

ENTREPRENEURSHIP AND RENT SEEKING IN INDIA

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Introduction

The role of entrepreneurship has never been far below the surface in discussions of rent seeking. In both market and nonmarket institutions, competition is ever-present; and since Adam Smith, the harnessing of entrepreneurship toward privately and (simultaneously) socially useful ends has constituted the principal justification of market institutions. In contrast, when institutions are nonmarket, entrepreneurship is often directed toward privately rewarding but socially wasteful ends. This form of entrepreneurship is directed at redistribution—i.e., diversion of value away from others—in contradistinction to market entrepreneurship that creates rather than diverts value (Buchanan 1980). Nonmarket entrepreneurship arises most often due to governmental action in various forms. It is most explicitly demonstrated in the case of government-sponsored monopoly, where in addition to the traditional Harberger (1954) deadweight welfare loss, society also incurs the loss of resources expended by each of the contending entrepreneurs seeking to transfer surplus from consumer to producer. It is to be expected, therefore, that the more extensive and entrenched such institutions are, the less value is created in society and the slower the rate of economic growth.

The term “entrepreneurship” is used here in a somewhat unfamiliar sense. In its traditional Schumpeterian meaning, entrepreneurship is the value-creating force in a competitive market order where the potential for rents provides the incentive for resource owners to seek out more efficient allocations of their resources. The

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presence of positive rents promotes entry by competitors into some activities, even as negative rents cause some resource owners to exit from theirs; returns are thereby restored to their normal levels over time.¹

The question of what constitutes the stuff of entrepreneurship cannot be directly answered from the postulates of received neo-classical theory, but Liebenstein (1968, p. 74) has listed some of the characteristics that entrepreneurs may possess. These include the ability to “search and discover economic opportunities, evaluate economic opportunities, marshal the financial resources necessary for the enterprise, make time-binding arrangements, take ultimate responsibility for management, be the ultimate uncertainty and/or risk bearer, provide and be responsible for the motivational system within the firm, search and discover new economic information, translate new information into new markets, techniques and goods, and provide leadership for the work group.” A striking feature here is the dependence of these characteristics on the *economic* opportunities mentioned at the head of the list. These opportunities are not exogenously given but are the product of a discovery process. As Kirzner (1980, pp. 17–18) put it: “. . . a concatenation of possible events may not be noticed at all unless the discoverer stands to gain from the price differential. In order to switch on the alertness of a potential discoverer to socially significant opportunities, they must offer gain to the potential discoverer himself . . . the most impressive aspect of the market system is for such opportunities to be discovered.”

Although these opportunities are not exogenously given but are revealed only through entrepreneurial discovery, it is nevertheless crucial to note that what *must* be given exogenously to potential discoverers are the institutions that make possible such discovery. As Demsetz (1983, p. 278–79) put it: “It is not enough to recognize that oil, not water, is coming from the ground—although even this involves the prior acquisition of the knowledge needed to distinguish between the two. A mind must devote itself to considering the prospect and judging its potential. That is a mind diverted from other tasks; therefore there is a cost to maintaining alertness. Alertness itself is a form of investment under conditions of uncertainty.” When societal institutions make the opportunity cost of economic alertness high and that of political/bureaucratic alertness low, entrepreneurial individuals may rationally be expected to invest their time, energy,

¹The role of the entrepreneur in neoclassical general equilibrium theory, however, is rather more obscure. As Baumol (1968, p. 66) observed: “[B]y ignoring the entrepreneur we are prevented from accounting fully for a very substantial proportion of our historic growth . . . yet the theoretical firm is entrepreneurless—the Prince of Denmark has been expunged from the discussion of Hamlet.”

and resources in pursuing political/bureaucratic opportunities rather than economic ones. Within such institutions, entrepreneurship will get translated into socially malevolent rent-seeking activity. Rent seeking then obtains in some settings and traditional profit seeking obtains in others, not because of differing modes of rationality among economic agents but because of the institutions that characterize those settings.

Some economists hold the view that entrepreneurship is a scarce resource like other economic resources and that poor countries are characterized by a particular scarcity of it (Lewis 1955, p. 196). The scarcity of entrepreneurship has subsequently been advanced as a rationale for governments to establish state-owned industrial enterprises (Government of India 1951). Others draw a sharp distinction between entrepreneurship and the traditional factors of production. Kirzner (1973, p. 66), for example, maintained that "the search for the elusive analytical category of entrepreneurship stems from the insight that an explanation of the market phenomenon of pure profits implies a role in the market which cannot be reduced to just a special kind of productive factor." The critical relationship between entrepreneurship and economic growth is not much in dispute, however, and most economists agree with Leibenstein (1968, p. 81) that "the motivations present—e.g. the profit rate—are such that those with gap-filling capacities are willing and able to exert themselves under some motivational circumstances and reduce the degree of exertion under others." These motivational circumstances thus determine the outcome of entrepreneurial behavior, and it is in regard to these circumstances that public choice theorists such as Tullock (1984) have suggested that widespread rent-seeking institutions are the most significant cause of poverty in poor countries.²

By focusing on entrepreneurship as alertness to opportunities permitted or constricted within exogenously given institutions, this paper attempts to show that rent-seeking theory can shed light on many aspects of empirical reality that are commonly observed in poor countries. Although the example of India is used here, economists have made similar empirical observations in many other poor countries (Bauer 1981) and explanations similar to those offered here suggest explanations for the rest of the "developing world."

Rent seeking is analyzed in this paper as a two-stage process of rent capture and subsequent defense/augmentation. The paper is organized accordingly. First, rent-seeking theory is discussed briefly

²Referring to the U.S. economy, Tullock (1984, p. 235) also expresses the fear that "the trends point to more and more rent seeking. Unless something is done to stop these trends, we may end up in the same situation as the backward societies."

using the property rights paradigm. Next, the nature of the specific investments made to capture public sector rents is elaborated upon and the various post-capture welfare losses are discussed. A rent-seeking explanation of the persistence of India's traditional caste system is then offered. The final section of the paper concludes with some normative implications of the analysis.

Rent Seeking and Property Rights

From the very genesis of the rent-seeking literature, India has been a classic example of the rent-seeking mode: there are government controls on investment, capacity creation, expansion, diversification, choice of technology, location, pricing, distribution, imports, foreign collaboration, private foreign investment, use of foreign exchange, credit supply, and so forth. In her seminal paper, Krueger (1974) estimated that the annual welfare costs from rent seeking due to India's import-export regulations were approximately 7 percent of GNP. Mohammed and Whalley (1984) subsequently estimated that if controls in capital markets, goods markets, and labor markets are included in the rent-seeking calculation in addition to external controls, then annual welfare costs are 35 to 40 percent of GNP. These studies suggest that in the context of the economy of a poor country, welfare losses induced by rent seeking are likely to be more significant than the losses originating from the traditional price-distorting effects of taxes and subsidies. This paper focuses particularly on state and local rent seeking rather than on the rent seeking that arises from federal controls. Although federal controls are the focus of much rent seeking due to the substantial rents lodged therein, entry barriers are also high. As a result, the ordinary citizen is most often an entrepreneur, not in the federal rent-seeking industry but in rent seeking at the state and local level. The anatomy of "underdevelopment" is thus best understood at this level, where ordinary citizens face the incentives and opportunities created by relative prices and wages and make choices correspondingly.

State and local public sector rents are lodged primarily in government and political jobs, and individual investment is directed primarily at acquiring them. Entrepreneurs who are unsuccessful at rent seeking are subsequently forced into the tax-generating economy, where relative rates of return to investment have been lowered due to administrative regulation³ and the high tax rates imposed to

³In India, these range from "target capacity creation" in "key sectors" reserved for government to detailed product-level setting of output and price levels (Bureau of Public Enterprises 1986).

support the entrepreneurs who capture the scarce government and political jobs.

Rents available to those who are successful in capturing these rent-access positions make politics and the civil service differentially productive employments. The rents are lodged in political offices, the administrative bureaucracy, and state-run "public sector corporations."⁴ These rents are in the form of the present discounted value of the excess of government salaries and perquisites over incomes for similar services in the private sector, bribes that can be exacted for disbursing permits and licenses, opportunities for theft of the public assets for which government officials are responsible, and threats of job nonperformance.⁵ The allocative unnecessary of these payments to attract people of comparable quality to these jobs makes these payments economic rents. Once the rents are captured, there is a lifetime guarantee of payments so that entrepreneurs who are successful in securing these jobs by investing in education, political lobbying, and so forth are in essence able to convert these positions into private property rights.⁶

Buchanan (1980, p. 5) observed that "rent seeking analysis can readily be incorporated within the property rights approach." Jagannathan (1986) further explored rent seeking as a process of property rights assignment. Unlike the textbook production function, production in the property rights paradigm is not a matter of physical output possibilities, given input quantities, knowledge, and the state of technology; it is rather a matter of the structure of property and contracting rights and the consequent incentives that confront indi-

⁴These corporations are not firms in the Coasian sense but governmentally created organizations that are statutorily granted monopoly over the domestic market. This was justified as follows in India's first five-year plan: "In the public sector the direction of investment is not governed by the profit and loss calculus; it has also to take into account wider considerations" (Government of India 1951, p. 26). These wider considerations were said to include "employment creation, export promotion, rapid growth in output and sales, import substitution, good employee relations, promoting technological self-reliance and independence, and promoting balanced regional development" (Bureau of Public Enterprises 1986, pp. 13-27).

⁵To appreciate the magnitudes of these rents, a useful example is provided by Wade (1985, p. 475) in his study of the irrigation department of an Indian state. Individuals who had *already* captured rent-access positions in this department were willing to bribe the relevant bureaucratic/political authority between Rs. 1,200,000 and Rs. 1,500,000 (or some 40 times the average annual official salary in that rank) for a two-year period as superintending engineer in the prized coastal areas of the state. In that year, India's annual per capita income was approximately Rs. 2,500.

⁶Being scarce goods, the concept of property rights readily applies to these positions. As Furubotn and Pejovich (1976, p. 3) observed, "the concept of property rights . . . applies to all scarce goods."

vidual entrepreneurs. The “firm” in this view essentially serves as a nexus for implicit or explicit contracts among individuals, and “production” occurs whenever individuals contract with one another for services. Rent seeking can then be said to occur in institutions that embody property rights that encourage the production of outputs with no welfare valuation (e.g., political lobbying) as opposed to market institutions that induce value-adding production. When viewed as such, rent-seeking welfare losses consist of the total social cost of all resources expended to capture a property right through governmental assignment.

A singular feature of the property right in a government job that have been secured in this manner is the legal prohibition against marketability of the claim on the sequence of future cash flows that have been captured by the rent-seeking activity. Rent extraction, in other words, is conditional on employment, the sale of the right to become a government employee being prohibited. The welfare costs of public sector rent seeking, therefore, can be alternatively formulated in terms of this prohibition of tradeable claims on the cash flows deriving from the rents embodied in government jobs. Specified in this way, the rights structure determines the individual’s incentives and, therefore, the social ends to which maximizing entrepreneurs will direct their investments. The absence of nonattenuated property rights in the scarce government and political jobs sets in motion investments in organizing interest groups, lobbying, education, vote-seeking, and bribery to have the scarce right assigned. After discounting the probability of failure and the high return if success is achieved, individuals will continue investing resources in such activity to the point where the marginal expected return matches that on other possible resource investments. Resources will then have been invested by each contending entrepreneur to the point where the present discounted cost of the resource investment is equal to the present discounted value of the job. Such investments, however, differ from traditional profit-seeking investments in one crucial respect: no social asset is created.

Rent Seeking as Investment without Asset Creation

In poor countries, where individual ownership of physical capital is at relatively low levels, the education market is an especially significant medium for various types of transfers; and the potential for such transfers gives rise to rent-seeking activity. Transfers may be carried out with a minimum of social resource waste, or they may be carried out with considerable social waste. In this section, we

examine a variety of rent-seeking costs arising from the inefficiency of the transfer methods employed. To highlight these inefficiencies, consider a hypothetical scenario in which scarce government jobs are converted into marketable private property rights by direct auction. In this case, government could initially secure the full value of the rents that it currently forgoes when entrepreneurs have to make various forms of investment other than direct pecuniary payment to government. These direct payments could then be treated like normal tax revenue and spent for governmental purposes.⁷ It will be argued that a system that includes the additional right of marketability would be allocatively more efficient than the government job/contract-seeking system currently practiced in India.

A major form of investment that job-seeking individuals in India currently make is in human capital acquired with a view to satisfying government stipulations for specific jobs. These stipulations, however, are qualitatively different from human capital acquired in response to market-generated incentives, and no definitive claim can be made *a priori* that positive social externality will result from such bureaucratically and politically determined requirements. The extent to which such a claim would be valid depends on whether or not the resources invested by the successful job-seekers improve their efficiency on the job and on the relative magnitude of the costs imposed on the economy by these job-seekers. The social cost of such investments is a large multiple of the investments made by the successful job seekers, because the number of people who spend time, energy, and money preparing for the necessary examinations is a very large multiple of the number of available jobs. In addition, the examination-specific human capital (e.g., for the civil services examinations) acquired by the rent-seeking entrepreneurs is rarely of any use in any other economic activity. With no real asset created due to the nontransferability of the investment to other uses, the overwhelming majority of the entrepreneurs get no return at all on their educational investment; they become the "educated unemployed." Such invest-

⁷Rent seeking would then shift to some other level within government (Buchanan 1980). The sale of government jobs is not without historical precedent; it was the rule in the states of 17th- and 18th-century Europe (Swart 1949). Purchasers of public offices in France, for example, had to put up large sums of money for the job; but once bought, they held it for life, receiving a return on their outlay in the form of fees, gratuities, and extortions. These jobs could also be sold by the incumbent in the open market or willed to whomever he pleased. On the efficacy of the resulting service, Tullock (1980, p. 22) observed that "during the period of two hundred years before the French Revolution (the period in which this system operated), France was usually accepted as the most powerful and progressive state on the continent of Europe. Certainly it would be hard to argue that its government was worse than its contemporaries."

ments continue to be individually rational, however, which leads to a growth of the high school–college–“personal tuition” industry.⁸ Economically, however, this waste of resources is identical to the social resource waste of traditional rent seeking, such as the cost of maintaining lobbyists who cultivate license-dispensing bureaucrats in the capital city. No economic value is added in either case.

We have assumed that the screening and selection process for these examinations (stipulated by regulation as a prerequisite to compete for the rent-access jobs) is neutral. In reality, however, graders of the relevant examinations exact rents for high grades so that professors compete to obtain the graderships, resulting in social resource waste. Rents are also secured by those on the “interview boards” for government jobs.⁹ There is, then, the rent-seeking cost of officials expending resources to obtain interview board jobs. The only difference between the system in prerevolution France and the present system in India is that it is not the government that directly captures these rents but those individuals who have successfully captured rent-access positions, such as public offices in interview boards and graderships for examinations. In addition to the resource waste of the job seekers, therefore, there is waste due to the competition that sets in to gain access to these other forms of rent. If the pure auction system were adopted, resource waste in competition for the jobs would be avoided, resource waste in competition for interview board memberships and examination graderships would be avoided, and government could receive the full value of the rents. If, on the other hand, all jobs were openly for sale by interview board members, there would be rent seeking by prospective board members (who are politically appointed) but none by job seekers. This situation would also have welfare-enhancing effects because the rent seeking would be only for the assignment of property rights among prospective

⁸*India Today* reported in its November 30, 1987, issue that for the 2,000 seats open to high school graduates in 1986 at the public sector Indian Institutes of Technology (IIT), “several lakhs had applied” (1 lakh = 100,000). In the same issue, an upper-middle class high school graduate from Madras (who had 3 personal private tutoring sessions a day from different instructors to prepare for the requisite entrance examinations), when questioned about his ambitions, informed the reporter that “his goal was IIT and then Caltech.” When asked what he wants most out of life, the reply: “A good job, a huge big house, a chauffeur-driven imported car.” Public support for such private ambition is an underexamined issue in the literature on developing countries.

⁹For the various departments under the state government, this board is the state’s Public Service Commission, which screens all job-seekers and awards an “entry rank” to every entrant; this rank determines all subsequent career promotions. Although the competition for rent-access positions in the federal government is similar in many respects to the state level rent seeking described in this paper, there are also important differences that manifest themselves in ways different from those described here.

board members, with society saving on resource expenditure by all job seekers.

It is useful at this point to consider the tax incidence of the educational system that generates the job seekers. The chief source of state revenue is taxation in the form of various value-added taxes and sales taxes on items of mass consumption. Given the low standard of living for the majority of the population, this tax burden is sharply regressive and falls most heavily on those who are the worst off. The subsequent tax support for higher education is a regressive transfer as well; that is, the revenues spent on higher education usually end up benefiting individuals in the upper income brackets who can afford the requisite investments in time, private coaching for the entrance examinations, and so forth. Professors and other employees who capture the scarce rent-yielding jobs at public universities and colleges are also beneficiaries of this transfer.

The economic justification for public higher education is normally offered in terms of the positive externalities produced because college graduates are more productive than they would be without that education, and the additional productivity accrues to society as a whole. Tullock (1983, p. 142) expressed skepticism about such claims. In the context of poor countries, it is much more plausible that public higher education serves largely to turn out ever-larger numbers of the "educated unemployed," which, if anything, produces social unrest by frustrating the heightened personal expectations of large numbers of citizens. In a society where only a small fraction are fortunate enough to obtain employment in the government sector, the benefits of education are captured entirely by the person who receives the education in the form of rents lodged in the government jobs that he or she manages to secure. In India, there is also a statutory maximum age for entry into the officer cadres of government service (usually the late twenties). The initial rank is set by the Public Service Commission, an interview board of government bureaucrats, and higher ranks are filled only by promotion within the service. A person entering service below the rank of officer can never be reclassified as an officer. Successful rent seekers, therefore, are necessarily individuals who have enough resources to devote to educational investment early in life; people in the lower income brackets who may choose to go to vocational schools or to college later in life are systematically excluded.¹⁰ Nevertheless, a small percentage of lower-income individuals of superior ability do find their opportunity sets

¹⁰In the irrigation department of a typical state, Wade (1985, p. 490) noted, "The difference between Supervisor and Junior Engineer is that the latter has a university

enlarged due to publicly subsidized higher education and the eventual prospect of a government job. Such educational investment by entrepreneurial individuals is precisely the kind that Leibenstein (1968, p. 82) described as “dysfunctional” in that “it increases the opportunity costs of potential entrepreneurs and may as a consequence decrease the supply of entrepreneurship.” The investments discussed in this section, however, do not reflect the total welfare cost of these institutions. Significant social costs are also incurred subsequent to rent capture.

Post-Rent Capture Welfare Losses

In the property rights approach to social cost, the problem of “market failure” is seen as the absence of nonattenuated property rights, and the extent to which property rights will be established is a function of the transactions costs involved: the lower the transactions costs, the easier property rights can endogenously evolve. When nonattenuated rights are involved, this combination is usually welfare enhancing because mutually beneficial exchanges can subsequently take place. But the property rights that evolve in the political arena into bureaucratic sinecures are what Buchanan (1980) described as instances of “diversion of value” from taxpayers rather than “creation of added value,” the value-diversion process that consumes the resources involved in rent seeking. The excess supply of these bureaucratic property rights is welfare-decreasing because of various post-capture welfare costs.

Post-capture welfare losses occur because successful rent capturers become, in effect, agents without principals for a wide range of actions. While supervisors impose some control on the job, both subordinate and supervisor operate with a fair amount of freedom permitted within the constraints of rent-sharing with the relevant bureaucratic/political superiors on the one hand and unusually excessive public harassment (which may affect the local legislator’s prospects) on the other (Wade 1985). When successful rent seeking yields guaranteed payments until retirement, such entrepreneurs face strong incentives to convert the public assets for which they are responsible into personal wealth. The planning horizon used by successful entrepreneurs with regard to government assets is their expected employment retirement date. Public projects for which the true risk-adjusted

degree in engineering, the former has only a two-year post high-school diploma in engineering. The difference in time spent in tertiary education is small, but makes a profound difference to their career structures. Supervisors are promoted, if at all, only at the end of their careers; Junior Engineers can expect much earlier promotion.”

present value of cash flows exceeds the present value of outlays have no necessary correspondence with the projects that maximize the net present value of the entrepreneur's cash flows captured by his rent-seeking activity. With no mechanism corresponding to market discipline that can elicit the true expected payoffs and risks, information on expected payoffs and risks for public funding requests will be projected so as to correspond with the entrepreneur's planning horizon. By reducing, postponing, or eliminating maintenance on government assets and by using material of substandard quality, successful rent seekers can also pay themselves higher salaries and perquisites.¹¹

This problem is exacerbated in cases where the major negative effects of such action occur beyond the entrepreneur's planning horizon. Therefore, it is common for dams to leak and bridges to collapse soon after the officials entrusted with their construction have retired. Government-sector borrowing as a whole similarly makes larger current salary payments and fringe benefits available by postponing the repayment burden beyond their own planning horizons.

Such behavior could conceivably be monitored in a market in which the value of rent-seeker claims get capitalized and traded. Successful rent seekers would then have the incentive to maximize the value of their claims by the optimal acquisition and maintenance of assets. Without such a market and the consequent lack of a control mechanism for the successful rent seeker's behavior, the incentives are to run down inventories, appropriate state resources as personal wealth, and generally employ government assets improperly leading to their deterioration. Several bureaucratic agencies have been set up purportedly to monitor such behavior throughout the government sector. Every state in India has an Anti-Corruption Bureau made up of police officers and officers from the various government departments. It investigates a case when asked to do so by the relevant minister or his secretary. An investigation results in a confidential report of findings, on the basis of which the government decides on a course of action. The government subsequently submits a confidential report to the state's Vigilance Commission, a body widely

¹¹In the irrigation department studied by Wade (1985, p. 474), "the desirable posts tend to be in Construction and in Operation and Maintenance (O&M) units, the undesirable ones in Investigations and in Designs . . . an Assistant Engineer in an O&M post on an upland canal might expect to earn illicitly at least one to two times his annual official salary each year, net of what he has to pay upwards to the Executive Engineer. The corresponding figure for the Executive Engineer is probably more like three to five times." "Cement is a gold mine," Wade quoted one engineer as saying, "whenever cement content is more, it is more paying."

known to have been created as comfortable sinecures for retired senior bureaucrats and High Court Justices politically appointed by the government. The Vigilance Commission's charge is to comment on the government's course of action and to recommend changes. The government does not have to accept the commission's recommendations; it can put the matter to a vote in the Legislative Assembly, where the ruling party or coalition has the majority by definition. (This is usually not necessary, because results of such inquiries are classified as "confidential" and are almost never released to either the public or the legislature.) Setting aside the circularity of these procedures, the Anti-Corruption Bureau, the Vigilance Commission, and the various federal agencies of similar lineage face prohibitive monitoring and detection costs, even if those activities were assumed to be their function. In reality, the agencies are politically created and subject to the same rent seeking as discussed earlier. Agencies, therefore, have been created to monitor the monitoring agencies, which expands rent seeking further still. Welfare losses thus increase substantially as the number of such government monitoring agencies increases.

Many economists (for example, Bauer 1981) have observed that everyday life is far more politicized in poor countries than in Western industrialized countries. Rent seeking, which is investment aimed at the governmental assignment of property rights, can lead to such politicization in a number of ways. Political jobs such as ministerships attract resources in the form of excessive political campaign spending and vote seeking. Returns to this form of entrepreneurship are highly uncertain, but the large magnitude of the rents lodged in political jobs make the expected payoffs attractive to many entrepreneurs. Because of the necessity for periodic elections, political jobs have limited tenure (unlike jobs in the civil service) so that these nonmarketable property rights are in fact rights to quasi-rents, and successful entrepreneurs have the incentive to appropriate their full value while in office. This usually implies disbursal of permits, licenses, and bureaucratic jobs to family and friends; approval of large-scale publicly funded projects that can be easily converted into personal wealth by theft and other means that are more difficult to detect; locating such projects in the minister's electoral district; and so forth.¹²

¹²Reports on these activities form the staple of journalism in India. A typical issue of any Indian news magazine is likely to devote the majority of its pages to such stories. The September 30, 1987, issue of *India Today*, for example, reported on the brothers-in-law of the chief ministers of Andhra Pradesh and Uttar Pradesh states who had enriched themselves considerably by appropriating as personal wealth public assets of substantial magnitude.

Entrepreneurs who are successful in the political arena through majoritarian elections also face strong incentives to further bureaucratic growth in order to attract votes from unsuccessful job-seeking entrepreneurs (who far outnumber the successful) by alternative rights modifications. This takes the form of creating additional government bureaus and public universities with various constituency-based "quotas" for the newly created rent-access positions. These rents are partially funneled back into the political process through the financing of elections by public-sector bureaucrats, contractors, and suppliers. Besides the rent seeking that sets in for these new positions, previously unorganized groups also enter the political arena. The free-rider problem that obstructs the formation of many political interest groups in industrially advanced countries is less significant in a poor, regulated economy because the opportunity cost of time spent applying political pressure has been made low for many citizens. Widespread political activity among large and diverse sections of the populace, therefore, is commonplace.

When this is the only legally permissible mechanism for rights assignments for scarce government jobs, investment in political organization may be expected not only by those seeking to change rights assignments but also by successful entrepreneurs seeking to defend and augment the rents procured. This investment—which typically takes the form of political activity after successful rent capture—must also be counted as a welfare loss due to its detrimental effect on job performance: officials are distracted from performing such necessary functions of government as maintaining public law and order.¹³ Thus, not only the unsuccessful but also the successful job-seeking entrepreneurs continue to engage in intense and continuous political activity in the form of agitations, public rallies, and threats of job nonperformance by government-sector unions made up of bureaucrats, university teachers, bus drivers, and so forth to extract salary increases and other benefits. Competition for governmental alterations in rights assignments thus sets in by rent defenders and by unsuccessful rent seekers for the creation of new property

¹³Jagganathan (1986, p. 128) gave the example of a typical farmer's plight: "If he wishes to sell his land, getting the deed registered in the local subregistry office . . . may involve a long wait. Even securing help from the police to simply enforce his rights when his house is burglarized is often an arduous task. Similar illustrations can be given indicating difficulties in securing the renewal of a motor vehicle license, obtaining a gun license or even a simple certificate of residence." Rashid (1981) has given an account of how operators in India's government-owned telephone monopoly act as individual discriminating monopolists arranging for international calls in order of the magnitude of bribe received.

rights through the expansion of bureaucratic and political opportunities by tax increases and regulation of the private sector. Successful rights modification subsequently increases the incentives of unorganized interests to enter the political arena. These interests are then articulated in ways that are specific to the social-historical conditions obtaining in India.

Rent Seeking and Caste

Politics can enter different societies in different ways. The form of entry will depend on the specific institutions that determine the parameters of self-interest around which interest groups are created. In many parts of Africa, politics is defined along tribal lines, for instance, while it is primarily based on caste in India. The dogged persistence of caste and religious politics (not the class politics predicted by Marxist theory) has often been explained in terms of the hypothesis that the "false consciousness" of citizens blurs their vision about where their true interests lie (Chandra 1984). The rent-seeking explanation offered below makes quite the contrary claim: that it is precisely individuals' rational responses to existing institutions that generate the configuration of caste-based politics.

India has all the traditional special interest groups, such as trade associations, labor unions, and professional associations, but the predominant one continues to be caste. Castes in India bear the names of various occupations. Olson (1984, p. 156), who explicated the notion of castes as a system of guilds, has shown that historically castes have exhibited cartelistic features, including restrictive membership, price fixing, "professional ethics" (caste codes of behavior), group bargaining, and various rules limiting output and competition. Olson (p. 157) also observed: "With modernization many new occupations have emerged and the caste system has changed for other reasons as well, so the caste need not be primarily an occupational or guild-type classification for the educated Indian today." It is to be expected, then, that modernization would weaken the caste system by breaking the cartelistic features of different occupations and facilitating entry, but this has not occurred. Although intergenerational mobility into previously restricted occupations has certainly increased, many Indian social scientists have pointed out that caste and religious barriers have been simultaneously strengthened (Chandra 1984). Caste endogamy is the rule even among families whose members are now in occupations that have no relationship to their caste classification. While the guild explanation is a satisfactory one for the

origin and evolution of the caste system, the question remains as to why the system has endured despite "modernization."

To this point, the analysis has suggested that when political control is gained by winning majorities in elections while the scope of the private economy has been constricted, interest group formation will be focused on capturing public revenues. This in turn will depend crucially on the *organizational costs* that have to be borne. The breakup of guilds depends on the incentives open to both guild members and outsiders to arbitrate between the guild price and the competitive price. Pervasive government regulation not only removes arbitrage incentives but also creates alternative incentives for the *strengthening* of these guilds even after the original guild-type functions have lost their significance. Insofar as capturing government resources depends on interest group formation, these old groups will not only continue to endure but also to gain in strength because the organizational costs for group formation have already been borne. Unlike the era of guilds in England, where the transition from the mercantilist to the market system was directly made, in India and many other newly independent countries the transition has been from a mercantilist system to one of government job/contract seeking. In such a situation, there is no economic incentive for the breakup of the original guilds.

This is reinforced by some traditional guild-type functions of castes that remain, especially in the case of the important landowning castes. These castes make the traditional lobbying-type rent-seeking investments to obtain subsidized seeds, credit, irrigation, electricity, fertilizer, inflated government-stipulated procurement prices for farm products, and so forth. These castes are occupation-based, and their activities fit the description of usual interest group activities. As Bardhan (1984, pp. 50, 52–53) observed, however:

A major economic issue that divides them (the landowning castes) does not relate to agriculture or land interests at all: it is their access to jobs in the public bureaucracy. . . . The proportion of professionals coming from business, farmer or trading families has increased significantly. . . . No wonder that some of the bitterest caste struggles in various parts of urban India in recent years have been over the issues of reservation of seats in medical and engineering schools and of jobs in the government for lower castes.

Rent-seeking theory suggests that these caste conflicts have their roots in various constitutional provisions that are open to interest group pressure. The Indian Constitution is replete with such provisions (it is the most voluminous of any country), but a few that are particularly relevant bear mentioning. Article 15.4 allows the state

to make “any special provisions for the advancement of any socially and educationally backward classes of citizens or for the Scheduled castes and Scheduled tribes.” More specifically, Article 16.4 allows the state to make “any provision for the reservation of appointments or posts in favor of any backward class of citizens which, in the opinion of the state, is not adequately represented in the services under the state.” Article 341.1 mandates that “the president may . . . by public notification specify the castes, races or tribes which shall for the purpose of this constitution be deemed to be Scheduled castes.” And Article 341.2 adds: “Parliament may by law include in or exclude from the list of Scheduled castes specified under 341.1 any caste, race or tribe or any group within any caste, race or tribe.” Articles 342.1 and 342.2 announce the same for the “Scheduled tribes.” More than 1,181 different groups in the country have been labeled “Scheduled castes,” more than 583 other groups as “Scheduled tribes,” and roughly an additional sixth of the population is officially termed “backward.” These provisions were initially to last for a period of ten years, but they were extended every 10 years and continue to the present day. Inclusion of different castes for these special provisions in the public sector depends on the political organizing ability of these groups. Thus, caste groups that have historically incurred the organizational costs may no longer have an explicit cartel function but they will continue to have the *political* function of seeking and maintaining favored constitutional status.¹⁴ This implies that as long as widespread rent-seeking incentives exist, one can expect caste-based groups to be dominant in Indian politics. Only in the absence of such incentives will caste deviants find it profitable to break caste codes and enter restricted markets.¹⁵

The economic proposition that growth is a function of the “extent of the market” is as old as Adam Smith. When the market is widened

¹⁴*India Today* reported in its September 15, 1987, issue that in the southern state of Kerala, an angry mob of persons belonging to the Thandan caste beat up a village officer for refusing to issue them caste certificates (for preferential admission to local colleges and universities) because of their ambiguous constitutional status. The ambiguity stemmed from their different histories in different parts of the state: in the south they were traditionally coconut tree climbers, whereas in the north they were headmen chosen by the local chieftains. Political organizations for all the other “Scheduled Castes” had launched a vigorous public agitation against the issuance of Scheduled Caste certificates to the Thandans. The state government’s response was to appoint a sociologist to head a commission that would “once and for all decide whether Thandans are Scheduled caste” (p. 31).

¹⁵It may be conjectured that the continuing endurance of tribal loyalties in the politics of modern-day Africa is also amenable to a rent-seeking explanation similar to the one offered here for India.

through improvements in transportation, communications, and the removal of trade restraints, transactions costs for market participants are reduced and economic growth is accelerated. The integration of the early German and Italian states into nations, for instance, was economically beneficial because the tolls imposed by the various principalities were removed and the larger economic market came into being. By contrast, the creation of the nation-state of India (along political boundaries drawn by the British for colonial administrative convenience) was accompanied by the preservation of incentives for perpetuating caste-based interest groups centered on rent-seeking activities, thus leading to a narrowing of the economic arena and a concurrent widening of the political arena. This has created a situation where political entrepreneurs continually find it profitable to *increase* transactions costs among economic agents by segmenting the political market along caste and religious lines. This segmentation process intermittently explodes into deadly conflicts over government quotas for public sector jobs and for reservations in the medical and engineering schools.

Conclusion

This analysis suggests that “underdevelopment” is symptomatic of entrepreneurship being directed toward the production of outputs that generate no consumer surplus rather than any paucity of entrepreneurship as a factor production. In such a situation, governmental intervention only creates further rent-seeking opportunities and still further resource diversion into unproductive activities. The tax base in such a society is generated by the *losers* in the rent-seeking game who are forced into value-producing activity at governmentally depressed rates of return. These shopkeepers, cultivators, masons, carpenters, construction workers, agricultural laborers, and so forth are forced into market activity, and their consumption is then heavily taxed to meet the rent requirements of government job/contract seekers. With the reservation of most profitable sectors of the economy to government and the consequently restricted property rights in productive assets, investment opportunities available to successful rent seekers are also constricted, thus choking off any possibility for the rents to be invested productively. The rents procured, therefore, are usually invested in personal assets—such as automobiles, ostentatious housing, gold and silver jewelry, children’s education, and savings bank accounts—in amounts that reflect individual marginal rates of substitution between current and future consumption.

From this positive analysis emerges the normative question of identification and reform of the institutions that create incentives for entrepreneurs to capture rents embodied in the public sector rather than to engage in the production of goods and services that generate consumer surplus. Any proposal for reform must drastically reduce the magnitudes of these rents. While this may seem to imply steep reductions in government salaries and perquisites, such a step alone may only exacerbate the problem as officeholders try to compensate for lost income through increased bribery, extortion, and obstruction. The more significant component of the rents is lodged in the discretionary powers attaching to public offices. Especially important among these are the extraction of bribes for permits, licenses, and the awarding of government contracts; opportunities for theft of public assets; and threats of job nonperformance. As long as the present discounted value of these opportunities exceeds the expected returns from alternative economically productive employments of individual resources, economic entrepreneurship will be undersupplied and political/bureaucratic entrepreneurship will be oversupplied. Failing the drastic curtailment of these discretionary powers, rent-seeking losses will continue to be significant. Because such curtailment is unlikely, an alternative that would eliminate such welfare costs and simultaneously preserve these rents is to remove differential advantages by allowing equal access for all to the scarcity values, that is, by instituting an "equal sharing" rule (Buchanan 1980). To avoid individual resource investment for the purpose of shifting society from an equal sharing rule (if it were to be adopted) to some other rule, the former will have to be permanently and constitutionally embedded in all possible scarcity-value distributions. Operationally, the rights to such values will have to be assigned randomly in each case, which means that all the scarce government jobs and contracts will be assigned by a random lottery. If a system approximating random allocation were to be adopted, individuals would expend no resources to gain membership in some eligible set. Also, because the political process would then have little incentive to create additional rent-access offices, traditional price-distorting welfare losses would be reduced due to lower tax rates, rent-seeking welfare costs would be minimized, and the supply of entrepreneurship would equilibrate at its optimal levels in the economic and political/bureaucratic markets.

Although the theory of rent seeking dictates random allocation as the solution, it also predicts that it is the solution least likely to be adopted by the political/bureaucratic process. Any second-best solution, such as Jagganathan's (1986, p. 131) proposal that "instead of fixed charges and fees, a more flexible pricing system could be used

based on the user's willingness to pay," is open to manipulation and information-concealment by the bureaucrat(s) charged with determining the user's willingness to pay for the service. How a transition to the theoretically best solution is to be effected remains an unsolved problem for normative rent-seeking theory.

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