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Constrained Optimization:

The State and the Indian Entrepreneur

Abstract

The quality of entrepreneurship has been considered by many scholars as a critical factor in the economic development of a society. While some scholars have sought to explain the difference in entrepreneurial quality among societies based on cultural grounds, this paper argues that entrepreneurship is a function of the incentives derived from institutions and the historical context that entrepreneurs face. It also argues that entrepreneurs are not inert actors in the institutional and historical process, but are actively engaged in shaping the political-economic landscape which they inhabit. The paper undertakes an historical analysis of Indian entrepreneurship in the last hundred years as an illustrative example of this theory of entrepreneurial dynamics in a society.

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Introduction

Economists like Schumpeter¹ and von Mises² have discussed the importance of the entrepreneur as a source of economic growth. Entrepreneurs have been seen by these economists as the catalyst that positively impacts productive and/or allocative efficiency within the economy. Quite reasonably, this has led some economists, sociologists, and historians to try and compare the level of ‘entrepreneurial’ energy in different economies in an attempt to explain their respective growth trajectories at different points in time. Much has been written about the cultural context that informs entrepreneurship: starting from the celebrated idea of the ‘Protestant Ethic’ as a source of development by Weber to more recent assertions on the ‘Confucian’ ethic in East Asian economies.

Such cultural contextualization of entrepreneurship has been applied to the case of India as well. India’s relative lack of growth in comparison to some other large late industrializing economies such as Japan, Russia, and later China and the ‘Tiger’ economies in South-East Asia, have been attributed to cultural and religious factors such as a rigid caste system and an extremely spiritual (as opposed to materialistic) approach to life³. In the opinion of the author such ideas are purely conjectural and ignore the multifaceted reality of a heterogeneous society like India.

Baumol⁴ provides a framework of analysis for entrepreneurial dynamics in terms of institutions and incentives rather than any focus on ethnocentric cultural analysis. For Baumol, while the supply of entrepreneurs might vary among societies, the real difference in entrepreneurial outcomes derives from the allocation of entrepreneurial activities. The central objective of all entrepreneurial activity is to make profits. How to pursue such an objective will depend on the institutions within which they operate. Such institutions provide entrepreneurs with different incentives, and entrepreneurs react to them in the context of their profit motive.

Thus, the entrepreneur will pursue productive (innovation) or allocative (managerial efficiency) functions if the institutions (primarily the state) provide the right incentives that allow profit maximization in the pursuit of such activities. However, if the incentives on offer are such that the entrepreneur sees profit maximization opportunities in rent seeking behavior (and other such unproductive activities), then it should come as no surprise that entrepreneurs will actively pursue such opportunities.

By extending Baumol's analysis one step further, we can argue that if identical profits are seen to exist in both productive as well as unproductive entrepreneurial activity, but

productive activities are seen as higher risk due to the uncertainty of the costs involved (transaction costs subject to institutions): the risk-averse entrepreneur will go for the unproductive activities. If one assumes that a majority of entrepreneurs are indeed risk-averse, then society will see the dominance of such unproductive entrepreneurship, *but with some exceptions*: these exceptions will represent the set of risk-loving entrepreneurs.

This paper also argues that there is a short-term and long-term view of profits, both of which are subject to the Baumolian framework of incentives. In the short-term, profit is purely a function of financial gains for the entrepreneurs. However, entrepreneurs are fully cognizant of the institutional constraints they operate under, and over the longer term would seek to change this institutional context to their benefit, i.e. they would actively pursue ‘institutional gains’ to ensure long-run profit maximization. In this long-term pursuit of institutional gains, entrepreneurs respond to historical opportunities. Thus, as long as they perceive that there is no feasible possibility of institutional change, they accept the incentives and the institutions as given and operate optimally within that given institutional context. However, if they perceive feasible opportunities for change, they will, as a group try and influence the outcome of that change so that it is optimal to their interests. This is a key element within this paper: the entrepreneur’s perception of political-

economic opportunities will play a major role in determining his political activism in pursuit of institutional gains. It needs to be reiterated that this political behavior is not separate from the profit seeking motive, only a somewhat longer-run version of profit maximization achieved through institutional gains, i.e. the creation of institutions more predictable, less costly, and more conducive to the pursuit of wealth.

Based on the theoretical discussion presented thus far, this paper posits that the post-colonial Indian state is a classic example of an economy where the incentives on offer led to a domination of unproductive entrepreneurial activity. It also argues that the colonial apparatus of the Indian bureaucracy, inherited by the post-colonial state, and characterized by the centralization of power and decision making, played a major role in creating such a set of incentives. It further argues that Indian entrepreneurs did not always accept their institutional context as given, but actively pursued institutional gains subject to the incentive structure on offer for such political activism. As and when historical events led to perceptions that there was a feasible opportunity for institutional change, there was an incentive for the Indian entrepreneur to actively seek such institutional gains. However, if the political situation was perceived as strongly resistant to change, entrepreneurs had little incentive to pursue such uncertain goals given the assumption of risk-aversion.

Baumol⁵ employs the method of historical analysis in his comparative study of entrepreneurship in ancient Rome, China and renaissance Europe. Following Baumol's example, four periods in India's modern history is analyzed to provide support for the theoretical arguments made in this paper. These four periods are:

- The period from 1870 to 1914, where the Indian entrepreneur lived with colonial state's institutions as given and responded accordingly.
- The period from 1914 to 1950, where the Indian entrepreneur saw opportunities for change arising out of world events, especially the visible prospect of decolonization.
- The period from 1950 to 1990, where the entrepreneur learned to live within the context of the post colonial Indian state.
- The period after 1990, where world events and India's subsequent economic liberalization opened up opportunities for the Indian entrepreneur to push for a change in institutional apparatus.

The discussion of every one of these four periods will be organized to present the institutional context of the political economy of that period, followed by the entrepreneurial response to that institutional context.

Colonial India and the Indian Entrepreneur: from 1870 to 1914

The Institutional Context

While the crux of this paper revolves around the two later periods i.e. the periods from 1914 to 1950 and from 1950 to 1990: it is important to discuss the 50 odd years preceding it as it was in this period that much of the centralized government and institutions that currently exist in India took shape. Most importantly, this was the period that saw the state take a primary role in what can be loosely termed as nation building. In a pre-modern agrarian economy like India, the basic infrastructure to facilitate modern commerce and industrial undertakings had to come from the government, and accordingly the colonial government went on to invest substantially in infrastructure development.

The colonial Indian state took the lead in building railways, warehouses, ports and shipping related industries across the country. It follows that the colonial bureaucrats had a major say in the allocation of private contracts that went along with such developmental activity.

The unchallenged political supremacy of the colonial apparatus during this period favored the exercise of economic power by the European residents of India⁶. Many European historians claim that since the colonial Indian state was a laissez faire economy i.e. the role

of the government was limited: the colonial state could not have been in a position to create economic privileges for any one set of entrepreneurs. But the fact is that in many industries, especially in engineering related fields, the government was the sole (or the primary) buyer, and this gave it enormous leverage in the growth of much of the modern sector of the Indian economy.

The privileges enjoyed by the Europeans did not have to be a matter of high government policy, and most often it was not. Much of the discrimination arose from oversight and the prejudice of various department heads and officers in charge of implementation⁷. The fact that the Indians remained excluded from much of the social milieu of the European life in India, such as exclusively 'whites only' clubs, meant that their social access to the bureaucratic chain of command was quite limited. Some economic historians tend to underplay the role of such social relationships, but the importance of such social linkages as enabling mechanisms for business relationships have been highlighted in the literature dealing with business networks, specifically in the social network analysis literature⁸.

Given this institutional context, indigenous entrepreneurship found some expression in industries like the cotton mills sector in western India. However, the modern industrial

manufacturing sector in India as a whole was dominated by the Europeans. The Europeans also had an advantage over Indians in the external sector of the economy as a result of the European firm's linkages to capital markets in London, and the control of the shipping lines that connected India to important export markets in Asia and Europe.

The Entrepreneurial Response to the Political-Economic Institutions

Given that the Europeans controlled the higher end of the industrial value chain due to their linkages with the government and external market, Indian entrepreneurs worked in partnership with European firms providing services and inputs in the lower end of the industrial value chain. These Indian entrepreneurs played an important part in trade and commerce: providing service and commodity links as well as marketing networks for European imports. They also facilitated the supply chain of raw materials for exports. Many great Indian business houses that exist today started out as agents of the British controlled managing agency systems⁹. These British managing agencies coordinated investment and economic activity in several sectors of the Indian economy¹⁰: their primacy in the economic life in India arising out of a combination of their greater access to international markets and governmental power¹¹.

The structure of the Indian state and its' economy instilled in the Indian entrepreneur a

sense of the vitality of linkages with the bureaucratic elite. At this point in history the Indian entrepreneur took as given the institutional situation given him. The near future did not hold any realistic hope for the end of colonial domination. The Indian entrepreneur remained largely apolitical, hoping that by keeping good relations with the authorities, they could obtain measures favorable to their interests¹². The Indian entrepreneur concentrated on the limited sectors and horizons within which he could make sustainable profits and often played a subservient role to British business interests to facilitate their own access to international markets and governmental contracts through their British partners¹³.

Operating within this strongly colonial institutional background, the Indian entrepreneur of this period lagged behind his Russian and Japanese counterparts in the grand design of a modern industrial sector. The lack of access to governmental contracts and the protective tariff walls behind which large modern industrialization could be carried out (as they were in Japan and Russia for the most part) were totally non-existent in India. To try and venture into areas outside traditional spheres of entrepreneurship that went beyond a subsidiary position within a largely European dominated industrial value chain¹⁴ was a highly risky and uncertain activity. The average risk-averse entrepreneur therefore could not be expected to become the flag bearers of modern enterprise in such a situation. There were some

entrepreneurs who did take on such grand projects, such as J.N. Tata's foray into iron and steel. But Tata's venture was undertaken at a great risk, and non-economic factors such as nationalism played some part in these activities¹⁵. However, Tata's successful experiment represented one of those outliers attributable to the breed of risk loving entrepreneurs that are exceptions rather than the rule. It is also interesting to note that Tata's eventual success was very much due to the First World War, which was to have a major impact on the institutional framework for entrepreneurship in India, as will be discussed in the next section.

Challenge to Colonial Hegemony and Path to Independence: from 1915 to 1950

The Institutional Context

The First World War came as a blessing for Indian entrepreneurship. The war had a triple impact on the Indian economy. First, it cut off the supply of British (as indeed German and French) manufactured consumer goods, creating an opportunity for Indian entrepreneurs to move into this space. Second, the British war effort in Mesopotamia against the Ottomans needed to be supplied with all kinds of capital goods. Since the imperial supply chain from Europe was cut off, the Indian entrepreneurs had the opportunity to take advantage of this war demand. Tata, who had undertaken an extremely

risky investment in steel, was one of the biggest beneficiaries. The British needed a steady supply of rails to support their infrastructure and transport needs in the war in Mesopotamia and Tata stepped in to provide the goods, saving his nascent iron and steel works from imminent bankruptcy. Third, India became a surrogate industrial base for the whole British Empire in Asia: an empire that had to be defended and supported during the war. Indian businessmen were thus able to find new markets throughout Asia.

The other great historical event that followed immediately after the war was the arrival of Mahatma Gandhi at the centre of the political struggle for independence in India. The Non-Cooperation movement (from 1921 to 1922), led by Gandhi, was the first truly successful mass political agitation for independence at an all India level. It provided the first glimpse of hope that independence from imperial rule was more than just a pipe dream. This challenge to the empire rattled the British imperial authorities and they were compelled to become more sensitive to the needs of the Indian capitalist class. The imperial authorities saw Indian capital as a counterweight to the more radical elements within the Indian National Congress (INC)¹⁶ such as socialists like Jawaharlal Nehru and Subhas Bose¹⁷. The colonial government felt that given Indian capital's sensitivities to organized labor agitation, an alliance of sorts could be formed with Indian entrepreneurs.

The Entrepreneurial Response to the Political-Economic Institutions

Given the changing circumstances, the Indian entrepreneur found himself in an exciting new period: a period where new economic opportunities, as well as opportunities to shape future institutions were presented to him. Perceiving this feasible opportunity for change, the entrepreneurial class shed its apolitical inertia and moved in several fronts to engage history. One major move came through the formation of the Federation of Indian Chambers of Commerce and Industry (FICCI). The FICCI was established in 1927 as counterweight to the influence that British lobbies wielded with the Government¹⁸.

Taking advantage of the colonial government's new found respect for India's entrepreneurial bourgeoisie and growing economic clout, the Indian business community became strongly involved in lobbying with the imperial government. Strong demands were made for protection from external competition and for a participatory role within the commercial apparatus of the British Commonwealth. Evidence of such economic and political activism is underlined by the keen interest and controversy over the participation and representation of the Indian business community at the Imperial Economic Conference held at Ottawa in 1932¹⁹. While FICCI had been eager to be a part of the deliberations at Ottawa, the colonial authorities in India were distrustful of many of the

leading lights in FICCI like G.D. Birla, whom they considered too nationalist. It nominated a member of the Tata group of companies and other less prominent 'loyalist' businessmen to represent India instead.

The absence of FICCI was keenly felt and the outcome of the Conference saw a victory of British interests (specifically that of the Lancashire cotton lobby) over Indian ones. In retaliation, FICCI went on an active offensive against the colonial government, criticizing it for double standards, and for having failed to defend the economic interests of Indians who they supposedly represented. Such stringent and public activism by the capitalist class marked the coming of age of Indian entrepreneurial efforts to shape the institutions within which they operated. As argued in the theoretical discussion, it was the perception of a feasible opportunity for institutional change that informed much of this activism on the part of Indian entrepreneurs.

The political activism by Indian entrepreneurs was not limited to their dealings with the imperial authorities, they clearly understood that the future dispensation, whatever form or shape it took, would involve a strong role for the Indian National Congress (INC). They accordingly engaged with the INC. This engagement was heterogeneous in character and

involved a mix of cooperation as well as confrontation. Cooperation took the form of participation in the 'Planning processes' for India's future economic development initiated by left-leaning leaders such as Bose and Nehru within the INC in 1938²⁰. Business participation in the planning process represented a tacit understanding between the socialist elements in the INC and Indian capital that that the state would need to be active in the economic sphere and that private entrepreneurs would be a partner in the that process. The dynamics of such a partnership and its actual design were not yet clearly delineated in 1938 and would have important repercussions in the future as will be discussed later. The confrontation between entrepreneurs and the socialists within the INC took place in two fronts. First was through direct electoral confrontation with the INC in the provincial elections in 1937. Second was through more covert support to 'liberal' pro business INC leaders. Both these dynamics deserve some discussion.

Increasing political pressure on the colonial government led to the Government of India Act in 1935 that provided for elected provincial governments that had substantial (in a relative colonial sense) powers, including control over industrial policy. Thus, the indigenous political class in India was vested with some control on policy variables. Several Indian entrepreneurs, observing opportunities for shaping the institutional framework

decided to run for elections²¹ in the reserved seats that were allotted to chambers of commerce and business associations. In many cases entrepreneurs opposed and won handsome victories against candidates that were supported by the INC. In the 'open' general seats, the entrepreneurial class tried to influence the choice of the INC candidate by lobbying against those who they perceived as too left leaning. One particular example is the removal of Nimbkar, a trade-unionist with socialist sympathies, from the INC list of candidates in Bombay province due to pressure from business groups²².

The efforts of the entrepreneurial class to confront the leftist elements within the INC did not stop at just trying to influence the outcome of elections. There was both open and covert opposition to the leftist elements. On May 20, 1936, a public manifesto signed by twenty-one leading Bombay businessmen strongly attacked a speech delivered by Nehru in Lucknow where he had been elected President of the INC²³. Nehru's speech had supported socialism and had upheld many of the leftist ideas that the Indian entrepreneurial class found distasteful. The manifesto not only represented an open attack against the newly elected INC President, it tried to create a broader political agenda addressing the concerns of small property owners, traders, middle peasantry and the professional middle classes²⁴. It represents a unique ideological attempt to create consensus

for a wider 'bourgeoisie revolution' in India. By making a commitment to self-government in the same manifesto, the entrepreneurial class in India upheld their nationalist aspirations.

This period of 1914 to 1950 represents a watershed for the Indian entrepreneurial class. It also clearly demonstrates the validity of Baumol's ideas in explaining the allocation of entrepreneurial energies. The Indian entrepreneur grabbed the opportunities provided by the First World War and the loosening grip of the colonial government with both hands and established their control in a wide array of sectors. Realizing that they had an opportunity to shape the future institutional arrangement, they shed their apolitical image and actively pursued 'institutional gains'. But while it is true that the Indian entrepreneurial class came to terms with itself and the world in a very proactive fashion, it failed to create a truly broad based bourgeois revolution. This failure is unfortunate: this meant that Indian politics would lack a credible and competitive bourgeois voice within its political class throughout the first four decades (from 1950 to 1990) following independence, and garbled socialism would become India's ideology of choice. The dynamics of the 1930s had provided the Indian entrepreneur with a golden opportunity to bring about a bourgeois revolution: it failed for three important reasons that merit discussion.

First, it never tried to build a broad based liberal coalition with pro-business leaders within the INC political hierarchy. Leaders like Vallabhbhai Patel, Rajagopalachari and G.B. Pant had a significant political base, and had an attempt been made to coalesce effectively around them, they could have provided a popular anti-dote to Nehru and later Indira Gandhi. Business leaders like G.D. Birla and many of his fellow industrialists were not fully committed to opposing Nehru. Given Nehru's wide popularity, opposition on the part of the entrepreneurs was limited to occasional bouts of belligerence against Nehru's ideas and policies²⁵. Many business leaders felt that Mahatma Gandhi could be counted upon to temper Nehru's socialistic tendencies.

Second, the outbreak of World War II and the subsequent anti-colonial 'Quit India' movement of 1942 created a very uncertain atmosphere in India. Most senior INC leaders were arrested and put in prison by the British. The colonial state built an elaborate system of controls on production and consumption to support the greater allied war effort. Political uncertainty of the anti-colonial movement and an environment of strict economic controls, where profit objectives dictated close cooperation with the colonial government, forced the entrepreneurial class to make a show of loyalty to the British. Even the nationalist FICCI came out in support of the war effort²⁶, greatly reducing their esteem in

the eyes of the strongly nationalist Indian public. The entrepreneurial class lost wider political legitimacy in the process and came to be associated with the widespread corruption and black marketeering that characterized colonial economic policy during the Second World War. Third, the class of large entrepreneurs was never really serious about trying to create a wider alliance with smaller, more localized entrepreneurs (mostly traders and small town merchants). Had FICCI served as a focal point for the articulation of the needs of this larger group, it could have potentially been more successful in shaping the institutional environment of post colonial India, the topic of our next section.

The Very Centralized 'Federal' Union: 1950-1990

The Institutional Context

The discussion of the period 1950-1990 must start with a seminal event in the history of the Indian entrepreneurial class: the formulation of the 'Bombay Plan' in 1944. The Bombay Plan was a blueprint for national development for the post war years prepared by five prominent Indian businessmen in Bombay, and as such gave a prominent place to the state in the process of industrialization. The Bombay plan has often been used as an example by some Indian historians to portray that the entrepreneurial class in India was in favor of the planning apparatus that came to be established soon after independence. This

is an extremely faulty reading of Indian business history and has been opposed among others by Das²⁷ and Chibber²⁸.

Chibber in particular makes the argument that the Bombay plan was an attempt by the Indian entrepreneur to articulate the needs of a late industrializing business community, which expects governmental support of infrastructure, easier access to cheap capital and protection from external competition that would allow them the pursuit of profit maximization. Such government intervention and economic planning does not have to be the socialist version evinced in India starting mid 1950s onwards. Japan and pre Soviet Russia served as great historical examples in which the government had intervened with some success, a fact that was clearly recognized by the Indian entrepreneurial class. What the Bombay plan did not want, and what the Indian planning process went on to establish, was a structural and disciplinarian planning system that gave the bureaucracy absolute primacy in both the choice of technology (productive efficiency) and allocative efficiency²⁹.

The Industries (Development and Regulation) Act of 1951 represents one of the hallmarks of Indian economic planning. Under this act, prior approval was required to:

- 1) Establish a new manufacturing unit

- 2) Expand output by more than 5% in one year
- 3) Expand output by more than 25% over a period of five years

The role of the state was not just confined to giving support and direction to industrialization as was evinced in Japan, and later in South Korea and Taiwan³⁰, it was being extended to the micro-management of all operational decisions on technology, location and even the scale of operation. This was the regulatory system that shaped the contours of Indian industry as well as the quality of its' entrepreneurship in post-colonial India³¹.

The Entrepreneurial Response to the Political-Economic Institutions

Since the micro-level productive and allocative functions were taken over by the government, the entrepreneur in effect became a rentier. He faced little competition because he did not have to make an effort to sell his products, only distribute them. The ambitious entrepreneur needed only to expand his market share in an oligopolistic market by pre-empting licenses. Such licenses would allow him, in most cases, not to expand his own output, but to limit that of his rivals³². It was natural that bureaucratic control of this enormous licensing process gave rise to massive corruption and extremely high transaction costs in almost every aspect of the formal economy³³. It also gave rise to a large 'informal' or black market economy and subsequently more corruption.

Large swathes of the economy became government monopolies, especially during the Prime Ministership of Indira Gandhi³⁴ who followed an active policy of nationalization of several industries and services. Thus, the entrepreneurial space was also reduced in terms of sectors, further squeezing entrepreneurial talent into rent-seeking behavior in the shrinking non-government sphere of the economy. Three important questions arise at this point: first, what informed the planning trajectory of post-colonial India. Second, what sustained it and third, why did the entrepreneurial class in India accept, and in many cases, collude with this framework without too much protest. The following paragraphs try to provide a cohesive overview to explain these issues.

Ideology, politics, history and colonial legacy in the form of India's federal bureaucracy all combined to create the quasi-socialist planning process in India. Jawaharlal Nehru was a Fabian socialist, and his visits to the Soviet Union, where he witnessed the phase of massive industrialization under Stalin, strengthened his resolve that socialism was superior to the market mechanism. Nehru's commitment to socialism received a further boost during his visit to China in 1954, whereupon he openly declared that his vision for India was a socialistic one³⁵. Nehru's convincing victory in the elections of 1957 added political

resolve to his ideology.

At this point, it is perhaps appropriate to look back at the failure of the bourgeois revolution in India referred to earlier. By the mid 1950s, Nehru dominated India's political space and political imagination. Senior pro-business leaders in the INC such as Patel, Rajagopalachari and Pant either died soon after independence or were eclipsed by Nehru and later Indira Gandhi. The INC, once a heterogeneous and largely liberal political forum, started to become increasingly leftist. There was a lack of conjunction between the incentives of large and small businessmen and between the interests of capital and the professional middle class and land owning elites (some of the reasons for which will be discussed subsequently). Such disjunction prevented the rise of a liberal opposition to Nehru or Indira Gandhi. The Rajagopalachari led Swatantra (Independence) Party provided some challenge to the INC, especially the radicalism represented by Indira Gandhi in the 1960s, but could never build the mass political base of the INC.

The political economy of the planning process in part also explains why the INC (and some later 'socialist' movements in India) was able to build the mass political base that eluded the liberal politicians. Nehru and his fellow socialists put in place a system that was

in some ways ‘oxymoronic’: a marriage of planned centralized economy with a liberal electoral democracy. This oxymoronic marriage created a vicious cycle of political patronage upon which the power structure of the Congress was built. The political leader in power became the dispenser of largesse in terms of economic rights as well as jobs in the lucrative government sector. Given India’s multi-ethnic and religious composition, political power that enabled the distribution of such largesse to the most influential among each sub group (ethnic and religious) became the driving force of Indian democracy. A large part of organized labor and the white collar workforce, essentially the Indian middle class, was employed with, or dependent on the governmental sector, making them an instrument of this system of organized largesse³⁶. Such political foundations sustained the INC, the Nehru-Gandhi political dynasty and ‘license’ Raj that replaced the British Raj. This paragraph is not a case against India’s democratic system. On the contrary it is an objective look at the non-democratic economic organization that turned Indian democracy largely into a system of organized patronage and corruption.

The last pillar of strength that sustained this structure was India’s federal bureaucracy: the Indian Administrative Service (IAS). The IAS cadre believed itself completely capable of implementing centralized economic plans given its experience in regulating the economy

during the Second World War. Nurtured in the traditions of the colonial administration, it felt no diffidence about its ability to handle the economic future of the country rather than Indian businessmen, towards whom they had inherited an attitude of hauteur³⁷. The fact that most of them came from a small urbanized elite with a westernized education, made their disdain for smaller entrepreneurs, who belonged to a different social class, even greater. Ideological impact of Nehruvian socialism and 'big' push developmental theories in vogue in the 1950s and 1960s increased their certainty in the planning system. With time, as economic power with its related privilege and rent seeking opportunities increased, the bureaucracy developed a vested interest in keeping alive this system of 'planned' economy.

Public policies of this period did not evoke strong protest from organized business³⁸. A possible explanation lies again within the Baumolian framework offered in this paper. While the period from 1914 to 1950 had presented feasible opportunities for entrepreneurs to shape their institutional destiny, the post-independence political situation defined above offered no hope of radical change in the near term. On the other hand, the existing system did provide profit opportunities to established big entrepreneurs through rent-seeking activity. Established entrepreneurs could, given the double protection from both external and internal competition, enjoy profits in a relatively large domestic market. To look

beyond that was inviting high transaction costs and related uncertainty. The average risk-averse entrepreneur will shun such a course of action: exceptions would represent the minority of risk loving entrepreneurs. As a matter of fact, some of the more risk-loving, dynamic entrepreneurs left India and operated from abroad³⁹.

The system of regulated production, high transaction costs and centralized planning also prevented the smaller entrepreneurs from becoming too ambitious. This was a direct benefit to the entrenched players in the system, thus creating a disjoint between the interests of entrenched and new entrepreneurs. Moreover, since the smaller entrepreneurs links to the political class and bureaucracy was mostly local⁴⁰ i.e. utmost at the provincial level, it was cut off from a large part of the largesse that was doled out from the centralized federal apparatus. Thus, the best the small entrepreneurs could do was to play a subservient role in the supply chain to entrenched capital.

Smaller entrepreneurs also tried to use the planning apparatus to their benefit through the 'reservation' of certain industrial categories for the 'small-scale' sector. Under this scheme, certain products could only be produced by small-scale plants defined by capital and labor force limitations. This system allowed smaller entrepreneurs to operate in areas that

otherwise would have been absorbed by large capital given scale efficiencies⁴¹. Thus, the small-scale reservation system created another element in the inefficient, rent seeking apparatus of production of the Indian state that hindered entrepreneurial allocation of resources. Small entrepreneurs also lobbied at the provincial level, with some success, for the location of public sector industries that would be beneficial for their interests⁴². Rent seeking behavior became the norm for the entire set of entrepreneurs: big and small, entrenched and new. Any incentive to try and change this institutional system was obfuscated by the fact that the economic regulatory system worked on a case by case basis, at the discretion of the bureaucracy. It made entrepreneurs prefer the individual approach to dealing with the state rather than a group approach. This totally reduced the power of entrepreneurs as a lobby, though individual entrenched interests remained influential⁴³. Any substantial change to this system had to come externally; it would require a shock to push it out of its inertia. The fall of the Berlin wall and the First Gulf War would provide precisely such shocks.

The Beginnings of Change: India Emerging

The Institutional Context

While 1991 is often designated as the 'official' date for the inception of economic reforms

that dismantled the license-quota planning regime in India, the move towards reforms started earlier during the Prime Ministership of Rajiv Gandhi, son of Indira Gandhi and the grandson of Nehru. Several factors came into play that led to the first baby steps towards dismantling of the planning regime in India. First was the rise of a younger generation of entrepreneurs who saw the global success of their counterparts in South Korea, Taiwan, Singapore and Malaysia. This new generation of entrepreneurs that came to control the boardrooms of Indian enterprise wanted to be more than just spectators in the process of globalization, and felt the need to push beyond the system they had inherited from a previous generation.

Second, the middle classes themselves became disillusioned with the high-cost, low quality goods and services provided by protected markets and monopoly public sectors. The 1980s saw a booming black market retail trade in 'imported goods'. Certain markets in metropolitan centers specialized in such retail. The author himself made a few trips as a child to Kolkata's (formerly Calcutta) Fancy Market to purchase video games made in Japan. Third, the older generation of politicians, schooled in orthodox ideas of socialism started to dwindle in number and decline in influence⁴⁴, to be replaced by a generation for whom pragmatism scored over ideology.

Fourth, the hostility towards private entrepreneurship and wealth accumulation prevailing at the time of independence became less acute⁴⁵ as an aspiring middle class started to look at entrepreneurship as a means to fulfill their ambitions. All of these forces helped activate the reforms initiated by Prime Minister Rajiv Gandhi that led to the first steps towards dismantling the 'license permit raj'⁴⁶. Rajiv Gandhi's vision included incorporating rapid technological changes and as such laid the foundations for the Information Technology boom that became India's entrepreneurial hallmark by the late 1990s.

The fall of the Berlin wall in 1989 disrupted India's 'Rupee-Ruble' trade with the erstwhile Soviet Union (the trade was carried out in terms of Indian Rupees and Soviet Rubles rather than hard currency). Less than a year later, in August 1990, the First Gulf War pushed up the prices of oil, a major item in India's import basket. The combination of these two events led to the balance of payments crisis of 1990 to 1991. India took recourse to the IMF to avert the crisis, and the IMF put forth certain recommendations and conditionalities to push India forward in the path of reform. Prime Minister Narsimha Rao and Finance Minister Manmohan Singh (the current Prime Minister), a well known economist, formed the core of the reform team that laid the foundation of India's

economic rejuvenation. The commitment to reforms and globalization was reinforced by India's accession to the WTO after the Uruguay Rounds despite much opposition (led, for the most part, by the Communist groups) to such an agreement.

In 1998, the Congress was defeated by a coalition of parties led by the Bharatiya Janata Party (BJP), i.e. the Indian People's Party. The BJP is a right-of-centre political group with a large support base among the urban middle-class and the trading community. The BJP led coalition (known as the National Democratic Alliance or NDA) also had a large number of regional political parties that were clamoring for greater decentralization and a larger say on economic policy. These political forces reinforced the 'liberalization' process to the degree that this process is now considered irreversible. Such is the commitment to reforms that even when the INC came back to power in 2004 with the support of the Communists, who been strong opponents of economic liberalization, such reforms have continued.

The Entrepreneurial Response to the Political-Economic Institutions

The entrepreneurial class in the post 1990 period once again displayed their commitment to profit, as predicted by Baumol. Many companies, including those in the information technology (IT) sector, went on to take advantage of the opportunities provided by globalization. The booming BPO (Business Process Outsourcing) sector in India and the

fears of such outsourcing displayed in white collar USA is a testimonial to the distance the Indian entrepreneur has traveled from the 1980s to the late 1990s. But such entrepreneurial activity towards productive (technology) and allocative efficiency was just not confined to the IT sector: manufacturing sector firms like Tata, Mahindra and Bajaj have gone on to become global players, acquiring companies abroad and integrating into the global supply chain in parts and components.

However, high transaction costs still haunt Indian entrepreneurs in the form of infrastructural bottlenecks, energy deficiencies and outdated regulatory and administrative procedures, much of which are a hangover from the days of quasi socialism. Such costs imbibe a sense of uncertainty and inefficiency, especially in the manufacturing sector. Thus, entrepreneurial activities continue to be constrained due to such risk and uncertainty, keeping many risk-averse entrepreneurs from making a full entrepreneurial commitment.

It is important to point out that this period provided the Indian entrepreneur with feasible opportunity for change and the pursuit of related institutional gains. It therefore comes as no surprise that the entrepreneurs grabbed this opportunity to influence the institutional structure of their operation. One clear example of this was the rise of the Confederation

of Indian Industry (CII). Many among the new generation of entrepreneurs felt frustrated by the old FICCI and wanted a fresh organization that could better articulate their demand for change. The Confederation of Engineering Industries (CEI) provided the nucleus around which the CII came into being in 1992, a year into the reforms process. The CII membership included several of the more dynamic manufacturing companies like Mahindra and Bajaj. The entrepreneurial spirit that drove the CII was forcing FICCI into relative oblivion, and FICCI in turn reacted by making itself more dynamic and conducive to the process of reforms⁴⁷.

Through much of the 20th century, the Indian entrepreneur has been constrained in his efforts to optimize opportunities and thus profits: first by colonialism and later by quasi socialism of the Indian state. After years of such ‘constrained optimization’, the Indian entrepreneur is finally getting the institutions and incentives that reward the pursuit of prudent productive and allocative decision making. The full impact of the reforms in India is yet to play out, but if trends in the last decade are any indication, then the world has not yet felt the true impact of Indian entrepreneurship.

Conclusion

Entrepreneurship is an important function of economic growth and as such India's low level of growth through much of the 20th century has been attributed to the lack of dynamism on the part of Indian entrepreneurs. Some social theorists have argued that the cultural context of India: specifically the spiritual beliefs and social organization of Hinduism, is a critical factor behind such low levels of entrepreneurial activity. This paper rejects such parochial and culturally relativist arguments in favor of a more objective look at the structure of entrepreneurial activity in India. In doing so, this paper uses the theoretical construct offered by Baumol in his comparative historical analysis of entrepreneurial activity in Europe and China.

The arguments offered in this paper uphold the Baumolian theoretical construct in the Indian context. The historical example of entrepreneurial response in India shows that it is incentives, shaped by institutions of governance, that inform the allocation of entrepreneurial energy, not cultural contextualization. As and when incentives and institutions improve, so does the quality and level of entrepreneurial activity in an economy. Moreover, the historical analysis offered in this paper shows that entrepreneurs are not inert bystanders that accept institutions as a given, they are engaged political-economic actors who actively try to change their institutional context in order to maximize the gains

from their economic activity. However, such political economic activity on the part of entrepreneurs is also informed by the same Baumolian construct: entrepreneurs will allocate their energies to political change only when there is a credible incentive to do so, i.e. when such activity has a feasible chance of success in the foreseeable future. With rapid changes in the institutional structure of India in the last 15 years, entrepreneurial allocation has improved leading to impressive growth rates. More growth and further reforms appear inevitable in the coming years, especially given the political-economic maturity of the Indian entrepreneurial community and their wide ranging engagement in the affairs of governance.

Endnotes

¹ J. Schumpeter, *Capitalism, Socialism and Democracy*, (HarperPerennial, 1976)

² L. von Mises, “Human Action: A Treatise on Economics”, 1949, Ludwig von Mises Institute; viewed 26th December, 2006. URL: <http://www.mises.org/humanaction.asp>

³ For elucidation of such ideas refer Vera Anstey, *The Economic Development of India*, (London University Press, 1957) and M.D. Morris, “Values as an Obstacle to Economic Growth in South Asia: A Historical Survey,” *Journal of Economic History* 27, 4 (1967): 588-607.

⁴ W. J. Baumol “Entrepreneurship: Productive, Unproductive and Destructive,” *Journal of*

Political Economy 98, 5 (1990): 893-921.

⁵ Ibid

⁶ A.K. Bagchi, "European and Indian Entrepreneurship in India", in *Entrepreneurship and Industry in India, 1800-1947*, ed. R.K. Ray (Oxford University Press, 1992): 157-186.

⁷ Ibid: pg. 162.

⁸ Good examples of such literature include J. Galeskiewicz and S. Wasserman "A Dynamic Study of Change in a Regional Corporate Network," *American Sociological Review* 46 (1981): 475-484 and Davern, M "Social Networks and Economic Sociology: Proposed Research Agenda for a More Complete Social Science," *American Journal of Economics and Sociology* 56 (1997): 287-302

⁹ For example, the industrial conglomerates of the Birlas and the Goenkas. .

¹⁰ R.K. Ray (1992) "Introduction" in *Entrepreneurship and Industry in India, 1800-1947*, ed. R.K. Ray (Oxford University Press, 1992), 1-69.

¹¹ A. K. Bagchi, *European and Indian Entrepreneurship in India* provides a great overview of the role of European governmental employees' savings, and the financial policies of government and Presidency Banks that also had an important role in differential access to capital within India.

¹² C. Markovits, *Indian Business and Nationalist Politics* (Cambridge University Press, 1985): 36.

¹³ A.M. Misra "Business Culture and Entrepreneurship in British India: 1860-1950," *Modern Asian Studies* 34, 2 (2000): 333-348.

¹⁴ The notable exceptions being the cotton mills in western India

¹⁵ A.M. Misra, *Business Culture and Entrepreneurship in British India: 1860-1950* provides a good account of the difficulties faced by Tata in starting a wholly Indian owned steel plant in colonial India.

¹⁶ Indian National Congress was an umbrella organization for Indian political action representing several regional and ideological groups. It played the primary organizational role in India's independence movement. Post-independence, the Congress emerged as a largely left of centre political party.

¹⁷ C. Markovits, *Indian Business and Nationalist Politics* (Cambridge University Press, 1985): 26

¹⁸ Ibid: 27

¹⁹ Ibid: 85-87.

²⁰ Ibid: 142.

²¹ Ibid: 120-121.

²² Ibid

²³ Ibid: 110.

²⁴ Ibid: 111.

²⁵ Ibid: 108.

²⁶ D. Tripathi, *The Oxford History of Indian Business* (Oxford University Press, 2004): 273.

²⁷ G. Das, *The Elephant Paradigm: India Wrestles With Change* (Penguin Books, 2002)

²⁸ V. Chibber, *Locked in Place: State Building and Late Industrialization in India* (Princeton University Press, 2003).

²⁹ Ibid: 85-87.

³⁰ E. Terence Gomez, *Political Business in East Asia* (Routledge, 2002)

³¹ P.N. Dhar, *The Evolution of Economic Policy in India* (Oxford University Press, 2003): 137.

³² Ibid: 138.

³³ D. Tripathi, *The Oxford History of Indian Business* (Oxford University Press, 2004): 286.

³⁴ Indira Gandhi was India's Prime Minister from 1965 to 1977 and again from 1980 to 1984. Daughter of Nehru, Indira Gandhi was a strong votary of socialist policies.

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- ³⁵ D. Tripathi, *The Oxford History of Indian Business* (Oxford University Press, 2004): 284.
- ³⁶ P.N. Dhar, *The Evolution of Economic Policy in India* (Oxford University Press, 2003): 100-101.
- ³⁷ Ibid: 17.
- ³⁸ D. Tripathi, *The Oxford History of Indian Business* (Oxford University Press, 2004): 286.
- ³⁹ Hinduja Group based in UK and Middle-East, Swaraj Paul's Caparo group based in London and the Mittal Group based in Luxembourg to name a few.
- ⁴⁰ C. Markovits, *Indian Business and Nationalist Politics* (Cambridge University Press, 1985): 25.
- ⁴¹ P.N. Dhar, *The Evolution of Economic Policy in India* (Oxford University Press, 2003): 103.
- ⁴² A. Sinha, *The Regional Roots of Developmental Politics in India: A Divided Leviathan*, (Indiana University Press, 2005)
- ⁴³ P.N. Dhar, *The Evolution of Economic Policy in India* (Oxford University Press, 2003): 120.
- ⁴⁴ D. Tripathi, *The Oxford History of Indian Business* (Oxford University Press, 2004): 318.
- ⁴⁵ Ibid: 319.
- ⁴⁶ Ibid
- ⁴⁷ This insight comes from the authors own conversations with CII officials during his period of employment in that organization.

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