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POLITICAL ECONOMY AND PUBLIC POLICY

Deepak Lal

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PREFACE

We are grateful to Deepak Lal for this essay, the nineteenth in the Center's series of Occasional Papers on development themes by distinguished scholars and policy makers.

As a consultant to the World Bank and various other international organizations and an adviser to numerous governments, Dr. Lal has gained extensive firsthand knowledge of the development experience in many countries. In this essay, he reflects on the evolution of policy-making concepts in the past century and identifies the new forces that he believes are slowly creating a movement toward economic liberalism among the governments of the third world. He also describes his own intellectual development in this direction, from a strong bias toward planning and government intervention, through a traumatic questioning of their efficacy, to a conviction that poverty-alleviating development cannot occur without a liberalization of economic controls.

Much like the mercantile states of sixteenth- and seventeenth-century Europe, modern third world polities have been wedded to industrial regulations, state monopolies, import and export restrictions, and price controls in their attempts at nation building. This essay provides valuable insight into the philosophical roots and the consequences of this public policy approach. Drawing on his vast experience, Dr. Lal suggests that the wise course for many policy makers in the third world today would be to recognize that economic problems cannot be divorced from political ones and that growth cannot be expected to occur without the entrepreneur, as the classical thinkers argued long ago.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
August 1990

ABOUT THE AUTHOR

Deepak Lal is professor of political economy at University College London. Educated at St. Stephens College, Delhi, and at Oxford, he served in Tokyo as a member of the Indian foreign service. As a specialist in development economics, he has taught at universities in the United Kingdom, Australia, and the United States and has advised governments in a number of developing countries worldwide. He has acted as a consultant to the Organization for Economic Cooperation and Development and to numerous other international organizations. From 1984 to 1987, he was research administrator, economics and research, for the World Bank. Professor Lal has written widely on the economics of developing countries. He has contributed to many journals of economics and development. His recent books include *Prices for Planning: Towards Reform of Indian Planning* (1980); *The Poverty of Development Economics* (1983); and *The Hindu Equilibrium*, in two volumes (1989). He is the author of *India* (1988), the fifth in the series of Country Studies published by the International Center for Economic Growth.

DEEPAK LAL

Political Economy and Public Policy

As I understand it, one purpose of this series of Occasional Papers is to give authors an opportunity to describe their intellectual development. I am particularly pleased to present a brief intellectual autobiography, because it provides a useful introduction to the central subject of this paper: the evolution of thought on public policy in the past 100 years and a defense of economic liberalism as a framework to replace the neomercantilism that has characterized public policy in much of the third world since the end of the Second World War.

The Making of a Political Economist

I first studied economics at Oxford, in the school of Philosophy-Politics-Economics (PPE), after obtaining an honors degree in history at Delhi; but I did not become an economist until I had done graduate work at Oxford, after a brief stint in the Indian foreign service. At that time (in the mid-1960s), Ian Little had just moved to the Development Centre of the Organization for Economic Cooperation and Development (OECD) in Paris and was setting up his comparative study of trade and industry and writing the now-famous Little-Mirrlees manual on project analysis. Through the good offices of my old Oxford tutor

Maurice Scott, who was a collaborator on these studies, I became involved at an early stage (as "an attendant lord") in what has since been called the "neoclassical resurgence" in development economics, based on the application of the second-best economics of public policy for imperfect economies.[1]

I spent a good part of the next decade helping to clarify and apply this "new economics"—particularly the Little-Mirrlees shadow prices—to many developing countries. The travel this work entailed, along with the comparative study of the price structure of particular economies, constituted the best apprenticeship that a development economist could have. During this period, I was a child of my background and education—a social democrat, a Keynesian, and a believer in planning (albeit increasingly through the price mechanism).

Naturally, because I am an Indian, I was constantly drawn to the economic problems of India, where, by the late 1960s, the national planning and economic policy (which I had been brought up to believe was benevolent and wise) was in the midst of a crisis. In 1968, Esra Bennathan, who was then at the Economic Commission for Asia and the Far East (ECAFE), commissioned me to do a report on controls and liberalization in India and Pakistan. This work was an eye-opener for me. But I was still wedded to the ideology of Indian planning. Hence, my report, although correct in pointing out the irrationalities and inefficiencies of direct controls, was much too concerned with making marginal improvements in the existing system of Indian planning rather than questioning the concepts behind it.[2] My remarks were much more favorable to dirigisme than the famous Little-Scitovsky-Scott book[3] had been, and I was shaken when Ian Little told me after reading my report that he no longer believed in planning.

Nonetheless, it seemed that two of the main lessons I had learned from the new economics could provide some intellectual coherence to—if I may so call them—my Indian biases in favor of planning. The first lesson came from the then-new theory of trade and welfare expounded by Max Corden in his *Trade Policy and Economic Welfare*,[4] which he was writing when I was a research fellow at Nuffield College, Oxford, in the late 1960s, and which was empirically substantiated in the book by Little, Scitovsky, and Scott. This lesson was that the case for free trade was separable from that for laissez-faire, and, except for the optimum tariff argument, most arguments for protection were second or third or fourth best. Other domestic taxes or subsidies could deal with market distortions far better than tariff protection could. This lesson, which has not been controverted by either logic or experience since, has left me a staunch free trader.[5]

The second lesson was that the new second-best economics embodied in the Little-Mirrlees shadow pricing rules and its natural extension—the theory of optimum taxation—provided the grammar for arguments about all public policy. Armed with this new economics, an economist had only to explain its logic and demonstrate its applicability in order to convince the countries of the third world that they should adopt rational planning (taken to mean government intervention that supplements rather than supplants the price mechanism). It seemed self-evident that the assumption behind this technocracy—namely, that the so-called policy makers were truly benevolent public servants moved solely by logic, evidence, and the public interest—was applicable to most governments, and certainly to the government of India (or at least its bureaucrats, those guardians of the public interest installed by the British).

An opportunity to apply this new wisdom arose during 1973–1974 when I spent a year as a consultant to the Indian Planning Commission, helping Lovraj Kumar set up the new Project Appraisal Division (PAD). This turned into a formative experience that forced me to question not only all the assumptions I had previously held about the benevolence, or public spiritedness, of bureaucrats and politicians, but the very intellectual basis for planning and government intervention. A few examples must suffice to give the flavor of this traumatic, but enlightening, experience.

One of my first tasks on joining the commission was to edit the draft of the Fifth Five-Year Plan. Although this task turned out to be impossible to do (the original authors of the various parts of the plan took great umbrage at any tampering with what they considered to be their perfect English!), it allowed me to see firsthand how the plan was put together. What quickly became obvious was that this was a purely political process, as underlined by the acrimonious debate that erupted between the two economists on the commission over what should be considered a feasible rate of growth for the next five years. The politicians settled what I had naively thought was a technical question by choosing the higher of the two growth rates being advocated, even though the technical arguments supported the lower rate—whereupon the proponent of the latter rate duly resigned from the commission. Meanwhile one minister was heard to remark that he could not understand all the fuss about having a realistic plan when unrealistic plans had always been acceptable in the past.

As I began the task of estimating shadow prices for the Indian economy,[6] I became increasingly aware that the country's planners were experiencing serious information problems. The data used to derive the various targets in the plan were, on the whole, inadequate, and in some cases even fraudulent. This state of affairs was most surprising, since India possessed one of the best statistical and survey infrastructures in the third world.

To make matters worse, the politicians clearly believed that the function of the new Project Appraisal Division was not to ensure that public investment projects were sound (i.e., socially profitable), but merely to make adjustments that would give the appearance of serving the social weal. The PAD was allowed to make some small, marginal decisions; but where political or "rent-seeking" interests were concerned, its economists were invariably overruled—usually with disastrous results. On one occasion, I was asked to evaluate a large public project that on the simplest analysis could not possibly break even, let alone have a positive rate of return, unless its output was purchased at some huge price far beyond the world price. The ministry concerned informed me that some foreign dictator had indeed agreed to purchase this output at this break-even price. I was still unconvinced of the project's viability, particularly because implementation was going to take a long time. Also, who could rely on the promises of a dictator, whose regime might be overthrown? PAD's advice was overruled on political grounds. The project went ahead. A number of years later, after very large investments had been made and the output began appearing, the dictator fell, and India was left with yet another large white elephant!

This experience, and others like it, pointed to a systemic problem. Mere tinkering was not going to help India escape from the economic irrationalities introduced by public policy. Economic growth would continue to be throttled as long as the country tolerated the unholy combination of ideas and interests that had turned its civil servants—most of them decent and intelligent people—into mere instruments of predatory politicians and their clients. Although my colleagues were deeply concerned about the situation, they attributed it to a lack of political will, rather than to India's policies, which were based on ideas they themselves espoused.

When it was suggested that India needed to liberalize its economic controls, a highly intelligent and idealistic senior civil servant responded that my whole case was based on the erroneous assumption that the businessmen on whose decisions the economy's investment and production outcomes would then depend were honest—whereas the Indian businessmen we knew were not. Nothing I said would convince him that market forces took little notice of honesty or benevolence, or that the current alliance of dishonest businessmen and the politicians who granted them monopolistic favors would do more harm to the country's economy than if they were forced to compete with other dishonest businessmen!

Toward the end of my stay, Prime Minister Indira Gandhi announced that it had become necessary to detain so-called economic offenders without habeas corpus to stem their illegal activities. I remarked to a distinguished economist who was also a civil servant that this measure was the thin edge of a big wedge, since what were deemed their economic offenses had been prompted by the country's indefensible controls, and that the arbitrageurs had actually served a useful economic purpose. I also pointed out that, given the pervasiveness of the controls, anyone could be put in prison, particularly many middle-class Indians who were driven by the controls to engage in some economic offense, however small. My friend dismissed this view as economic liberalism gone mad. But I felt vindicated when a few months later Mrs. Gandhi used the same laws during her emergency regime to harass anyone opposed to the government, and even innocent bystanders.

This Indian experience made me question the relevance of the new economics of public policy in countries where its central assumption about the benevolence of governments did not hold. I was becoming a political economist. Subsequently, I found myself moving in two directions. First, I wanted to understand why nonbenevolent states act the way they do. Second, on a more personal level, I wanted to find the true cause of the deep-seated malaise that was troubling India's political economy. My conclusions in the latter case are presented in a two-volume work called *The Hindu Equilibrium.*[7] In the former case, I have been trying to devise models that best represent the types of polities actually found in the third world.[8] This effort has culminated in a study for the World Bank, written with Hla Myint, of the political economy of poverty, equity, and growth in twenty-one countries.[9] This is not the place to summarize the results of that study, or the political economy models we found most useful. Instead I wish to pick up one of the themes that emerged from that endeavor.

This recently completed study, as well as my frequent travels in numerous developing countries, has convinced me that the disjunction between reality and theory that I observed in India is actually a worldwide phenomenon that has its roots in what I call the dirigiste dogma.[10] In the rest of this essay, I outline what I now think were its causes and consequences.

The modern-day dirigiste dogma has had a strong hold on economists and intellectuals in two important respects. First, it has led most of them (except, until recently, those in the public-choice school) to neglect the polity completely in their economic policy prescriptions, which have otherwise been based on rigorous analysis. Second, it has led them to believe that questions of the efficiency of production and of the distribution of income can be separated in designing public policy. Their idea has been to strive for the optimal combination of the two (which, of course, may only be a second-best optimum when there is a trade-off between efficiency and equity). These views can be traced to J. S. Mill, whose *Principles of Political Economy* stands Janus-like looking back toward the concerns of the classical thinkers and forward to those of the later neoclassicists. The problem is that in designing public policy we can no more separate politics and economics than we can separate production and distribution. Why so many professional economists have come to accept almost unthinkingly these assumptions is an important question to examine.

The Evolution of Thought on Economic Policy

Broadly speaking, there have been only three cogent systems of thought on public policy—mercantilism, economic liberalism (of the nineteenth-century variety), and what can be called the neoclassical policy consensus. I am ruling out various more controversial systems such as Marxism and structuralism, which, despite their numerous adherents, have failed to build a following among mainstream economists over the past 200 years.

Historians of economic thought tend to agree that mercantilism provided the first coherent and systematic set of economic policy prescriptions to be adopted by states.[11] Interestingly, the policies of many third world countries—with their industrial regulations, state-created monopolies, import and export restrictions, price controls, and so on—are similar to the mercantilist policies adopted by the absolutist states of Europe after the Renaissance.[12] Furthermore, the goals of modern-day third world governments are also similar to those of their seventeenth- and eighteenth-century European predecessors. They can be described broadly as nation building.

In the mid-1970s, with my belief in the usefulness of technocratic economics greatly shaken, I turned back to two subjects that I had hitherto neglected—politics and philosophy. I needed to broaden my education beyond the narrow welfarist ken of my early years. The works of Hayek, Buchanan, Tullock, Olson, and later Bauer, on political economy, which my peers (and teachers) had ignored but which I now read avidly, stimulated me to reconsider what policy makers in most developing countries were up to.[13] This move seemed essential if I was to explain the motivations underlying that concoction of economic illiteracy, the "new international economic order." I wrote a pamphlet, published, surprisingly, by the Fabian Society, in which I tried to identify and explain these motivations.[14] In a later paper, I tried to explain the links between nationalism, socialism, and planning and the appeal of these three ideas for third world elites.[15]

The view that I came to can be put as follows. Whether it is because of memories of colonialism (in much of Africa and Asia) or a feeling of inferiority (in much of Latin America) with respect to the Western metropolitan powers, most third world governments think they lack power in their dealings with the West because they have a weak industrial base. They see industrialization as a means of restoring their self-respect and of waging modern wars. They think that by promoting industrialization they can overcome the inherent military weakness responsible for their subjugation by superior Western arms in the past. Consequently, they have found the dirigiste example of the Soviet Union (though not necessarily its communism) particularly attractive, since it was deemed to show how a weak and poor underdeveloped country, industrialized through planning, had become a great power within one generation.

The fact that these countries are suspicious of free trade and of foreign capital is another reflection of their desire for a national identity and economic independence. Third world rulers fear that their hold over the ruled may be subverted or weakened (through direct or indirect pressure) if they become dependent on foreign transactions. They also see this threat of direct or indirect subversion as a means of putting pressure on the medium-size or small powers to change a policy course "which the national interest—or the interest of its leaders—would appear to require."[16]

The dirigisme that has evolved in developing countries in the interest of nation building was given a fillip by their baleful experience during the Great Depression. Particularly hard hit were the countries of Latin America, which until then had been integrated into the world economy for nearly seven decades and had seen considerable economic expansion. In the early part of the twentieth century, many Latin American countries (notably Argentina) were considered part of the economically vigorous North. But the havoc caused by the Great Depression and Latin America's subsequent repudiation of outward-looking policies after the Second World War left them part of the economically pressed South.

Economic development under dirigiste regimes since the late 1940s has thus been guided by a desire for national integration and self-respect, which the elites believed would flow from the mounting national power that economic growth would foster. But the dirigiste policies have fallen far short of this goal. If anything, they have made it even more