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Will Modi's arrows hit the mark?

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A visionary new leader, Narendra Modi, has recently come to power in India. He seeks to realise India's huge growth potential and make it a major global player. This has generated enormous optimism nationally, and internationally, about an Indian resurgence. What challenges must India overcome to achieve this?

There is a broad consensus that structural reform should centre on three critical economic policy arrows, and the new government seems intent on pursuing these. The first arrow is agriculture, where major market failures have made consumer price inflation endemic. The second arrow comprises the clutch of reforms to facilitate labour-intensive manufacturing to make the government's 'Make in India' [1] campaign reality. The third arrow is fiscal restructuring to free up taxpayer resources for major investment in physical and social infrastructure.

But is it possible that India could once again miss the bus?

Beyond the three major structural reforms there are, arguably, three fundamental factors holding India back. These operate at three interrelated but heuristically distinct planes: economic, cultural, and social.

On the economic plane, the chief constraint is the failure to strike the right balance between the market and the state. Fear of the market has long pervaded economic policy and civil society in India. This fear has tilted the balance between the market and the state sharply towards the latter, undermining economic efficiency and productivity growth. Crony capitalism [2], or rent seeking, was the direct outcome of this imbalance.

The state no doubt has a critical role to play in regulating markets and providing public goods. But there can also be state failures and markets often fail because of excessive state intervention. Agricultural commerce in India that prevents farmers from selling directly in the open market is a case in point. Like all monopolies, state monopolies risk becoming inefficient in the absence of competition, and they are also eminently corruptible.

But even as the state has overextended itself in market regulation, control and substitution, it has not invested sufficiently in critical physical and social infrastructure, where private enterprise has much less of a role to play. This has constrained productivity and income growth.

While the fear of markets has tended to limit efficiency and productivity gains, on the cultural plane India’s predominantly inward orientation has constrained competitiveness in a rapidly integrating global economy. India is now an outlier among emerging market economies in running structural current account deficits.

Despite the far-reaching trade reform of the early 1990s, India remains one of the most protectionist of the world’s major economies. While East Asia scours the world to learn and implement global best practices in a bid to catch up rapidly, India seems to think that it is different, has little to learn from the experience of others and must chart its own unique policies. There is, of course, no need to uncritically follow everything Western, but if India is to tap its potential, and not fall behind yet again, it needs to engage more with the outside world — both West and East.

On the social plane India must address social inequalities that limit equal access to opportunities.

The caste system has long been a defining feature of India. It segmented society into communities with limited social contact and gave asymmetric, hierarchical access to opportunities. The lingering effects of the caste system still segment access to opportunities and undermine the dignity of labour in civil society at every level.

A startling outcome of these lingering effects is India’s poor human development indicators. On average, even sub-Saharan Africa does better nowadays. This cannot be attributed to scarcity of resources because the state has pampered a large middle class, at the expense of investment in social infrastructure for those on the margins of society.

Yet it is not the moral argument against inequality — strong as it is — that needs to be underscored, but the economic one. A large chunk of the population is denied opportunities for educational and skills advancement. The full potential of the nation’s enormous talent pool cannot be tapped.

This is yet another area where the state–market balance has floundered. The state has tried to equalise outcomes through reservations, regulation and poorly targeted redistribution that puts increasing restrictions on the market. Instead the state should put in place the infrastructure to equip every individual to effectively compete and expand incomes under a market framework. The tendency to shift the burden of social protection from state to non-state market participants, such as private corporations (through stringent labour laws) and schools (through a quota system) has resulted in a vicious cycle of decapitalising affected sectors or pushes them towards informality. This depresses investment, productivity and growth, and further constrains tax revenues that could be used to redistribute resources.

The global economy is still recovering from the biggest financial and economic crisis since the Great Depression of the 1930s. The old growth model, based on leveraged consumption in advanced economies, has broken down. A major global rebalancing of demand and structural reforms is required to get growth back on track. A stagnant global economy is an economy in search of new engines of growth.

India could be this new engine of growth [3]. The two major drivers that recently pushed Indian trend growth from 5.5–6.5 per cent into the 8–9 per cent trajectory are intact. The dependency ratio continues to decline, while the roughly 10 per cent increase in domestic savings, as a share of GDP, is largely intact except for some short-term damage to financial savings.

Unlike other emerging markets that are dependent on external levers to return to high growth, India’s economy is balanced. The necessary reforms are mostly domestic, making now the opportune time for an Indian resurgence.

To realise its vast potential, India needs major policy and structural reform over the short- to medium-term. In particular, it needs to fire three arrows — agriculture, labour-intensive manufacturing and fiscal restructuring — from the bow of good governance.

Pulling these three strings is the immediate challenge for the Modi government. But if India is to sustain high growth over an extended period, beat the middle income trap [4] and become a major global player, it also needs to change its mindset. Civil society needs to overcome its fear of markets, engage more fully with the outside world and empower its citizens with equal opportunities. The real wealth of nations lies in their people.

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An extended version of this article appeared in the recent edition of the East Asia Forum Quarterly, ‘Asia’s Minorities’ [5].

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[5] East Asia Forum Quarterly, *'Asia's Minorities'*:
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