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Essays on Indian Economic Policy and Institutional Reform

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Author's Note

These essays first appeared as columns in the Financial Express, one of India's leading financial dailies. Together, they provide what I hope is an integrated perspective on where Indian policy and institutional reform is going, and what remains to be accomplished. Each piece is self-contained, but several themes of institutional reform, especially of governance, run through them. Many of the issues raised are long run problems that transcend the specific time at which the pieces may have been written. These articles also draw on academic empirical and theoretical research wherever possible. Thus, I hope these essays together have some lasting value.

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1. India and the World Economy in 2005

December 2004

2004 has been a surprisingly good year. The world economy this year grew at an average of 5%, according to the IMF's September 2004 World Economic Outlook – the highest in nearly three decades. Stock markets went up, as did housing prices. Inflation remained in check. China and the United States both continued to drive global growth, in different ways. Politically, many things could have gone wrong in the world, and some have, but not enough to derail the economic expansion. One can say quite confidently, however, that 2005 will be worse for the global economy. Maybe not a whole lot worse: the IMF, in the person of Chief Economist Raghuram Rajan, was quoted on December 16 as predicting better than 4% growth for 2005. However, there are reasons to be less optimistic.

Experts have similar lists of the risks that threaten world economic growth. Fred Bergsten, director of the Institute for International Economics in Washington, D.C., highlights five risks: the United States' federal budget deficit and its current account deficit, international trade protectionism, high oil prices, and an abrupt slowdown in China's economy. The last three of these are obvious in their negative impacts on economic expansion. The impact of the first two bears further discussion. The 'twin' US deficits are not really twins – they happen to be coincident, but are not really causally related. Nevertheless, their coincidence does mean that the countries of the rest of the world, rather than US citizens, are financing the US government deficit. In a Latin American country, this would be a recipe for disaster. So far, the US has proceeded blithely, growing through high consumption of imported goods, ultimately made possible by foreign borrowing. Interestingly, China has effectively taken on the role of provider of goods and of the credit required to purchase them.

My colleague at UC Santa Cruz, Michael Dooley, writing with two colleagues at Deutsche Bank, where he also does duty part-time, thinks this situation is fine, and can continue, perhaps for as much as a decade. This is because the Chinese government will want to ensure continued export-led growth. However, the current imbalances are just too large. We can see the effect of this in the large decline of the dollar against the Euro over the past three years. While Asian currencies attempt to maintain dollar pegs, the euro has borne the brunt of the dollar's weakness. With US elections over, and a convincing victory for Bush and the Republican Party, it is fair to guess that 2005 will see a substantial tightening of monetary policy, which has been exceptionally lax in recent years. Real interest rates have some way to rise before they are even neutral, and not further stimulating a growing economy. The fact that the US economy is seeing some job growth is an indicator that labor market conditions will tighten, and this will also prompt the US Federal Reserve. The US budget deficit will also receive some attention, with the Republicans almost surely following a strategy of expenditure cuts rather than tax increases. One will likely see slower growth in the US, and 2005 will probably not be a great year for US stock markets or for house prices.

Add US fiscal and monetary tightening to high oil prices (even if they are below their recent peak, they will probably stay high, based on demand and supply conditions), a

Chinese economy that is also being reined in, and continued frictions in international trade, and one can easily see why the new year may not bring as much global economic cheer as the old one. This is the scenario without any unpleasant political shocks, so one has to be cautious about the overall outlook.

What does this all mean for India? The caution and pessimism expressed above might be expected to carry over to this country. However, I would like to offer a more upbeat assessment, contingent on the course of economic policy. India's economy now chugs along at over 5% growth without much problem. It has more than ample foreign reserves, and many dynamic and globally competitive companies. Its own fiscal deficit has been a drag on the economy, because of how poorly government money is spent, and its financial sector still has too many skeletons in its cupboards. What is interesting is how well the Indian economy does despite all its handicaps. While policy makers certainly deserve some credit for making things better, the unsung heroes of India's economy has been the Indian entrepreneur and Indian manager. They proved themselves in the global boom of the 1990s, and even more so in the bust that followed. Any policy initiatives, whether in the form of more rational labor laws, removal of counter-productive small scale industry reservations, removal of impediments to internal trade, or improvements in the efficiency of financial intermediation that generate more savings, will give them more ability to weather any future global storms. Monetary policy in India has been very conservative, and more than made up for fiscal profligacy. Assuming that situation continues, policies that boost Indian enterprise will brighten 2005.

2. Piecemeal Policymaking

Infrastructure Financing and Employment Guarantees

January 2005

The Indian government has recently proposed two policy initiatives that have captured attention. One is innovative in legislative implementation though not in concept, the other seems conceptually more novel at first sight, but may just differ in scale and scope from previous policies. Both initiatives illustrate a piecemeal approach to reform that is well recognized, but needs to change. They are also indicative of a paternalistic approach to India's governance that has not changed with liberalization, but which also must be confronted and reassessed.

The first initiative is the proposed Employment Guarantee Act (EGA), which says that "Every household in the rural areas of India shall have a right to at least 100 days of guaranteed employment every year for at least one adult member, for doing casual manual labour at the statutory minimum wage...". The second idea is the Planning Commission's proposal to tap foreign exchange reserves for financing infrastructure investment. Each of these initiatives addresses a critical need: we must do more for India's poorest, and we must have better infrastructure to grow faster. In each case, therefore, there is a worthy goal. Given India's intellectual talent and free media, both these proposals have already been debated extensively. What more is there to add?

Begin with the infrastructure initiative. Much of the debate has focused on the degree of import intensity of the spending, and, indeed, whether that issue is relevant (the answer is, "not really", as long as the private sector, instead of the government, imports more in the end). Discussions have also raised questions concerning the appropriate level of foreign exchange reserves, the impact of a higher fiscal deficit, and the true, underlying constraints on infrastructure development in India. China and Taiwan have been held up as successful examples of using foreign exchange reserves creatively. Surprisingly, some of the questions revolve around facts about the economy and policy responses that the Planning Commission, even after fifty years of model-building, does not seem equipped to deal with. As T. N. Srinivasan and I argued in an *EPW* article last June, having an adequate model of the economy, incorporating and integrating its real and financial aspects, would allow a discussion that goes beyond raising concerns and airing opinions. It would allow one to weigh and compare alternative policy options, and search for policy mixes that might be closer to optimal. It would also allow one to do a more serious comparison with other economies.

Here are some questions, for example, that come to mind, in thinking about policies for improving infrastructure investment in India. Given that the RBI accumulated reserves at the current level, is the Planning Commission saying these are too high? Was the RBI wrong? Is the difference between the two organizations one of goals or of economic models? What is the current and historical effectiveness of the Planning Commission's spending on infrastructure projects? Can improving the effectiveness of India's governance (much lower than China's and Taiwan's, by some measures), in direct government spending as well as in regulatory oversight make a difference? If so, how and

how much? Would further liberalization of imports be a better policy? If so, would this work best through easing import of capital goods that go into infrastructure investment, or would a general boost to private investment make firms willing to bear some costs (individually or collectively) of infrastructure investment? Will the proposed special purpose vehicle really be more efficient than other government attempts to direct investment (think of nationalized banks and credit cooperatives)? As long as we do not have a serious model of the Indian economy, policy making will remain hamstrung, and rely on piecemeal, partial approaches. This has been recognized as characteristic of economic reform in India, perhaps even a necessary feature of “reform by stealth” to avoid political battles, but the time may have come to modernize and upgrade our formal analytical machinery for economic policy making. In fact, this upgrade may even create scope for policy packages that will identify and efficiently compensate the “losers”, making political acceptability easier to achieve.

How to finance infrastructure investment for future economic growth seems like an appropriate topic for economists to wrangle about, and to use to make a case for better models. When one is trying to do more to look after the poor and destitute, it seems even economists should be in total agreement. Indeed, the EGA has, in some ways, provoked less debate: targeted welfare schemes that rely on self-selection are theoretically sound, and many of the issues raised focus on precise effectiveness and details of implementation. Yet here, too, one would like to see the discussion broadened to consider the new proposal in the context of existing transfer schemes of all kinds. Do we have clear data on alternatives to employment guarantee programs? What about other “below poverty line” schemes, school lunch programs, micro credit allocation programs, and even the funds allotted to individual MPs? One has the sense that one more worthy program is being legislated into being, without sufficient analysis of the relative costs and benefits of alternative policies, including an assessment of what individual states (besides Maharashtra) can do and are doing.

Lest the above sound curmudgeonly, let me say that the argument here is not one against the social insurance concept behind the EGA, nor, for that matter, against improving infrastructure. Instead, it is plea for more comprehensive economic policy analysis and policy making. We have a long way to go in this respect, despite the progress that India’s economy has made over the last years. We still rely on personalities and trusting the pronouncements of those whom we have anointed. This goes with a continuing top-down attitude (not just paternalism, but also “maternalism”!) that encourages trying to solve problems by fiat, rather than careful policy design, and that tries to protect every group in society in some way or other, resulting in long lists of policies and laws that overlap, conflict, and fail to achieve their objectives, indeed, are often counterproductive. This paradox of centralization without policy coordination needs to be addressed.

3. Beyond the Budget: Leadership, Governance and India's Future

February 2005

With the 2005-06 Budget just around the corner, I took some time to look at the highlights of the last half-dozen budgets. It seems to me that the Budget ritual has three components. The core of the exercise is the announcement of detailed changes in tax policies, embodied in the Finance Bill, with implications for revenues (though how the Finance Ministry gets from changes in who and what is taxed at what rates, to projected changes in receipts, remains a mystery to those outside the process). This part of the Budget probably receives the most attention, and accords reasonably well with what actually happens over the following fiscal year.

The second component of the Budget is the expenditure side, where, given the history and nature of India's governance, one has come to expect a cornucopia of schemes designed to improve the welfare of the myriad groups in India that remain deprived in various dimensions of well-being. There is usually some acknowledgment that previous expenditure schemes have weaknesses, or have failed to achieve much, and affirmation that these problems will be fixed in the new proposals, though typically without any clear statement of what principles are to be followed for more effective implementation in the future. So the next year is more of the same.

The third component of the Budget exercise has nothing to do *per se* with the nuts and bolts of receipts and expenditures, but provides the government's vision and overall policy thrusts, which are (hopefully) what guides the detailed revenue and spending proposals. Growth rate targets, sectoral foci (recent examples include, unsurprisingly, agriculture and infrastructure), basic needs (most obviously, education and health) and cooperation with state governments are examples of what gets mentioned here. This rhetoric has been quite stable through India's reform period, across finance ministers and across governments. Much of this is what is known in the United States as "motherhood and apple pie" statements. Even if implementation is weak, one at least gets a flavor of the leadership's thinking.

Why is implementation of the government's vision, as expressed in the Budget speech, always so weak? First (a legacy of the past that has survived reform), the central government tries to do too much, and too many things, on its own, without the capability to execute. A multiplicity of narrow, poorly conceived expenditure schemes that must be implemented by disinterested or dishonest functionaries, who are many links removed in the organizational chain from the leadership, are bound to fail. A second cause of poor implementation is the failure at all levels to monitor results and evaluate performance. It is time to accept the reality of the government's internal organization, and stop pouring money down "rat holes" (another Americanism), until the twin problems of poor incentives and poor information are fixed. Even when (if) they are fixed, the design of government policy in India needs to change quite radically for effective implementation. Until this happens, India's leadership will remain a failure.

What is the solution? Interestingly, the Prime Minister, Dr. Manmohan Singh, this month provided some guideposts himself, in a remarkable speech delivered at the inauguration of the Infosys Leadership Institute in Mysore. In it, the Prime Minister said, “One cannot but be moved and inspired by the story of Infosys. ... What truly inspires me is the manner in which a group of educated and talented young men have been able to convert ideas into products, jobs and incomes.” He went on to say, “I believe the twin responsibilities of Government are, on the one hand, *to create an environment conducive to the flowering of private enterprise and individual creativity*; and, on the other hand, to take care of those who are marginalized by the development process and empower them with capabilities that enable them to become productive citizens of our society.” (my italics) The first goal is a remarkably forthright statement, which I hope becomes a beacon for every politician and bureaucrat in India, and influences the forthcoming Budget exercise and policymaking beyond it. The second goal, however, is one that India’s governments have consistently espoused, and typically failed to deliver on.

While urging readers to study the Prime Minister’s speech in its entirety, I want to return to the issue of achieving the government’s second responsibility, as quoted above. In commending Infosys and its leadership, particularly founder Mr. Narayana Murthy, Dr. Singh emphasized Mr. Murthy’s strong ethical values, and, speaking of Infosys, said, “We need scores of such centres of excellence.” Ethics and values are certainly important, especially in government (Happily, the Finance Minister concluded on this note in last year’s Budget speech, quoting Saint Tiravallur, on walking “the path of honour and courage”). But even if Mr. Murthy did not have his Gandhian simplicity, as extolled by Dr. Singh, I think Infosys would remain a wonderful model. What Infosys does is train its employees, from executives, through project managers and software developers, down to gardeners and sweepers, to be committed to achieving honest results through hard work. And it rewards them for doing so. How Mr. Murthy or any of his employees spend their rewards should be of less concern. In the government, in contrast, once one goes a little below the top rungs, or moves beyond the national government, there tends to be a sharp drop in acquired skills and capabilities – though not in innate abilities. The internal organization of Infosys and other companies in India’s IT industry can and should be a model not just for the rest of India’s private sector, but also for reinventing India’s government. This is the first step the government should take, if it is really to take care of the marginalized. My prescription is “physician heal thyself,” and I hope the government’s vision will eventually encompass this.

Dr. Manmohan Singh and his Finance Minister rival Mr. Murthy in values and in vision. Unlike Mr. Murthy, they do not have the opportunity to build an organization from the ground up. If they can take the organization they have inherited, and reshape it to match their values and achieve their vision, their leadership will be for the ages: the Budget is only a small step on the path.

4. A Safe, Smart Budget Points India in Right Direction

No Major Surprises, but a Few New Twists, and Some Potential Gems

February 2005

Sitting halfway round the world, I had the pleasure of staying up late on a Sunday night to watch Finance Minister P. Chidambaram's latest budget presentation performance via a live web cast. As usual, Mr. Chidambaram looked confident and sounded smooth, despite the occasional garbling of bits and bytes in both the video and audio. There have been plenty of advance indicators of the budget vision, and even of specifics of tax and expenditure policies, and there were no real deviations from these early signs. Rural development and infrastructure are areas where the government hopes to put its money where its mouth has been. Agricultural credit and insurance; rural infrastructure such as telecom, irrigation, electricity, and even knowledge centers; and health and sanitation are some areas that will receive government funding attention. Road building gets a big budget boost, as does other infrastructure, through an off-budget Special Purpose Vehicle. Beyond the main areas, there is, as always, a long list of expenditure allocations, just as one would expect from any coalition government in a large, heterogeneous democracy. The Planning Commission gets 25% more money to play with for next year: it will be interesting to see what it accomplishes. On the revenue side, indirect and direct taxes will continue their slow march towards rationalization, with mostly fewer and lower rates (especially customs duties), simpler structures, and continued attempts at base broadening. Again, there is nothing that is unexpected, or untoward in the overall picture, seen at this basic level.

There were several nuances, however, which imbue the latest budget with more interest. Several items illustrated the new concern with building human capital at different levels, from the creation of new medical institutes, to the goal of making the Indian Institute of Science in Bangalore truly world class, to trying to revive and upgrade the it is, and even those rural knowledge centers already mentioned. Second, there were several proposals for various financial sector reforms, all of which will continue to improve India's ability to attract and allocate capital effectively. A nice image offered here was of Mumbai as a future regional financial hub, halfway between London and Tokyo: more power to this vision. Third, the continued rationalization of support for the "small scale sector", including its gradual morphing from protection into encouragement of the broader category of small and medium enterprises, is a good sign. Complementing this was an indication that manufacturing competitiveness, more broadly, will receive some attention down the road.

As one might expect, there was nothing to upset the government's left allies – no real action on labor law reform, or industrial exit. Also on the down side, the fiscal deficit and revenue deficit are slated to grow slightly, though with promises of a return to the FRBM track next year. If the government could spend its money well, this would be less of a concern. However, there was no indication of how the government proposes to improve its efficiency or effectiveness on this count. It was announced that the Planning Commission will measure outcomes of major projects (something that should not have taken decades to figure out is a good thing): how this is done will be interesting to see. Of course the Deputy Chairman was most recently in charge of operations evaluation at the

IMF! On the revenue side as well, improvements in tax administration still hold the key to successfully raising the tax-GDP ratio. On this score, the Finance Minister's quote from Saint Tiravallur was somewhat bland this year (about health, wealth, produce, happiness and security, though nicely tied to Amartya Sen's broad vision of development) – much less dramatic than last year's, on walking “the path of honour and courage.”

Interestingly, the biggest rise that Mr. Chidambaram got out of the Members of the House was when he proposed his tax of 0.1% on bank cash withdrawals of over Rs. 10,000 in a day, as a measure to track potential black money. If this comes to pass, I can foresee many withdrawals of Rs. 9,999. In any case, there are many other channels that this measure will fail to touch. My guess is that there are better ways of tackling the problem, including strengthening reporting requirements and monitoring systems in the financial sector, within government, and elsewhere. Perhaps it was a bit of fun to liven up a safe, serious budget with solid potential, put together by a talented team.

5. Twelfth Finance Commission Inches Federal Transfer System toward Maturity *Some Major Reforms Suggested, but Much Left for the Future*

March 2005

The report of the Twelfth Finance Commission (TFC), recently made public, marks another slow step towards the maturation of India's system of intergovernmental transfers. The bottom-line product of the TFC is, of course, its recommendations on how much money each State gets out of the consolidated fund of India, with the Centre's share being determined somewhat by default. In his budget speech, the Finance Minister highlighted the increase in transfers proposed by the TFC, and the implications for fiscal consolidation at the Centre. Studying the report of the TFC, however, it seems that they have been relatively conservative, and their proposed overall share of revenues allocated to the States does not represent a significant increase over previous precedent. Of course, when every level of Indian government is badly in hock, every Rupee counts, particularly in making the accounts look better on paper, so one can understand the Finance Minister's concern. In any case, the TFC has only tinkered with the tax devolution formulae, increasing some weights and decreasing others, increased the States' share slightly, and upped grants-in-aid somewhat more, targeting them particularly to poorer states, and earmarking some of these grants for priority areas such as health and education. Much of this is in the spirit of previous Finance Commissions.

The TFC also follows the precedent of the Eleventh Finance Commission, which was the first to be given broad terms of reference with respect to assessing the overall fiscal situation of the Centre and the States. It is useful to have the TFC do this independently of the Finance Ministry, though one would like to see some more in-depth analysis and comparison with other assessments and projections. As it is, the TFC report complains of the Commission being short on time and resources. A lengthy plea for a permanent secretariat and proper funding, articulated often in the past, surely ought to be finally heeded by the Central Government, if it is serious about the terms of reference it gives the Finance Commissions. The marginal benefit of proper analysis must surely be worth the expense.

The key missing ingredient in the TFC's report, as in much of what comes out of such exercises in India, is the lack of any well-specified behavioral models that are empirically operational at a level that permits informed policymaking. For example, the increased grants-in-aid are accompanied by a statement that they are not "gap-filling" grants with adverse incentive effects, because they are based on normative projections of State government revenues and expenditures – what the States ought to be doing. Yet the only thing that is clear about these normative projections in the report is that they are not based on any clear criteria of what a State government operating with a particular set of characteristics might be expected to achieve in its taxation and spending. Nor is there any estimate of the degree of fungibility of earmarked grants. There are several mentions of what Australia and Canada do in the arena of federal devolution, but there is no obvious attempt (that I could see) to apply such lessons to Indian practice. It would be much better, for example, to overhaul the tax devolution formulae to incorporate horizontal equity criteria explicitly, rather than tinkering with the formula to reduce transfers to the

worse-off states, and then dealing with horizontal equity again, in a more ad hoc manner, with various grants, as the TFC has done.

Of course, only so much is politically feasible, and the TFC has done a great job of highlighting some tough areas for reform. The continuing reform of India's indirect tax system gets considerable attention, and the fact that Central service taxes, being introduced by the 88th Amendment, are not part of the shareable pool, is rightly highlighted as a retrograde feature of the new law. The FRBM Taskforce's recommendations on indirect taxes are discussed quite sensibly. The TFC also says many of the right things about the muddle that constitutes the Planning Commission's transfers. The report is also very clear and sensible on the need for proper accrual accounting in government (though this shift will not, of course, remove the need to track cash flows as well).

The most significant recommendation of the TFC is in its push for market borrowing by States for Plan expenditures, rather than loans from the Centre. This recommendation is not a novelty, of course, but the TFC's strong support is useful in nudging along this institutional reform. There will be a huge amount of effort in making this happen in a manner that actually works, as the RBI is already recognizing and preparing for. The biggest challenges will be in ensuring transparency and monitoring, so that market liabilities of the States do not simply replace Central loans as regular bailout candidates.

Ultimately, of course, the real issue is making India's governments at all levels (Centre, State and local) less wasteful and better at serving their constituents. The Finance Commissions cannot really directly achieve this goal, which will require more transparency, better monitoring, and clear accountability of governments to their constituents (as well as constituents who care about these goals, rather than just opting out of their own public responsibilities). However, the TFC's recommendations with respect to accounting and market borrowing are very important enabling steps. It will be nice to see the next Finance Commission do some serious behavioral modeling of India's public finances, as an additional component of making India's governments and federal system work better. Doing this outside the confines of the Finance Ministry and Planning Commission, but with official access to data, will be a unique contribution of the Finance Commissions, and enhance the value of their work. After all, it is better that this kind of analysis be done within India, by those who understand its institutions, rather than at the World Bank or International Monetary Fund.

6. The Future of India, China and the World Economy *What India's middle class and its government need to do*

April 2005

The world economy is on the threshold of a new era. Many people realize this, of course, though from different perspectives: the software developer in the United States feels his job is threatened, the call centre employee in India finds a new lifestyle, European and American business schools look to Singapore for greener educational pastures, and third world immigrants make up sizeable fractions of the populations of many industrialized countries. Some have argued that globalization is nothing new – that we saw it all a hundred years ago – but today's low costs of physical transport and (especially) of information transfer will have much deeper impacts than before. To paraphrase Al Jolson in the first 'talking picture', "You ain't seen nothing yet."

Another new development is the rise of China, which looms large on the world's radar as a low cost producer of an enormous quantity and variety of manufactured goods. Japan's rise through the 1980s created plenty of worry in the United States: China is ten times as big and still has a long way to go in its growth. Some researchers have drawn parallels between what is happening now – with China's export-led growth, the dollar's role as a reserve currency, and the US current account deficit – and the period of Europe's spectacular post-war growth, when US external economic policies also supported that process. But that was a recovery – Europe had been economically advanced since the Renaissance. China's rise will bring about a world economic order that has not been seen for 500 years or more.

India has the potential to be yet another global growth pole. India and China both realize this of course, and the prospects of gains from trade and cooperation have spurred historic moves towards resolving the sources of past political and strategic tensions (and with the glimmer of a hope of extending this change to relations with Pakistan). 'India's software and China's hardware' is one popularly perceived complementarity. India's management and China's labour might be another one, at least in some contexts. With all their differences, one commonality between both countries has been their relative shift from state to market as driver of economic growth. The two countries also have similar concerns about growing economic inequality.

In India, somewhat old-fashioned rhetoric about the links between globalization, the market and inequality still persists, driven by the 'old left'. Responses based simply on extolling of the virtues of the market for economic growth do nothing to resolve these concerns. At a different level, Gurcharan Das goes back to Aristotle to stress the importance of the middle class, and praises the role of this brash new class in India, while writers such as Pavan Verma (*The Great Indian Middle Class*) and Pankaj Mishra (*Butter Chicken in Ludhiana*) are disturbed and even repelled by this class's lack of social concern. Policy discussion in India often has this flavor of a college debate, with eloquence overriding analysis.

In an important paper, published in 1998 in an obscure economic journal (*Keio Economic Studies*), Abhirup Sarkar provided an important component of the analytical

underpinnings of the kinds of policy approach that India's current Prime Minister and Finance Minister have articulated in the past few months. The essence of the dry mathematical model is as follows. The middle class is distinguished from the rich and the poor not only by their income levels, but what kinds of goods they purchase. These middle class consumption patterns are important in affecting the extent of innovation, and the extent of innovation is what drives growth. Sarkar shows that simple redistribution policies will not break an equilibrium where the economy is stuck in stagnation. Instead, raising enough of the poor to the middle class by improving their productivity is what works. Thus, there is room for the perspective of Milton Friedman as well as Amartya Sen in such an analysis: the market does its work, provided the initial conditions are right. But the easiest or most obvious policies are not necessarily the ones that the government should follow.

Putting the above in concrete terms, policies to improve the human capital of the poor, or, more broadly, their capabilities, are exactly the right ones, if the model is to be a guide. This is precisely where India lags seriously behind China, in areas such as health, nutrition, and education. The policy focus should be squarely on how the government can achieve this better than it has over the last 50 years. Getting the government out of the habit of meddling in all kinds of things where it has no business, or which are lower priorities, would certainly help. Reorganizing government to be more transparent and accountable cannot hurt either.

This is not the end of the story, however. Public goods, such as infrastructure and law and order, matter for private productivity. This is another important role for government (which can easily be added to Sarkar's model, complementing, not replacing, the market). The problem in India is again how to do this efficiently in practice. The middle class has been used to a low level of public goods, and has dealt with government inefficiency through *de facto* private provision, following the lead of the elite in essentially seceding from participation in the requisite collective action. This has to change in India, else it will end up more like Latin America than East Asia. Latin America has high inequality and a narrow middle class, and governments there have never achieved sustained, broad-based growth.

India can do better, and it is up to the middle class to make it happen, because it wields disproportionate influence on government policy, and sets expectations for government performance. Karnataka's new chief minister recently claimed, "Bangalore cannot become Singapore." But it can, if the government does its job well. And India can be China, or rather, China plus political freedom. India's middle class, as it swells in numbers through market-driven growth, has to shoulder the responsibility to make it happen. *L'état, c'est vous.*

7. Make India Flat

Level the Economic Playing Field for the Masses

May 2005

Earlier this month, I attended TiEcon 2005, the annual conference of The Indus Entrepreneurs, the South Asian networking organization for entrepreneurs, born in Silicon Valley, and now becoming a global force. This year's theme was "Energizing the Global Entrepreneurial Spirit," with CEOs of tech companies such as Google and Adobe, venture capitalists, and start-up entrepreneurs all providing insight into what makes the global economy tick, where cutting-edge innovation is heading, and how to make it work commercially. However, the conference kicked off with a keynote address by a journalist, Thomas Friedman, the international affairs correspondent for the New York Times, whose travels to India, China and elsewhere led him to take a year off to write his new book, *The World Is Flat*. What Friedman means, of course, is that the global economic playing field has been leveled by advances in technology, coming on the heels of political developments that spurred economic policy reforms. The Internet, World Wide Web, supporting physical infrastructure, and collaborative software applications layered on top of these, have changed the manner in, and extent to which, people in India, China and Eastern Europe can and do participate in the global economy.

For educated Indians, this observation is nothing new. It is more of a wake-up call for the citizens of Friedman's own country, who will now face a different kind of global competition for jobs, careers and lifestyles. Friedman puts it quite picturesquely: earlier parents in the United States might tell their children to finish what was on their plate, since children in India and China were starving. Now, American parents should tell their children to finish their homework, since those Indians and Chinese are starving for their future jobs. This American perspective also means that, even if 150 million people in emerging economies are capable of competing globally, that is enough to make a difference – that matches the size of the US labor force. However, as Friedman probably realizes, this will not be good enough for India and China. The world will not truly be flat until these countries themselves are flat. Let us put aside China (not to speak of Latin America and Africa), and focus close to home.

How can India become flat? We know the main way station on the road to this goal: make sure everyone has basic levels of health, nutrition and education, and provide broad access to higher education, credit, and certain types of insurance. Where disputes arise in India is in how to even get to this point. We know by now that the government cannot easily achieve this. In *The Federalist*, No. 51, James Madison put it thus: "If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary." This statement is in Madison's argument for checks and balances, and for decentralization, but also has implications for thinking about the benefits of competitive markets. When India's constitution was being written, people like Dr. Ambedkar had no illusions about the shortage of angelic qualities in the Indian village, but the framers of that document did seem to think they were somewhat closer to the angels, and set in place institutions that they hoped would flatten India from the top down. That has not worked.

India is in the process of dramatic changes, which go beyond simply taking the government out of its misguided attempt to occupy the commanding heights of the economy. Economic activity driven by private sector competition rather than government control and monopoly has led to a flatter India. One only has to see the diversity of backgrounds of those who have succeeded in India's IT industry to see the truth of this. Ceding some policy space to state governments by the Centre has also flattened India in some ways, though some of the poorer states have fallen further behind. Local government reform will, in the long run, flatten India too, moving the country away from an administrative and governance system that retained too many features of the colonial (or even Mughal) era. Local governments have the potential to be more responsive to local needs for basic schooling, sanitation and health care, if true democratic participation is enabled, and efficient revenue sources enabled and developed.

However, let us go back to Friedman's observation on what made it possible for Bangalore to compete with Silicon Valley. The driving force was the enormous expansion in communications and collaboration made possible by information technology. Of course, Bangalore was ready to take advantage of the opportunities that opened up. The problem for Bathinda, Baroda or all of Bihar may be much greater. Capabilities have to be built up before opportunities can be exploited. But information technology helps here as well. I have seen this in my own fieldwork, in many villages in India, where even a single Internet-enabled kiosk can become an information services hub, providing education, health services, guidance for farmers, and much more.

The economics is simple, once one thinks about it. In rural India, high transaction costs not only reduce the efficiency of functioning markets, but they also preclude some markets all together. Bringing down those transaction costs through information technology enables these rural markets to function, raising productivity and growth. One can build an abstract model to show this (and I have done so), but the reality is powerful enough. In a recent survey of the 'digital divide, *The Economist* magazine extolled the importance of cell phones, and pooh-poohed rural computers. They missed the point. All kinds of digital communication, storage and processing devices are important, and the boundaries between them are blurring. What will be important is scaling up from small experiments, and this requires organization-building and entrepreneurship (check out what n-Logue has achieved, for example). Put commercially sustainable information kiosks in 250,000 villages (with government support for infrastructure, perhaps, but keeping it out of operations) and this will be another significant step in making India flat. The best part is, even those at the top of the heap in India (except those who rely solely on corruption) will do quite well if this happens.

8. Miracles and Reform in India

What is the Secret Sauce for Success?

June 2005

Seven years ago, I attended one of the early United States-based conferences on Indian economic reform, and presented a paper titled “Miracles and Reform: Policy Reflections for India.” The paper was about how Indian economic and political reform, if carried forward properly, could lead to East Asian-style “miraculous” growth. We are not there yet, but might be much closer to that breakthrough than at any other time since the reform process began. But we can still go wrong. What are the key things that need to be done, or the ones that need to be avoided? Ask different people, and you will get different answers, all with some truth in them. Each year, though, I have a good place to ask, and listen to, people who might know best.

Since 2000, the Stanford Center for International Development has organized an annual conference on Indian economic reform. In the beginning of June, top academics from all over the world get together with top Indian policymakers in a small room and present ideas, abstract models, analyses, data, visions, complaints, suggestions, and, this year, even a film. Influential Indian visitors have included Finance Ministers, Chief Ministers, MPs, CEOs, civil servants, think tank heads and journalists, all sitting around the same table, and participating in vigorous question-and-answer sessions with none of the hierarchical flavor that tends to shape conferences in India.

So what did I learn this year? To tell the truth, much of it does not come as a surprise to me, nor will it to readers. India has done quite a good job of financial sector reform, as far as the stock markets go, and this has opened the door for a great deal of further progress in other parts of the financial sector. Of course, if one starts to list all the remaining problems in the sector, including areas where some reform has taken place, the list can be daunting. But, as a senior technocrat pointed out to me, India is doing a reasonably good job of collecting savings and efficiently converting them to investment. Doing more here will help, since higher investment is a key input for higher growth, but there is plenty of momentum.

Infrastructure is, of course, high on everyone’s priorities for progress. At this year’s conference, the focus was on the transport sector. Barring the railways, again there seemed to be the view that progress can and will be made sooner rather than later. The government is slowly figuring out how to let the private sector in, so that competition and efficiency can take hold. One area that did not get discussed this year was electric power. When I asked the same top policy maker what the most critical area for reform is, the answer was “electric power.” The Electricity Act of 2003 was notified that year, but was threatened with review by the new government in 2004. Luckily, the urgent needs of the sector have prevailed over interest group pressures, and implementation seems to be on the cards, despite continued opposition from the Electricity Employees Federation of India. Who can blame them, though? Livelihoods in India are scarce, and the prospect of losing a secure job is frightening. The railways are a huge employer, and face the same problem.

One of the reform areas I highlighted in my paper seven years ago, one which falls outside economic reform proper, was governance. In many respects, India is still struggling here. Government corruption and incompetence are major problems for India's citizens, who are supposed to be served by politicians and bureaucrats, not exploited and bullied by them. Some surprisingly candid and forthright statements were made at the Stanford conference, about the need for administrative reform in particular. My own sense is that the bureaucratic mindset in India still has some way to go towards adjusting to a market economy. Our politicians and bureaucrats are often still feudal in their attitudes, and prey on the fears of workers and citizens. Judicial reform, which I remember first being highlighted by Dilip Mookherjee at a conference in Berkeley in 1993, was also mentioned as a high priority.

On the other hand, a tremendous amount has been accomplished at a different level of governance: intergovernmental relations. The Finance Commission now is allowed to make broad recommendations on government finances, well beyond its artificially narrow scope in the pre-reform era. Tax reform is gathering steam, and the benefits of improved tax administration are large enough that administrative and organizational inertia (even resistance) will eventually be overcome. The Planning Commission promises to start paying attention to how its money is spent. The leaders of (some) state governments are slowly realizing that the enemy has been themselves. State Chief Ministers, given new prominence after economic reform, see themselves as ambassadors for their constituencies, seeking out foreign investment in Silicon Valley, though maintaining traditional hierarchical dominance at home. Even local government reform (another topic at the conference) is creeping forward.

What's missing? What's the secret sauce, without which the Indian miracle will not occur, without which corruption will blight citizens' lives, fear rule the labor unions, and feudal attitudes persist? Abhijit Banerjee's documentary film, shown at the conference, was about rural health care in Udaipur, Rajasthan. One thing I took away from it was the extent of ignorance on all sides, and the lack of information that prevented people from making wise decisions, even when reasonable, low-cost health care might be available. Knowledge matters in all kinds of situations, whether it is basic literacy, new job skills, consumer decisions, or bureaucratic performance. Seven years ago, I quoted Milton Friedman's 1955 statement on the secret sauce: "In any economy, the major source of productive power is not machinery, equipment, buildings and other physical capital; it is the productive capacity of the human beings who compose the society." I think left, right and center can agree on this, and work towards policies that build this capacity for all of India's citizens, in as many circumstances as possible.

9. People Power and India's Potential

How to Upgrade Higher Education

July 2005

India was an economic underachiever for four decades after independence, but that has changed. Debate still continues in India about aspects of economic reform, but, after a decade and a half, many people's mindset has also changed. Remarkably, as early as 1994 (when many in India and elsewhere remained skeptical or uncertain), Goh Chok Tong, then Singapore's Prime Minister, saw the economic and strategic potential emerging from India's new policy direction. Ten years later, one consequence of Mr. Goh's vision was a new Institute for South Asian Studies (ISAS), established at the National University of Singapore. Already, the Institute has hosted the Prime Ministers of Bangladesh and Pakistan in quick succession. Meanwhile, India has been initially represented by Finance Minister Chidambaram, speaking in March of this year on "The Decade Ahead for the Indian Economy." The Minister's assessment was expectedly upbeat, stressing achievements in a variety of areas of the economy. He noted the infrastructure deficit as "India's biggest deficiency," as well as steps to fix this problem, including "bringing in other players." As he put it, "Public-private partnerships are an accepted norm."

Mr. Chidambaram also remarked on the "less well-known...concealed strength in the demographic dynamics of the coming decade." India is poised to increase in its percentage of working age population. Mr. Chidambaram stressed the determination to "accelerate our achievements in the fields of education, basic health and skill formation," to make this increasing labor force more productive, but did not go into specifics on this point. As I have argued in previous columns, human capital is, in some respects, the crucial resource for India. One can also argue that India's underachievement in economic development and growth has been epitomized, as well as caused, by its failures in human development. Primary education and basic health are clear examples of government failure ("chronic underactivity," as Professor Amartya Sen puts it) in India. Yet higher education presents a different case. This difference has not been sufficiently recognized in India, and, as a consequence, higher education policy has floundered.

In his ISAS speech, Mr. Chidambaram detailed successes in developing the financial sector, and in attracting foreign direct investment (FDI). These are areas where there has been a major shift in the policy consensus from the pre-reform era. The implications of this shift for higher education policy now need to be worked out. The Mid-Term Appraisal (MTA) of the Tenth Plan, after noting shortfalls in numbers (only 9.2 million enrolled, or well under 10% of the relevant age group) and quality (no institution in the global top 200) with respect to higher education in India, makes an obvious, but extremely significant recommendation: "The Planning Commission has carefully considered the issue, and feels that a substantial increase in fees, combined with an aggressive means-based scholarship and loan programme, is the need of the hour." Economically, this makes perfect sense. Much more than primary or secondary education, higher education is a private, not a public good, and students should not be subsidized *en masse*, without consideration of return on investment or ability to pay. The financial sector, if it is as strong as Mr. Chidambaram argues, can and should be a source

of funds for investment in human capital, not just for physical investment and consumer durable loans. No doubt there will be opposition to the reduction of the higher education subsidy, but it is refreshing to see it so clearly on the policy agenda.

The Planning Commission's MTA goes on to state another significant policy goal: "A clear policy for inviting private sector investments in education should also be formulated." The Chhattisgarh fiasco, where a Supreme Court ruling in February in response to public interest legislation led to 110 of 117 private universities in the state ultimately being deregistered, is relevant here. The Court's decision was based on its perception of the need for national standards, according to the constitutional assignment of authority over higher education. It stated, "It is the responsibility of the Parliament to ensure that proper standards are maintained in institutions for higher education or research throughout the country and also uniformity in standards is maintained." Interestingly, the MTA has a similar theme, calling on the newly formed National Knowledge Commission to come up with ways to "reduce the disparities in academic standards of various Universities."

I would argue that there are serious conceptual deficiencies in the above statements. Parliament is not really competent to directly set, monitor or maintain standards. Delegated national bodies such as the Universities and Grants Commission (UGC) currently have serious deficiencies. Before we give the UGC more regulatory authority, when it has not proved competent in the past, we should consider alternatives. Regulation is always important with respect to fraud and malfeasance. In the financial sector, the potential for systemic failures requires very careful regulation. Health and safety for consumers and workers also need government regulation. But in higher education, the principle of *caveat emptor* – buyer beware – may be much more applicable. Furthermore, there is a huge difference between minimum standards and uniformity. The former is much more relevant and desirable than the latter. Even for the former, competition, reputation maintenance, self-regulation and independent certification are more likely to support successful private investment in higher education than continued incompetent, self-serving government regulation. Discussion in India is sometimes quite muddled on these points.

FDI in higher education also deserves more consideration, as a source of both funds and know-how. Interestingly, both the left and the nationalist right have been suspicious of such investment, using spurious cultural pollution arguments (going abroad to study is all right, though!). Potential foreign providers of higher education, like private domestic entrants, are preemptively accused of being liable to fleece poor Indian students. These kinds of arguments falsely treat Indian students as being either naïve or stupid. Mr. Chidambaram spoke of today's India as "confident and optimistic," ready to take on globalization on its own terms. Singapore is acting fast on its vision of being a regional knowledge hub, attracting universities from all over the globe, including India. India's current policies toward foreign investment in higher education are wrong-headed, unduly restrictive, and a drag on the future. A confident and optimistic India can do better on this front. Let us see if the C.N.R. Rao Committee on this topic agrees, when its report comes out.

10. India's Role in the World

Lessons of the Prime Minister's U.S. Visit

August 2005

Prime Minister Manmohan Singh's visit to the United States last month can be termed a strong success, achieving concrete objectives as well burnishing India's image with U.S. lawmakers. The biggest headline grabber was the agreement on sharing nuclear know-how – certainly a coup for India. Even though India's request for support for a permanent UN Security Council seat made no headway, we know that that is part of a bigger, more slowly moving game, and so will take more time. Why did the U.S. make a nuclear exception for India? According to the *Washington Post*, "much of the plan was conceived by Robert Blackwill, former ambassador to India and a deputy national security adviser under Condoleezza Rice, along with his close confidant, Ashley J. Tellis, a specialist on U.S.-India relations" at the Carnegie Endowment for International Peace. Tellis had earlier laid out a vision for India-U.S. relations in a paper titled "India as a New Global Power," promoting strategic cooperation between the two countries rooted in U.S. defence sales to India, and support for India's growing military nuclear capability. This is an easy connection to see, between the explicit agreement on "civilian nuclear technology" and the strategic, military goals of both nations. It is also clear that competition for natural resources, the oldest (and traditionally the only) driver of geopolitics, remains a salient factor in these interactions. India's push for a natural gas pipeline from Iran, which failed to get a positive response from the U.S., also falls in this category. India's current attractiveness to the U.S. comes from its potential role as a partner against terrorism and as a fellow democracy – pragmatism and principle, as the Prime Minister put it, in his address to the Joint Session of the U.S. Congress.

While acknowledging the importance of security, and of access to natural resources, it is imperative to take a broader view of what constitutes "success" for a country like India. International prestige and military clout should not be goals that divert attention from raising the economic well being of the population. It is better to be a Japan, than a Soviet Union. In this respect, it is useful to note that much of the PM's speech to the U.S. Congress was taken up with economic matters, though these did not garner any headlines. Of particular interest is the PM's announcement of the launching of "a second generation of India-US collaboration in agriculture." The emphasis seems to be on "basic and strategic research," as well as promotion of technologies for enhancing efficiency in storage. Yet one wonders if this is being pursued in the right way. Institutional development and changes in domestic economic policy are probably going to be much more important in increasing agricultural productivity and sustainability in India than will any research that the U.S. government can fund. Perhaps opening up higher education to foreign collaboration and partnerships, particularly for India's agricultural universities, would be more significant than U.S. government involvement.

Agriculture is only one example of areas where allowing foreign partnerships, with consequent knowledge transfer, would help the Indian economy. India's top-level policymakers, with the PM leading the way, have articulated the potential gains for India from cultivating and taking advantage of global interdependence. Unfortunately, there are enough people with vested interests (economic and ideological) to make progress slow.

Their positions are defensive and suspicious, rather than the confident and optimistic attitude explicitly ascribed to the country by the Finance Minister, Mr. Chidambaram, in a March 2005 speech in Singapore. India's economic growth will be promoted by allowing much more, and broader import of foreign know-how, and letting it be led by domestic entrepreneurs rather than managed by government bureaucrats.

Ultimately, successful implementation of the vision articulated by India's current government will have a much more important and long lasting impact on the world than any deals that were recently struck between the U.S. and Indian governments. And India has the opportunity to avoid the mistakes that the U.S. is making, and has made in the past. What exactly do I mean by these claims? My contention is that India can do more for the world by demonstrating that democratic politics and sustained, inclusive growth at high rates are possible in a diverse (non-white, non-Christian majority) society, than by increasing its strategic clout and international prestige. How is that? Recall that the U.S. is cozying up to India largely because of its post 9-11 global strategy. The U.S. Middle East strategy relies on military strength, political manipulation and, now, in Iraq, a haphazard grafting of institutions on to an unstable society and weak economy. U.S. policy has never focused on dealing with the underlying problems of governance and economic development that have made the Middle East what it is today.

India, as a country with historic ties to the Islamic world, a sizable Muslim population, and many of the economic challenges faced by Middle Eastern countries – especially the need to generate employment for their youthful populations – has the potential to show the way to its Islamic neighbors, and countries beyond South Asia. The PM's U.S. visit was bracketed by the two sets of London bombings. To my mind, these events show that the current problem of terrorism cannot be solved for the long run by surveillance and suppression. The swathe of nations stretching from Morocco to Pakistan to Indonesia needs more nuanced attention. India has a role to play as a model of what can be achieved: high, inclusive growth while preserving democracy and diversity. The PM has articulated this objective beautifully. His government needs to follow through.

11. Policies to Make Small (Business) Beautiful

August 2005

The United States is a land where the rags-to-riches tale is a powerful social driver. This tale has pulled in immigrants throughout the country's history, and been mythologized in fiction such as Horatio Alger's 19th century stories of poor boys making good through pluck and determination. The path to riches (and even just middle class comfort) often comes through entrepreneurship: starting new business enterprises. In particular, this route is followed for entry to the middle class by Indian, Korean, Vietnamese and other immigrants to the U.S., who often come without impressive enough educational credentials, and run corner grocery shops, petrol pumps and numerous small businesses that require hard work, risk taking and street smarts more than university degrees. Their children become doctors, lawyers and engineers. It is not just immigrants, though – Americans of all stripes dream of innovating, of making it big, or simply making a good living while being their own boss. 'Selling on eBay' has become an income generator for millions, including part-timers working from home.

Unsurprisingly, the United States celebrates entrepreneurship and small business, and this is reflected in government policy. What does the government do, and what does it not do? First, to understand the motivation for small business policy, one has to be clear about the special challenges that may face a start-up business or first-time entrepreneur. The biggest challenge is probably that of information – where to get finance, how to get organized, how to identify various sources of support, how to perform various business tasks, and so on. This is done in the form of education, and dissemination of simple 'how-to-guides.' This is undoubtedly where U.S. government policy plays its biggest role. Through its federal Small Business Administration (SBA) and associated decentralized Small Business Development Centers, the government makes all kinds of information and guidance available to facilitate the starting and successful operation of new businesses. Second, the government deals with the disproportionate impact of fixed start-up costs on small businesses by making sure that legislative requirements for incorporation and small-scale operation are not onerous. There are certainly all kinds of health, safety and environmental regulations, but these are enforced relatively efficiently and judiciously, not in a punitive or extortionary manner.

The SBA provides some direct help with financing, through loans, though this avenue is very limited. More significantly, the SBA assists small entrepreneurs by teaching them how to get bank funding. However, the government does not influence bank lending, nor are there policies favoring one or another sector. Note that most of these businesses are outside the venture capital radius – VCs specialize in high tech, mainly because they look for certain kinds of growth potentials which are not available in the average start-up. Some tax incentives (particularly for investment) may also exist for small businesses, but these may anyway be much greater for larger enterprises in specific industries: the U.S. corporate tax code is very complex in this respect.

To sum up, the U.S. policy approach emphasizes creating an enabling environment, and providing as much information as possible that can improve the efficiency of decision-making by entrepreneurs. There is little in the way of direct subsidization, and there is no

attempt to do away with the biggest challenge of all, namely, risk. Most start-ups fail. Many small businesses do not make it for very long. Yet U.S. policy does not try to control outcomes or protect small businesses from competition, because that attempt would destroy incentives for honest effort and would gut efficiency and innovation.

This observation is the biggest lesson for India, as it considers reshaping its dysfunctional policy towards the “small-scale sector.” Getting rid of reservations, getting rid of the mentality that failure cannot be allowed (instead trying to mitigate the causes of failure), getting rid of the attitude that “government bureaucrats know best,” all of these changes will allow the small-scale sector to flourish. Note that the definitional issue is important, but not critical: what ultimately matters is whether the policies are sensible. Applying poorly designed policies to “small and medium enterprises” rather than “small-scale industry” will not lead to any improvement in outcomes. It will be a real challenge, however, for Indian bureaucrats to move from “government knows best” controls to providing genuine assistance, through information and an enabling environment, to SMEs. Perhaps the best that a government that cannot ensure honest implementation of regulation can do, in the short run, is to stay out of the way.

In the U.S., small businesses are defined as those with fewer than 500 people. Such enterprises are estimated to account for 50 percent of all private sector employees, and studies suggest that they have been responsible for 60 to 80 percent of recent job growth in the U.S. While small firms fail all the time, new ones take their place. A few become world-beaters. Even Microsoft and Wal-Mart started small. India needs to let its small businesses be flexible in both directions (exit and growth), and not have policies that kill this flexibility. It will be nice when India’s population is as well educated as that of the U.S., so we can have more professional jobs for them. Meanwhile, quick and simple fixes to its SSI/SME policies can begin to generate badly needed employment in a relatively short time.

12. Getting India Working

Paths to Job-Friendly Growth

September 2005

Lack of sufficient job growth has been a weakness of economic reform in India. This is apparent in public perceptions, as reported in opinion polls: jobs are a top concern for India's citizens. The perception alone is enough to suggest that job creation requires attention, since political support is critical for successful economic reform. Sidestepping arguments about precisely how good or bad the employment numbers are, we can broadly agree that a given level of growth is better, the more new jobs it generates. If employment generation spurs faster growth (as may well happen), then all the better. Job-friendly growth might silence critics of reform among a section of the intelligentsia, and start to get broader buy-in from the '*aam aadmi*' (and *aam aurat*) of India. It is critical in view of India's demographic profile, with a working-age bulge now appearing in the population.

Begin with some basic official numbers. We focus on employment, to avoid the statistical problems that bedevil unemployment rate calculations. Organized sector employment in 1991 was 26.73 million (19.06 public and 7.67 private). By 1997, this had grown to 28.25 million (19.56 public and 8.69 private). However, in 2003, the numbers had shrunk: 18.58 million public sector employees, 8.42 million private, and 27 million total. While the reduction in public sector employees represented a welcome squeeze in an era of large deficits and public sector pay hikes, it can hardly have been popular. The reduction in private sector employment can be explained at least partly by a cyclical downturn in industry, and not by economic reform, but again that provides no comfort for job seekers. According to these figures, organized sector employment growth has been disappointing. What can be done?

As is often the case with conceptualizing Indian economic policy reform, basic microeconomic theory is a big help. First, the public sector cannot be counted on as a job creation machine – it has done its best over the last five decades, at the cost of its own efficiency and of being a drag on the rest of the economy. Incentives for public sector employees are just not right. The public sector has a role in providing physical and institutional infrastructure, but India must look to the private sector for job creation. While the small scale sector has generated job growth as high as 7% a year, it remains shackled by policies that preserve inefficiently small scales of operation, and act as disincentives to expansion and job creation. The rest of industry is hampered even more, by labor laws that needlessly raise the cost of hiring, and severely restrict employment growth. And, of course, the labor laws act as a disincentive for small firms to grow into the shadow of these laws. Theory tells us that raising the cost of labor will reduce employment, other things equal. Empirical studies with firm level (e.g., a joint CII-World Bank study in 2002) and industry level (e.g., an analysis by Philippe Aghion and Robin Burgess in 2003) data strongly suggest that inefficient labor laws, coupled with predatory implementation, negatively affect productivity.

Any counter argument about worker welfare should not carry too much weight, since, as the numbers above indicate, organized private sector workers represent a small minority – a labor aristocracy – of India's workforce. In any case, it is possible to come up with

reforms that protect worker welfare more intelligently than the current set of laws. The counter argument of political infeasibility can be finessed by allowing ‘grandfather clauses’ in new laws to protect incumbents, while allowing a more sensible regime for additions to the workforce. (A similar approach can also work for small-scale industry incumbent firms.) The failure to significantly reform labor laws in 15 years of reform represents a failure of imagination and attention, rather than any real constraints, and it is the majority of the Indian workforce that has suffered.

Making labor less costly increases the quantity demanded. If labor is more productive, then the demand for labor also increases. Labor productivity increases with greater physical capital, managerial ability, or education and training. If domestic savings are insufficient, then foreign savings can substitute as a capital source. These have been coming into India, but cannot be fully absorbed because of institutional failures in the financial sector and because of government fiscal imprudence that forces a relatively tight monetary policy. There is no shortage of managerial talent in India – much of it is being exported, in fact. The biggest constraint lies in the human capital of the workforce. Currently, government jobs in India (except for the elite services and the armed forces) rarely provide opportunities for developing productive human capital. Software and BPO have shown what can be accomplished by industry-led training. However, there is a tremendous supply bottleneck in India’s higher education. The government’s traditional response seems to be based on the assumption that private sector incompetence or malfeasance mirrors its own. Thus, for example, private and foreign investment in higher education, which would generate jobs both through expanding education and by raising the productivity of new entrants to the workforce, are government-constrained in ways that make no sense. In this respect, the recent CNR Rao committee report on foreign entry in higher education is a grave disappointment.

So critics who point out the shortcomings of economic reform on the employment-generation front are half right. But the answer is not backtracking or hand wringing, but more reform, in labor laws and in the education sector. None of this is to say that agriculture and rural India are unimportant – in fact, there is a complementary reform process required there for job growth (see the comprehensive 2002 ILO study of K. Sundaram and Suresh Tendulkar). But creating more organized private sector jobs, good jobs that are productive and human-capital enhancing, is both imperative and feasible through intelligent reform.

13. Rebalancing the World Economy *It's About Putting New Ideas into Practice*

October 2005

Earlier this year, Ben Bernanke, then a member of the U.S. Federal Reserve Board of Governors, and now the head of President Bush's Council of Economic Advisers, suggested that there might be a "global savings glut," with high savings outside the U.S. leading to low interest rates in a time of strong economic growth, as well as allowing the U.S. to run record current account deficits. What was the basis for this claim? Savings as a percentage of world output are not high by historical measures, but weaker investment demand has been a widespread phenomenon since the Asian crisis of the late 1990s, the stock market deflation in 2000, and the uncertainties of the post-11th September world. At the same time, differences in demography (particularly the aging of some nations' populations), national policies, and ownership of natural resources (i.e., oil and gas) have led to swings in domestic savings-investment balances at the country level (a global "thrift shift"). The main symptom of these changes seems to be that China is, in effect, financing U.S. consumption and housing expenditure to enable its own rip-roaring, export-led growth.

Economists disagree on how long the current global macroeconomic imbalances can continue, and how best to rebalance the world economy. Various prescriptions include fiscal consolidation in the U.S., reductions in U.S. tax breaks for housing, monetary loosening by Europe, and greater government social spending in China. There is also the issue of the windfall gains of the oil-exporting countries – a projected \$400 billion savings surplus in 2005, according to the IMF. Certainly, short-run macroeconomic policies are important: they can prevent imbalances from blowing up and leading to panic and crisis. However, there are longer-term issues at stake, and the rebalancing of the world economy will not be a return to the *status quo ante*. What is at stake, what might happen, and where does India fit in to this major global shift?

Economic historian Joel Mokyr termed technological innovation *The Lever of Riches*, in his classic book with that title. Much of his story is familiar, since it deals with the harnessing of science for material wealth and economic growth – the Industrial Revolution that changed the world forever, and gave the West its huge economic lead. This is a different kind of global imbalance than the short-run macroeconomic one that currently exercises those in richer nations. Mokyr's story also contains a less well-known thread. Why did China, level with the West before the Industrial Revolution, and the source of so much innovation itself, fall so far behind? In a nutshell, significant factors in this relative decline were a closure to new ideas from outside, and a rigid bureaucracy that stifled domestic innovation. This has changed, and after five centuries, China is beginning to take its rightful place in the global economy. It is doing so through rapid technological and institutional learning, absorbing and adapting ideas from abroad. One day, it will be where Japan is now, with material standards of living comparable to the West. This rebalancing process – if it does happen – will ultimately dominate the global economy.

The process is not guaranteed to be smooth, or even ultimately successful. China's ruling class – its military and its bureaucracy – is not certain of controlling the forces it is unleashing, and often still flinches from openness and innovation. Its governing institutions are riddled with imperfections, resulting in sometimes-gross inefficiencies. One major threat to China's development as well as to global economic growth is in the use of energy, where China's appetite may add to global tension and conflict over oil and gas resources, and where the by-products of inefficient energy use are pollution and global warming. The developed nations of the West will have to work with China, and accommodate it, to tackle these issues for the long run. Much more than tax breaks for housing, or deficit spending in the U.S., it is that country's total failure for the last five years to face up to global energy issues that represents a major policy failure. Here, too innovation can save the day, but the public nature of the benefits surely requires government policy nudging innovation efforts in the right direction.

Where does India come into this picture? It, too, is an oil importer, with its own sometimes-fearful bureaucracy, and its own strong desire for security and stability. It lags well behind China in income levels, and is not growing as fast as its fellow Asian giant. Too many of its people are still uneducated and undernourished. However, India has economic and political institutions that are, in many respects, more robust and transparent than China's. One of the reasons that net capital flows are presently from poor to rich nations is that poor nations do not have trustworthy institutions for financial intermediation. Asia's 1997 financial crisis was partly caused by this lack. India, with its ongoing financial sector reform, is not too far from overcoming this problem. It is, perhaps, no coincidence that private equity firms and other "foreign institutional investors" are looking to India with great interest. Improvements in corporate and public governance can only help this development. So can policy changes that allow entrepreneurial firms to come up more easily and effectively, through venture capital. There is no reason that, with the right enabling policies, Mumbai cannot become a global financial hub, as envisioned by the Finance Minister in his budget speech.

India is considered to be ahead of China in terms of dynamic, globally oriented firms. Indian managers are figuring out how to operate in China and leverage that country's advantages for their own benefit. If India's firms are allowed to thrive, with freer access to foreign capital and new ideas, and a supportive policy environment, India can be perfectly positioned to join China and the West in a newly balanced global economy. If new ideas, leading to institutional as well as technological innovation, are the lever of riches, India has the chance to be the global fulcrum.

14. A Different Italian Connection

Lessons for India from Italy's Growth Experience

November 2005

Italy's most obvious tie to India is through a fluke of personal histories intertwined with politics. Yet when one compares the two countries, deeper connections come to light. Both countries have strong family traditions, and mothers who dote on their sons. (In Italy, these sons even have a label, “*mammoni*”, or “mama’s boys”.) Both countries have governments that are not particularly efficient – to put it mildly – and Italy has matched, and even outstripped India in the instability of its national politics. Yet, despite its political problems, Italy has grown strongly, and its post-war economic development has given its people a comfortable standard of living, comparable to countries such as Britain, France, Germany and Sweden, which were earlier far ahead of it. At the same time, southern Italy has continued to lag behind the north, posing a puzzle that goes beyond country-level explanations such as membership in the European Economic Community (now European Union) and Italy's strong tourist industry.

Understanding the causes of Italy's strong economic performance as well as its persistent North-South regional disparities can provide important lessons for India. The classic work on these issues remains Robert Putnam's 1993 book, *Making Democracy Work: Civic Traditions in Modern Italy*. As the title indicates, Putnam (with two co-authors) focuses on civic traditions, including political engagement, but also networks of non-political associations, that strengthen social structures of trust and cooperation, and build “social capital”. Putnam measures the level of civic community, or involvement, and presents empirical analysis that suggests that, over the course of the 20th century in Italy, “economics does not predict civics, but civics does predict economics.” This is a striking conclusion, which continues to be debated and further analyzed. It must ring true to those familiar with India's experience, where the civic traditions of Mumbai are markedly different from those of Delhi, and where the South and West, in general, have been doing better than the North and East. Changes in policy that came with economic reform found more fertile ground in those parts of the country where civic community was stronger. Arguably, factors such as the self-respect movement in southern India played a role in reshaping social relations and civic engagement, with positive consequences for growth once government policy no longer was a constraint.

Civic traditions can be long lasting. In Italy, the North-South differences in civic traditions can be traced as far back as the 12th century. Similarly, Amartya Sen has identified the origins of Kerala's superior performance in educating its citizens in policies of an enlightened ruler 200 years ago. In work exploring related ideas, Abhijit Banerjee and various co-authors have shown that the nature of Mughal/British-era land policies and social fragmentation continue to affect current spending on public goods in different regions of India. Nevertheless, modern technology and the realization of the importance of civic community can together hasten change in positive directions. One can explore the implications of this perspective for the role of India's NGOs, in building institutional capacity at the local level (e.g., PRIA) and highlighting the importance of civil society (e.g., the Centre for Civil Society). One can also begin to understand the consequences of an overly paternalistic state, which undermines civic institutions. Of course, economic

policy is not unimportant in this view – but the context of its application, its unintended social consequences, and hence its proper focus, receive more importance.

There remains the important question of the nature of the causal link, from civic involvement to economic performance (as well as to governance, as an intermediate channel). As Putnam puts it, “Through what mechanisms might the norms and networks of the civic community contribute to economic prosperity?” For Italy, several analysts have emphasized the economic importance of decentralized but integrated industrial districts, combining cooperation in financing, research and infrastructural services with competitive innovation in quality, design and efficiency. This could be a description of Silicon Valley as well. The term “flexible specialization” has been applied to this kind of industrial structure. One can easily see how India’s policies towards industry – small and less small – have constrained the development of such regions. One can also see their recent emergence in Bangalore, the National Capital Region, Chennai and elsewhere, around IT and ITES. Much remains to be done, but at least economic policy has moved in the right direction to allow such development.

Underlying the formal and informal industry networks that support economic success are “norms of reciprocity and networks of civic engagement,” which promote information flows, trust and social cooperation. Putnam does not claim that the evidence for this connection is conclusive. Nevertheless, the Italian case provides some provocative evidence for this view, as does Silicon Valley in the US. In the Indian case, with higher social fragmentation, the lessons may be harder to draw and build upon. However, one possible implication is that government, by making its economic role less intrusive, might instead allow India’s dynamic new firms to support the growth of new private associations, and of civic equality and engagement. This goes beyond attempts such as the Bangalore Agenda Task Force, which was initiated by industry to improve the city’s infrastructure, but sabotaged by government. If the lessons of Italy are relevant, *gram sabhas*, sports clubs, residents’ welfare associations, rotating credit groups, and recreational and cultural organizations can all play a role in developing higher levels of civic community, building new social capital, and – ultimately – improving economic performance.

15. Doing Business in India: A Report Card

India Ranks Low, But Reforms in Insolvency Laws Show Promise

December 2005

In September, the World Bank's International Finance Corporation published the third round of its annual rankings of countries based on an index of ease of doing business. India finished 116th out of 155 countries surveyed, behind its South Asian neighbors (Pakistan was 60, Bangladesh, 65, and Sri Lanka, 75) and China (91). The index is constructed from multiple categories, each with subcategories. The only area where India does relatively well is investor protection (see table).

Category	India's Rank
Starting a Business	90
Dealing with Licenses	124
Hiring and Firing	116
Registering Property	101
Getting Credit	84
Protecting Investors	29
Paying Taxes	103
Trading across Borders	130
Enforcing Contracts	138
Closing a Business	118

While India's weakest ranking is in contract enforcement, in one of the components of "closing a business," namely time taken, India tied with Brazil and Chad for worst performer, with the survey estimate being 10 years. India's industry associations responded in mixed fashion to this report card. Surprisingly, two of them questioned the validity of the rankings. Only FICCI used the report to press for further reform. This is at a time when India is indeed on the cusp of potentially major reforms in company law. The Minister of State for Company Affairs outlined this agenda at the Economic Editors' Conference in November. In fact, the conference background paper of his ministry stated that it takes 15 to 20 years to liquidate a firm in India, not "just" 10.

Looking down the list, one can see how incomplete trade reforms affect the measured ease of doing business. The lack of reforms in labor law and tax administration also shows up in India's low rankings in those areas. The enormous need for micro-level reforms in governance, general administration and judicial processes is reflected in low rankings for India in licensing, registration and contract enforcement. Rather than trying to contradict the report, Indian industry ought to welcome it as an opening to take reform forward. After all, the Company Affairs minister said explicitly on November 18th, "In our NCMP we are committed to unleash the creative energies of our entrepreneurs, businessmen, professionals and productive forces of society." That surely means making it easier to do business. Indian industry might take a leaf from United States history, and work towards drafting new legislation. That is what US merchants and manufacturers did from 1881 onwards, until the US passed its first permanent bankruptcy law in 1898. The

conceptual approach in that law continues to be the foundation of that country's current legislation.

The anxious industry associations might also have noted that India received high marks for reforms that have yet to show up in the rankings. In particular, significant developments are on the horizon with respect to closing a business. Recent pieces of legislation that promise to speed up the process of restructuring or liquidation of companies in financial trouble, and the consequent repeal of the Sick Industrial Companies Act of 1985, can only help. At the same time, there are question marks about the new insolvency laws. Some of these have to do with the functioning of the new institutions, such as the National Company Law Tribunal, which will replace the ineffective Board for Industrial and Financial Restructuring, but may still be subject to the typical inefficiencies of India's governmental institutions, including bureaucratic capture.

Other issues revolve around the fundamental analytics of restructuring and liquidation. Everyone recognizes the high costs of the long delays that have plagued India's industrial exit processes. Beyond that simple insight, however, there tends to be some loss of conceptual clarity. One of the problems in India has been the tendency of some company promoters to strip their firms of assets, using the old legislation (which gave them protections both unintended and intended) as a cover. However, there is a tendency to extrapolate from these cases to potentially criminalize all business failure. Many of the new legal provisions are designed to deal with fraud by debtors. In fact, there is documentation of the opposite problem, where debtors face harassment from creditors. In one case, the bank that had lent to a small firm made accounting and transaction errors that created financial problems for its borrower, and then used that situation to drive the previously flourishing firm towards liquidation. Bankruptcy laws and institutions must balance the interests of creditors and debtors. They must separate failure from fraud, and have different responses to each of them. They must also separate failure (requiring liquidation) from correctable difficulties (requiring restructuring). It is not clear that the new laws, while a great improvement over the old, deal fully with these conceptual distinctions. On the other hand, even the US has continued to tinker with its bankruptcy laws for a century – there is no perfect solution.

The case of small firms also deserves more attention in India. They have little bargaining power vis-à-vis the banks that lend to them, and little expertise to draw on when things go wrong. A US-style bankruptcy code for small firms that replaces the current mix of RBI regulations and free-form negotiation would give greater protection for entrepreneurs and support more effective risk-taking. Combine that with simpler, streamlined regulation, and the result will likely be more, and more robust, small enterprises, and higher job growth.

16. Good (and Not So Good) to Great *A Prescription for Improving India's Governance*

December 2005

The year is coming to a close, with the world economy having dodged several bullets: natural disasters, terrorist attacks and spiking oil prices all failed to cause significant problems for growth. Structural imbalances and political instability still suggest caution, but the IMF's best guess is that global growth in 2006 will match this year's. The IMF predicts slightly slower growth for India next year, below 7%, but India may do better: one can certainly be hopeful in the short run.

The bigger issue is whether India can add a couple more percentage points to its trend growth rate. In answering that question, I would reason as follows. Physical infrastructure and bad laws are the twin constraints holding India back. Since most people agree on these broad problems, and even on specific steps that are necessary, the failure to tackle them effectively is a failure of governance. India's poor governance keeps its economic performance from moving from "good" to "great." Why is India's governance, to put it mildly, not so good? What can be done to make it better?

One can get a creative answer by putting aside conventional explanations of poor governance – coalition politics, vested interests and corruption – and learning from areas where India is doing great. In my February 24th column, I noted how the Prime Minister had praised the achievements of Infosys and Mr. Narayana Murthy, and I suggested that the internal organization of India's government could benefit from emulating companies like Infosys, including training its employees and setting performance standards. Jim Collins, in his book, *Good to Great*, provides a set of common factors for great companies, based on detailed case studies. There are lessons there for improving India's governance.

First, is "Level 5 Leadership," which refers to leaders with a "paradoxical blend of personal humility and professional will." It was reading this description, which seemed to fit the PM rather well, that suggested digging deeper. The second principle behind greatness is "First Who...Then What," which refers to having the right people on board, in the right positions. This may be where coalition politics, or all politics, rears its head, saddling the leadership with people who are not able or willing to make a positive difference. But plenty of politicians are shrewd and capable, and they do have an interest in looking good for their constituents. The bureaucracy may be the greater problem. Many have recommended reforms that will improve the chances of getting the right people in the right bureaucratic positions. Arvind Panagariya, in January of this year, wrote, "Any reform of the top civil service must solve two related problems: it must open the door to experts and break the current monopoly of the IAS and IFS over top bureaucratic jobs. There is a common solution to both problems: open all jobs at the level of Joint Secretary and up to outsiders." However it is done, India must consistently draw more talent and expertise into government, or have their ideas incorporated into policymaking. This includes academics, business people, and NRIs, and must go beyond co-opting them with perks in commissions and committees.

Collins' third idea is almost self-explanatory, "Confront the Brutal Facts (Yet Never Lose Faith)." Adherence to this has been poor in the past, but India's current leaders have made a number of refreshingly honest statements about its shortcomings in performance. The fourth principle is "The Hedgehog Concept," based on the ancient Greek parable: "The fox knows many things, but the hedgehog knows one big thing." In Collins' analysis, great companies were ones that tried to be best at a narrow set of activities with measurable performance. This has been India's greatest governance failure – trying to do too many things for too many ends, including a host of activities where government could not be best, or even good. Even now, this is where government can fix itself most significantly, putting itself on a path of goodness, and setting India's economic growth performance towards greatness. Cutting out numerous extraneous activities (Collins tells companies to "Start a 'Stop Doing' List"), including commercial enterprises, unnecessary controls, unenforceable regulations, and opportunities for badly exercised bureaucratic discretion could leave room and resources for government to do better where it should, with basic law and order, health and education.

The last important greatness factor is a "Culture of Discipline," but combined with an entrepreneurial ethic. In fact, this idea of discipline (self-disciplined people thinking with discipline) runs through the first four greatness principles. Government is not a company, but it is still an organization, made up of people, principles and policies. There is no reason that the prescription for private sector greatness cannot light a path to improved governance. In my earlier column, I noted that the Prime Minister does not have Mr. Murthy's luxury, of building an organization from the ground up. But each of the eleven great companies analyzed by Jim Collins existed well before it achieved a breakthrough. Some, like Nucor, which went on to be the most profitable steel company in the US, were "awful." Each made changes gradually, with a long period of build-up leading to breakthrough performance. That is the long-run hope for India, that its leadership, with the right people in the right positions, facing brutal reality with focus and discipline, can change the quality of governance. The right policies and sustained economic success will then follow.

17. India's Growth and the Services-Manufacturing Debate *What Matters and What Doesn't*

January 2006

The pattern of India's strong growth since the 1990s has raised somewhat of a puzzle for economists. At least since the 1950s, following the detailed empirical work of Nobel prizewinner Simon Kuznets, the pattern of development has been understood to be in a sequence from agriculture to manufacturing to services. India, on the other hand, seemed to be growing rapidly (among the fastest in the world) without robust manufacturing sector growth. Observers have been divided on the nature and consequences of this phenomenon. Some suggested that India was following a new pattern of services-led industrialization. Others (notably former Chief Economic Adviser Shankar Acharya) cautioned against "hype," questioning the reality, robustness and sustainability of the apparent services boom.

A significant recent event, as well as much new research, together suggest returning to the debate on India's pattern of development. The major news came last month when China revised its GDP figures upwards by a whopping one-sixth, with most of that increase coming from a revaluation of services sector activity. At a stroke, the estimated contribution of services to China's GDP went up by nine percentage points, crossing 40 percent. This is a much more plausible figure than previous estimates, even though still short of the average for countries with a similar per capita income levels. India, on the other hand, calculates its share of services at about half of GDP, somewhat above the average for its income class. That discrepancy has arisen essentially within the last decade. The questions for researchers are: can we believe the numbers? What are the sources of services growth? What are the consequences for India's current and future growth?

Can we believe the numbers? Shankar Acharya has pointed out the fragility of India's services sector numbers, suggesting some deficiencies in CSO methodologies and resulting overstatement. On the other hand, China's example indicates that there might be biases in the other direction. To take one case, a survey of doctors in Delhi once found massive under-reporting of income to evade taxes. It is easy to imagine that much service activity of this nature has not been fully captured in the national accounts. There are other problems with India's economic statistics, and China's bold example should encourage India to put its own statistical house in order. But this is a general need and prescription, going beyond accounting for services activity.

What are the sources of services growth? Shankar Acharya and others have pointed out that the excitement over software and IT enabled services is not matched by numbers. While business services grew fastest in the 1990s among service categories, this was from a tiny base. The biggest contributors to the change in the share of services in GDP were, in order, banking, wholesale and retail trade, community services and communication. However, business services were not far behind the last two in their increase, and this suggests that some of the optimism about services is not misplaced.

The last and most important question has to do with consequences. Sanjay Hansda, of the Reserve Bank of India, conducted a detailed input-output analysis (using 1993-94 data) and suggested that linkages from services to industry were strong. Taking a quite different approach, Rashmi Banga and Bishwanath Goldar, in an ICRIER working paper, estimated manufacturing production functions for data from 1980-81 to 1997-98, and found that services inputs made a significant contribution to manufacturing output. Neither of these studies posits a growth mechanism, but they support the intuition that services growth and innovation can spill over positively to manufacturing, just as China's national accounts revision accords with the idea that its manufacturing prowess has also fueled domestic services growth. In fact, linkages work both ways: automobiles need servicing, while call centers need computers.

There are other reasons to be optimistic about services. Several analysts have highlighted the importance of the nature of the services growth. In particular, to the extent that parts of the services sector are becoming more like industry, with the use of modern technology, routinization and the reaping of economies of scale, services-led growth becomes a more plausible model of industrialization. Furthermore, the tradability of some of these kinds of services has increased, on the back of modern communications technology – thus services are making a well-known and strong contribution to India's balance of payments. Finally, the development of more efficient corporate organizational cultures and institutions, which arose in India's software services industry, has had a salutary effect on how Indian industry runs. Interestingly, if one goes back in time before the industrial revolution, it was a merchant and finance (i.e., services) revolution that got the whole process going, as Sir John Hicks argued in his *Theory of Economic History*.

For policy makers, the lessons ought to be clear. Rather than targeting manufacturing in isolation, policy should focus on areas where the government can and should make a difference. Software got going because it was not strangled by government, but at the same time it benefited from government investments in higher education. Allowing both manufacturing and services to flourish by reforming misdirected regulation and removing constraints in infrastructure and human capital is the way forward for job-friendly growth. Given the parlous state of public finances and the poor efficiency of public delivery, more private sector involvement in these core areas should be encouraged. Ultimately, making the conditions right for enterprise and innovation throughout the economy matters more than the services-manufacturing debate.

18. A CEO Dashboard for India

February 2006

Information technology (IT) has created new markets, allowed firms to unbundle and outsource as never before, and, less visibly to the layperson, changed the way that firms manage internal information flows. The latest manifestation of this latter trend is the creation of “CEO dashboards,” which use IT to give the big boss a concise and current picture of the essentials of a company’s performance, starting with an aggregate view, but drilling down as deeply as needed, even to individual performance. What should be on the dashboard, and its effects on employees, are still the subject of experiment and learning, but the idea is clearly here to stay.

At budget time, it is natural to think about what a CEO dashboard for India, if we had one, might tell the PM and FM. (Put aside for the moment the differences between a company and a country.) This would presumably start with measures of performance: overall growth and its sectoral breakdown, plus employment growth, inflation and the like. Trade, capital flows, exchange rates and reserves would also be significant indicators. Of course, such measures are available in the Economic Survey of India, Reserve Bank Annual Reports, and various other statistical compilations. How would our hypothetical dashboard data be different? First, they would be more up-to-date and more reliable. Second, they would be compiled from the ground up, allowing our “CEO” immediate access to the disaggregated source data. Suppose manufacturing growth is looking anemic – let’s find out which sectors are worst off, and even whether specific firms are struggling. Even better, one could see how the head office – in this case, the ministries that are supposed to put governance into practice – is doing in coordinating and supporting the different parts of the organization (or in this case, the economy). Where is the money coming from, where is it being spent, and does it make a difference? Are those big fiscal deficits worth it, in terms of the bottom line, or do they represent a black hole, swallowing money without leaving any trace?

For now, in the absence of a real dashboard, which would distill all the data that is out there – from government, industry and academic sources – one relies on conventional analyses, or meta-analyses. For example, Brian Pinto, Farah Zahir and Gaobo Pang, of the World Bank, have recently asked “whether India can grow even faster, all without ... fiscal adjustment.” In exploring the links between “the soundness of the public finances and the microfoundations for growth,” they come down against any prescription for increasing government spending on infrastructure that ignores the short-term fiscal deficit consequences. They conclude: “Chief among the fiscal policy priorities are steps to improve the composition and efficiency of existing expenditure and revenue mobilization. Revenue deficits need to be lowered and capital expenditure raised. The recommendations of the Twelfth Finance Commission (TFC) aim precisely to do this.”

Actually, it is not clear that the TFC’s scheme for getting the states to better balance their budgets will work: it is complex and hard to enforce, especially in the absence of a good dashboard. The push for market borrowing will have a more lasting effect, but will take time. The TFC and its predecessor have both critiqued the muddle of planning and plan transfers, and made specific suggestions for reform there, but they have failed to touch

the core problem of “gap-filling” transfers. Ultimately, the missing link, as I have argued previously, is the need to incorporate standard microeconomic incentives into the working of government at all levels. The studies synthesized by Pinto et al document how Indian industry has made itself more efficient, given the necessity and opportunity to do so after 1991. Only now, with civil service reform on the agenda, is there a similar move for government. Only detailed organizational restructuring of government will improve the “efficiency of existing expenditure.” There will be resistance, of course: in tax administration, detailed microeconomic reforms would aid “revenue mobilization,” but have lagged far behind problem recognition.

Structural reforms of the internal organization of government will make dashboards possible as well as productive. When one focuses sufficiently, the dashboard idea becomes less fanciful. A Planning Commission dashboard might be a place to start, accompanied by a restructuring of the process of plan formulation, transfers and implementation. If Oracle CEO Larry Ellison can track 20,000 salespeople, tracking 600-odd districts is in the realm of the possible. This may sound just like Chandrababu Naidu redux, but that should not be an argument against it – how well it is done is key.

What does all this have to do with the upcoming budget? Much of that exercise will involve policy changes that will please some and not others. The hope is that overall, tax policy will continue to be rationalized, and more of the remaining nonsensical restrictions on agricultural and industrial development will be relaxed. It is heartening that more and more policymakers in India understand how to shape economic policies that favor growth and development. The weak spot remains expenditure quality and policy implementation. Restructuring government incentives, based on improved information flows, will go a long way towards tackling this weakness. That is what corporate dashboards are about. Our government can use them too. Our government can choose to be efficient. It can seriously put its world-class IT industry to work, to make that happen.

19. Learning from China

Ends and Means

March 2006

India's nuclear deal with the US, now before the Senate and House of Representatives, is a milestone of diplomacy for India. It leverages the geopolitical situation and a favorable personal equation at the leadership level to try to put India on par with the world's official nuclear powers. Given the advantages to India, it is surprising to see some in India opposing the agreement on the grounds that one should not cooperate with George Bush. There are other reasons to criticize the deal, and those may still scuttle it in the US Congress, but the "holier-than-thou" attitude that characterized India's earlier approach to diplomacy was always a loser. Instead, India seems to be falling more in line with the Chinese *realpolitik* stance, to achieve some degree of nuclear parity with China. This fits in with an overall perspective of using China as a benchmark, especially for defining ends, though less so for the means to be used.

While the nuclear deal's avowed purpose is to serve India's future energy needs, one should take that objective with a grain of salt. There are other things that India's policymakers can do that would provide greater immediate and lasting benefits, including more rational energy pricing and organizational reform of public sector energy suppliers. Nevertheless, energy supply will be important for India's future growth, and economic growth should be the main end where India benchmarks itself against China. It is also where India falls short. Comparing how the two countries tackle some of the means to achieve this end of high growth is illuminating.

Begin with higher education. In March 2004, China announced some opening of the education sector to foreign participation. Six months later, a wide variety of joint ventures in higher education were under way. Last month, Pallavi Aiyar, Beijing correspondent of the Indian Express, reported in the Asia Times that there are now over 700 foreign-affiliated colleges in China. Along with this injection of foreign organizational expertise have come successful attempts to hire internationally renowned faculty and host high quality foreign visitors. There has also been a shake-up of the incentive system in China's universities, with a new emphasis on rewarding productivity and talent rather than seniority, and paying internationally competitive salaries.

In contrast, India produced a committee report last autumn on the entry of foreign universities, which is full of qualifications and restrictions that can only discourage investment: no "poaching" faculty from Indian institutions; no repatriation of profits; no franchising or offshore campuses. The committee stipulated probationary periods and large security deposits, and suggested that only foreign universities from countries that offer Indian universities reciprocal opportunities abroad should be allowed entry. These conditions are designed to protect inefficiency in Indian higher education and restrict supply, rather than promote positive change and growth in a sector that is even more important than energy. The report's recommendations are bad economics (see my July 2005 column), and a resurgence of the license-permit *raj* mentality. This, in a country where according to an anecdote from Raghuram Rajan, the IMF's chief economist, quality higher education is in such short supply that there are coaching classes to prepare

for entrance exams for other coaching classes, which then prepare students for the IIT entrance exams.

Next, consider research and development (R&D). After some India hype associated with Bush's visit, the US press returned to reality, which is that China is the country that matters most. A report in the Wall Street Journal on March 13th described a surge in foreign-invested R&D centers in China, its top place in the list of countries slated for R&D expansion by multinationals (with the US and India following), R&D spending well ahead of India's (1.3% of GDP compared to 0.77% for India – translating to six times as much spending), and clear targets to boost spending and to train and attract talent. In contrast, India's "top official" is quoted as saying, "the scale of investment is not much" because of budgetary constraints. India is "trying to build R&D," but the government does not have the financial resources or expertise, nor does it seem willing to allow those to come freely from abroad. According to the US National Science Foundation, China (with Israel) tops emerging economies in technological competitiveness, with India some distance behind.

Finally, consider venture capital. The Wall Street Journal on March 14th ran a headline "Venture Capital Swarms China." The story reported that a flood of venture capital is competing to fund tech companies, with funds raised by VC investors reaching \$4 billion last year. This compares with well under a billion dollars of foreign investment for true venture deals (excluding late-stage private equity deals) in India. Of course VC investment in India has increased. The problem in growing it even more is India's policy environment, with the persistence of needless government controls and interference.

The bottom line is that India has much to learn from China in areas of international economic policy as well as foreign policy. Even if the government cannot become more efficient in its basic functions, it can at least create an enabling environment for foreign capital and expertise to enter more freely in areas where they can make a long run difference to India's growth: higher education and R&D. This will ultimately be more important than matching China in foreign policy and nuclear prestige, and more fitting with India's new global confidence.

20. Capital Account Convertibility *Sense and Sensibility vs. Pride and Prejudice*

April 2006

Prime Minister Manmohan Singh's call last month for a roadmap to full capital account convertibility (CAC) has generated a torrent of ink on both sides of the debate. This is not surprising, given the money at stake. Global capital flows dwarf many national economies, and their volatility has had enormous welfare consequences in the past. One couldn't ask for a hotter hot-button policy issue, evoking fear, greed and much else. What is the reality?

First, India's capital account is already substantially open, both directly through lack of restrictions on certain groups of economic agents and classes of capital transactions, and indirectly through the openness of the current account. Full CAC will just level the playing field (especially for Indian residents vis-à-vis nonresidents) and reduce transaction costs, rather than leading to a flood of new capital flows. Full CAC will rationalize the host of piecemeal liberalizations that have taken place since 1998, and which are already reflected in market data. Some critics of full CAC recognize all this, but oppose it nevertheless.

Second, the fundamental reason for opposing full CAC is the downside risk, especially in a context where empirical research does not provide a clear and unequivocal case for its benefits. The downside risk, put simply, comes from two sources: fickle foreigners and dishonest domestic elites, who can exploit CAC at the expense of the less fortunate domestic populace, using institutional weaknesses in the operation of the financial sector. The domestic concerns echo the reasons behind financial crises in several countries in the 1990s. The implication is that full CAC must be predicated on building sufficient institutional strength, and having strong initial conditions. But the last Tarapore Committee report recognized all this, and nothing in the latest policy statements or actions invalidates this view – a transparent, measured roadmap for an integrated policy reform in this area seems hard to oppose on grounds of risk, unless one fundamentally distrusts the Indian business elite. Some commentators have this prejudice, but they are the same ones who oppose every market-oriented reform. The fickle foreigner argument is ultimately also about what the country can achieve – if India can continue to generate high growth, using foreign capital and know-how where necessary, foreigners will not pull their money out in a hurry. Full CAC is not enough, but must be accompanied by, and may in fact accelerate, other institutional and policy reforms to sustain high growth. T.N. Srinivasan had earlier articulated this 'market discipline' rationale for CAC.

Third, the initial conditions may be quite propitious right now to begin a measured march to full CAC: reserves are high, growth is strong, the modern sector of the economy has proved itself to be robust when challenged and innovative when given the chance, and only physical infrastructure and human capital constraints seem to be holding the country back. Of course there are risks, with the United States housing boom deflating, its interest rates rising, high oil prices, and the constant shadow of terrorism. But there will always be some risks in the global economy. On the other hand, Vijay Kelkar, Ajay Shah and

others have argued that India has a window of opportunity to capitalize on its demographic dividend, of a large working age population. Labor needs capital.

Fourth, there are some microeconomic motives for full CAC that are outside the experience of East Asia or Latin America. India's equity markets are exceptionally strong for a country at its income level – indeed, they are world class in many respects. With some policy attention, the rest of India's financial sector (with banking bringing up the rear) can be brought to this level. Full CAC will allow the benefits of a strong financial system to be leveraged globally in ways that the current policy mishmash does not permit. The PM clearly has something like this in mind, since his speech on CAC reiterated the goal of making Mumbai an international financial hub. Note that this vision is quite different from the East Asian model of growth driven by manufactured exports behind capital controls. Once one recognizes this difference, the argument that the general development experience establishes no firm benefits from CAC loses force. The development of a CAC roadmap to support building a modern financial hub is good sense, and not a case of empty pride. A development path that does not rely solely on manufactured goods exports also reduces the need to mimic another feature of the East Asian model: a fixed exchange rate. A roadmap to CAC could also be a path to monetary policy autonomy with a floating exchange rate, rather than the current uneasy struggle with the impossible trinity (CAC, a fixed exchange rate and monetary policy freedom). At least it will make the macroeconomic policy choice transparent.

So, the latest policy thrust on CAC is one that illustrates a welcome sensibility to the bigger picture with respect to India's economy. It is not without risks, but it can have benefits that may not have been fully appreciated in initial critical reactions to the announcement. It will be important for many large and small financial sector and fiscal reforms to be incorporated in the roadmap. Finally, it is imperative that the nation as a whole is put in a position to benefit as the financial sector flourishes – that means making human capital acquisition and entrepreneurship easier through policy rationalization, i.e., removing needless restrictions and improving institutions.