Inequality, rents and the long-run transformation of India

Michael Walton

Abstract

This paper explores the relationship between inequality, rents and the growth process in India. It argues that it is useful to explore the political economy of India’s growth in terms of the joint influence of institutionalized rent-sharing processes on both inequality and growth. These can be thought of as forms of implicit social contracts between the state and business, and the state and various social groups. The inequalities of interest are not those measured in terms of inter-household distribution but rather those reflected in various structural features and relationships—in relation to corporate wealth, identity-based differences, spatial inequalities and education. These are the ones that do work in the variety of political, social and economic interactions that are the basis of the rent-creation and rent-sharing processes. Some of these have been consistent with the past growth acceleration. But, in looking to the future, the paper speculates that failure to resolve the structural inequalities could lead to India getting stuck in a future growth deceleration, as happened in many Latin American countries. Real long-run transformation will involve tackling these inequalities and shifting to new forms of the social contract.

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Introduction

Does inequality matter for long-run development in India? With the extraordinary acceleration in growth of the past twenty-five years, can’t we put troublesome arguments over distribution aside? Rapid growth is indeed the most effective way of improving the incomes of the poor in the long term. Growth also generates government revenues, providing the wherewithal for governments to deliver the social and economic services needed for economic transformation and support better living conditions. But is this story incomplete?

India has impressive medium-term growth momentum. After an initial acceleration in the 1980s, there was a consolidation of annual growth around 6 percent in the 1990s, followed by an impressive further acceleration to over 8 percent after about 2003. This was associated with an increase in savings and investment rates to well above 30 percent and the rise of a range of Indian corporations to global prominence, symbolized by major acquisitions in rich countries. Even the dramatic global financial crisis only led to a growth slowdown—followed by swift recovery.

So where does inequality come in? Questions over inequality are usually framed in terms of whether all Indians are adequately sharing in this extraordinary burst in aggregate economic performance. Incomes of the poor have indeed increased significantly, but at a lower pace than overall growth in incomes per capita. Malnutrition in rural areas has failed to improve, especially worrying as this can hurt long-term development of kids, reducing their future opportunities. Basic education services have expanded, but remain of dismal quality. Basic health services are even worse. Urban slums continue to be a major feature of the urban landscape—millions of urban dwellers live in awful conditions. There are truly massive contrasts between the overall quality of life in areas such as rural Bihar, Chattisgarh, Orissa and Uttar Pradesh and the emerging gated suburbs around the major cities.

In this narrative, distribution matters, but the issue is how to organize policies and institutions in ways that ensure that the poor get a larger share of aggregate economic advance, in terms of jobs, markets and services.

These are important considerations, and will form part of the story here. There are indeed strong ethical reasons for a concern with some kinds of inequalities, both because higher inequality is—other things equal—associated with higher poverty, and because many societies place value on some aspects of equality. This is probably especially true
with respect to equality of opportunity, a major theme in the foundational principles of independent India, and incorporated explicitly into the constitution.

However, the central framing of the question here is different. I explore the following view: failure to tackle a variety of social cleavages in Indian society will impede the political, social and economic transformations that are necessary for long-term progress. The issue is not one of adding inclusion to growth, but of achieving inclusion for growth.

Is this scare-mongering? Isn’t their terrific growth momentum, now that the shackles of the License Raj have been lifted, and the intrinsic entrepreneurial and resource potential of India has been released?

As Figure 1 illustrates, in the 25 years since the 1980s acceleration, India’s growth performance has been rosy, relative to the past and other countries. Compare the experience with a large Latin American country, Mexico, a country that had substantial overall institutional stability from around 1930—following a highly unstable period in the wake of the 1911 Mexican Revolution. Genuine democratisation really only got underway from the 1990s. By contrast with India, Mexico has a poor growth experience in this period: there were two major economic crises, in the early 1980s and mid-1990s, and the country struggled to get above four percent annual growth.

Figure 1. Who has a growth problem (I)? The recent period: annual growth of India and Mexico, 1980-2010

![Growth rates of real GDP](chart)

Source: World Economic Outlook Database, April 2010 (estimates from 2009)

However, let’s take a longer-term perspective. Figure 2 shows the levels of GDP per person in these same two countries, adjusted for purchasing power parity (so the rate of growth is given by the slope of the line.) Korea and Indonesia have also been added to the comparison. This shows four things.

- First, Mexico had a growth “miracle”, lasting almost three decades, until the early 1980s. The last few years of this were driven by unsustainable fiscal deficits and
external borrowing, but the longer term picture is of a major increase in economic capacity.

- Second, Mexico then got stuck, as we’ve just seen from Figure 1, with little advance in the past 25 years, and this in spite of a highly favourable geographic location, next door to the most productive rich economy in the world, and a radical opening to trade and foreign investment following the coming into force of the North America Free Trade Agreement (NAFTA) at the beginning of 2005.

- Third, even after adding the additional growth since 2006 (not included in Figure 2 to ensure consistency of data sources), India’s per capita GDP in 2008 is still only at the level prevailing in Mexico in the mid-1950s!

- Fourth, it illustrates the obvious message that Korea did something that Mexico didn’t, and went a very long way toward achieving high income status.

Figure 2. Who has a growth problem (II)? A longer-term perspective: GDP per capita in India, Indonesia, Korea and Mexico between 1950 and 2007

![GDP per capita in 2005 PPP US $ for India, Indonesia, Korea and Mexico](chart)

*Source: Alan Heston, Robert Summers and Bettina Aten, Penn World Table Version 6.3, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, August 2009.*

This is only one, illustrative, set of comparisons. A similar comparison could have been undertaken with Brazil (see Kharas, 2009): Brazil had miraculous growth, that took her to upper middle income status, and then stalled. (Brazil has started growing recently, in part on the back of the China-induced growth in commodity demand). These examples are relevant to a broader point. If we look across country experiences of growth, *most* episodes peter out. In a review of a large number of growth experiences, Hausmann, Pritchett and Rodrik (2005) find that periods of rapid growth are quite common. What is less common is sustaining rapid growth for several decades. Rodrik (2005) further argues that quite different processes may be involved. Many factors can launch a growth spurt, but consolidation of the institutional bases for long-term growth is a distinct undertaking.
To shift to the upper middle income levels of a country such as Mexico, let alone high income levels, will involve major economic, social, and political transformations. Just what institutional transitions are required to underpin these, and how these may—or may not—occur, are the questions that cut across all parts of this project. This paper’s focus is on the role of inequality, social cleavages and their interactions with these institutional dynamics. This is only one part of the story, but I suggest it is a quite fundamental part.

The argument

The starting point for the paper is the following set of propositions. The current medium-to long-term conjuncture in India is characterized by a combination of:

A range of economic pressures for either further disequalisation or continued inequality (of incomes, risks, human capital, social status), across four axes:

In the returns to corporate ownership, as manifest at the very top of the wealth distribution, in the surge in billionaire wealth in the recent growth period.

Across identity-based groups, with slow progress on differences with scheduled castes, widening differentials with adivasis (tribal groups), and continued divisions along religion and language lines.

Across spatial areas, as seen in rising inter-state and rural-urban differentials of income.

By skill category, with sharp rises in returns to highly skilled workers.

These combine with political pressures for redistribution, that are either already present or latent with respect to all the above four axes of inequality, and will only rise as growth, urbanization, mass education and increased communication sharpens awareness of these inequalities, working through the formal democratic system and other mechanisms.

This state of affairs is a product of India’s past economic, social and political dynamics. With respect to economic dynamics, the post-1980s surge in growth was led by largely urban-based industrial and service sectors. Most observers argue that some combination of a shift to a “pro-business” orientation of the government, including de-licensing, in the 1980s and the external opening that started in 1991, were major drivers of this change. The subsequent growth has had, by East Asian standards, a low contribution of labor-intensive manufacturing, and a high contribution of skill-intensive activities—in both industry and services. IT is the most dramatic emblem of this. This pattern was in part an unintended consequence of the Nehruvian emphasis on high quality tertiary education, notably in the Indian Institutes of Technology, combined with learning in protected

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2 There has been a lot of discussion on the sources of the first acceleration; for selected references see Rodrik and Subramanian (2004), Kelkar (2004), Kohli (2006) and Panagariya (2008).
industries during the extended period of protection. However, in the 2000s some manufacturing industries have been growing fast, raising the prospect that India could follow a more conventional growth path, with industry playing a central role.

Three other features of the growth process are relevant.

- First, in contrast to East Asia, but similar to much of Latin America (especially Brazil), there has been very slow progress in basic education—even with the gains in enrollments of the past decade, quality remains very bad.
- Second, again in contrast with East Asia—and more like most of Latin America—there has been slow rural productivity growth, after the initial, and important, gains in the irrigated areas from the Green Revolution.
- Third, like many countries, both in East Asia (say China) and Latin America (Brazil and Mexico), growth has been spatially uneven, with fastest growth in those parts of the economy favoured by opening—coastal China and the regions of Mexico on the US border. However, here too there is a contrast: the lagging spatial areas in India include the most important population centres, especially the highly populous areas of North India, such as Bihar and Uttar Pradesh.

This growth pattern already goes some way to providing a proximate account of the disequalizing pressures at work: the “pro-business” orientation laid the basis for concentration of corporate wealth; spatial concentration is a common feature of growth bursts; and opening in the past 20 years has typically involved skill-biased technical change (and this typically leads to sharp rises in the premium to skills if there are lags in the expansion of education systems).

These features of growth interacted with a high degree of social difference, a product of India’s long history of group-based differentiation, along lines of caste, religion, gender, “tribal” or adivasi status, and linguistic and regional differences. These durable, socio-cultural differences are relevant to two parts of the interpretation here. First, they led to significant policy and institutional designs, especially in the federal character of the polity, and the constitutional commitment to affirmative action in favour of historically deprived groups, via reservation of political seats and of access to tertiary education and public sector jobs. But second, as in comparable case of social difference—blacks in the United States, indigenous and Afro-Latinos in Latin America, minorities in Vietnam—inequalities in social structure has proved impressively resilient, despite affirmative action, and despite the pliability of the meaning of identity-based grouping.

Finally, both growth and social structure interacted with a central feature of India’s political system, India’s transition to democracy at an unusually low level of income. In the past, democracy has been both resilient and has done a not-too-bad job at managing distributional struggles, in the sense that the latter have not led to major, systemic disruption of the overall development process or the integrity of the state. (In areas of

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3 See Kocchar et al (2006) for discussion of this theme; and the comment by Banerjee (2006).
Maoist-Naxalite insurgency the state is often absent or itself a source of abuse, but this is spatially confined.) By contrast democracy has arguably done a weak job with respect to some measures of inclusion—basic services of decent quality for the rural and urban poor, and across the board for adivasi groups—has tended to lead to a heightening of group-based identities, and has done poorly, at least at times, in managing inter-group conflict when it erupts. Some political scientists characterize India as essentially a “patronage democracy” (Chandra, 2004). I argue below that “rent-sharing” remains a central part of the social contracts between state and society, and is now embedded in a variety of formal and informal institutions.

What does this mean for the future? Kharas (2010) developed the idea of a “middle income trap”—that a common pattern is for countries to lose their growth momentum, as Brazil and Mexico did, and that this often leads to failed transitions beyond middle income status. In exploring the future, this paper seeks to fill out this argument in terms of how institutional processes are integrally linked to the longstanding structural inequalities. The implications that the evolution and management of inequalities in power, wealth, status and influence lies at the heart of the nature—the success or failure—of this institutional transformation.

These issues are framed in terms of two illustrative scenarios.

The first can be thought of as the “Latin Americanisation” of India, since it has parallels with countries such as Brazil and Mexico. (This is in part metaphor, since it is not exclusively a Latin American phenomenon: it is not hard to imagine Thailand getting stuck; and Indonesia experienced an extended period of slow growth in the wake of the 1997/98 economic crisis and transition to democracy. But Latin America has more experience of this!) Under this scenario, structural inequalities interact with current political, social and economic institutions in ways that lead to a combination of the entrenchment of large inequalities of wealth and political influence, with a variety of rent-sharing policies to assure a minimum level of political support from middle and poorer groups. This will be bad for long-term growth. Business dynamism could increasingly become a form of consolidated oligarchic capitalism, undercutting the creative-destructive process and further weakening the autonomy of the state. Identity-based differences could become even sharper and lead to heightened distributional conflict and populist backlash. Failures in the education system could lead to skill differences perpetuating inequalities and hurting growth. Spatial differences could continue to slow gains for large numbers of Indians, and could also be as source of national political conflict and inefficient national policies. A relatively “weak” state could increasingly become a product of these processes, characterized by symptoms of inadequate and unequal service delivery, and the further consolidation of corruption and money-related political influence.

These issues are certainly present today, as evidenced, for example, in continued deep deprivation and periodic group-based conflicts. In the short run, they may not be
systemically destabilizing and can be consistent with rapid growth. The big issues are over the medium to long term, since the associated institutional structures are bad for the overall dynamism of the system, and block the kinds of changes needed for rapid long-run development. It is also highly inequitable, in terms of inequality of opportunity, that in turn lead to inequalities of outcomes across many dimensions of well-being.

An alternative scenario is termed “transformational” and involves the institutional change to support the transition to genuine prosperity. This involves change in institutions in the economic, social and political realms. For example, in the economic realm, this would include effective competition policy, a broad-based, financial system, and rule of law as a genuine public good for all, with implications for the effectiveness of the judiciary and police services. Social institutions include not only provision of core services to all, notably in education, health, water and sanitation and urban services, but the effective management of group-based differences, in terms of economic and political opportunities across groups, the management of conflict, and group-based dignity and mutual respect. Political institutions include the maturation of the party system, reform of political finance, effective information on political performance available to voters, and the accountability, decent quality and an adequate information base for legislators.

Cutting across all of these areas is an evolving and changing role for the state: rapid long-run transformation requires a state that is effective and accountable, with incentives for, and a culture of, delivery and responsiveness, both to political leaders (in terms of overall policy direction) and to citizens. This implies a state that is less susceptible to corruption and response to the particular interests of politicians and the influential, and, in some areas, has greater autonomy, for example in a range of areas involving the regulation of private sector functioning.

Policy and institutional choices over the medium term (5-10 years) will define which path India follows. Tackling longer-term questions is easily forgotten or distorted by short-run political pressures—especially where the latter are deeply embedded with the current structure of interests, and established processes of managing distributional fights.

The underlying political economy of decision-making and institution formation is more likely to lead to the perpetuation or deepening of structural inequalities—with the associated inefficient institutional designs—that will threaten the long-term development process.

The remainder of this paper is divided into three parts. The next section provides material on trends in inequality, focusing on four domains of “structural” inequalities. The following section turns to interpretation, providing a schematic account of how inequalities interact with institutions in the overall polity, arguing that India is still in a “rent-sharing” political equilibrium. The final section explores questions of change for the future, framing this around alternative qualitative scenarios.
Patterns and trends in inequality

This section looks at inequality from several angles. It first summarizes patterns in terms of the traditional presentation of overall trends in income/expenditure poverty and inequality across households. Then it turns to what I here refer to as “structural” inequalities, in terms of four axes highlighted above—corporate wealth, group-based identity, spatial differences and education.

Overall poverty and inequality

Let’s start from a specific, and in many respects, narrow dimension of welfare and inequality—outcomes in household incomes and expenditures. This is narrow in three respects: it is about outcomes rather than opportunities; it does not include important dimensions of well-being, such as health, education, insecurity and dignity; and it refers to individual households. But it is the most commonly used measure of economic welfare and there is great interest in the relationship with aggregate economic growth. I will refer to broader conceptions of well-being and influence along the way.

Trends in the poverty of individuals

The most common definition of the income poverty of individuals in India is based on per capita household expenditure, and a poverty line based on expenditures required to meet basic, caloric food requirements, adjusted for price changes over time. This is extreme deprivation. On this measure there has been a substantial, if less than spectacular, decline between the early 1980s and the mid-2000s. 46 percent of the Indian population were living below this line in 1983; 27 percent in 2004/05 (Figure 3).

Figure 3. Overall trends in rural and urban income poverty in India, 1983-2004/05

Source: National Sample Survey
There is nothing magical about the particular poverty line. In 2010 a Planning Commission expert group chaired by Prof. Suresh D. Tendulkar developed revised estimates, based on updated work on price differentials and alternative recall periods. Table 1 summarizes the comparison: the pattern of change is very similar, but levels of poverty are significantly higher in rural areas under the proposed new poverty line.

Table 1. Rural and urban poverty under the official and Tendulkar poverty lines, 1993-94 and 2004-05

<table>
<thead>
<tr>
<th>Planning commission expert group 2009 (Tendulkar)</th>
<th>Poverty Ratio (%)</th>
<th>Number of Poor (million)</th>
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<tbody>
<tr>
<td></td>
<td>Rural</td>
<td>Urban</td>
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<tr>
<td>1993-94</td>
<td>50.1</td>
<td>31.8</td>
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<td>2004-05</td>
<td>41.8</td>
<td>25.7</td>
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<table>
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<tr>
<th>Official estimates</th>
<th>Poverty Ratio (%)</th>
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<tr>
<td></td>
<td>Rural</td>
<td>Urban</td>
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<tr>
<td>1993-94</td>
<td>37.3</td>
<td>32.4</td>
</tr>
<tr>
<td>2004-05</td>
<td>28.3</td>
<td>25.7</td>
</tr>
</tbody>
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Source: [http://planningcommission.nic.in/data/datatable/2803/tab_33.pdf](http://planningcommission.nic.in/data/datatable/2803/tab_33.pdf)

**Trends in inter-household inequality**

There is controversy over the level and trends in inequality in India. With respect to inequality, the dominant prevailing view is that India’s measured, household income or expenditure inequality is modest by international standards. This is true with respect to measures based on the National Sample Survey, though there is considerable debate as to whether this effectively captures a lot of what is going on.
Using the Gini index—the most commonly used aggregate index of the level of inequality between individuals in a population\(^4\)—the inequality that is captured in the NSS survey is indeed moderate. It has shown a modest increase since the early 1990s, after an earlier modest decline from the early 1980s.

More detail on the recent period is provided in Figure 4, that graphs the annual growth rate in per capita expenditure across the whole distribution—this is known as a “growth incidence curve”. It is not a panel of the same individuals, but of inter-temporal differences between individuals in the same relative expenditure position—say the same percentile—in the population (from bottom to top.) Between 1993/94 and 2004/05 there was somewhat faster average growth in urban than rural per capita expenditure (about 1.4 percent annual growth compared with 1 percent in rural areas), and significantly faster growth at the top, especially in the top 10 percent of individuals. This is primarily driven by unequal growth within urban areas: richer urban dwellers experienced relatively rapid growth, while the bottom four percent experience growth at or below that of their rural counterparts (consistent with the quite similar urban and rural poverty rates seen in Figure 3). This pattern is quite different from what occurred in the preceding decade, between 1984 and 1993/94, in which the fastest growth was amongst poorer rural households, with no significant variation in growth across the distribution in urban areas.

\(^4\) All aggregate indices have their limitations: the Gini index is relatively insensitive to changes at the top and bottom of the distribution.
This is where the controversy starts. As extensively discussed in the literature on poverty and inequality in India, the National Sample Survey covers a relatively low and declining share of measured private consumption (see articles in Deaton and Kozel (2005) for a review). There is not the space to review this here, but here is an assessment:

- Both the NSS and the National Accounts have imperfections, but it is clear that NSS fails to capture all private consumption.
- It is highly likely that under-reporting is greater at the top of the distribution, and especially for the rich; conversely the NSS expenditure module is probably the best measure of spending of the poor.
- Rising overall inequality—and especially at the top—is consistent with other sources, including on tax returns (Banerjee and Piketty (2005), analysis of the labour earnings module of the NSS itself (Debroy and Bhandari, 2007, and Himanshu, 2007).
Finally, a nationally representative survey conducted by the NCAER, also for 2004/05, but using an income concept, found a Gini of 54, that is well into the high inequality and Latin American range, compared with 33 from the NSS. There are certainly issues of comparability between the surveys, but the point is that even with a narrow conception of welfare, defined in relation to incomes or consumption, there is a plausible case to be made that inequality is high in India.

In this paper, however, I focus less on inter-household inequality than on the four types of structural inequality introduced above. These relate to two different reasons for going beyond a focus on the distribution of individual per capita household spending: first, to capture inequalities not there captured (high level skills and, especially, corporate wealth); and second, to focus on aspects of inequality that may be more salient than others, in terms of societal concerns, behavior and political influence. But before turning to this, let’s take a look at one of the most famous characterisations of the relationship between income inequality and the growth process—the Kuznets curve.

An aside on the Kuznets curve

Simon Kuznets drew on data available in the 1950s on the historical experience of rich countries to argue that inequality systematically rises and then falls with the growth process, as countries transit from poverty, through middle income, to high income status. This was driven by structural changes, and in particular the shift of population from low-return rural, agricultural activities into higher-return urban industrial work. Income differences initially widen, since those who benefit from new sources of growth have much higher productivity and incomes, but then eventually decline as most of the population moves into higher return activities.

In similar vein (though without a specific structural analysis), the recent Commission on Growth (2008) argues that rapid growth episodes often intrinsically involve some widening of incomes as some individuals, groups, or spatial areas take off before others.

Let’s look at the cross section as a proxy for long-term changes across levels of development. India is a large country, and Figure 5 plots the Gini coefficient (using the low NSS measure) with several of the largest other countries in the world. China is more unequal—and indeed experienced a sharp rise in inequality during its fast growth of recent decades. Brazil and Mexico are also much more unequal, whereas, at higher incomes the United States and (especially) Japan are more equal again. At first glance this looks like a Kuznets curve!
Figure 5. Is there a Kuznets curve here? The Gini coefficient and income per capita in a few large countries.

![Graph showing Gini Index vs. Log of GDP Per Capita PPP for various countries.]

Note: The Gini Index is for the mid-2000s, per capita GDP figures are for 2007
*Source: World Bank (2007)*

But unless there is something special about large countries, this choice turns out to be highly misleading. If we plot all the countries with available data from the World Bank’s data base, we find there is *no* relationship in the cross-section (Figure 6). The intertemporal experience is also highly varied: some countries have experienced little change, some have experienced falls and some rises in income inequality. In the past couple of decades more have experienced rises than falls, but this is not related to income level. While there was debate amongst economists on the patterns in the 1990s and early 2000s, there is no robust evidence for a general, systematic relationship at the aggregate level (see Banerjee and Duflo, 2005, for a review and careful empirical analysis). However, this should not be interpreted as implying there is no relationship between growth-related processes and inequalities. Such relationships, if they exists, would be expected to be contingent on the particular structures of inequality and processes—and more likely to be shaped by differences in wealth, status and political power.

Figure 6. No: there is no Kuznets curve in the overall cross-section

![Graph showing Gini Index vs. Log of GDP Per Capita PPP for all countries.]

*Source: World Bank (2007)*
There is a final important issue. The Kuznets curve is at one level optimistic. Inequality rises in the growth process, but then falls as growth continues. So if a country just keeps growing, inequality will take care of itself. The perspective here is more pessimistic, that particular forms of inequality can be pernicious both for long-term growth and other aspects of the development process delivery of services. The next sections explores some of the relevant dimensions.

**Corporate wealth**

The past quarter of a century has been a period of business expansion, with only temporary slowdowns in the late 1980s and in 2009, the latter induced by the global financial crisis. This has been associated with a substantial rise in the share of profits from the corporate sector in national income. As Figure 7 indicates, national accounts statistics indicated the corporate profit share doubled in this period, while the ratio of reported profits of publicly listed companies (including their historical profit levels before going public) rose from four percent in 1989 to 18 percent in 2008. Some of this represents a rise in the corporate share of total production and coverage. The ratio of corporate assets to GDP increases by about the same proportion.

Figure 7. India’s rising corporate profit share, 1988-2008 (in percent of GDP)

This expansion in corporate wealth was an important source of rising personal wealth. Let’s start at the top of the distribution, with the truly wealthy. There is no comprehensive data for this group, but what exists suggests major wealth accumulation. Take the net worth or Indian billionaires as reported in Forbes.com.

5 This is based on a range of sources as investigated by Forbes staff, and is intended to capture all sources of an individual or families net worth.
rising numbers of billionaires and by rising wealth for existing billionaires. The sources of wealth come primarily from the business sector, with a wide range of activities listed, including mining, energy, petrochemicals, pharmaceuticals, information technology, construction, real estate and finance. In the short run, there is a big impact of the rise and fall of the stock market: there were large falls in billionaire wealth between February and November, 2008, by when the market had fallen some 60 percent off its highs. But this proved temporary. By early 2010, total wealth was way above 2007 levels, if still below the 2008 high, with little change by early 2011. In Figure 8 this large rise and temporary fall is shown in terms of the ratio of net worth to total GDP. This indicator is still way above levels prevailing in the early-2000s and 1990s. It is of course, an imperfect indicator: apart from probable measurement problems, it only captures those amongst the wealthy that cross the level into reporting a billion dollars of net worth.6 Below this there are a much larger number of millionaires.

Figure 8. The rise (and temporary fall) in the reported net worth of India’s billionaires relative to India’s GDP

![Figure 8](image)

Note: this only includes Indians resident in India.

Source: Forbes.com and World Development Indicators

How does this compare internationally? Figure 9 compares the mid-1990s with early 2011. In the mid-1990s, India hardly appears. It is notable that East Asian countries such as Indonesia, Malaysia, Thailand, and Singapore—sometimes praised as exemplars of “shared growth”—are high in the rankings. All have large family-based corporate structures. However, by 2011, Indonesia and Thailand have fallen sharply, reflecting the continuing effects of the 1997/98 crisis. Meanwhile India had risen to levels above Mexico, Brazil, and Colombia—all highly unequal Latin American countries—and the United States. Billionaire wealth as a share of GDP was close to Russia and Saudi

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6 It is is also a ratio of a stock (net worth) to a flow (GDP), since there are no direct measures of India’s total net worth. However, intertemporal and inter-country comparisons still carry information value; they would be strictly comparable only if national ratios of capital to income were constant.
Arabia. Moreover, this occurred at a much lower level of income per capita than any other country in the data base.

Figure 9. By international standards, India shifted from having low to high reported net worth of billionaires relative to GDP between 1996 and 2011.

Many of the billionaires are established household names in India, often coming from longstanding business families, and from particular social groups associated with business activity, such as Jains, Marwaris and Parsis. India’s genuinely long-term business capabilities have truly come into play in this period. But there have also been new entrants to the large-scale business community, most famously Dhirubai Ambani, whose two sons became the two richest individuals living in India, according to Forbes. This has been complemented by a broader entry of individuals into successful business—including from castes traditionally not associated with business, amongst Hindus.

Source: Forbes.com and IMF World Economic Outlook (2010) for actual and projections
especially from Brahmin and other backward castes (Damodaran, 2008). The interpretation and implications of rising corporate wealth is discussed in the interpretative section below.

Identity-based differences

Some of the most socially and politically salient inequalities in India are linked to identity-based differences. These are of various types. Some flow from a history of vertical social differentiation, reflected in the (primarily Hindu) caste structure. Others are in principle horizontal, but are nevertheless associated with differences in socio-economic status, for example with *adivasi* groups, and along lines of religion, language and regional origin. Identity-based differences have also frequently been sources of conflict and violence, whether along lines of caste, religion, language or region. A further, and fundamental, identity-based difference is of gender: this is of immense importance in the Indian context, with long histories of subordinate status of women, but is not covered in any detail in this paper.

A broad-brush picture of the population composition is given in Figure 10. The historically most deprived groups, scheduled castes (or *dalits*) and scheduled tribes (or *adivasis*) are minorities, as are Muslims. The largest single group is of middle caste categories, and are predominantly Hindu. These became known as the Other Backward Classes (or Castes) and account for a third of the population. The historically “forward” castes, and various other religious groups, including non-scheduled tribe Christians, Jains and Sikhs, are in “other”, together make up a quarter of the population.

Figure 10. The distribution of the population across social groups in 2004/05

![Pie chart showing population distribution](image)

*Note: ST is scheduled tribe, SC is scheduled caste, and OBC is other backward classes (or castes). The Muslim category includes those who report as being other backward caste and very small numbers reporting as scheduled tribe or scheduled caste. Source: National Sample Survey*
Even this simple population distribution is of immediate political interest. The most striking aspect is the numerical importance of OBCs—and to the extent that they are in the middle with respect to socio-economic status and voting preferences, democratic theory would suggest that they are of especial political salience. Add to this a further consideration emphasized by political scientists: India’s social history has led to their being weak underlying social solidarity between middle groups and either dalits or adivasis (Ahmed and Varshney, 2007). Furthermore, the complexity of the relationship between Muslims and Hindus is a central part of India’s history. Political alliances are formed all the time, but this is quite different from, say, the broad lower class alliances typical of European history. There is a closer resemblance to societies with subordinate ethnic minorities, such as the United States (Afro-Americans) and Latin American societies (Afro-Latinos in Brazil and Colombia, indigenous groups in Mexico or Peru.)

Let’s now look at relative well-being. In Table 2 the average per capita household expenditure since 1983 from the National Sample Survey is given (that, as already noted, almost certainly excludes the rich). The first big result from this is the continuity in the relative position of most groups over this period of over two decades—that broadly encompasses the major reforms. The relative position of Hindu scheduled tribes rose between the early 1980s and early 1990s and then fell substantially by the mid-2000s. By contrast, Christian scheduled tribes experienced large relative gains. Hindus continued to be disadvantaged relative to Hindus on average, but less so than scheduled tribes or scheduled castes. All distributions overlap—for example, better off households amongst scheduled castes have higher per capita spending than poorer OBCs.

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1993-94</th>
<th>2004-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hindu: ST</td>
<td>70%</td>
<td>75%</td>
<td>67%</td>
</tr>
<tr>
<td>Hindu: SC</td>
<td>79%</td>
<td>78%</td>
<td>78%</td>
</tr>
<tr>
<td>Hindu: Others</td>
<td>109%</td>
<td>110%</td>
<td>111%</td>
</tr>
<tr>
<td>Hindu (all)</td>
<td>99%</td>
<td>100%</td>
<td>97%</td>
</tr>
<tr>
<td>Muslim</td>
<td>90%</td>
<td>89%</td>
<td>89%</td>
</tr>
<tr>
<td>Christian: ST</td>
<td>92%</td>
<td>95%</td>
<td>103%</td>
</tr>
<tr>
<td>Christian: Others</td>
<td>128%</td>
<td>131%</td>
<td>158%</td>
</tr>
<tr>
<td>Other Religion</td>
<td>139%</td>
<td>128%</td>
<td>132%</td>
</tr>
</tbody>
</table>

An important strand of political theory is based on the view that democratic outcomes will reflect the preferences of the “median voter”. This is over-simplified of course, but carries a kernel of insight. This may have reflected spatial location.
That’s about relative spending. Since average spending per person rose almost 30 percent in real terms between the 1983 and 2004/05, all groups experienced some absolute real gains. With respect to deprivation, overall poverty incidence fell some 18 percentage points on average, 19 percentage points for Hindu scheduled tribes, 21 percentage points for scheduled castes and 17 percentage points for Muslims (Table 4). All three of these groups continue to have higher poverty incidence than the average in 2004/05: Hindu scheduled tribes continued to have the highest incidence in the most recent survey, at 47%, and experienced relatively low gains in the 1993/94 to 2004/05 period.

Table 3. Poverty incidence amongst scheduled tribes, scheduled castes and others

<table>
<thead>
<tr>
<th>Groups</th>
<th>Incidence (%)</th>
<th>Changes (% points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hindu: ST</td>
<td>65.3</td>
<td>51.3</td>
</tr>
<tr>
<td>Hindu: SC</td>
<td>59.0</td>
<td>49.2</td>
</tr>
<tr>
<td>Hindu: Others</td>
<td>39.0</td>
<td>28.6</td>
</tr>
<tr>
<td>Hindu</td>
<td>45.2</td>
<td>35.1</td>
</tr>
<tr>
<td>Muslim</td>
<td>53.0</td>
<td>45.9</td>
</tr>
<tr>
<td>Christian: ST</td>
<td>41.7</td>
<td>32.8</td>
</tr>
<tr>
<td>Christian: Others</td>
<td>31.7</td>
<td>25.0</td>
</tr>
<tr>
<td>Other Religion</td>
<td>25.3</td>
<td>23.7</td>
</tr>
<tr>
<td>Total</td>
<td>45.2</td>
<td>35.9</td>
</tr>
</tbody>
</table>

A similar story comes from information on human indicators (Tables 4 and 5). Scheduled tribes and scheduled castes experienced significant absolute gains, but STs’ progress was relatively slow. A related finding from analysis of information from the censuses to 1990, is that areas with high proportions of scheduled castes enjoyed relative advances, but this did not apply to areas with more scheduled tribes (Banerjee and Somanathan, 2007). With respect to the position of Muslims, the 2006 Sachar Committee reported that, on average, this group suffered relative deprivation on a wide range of indicators—literacy, access to education, public employment, access to bank loans and (as seen here) levels of household per capita expenditures.
Table 4. Infant mortality rate by social category, 1993 to 2006 (in number per 1000)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Scheduled caste</td>
<td>107.3</td>
<td>83</td>
<td>66.4</td>
<td>-40.9</td>
</tr>
<tr>
<td>Scheduled tribe</td>
<td>90.5</td>
<td>84.2</td>
<td>62.1</td>
<td>-28.4</td>
</tr>
<tr>
<td>OBC + Others</td>
<td>82.2</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Of which*

<table>
<thead>
<tr>
<th>Other backward class</th>
<th>76</th>
<th>56.6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other</td>
<td>61.8</td>
<td>48.9</td>
</tr>
<tr>
<td>All</td>
<td>78.5</td>
<td>67.6</td>
</tr>
</tbody>
</table>

*Source: National Family Health Survey, Various Rounds*

Table 5. Literacy rate by social category, 1980 and 2000 (in percent)

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>2000</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scheduled castes</td>
<td>24</td>
<td>55</td>
<td>30</td>
</tr>
<tr>
<td>Scheduled tribes</td>
<td>19</td>
<td>47</td>
<td>28</td>
</tr>
<tr>
<td>Others</td>
<td>47</td>
<td>69</td>
<td>22</td>
</tr>
<tr>
<td>All</td>
<td>41</td>
<td>65</td>
<td>23</td>
</tr>
</tbody>
</table>

*Source: Thorat, 2007*

What about the top of the distribution? Disadvantaged groups were also significantly under-represented amongst households with relatively high levels of spending in the survey data. Take the top 5 percent of the overall distribution. Only 1 percent of Hindu STs, 1.8 percent of SCs and 2.9 percent of Muslims were in this group, while if they had the same share as the population average this would be 5 percent.

In light of the reservation policies on tertiary education and public employment for STs and SCs, another interesting angle is access to high-level jobs. There were almost no *adivasis* and *dalits*, in professional or technical jobs at independence, with the exception of a few outstanding individuals (most notably B.R.Ambedkar, the chair of the drafting committee of India’s constitution). By 1983 this had changed significantly, with further gains by the mid-2000s, by when 4 percent of professional and technical jobs were held by individuals from STs, and 11 percent by SCs, compared with population shares were 13 percent for STs and 16 percent for SCs (Table 6). This again shows SCs enjoying more rapid gains than STs. However, the more striking result is that these “elite” groups represented only around two percent of their groups: for most people the real action lies elsewhere.

Table 6. The share of scheduled tribes and scheduled castes in professional and technical work

<table>
<thead>
<tr>
<th>Year</th>
<th>Scheduled tribes</th>
<th>Scheduled castes</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>3.8</td>
<td>7.8</td>
<td>88.4</td>
<td>100</td>
</tr>
</tbody>
</table>

(i) As a share of the total number of professional and technical jobs.
Inter-group differences often intrinsically involve some form of conflict. Take the extreme manifestation, that of physical violence. India still has a notably low level of personal criminal violence. As Figure 11 shows, the homicide rate is very much lower than a group of Latin American countries, and unlike these countries, has shown essentially no upward trend in the past 30 years. But while personal violence may be linked with inequality, it is not intrinsically associated with group-based differences. Much more important are acts associated with collective identity, whether in communal (typically Hindu-Muslim, but also sometimes language-based, such as Kannada-Tamil in Bangalore, Nair, 2005), in caste-related violence, and in conflicts at the margins of the state. Most communal violence is urban (Varshney, 2002), though the usually smaller-scale caste-based violence is more of a rural phenomenon.

Figure 11. The homicide rate in selected Latin American countries and India (incidence per 100,000)

By contrast the Naxalite (Maoist) insurgency is rural. In affected parts of the country, poor, often adivasi groups are caught between Naxalite violence and the reciprocal

9 See Fajnzylber, Lederman and Loayza (2002) for statistical analysis suggesting links between measures of inequality and murders across countries.
predations of the state. To quote Ramachandra Guha, “The first tragedy is that the state has treated its adivasi citizens with contempt and condescension. The second tragedy is that their presumed protectors, the Naxalites, offer to long-term solution either.” (Guha 2007, p. 3305).

As discussed further below, competition for state-mediated preferences can also be a source of conflict. The Gujjiar group has been campaigning for Scheduled Tribe status for some years, and were promised it by the previous Rajasthani government. But the government did not deliver, in part because this would lead to direct competition for reservations with another group that already has ST status. One Gujjiar representative said “Rajasthan could become another Kashmir if the Meenas get more reservations in 2010” (reported in Tehelka, 2008).

Overall there has been some, if slow, progress on severe deprivation of disadvantaged groups, and possibly relative gains for scheduled castes. The picture looks much more like a situation of the reproduction of inequalities than the reproduction of poverty. With respect to the bottom of the distribution, there is no evidence of poverty traps at the level of these aggregate groups. At the top of the distribution a small proportion of disadvantaged groups have experienced gains, but this has not had a significant impact on relative positions on average. Identity-based differences remain central to social and political interactions, and will continue to be a core feature of distributional struggles in India in the coming years.

Spatial inequalities

Spatial differences in incomes have risen with respect to both rural-urban and inter-regional differentials. Let’s focus on inter-state differences, and use the per capita net state domestic product, for which an annual series is calculated. There has been a substantial rise in an overall measure of dispersion, with a particularly large increase in the decade after 1990, followed by stabilization at a higher level in the recent past (Figure 12). Richer states seem to have benefited more from the economic liberalisation. The scale of the change can be illustrated by comparison with Bihar, the poorest state in this period. Both Gujarat and Tamil Nadu had average state incomes around twice that of Bihar for the twenty-year period from 1970 to 1990. But since then, this ratio has risen to four times (Figure 13), entirely due to the growth acceleration, since Bihar continued to grow slowly. The recent acceleration in Bihar’s growth has only made a small difference to this ratio.
Figure 12. Rising divergence across major states

Source: Central Statistical Organisation

Figure 13. Tamil Nadu’s and Gujarat’s income per capita relative to Bihar, 1980/81 to 2009/10

Source: Central Statistical Organisation

This divergence has implications for the relative pace of poverty reduction—illustrated in Figure 14 for changes in rural poverty for the same three states plus Uttar Pradesh. Note, however, that rural poverty remains significant in Gujarat and Tamil Nadu, indicative of the continued inequality in these states. And recall that this is a highly restrictive definition of poverty: by the standards of middle income countries the “rich” states in India have deep and widespread income poverty.
Figure 14. Rural poverty incidence in Bihar, Gujarat, Tamil Nadu and Uttar Pradesh, 1983-2004/05

Source: National Sample Survey

Finally, note that the overall divergence contrasts with significant *convergence* amongst the richer states, that here include Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Punjab, Tamil Nadu and West Bengal, until the middle of the 2000s (Figure 15). However, too much should not be read into this. It may be driven by more by state-specific processes driving, for example, slow growth of Punjab and fast growth in Gujarat, rather than any general tendency for a higher-income convergence club. Since 2007 there are signs of divergence within this group.

Figure 15. Convergence in incomes amongst richer states since the early 1990s

*Note: high income states are Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Punjab and Tamil Nadu.*

Source: Central Statistical Organisation

There are two categories of influence on inequality: specific economic processes and political and social processes that shape institutions.

There is extensive work in economic geography in developing countries (Gill and Kharas, 2007, World Bank) that explains why concentration of activities occurs. In the
case of India, on the basis of detailed empirical work, Chakrovorty and Lall (2007) attribute this to a mixture of the economics of agglomeration—especially the benefits to firms of the wide range of services available in urban economic concentrations—and the persistent effects of institutional divergence.

This has two implications. First, the attraction of locating in established centres of urban industrial and service activity is, and will continue to be, a central and rising feature of India’s modern growth path. This only heightens the importance of access to urban land and infrastructure as a central domain of rent-seeking and contestation. There may well be opportunities for some relocation to smaller towns (as is beginning to happen in the business process outsourcing and IT sectors), but this will only create new locales for rent-creation and management. Second, the benefits of agglomeration make it harder for economically lagging and institutionally weak states or districts to make the “big push” needed to catch up: the evidence of either infrastructure-led catch up, or benefits from fiscal subsidies is very weak for India (as for most countries, see Chakrovorty and Lall, 2007). Moreover, many of these “backward” areas are also stuck in a more “extractive”, private rent-sharing equilibrium between business and state, making the challenge of an “institutional big push” even greater. In particular, where there is a confluence of mining resources, forests, adivasi populations and weaker state traditions, the forces will tend to support more unequal and corrupt resolution, that will continue to weaken institutions.

Skill-based differences

Part of the rise in per capita household expenditure inequality caught in Figure 6, especially for urban areas, is associated with rising differences across earnings with respect to skills. A theme in the interpretation of India’s growth acceleration has been that the pool of high skilled, graduates, especially in engineering, was both an important initial condition and shaped the pattern of growth (Kochar et al. 2006). Rapid growth occurred in relatively skill-intensive industrial and service activities.

However, with the further growth acceleration of the 2000s, the main concern in the market has been over shortages of highly skilled labour, with rapid rises in salaries for highly qualified people. By 2007-08, there were anecdotes of IT companies reversing their locational decisions back to Silicon Valley.

As one measure of this, Figure 16 shows the average starting salaries of graduates of the Delhi School of Economics. DSE graduates are attractive to the private corporate sector because of a tough selection process to get into the school, and the quantitative training they get. In this period, well over 90 percent of graduates went into the corporate sector. Between 2001 and 2008 the average starting salary rose from less than Rs.300,000 per annum to over Rs 800,000 (around US$21,000).
The interaction between the relative demand and relative supply of skills is a central force in inequality dynamics, both in rich and poor countries. On the demand side, the traditional view from Heckscher-Ohlin trade theory, based on the Stolper-Samuelson theorem, was that opening up to international exchange would lead to increases in the relative returns to the abundant factor or production. That was the basis for many economists believing that opening would favour the returns to unskilled workers in labour-abundant economies. This seemed to be consistent with the experience of the first set of East Asian countries as they entered their periods of rapid growth.

Things are more complicated in practice, both in general and in India’s experience. On the demand side, a dominant influence on returns to labour is agriculture, the most important labour-intensive sector, and rural productivity growth has been sluggish. A second demand-side influence, as already noted, has been the fact that India has followed a relatively skill-intensive path in industrial growth—under most interpretations a product of both her comparative advantage in the associated skills, and the high cost of labour in formal manufacturing.\(^\text{10}\) More broadly, there is considerable international evidence,

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\(^{10}\) Panagariya (2008) is an articulate advocate of the burden of labour regulation thesis; cross state evidence consistent with this is in Besley and Burgess (2004) who construct an index of the restrictiveness of labour regulations across Indian states. However, this index has been criticized by Bhattacharjea (2008).
especially from Latin America, that the process of opening up to trade and foreign leads to skill-biased technical change, as companies shift to new techniques.\textsuperscript{11}

On the supply side, there are major institutional issues, both at the level of basic and tertiary education. This is overlaid on the intrinsically slow impact of changes in the flow of educational on the stock of workers: India will have to live with the heritage of poor education for some decades.

With respect to basic education, while there has been a large growth in enrollments in India in the past decade, the quality remains dismal (ASER, 2008-2011) and this is intimately tied up with how the state functions in the education system. The central and state governments have been significantly increasing public resources—not least in poor North Indian states such as Bihar. But deep questions around teacher motivation and organisational incentives remain (see Pritchett and Murgai, 2007 for a discussion). Private education is expanding rapidly; while this may improve standards for those who attend, it could also lead to widening of educational inequalities in the bottom of the distribution.

With respect to both secondary and tertiary education, India is clearly now lagging, in contrast to her earlier reputation of having invested in higher education. Tertiary enrollments were around half those of China in 2007, and substantially below Indonesia (Figure 17). The state system is again bedeviled by organisational problems and low quality, outside the few islands of excellence. It is not at all clear that the big plans for expansions will be successful absent major reforms.

Figure 17. India lags Indonesia and China in secondary and tertiary enrollments

\textit{Source: World Development Indicators.}

\textsuperscript{11} There are now a lot of studies on the Latin American experience; see de Ferranti et al (2004) and Sánchez-Páramo and Schady (2002).
The underlying dynamics of relative demand and relative supply would suggest that India is in for an extended period of pressure on skill differentials. Institutional weaknesses on the supply response reinforce this. Offsetting this would require a major shift toward unskilled and semi-skilled labour on the demand side.

### Inequality, the state and economic processes

Each of the four domains of inequality reviewed here has been historically shaped and remains embedded in the social and economic system. In each case there is a significant probability of either further deepening or only slow resolution of the structural inequalities. But the big question for this paper is how these are linked to both political and economic processes, and in particular whether such entrenched inequalities could distort or jeopardize the long-term development process, notably with respect to aggregate growth and service delivery. I turn to this now.

The core of the interpretation concerns the relationship between society (including business), the state and political processes. The thesis can be summarized as follows.

- It is useful to think of India (and states within India) as in a “rent-sharing equilibrium” (or rather a range of such equilibria), in which political support is exchanged for provision of economic rents by the state and politicians. This creates incentives for the perpetuation of institutions that create and then share the rents. These might be thought as particular forms of social contracts.
- The reforms of the 1980s and 1990s affected the nature of rents, but only partially, with the corporate sector shifting, to some degree, from a “static” to a “dynamic” rent-sharing system. There was not a major shift in the rent-sharing relationship between the state and social groups, though there were shifts in the patterns of rent distribution and, in some areas, further politicisation of group-based identities.
- The unequal structures described above have a strong tendency to support and sustain the rent-sharing processes, including through clientelistic political structures and a state that does a bad job at delivering many public goods. There are also likely to be periodic conflicts over rents, between business and social groups, between different social groups and between the various states of the federal system.
- There is no guarantee that the rent-creating and rent-sharing processes will automatically disappear with the process of economic growth and likely political developments.
- While the rent-sharing equilibrium (or rather series of equilibria) has been consistent with the current growth acceleration, over the long term it is more likely to undercut it, especially through weak public good provision, periodic distributional conflict and undermining of the development of the state.

I discuss these points further below.
India as a rent-sharing equilibrium

By a rent-sharing equilibrium, I mean an economic and political system in which structured mechanisms for sharing economic rents across competing groups leads to a stable, self-sustaining path for the economy and society.

Economic rents can be thought of as returns to factors that exceed their opportunity cost in other uses. In the economic literature the most common kinds of rents analyzed are created through restrictions on economic competition (though more on “bad” and “good” rents below). Sustainability refers to an economically and politically stable path. Economic stability is used in the sense that shifts in resource allocations and other economic transformations don’t automatically take the economy away from the initial structure of rent-creation and sharing. Political stability is used in the sense that political mobilisation and decision-making does not automatically lead to policy changes that transform the system.

A “static” rent-sharing equilibrium is so-called not because there is no growth, but because the primary effort of actors involves competition for rents that have been established under the existing economic and political system. This may include rents that will actually be received in the future, for example government commitments to long-term access to jobs, reservations on education, or support for policies and institutions that restrict competition now and in the future. But this does not involve creation of new products or processes.

A “dynamic” rent-sharing equilibrium is used in the sense that some of the rents, and associated rent-sharing arrangements, provide incentives for growth-related processes. This can include innovation, accumulation of human or physical capital, resource shifts into new activities and so on, and can be taken by individuals, households, firms or the state. At a deeper level they may lead to transformation in the ways in which institutions function.

This distinction is related to different kinds of rents. Let’s draw a heuristic distinction between “bad” and “good” rents, based on whether they tend to spur or inhibit growth-related processes (see Table 7 for a summary and Khan, 2000a,b, for a more extensive discussion). As already noted, “bad” rents are traditionally considered to be those created by restrictions on competition or access (see Krueger, 1974, for a classic account). They can flow from the exploitation of market power by a monopolist or group of oligopolists, or through the creation of market restrictions by a government, through licenses on production on investment or a protective trade regime.

Table 7. On “bad” and “good” rents.

<table>
<thead>
<tr>
<th>Sources</th>
<th>Effects</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>“Bad” rents</td>
<td>“Good” rents</td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Restrictions on economic competition</td>
<td>Schumpeterian rents from newly created profitable activities</td>
</tr>
<tr>
<td>Political or administrative biases or exclusions</td>
<td>Learning rents for early movers</td>
</tr>
<tr>
<td>Social differences</td>
<td>Natural resource rents</td>
</tr>
<tr>
<td></td>
<td>Rents from agglomeration economies</td>
</tr>
<tr>
<td></td>
<td>Provide incentives for innovation, restructuring and learning</td>
</tr>
<tr>
<td></td>
<td>Integral to resource exploitation</td>
</tr>
<tr>
<td></td>
<td>Typically intrinsic to efficient spatial location</td>
</tr>
<tr>
<td>Divert effort into creation and capture of rents via economic, political and social processes.</td>
<td></td>
</tr>
<tr>
<td>Encourage distributional fights</td>
<td></td>
</tr>
<tr>
<td>Can amplify biases against public good provision</td>
<td></td>
</tr>
</tbody>
</table>

*Source: Author*

More subtly, structures of social difference can be associated with rents, and create implicit incentives for their perpetuation. While this is a general phenomenon, India is unusual in having historically explicit restrictions on occupation within the caste system. This is of interest not only for their economic costs, but also for the interaction with symbolic structures of dignity and humiliation—and the contemporary political demand of historically “inferior” groups for recognition of their equal status, that is for symbols of dignity.

Why are such rents bad for growth? There are efficiency costs associated with the static resource allocation effects from lack of competition, but these are not large. More important are the consequences for “effort”: in a system thick with rents created by restrictions, individuals and firms have incentives to put their energy into getting access to these rents, rather than into investment and innovation. Furthermore, beneficiaries have an incentive to maintain the institutional structures that are the source of the rents. On the other hand the very existence of differential access to rents sharpens the possibility of distributional fights, that can also undercut growth processes, for example through effects on expropriation risk, whether for corporations or the self-employed. Finally, rents can form part of a political system that is based on patronage rather than provision of public goods.

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12 This is at the core of anthropological and sociological work, notably by Pierre Bourdieu, that interprets social practices and distinctions as serving the purpose of maintaining differences in power and economic position. The practices are often internalized in the implicit or tacit attitudes and behaviours of different groups, rather than being consciously pursued. See Bourdieu (1990).
But not all rents are bad for growth. Some rents are integral to core growth-related processes.\textsuperscript{13} Schumpeterian rents, so-called after Joseph Schumpeter’s classic account of the creative-destruction process, are the rewards to innovation in new products or lower cost processes, over and above the post-innovation cost of production. In the absence of such rents there can be suboptimal effort in innovation, since innovators face a combination of costs of exploration and risks of low returns. Risks flow from uncertainty over the demand and cost characteristics of the new product or process. Risks of low returns also occur if an innovation can be easily imitated, since competitors can then copy, push prices down, and reap the cost advantages without the costs of developing the innovation. In a variant of this argument, Hausmann and Rodrik (2005) argue that there are costs to the “discovery” of whether it is profitable to produce a new product in the specific conditions prevailing in a country (roses in Ethiopia for example, that took some years to turn a profit, even though they were produced in Kenya.) So rents can occur either because an innovator has a first-mover advantage, or if policy supports protection through patents or subsidies. What pattern of rents is desirable to support these processes? The answer is easier to state than to set in practice: it is a level and trajectory that is of sufficient size and duration to induce a desired level of innovation, followed by extensive imitation to ensure the benefits are passed to consumers.\textsuperscript{14}

Learning rents have a similar structure. Costs of production can decline as firms learn new techniques, labor processes and markets. At initial cost structures they may be uncompetitive (for example at international prices) and so have to receive protection or subsidies until the process of learning occurs. As with Schumpeterian rents, support for learning rents makes sense if there really is cost-reduction and if the support is eliminated once the learning has occurred.

Rents can also be linked to other economic development processes. Natural resource rents are intrinsic to resource extraction, and will exist even with efficient production that fully incorporates externalities on the environment or social conditions. Of course their existence can also lead to incentives to extract favourable (and so inefficient) deals from politicians. Similarly, there are powerful agglomeration economies in many types of industrial and service production, and this can also lead to economic rents to those closer to “centres” of economic production. It is noteworthy that the natural resources—in mining, land, the spectrum—has been central to the spate of corruption scandals that came into the centre of public debate in 2010 and 2011.

A broad-brush indication of the absence of any simple relationship between rents and economic growth is given in Figure 18, that plots an index of corruption in the 1980s, as a proxy for rents, with subsequent economic growth in the 1990s. Now many people

\textsuperscript{13} See Khan (2000a,b) for the role of Schumpeterian and learning rents in the East Asian growth experiences. See also Hausmann and Rodrik (2005) on “self-discovery”. Modern “Schumpeterian growth theory” (see Aghion and Howitt, 2006) is centrally about the theory and empirics of innovation.

\textsuperscript{14} This is of course a version of the classic problem of balancing patents for intellectual property with cheap access once a new product has been developed, for example in pharmaceuticals.
might have the intuition that corruption is a better proxy for “bad” than “good” rents. Even so, there is effectively no relationship in the data! Korea, India, China and Malaysia grew fast relative to other countries with similar levels of corruption; Brazil and Mexico grew relatively slowly.

Figure 18. No simple relationship between rents and economic growth: corruption in the mid-1980s and growth in 1990-2007

Note: a higher level of the index indicates a lower level of corruption.

Source: International Country Risk Guide and World Development Indicators.

The cross-sectional pattern is far too general to be of interest in its own right, and is only shown as a corrective to simplistic accounts. The focus here is on putting more structure on the interpretation. Any system will have both static and dynamic elements, but this distinction is particularly useful in the interpretation of past (and potential future) institutional changes in India, including the economic reforms of the 1980 and 1990s. Note by “dynamic” I mean the effects on economic processes, as opposed to whether the equilibrium itself is changing. That is an important, but separate issue: indeed one of the big question is whether the institutional systems are evolving, or could be induced to evolve, to structures that support more dynamic rent-sharing processes.

A schematic representation of the central relationships is given in Figure 19. This organizes the actors into three groups: large-scale business; middle and lower social groups, including both households and small-scale business (that more often than not overlap in the farming and informal sector, in the form of household enterprises); and the state, that here includes politicians, the bureaucracy, legislature, regulatory agencies and
the judiciary. The underlying sets of relations are organized in terms of two categories of interaction.

- First, large-scale business needs various kinds of “permissions” to undertake investment or business activity; this could include an approval, or a specific, complementary public good. Politicians and other state actors dispense these, under a mix of legal and illegal decisions and regulations. The outcome is a configuration of private investment, market designs, and public choices over provision of specific public goods.

- Second, social groups receive various kinds of benefits from the state, in the form of services, jobs, local public goods, or other actions in line with their preferences—such as official language, or action furthering symbolic aspirations etc.—in return for political support for state actors. The latter can occur through formal voting or other means of providing political loyalty.

Figure 19. A schematic representation of the relations between social and economic interests and the state

These two circuits of reciprocal interaction have a direct relationship to the first two categories of structural inequalities surveyed in the previous section—corporate wealth, and group-based differences—and I argue that these inequalities are intrinsic to the causal

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15 See Hausmann (2008) for a discussion of the importance of a range of highly specific public goods that are complements to private investment activity.
processes sustaining the rent-sharing equilibrium. The other two categories of inequality, of spatial and education differences, are also embedded within this system, falling within these two general categories of relationship.

How does this relate to growth? This is already partly there in the treatment of good and bad rents, and static and dynamic rent-sharing. Let’s now put more structure on this. Here are four areas in which action by the state is central to the growth process.

- **Credible policy commitment.** Private investors need assurances that they will not lose part or all future returns, whether through expropriation (including partial, policy-related expropriation), macroeconomic instability, absence of law and order, or inadequate conflict resolution mechanisms.
- **Permissions and incentives for production, investment and innovation.** Many activities require specific permissions—on land use, production, investment etc—while market regulations (including on external tariffs) influence profits in these activities.
- **Provisioning of social and infrastructural systems.** Infrastructural services and skills are complementary to, or inputs into, private production, and the state has an intrinsic role where there is a high public good element or externalities are relevant. This at a minimum implies setting and managing the regulatory framework and typically also involves a major role in direct provisioning.
- **Coordination and increasing returns.** There are often complementarities in the growth process, that will not automatically be taken account of with fully decentralized decision-making. This can be a source of increasing returns to scale and agglomeration economies.

To varying degrees, these can be linked to the four domains of structural inequality that were discussed above, with rents being an important intermediating mechanism. This is summarized in Table 8. In the following subsections I use the framing in Figure 19 and Table 8, to explore answers to four questions: What are the mechanism of rent-creation and sharing? What is the relationship between these mechanisms and inequality? What are the effects on growth and development? And what are the dynamics of the system—is it self-enforcing?

**Table 8. Growth-related processes, rents and domains of inequality**

<table>
<thead>
<tr>
<th></th>
<th>Corporate wealth</th>
<th>Social groups</th>
<th>Spatial</th>
<th>Education</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credibility</strong></td>
<td>Rents part of credibility-assuring mechanisms</td>
<td>Credibility in delivery of private and club goods integral to political strategy; public goods</td>
<td>Credibility on (local) policy has a strong spatial dimension—especially at</td>
<td>Credibility on quality of education affects household investment</td>
</tr>
</tbody>
</table>
The corporate sector and the state

The large-scale business sector is in a relation of reciprocal interest with the key state actors, a relationship consistent with medium-term growth, but likely to be costly to long-term growth. There are in particular risks of undermining the independence of the state.

Rent-creating and sharing mechanisms

In the schematic presentation of Figure 19, the relationship between large-scale business and the state is referred to as “permissions for finance”. This is in part metaphor, intended to capture the reciprocal interests in actions between each party. The state depends on large-scale business for important parts of the investment needed for growth, employment creation and expansion of the tax base. This applies whether the focus is on

<table>
<thead>
<tr>
<th>Permissions and incentives</th>
<th>Large influence on orientation of effort, whether for monopoly rent-extraction or support for Schumpeterian processes</th>
<th>Permissions typically a burden on firm-households, especially in informal production; political biases toward subsidies, especially for farmers</th>
<th>Land-related permissions central to spatially linked rents</th>
<th>Historical biases created rents for elite; reservations now overlaid on this</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure provision</td>
<td>Specific infrastructure a source of corporate rents and growth</td>
<td>Social and economic infrastructure distorted to target specific groups</td>
<td>Spatial allocation of infrastructure can complement other sources of rents</td>
<td>Education system thick with rents on supply side at basic and tertiary levels</td>
</tr>
<tr>
<td>Coordination and increasing returns</td>
<td>Production complementarities a source of rents, but also of growth</td>
<td>Complementarities between health, education, production-linked inputs key to micro growth, can be hard to reap</td>
<td>Agglomeration economies central to spatial rents</td>
<td>Unclear if matters</td>
</tr>
</tbody>
</table>

Source: Author.
the national state’s interaction with the corporate sector as a whole, or local interactions, such as Bangalore’s support for the IT sector—subsequently copied by Hyderabad and elsewhere. In similar fashion, it applies to regional state-level efforts to attract private investors, as illustrated by the competition for Tata’s investment in its greenfield investment for the Nano car in 2008, that West Bengal lost because of local social and political conflicts, and that Gujarat subsequently won.

There are several specific mechanisms.

First, there are explicit, specific permissions, when firms need to get a license or contract to undertake business. These were pervasive under the License Raj, in which production and investment of large-scale business depended on the granting of licenses for production and investment, and these were explicitly governed by considerations of protecting small-scale protection, avoiding excess capacity, and equitable spatial distribution. These restricted opportunities, but also (often) guaranteed profits once permissions were granted, especially when licenses to produce were complemented by trade protection. Corporations learnt to work within the system, through connections and corruption. Where there are bribes, this amounts to specific rent-sharing between participants, that often also involves actors up the hierarchy of the state administrative and political apparatus.

With the delicensing and external liberalisation of the 1980s and 1990s, an important segment of these permissions were eliminated or reduced. However, there remain many areas where either explicit permissions or government contracts are still involved, especially around land (urban and rural), natural resource exploitation, the spectrum and private participation in infrastructure.

Second, there are many areas in which there is a reciprocal relationship of support outside the specific structure of regulated permissions. Businesses depend on a range of infrastructural services—electricity, roads, water etc.—and the state is either a provider or decision-maker. Such specific public goods are central to growth dynamics, and involve at least transitional rents. On the side of the state, this may involve more diffuse political gains. An example is the relationship between state and business in Bangalore: an important focus of the urban policy—managed as much by the Karnataka State Government as the Bangalore city—has been support for the IT industry, including what some have argued to be excessive land allocations to the industry (Ramanathan, 2007). This does not mean that all the business sector’s infrastructural needs are taken care of: indeed the dominant narrative is of infrastructure constraints. One of the puzzles of Indian political economy is why the business sector has failed to induce the state to solve infrastructure shortfalls: a provisional view is that this is because of a combination of organisational problems on the supply side (some of which are linked to corruption and other rent-seeking processes within the supply chain) and suboptimal functioning of the second circuit of Figure 20, that is of interactions with social groups, that often lead to social hold-up.
A third area is that of political finance. This is murky, and is inadequately documented precisely because it is murky (Mehta, 2009). Political parties—and individual politicians—need finance to run for elections, with rising financial stakes as the political system has become increasingly embroiled with money, via both legal and illegal channels. There is a growing overlap between politicians and business. A striking example is the entry on to the Karnataka political scene of the Reddy brothers, iron ore miners from Bellary District in the 2008. They are judged to have been central to financing BJP candidates into power, they competed and won in local elections (as Members of the State Legislative Assembly) and were rewarded with three ministerial positions in the new Government. (Tehelka, 2008). As Rajan (2008) speculates, these mechanisms of state support for business, and business finance of electoral campaigns, can form part of a circle of interactions between business, politics and voting blocks—that is a bridge to the second circuit in Figure 19.

Finally, a fourth area concerns networks—or connections—facilitated by histories of family, schooling, social status and group-based identity, and a range of informal business, government and social interactions. Such connections provide access, and also a source of trust that informal or illegal transactions will be honoured, and will sanction opportunistic behaviour. To take one specific area, think of the solidarity, information flows, and informal connectivity amongst IAS officers, especially strong for those of the same batch (or year of entry.) The longevity of both family businesses and political families can be an additional source of trust and sanction. 16

These four mechanisms all refer to state-business interactions. They are overlaid on “natural” market-based source of rents, both “good” and “bad” for growth, from discovery of new activities, learning, resource extraction etc (Table 7).

**Links with inequalities**

The various rent-creating and sharing mechanisms have a structural relationship with inequality. The capacity to use financial means to effect influence—whether for permissions, specific complementary public goods or political finance—is a function of initial wealth, and so leads to the perpetuation or deepening of inequalities, as permissions or complementary public goods lead to further wealth creation for those initially wealthier. 17

Mechanisms in the state-business relationship interact with market-based sources of inequalities. Take the classic market failures around financial markets, that lead to greater financial access to businesses, or individuals, who have higher initial levels of

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16 Morck and Yeung (2004) argue that oligarchic families have a particular advantage in having the financial resources and the long-term time horizon in what is for them a repeated game with politicians, often with a changing cast of political actors.

17 This is formally argued in a theoretical paper by Esteban and Ray (), who use the License Raj as a heuristic point of departure.
financial or social collateral. This not only implies lack of finance for productive investment of poorer individuals or smaller businesses, but also reduced access to financial resources to bribe or influence state actors. And this further reduces the credibility of less influential business actors to deliver on their side of deals in a repeated game of business-state interactions.

An important additional link with inequality occurs when powerful interests are associated with a “weaker” state—weaker here in the specific sense of being less autonomous from specific influence, or more distant from the Weberian ideal of rule-bound custodians of the general public interest. The capacity of unequal material wealth or social connectivity to secure unequal outcomes from the state will be enhanced, the weaker the state is. A justice system in which judges can be bribed, or a regulatory structure in which regulators are captured are salient examples.

Some indirect support for this being a potential issue comes from the data on billionaires. Forbes has information on the primary sources of wealth of each billionaire. This is qualitative, but still yields interesting patterns. Some sources of wealth are more likely to be thick with rent than others: natural resources, land, and sectors involving government contracts, are obvious examples. We reviewed the reported source of wealth in the Forbes list, and other information on business behaviour to categorize the primary sources of corporate wealth of billionaires into three categories:

- sectors that are “rent-thick”, involving intensive interactions with the state for permissions; also in which there are frequent, credible allegations of fraud;
- “others with some government approval”, in which there is nevertheless a governmental Memorandum of Understanding of supply agreement, e.g. vaccine, engineering, software and private sector power companies;
- “others” in which either government permissions are relatively unimportant, such as general pharmaceuticals, or, for the particular case of banking, where the Reserve Bank of India has a reputation of stringent regulatory enforcement.

There is clearly some subjectivity in the classification, and activity in a rent-thick sector does not itself mean that wealth was acquired through the legal or illegal exercise of influence. But the pattern does carry information value. Figure 20 shows the proportion of individual billionaires in the early 2011 listing in each category, both unweighted and weighted by their wealth. At this point in time, some 45% of billionaires (by number) had their primary sources of wealth from rent-thick sectors, with a further 29% having their primary source involving some form of engagement with the state. These proportion were even higher in terms of shares of total billionaire wealth. Figure 21 then charts the

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18 This is one of the classic mechanisms for the perpetuation of inequalities in the economics literature, see Aghion et al (2006) for a review.
19 Glaeser et al (2003) refer to this as “the injustice of inequality”. Regulatory capture is a classic area of distortion where business has greater power than the state actor.
composition of measured total billionaire wealth in each year. Over time, there was a period from the late 1990s to early 2000s when billionaires from less “rent-thick sectors, but especially ones still involving some form of connection with government (including IT and pharmaceuticals) accounted for a high fraction of the total, but this shifted back to dominance of those from rent-thick sectors in the second half of the 2000s.

Figure 20. The proportion of billionaires and total billionaire wealth by whether “rent thick” or otherwise connected with government in 2011

Source: Forbes.com and author’s calculations
While these numbers do not say anything about actual corruption or influence, it is notable that the impressive wealth creation often occurred in sectors in which there was substantial potential for “static” rent-extraction and rent-sharing, based on monopoly power or predatory economic deals. This does not take account of cases in which billionaires acquired their wealth in rent-thick sectors and then diversified into competitive areas—but arguably the core sources of wealth are of particular interest, as they provide the platform for creating the capabilities of organisation, financial resources and influence for further growth and diversification.

India has, in fact, been the scene of many alleged “scams” over many years. These came to a head in public debate in 2010 with the report of the Comptroller and Auditor General of India on the allocation of the 2G spectrum in 2007/08, that had a “presumptive” loss of over USD 31bn (Rs 1.4 lakh crores) compared to pricing at market prices. While much of this loss is hypothetical, this did involve a transfer of rents to private companies, and was associated with widespread allegations of bribes, and the arrest of the former telecoms minister A. Raja in February 2011 on charges of fraud. This was only the largest of many such alleged scams. For example, at the time of writing there was a corruption inquiry into allegations of corruption by the organisers of the Delhi Commonwealth Games. Another apparent scam involving the allocation of homes for war widows to cronies led the Congress party to sack the Chief Minister of Maharashtra in late 2010. Since scams intrinsically involve access to scarce rents and their allocation to those with connections, this is closely linked to the unequal pattern of economic and political influence.

A different aspect of inequality concerns the division between profits and wages in the corporate sector. As Figure 22 shows, using data from the Annual Survey of Industries, there has been a striking shift from wages to profits that started in the late 1980s and then stepped up both in the 1990s and mid-2000s. Wages in the formal sector are substantially
higher than in urban informal and rural activities, so the effect on overall measured inequality is ambiguous, but this nevertheless represents a large pro-profit shift in shares of this part of wealth creation.

Figure 22. The share of profits and wages in value added in India’s industrial sector

Source: Annual Survey of Industries, Ministry of Statistics and Programme Implementation

Effects on growth

The potential links between forms of corporate wealth and growth were framed in the discussion on “bad” and “good” rents and in the summary in Table 7. The net effects of economic rents on growth can be ambiguous. While some rents can be costly for growth, they are pervasive both in cases of extraordinary success in growth and long-run transformation, such as Japan and Korea, and in countries that got stuck in the “middle income trap”, such as Brazil and Mexico. This depends a lot on the institutional context for business state interactions\(^\text{20}\); here I put some structure on the interpretation.

Four areas were listed as influencing growth dynamics: credibility; incentives for resource allocation; infrastructure delivery; and issues around coordination. Each depends on the nature of the interaction between two sets of organisations: elements of the state, and corporate firms. Each area involves market failures, and the state is often intrinsically involved. An effective, growth-supporting state can be thought of as one that is:

--credible with respect to avoiding expropriation or major policy instability;

--provides incentives for pursuit of “good” rents—associated with Schumpeterian and learning processes, efficient resource extraction, and agglomeration;

\(^{20}\) See the contributions in Maxfield and Schneider (1997) for a general review of the state and business in developing countries.
--is responsive to the specific infrastructure and regulatory requirements of business;

--but is also able to check the power of corporations to extract monopoly rents and distort state functioning.

Evans (1995) in his interpretation of Korean success, argued that can occur when the state is in a situation of “embedded autonomy”: sufficiently linked to business and societal structures to have the information on, and be responsive to, changing conditions and needs, but sufficiently autonomous to set incentives for corporate performance and provide checks on excessive abuse. Hausmann (2008) has more recently argued the case for a state that is be responsive to the evolving mix of conditions that influence growth dynamics.

This is a difficult balance. Government credibility is central both to overall expropriation risk and the management of incentives and infrastructure delivery. There is a paradox here. A government that is strong enough to protect property rights of investors can also expropriate them. Conversely, a private sector powerful enough to punish a government’s opportunistic behaviour is likely to be strong enough to subvert government functioning. In an ideal world of “limited government” there are effective checks and balances on such opportunistic behaviour on both sides, including an independent judiciary and effective, autonomous, regulation in areas of market failure or lack of competition. As in all developing countries, the Indian state is far from such an ideal, through a combination of influence and lack of capacity (think of the huge backlogs in the courts as an example).

In the absence of the ideal of “limited government”, it is useful to interpret the relationship between the state and business as an ongoing strategic interaction.

An important part of the story lies in the nature of organisation on the business side. India is dominated by family-based business structures in terms of overall corporate wealth (if not in terms of numbers of firms). These are, in fact, the most common form of organisation in both developing and industrialized countries. Dispersed ownership, exemplified most extensively in the United States and the United Kingdom, is the exception rather than the norm around the world. The concentrated wealth that was reviewed above is closely linked to family-controlled business groups. This includes many publicly listed companies, in which core families retain a controlling interest, even when they do not have a majority stake. This can be through various mechanisms, including through indirect family and social connections on boards, and cross holding. A particular, and common, organisational form is the pyramidal structure in which firms further up the hierarchy have holdings of those lower down. This can allow effective control with only minority ownership stakes for the firms lower down in the pyramid.

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21 See Haber et al (2003) for a full development of this argument in the context of the evolution of Mexico’s economy and polity.

This is a common form in developed countries such as Canada and Sweden, as well as in many (probably most middle income) developing countries, including Korea, and other dynamic East Asian countries, as well as Mexico.

Both in theory and in practice the effects on overall development are ambiguous, because of countervailing effects. There are a range of influences:

- Business groups, and more broadly an influential business sector, can help solve market failures, through their greater ability to raise capital, both internally and externally, manage risk, support innovation, solve coordination problems, and access global networks. Greater influence over the state can reduce risk and induce more responsive delivery of the complementary permissions and public goods needed for business expansion.

- Concentrated family-controlled business (perhaps especially when organized into pyramids), can become entrenched, exploiting minority shareholders in favour of controlling groups, shaping the political economy of institutional and policy design to favour their own interest, and undermining the autonomy of the state.

While the effects are ambiguous in theory, I suggest an account of the growth experience, and especially the growth accelerations, that is consistent with what is known about Indian state and business conditions.

Prior to the 1980s reforms, there was already a long-term relationship between the state and the large-scale business community. Credibility had been weakened by the nationalisations of banks by Mrs. Gandhi, and also by the pervasive cost of doing business with the state, that often involved specific bribes for permissions. Liberal critics of the system were surely right in characterizing this as a low-growth system, with only modest levels of private investment and significant efficiency costs from resource misallocation and low productivity efficiency. However, from the prism of this paper, the system did not involve strategic threats to private business, there were widespread specific rents, often shared between businesses and state actors, and there was also significant nurturing of industrial capabilities, embodied in individuals and the organisational structures of firms.

So let’s now interpret the reform.

First, as many authors have argued, the 1980s policy changes involved both a shift to a more “pro-business” orientation of the state, and the release of many constraints on sector-specific constraints, through de-licensing. The latter started in the 1980s, with a concentrated episode in 1991, and a further wave in the late 1990s. This had the dual effect of increasing the credibility of government policy toward business and opening up possibilities for deploying resources into new activities. In this kind of system rents can

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24 See Panagariya (2008) for one amongst many reviews from this perspective.
play a role in creating interests in the system’s continuance, making it costly for participants to behave opportunistically. The specific mechanisms for assuring credibility have not been carefully documented. But there is a strong presumption that it has become increasingly costly for actors on both sides of the state-business relationship to renege on a broadly supportive relationship, both because of the general political costs of an investment strike, and specific benefits, including in payoffs. Anecdotally it is said that businesses in Tamil Nadu pay off both the government and the opposition on receipt of contracts. I have not seen specific evidence for this, but it illustrates the spirit of an ongoing relationship. This is further reinforced by actual linkages between politicians and businesses, with increasing overlaps between politician and business activity.

Opening up previously restricted sectors also provided opportunities for new rents for those with the organisational and financial capability to exploit the possibilities. These were often Schumpeterian rather than monopoly rents.

Second, from the early 1990s there was an implicit modification of the deal, with continued support for the business sector in return for opening up, and the associated need for efficiency improvements (Kohli, 2006). This led to further restructuring and shakeout in some sectors, but to dynamic growth in areas of potential profitability.

The effects of de-licensing and opening are in principle ambiguous, since it both allows dominant firms to expand, as well as allowing entry. A couple of pieces of evidence support the view that business did well. As seen above in Figure 22, the share of profits in the industrial sector rose substantially. That looks pretty pro-business!

The increase in billionaire wealth occurred in a period of rapid growth in corporate investment (Figure 23), and an increasing share of the corporate sector in total fixed investment (Figure 24), apart from a fall in the period of relative macroeconomic stringency between the late 1990s and early 2000s. The corporate sector was an important player in India’s growth acceleration, especially in areas of technological innovation and catch-up.²⁶ Particularly notable is the surge in investment in the 2000s: this occurred in the context of a long-term boom in the stock market and a large, step-increase in the private investment rate, that contributed to a rise in the aggregate investment rate to East Asian levels in the high 30s as a percent of GDP. This was financed to a significant extent by rising corporate savings—fueled by the rapid growth in profits—as well as substantial capital inflows of portfolio and foreign direct investment.

²⁶ There is some debate over the size of the contribution, owing to questions over the accuracy of national accounts statistics (Nagaraj, 2007).
Figure 23. Real annual growth of corporate sector investment in India, 1970-2008 (in percent per annum)

Source: Central Statistical Organisation

Figure 24. The share of the private corporate sector in total fixed investment (percent at nominal prices)

Source: Central Statistical Organisation

This was associated with an interesting dynamic of new entry into the more established part of the business sector—those firms listed on the Bombay Stock Exchange. As Figure 25 illustrates, there was a burst of new entry in the 1990s, followed by virtual stagnation in numbers of firms thereafter. (New entry is defined as the year of incorporation of a firm in the underlying data base, not the year of going public, so there is a reasonable presumption that this capture actual entry into the market. See Mody, Nath and Walton, 2010)
A further piece of evidence is from comparison of the degree of concentration across industries. Ramaswamy (2006) found a varied experience, with some sectors becoming less concentrated and some more so. This is illustrated for the overall sectoral pattern of firms in the Bombay Stock Exchange in Figure 26, that uses Herfindhal-Hirschman Index, that rises with the degree of concentration, to a maximum of 10,000 for a pure monopoly. With respect to firms on the BSE this finds some de-concentration between 1993 and 2000, followed by re-concentration by 2007. The US Justice Department uses a value of this index of 1000 as critical cutoff for careful investigation when it evaluates merger proposals. (In Figure 26 this is presented as from 0 to 1, so the cutoff of 1000 is equivalent to 0.1). If import competition were fully effective, domestic concentration would not matter in tradable activities. The extent to which this is the case is unclear. Import penetration ratios remain very low in many sectors, and tariffs are non-trivial. And, of course, this is not a source of competitive pressure in the non-tradable sector.

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27 This analysis is based on data from the Centre for Monitoring the Indian Economy. It overestimates concentration through not taking account of imports and the unorganized sector. It also does not capture foreign firms that are not publicly quoted in India—some of which are dominant players in their sectors. Nevertheless, the trends provide useful information on part of the picture.

28 The Herfindhal-Hirschman Index is calculated as the sum of the squares of market shares, in percent, of all firms.
Third, the government has had a mixed experience in tailored support for new activities. Some parts of the government, perhaps especially at state level, have vigorously promoted business investment. Think of the tax breaks and provisioning of land for the IT industry, or the more broadly favourable environment for local industry in Gujarat and Tamil Nadu. However, there remains in most of India—with perhaps a partial exception of Gujarat—widespread infrastructure problems, thrown into sharp relief by the comparison with China, that has seemed to be successful in running ahead of infrastructure needs, rather than running behind. As already noted, there seem to be two quite distinct aspects to the initially puzzling failure of business to effectively pressure the state to deliver on infrastructure services. There is first, the capacity of social groups to hold up infrastructure where this involves resettlement (or environmental damage). The social concerns are often valid, but the process of dispute resolution is slow and looks highly suboptimal. Then there is the process of infrastructure implementation itself, that remains, in most cases, still caught in the mix of turgid bureaucratic process and varieties of influence and corruption involved in infrastructure contracts.

Fourth, one objective of the License Raj was to have to have an equitable spatial distribution of industry, though this was in practice mediated by influence of state governments and business. In any case, with the liberalisation there was a lifting of the lid on economic processes shaping spatial concentration. At one level this is a good thing: agglomeration economies are genuine, and are sources of growth, whether they flow from
concentrations of specialized skills for specific industries, inter-industry linkages, or the broader set of legal, marketing, logistic and other ancillary services that make business more efficient and profitable. Recent empirical work by Chakroverty and Lall (2007), indicates that the third of these—generalized economic services—are most important to locational decisions. This is good news for generally well-functioning cities, bad news for others. For the other side of this is higher economic rents for those close to spatial agglomeration (not to mention higher land rents), and the perpetuation of spatial differences—an issue I discuss further below.

Fifth, and of great importance, there are extensive area in which controls still rule. Infrastructure has already been referred to, and will (hopefully) be a huge area of investment in the coming years. Of at least equal importance is land allocation, and more broadly the nexus of explicit permission required for business location in towns and cities. Urban land issues are generally considered to be thick with inefficiency, corruption and influence. This is central to future phases of economic growth and transformation, since this will be predominantly in urban areas. The Special Economic Zones can be thought of, at least in part, as an attempt to escape the morass of the urban land nexus. While they share the name of Chinese spatial policies, in practice they seem to have little in common. And it is highly likely that they will also be embroiled in the nexus of rent-allocation, influence, and—in some cases—social hold up.

In sum, there are two general interpretive ideas on the Indian growth experience from the perspective of state-business interactions. The first is that there has indeed been an important, but partial, transition from the regulatory-monopoly rents of the License Raj, to Schumpeterian and learning rents, where the rents flows from advantages of innovation, being an early mover, and temporary monopoly. Note that this is particularly likely in the context of imperfect markets for capital and information, and large business groups would have intrinsic advantages.

The second idea concerns the continuance of regulatory and monopoly rents, especially in activities in which there are either high natural rents—mining for example—or in which regulatory provisions are still salient.

In parallel work on profit patterns of firms listed on the Bombay Stock Exchange, we sought to explore whether the pattern has been more consistent with a story of competitive pressures of entrenchment (Mody, Nath and Walton, 2010). This found that so far the pattern has been more consistent with competitive firm environment, with no evidence that this is significantly different for business houses. At a broad brush level, this is consistent with the overall dynamism of the business sector. On the other hand, there is considerable anecdotal evidence—notably in the series of scams—of the continued importance of influence and corruption linked to corporate activity.

In both cases the issue is not the disappearance of rents but their continuance in new forms. More broadly, while there was important alignment in the past 20 years of so
between the structure of rent creation and sharing in the state-business relationship and rapid aggregate growth, it is unlikely that this alignment will be for the long term. Beyond effects on inequality, growth-sapping effects could dominate growth-enhancing effects over time. I explore this theme further in the forward-looking part.

**A self-enforcing or changing equilibrium?**

Are current business-state relationships stable in India? More precisely, does the existing structure of benefits and the institutional context for interactions support a self-enforcing equilibrium, or is it likely to shift over time? If the assessment that current institutional structures could be problematic for economic transformation is correct, this is a central question.

With respect to market influences there are two conflicting forces: from the consolidation of market power by now-established business groups, and from potential new entry from new firms, as well as competition from the international marketplace. History—from India and elsewhere—suggest both processes will play out. Many of the current major actors amongst business groups will continue to play a central role. They benefit from the established industrial and organisational capabilities that have been built up over past decades. They also have the advantage of large internal and external resource mobilisation capabilities—especially important in light of the major capital market failures in India. And finally, they have the advantage of greater wealth and connectivity with the state, whether this is in the form of legal influence, corruption or greyer areas of political finance. On the other hand, despite the marked slowdown in entry to the Bombay Stock Exchange in the 2000s (Figure 25), there will surely continue to be new entry in the future, in a country as large and diverse as India, as entrepreneurs emerge from the broader expansion of the middle classes, and as access to finance improves. As noted above, Damodaran (2008) has documented the entry of new entrepreneurs from beyond the traditional families and castes associated with business activities.

Then there are greater uncertainties with respect to relations with the state itself. A striking feature of this period that this paper has highlighted has been the enormous expansion of business wealth—in the aggregate and in individuals. The story on billionaires is only the tip of the iceberg. While there are no analogous measures of state capacity, it is not at all clear that there has been a comparable gain—thus Pritchett’s (..) characterisation of India’s ”flailing state”. Meanwhile corporate wealth has continued to be linked, to at least some degree, with government interactions. And in 2010 and 2011 the dominant story has been of a corruptible state, via politicians and others. Take the example of Karnataka: in India’s post-liberalisation economic story this was most commonly known as the home of the Bangalore boom; in this recent period has often been characterised as India’s ”most corrupt” state, and is known for the tight links between the Reddy brother’s mining interests in Bellary district, and political finance, with no less than three individuals from the family and close associates in the state cabinet.
The honest answer to how the system will evolve is that we don’t know, except that it will surely change. However, consider the following account on potential dynamics:

- Many large business houses will become major global multinational players—analogue to the rise of Japanese and Korean firms such as Toyota and Samsung in an earlier period.
- At the same time there will be further entrenchment of major business groups, both within the corporate structure and in terms of concentrated power and influence with respect to state actors.
- This is associated with a further relative erosion of autonomy of state actors, in the executive at federal and (especially) state levels, amongst politicians, in many parts of the judiciary and in regulatory processes. This will be especially important in rent-thick activities, and will be a salient process even if the absolute capacity of the state increases.
- There will also be a process of entry into the large-scale business sector as new actors emerge: this will change patterns of economic competition and rent distribution but won’t change the overall system.
- The extensive informal economy of small firms will remain both competitive and largely outside the domain of interactions between state and large-scale business, even while this sector has wide-ranging production linkages with large firms.

Under this scenario both large-scale business and state actors benefit and have an interest in the continuance of this system. Small-scale firms are outside the system and political equilibrium that keeps that part of the system politically stable forms part of the second social circuit, to which I turn next.

Social groups and the state

For middle and lower groups the rent-sharing relation with the state is distilled into the phrase “goods for loyalty” in Figure 19. Here ‘goods’ can involve material benefits, including private goods, such as government jobs (or even goods such as televisions, that are now a standard feature of elections in Tamil Nadu), to club goods that benefit particular groups, and public goods that benefit all. It also includes symbolic goods of respect or dignity, of particular relevance in light of India’s history of humiliation of subordinate castes and tensions over religion. “Loyalty” can literally mean votes in an election, but can also extend to other forms of political support for local or national elites. These interactions lead to particular patterns of provisioning of economic and social services, the responses of individuals and groups, and the social and economic outcomes that are the final concern of development.

Rent-creating and sharing mechanisms

It is useful to organise the mechanisms of rent-sharing into two categories: legally sanctioned reservations for tertiary education, public employment and political office;
and clientelistic political processes—that merge into the more politically diffuse category of populism. I discuss both in turn, and then turn to the question of how violent relations fit into the picture.

_Reservations._ Reserved places for study in tertiary education and public jobs for scheduled castes and scheduled tribes were started in the 1930s, and then enshrined in the Indian constitution of 1950. These were complemented by political reservations—with some legislative seats also reserved for SCs and STs based on population shares. The intent was to offset the historically deprived position of these groups, and the associated profound inequalities of opportunity. The college and employment reservations were particularly focused on creating SC and ST leaders—creating an elite that could influence policy, provide symbolic advances, and shape aspirations from within their groups (Somanathan, 2007).

While reservations were intended to support the emergence of professional and political elites, inequalities in opportunity of poor and middle SCs and STs would be tackled by universalistic provision of social and economic services—perhaps most of all in education—along with removal of restrictions on access to land and occupations.

Some states have used reservations to a significantly greater extent than the constitution demanded—in Tamil Nadu, for example, such reservations were aligned with a broader anti-Brahmin political impulse and the emergence of Dravidian parties based on middle groups amongst Tamils. At a national level, the 1980 Mandal Commission recommended substantial extensions of reservations to socially deprived groups outside the SC and ST category—referred to as other backward castes or classes (OBCs). This maintained the principle that access to reserved college place or job would be a function of group-based membership of a specific caste. Reservation of public jobs for OBCs was added in 1993 and to tertiary educational establishments only in 2008, amid continuing controversy in the political and judicial realms.

Reservations have had an influence on outcomes, especially on elites within SCs and STs. Some indicative evidence was provided in Table 5, that showed that SCs accounted for some 11 percent and STs over 4 percent of all professional and technical jobs in 2004/05. However, this outcome could also reflect other influences. More direct evidence is provided by analysis of effects in one tertiary educational institutions by Bertrand et al (2008): this finds that SCs indeed benefited in terms of access to positions, and substituted for non-SCs with higher grades. They also eventually benefited in terms of better jobs.

With respect to political reservations, there could be a different dynamic, since here the objective is to grant greater influence of SC and ST political leaders, that could well extend beyond elites. Pande (2003) finds that changes in reservations over time—since the number of reserved seats is a function of SC and ST population shares—explain shifts in state government priorities: more SC seats are associated with more job quotas, but
with no influence on either total or education spending. By contrast more ST seats have no influence on job quotas, but do lead to increases in ST-related welfare spending, apparently from a mix of higher overall and reduced education spending.

Reservations have benefited the few, with possibly more extensive symbolic and longer-term political effects for the groups affected. For good or ill, they remain part of a rent allocation system, since the core allocations are for rationed positions. They have also contributed to the politicisation of group membership as a source of access to rents, in what Somanathan (2007) has referred to as the “demand for disadvantage”. This is vividly exemplified by the periodic Gujjiarmobilisation in pursuit of acquiring scheduled tribe status.

Group-based politicisation can be a good thing, especially if it leads to greater political salience of issues affecting deprived groups. The relative greater advances of SCs relative to STs may be linked to more effective political mobilisation of SCs: Banerjee and Somanathan (2007), for example, suggest that greater gains in terms of public goods in districts with more SCs—but not STs—is associated with the emergence of SCs as an independent political force. However, where politicisation leads to a primary political focus on static rent allocation this can divert attention from more fundamental drivers of well-being, including, and perhaps especially, for the deprived. And this is particularly problematic in light of the profound failures in the universal provision of social and economic services—the second leg of the social contract for deprived groups in the Constitution.

Clientelism, patronage and populism. Let’s now move to directly political processes. The aggregation and effective pursuit of the preferences of individuals and groups depends on the nature of political interactions. In this respect, one of the most important features of India is that is has a state that is both pervasive and deeply engaged in patronage. Chandra (2004) describes India as a “patronage democracy”. This can be thought of as a form of clientelism. In an electoral context, Stokes defines clientelism as “the proffering of material goods in return for electoral support, where the criterion of distribution that the patron uses is simply: did you (will you) support me?” (Stokes, 2007, p. 2). Clientelism is typically embedded in unequal relations between a person with greater power, status or wealth, and a person of socially inferior status, whose support is valuable to the former. While the electoral link is clearly relevant to India, clientelism can also be linked to other forms of political support in return for material benefits.29

Patronage can take many forms. It includes access to public sector jobs, subsidies, public sector credit, water, roads, power supply and so on. It can function at the individual level, or for particular groups, whether in terms of location (where a road is built) or

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29 See also the contributions in Kitschelt and Wilkinson (2008) for analysis of international and Indian experience, and Keefer and Khemani (2005) for a general discussion of the bias against public goods inherent in clientelism, in relation to "political market failures".
social identity. Often these overlap, where, for example, scheduled castes live in a distinct part of a village, or a schedule tribe occupies a particular location.

The major locus of patronage in the post-independence period has been discretionary provisioning by actors with influence within the state. This is often effected by bureaucrats, but politicians also wield considerable influence over state allocations, through their influence over civil servants, notably via their power to transfer public sector workers. Chandra argues that politicians have greatest access to rents at the level of the state—or second tier of government. She also addresses the question of credibility in the clientelistic relationship: how do citizens credibly commit to provide political support? She argues that this occurs through the extensive information collecting on voting patterns by political parties, backed by the generation of uncertainty amongst subordinate groups as to whether the ballot is really secret. (ibid. pps 139-141)

Why is a patronage-based system relevant to the framework proposed in this paper?

- A patron-client relationship involves the preferred allocation of rents, whether to individuals or groups. If there were no scarcity value—that is no economic rent—in material benefits, then they would not be valued by the client. Thus the attraction of public sector jobs, that provide security, and in many cases, a significant premium over alternative occupations. Similar considerations apply to water, subsidized credit, local roads etc.
- Conversely, genuine public good provision provides a weak underpinning for a relationship of patronage, since it is not linked to the provision of particular benefits by an individual politician. In many cases—policy legislation for example—provision of a public good will not be repeatable, and this further weakens the incentive for continued support, since the threat of withdrawing the benefit lacks credibility.
- Finally, a patronage-based system is likely to undermine those elements of state capacity that are oriented toward collective welfare and associated with an independent bureaucracy, since it intrinsically involves discretionary action linked to political support rather than either need or efficiency. However, there may be ambiguities in practice, since a patronage-based system can also gain from effective state capacity in the delivery of material benefits. One of the more interesting questions in India’s political functioning is how Tamil Nadu appears to combine both a highly patronage and populist based processes with high levels of state capacity.

The patronage character of the state has important links with the salience of group-based identities in India. As discussed by Ahmed and Varshney (2007), despite the extensive rhetoric on poverty reduction since independence, there has not been a potent political coalition in favor of tackling poverty. They ascribe this to the history of identity-based

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30 See the large premium for teachers noted above from Pritchett and Murgai (2007)
differences across groups, whether in the explicit hierarchy of the caste system, the neglected and socially inferior position of adivasis, and the weak political position of Muslims. There are equally deep issues around the position of women, but these show up less in household welfare and voting patterns, though see Chattophadhay and Duflo (2008) on the influence of reserved leadership positions for women at the local level. To quote Ahmed and Varshney (2007) “ethnicity became the category through which the full extent of deprivation was experienced by the poor in India. Class, or poverty per se, could not become the driver of politics. The poor were always talked about in Indian policy circles, but the polity has felt the greatest pressure to attack discrimination and denials of dignity, not poverty.” (p 20)

Historically shaped distinctions in social status have had two consequences:

- First, they have magnified the difficulty of building coalitions between scheduled castes and tribes on the one hand and middle groups on the other—especially the numerically, and so politically, important OBCs that typically form either a majority of voters, or cover the middle of the voting distribution; they are especially important amongst farmers. With the consolidation of democracy, the latter groups were major beneficiaries of the broadening of influence. By contrast, a middle-poor alliance, say with scheduled castes, involves bridging a social divide and competition for rents.

- Second, for all lower groups, a major initial concern has been the attainment of dignity, in the context of a social history of humiliation and abuse. This has strengthened the importance of symbolic dimensions of group-based advancement. Examples from Uttar Pradesh under the BSP, include building of Ambedkar statues and the focus of public action in stopping police abuse of dalits.

Now let’s return to the links with the patronage. Both state action to respond to group-based disadvantage, and the political mobilisation of group-based identity, has tended to work within, and sharpen, the rent-sharing features of the state. At least in the short run, this has been oriented toward what I termed “static” rent-sharing. There has been greatest relative success—in the sense of appropriation of rents—where there has been most effective alignment between group mobilisation and political organisation.

The ethnic group as a voting block is a central concern of political parties. Chandra (2004) analyzes this as consequence of the interaction between a patronage democracy and the salience of ethnic identities. She in particular explores how the voting preferences of scheduled caste groups can be linked to a combination of the ethnic

31 As noted above, this is sometimes rendered as Other Backward Castes, especially when this serves the purpose of political entrepreneurs (Chandra, 2004)
32 This is analogous to the weakness of middle-poor solidarity in the United States relative to Europe: in Alesina and Glaeser’s (2004) analysis this is not because of greater upward mobility in the US than in Europe, but at least in part because of greater social distance across the racial divide between whites and blacks.
identity of party leaders and the numerical importance of the group in question—and thus
the probability of being the supporter of a winning, or influential party. The intrinsic link
with patronage comes from the importance of private or group benefits from such
political support. She documents the rise of the BahujanSamaj Party (BSP) in these
terms. The BSP started as an explicitly dalit-based party, that has expanded through
construction of specific coalitions. An element of the dynamics was the emergence of a
critical mass of elites amongst scheduled castes, products of the reservation policies for
higher education and public employment, who had an interest in entering politics. These
were blocked from advance in the Congress party (the original political home of this
group), after this party ceased to be internally competitive. This provided an incentive
for the elites to move to the BSP party. And since scheduled caste individuals voted with
the identity of the leaders rather than stated policies, this formed the basis of a winning
formula in Uttar Pradesh.33

Clientelism merges into populist political strategies. Populism is a more diffuse concept,
that typically involves the provisioning (or promises) of material goods to middle and
poorer groups in return for political support, but without ties to particular groups or an
ongoing political relationship. TVs and bicycles are classic examples of goods used for
this purpose in an Indian context. Populism typically also carries the connotation of a
short-term focus—providing consumption gains to sustain immediate political support,
with weak attention to issues of longer-term policy, investment or public finance
constraints.

*Violence between the state and social groups.* The emphasis so far has been on reciprocal
exchanges between state actors and social groups. Yet India is also characterized by
violent relations between the state and citizens. This is distinct from the currently low
levels of criminal violence that India still enjoys (see Figure 11). Three categories are
important:

First, the most extreme form of violence relates to explicit challenges to the state as it
now functions. India has had its far share of challenges in the post-independence period,
from early Marxist movements in Andhra Pradesh and a series of secessionist threats
from the periphery (Guha, 2007a). Of most interest here is the Naxalite (Maoist)
movement, originally named after a village in West Bengal, but now concentrated in
forest areas in the central states of India. The ideology of the movement is based on
redressing social deprivation, land-based struggles and anti-capitalism. However, in
practice poor villagers, often adivasis, are caught in the violent cross-fire and fights for
territorial control between Naxalite insurgency and behaviour of the state that is equally
based on violent action (see Guha, 2007b, and the quote from this source above).

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33 By contrast, in Karnataka the main parties were still open to entry form outsider groups, of scheduled
caste elites, and there was not an incentive to join a new party. The BSP failed to take off in Karnataka.
Second, there are periodic violent interchanges between the state and social groups, for example over resettlement, land use or status. Both of the extended, high profile, episodes of violence in West Bengal in the recent past involved disputes over the use of land for industrial purposes: in Nandigram over the granting of rights to the Indonesian Salim group to develop a Special Economic Zone, and in Singur, over the granting of rights to the Tata group to produce its Nano car. Both were also entangled in local political divisions.

Third is the daily violence of police, or the more subtle forms of abuse by state actors. While much police violence is enacted on unlucky individuals with little apparent links to social identity, there is also a tradition of violence against lower caste groups and, in periods of intense communal violence, there is sometimes implicit support for violence against one of the communal groups involved—against Sikhs in the 1984 social violence and against Muslims in the 2002 Gujarat violence.34

How should we think of these via the prism of rent-creation and sharing? They can be seen as a mixture of failure in constructing a functional political relation and a product of a rent-sharing system. The Naxalite conflict, and the police violence against social groups, are manifestations of failure. After all a patronage or clientelistic form of inclusion is far better than Naxalite violence and the reciprocal predations of a violent state. This is analogous to the valuable second-best properties of a rent-sharing relationship between the state and business: while that may be inferior to an ideal of limited government, it is, and has been, sufficient to underpin credibility of state behaviour, decent investment levels and, in the past couple of decades, a Schumpeterian processes of discovery and innovation. Similarly, patronage-based inclusion can be a source of social peace, and provisioning, albeit imperfect, of a range of social and economic services—that have been provided to middle groups and SCs in particular. Clientelistic inclusion was a reasonably effective form of bringing ethnic, often immigrant, groups into US cities in the first part of the 20th centuries. It is noteworthy that Naxalite violence is concentrated in adivasi areas: that is partly an issue of the forest terrain, but also surely associated with weaker levels of political and social inclusion of these groups relative to SCs and OBCs.)

A different failure concerns the weakness of the state itself, as vividly manifested in the abusiveness and corruption of the police service. This is partly associated with the declining autonomy of the government in the decades since independence, since this renders government actors more susceptible to the particular pressures and preferences of politicians.35 However, it is not clear that there is a necessary link between a more embedded and rent-sharing government and an ineffective, corrupt and abusive one: a case in point is again the case of Tamil Nadu, apparently an example of a patronage-ridden polity with quite high levels of state capacity, including in areas thick with public

34 See Das (2004) for discussion of the latter case.
35 See various papers collected in Rudolph and Rudolph (2008).
goods and complex coordination problems such as nutrition services (FOCUS, 2006, Walton, 2009). Rudolph and Rudolph (2008) have argued that the Weberian ideal of an independent, rules-based bureaucracy is not only unrealistic, but may not be the best means of getting high levels of commitment and effort from public sector workers: they suggest that group-based identification can also be a source of such beneficial outcomes.

Finally, some of the domains of violence can be seen as intrinsic products of the competition for rents within a patronage-based system. This is most clearly the case where there are struggles over land between business and social groups, or between different social groups. Here too there is a link with a “weak” state, in the specific sense of a state that has poorly developed, and non-credible, mechanisms for peaceful conflict resolution between social groups.

In the final, forward-looking section, I return to the question of whether state capacity can be strengthened even within an essentially rent-creating and rent-sharing system.

**Links to inequalities**

What is the relationship between rent-sharing mechanisms with social groups and inequalities? A qualitative assessment would be “mixed”: in some domains there has indeed been inequality-reducing sharing with middle and poorer groups; but there have also been major failures in the genuine creation of equality of opportunity, either on an individual or a group basis.

On the positive side, rent-sharing has led to some gains, albeit often via patronage-based mechanisms, for OBCs, probably increasingly to SCs and least of all to STs, as seen in above. OBCs and SCs have become central to the general functioning of the polity in most if not all states: many states have important OBC-based parties and leaders, Uttar Pradesh now is under the SC-based BSP and has a SC chief minister; and a small minority from all groups have risen into the professional elite (Table 5), with a parallel emergence of business elites, especially from OBCs (Damodaran, 2008). There has been a major, long-term shift in the political dominance of upper castes, with the transitions in the Southern states substantially ahead of Northern India. The variety of measures to support smallholder agriculture—from the green revolution, to rural banking, and water, fertilizer and electricity subsidies—have been driven by the political salience of the OBCs in particular. And, as seen above, there is evidence of expanded provision of public goods to poorer areas and groups, some of this in response to political reservations. Furthermore, in some areas, the first priority has been to achieve gains in dignity, with economic advance coming later (Ahmed and Varshney, 2007).

However, as also seen in the descriptive section, there has not been any dramatic movement in the relative position of different social groups. Indeed, with a few exceptions, the broad-brush impression given by Table 1 is of the persistence of group-based inequalities of private expenditures over the past two decades. This can be related to three phenomena:
a) The substantial failure of the universalistic side of the post-independence social contract, in turn linked to apparent weaknesses in state functioning. This is dramatically illustrated by the weaknesses in social provisioning, and associated deprivations in education, malnutrition and health: see, for example the PROBE report (1999) on education and the FOCUS report (2006) on the conditions of children under six.

b) The continued salience of a range of social, cultural and economic inequalities. These may have been partially shifted by the rent-sharing system, but as Mehta (2003) argues, inequality remains a central feature of Indian society.

c) Continuing areas of substantial exclusion from core social and economic processes—most vividly for large parts of the adivasi population, also to the most vulnerable segments of urban slum-dwellers and perhaps more subtly for many Muslims.

There is also a separate argument, that the pro-business and pro-market orientation of the government has been a source of inequality since the 1980s. There is something in this, as has been seen in the relative rise in business wealth and profits, spatial differences and rising returns to higher education discussed above. However, the focus here is on the relationship between inequalities and rent-sharing mechanisms. A provisional conclusion is that these have been, for the most part, successful in furthering a degree of political inclusion and some sharing state-mediated benefits of growth, but have not created equality of opportunity in any fundamental sense.

Links to growth

Now let’s turn to links with growth-related processes. Here a narrower criterion is relevant: whether the kinds of rent-sharing mechanisms being considered are aligned with both economic efficiency and, especially, processes of capital accumulation and innovation amongst social groups. Note that most members of social groups are firm- or farm-households, so efficiency and accumulation processes refer both to decisions conceptually under the ambit of households—especially around human capital formation and migration—and decisions of farmers and small enterprises over innovation and physical capital investment. These are made within the same firm/farm-household.

I have argued that rent-sharing mechanisms can sometimes support human and physical capital accumulation, and so growth. However the primary political forms of rent-sharing with social groups in India—around patronage and populism—have led to intrinsic biases against public good provision and in favour of short-run subsidies and transfers. This is why the dominant relationship has remained one of static rent-sharing. Figure 27 provides an illustration: the top line refers to subsidies (of fertilizer, water, and the loan waiver) while the bottom is of public investment—the actual divergence would be even greater if electricity subsidies were included. These biases have been magnified
in the Indian context by the recurrent theme of the “weakness” of the state in many areas of service delivery relevant to social groups.

Figure 27. High subsidies and low public investment in agriculture, 1994-2009 (in percent of GDP)

![Chart showing subsidies and public investment in agriculture from 1994 to 2009.]

*Source: Agricultural Statistics, Ministry of Agriculture, Central Statistical Organisation and RBI Annual Report (various years).*

There is heterogeneity and areas in which the state-social group relationship has been aligned with growth-related processes. To put more structure on the argument, let’s look at each of the four categories in table 7.

**Credibility.** At first sight, credibility may seems less fundamental an issue than for big businesses, where the risk of expropriation of the fruits of investment are a central concern. This is misleading: credibility is a pervasive issue. This is most clearly true for the “farm” and “firm” domain of household decision-making: while small in size, such households face exactly the same problem as large businesses, and in the context of even greater market failures and uncertainty over their political influence to secure consistency of policy. Moreover, the very pervasiveness of the Indian state makes it a source of potentially arbitrary action, as well as a source of inputs and services. This is evidenced in the power of water managers to channel flows of water to different producers, documented in the classic study of Wade (1985). It is also seen in the many anecdotal reports of harassment of informal producers by bureaucrats or police. This is almost certainly of greater continuing importance than for the large firm sector, in light of the relatively small changes in regulatory reform in areas of relevance to small producers, especially in an urban setting.

Credibility is also central to reform efforts. The subsidies in Figure 27 largely go to middle farmers, and especially to politically salient voters amongst OBCs. These subsidies are typically associated with low levels of service—especially in the power sector, that is beset with outages; farmers often have to leave their pumps on all night to
catch any periods in which power is on. Now a common argument is that there is an alternative political and economic equilibrium of more reliable delivery of power (or other service), and lower subsidy. But this has to be backed by a credible commitment to delivery on this. Dubash (2008), in a study of one set of farmers, has documented how such credibility can be lacking, making it rational for farmers (and politicians seeking their support) to prefer continuing subsidies with dismal services over reforms that would be growth-promoting for these same groups over the medium term.

Permissions and incentives. The category of “permissions and incentives” includes both regulations over economic behaviour and the diverse range of subsidies that shape the relationship between the state and social groups. Here is an interpretation:

- In some areas, of which the most important example was support for the green revolution technologies, state action has been aligned with growth-promoting change amongst farm-households.
- However, a large part of the politically and ideologically salient support for rural development has been dissipated in subsidies that got caught in static rent-sharing. The rents were typically shared between those with control over their distribution—administrators in the food distribution network, bank operatives—and households. These brought consumption benefits to some groups, most commonly middle or richer farm-households, but with little benefit in growth and at the cost of institutionalizing local systems of management and distribution of rents. Take the extensive subsidies intended to support rural banking: while there is some evidence that the expansion of the rural bank network brought small reductions in poverty (Burgess and Pande, ), the vast majority of rural households remained outside the banking system in the early 2000s, and the all-in cost of a loan was typically much higher than the formal, subsidized rate, owing to the need to bribe (Basu,)
- Other subsidies, for water, electricity, fertilizer etc, have increasingly locked farming into inappropriate patterns of production or input use: in the case of the water-electric power nexus, this has potentially serious long-run effects both on environmental management and the profitability of water-intensive agriculture.
- The periodic loan write-offs for farmers are an understandable response to genuine distress amongst farmers, and generally command broad political support—the write-offs of 2008 are an example. Yet they go directly against the objective of financial inclusion, since they provide disincentives for farmers to repay and bankers to lend.
- The urban informal sector—comprising self-employed, firm-households and very small enterprises—for the most part suffers from the threat of regulatory burden and potential for harassment, especially for bribes, but without the (inefficient) subsidies that go to farming. This is especially true given the continuing relevance of licensing and control policies and practices in urban areas. This sector has been much more dynamic than agriculture, but this has been pulled by the rapidly evolving pattern of private sector demands, not because of state support.
These are illustrations of the theme that the relationship between the state and social groups—that is with groups of farm/firm-households—is embedded in a mixture of static rent-sharing (at best) and regulatory overload at worst. This is not a necessary consequence of political strategies that favour redistribution or provisioning of safety nets: such objectives are desirable and appropriate design can align policies with efficiency and growth. To take a major example the National Rural Employment Guarantee Scheme is, if implemented effectively, potentially aligned with efficiency and growth, as well as providing short-run poverty relief. The issue is rather that political strategies have tended to channel regulations and subsidies into static rent-sharing, often with negative effects on growth.

Social and economic infrastructure. The striking failure of the Indian state in delivery of social services has already been commented on. While there has been significant expansion in the past 10 years, the quality, of schooling, health and nutrition related services often remain very poor (PROBE, 1999, ASER, 2008-2010, FOCUS, 2006). This is not only a source of profound inequality of opportunity, it is also a potential future drag on growth. Especially as India moves into middle income status, it will depend on a growing stock of secondary school leavers with more than basic skills; these further form the basis for the expansion of tertiary education. The long-term East Asian successes in growth have all had broad-based human capital accumulation as an ingredient of their long-term transformation.

At one level, failures in delivery of social and economic services is linked to the bias against provision of public goods in clientelistic political systems. But this is not the whole story: for example, the expansion of schooling can bring immediate political benefits when there is clear demand from communities, with teaching jobs and school supplies traditional sources of patronage. Additional factors lie in the interaction with highly unequal social systems, with low priorities to provisioning for poorer groups, the weakness of poor-middle political alliances, and low incentives within the state to deliver quality services, a general theme that is returned to below. The net effect is for the state, both politicians and administrators, to have incentives to provide short-term benefits, to extract rents for themselves, and not to provide quality services for all.

Coordination and complementarities. Where economic and social change requires coordinated action this can make the task for public action harder, and even more misaligned with incentives for politicians and the capacity of the state. Take malnutrition as an example: India has shockingly high child malnutrition rates for her level of income, despite the fact that the techniques for tackling child nutrition are well-known. The problem is that it involves a combination of action around information (care practices, knowledge on micronutrients), availability of food, environmental conditions affecting disease, and health care. Since this requires both delivery of a variety of public goods and coordination across several agencies, it is particularly badly aligned with the incentives for state actors; add to this socio-cultural biases against women, who are the most important actors affecting child health, both within the household and in the
interface with public and private external agencies (FOCUS, Walton, 2009). Yet again, the long-run economic costs of child malnutrition are likely to be high, in addition to the reproduction of inequalities: for human capital formation in the pregnancy and the first eighteen months of life have irreversible long-term effects on mental and physical development.

*Group-based conflict.* A final comment concerns group-based conflicts: these are likely to be endemic in a rent-sharing system in which group-identity is a source of both allocation of rents and political mobilisation—and India indeed has a high frequency of such conflicts, along lines of religion (Hindu-Muslim, and Hindu-Christian) language and geographic origin. Such conflicts are a source of heightened risk for the participants, and for businesses considering investment. This will lead to lower investment, or suboptimal investment strategies relative to a situation without conflict, or with effective conflict-management institutions. Indeed, Latin American populism is in large part a response to failures to manage distributional conflict, leading to short-run political strategies to deliver to middle and poor groups and typically business the sector as well.36

*A self-enforcing or changing equilibrium?*

The final question in this section again concerns whether the interactions between the state and social groups are in an equilibrium that is likely to be perpetuated. This is of importance to the extent that the current rent-sharing structures are a constraint on economic and social advance, especially for poor and middle groups. As with the business-state relationship, there are conflicting tendencies, some leading to greater inclusion, some tending to consolidate the rent-creation and sharing. Here is a list of the main internal processes:

- A continuation of the steady rise in the political salience of many middle and poorer social groups, alongside some groups remaining at the margins of the state—especially adivasis in Naxalite areas
- The continued sharpening of group affiliation as a political factor, with both local and broader strategies (but still primarily within geographic states) having incentives to seek rents.
- State actors—politicians, administrators, judiciary—having strong incentives to predominantly work within the rent-creating and sharing system—whether in terms of delivery of private and public goods, or extraction for their own benefit. The other side of this is low effort to delivery quality services.
- On the other hand, there will be slowly rising demand for quality service delivery, with the expansion and consolidation of the middle class, as well as other forms of mobilisation of civil society, but with uncertain effects on overall functioning of the state.

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36 Though in most Latin American cases, this was frequently in opposition to landed elites—a function of the particular historical circumstances in which populist strategies, and associated alliances, arose.
The net effect of these forces will have a major influence on long-term growth, as is taken up in the forward-looking section below.

**Spatial development and rents**

Questions of the spatial allocation of resources were incorporated into the legal and institutional design of the Indian state. They are also intricately linked to issues of the design and functioning of the rent-creating and rent-sharing system. They are reviewed briefly here.

In the “pre-reform” period, the spatial direction of resources was both a core criterion for industrial permissions under the License Raj and central to the priority to rural development. While these two impulses of policy design were notionally driven by goals of equitable development, both were distorted in practice.

With respect to industrial policy, there were sharply contrasting experiences depending on the nature of the relationship between state-level actors—in government and business—and the central government. Based on an in-depth study of three states, Sinha (2005) explores the contrast between the essentially cooperative relationship between business, state government and the Union government of Gujarat, a more conflictive relationship between the West Bengal government and both business and the Union government, and a mixed relationship with the Tamil Nadu government. This was consistent with Gujarat’s long-run takeoff and West Bengal’s industrial stagnation.

With respect to rural development, as noted in the preceding section, the strategy was substantially distorted by the emphasis on subsidies and other forms of rent distribution.

With the reforms, the most interesting changes occurred for large-scale firms in the industrial and service sectors. There was an effective liberalisation from the License Raj goal and practice of seeking to equitably direct activities across geographic locations. But there are then important twists to the story:

- The spatially divergent patterns described in the descriptive section emerged as firm investment strategies pursued a mix of the benefits of agglomeration economies and better business environments—with more responsive state governments with greater credibility in the states such as Gujarat and Tamil Nadu than in West Bengal or Uttar Pradesh. Such agglomeration effects can lead to new sources of rents driven by increasing returns to proximity. To a significant degree these are “dynamic” rents, associated with Schumpeterian and learning processes.

- However, the urban setting in particular, and land in general, has remained a major domain of government licensing and control. The policy of introducing Special Economic Zones can be seen in part as an attempt to avoid the constraints in land allocation in urban areas, but has emerged as a new site for rent-seeking and sharing.
These two processes often occur in the same site and industry. Take the iconic IT industry, that became one of the highest profile Indian economic activities in the past decade, first in Bangalore and then in Hyderabad and other cities. This seems a quintessential example of Schumpeterian creation. Yet the IT sector was also a major beneficiary of favourable land allocations (Ramanathan, 2007), not to mention the tax breaks provided to the sector.

By contrast with the major changes in urban-industrial-service interactions, it is not clear that there has been a major qualitative change in the major instruments of policy affecting rents in rural areas. Where there has been a large change is in the institution of Panchayati Raj: after the 73rd constitutional amendment of 1993 significantly greater powers were devolved to the third tier of government. There is already a significant literature on the effects of this (see Besley, Pande and Rao, 2004 for one example). This is a major experiment in deliberative democracy, but it is too early to assess whether it leads to a transformation in political-economic relations at the local level. Meanwhile the primary locus for rent creation and allocation is still at the level of the (geographic) state.

The other major change has been the rise of regional political parties in many states, increasing their influence not only in their states but also over the centre in an era in which the two national parties—Congress and the BJP—have had to rely on coalition partners. While this has had a major influence on political dynamics it has not led to any fundamental shift away from a rent-sharing system. It has at times been associated with different patterns of rent-sharing from the centre: the Tamil Nadu parties have been particularly adept at getting control of rent-thick union ministries, with telecoms a notorious example in the wake of the 2G scandal. What has happened to state-level rent-sharing systems has followed local political dynamics, with continued high levels of variation in terms of consequences for growth and human development.

How do spatial aspects of the rent-sharing system interact with the questions of inequality and growth, and is it a changing system? Here is a summary assessment.

**Inequality.** In this period, spatial influences have been tended to bedisequalizing via two mechanisms. First there has been an often unequal spatial location from the shift in relations between the state and business—between Indian states, and between districts. Some geographic centres effectively made the transition to dynamic rent-sharing paths: for example, Gujarat, Andhra Pradesh, Karnataka and Tamil Nadu did particularly well. But this was not because they shifted to a clean politics and Weberian bureaucracies! Rather their rent-sharing systems were highly aligned with dynamic growth. Other states—Bihar (until the mid-2000s), Uttar Pradesh, West Bengal—effected less change. The second reason is the continued embeddedness of most rural policy in static rent-sharing, that meant that rural areas generally got left behind, with Indian agricultural productivity suffering slow progress, despite often low initial levels.
Growth. Effects on growth have been positive, in large part because of the takeoff of the more dynamic states. But even in the dynamic centres, there are potentially rising distortions that could hurt growth in the long term: within urban-land-industrial nexus in the continued importance of controls and their links with political processes; and again within the rural nexus, in the long-term failure to increase the growth in productivity. On the other hand, there may be potential for poor states to catch up, as exemplified by the growth acceleration in Bihar under a more developmentally oriented administration.

A self-enforcing or changing equilibrium? As in other areas, there are internal forces that move in different directions. On the one hand, both economic agglomeration influences and divergence in institutional capacities tend to lead to the consolidation of spatial inequalities. However, slow-growing political regions could potentially benefit from the economic proximity to dynamic areas in terms of markets and mobile capital, and political pressures to emulate development success in other states.

Educational processes and rents

Rents have been a central feature of India’s educational system. This applies first of all to the recipients of education, at all levels. Access to schooling of decent quality has been effectively restricted, at least until the most recent period, starting with the most basic education. Higher levels of education, especially access to the elite tertiary institutions, is at one level meritocratic, in the sense that test scores on entry exams are the primary determinant of entry. But preparedness for these exams is profoundly influenced by the history of educational access to primary and secondary schooling. At tertiary levels, the reservation system for SCs and STs is overlaid on this underlying inequality in access. As noted above, this has indeed brought benefits to a small minority from these historically deprived groups, but it is generally from households that are substantially better off than the average within SCs and STs.37 This is not necessarily a bad thing: part of the intent of the reservation policy was to create an elite amongst these groups. But they, like others, are effectively recipients of rents.

There are also large rents on the supply side. This is first of all true amongst teachers: while by no means well off by international standards, teachers in government schools have incomes that are much higher than they would otherwise have obtained in the market, given their qualifications, according to Pritchett and Murgai (2007). Teachers in private schools generally earn much less. Less well-documented is the presence of rents on the supply side of tertiary education. While there are pockets of real excellence, the government university system seems to be stuck in a low-effort, high inertia equilibrium. Yes, teaching faculty tend to receive low salaries (if somewhat less so after the 2008 adjustment), but there is job security, weak incentives for high effort in teaching (again outside the elite institutions) and sometimes housing. On the private side, there are

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37 This is illustrated by the careful empirical study in Bertrand et al (2008): the expenditure per capita of households of students who gained entry to the engineering school is much higher than the average for the same group in the population.
anecdotal reports of favors in the permissions to open new colleges, that is a potentially lucrative source of income, given the surging demand for skills.

Cutting across these conditions are two truly large changes: the expansion in government education, and the entry of private schooling, in the form of educational establishments and tuition. Both are occurring at all levels. This is important context for a suggested interpretation on the three areas of focus.

**Inequality:** The education system plays a central role in the reproduction of inequalities within and between generations: poor kids go to poor schools and end up with poorer jobs and lower incomes; their children also have worse schooling. This contrasts with the longstanding aspiration to use education as a mechanism for creation of more equality of opportunity. The growing access of poorer children to basic, and increasingly beyond-basic education, is an immensely good thing, but will not necessarily lead to greater equality. The educational mechanisms for sustaining inequality could shift to differential access to (better quality) private education and consequentially differential access to higher education. Latin American countries have had major educational expansions in the past—with a further push in the wake of the 1980s wave of democratisation—but it has taken along time for their to be a major impact on inequality. Rather access to tertiary education has become the primary locus for the perpetuation of inequalities (De Ferranti et al., 2004)

**Growth:** Some commentators have argued that India’s unusual pattern of growth acceleration was shaped by her unusual educational endowment: poor basic education alongside tertiary centres of excellence producing large absolute numbers of engineers at low international prices (Kochar et al. 2006). This also explains the relatively slow take-off of labour-intensive manufacturing by East Asian standards, and impressive growth in services, such as outsourcing. However, the absorption of the stock of highly skilled workers is of course the reason why high-level salaries have taken off. So the big growth question is whether the supply response at basic-to-secondary level and of tertiary high skills with be sufficient. Absent this, skills will become a constraint on growth.

*A self-enforcing or changing equilibrium?* The education system is clearly in transition, and is not in a self-enforcing equilibrium as a whole. But the questions remain: will the beneficiaries of rents on the supply side of the governmental system successfully preserve the existing system, with its inertia and strong tendency to low quality? And how large will the medium and long-term response the private sector be? The answers to these will shape both growth and inequality dynamics in the coming decades.

**Is the Indian state weak?**

A cross-cutting issue in much of the interpretation here has been the apparent failings of the Indian state. A recurrent theme has been that rent creation and rent-sharing may be suboptimal relative to some ideal of limited government, with Weberian bureaucracies enthusiastically following rules of behaviour, driven by goals of set by democratic
processes. But such an ideal is unrealistic, and rent-based systems can be a “good-enough” second best, for growth dynamics, for social peace and service delivery. The problem is that when this is also combined with an ineffective state the outcomes can be really bad.

So is the Indian state ineffective? And is this a necessary consequence of rent-based systems?

The Indian state is typically characterized as being active, pervasive, but “weak” in its implementation of public action. Pritchett (2008) refers to India as having a “flailing” state. However, an account of generalized weakness is unsatisfactory. At a cross-country level, there are indicators of “government effectiveness”, based mainly on subjective assessments by investors and citizens. As Figure 28 shows, there is, on average, a strong positive relationship, but lots of variation at any given level of income. India performs reasonably well for its current income level, comparable to China and Mexico, but significantly below Chile, Malaysia and Korea, as well as rich countries. That may come as surprise to many. It could be based on problems in the data, that is largely based on synthesis of various subjective sources. However, it is capturing perceptions of at least some groups who deal with the state.

**Figure 28. Government effectiveness and national income: India in international perspective (2009)**

![Graph showing relationship between government effectiveness and national income](image)

**Source:** World Bank Institute governance data base and World Development Indicators

There is also substantial variation within India. Macroeconomic policy is generally well-managed, or, more precisely, while there is room for disagreement of choices over interest rate and fiscal policy, the macroeconomic managers, especially in the Reserve Bank of India, effectively implement what they judge to be desirable. Or take Indian Railways, that is one of the largest companies in the world, with over 1.5 million employees, and a natural vehicle for patronage. Trains are not always on time, but it is a

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38 See Kaufmann et al (2008). This is based on a compilation of a range of mainly subjective measures by investors and citizens.
system that works—perhaps remarkably well relative to its size. By contrast, the state health and education systems generally perform dismally—with problems even in getting nurses and teachers to attend their clinics and schools. When they do attend there is widespread evidence of low quality. Similarly, most observers agree there large differences in performance across states—a standard comparison is between the Southern States of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu and Northern and Eastern states such as Bihar, Orissa and Uttar Pradesh.

As an example, consider nutrition-related services again. As noted above, India’s performance with respect to child malnutrition is awful—with respect to other countries at a similar or lower income level, and in terms of the lack of progress over time, including in a period of rapid aggregate growth. This is in spite of the fact that India has had a large-scale programme oriented toward child development, in the form of the Integrated Child Development Services, for decades. There is little or no evidence that this programme has had a positive impact in the aggregate. According to the FOCUS report this was associated with a classic mixture of weak incentives for effort and disempowered front-line workers in the anganwadis (village-level child development centres). The general assessment seems even worse than for basic education; it was suggested above that this is due to the importance of both public good provision and coordination across agencies, making it badly aligned with political incentives to deliver to supporters. However, this does not seem to be inevitable. Even within this programme, the FOCUS report found a markedly different level of performance in Tamil Nadu, with well-supplied and attractive anganwadis managed by motivated staff. Tamil Nadu has a long history of developing an initially distinct programme, and has maintained an equilibrium in which the organisational culture and individual incentives supported reasonably effective state performance.

Alongside this variation across agencies and space, a central narrative of the Indian state in the post-independence period is of transition from a significantly autonomous state to a pervasive but constrained one. In the initial period the political leadership—and especially that of Jawaharlal Nehru—used the state as an instrument of change for the modernisation and socialist project. This was facilitated by the decision to take over the core structures of the colonial civil service and put them to use to this end. However, in the decades from Nehru’s death to the present, societal embeddedness has risen through processes of politicisation, patronage and the institutionalisation of corruption. While the state is not fully embedded, it has become substantially constrained by societal and political influences, in the diagnoses of Rudolph and Rudolph (2008).

So how can this be interpreted? This is one of the major questions for India’s future. Rent-based systems can undercut the performance of the state, through diverting effort into preservation of public sector rents, the pursuit of corruption, and channeling of goods and services to favoured groups. Furthermore, there is an argument that the very ineffectiveness of the state in areas of public good delivery helps sustain an equilibrium in which politicians rationally choose to provide short-run benefits—either to specific
groups or, in populist vein, to all—since the state cannot be relied upon to deliver on promises on real public goods of quality education or better nutrition. However, the areas of relative success—the railways, malnutrition in Tamil Nadu, and the broader reputation of the state getting things done in Gujarat and Tamil Nadu—suggest there is no necessary link with rent-seeking and sharing processes. It is not because Gujarat and Tamil Nadu are innocent of rents. And the issue is not how to move “weaker” parts of the Indian state to a Weberian or other ideal, but how to get shifts in the existing, rent-thick system, to an equilibrium that is consistent with the overall political and social conditions, but in an equilibrium that supports both more effective state action, and action that is more likely to deliver on public goods. That is a big question for the future.

**Alternative scenarios and the process of transformation**

This section turns to the future. I sketch a qualitative account of the relationship between potential trajectories of institutional change and long-term development. This flows directly from the interpretation of the nexus of unequal structures and institutions developed in the preceding parts. While speculative, I believe it provides a useful way of framing the issues.

As a heuristic device the discussion is constructed around two qualitative scenarios (Figure 29): one involving the entrenchment of old and new inequalities; the other of transformation.
The first scenario is termed the (further) “Latin Americanisation” of India. This is a metaphor. It may not work for everyone, but I think it is a useful metaphor, since it captures the mix of structural inequalities and the middle income trap that have typified countries such as Brazil and Mexico. It has become even more apt in the past two decades since most of Latin America returned to democracy in the 1980s. I also think it may provide additional, and potentially more relevant, insights, than the more commonly used comparison of India with China. (A structured comparison with China’s rent-sharing system would be fascinating, but falls outside the scope of this paper.) The key features of this scenario are:

- Consolidation of oligarchic capitalism, in which major business groups wield disproportionate influence over markets and the state.
- Intensification of group-based conflicts, in legal and extra-legal arenas.
- Continuation or deepening of spatial disparities with respect to economic, social and institutional conditions.
- Basic and tertiary education continuing to be sites for the reproduction of inequality, despite expansion in overall access.

The second scenario is termed “transformational”, so-called because there is major institutional evolution in the political, social and economic domains, that fosters greater
equality of influence and citizenship, and does so in ways that supports dynamic growth. This is the counterpart of sustained rapid growth rate comparable to the experience of Japan, Korea or Taiwan in their high-growth periods. As discussed in Kharas (2009), this could lead to India becoming a high income society in a generation—by around 2040. This scenario contrasts with the previous along all four dimensions:

- Consolidation of competitive capitalism, in which the dynamism of large and small businesses depends on innovation rather than influence.
- Genuine group-based equity, but effected by increasingly programmatic politics, with reduced politicisation of group-based identities.
- Upward economic and social convergence of poorer regions, effected by institutional convergence in poorer states and districts.
- An increasingly meritocratic education system, in which all children have access to similar educational possibilities.

There are connections between the varying elements of these scenarios, with the functioning of the polity and society central to all. Figure 29 uses the term “institutional design” not to refer to some external, technocratic choice, but to the product of internal political and social processes. While interconnections are important, the remainder of the discussion is organized around each of the four dimensions of structural inequality. In each case I discuss both how current forces may lead to the adverse inequality-development dynamics of the Latin Americanisation scenario, or alternatively the institutional elements and scope for agency to achieve a transformational path.

**Concentrated corporate wealth**

Concentrated corporate wealth, often linked to family-controlled business groups, could shift over time from being a source of growth to becoming a rising drag on the growth process. Here I outline elements of alternative scenarios of oligarchic and competitive capitalism, and draw lessons from historical transitions on the potential for change.

A central aspect of the story to date is the rising relative power of the large-scale business sector vis-à-vis the state and society. Here are features of a scenario.

- As discussed in preceding sections, business groups can play a valuable, growth-promoting role during periods of rapid growth, through their capacity to manage risk, solve capital market failures and coordination problems, and enforce “pro-business” state behaviour.
- But this can go hand in hand with the entrenchment of power, with a combination of consolidation of market dominance and influence over a corruptible state. Market dominance, especially when supported by influence over the state, can lead to creation of high-cost production structures, especially in the production of non-tradables, and pursuit of monopoly rather than dynamic rents. Both are detrimental to long-term growth dynamics.
The common organisational form of pyramidal, family-controlled groups can lead to corporate control by the core family that is substantially in excess of ownership shares, and potentially a source of expropriation of minority shareholders. A common mechanism (documented for India, as noted in the preceding section) is through “tunneling” of profits up the pyramid—to parts of the business group with a higher share ownership by controlling shareholders. This can be legal; other techniques can involve outright fraud, as in the case of Satyam, that came into the open in early 2009.

A further, pernicious, effect works through the undermining of the autonomy of the state, whether through use of direct financial influence over the judiciary, politicians and the executive, or, more subtly, in a failure to advocate for thoroughgoing judicial and state reform that would assure more equitable and transparent processes. A particularly problematic area lies in the murky area of political finance.

In some sectors and firms, e.g. in mining, there could play out a particularly damaging relationship with “weak” governments (e.g. Chattisgarh, Jharkand, Orissa), leading to widening institutional divergence between states or districts. The management of land access in cities is also highly vulnerable to the deepening of unequal influence from powerful businesses.

Two issues are relevant to this scenario. First, external trade liberalisation is no guarantee against the entrenchment of oligarchic capitalism. And, second, the transition from big business being a source of growth—albeit with concentrated wealth—to a drag on growth is highly plausible. Both can be illustrated by Mexico—that has an economy still around the same size in current dollars as India. As Figures 1 and 2 vividly showed, Mexico had “miraculous” growth, and then got stuck.

Mexico started opening up its economy from the late 1980s, and in 1994 joined a free trade area with the United States and Canada, under NAFTA. From then it has been substantially more open than India after her liberalisation. This did induce major industrial restructuring, substantial growth in non-traditional exports (much faster than the rest of the economy), and major inward investment. Moreover, there is evidence that rents in manufacturing are lower than in other sectors: the premium on worker wages (a sign of shared rents) is significantly lower than in sectors such as petroleum, electricity, teaching and telecoms, all sectors that continue to be protected. Meanwhile, family-controlled business groups have continued to dominate the economy, and, as in India, this has led to major growth of billionaire wealth (LópezCalva, Guerrero and Walton, 2009).

With respect to effects on growth, an important part of Mexico’s problem has been its high costs in non-tradable sectors—or sectors rendered de facto non-tradable by market structure (telecoms) or explicit policy (public ownership of petroleum and gas). Telecoms is an iconic case: the state telecoms company, TELMEX, was privatized at the beginning of the 1990s, given a temporary, five-year, monopoly, but has since then managed to use its initial position of market dominance, backed by substantial influence
over the telecoms regulator, to maintain substantial market power. TELMEX’ profits was a major source of the wealth creation of one of the richest men in the world, Carlos Slim Helú. This has led to Mexico having some of the highest telecoms prices in the world plus relatively low coverage—classic behaviour of a monopolist. And this is not because of inefficiency: after privatization TELMEX became an efficient company by international standards, but the gains have been captured by the operator (and partially shared with telecoms workers) rather than passed on to consumers. Given the centrality of telecommunication to modern production, this puts Mexico at a significant competitive disadvantage. Meanwhile, TELMEX has been successfully expanding into other countries—where it is a beneficiary of more competitive market structures!

Now why is this relevant to India? Is India at risk of following the oligarchic capitalist route? And why the concern with family-run, pyramidal businesses? After all, some of the most successful countries in the world have had similar business structures. Think of the Wallenberg business empire of Sweden; Japan in the early phases of her industrialisation; or Indonesia, Korea, Malaysia and Thailand in their recent periods of rapid growth. (And note in Figure 9 the importance of billionaires in East Asia prior to the 1997/98 crisis.)

A central theme of this paper is that family-dominated business groups bring both advantages and problems. As already discussed, Evans (1995) has argued that securing the dynamic benefits of large-scale corporate entities depends on the nature of the relationship between the state and business. His interpretation of the success of countries such as Korea is that a state that is both “embedded” (well-connected and responsive to business needs) and “autonomous” (and so resistant to capture and distortion) is most likely to get the balance right. But in the very cases of great success in fostering major business enterprises, there are the seeds of destruction of such a relationship, precisely because of the rise in the relative power of the large-scale business sector. Many of Korea’s chaebols brought spectacular productivity gains and became globally competitive firms. Yet corruption and influence is reckoned to be part of the problem behind Korea’s vulnerability to the 1997/98 East Asian crisis. After this crisis, East Asia became known as much for its crony capitalism as its miraculous shared growth.

India looks structurally vulnerable to a shift toward entrenchment of oligarchic capitalism, precisely because of the relative lack of autonomy of the state—that is relative both to historical cases such as Korea and to the rising market power of the Indian business sector. And as seen in the case of TELMEX, oligarchic capitalist structure is consistent with globally competitive firms.

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39 See Del Villar (2009) and Noll (2009) for discussion.
40 Indeed Evans thesis of the nature and success of embedded “autonomy” in Korea is developed in contrast to Brazil and India. See also Subramanian () on the interpretation that there has been at least a decline in the relative performance of India’s state (relative to other countries).
What are the elements of an alternative? Does capitalism need to be “saved from the capitalists” (Rajan and Zingales, 2003)? Let’s look at this from two angles: first the ingredients of market and institutional structures; and second, historical cases of transition from oligarchic to more competitive market structures.

Here are some elements of institutional design that will support dynamic, competitive capitalism.

- Competition effected by open markets, where this is feasible, complemented by an effective, independent regulatory structure to tackle anti-competitive practices. In India a striking symptom of the recent period was the large delay in implementation of the 2002 competition law. It was enacted, challenged, and then took four years to be amended, and then only began to be implemented from 2009. And while the legislation is an improvement on the preceding law, it still has weaknesses, excluding, for example, the critical infrastructure sector (Bhattacharjea, 2008). The procedural reasons for delay were not without validity, but the delay is symptomatic of a failure in political and executive commitment in resolution and implementation.

- Legal designs and practices to protect minority shareholders and support shareholder rights.

- Development of effective procedures to reduce influence and corruption in areas of government discretion—notably in infrastructure (whether in public-private partnerships or public provision), land allocation and mining rights. As often in India, the issue will sometimes be around legal designs, but equally around the ways in which well-intentioned policies are distorted or subverted in implementation.

- A broad-based financial sector, that provides access to finance for all viable firms and products—subject of course to a sound risk-management framework. This is uncontroversial in principle, though there are important issues in policy and institutional design in developing an efficient and inclusive financial system.41

- Reform of political finance, in the first instance through transparency over donations and sources of financing for political campaigns.

- Transparency and accountability vis-à-vis broader societal and political structures—both societal watchdogs and the legislature (especially as the latter evolves in competence and autonomy.)

- Last, but far from least, an independent and effective judiciary, backed by other ingredients of a law and order system. Here too a fine tradition of judicial independence has been steadily eroded, and made substantially worse by the extraordinary backlog in cases.

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41 There have been a series of independent reports on financial sector reform; see in particular the report of the Rajan Committee (2008) on the need to combine efficiency-related reforms with greater financial inclusion.
It would be foolhardy to predict how India’s business structure will look in 30 years. It is likely that it will have a mix of familiar and new names, with India-based global firms alongside medium and small firms. However, a scenario of transformation to high income status will require institutional underpinnings such as these, that support competition, regulatory independence and transparency; underpinnings that channel capitalist energies into Schumpeterian creation and learning rather than pursuit of influence-based rents. This is likely also to involve the predominance of dispersed ownership of large publicly listed firms, or at least with family-controlled firms subject to internal checks and balances from shareholder pressure and auditing procedures.

So the next question concerns why change would occur. Why should emerging business empires, able to make the existing system work for their own interests, support a shift to a system with institutionalized checks and balances, especially when this involves the long haul of state reform? Part of the answer lies in the view that such a shift is in the collective interest of the business sector. But first let’s look at two historical episodes of transition.

Japan provides a first example (Morck and Nakamura, 2007). In the modernisation drive after the Meiji restoration in the late 19th century, the Japanese state initially tried itself to solve the coordination and financing issues that are central to economic takeoff at low levels of development. This largely failed. (There may be parallels with India’s post-independence history here). It then effectively handed over the problem to emerging family-controlled business groups, that became known as the zaibatsu. These conglomerates were central actors in Japan’s industrialisation through the first few decades of the 20th century, a period that also laid the basis for the post-war growth. The zaibatsu were solving coordination and financing issues within their conglomerate structures, and through their broader scale and influence in the economy. It is worth quoting Morck and Nakamura’s conclusion from their interpretation of this case:

"A big push can succeed under certain circumstances despite gloomy evidence to the contrary. Specifically,
1. The state gives an initial shove, marginalizing traditional elites, reforming basic institutions, perhaps even subsidizing technology imports, and then withdraws its hand. This withdrawal checks government failure problems.
2. Pyramidal business groups emerge to propel the big push. An undisputed controlling shareholder focusing on the apex firm’s value, prevents hold up problems and coordinates cross-industry subsidies, as group member firms tap public equity markets to capitalize cascades of subsidiaries spanning all relevant industries. At least to some extent, this echoes what a selfless central planner coordinating a big push would do.
3. The controlling shareholders are marginalized as the big push nears completion. This prevents entrenched oligarchy problems from reversing the big push.
4. All this is done with limited trade barriers and no barriers against foreign investment.

If this thesis is valid, Japan offers an alternative big push prescription for today’s emerging economies."

Morck and Nakamura (2007) p.43-44
In Japan’s case the rising power of the zaibatsu was checked first by the Japanese state itself, with the rise of the militarized state in the 1930s, and then by external action in the form of the United States occupying force, after the Second World War. Morck and Nakamara themselves express uncertainty about the replicability. Note in particular two crucial elements of this account that would need to be faced in India: the “reforming of basic institutions” and preventing “entrenched oligarchy problems.”

A different process occurred in the United States, even more instructive for India since it occurred under democratic auspices (Robinson, 2009). The background lies in the rise in the “Robber Barons”, a group of extraordinarily successful businessmen who emerged in the last third of the 19th century. In this “Gilded Age” the United States went through major economic transformations in transportation and industrialisation and became the largest economic power in the world. Businessmen such as Andrew Carnegie, John D. Rockefeller and Cornelius Vanderbilt were central players. They amassed enormous personal wealth, and were called robber barons (by some) on the grounds that this was acquired in part through unethical practices and abuse of monopoly power. Construction of railroads—and the benefits from land granted as part of the process—was a source of many of the barons, and they developed diversified conglomerates, known as “trusts”, often with immense market power. John D. Rockefeller formed and controlled Standard Oil, and became one of the first billionaires in modern history. (He later distributed much of his wealth in philanthropy.) A vivid contemporary view of the power and reach of Standard Oil is shown in Figure 30. Yet the other side of personal wealth creation and unethical business practice was the contribution to the United States’ overall economic transformation and development of industrial capabilities. There are again echoes of India’s recent period.
By the early years of the 20th century, there was extensive social reaction to the wealth and power of the trusts. This was made effective by its base in organized political movements (Robinson, 2009). Much of the criticism was over wealth concentration, but there was also concern that the trusts were strangling overall growth—just as in the recent debates over the role of monopolies in Mexico. The political movement laid the basis for a concerted effort, led by the state, to break up the trusts. Standard Oil itself was broken up by order of the Supreme Court in 1911, though the work of balancing the power of large business continued for decades.

In these historical cases, concentrated business power played an important role in early phases of economic transformation, but excessive power was then checked in the transition to further phases of growth. In Japan, non-democratic state actors were the main players in controlling oligarchic business power. In the United States it was a democratically elected executive working in alliance with political and social movements. For India, it is the US experience that looks most relevant.

Add to this consideration of the interests of the business sector itself. The business community as a whole has a strong interest in pushing for institutional structures that provide both checks on opportunistic, corrupt or exploitative behaviour of individual businesses and development of a more effective state, alongside greater societal pressure for competitive capitalism. This is fundamentally a collective action issue, and thus displays the classic problems of collective action: beneficiaries of the current system can make it work for their private business interests; movement to a better system is uncertain
and could involve forsaking such individual interests. Yet the business community as a whole has to be a central player in any change. Debate within the community and development of a code of ethics can play an important role. But it is difficult to imagine creation of the checks and balances on business without an effective state, designing and implementing the institutional design outlined above. Business also has a role here, in utilising its political capital and skills to push for state reform.

Identity-based differences

The dynamics and associated risks of identity-based differences, distributional fights, and implications for patronage, were discussed in the interpretative section. Here too India has parallels with the Latin American experience, for which cleavages between groups of European, indigenous, and African origin have been salient for a long time—and remain so despite extensive mixing. India is arguably “ahead” of much of Latin America in two respects: both vertical and horizontal group-based conflicts are more open and explicit; and there has been concerted public action and legislation to tackle this along at least some of the dimensions. But it is also easy to be pessimistic, along several lines:

- Hindu-Muslim differences show few signs of abating, along with the continued salience of Hindutva political movements. Moreover, these interact with an inauspicious regional context, especially with respect to tensions with Pakistan.
- While the rise in the dalit-based political movements is an important, and in many ways a desirable, phenomenon, it is unclear whether this will develop in terms of provisioning of public goods and development dynamics.
- Conversely, adivasi groups suffer from much weaker organisation, and are particularly caught in the destructive interaction between Naxalites and the state.
- Other axes of group-based conflict continue to be salient—in 2008-09 period, this included Hindu-Christian violence in Orissa and Karnataka, and violence against Northern Indians in Mumbai.
- Identity-based politics could continue to hold back the development of programmatic parties.

International experience only confirms that these are tough issues to manage in a heterogeneous society. Identity-based differences are extraordinarily persistent, and can lead to either sustained deprivation and stigma, or open conflict. The United States is a partial model, with its history of incorporation of immigrant groups. It is currently a symbolically potent one with the election of a black president. But that should not hide the extraordinarily persistent relative deprivation and stigma attached to African Americans (Loury, 2002). The United Kingdom experienced decades of violent conflict in the Troubles between Catholics and Protestants in Northern Ireland. South Africa is struggling with policies that foster black empowerment, but may be creating a small rent-sharing black elite rather than genuine equality of opportunity for all.
Affirmative action will clearly continue to be part of the story, and there is a particular challenge in escaping from the trap of the “demand for disadvantage” (Somanathan, 2007) and fights over static rents that have become integral to the reservation approach. There is some creative thinking on how to pursue the end of affirmative action through alternative means, that seek to escape this trap: for example through use of a “diversity index” in organisations affected by reservation policy, as opposed to quotas, and strengthen anti-discrimination legislation.

Making affirmative action work better is important, but reservations will continue to receive too much weight within a strategy oriented towards pursuit of equity if:

(a) the political classes continue to have incentives to mobilize support around group-based identity;

(b) universalist principles of citizenship continue to fail.

These have counterparts in public action that are outlined here.

*Reducing political incentives for group-based mobilisation.* The second interpretive section discussed the reinforcing links between group-based political mobilisation and a patronage democracy, drawing on Chandra (2003). So what could make a difference? Here are three areas:

- **A more effective state.** One of the reasons politicians have low incentives to follow political strategies promising public goods that benefit all groups is precisely the ineffectiveness of the state. If they cannot rely on actors in the executive branch, promises to deliver on public goods will not be credible. Strategies that emphasize conflicts with “other” groups can then be more reliable, in an extreme making a politics of hate a means of sustaining support. Conversely, a more effective state will shift the relative incentives toward political strategies that favour public good provision, or at least cross-group appeals.

- **Greater intra-party competition.** The lack of internal competition within parties means aspiring politicians have incentives to please the party hierarchies rather than be accountable to their constituents. As noted above, this was an important reason why emerging *dalit* elites pursued a strategy of leaving the Congress to set up the BSP. Democratisation within parties is intrinsically desirable, especially if linked to stronger links between individual politicians and constituencies.

- **Deepening of local democracy.** The development of local fora for social and political debate in the *panchayati raj* system provides an arena for deliberative processes between different groups. Evidence from the functioning of deliberation now finds that the form of interaction often remains embedded in socio-cultural differences linked to group-based status, but there is the potential for the very process of deliberation to shape the identities and agency of subordinate groups

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42 I am indebted to Pratap Banu Mehta for this argument.
(Rao and Sanyal, 2008). If successful, this would be a different process from those that occur via reservations, and one that could foster a move toward genuine equality of agency. There appear to parallels with the political and socio-cultural transitions in sites with deep participatory processes, notably Porto Alegre in Brazil (Abers, 2000).

Universalism and citizenship. As frequently emphasized here, the post-independence vision for dealing with historically shaped deprivation involved two elements of a social contract with historically deprived groups: creation of political and intellectual-managerial elites via the reservation policy; and universal provision of services for all. The bigger failure was on the second part of this.

Deepening of universalist policies is both intrinsically desirable and could gradually offset harmful aspects of identity-based conflicts. Some of the action falls within the realm of making established policies work—provision of basic education for all, water and sanitation for all, and so on. However the issue goes beyond the adoption of policies; Indian governments have been good at that. The real issue lies in changing incentives for the behaviour of state actors, for which changes in the nature of state-society interaction is central, complementing strengthening of specific rights with social mobilisation. There has been significant creativity in India in this area in the past decade or so. The Right to Information Act is an important example of a policy that can potentially empower citizens, though the capacity of different citizens to access remains unequal.

The design of the National Rural Employment Guarantee Scheme is an important and interesting example, because of its incorporation of a right of all citizens to access a given number of days of work, the prohibition of private contractors and complementary requirements on social audits. The social and economic rationale is to provide a safety net in the context of highly imperfect private and informal insurance markets (especially when communities suffer common shocks.) But these institutional designs are also concerned with breaking through the pre-existing political equilibrium around provisioning of local works, that involved discretionary action by politicians or other state actors. The old system intrinsically involved provisioning of rents to both recipients and contractors, creating incentives for bribes and patronage. The NREGA institutional form—when it can be made to work—removes these incentives. Implementation appears to be highly varied, with resistance to the new mechanisms in parts of the country, including violence against some involved in social audits. These are important issues to tackle, that could undermine NREGA’s effectiveness. But they can be seen as evidence that the institutional change is indeed challenging the existing, distorted system.

History suggests that resolution of group-based conflicts is a long and complex process. The suggestions here are not intended to deny or dissolve socio-cultural differences, that will continue to evolve and form a central part of India’s society. Differences per se are a source of a society’s cultural wealth. What is problematic, in both the short term, and for long-term development, is the politicisation of group-based identity and the associated
heightening of conflict, especially over static rents. There is a need to pursue complementary mix of continued (and potential reformed) affirmative action, political reforms that reduce incentives for political classes to utilize group-based identities and a broader pursuit of universal citizenship.

Tackling spatial inequalities

On spatial inequalities, Latin Americanisation remains a relevant comparator—all large Latin American possess have regions that have experienced long-term relative deprivation, with political, economic and social institutions inter-twined in the nexus. The Southern states of Mexico and the North East of Brazil are examples. Such spatial inequalities are not a Latin American preserve, but also a feature of virtually all large countries: examples from Asia include China’s inner provinces and Indonesia’s Eastern Islands.

There are several reasons why current forces could lead to continued inequalities, and adverse aggregate development effects:

- The interaction between agglomeration forces and institutional divergence tends to lead to persistence, and this can be magnified by differential benefits from global integration. This has been a source of divergence across and within India’s states, and was also experienced by Mexico when it joined the North American Free Trade Areas.
- The evidence on successes from proactive national pushes for regional catch-up, for example via pushing infrastructure are weak. In a recent review of the potential for this strategy for India, Chakravorty and Lall (2007) were pessimistic of this working. The North East of Brazil or the South of Italy have experienced decades of regional policies but still suffer relative deprivation. Indeed, such regional policies often become new domains for the distribution of rents.
- Urbanisation is a huge and unruly domain of action: India is highly under-urbanized now, will go through massive urbanisation in the coming decades (Figure 31 is suggestive); and yet she already has immense urban problems and weak urban governance. This is an area in which many Latin American countries and cities are way ahead.
- There is plenty of scope for adverse effects from continued lagging regions, precisely because they are so populous. This could occur through two pathways: through the potential electoral and political pressures for populist national policies from poorer states (i.e. further pursuit of static rent-sharing with a short-term horizon); and the interaction with identity-based conflicts in migration-receiving areas, as seen in 2008 in Marathi-North India conflicts in Mumbai.
What might an alternative path look like?

- In the medium term, the most hopeful scenario is of institutional changes within lagging states, perhaps spurred by democratic deepening and inter-state competition. The 2005-10 government in Bihar came in on a development platform, and pursued a dramatic expansion of educational efforts, with a three-fold increase in teachers, a push on roads, and—according to initial reports—a more effective response to relief in response to the catastrophic flooding with the breaching of the Kosi embankment in 2008. The coalition was re-elected with a sweeping victory in 2010. This looks like a shift in the political equilibrium, with a realignment in the incentives for politicians and other state actors in favour of development, but it is too early to assess if this will be consolidated. Uttar Pradesh is even less clear: an optimistic interpretation of the rise of the BSP, is that this is part of a long-term resolution of caste-based conflicts, analogous to what occurred in Southern States some decades earlier. But other scenarios of the persistence of rent-extraction and sharing are also plausible.

- In urban areas, it is attractive to argue that decentralisation and local democracy will need to be drivers of change. Here there are salutary lessons from Latin America: such democratizing reforms have brought changes via diverse pathways (e.g. Bogotá in Colombia, and Porto Alegre in Brazil), but there also many cities that have similar legal context but have not effected a transformation. In India, given the centrality of urban-based rents, there is likely to be substantial resistance to further devolution from state governments.

- If long-run development to high income status is successful, the United States is an example of long-term inter-regional convergence; but this occurred in an unusually mobile society, in which migration has played an important role.
Skill-based differences

With respect to the inequality-skill-growth nexus, Latin Americanisation is already fully present in India.

- As noted above, liberalisation and globalisation will be sources of pressures for rising skill-based differences, with the bottom of the wage ladder set by the Bihar labour market, and the top converging to levels in New York and San Francisco.
- India is moving quite fast, if belatedly (like most of Latin America) to massification of access to basic education, but has not worked out how to get decent quality in state education systems. Middle class flight to private education will rise: and here “middle class” is used ambiguously to refer to both elite shifts to top schools in urban areas, and the shift of rural children, disproportionately from the middle and top half of the distribution, to better rural private schools.
- Tertiary education will become an even more important source of the reproduction of inequalities, especially if the quantity and quality problems are not resolved at this level, with a continued growth in the premium from the high quality institutions.

Is there an alternative? This is an area where it is relatively easy for an educational specialist to describe the contours of broad-based, high quality basic education and meritocratic tertiary education. This paper doesn’t try going into the specifics beyond emphasizing that throughout the system the fundamental questions are institutional, in terms of the teacher’s incentives, improved organisational functioning, and local political economy.

With respect to basic (primary and secondary) education there will be a large and growing role for the private sector, in the form of schools and tuition. However, this has to be complemented by a major improvement in quality of the state sector: there are experiments underway in many states. One important example is in the work of the NGO Pratham, and its sister organization, the ASER Institute. This group developed the organisational capacity to conduct a test a statistically representative sample of children in basic reading and maths skills in almost every district in India. This has already revealed the potential for information to spur action by state governments, through the evidence it provides on (severe) learning deficits. It is now being complemented by the Read India campaign, in which Pratham develops teaching materials and works with the state school system to support teachers in basic, and beyond-basic, skills development. It is too early to assess its impact, but this kind of initiative is an essential complement to the expansion of private education if all children are to have access to decent education.

43 The Read India campaign is being independently evaluated in two of its sites with a randomized control trial, by the Poverty Action Lab in South Asia.
 Governance, accountability and the state

A recurrent theme of this paper has been that a central element of any transformation—good or bad—will be the performance of the state. It is again relatively easy to describe what would be desirable: a state that is accountable to citizens, in which there are sufficient internal and external checks and balances to minimize capture by particular groups, whether this is over a specific judicial decision, the design of policy, or the local allocation of public resources. It also means a state that has an effective organisational structure, with a balance between financial incentive systems, hierarchy and organisational cultures that support reasonable high levels of intrinsic motivation.

Effecting change is much harder, precisely because the state is to a significant extent endogenous, and will co-evolve with the structure of inequality described here. Large-scale businesses can have an interest in a weaker state, that is more susceptible to its influence. A more effective and more universalistic state is critical to more effective management of identity-based conflicts. Yet, identity-based structures have also been a source of the continuance of patronage, with dangers of parts of the state itself becoming more sharply aligned with communal forces. In every domain, transforming the state will be central to success. As argued above, all is not bleak now. The state is heterogeneous in performance across sectors and across space. Future change is likely to involve a combination of social pressure—from business interests with longer-term interests, from the growing middle class, and from civil society groups—and internal reforms around governance.

Conclusion: the need for and possibility of change

In the coming decades India will experience major social, economic and political transformations. Structures of inequality will co-evolve with the changes in the economy, the functioning of the state, and service delivery. This co-evolution will involve processes of mutual causation, that are imperfectly understood. While quantitative scenarios have been avoided, the interpretation here suggests there is a substantial probability of the continued entrenchment of some inequalities, combined with redistributive efforts that are often inefficient. This is deeply connected with the way in which the Indian political system functions and the nature of the Indian state. A metaphor for this is the Latin Americanisation of India. As we saw in Figure 2, Mexico did achieve upper middle income status—and this would bring truly significant benefits to Indians. But this occurred in the context of substantial state capture by vested interests, inadequate mechanisms for the management of distributinal conflict, rising violence, and real difficulties in effecting the transition to high income status.

The creation and sharing of economic rents is pervasive and central to the current political equilibrium in India. The process of economic liberalisation, while a necessary condition for India’s long-term transformation, has tended to heighten structural
inequalities. It has shifted the locus of rent creation and distribution, rather than fundamentally changing this. Some kinds of rents—associated with innovation, the Schumpeterian process of creation and destruction, and agglomeration—are intrinsic to positive, long-term economic transformation. Institutional structures that encourage, share and manage these “dynamic” rents are necessary for growth and change, and need to be sharply distinguished from the “static” rent-sharing that has been so central a feature of India’s polity, distorting the functioning of the state, and diverting it from the essential tasks of delivery of a range of public goods, and assuring genuine equity for all citizens.

Long-run development will required transformation in societal, economic and political institutions. Effecting change is a complex and ill-understood process. It is especially challenging when desirable changes are in conflict with endogenous political forces and patterns of influence. Historical experiences suggest change can occur, even though no country experience provides a blueprint for India’s options. Three inter-connected areas have been systematically emphasized throughout this paper: the need to develop a competitive corporate sector with checks and balances against excessive market or political influence “saving capitalism from the capitalists” in Rajan and Zingales’ phrase; tackling group-based inequalities, but with an emphasis on reduced politicization and the pursuit of universal citizenship; and the development of a more accountable state.

There are many issues not on this shorter list, that are clearly of importance to the joint evolution of inequality and growth—the deep problems in both basic and tertiary education, spatial differences, rural productivity, inequalities in urban areas, and so on. There is uncertainty over which will matter most. This returns to the centrality of the state and overall governance. Technical design questions are crucial in all of these areas. But whether the most important issues for change are identified, and whether the political process and public decision-making leads to institutional changes in the right direction for growth and equity, will depend fundamentally on the relationship between government and society over the coming decades.
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