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The India Model

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Summary: After being shackled by the government for decades, India's economy has become one of the world's strongest. The country's unique development model -- relying on domestic consumption and high-tech services -- has brought a quarter century of record growth despite an incompetent and heavy-handed state. But for that growth to continue, the state must start modernizing along with Indian society.

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AN ECONOMY UNSHACKLED

Although the world has just discovered it, India's economic success is far from new. After three postindependence decades of meager progress, the country's economy grew at 6 percent a year from 1980 to 2002 and at 7.5 percent a year from 2002 to 2006 -- making it one of the world's best-performing economies for a quarter century. In the past two decades, the size of the middle class has quadrupled (to almost 250 million people), and 1 percent of the country's poor have crossed the poverty line every year. At the same time, population growth has slowed from the historic rate of 2.2 percent a year to 1.7 percent today -- meaning that growth has brought large per capita income gains, from $1,178 to $3,051 (in terms of purchasing-power parity) since 1980. India is now the world's fourth-largest economy. Soon it will surpass Japan to become the third-largest.

The notable thing about India's rise is not that it is new, but that its path has been unique. Rather than adopting the classic Asian strategy -- exporting labor-intensive, low-priced manufactured goods to the West -- India has relied on its domestic market more than exports, consumption more than investment, services more than industry, and high-tech more than low-skilled manufacturing. This approach has meant that the Indian economy has been mostly insulated from global downturns, showing a degree of stability that is as impressive as the rate of its expansion. The consumption-driven model is also more people-friendly than other development strategies. As a result, inequality has increased much less in India than in other developing nations. (Its Gini index, a measure of income inequality on a scale of zero to 100, is 33, compared to 41 for the United States, 45 for China, and 59 for Brazil.) Moreover, 30 to 40 percent of GDP growth is due to rising productivity -- a true sign of an economy's health and progress -- rather than to increases in the amount of capital or labor.

But what is most remarkable is that rather than rising with the help of the state, India is in many ways rising despite the state. The entrepreneur is clearly at the center of India's success story. India now boasts highly competitive private companies, a booming stock market, and a modern, well-disciplined financial sector. And since 1991 especially, the Indian state has been gradually moving out of the way -- not graciously, but kicked and dragged into implementing economic reforms. It has lowered trade barriers and tax rates, broken state monopolies, unshackled industry, encouraged competition, and opened up to the rest of the world. The pace has been slow, but the reforms are starting to add up.

India is poised at a key moment in its history. Rapid growth will likely continue -- and even accelerate. But India cannot take this for granted. Public debt is high, which discourages investment in needed infrastructure. Overly strict labor laws, though they cover only 10 percent of the work force, have the perverse effect of discouraging employers from hiring new workers. The public sector, although much smaller than China's, is still too large and inefficient -- a major drag on growth and employment and a burden for consumers. And although India is successfully generating high-end, capital- and knowledge-intensive manufacturing, it has failed to create a broad-based, labor-intensive industrial revolution -- meaning that gains in employment have not been commensurate with overall growth. Its rural population, meanwhile, suffers from the consequences of state-induced production and distribution distortions in agriculture that result in farmers' getting only 20 to 30 percent of the retail price of fruits and vegetables (versus the 40 to 50 percent farmers in the United States get).

India can take advantage of this moment to remove the remaining obstacles that have prevented it from realizing its full potential. Or it can continue smugly along, confident that it will get there eventually -- but 20 years late. The most difficult reforms are not yet done, and already there are signs of complacency.

A 100-YEAR TALE

For half a century before independence, the Indian economy was stagnant. Between 1900 and 1950, economic growth averaged 0.8 percent a year -- exactly the same rate as population growth, resulting in no increase in per capita income. In the first decades after independence, economic growth picked up, averaging 3.5 percent from 1950 to 1980. But population growth accelerated as well. The net effect on per capita income was an average annual increase of just

1.3 percent.

Indians mournfully called this "the Hindu rate of growth." Of course, it had nothing to do with Hinduism and everything to do with the Fabian socialist policies of Prime Minister Jawaharlal Nehru and his imperious daughter, Prime Minister Indira Gandhi, who oversaw India's darkest economic decades. Father and daughter shackled the energies of the Indian people under a mixed economy that combined the worst features of capitalism and socialism. Their model was inward-looking and import-substituting rather than outward-looking and export-promoting, and it denied India a share in the prosperity that a massive expansion in global trade brought in the post-World War II era. (Average per capita growth for the developing world as a whole was almost 3 percent from 1950 to 1980, more than double India's rate.) Nehru set up an inefficient and monopolistic public sector, overregulated private enterprise with the most stringent price and production controls in the world, and discouraged foreign investment -- thereby causing India to lose out on the benefits of both foreign technology and foreign competition. His approach also pampered organized labor to the point of significantly lowering productivity and ignored the education of India's children.

But even this system could have delivered more had it been better implemented. It did not have to degenerate into a "license-permit-quota raj," as Chakravarthi Rajagopalachari first put it in the late 1950s. Although Indians blame ideology (and sometimes democracy) for their failings, the truth is that a mundane inability to implement policy -- reflecting a bias for thought and against action -- may have been even more damaging.

In the 1980s, the government's attitude toward the private sector began to change, thanks in part to the underappreciated efforts of Prime Minister Rajiv Gandhi. Modest liberal reforms -- especially lowering marginal tax rates and tariffs and giving some leeway to manufacturers -- spurred an increase in growth to 5.6 percent. But the policies of the 1980s were also profligate and brought India to the point of fiscal crisis by the start of the 1990s. Fortunately, that crisis triggered the critical reforms of 1991, which finally allowed India's integration into the global economy -- and laid the groundwork for the high growth of today. The chief architect of those reforms was the finance minister, Manmohan Singh, who is now prime minister. He lowered tariffs and other trade barriers, scrapped industrial licensing, reduced tax rates, devalued the rupee, opened India to foreign investment, and rolled back currency controls. Many of these measures were gradual, but they signaled a decisive break with India's dirigiste past. The economy returned the favor immediately: growth rose, inflation plummeted, and exports and currency reserves shot up.

To appreciate the magnitude of the change after 1980, recall that the West's Industrial Revolution took place in the context of 3 percent GDP growth and 1.1 percent per capita income growth. If India's economy were still growing at the pre-1980 level, then its per capita income would reach present U.S. levels only by 2250; but if it continues to grow at the post-1980 average, it will reach that level by 2066 -- a gain of 184 years.

PECULIAR REVOLUTION

India has improved its competitiveness considerably since 1991: there has been a telecommunications revolution, interest rates have come down, capital is plentiful (although risk-averse managers of state-owned banks still refuse to lend to small entrepreneurs), highways and ports have improved, and real estate markets are becoming transparent. More than 100 Indian companies now have a market capitalization of over a billion dollars, and some of these -- including Bharat Forge, Jet Airways, Infosys Technologies, Reliance Infocomm, Tata Motors, and Wipro Technologies -- are likely to become competitive global brands soon. Foreigners have invested in over 1,000 Indian companies via the stock market. Of the Fortune 500 companies, 125 now have research and development bases in India -- a testament to its human capital. And high-tech manufacturing has taken off. All these changes have disciplined the banking sector. Bad loans now account for less than 2 percent of all loans (compared to 20 percent in China), even though none of India's shoddy state-owned banks has so far been privatized.

For now, growth is being driven by services and domestic consumption. Consumption accounts for 64 percent of India's GDP, compared to 58 percent for Europe, 55 percent for Japan, and 42 percent for China. That consumption might be a virtue embarrasses many Indians, with their ascetic streak, but, as the economist Stephen Roach of Morgan Stanley puts it, "India's consumption-led approach to growth may be better balanced than the resource-mobilization model of China."

The contrast between India's entrepreneur-driven growth and China's state-centered model is stark. China's success is largely based on exports by state enterprises or foreign companies. Beijing remains highly suspicious of entrepreneurs. Only 10 percent of credit goes to the private sector in China, even though the private sector employs 40 percent of the Chinese work force. In India, entrepreneurs get more than 80 percent of all loans. Whereas Jet Airways, in operation since 1993, has become the undisputed leader of India's skies, China's first private airline, Okay Airways, started flying only in February 2005.

What has been peculiar about India's development so far is that high growth has not been accompanied by a labor-intensive industrial revolution that could transform the lives of the tens of millions of Indians still trapped in rural poverty. Many Indians watch mesmerized as China seems to create an endless flow of low-end manufacturing jobs by exporting goods such as toys and clothes and as their better-educated compatriots export knowledge services to the rest of the world. They wonder fearfully if India is going to skip an industrial revolution altogether, jumping straight from an agricultural economy to a service economy. Economies in the rest of the world evolved from agriculture to industry to services. India appears to have a weak middle step. Services now account for more than 50 percent of India's GDP, whereas agriculture's share is 22 percent, and industry's share is only 27 percent (versus 46 percent in China). And within industry, India's strength is high-tech, high-skilled manufacturing.

Even the most fervent advocates of service-based growth do not question the desirability of creating more manufacturing jobs. The failure of India to achieve a broad industrial transformation stems in part from bad policies. After India's independence, Nehru attempted a state-directed industrial revolution. Since he did not trust the private sector, he tried to replace the entrepreneur with the government -- and predictably failed. He shackled private enterprise with byzantine controls and denied autonomy to the public sector. Perhaps the most egregious policy was reserving around 800 industries, designated "small-scale industries" (SSI), for tiny companies that were unable to compete against the large firms of competitor nations. Large firms were barred from making products such as pencils, boot polish, candles, shoes, garments, and toys -- all the products that helped East Asia create millions of jobs. Even since 1991, Indian governments have been afraid to touch this "SSI holy cow" for fear of a backlash from the SSI lobby. Fortunately, that lobby has turned out to be mostly a phantom -- little more than the bureaucrats who kept scaring politicians by warning of a backlash. Over the past five years, the government has been pruning the list of protected industries incrementally with no adverse reaction.

In the short term, the best way for India to improve the lot of the rural poor might be to promote a second green revolution. Unlike in manufacturing, India has a competitive advantage in agriculture, with plenty of arable land, sunshine, and water. To achieve such a change, however, India would need to shift its focus from peasant farming to agribusiness and encourage private capital to move from urban to rural areas. It would need to lift onerous distribution controls, allow large retailers to contract directly with farmers, invest in irrigation, and permit the consolidation of fragmented holdings.

Indian entrepreneurs also still face a range of obstacles, many of them the result of lingering bad policies. Electric power is less reliable and more expensive in India than in competitor nations. Checkpoints keep trucks waiting for hours. Taxes and import duties have come down, but the cascading effect of indirect taxes will continue to burden Indian manufacturers until a uniform goods-and-services tax is implemented. Stringent labor laws continue to deter entrepreneurs from hiring workers. The "license raj" may be gone, but an "inspector raj" is alive and well; the "midnight knock" from an excise, customs, labor, or factory inspector still haunts the smaller entrepreneur. Some of these problems will hopefully diminish with the planned designation of new "economic zones," which promise a reduced regulatory burden.

Economic history teaches that the Industrial Revolution as it was experienced by the West was usually led by one industry. It was textile exports in the United Kingdom, railways in the United States. India, too, may have found the engine that could fuel its takeoff and transform its economy: providing white-collar services that are outsourced by companies in the rest of the world. Software and business-process outsourcing exports have grown from practically nothing to $20 billion and are expected to reach $35 billion by 2008. The constraining factor is likely to be not demand but the ability of India's educational system to produce enough quality English-speaking graduates.

Meanwhile, high-tech manufacturing, a sector where India is already demonstrating considerable strength, will also begin to expand. Perhaps in a decade, the distinction between China as "the world's workshop" and India as "the world's back office" will slowly fade as India's manufacturing and China's services catch up.

RISING DESPITE THE STATE

It is an amazing spectacle to see prosperity beginning to spread in today's India even in the presence of appalling governance. In the midst of a booming private economy, Indians despair over the lack of the simplest public goods. It used to be the opposite: during India's socialist days, Indians worried about economic growth but were proud of their world-class judiciary, bureaucracy, and police force. But now, the old centralized bureaucratic Indian state is in steady decline. Where it is desperately needed -- in providing basic education, health care, and drinking water -- it has performed appallingly. Where it is not needed, it has only started to give up its habit of stifling private enterprise.

Labor laws, for example, still make it almost impossible to lay off a worker -- as the infamous case of Uttam Nakate illustrates. In early 1984, Nakate was found at 11:40 AM sleeping soundly on the floor of the factory in Pune where he worked. His employer let him off with a warning. But he was caught napping again and again. On the fourth occasion, the factory began disciplinary proceedings against him, and after five months of hearings, he was found guilty and sacked. But Nakate went to a labor court and pleaded that he was a victim of an unfair trade practice. The court agreed and forced the factory to take him back and pay him 50 percent of his lost wages. Only 17 years later, after appeals to the Bombay High Court and the national Supreme Court, did the factory finally win the right to fire an employee who had repeatedly been caught sleeping on the job.

Aside from highlighting the problem of India's lethargic legal system, Nakate's case dramatizes how the country's labor laws actually reduce employment, by making employers afraid to hire workers in the first place. The rules protect existing unionized workers -- sometimes referred to as the "labor aristocracy" -- at the expense of everyone else. At this point, the labor aristocracy comprises only 10 percent of the Indian work force.

No single institution has come to disappoint Indians more than their bureaucracy. In the 1950s, Indians bought into the cruel myth, promulgated by Nehru, that India's bureaucracy was its "steel frame," supposedly a means of guaranteeing stability and continuity after the British raj. Indians also accepted that a powerful civil service was needed to keep a diverse country together and administer the vast regulatory framework of Nehru's "mixed economy." But in the holy name of socialism, the Indian bureaucracy created thousands of controls and stifled enterprise for 40 years. India may have had some excellent civil servants, but none really understood business -- even though they had the power to ruin it.

Today, Indians believe that their bureaucracy has become a prime obstacle to development, blocking instead of shepherding economic reforms. They think of bureaucrats as self-serving, obstructive, and corrupt, protected by labor laws and lifetime contracts that render them completely unaccountable. To be sure, there are examples of good performance -- the building of the Delhi Metro or the expansion of the national highway system -- but these only underscore how often most of the bureaucracy fails. To make matters worse, the term of any one civil servant in a particular job is getting shorter, thanks to an increase in capricious transfers. Prime Minister Singh has instituted a new appraisal system for the top bureaucracy, but it has not done much.

The Indian bureaucracy is a haven of mental power. It still attracts many of the brightest students in the country, who are admitted on the basis of a difficult exam. But despite their very high IQs, most bureaucrats fail as managers. One of the reasons is the bureaucracy's perverse incentive system; another is poor training in implementation. Indians tend to blame ideology or democracy for their failures, but the real problem is that they value ideas over accomplishment. Great strides are being made on the Delhi Metro not because the project was brilliantly conceived but because its leader sets clear, measurable goals, monitors day-to-day progress, and persistently removes obstacles. Most Indian politicians and civil servants, in contrast, fail to plan their projects well, monitor them, or follow through on them: their performance failures mostly have to do with poor execution.

The government's most damaging failure is in public education. Consider one particularly telling statistic: according to a recent study by Harvard University's Michael Kremer, one out of four teachers in India's government elementary schools is absent and one out of two present is not teaching at any given time. Even as the famed Indian Institutes of Technology have acquired a global reputation, less than half of the children in fourth-level classes in Mumbai can do first-level math. It has gotten so bad that even poor Indians have begun to pull their kids out of government schools and enroll them in private schools, which charge $1 to $3 a month in fees and which are spreading rapidly in slums and villages across India. (Private schools in India range from expensive boarding schools for the elite to low-end teaching shops in markets.) Although teachers' salaries are on average considerably lower in private schools, their students perform much better. A recent national study led by Pratham, an Indian nongovernmental organization, found that even in small villages, 16 percent of children are now in private primary schools. These kids scored 10 percent higher on verbal and math exams than their peers in public schools.

India's educational establishment, horrified by the exodus out of the public educational system, lambastes private schools and wants to close them down. NIIT Technologies, a private company with 4,000 "learning centers," has trained four million students and helped fuel India's information technology revolution in the 1990s, but it has not been accredited by the government. Ironically, legislators finally acknowledged the state's failure to deliver education a few months ago when they pushed through Parliament a law making it mandatory for private schools to reserve spots for students from low castes. As with so many aspects of India's success story, Indians are finding solutions to their problems without waiting for the government.

The same dismal story is being repeated in health and water services, which are also de facto privatized. The share of private spending on health care in India is double that in the United States. Private wells account for nearly all new irrigation capacity in the country. In a city like New Delhi, private citizens cope with an irregular water supply by privately contributing more than half the total cost of the city's water supply. At government health centers, meanwhile, 40 percent of doctors and a third of nurses are absent at any given time. According to a study by Jishnu Das and Jeffrey Hammer, of the World Bank, there is a 50 percent chance that a doctor at such a center will recommend a positively harmful therapy.

How does one explain the discrepancy between the government's supposed commitment to universal elementary education, health care, and sanitation and the fact that more and more people are embracing private solutions? One answer is that the Indian bureaucratic and political establishments are caught in a time warp, clinging to the belief that the state and the civil service must be relied on to meet people's needs. What they did not anticipate is that politicians in India's democracy would "capture" the bureaucracy and use the system to create jobs and revenue for friends and supporters. The Indian state no longer generates public goods. Instead, it creates private benefits for those who control it. Consequently, the Indian state has become so "riddled with perverse incentives ... that accountability is almost impossible," as the political scientist Pratap Bhanu Mehta reported. In a recent study of India's public services, the activist and author Samuel Paul concluded that "the quality of governance is appalling."

There are many sensible steps that can be taken to improve governance. Focusing on outcomes rather than internal procedures would help, as would delegating responsibility to service providers. But what is more important is for the Indian establishment to jettison its faith in, as the political scientist James Scott puts it, "bureaucratic high modernism" and recognize that the government's job is to govern rather than to run everything. Government may have to finance primary services such as health care and education, but the providers of those services must be accountable to the citizen as though to a customer (instead of to bosses in the bureaucratic hierarchy).

None of the solutions being debated in India will bring accountability without this change in mindset. Fortunately, the people of India have already made the mental leap. The middle class withdrew from the state system long ago. Now, even the poor are depending more and more on private services. The government merely needs to catch up.

REFORM SCHOOL

India's current government is led by a dream team of reformers -- most notably Prime Minister Singh, a chief architect of the liberalization of 1991. Singh's left-wing-associated National

Congress Party was swept into power two years ago even though the incumbent BJP (Bharatiya Janata Party) had presided over an era of unprecedented growth. The left boasted that the election was a revolt of the poor against the rich. In reality, however, it was an anti-incumbent backlash -- specifically, a vote against the previous government's poor record in providing basic services. What matters to the rickshaw driver is that the police officer does not extort a sixth of his daily earnings. The farmer wants a clear title to his land without having to bribe the village headman, and his wife wants the doctor to be there when she takes her sick child to the health center. These are the areas where government touches most people's lives, and the sobering lesson from India's 2004 elections is that high growth and smart macroeconomic reforms are not enough in a democracy.

Still, the left saw the Congress victory as an opportunity. Unfortunately, it stands rigidly against reform and for the status quo, supporting labor laws that benefit 10 percent of workers at the expense of the other 90 percent and endorsing the same protectionist policies that the extreme right also backs -- policies that harm consumers and favor producers. Thus, Singh and his reformist allies often seem to be sitting, frustrated, on the sidelines. For example, the new government has pushed through Parliament the National Rural Employment Guarantee Act, which many fear will simply become the biggest "loot for work" program in India's history. Although some of the original backers of the bill may have had good intentions, most legislators saw it as an opportunity for corruption. India's experience with job-creation schemes is that their benefits usually do not reach the poor; and they rarely create permanent assets even when they are supposed to: the shoddy new road inevitably gets washed away in the next monsoon. There is also the worry that the additional 1 percent of GDP borrowed from the banks to finance this program will crowd out private investment, push up interest rates, lower the economy's growth rate, and, saddest of all, actually reduce genuine employment.

Singh knows that India's economic success has not been equally shared. Cities have done better than villages. Some states have done better than others. The economy has not created jobs commensurate with its rate of growth. Only a small fraction of Indians are employed in the modern, unionized sector. Thirty-six million are reportedly unemployed. But Singh also knows that one of the primary reasons for these failures is rigid labor laws -- which he wants to reform, if only the left would let him.

Singh's challenge is to get the majority of Indians united behind reform. One of the reasons that the pace of reform has been so slow is that none of India's leaders has ever bothered to explain to voters why reform is good and just how it will help the poor. (Chinese leaders do not face this problem, which is peculiar to democracies.) Not educating their constituents is the great failure of India's reformers. But it is not too late for Singh and the reformers in his administration -- most notably finance Minister Palaniappan Chidambaram and the head of the Planning Commission, Montek Singh Ahluwalia -- to start appearing on television to conduct lessons in basic economics. If the reformers could convert the media and some members of Parliament, the bureaucracy, and the judiciary to their cause, Indians would be less likely to fall hostage to the seductive rhetoric of the left. If they were to admit honestly that the ideas India followed from 1950 to 1990 were wrong, people would respect them. If they were to explain that India's past regulations suppressed the people and were among the causes of poverty, people would understand.

PEOPLE POWER

Shashi Kumar is 29 years old and comes from a tiny village in Bihar, India's most backward and feudal state. His grandfather was a low-caste sharecropper in good times and a day laborer in bad ones. His family was so poor that they did not eat some nights. But Kumar's father somehow managed to get a job in a transport company in Darbhanga, and his mother began to teach in a private school, where Kumar was educated at no cost under her watchful eye. Determined that her son should escape the indignities of Bihar, she tutored him at night, got him into a college, and, when he finished, gave him a railway ticket for New Delhi.

Kumar is now a junior executive in a call center in Gurgaon that serves customers in the United States. He lives in a nice flat, which he bought last year with a mortgage, drives an Indica car, and sends his daughter to a good private school. He is an average, affable young Indian, and like so many of his kind he has a sense of life's possibilities. Prior to 1991, the realization of these possibilities was open only to those with a government job. If you got an education and did not get into the government, you faced a nightmare that was called "educated unemployment." But now, Kumar says, anyone with an education, computer skills, and some English can make it.

India's greatness lies in its self-reliant and resilient people. They are able to pull themselves up and survive, even flourish, when the state fails to deliver. When teachers and doctors do not show up at government primary schools and health centers, Indians just open up cheap private schools and clinics in the slums and get on with it. Indian entrepreneurs claim that they are hardier because they have had to fight not only their competitors but also state inspectors. In short, India's society has triumphed over the state.

But in the long run, the state cannot merely withdraw. Markets do not work in a vacuum. They need a network of regulations and institutions; they need umpires to settle disputes. These institutions do not just spring up; they take time to develop. The Indian state's greatest achievements lie in the noneconomic sphere. The state has held the world's most diverse country together in relative peace for 57 years. It has started to put a modern institutional framework in place. It has held free and fair elections without interruption. Of its 3.5 million village legislators, 1.2 million are women. These are proud achievements for an often bungling state with disastrous implementation skills and a terrible record at day-to-day governance.

Moreover, some of the most important post-1991 reforms have been successful because of the regulatory institutions established by the state. Even though the reforms have been slow, imperfect, and incomplete, they have been consistent and in one direction. And it takes courage, frankly, to give up power, as the Indian state has done for the past 15 years. The stubborn persistence of democracy is itself one of the Indian state's proudest achievements. Time and again, Indian democracy has shown itself to be resilient and enduring -- giving a lie to the old prejudice that the poor are incapable of the kind of self-discipline and sobriety that make for effective self-government. To be sure, it is an infuriating democracy, plagued by poor governance and fragile institutions that have failed to deliver basic public goods. But India's economic success has been all the more remarkable for its issuing from such a democracy.

Still, the poor state of governance reminds Indians of how far they are from being a truly great nation. They will reach such greatness only when every Indian has access to a good school, a working health clinic, and clean drinking water. Fortunately, half of India's population is under 25 years old. Based on current growth trends, India should be able to absorb an increasing number of people into its labor force. And it will not have to worry about the problems of an aging population. This will translate into what economists call a "demographic dividend," which will help India reach a level of prosperity at which, for the first time in its history, a majority of its citizens will not have to worry about basic needs. Yet India cannot take its golden age of growth for granted. If it does not continue down its path of reform -- and start to work on bringing governance up to par with the private economy -- then a critical opportunity will have been lost.
