● SUSTAINING LONG-TERM GROWTH

LACK OF CAPACITY OF THE STATE IS NOT MERELY A MATTER OF INCOMPETENCE. IT HAS MORE TO DO WITH 'SPECIAL INTEREST GROUP' POLITICS

Need to build state capacity

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INDIA'S GROWTH PERFORMANCE, of over 6% per year for a sustained period of over 25 years, has been impressive. However, after 2008-09, there have been questions about sustaining the fast growth over the medium- and long-term. The slowdown since the March 2016 quarter has been particularly worrisome. The estimate of Gross Value Added (GVA) decelerated from 8.7% in March 2016 to 5.6% in March 2017, and the growth of GVA in the core sector (excluding agriculture and public administration) shows a sharper deceleration, from 10.7% in March 2016 to 3.8% in March 2017. Thus, the deceleration started much before the demonetisation disruption, but it was precipitated further by the latter as virtually all sectors except agriculture and public administration slowed down and the growth in the construction sector was negative.

The slowdown in the growth of the economy has not come as a surprise. Both savings and investment levels, relative to GDP, have declined steadily over 10 percentage points since 2007-08. Much of the growth has been due to the growth in private consumption and government spending; corporate investment has shown a steady decline and the investment by top-1,000 firm in 2016-17 was just about 5.8% higher than the previous year, the lowest increase in the last 25 years. Exports, too, have failed to pick up after the global financial crisis.

The reasons for the deceleration in savings, investment and growth are not far to seek. The twin balance-sheet crisis was as much due to the overconfidence of the corporate sector as it was a product of the government's policy flippancy and cronyism and poor appraisal capacity of the banking system. The corporate sector—particularly, the public-private partnership projects in roads—indulged in aggressive bidding. There was overconfidence in making large-scale investments in the power, steel and telecom sectors, too. If PPP in the roads sector suffered from the government's inability to acquire enough land in a timely manner, the controversies surrounding the discretionary allocation of spectrum and coal brought the telecom, power and steel sectors to a grinding halt. With a large volume of investments stuck and the banking system unable to recover the loans, the twin balance-sheet crisis was inevitable. Of course, poor capacity of the public sector banks in appraising loans and politicisation in lending decisions by the PSBs did not help matters. The passing of the Insolvency and Bankruptcy Code and empowering the Reserve Bank to expedite the process of restructuring are not likely to solve the problem of incentives and accountability, at least in the short- and medium-term. Curiously, no one is asking the question as to what the government and RBI nominees in the PSB boards were doing when such large-scale loans were dispensed.

The inability to provide a stable and objective policy environment points to the lack of state capacity. Therefore, creating an environment for sustained growth for a long time-period requires building of state capacity. Lack of capacity of the state is not merely a matter of incompetence. It has more to do with 'special interest group' politics and, obviously, any attempt to build capacity will be met with resistance. Capacity development has to be in all the three branches of the government—legislature, executive and judiciary. The legislature does not seem to bother about making laws to effectively govern; the executive is busy undertaking policies for winning elections and the delay in dispensing justice and piling cases point towards the ineffectiveness of the judiciary and prompts recourse to informal systems of justice. When the state is not able to provide the basic public good of ensuring safety and security of people and protect the property rights of the citizens, the issue becomes serious and the lack of capacity becomes a binding constraint on development.

The reforms after 1991 have helped unleash market forces to pivot development. Yet, the state has the responsibility of providing basic public and merit goods and to redistribute incomes. In the new environment, the state still retains the power of allocating natural resources. Furthermore, ensuring competitive market conditions requires effective regulation. In an economy where there is considerable information asymmetry and undeveloped and imperfect markets, the state has the important role of making the system transparent. The focus will have to be to creating an enabling environment though effective governance, ensuring transparency, creating and deepening markets and providing effective regulation to ensure competitive conditions. The limited resources and capacity of the government should be utilised for creating enabling conditions rather than running businesses.

> **The cronyism in lending decisions by PSBs, lack of objectivity in the allocation of natural resources like spectrum and coal and the inability to facilitate land acquisition for highways after the contract has been signed are symptoms of government-failure**

The rationale for government intervention comes in when the markets fail. What happens when the governments fail? In Indian context, the record of government failure is alarming. When life and property themselves are insecure, when justice is delayed for years and when the common people do not have access to basic education, healthcare, water supply and sanitation, where do they go? The cronyism in lending decisions by public sector financial institutions, lack of objectivity in the allocation of natural resources like spectrum and coal and the inability to facilitate land acquisition for highways after the contract has been signed are only symptoms of it. While talk on corruption and black money make a good electoral pitch, no one likes to go into the question of incentives for their generation. Subsidies and loan waivers galore are earmarked for agriculture, but the governments are not interested in making and promoting investments in storage, marketing, processing and transportation networks to stabilise prices of farm products so that the farmer does not have to indulge in distress sale to the money-lender. While the remuneration of the government employees continue to be hiked from time to time, there is no attempt to ensure accountability from them. The public sector enterprises continue to bloat and the government continues to bleed the taxpayers for meeting the losses of businesses like airlines, travel agency and hotels. The NITI Aayog has done well to make significant recommendations to cleanse the regulatory systems in health and education sectors and to get rid of many public enterprises, but the powerful vested interests continue to thwart any reform in these areas.

The point is that building state capacity is not a simple task. It is not just the inefficiency of the government that needs to be tackled. Keeping the state capacity low is a deliberate attempt by distributional coalitions to redistribute incomes and power in their favour. It is here that spreading awareness about the state failure and creation of institutions of checks and balances to minimise the damage from state failure is important. This calls for community action. Building state capacity for accelerating and sustaining growth and employment in the country is essential and unless it is done, India will continue to grow much below its potential.