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The strategy and the tactics

We need a conceptual framework for economic strategy, alongside the practical problems of building government organisations

SNAKES & LADDERS

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We now start on the next five years of economic policy. Building state capacity, where organisations diagnose problems and act in response, is required. Alongside this, a consistent intellectual framework of economic policy is required. This helps in long-term planning. State effectiveness is enhanced by rules rather than discretion, as has been seen so clearly with monetary policy. The presence of a framework improves the coherence of practical actions by unrelated arms of government. The framework improves coherence across time, establishes expectations, and reduces policy uncertainty.

Economic policy now has a five-year horizon. As was the case in 2014 and 2015, this will encourage long-range projects. The three biggest achievements of the previous period were the goods and services tax, inflation targeting, and the bankruptcy code, and all three began early. In similar fashion, a few transformative projects should kick off in 2019-20.

A key barrier that is faced in India is that of state capacity. An ideal government organisation is one that is able to perceive the world every day, understand the problems that are faced, identify root cause solutions, debate alternative solutions so as to find the lowest coercion option, and effectively implement the chosen solution. Whether it is tax policy, tax administration, food safety, air quality, or the Delhi-Mumbai Industrial Corridor, the basic challenge that is faced is that of establishing such organisational capability.

Building organisations that engage in such rational diagnosis and problem-solving is the need of the hour. Alongside this, one more thing is required: A conceptual framework of the strategy of economic policy. What is the role of the Indian state in a market economy? What is the institutional machinery that is sought to be constructed? What is the desired destination, of institutions and state intervention, which will come about over time? In the 1990s, there was clarity about what was being done. Conditions have changed considerably since then, which calls for a fresh search for a conceptual framework.

Such a conceptual framework matters in many ways. At the simplest, it establishes the long-run goals of economic policy. It guides policy planning in the many situations where the data is weak, and there is the risk of actions being excessively shaped by practical political compulsions. Going beyond these, there are three big aspects where the framework matters.

The first big idea is rules rather than discretion. This is the paradoxical idea that state effectiveness is actually enhanced by taking away day-to-day discretion. As an example, in the olden days, monetary policy was all discretion. Central banks could do as they liked, in response to a variety of political and economic considerations. Monetary policy has become more effective because central banks have tied their hands with inflation targets. Now, the Reserve Bank of India (RBI) is obliged to act in ways that deliver consumer price index (CPI) inflation of 4 per cent. Private persons know how the RBI will behave at future dates when faced with certain scenarios. The potency of monetary policy has gone up by ruling out discretionary actions.

In the field of macroeconomics and finance, the monetary policy framework is in good shape, and the task ahead lies in pouring concrete on the inflation target. In 1992-2011, there was a conceptual framework around financial markets and internationalisation. Comparable policy frameworks are now required for fiscal policy and financial policy.

The second big idea is that of coherence across a large number of government agencies. This coordination will work better when there is a shared conceptual framework.

As an example, through the 1990s, all arms of the state knew that the Indian fear of engagement with the world, of hostility to the world, was a throwback to India's post-colonial insecurities. All policy decisions, ranging from customs duty cuts to the nuclear deal, were made in a way that increased India's integration into the world economy. Actions taken by numerous elements of government were coherent because they all drew on the same conceptual framework. It would have been more complicated if each element of the state made its own tactical decisions.

The third and most valuable aspect of a consistent conceptual framework is the way it reshapes the expectations of the private sector. When private firms evaluate making the long-term commitment that is implicit in private investment, policy risk is a key concern. Establishing, and living by, a coherent conceptual framework helps reduce this risk. If state organisations have full discretion in making policy decisions in the future, then there is greater uncertainty about the future. A consistent conceptual framework brings coherence across time.

As an example, from 1991 onwards, the private sector knew that barriers to foreign direct investment and imports will only go down. There was no big bang reform, but year after year, the barriers were going to be gradually and steadily lowered, and new barriers were not going to go up. These concepts had an enormous impact upon private firms that planned for 10 years, based on the certainty that imports and foreign competitors were inexorably coming in. This was the foundation of the big productivity gains by firms from 1997 to 2004.

In similar fashion, long-term thinking in tax policy is required in order to enable the long-range investment projects of firms. If tax policy fluctuates every year, in a discretionary way, then there is greater uncertainty, and private investment is harder to plan. From this point of view, the best path for the government will be to promise, in 2019, the major contours of tax policy of the five Budgets that are coming. These commitments, about future changes in tax policy, will improve certainty for private firms and spur investment today.

To conclude, policymakers have to be pragmatic, responding to everyday problems. But alongside this, there is a need for a coherent strategy in economic policy. This requires articulating and then living by certain big ideas. This helps create coherence across space and time, and reduced policy risk.

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