India's economic future: Moving beyond State capitalism

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India on the growth turnpike

- Certain key elements are strongly in India's favour:
  1. Globalisation
  2. Demographics
  3. Savings and access to global capital
  4. Rapid catch-up with global knowledge.
- It is possible for us to be on a "growth turnpike".

But this is only an opportunity.
It is not inevitable destiny.

Dismal scenarios: Staying on course with State capitalism

- Populism
- Fiscal deterioration
- Inflation
- Inefficient use of resources with State capitalism
- Poor incentives for knowledge and innovation under State capitalism.
- Low growth, low employment and continued curse of poverty

How can we avoid the dismal scenario?
Moving beyond State capitalism

- State capitalism played a creative role 1950s and 1960s
- Now we need to move towards a full-fledged advanced market economy.
- Build the institutional framework of modern capitalism.
- This requires not just an idea of liberalisation as in decontrol and delicensing.
  It requires an operational blueprint for the positive agenda of moving rapidly towards an advanced market economy.
- Anglo-Saxon model? Rhine-Alpine model? East Asian model? We need our own, *sui generis*, fully articulated, internally consistent path.

Part I

Our journey

Pre-independence

- Largely feudal production system
- Key institutional achievements of law & order, banks, stock markets and property rights.
- Indian capitalists made a little headway.
- Ruler was fundamentally not interested in India's progress.

Nehru's period

- The State actively supported domestic capital.
- State as entrepreneur
- IITs, CSIR, physical infrastructure.
- Heavy industry, withdrawal from the world market.
- Terms of trade turned against agriculture.
- The 1966 drought.

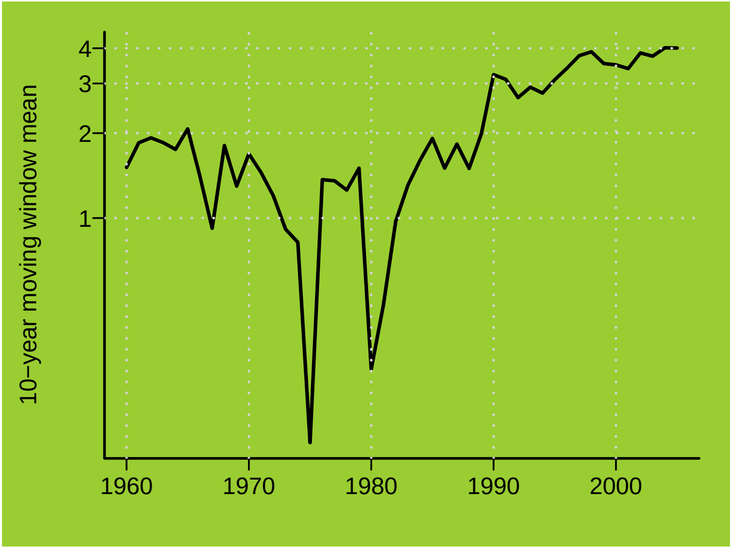
The next phase

- Capitalist form of agriculture; with great success.
- But deteriorating state-led capitalism.
- Rent-seeking, populism.
- Small scale reservation; IDA; FERA; Urban land ceilings; MRTP; bank nationalisation.

Output per worker

- GDP growth is a mixture of labour, capital, productivity.
- Per capita GDP growth reflects demographics.
- GDP per worker is a good reflection of our ability to add capital and add productivity.

Growth of GDP per worker: 10-year moving window means



Our 3 phases

Period	Average growth of GDP per worker
1951-52 to 1964-65	2.02
1965-66 to 1976-77	0.58
1977-78 to 2004-05	3.09

Part II

Key building blocks for India's economic future as an advanced market economy

Building block:
India as a common market

India as a common market

- To harness economies of scale and thus growth,
- To participate in globalised production,
- To have a level playing field between goods and services,
- To reduce inter-state income disparities,
- We need the Goods and Services Tax.

Two possible structures

Level I GST A Central GST and a State GST: distinct but synchronised. Each firm will deal with only 2 taxmen: one GST authority and one income tax authority.

Level II GST A single national GST. This requires amending the constitution.

At present, we should only focus on the Level I GST: a cooperative and voluntary arrangement of a coalition of Centre and states.

How to get going

What is feasible

- "Grand bargain" between the Centre and States, to launch a Level I GST.
- The 12th finance commission has shown how to introduce conditional transfers.

Building block:
Open economy macroeconomics

“Capital account convertibility is dangerous”

- “The east asian crisis was caused by an open capital account”: this is a widespread belief
- Less than correct reading of events: The crisis had more to do with governments trading on the currency market.
- A hundred countries have an open capital account: this is a perfectly normal and learnable arrangement.

India's march to *de facto* convertibility

Gross flows:

	Billion nominal USD		Percent to GDP	
	1992-93	2004-05	1992-93	2004-05
Current account	59.9	323.1	25.1	45.4
Capital account	36.7	182.6	15.3	25.7
Total	96.6	505.7	40.4	71.1

De facto convertibility

- FDI, FII are open
- The current account is open
- Now three big doors are open
- Tinkering with other doors does not help.
- And capital controls introduce inefficiencies as with all control raj.

The way forward

India as a modern open market economy

- Shift to thinking in terms of open account macroeconomics
- Harness the *benefits* of convertibility: competition in finance. Do for finance what the 1990s trade reforms did for industry.
- Impossible trinity: Currency trading comes at the price of monetary policy.
- Every modern market economy has monetary policy: too precious to give away.
- Empower RBI to truly run monetary policy - take away other conflicts of interest.

Building blocks:
The *dharma* of competition

Why competition matters

- People respond to incentives
- The individuals inside a firm respond to competition.
- If you want competent, low-cost, efficient production: competition!
- Schumpeterian process of creation & destruction.
- Labour and capital must get reorganised in the most efficient combinations.

Telecom: the canonical competition policy story

- Old state: DOT made policy, DOT produced services, DOT blocked competition. Arguments about stability / safety / security.
- The key was influences from outside DOT which opened up the sector.
- New regime: TRAI is regulator, there are multiple competing firms producing services.
- India got a revolution.

Some examples of applying this idea

- Remove residual trade barriers (non-tariff barriers & customs)
- Privatisation: conflict of interest for the State, level playing field issue.
- Petroleum products: Make it possible for the Indian consumer to access the Dubai price of petrol.
- Railways: Rails can be a public sector monopoly, but trains can have competition - as in roads / airports.
- Bond market: RBI at the DOT stage.

Privatisation

- Privatisation is of essence in furthering the competition agenda.
- For going concerns, our best path is to build broad-based shareholding, with dispersed ownership across millions of households in India.
- For defunct companies, strategic sale should be done through open auction, and negative bids should be permitted.

Regulation

Proper regulation is of fundamental importance in order to maximise competition. This comprises two issues:

Architecture Each regulator should have a clear focused mandate, without conflicts of interest.

Implementation The staffing, processes, transparency, accountability of the regulator needs to be done well.

Building blocks:
Cities as engines of growth

The crisis in urban infrastructure

- The light is at the end of the tunnel on telecom, roads, ports and airports.
- Recent floods in Bombay; Bangalore: We haven't even begun on urban infrastructure.

Cities are the engines of growth

- Only 20.4% of GDP comes from agriculture, and in a decade, it'll be down to 10%.
- Census data overstates "rural" population, because it ignores the endless urban sprawl outside every town/city.
- Only 30% of the earners of India are in agriculture.
- Non-ag GDP should now be our dominant concern, and this is made mostly in the cities.
- 30% of the poor are in the cities.

Is it about funding?

- User charges need to be properly applied
- And these should be paid to a utility; they should be off-balance-sheet for the local government.
- Once this is done, there is no fundamental funding gap in local government.
- GST, finance commissions for transfers, and property tax will deliver adequate resources.

The problem: No one person / agency is in charge

- Responsibilities for urban governance are dispersed across too many state and local agencies.
- State governments do not have adequate incentives to maximise for their cities. E.g. Maharashtra/Bombay or Karnataka/Bangalore.

The Delhi role model

- Delhi is a city state
- Elections in Delhi are focused on urban governance in Delhi
- The chief minister of Delhi has one clear task: urban public goods in Delhi.
- There is a clear management structure and accountability.
- And Delhi as a State fits well into the intergovernmental fiscal system of India.

Building blocks:
Rethinking how public goods are produced

The defining challenge of governance

- India has inadequate quality and quantity of public goods.
- We are good at outlays, very bad at obtaining outcomes.
- Principal-agent problem: How is the citizen to ensure that the State produces public goods, and does not squander tax revenues?
- Let me use education as a case study of rethinking these issues.

Government schools

- Teachers are government employees.
- Teachers don't show up at work; teachers don't teach.
- No gap in funding.
- Spending more money will not help – e.g. Bihar and West Bengal (massive increases in expenditure) as compared with rest of India (superior outcomes).
- Need to rethink incentives; rethink the role of the State.

The solution: Scholarships

- The State gives a scholarship of Rs.2000 per child per year.
- Parents choose which private school they use.
- Parents have the best incentive to take care of the interests of their children.
- Empower the poor by making them paying customers.
- Schools will compete.

Go further: Paying for results

- We don't merely want children to *attend* school.
- We want them to *learn*.
- Solution: Run standardised tests of reading, writing, mathematics. Pay schools a bonus in proportion to the scores that each child obtains.

Solving the principal-agent problem

Rethinking elementary education

- Two-part solution.
- First, get parents to choose between competing schools. Pay Rs.2000 per child per year through this route.
- Further, setup independent testing mechanisms, and measure how well the children fare on standardised tests (e.g. OECD PISA). Pay a bonus of Rs.2000 per child per year, on average, but make it a formula that is proportional to the score.
- This structure will replicate the *existing* expenditure of GOI on education.
- Key messages: Solve the principal agent problem; hold teachers accountable; use parents + tests to achieve accountability.

Building blocks:
Direct attack on poverty

Why?

- Moral arguments
- Political economy of growth
- There is no question that high GDP growth is the best anti-poverty program.
- But it is still a good idea to spend 1% of GDP on the poorest 10% of society – this is Rs.15,000 per year per family of 5.
- Free up all other policy debates for maximising growth.

What is a good poverty program?

- Self-adjusting
- Self-targeting
- Self-liquidating.

Employment guarantee

- Self-targeting, self-adjusting, self-liquidating. !
- But :
  1. Rural only,
  2. The price should be set correctly to reach the left tail, and there should be one single national price.
  3. Leakages - use of IT.
  4. Distorts labour markets: can increase unemployment.
  5. A bad way to produce public works.

Social insurance

- US/European style social insurance systems: huge costs, huge distortions.
- New Pension System in India is a fundamentally sound path.
- It is possible to setup procedures whereby NPS participants are able to take loans against their balances, to cope with spells of ill-health or unemployment.

A cautious way forward

Three elements in attacking poverty

- EG is a good weapon. We need to perfect the policies & administration.
- We also need to move towards cash transfer programs
- Build the NPS, and setup for some credit mechanism to cope with ill-health and unemployment.

Building blocks:
Corporate governance

CG is vital

- Modern economic growth in India is critically about perfecting the institution of the corporation.
- We now have an equity-market-dominated financial system.
- This requires sound CG.

Core ideas

- The management team does not own a company.
- The shareholders are the owners of the company.
- The management team is only an agent acting on behalf of the shareholders.
- The shareholders should recruit a management team of *their* choice.
- The cashflows received by every share should be identical.
- If the management team, or a subset of shareholders, extracts monetary or non-monetary benefits from the firm which are not equitably delivered to all shareholders, this is plain theft.

What can we do?

Elements of an Indian response

- Very low and very high shareholding by insiders are safe solutions. The danger zone is the middle.
- Speculative price discovery on the stock market is working well, and exerts good pressure. Firms with better CG are getting better valuations.
- Market discipline: do better on disclosure, short selling, hostile takeovers, rational voting by institutional shareholders, block insider trading, better compensation policies to align incentives.
- Avoid checkbox mentality; avoid CG “rating”.
- Integrity.

Review the seven building blocks

1. Free flows of goods & services; labour & capital across the country.
2. Open economy macroeconomics.
3. The *dharma* of competition.
4. Cities as engines of growth.
5. How to provide public goods?
6. Direct attack on poverty.
7. Corporate governance.

Part III

How feasible is this policy direction?

Is India capable of fundamental, far-reaching change?

- Tariff reform
- Exemption raj.

The use of knowledge in society

- Nothing matters more in an open society than ideas.

Part IV

Conclusion

Moving beyond State Capitalism: Towards a growth miracle

- If India plays the right moves from 2005 to 2025, we will achieve prosperity by harnessing the demographic transition.
- There is an opportunity, in this window, for our tryst with destiny: Spectacular economic growth, the elimination of poverty, and India as a world power in all respects.

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- There is an opportunity, in this window, for our tryst with destiny: Spectacular economic growth, the elimination of poverty, and India as a world power in all respects.
- But this is our last chance.
- If we miss this opportunity, then we will be in the dire straits of being a poor ageing country.

Thank you.