POLITICAL ECONOMY AND PUBLIC POLICY

Deepak Lal

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PREFACE

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

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

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

Nicolás Ardito-Barletta
General Director
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Panama City, Panama
August 1990

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

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DEEPAK LAL

Political Economy and Public Policy

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

The Making of a Political Economist

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Evolution of Thought on Economic Policy

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

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

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

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

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

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

Economic development under dirigiste regimes since the late 1940s has thus been guided by a desire for national integration and self-respect, which the elites believed would flow from the mounting national power that economic growth would foster. But the dirigiste policies have fallen far short of this goal. If anything, they have made it even more difficult to promote the economic progress required to provide the material basis for the desired national autonomy. In fact, many third world countries are now beginning to liberalize their repressed economies, as experience has taught them that the old dirigisme does not serve the twin purposes of economic development and national integration.

This pattern of economic repression followed by reform in the name of nation building is reminiscent of the course many European states followed during their evolution. As Heckshher has noted, mercantilist policies arose to consolidate the power of the relatively weak states built "on the ruins of the universal Roman Empire. . . . [T]he state was both the subject and the object of mercantilist economic policy." Its purpose was to achieve "unification and power," making the "State's purposes decisive in a uniform economic sphere and to make all economic activity subservient to considerations corresponding to the requirements of the State." Mercantilism sought to control economic forces "not directly in the interests of the subject but to strengthen the state authority itself; it concentrated on the *power* of the state . . . primarily [on] the state's external power, in relation to other states."[17]

This view that nation building should be served by mercantilist practice is similar to that espoused by most third world political leaders and elites.

One of the main objectives of the various mercantilist regulations of the sixteenth and seventeenth centuries was to exchange royal favors (by granting trade privileges) for revenue to meet the chronic fiscal crisis of the state—a problem shared by many countries of the modern-day third world. But the system collapsed under the administrative burden it created. As Keynes pointed out,

> Above all, the ineptitude of public administration strongly prejudiced the practical man in favour of laissez-faire—a sentiment which has by no means disappeared. Almost everything which the state did in the eighteenth century in excess of its minimum functions was it seemed, injurious or unsuccessful.[18]

The consequences of the regulations, particularly in internal trade and industry, were similar to those observed in many developing countries—corruption, rent seeking, tax evasion, and the growth of illegal activities in underground economies.[19] The French Revolution was in part a reaction to this mercantilist ancien régime. The processes that caused mercantilism to be replaced by economic liberalism for a brief period in the mid-nineteenth century are beyond the scope of this discussion. The important point here concerns the consequences of the new policy prescriptions that it generated. I do want to emphasize, however, that this (what I have elsewhere called) "unMarxian withering away of the State"[20] also helped to bring about the change in the policy regime in nonrevolutionary countries such as England.

Paradoxically, the new economic liberalism (although short-lived) achieved the goal sought by mercantilism:

> Great power for the state, the perpetual and fruitless goal of mercantilist endeavour, was translated into fact in the nineteenth century. In many respects this was the work of laissez-faire, even though the conscious efforts of the latter tended in an entirely different direction.
>
> The result was attained primarily by limiting the functions of the state, which task laissez-faire carried through radically. The maladjustment between ends and means was one of the typical features of mercantilism, but it disappeared once the aims were considerably limited. Disobedience and arbitrariness, unpunished infringements of the law, smuggling and embezzlement flourish particularly under a very extensive state administration and in periods of continually changing ordinances and interference with the course of economic life. It was because the *regime de l'ordre* bore this impress that disorder was one of its characteristic features.[21]

The resulting framework for economic policy can be described as economic liberalism in the original sense of the term, and not in the sense of social democracy used in the mid-twentieth century, at least in the United States.[22]

Mill defined explicitly the policy prescriptions of classical economic liberalism. Thus, it is useful to look at the justifiable government interventions listed in his *Principles*. He begins his chapter "Of the Grounds and Limits of the Laissez-faire or Non-interference Principle,"[23] by distinguishing two types of intervention. The first he calls *authoritative* interference (p. 305), by which he means legal prohibitions on private actions. Mill argues on moral grounds that such prohibitions should be limited to actions that affect the interests of others.

But, even here, "the onus of making out a case always lies on the defenders of legal prohibitions. Scarcely any degree of utility, short of absolute necessity, will justify a prohibitory regulation, unless it can also be made to recommend itself to the general conscience" (pp. 306–7).

The second form of intervention he calls *government agency*, which exists "when a government, instead of issuing a command and enforcing it by penalties, [gives] advice and promulgates information . . . or side by side with their [private agents] arrangements an agency of its own for like purpose" (p. 305). Thus the government can provide various public goods (the examples Mill gives are banking, education, public works, and medicine) without prohibiting private supply.

Most of the government interventions Mill allows belong to this second category. But he warns against their costs: They have large fiscal consequences; they increase the power of the government;[24] "every additional function undertaken by government, is a fresh occupation imposed upon a body already charged with duties," so that "most things are ill done; much not done at all" (p. 309); and the results of government agency are likely to be counterproductive. In a passage that seems prophetic for many public enterprises in developing countries, he writes:

> The inferiority of government agency, for example, in any of the common operations of industry or commerce, is proved by the fact, that it is hardly ever able to maintain itself in equal competition with individual agency, where the individuals possess the requisite degree of industrial enterprise, and can command the necessary assemblage of means. All the facilities which a government enjoys of access to information; all the means which it possesses of remunerating, and therefore of commanding the best available talent in the market—are not an equivalent for the one great disadvantage of an inferior interest in the result. (P. 311)

On these grounds he concludes:

> Few will dispute the more than sufficiency of these reasons, to throw, in every instance, the burden of making out a strong case, not on those who resist, but on those who recommend, government interference. Laissez-faire, in short, should be the general practice: every

> departure from it, unless required by some great good, is a certain evil. (P. 314)

But Mill also provides a bridge to the ideas that were later to undermine economic liberalism. The most important of these was the socialist ideal of equality, which was later used to develop a powerful antidote to the liberal tradition through Marxism and was implemented as state socialism by the Bolsheviks. Thus Mill allows various forms of government agency, many of which echo what later came to be recognized as causes of market failure that could seem to justify appropriate government intervention. Such causes might be externalities in the provision of basic education and public services like lighthouses and the need to supervise financial institutions against fraud, or to resolve various forms of what today would be called Prisoner's Dilemmas. Mill also cited the relief of poverty as another possible reason for government intervention:

> The question arises whether it is better that they should receive this help exclusively from individuals, and therefore uncertainly and casually, or by systematic arrangements in which society acts through its organ, the state. . . . The claim to help, . . . created by destitution, is one of the strongest which can exist; and there is *prima facie* the amplest reason for making the relief of so extreme an exigency as certain to those who require it, as by any arrangements in society it can be made. On the other hand, in all cases of helping, there are two sets of consequences to be considered; the consequences of the assistance, and the consequences of relying on the assistance. The former are generally beneficial, but the latter, for the most, part, injurious; so much so, in many cases, as greatly to outweigh the value of the benefit. And this is never more likely to happen than in the very cases where the need of help is the most intense. There are few things for which it is more mischievous that people should rely on the habitual aid of others, than for the means of subsistence, and unhappily there is no lesson which they more easily learn. The problem to be solved is therefore one of peculiar nicety as well as importance; how to give the greatest amount of needful help, with the smallest encouragement to undue reliance on it. (Pp. 333–34)

This is a prescient summary of both the attractions and pitfalls of welfare programs, which have since been validated empirically in many developed and developing countries alike.[25]

Indeed, nowhere in Mill's authoritative text on nineteenth-century economic liberalism do we find any hint that its principles worked against the state, or the poor, as has been charged by modern thinkers.[26] It is important to recognize, however, that although liberalism granted these important exceptions to Mill's "*practical maxim*, that the business of society can be best performed by private and voluntary agency" (p. 345), what Keynes called the "laissez-faire dogma" had become entrenched among the political classes.[27] But this "dogma" was not completely without its uses. As Hecksher notes,

> Free competition, individualism and the limitation of state encroachment often became pure dogmas among practical men of affairs and politicians . . . without any conscious rational foundations. That such a normative outlook existed is, in itself, by no means a criticism of laissez-faire. *Some norm or other is always behind conscious action, for every action presupposes such a conception of the norm as, in itself, is not demonstrable.* Here it was a question, in fact, not of science, but of economic policy, that is not of thought but action.[28] (Emphasis added)

This liberal "disposition toward public affairs," to use Keynes's phrase did not, however, outlast the economic nationalism and socialism that arose in Europe toward the end of the nineteenth century, and, more important, after the First World War.[29]

Diverse social and intellectual trends, including important advances in scientific economics, led to the subsequent development in the post-1930s world of what I have labeled the dirigiste dogma.[30] The various forms of discretionary government intervention, most cogently justified on grounds of market failure within the so-called Arrow-Debreu paradigm, provided the intellectual ballast for a new form of mercantilism, particularly in the third world. Can anyone doubt that the ensuing mercantilist view of social causation also underlies our modern-day optimal tax theory, planning in its various forms, and the discretionary use of public action to correct the perceived ills of private agency? In the modern variant of mercantilism, of course, the objective of economic policy is no longer the welfare of the state but the welfare of the citizens, as summarized in a social welfare function *laid down by the state*. Hecksher writes:

> The underlying idea of mercantilism may be expressed as follows: people should be taken as they are and should be guided by wise measures in the direction which will enhance the well being of the state. No one was more explicit in this view than Mandeville (1723). "Private vices," he observed, "*by the dexterous management of a skilful politician* maybe turned into public benefits."[31]

The consequences of the neomercantilist practices that the dirigiste dogma has engendered in the third world (and in its macroeconomic aspects in the first world), not to mention in the wholly centralized socialist states of the communist world, are very similar to those that helped undermine the mercantilist states of seventeenth- and eighteenth-century Europe.[32] The contemporary reaction (as in the past) has been to move toward economic liberalism, in large part to gain state control over unmanageable economies. This recent worldwide movement toward economic liberalism, embracing governments of all political complexions, has been labeled a new age of reform by OECD observer David Henderson. But it is still progessing half-heartedly, in part because the dirigiste dogma continues to have a hold on the minds of the thinking (or as Prime Minister Thatcher calls them, the "chattering") classes. There are a number of reasons for this state of affairs.

The first reason is self-interest. Enlightened government intervention (the neomercantilist objective) requires experts. The rise of the professional classes is well documented in Britain.[33] "It is professionals, whose power lies in expertise and in the rent they are able to extract for that, who have come to run the country . . . Its natural base was the state; its preferred model, what was later called corporatism."[34] These mandarins are, for self-interested reasons, supporters of the dirigiste dogma.

As we have seen, however, two other currents flow through the dirigiste dogma. The first is the belief initially propounded by Mill that questions of allocation can be separated from those concerning the distribution of income:

> The laws and conditions of the production of wealth, partake of the characters of physical truth. There is nothing optional, or arbitrary in them . . . It is not so with the distribution of wealth. That is a matter of human institution solely. The things once there, mankind, individually or collectively, can do with them as they like. They can place

> them at the disposal of whomsover they please and on whatever terms.[35]

This view, with its implicit support for what is technocratically called the social welfare maximization of an objective function encompassing both efficiency and equity, has since become the staple of every modern textbook on public policy. But it is at odds with the view of the classical thinkers, including Marx.[36] Economic history—not merely of the sample of developing countries Myint and I recently examined,[37] but also that of many Western economies and (as is increasingly apparent to their own rulers) also of commmunist countries—has shown that the efficiency-equity trade-off is a chimera, because it creates enormous information and incentive problems.

The second current, another legacy of Mill, is the neglect of the polity. This neglect has reached its apotheosis in contemporary technocratic economics, which assumes that the two fundamental theorems of welfare economics derived within the Arrow-Debreu framework are to be *applicable in practice* to any polity when it comes to policy analysis. The same framework, however, provides an antidote to this problem that is gaining increasing attention. According to Partha Dasgupta, one of the more distinguished theorists of this technocratic mold,

> The operational appeal of the Fundamental Theorem of Welfare Economics is of course minimal. The informational requirements for the state are awesome. It is required to know the preferences, endowments and the (personalised) production set of all individuals. These observations alone suggest that individual rights to certain private decisions may not only be a moral imperative, but may at once be a necessity prompted by the fact that the state possesses incomplete information.[38]

With support from the recent mathematical economic literature on "incentive compatibility," Dasgupta illustrates the problems this approach raises for a command economy run by mandarins, as Hayek and Mises pointed out at the start of the "planning debate" in the 1930s.[39] The only feasible incentive-compatible mechanism for allocating resources in this framework is not a command economy but one that achieves a full optimum by working through the price mechanism supplemented by optimal taxes and subsidies.

The question is, what sort of mandarins would be needed to design and administer optimal taxes? To achieve the desired outcomes, the mandarins would have to be "economic eunuchs" (in Professor James Buchanan's apt phrase), as Dasgupta has also pointed out:

> It has been an abiding shortcoming of applied welfare economics that it has for the overwhelming part supposed a perfect government—one that faithfully goes about its tasks. But if one addresses oneself to the question of what incentives there must be to ensure that governments undertake their tasks faithfully one is, at a minimum faced with the principal-agent problem with all its attendant difficulties.[40]

Both events (experience) and ideas have therefore undermined the post-war dirigiste dogma. Above all, particularly in the third and second worlds, the undesirable consequences of post–World War II neomercantilism—*not least for the state*—have made a return to economic liberalism possible, as did the consequences of seventeenth- and eighteenth-century mercantilism.

Toward an Economic Liberal Framework for Policy

A succinct restatement of the case for economic liberalism and what it does and does not entail has recently been provided by David Henderson:

> The objections to economic liberalism and the market economy centre round the role of governments and states, both nationally and internationally. For many people liberalism goes with laissez-faire, which in turn is viewed as outdated, negative, unconcerned with what happens to weaker members of society and de facto favouring the stronger, and uncompromisingly negative in its attitude to the state. This rests on a double misconception. First, it distorts the message of laissez-faire. Second, it wrongly identifies belief in a market economy with an extreme interpretation of the laissez-faire principle.
>
> As to the first point, laissez-faire gets an undeservedly bad press. The message it conveys is not that governments should be inert or indifferent. Its emphasis is a positive one. It is concerned with economic freedom, including the freedom of individuals and enterprises to enter industries or occupations, to choose their place of

> residence or operation within a country, and to decide their own products, processes and markets. There is nothing outdated about these principles, nor do they operate against the weak. To the contrary, they enable opportunities to be opened up more widely, and thus operate against special privileges within an economic system. It is no accident that outside the communist world the economy which most conspicuously departs from laissez-faire is that of the Republic of South Africa.
>
> In any case, liberalism is not to be identified with hostility to the state, nor with a doctrinaire presumption that governments have only a minor role in economic life. On the contrary, the liberal view of the role of the state, both internal and external, is strongly positive.[41]

What is even more important, however, the widespread acceptance of economic liberalism as a *practical maxim* would in all likelihood put a stop to the activities of the ubiquitous rent-seeking predatoriness of many third world states, as it did briefly in the liberal phase in Europe. It would provide some internalized commitments against those neomercantilist interventions of the state that have impaired growth performance and thus reduced the chances for alleviating poverty in many countries.

One of the main conclusions of the Lal-Myint study is that the mainsprings of growth (entrepreneurship, productivity, and thrift) can best be fostered within an economic framework that maintains relatively stable property rights. Various forms of dirigiste interventions upset the stability of these rights and hence increase the fog in which economic agents undertake their actions. The ignorance-based, externality-creating form of investment that Scott has recently emphasized as a source of growth, is considerably more difficult to undertake in such an environment.[42]

Many economic historians have argued that the European growth miracle of the eighteenth and nineteenth centuries is directly related to the creation of property rights that are broadly associated with a market economy.[43] These property rights made it possible to curb the inherent predatory power of the state through various forms of taxation based on representation. The resulting liberal economic framework gave freer rein to the entrepreneurial talents and instincts of private agents. The classical thinkers and their modern-day successors, the neo-Austrians, have always emphasized that the entrepreneur plays an important role in an economic environment characterized by ignorance, which, *faute de mieux*, is characteristic of the kinds of forward-looking investment decisions that typically fuel the growth process.[44] Investment efficiency depends just as much on free entry by potential competitors as it does on departure by unviable firms. This freedom of entry and exit by entrepreneurs must not be impaired, as it often is by dirigiste interventions.

These classical and neo-Austrian insights are not available to the technocratic tradition that now dominates public policy, since the entrepreneur is redundant in neoclassical economics, which assumes an environment of purely actuarial Knightian uncertainty.[45] But he is at the center of the neo-Austrian stage, creating and searching out investment opportunities and gambling on the future. The liberal economic framework allows this entrepreneurial function (which, even though unquantifiable, is undeniably at the heart of the growth process) its fullest play. The neomercantilist policies of most third world countries divert these entrepreneurial talents and resources away from productive activities into the zero-sum redistributive games involved in wasteful lobbying and rent seeking.[46] By contrast, the liberal economic framework provides the necessary incentives for entrepreneurship, productivity, and thrift. These qualities (and their determinants) are only dimly understood by economists in a formal sense. But at bottom they are the mainsprings of sustained and sustainable economic growth.

The two most important features of the liberal economic framework are its emphasis on Gladstonian finance and on sound money. The requirements of the latter are self-evident. The nature of the former is less well known and has stirred more debate. Schumpeter lists three basic principles of Gladstonian finance: (1) *Retrenchment* means that "the most important thing [is] to remove fiscal obstructions to private activity. And for this, it [is] necessary to keep public expenditure low." (2) *Neutrality* implies "rais[ing] the revenue that would still have to be raised in such a way as to deflect economic behaviour as little as possible from what it would have been in the absence of all taxation." (3) *Balance* refers to the principle of the balanced budget, or rather, since debt is to be reduced, "the principle that Robert Lowe . . . embodied in his definition of a minister of finance: 'an animal that ought to have a surplus.'"[47]

A recent OECD study concludes that the present-day concerns and objectives of most OECD countries, irrespective of their political complexion, seem to revolve around reinstituting the principles of Gladstonian finance in their economies.[48] Nevertheless, many mainstream economists, who are increasingly seen as irrelevant by governments and their populace in most of these countries, remain wedded to the highly sophisticated and interventionist optimal tax theory of F. P. Ramsey and his followers.

This theory assumes that "the government has coherent, unified and largely benevolent objectives, captured in the social welfare function, and we search for ways in which the tools available to it can be used to improve the measure of welfare."[49] That the theory does not apply to most developing countries is patently obvious, since their polities do not even come close to these assumptions about their character.

Once a predatory state or rent-seeking society is accepted as the norm, however, the pattern of optimal taxes envisioned by Ramsey—even from the point of view of a *neutral outside observer*—is no longer desirable. Thus,

> the well known inverse elasticity rule which calls for concentrating excise taxation on inelastically demanded commodities in order to minimise the social cost for acquiring a given amount of tax revenue is altered by the existence of rent-seeking. Rent-seeking increases the marginal social cost of excise taxation across commodities in such a way as to confound the traditional result. It can easily follow that the correct pattern of excises is to tax relatively more elastic demand curves first.[50]

An important distinction to make concerning the neutrality of taxation is that in the optimal tax tradition this means minimizing the deadweight costs of taxation, whereas in Gladstonian finance the term refers to the generality or uniformity of a tax.[51] A number of arguments (apart from rent seeking) can be made against the former and in favor of the latter, classical prescription of neutrality.

First, Ramsey's optimal taxation is based on the assumuption that even though nonuniform taxation tends to encourage individuals to shift their demands and supplies from taxed to nontaxed goods and activities, such leakages will be small. Only if tastes are given, as optimal tax theorists assume, will such counterproductive behavior, from their viewpoint, not arise. Second, as Harberger has argued,

> Economic theory assumes that the dominant source is substitution. . . . There is thus a very strong presumption that broadening the coverage and lowering the rate of a uniform tax will reduce the deadweight loss. . . . One can build policy on this basis without having any detailed knowledge of the parameters of supply and demand, without any particular hope of gaining anything more than a very patchy knowledge about them in the future, and indeed *with* an almost absolute assurance that wherever the relevant parameters might be now, they will undergo substantial changes in the future. If one believes that these conditions come close to describing our present and likely future state of knowledge about the relevant parameters he will likely be predisposed toward uniform as against Ramsey-rule taxation.[52]

Finally, as Harberger notes, "to tax salt more heavily than sugar" on Ramsey-optimal lines "simply and solely because it has a lower elasticity of demand is at least as capricious (from the standpoint of equity) as taxing people differently according to the colour of their eyes." The main difference between the two approaches to neutrality in taxation, according to Harberger, is their different philosophies of government, one of which corresponds to the classical liberal view, the other to the neomercantilist social-engineering view.[53] I have drawn attention in this essay to the importance of using the former and the perils of relying on the latter as a framework for public policy geared toward poverty-alleviating growth in the third world.

Concluding Remarks

To understand the differing wealth of nations, we need to return to the concerns and perspectives of the classical thinkers, but without abandoning our powerful theoretical and statistical tools. Mercantilism, in its various guises, remains the dominant impediment to the attainment of that poverty-redressing growth that many developing countries have shown to be feasible for all the countries of the third world. In fighting mercantilism—old or new—these countries should make it their top priority to establish a policy framework that emphasizes economic freedom (misleadingly called laissez-faire), in the classical sense.

NOTES

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1. See I. M. D. Little, *Economic Development* (New York: Basic Books, 1982).

2. This was published in the *ECAFE Survey 1969* and subsequently issued as *The Implications of Economic Controls and of Liberalisation*, ECAFE Growth Studies Series, no.6 (Bangkok: United Nations, 1969).

3. I. M. D. Little, T. Scitovsky, and M. Fg. Scott, *Industry and Trade in Some Developing Countries* (Oxford: Oxford University Press, 1970).

4. W. M. Corden, *Trade Policy and Economic Welfare* (Oxford: Clarendon Press, 1974).

5. The debate about protection in the United Kingdom in the mid-1970s clearly demonstrated that this lesson had yet to be learned by developed as well as developing countries. See my exchange with Edmund Dell, then secretary of trade and industry in the United Kingdom, in D. Lal, "The Wistful Mercantilism of Mr. Dell," *The World Economy*, June 1978; E. Dell, "The Wistful Liberalism of Deepak Lal," ibid., May 1979; Lal, "Politicians, Economists and Protection—the Deaf Meet the Blind," ibid., September 1980. For critiques of two other proponents of protection in the United Kingdom, see Lal, "Mr. John Biffen M.P. at the Pearly Gates," ibid., March 1982; and Lal, "Comment" [on R. Nield], in R. Major, ed., *Britain's Trade and Exchange Rate Policies* (London: Heinemann, 1979).

6. This work was published as part of a general book on Indian planning, *Prices for Planning—Towards the Reform of Indian Planning* (London: Heinemann, 1981).

7. D. Lal, *The Hindu Equilibrium*, vol. 1, *Cultural Stability and Economic Stagnation, India c1500BC–1980AD*; vol. 2, *Aspects of Indian Labour* (Oxford: Clarendon Press, 1988, 1989).

8. D. Lal, "The Political Economy of the Predatory State," Development Research Department Discussion Paper no. 105 (Washington, D.C.: World Bank, 1984), published as Chapter 13.2 of *The Hindu Equilibrium*, vol. 1; Lal, "The Political Economy of Industrialisation in Primary Product Export Economies: Some Cautionary Tales," in N. Islam, ed., *The Balance Between Industry and Agriculture*, vol. 5, *Factors Influencing Change* (London: International Economic Association and Macmillan, 1989); Lal, "After the Debt Crisis: Modes of Development for the Longer Run in Latin America," in S. Edwards and F. Larraine, eds., *The Aftermath of the Debt Crisis* (Oxford: Blackwell, in press).

9. D. Lal and H. Myint, *The Political Economy of Poverty, Equity and Growth* (London: University College, January 1990), photocopy. A revised version is to be published for the World Bank by Oxford University Press.

10. In *The Poverty of Development Economics* (London: International Economic Association, 1983; Cambridge, Mass.: Harvard University Press, 1985).

11. See, for instance, J. Schumpeter, *A History of Economic Analysis* (New York: Oxford University Press, 1954).

12. I noted this explicitly in *The Poverty of Development Economics*. This is also a major theme in H. De Soto, *The Other Path* (New York: Harper & Row, 1989).

13. This was also the period in which the philosophical scene was alight with the controversies surrounding the great books by J. Rawls and R. Nozick. I examined the growing distributivist literature emerging from many international organizations in the 1970s, in the context of these philosophical debates, in "Distribution and Development: A Review Article," *World Development* 4 (September 1976).

14. D. Lal, *Poverty, Power and Prejudice: The North-South Confrontation*, Fabian Research Series 340 (London: Fabian Society, December 1978).

15. D. Lal, "Nationalism, Socialism and Planning: Influential Ideas in the South," *World Development* 13 (June 1985).

16. D. Vital, *The Inequality of States* (Oxford: Clarendon Press, 1967): 5. Also see D. Lal, *Appraising Foreign Investment* (London: Heineman Educational Books, 1975).

17. E. Hecksher, *Mercantilism*, 2 vols., rev. 2d ed., (London: Allen & Unwin, 1955): 21, 22. The original Palgrave has the following entry on mercantilism. It notes that the various mercantilist measures undertaken in the sixteenth and seventeenth centuries were

> the result of the efforts of statesmen so to direct the economic forces of their time as to create a strong and independent state. The object of the mercantile system was the creation of an industrial and commercial state in which by encouragement or restraint imposed by the sovereign authority, private and

> sectional interests should be made to promote national strength and independence. . . . There are many points of resemblance between the mercantile system and state socialism. An organised industrial and commercial state is an ideal common to both, and many of the measures adopted under the former would no doubt reappear if any considerable approach to the latter took place.

"Mercantile System" in *Dictionary of Political Economy*, vol. 2, ed. by R. H. Inglis Palgrave (London: Macmillan, 1896): 727. The author of the entry was W. A. S. Hewins, then director of the London School of Economics.

18. J. M. Keynes, *The End of Laissez-Faire* (London: Hogarth Press, 1928): 12.

19. For a fuller elaboration and references, see De Soto, *The Other Path*.

20. See D. Lal, "The Political Economy of Economic Liberalization," *World Bank Economic Review*, January 1987.

21. Hecksher, *Mercantilism*, 325.

22. Schumpeter noted "the term has acquired a different—in fact almost, the opposite meaning—since about 1900 and especially since 1930 . . . as a supreme, if unintended compliment, the enemies of the system of private enterprise have thought it wise to appropriate its label." *History*, 394.

23. J. S. Mill, *Principles of Political Economy*, ed. Donald Winch (London: Pelican Classics, 1970). This is Chapter 11 of Book 5. Page numbers cited are from the Pelican edition.

24. Mill is not sanguine with the consequence that "the public collectivity is abundantly ready to impose, not only its generally narrow views of its interests, but its abstract opinions, and even its tastes, as laws binding individuals" (p. 308).

25. See Lal and Myint, *The Political Economy of Poverty, Equity and Growth*.

26. The refurbished modern text on economic liberalization remains F. Hayek, *The Constitution of Liberty* (London: Routledge and Kegan Paul, 1960). This point is argued more fully in T. Sowell, *Classical Economics Reconsidered* (Princeton, N.J.: Princeton University Press, 1977).

27. Keynes, *The End of Laissez-Faire*.

28. Hecksher, *Mercantilism*, vol. 2, 331.

29. Keynes, *The End of Laissez-Faire*, 5. Keynes cites Cairnes's introductory lecture "Political Economy and Laissez Faire," delivered at University College, London, in 1870, as the first by an orthodox economist to launch a frontal attack upon laissez-faire in general. That the socialist ends had grudgingly come to be accepted, however, is noted by Keynes, who quotes Cannan: "Scarcely a single English economist of repute, as Professor Cannan has expressed it, 'will join in a frontal attack upon socialism in general,'" although, as he adds, "nearly every economist, whether of repute or not, is

always ready to pick holes in most socialistic proposals." Keynes, *The End of Laissez-Faire*, 26. Of course Keynes himself explicitly claimed that his views were descended directly from the mercantilists in his *General Theory*. For a scathing critique of Keynes's support of mercantilism, see Hecksher, *Mercantilism*, vol. 2, Appendix, "Keynes and Mercantilism." As Keynes noted,

> experience in the organisation of socialised production has left some near observers optimistically anxious to repeat it in peace conditions. War socialism unquestionably achieved a production of wealth on a scale far greater than we ever knew in peace for though the goods and services delivered were destined for immediate and fruitless extinction, none the less they were wealth. (P. 35)

30. Lal, *The Poverty of Development Economics*, 25. Two books by A. O. Hirschman are important in exploring the changing fortunes of economic liberalism: *The Passions and the Interests—Political Arguments for Capitalism before Its Triumph* (Princeton, N.J.: Princeton University Press, 1977); and *Shifting Involvements—Private Interest and Public Action* (Princeton, N.J.: Princeton University Press, 1982).

31. Hecksher, *Mercantilism*, vol. 2, 293.

32. Although in this section I am emphasizing the evolution of ideas and relating them to changing policy regimes, this does not imply that I necessarily subscribe to the view most celebratedly propounded by Keynes, that ideas (often defunct) determine policies. On the lines of the new political economy, it is as likely that interests determine events, including changes in policy regime, and if these are far reaching, a new set of ideas may emerge (or reemerge) to rationalize them. That ideas lag behind events moved by interest seems to me as valid a position to take on the interaction of ideas and interests as the self-serving view of Keynes and many economists that ideas necessarily determine policy. For an interesting discussion of the issues, see the recent collection of essays from a Liberty Fund Conference published by the Institute of Economic Affairs, *Ideas, Interests and Consequences* (London, 1989).

An interest-based explanation for the rise and demise of mercantilism is provided by R. E. Ekelund and R. J. Tollison, *Mercantilism as a Rent-Seeking Society* (College Station: Texas A & M University Press, 1985).

33. See, for instance, the recent book by Harold Perkin, *The Rise of Professional Society: England since 1880* (London: Routledge and Kegan Paul, 1988); and the excellent review of this by Geoffrey Hawthorn, "A Triumph of Self-Interest," *Times Literary Supplement*, July 14–20, 1989, 266. In *The End of Laissez-Faire* Keynes explicitly recommended corporatism as his preferred form of economic organization.

34. Hawthorn, "A Triumph," 266.

35. Mill, *Principles*, Book 2, Chap. 1, 349–50.

36. John Gray, *Hayek on Liberty* (Oxford: Blackwell, 1984), 102, notes that Hayek has always recognized that Mill began the

> "manna from heaven" presumption of contemporary distributist theories. It may be said that what distinguishes Mill from Hayek—and, for that matter, from Marx—is Mill's lack of any clear view of production and distribution as inseparable parts of a single economic system. We may have a choice between economic systems (though it is the burden of the Mises-Hayek-Polanyi argument about resource allocation under socialism that our freedom is far more restricted than we suppose); we do not have the freedom to mix the productive arrangements of one system with the distributive arrangements of another. This is a truth understood by all classical economists, including Marx, which Mill's influence has helped to obscure.

37. In Lal and Myint, *The Political Economy of Poverty*.

38. P. Dasgupta, "Decentralisation and Rights," *Economica* 47 (May 1980): 112.

39. See F. Hayek, ed., *Collectivist Economic Planning* (London: Routledge, 1935).

40. Dasgupta, "Decentralisation," 119.

41. D. Henderson, *Innocence and Design—The Influence of Economic Ideas on Policy* (Oxford, Blackwell, 1986): 98–99.

42. M. Fg. Scott, *A New View of Economic Growth* (Oxford: Clarendon Press, 1989).

43. For instance, Hicks, North, and Braudel.

44. The early neoclassicists like Alfred Marshall were conscious of the importance of entrepreneurship. See, for instance, Marshall's "The Social Possibilities of Economic Chivalry," in A. C. Pigou, ed., *Memorials of Alfred Marshall*, especially 331–32. Keynes, of course, apart from attacking thrift also denigrated businessmen (see his comments on Marshall in this context in *The End of Laissez-Faire*, 36–38), picking up on a common sentiment among the educated bourgeoisie of which he was a self-confessed member. See his "Am I Liberal?" in his *Essays in Persuasion* (New York: W. W. Norton, 1963): 324. For the rise and growth of antibusiness sentiment among the English chattering classes, see M. Wiener, *English Culture and the Decline of the Industrial Spirit* (Cambridge: Cambridge University Press, 1981).

45. For a fuller discussion, see Lal, "Markets, Mandarins and Mathematicians," *Cato Journal* 7, no. 1 (1987). For the importance of entrepreneurship, see the detailed analysis in Alwyn Young's chapter on Hong Kong in R. Findlay and S. Wellisz, *Five Small Island Economies* (Oxford: Oxford University Press, in press). For a study that questions the usual pessimistic view about entrepreneurship in Africa, see W. Elkan, "Entrepreneurs and Entrepreneurship in Africa," *World Bank Research Observer* 3, no. 2 (July 1988): 171–88.

46. The seminal contributions on this phenomenon are by G. Tullock and A. Krueger, which are collected with various others in J. M. Buchanan, R. D. Tollison, and G. Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station: Texas A & M University Press, 1980).

47. Schumpeter, *History of Economic Analysis*, 403–5. Also see Henderson's lecture to the Institute of Fiscal Studies, "A New Age of Reform?" (1989), in which he notes the increasing acceptance of these principles in the fiscal policies of developed countries.

48. Organization for Economic Cooperation and Devlopment, *Economies in Transition* (Paris, 1989), cited in D. Henderson, "A New Age of Reform?"

49. A technically sophisticated and comprehensive application of these principles to developing countries is to be found in N. Stern and D. Newbery, *The Theory of Taxation for Developing Countries* (New York: Oxford University Press, 1987): 653. But they themselves acknowledge,

> The book is silent on the positive theory of public finance. The reason is not that we regard the study of ways in which policies are actually determined as uninteresting. . . . Rather we think it is important to discover what would be desirable even when it may be currently politically infeasible or when prudence cautions against creating an institutional framework to administer proposed taxes. (P. 14)

50. D. R. Lee and R. D. Tollison, "Optimal Taxation in a Rent-Seeking Environment," in C. K. Rowley, R. D. Tollison, and G. Tullock, eds., *The Political Economy of Rent-Seeking* (Boston: Kluwer Academic Publishers, 1988): 349.

51. See A. C. Harberger, "Neutral Taxation," in *The New Palgrave*, ed. J. Eatwell, M. Milgate, and P. Newman (London: Macmillan, 1987) 3: 645–47, for a lucid and important discussion of these traditions of "neutrality" in public finance, one classical, the other neoclassical, if we may so term them. The following discussion draws heavily on this source.

52. Harberger, "Neutral Taxation."

53. Thus Harberger writes:

> Consider the philosophy of government that assigns to governments the role of creating a framework of laws and regulations within which the private sector then is encouraged to operate freely. Under this philosophy a positive value is placed on the authorities not caring what private agents do. . . . It is a positive desideratum to create a tax system that is robust against changes in risks and technology. . . . On the other side of the coin we have a philosophy of social engineering in which the detailed tastes and technology of the society enter as data into a process by which the polity makers choose parameters such as tax rates and coverages so as to maximise some social measure of social benefit. (P. 646)

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