India's Dilemmas: The Political Economy of Policy-Making in a Globalized World

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1. PRESENT CONTINUOUS TO SIMPLE PAST

The Indian economy is in an age of the present continuous. This is evident from a spate of recent titles: India Arriving (Rafiq Dossani), Propelling India (2 volumes, Arvind Virmani), India: Emerging Power (Stephen Cohen), India Globalizing (paper, present author). If India does not arrive, emerge or get propelled, there will evidently be a lot of disappointed authors. What are the chances that these same verbs will apply to India in the not too distant a future, but in the past tense? This is a convenient question with which to begin this enquiry. And to get to that we must start with the facts.

That the aggregate Indian economy is growing very rapidly is now beyond question. Having grown at around 1% per annum from 1900 to 1950, and at a sluggish 3.5% through the 1950s and 1960s, India's growth rate suddenly picked up in the late seventies. From 1993 the economy was growing even faster. Powered by the services sector (Chanda, 2007; Basu and Maertens, 2007), it seemed to be on a growth path of 6% per annum; and, over the last four years, the growth has been an astonishing 9%. This is clearly remarkable performance compared to India's past, but how does it compare with other nations of the world? The answer is, very well; and this can be illustrated by creating a league table of nations in terms of per capita incomes.

For this let us go back to 1975, the time when purchasing power parity (ppp)-corrected international data became widely available. If we take the 109 nations for which consistent data are available and track India's movement through this chart, one can immediately see how the

Indian economy has performed vis-à-vis other nations. 109 nations are, however, difficult to display on a page, so let me consider the poorest 52 nations among them. The rankings are presented in Table 1. In 1975 India had a rank of 90 among the 109 nations. In other words it was the 90th poorest nation. There were only 19 nations behind it. By 1984 it had a rank of 89, a small improvement. By 1994 it had moved up to rank 80, and by 2004 to rank 75. This is good performance but it is sobering to see China climbing from 108th rank the 58th over the same period.

Indeed, if we take the last decade and a half and do a global cross-country comparison, there turn out to be two nations in the world that had consistently higher growth than India. These are China by a wide margin, and Vietnam by a sliver. Pakistan, it is interesting to note, grew faster than India between 1975 and 1984, but after that it fell behind. During this entire period, much of South Asia, even with India excluded, has performed better than the global average (Basu and Maertens, 2007a).

Table 1: Bottom 58 countries GDP/capita [PPP, 2000 international dollars]

Rank	1975	1984	1994	2004
58	Paraguay	Dominican Republic	Dominican Republic	China
59	Tunisia	Philippines	Swaziland	Peru
60	Dominican Republic	Botswana	Peru	Swaziland
61	Guatemala	El Salvador	El Salvador	El Salvador
62	Swaziland	Guatemala	Jordan	Paraguay
63	Malaysia	Ecuador	Jamaica	Jordan
64	Ecuador	Jamaica	Philippines	Philippines
65	Belize	St. Vinc./Grenadines	Guyana	Guyana
66	Zimbabwe	Belize	Guatemala	Sri Lanka
67	Jordan	Guyana	Morocco	Guatemala
68	Bolivia	Thailand	Ecuador	Morocco
69	Morocco	Morocco	Nicaragua	Egypt
70	Syria	Swaziland	Syria	Jamaica
71	Cote d'Ivoire	Egypt	Egypt	Ecuador
72	Papua New Guinea	Syria	Indonesia	Nicaragua
73	Congo, Dem. Rep.	Cameroon	Sri Lanka	Syria
74	Honduras	Zimbabwe	Papua New Guinea	Indonesia
75	St. Vinc/Grenadines	Honduras	Zimbabwe	India
76	Thailand	Bolivia	Honduras	Honduras
77	Ghana	Sri Lanka	China	Georgia
78	Cameroon	Papua New Guinea	Solomon Islands	Bolivia
79	Togo	Cote d'Ivoire	Bolivia	Lesotho
80	Mauritania	Solomon Islands	India	Papua New Guinea
81	Gambia	Congo, Dem Rep.	Pakistan	Ghana
82	Central African Rep.	Indonesia	Ghana	Pakistan
83	Botswana	Gambia	Cameroon	Cameroon
84	Sri Lanka	Togo	Mauritania	Chad
85	Senegal	Mauritania	Lesotho	Zimbabwe
86	Egypt, Arab Rep.	Senegal	Gambia	Gambia
87	Zambia	Ghana	Cote d'Ivoire	Sudan
88	Madagascar	Central African Rep.	Togo	Mauritania
89	Solomon Islands	India	Georgia	Bangladesh
90	India	Rwanda	Senegal	Solomon Islands
91	Sudan	Pakistan	Bangladesh	Senegal
92	Indonesia	Bangladesh	Sudan	Cote d'Ivoire
93	Niger	Zambia	Nepal	Togo
94	Sierra Leone	Sudan	Central African Rep.	Nepal
95	Chad	Congo, Rep.	Kenya	Rwanda
96	Bangladesh	China	Congo, Dem. Rep.	Burkina Faso
97	Pakistan	Sierra Leone	Burkina Faso	Nigeria
98	Kenya	Kenya	Guinea-Bissau	Kenya
99	Rwanda	Madagascar	Chad	Central African Rep.
100	Nigeria	Benin	Nigeria	Benin
101	Guinea-Bissau	Lesotho	Benin	Congo, Rep.
102	Benin	Nepal	Madagascar	Zambia
103	Nepal	Burkina Faso	Zambia	Madagascar
104	Burkina Faso	Niger	Congo, Rep.	Niger
105	Burundi	Chad	Sierra Leone	Guinea-Bissau
106	Congo, Rep.	Guinea-Bissau	Burundi Rep.	Congo, Dem.
107	Lesotho	Burundi	Niger	Burundi
108	China	Nigeria	Rwanda	Malawi
109	Malawi	Malawi	Malawi	Sierra Leone

Source: World Development Indicators 2006. World Bank.

Just as the superior performance of the aggregate Indian economy is now beyond question, equally beyond question is the fact that inequality in India, no matter how one measures it, is growing[1]. The outstanding average figures for GDP and growth are being achieved largely by a small segment of the well-off population growing at phenomenal rates, the middle income group growing well but less rapidly and a bottom segment of around 20% of the nation growing at snail's pace. What this suggests about poverty is true. Poverty, as measured by the percentage of people below the poverty line, is declining but at a rate that is unacceptably low. It is unpardonable that an economy that is doing so well overall has somewhere between 220 and 280 million people living below the poverty line. And it is important to remember that we draw our poverty line really low, which is a useful technique for keeping these numbers low.

I will return to the question of inequality and poverty later; let me for now persist with the question of the prospects of overall growth. To understand this we need to know the sources of India's rapid growth. Though ideologues will disagree, a dispassionate analysis shows, not surprisingly, that many factors lie behind this. One indicator of the multiplicity of causes is the fact that the economy has reached its current phase of high growth in several steps and with different factors of propulsion behind each one.

The question of when the first break in growth in independent India occurred has exercised many minds and as research has progressed

[1] This is particularly true of regional inequality, which seems to be growing since the 1960s (Rao, Shand and Kalirajan, 1999).

we have gone further and further back: early 1990s, early 1980s and even late 1970s (see Rodrik and Subramanian, 2004; Panagariya, 2004; Balakrishnan and Parameswaran, 2007; Basu and Maertens, 2007; Sen, 2007). I would argue that the first of the growth spurts occurred in the year that most of us Indians block out from our psyche as non-existent—1975. In that first year of the Emergency the nation grew at 9% and it was not just a one-year spurt. Barring a severe downturn in 1979-80, when the economy shrank by 5.2% (the worst year in the history of independent India), the economy never looked back after 1975.

What caused this initial breakaway from stagnation is a matter of some debate, but one undeniable factor is that India's savings and investment rates had risen sharply from the late sixties to the late seventies. What caused this? Clearly, the nationalization of banks in 1969, with the state-owned banks being forced thereafter to open branches in remote areas of India, and the start of Unit Trust of India in 1964 were key factors in boosting the savings rate, which in turn was the first impetus for rapid growth. Data on the number of bank branches (see Basu and Maertens, 2007) show a sharp rise after 1969, suggesting that the government's directive was actually carried out.

The next step up in growth occurred in 1993 and the cause here was very different. The reforms of 1991-93, which led to the removal of India's notorious licensing system, and initiated a range of policy measures in the international sector, were arguably the most important policy event in India since 1947, and one can see its impact in the faster growth and the exponential build-up of foreign exchange reserves that happened subsequently[2]. This is evident from Table 2. From 1977 to 1990 our foreign exchange reserves hovered around 5 billion dollars, occasionally dropping to a precarious low level and more occasionally crossing 6 billion dollars. From 1993 the reserve started rising, steadily and on a high gradient, and is now well over 200 billion dollars. The reforms of the early nineteen nineties were primarily concerned with India's international sector and the success which India saw after that occurred primarily in the nation's international dealings[3]. Not only did the reserves build up but the precarious situation that we were in in the early nineteen nineties, with large short-term debt and unmanageably high debt-service ratio, rapidly abated. India's exports picked up and the software boom was firmly on course (see Murthy, 2007).

Table 2: Foreign Exchange Reserves

Year	Foreign Exchange Reserves ($ millions)	Aggregate Export of Goods and Services ($ millions)	Short-Term Debt, as % of Forex Reserves	Debt-Service Ratio
1977	5,824			
1990	5,834	18,477	129	35
1994	25,186	26,855	14	26
1998	32,490	34,298	16	18
2002	75,428	52,512	10	14
2005	130,000	83,500		
2007 (early)	199,179	126,330		

Source: Economic Survey (various), Ministry of Finance, Government of India; Reserve Bank of India; and Press Releases of the Ministry of Commerce.

[2] These reforms have been analyzed arguably more than any other policy changes since India's independence (see M. S. Ahluwalia, 2002; I. J. Ahluwalia, 2007; Basu, 2006a; and the papers in Basu, 2004). The morass of controls that shackled enterprise in the Indian economy has also been well-documented (see Mohan, 1992; Rangarajan and Jadhav, 1992; Jalan, 1991). The comparable economic downturn, which was also centered on a balance of payments crisis, was the one that occurred in 1956-57 and was the cause of erosion of power of the Planning Commission and consolidation by the Ministry of Finance (see Kudaiysia, 2006).

[3] Some of these changes were explicitly meant to liberalize the foreign exchange market, such as permitting banks to fix their own trading limits and interest rates on foreign currency non-resident deposits (Chakrabarti, 2007).

Finally, let me turn to the last and most recent growth spurt that began four years ago and is continuing. Not surprisingly, since the analysts have not had time to catch up with the events, this is the least understood of India's three growth surges. Among the chief causes of this latest surge there are four contenders that I would like to comment on.

1. The nation's savings (and investment) rate, which is the critical driver of economic growth, has seen the most astonishing rise over the last four years, from 24% to 34% of the nation's GDP, after remaining virtually stagnant since the late seventies. This places India, for the first time, a participant in what was once thought of as an exclusively East Asian phenomenon—the ability to save and invest over 30% of the national income.

2. The last US presidential election caused a second outsourcing boom helping our economy greatly. During the election there was a lot of criticism of US firms that were outsourcing back office work to developing countries, India being the major destination. This had the unexpected effect of advertising the major cost-savings possible by outsourcing. Medium to small American firms that did not know about the profits to be made by outsourcing suddenly became aware of this. Advertising on US television is very expensive and Indian firms could never have financed this on their own. The advertisement effect of the debates on television during the last US election and subsequent attacks on outsourcing by some conservative television commentators have turned out to be an unexpected boon—someone else paying for your publicity.

3. Though this is hard to prove since it is difficult to measure and quantify, I believe there is a major cultural and social revolution on in India. For a market economy and, for that matter, any modern, industrial economy to function effectively requires a certain culture and a set of enabling social norms. The instinctive urge not to renege on contracts, the ability to restrain oneself from cheating to make small gains, having a culture of trust, and a multitude of other matters of habits and consuetude play a vital role in making a market economy possible. It is my belief that nations that have faltered on the path to industrialization—the sub-Saharan African nations, the South Asian economies, including India till recently, and many Latin American ones, have done so not because of large government (as the Chicago School would have us believe) or wrong fiscal or monetary policies as much as because the underlying structure of social norms and culture needed for an industrialized market economy were not in place.

4. Finally, there is the changing position of India in the world. For reasons that lie mostly beyond India's borders, India finds itself today with some strategic advantages and opportunities. These opportunities are mainly in politics but they are also beginning to yield some tangible economic benefits. This is a subject that I will return to in the last section of this paper.

Comment 3 above deserves some elaboration for it has important implications for often-heard counter-factual observations, such as "only if India had undertaken the reforms of the early nineties in the early

fifties, we would not have lost forty years of growth". We have plenty of examples of Latin American countries that opened early and were ravaged or, more accurately, savaged by global capital. Interacting with global corporations requires a certain amount of sophistication, without which it is easy to cut so many bad deals that one is left worse off in the end. It is difficult to know what an early opening up would have done to India, but it cannot be ruled out that we would have gone the route of so many banana republics that were ruined by this. One has to read accounts of native Americans doing "voluntary business" with the settlers and losing land in scandalous deals to understand what an unprepared launch into completely free-market transactions can do (Banner, 2007). Even recently India cut a very poor deal for power generation with Enron. And we were saved only because Enron was ruined.

The exact link between culture and the economy is ill-understood though a recent literature on 'trust games'—games in which, if two players can trust each other, they do very well, but, if one person betrays the other's trust, then he does even better—is beginning to give us some vital clues about the connection between social variables such as trust and integrity and economic success.

A conjecture that I would like to maintain is that the success of the nineties and other factors that we may not even be aware of are now triggering a change in vital cultural variables that is giving this third growth surge an additional vitality. It is arguable that there is something common between higher savings and greater trustworthiness. Being trustworthy means foregoing small, immediate gains (the gain that one could make by letting down an investor, for instance) and achieving a greater return in the long run, because the reputation of trustworthiness means that more business and investment will come one's way. Hence, greater trustworthiness is a counterpart of greater savings, which amounts to foregoing some current consumption to get even more consumption in the future. The latter is financial and the former social but they probably have the same fundamental root, a growing ability to wait, greater patience or, what we economists would describe as a lower time discount rate. So my conjecture is that in India there is a lowering of the discount rate that is occurring. This is resulting in higher savings which we can see and is well-documented and also improving trustworthiness and the culture of business, which we cannot formally document and so must be treated, for now, as conjecture.

The social and political infrastructure of business is still poor in India, as is easy to see from the World Bank's new cross-country data on doing business in different nations, some of which are presented in Table 3 below.

Consider starting a new enterprise. To get all the requisite clearance will take 5 days in the US, 6 days in Singapore, 48 days in China and 71 days in India. Take contract enforcement, which is vital for the effective functioning of markets. To enforce a contract takes 69 days in Singapore, 241 days in China and 425 days in India. Even if you can start a business and have contracts enforced, the real catch is in closing a business. The time taken to close an insolvent business is 9 months in Singapore, 2 years in the US, 2.4 years in China and an epic 10 years in India.

Table 3. Bureaucratic costs, 2005

	No. of Procedures to Start Business	Time to Start Business (Days)	Cost to Register Business (% of Per Capita Income)	No. of Procedures to Enforce Contract	Time to Enforce Contracts (Days)	Time Closing a Business (Years)	Difficulty of Firing Labor Index, 0-100
India	11	71	62	40	425	10	90
China	13	48	14	25	241	2.4	40
Hong Kong	5	11	3	16	211	1.1	0
Malaysia	9	30	21	31	300	2.3	10
U.S.A.	5	5	0.5	17	250	2.0	10
Singapore	6	6	1	23	69	0.8	0

Source: **Doing Business 2006**, World Bank, 2006.

To improve these constraints requires changes in the law but also changes in institutions and the culture of governance. How the latter can be achieved is ill-understood. One reason for this is that economists treated culture and institutions dismissively in the past. But clearly the links between these and the economy hold vital clues to development and deserve much greater research initiatives. It is arguable that law itself should be thought of as part of the larger idea of social and political institutions in which the economy is embedded. This has theoretical implications (Basu, 2000, Chapter 5) but also places subtle burdens on our regulatory structure, especially as India becomes a more market-oriented economy (Anant and Singh, 2007).

To sum up, the infrastructure of norms and culture that enable enterprise and innovation and help build up an industrial society still has a long way to go in India, but my surmise is that it has begun changing. On the financial and economic side savings and investment are up and the international sector of India is doing very well.

These are trends that do not change too rapidly. Savings behavior and culture, for instance, do not change dramatically from one day to another (unlike share prices or the rate of inflation)[4]. Since international performance and savings are the bulwarks of India's recent high growth, and, to the extent that the culture of the market is changing for the better, my expectation is that India is now in for a long phase of high growth. So the growth rate of between 8 and 10% per annum is, in all likelihood, here to stay for a few decades. And if this happens, a simple back-of-the envelope calculation shows that by 2030 India will have a per capita income of 20,000 dollars, which will place us in the category of industrialized nations. Even though a war or political instability can upset the scenario, this is not a scenario that can be dismissed out of hand.

2. INEQUALITY AND POVERTY: THE QUINTILE CRITERION

Where there is reason for greater apprehension and concern is in the area of poverty and inequality. In distributing the spoils of the high growth we have done singularly badly. The bulk of India's aggregate growth is occurring through a disproportionate rise in the incomes at the upper end of the income ladder (see Banerjee and Piketty, 2005; Bardhan, 2007). As a result, India's income distribution is deteriorating; and the size of the population living below the poverty line remains embarrassingly

[4] There is reason to expect that if there is some further change in the savings rate it will be a movement upwards in the medium term. This is connected to the 'demographic dividend' that India is expected to have over the next three decades as its working age population rises in relation to its dependent population. Since workers are the big savers in society and the dependent population usually consists of dissavers, this change in demographic structure should cause the savings rate to witness a gentle rise.

large (even though the percentage of the population below the poverty line is declining)[5]. These can of course become the cause of political instability and upset the aggregate growth scenario. But even if that were not to happen—the elite in India is quite good at the art of re-distributing just enough crumbs to the toiling masses to keep insurgency at bay—such inequality and poverty are morally wrong in themselves and so we need to address them urgently.

To do so it is important to understand the main cause of India's and, for that matter, the world's large population below the poverty line. At the deepest level this is a consequence of unfettered capitalism with its current system of inheritance that allows those who manage to become rich once to keep their wealth for their progenies[6]. Children are therefore born into wealth, with plentiful opportunities for prospering and amassing even more wealth, or into poverty, with their chances, for all practical purpose, blighted at birth. The resemblance to a system of caste or apartheid is unmistakable.

The fact that this system is grossly unfair does not mean it is obvious what should be done about it. When people have rushed in thoughtlessly to alter it, this has at times led to chaos and exploitation

[5] For a comprehensive statistical analysis on the subject, see Deaton and Dreze, 2002, and Himanshu and Sen, 2004. As I write this essay I have been traveling in the South 24 Parganas district of West Bengal. It sounds hackneyed to say this but one does not need statistics to see that poverty in India is large and, given the backdrop of the nation's economic boom, this is intolerable.

[6] Unfettered capitalism in reality is different from the benign models of capitalism described in textbooks of economics. In reality the acquisition of resources, goods and services occurs not just through markets and the price mechanism but through the use of state power to corner vital contracts and to keep competitors at bay.

and at other times it has meant that wealth has merely changed hands, with the system intact. Jose Saramago was right when he remarked that the fall of the USSR was not the fall of socialism but of one kind of capitalism – one that the Russian ‘communists’ had ended up creating, no matter what their initial intention. There is reason to enquire into how to change the present system, but that is too large a question for this essay, and in any case this is not likely to be resolved soon and there is a lot to be done in the interim.

I wish to restrict myself here to the interim and more limited questions of what can be done now, in today’s India and given the system that we find ourselves in. Even to such more limited questions, however, the answer can take myriad forms of complexity. Two important instruments for climbing out of extreme poverty are education (or the acquisition of human capital) and health (which enables one to work hard and be productive).

Even if we cannot alter the system through which some dynasties manage to keep large amounts of national resources to themselves and their progeny, government can do a lot by ensuring the population gets basic education and healthcare. To the extent that this is financed by taxing the rich and from resources generated by government, this entails some transfer of resource in the correct direction. Hence, India’s civil society must bring pressure on government to undertake a certain amount of direct action, much more than it does now. In these times of revenue buoyancy, government ought to divert more funds to directly supporting the poor—by ensuring that they have access to basic food, schooling and

healthcare (Dreze and Sen, 2002). That India has lower literacy rates than several poorer sub-Saharan African nations speaks volumes about our government’s neglect of the poor. That malnutrition in the masses is rife and, by some measures, rising (IIPS, 2007) speaks of the same neglect. There are numerous ways in which the rich are subsidized. The richer classes, through their ubiquitous Residents Welfare Associations in all major cities, often complain about vendors occupying public space and say this amounts to an uncalled for subsidy to the vendors. But if we add up the areas that the wealthier residents of our cities, who are the members of Residents Welfare Associations, carve out outside their homes as parking space for their cars and have security personnel guard and shoo away people from these cemented spots, the total will, in all likelihood, be more than what the vendors occupy. If we can turn a blind eye to such sops to the rich, there is no reason to flinch at every little subsidy that goes to the poor. There is a lot on the poverty front that can be achieved through direct budgetary provisioning and one of the immediate tasks for our Union and state governments is to allocate more money for this and ensure that the money is properly spent.

But it is also a fact that, even after such provisioning, there will be a lot that will remain to be done; and what action can be taken beyond this is a difficult question, where politics and economics intertwine inextricably. We have seen this in the experience of West Bengal’s Left Front government. For nearly thirty years it took a tough line on industrialists—if you want to function in the state you have to pay workers good wages and offer good terms, the government insisted. This sounds unexceptionable but reflects a failure to understand *realpolitik*.

In response to this the industrialists did not employ workers on better terms; they just did not employ workers. They left the state. What West Bengal saw over thirty years was a steady de-industrialization. Since agricultural growth cannot in the best of times match the high rates at which industry and services can grow, West Bengal lost out overall, despite its good agricultural performance. This mistake was realized four or five years ago. It was realized that one does not have to love capitalists to invite them to the state. It is a simple matter of choice. Do you have an option? *For each single government,* the answer in today's globalized world is no, and it is unfortunate that West Bengal took so long to recognize this. The Chinese recognized this in 1978. There has been a lot of effort to make amends for this mistake, starting with the wooing of Tata's small car project (the "ultra-affordables") away from Uttranchal to Singur, in West Bengal[7].

There is no question that today the large corporations are getting a wonderful deal playing one government against another. But equally beyond question is the fact that there is very little else that each government can do on its own. Not to attract capital is to doom your workers to poverty and unemployment. To attract capital is to contribute to growing global inequality. This is a problem that is afflicting not just poorer nations like India and China but also OECD nations. Thanks to inter-country competition to attract capital, there has been a steady erosion of the corporate tax rate in OECD countries. Inequality has been

[7] For an extremely lucid and valuable analysis of the policy dilemmas raised by West Bengal's effort at late industrialization, see the two-part essay by Amartya Sen in **The Telegraph** newspaper on 29 and 30 December, 2007.

growing in China, India and the U.S., but also in the bastions of equality like Japan and the Scandinavian nations. This is a consequence of globalization.

How do we think about policy-making in such a world? I want to discuss some analytical tools for answering this question. At the root of the policy dilemma is the fact of a trade-off between inequality and poverty[8]. *In some contexts*, a government is compelled to choose between greater inequality and greater poverty. In a poor nation when one faces such a choice, I believe one has to choose less poverty. So *there are situations* where one may have to live with a greater inequality to achieve not higher growth (I would consider that an unacceptable trade off) but less poverty.

The reason I place the qualifiers "in some contexts" and "there are situations" in italics is to emphasize that this claim must not be reduced to a license for tolerating any inequality. People often say that, though over the last two decades India's inequality has risen a lot, poverty has declined, so that is fine. This is not what I am claiming, since there is no reason to believe that the lower poverty was made possible by the greater inequality.

To handle this policy quandary in a practical way, I would suggest a simple welfare criterion. We should judge a nation's performance by the condition of the nation's poorest 20% people. So instead of looking at the per capita income of the entire population of each nation and

[8] This trade-off has received relatively little attention in the literature. The trade-off between growth and inequality or aggregate national income and inequality has received much more attention and we also have an elegant mathematical formulation of how to take the two on board in one index (Sen, 1976).

making inter-country comparisons (as most international organizations do), we should look at each nation's per capita income of the bottom 20% of the population—I have elsewhere called this the 'quintile income'—of the nation, and compare these values (Basu, 2006; Subramanian, 2006, 2007). This entails a practical, policy-oriented formulation of John Rawls' famous criterion of focussing on the primary goods consumption of the poorest person in society.

The quintile principle that I am suggesting here has several attractive features. It does not mean that one totally ignores the rich. If one did so and just tried to enhance the welfare of the poorest people, then the poorest people after some time would cease to be the poorest people. Some of the previously rich would now fall into this category, replacing some of the previously poor. But since by the quintile principle the focus is always on the bottom quintile of society, focus would now automatically shift to the previously richer person who would now be overtaken by the previously rich.

Second, the quintile principle does not ignore growth, but its focus is on the growth of income of the bottom quintile of society.

Basing policy on the quintile criterion leads some interesting insights into how to handle trade-offs between poverty and inequality and the special dilemmas that globalization give rise to. This is the subject matter of the next section.

3. GLOBALIZATION, POVERTY AND INEQUALITY

I shall in this section develop a simple, highly-stylized model to illustrate some of the principles discussed thus far. In particular, the model will illustrate (1) how the 'quintile axiom' may imply that we have to tolerate a modicum of inequality and (2) how globalization weakens each nation's ability to control poverty and thus directs our attention to the need for inter-country coordination of policy[9].

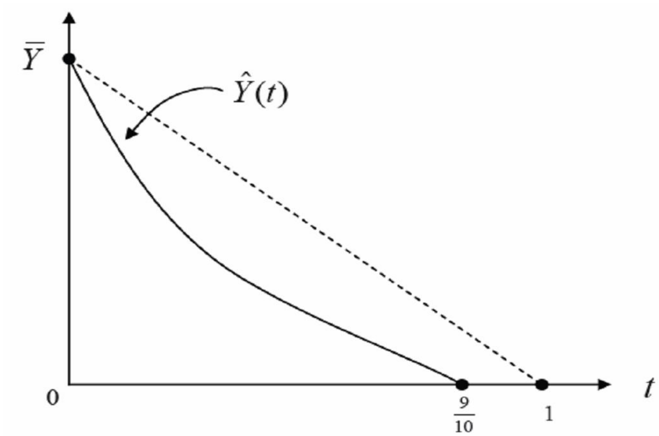
Consider a world with 'many' identical countries. Each country has a certain population. And of these people, half are 'rich' and half are 'poor.' What we mean by 'rich' and 'poor' is simply that in the absence of any government or community intervention, the rich are individuals who have an income of $\overline{Y}$ and the poor have an income of $\overline{y}$. Needless to add, $\overline{Y}$ is greater than $\overline{y}$, otherwise, my use of the words rich and poor would be rather alien.

Let us now introduce a minimal government into the picture. All this government does is to tax the rich and transfer that money as a direct subsidy to the poor. Suppose the government sets the tax rate at *t*. That is, a fraction t of the income of the rich is collected by government as tax. Let me denote the post-tax income (or disposable income) of the rich to be $\hat{Y}(t)$, the t in the bracket being a reminder that the post tax income depends on how high the tax is. Clearly, as t rises, $\hat{Y}(t)$ will fall. This happens for two reasons. As more tax is taken away of course there

[9] For a general discussion of globalization and its consequences for the poor, see Kanbur and Jhabvala, 2007).

will be less money in hand. But also, the fact that a part of one's income is taken away may mean (at least in today's world) that the rich will work less hard and so earn less to start with. A picture of a $\hat{Y}(t)$ -curve is drawn in Figure 1. If people worked as hard as in a world of no taxes, then this line would decline as *t* rose but in a straight line and would be zero when *t* = 1, that is all one's income is taxed away. In that case the $\hat{Y}(t)$ -curve would be given by the downward-sloping straight line shown in the figure. Since we are assuming that taxes also discourage the rich from working as hard, their post-tax income is lower than the straight line and explains why $\hat{Y}(t)$ takes the shape that it does in the figure. As shown, it is being assumed that when the tax rate reaches 9/10, the rich do not work at all. This is not a realistic assumption but a harmless simplification in the present context[10].

Figure 1



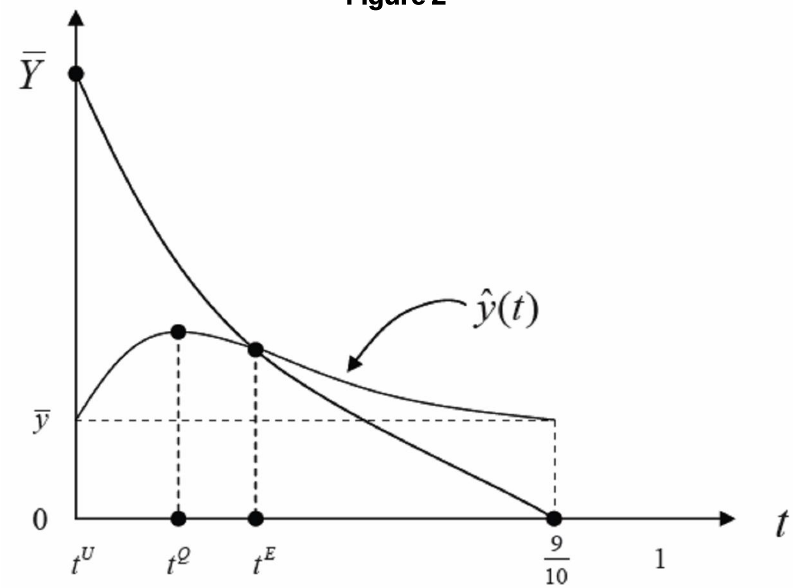
[10] One mathematical derivation of this is as follows. Suppose the pre-tax income of the rich, *Y(t),* when the tax rate is *t,* is given by $Y(t) = (1-(10t)/9)\overline{Y}$. Then the post-tax income is given by $\hat{Y}(t) = (1-t)(1-(10t)/9)\overline{Y}$, which can be taken to be the graph shown in Figure 1.

What happens to the income of the poor once government steps in with the simple fiscal policy just described? In addition to their earned income $\overline{y}$, they now receive transfers from government. Since the transfers depend on what is collected from the rich and is not dependent on the income of the poor, I shall assume, for simplicity, that the latter remains unchanged. Hence, when the tax rate imposed on the rich is *t*, the post-tax income of the poor, denoted by $\hat{y}(t)$, is equal to $\overline{y}$ plus whatever is collected as tax from each person (recall that for simplicity I assumed that the number of rich people is equal to the number of poor)[11]. This curve is depicted in Figure 2 by the inverted-U line. And the post-tax income graph of the rich is also shown in this figure. Basically, we now have in Figure 2 the post-tax (recall the tax is imposed only on the rich and the money is given to the poor) incomes of the rich and the poor. When the tax rate is 9/10, we assume the rich earn nothing. So the poor get no tax transfers and their income is back to $\overline{y}$, as shown in the figure.

In the light of the income scenarios that get created by the tax rate, as shown in Figure 2, the government will have to choose a tax rate that it will impose. This will surely depend on what the government's objective or social welfare function is. Let us begin with a government that is 'utilitarian', in the sense that it is interested in maximizing the total national income without regard to who gets how much. Then clearly the tax rate will be set at 0. That will make the rich work the hardest and make the national cake as large as can be.

[11] If we take the income of the rich to be given by the formula in the previous footnote, then we get $\hat{y}(t) = \overline{y} + t(1-(10t)/9)\overline{Y}$.

Figure 2



Next consider a government that is focused on the poor and wants to maximize quintile income as discussed above. This government will choose to set the tax rate at t^Q as shown in the figure. At that tax rate, the income of the poor reaches the maximum it can[12]

Finally, consider a government that is totally focused on inequality minimization. Such a government will set the tax rate at t^E, as shown in the figure. At this point the rich and the poor earn the same amount. Notice however that to get to this point, the poor are made poorer. That is from a tax rate of t^Q as we raise tax further and move to t^E, equality rises but so does poverty since the poorest people become poorer.

[12] In the specific mathematical example described in the above footnotes, t^Q turns out to be 0.45 or a tax rate of 45%.

This is the sense in which poverty and inequality can entail trade-offs. There is a lot of writing on the trade-off between poverty and growth. To me this constitutes no dilemma: the priority ought to go to poverty removal. A more troubling trade off, and one that is poorly understood, is that between poverty eradication and controlling inequality. The model just constructed shows how such trade-offs can occur. I would take the view that, in poor countries, the priority should be on the betterment of the poor.

So I would take the view that in a situation like the one just described, the inequality that occurs at t^Q is worthwhile tolerating, because this is the inequality needed not to maximize growth but to maximize the well-being of the poorest sections. This is the idea of tolerable inequality discussed above.

It is worth clarifying that it is not always the case that the poverty minimizing tax will be less than the inequality minimizing tax, as shown in the figure. If this does not happen, then of course there is no quandary between poverty minimization and inequality minimization. So all that is being suggested here is that there are possible scenarios where a nation faces a trade-off between inequality and poverty; and it is my belief that these scenarios are realistic and widespread.

The shrinkage of policy space that occurs with globalization and how globalization may contribute to greater inequality and greater poverty can also be illustrated using the above model. To see this, suppose that workers can choose to migrate from one nation to another and they choose to go where they have the highest income. I shall also assume that when a worker decides to migrate, she needs permission (a work permit or visa) from the host nation before she actually manages to migrate. It will be assumed that, if all countries have the same tax/subsidy rates, then each person stays in his or her home country. That is, when indifferent between migrating or not, a worker prefers not to migrate.

In reality, with globalization, movement between nations can occur for not just labor but corporations, goods and services. But, since this is a very simple model with only labor, I assume that this is the only factor or agent that can migrate. The instrument that governments have for attracting skilled labor is the tax rate. So what I am considering is, effectively, a model of 'real tax competition' (Atkinson, 1999).

The problems of domestic policy in the event of globalization of the kind just described can be illustrated in many different ways. Let me here consider the case where each country aims to maximize its quintile income. In other words, each country has a government that is genuinely concerned with raising the standard of living of its poorest citizens. If the boundaries of nations were exogenously closed (that is, no labor movement was allowed), each nation would set $t = t^Q$, as shown in Figure 2.

Now, let globalization remove the exogenous hindrance to labor movements. Note that each country setting $t = t^Q$ is no longer an equilibrium. Suppose one country lowers *t,* clearly all productive people from other nations will want to migrate to this country. If the government now decides that it will (1) allow some of the rich people to come in and (2) not allow any poor person to come, it will clearly be able to increase the income

subsidy-per capita that it gives to its poorest citizens. And for this reason it will be in each national government's interest to cut tax rates a little. So t^Q cannot prevail in equilibrium. To use the language of game theory, every government setting the tax rate at t^Q is not a Nash equilibrium.

From the above analysis it should be evident that there is no tax rate t greater than 0 that will prevail in equilibrium. Because if all other nation's are charging t, a government can lower tax a little, attract the rich and use the tax collection to subsidize the poor citizens of the nation. Hence, in equilibrium every country will set $t = 0$. Real tax competition in a globalized world results in the erosion of taxation; and in equilibrium we will have all rich and poor people earning as if there is no government. Each country ends up behaving *as if* it were interested in maximizing national income with no concern for poverty or equity. Globalization erodes each national government's power to have equity-conscious policy. The mobility of labor (and, in a more realistic model, the mobility of capital) compromises a nation's policy efficacy.

Evidently what we need is the international coordination of anti-poverty policies. This is not to deny that re-distributive policies and more aggressive anti-poverty policies by individual governments are possible; and one must not let governments off the hook totally. But, at the same time, it has to be recognized that, as globalization progresses, there is increasing need for the coordination of policies across nations.

When we see the enormous poverty in Ethiopia or Tanzania, we tend to blame it on its government. While most governments have room to improve their performance, it would be wrong to overlook that how much control Ethiopia has over Ethiopian poverty or Tanzania has over Tanzanian poverty depends in part on what happens in Kenya, India, China and the United States, on the trading rules that apply between nations, the facilities that are there for the movement of foreign direct investment and the nature of global institutions. As discussed above, one sees this played out within India, with large industrial houses increasingly mobile between regions and states and with state and local governments having been granted greater autonomy of policy. But my point is that this greater legislative autonomy may well be compromised in effect by the limitations in policy space that occurs through the increasing mobility of labor and capital that may happen naturally as technology makes travel, relocation and communication less onerous.

4. A COMMENT ON FOREIGN POLICY ORSE

I have saved the unsavoury for the last. The world of foreign policy is murky in the best of times. For India this is a time of change and difficult choices, a time when the nation finds itself at the cross roads with paths that can set it off into uncharted territories, where there can be a lot to gain but also the risk of losing a great deal. As mentioned above, there is a connection between India's recent economic performance and opportunities, and the strategic space that it, for reasons beyond its control, has come to occupy in the world, especially vis-à-vis the United States and China. Hence, our foreign policy and domestic economics are probably more intertwined today than at any time in the past.

The growth of the Indian economy is important to the U.S. and other industrialized nations for the demands that this creates for goods and services and, in particular, defence products. For the industrialized military powers and, in particular, for the exporters of weaponry and defence-related material ("defence" in these situations, in case the reader needs to be reminded, is a euphemism for "defence and offence"), the ideal situation in Asia is a build-up towards war but no war. A war is too destabilizing for the whole world; so not desirable. But a build-up towards war means more profits for the defence industries. Apart from this narrow economic interest, for the United States, India is the only realistic counterpoise to China in the long run. As China rises to global prominence there is concern that matters which are relatively dormant currently, such as the global position of Taiwan or the status of North Korea, will come to the fore. There is worry, for instance, that, if China establishes full control over the Straits of Malacca, it will have its hands on a vital artery of world trade. The encouragement given to India by the United States to conduct naval exercises in the Straits of Malacca is to keep the region from slipping into solely China's charge (Basu, 2006a).

These essentially political matters have had spillovers for the Indian economy. About half of all H1-B visas that the U.S. gives out (these are visas for engineers, scientists and other professionals) go to Indians[13]; about 70% of India's software exports end up in the U.S. (Murthy, 2007). The big market for India's pharmaceutical industries is North America (Chaudhuri, 2005).

[13] The Indian migrants to the US have higher education than migrants from all other nations to the US and also higher than Indian migrants to any other nation (Kapur, 2007).

These are not matters on which the U.S. takes an unambiguous stand since China is a major trading partner of the U.S., much more important than India. Hence America's business and political communities often have differences of opinion on what constitutes 'American interest'. But, with their focus on the long-run, the recent influential neo-conservative writings in the U.S. have made frequent reference to the need for the "containment of China". And it is now widely recognized that, since 2002, the U.S. has been viewing India as an important pole in a future multi-polar world and, as such, a safeguard against the risk of the world becoming bi-polar, with the U.S. witnessing a face-off with China in a playback of the Cold War days.

These changes are viewed in India as presenting the nation with a serious dilemma—whether to retain its commitment to the policy of non-alignment, which India has adhered to with considerable diligence through the years, or to collaborate with the U.S. on vital matters such as nuclear energy, defence, trade and investment. The fear, often expressed, is that to enter into these kinds of collaborations will amount to India giving up its independent foreign policy positions and falling totally into the ambit of western nations. In an elegant and skilfully-argued essay Chenoy and Chenoy (2007) have analyzed the recent shift in Indo-American relations, its implications for our economy and the risky foreign policy options that India is faced with today as a consequence of it. They end up cautioning India against these new interactions, be it in matters of foreign policy, foreign direct investment or the pending nuclear deal, 'agreement 123'. This is a paper where I find myself in agreement with most of the analysis but not with the conclusion. This needs explanation.

The source of the disagreement is an implicit belief which underlies the analysis of Chenoy and Chenoy and with which I find myself at variance. The implicit axiom is that to engage with the U.S. is to give in to the U.S., to interact on issue *a* is to be drawn inexorably into toeing the American line on *b, c* and *d.* Just as the belief held by several conservative American scholars that, because India had close defence and trading relations with Russia, its non-aligned policy was compromised, was flawed, the apprehension among some analysts in India that, if India signs a nuclear agreement with the United States or has close investment and trade relations with it, its non-aligned policy will stand abandoned is not valid. The dilemma expressed in the opening sentence of the previous paragraph is therefore not a valid one. I would argue that while this may have been the case twenty or thirty years ago, with the Indian economy having grown so much, this is not the case anymore. In today's world India and the U.S. have enough mutual interest in each other for one not to be able to overwhelm the other. It is possible for India to act collaboratively on some matters and resist collaboration on others, without jeopardizing the former. On foreign policy matters it will indeed be disappointing if India moved into the U.S. camp. India has generally had a morally more defensible foreign policy than the one that western nations have had, and we must make every effort to hold on to it. In fact, there should be greater effort to engage with sub-Saharan Africa and other parts of the developing world. This was a part of Indian policy at the time of the country's independence. Given the trading links that India has had for centuries with Africa and some of the poorer regions of East Asia, this engagement simply requires the government to take a lead.

Greater interaction with the U.S. on matters of nuclear energy and trade is unlikely to damage India's relation with China. Our relation with China has been improving in recent times, with bilateral trade now being at an all time high and growing in leaps and bounds, and with several Indian firms directly investing in China. If India continues to grow economically, India will be a vital trading partner of China and a stable political relation will then be in our mutual interest. Both nations would be more inclined to solve cooperatively the relatively small irritants that exist between them, such as border disputes. With the United States, India has a relation where there is a lot to be gained from trade, investment and engagement in general. In fact, if India can utilize the strategic advantage of the moment and further its economic prowess, this will be a better guarantor of both India's ideological independence and good relations with China, which will then have an even greater stake in trade and investment with India.

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