

**95<sup>th</sup> ASSOCHAM FOUNDATION DAY LECTURE**  
**on**  
**“Economy, State and Society in a Changing India”**  
**Monday, 19<sup>th</sup> January 2015**

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- 1. Ladies and gentlemen,** It is a privilege to be here for the 95<sup>th</sup> ASSOCHAM Foundation Day Lecture. As the oldest business organization in India, ASSOCHAM has played a catalytic role not only in shaping the economic landscape of the country but also in bringing government and business closer to make India’s emergence onto the world stage a reality. I congratulate you on your distinguished history and achievements. Thank you, Rana Kapoor ji, for giving me this opportunity. The speakers who preceded me are luminaries from the business and policy establishments of the nation. I am honoured to be a part of this distinguished set.
- 2.** As the title of my lecture suggests, I propose to share my reflections on the changing contract of the Indian state both with the economy as well as society.
- 3.** Why have I chosen to speak on this subject? The subject is not about the problems and challenges faced by you; yet it is my belief that captains of industry cannot be oblivious to the institutional milieu in which they are operating; they cannot ignore the changing governance paradigm.
- 4. Ladies and gentlemen,** the economic working of the state may be dated from the influential work of Anthony Downs in An Economic Theory of Democracy (1957), and James Buchanan and Gordon Tullock’s The Calculus of Consent (1962). That was then. It has since been accepted that public choice made by a modern democratic state should keep in mind redistributive

effects. It has to ensure that economic growth is rapid, yet, broad-based in which all sections of the people have a stake. The Indian state is no exception; it must embrace growth strategies which seek to spur efficiency while also making the growth process inclusive.

- 5.** The dominant intellectual tradition of development economics, which until recently highlighted the role of state intervention through the establishment of protectionist barriers and monopolies at the expense of markets, is now passé. An increasing reconciliation between development economics and competition economics, if I may say so for want of a better term, is taking place.
- 6.** State responsibility for the provision of services is no longer synonymous with state ownership. The command and control mode of governance that relied on state ownership of services is gradually yielding place. A new mode of regulatory governance is emerging wherein public private partnerships and private sector participation require governmental priorities to be achieved through independent regulation and the law of contract.
- 7.** Many in this room would recall the slow yet definite changes that have taken place in the socio-economic space over the last 25 years or so. However, patience is now running low and the desire to improve the quality of life of future generations is red-hot. This restlessness led to a major change in the political dispensation last year. The new Government at the Centre constituted on the mantra of “minimum government, maximum governance” brought growth and development centre stage in

the governance narrative. Though, since 1991, there has been a progression towards market as an instrument of growth, this is the first time that this ideology has received such a thumping endorsement from the electorate.

- 8.** This shift means not only a shrinking of government; it also means a changing role of the government. The State is now a facilitator in the economic architecture. Business in India has had substantial freedom to take commercial decisions since the de-regulation of the early 1990's. However, crucial segments continued to be subject to discretionary administrative intervention. For instance, factors of production till now have been tightly controlled. Recent years have seen a number of specific cases of corruption or the apparent exercise of influence of the State in the allocation of natural resources.
  
- 9.** Fortunately, the matrix of allocation and pricing of natural resources is being gradually re-engineered. In 2011 when I demitted office as the Union Finance Secretary, I was asked by the government to Chair a high level committee of Secretaries and representatives of Business chambers to examine the area of natural resources. The Committee focussed on resources within the ambit of the Union Government. As such, Coal, Minerals, Oil & Gas, Spectrum, Government owned land and forests were the subject of study. The findings were clear and sharp: lack of transparency; administrative discretion; absence of proper price discovery of the resource resulting in rent seeking behavior on the part of the beneficiaries. The economic governance model thus clearly showed a duality: a relatively forward-looking regime for encouraging domestic and foreign investment; on the other hand, an archaic, if not feudal, system

for giving out precious natural resource. While most end-product prices were market determined, prices of crucial resources were administratively decided, albeit, due to public policy goals. This arrangement had all the potential for windfall arbitrage. Hence, capitalism of the crony variety.

**10.** It is heartening to note that the events of the last few years, judicial intervention and the democratic verdict of the people are bringing winds of change. Auctions are set to become the norm in grant of many resources. Transparency and clarity of process is being injected. However, it would be desirable if these tentative attempts are carried to their logical conclusion. This can be done in two ways: (i) by converting executive orders into rules under relevant laws thus bringing them under Parliamentary over-sight; and (ii) by institutional re-jig so that the agencies who supervise are independent and not extensions of the executive.

**11.** The second shift in the economic contract of the State is in its role as a regulator. The theory of economic regulation, which has been around in one form or another since Adam Smith, regarded market failure as the motive for regulation. The centrality of regulation in the development paradigm is the cornerstone of modern public economics. It emphasizes 'public interest' theory of regulation and is based on the premise that governments are capable of correcting these market failures through regulation. Even though the Chicago critique of regulatory theory places heavy reliance on private decisions to correct the failures of the market, a more nuanced position is generally accepted globally.

**12.**Government intervention in the modern economy impacting industry structure and behavior takes two forms: Regulation and Antitrust. Regulators define *ex-ante* a set of rules of the game for operators by regulating entry conditions, licensing requirements, tariff standards, control over price, quantity and quality etc. Antitrust enforcers, in contrast, check *ex-post* whether the game was played in accordance with the competition law and its principles.

**13.**This transformation, however, remains an inadequately understood process in India. The philosophy guiding the creation of independent regulatory institutions is that direct regulation by the state is not appropriate as it amounts to the fox guarding the chicken coop: it invites state actors (politicians and bureaucrats) to frame regulations, which may not be aligned with the larger public interest and the commercial interests of the service providers. Hence, the creation of independent regulatory institutions is a way for the state to credibly step back from direct regulation by the sovereign.

**14.**Regulation has **two** important components: one is governance which includes the organizational structure and mechanisms; the other is regulatory incentives which are the rules governing pricing, cross or direct subsidies, etc. Effective regulatory incentives and regulatory governance regimes both need to be in place. Where one or both are weak, there is likely to be a continuing threat of regulatory failure.

**15.**In India, as in most parts of the developed world, the regulation of various sectors of the economy has been transferred from the relevant government ministry/department to independent federal or state-level sectoral regulators.

Starting with the Securities regulator – SEBI - in 1992, the government has established independent sectoral regulators in various sectors, including telecom, electricity, natural gas, petroleum, insurance, etc. These have been supplemented recently by an economy-wide regulator : the Competition Commission of India.

**16. Ladies and gentlemen,** Where do we stand in terms of the efficacy of economic regulation? What has been the report card? I believe you and other stakeholders would be better placed to assess this; however, let me give you my views.

**17.** I would identify five broad issues. First, the regulatory framework in India developed in silos across sectors with little cross-cutting coordination. The existing statutory and institutional framework suggests the absence of a common regulatory philosophy. Perhaps there is need for a helicopter view of the regulatory structure and an over-arching legislation which brings about uniformity in design and structure to the extent necessary. Regulators also seem to have become the “mantra” and there are perhaps one too many, particularly in the financial sector.

**18.** Second, early years as they are, the capacity and knowledge housed in the regulators is shallow. The asymmetry between what the regulator knows and what the regulated entities have access to is huge. Can the regulator in such circumstances intervene intelligently and do justice?

**19.** Third, regulation suffers from a legacy of weak institutions in countries such as India which renders the regulatory contract between Governments and regulated entities incomplete. This year’s Nobel laureate Jean Tirole has built a sophisticated

theory to guide regulators and thereby accorded them an important institutional space in market economies.

- 20.**Fourth, of late a view has gained currency that sector specific regulation has the potential of capture by the regulated industry. Simply put, regulation may end up benefitting producers rather than consumers. Empirical studies on effectiveness of regulation show that every business that has political leverage will seek to control entry. There is thus a real danger that the regulators may end up becoming an instrument of protecting the incumbent firms.
- 21.**Fifth, of critical significance from the point of business is regulatory uncertainty and, consequently, regulatory risk. Since the architecture is work in progress, conflicting policy signals could clash with regulatory objectives. The end-result: a foggy horizon which business, particularly, cross-border ones, find difficult to decipher.
- 22.**Given the limitations of regulation, competition must be seen, not as a substitute for regulation, but as a valuable tool of regulation. In many circumstances it can be the most effective vehicle for achieving both efficiency and social policy objectives.
- 23.**There is, therefore, a need for Indian economic policymaking to shift from a structural to a more behavioural paradigm; where pro-competitive reforms are supported by pillars of an institutional framework which has the 'centrality of markets' as the core regulatory mandate.
- 24.**It is equally important to delineate appropriate means and degree of control exercised by the state over the regulator.

Continued interference by the state compromises the efficiency enhancement role of the regulator. For an independent regulator to deliver, state actors have to forbear. Intervention to promote public policy or redistribution objectives is to some extent “understandable”. However, interference to protect vested interests is “undesirable”.

**25.**Creation and sustenance of independent regulatory institutions requires a high degree of political and judicial maturity. We are slowly moving in that direction. But this cannot happen in a day. It takes years of evolution and other complementary reforms for economic regulators to carry out their fiduciary responsibility effectively.

**26.****Ladies and gentlemen,** let me now turn to the shifting contours of the state’s contract with society. India recently broke out of the low-growth paradigm and experienced a record decade of growth. This new growth on the one hand provided the state with resources to spend on social development, on the other brought about a palpable change in aspirations and social consciousness. While the India growth story has faltered in the last two years, the psychological transformation that it brought along is irreversible. Inclusion is now a demand of the populace. Also, with deepening of democracy and increased mobility, has come a shift in focus from mere entitlement to real empowerment. The challenge for the state is to address the disjunct between the existing welfare architecture and the evolving social needs.

**27.**Growth and development are not mutually exclusive; neither are they perfectly correlated. A rising tide may not lift all boats

alike. While propelling economic growth should remain a priority, policy armoury of the state must also include instruments that create right conditions for the growth-benefits to percolate to the bottom of the pyramid. There is a growing consensus that development outcomes are not merely a function of the public spending on social services or the number of welfare schemes but also of the efficiency of service delivery. And so the state has to pursue its role differently than it did in the past to make redistributive policies well-targeted. A framework must be set out that will encourage creative partnerships between the state, society and market to help meet development objectives.

**28.** Friends, the social welfare programmes of India are complex systems with millions of beneficiaries depending upon these programmes for basic sustenance. There has been consternation about these schemes being riddled with pilferage and leakages – be it the TPDS, the fuel and fertiliser subsidies or the MGNREGS. Public provision of goods and services in India has been highly inefficient with limited delivery of the subsidy to the intended beneficiaries.

**29.** Direct benefit transfer (DBT) offers a 'silver bullet' solution to this problem. It ensures that goods move in the supply chain at market prices while the consumer is empowered through cash transfer. I believe that the launch of Aadhar-linked cash transfer schemes can be a game changer. With the potential to remove intermediaries and to liberate us from the worst distortions in pricing, Aadhar, Ladies and Gentlemen, can be a catalyst for welfare reform.

**30.** The implementation challenges cannot be overlooked. We cannot expect miracles overnight. A reality check: it took over

15 years for the United States to migrate social security payments from paper checks to electronic transfers. However, even with 50% implementation, large gains in programme performance are possible<sup>1</sup>. So implementation challenges must not be an excuse for delay or inaction. It is also essential to align the incentives of banks and Technology Service Providers to provide the last-mile financial inclusion services.

**31.** Evidently, there are strong synergies between direct benefit transfer and financial inclusion. As we have seen in the past, providing banks with account-opening targets is likely to result in large numbers of dormant accounts. Paying banks commissions on payments made would, on the other hand, rather create the right incentives for not just opening accounts but keeping them active.

**32.** Financial inclusion is not and cannot be a goal in itself. It is a means to lift the underprivileged from poverty. According to the NSSO's 59<sup>th</sup> Round Survey Results, 51.4 per cent of the farmer households in the country did not access credit. Despite the vast network of bank branches, only 27 per cent of the total farm households were indebted to formal sources. In 2013, CRISIL's **Inclusix** Index gave India a score of 40.1, which means only about 40 per cent of the country has access to formal banking services. These figures are appalling.

**33.** The Pradhan Mantri Jan Dhan Yojana provides a holistic framework moving beyond mere opening of 'no-frills' account. However, there still remain challenges, in view of the already strained balance sheets of the government run banks. While

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<sup>1</sup>'Building state capacity for better programme implementation: Lessons from the Andhra Pradesh Smartcard Programme', Karthik Muralidharan; December 2014

there is no doubt that the goals of comprehensive financial access are important, they need to be pursued in a manner that does not end up eroding the competitiveness of the financial institutions.

**34.**Efforts must also be made to tap into the strengths of non-banks to offer payments, deposits, etc. Enabling an inclusive competitive landscape could be the way forward. The Mor Committee recommendation for Payments Banks and a national 'Payments Services' ecosystem opens the door for more players to enter. World over, countries are doing away with regulations that restrict entry of non-banks in payments space, with the aim to encourage competition and innovation. India should also develop an enabling environment that optimizes the potential of technology and market participants.

**35.Ladies and gentlemen,** most families in India today, no matter how poor, want better education for their children. But nowhere has the Indian state failed more miserably than in providing universal quality education to its young. Learning levels among primary school children in rural India remains shockingly low despite a steady increase in education spending under the Sarva Shiksha Abhiyan (SSA) and the Right to Education (RTE). There has been a rise in parents shifting from free government schools to fee-charging private schools, with the share of private school enrolment in rural India increasing from 19% in 2006 to 29% in 2013.<sup>2</sup> The prevalence and enrolment share of private schools presumably should be even higher in urban areas.

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<sup>2</sup> 'Understanding the relative effectiveness of government and private schools in India', Karthik Muralidharan, January 2014

- 36.** In addition to improving the effectiveness of government schools at the current level of spending, it is time we experiment with models of education with public funding (to ensure universal access) and private provision (for better school management). The policy discourse must move away from simplistic public vs. private provision of education. The focus should rather be on design of better education 'systems' that leverage the strength of both.
- 37.** One idea that effectively captures this new paradigm is school vouchers. The voucher will put purchasing power in the hands of every parent. It provides the vulnerable sections of society with the same set of choices available to their privileged counterparts while also compelling the public schooling system to improve. The underlying premise is that competition can be a force for improving both public and private schools.
- 38.** The legislative framework governing education recognizes this principle. Specifically, I would like to mention **Section 12** of the The Right of Children to Free and Compulsory Education Act (2009). It aims to reduce social stratification in education by requiring private schools to reserve one-fourth of their seats for the economically weaker section, while the government reimburses their fee up to a maximum of per-child spending in public schools. By design, it has the potential to leverage the efficiency of the private sector, induce competition between public and private schools without distorting incentives for private investment.
- 39.** Besides an ill-educated population, an unhealthy, malnourished population can also be a major limiting factor in pushing the growth frontier. Providing quality and affordable healthcare to

the large Indian population is a formidable task. For India, health sector reform must, therefore, be central to the policy agenda. Expenditure on health is just 1.4 per cent of India's GDP, which certainly needs to increase. More importantly, a critical part of health sector reform will also have to be purposeful collaboration between the public and the private sector in financing and provision of healthcare services.

**40. Ladies and gentlemen,** having spelt out the terms of engagement of the state with the economy and society, it is also important to recognize that fulfilling the terms of the contract rely on Government Effectiveness- measured by the vision of the political elite, the competence of the bureaucracy and the quality of institutions. Stressing their importance, Daron Acemoglu and James A. Robinson in their highly acclaimed book "Why Nations fail?" (2012), argue that a key differentiator between countries is "**institutions.**" Nations thrive when they develop "**inclusive**" political and economic institutions, and they fail when those institutions become "**extractive**" and concentrate power and opportunity in the hands of only a few. The writers say:

*"Inclusive" economic institutions that enforce property rights, create a level playing field, and encourage investments in new technologies and skills are more conducive to economic growth than extractive economic institutions that are structured to extract resources from the many by the few."*

**41.** I ask myself: Is all this reasonably possible? Creation of institutions meeting these criteria and the implementation of complementary reforms is in the hands of the very groups that stand to lose the most from these changes. But the time seems

to have come. Slow and hesitant attempts to untangle the mess are under way in the wake of pressure from various stakeholders. It will now need a passionate statesman to rise above myopic political interests and cut the Gordian knot.

- 42.** I would like to end with a verse from Shakespeare's 'Julius Caesar', which captures the sense of urgency in building a new India: "There is a tide in the affairs of men./ Which, taken at the flood, leads on to fortune;/ Omitted, all the voyage of their life/ Is bound in shallows and in miseries./ On such a full sea are we now afloat,/ And we must take the current when it serves,/ Or lose our ventures."

**Thank you, ladies and gentlemen.**