WHY INDIA IS STARING AT A MIDDLE-INCOME TRAP

India needs to urgently address its underperformance after 2011. This needs more than 'single-window' approvals

Vijay Kelkar & Ajay Shah

The founding energy of liberal democracy is the pursuit of freedom, of people being masters of their own fate. REUTERS

For India, there are few things more important than our challenge of becoming rich before we become old. We know, from historical experience, that the only way out of mass poverty is to obtain modest rates of growth of per capita gross domestic product (GDP) that are sustained for many decades. As an example, if per capita GDP grows at 4% per year, there is one doubling every 18 years. Per capita GDP would then go up by eight times in 50 years, and at the end of this, we would have graduated beyond middle income.

The early rhetoric about economic development viewed an underdeveloped country as a child. Growth was inevitable. It was only a matter of putting in a few auxiliary actions which helped and enabled that process. In this world view, we run the risk of thinking that progress is inevitable, that progress involves steel mills, and we can save everyone the time and trouble by having state-run steel mills.

We now know that there is no inevitability about the rise of a country into the ranks of a prosperous democracy. There are only four countries which were poor in 1945 that are now prosperous democracies: South Korea, Taiwan, Chile and Israel. In all those countries, growth came as a result of improvements in state capability.

A prominent measure of state capability, in a globally comparable data set, is available for the 1996–2012 period. By this measure, state capability has risen in only a few countries over this period, and state capability in India declined in this period. Our institutional capacity got worse in a period of strong GDP growth. We do wrong in equating GDP growth with improvement in the foundations for GDP growth.

Based on the Indian experience, we can conjecture a mechanism through which higher GDP growth caused reduced state capacity. When bigger rupee values are at stake, private persons have more to gain by undermining state institutions. The resources that are brought to bear to attack the working of state institutions are larger when GDP is higher.

We vividly saw this in India in the period after 2005 when the country was starting to reap remarkable success by private sector firms. The prospective gains from subverting state institutions were suddenly larger and we got bigger investments into attacks on institutions. State apparatus that used to work when million-rupee bribes were offered broke down when the offers went to billions of rupees.

Perhaps India's growth of 1979–2011 was not adequately grounded in the required institutional capacity to be a prosperous liberal democracy, and perhaps this has something to do with the difficulties that have been seen after 2011.

The growth model of 1991–2011 has not carried forward into the following years. Private "under implementation" investment projects rose from ₹10 trillion in 2006 to ₹50 trillion in 2011. After that, there has been a decline in nominal terms to ₹40 trillion in mid-2019. The share of non-workers in the working-age population stands at 60.43% in April–June 2019. These statistics illustrate the difficulties that have arisen in the post-2011 period.

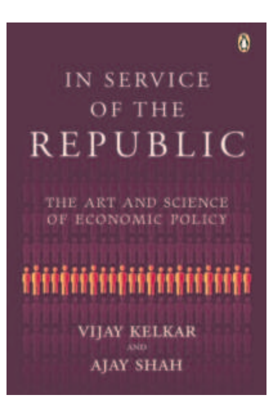
MIDDLE-INCOME TRAP

In many other countries, the phenomenon of a "middle-income trap" has been observed. At the early stages of development, the simple mobilization of labour and capital suffices to escape from abject poverty. But once the minimal market economy is in place, a different level of institutional quality is required. The maturation of firms and the government creates the need for complex contracts, contract enforcement, economic regulation, and institutions that intermediate and channel the conflicts between social groups.

When a middle-income country seeks to rise to a mature market economy, and institutional capacity is weak, growth stalls. Long years ago, we made a tryst with destiny, and we must find our way out of these dark woods. The most important question in Indian economics and policymaking today is that of diagnosing and addressing the sources of underperformance that have arisen from 2011 onward.

> The most important question in Indian economics and policymaking today is that of diagnosing and addressing the sources of underperformance that have arisen from 2011

A phenomenon of this size cannot just come about owing to some events. There is a need for a conceptual framework in understanding what happened, and then, in changing it.



Our key submission is that a lot of government intervention, and the licence-permit-inspector raj remains in place. The early dawn of economic freedom that was promised in 1991 has not evolved into a mature market economy. Private persons are beset with government intervention. The instincts of central planning are alive and well among policymakers. There is a great deal of arbitrary power in the hands of the government. Extensive interference in the economy by the government, the policy risk associated with future interventions, and the fear of how arbitrary power in the hands of the government will be used have led to a loss of confidence in the private sector.

STATE CAPACITY DEFICIT

When India was a small economy, the GDP was small, and the gains from violating rules were also relatively small. The tenfold growth in the size of the economy created new opportunities to obtain wealth. The gains from violating rules went up sharply. Large resources were brought to bear upon subverting state institutions.

The foundations of state institutions in terms of the rule of law, and checks and balances were always weak. This combination of an amplified effort by private persons to subvert institutions, coupled with low state capacity, has resulted in a decline of institutional quality.

Addressing these problems requires going to the foundations. Why do we require state intervention? Why is state capacity low? How should state organizations be constructed so as to cater to a gradual improvement of state capacity? What is the right approach to public policy when state capacity is low? These are the most important questions of Indian economics today.

Economic thinkers of the previous decades tended to focus on economics more narrowly, on issues such as the green revolution or heavy industry or trade liberalization. Now, we need to more explicitly locate ourselves in the intersection of politics and the economy. To make sustained economic growth possible, we require the republic.

The founding energy of liberal democracy is the pursuit of freedom, of people being masters of their own fate. We need to shift away from notions of a developmental state, where big initiatives originate from the government, towards a philosophy of respect for the self-organizing system that is a free society. We need to rely far more on private negotiations, private contracts and civil society solutions, rather than turning to the government to solve problems. The state should be the last resort in resolving difficulties, not the first.

Intervening in social systems is a messy business, and very often, things go wrong. The Indian landscape is littered with outcomes that are the opposite of what was intended. APMCs (agricultural produce market committees) were not intended to create entrenched power in the hands of traders. Land ceiling Acts were not intended to create shortages of real estate and high prices for real estate. Bank nationalization was not intended to hamper growth, stability and inclusion.

Every now and then, we hear proposals in India to hold state coercion intact and make life easier for private persons by setting up "single-window approval". There are two problems with this approach. First, we do not make the Gestapo nicer by setting up a pleasant front desk. Single-window systems do not solve the problem of state coercion, and the threat of raids and punishments, including possibly criminal sanctions.

Second, in the absence of deeper reform, it is hard to build single-window systems that overcome a maze of restrictions. Many or most enthusiastic announcements of single-window systems fail to work out in practice.

We must go deeper. We reform by whittling down and correcting state intervention, not putting a user interface on it. The reform required in the early 1990s was not a single-window system governing IPO (initial public offering) approvals, it was the abolition of the office of the Controller of Capital Issues. The reform required in trade liberalization was not a single-window system for import approvals, it was the removal of trade barriers. Our problem in India is inappropriate state coercion that limits cross-border activities and this is not solved by a single-window system governing approvals for cross-border activities.

> **mint SHORT STORY**
>
> **WHAT**
>
> The growth model of 1991–2011 has not carried forward into the following years. When a middle-income country seeks to rise to a mature market, and institutional capacity is weak, growth stalls.
>
> **WHY**
>
> The early dawn of economic freedom that was promised in 1991 has not evolved into a mature market economy. Private persons are beset with government intervention.
>
> **WHAT NEXT**
>
> We need to shift focus from gross domestic product growth to the state of health of state institutions. Ultimately, a complex modern economy only works when it is a self-organizing system.

A TEMPLATE FOR REFORM

But India can and must change. There are many elements through which the scope of state intervention can be reduced.

Can some of the work of regulation be pushed down to private firms? Consider the problem of regulating taxis. One possibility lies in setting up a bureaucratic machinery that engages with each taxi driver. Another pathway lies in contracting out this regulation to private taxi companies. Aggregation business models, such as Airbnb, have an incentive to utilize customer feedback and supervisory staff to improve the quality of their customer experience. In general, this is an easier path for the construction of state capacity as the number of transactions is reduced.

Does modern technology make it possible to remove the market failure? Sometimes, there are clever solutions through which a market failure can be eliminated. Consider the electromagnetic spectrum.

At first blush, we think that the use of spectrum is rival: one person communicating at a certain frequency precludes others from using it. The state is then needed in establishing property rights to spectrum. This requires creating a bureaucratic machinery which auctions spectrum and polices for violations.

However, there is an alternative methodology, which is used in cordless phones or Wi-Fi, where intelligent devices establish a self-organizing system through which the spectrum is shared. Intelligence at each device coupled with healthy protocols makes sharing of spectrum possible. Such technologies convert spectrum from rival to non-rival. Once this is feasible, the need for government control of spectrum allocation is removed. This is an attractive path, particularly under conditions of low state capacity. All that the state needs to do is to say that certain frequencies are available for unlicensed use and back this up with rules for fair play by devices as has been done by the US Federal Communications Commission.

> We need to rely far more on private negotiations, private contracts and civil society solutions. The state should be the last resort in resolving difficulties, not the first

In recent years, there has been a debate in India about the V-band and the E-band, where the department of telecommunications has a choice between making it unlicensed spectrum or auctioning it off to private persons. We would favour the former: a non-state solution is generally superior, particularly under conditions of low state capacity.

Do traditional community solutions work well? Nobel Prize-winning economist Elinor Ostrom has reminded us of the remarkable outcomes through some traditional community arrangements. Those wielding state power should respect the possibilities for purely decentralized solutions that allocate common goods without requiring a bureaucratic apparatus to spring up.

Do we have the state capacity? There are many elements of market failure which are legitimate areas for state intervention, and such state intervention is being done in mature market economies. But in India, we have much less state capacity, so certain areas of work are outside our budget constraint and should be dropped.

Ultimately, a complex modern economy only works when it is a self-organizing system. It has to have the creative efforts of a large number of individuals.

Building the republic, then, is about the policy institutions which shape the incentives of each person and help intermediate the interactions between individuals. Building these institutions is a slow and complex problem. In the short run, it is always possible to obtain GDP growth without solving these deeper problems. We would all do well to shift focus from the numbers for GDP growth to focusing on the state of health of state institutions.

The only way to run the 50-year marathon is through building institutions. Sustained improvement in institutional quality is hard, but it is the only way to obtain sustained GDP growth.

Extracted with permission from In Service of the Republic: The Art and Science of Economic Policy, *by Vijay Kelkar and Ajay Shah.*

Vijay Kelkar is chairman and Ajay Shah is professor at the National Institute of Public Finance and Policy.