How can India be a G-5 power?

Mr Chairman, ladies and gentleman:

I am glad to be here and I thank the India Today group for inviting me to be part of this illustrious group of speakers. Let me start by pointing out that because of our sheer size we are already a G-5 country, certainly in terms of population but also in terms of total GDP at purchasing power parity. Rather than stop here, let me restate the theme. I think the intent is to ask how India can join the ranks of high per capita income countries within a generation or two – how can India have sustained explosive growth of 8 percent and above for the next few decades.

In many ways, the fact that we are asking this question itself shows how far India has come. Thirty years ago, we were poor and, if not actually proud of it, happy with our Hindu rate of growth of 3.5 percent. After all that was a tremendous advance compared to the virtual stagnation under the last five decades of British rule.

Thirty years ago, it was a miracle if one was allotted a phone, and it took a further Act of God and the benevolence of the P&T man for the phone to work after that. Thirty years ago, we had black and white TV, and that too only in a few cities. Urban schoolboys like me watched Krishi Darshan for entertainment on the monopoly Doordarshan network, fascinated by farmers being asked penetrating questions like “Kya aap khet ko pani deite hain?” We have come a long way indeed.

But by other measures, we have not come far enough or fast enough. In 1962 South Korea had a per capita close to India’s. Today, South Korea’s per capita GDP is twenty times ours despite having suffered a significant debt crisis in the 1980s as well as in the 1990s. The increase in China’s steel consumption last year was as much as India’s entire steel production. And when we turn to broad social indicators, the picture gets worse. We have the world’s largest number of illiterates as well as the largest number of people living in absolute poverty. Infant mortality at 93 infants under five per 1000 live births compares unfavorably with say, Bangladesh’s at 77 or Egypt’s 41.

And while we may have a Sachin Tendulkar, we have only one bronze to show for each of the last two Olympics, the least number of medals per million among medal winning nations.

So why the optimism? Does India have the right to feel good? I think it does, but one has to guard against complacency, for much still needs to be done, and much could go wrong. The reason for optimism is not the recent upward blip in growth which may well be due to temporary factors but that a number of factors are lining up that could propel India into sustained stratospheric growth.

The first comes from a recent study by Dani Rodrik and Arvind Subramanian (of the IMF Research department): Since 1980, nearly 60 percent of India’s growth has come from Total Factor Productivity, that is from using men and machines more effectively. The
The contribution of productivity to growth is close to the highest in the world over this period, and is important because it says India has managed well with the resources it has. It also augurs well for the time India has more resources.

And that time may soon be upon us. The ratio of non-working population to working population will fall from 0.62 to 0.48 over the next 25 years in India. Not only will this mean more potential labor, but if fully employed, it also will mean more savings – by one count a savings rate of 14 percent more as a fraction of GDP over the next 25 years. Add to the greater savings the capital India should be able to attract from abroad as it improves its governance and as foreign aging populations save for retirement and it should be clear that neither labor nor capital should be a constraint going forward.

The third reason for optimism is recent studies of economic growth, which suggest that the quality of a country’s institutions is perhaps the most important factor in determining its per capita income today. Given India’s basic institutions – its democracy, its judicial system, its free press, its education system, and its professional and business classes, India underperforms – according to Rodrik and Subramanian, India’s per capita income should be between 4 to 6 times what it is now. Clearly, some of India’s institutions have deteriorated over time. But others have become better.

At one time, our host, India Today was one of the very few sources of reliable independent news in India. Today, not only are more magazines snapping at its heels, but high quality TV news shows and even investigative Internet journals provide the citizen news. That India has strong institutions augurs well for growth.

But why despite strong institutions has India underperformed? The reason, I believe is India has lacked the political will for growth. What Gandhi feared came to pass after independence. The brown sahib took over from the white sahib and India’s new elite, the unholy coalition of politicians, bureaucrats, business houses, and trade unions captured the economy. No doubt India progressed. But it was slow and grudging at the famous Hindu rate.

Then something changed in the 1980s. A new wind started blowing, one where competition was no longer a dirty word and where consumer choice was no longer seen as capitalist excess. Business was no longer what one did when all other careers failed and profit was not theft. What caused the change? To some extent the world changed and India started taking notice. But more important, the old coalitions stopped getting along.

As the pie grew more and more slowly, the fights over the spoils became more vicious. Big business finally saw itself strangled by the monster it had created of the License Permit Raj. Politicians took heed, and slowly the infrastructure of command and control was dismantled. But competition really took off when the economy was liberalized in the crisis of the early 1990s, a process in which the IMF had a catalytic role. While big business initially feared unfettered competition from abroad, it has learnt to deal with it by becoming more efficient. And with new found confidence, it is now pushing to get rid of the remaining barriers.
That the smart young graduate today aspires to become an entrepreneur rather than study for the IAS is a sign of a tremendous improvement in the business and political climate. India’s elites now have the political will to grow – from a “chalta-hai” economy we have become a “can-do” economy -- and that is the single biggest reason for optimism.

Is growth everything though? What about the 250 million desperately poor and destitute people in India? Will the benefits of growth trickle down to them? The answer is yes. Economic growth typically is a rising tide that lifts all ships. A recent paper by Art Kraay at the IMF Research Department suggests between 66 and 90 percent of changes in poverty indices is due to changes in average incomes. In other words, growth in average incomes substantially reduces poverty.

This is not to say that redistribution is unimportant, but it is far less important than growth for reducing poverty. We also know far less about how to redistribute well and prevent the process from being captured by vested interests. We should let growth help the process of redistribution rather than let redistribution stop growth.

Thus far I have said the preconditions for sustained growth are good in India. Coupled with this is the moral imperative that strong growth will help us banish poverty. So how then do we go about achieving growth?

We need to do at least 4 things. (1) Keep strengthening incentives for growth (2) improve the infrastructure for investment broadly defined (3) constantly improve the flexibility of the economy and last but not least, create better safety nets.

There is no better time than the present recovery to embark on these reforms – typically the fears about the consequences of change are lower during a recovery, and governments have the budgetary room to help make changes palatable. The recent interim budget sops should have been tied to hard-nosed reforms. Hopefully the post election budget will do more.

Let me go into a little more detail into the four pillars I have detailed.

First, incentives. Perhaps the best source of incentive is competition. The right way to make our large firms world class is to make them go head to head with international firms, by unilaterally bringing down tariffs, especially in input sectors. The right way to help the small-scale sector is not to protect it but to give it better access to finance and power, and to reduce bureaucratic impediments. The right way to help agriculture is to expand its opportunities – by providing it with access to credit, insurance, processing and storage facilities, improving transportation, and reducing the barriers to internal and external trade.

India has been a producer oriented economy for too long, in the process helping neither producer nor consumer. Protection from competition not only reduces the incentive to become efficient but it also reduces the demand for better infrastructure.
Turning now to the latter, it is obvious India needs better infrastructure. By this, I don’t mean just physical infrastructure like roads, power, and airports, which it certainly needs. As an aside, I have just been to Beijing. Beijing has six ring roads encircling the capital. We have one. China has probably two too many, we have probably two too few. China needs more private involvement in growth, we need more public infrastructure, especially if we are two provide employment to the many millions who will join our labor force.

In addition to physical infrastructure, we need regulatory infrastructure. And here less may be more. According to the World Bank, it takes 88 mandays for an entrepreneur to fulfill all the regulations needed to register a limited liability company in India. Compare this to 4 days in the United States, 45 days in China and 73 days in Sub-Saharan Africa. Our regulations are framed with mistrust of both the regulator and the regulated and end up creating high costs and few benefits.

We need lighter rules, well enforced, with few or no exemptions. Brazil now uses the World Bank measure as a benchmark of how well it is doing in ridding itself of useless regulations. India should follow suit.

We should also not neglect investment in our greatest resource, our human capital. Better nutrition, health care, and education should be a priority. These are interrelated investments. For example, better education, especially of women, can improve the health, education, and nourishment of children. We have to improve ways to deliver these services to the people, ways that reduce leakage while preserving quality – often, this implies giving recipients more information and control about the resources that are being spent.

I should mention that in Uganda, the central government started publishing what was being allocated to district schools – this magically increased the resources that actually arrived at the schools from 20% to 80% of the amounts allocated. A number of states in India are experimenting with Freedom of Information laws which allow the people to know what is their due. We need these to be implemented more widely.

Turning to education, the government should completely sever the umbilical cord that ties existing higher education institutes to it and devote the resources to primary education. The nation will not lose. By setting these institutions free to compete, it will improve the quality of the education they provide and it will reap an enormous dividend from the work the graduates of these institutions will do. The institutes will not lose. They have enough of a reputation that students can obtain the financing to pay high tuition fees, and enough of an alumni base to finance the rest. The poor will not lose – they have a better chance of getting into these institutions if they receive a better primary education.

If the government truly wants to democratize higher education, a laudable objective, in addition to reordering education spending priorities towards the primary sector, it should facilitate the setting up of more quality institutions by the private sector.
I could go on but the point should be clear. More investment is needed. If the private sector is to be enlisted in the process, one final area needs shoring up: India needs better planning – not the heavy handed Five Year plans that allocate resources to the last detail only to go off-track immediately but the laying out a predictable and credible future framework for reform. The less policy uncertainty there is, the more forthcoming the private sector will be.

But even if policy is more certain, the environment is not. Today business process outsourcing is in, tomorrow it may not. We need to build more flexibility into the economy so that it can react to inevitable change quickly. India has too much preservation, and too little creation or destruction. Interestingly, studies show the way to get more creation of new businesses is to allow easier exit or destruction. This means more flexible labor laws, and a better and more rapidly enforced bankruptcy code.

Increased flexibility will inevitably create losers – for example, workers who lose their jobs as the economy changes. The best form of insurance is for the worker to be able to learn new skills – all the more important to invest in education and healthcare. But for those who cannot adapt, we need to find better ways to cushion them, especially because old social support networks like the extended family and the village tend to erode in the modern market economy. As we modernize, we have to create an explicit safety net, including unemployment insurance, pension schemes, and health care, targeted at the individual worker to shield him or her from business cycle fluctuations.

There is therefore much to do if India is to achieve our potential. What could go wrong?

Geopolitical risk is always a concern in these uncertain times. Equally of concern is internal political risk. States have competed in reforming. This has been good for it has led to more experimentation, with states emulating each other’s successes. But the disparities between reforming states and laggard states have increased. Hopefully the laggards will also reform and eventually catch up but in the meantime, the ensuing tensions have to be managed.

In a similar vein, some communities are better positioned to benefit from growth and the liberalized market than others. If the economic divide exacerbates existing social divides, our society will become yet more polarized. Our politicians will need all the wiles of a Kautilya to ensure that neither growth nor consensus are sacrificed.

Finally, a more immediate problem that prevents public investment: our enormous fiscal deficit is in some ways a consequence of our failure to build the necessary consensus. There are very few countries that have run such a large fiscal deficit for such a long period of time without damage. We cannot defy the laws of economics. Hard decisions have to be made about how to raise revenue and where to cut expenditures and sold to the public. After all, this is what statesmanship is about. It will be far better to draw people in to the reform process by enabling them to participate in the fruits of growth than by continuing to bribe them to stand aside with sops. The fiscal deficit, in the final analysis,
has political roots and India’s political leadership has to rise to the challenge to rid India of it.

In conclusion then, there is a sense of confidence in the country today. Confidence is good for without confidence, nothing can be achieved. But confidence must be tempered with caution for much remains to be done.

This is a Marathon, and India has just finished warming up. Others have already started the race but India is young and has fresh legs. Let us not relax too soon. We should be proud, but not satisfied, with a Rajat Gupta here or an Amartya Sen there. If India is to take its rightful place among nations, every sixth CEO of a Fortune 500 firm should be an Indian, every sixth Nobel prize winner should be an Indian and there should be food on every table in the land. It is only when that comes to pass that we can afford to pause and say with justification Mera Bharat Mahan Hai.