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India: Democracy and Economic Growth

by Ila Patnaik

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Introduction

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Unlike a cross-country or cross-state study of growth and democracy, this paper does not try to establish an econometric relationship between growth rates and electoral performance. Through discussion of whether democracy in India has hampered economic growth, it is argued that Indian democracy has matured, and that the relationship between the electorate, various stakeholders, and their elected representatives who form the government, has changed.

In the early stages of Indian democracy, a command and control economy was acceptable to the population that was still learning self-governance. The Indian economy witnessed low growth in those years. Direct control, such as through public-sector enterprises, public ownership of banks, price controls, and industrial and import licensing were the main means which could enrich any interest group. However, that resource-allocation became increasingly inefficient and growth fell, as the benefits of control and the opportunities available to the political class to gain rents also fell.

The dissatisfaction with the model, along with a changing world environment, resulted in a change to a market-based economy with an unwavering emphasis on growth. The share of power and the benefits of growth gained by different interest groups in India vary depending on the party in power. However, there appears to be an implicit understanding that no party can satisfy its supporters without growing the economy, as only growth gives politicians the capacity to serve the interest group they represent. The idea that wealth is increased through overall growth, rather than a group increasing their share of the wealth, seems to be an enduring theme.

This paper shows the lack of emphasis on growth when India was a young democracy and how through the years, the maturing of democracy has ushered in growth. Yet, the focus on public goods, health and education, better governance, and more transparency and less discretion in decision making by the government is new. These themes are expected to be the next focus surrounding Indian democracy, as they lay the foundation for the complex interaction between democracy and growth in the years to come.

In the 66 years since independence was established, India has had a reasonably good record of maintaining and expanding political freedoms. With the exception of the Emergency imposed for a period of less than two years in the mid-1970s, the country has been governed by legitimately elected representatives and governments. This is something to celebrate, for it is as rare as it is essential. India's record on economic development is far less satisfying. For decades after independence, it was very difficult to start, run, and close businesses without dealing with labyrinthine procedures in the bureaucracy, and making informal payments to the powerful. Though economic policies in India have undergone major shifts since independence was estanlished, economic freedoms are still quite constrained. For the most part, economic growth has been sluggish. The country's per-capita income remains among the lowest in the world, especially when compared with other countries that were at a similar level of prosperity about half a century ago.

Growth requires certain factors to be in place before it can occur. A key source of growth is the existence and functioning of good institutions. The productivity of an economy is influenced by the environment in which it operates. An important part of this environment is the legal and regulatory framework provided by the state. If this environment is excessively restrictive, or not based on the rule of law, productivity will suffer. The market for each factor of productivity develops within the institutional framework provided by the state. For example, the quality of human capital is an important determinant of economic growth for a country such as India. If the state's policy hampers improvements in human capital, it will show in poor levels of economic growth. Even if high quality human capital is available, labour laws and regulations must enable efficient allocation of this capital; the state lays the foundations for growth.

Based on this assessment of the role of the state in enabling or hampering growth, it is puzzling that, in spite of low growth for most of the years since independence was established, the democratic process has not done much to correct the state's approach to economic policy; it is clear that the economic policy has not served the interests of most people. Prior to the reforms of the last two decades, the economy was in a far worse state, yet little was done to put things in order. This calls for an understanding of the ways in which democracy affects economic growth, not generally but in the context of the way democracy is practised in India, and highlights that there are significant illustrations of the disconnection between policies and the needs of the people.

A Brief History of the Interface Between the State and the Economy

After 1947, there was initially much confidence in India's ability to reinvent itself and reach global frontiers. Attempts at accelerating growth were superimposed on the existing economic structure. That period, instead, led to a derailment of growth through a sprawling scale of government interference in the economy, where the state ended up running hotels and airlines, selling liquor, making bread, and granting land and industrial licences.

India came to be a state-led economy mostly by chance. The Indian National Congress was the only viable party to have a chance of getting elected after independence; most of the freedom fighters and leaders were in that party. When people voted for the party they did so for a whole host reasons, including the party's role in the struggle for freedom, and the party's economic policies were perhaps a minor consideration for the electorate.

From the first elections in 1952 until 1977, Indian National Congress was in power in the central government. It had an absolute majority in parliament. The economic thinking of the party could easily be translated to law and then implemented through the executive branch, with almost no opposition. Most of the leaders of the party were committed to a state-led model of economic development, wherein rapid industrialisation was brought about by the state. It was styled on the Soviet model, and it had negative consequences for economic growth. Soon, the country collapsed into the 'Hindu' rate of growth at 3.5 percent. In this period, per-capita GDP growth was 1.5 percent, a rate that would have given India a doubling of per-capita GDP every 45 years, taking many centuries to catch up with the West. During the 1950s and 1960s, India was not unusual in adopting statism; it was a norm and not an exception during those decades. However, by the late 1960s, India was a member of an ever shrinking club. At that time, several countries in Asia were adopting an export-led growth model, but India failed to follow this pattern.

By the late 1960s, it was clear that the state-led approach was not yielding the desired results, except for rent-seekers and their beneficiaries. A reasonable response would have been a shift towards a more liberal economic policy, a path that seemed obvious but which India failed to take, leading to economic policy that became even more statist in the period between 1969 and 1977. The main explanation for this can be found in electoral strategy, rather than sound economics. The first time a credible opposition to statist economic policies took shape was in the 1967 national elections, when the parties that won the second and the third largest number of seats in parliament were committed to reversing the existing model, in favour of greater economic freedom. The Swatantra Party and the Bharatiya Jan Sangh party, both on the economic right, together won 80 seats in the lower house (Lok Sabha), which was around 15 percent of the house. In that election, the Indian National Congress (INC) won a slender majority.

The low number of seats secured by the INC at the 1967 elections and rise in the number of parties with substantially different economic ideologies saw the INC steer further towards the left. The party was looking to marginalise the forces supporting a private sector led approach to growth. It ran the 1971 election campaign on a catchy 'Gareebi Hatao' ('Eliminate Poverty') stance, promising that that the state would take direct measures to help the poor and eliminate poverty. On the back of this strategy, and victory in a recent war, the INC retained power in 1971 with a landslide victory, winning more than 60 percent of seats. Ironically, the political emergence of the opposite economic model may actually have led to an even more statist model of economic development, just at the time when countries geographically close to India were radically changing their growth models and benefiting from these changes. The expansion of statist economic policies which had started before the elections continued and intensified.

THE SPRINT TO STATISM: 1969–1977

Economic policy of the 1969–1977 period consisted of enormous powers being usurped by the state. From 1969, India witnessed an unprecedented increase in state control of the economy, as economic enterprise and private initiative were sharply restricted. Many of the policies of the period are still in place.

In 1969, the policy of explicitly reserving certain items for production by small companies was created. Indian industry lost out enormously because of an inability to harness economies of scale, but consumers were the biggest losers. India missed out on the enormous rise in exports of labour-intensive items, which was instead harnessed by East Asia.

The most striking move by Indira Gandhi, before the declaration of the Emergency, was a midnight ordinance in July 1969. In one stroke, the ordinance gave the government control over a big chunk of the savings of the Indian people. On July 19, 1969, India woke up to headlines that the country's major private sector banks had been nationalised, a monumental loss of economic freedom.

To offer nationalised banks protection from competition, foreign banks were prevented from coming in. Indeed, not just foreign banks but foreign money was not welcome. Under the Foreign Exchange Regulation Act (FERA) of 1973, draconian currency controls and restrictions on foreign investment were imposed in 1973. While FERA has been replaced by a supposedly more liberal Foreign Exchange Management Act (FEMA), the mentality of controls exists in FEMA as well.

Central planning logic also went into other areas. For example, on February 17, 1976, the Urban Land Ceiling Act was passed. It covered 73 towns and cities and imposed a ceiling of 500 to 2000 square metres on urban land holdings and constitutes a major distortion of the urban land market. While this was a state-level matter, the Constitution allows parliament to pass a bill if more than two states agree, and this path was chosen during the Emergency. Another law that gave disproportionate powers to the government was the Monopolies and Restrictive Trade Practices

(MRTP) Act, which became an act and came into force from June 1, 1970. The MRTP Act, which gave huge powers to the government, sought to limit the expansion of large industrial houses with assets over Rs.10 million in businesses with a share in the market exceeding 33 percent. The MRTP Act remained in place even after liberalisation until 2002 when it was replaced by the Competition Act.

By the 1970s, the strange logic of state control was fully in place. While on one hand there was a policy that industries should be small, if there was a large industry that wished to become small, the Industrial Disputes Act (IDA) was passed to prevent it. Until then, factories with over 1000 workers used to require government permission for layoffs. The size threshold was amended in 1976 to 300. In 1982, when Indira Gandhi was back in power, this was further reduced to 100. Chapter V-B was introduced into the IDA in 1976. The provisions Chapter V-B/Sections 25-K, 25-L, 25-M, 25-N, and 25-0 apply to industrial establishments that require prior permission from the government before layoffs, retrenchment, and closure. Most problems connected with the IDA arise from Chapter V-B, since the government becomes a third party to the dispute even if the employee is satisfied with the severance package. These sections of the Act need to be considered along with Section 2-A, which makes any dispute between an employer and an individual workman an industrial dispute, regardless of the fact that no other workman nor any trade union is a party to the dispute. Even today, this requirement is still in place for many industrial establishments.

In this period, there was an effort to grab power and make India into a communist-style state. While there was uproar among politicians, judiciary, and media, whose freedoms were denied, no such uproar took place on the loss of economic freedom. The damage in the political sphere was reversed, but the economic sphere is yet to fully recover from the onslaught of this power grab by the state. The instruments of democracy worked well to restore political freedoms, but they did not do much for economic freedoms. There was no rallying cry for restoring private ownership of the nationalised banks, or to take the industrial restrictions to the level they were at before the draconian steps were taken. The decade of the 1970s saw the lowest average annual GDP growth rate in independent India: 3.2 percent. The Constitution was amended to call India a socialist republic, and that name stands today.

REFORMS

India learned from its mistakes, and from the 1980s onwards, policy reforms started falling into place, first focused on the domestic economy and then increasingly breaking away from autarky. Though some reform measures were introduced during the 1980s, the real thrust towards economic reforms began in 1991. The 1991 reforms continue today and were underpinned by major shifts in economic policy that recognised:

- The role of the private sector in generating economic growth,
- The role of competition in increasing efficiency,

- The importance of international trade and foreign investment in improving productivity,
- The need to focus the state's resources towards regulatory and policymaking functions that are motivated by market failures,
- The fact that state agencies may not always work in the best interests of the people; there is a need to design accountability mechanisms to ensure their performance.

Politically, the 1991 reforms were brought about by an unlikely government. The Congress party, under the leadership of P. V. Narasimha Rao, had minority seats in parliament with tentative outside support of other parties.

The main trigger for the crisis was the balance of payments crisis that pushed the government into a corner. Reforms as response to the crisis were not unexpected, but the continuation of the response was surprising. Once the crisis abated, the government could have returned to the previous policy, but the reforms persisted. During the 1990s, two coalition governments—the left-of-centre United Democratic Front (UDF) government and the right-of-centre National Democratic Alliance (NDA)—continued the reforms. Both had come to power on anti-liberalisation planks.

This persistence of reforms can only be explained by the fact that after the 1991 reforms there was some consensus about the reforms among a majority of the governing elites. Parts of the existing interest groups perhaps saw that the reforms may actually help them expand their scope, and new interest groups began to take shape. In a democratic context, it is surprising how little effort was made to build consensus for reforms at the grassroots; there were no large scale communication campaigns to convince people of the merits of economic reforms. Still, 'reform' became a good word in the Indian political lexicon, and even words such as 'liberalisation', 'privatisation', and 'globalisation' gained currency.

The 1991 reforms yielded quick results in terms of higher growth, marking a watershed event in India's history, and the markets responded with stupendous gains in enterprise valuations. Within a year, the stock index doubled in value, summarising the expected increase in business cash flows. An investment boom came and gave a surge in GDP growth.

Compared to pre-1991 India, the legal and regulatory environment for the economy is now much more liberalised:

- *Industrial policy:* The system requiring government permission for new investments and for substantial expansion of capacity has been abolished. Very few industries are exclusive to the public sector.
- *Capital controls:* Both inbound and outbound capital flows have been liberalised and have increased manifold.

- *Trade:* The import control system for inputs into production and capital goods has been discontinued for most industries. Custom duties and tariffs have been radically lowered.
- *Exchange rate:* The Rupee is now on a floating exchange rate.
- *Taxation:* Marginal tax rates on individuals and firms, as well as customs and excise duties, have been reduced significantly.
- *Finance:* Competition has transformed the solutions available in banking, insurance, and investments. Equity markets have undergone a veritable revolution.
- *Public sector:* The government has divested shares in some public-sector undertakings, privatised some such undertakings or some of their functions, and improved transparency and accountability by listing many public sector firms.

In some areas, new institution building has taken place that has created new state capacity, and improved the state-to-firm interface:

- In the financial system of 1991, separate regulatory agencies have been set up for different sectors. Some world-class infrastructure institutions (e.g., stock exchanges and clearing houses), especially in the equity market, have emerged.
- There has been a rapid advent of public-private partnerships. In some sectors, this has come with the establishment of independent regulators to regulate and supervise markets.
- The Right to Information Act, 2005, with its accompanying institutional framework, has improved transparency of the Indian state.
- The major market failures are rooted in asymmetric information, externalities, and monopoly power. The Competition Commission of India constitutes a sector-agnostic agency which works on monopoly power.

The post-1991 reforms yielded high GDP growth, but this period also shifted the debate on the economic policy in India. There has been much discussion on the impact of the economic policy on poverty and inequality.

High GDP growth in India since the reforms has often been accused of being growth without a reduction in poverty. There have been two main arguments in this debate. The first relies on a measure of poverty, using data for poverty lines, and the second relies on consumption data. This debate is largely inconclusive due to measurement problems. The poverty rate dropped from 65 percent in 1990 to 35 percent in 2010, and the per capita income almost quadrupled. About 200 million Indians have been lifted out of poverty in this period.

Data from the Third National Family Health Survey (NFHS-3) shows that according to many important health indicators that measure the quality of life, such as infant mortality, there have been marked improvements over the last few years. A study based on the survey data from NFHS-3 reports preliminary findings from the five states of Punjab, Gujarat, Orissa, Maharashtra, and Chattisgarh to compare to the previous survey in 1998–99. The percentage of infants dying before they attain the age of one has dropped significantly over the last seven years in all five states. It has reduced in by 26 percent in Punjab, by 21 percent in Gujarat, and by 20 percent in Orissa. When compared to the data from NFHS-1, carried out in 1992–93, Orissa, one of the poorest states in India in terms of per-capita income, has witnessed a decline in infant mortality of 40 percent.

An improvement in an indicator such as infant mortality is a reflection of an improvement in a large number of factors. These include income, drinking water, sanitation, education of women, and health services. Often, no single indicator can be identified as the reason behind the improvement in infant mortality. This also means that it can often not be 'rigged'; a decline in infant mortality cannot be engineered by simply improving one factor. It is, therefore, considered to be a better indicator of the quality of life compared with any other single measure.

Put simply, progress can be attributed to two areas of improvement. On one hand, sheer GDP growth makes people richer, and generates improvements through increased ability to buy better food, nutrition, and education. On the other hand, public health services that provide better facilities to people can improve health outcomes. In principle, both these factors could be at work in India, but in reality, as discussed earlier, the health system outcomes are not getting better. This suggests that the real story in the improvement in health in India, as the case has been in historically rich countries, might be sheer growth of income.

There is also some anecdotal evidence suggesting that the growth of the market economy has ushered in a reduction in caste and social inequality with an impact more fundamental and far reaching than the changes in average income or expenditure patterns. A recent paper presents results from a study of Dalits[1] in two blocks of Uttar Pradesh—one in the Azamgarh district in East Uttar Pradesh and one in the Bulandshahar district in West Uttar Pradesh.[2]

The study found that there have been major changes in the grooming, eating, and ceremonial consumption patterns of Dalits, signalling their higher social status by adopting higher status consumption patterns. Change in grooming and in dress is seen as an assertion of social aspirations. The study found massive shifts in the use of the three particular personal grooming products and also showed shifts in the eating habits among Dalits as some foods with low social markers, which were the community's main sources of calories, have practically disappeared while new items—spices and vegetables in particular—have appeared. Tomatoes and packaged salt were uncommon in the diets of Dalits in 1990 and are now regular consumption items.

Respondents reported changes in the accepted behaviours between castes, with rapid erosion in discriminatory processes that stigmatised Dalits. Dalits are less likely to be seated separately at weddings; they no longer are expected to handle the dead animals of other castes; there is a noticeable increase in births in Dalit households that are attended by non-Dalit midwives; and non- Dalits increasingly accept hospitality in Dalit homes. None of these practices were common in 1990.

There have been large shifts in the pattern of economic life in Dalit communities both away from and within villages. In particular, there has been a considerable increase in migration to distant cities for work, with nearly half of Dalit households now having a member working in a city. In villages, Dalits are now employed as tailors, masons, and drivers and own businesses such as grocery stores. Agricultural relations have changed such that almost no Dalits participate in bonded economic ties and fewer Dalits work as agricultural labourers on upper caste lands. Dalits now are much more likely to contract in factors from high caste groups (e.g., tractors and land) than sell their labour to them.

The Continuing Difficulty of Business in India

While much changed after 1991, the empirical facts about the difficulties faced by firms in India are a sobering reminder of the journey that remains. These facts become more disheartening when juxtaposed with comparable indicators from other countries. Though the post-reform era is remarkable when compared to pre-reform era India, not enough has been done.

Compared to most of the world, India is still not an easy place to setup businesses, employ workers, and produce. It does not enjoy sufficient economic freedoms. These gaps are visible when India is compared with the leading industrialised countries of the world, such as Canada or Australia (which are now experiencing a wave of investment by Indian firms) and also when India is compared with top-quartile emerging markets (in direct competition with India for attracting investment by global firms).

Where does India stand: international comparisons

India's rank on global indices of doing business has been consistently low. The World Bank's Doing Business Report (2013) places India at rank 132 out of 185. From the ten indicators the report looks at, India's rank is particularly bad when it comes to enforcing contracts (rank 184 out of 185), dealing with construction permits (182 out of 185), starting a business (173 out of 185), paying taxes (152 out of 185), trading across borders (127 out of 185), resolving insolvency (116 out of 185), and accessing electricity (105 out of 185).

Even if India is compared with other emerging market economies, which would reflect the perspective of global firms, India's rank is 21 out of 24. As shown in Tables 1 and 2, India is in the bottom quartile on half of the factors considered, with egregiously poor ranks in enforcing contracts, dealing with construction permits, and starting a business.

A time-series perspective shows an inadequate pace of change. For example, in spite of significant progress in reducing the number of days it takes to start a business (from 87 days in 2004 to 29 days in 2013), India is still languishing at the bottom of the world on this measure. India may be doing a lot, but others are doing more.

While the Doing Business Report captures some ground-level indicators on how firms interact with the state, there are other rankings and indices that compare countries on the basis of underlying factors. The 'Index of Economic Freedom' is an annual index and ranking created by the Heritage Foundation and the Wall Street Journal. The index is based on ten factors of economic freedom: business freedom, trade freedom, monetary freedom, government size/spending, fiscal freedom, property rights, investment freedom, financial freedom, freedom from corruption, and labour freedom. India ranks 119 out of 177 economies.

The report points at a few key impediments to economic freedoms in India, most of which are due to institutional shortcomings that undermine the foundations for long-term economic development. The report states that in the absence of a well-functioning legal and regulatory framework, corruption throughout the economy is becoming a more serious drag on the emergence of a more dynamic private sector.

Finally, the World Economic Forum's Global Competitiveness Index ranks countries on the basis of the competitive advantages they offer to firms doing business there. It looks at institutions, policies, and factors that set the sustainable current and medium-term levels of economic prosperity. India ranks 59th (out of 144 economies) on the Global Competitiveness Index.

TABLE 1

SOURCE: DOING BUSINESS 2013, THE WORLD BANK.

RANK	STARTING BUSINESS		GETTING ELECTRICITY	REGISTERING PROPERTY	GETTING CREDIT
1	Chile Mexico	Thailand	Thailand	Lithuania	Malaysia
2	Estonia	Estonia	Malaysia	Estonia	South Africa
3	Ukraine	Mexico	Chile	Peru	Latvia
4	Hungary	South Africa	Estonia	Thailand	Poland
5	South Africa	Lithuania	Philippines	Latvia	Romania
6	Malaysia	Hungary	Brazil	Malaysia	Peru
7	Bulgaria	Indonesia	Turkey	Turkey	Ukraine
8	Latvia	Chile	Argentina	Hungary	**India**
9	Peru	Peru	Lithuania	China	Estonia
10	Romania	Malaysia	Peru	Russia	Mexico
11	Turkey	Philippines	Latvia **India**	Chile	Bulgaria
12	Thailand	Pakistan	Hungary	Poland	Lithuania
13	Pakistan	Venezuela	China	Bulgaria	Chile
14	Russia	Latvia	Bulgaria	Romania	Hungary
15	Lithuania	Bulgaria	Mexico	South Africa	Thailand
16	Brazil	Romania	Poland	Venezuela	China
17	Poland	Brazil	Indonesia	**India**	Pakistan

18	China	Turkey	South Africa	Indonesia	Argentina
19	Venezuela	Poland	Venezuela	Brazil	Turkey
20	Argentina	Argentina	Ukraine	Philippines	Russia
21	Philippines	Russia	Romania	Pakistan	Brazil
22	Indonesia	China	Pakistan	Argentina	Philippines
23	**India**	**India**	Russia	Mexico	Indonesia
24		Ukraine		Ukraine	Venezuela

TABLE 2

DOING BUSINESS 2013, THE WORLD BANK.

RANK	INVESTOR PROTECTION	PAYING TAXES	INTERNATIONAL TRADE	ENFORCING CONTRACTS	RESOLVING INSOLVENCY
1	Malaysia	Malaysia	Estonia	Russia	Mexico
2	South Africa	South Africa	Malaysia	Lithuania	Latvia
3	Thailand	Chile	Latvia	Hungary	Poland
4	Peru	Estonia	Thailand	China	Lithuania
5	Chile	Latvia	Lithuania	Thailand	Malaysia
6	Pakistan	Lithuania	Indonesia	Latvia	Russia
7	Mexico	Russia	Chile	Estonia	Thailand
8	Poland	Turkey	Poland	Malaysia	Hungary
9	Bulgaria	Peru	Philippines	Turkey	Estonia
10	Romania	Bulgaria	Peru	Ukraine	Pakistan
11	Indonesia	Thailand	Mexico	Argentina	China
12	**India**	Mexico	China	Poland	South Africa
13	Estonia	Poland	Romania	Romania	Bulgaria
14	Latvia	Hungary	Hungary	Chile	Argentina
15	Lithuania	China	Turkey	Mexico	Chile
16	Turkey	Indonesia	Pakistan	Venezuela	Romania
17	Brazil	Romania	Bulgaria	South Africa	Peru
18	China	Philippines	South Africa	Bulgaria	**India**
19	Russia	Argentina	Brazil	Philippines	Turkey
20	Argentina	**India**	**India**	Peru	Brazil
21	Ukraine	Brazil	Argentina	Brazil	Indonesia
22	Hungary	Pakistan	Ukraine	Indonesia	Ukraine
23	Philippines	Ukraine	Russia	Pakistan	Venezuela
24	Venezuela	Venezuela	Venezuela	**India**	Philippines

ADVERSE EFFECTS OF HOW THE STATE AND FIRMS CURRENTLY INTERFACE

- *Investment suffers.* From the viewpoint of firms, the present configuration in India is seen as being inimical to firm formation and firm expansion. Investment projects take a long time to execute. There is substantial legal risk—a firm may discover problems in its dealings with the state many years after a business strategy was adopted.
- *Micro, small, and medium enterprises suffer the most.* The scores and rankings on doing business, economic freedom, and competitiveness do not show the disaggregated picture, based on firm-types, stakeholders, and regions. It is likely that the micro, small, and medium enterprises pay much more for the problems of poor legal and regulatory framework. For example, the high costs of starting a business disproportionately hurt the competitiveness of smaller firms, because the per-unit costs go up for them than they do for big firms.
- *Consumers and competition suffer.* In the public discourse, there is much focus upon the implications of these constraints for job creation. However, in addition, this is also hampering the interests of consumers by reducing entry in markets. Entry is reduced, which increases the profits of incumbents. This harms the interests of consumers by elevating prices and reducing choice.
- GDP growth suffers. Competition spurs firms towards greater efficiency, to the extent that the force of entry is weakened, and this reduces incentives for reallocating factors of production and improving knowledge in firms, which undermines the mainspring of GDP growth.
- *Poor people and poor regions suffer the most.* Addressing the problems of poverty traps in India is critically about creating jobs. In the long run, India's backward regions will emerge only through job creation. For this to take place, the environment faced by firms needs to be supportive of investment, through which the process of 'equalising differences' of the market economy would work, where firms are attracted by low prices of factors of production.

Why has the State-to-firm interface not delivered?

At first glance, the problem appears to lie in malfunctioning government agencies. However, the behaviour of these agencies is ultimately determined by laws and regulations that govern them. As an example, the Motor Vehicles Act explicitly gives preference to state transport undertakings over private parties if both have applied to ply as stage carriages on a route. The Agricultural Produce Marketing Committee (APMC) Act is the source of many distortions. The behaviour of front-line civil servants who deal with firms is ultimately shaped by the accountability mechanisms built into law.

To understand the root causes of these inefficiencies, the power and the limits of most of the post-1991 economic reforms must be acknowledged. These economic reforms were certainly built on sound intellectual grounds, but on weak legal foundations. The government willed its ways to reforms, and many reforms were pushed through. However, with a crisis at hand and subsequent pressing concerns of nation building, the project remained incomplete. The legal and operational foundations of these reforms remained weak. Policy freedoms were granted, but without commensurate reform of laws and deeper redesign of government agencies. As an example, a few banking licences were given out, which yielded the benefits of entry in banking and a few good private banks, but the deeper modifications to banking law and to RBI were not undertaken.

This patchwork quilt of stroke-of-the-pen, first-generation policy reforms have been extremely successful in many respects: the Indian economy has gone from a GDP of US$ 0.2 trillion to a GDP of US$ 2 trillion. At the same time, there is increasing tension between the state-to-firm interface requirements of a US$ 2 trillion GDP and ill-equipped public institutions, some operating under laws written in the early twentieth century.

In the hands of good individuals, good outcomes can arise, even without good institutions. However, there is then considerable risk that derives from staffing changes. The identities of the prime minister, minister of finance, the Reserve Bank of India governor, and other key people, matter greatly, given the weaknesses of the institutional arrangements. Even though India has seen many economic reforms, the spirit of its laws and the design of institutions implementing the laws are rooted in the pre-1991 era. This generates acute risk in the appointments process, which ultimately translates to macro-economic risk and investment risk as seen by firms (the economic policy climate can deteriorate dramatically owing to a few wrong appointments).

Digging deeper, it is clear that even the greatest success stories of the last 20 years contain arbitrariness of process, a small group of individuals leading the charge, and weaknesses in public administration. Reformers were, too often, focused on achieving a desired outcome and not adequately focused on establishing sound processes of public administration including legal system reform and the rule of law.

Weaknesses in process in the reforms experience are found in numerous areas. As an example, though the private sector was given a larger role in the economy, decisions about which firms get permissions and natural resources have been taken in ways that are not widely perceived to be transparent or fair. In the recent years, India has experienced some negative consequences of this approach. While the narrative often emphasises private firms as being the culprits, it is important to also see this as a problem of risk faced in investment. The firms that benefited from the combinations of policy reforms and allocation of resources and permissions without due process have had to face problems due to the emergence of a sceptical citizenry, an agitated judiciary, a watchful media, and an activist apex audit institution.

The Current Slowdown

There are two elements to the present slowdown: a cyclical factor that has been exacerbated by pro-cyclical fiscal and monetary policies, and structural issues. This emphasises two key points. First, India does not have a framework for counter-cyclical macrostablisation policy, nor does it have a monetary policy law or an adequate fiscal responsibility framework. Second, there are various structural and institutional constraints that have arisen; the institutional framework required for a fast growing modern economy, such as regulation of infrastructure, finance, transparent, and non-discretionary mechanisms allocation of resources by the state, environmental standards, and land zoning need to be put in place. In the absence of these, crony-capitalism, corruption, discretion, and political favours prevail. As countries grow richer these trade-offs pose problems and need to be addressed. The pressures placed on India by democracy have highlighted the trade-offs more than in countries like China, where the media and judiciary may not be as pro-active.

STRUCTURAL CONSTRAINTS

Indian growth has slowed down sharply in recent years. The main source of the slowdown is the sharp fall in investment, due to issues of government policy and implementation. In addition, India faces challenges from corruption, cronyism, red-tape, and lack of a healthy and educated workforce. On the positive side, India has an independent judiciary, vigilant and free media, free and fair elections, and a constitution. While some people attribute the slowdown in growth to India's democracy, many others continue to see democracy as India's strength, rather than its weakness.

The India story is increasingly troubling. While economic reforms unleashed economic growth, it now appears that growth is at risk owing to the lack of institutional reforms that should have accompanied the rapid growth seen in the 2000s. Legal, regulatory, and governance reforms have not kept up with the spurts of growth during the last generation of reforms.

To match the per-capita growth of advanced economies, India's per-capita GDP would need to grow by at least at six percent. This would give a doubling in per capita GDP every 11 years, meaning that if this rate kept up for 55 years, per-capita income would increase by 32 times, and India would be a developed country. A handful of countries have achieved prosperity in a very short time and, in the years of fast growth during the 2000s, this seemed possible.

However, a large number of countries have seen a sharp rise in growth immediately after globalising and then later collapsed into stagnation. After 2002, when growth rates rapidly rose, India perhaps became overconfident. Many issues were neglected due to the claim that the growth rate was eight percent or more. One often repeated argument is that India has an economy better than, for example, the US, because

India achieves eight percent growth while the US achieves two percent. In the 1970s, India was at one extreme, a time when many believed that it would take hundreds of years of fundamental transformation in order for India to become an advanced country. In the last few years, there has been a shift to another extreme, with many believing that within half a century India would become an advanced country, despite gross neglect of the human and institutional elements that make an advanced country.

Currently, there is reappraisal of the difficulty of attaining high and sustained growth, with an appreciation that sustained high growth will require a transformation of human and institutional foundations of the country, something that has not occurred over the last few years. Many commentators blame the slow and consensual democratic process that is required for institutional change, or attribute it to the rent-seeking and vote-gathering nature of politicians. However, India has a history of politicians being able to find ways to continue with reforms, yet at the present moment it seems to be more difficult than ever before.

In economic reforms, India has never got beyond a few incremental changes, affecting 'reform by stealth' while leaving existing laws and institutions un-touched. This has led to the juxtaposition of archaic rules riddled with special exceptions, and government agencies that lack clear purpose and accountability. There is little sign that parliament will attempt to redress these lacking areas and radically restructure government agencies, which would be necessary to achieve good quality public administration. Clarity of purpose, strong accountability, and the internal processes are all required if improved performance is to be achieved.

That India has thus far avoided staunch changes to law, government processes, and institutions is a concern—high economic growth creates a sharp requirement for precisely this. In the West, doublings of GDP have taken place every 25 years and, roughly speaking, they have coincided with re-organisation of government in each generation. In India, with GDP doubling every decade, an even more rapid transformation of the state is required. There is a particularly troubling mismatch between India's inability to achieve institutional change and the high GDP growth that demands rapid institutional change. This gap has created a sharp gap between existing state structures and those needed in order to sustain growth.

Instead of strengthening the existing institutions through increased transparency and accountability in the executive and the judiciary, shortcuts to better governance are being sought through the Supreme Court and by creating watchdogs. This approach is problematic; if the huge tax administration machinery does not focus on improving tax administration, it is difficult for a specially created body to address the issue to improve the system; if instead of strengthening the capacity of the judiciary to improve law enforcement an additional institution is created to do the job, the judiciary does not improve. Assuming that the solutions being offered are good and workable, even if they appear to be shortcuts to better governance, they will not solve the long-term problems stemming from India's lack of a well-functioning executive and judiciary.

Despite these problems, India has managed to show an impressive growth performance for a number of years: starting from the bottom, very modest changes can unleash substantial improvement. Whether this growth is sustainable is another matter.

THE REFORM AGENDA

Removing restrictions on entrepreneurs and connecting to globalisation in an economy with centuries of experience with trade, commerce, and cross-border business saw economic activity revive across millions of firms. Still, much remains to be done in order to disentangle the many laws and government agencies that interfere in the smooth running of the economy. The market economy involves a major role to be played by the government.

One issue is that of public goods. Every firm requires the same underlying infrastructure: safety of life and property, contract enforcement, and a sound judiciary. India is failing on all three counts. Basic public goods require a pro-active approach by the government to build systems, implement procedures, and develop staff agencies. India's long socialist detour took the focus of top leadership away from core issues of law and order and courts. Instead, the political class has been focused on building and running welfare programmes.

An aspect of the economy that has appeared untainted by corruption is the tradable sector. Here, every firm in operation is competing with global providers, meaning that each firm is likely to export, otherwise it cannot challenge global competition. These firms function in a globally competitive environment, but they still must rely on government to provide public goods. India's failures in the basic task of government—law, order, and judiciary—are hindering the market economy in otherwise simple areas, and this leads to problems with the export of Business Process Outsourcing (BPO) exports. Similarly, India's ability to increase export earnings and generate employment for low-skill workers has been hobbled by its labour laws.

A particularly troublesome area of the economy is fields with a government interface, for example land and mining, regulated industries such as infrastructure and finance, and fields such as health and education, where there is extensive interference by the government. As Indian GDP has grown, the stakes in these fields have amplified. Global competition does not act as a check that regulates the sector, as is the case with the tradable sector.

To some extent, this problem can be diminished by deregulation. However, there will always remain a large swathe of the economy which is affected by strong government interface. Alongside the deregulation agenda, then, is the positive agenda of constructing sophisticated institutions. As an example, the securities regulator, the Securities and Exchange Board of India (SEBI) needs to have top quality legal foundations; the recruitment process that chooses the leadership team of 20 key people at SEBI needs to be of the highest standard; SEBI needs the ability to honestly investigate wrong-doing and write tough orders that have the ability to punish those who abuse their power. Across the board in the Indian state, such capable institutions are currently lacking.

The contrast between India's performance on growth and India's performance on the quality of institutions is striking. India ranks among the fastest-growing countries in the world. Yet the Transparency International Corruption Perception Index ranks India at 87, between Malawi and Djibouti. In the past, it was felt that mere deregulation was enough to deliver rapid growth, without paying attention to institutional quality.

India's institutional failings are now visibly hitting its growth. However, political consensus to bring about fundamental change in the role of the state in a way that would reduce rents for the political classes is not achieved easily. It would entail dismantling the existing systems, and replacing them with newer, more accountable, and transparent systems. Many people with vested interests would be affected, and many of those people would be so powerful that it would be difficult to overcome their opposition. One difficult but durable way of achieving change is to create consensus around redefining the role of the state and the markets, and restructuring the interface between them. This would be unlike the reform pathways India has pursued until now, where reforms were introduced and people had to then accept them. The next generation of reforms will have to be more broad-based.

Certain recent trends create reasons for hope for such a strategy. The persistence of corruption and inefficiencies has given credence to the opinion commonly held that the present way of doing things is just not working. This is an opportunity to make a case for the rule of law. Many people accept that the arbitrary and discretionary powers given to the government have mostly been misused. This is reflected in the accountability movements taking shape across the country. Indian citizens are using their right to information, and demanding better accountability; this impetus for change could mean that Indian voters are willing to listen to ideas of better laws and better governance of institutions under the control of the state. It would require large-scale change to convince people at the grassroots that good economics and good politics need not contradict each other.

The Rise of the Welfare State

Historically, in India there has been limited focus on pure public goods like law and order, attainment of a low and stable inflation rate, and implementing a well-functioning and timely judicial system. However, over the years, as democracy has matured, there has been an increased focus on governance and public goods. The Indian state was not accountable for public goods in its early years. During the socialist era, the focus was on production of goods by the state and the political class was not held accountable for its poor governance. However, as the years have gone by, the accountability of elected representatives has been seen to increase. The approach of Gerring et al. who emphasise the stock of democracy, offers a framework in which to study Indian democracy and growth.[3] The pressures of democracy have increased in recent times and so has the emphasis on public goods. Yet, pure public goods like law and order are still not the most prominent issue. Rather, it is merit goods that have received more emphasis.

Public Systems for Education and Health

Public systems for education and health suffer persistently from problems of under-funding and poor implementation. In 2011–12, while India spent about 4 percent of GDP on health, only about 30 percent of this was public spending.[4] The total of India's GDP spending is among the lowest among comparable countries (e.g. Brazil, South Africa, and China), and public spending amounts are abysmal. Higher spending isn't necessarily an indication of better outcomes, but at India's stage of human capital development, investments in health could have significant positive impact. Public spending on education is currently at around 3.3 percent of the GDP, which is lower than in comparable countries such as Brazil and South Africa.[5] In all, spending on health and education comprise only about 15 percent of the total government expenditure. The corresponding figures for comparable countries are much higher, indicating that India is not committing sufficient fiscal space to these areas.

The problem is not just limited to low expenditure. The outcomes for health and education are poor too, partially because of low expenditure but also because of poor use of the expenditure. Effectiveness of primary education schemes, such as the Sarva Shiksha Abhiyan (Education for All) movement, which is a scheme for universal primary education, is very poor. A recent study by Pratham, non-governmental organisation found that only about 30 percent of children in rural government schools who are in Standard 3 could read a Standard 1 text.[6] Less than 55 percent of these children could identify numbers up to 100. Similarly poor results were also found with children in Standard 5. These statistics point to a worrying lack of competency in school-based learning.

A diverse array of private providers has sprung up in the education sector, despite a hostile policy framework. The quality of a large number of these private-sector funded schools is highly suspect, and this has a detrimental effect on those families with less income. Innumerable lower-middle class and poor parents across rural and urban India, having lost hope at the lack of teachers and teaching in government schools, send their children to these private schools in the belief that the child will have a better chance there to learn reading, writing, arithmetic, and English, skills which will enable them to get ahead in life. A recent experimental study on the impact of school vouchers in a southern state of India found that privately-operated schools deliver better test score gains than their public counterparts, and do so at substantially lower costs per student.[7] Though conclusive evidence will emerge only from a wide range of such studies across various contexts, parents who can afford to do so are already voting with their money by sending their children to privately operated schools.

Rural healthcare in most states in India is marked by absenteeism of health providers, low levels of skills, shortages of medicines, inadequate monitoring, and callous attitudes. An approach paper assessing the Eleventh Five Year Plan of the Planning Commission reported that there exist neither rewards for service providers nor punishments to defaulters. The paper reported that random checks showed that 29 percent to 67 percent of doctors were absent. As the Planning Commission's midterm appraisal of the Tenth Five Year Plan observed, "When people first seek treatment, an estimated 70–85 percent visit a private sector provider for their health care needs." This is also shown by the fact that 70 percent of total spending on health is private spending.

Evidence shows that the quality of public health services has been worsening. National Family Health Survey data shows, immunisation, which is carried out by the government, has declined in many states in recent years. This data is in conformity with data from the report on Reproductive and Child Health Project of the World Bank which found that out of 274 districts in India, child immunisation declined in 197 districts. The Reproductive and Child Health Project report found that the increase in in-hospital childbirth is caused by a rise in in-hospital births in private hospitals. There has been a decline in in-hospital births in public hospitals.

Despite evidence of the poor effectiveness of spending on health and education, these schemes continue without any fundamental reforms, and without a significant increase in outlays. Though there have been some initiatives in recent years, for example, the National Rural Health Mission and Sarva Shiksha Abhiyan, there has been little political and technocratic effort for a fundamental change in these systems.

One possibility is 'voucherisation' of spending to empower citizens to continue seeking these services from the private sector while they also benefit from government support. This is just one example; there are several other innovative financing schemes that help make the most of the private sector's demonstrably better service delivery capabilities, while continuing with the policy of providing subsidy for these services for those who cannot afford them. A more ambitious and challenging pathway is to undertake comprehensive and persistent efforts to reform the public systems so that they deliver high quality services. Other comparable countries have been able to make progress in improving the efficiency and effectiveness of public systems. Two key tools of improvement are known to be enhanced accountability and better incentives for those running these systems.

Instead of pursuing reforms and radically increasing outlays for these services, both of which would be an appropriate response to meeting the needs expressed by voters, the state has taken sporadic steps, some of which may be detrimental to the Indian people. For example, in education, the state has decided to pursue an approach of mandating private schools to take 25 percent of students on government's instructions (imposed under the Right to Education Act). This immediately makes the cost of education more expensive for the remaining 75 percent. This is a form of tax on these schools, and consequently is a substitute for significantly increasing outlays for education. This is done in the name of education for the poor, many of who will now have to pay higher fees for their children's

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education. In some cases, the increase in school fees leads to parents withdrawing their children from privately-operated schools.

Increasing outlays and pursuing reforms is a difficult task, but these changes are consistent with what the people of India seem to want. Health and education services are essential, and at the moment people are spending significant proportions of their income to obtain these services from outside of public systems.

Though there is some evidence that the reforms have had a positive impact on poverty alleviation, lifting millions out of poverty and improving quality of life across the board, there is a very strong constituency that believes that the state should do much more to make the growth more inclusive. There are strong arguments both for and against such an approach, and many arguments on what strategy would work to make this growth inclusive without compromising on growth itself. It is vital to understand the nature of the new welfare state that is taking shape amid these debates and discussions.

The removal of state control over the economy was initiated with the hope that it would usher in a market economy, which happened to an extent, but in the absence of the next generation of reforms, the growth of the market economy is constrained. The focus of the government in the last ten years has been quite different. Instead of pushing forward with next generation reforms that were meant to help India turn into a fully-fledged market economy, the government has largely focused on providing benefits to the people. Both are meant to reduce poverty but the basic philosophy of the two approaches is quite different. While the former is meant to increase overall wealth, the latter focuses on redistributing wealth.

In recent years, the discourse on India's growth has been dominated by the claim that the growth is concentrated. It is claimed that the post-reform Indian growth process has been such that the rich have been getting richer while those who live in poverty are becoming worse off. It is true that, by measures of income concentration, inequality has increased since the reforms were introduced. It can also be argued that this is expected and historically documented in early stages of rapid growth, because the better-off people are also better placed to benefit from the fruits of newfound opportunities. The poor are more constrained by limitations of human capital, networks, credit, and other factors required to benefit from growth. Moreover, income inequality in India compares well with other BRICS countries, for which the average Gini coefficient is 0.47 compared to India's 0.33 (0 is perfect equality).

The problem of inequality could be addressed by several different strategies. The state could invest in building capabilities and infrastructure that help the poor participate in market-based economic processes, while continuing to bring in reforms that expand the market economy. To a small extent this has happened, but the state's dominant approach has been that of addressing the problem of inequality through the use of welfare programmes. Rapid growth has given unprecedented revenues to the government, which is beginning to act as though a brave new welfare state can be designed around this growth. The new mantra for governance is 'Inclusive Growth'.

There are some genuine concerns and questions about the commitments and design choices being made under these programmes. These must be seen in the context of electoral politics.

THE ASSUMPTION OF CONTINUING GROWTH

A flagship government programme in recent years has been a large scale employment guarantee scheme, National Rural Employment Guarantee Scheme (NREGS). When NREGS was proposed, it was popularised as a promise that the poor will not be left out of the growth process. In other words, it implicitly assumed that India would be growing fast and a section of the rural poor would be left out of the growth process, and this was why the country needed NREGS. Implicit was also the argument that NREGS will be paid for by the high tax collection that the fast growing sectors of the economy would yield. It was a scenario that might stand the test of time if India continued to grow at a long-run steady state of ten percent growth. This plan did not appear to evaluate the fiscal path of such a programme when growth halved.

These are serious concerns about a few years of fast growth having convinced the government that it could roll out large welfare programmes. It has been seen that countries with low per-capita income of US$ 1500, such as India, have tax collection to domestic production ratios (tax to GDP) of less than 20 percent. It is only when a country's capita income rises to about ten times as much, that the government is able to collect more than 20 percent of domestic production in taxes. A large part of the Indian economy is in the informal sector. There is little participation in tax paying by production chains and agricultural income is not taxed. Consequently, India's tax to GDP ratio is roughly 18 percent when central, state, and local governments taxes are combined - close to the developing country average for tax payments.

While resources can be raised by disinvestment, selling spectrum, reducing subsidies, and increasing efficiency, the tax to GDP ratio cannot be expected to rise unless the structure of the economy changes adequately. This has been seen to happen in other countries when income levels are at about US$ 10,000 per capita.

These outcomes imply that the government needs to focus on higher GDP growth, and that the focus on GDP growth needs to be put on the expenditure side as well. Faced with a trade-off between spending on building roads and bailing out loss-making public sector enterprises in competitive markets, the former needs to take a clear precedence. Further, there are a number of issues, including foreign investment, infrastructure, and taxes, for which a laundry list of reforms is available.

In India today there is not so much a lack of reform as a new philosophy. The government today emphasises welfare programmes through various rights such as to employment, education, and food which are redistributive in nature. These benefits are enacted into laws, creating fiscal liabilities for the government in the years to come. There appears to be little concern about how the Indian government is going to meet these liabilities. If GDP growth slows, as it is at present, it could well mean that India rapidly falls into a debt trap. High inflation, large deficits, and slow growth are one scenario that countries with such policies have experienced. If this does happen, it takes a very long time for the country to stabilise (Brazil is one example of this outcome).

If growth in India drops for a few years, and fiscal resources are constrained, it would be difficult for the government to cut benefits. Compulsions of electoral politics would make it almost impossible to do so, unless a political consensus emerged to allow such a step to be taken. Such governments usually expand and rarely, if ever, contract. It is more likely that in bad times investment in infrastructure and public goods would be reduced, and taxes would be increased in a manner that would impact investment negatively.

TWO COMPETING PHILOSOPHIES

Notwithstanding the problems of fiscal prudence, there are many philosophical and design choices that the state can make to deliver welfare more effectively. It seems that there is currently a genuine debate going on between two competing philosophies of welfare.

Driven by fiscal obligations and problems with inefficient implementation of government schemes, the government is trying to further push subsidy expenditure through cash transfers. At the same time, it has sponsored and enacted the Food Security Act, which guarantees a certain amount of food availability at a subsidised rate for two-thirds of the population.

However, there is a clear contradiction between these two philosophies. The strategy of cash transfers (giving money to poor households to bring them above the poverty line) is based on the philosophy that households should be free to choose what they buy. Providing subsidised foods, such as cereal, to households is a policy based on the notion that it is best if the state decides what is good for people and provides it.

Currently, cash transfers are limited to items like scholarships and pensions. They can be restricted to these items and incrementally expanded to include a few more, or they could be used to cover all subsidies, with an income subsidy amount paid directly to the beneficiary, rather than through a price subsidy on particular items. If the logic of cash transfers was to be carried forward, each poor household would be given a sum of money to pull it above the poverty line. Like an income tax, which is paid by better-off households to the government, this would be a 'negative income tax' that the government pays to households.

Giving poor household's money is based on the belief that the needs and priorities of a household are best understood by the individual householder. If that householder chooses, the funds can be used for transport that to a hospital instead of buying 10 kg of rice, for example. Cash transfers are genuinely meaningful if they become the main element of a government's anti-poverty programme. If it is one of many programmes then it has a marginal impact on efficiency and government expenditure.

Cash transfers in scholarships or pensions can only solve the problem of delay in payments. If combined with proper authentication, there will be some savings made by the government, as ghost and duplicate beneficiaries can be removed from the system. This might save as much as ten to 15 percent of expenditure under that heading. The big savings through cash transfers can come if instead of paying a price subsidy, say on wheat, the government transfers money directly to a family so that the family can buy a minimum consumption bundle and rise above the poverty line. Problems with theft and wastage in the public distribution system would be reduced.

The Food Security Act is based on an entirely different philosophy. Not only does it assume that it is best for the poor in India to eat wheat and rice instead of pulses, fish, vegetables, eggs, or milk, it also assumes that the state will handle the purchase, storage, and sale of this wheat and rice better than the market can. It assumes that the wheat and rice (often rotting, as it is stored in the open because of a shortage of warehouses with the Food Corporation of India) will be bought by the people. It assumes that people are not buying large quantities of wheat and rice because the price is too high, and that once it is supplied by the government at a low price, they are going to buy it.

Several assumptions about individual preferences are being made here. It is assumed that the behaviour observed in household data that shows diversity in food, and particularly the preference for protein such as dal, eggs, fish, chicken, and meat, will not hold true as incomes rise. However, evidence suggests otherwise. In the last few years, there has been an increase in the price of protein rich foods and some observers have linked the price rise to an increase in demand resulting from higher rural incomes. Cereal prices have not been the fastest growing prices; it is the prices of non-cereal food items that have grown the fastest, reflecting growing demand.

Since both these programmes are being pursued at the same time, it is possible that both have advocates in the state. The state can live with contradictions, but if the government eventually chooses to pursue one direction, the cash transfer route holds much more potential than the food subsidy route because it would empower the many at the cost of the few rent-seekers.

EMPOWERING THE BENEFICIARIES

The new welfare state has made an important shift in its approach to beneficiaries. The recent wave of welfare schemes has been headlined by certain rights that the beneficiary is given to claim benefits from the scheme. This approach, if implemented properly at the grassroots, radically empowers beneficiaries to demand what is due to them. In the 2009 elections, this approach was widely credited to be responsible for the incumbent government electoral victory.

Such rights would be incomplete without a proper system of identification and authentication of beneficiaries. In the absence of such a system, it would be difficult to establish claimants are who they profess to be, and that would be detrimental to empowerment. The government is building an important piece of infrastructure called Aadhaar—a unique identification system based on biometric information.

While there are reasonable concerns about the potential to misuse such information, and the need to secure the system to avoid such abuse, there is one class of applications of biometric identification which is unencumbered by controversy: implementation of government transfer and subsidy programmes.

Introducing the Aadhaar identification system has significant advantages. At present, product subsidisations such as for diesel or Liquid Petroleum Gas (LPG), are put in place when the government is not able to clearly identify the poor. The bulk of LPG or diesel is consumed by the rich, so the existing subsidy programme is low on allocative efficiency. The money that is spent on these subsidies could be used for producing genuine public goods, such as the police or judiciary, in establishing water and sanitation systems, or in building railway lines. Despite decades of complaining about these problems, the status quo has stayed in place. The Left and Right agree that diesel and LPG subsidies are wrong, and that the bulk of Public Distribution System (PDS) grain is stolen, yet there is no sign of subsidy reform.

Not all instances of theft can be attributed to cases of ghost or duplicate identity. Corruption also happens when better-off households are misidentified as poor and theft occurs when trucks carrying wheat are stolen. Wastage happens when foods are eaten by rats in warehouses, or rot before it even reaches the warehouses. These are all problems that need to be addressed. The problem of duplicate and ghost households obtaining PDS grain and kerosene can be taken care of if every household that is supposed to be given subsidised wheat and rice is issued a unique identity, through which it obtains the subsidised products.

If the proof of identity is linked to bank accounts, then it is possible to conceive of a system in which instead of the government hoarding millions of tons of grain, poor families would buy rice from the open market.

This outcome would be only a small part of the gain. The bigger gain would be in products such as diesel or LPG, where the subsidy can be given to all consumers. Individuals can be provided with stamps or vouchers, or the subsidy amount could be paid directly into bank accounts, for every litre of diesel bought, for example by farmers, who would be expected to use the fuel for pump irrigation.

If all payments currently are made by the government, whether pensions, NREGS payments, girl child payments, or others, were paid electronically and using a biometric identification system, it would help reduce harassment. Harassment, especially of young widows trying to get their pensions, is a feature of daily life that few women dare to protest against. Instead of physically presenting themselves at a government office, a biometric identification document presented at a bank branch would establish proof of living as well as prevent delays and harassment.

CONFLICTS BETWEEN POPULIST SCHEMES AND GROWTH

Two years after the implementation of the NREGS, the ministry of agriculture asked for NREGS to be suspended during peak farming seasons of sowing, transplantation, and harvesting. NREGS had raised the cost of farming, by pushing up labour costs as much as 40 percent. This was particularly problematic in states such as Punjab and Haryana, where farmers depend on migrant labourers from poorer states at peak times.

The agricultural ministry's request raises some fundamental questions about the design of the NREGS. The public discussion about NREGS emphasises implementation problems such as leakages and a lack of social audits. However, NREGS also suffers from deeper design problems, and a solution cannot be found in better implementation.

The Act entitles people working under this scheme to 100 days of wages at the minimum wage rate fixed by the state government for agricultural labourers or a wage notified by the central government. If employment is not provided under NREGS to a worker who has applied for work, then the state government has to pay an unemployment allowance. This design does not take into account the nature of India's unemployment problem. Further, it is likely to make unemployment persistent and keep productivity growth weak.

Unemployment in India can be described as mainly structural and seasonal. Structural unemployment occurs, usually as a long run phenomenon, when there is a mismatch between demand for labour and the skills and location of the workers looking for employment. This is the biggest source of unemployment in India. Structural unemployment is normally seen as permanent unemployment and can be solved only in the long term. On the demand side, an increase in demand of labour arising from growth of industry and services and capital accumulation reduces structural unemployment. On the supply side, better skills and greater mobility of labour addresses the problem.

Seasonal unemployment is seen when the demand for labour is seasonal, as is the case with farming. Since nearly 60 percent of Indians live in rural India, and the nature of work there is often linked to agriculture, these opportunities tend to be seasonal. Hence, in rural India seasonal unemployment is a major problem.

Cyclical unemployment, atypical to India, arises when employment grows or declines with the business cycle. Since India did not have economy-wide business cycles in the pre-liberalisation era, cyclical unemployment was not significant. Even since the 1990s, when business cycles have become a regular feature of the Indian economy, cyclical unemployment is primarily seen in urban India when industry and services see low growth.

Structural unemployment in rural India has been a source of concern for the country. In the pre-NREGS era, the solution for underemployment and unemployment was understood to be a transformation of the Indian economy with growth of industry and services. Migration and improved human skills through education and greater participation in the labour force were viewed as the key ways in which employment in India would grow. Earlier employment programmes in India, such as in the state of Rajasthan, which has suffered from frequent droughts, were mainly public work programmes intended to give employment to people during periods of drought and famine. When conditions in the labour market changed as the drought ended, the programmes ended. While the NREGS was designed along the lines of such public work programmes, it introduced a big conceptual shift. It was made a regular feature of the labour market regardless of conditions in the labour market. Under the scheme, the government is required to pay a statutory minimum wage for each state. This wage is often above the market clearing wage in the state.

Prior to NREGS, the minimum wage in many states was often actually higher than the market wage. The market clearing wage was the one at which labourers were willing to work and employers were willing to hire them. The enforcement of minimum wages was often weak and a feature of unionised labour. The informal sector and non-unionised labour market would often clear at wages that were below those set as the officially designated minimum wage. In those circumstances, while the minimum wage was not a strong feature of Indian labour market regulation it did not do damage. Workers accepted market wages below minimum wages when they could not do better.

With the launch of NREGS, work was made available at above market prices to many individuals who would otherwise have engaged in improving skills or migrating. By paying for rural labour, the NREGS took away the incentive to look for work in the nearest city or in faraway states. It took away the incentive to gain knowledge about work and the human networks required to find jobs.

NREGS has the potential of making India's structural unemployment problem a persistent one. In the long run, no country has been able to become advanced without large scale skill upgrading, migration, and urbanisation. Problems related to urbanisation have to be faced and solved. The lack of migration will have consequences for urban India as well. Labour shortages in low-skilled urban jobs are likely to push employers into more capital intensive production technologies. On the other hand, a large mass of low-skilled labour will be trapped in a state of dependence on the government.

Instead of reforming labour laws and improving infrastructure, which could provide higher employment growth, the government enacted NREGS as a quick-fix solution and a vote winner. However, NREGS will not solve the problem of unemployment in India: instead, it is likely to create poverty traps containing millions of people who are cut off from the growth of India into a modern market economy.

The new welfare state in India has added burdens and risks to fiscal resources, and created big distortions in the market economy, but there are also encouraging trends in terms of the intent of the state to achieve efficiency in implementation of welfare schemes. If the state succeeds in improving efficiency by sound targeting and better identification and authentication of beneficiaries, the distortions created by these schemes would be mitigated to an extent. However, this strategy has not been tested in elections. Depending on the feedback received in elections, the strategy could persist or die a quiet death.

THE CONFLICT BETWEEN POLITICS AND LOW FOOD PRICE INFLATION

Since 2006, consumer price inflation in India has been rising. The main component of the rise in inflation has been food prices. While cereal prices have risen due to the steady rise in minimum support price or procurement price set by the state to ensure growth and stability in the incomes of surplus producing farmers, the biggest rise has been in vegetable and protein prices. This has hurt voters all across the country and has often been seen to be a prime concern for elections. Yet, the pro-rich farmer policies of the government have not been able to move away from this framework in which food prices continue to put pressure. Food constitutes half the average consumption basket, yet this large-scale problem is yet to be solved.

The single largest occupational group in India is of those working on farms (as cultivators or labourers) or in farm-dependent enterprises. This group constitutes a majority in the Indian work force. Understandably, the state has placed considerable policy emphasis on ensuring the welfare of this group. A closer look at the policies reveals their lopsided nature.

Indian agriculture today has a huge pro-cereal bias. Policy favours production of grains, a policy that has worked in favour of grain-producing farmers. This policy has an adverse effect on agricultural growth, on production of high value added crops like fruit and vegetables, and thus on food prices and standards of living of the population of India. Farmers are a powerful interest group in rural India and despite the inflationary impact, which hurts millions of voters across the country, these policies continue.

The Green Revolution in the 1960s focused on grain production with high yield varieties of rice and wheat. Shortages of grain are now a thing of the past but the policies of government are unchanged.

Under this policy, the government first promotes cultivation of cereals through a plethora of subsidies on fertilisers, power, water, and seeds. It then buys vast quantities of cereals at above-market prices, through minimum support prices. The procurement is done through the Food Corporation of India, which receives subsidised food credit from banks. Part of the grain is lost due to storage and this loss is borne by the government. Some is sold at low prices through the Public Distribution System (PDS) and this loss is also borne by the government. Some of it is exported at ridiculously low prices, as low as Rs.2 per kg, to be used as animal feed abroad, and this loss is also borne by the government.

The poor do not benefit from this policy. The bulk of the wheat sold to PDS is from rich farmers who have large land holdings and a marketable surplus. The poor often buy wheat, and they suffer when the government's policies elevate the price of wheat. Various middlemen make enormous profits out of PDS, and these middlemen are emphatically not poor. This logic shows that the existing cereal policy is not pro-poor. It is a warped and expensive way of trying to provide a subsidy to the poor, but is mostly increasing the wealth of the rich. A 2005 Planning Commission report evaluating the targeted PDS system shows that this is one of the most inefficient ways of implementing income transfers to the poor. For every Rs.1 worth of income transfer to the poor, the government spends Rs.3.65. Some politicians argue that India should continue producing additional grains until the problems of hunger and poverty are solved in the country.

The world of agriculture beyond cereals offers higher incomes for small farmers. These crops generate greater income, for more people, than the production of cereals. Vegetable cultivation is estimated to be five times more profitable than cereals. Fruit cultivation is found to be eight times more profitable than cereals. Indian farmers can earn enormous revenues by selling high value agricultural products across the globe.

The production of high-value crops such as milk, eggs, fish, and vegetables generates far more employment than do cereals. A study shows that a one hectare shift in area from wheat to potatoes would generate 145 additional days of employment.[8] While wheat requires 55 work days per hectare on average, onions require 124 work-days, cabbage 110 work days, and tomatoes 195 work-days. A fascinating fact highlighted by Joshi et al. is the extent to which small farmers have shifted away from cereals. Cereal production is mechanised, and works very well for large land holdings using equipment like tractors. In contrast, the production of fruits, flowers, and vegetables is highly labour intensive. Small holders tend to diversify more as it provides them with the opportunity of incomes that are both higher and more regular.

There are other factors hindering this revolution, apart from government resources going into propping up the cereal economy. Road networks, cold storage, and access to markets have been seen to have a very significant impact on the shift towards production of high value agricultural products. Milk, fish, meat, fruit, and vegetables are more perishable and require better infrastructure facilities, such as cold storage chains and good roads, than do cereals. A highway development project may do more for agriculture than tens of thousands of crores in direct state support to the agriculture sector.

Income and employment in rural India cannot increase by growing more cereals. Today, the bias in favour of cereals has little to do with the objective of raising employment and income of the poor. It has more to do with the political power of the rich farmer, the main beneficiary of subsidies for cereal production.

In a system of representative democracy, the actions of the elected representatives and governments ought to reflect the hopes and aspirations of the voters, who are also the users of public systems and beneficiaries of subsidies. The democratic system is often derided for its tendency to lurch towards populist policies, so much so that the long term interest is thought to be compromised by the election cycle. Yet, there are some examples of a disconnect between what the Indian people want and what is being done.

The main explanation for this is in an understanding of the role of interest groups. It is in the interest of the large-scale farmers to maintain the narrative at the level of 'farmers' as a category, without any differentiation on the basis of landholdings or incomes. Therefore, policies that are seen as pro-farmer are considered to be good, even though most of the benefits may accrue to rich farmers. The loan waiver scheme in the United Progressive Alliance (UPA) government's previous tenure (2004–09), largely benefited the wealthier farmers, but was talked about as a welfare scheme.

Similar narratives on interest group influence could help make clear the structural status quo in the fields of health and education. Some commentators have suggested that this is because of the political power of teachers in state and local politics.[9] Government education and health personnel benefit from the narrative of the state's role in ensuring these services are accessible. Not much importance is given to the potential conflict between the interests of the users of these services and that of those running the systems for providing them. In the absence of good incentives and mechanisms of accountability, public systems can actually turn out to be inimical to the interests of the users. On the other hand, those earning from these systems would benefit from low accountability, and from incentives that are not linked with performance.

There are structural reasons for this disproportionate influence of certain interest groups. State power is a monopoly power, and if the constitution and the laws legitimise its use in any sector of the economy, it is likely that those with most influence in that sector will be able to corner most of the state's favours. The invisible hand of competition works in unseen and unpredictable ways, while the state works through its visible instruments, and is therefore vulnerable to undue influence. The state operates at a level above the market participants legislating, supervising, and passing judgment. When it uses its powers to meddle in the economy, as it has in India, it often ends up benefiting some at the cost of many.

India's embrace of a state-led model of economic development laid the foundations for all economic policies since then. It set the initial conditions, which have loomed large over the thinking on economic policy ever since. Once the system takes a certain direction, it is usually difficult to make structural changes, especially since the existing policies create interest groups that are interested in the status quo. The examples discussed above point to such problems.

The narrative of interest group dominance leading to status quo is not all pervasive. India has undergone significant economic reforms since the 1980s. Many of these reforms have helped a large number of people, while negatively impacting certain entrenched and organised interest groups. The political system seems to have successfully dealt with the interest groups while pushing through the reforms.

Some of the most important interest groups that would have been against the reforms were certain constituents of the state itself. In the licence raj, the bureaucracy and the political class had greater discretionary powers. Elections in India are largely funded from private sources, which at any given point mainly constitute of wealthy donors. So, for the political class also it must have been expensive to take steps that alienated the entrenched interest groups. However, some important economic reforms did happen, and many interest groups did lose out, and fragments of a new economy were ushered in.

One plausible explanation for this is that the interest groups themselves were divided into those who stood to benefit from reforms and those who stood to lose out. The politicians and bureaucrats also saw future constituencies of rent-seeking emerging in the post-reform period. This could be one of the reasons they could overcome interest group pressures, in addition to many other reasons that could be reasonably used to explain economic reforms in India.

This paper will now turn to discussion of the economic reforms in India in the context of the democratic politics of the country and present ideas on next generation reforms and where they could be situated in the political discourse. First follows a brief history of the economic policies of the Indian state.

Politics and Economics After the Global Financial Crisis

Policymakers in India were able to respond quickly to the demand contraction caused by the crisis through expansionary fiscal and monetary policy, and the Indian economy continued to witness high growth. However, soon the policy stance became excessively expansionary as inflation, the fiscal deficit, and current account deficits rose sharply.

The finance minister's post-crisis budgets focused on safety nets required to prevent the global recession from hurting the poor in India. The reforms required to keep investors optimistic about medium term prospects for the Indian economy were not prioritised. Even the reforms promised by the United Progressive Alliance (UPA) government were not carried through. The dismantling of the state control system, however slow, that had characterised the previous 20 years, was put on hold. The corruption scandals hitting the government have only made the situation worse.

A difficult question faced by the government was one of government finances. The UPA put government spending on a new path. The consequences of this increased spending could have meant rising interest rates, high inflation, and the pre-emption of household savings by the government, and a possible rise in the debt to GDP ratio to unsustainable levels. While subsidies are a legacy of the past, the UPA focused on setting up a large welfare programmes such as the NREGS. These have become a major source of concern, as they mean increasingly larger government spending. Expenditure requirements of the Food Security Act and wage indexation for NREGS have been key concerns.

Spending on large welfare programmes is difficult to sustain in India. As discussed in a previous section, it has been the case that countries with a low per capita income of US$ 1000, such as India, have tax collection to domestic production ratios (tax to GDP) of less than 20 percent. The government must focus on increasing GDP growth.[10]

By 2013, fiscal expansion in the post-crisis years made macro-economic management difficult. The budget had to be finely balanced between the instincts of the Congress and the needs of a government rapidly losing the confidence of industry, foreign investors, and credit-rating agencies. The budget had to be seen as a tax and spend document—expenditure on the Congress's pet projects was increased, to be financed by higher taxes on the super-rich.

The message of the budget speech had to be a Congress message: pro-rural poor and anti-rich; more Congress-friendly than market-friendly. The government could not afford to make budget allocations of the kind expected. The political twist of the budget speech was an interesting example of how the government balanced the needs of democracy and the policies required for growth and investment. In one budget, it delivered both.

The same budget could have been used to convey a very different message—one of moving towards a smaller government and restricted spending on welfare schemes.

For example, in his Congress-friendly speech in parliament, Chidambaram said:

> "I have been able to set the budget estimates of total expenditure at Rs.16, 65,297 crore and of plan expenditure at Rs.5, 55,322 crore."

A hypothetical market-friendly version of the same numbers would have read:

> "I propose to allocate Rs.16, 65,297 crore for total expenditure, thus raising expenditure by 11 percent over last year's budget estimates. Since I expect the GDP to grow by 13.5 percent in nominal terms, this means reducing the size of the government in the total GDP."

Further, in his Congress-friendly speech, the Ffinance Minister said:

> "The ministry of rural development steers a number of flagship programmes. We estimate that they will be able to spend Rs.55,000 crore before the end of the current year, and I propose to allocate Rs.80,194 crore in 2013–14, marking an increase of 46 percent. MGNREGS will get Rs.33,000 crore." A market-friendly version of the same speech might have read: "Last year the ministry of rural development had a budget allocation of Rs.76,000 crore. This year, I propose to allocate Rs.80, 194 crore, a contraction in real terms. Expenditure on MGNREGS was budgeted to be Rs.33,000 crore in 2012–13. I do not propose to raise the allocation for MGNREGS in 2013–14. This implies almost a 10 percent reduction in the allocation for MGNREGS in real terms."

Such political management is central to the way politics and economics interact in India. Chidambaram's speech reflects good economics and good political management, but it does not indicate intent to convince people that good economics is the best course of action. The 1991 reforms were brought about by stealth, and as a result, though many policies have changed, fundamental changes in the systems and processes of governance remain. Such changes would perhaps require more broad-based support.

Conclusion

Since independence, India has enjoyed considerable political freedom, but, for the most part, economic freedoms have been low. Immediately after independence, the state restricted private business and international trade in many ways. It was difficult to start, expand, run, and close businesses because of the severe regulatory restrictions placed on such activities. International trade was restricted by tariff and quantitative restrictions. Most economic activities were either monopolised or controlled by the state. For some activities, though in theory private sector participation was possible, the state's presence crowded out such participation.

Low economic freedoms and poor human capital have resulted in low GDP growth for most of the years since independence. Yet there has been a marked policy shift since 1991. The period since 1991, when India moved to a market based economy, has been the most dynamic in the history of independent India. Since 1991, economic freedoms have been considerably expanded, and GDP growth has risen sharply. However, these reforms have come with little structural change in the laws and the governance systems of the institutions of the state.

The growth generated by these reforms has expanded the revenue-raising potential of the state and the rent-seeking potential of the politically powerful. The expanding revenue-base has been deployed for a wide range of uses. One use has been to gain the support of those voters who are excluded from the growth process through the expansion of welfare schemes and public programmes.

The Indian people are increasingly demanding accountability. Due to this pressure to reform, and strains on the fiscal resources, the state has started implementing policies and developing infrastructure that will lead to more efficient implementation of welfare schemes. These shifts in implementation systems and the emphasis on beneficiary rights create encouraging possibilities for improvement.

The signals on improving governance and reducing rent-seeking potential are less encouraging. India continues to be a difficult place to do business, and scores low on economic freedom, competitiveness, and transparency. If India's growth story is to persist, the Indian state must reform its governance systems.

The next generation of reforms must be more fundamental. The reforms will have to be structural, requiring a redesign of systems and processes of governance that India has not seen in a very long time.

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