India: Seeing the Future in its Past

Dr. Raghuram G. Rajan

FORUM
of Free Enterprise

"Free Enterprise was born with man and shall survive as long as man survives".

— A. D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

FORUM OF FREE ENTERPRISE – Fifty Years

Forum will be completing 50 years of its eventful journey this year. It is worth recounting its genesis.

In the mid 1950s ominous clouds of socialism were gathering momentum. The Indian National Congress, under Prime Minister Nehru, had adopted a resolution assigning commanding heights of the economy to the public sector. The nationalization of coal mining, civil aviation, life insurance and state entry into trading had already caused serious concern in business circles. However very few businessmen had the courage to take on a powerful Government.

A few leading businessmen, among them A.D. Shroff, Murarji Vaidya, N. Dandekar, M.A. Sreenivasan, were stirred by the developments and decided to start a movement to educate the public of the adverse consequences of adopting the socialist path of development. They fervently believed that a Centralized Command Economy and a Pluralist Democratic Polity did not go together especially with one dominant party and an ineffective opposition.

The Forum was launched officially in July 1956 to highlight the contribution of the private sector in the pre-Independence era in placing India among the eight most industrialized nations of the world.

In the initial years senior Ministers used to describe the leaders of the Forum as disgruntled businessmen who were advocating unbridled laissez-faire capitalism and were doing nothing to counter malpractices. In response the Forum published a comprehensive code of conduct for businessmen way back in 1957, which in its scope was as wide as any code of governance formulated later.

In 1968 the redoubtable Nani Palkhivala took over the mantle and continued to be the President till 2000. Besides espousing the cause of free enterprise, he vigorously defended individual freedoms which were sought to be curbed by the State. He also forcefully articulated the case for a more rational and equitable tax structure, as ridiculously high rates had led to widespread evasion.

We must recall here with deep gratitude the sense of rare commitment and passion displayed by our indefatigable late Vice President, M.R. Pai, from Forum's very inception. He deserves as much credit as anybody else for the present stature of the organisation.

The Forum feels extremely gratified that our campaign over the years for liberalization and giving greater scope to private enterprise as well as rationalisation of the tax structure have borne fruit.

In recognition of their outstanding contribution to public life the Government of India issued commemorative stamps in honour of Mr. A.D. Shroff and Mr. Nani Palkhivala.

In recent years the Forum has changed its focus. It is increasingly concentrating on issues of governance and development of the youth. Numerous essay and elocution competitions, leadership camps and career guidance sessions have been held throughout the country. The feedback has been most heartening.

Forum has launched its **website** to meet the long expressed desire of our members that many of our booklets, which contain excellent material, should be made readily available on the web to serious students of the subject. The **website** will be constantly updated with future publications.

M. R. Shroff
President
Forum of Free Enterprise

Mumbai,
21st February 2006

EDITOR'S NOTE

In the last few years, India has already traversed a fairly good distance from its campaign of "Advantage India" in the close of nineties to "India Shining" in early 2004 and to "India Everywhere" at present. No longer are these perceived as mere symbolic slogans (or rhetoric!). There is a definitive substance in India's growth story, as is evident in the gradual "step jump" in our real GDP growth from the erstwhile Hindu rate of 3.5% to 5.5% in the eighties, to 6.5% in the nineties and now over 7.5% in the last three years.

There is certainly a flourishing of confidence now across-the-board among Indian policy makers, business and industry, professionals, the middle-class, investors, et al. At the same time, there is a global recognition of India rapidly emerging as economic super power. In substance, practically all the stakeholders are virtually swearing by the present performance and the immense future potential of the Indian economy.

Not surprisingly, Dr. Raghuram Rajan delivering his lecture under the auspices of the Forum of Free Enterprise recently stated that "There is a buzz today in India, a sense of limitless optimism. But is it justified?" It is most appropriate that a person of his eminence and one of the most promising young Indian economists and an international bureaucrat, adorning the position of Chief Economist at the IMF, should have raised such a pertinent issue.

He, therefore, seeks to see India's future in its past. While doing so, Dr Rajan has highlighted many shortcomings of the policies relentlessly pursued in the first three decades of India's planned economic development. Evaluating the outcome of those policies, he very perceptively concludes that "despite all the rhetoric about socialism, government polices were of the few, by the few and for the few". Although economic growth was "not disastrous" ("famously dubbed as the Hindu rate of growth"), it did not make an impact on India's massive problems of poverty and various socio-economic imbalances.

At the same time, he brings out several gains during this phase of India's economic development. Many of these manifested in (a) diversified manufacturing base with capability to produce capital-and skill-intensive goods; (b)creation of successful institutions of higher learning, especially in science and technology, like IITs; (iii) greater political decentralisation; etc. According Dr. Rajan, "India is building on the capabilities created before the 1980s …..”

The subsequent process of policy reforms has been characterised by what Dr. Rajan perceptively observes as "constrained adaptation". The transformation this has brought about in the last over a decade offers a very fascinating story of the positive impact of liberalisation and its different dimensions.

But to accelerate and sustain this momentum, he has many significant policy prescriptions to offer. These are interspersed in his lecture, and to capture and mention only the most significant among these are: (a) to open the capital account, if India is to achieve its legitimate aspirations of becoming a world-class financial center; (b) to build up skilled manpower by expanding capacities of IITs and engineering colleges, and for which to charge higher fee for higher education and encouraging entry of private and foreign institutions; (c) to create better infrastructure within the existing cities; and (d) to improving incentives for the creation of unskilled jobs as well as primary education and not to throw more resources on this score. Of course, the underlying message is also about the pursuit of fiscal discipline.

At the end, while concluding his lucid and thought-provoking lecture, Dr. Rajan very correctly cautions by stating that "even though India is approaching growth rates of 8 percent, let us not think the struggle is over". We, therefore, hope that the current optimism does not derail into "irrational exuberance", and that the policy makers continue to respond positively to the present and emerging requirements of further economic reforms and their effective implementation!

– Sunil S. Bhandare

India: Seeing the Future in its Past

Dr. Raghuram G. Rajan*

AD Shroff, who started the Forum of Free Enterprise in the 1950s, was an unofficial delegate to the Bretton Woods Conference that set up the International Monetary Fund – an interesting connection between this forum and my organization. His aim was, in part, to combat the tendencies towards excessive regulation that permeated the Indian economy. Among the others associated with this organization was Nani Palkhivala. These were important but lonely voices against the socialism practiced in India then, arguing as Palkhivala said, that it was a fraud – transferring wealth from the honest rich to the dishonest rich. Instead, people like Mr Shroff and Mr Palkhivala maintained a lonely but necessary vigil then, keeping alight the lamp of free enterprise. I am privileged to be speaking from the same forum as these stalwarts.

Since I am an international bureaucrat, what I say reflects my own opinions, and not necessarily those of my

*The author is currently Chief Economist, Intrernational Monetary Fund. The text is based on the lecture delivered in the Forum's Golden Jubilee series on 20th January 2006 in Mumbai.

organization. But the Fund clearly welcomes free enterprise, and attempts to help create the conditions for it to flourish around the world. I therefore particularly welcome the opportunity to speak at this forum and thank the organizers for inviting me. What I want to focus on today is not just how far India has come from those lonely days, but also how far it has to go.

Let me start by asking you to go back just 25 years. Unlike today when you can walk across to a shop to get a working state-of-the-art mobile phone, then one had to wait for years to be allotted a phone, and when that miracle happened, it took a further act of God and the benevolence of the P&T man for the phone to work after that. We had black and white TV then. Urban youth like us had to watch Krishi Darshan for entertainment on the monopoly Doordarshan network, where farmers responded to penetrating questions like ***"Kya aap khet ko pani dete hain?"*** Of course, most of the intended audience, villagers, did not have access to a TV even in the few cases they had the electricity to power it with.

Starting around 1980, the Indian economy became a veritable dynamo, posting an average growth of nearly 6 percent per year over the last twenty five years. Despite the inevitable unfavorable comparisons with China, very few countries have grown so fast for such a prolonged period of time, or reduced poverfy so sharply. We should indeed be proud of what India has achieved, and clearly, many of us are. There is a buzz today in India, a sense of limitless optimism. But is it justified?

To answer this question, let us start by asking how we got here. The best description of India's path is really "constrained adaptation"[1]. "Constrained" because of the numerous policies and regulations inflicted on us by an untrusting government and "adaptation" because Indians are by nature entrepreneurial. As a result, the law of unintended consequences was at work big time – what the policies produced was very different from what was intended. Consider some. Barriers were erected against foreign competition to protect domestic enterprise – the idea was this would give a respite to our infant industries, allowing them a nurturing environment while they would grow up and became competitive. But the nurturing environment proved so comfortable that our infants adapted by never growing up. The canonical example was the Ambassador car – a version of the Oxford Morris which remained virtually unchanged over 40 years of production. We waited with bated breath for every new model to see what the shape of the headlights would look like – for it seemed that was all that changed.

A second objective was to use scarce capital resources in the most effective way possible. To do this, the so-called "commanding heights", such as steel, petrochemicals, and heavy electricals, were commandeered by the public sector. In yet other sectors, private entrepreneurs were allowed in, but heavily constrained by regulations on how much, and what they could do, and where. But because much of the economy was in the hands of those who did not care about profits, and in the rest the profitable could not grow, the outcome was that India used its scarce capital very inefficiently.

Because employment was so important for India, encouragement was given to small-scale industries by reserving specific areas of production for them. But because firms could not grow to efficient scale, production was unprofitable, so few jobs were actually created. Government sought to protect unskilled labor in large firms – for example, through laws against firing. But this again meant that large firms stayed away from labor intensive industries, so fewer jobs were created. Moreover, firms resorted to temporary workers or stayed small so that labor laws did not apply. In short, labor laws neither led to the creation of more jobs, nor to the protection of most workers.

I can go on, but will stop with one last example. An overarching principle was to prevent the concentration of wealth in a few hands. This was another rationale for licensing, as also the Monopolies and Restrictive Trade Practices Act. But again, in an attempt to use government rules to eliminate privilege, we created the opposite — the industrialist who magically got all the licenses as well as the requisite financing. No wonder business was a dirty word.

So what were the consequences of this jumble of policies for India's pattern of development circa 1980? First and foremost, these policies held India's growth to a low, but not disastrous, level, famously dubbed the Hindu rate of growth. Indian industry was inefficient, not innovative, and exported very little. Surprisingly, these policies did not mean that India produced less manufacturing goods as a whole for a country at its stage of development. It did mean, however, that the composition of its manufacturing activity was unusual: India produced more than its share of capital- and skill-intensive

goods (think public sector petrochemical plant), while underutilizing what it had in plentiful supply—its abundant labor or even its innovative capacity.

That many engineering graduates like me left engineering or even the country was partly because the economic environment in the country at that time simply did not need the creativity and the innovation that we brought to the table.

To me, this message was forcefully reinforced when after doing a degree in management, I joined one of the country's foremost business groups as a management trainee. A CEO of one of the group companies berated the engineers in the group of management trainees he was taking around, arguing that we had wasted the nation's money by taking a precious engineering place and then departing to the ranks of management. While he was showing us around the factory, however, we noticed two elevators going up. We appeared to be waiting for the elevator on the left even though the elevator on the right was available. When asked why, he replied "We are waiting for the management elevator, this one is for the engineers and workers".

It was not just the middle class that did not benefit, our villages were still not electrified and our poor still had no access to safe clean drinking water. So despite all the rhetoric about socialism, government policies were of the few, by the few, and for the few. I have argued that this may have been unintended, but perhaps I am being charitable. Perhaps indeed the consequences were fully intended, but were cloaked in the rhetoric of social purpose, and the public confused with smoke and mirrors. Perhaps India's greatest enemy was not the proverbial foreign hand but the vested interests inside.

Be that as it may, there was a silver lining. The constraints caused India to be highly diversified in its manufacturing even back in 1980. And a portion of its labor force was highly skilled, a clear legacy of Pandit Nehru's emphasis on science, higher education, and also leading edge technologies for the public sector. How many countries, at India's then stage of development, could boast of having a space program? How many advanced countries even now can boast of schools of the caliber of the IIT's? Thus India had the capabilities provided the constraints were loosened and the right opportunities emerged. And that is indeed what happened.

In 1980, government attitudes towards the economy, and the private sector in particular, started to change. Under Mrs. Gandhi and then Rajiv, pro-business reforms were set in motion, with liberalized access for domestic firms to capital imports (including, presciently, to computers), technology, and foreign exchange, and the gradual relaxation of industrial licensing. Later, in the aftermath of the foreign exchange crisis in 1990, broader reforms that were more genuinely pro-competition were introduced—barriers to foreign trade were dismantled, inward foreign investment was liberalized, and important services such as telecommunications and finance were opened up.

Second, but no less important, India started becoming more decentralized politically. The decline of the Congress' power and the rise of regional parties conferred greater political autonomy on the states, translating to autonomy even in the

economic sphere. States increasingly prospered, or not, based on what they did rather than because of actions at the center.

What did these changes accomplish? Many things. Above all, the economy responded with the vigor of an uncaged tiger as per capita growth surged from less than 1 percent a year to over 3½ percent, not so much by employing more workers and capital but by using them more efficiently. Surprisingly, though, neither the reforms nor the pick-up in growth have altered India's specialization in capital- and skill-intensive industries. In fact, the fastest growing services – finance, telecommunications, and business services – are also skill-intensive. In many ways, India is building on the capabilities created before the 1980s, with veterans from the state-owned Bharat Electronics, CMC, or ECIL seeding the companies that were in the vanguard of the software boom, and alumni from the State Bank of India permeating the financial sector to launch the boom in finance.

These developments are mirrored at the state level. With greater decentralization, better run states, such as Delhi, Gujarat, Karnataka, Maharashtra, and Tamil Nadu, have improved the quality of their infrastructure and business climate, attracted more investment, and surged ahead. The pattern of development in these states has been unusual: they seem to have skipped entirely a phase that most high-growth countries in East Asia, went through – of specializing in labor-intensive activities (for example, making clothes or leather goods, or assembling consumer electronics). Instead, these states are behaving more like the United States and Europe, exploiting their diversified skill base and emphasizing skill-based manufacturing (pharmaceuticals, petrochemicals, and auto parts) and especially services.

The auto industry offers a great case study of the effects of liberalization. To start with, the worst fears of the domestic producers were realized. The public virtually abandoned them for the new foreign models. The Ambassador turned almost instantaneously from mass production car to antique, and I understand it is finding a foreign market as such. But it simply did not make sense for the foreign manufacturers to continue sourcing their sub assemblies from outside India. Instead, they started developing local ancillary manufacturers, and gave them the technological assistance for them to become world-class. Soon India started exporting ancillary automotive products to the developed world.

The story does not end here. Telco, capitalizing on the existence of world-class suppliers of ancillaries in India, started producing a state-of-the-art, indigenously-designed car, the Indica. The car had teething problems at first and was rejected by a now-discriminating public. But Telco engineers went back to the drawing board, fixed the flaws, and brought out a new version that swept the market in its category. From about 50,000 cars in the early 1980s, India produced over 1,200,000 in 2004, and exported 160,000 cars, many to the developed world. The Indian automobile industry offers an example of what trade liberalization and domestic competition can do – potentially some pain in the short run but enormous gain in the long run. Equally important, its success and the success of industries like IT offer young Indians convincing examples that Indian entrepreneurs can be globally competitive. The change in

mindset towards business is as important as the regulatory and political changes I discussed earlier.

So what does this mean for the future? Fast-growing states will need more capital and skilled workers (as well as, of course, the necessary infrastructure, a matter on which there is consensus in India). India has a vibrant financial sector and it should have no problem raising and allocating capital but for one impediment – the government appropriates significant amounts of savings to finance its deficit.

Not only does this leave less to allocate to private investment or infrastructure, it is also a source of vulnerability if the country were to rely more on foreign capital. The need to forcefeed the fiscal deficit to domestic banks also makes it hard for the country to open the capital account (or to privatize banks), a must if India is to achieve its legitimate aspirations of becoming a world-class financial center.

The greater bottleneck will likely be skilled workers. India's universities have not expanded in a manner commensurate with the growing skill intensity of its production. Even as India redresses its previous neglect of primary education, it needs to multiply institutions like the IITs and regional engineering colleges on which its current success is based. A recent experience suggested it is infinitely more difficult to get into the IITs today than it was in my time. I met a teacher who was coaching a student in maths. I asked her whether it was for the IIT entrance exam. She said no, it was for the entrance exam for a coaching class. I said, ah, a coaching class for the IIT entrance exam. She said no, a coaching class for the entrance exam for another, more prestigious coaching class, which would coach the student for the IIT entrance exam. If this is the level of intensity of effort needed to get admission, we certainly need many more colleges like the **IITs,** and in many other disciplines also. To generate the needed resources, not only should we charge a reasonable fee for higher education, while offering scholarships to the truly needy, but also we need to encourage more entry by private and foreign institutions. An uneducated mind is a terrible waste of national resources. China recognizes this. Unfortunately, in India, higher education continues to be one of the last bastions of the license-permit **raj.**

In addition, India also needs to focus on the deteriorating condition of urban living, especially given the increasing rural to urban migration. If India is to be internationally competitive in services, it needs to be able to attract knowledge workers who have attractive options elsewhere. We need better infrastructure within the existing cities, and new planned townships that can provide the amenities that a discriminating middle class and a growing migrant population want. Much of this primarily requires better management. It is a shame that Mumbai, which has access to twice as much water per day per capita than Paris has water available on average for only 10 hours per day, while Paris has 24x7 supply. And Mumbai is by no means the worst city. What is of particular concern is that the poor are the worst hurt by poor public amenities.

Despite the concerns I have expressed, India's fast-growing states and industries have a certain success-breeds-success dynamic which will be difficult to derail. More worrisome is job creation for India's growing unskilled labor force and the

related problem of the laggard states, where the majority of low-skilled, undereducated Indians still reside. Ideally, of course, the laggard states would reform on their own. They would scrap archaic labor laws (few realize how pernicious these are because their effects, in terms of the labor-intensive firms that are unborn, cannot easily be seen), improve infrastructure and the business climate — and utilize their vast pools of underemployed low-cost labor to attract investment in labor intensive manufacturing and agri-business. They would thereby catch up with the leading states in India. Unfortunately, though, there is a reason these reforms have not been undertaken so far – there are few things more persistent than bad governance.

Is the country then likely to face increasing political strife as the populous, politically powerful, but economically laggard states hold back the economically powerful fast-growing ones?

There is a more hopeful scenario – Europe had similar disparities but through various initiatives, prosperous Western Europe offered incentives for laggard European countries to reform. The external pull set reforms into motion, so much so that some of the former laggards like Ireland and Spain are now Europe's locomotives. If a loosely'knit community of nations could do it, why can't a united nation of states? A reformist center – and India cannot afford to not have one — could play the role of the European Commission (expanding what the center is already doing on the fiscal side) and offer laggard states more incentives to reform.

Let me conclude with the lessons we draw from our past. First, our past policies, no matter how distorted, gave us a set of capabilities – in skilled manufacturing and in services. Our comparative advantage now lies in these areas. We should not sacrifice all this in a blind attempt to follow the Chinese path of unskilled, labor intensive manufacturing. No doubt, we need to improve the incentives for the creation of unskilled jobs – not just by getting rid of the archaic job protections of the past even while building a genuine safety net for all workers but also by improving infrastructure, especially in laggard states and rural areas so these areas connect better to the larger economy. But we also need to create a greater supply of skilled workers by energizing higher education. We need 50 IITs, not 7. The government need not do this – it has, however, to clear the way for private enterprise to flourish.

Second, we should realize the government cannot simply legislate outcomes. People react to government policy, so what is intended and what materializes can be very different. Government has to focus on getting the incentives right, and thereby enlist the energy of the people in support of change, rather than force them to use their energy to outwit the government.

This mindset that believes in the extraordinary powers of the government is not entirely a relic of the past. If we suffer from a shortage of university teachers, it is better to examine why no one wants to teach — could the fact that teachers in top management schools earn less than fresh graduates be a factor – than to resort to the old command economy tactic of banning schools from expanding abroad.

Similarly, if the goal is to improve primary education, we should avoid the knee jerk reaction of throwing more

resources at the problem. We should ask why on any given day in a government school, only 25% of the teachers are playing truant, why at any given time only 45% of the teachers in a classroom are teaching, why the poor are willing to pay hundreds of rupees per month for a private school while avoiding the free government school across the street, and why a private school teacher shows up to teach as often as the government school teacher even though his pay is one fourth to one eighth that of the latter's. Government has to understand how to improve incentives better before throwing more resources.

Third, the overregulation of the past has bred public cynicism towards rules and towards government. In a market economy, however, trust in rules and public institutions is absolutely critical. Instead of government standing above the people, it has to be by the people, for the people, and of the people. Even while paring down the role of government, we should make it more transparent, effective, and responsive to the needs of the people. We need to rebuild public trust in government.

If young people take more interest in local government, as many of you are, there is no doubt that the quality of our institutions will be forced to improve – the recent journalistic exposes of Parliamentary bribe taking area, and the prompt salutary reaction by Parliament, are a case in point.

Finally, even though India is approaching growth rates of 8 percent, let us not think the struggle is over. Our current growth reflects what we did right in the past. To sustain growth rates of 8 percent, a lot of policies have to go right – at high speeds, even a slight swerve can cause a major accident. Moreover, capacity quickly gets exhausted at high growth rates. So despite the warm glow generated by reports like the famous Goldman Sacks BRIC report, let us treat straight line extrapolations of current trends with the caution they deserve.

In sum, perhaps the defining metaphor for India today is churning, as entrenched interests lose power, as new jobs are created and old ones lost, as people move across states in search of better opportunities, as yesterday's Bharat becomes today's India, which 'becomes tomorrow's Bharat again. Recall the story of the devas and asuras churning away as the ocean of milk frothed and foamed. Out of the churning, first came poison, but further hard work yielded the divine nectar, amrita. Limitless optimism is justified, but hard work and churning lie ahead.

7

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good:

— Eugene Black

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FORUM

of Free Enterprise

The Forum of Free Enterprise is a non-political and non-partisan organisation – started in 1956, to educate public opinion in India on free enterprise an3 its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets, meetings, and other means as befit a democratic society.

Membership of the Forum : Annual Membership fee is Rs. 1001- (entrance fee Rs. 1001-). Associate Membership fee Rs. 601- (entrance fee Rs. 401-). Students (Graduate and Master's degree course students, full-time Management students, students pursuing Chartered Accountancy, Company Secretaries, Cost and Works Accountants and Banking courses) may enrol as Student Associates on payment of Rs. 101- per year. Please write for details to : Forum of Free Enterprise, "Peninsula House", 2nd Floor, 235, Dr. D. N. Road. Mumbai 400 001. E-mail: ffeQvsnl.net

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