



CENTRE
FOR CIVIL
SOCIETY

Why is India Poor?

PARTH J SHAH

LIBERTY
& SOCIETY
SERIES

1

Based on the lecture delivered by Parth J Shah at Liberty & Society Seminars and ipolicy courses since 2001.

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LIBERTY & SOCIETY SERIES

Centre for Civil Society organises academic programs for students, professors, journalists, and NGO leaders all across India. At first, these courses were titled as Liberty & Society Seminars (LSS) for college students. CCS has since revised the program to focus more on public policy and its implications in India, renaming the program as ipolicy. These four-day residential courses engage students in vital issues of public policy, and in creating a new vision for India. They provide participants with a greater understanding of the larger world—society, economy, and culture—within a liberal framework, which emphasises limited government, individual rights, rule of law, free trade, and competitive markets.

Challenging conventional wisdom, coupled with the excitement of discovery provides participants a once in a lifetime experience. The success of these courses, in creating new thinkers and leaders brought forth the idea of publishing key lectures so that others could experience the intellectual adventure. The lectures are a synthesis of research studies and various arguments that are by nature polemical. This series seeks to make these stimulating lectures from various CCS programs available to a wider audience.

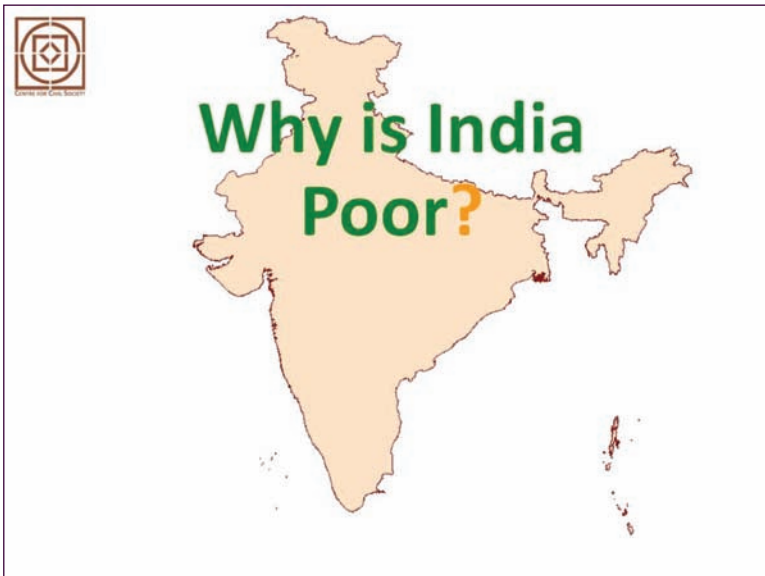
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WHY IS INDIA POOR?*

INTRODUCTION

Why is India poor? This is a vital question all of us have asked at one time or another, either as part of our formal studies or just as a concerned citizen of India.

Before we can try to answer the question, we have to define our terms.



First, let's clarify what we mean by poverty. For the sake of this talk, when I say "poor" I am talking about material factors. Many have argued that India is the wealthiest country on Earth when it comes to the "spiritual" part of life. I'm not referring to these spiritual aspects. Not because they are unimportant, but because I'm just looking at the material aspect. Why India is poor—materially—

* Special thanks to my colleagues Andrew Humphries and Manasi Bose for transcribing and editing this document and to Kumar Anand for updating some of the figures.

is important. Material prosperity is a precondition for most of what we want to achieve, from improving our own lives and opportunities to achieving social objectives like a healthier and more literate population.

Second, how do we know that India is poor? One rough-and-ready way to know is to look the average person's income in a country called per capita GDP. Per capita GDP stands for the money value of all the goods and services produced in a year divided by the number of people. Of course, some Indians are very rich and some are very poor. What we are asking, however, is not why some are poor and others are rich, but why Indians are poor on average compared to people in other countries. We know that when we travel to different places we can see the difference in the average level of wealth. GDP per capita captures this difference succinctly.

Per capita GDP is not a perfect measure. Aspects of the household and informal economy like household washing and cooking, for example, are not captured by it because they are not exchanged for money, or because statisticians find it difficult to survey informal transactions. There are alternative measures like the Human Development Index to compare the relative prosperity of different countries. But in general there is a correlation between per capita GDP and these other indexes. So we will use GDP per capita for our purposes.

Now, if we compare India's per capita GDP to other countries, what do we see? The per capita GDP of India is around \$3,500.¹ In South Korea it is about \$30,000 and the United States is about \$48,000. So the question is, what are the reasons for this difference?

People often respond by saying that there are not enough opportunities, not enough jobs, wages are low, etc. But these responses are not getting to the root. In a way they are restating the fact underlying the question: that India is poor. What we need to do is ask *why* are there not enough jobs, *why* are wages low, *why* are there not good opportunities, etc., until we get down to *root causes*. For example, when we ask why there are not enough opportunities, people might say, because there are "too many people." This is the kind of response we are looking for; it's a plausible root cause.

So what do you think? Why is India poor?

Activity 1

Before reading on, list on the following lines all the reasons you can come up with why you think India is poor. Keep asking why until you get to plausible root causes that can be captured in one word or a short phrase.

After coming up with your own list, look through the common list of answers people usually give on the next slide. Are your answers the same or different?



Through this talk, I am going to challenge each of these most commonly cited causes. My goal is twofold. In part, I want to try to offer you a plausible answer for why India is poor. But more fundamentally, I want to convince you of an approach to analysing this type of question for yourself. Why India is poor is only one question. If you encounter new questions and new hypotheses in response to those questions, how do you judge which reasons people offer are most sensible or valid? By the end of the talk, I hope you gain a pattern of thinking that will help you assess different possible answers to these kinds of questions and make a judgment of your own.

Hypothesis 1: Overpopulation is the Cause of India's Poverty

The first reason people usually give when asked why India is poor is that there are “too many people.”

I don't know if you remember this, but in 1997 on India's 50th anniversary—the year CCS was founded, incidentally—parliament called a special session because they wanted to debate what the big issues were facing the country after 50 years of independence in order to see how they were going to deal with them moving forward. Which issue was at the top of the list? Population.

All the MPs agreed that this was the biggest issue facing the country and that something had to be done about it.

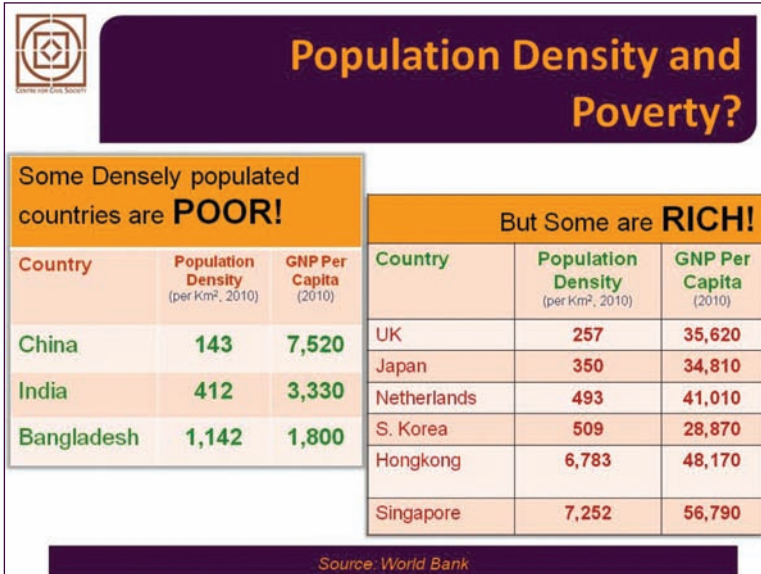
Now think about the irony of the situation. Here you have the people's representatives, the Members of Parliament, saying that the biggest problem facing the country is the people themselves. Isn't that bizarre? Here we have our own representatives saying that the biggest problem in India is...you!

Who are these people? Please raise your hand if you think you are the reason for India's poverty. The first thing to notice in this way of thinking is that people don't identify themselves as the problem. It's always other people who are "the problem" and need to be controlled. To me, this is one of the compelling reasons not to think this way. It divides people into "us" vs. "them." Depending on your background, the "them" will differ: "the poor," "the illiterate," "Muslims," "tribals."

Operating along these lines, Sanjay Gandhi wanted to control "them" with compulsory sterilisation. There was no public uproar against the idea. People thought, "Yes it's harsh. But because population is the problem, the policy is desirable. And of course, it's not 'us' who will be coerced." So you see how important the way we think about this issue is for public policy. The discussion about the causes of poverty is not just academic. People's beliefs about the causes of poverty and prosperity will influence what they are willing to allow their governments to do—even to the point where violations of basic human rights could be popularly condoned.

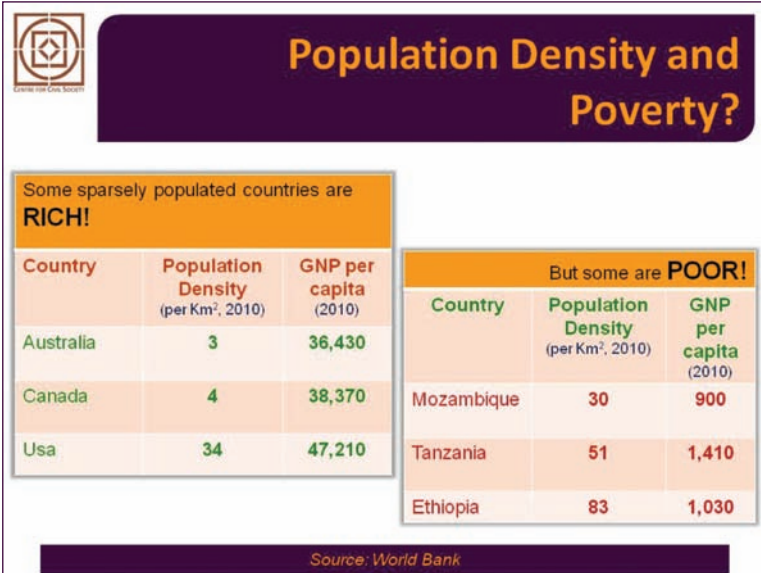
So let's consider, is population really a problem? How do we use data to answer this question? What kinds of data do we need to make an assessment if population is really the cause of poverty in India or not?

If high population is the cause of poverty, we should expect to see that countries with high population density are poor.² We can look at the population in different countries and see if there is a correlation between population density and per capita GDP.




From this data, we see that there are indeed densely populated countries that are poor like India and Bangladesh. But there are also countries that are densely populated that are rich. South Korea, for example, is more densely populated than India, but its per capita GDP is almost ten times that of India. Hong Kong and Singapore are extremely densely populated and are extremely prosperous. We can see, therefore, that population does not “cause” poverty. It’s possible for a country to be very densely populated and be rich.

We also find that there are sparsely populated countries that are rich and sparsely populated countries that are poor.



Because there are examples in all four quadrants (densely populated countries that are rich, densely populated countries that are poor, sparsely populated countries that are rich, and sparsely populated countries that are poor) we can see that there is no simple correlation between a country's population density and its per capita GDP. The data shows that high population density is not a sufficient condition for poverty and that low population density is not a necessary condition for prosperity.

These charts should convince you that a large population at the country level is not the problem, but what about poor having large families. Is that a problem?



Poverty & Family Size

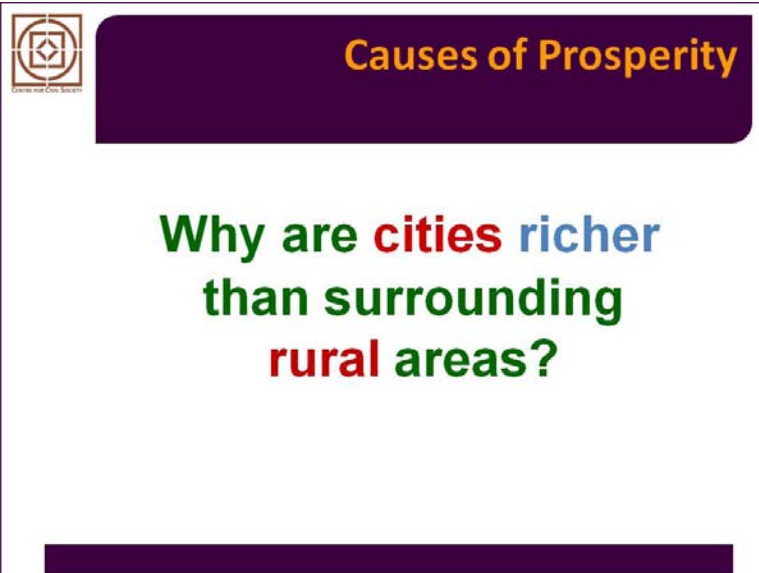
Why do the **poor** have larger families than the **rich**?

As we said earlier, the population issue usually turns into an issue of us vs. them. The “us” is very educated and makes good decisions, while the poor are uneducated and make irresponsible decisions, have too many children and thereby create a problem. But is this so? Why do the poor tend to have more children? If you ask them, one thing you find is that they see that each child offers an extra set of hands for the family. The cost of having an additional child for them is often less than the additional benefit that child will bring to the family. A second reason is that children offer a kind of social security to the poor when they become old. Finally, child mortality rates are high among the poor and so they try to have more children to increase the probability that some will survive until adulthood. A classic example was that my own domestic helper wanted to have a surgery after having two children. But everyone else in the family said ‘no!’ because of the fear that one or both of them might not survive and that he should keep the option open to having more children.

Wealthy families on the other hand can afford to save and have other forms of safety nets when they are old or sick. They also have higher aspirations for their children such as sending them to college, so the additional cost of an extra child is often much higher than the additional benefit. And finally the

wealthy are much more likely to have their children survive into adulthood. So if you put yourself in the position of others, you often see that you would make the same decision they do if you were in their situation. What the poor are doing is actually quite rational. Having larger families can be beneficial to them.

Ask yourself how many siblings you had, how many your parents had, and how many your grandparents had. Your own great grandparents had many more children than your parents. Did your parents have fewer children because they were more “enlightened” and wanted to solve India’s “population problem”? Given the different circumstances they faced, it was rational for your great grand parents to have larger families and for your parents to have smaller families.




The image shows a presentation slide with a white background and a dark purple border. In the top left corner, there is a small square logo containing a stylized geometric design. To the right of the logo, the text "Causes of Prosperity" is written in a bold, orange font. In the center of the slide, the question "Why are cities richer than surrounding rural areas?" is displayed in a large, bold font. The words "cities" and "rural areas" are in red, while "Why are" and "than surrounding" are in green. At the bottom of the slide, there is a solid dark purple horizontal bar.

Now, not only is population density not a problem, per se, it can actually be the cause of prosperity. Ask yourself, why is it that city dwellers are typically wealthier than people in the surrounding rural areas?

One answer was given by Adam Smith in the first chapter of his book *An Inquiry into the Nature and Causes of the Wealth of Nations*.³ He argued

that wealth is created through division of labour and specialisation. He illustrated his point by showing how division of labour in the making of pins increased people's productivity. One person during his era, he explained, could make 20 pins a day working by himself. But he observed a situation in which 18 workers divided up the making of pins into several distinct and complementary tasks (drawing the wire, cutting it, sharpening the tip, adding a head, etc.). He saw that each worker became more efficient at his own part of the process. Focusing on one part enabled the workers to innovate, save time, and become more dexterous at their part so that at the end of the day the total number of pins produced per person (by people who had learned to specialise in this way) was about 4,800 per day – 240 times more pins per worker! The division of labour enables greater efficiency and increases productivity per person, which increases the amount of wealth they can create.

So why are people in cities typically wealthier than people in rural areas? Why do people often want to move to cities? In other words, what is it that cities have that rural areas don't? High population density! Cities are places where lots of people are very close together – and have more producers as well as more consumers – so the costs of transacting and exchanging are low. More people and lower transaction costs means more specialisation and a higher division of labour.⁴ If you think about it, if you wanted to start a French restaurant, would you be able to do it in a village? Probably not. There would not be enough customers who wanted French food each day. But in a city, a small portion of the population is more likely to want French food every day. To take another example, in cities we have medical specialists. Not only are there doctors who focus entirely on treating ears, there are now doctors who focus exclusively on left ears, while others focus exclusively on right ears. The more patients there are, the more potential for specialisation. However, a village doctor must be a generalist because he or she can't afford to specialise as much and therefore is unlikely to be as efficient, knowledgeable, and skilled at any one task.



Wealth Creation

People
 =
Wealth Creators

The extent of specialisation is
 limited by the **SIZE** of the market.

If you apply this logic across all different goods and services, you see that a finer division of labour in cities makes people more productive and thus their incomes are higher. The very word civilisation comes from the word *civitas*, which means city. The most urbanised areas have always been the engines of wealth creation and innovation.⁵



Wealth!!!!

DISASTER???

$$\text{GDP per capita} = \frac{\text{GDP}}{\text{Population}}$$

One reason people worry about population is that population is the denominator in GDP per capita. What they usually forget is that it is people who are the wealth creators. For every stomach they add to the world, they add two additional hands and a creative mind. People are not just the denominator, they produce the numerator in GDP per capita. So long as the conditions enable people to produce more than they consume, the per capita GDP will rise.

Hypothesis 2: We're Running Out of Resources

Maybe population is not the cause of poverty in each individual county. But surely for the world as a whole population does matter. The population on the planet has mushroomed from 1 billion in 1800 to 7 billion today and is projected to go to 10 billion in 2050. Aren't we going to run out of resources at some point? How are we going to sustain ourselves if the population keeps increasing from seven billion, to nine, to ten?

This has been a concern for a long time, at least since Thomas Malthus predicted in 1798 that population would tend to outstrip the food supply until checked by famine and war resulting from the struggle for resources. One recent advocate of this fear was Professor Paul Ehrlich from Stanford University who wrote a very popular book *The Population Bomb*⁶ followed by *The Population Explosion!* He predicted that the unprecedented population growth in the developing world would lead to mass starvation.

Take a guess which year professor Ehrlich made this statement in the slide:



"The battle to feed all of humanity is over. In 12-20 years hundreds of millions of people will starve to death in spite of any crash programs embarked upon now. At this late date nothing can prevent a substantial increase in the world death rate"

Professor Paul Ehrlich in
The Population Bomb

Stanford University,
MacArthur Foundation Genius Fellow

Notes:

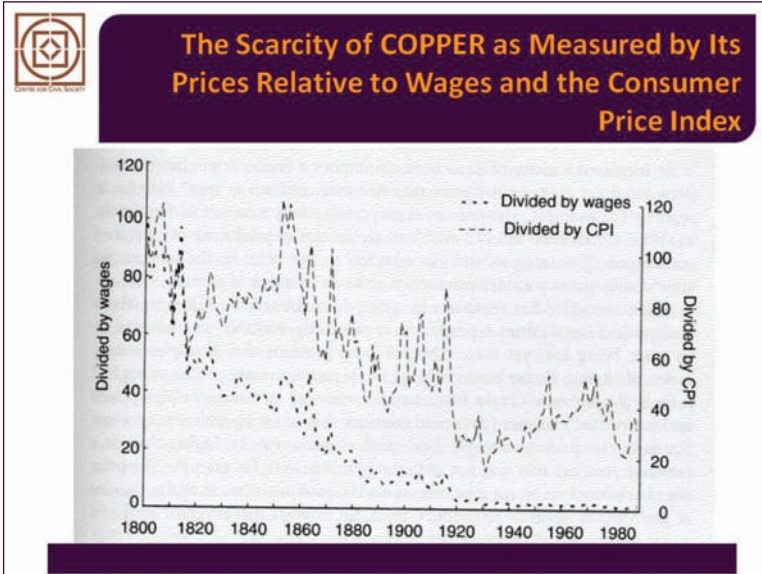
1968! If his prediction had been correct, we should have seen mass starvation and high death rates by 1988. It didn't happen. His fears were widely shared and many people still worry about it today.

So again, how do we actually tell if we are running out or are going to run out of resources? You have your opinions and I have mine. But how can we make a sensible judgement whether this is true or not?

One clear way of judging if a resource is becoming more scarce or not—if it is becoming more or less available—is its price. Assuming that the price is an open market price, not a price controlled by government or other coercive institution, the price reflects basic supply and demand conditions. If the supply goes down while the demand stays the same or increases, the resource becomes more scarce and the price goes up. Conversely, if the supply increases while the demand stays the same or goes down, the scarcity decreases and the price goes down. So economists have a pretty simple way of telling whether resources are running out: see whether prices of resources are going up or down.⁷


This is something a famous economist called Julian Simon did. He spent a large part of his career tracking the prices of resources all the way back to the 1800s.⁸ What he found was very surprising: the prices of commodities have steadily declined across the board.

For example, you can see in the next slide the price of copper in terms of constant dollars and in terms of average wages since 1800. What we see is that, although the prices zigzag up and down, the trend is unmistakably downward. Copper has become cheaper and cheaper. Simon found that this was true of basically all other raw materials. How could this be? The population has increased by a factor of seven. Not only that, but people are consuming more and more per person. (Look at your grandmother's wardrobe compared to yours. You can see that we consume more today than she did when she was your age). Yet despite this fact, the price of these raw materials is continually decreasing.⁹ What does this imply? It must be that the supply of copper and these other resources has increased even more than the demand.



The more Simon studied the matter, the more convinced he became that this trend would continue into the future, in spite of the common wisdom. His ideas were so much out of the mainstream he decided to put his money where his mouth was. He offered a wager to the world: he challenged anyone to choose a basket of any five raw materials to see if the price would go up or down. The bet was that if the price were higher after ten years, Simon would pay the winner the difference, if the price was lower, the loser would pay Simon the difference. In 1980, Paul Ehrlich, who famously argued the opposite case from Simon, took the bet.

What do you think happened? Did the prices go up or down by 1990? And by how much?




Julian Simon - Paul Ehrlich Bet

Copper, tungsten, chrome, nickel and tin

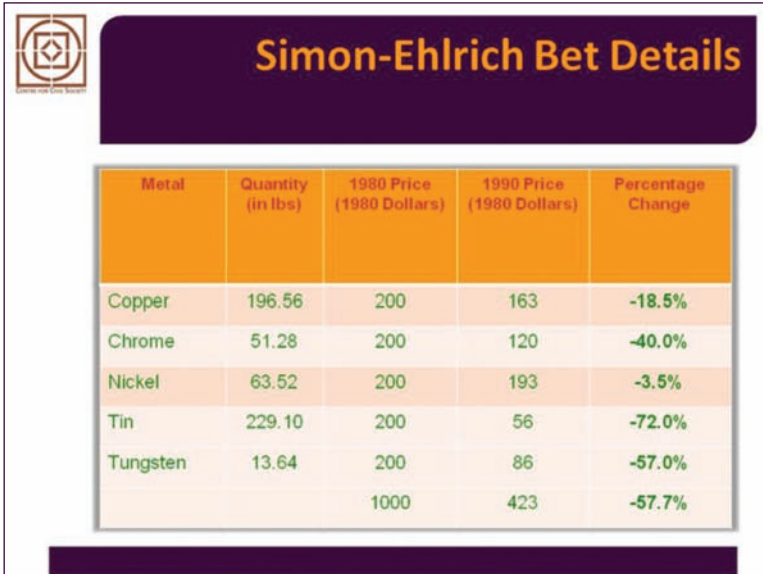
Basket Value in 1980: \$ 1,000
Basket Value in 1990: \$ 423

↓

Paul Ehrlich sent Julian Simon a cheque for \$ 577



The price fell significantly. The cumulative prices of the five metals Ehrlich had chosen was less than half of what it had been ten years before, despite population increase. Ehrlich made out a cheque to Simon for \$577, which became the most photographed cheque in history.



The image shows a slide titled "Simon-Ehrlich Bet Details" with a table of metal prices. The table has five columns: Metal, Quantity (in lbs), 1980 Price (1980 Dollars), 1990 Price (1980 Dollars), and Percentage Change. The data is as follows:

Metal	Quantity (in lbs)	1980 Price (1980 Dollars)	1990 Price (1980 Dollars)	Percentage Change
Copper	196.56	200	163	-18.5%
Chrome	51.28	200	120	-40.0%
Nickel	63.52	200	193	-3.5%
Tin	229.10	200	56	-72.0%
Tungsten	13.64	200	86	-57.0%
		1000	423	-57.7%

How can we explain this fall in prices despite growing populations? Some of the answers are that human beings find substitutes for things when their prices go up. They also look for more efficient ways to extract usable material from known supplies and technologies that make it economical to tap new sources. To take an example, we now use radio waves in the electro-magnetic spectrum to carry signals that we once used copper wires to carry (think about your cell phone vs. the old land line phone). Where physical wires are still used to send signals, instead of using copper, more and more fibre optics are being used, which are made from silica, which is made from sand. Can you imagine? We are now using air and sand to do what we once used copper for.

Where do these innovations come from? The human mind. This is why Simon called human beings "the ultimate resource." In fact, when you ask an even more fundamental question, what *is* a resource, you realise that it's something we can use to satisfy human wants. Things are not resources, *per se*. It is the human mind that knows how to use things to satisfy our wants that *makes things into resources*. Without human minds, there are no resources.

So long as human ingenuity is unbound, as long as human imagination, creativity, and knowledge are expanding, there is potentially no limit to the amount of resources we can create to satisfy human wants.

The fuel that launched Britain's Industrial Revolution was wood. Whole forests were cut down. But as wood became more scarce, the price signal caused people to focus their creativity and ingenuity to find another source of energy. Someone discovered an economical way to turn coal in the ground into energy. Coal enabled the Industrial Revolution to continue and slowly Britain's forests came up!

People also used whale oil to light their lamps, which threatened to decimate whale populations. During this same time, if you found crude oil—a noxious and foul black soup—bubbling up on your land, you were ruined. You would not be able to grow crops, raise cattle, build real-estate, and your land value would plummet. Oil was not a *good*, it was a *bad*—until one day someone discovered how to turn oil into fuel and plastics. Then oil *became* a resource.

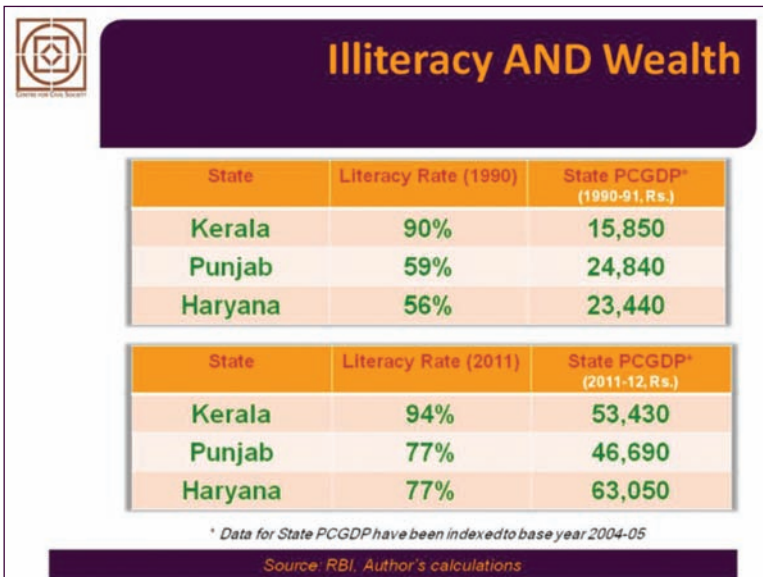
One lesson to take away from this is that discoverers of how to use coal and oil for fuel did far more to save forests and whales than anything Greenpeace and the WWF could ever do. Another lesson can be seen in the fact that there is still coal in the ground that no one is mining today because we have found more economical ways of getting energy. Similarly, if the price of oil is allowed to rise, people will one day sit on oil that no one wants to take out of the ground because we will have new energy technologies that are more economical – perhaps solar power or fuel cells.

You may argue “okay, the human mind finds ways to create new resources, to tap new supplies, to find more efficient ways to use what we have, and to find substitutes. But there is only so much *stuff* on the Earth and eventually we will run out of things to use!” But you're not thinking creatively enough. The amount of matter and energy on the Earth may be limited, yes. But the matter and energy in the whole universe is almost infinite. There are tonnes of industrial and precious metals floating around the solar system, for example, in the form of asteroids. Right now, there are several companies investing in developing “space mining” technologies to bring these metals down to earth to make things of value for human beings. So you see, all we need to make everything in the universe a resource is human knowledge and ingenuity.

Several people have reoffered Julian Simon's bet since 1990, but no one will take it. Yet the news still hasn't sunk in to popular culture. Despite the Simon-Ehrlich bet and all the evidence we can muster, people are still afraid that we are running out of resources. What they don't see is that we have consistently found ways to increase the supply, do more with less and find better alternatives.¹⁰

Hypothesis 3: Lack of Education is the Cause of India's Poverty

Hopefully, we're starting to see how to approach these kinds of questions. What data would we need to tell if literacy is required for prosperity? One interesting approach would be to compare rates of literacy in different states of India to see if there is a correlation with state per capita GDP.



Again, there is no simple correlation. Cubans, for example, are more literate than people in the U.S. But they are not as wealthy. Often throughout history, people have become wealthier and then invested in education of their children. For a long time, illiterate immigrants went to America, became wealthier, and then educated their children. The children of these immigrants went on to occupy top positions in business, academia, and government.

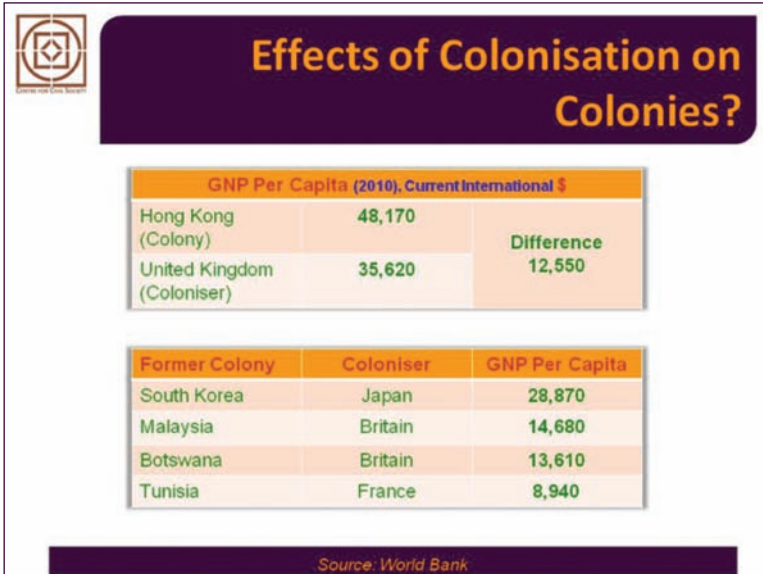
One interesting episode that strikes me is that between the 1991 census and the 2001 census, literacy jumped 13%—the highest increase in literacy in India’s history. What’s interesting is that in 1991, the IMF required “structural adjustments” as a condition for receiving a loan to help India through its foreign exchange crisis. The government had to cut expenditures and it made significant cuts to government spending on education. So government spending on education decreased throughout the 90’s and yet this was the period of the fastest growth in literacy we have ever seen. How do we explain that? I have asked myself why. I don’t know. But my best guess is that as parents began to make more income they started investing in their children’s education and the low-fee private schools really expanded as a phenomenon during this period. This would be an interesting question for more research.

If you think in your own experience about the connection between economic success and formal education, you will probably notice that the people who are most educated are not the most wealthy. Dhirubhai Ambani came up with basically no education. How many of the CEOs of Fortune 500 are MBA graduates? Harvard MBA graduates work under much less educated entrepreneurs. Entrepreneurship does not depend on education.

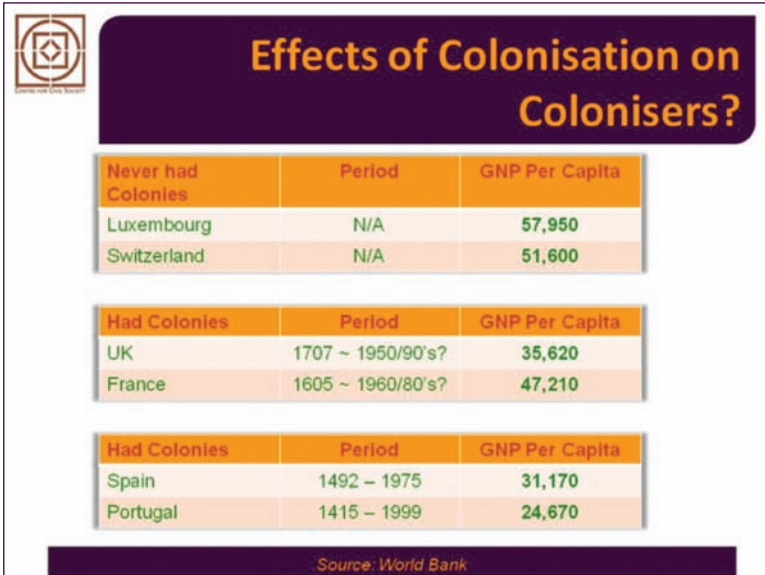
None of this is to say that literacy or education is unimportant. I’m just saying that as a policy issue, the idea that literacy will solve our basic economic problems doesn’t bear out. We need a lot more than literacy to be a prosperous society.

Hypothesis 4: Colonial Exploitation is the Cause of India’s Poverty

Is there a connection between a history of colonisation and poverty today? Perhaps, but the connection is not simple. As you see in this slide, there are many former colonies across the world that are very rich. Hong Kong, like India, was a colony of Britain. Yet its per capita income far exceeds the per capita income of the U.K., its former coloniser.



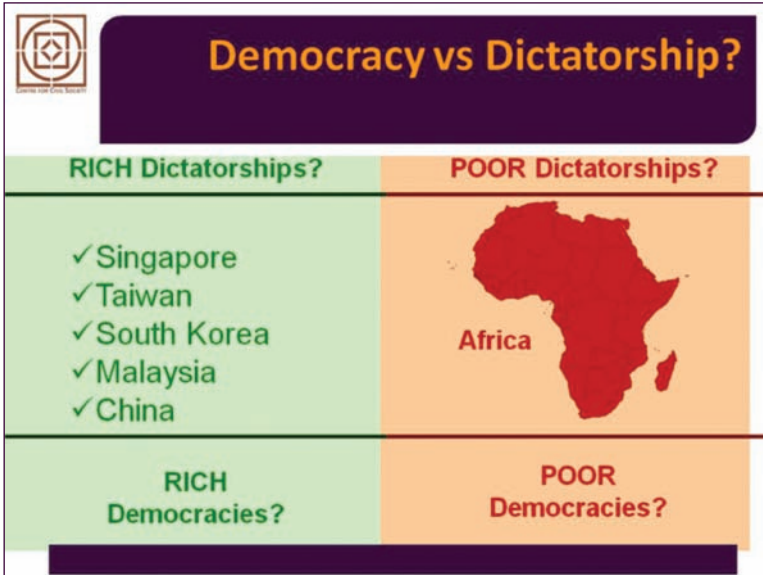
What about on the other hand? Are colonising countries richer? Is having colonies required to become wealthy? We see that Spain and Portugal had colonies for the longest period of time, yet they are among the poorer countries in Western Europe, while countries that never had colonies are among the richest.



This shows that having a colony is not a necessary path to riches and may even be an impediment to wealth creation in the long term. It also shows that being a former colony does not necessitate that a country be poor. The issue then cannot be whether a country was a “colony,” *per se*, but rather what the colonising country did while in charge and more importantly what these countries have done since gaining their independence.

Hypothesis 5: Chaotic Democracy is the Cause of India’s Poverty

This issue relates very closely to the issue of democracy vs. dictatorship. Some argue that democracy is needed for prosperity. We see, however, that the freedom to participate in the election of one’s own government, though important, is not necessary or sufficient for economic prosperity. On the other side, some argue that democracy is too costly because it is difficult to get things done. But authoritarian government is no guarantee of prosperity, either. We see authoritarian countries that are rich, and authoritarian countries that are poor, democracies that are rich, and democracies that are poor.



Hypothesis 6: Indian Culture and Attitudes are Responsible for India's Poverty

This hypothesis says that Indian's culture is anti-materialistic, fatalistic or lazy. Now we laugh at this. But in the 60s and 70s, many academics argued that such cultural attitudes were the cause of Third World poverty. They tried to find the roots of poverty in Hindu and Confucian philosophy. A well-known phrase that is used even today is the "Hindu" rate of growth, as if the slow rate of growth was caused by the religion.



Culture AND Attitude

Anti-materialistic

Fatalistic (Karma)

Lazy

One way to judge the effects of culture is to compare Indians in India with Indians in other places. Culture is a complex issue, but what we generally mean by culture is the way people act, their practices, how they respond to things, art, dress, food, the functions they celebrate. Now someone who gets on a plane and goes to the U.S. after graduating from college in India is already culturally Indian – by the age of 21, Indian culture is in him. Indian emigrants do better abroad than they do in India. This is true of Indians everywhere – in Africa, Malaysia, Fiji, Hong Kong, Singapore, the U.K or the U.S.A.



You can take other examples. If you take an illegal Mexican immigrant to the U.S. you will see that his income can jump by a factor of ten. Is his culture washed off him as swims across the Rio Grand into the U.S.? No. The same is true of Bangladeshis coming to India. Why do they immigrate here? Because they can find better opportunities. Culturally, they are the same Bangladeshis, but their income increases when they come to India. These examples show that people can overcome their culture to achieve economic prosperity when the conditions are right. So it's difficult to argue that cultural attitudes are the cause of poverty.¹¹

This brings us to our last proposition.

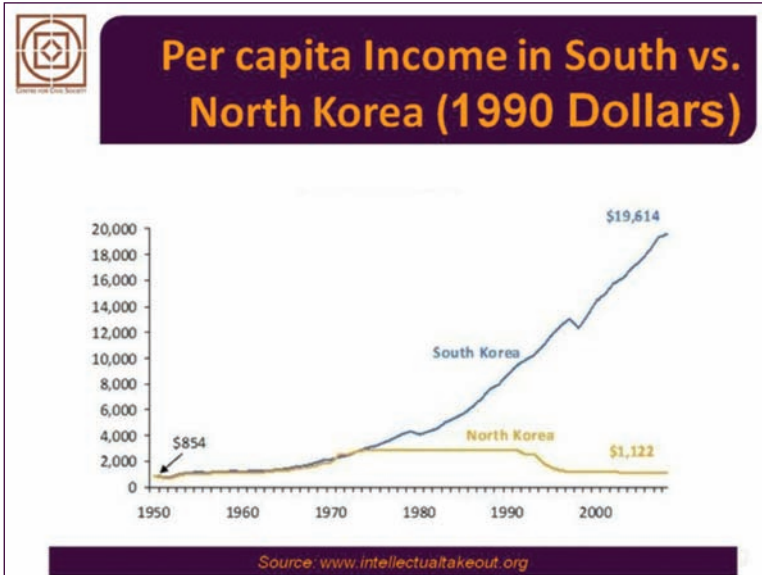
Hypothesis 7: Lack of Institutions & Policies that Support Economic Freedom is the Cause of India's Poverty

If we look at examples where one people have been divided into two countries, where you have the people with the same culture, the same resources, the same level of education, the same level of capital, etc., but which are run under different political economic systems, we see that the policies people live under create radically different outcomes.

Look at this satellite image of North and South Korea at night. North and South Korea were composed of the same people and had the same level of wealth. But they were divided after the Korean War and followed two different political economic systems.



You see that South Korea is well lit and prosperous while North Korea has no electricity except for one dot which is Pyongyang, the political capital. South Korea followed generally more capitalist, market friendly policies, while North Korea followed policies of Communism and Socialism. Why does this disparity persist? Why don't people flock to the South? Because there is a thick line of electric fences and land mines separating the two countries. If you escape North Korea and are found out, the North Korean government will put your family in a concentration camp.



Different episodes in history show the same results. Germany was divided after World War II into East and West Germany. The control of West Germany fell to market liberals after the War and followed the most capitalist economic policies in Europe in the post war period. What followed was known as the “German economic miracle.” East Germany, however, fell to the Soviets and had to follow an authoritarian communist model. The wealth of the two places diverged significantly. Because the wealth disparities were so much, the Soviets had to build a wall and threaten to shoot anyone trying to leave to keep the East Germans in.

Hong Kong is interesting because it is basically an island with no natural resources except an excellent natural harbor. Thousands of refugees fled mainland China with nothing but what they could carry. However, Hong Kong had English law fairly well enforced, policies of free trade and low taxes, so people invested in Hong Kong to employ these poor refugees and lent them capital to start their own businesses. Now it is far wealthier than China. Something similar is true of Taiwan. Again, these are situations with the same people, but different economic systems. In fact, much of China’s recent economic success has come from creating coastal SEZs that mimic the economic policies of Hong Kong.¹²



Natural Experiments in Economic Freedom

- South vs. North Korea
- Hong Kong vs. Mainland China
- West vs. East Germany 1950's

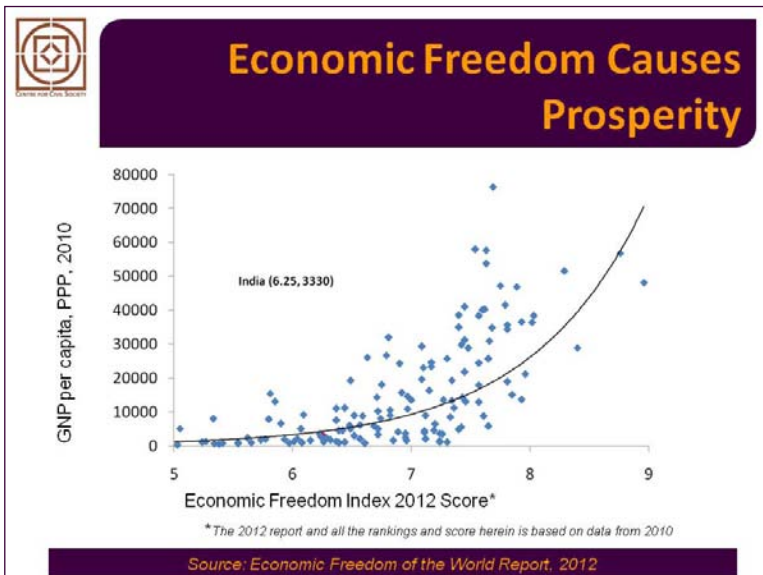
In each of these natural experiments where two countries had basically the same starting conditions, the main characteristic separating the successful and wealth creating one from the one stagnating over time was the degree of economic freedom they each enjoyed. The economically more free group became more prosperous, the more economically unfree one experienced stagnation or decline.

James Gwartney, one of the principal editors of the Economic Freedom of the World Report defines economic freedom: “Individuals have economic freedom when property they acquire without the use of force, fraud or theft is protected from physical invasions by others and they are free to use, exchange, or give away their property as long as their actions do not violate the identical rights of others.”¹³

Two prominent indices measure economic freedom in the world. One is organised by the Heritage Foundation and the Wall Street Journal in the United States and the other by the Fraser Institute in Canada and the Economic Freedom Network, of which Centre for Civil Society is a member. These indices rank countries according to the degree of economic freedom they enjoy. The Fraser Institute *Economic Freedom of the World Report*

collects data on five facets of economic freedom: 1) size of government (taxes and extent of government vs. private consumption and investment), 2) effectiveness of legal system in securing property rights, 3) stability of money, 4) freedom to trade internationally, 5) regulation of credit, labour, and business.

When we compare a country's economic freedom with per capita GDP, we see that there is a strong positive correlation. The reports also show that the faster a country improves its economic freedom score, the faster it grows.

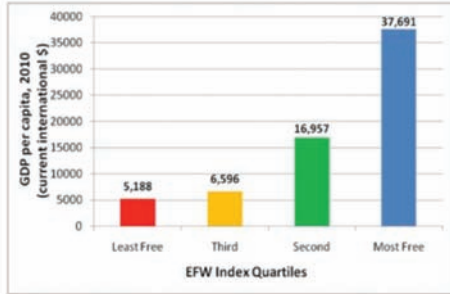




Economic Freedom and Income per Capita, 2010

Countries with more economic freedom have substantially higher per-capita incomes

Source: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*



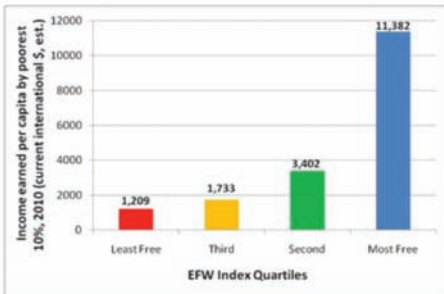
Source: *Economic Freedom of the World Report, 2012*



Economic Freedom and Income Level of the Poorest 10%

The amount of income, as opposed to the share, earned by the poorest 10% of the population is much higher in countries with higher economic freedom.

Source: Fraser Institute, *Economic Freedom of the World: 2012 Annual Report*; World Bank, *World Development Indicators 2011*



Source: *Economic Freedom of the World Report, 2012*

If we disaggregate incomes within countries, we also see that the poor in economically free countries are also much wealthier than the poor in economically unfree countries.

Among all the discussions about income inequality, I think that my 'First Family Meal Test' gives a more accurate picture. The First Family means the family of the President, Prime Minister, King or Queen. In which country do you see a bigger difference between the meal of the First Family and the Average Family? The difference is narrower in mostly free countries like Canada, Germany or the U.S., and wider in not-so-free countries like North Korea, Cuba or the former U.S.S.R.



Population, illiteracy, corruption, culture, democracy, and colonisation are, at best, **half-truths.**

Institutions and policies determine economic success.

The most important institutions and policies are those that enable...

**ECONOMIC
FREEDOM!**

So population, illiteracy, culture, democracy, colonialism, are at best half truths. What is most important are institutions and policies that allow and protect economic freedom.¹⁴

Many experts including Professor Amartya Sen argue that without prior huge investments in education and health, a country is unlikely to have economic take-off. The government must first improve literacy rates and health indicators like malnourishment and infant mortality, only then

can the country walk the path of economic success. However India's own experience is the biggest proof of the power of increasing economic freedom. The trade liberalisation and industrial delicensing of the 1991 reforms significantly expanded economic freedom in India, atleast for the formal sector. Indians produced 7-9% rate of growth compared to the earlier rates of 3-4%. In 1991, the literacy rate was 50% - that is, half of India was illiterate. There was not much change in health indicators either. Despite being illiterate and undernourished, Indians achieved the second highest rate of growth in the world! What could be a more powerful proof that economic freedom is the key to economic success?

Hopefully the data I've presented prompts you to learn and read more about the evidence of the correlation and causation between economic freedom and material prosperity. You can find the data and read more at Freetheworld.com.

I also hope you've gained a more critical approach to looking at these kinds of questions for yourself and have a more inquiring mind to look for evidence and arguments that may challenge conventional wisdom.

So why IS India poor? The lack of economic freedom!

Endnotes

¹ Per capita GDP can either be presented in current dollars or it can be adjusted for differences in purchasing power in different countries. These are purchasing power parity adjusted numbers.

² The issue is not absolute population, *per se*, but the number of people *per unit area*. What we want to see is how many people are competing for how many resources. A population of “100 million,” for example, doesn’t tell us anything. What matters is how densely packed these people are. This is why we must look at population *density*.

³ It is worth reading chapters 1-4 of Adam Smith’s *Inquiry into the Nature and Causes of the Wealth of Nations* (Oxford University Press, 1976).

⁴ Close proximity also allows more people to share infrastructure, allowing them to economise on resources. The same length of tarmac road, electrical wire, sewage pipe, can serve more people when they are tightly packed than when they are spread out.

⁵ If you’re interested in exploring the connection between population and prosperity further, see the CCS publication *ViewPoint 2: Population Causes Prosperity* by Sauvik Chakraverti.

⁶ Ehrlich, Paul. *The Population Bomb*. Ballantine Books, 1968

⁷ Do today’s prices reflect the possibility of resources running out in the future? What’s interesting is that speculation on commodities makes present prices reflect expected future prices. If resources are projected to become more scarce in the future and current prices do not reflect this judgment, speculators seeing that the prices will rise in the future stockpile the resource at today’s prices in order to make a profit by selling them at a higher price later when they become more scarce. This increases the demand for the resource today pushing up the price until the current price reflects people’s expectations of future conditions. Speculators have a strong incentive to gather information that will help them make accurate judgments about future conditions of supply and demand.

⁸ Simon, Julian L. *The Ultimate Resource 2*. New Jersey: Princeton University Press, 1996

⁹ One interesting point to note from this chart is that the price of copper has fallen not only in terms of other goods that constitute the Consumer Price Index, but also

in terms of human labour. You might expect that so many more workers would mean lower wages per person, but the opposite is true. Even though the “supply” of labour has increased with the population explosion, real wages—what people’s wages can buy—have increased. It now takes less labour time to produce or purchase copper and other commodities than ever before, i.e., labourers are now paid more for their labour effort.

¹⁰ Simon acknowledged that prices could go up for a time, but he argued that the price rises would spur people to find new solutions and reduce the prices in the long run.

¹¹ Insofar as cultural attitudes affect social capital like trustworthiness, lawfulness, and affect the laws, policies, and institutions of a country, culture could be relevant.

¹² Finally, in his book *Free to Choose* (Orlando: Harcourt Inc., 1979), Milton Friedman argues that there are significant parallels between mid 19th Century Japan and India at Independence. Both were feudal societies with rigid status-based social systems. They both had self-sufficient cottage industries including hand weaving and simple farming. But Japan followed more free trade policies relying predominantly on voluntary cooperation and free trade to organise economic activity, while India followed more protectionism, self-sufficiency and a central economic planning model. We can see the difference in result after 40 years of independence in each country.

¹³ Gwartney, James, Lawson, Robert and Hall, Joshua. *Economic Freedom of the World Report*. Fraser Institute: 1996.

¹⁴ There are many great books that will help explain what economic freedom is, what institutions support economic freedom, and why economic freedom is a necessary condition for prosperity. Among the best introductions you can read on this subject are *Free to Choose* by Milton and Rose Friedman (Ibid.), *The Mystery of Capital* by Hernando de Soto (New York: Basic Books, 2000), a CCS publication called *Economic Freedom & Development* by Wolfgang Kasper, *India Unbound* by Gurcharan Das (New Delhi: Penguin Books, 2000), *Reviving the Invisible Hand: The Case for Classical Liberalism in the Twenty-First Century* by Deepak Lal (New Delhi: Academic Foundation, 2006), and *India’s Tryst with Destiny* by Arvind Panagriya and Jagdish Bhagwati (New York: Harper Collins, 2013).

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Friedrich Naumann
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CENTRE FOR CIVIL SOCIETY

A-69 Haus Khas, New Delhi 110 016

Voice: 2653 7456 / 2652 1882 Fax: 2651 2347

Email: ccs@ccs.in Web: www.ccs.in