy yielding increasing returns.

In addition to its obvious simplicity and power as a theory of growth, the Smith-Young model can also serve, much better than conventional arguments, as a more transparent and straightforward rationale for dividing labor across the globe (globalization as it has come to be called). Standard trade theories appeal to gains from global specialization based on comparative advantage (Ricardo), relative factor endowments (Hekscher-Ohlin) or the demand for product diversity (Krugman). While distinct, each of these theories shares with the others the assumption that productivity levels are exogenously given and a purely static view of the gains from trade, thereby failing

to furnish any link between trade and growth. That is exactly what the Smith-Young thesis supplies.

Notwithstanding its indubitable attractions, the Smith-Young model of growth is quite minimalist and subject to crucial qualifications both as theory and guide to policy. To see these limitations, it is germane to note its apparent policy imperatives:

- Markets must be the benign medium for realizing increasing returns
- Every extension of the division of labor must be advantageous
- Unrestricted globalization must be mutually beneficial to rich and poor nations
- Being carried by its own momentum, the whole process must be automatic

These imperatives are only "apparent" because the model suggests rather than establish that the growth process automatically produces all the conditions required for its own continued motion. But the policy formula *laissez faire, laissez passer* is also consistent with Adam Smith's other famous theorem that "every individual ... intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote [the public interest] which was no part of his intention." (Smith, 1776: Book IV Chapter II). But one must wonder: if the growth benefits can come about so effortlessly and automatically, then, why have so many countries had such a hard time? It is not simply that the Smith-Young thesis is wrong: far from it, the thesis captures an important facet of the growth process. Rather, the problem must lie in its being too deterministic, mechanical, incomplete. In reality, the wheels of this conceptually beautiful machine can come to a grinding halt or remain stuck for at least five reasons:

1. *Poverty/Inequality Traps*: A low-income economy may be trapped by vicious circles that keep people ill-fed, productivity and saving low, and fertility and mortality rates high. Often, inequalities favoring landed elites, or between rural and urban areas and the state class and civil society are the major stumbling blocks underlying such traps.

2. *Market Failures*: Markets may be absent or fail in ways that slow the process of growth. Such failures or absences often differentiate between outsiders and privileged insiders. An example is the profound asymmetry in access to long-term finance and short-term credit in India - between the rich and poor, urban and rural sectors, large and small firms, formal and informal sectors. Exclusionary markets not only intensify inequality and inequity but also drag down growth by ceasing to function as the benign carriers of the Smith-Young growth process.

3. *North/South Structure*: In the rich-poor, North-South context that is the historically evolved reality of the world economy, the Smith-Young thesis is at variance with the Prebisch-Singer thesis which deduces divergent growth and/or declining terms of trade for the South on the basis of Southern exports having a lower income elasticity of demand than Northern exports (Bacha, 1978). Contrary to the pleasant up escalator of the Smith-Young model, the Prebisch-Singer thesis finds the South on a treadmill compelled to run even to remain in place relative to the North. This implies that unrestricted international openness (or globalization) is not the optimal means to achieving Smith-Young development for developing countries.

4. *Underutilization*: While the increasing returns process is not inconsistent with the

view both that investment drives the growth process and growth itself is the main driving force of investment, its implicit faith in the automatic, self-stabilizing character of markets is often belied because investment depends on business psychology and expectations of the future but these are tend to be self-fulfilling beliefs, not self-stabilizing objective laws. With weak "animal spirits" driving investment will constrain system utilization and the productivity potential remain unrealized. Apart from the potential for capacity underutilization within the capitalist sector, there is also the actuality of vastly underutilized reserves of labor in the peasant sector, within families and in self-employed informal firms. This implies also that the growth dividend from the demographic transition will remain unrealized as will the additional source of increasing returns from the economy-demographics interaction.

5. *Policy Failures*: For the dynamic to keep going, suitable macro policies, market regulations, and public investments in economic and social infrastructure are necessary. But the required public actions may be hostage to competing interests and other sources of counterproductive politics that slow or even halt the wheel.

Several of these reasons for why the growth machine might falter relate to wealth and income distribution which has no explicit presence in the model itself (see Rao, 2002, for a fuller treatment). They point to growth failures that can arise precisely when distributional fairness and conflict are shoved under the rug rather than addressed on par with the concern for growth itself. Another underlying consideration has to do with economic structure which is not just a matter of the division of labor across an otherwise undifferentiated economy with a homogeneous dynamic but also has to do with the institutional rules by which distinct sets of enterprises and their inter-relations are organized and regulated. For example, peasant family farms and capitalist plantations scarcely follow a uniform logic; nor do small, informal firms and large formal sector enterprises ('non-corporate' and 'corporate' or, in Indian parlance, 'unorganized' and 'organized'). The former are motivated as much or more by economic livelihood or subsistence motives as the latter are driven by the profit motive. Finally, state policy can impinge very differently and unequally on them as is evident in the ways in which both federal and state government policies in India affect the viability and fate of the peasantry, the unorganized sector and the formal sector.

Consider next a model of growth that incorporates some of the distributional and structural considerations absent in the Smith-Young model to derive an unequalizing spiral of growth (Taylor and Bacha, 1976). "Belindia" was coined to describe Brazil during the years of its unequalizing "growth miracle" when the uppermost deciles came to enjoy living standards at about Belgian levels whilst the vast majority languished at the average living standard in India. In the rest of this Section, the model structure is first described leaving aside its technicalities followed by a discussion of its dynamics. The applicability of the model to the Indian case is not explicited any detail apart from a few pointed remarks.

The Belindian economy has a modern (or corporate) capitalist sector producing luxury goods, wage goods and capital goods. It employs two types of workers - the skilled and the unskilled with a significant though rigid wage premium to match their productivity difference. While skilled workers are more productive in proportion to the premium,

there is no scarcity of labor of either type since the capitalist sector is anchored by a traditional non-capitalist sector with plenty of surplus labor (in urban slums and in the countryside) and the costs of upgrading the unskilled are relatively low. An alternative or complementary explanation of the wage premium can be built in terms of the "Fordist" model of the capitalist enterprise, resting more on the sociology of work and wages than the narrowly economic basis in *real costs* of supply. In the Indian context, with its ancient caste, ethnic and religious institutions of economic segregation, the productivity and Fordist explanations can be readily supplemented with a sociological account of occupational segregation and institutionalized discrimination in the matching of workers to the educational system as well as to job ladders inside the enterprise.

Belindia is also characterized by a deep divide in demand structure with the skilled having a higher propensity to consume luxuries (relatively speaking) than the unskilled. The corporate sector plays the leading role in supplying luxuries, while the non-corporate sector (comprising small enterprises, informal sweatshops and self-employed producers including the peasantry) largely caters to the consumption demands (including food) of the masses. The same holds, in practice, also in the supply of modern services such as retailing, finance, construction, real estate, hotels and restaurants. Thus, the economy is effectively bifurcated into high-end and low-end sub-economies. Economic growth is described by the initially small corporate sector experiencing a rising share of output and capital stock with a growing share of its labor force being of the relatively skilled type and producing mostly luxury goods. The non-corporate sector along with the unskilled lower rungs of the corporate labor force declines in relative terms. This dynamic divide is akin, in level terms, to the contrast between Belgium and India and, in growth terms, to the demarcation between *India Shining* and the rest of India's 80-90% of the population dependent on the rural and urban unorganized sectors.

Consider a growth impulse from an initial rise in investment. The growth spurt sets off a spiral that follows the structural contours described above. Dynamics are governed by the plausible presumption that the corporate sector's inducement to invest ('animal spirits' in Keynes' terminology) responds chiefly and strongly to the escalating demand for luxuries. There is, then, a symbiosis between the growing corporate sector and the growing middle class arising both from the former being the main source of supply of the luxuries that the middle class, by definition, demands and from the corporate sector's demand for skilled labor that the middle class, by definition, supplies. In dynamic terms, Belindian growth in luxury demand and investment are inter-linked to produce an unequalizing spiral.

According to a long-standing view in the high theory of development economics, capitalist development is supposed to expand modern sector employment at the expense of surplus labor in the traditional sectors. However, many late-developing countries (India being paradigmatic rather than exceptional) have witnessed a persistent disjuncture between the capitalist sector's capacity for output growth and its ability to absorb labor. In phases of rapid growth, the disjuncture is often heightened. This observation is consistent with the Belindian spiral producing a rising share and volume of skilled employment while shedding unskilled labor that replenishes and even augments the reserve army of labor.

The spiral may be exacerbated by labor-saving technical change. In Chapter 31 ('On Machinery') of his famed *Principles*, Ricardo (1817) had effectively argued that a continuous flow of labor-saving technical change can produce a declining wage rate even in the long run. This was later elegantly formalized in Johansen (1967). The Taylor-Bacha result of a rising army of the underemployed may be seen as a sort of *dual* to Ricardo's argument. To the extent that the Belindian process is accompanied by investments in labor-saving investments (as indeed seems to have occurred in India with the opening up of the economy to the forces of globalization), the two results are joined. It can be further inferred that as the pools of surplus labor rise, any diminution in living standards that this causes outside the capitalist sector (due to the sharing of work and income that is both typical and inevitable there) may delay the demographic transition with the potential for a negative spiral.

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Babel in Washington?

The above discussion points to what might constitute an acceptable growth theory, one that helps us not just to understand the world but also to change it in ways that meet our needs and wants. Such a theory or approach must replace the various *either/or* dualities or separations that prevail in economic thinking with *both/and* unities: both growth and structural change, demand- and supply-side constraints, endogenous and exogenous sources, distribution and growth, and, above all, both economics and politics.

Issues in Governance

In conceptual terms, the specific silences or absences in the invisible hand model of increasing returns can be categorized as problems of coordination and cooperation. Both signify the inadequacies of the market mechanism that apparently underpins the Smith-Young model and that contemporary economists place their faith in. The model of Belindia too does not make explicit the need for public goods such as infrastructure that can occasion failures of coordination although it does focus on social divergence that can produce conflict rather than cooperation. In what follows, these momentous issues are illustrated and conceptualized in the language of game theory only to derive the caveat that theory provides neither a complete account of how they are resolved nor a definite prescription of how they ought to be.

A particularly prominent instance of the coordination problem in development appears in a seminal paper by Rosenstein-Rodan (1943). The paper that inaugurated modern development economics shows the critical value of investment coordination for getting the growth process going. The economy has a low-productivity, low-income peasant sector using traditional technology and with vast pools of underemployment. There is also a small capitalist sector which has the potential to carry out large-scale investments using modern technologies to produce a wide range of commodities and drawing on the pools of surplus labor by paying them a premium wage. These technologies are characterized by scale economies with the economic scale being of

the same order of magnitude as the size of the market itself. Rosenstein-Rodan then argued that an investment of this order in, say, a shoe factory alone or in a textile mill in isolation will prove unprofitable since the volume of shoes or cloth produced will be too large to be absorbed by the demand from the newly employed shoe or textile workers themselves and too large to be demanded by poverty-riddled peasants. On the other hand, when the shoe and textile investments are accompanied by similar large-scale investments in a range of other industries, the problem is solved.

Tabel 1 : Profits with and without Investment Coordination

		Industries N-I			
		Status Quo		Invest	
Industry I	Status Quo	200	1800	220	3500
	Invest	150	1900	400	3600

The investment coordination problem is illustrated in the payoff matrix above. Industry I's options ("invest" or "status quo" which is business as usual) appear as rows with payoffs in terms of net profits being the first entry in each cell. The options of the remaining industries N-I are shown in the columns with their profit payoffs being the second cell entry. Consider the deliberations over the decision to invest by any one industry, say industry I (it is assumed, without loss of generality, that there is just one firm in each industry). If I invests in isolation with the other industries N-I staying put, its profits are reduced from 200 to 150 since output and costs rise but the rise in demand is insufficient to prevent a possibly steep price drop. The larger complement of its relatively well-paid workers will spend a good deal of their new found income on other industries whose profits accordingly witness a slight rise from 1800 to 1900. But if there were to be a *big push* with I's decision to invest accompanied by investments in all other industries N-I as well, then, profits will rise all around (shown as a doubling of profits to 400 and 3600 respectively).

The upshot, then, is that with each industry making its own calculations in isolation (i.e., on the assumption that the status quo prevails) none will find it profitable to go it alone. Lacking any assurance that others also will invest, no industry will invest and the status quo, a Nash equilibrium, will remain stubbornly in place. Rosenstein-Rodan concluded that absent conscious economic coordination (planning, for short) that provides such assurance, a low-income developing economy could suffer extended periods of economic stagnation. Investment coordination can move the economy to the high growth outcome. In game-theoretic terms, such a coordinated outcome is the other Nash equilibrium (both equilibria are shown as shaded cells). The argument also shows that even if an increasing returns potential exists, it may well remain unrealized without credible means to bring about coordination to overcome inertia. The *big push* can be an important missing ingredient of the Smith-Young process and, as just demonstrated, may not be secured by the invisible hand.

Failures of social cooperation can also destroy productive potential. Consider the endemic problems of corruption and tax evasion that many countries including India confront. That these reflect failures to cooperate is also demonstrable in game-theoretic terms. Among the fundamental functions of the modern state are the provision of public productive and consumptive services and the collection of taxes. Tax collection may be subverted through outright evasion and artifices of avoidance facilitated in part by the motivated design of tax laws. Some part of the tax due may be paid by the tax-payer but

not received by the state, accruing rather as bribes to deal brokers and officials. This impoverishes the state and service provision alike, a phenomenon that may be termed *the social un-contract* whereby citizens and firms pretend to pay taxes and the state pretends to provide services.

Wasserman, 2008 (November 25)
Saved from itself?

The foregoing description assumes that state services are either jointly consumed by the population or, if not, their assignment to individual regions, industries or agents is unproblematic e.g., purely *technically* determined. In practice, however, there is always room, through deliberate acts of omission and commission – that may be called *privatization of commons* - for agents to seek to capture a disproportionate share of these services. Such acts may be termed. The privatization of commons must inevitably impose another cost on society. For example, companies that violate labor or anti-pollution legal provisions in order to reduce their own costs will externalize those costs plus the costs of covering their tracks either on the injured parties or on the state. The result will be resource misallocation in the form of an excess supply of pollution or bad labor practices with a possibly adverse fiscal impact as well.

The payoff matrix below serves to represent both of the above-noted problems. Suppose there are N tax-payers, whether firms or households, who are potential recipients of state services. As before agent I's options (business as usual which is "evade taxes" and "skirt laws" or "pay taxes" and "obey laws") appear as rows with payoffs in terms of net bottom lines (utilities or profits) being the first entry in each cell. The options and payoffs of the remaining agents N-I appear in the columns. The south-east cell with cooperation shows two cases: one in which the laws and so the payoffs as well are given (exogenous laws), perhaps by the technical conditions of tax collection and service provision, and another in which the laws under cooperation remain to be designed depending on what the cooperators agree on (endogenous laws). In the latter case, only the social payoff is determinate, individual payoffs are not.

Tabel 2 : The Possibility of Gains from Cooperation

		Agents N-I	
		Evade Taxes/ Skirt Laws	Pay Taxes/ Obey Laws
Agent I	Evade Taxes/ Skirt Laws	100 2000	230 3500
	Pay Taxes/ Obey Laws	70 2020	200 4000 / Ó=4200

Inspection of the matrix shows that with exogenous laws, it never pays agent I to cooperate regardless of what other agents are hypothesized to do: if others evade but I pays taxes, I's payoff is smaller than if I also evades (70 rather than 100); likewise, if others pay but I evades taxes, I's payoff is larger than if I also pays (230 > 200). The result - business as usual with widespread tax evasion and skirting of laws - is an instance of the Prisoners' Dilemma (PD). With endogenous laws, the payoffs will be specified if and when the laws become defined and so are indicated as a collective

sum. Accordingly, the solution to the game depends on the solution to the indeterminate number of PD games that are embedded within it (corresponding to the indeterminate number of specifications of the laws, in the southeast cell). Clearly, failures of cooperation in the form of tax evasion, violations of laws, or incomplete laws impose social costs. Note, in particular, that such failures may also undermine the ability of the state to implement coordination where that is required.

In the policy literature on economic development, while *governance* is taken to refer to questions of cooperation and coordination (especially those involving the state such as management, implementation, corruption and enforcement), it is all too common also to separate governance from politics and treat it as a set of technical matters with determinate solutions in social science. The foregoing analyses of cooperation and coordination stand as a reproach to such a stance, not least since extant social science offers no such solutions. Yet, in that very indeterminacy lies the possibility of politics which, in the final analysis, must be seen as the freedom collectively to either construct successful solutions or let failures prevail, even proliferate.

That the pursuit of any given goal through public policies (say, growth alone or growth specially designed to benefit the poor first and most, here termed *pro-poor growth*) must confront administrative and informational as well as fiscal constraints is obvious enough. But such *constraints in implementation* may be altered subject only to the ultimate constraints of resources and responses of the population. Hence, these are not so much constraints as themselves policy choices dependent on the goal. Nor can there be any *political constraints* apart from the goal. All this is to say that when choices are to serve a given goal, political ownership (social arrangements that define who 'owns' or controls the decision process) is implicit in the very existence of the goal. While ownership is thus generally implied, neither the particular goals being pursued nor the underlying structure of political ownership are readily or objectively discernible.

Of particular interest here is the effective weight that the alleviation of absolute poverty and relative inequality actually command. National 'governance' may enable or disable the poor to help themselves in both economic and political spheres. The key words are empowerment, participation and accountability. The poor suffer not merely from a low income-generating capacity but also an absence of freedom of choice and action. They have little influence on decisions, made at the global, national and even local levels, which affect their own fate. This lack of influence or of voice is not just a consequence of their poverty but also its crucial cause. The problem is compounded by corruption among the elites, whether private or public. Administrative or technical incapacity to intervene effectively in favor of the poor must then be the consequence, not the cause of failed anti-poverty or redistribution policies or programs.

According to the *New Institutional Economics*, which is the prevalent approach in mainstream economics to explaining the origins and functioning of social rules and institutions e.g., private property, LHS driving, polygamy, limited liability companies, government policies, patents, etc., institutions matter in explaining both growth and distribution outcomes. In particular, the *governance system* - consisting of political and legal institutions - regulates the exercise of authority and control, and determines how decisions are made and implemented. This

definition does not, however, tell us who actually governs. If a central problem of development failure indisputably is the failure of governance, then, it is crucial to know what fundamental forces determine who are in and who are out of the governance system, not only in making decisions within the frame of the existing system but also in shaping that frame itself.

Our understanding in this crucial area remains severely limited. Some have claimed that at low levels of income, greater institutional efficiency is linked to greater income inequality while at high levels, the relation is reversed. Others find a positive relation between governance indicators and development outcomes (independent of income level). It would seem prudent to conclude that we know very little about what "good governance" consists in and even less about its linkage with development. We can all agree that good governance enables favorable social outcomes. But this, the easy part, seems true by definition. The hard part is: What and who defines "good"?

Consider another formulation according to which unequal productive assets and unequal political power are the ultimate causes of poverty and that the two are "intimately tied" (Dethier, 1999). But we need to know exactly what constitutes these intimate ties; yet, no generalization seems possible. An important area of ambiguity relates to the conditions under which cooperation may succeed. Cooperation is a key to the provision of public goods including good governance itself. Cooperation (particularly via reciprocity) is more effective among people who are relatively equal than in very unequal situations. Does this allow the generalization that greater equality is always good for cooperation or that inequality necessarily limits cooperation?

Improving the governance system, Dethier argues, involves the enactment of new laws and changing the formal rules or institutions through which political and economic power are expressed (or powerlessness enforced). However, he allows that it will also require changing the norms - both values and behaviors - so that concern for the poor acquires some weight. But how far can such concern go? Can it go so far as to design economic and social policies so as to maximize the well-being of the worst off person in society, a definition of justice that Rawls (1971) defended?

It is notable that although there is a significant world-wide trend toward decentralized governance, this has not produced any clear trend of superior governance and its impact on development performance is even less clear. It seems that even the formal moves signifying a shift of power to the masses may be manipulated by the elites for their own ends! Thus, politicians use decentralization to reconnect with powerful social groups from which they have become disconnected (perhaps under the influence of globalization) or to cope with the general loss of confidence in the central state.

Wasserman, 2008 (December 5)
Where should the buck stop?

We must conclude that perhaps the question of political ownership has no definite answer. In particular, it should not be assumed that the successful pursuit of pro-poor policies necessarily depends on a shift in the balance of political power in favor of the poor even if past experience makes this seem necessary. Identifying the balance of political power may be no easier than identifying political ownership. What is more, if such necessary relationships did hold, then, specific policy goals and policy choices would already be implied in these necessities. But to affirm this proposition is to deny the possibility of political alternatives. None of this is to say that politically mobilizing the poor is irrelevant to achieving successful pro-poor growth. At the least, mobilization will help reduce implementation costs by harnessing the knowledge and energies of the poor and make for greater success of pro-poor policies. Rather, political shifts and mobilizations are neither necessary nor sufficient to make for a political ownership that can be identified with a pro-poor regime.

Conclusion

If a principal charge against India's governments in the era of planned development is that they failed to set up or implement effective policies for expanding social opportunities, governments adhering to the neo-liberal nostrums have not proved immune to the same charge. Without an account of this failure, skepticism seems warranted that meaningful development with justice can be assured by the neoliberal strategy. Such an account must be found not just in the purely economic assumptions underlying the prevalent wisdom but also in the realities of India's political economy.

The general point may be illustrated in relation to agriculture. If genuinely equitable agricultural growth and rapid rural poverty alleviation are to be achieved, this will require a substantial step-up of public investment in rural infrastructure, research and extension, and thorough-going reforms in land relations and credit delivery. There is little room to believe, however, that such a program can be pursued without producing insurmountable contradictions within the fiscal, economic and, ultimately, political priorities of the reform regime presently in place. This also helps account for the profound disconnect between the views expressed by India's economics Nobel laureate and economist Prime Minister at a national science conference on January 3, 2006: while Manmohan Singh called on the scientific community to work towards bringing about a second green revolution thus offering an emphatically technocratic vision for Indian agriculture which employs nearly three-fifths of the labor force (Sunderarajan, 2006), Amartya Sen insisted that India cannot become a major player in the global economy unless it completed serious land reforms offering the Marxist-ruled state of West Bengal as inspiration for the country as a whole (The Hindu, 2006).

The irony, however, is that while agrarian reforms to promote equity (the *old* land question) have been forgotten by the rulers, a *new* land question has reared its ugly head with the states, abetted by the center, competing to promote wholesale inequity in the name of growth. India's Special Economic Zones (SEZs) have been officially advertized as export promotion devices designed to hasten the growth process but critics have loudly condemned them as nothing but large-scale land grabs by private interests using the state's instrumentalities. The state either assigns land at throwaway prices or "acquires" it from current users, usually the peasantry, employing the laws of eminent domain backed by the law of the jungle. Either way, the private promoters of SEZs

gain access to other people's lands for pursuing nothing more socially exalted than their own private profits (often via developing prized real estate, not just productive activity), lands moreover that would either be inaccessible through a market exchange process or accessible only at considerably higher prices. Given the already pervasive rural distress and slow growth of formal employment, the loss of agricultural lands can only have extremely deleterious impact on the livelihoods of poor peasants and especially landless laborers (who cannot gain from a good land price even if one is forthcoming). The greater irony, in view of Sen's counsel, is that popular agitations against SEZs came to a dramatic head in Singur and Nandigram (both in West Bengal). But state repression and violent protests have scarcely been absent elsewhere. States have acted with impunity instituting egregious rules and enticing corporate movers and profiteers in order to enrich them and, doubtless, their own electoral war chests.

Even leaving aside the land question, do investments in SEZs involving the creation of high quality infrastructure within select areas by developers who are offered major tax concessions promote growth? Like gated communities that privatize elements of law and order, infrastructure-centered SEZs effectively privatize infrastructure, both cases exemplifying the private appropriation of what are essentially public or quasi-public goods (including, in the final analysis, state power itself). Recent experience shows that SEZs have come up in the more advanced regions of the country representing a further concentration of already highly unequally spread infrastructure across India. It presages further increases in regional inequality. At the same time, these tax havens will reduce state revenues (a fear expressed by India's Finance Ministry itself). In turn, this must undermine the state's ability to make the much needed public infrastructure investments that are particularly crucial in the backward areas of the country. The potential costs of such imbalances must be reckoned not just in terms of inter-personal equity but also in terms of political stability and even growth itself since there is no presumption that the politically-driven pattern of regional location of SEZs must also be optimal in efficiency or growth terms.

There are other considerations to suggest that the whole scheme detracts from both growth and equity (see Thomas, Rayadurgam and Rao, 2007). For one, there is the question whether the investments taking place in SEZs would have been carried out any way. It seems eminently plausible that a great deal of these investments are doctored and relocated opportunistically only to capture the *rents* offered by the SEZ schemes in the form of the land, fiscal and other concessions. To that extent, therefore, it is evident that quite apart from the inequities they impose, the additional growth that SEZs offer must be purely illusory! This is powerfully supported by the fact that the period of economic reforms has been characterized by a high degree of inter-state competition in attracting investments. In this light, the shift from concerns about the *old* land question to the *new* land question should come as no surprise. It parallels the shift in the growth regime from one that attached some weight also to equity, not just growth, to the *Belindia* way, both shifts signifying changes in political ownership and, therefore, in the ends of economic activity. That the shift has come to be rationalized in terms of efficient means only serves to draw attention away from the change in ends.

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