

## Is There a Threat of Oligarchy in India?<sup>1</sup>

Good evening. When Rajiv Lall invited me to speak to this august group, I accepted with some trepidation. What can I say that you do not know already? So instead of speaking about the day-to-day issues that you grapple with every day, I want to engage you in a conversation, and I hope it will be a conversation, about the trends we see in India. In some ways, it is easier for an outsider to attempt to discern trends from every day noise, but it is possible to be totally mistaken. So in the spirit of inquiry and discourse that we follow at the University of Chicago, let me lay out some thoughts that could be the basis of a debate.

I think it is fair to say that we are entering one of the most critical periods in India's history. The next ten years will determine whether we will take our place amongst the group of nations like South Korea and Taiwan that have made their way from poverty to moderate prosperity in a couple of generations, or whether the last few years have flattered only to deceive – whether the tremendous Indian growth of the last 5 years, following on the growth acceleration starting in the 1980s, is simply a growth spurt whose underpinnings are unsustainable. History should warn us against hubris – others have grown rapidly before, only to be overcome by problems that were papered over during the period of growth. In the eight years after 1967, Brazil grew at nearly 8% in real terms on average. Unfortunately, this was followed by decades of crisis and military rule that it only recently has recovered from.

*Hubris* defined in the dictionary as “excessive pride or confidence” is a new concern. For much of our post-independence past, we have been under-confident. It is our successes, due to many of you in the room -- ranging from the Scorpios sold by Mahindra and Mahindra right in

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<sup>1</sup> Speech to the Bombay Chamber of Commerce on its Founders Day celebration, September 10<sup>th</sup> 2008.

the heartland of the United States, to the lowest cost and fastest growing cell-phone network in the world -- which are responsible for our pride. And pride is a necessary spur to further achievement – I have no doubt that Abhinav Bindra’s gold medal will convince more Indian sportspersons that they can be second to none in the world, and give them the *atmavishwas* to succeed. I fully expect we will win more than one gold medal in the next Olympics, especially if our officials get their act together starting now.

But while believing one *can be* second-to-none is a spur to action and achievement, believing one *is* already second-to-none, or worse, better than everyone else, is, you will agree, dangerous. And I see signs of complacency, whether it be a lazy acceptance of straight line extrapolations by Goldman Sachs indicating that India is destined to become a great economic power, or a willingness of some Indian corporations to pay unconscionable prices in making trophy foreign acquisitions. The few countries that have sustained growth over the decades needed to emerge from poverty, as Dani Rodrik from Harvard suggests, have invariably used the initial period of high growth to reform their institutions. And while we have some new institutions like 24-7 investigative TV and extraordinarily committed voluntary organizations, tremendous pressure is coming on our existing institutions, and some of them are crumbling under the weight.

We are at a crossroad. With the right policies and some luck, we will become a middle income constitutional democracy in my lifetime. But inaction coupled with bad luck could make us an unequal oligarchy or worse, perhaps far sooner than we think. I do not want to be alarmist. India is usually far more resilient than we give it credit for. But it is important for right minded people like those assembled here to put their considerable weight behind policies that can set us firmly on the right track.

Let me briefly assess the reasons we have done so well over the last few years and why I fear the environment is likely to become much tougher in the next few years. The world economy has been flourishing, especially over the last four or five years. Even though on net we are not large exporters, the rising tide has lifted all boats, including ours. But the industrial world is slowing, and as it tightens its belt, exports, and thus growth, will become more difficult. Despite some boost from exports to other emerging markets, and some softening in commodity prices, we will tend to run larger current account deficits, always a source of fragility.

Also, when we started on our growth spurt, we were very far from the frontier of what was possible because of the constraints we had imposed on ourselves through the License Permit Raj. But many of the low hanging fruit that emerged post liberalization have been picked, certainly in the well-governed and well-connected coastal states. The resources that were underutilized when we started on our growth spurt – such as the cheap land in major cities and the unemployed IIT graduate – have now been used up, as evidenced by the tremendous increase in the price of land and in the wages for skilled labor. There are still great opportunities for growth in the interior areas, but governance and the connectivity to domestic and global markets is far worse there.

Finally, many of the reforms in the recent past involved taking off self-imposed shackles that everyone knew were unproductive. I don't want to minimize the heroic political effort involved in consigning large parts of the License-Permit Raj to the dustbin of history – and I have to say that the task is still unfinished, especially in the financial sector. But reducing the activities of the government is easier than getting it to do essential activities better. And in my view, much of what needs to be done in the years to come requires better, cleverer, focused government rather than less government. And we are woefully deficient here.

I want to pick three of the challenges that face us – the lack of jobs, especially in the hinterland, the terrible access to public services, especially for the poor, and the growing private expropriation of public wealth. I will argue these problems are connected, and governance is at their center.

Start first with jobs. Everyone talks about India's demographic dividend, and it is clearly a possibility. But to reap it, we need more, and better, job creation. This year's Economic Survey suggests that organized sector employment has not grown since 1991 – public sector and government employment has shrunk a little while private sector employment has barely made up the deficit.

Why has the organized sector not grown? After all, workers around the world aspire to a steady job with protection and benefits, something the informal sector does not provide.

The immediate answer is that the organized sector is overly protected and regulated, so it is not cost effective to create jobs in that sector. For example, today a large factory owner will not employ full time workers unless he is pretty sure he can employ them for life. Indeed, there was a recent report that Bajaj had set up a factory with only engineers, no workers – this in a country with a surplus of unskilled and semi-skilled labor. But such actions are understandable for in this competitive world, the owner cannot be sure he has orders for next month let alone next decade. We need more flexibility in the labor market, especially in low skilled industries like textiles, else our factories will either become fully automated, or full of temporary workers. In protecting some workers, we condemn the majority to a totally unprotected existence, an example of the law of unintended consequences.

At the same time, changing labor laws cannot simply be a matter of changing the statute. If workers have no protection against arbitrary dismissal, if the courts take an eternity to decide a

case, and if workers have no unemployment insurance to support them when unemployed, then they will take to the streets if fired. The law of the land will be replaced by the law of the jungle. Statutory reform has to be accompanied by legal reform that ensures courts respond cheaply and in finite time to even lawsuits filed by poor workers. It also has to be accompanied by a stronger social safety net. We therefore need reforms on a number of fronts.

But labor market flexibility is just one of the actions needed to make us competitive in low skilled manufacturing. The entire cost structure of production has to be brought down, which means cheaper and more reliable power, better transport and communications, and healthier, better educated workers.

Indeed, businesses in some states, especially in the coastal states of the South and West, have found new ways to foster growth, often by bypassing traditional unskilled industries where competition is on the basis of costs, and focusing on more skilled industries like pharmaceuticals and auto ancillaries, where higher skills are brought to bear and infrastructure costs are a small part of the total value of the product.

But what are the interior states such as Madhya Pradesh, UP, and Bihar, which have not emphasized broad based higher education as much, to do. People can migrate, of course, from these states to do the low-skilled jobs that open up in the fast-growth states. But there are political and social limits to migration. Moreover, highly skilled people are also migrating, hollowing out human capital capabilities in the interior states.

The reality is that jobs have to be created where the people are, and much of India lives in states where the state governments have not done a good job in assuring businesses safety and security, or providing adequate power, cheap transport, and communications infrastructure. The

public schools and public health system work far less well than in the coastal areas, so the capabilities of workers is not as high. In the past, during the License Raj, these states were allocated investment by fiat – and in the convoy system operated by the central government, all states were placed in a convoy that grew at a common slow Hindu rate. With liberalization, these states are falling further and further behind. They will be tempted to use their political clout to claw back the goodies that liberalization has denied them. Murmurs of conflict over the allocation of central resources are already being heard.

So why do the people of these states not demand better governance? Why don't they elect politicians who will give them schools where teachers show up, and roads that do not get washed away at the first heavy downpour? In my view, the tolerance for the venal politician, for the politician who does so little to reform the system is simply because he is the crutch that helps the poor navigate a system that gives them so little access.

Let me explain. Our entire bureaucratic system of provision of public goods is biased against access by the poor. Ration shops do not supply what is due, even if one has a ration card, teachers do not show up at schools to teach, the police do not register crimes, or encroachments, especially by the rich and powerful, public hospitals are not staffed, public sector banks do not want to lend...I can go on, but you get the picture. This is where the local politician fits in. While the poor do not have the money to purchase services that are their right, or to bribe the public servant, they have a vote that the politician wants. The politician does a little bit to make life a little more tolerable for his poor constituents – a government job here, an FIR registered there, a land right honored somewhere else. For this, he gets the gratitude of his voters. But he then also has little reason to improve their lot – because the local politician in India today owes his

reelection to the totally corrupt and compromised system of delivery of public goods, and the paucity of reliable jobs, especially for the very poor.

And the system is self-sustaining. An idealist can promise to change the system, but the voters know there is little one person can do. Moreover, who will provide the patronage while the idealist is fighting the system? Why not stay with the devil you know...Of course, for those who are truly disillusioned with the system, violence offers an alternative path. The growth of Naxalites that the prime minister has warned about is only more evidence of the total breakdown of the delivery of public goods to the poor.

There is a missing piece though. How does the politician make the money that he requires to provide the patronage? In the past, the License Raj provided the necessary rents. But with liberalization, rents have moved elsewhere.

To see where, let me digress a little. My former classmate from IIT, Jayant Sinha, recently sent me a spreadsheet he had compiled. It lists the number of billionaires per trillion dollars of GDP for the major countries of the world. Guess which country tops the list? It is Russia, with 87 billionaires for the 1.3 trillion dollars of GDP it generates. "Of course!", you will say – these are the oligarchs who stole the country's mineral resources, who participated in the Loan for Votes scheme, etc. But guess which country comes second? It is India with 55 billionaires for the \$1.1 trillion it generates.

Some comparisons might be useful to convey to you how extraordinary this number is. Remember, our per capita GDP is tiny, even compared to Russia's. So we are really an outlier in terms of the wealth of the extraordinarily wealthy relative to per capita income. Brazil, which is thought to have extreme inequality of income distribution, has only 18 billionaires despite a

greater GDP than India. And Germany, with three times India's GDP and a per capita income forty times India's has the same number of billionaires.

You might think these are the software billionaires. But there are not that many among India's billionaires. Indeed, three factors – land, natural resources, and government contracts or licenses – are the predominant sources of the wealth of our billionaires. And all of these factors come from the government.

Why should this be a source of concern? We should certainly welcome it if businessmen make money legitimately. People like Narayanamurthy, Azim Premji, and Ratan Tata are widely respected in this country, and deservedly so. I also do not want to say that every government license or contract should prima facie be suspect. We have extremely efficient private banks and telecom companies that obtained their start from a government contract or license. But I do want to argue that the numbers are alarming – too many people have gotten too rich based on their proximity to the government. If Russia is an oligarchy, how long can we resist calling India one?

The point I am making is that corruption in India's political establishment used to be about the sale of permits during the License-Permit Raj. Reforms have created new sources of rents for the establishment, as the political scientist, Ashtosh Varshney argues: Scarce national resources like forests, coal, and minerals can be allocated. Land can be expropriated from those who do not have connections or formal title, converted to industrial use and allocated. Public land can always be disposed off to favored parties. Contracts can be assigned to chosen friends despite a sham of public bidding. In all this, the public exchequer is defrauded, while the rents are shared between the politician and the corrupt businessman.

So the circle is complete. The poor need the savvy politician to help them navigate through rotten public services. The politician needs the corrupt businessman to provide the funds that allow him to supply patronage to the poor and fight elections. The corrupt businessman needs the politician to get national resources cheaply. And the politician needs the votes of the poor, who are numerous enough to assure him reelection, no matter how much an idealistic middle class may rail. Every constituency is tied to the other in a cycle of dependence, which ensures the status quo prevails.

Clearly, reality is more complex than what I have sketched. And there are many fine upstanding politicians and businessmen, greatly outnumbering the corrupt, in the country today. But oligarchies do not require many participants to flourish. They only require silence and complacency among all of us.

What is to be done? Of course, powerful bodies like this one can apply its influence to break the nexus of corruption and improve governance for all. You could stress the importance of transparency and bidding in all government contracts, and protest the now-routine revisions to contracts once a favored bidder wins. You could demand that the land-titling and registration system be reformed so that the public has clear title. This will also ensure the businessman does not need the government to acquire on his behalf. You could press for a framework for land acquisition that allows land transfers to be negotiated in a clean and transparent manner, with some provision for coercing minority holdouts. You could bring pressure on businesses that routinely violate ethical norms. You could demand greater disclosure of agreements between states and businesses, and as a body, rate them on the overall transparency, process, and value creation for the state. You could push for a clean competition commission with a clear and not-overly-intrusive mandate. In all this, you will have to step up and judge the conduct of your

fellow businesspersons, something that has not been the norm in the past. And you will have to press for more, better, government action – such as mapping land title or creating an effective competition commission – rather than less.

But will this be enough? Perhaps we can draw a lesson from the historic experience of the United States. The United States went through its Gilded Age in the late 19<sup>th</sup> century, characterized by robber barons like Jay Cook and Commodore Vanderbilt, who joined hands with a corrupt political establishment, such as the fabled Tammany Hall in New York, in their pursuit of wealth. As the historian, Richard Hofstadter, argues, the Progressive reform movement did little to break this unholy nexus. The Progressive reform movement was led by professional businessmen and the middle class, and it foundered because the masses continued to support the corrupt politicians, who were their employment exchange and social security all rolled into one. What broke the corrupt status quo was the New Deal in the 1930s, which provided public services like social security and unemployment insurance directly to the masses. This eliminated the traditional function of the local politician, and allowed the masses to switch their support to clean reformers.

By analogy, perhaps the way to break out of this trend towards ever increasing concentration of wealth and power, and of corruption, in India today is to reduce the reliance of the masses on the politician for basic public services, and to improve the social safety net. For instance, if many of the current public programs targeted at the poor are wound up, the amounts saved, as Devesh Kapoor and Arvind Subramanian suggest, could be substantial. If transferred directly to the poor, the poor would have the economic power to command services from the private sector. This would immediately eliminate a substantial part of the need for politicians to intervene. Indeed, much of this is already possible. We have the capacity today to indentify the

poor, create unique biometric identifiers for them, get them bank accounts, and make government transfers into those accounts. Money will give the poor respect as well as the services they had to beg for in the past, and break a link that is growing more dangerous over time.

Similarly, there are a number of worthwhile proposals to improve the quality of public education and to improve public health care for the masses. We should undertake experiments to see what works and roll them out on an expedited basis. We need to improve old-age security schemes and initiate unemployment insurance schemes. Even the National Rural Employment Guarantee Scheme, if properly administered and made transparent, should empower villagers and loosen the umbilical cord that links them to the politician and patronage.

The point I would like to stress is that expanding economic inclusion may be a way to disrupt the trend towards oligarchy that is emerging today. This is one reason why the report on financial sector reforms that we have just finished for the Planning Commission stresses financial inclusion as one of the main objectives of reform. While inclusion is of direct merit, its indirect value for furthering reforms is equally important. As we put it in the report, the road to Mumbai as an international financial center runs through every village in India.

Let me conclude. I have been frank, not because I am pessimistic about India but because I think self-delusion is the first step towards disaster, for businesses as much as for countries. There are many fine, upstanding, committed people in this country, even throughout the political establishment, who want it to succeed. And we have a strong tradition of democracy, with hundreds of millions of first time voters who are eager for change and not constrained by the past. Their energy has to be exploited, with agendas laid out by influential bodies like yours, to

combat the very real dangers that face our country. The battle lines are laid out. The choice between self interest and public interest is clear. And if you join the battle, I have no doubt who will succeed. Thank you.