Working Paper No. 67

India’s Reforms
Achievements and Arrears

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October 2000

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August 2000
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SUMMARY

When India’s economic reforms began in 1991, the immediate crisis and by the Fund-Bank conditionalities that accompanied their assistance defined them. The limited reforms succeeded so well that they have receded into obscurity. Almost all the political groups that opposed them have now embraced a reform agenda. As a result, reforms have lost focus, and acquired a range of often contradictory meanings. This paper defines a set of reforms still required if the gains made hitherto are to be consolidated and India’s economic performance is to be decisively improved. The reforms must begin with the administration. The present first-past-the-post system of election has favoured parochial and sectarian forces, and failed to ensure governments with a decisive majority; it needs to be replaced by proportional representation with a high cut-off point which would eliminate minor parties from the legislatures. They should be elected partly on universal adult suffrage as now and partly by income tax payers with votes in proportion to tax paid; budgets and financial legislation should require the approval of taxpayers’ representatives. The gazetted officers of the civil service at present are appointed for life; they should instead get ten-year contracts, so that their numbers can be matched with the work to be done. The present free-for-all civil service examination should be replaced by an examination in a small number of practically useful subjects. The junior bureaucracy should be appointed on short-term contracts that should not extend beyond the age of thirty. All government salaries should be comparable to those obtaining in the private sector; judges’ salaries should be comparable to those of the lawyers who argue before them. The present patchwork of states should be replaced by a larger number of states centred on the major cities; within the states, communities should have considerable freedom to set up their own local authorities.

Import duties and import restrictions should be abolished; protection to domestic producers should be given only by means of the exchange rate. The present excise duty and income tax on profits should be replaced by a flat-rate value added tax, in addition to which there may be a personal income tax. State-owned banks should be mutualized and sold to depositors. Their business should be divided into custody of depositors’ cash and investment of the depositors’ funds. On deposited cash, banks should offer complete security and no return. In addition, they should offer depositors a range of investment options varying in liquidity, risk and return. To improve liquidity and reduce risk, Reserve Bank should encourage the emergence of local bill markets in which businesses can raise money and banks can invest. Regulators should be given clear and non-overlapping tasks, and their authority should be commensurate with their tasks. Regulators should be appointed who are not beholden to the government, and they must have powers of instant punishment. Regulators who oversee natural monopolies should enforce the common carrier principle and the principle of fair pricing. The government should privatize schools, and limit itself to subsidizing students – not schools and colleges. DTH television should be extensively used to impart education; the government should confine itself to setting common standards. The aim should be to create a political system that can learn from its own performance and improve upon it.
India’s performance in the 1990s has been creditable – good enough to give us self-confidence to go ahead with further reforms. The government today is far more stable than any government in the 1990s. And it has shown a will to reform. It is reflected in the work of the Prime Minister’s Economic Councils as well as in the various commissions appointed by ministers. Some of this spadework has resulted in legislation. Whether one agrees with what has been done or not, the will and the determination are unmistakable.

For this reason this is a good time to put forward ideas about what needs to be done, what is a reform and what is a pseudo-reform. That is what I propose to do in this paper.

**A balance sheet of the 1990s**

The state of the Indian economy appears to be embarrassingly sound. It is now two years after the nuclear ceremony, which brought universal condemnation and sanctions upon India; during his visit to India President Clinton christened our subcontinent the most dangerous spot in the world, thereby telling American business not to invest in India. Despite this confrontation with the capitalist world, India’s balance of payments remains surprisingly strong; through hail and high water, the reserves keep rising.

And that is not because of foreign investment. Foreign direct investment is distinctly down after the coming of the BJP governments. Portfolio investment is not, but it is a fickle bird of fancy. It has been down and up. It is here today and may be gone tomorrow. In any case, capital inflows are not responsible for the rising reserves. One cannot avoid the conclusion that the external fundamentals are strong.

And more surprisingly, inflation is down. The level of inflation showed a distinct fall from 1996 onwards; in the past year it has come down to levels that have not been seen since the days before socialism and the grand follies. Something has changed; we are no longer in the boom-and-bust mode of the 1960s, 1970s or 1980s.

What has changed? Five things in particular. First, industry is no longer in a position to pass on cost increases. Domestic competition has increased, and now there is some competition from abroad as well. This accounts for much of the fall in inflation. For this, the credit must go to the Fund and the Bank, which forced us to abolish industrial licensing in 1991, and to Narasimha Rao who had the sense to yield
to force. If the Fund and the Bank had any strategic sense, they would be advertising their success in India instead of drawing comfort from Côte d’Ivoire and El Salvador.

Second, the illegal balance of payments has collapsed. The havala premium has disappeared, and billions of dollars that used to be siphoned off into illegal foreign exchange transactions. For this, credit again goes to the Fund and the Bank – they forced us to devalue in 1991, begin to dismantle import licensing in 1992, and start reducing tariffs in 1993 - and to Manmohan Singh at the Finance Ministry and P Chidambaram at the Commerce Ministry who carried out these changes. But I would now give greater credit to Chidambaram. For when Manmohan Singh liberalized gold imports through NRIs without releasing foreign exchange for them, he in effect legalized smuggling; most of the gold came to be brought in by couriers of big Dubai smugglers. When Chidambaram allowed a few banks to import and sell gold in 1996, he dug the grave of gold smuggling. We see the effects of this single measure today in the death-throes of havala. The rise in the reserves is due to the fall in the demand for gold and smuggled goods, and in foreign exchange balances illegally held abroad.

The third change is something Manmohan Singh did in a moment of righteousness. He felt it was unfair that the government should take away people’s savings without a by-your-leave through the loans it compulsorily sold to the banks. So he resolved in 1992, without anyone asking him, that the central government and its institutions would no longer resort to the Statutory Liquidity Ratio. On the face of it, it changed nothing; even now the Reserve Bank sells thousands of crores of central securities to the banks. But the absorption is no longer automatic; the Reserve Bank has to cajole, threaten, twist arms, and even then it sometimes cannot sell the loans. It has had to raise interest rates; the cost to the government has gone up. IDBI and ICICI have had to raise money from retail investors at high interest rates. The change is working its way through the system. When Yashwant Sinha inveighs against the fiscal deficit, he is not being a reformer; he is just reflecting the consequences of Manmohan Singh’s decision.

The fourth change is in taxation. Manmohan Singh brought down the income tax rates. In a country where tax evasion is so rife, all taxation is unfair to honest taxpayers; the reduction in taxes has evened the scales slightly in their favour. It is not just the tax reduction; there are two further fiscal changes. One is that the rate of corporate tax and the peak personal rate of tax are about the same, so the gains from declaring personal expenses as corporate expenses have declined, and so have the advantages of controlling companies for that purpose. And Yashwant Sinha abolished the tax on dividends in the hands of shareholders, and thereby reduced the double taxation of dividends (as against the single taxation of undistributed profits). This too reduced the advantage of controlling companies. With these two changes, a promoter no longer has to control a company to be able to live off its profits; he can hand it over to
competent managers and live comfortably as a shareholder. A handful of promoters have done so already; many more have hired more competent CEOs than themselves.

The last change is not very clear to me: something has happened in the foodgrain market. In the 1970s, the green revolution created a flood of wheat; to save Punjabi farmers from distress, the central government turned the rationing scheme into a scheme to subsidize foodgrains and increase their consumption. But there are always many claimants for a subsidy: farmers, who would like higher prices, consumers, who would like lower prices, and the officials of Food Corporation, who would like fat margins to blow up on themselves. The farmers have politically been the most powerful, and have won an annual support price increase of 10-15 per cent year after year. That is what raised the rate of inflation from an average 7 per cent in the 1950s and 1960s to 11 per cent in the 1980s, even though the growth rate of foodgrain output rose. In the 1990s, somehow, the political advantage of pushing up support prices petered out. The first sign came in the eight state elections of 1994-95, of which the Congress lost six. Manmohan Singh connected this to Balram Jakhar’s pushing up of support prices by 60 per cent in three years. He applied all brakes and brought down inflation to an incredible 4 per cent by the general election of 1996; but the Congress still lost it. The present government is, if anything, even more beholden to Punjabi farmers; but it has been more circumspect in raising support prices. The urban supporters of the BJP have at last found a voice. So inflation has come down, and I think the fall may last.

Other readings of the balance sheet

That is my view. However, there are other views, other answers to the questions: what have we achieved? Has India gone forward? Or back? Or is it not such a different country from what it was before the Chandrashekhar crisis of 1991?

There is an official answer to this question: we have done Reforms. They have worked, and have been accepted even by their erstwhile opponents. Everyone has been converted to Reforms. They will go on whatever the government.

There is a leftist answer, much muted these days: the government fell into the hands of Lackeys of International Capitalism; they dismantled the defences of the economy and let in Global Capital. That has done nothing for the Masses, who remain as Poor as ever. The Rich have got richer, and now have many more luxuries, Indian and foreign, to spend their riches on. The Lackeys have been followed by the Communalists who are an even bigger curse. They have forged an alliance with the Comprador Capitalists and launched on a Hegemonist course. It will sharpen both domestic and external Contradictions, and surely bring disaster.
There is a *Hindu nationalist answer.* They too believe that the lackeys had let in foreigners to exploit our Huge Market. The result was a sharp increase in competition, and a slowing down of industrial growth. Luckily the BJP came to power just in time, closed the gates to foreign companies trying to enter consumer goods and inessential industries, and gave timely protection to our industries. Patriotic industrialists and politicians work hand-in-hand in successful countries like Japan and Korea; henceforward, BJP will ensure such cooperation in India as well.

And finally, there is the *answer of foreign capitalists.* It is that India is the world’s greatest underachiever. India has a capable entrepreneur class that does well in more liberal climates abroad and would transform India if only it were allowed; but political and bureaucratic predators exploit and obstruct it so much that it has no chance to show its mettle. Manmohan Singh began in the early 1990s to break the chains, but the politicians and the bureaucrats saw their means of prosperity threatened and stopped them before they got far. India needs to open up to foreign investment and foreign competition; its government needs to get out of production and privatize the industrial and financial enterprises it owns, and it needs to shift public expenditure from unproductive subsidies and military aggrandizement to public investment and collective welfare. It is far from doing so, and unless it does, it has no chance of dragging itself out of its poverty.

How good are these answers? The official answer mistakes semantics for reality. Of course everyone is for reforms. Reforms are like motherhood; no one is ever against them. What matters is the content of the reforms. No one has defined it – least of all the government. Everyone is free to label as a reform anything he is in favour of. That only implies the trivial truth that everyone favours whatever he likes; it means no consensus on anything substantial.

If political doubletalk leads politicians to label anything they like as a reform, the leftists’ faith obliges them to believe that the masses will be in increasing misery until the leftists take power at the centre. Hence by definition, the reforms must have increased misery. Indian poverty statistics are unbelievably crude. They give no firm indication of a distinct change. Employment statistics, which would show the impact of the reforms if any, are non-existent. Production statistics suggest better performance in industry and worse in agriculture in the 1990s than in the 1980s and earlier. Whilst the leftists should feel depressed, there is no objective reason for their depression.

Although the Hindu nationalist perception of a foreign threat to Indian industry is echoed by organized big business, it is not certain at all that Indian business has suffered unduly from foreign competition. Hardly any big Indian company has been bought up by foreigners. The slowdown has been followed by hectic merger and acquisition activity in which foreign companies have also participated. What is true,
however, is that the brotherhood that characterized the relations between Indian and foreign businessmen in the early 1990s has weakened, and that the foreign companies that are prepared to come to India want to go it alone. The role of Indian businessmen as gatekeepers is coming to an end. The BJP is trying to restore it, for instance by insisting that if a foreign company has a joint venture and wants to set up a new subsidiary, it has to get its Indian partner’s permission. The BJP would like to aid Indian businessmen more openly against foreigners, but is inhibited by the huge balance of payments deficit which can only be financed by foreign inward investment. Unless the BJP considerably improves the current account, it is in no position to favour Indian against foreign businessmen. And it is taking no steps to improve the current account. So it is not being true to its ideology – either because its ruling faction does not believe in that ideology, or because it does not understand the economics.

Finally, the foreign capitalist’s view. Only official apologists would contest that India has grievously underachieved. Nationalists, whether Hindu or Muslim, Parsi or Christian, should be even more convinced of and sore about the underachievement than foreign capitalists. In any case, no serious thinker believes that India has grown at the outside limits of its capacity, not even in the 1990s. India can surely do better. Nor can the foreign capitalist’s characterization of the Indian governments be seriously contested. The Indian governments are predatory; there is no denying either the character of the Laloo or Jayalalitha or Thackeray government, or the daily experience of the businessman who has to deal with excise officers or labour inspectors. What is less certain is the logical connection between the predatory state and the underachievement. Some countries that rival India in corruption and arbitrary government have grown and improved their social conditions much faster than India.

So none of the above views is correct. If we are to decide what needs to be done, or even if we want to judge what is going to happen, it is necessary to define what reforms are, to apply the definition of reforms to different fields, and to arrive at a more black-and-white picture of our political and economic realities.

I The context

Every country has a tendency to magnify itself. This is all right as a part of leaders’ ceremonial speeches. If children are made to do it, it is a waste of their time, but otherwise probably does not harm them too much. But in making policy, megalomania can be disastrous – as Pandit Nehru discovered when he asked the army to “throw the Chinese out” in 1962. A government has to take a realistic view of where the country stands.
But this is the first step. Beyond it, it is possible to analyze a country’s situation with greater or less intelligence. Just as a firm must work out its assets and liabilities, its strengths and weaknesses, the web of competitors, cooperators and stakeholders and the opportunities inherent in it, a country too must make the best of its geography and history.

**Making sense of history**

History is what once happened. What happened cannot be undone. What we know happened is a fraction of what actually happened, and our knowledge of it is imperfect. History is a good subject for historians to debate. For the rest of us, it can be useful – or harmful.

The use our rulers have put history to since independence has been highly destructive. Take the running sore of our conflict with Pakistan. This has been by far the most damaging choice made at independence. Its cost in terms of military expenditure has been enormous. It has done incalculable damage to our weight in the world; India at loggerheads with Pakistan is a far more lightweight world player than an undivided India – or even an India at peace with Pakistan. Pakistan says this conflict is due to Kashmir – which itself is a product of history. But no one can seriously believe that the tensions would disappear if Kashmir went to Pakistan. For they arise out of the fact that the people in power in both India and Pakistan regard themselves as inheritors of historical traditions which brought Hindus and Muslims into conflict over a millennium. Hindu nationalists get all heated up about the way Muslim kings treated Hindus centuries ago. Muslim nationalists in Pakistan equally regard themselves as descendants of glorious warriors who conquered and ruled India, and seek to forge relationships with Muslim countries to their west that once belonged to the marauding brotherhood. Since the coming to power of BJP, our paranoia has sought new territories. I have heard foreign policy experts of Hindu persuasion arguing that there is a global Islamic conspiracy that foments terrorism and undermines democracies. They have an ideological guru in Samuel Huntington. They would like to forge an alliance with the west to combat Islamic criminality. It is not going to happen; the west does not find India worth having as an ally.

Nationalists on both sides are living in a nightmare of their own imagination. Hindus of today have nothing in common with their oppressed forebears; Pakistanis of today have not the slightest hope of reliving the exploits of their supposed forefathers. Both Indians and Pakistanis would be far better off if they saw the irrelevance of their history to the present and asked themselves how best they can get on in the twenty-first century. If they did, the answer would be blindingly obvious. It would be in the best interests of both countries if they moved as close to each other as the US and Canada, or as France and Germany. Their border is for all practical purposes an irrelevance and a nuisance; people and goods
should be able to move across it without hindrance. And if they did, the question whether Kashmir should be in India or Pakistan would lose all meaning; it would not matter where it belonged.

The border cannot, of course, be dismantled by one country alone; if Pakistan remains hostile, India has to engage with it irrespective of history. But in that event the aim of foreign policy should be to maximize the cost of hostility to Pakistan. It would, for example, involve developing closer economic ties with Pakistan’s Muslim neighbours and friends, and ensuring that the tangible benefits to them from those ties outweigh their religious sentiments.

At home, it just happens that there are far more imposing Muslim monuments than Hindu ones. Hindu paranoiacs would like to believe that this is because Muslim rulers destroyed temples. So they probably did; but those temples are gone forever, and it makes not the slightest difference to anyone whether they are rebuilt in the same place or not. But the Muslim monuments, whether they are mausoleums, palaces, or fortresses, are potentially an enormously useful part of our heritage. It does not matter who built them, on the site of what there was before, with whose sweat, out of whose taxes. There are these exotic edifices strewn all over northern India which, if properly maintained, landscaped and refurbished, could be as great a draw for tourists as the entire architectural heritage of Europe. The communists of China do not ask themselves which hateful feudal monarchs built the tombs in Xian or Peking; they have simply made them imposing enough to attract hordes of tourists. Whilst the Red Fort is littered with ugly barracks built by the British in the nineteenth century, Imambara in Lucknow is dirty and decrepit; the mighty fortress of Tughluqabad is a wilderness where monkeys roam. If our rulers had any sense, they would clear land around these monuments and turn them into jewels of architectural beauty – not because of who built them, but simply to turn a national heritage to profit.

We have inherited far more from the British, simply because they ruled us more recently; and the way we go about destroying their heritage is appalling. Mani Shankar Aiyar, in a moment of sycophancy, proposed that Connaught Place and Connaught Circus be renamed Rajiv Chowk and Indira Chowk. With this single stroke of folly, the Congress destroyed billions of brand value that belonged to the shopkeepers of Connaught Circus. But their losses are dwarfed by the massive damage from the renaming of Bombay, Madras and Calcutta. The people of those cities never asked for a change; they were perfectly happy with the old names. But opportunistic politicians – Bal Thackeray in Bombay, M Karunanidhi in Madras, Jyoti Basu in Calcutta – sought to collect some ephemeral credit with their supporters. Shiv Sena vandals renamed Victoria Terminus, and called it Chhatrapati Shivaji Terminus. No one, absolutely no one I know calls it by that name; it has become prosaic CST. Every city in India has a Mahatma Gandhi Road. It
reflects no honour to Gandhi. No one who refers to Mahatma Gandhi Road gives Gandhi a thought; in fact, it has been trivialized into MG Road almost everywhere.

Compare this with Singapore. It kept all the British place and street names unchanged. The result was that foreigners felt more comfortable in that city, and brought so much capital and employment to it that it is the richest part of continental Asia today. It capitalized on the brand value of the names that the British carelessly left behind when they quit Singapore. No one knows or cares which Newton Newton Circus is named after. But the rich global traveler would much rather go shopping in Newton Circus than in Hutatma Chowk. And to think that Hutatma Chowk had a far better brand name once – Flora Fountain.

Petty politicians will try to put history to their own uses and extract some temporary mileage out of it. But in the process, they have done incalculable damage to India’s power, India’s reputation, and India’s prosperity. After doing all this damage, they think of taking a few more billions from the taxpayer and putting it into an India brand fund. That is quite unnecessary. Instead of this shadow boxing, let us ask ourselves how we can make the most money out of what we have inherited, and almost invariably we will find the right use for it.

**India’s place in the world**

The world suddenly changed political shape with the collapse of the Soviet Union. The Congress adapted itself nimbly to the change. But neither the left nor the right was happy with the change in direction; when the BJP got a chance, it took an overtly nationalist direction. The leftists are stuck in their traditional anti-Americanism. These attitudes towards world politics are reflected in the parties’ view of the external economic reforms of the early 1990s, and particularly of foreign trade and foreign investment.

We must start from the position where the BJP has brought us; whatever has happened cannot be wished away, and it is unrealistic to think of reversing direction. The Pokhran ceremony opened a rift between India and the US, and attracted sanctions. Vajpayee’s friendly overture towards Pakistan was followed by betrayal and by a costly and fruitless war. His move for freer trade with Sri Lanka and Bangladesh became ensnared in the bureaucratic tangle of the commerce ministry. In sum, major initiatives have been taken without any positive result.

The Pokhran ceremony made it impossible for India to sign the CTBT; luckily, US Congress torpedoed it. Despite that, however, it is necessary to bring the nuclear chapter to an early end. Whatever needs to be done to make nuclear weapons operational should be done with utmost dispatch; once it is done, we can
put it on the table and begin to negotiate a modification of the CTBT or something equivalent, which is bound to come sooner or later.

This may take some years; in the meanwhile, India must seek the defeat of the sanctions by other means. Those means involve raising the growth rate, and opening the Indian economy further to trade and foreign investment. If industrial countries find tempting opportunities in India, if they find themselves likely to miss the opportunities on account of the sanctions, they will relax the sanctions. The BJP has been in a dilemma here. On the one hand Indian industrialists have been asking it for protection against imports and foreign investment; on the other hand, foreign companies that enter India or are treated well here can be a powerful help in dealing with the governments of their home countries.

Many in the BJP think that India is already a powerful magnet and that they can use the domestic market to bargain with foreign companies. This is reflected in the growing complexity and arbitrariness that the BJP has introduced in foreign investment policy. The list of industries subject to automatic approval has grown as long and opaque as such lists used to be in the days of planning. The Foreign Investment Promotion Board meets irregularly, and often rejects applications or postpones decisions without clear reason. The policy that foreign companies that have joint ventures should get their joint venture partners’ approval before they can set up subsidiaries discriminates between foreign companies with and without joint ventures, and gives a signal to the latter not to go into joint ventures lest they store up future trouble for themselves. Pramod Mahajan’s petty nationalism over DTH broadcasting and foreign investment in media, the DoT’s messing up of private operators and their foreign partners, and Kumaramangalam’s sabotage of independent private producers through his proposed megaprojects have all made India look more like its older unreliable self. There is a venture capital firm in San Francisco which finances only Indian software startups. But it gave up financing Indians in India because of the Indian bureaucracy. The BJP needs to think things through and bring simplicity, consistency and transparency into foreign investment policy – and that means disciplining a number of its ministers.

Vajpayee had a good idea in bringing Sri Lanka and Bangladesh closer by giving them trade concessions; removing import licensing over thousands of items and unilaterally reducing tariffs could have paid immense dividends. But the commerce ministry was slow in implementing the agreements; and it made a terrible mess over import of Sri Lankan tea. It should be our object to provide substantial markets in India for the major products of small neighbours – Bangladeshi jute goods and textiles, Sri Lankan and Kenyan tea, Burmese rice and teak, Pakistani rice, sugar and cotton etc. The greater the trade, the less is it possible for governments to fight. Trade is a substitute for movement of people: if Bangladeshi workers can make goods for the Indian market sitting at home, they will not have to migrate to India. Conversely, economic
warfare is less costly than real warfare, and now that we have exhausted the possibilities of the latter, the former is the only choice in respect of Pakistan. The Prime Minister should exercise stronger leadership in this regard, and should not allow his ministers to wreck his initiatives.

The same argument applies to our Middle Eastern neighbours. We had a useful relationship with Iraq which was wrecked by the Gulf War and the ensuing ostracization of Iraq. But similar ties can and should be built up with Iran, the states on the east coast of the Arabian peninsula, and Egypt.

This also means that economic policy must have primacy over foreign policy – a fact the external affairs ministry finds most unpalatable. The Indian Ocean Rim Initiative was originally an economic and strategic concept – the idea was to bring the three big countries of the Indian Ocean, South Africa, India and Australia, into a trade and investment partnership. But it fell into the hands of the external affairs ministry, which brought in a lot of irrelevant countries, and went on to have a row with Australia over defence. Japan has long been India’s biggest aid donor; it was Japan that rescued India in 1991. Japan was understandably upset by the Pokhran ceremony. The way the external affairs ministry went about snubbing the Japanese ambassador and generally making things unpleasant was juvenile and wanton. India is not the US, or even China; our government should work harder on making friends, and should keep out of affairs that do not concern us, such as Kosovo and East Timor.

The external affairs ministry has never got out of the mould in which it was cast in the days of Nehruvian non-alignment. If foreign policy is to be subordinated to economic policy, if India is to adopt a more low-profile and friendly stance, a major change in the attitudes of the foreign service is necessary. Stronger policy coordination by the PMO and a stronger external affairs minister would help, but what is really necessary is to raise the quality of the foreign service and to retrain it. This forms a part of the reform of the civil service, about which I shall write later. In the meanwhile, what is needed is a sustained rethinking exercise. The members of the foreign service are trained to be infatigable talkers; they should be trained to be good listeners, information gatherers, and facilitators of Indian business.

II Government

One of the foremost lessons of the 1990s is that economic reform cannot go far unless the working of the government improves. All governments are born with trappings of power. But it is not these that make a country great; it is the size and resourcefulness of its economy that decide its international weight. And the economy cannot function well unless the government itself becomes a service to the people. Below I outline the basic steps that need to be taken for the transformation of the government.
The administration of law and justice

All Indian governments work badly because their systems of management have not kept up with the size of their task. But the legal system is the least satisfactory part of them. The public impression is different; the public would give much higher marks to the judiciary than to the administration or the legislatures. That is for a number of reasons. First, the common man comes into infrequent contact with the law; his impression of it is based largely on what he reads or hears. Second, the literate man or woman comes into even less frequent contact with the law; those whom the law punishes are overwhelmingly less educated, and their experiences never reach the media. Third, the media give far more attention to the Supreme Court, and next to it, to the High Courts; whereas they are only the tip of the iceberg. The bulk of justice is delivered by lower courts, whose standards never come up for public scrutiny. Finally, the media are largely passive purveyors of news, and regurgitate what is fed to them by the government and business; although the judicial system mostly functions openly, it does not feed the media, which in turn neglect it.

When people like us get exercised over the law, it is usually over delays. Actually, they are perhaps the most tractable problem. Lord Wolfe dealt with it in great detail in his report on British court procedures in 1996; it gives an excellent starting point for tackling the problem. To give just the major features of a solution, the case load of every court must be computerized, similar cases should be bunched and heard together, and the rule of priority – of hearing the oldest case first – applied. Justice Ahmadi cut down delays massively in the Supreme Court by computerizing the case load; the same can be done in every court. It will also transfer the power of scheduling cases from registrars to the chief justices. Second, judges must decide and stick to schedules of hearings for each case; the litigants’ and their lawyers’ wishes should not govern the course of litigation. Third, time limits must be set down for the length of pleadings. The US Supreme Court generally gives half an hour to counsel on each side. more reliance must be placed on written submissions and less on oral pleadings. Fourth, court fees in civil cases must be fixed as a high percentage of the amount awarded in the verdict. Finally, judges need to get more assistance, in the form of legal clerks, libraries, computerized databases etc.

Far more important than delays is the uncertain caliber of players. Lawyers earn far more than bureaucrats (including those in the law ministries) and judges; so those who have the choice would rather become lawyers, and the law ministries as well as the judicial service tend to receive more of those who would not be successful lawyers. That does not necessarily make them incompetent lawmakers; but they would be recruited from a wider field if their incomes were comparable to those of lawyers. For that reason, I think that judges’ salaries should be decoupled from those of the bureaucracy, and that courts should be financed from a certain proportional tax on the earnings of the lawyers that appear before them, such that
judges’ incomes can be made comparable to those of lawyers. The law ministries should be manned by well known lawyers employed on fixed contract – rather as the attorney general at the centre and the advocates general in the states are now – and should not have a permanent civil service at all. And finally, certain services in which law is important – for instance, the police service and the revenue services – should be manned by bureaucrats qualified in law, and their salaries related to that of the judicial service. They should invite penalties for misapplication of law. If, for instance, a police officer acts in disregard of the law, or a revenue officer makes levies that are overturned by two tiers of courts, they should face demotion.

So much for the caliber of the judicial and legal bureaucracy. But ultimately the law is made by legislators. One only has to visit any Indian legislature to see how few legislators are qualified to understand the laws they are making. Whenever legislation is being debated, attendance is less than 5 per cent of the strength of the house, and the speeches of those 5 per cent little reflect the legal implications of what they are discussing. This is a general problem with legislatures. After all, they are supposed to comprise the elected representatives of the people; skills or academic qualifications hardly come into the picture.

Countries try in different ways to make up for this lacuna. Much of the burden of legislation in the US is carried by the Senate, which has a fair proportion of lawyers and other qualified people. All the members of Congress get general allowances to engage staff and consult professionals. And finally, Congress has its own staff to formulate and vet laws, separately from the executive. In Britain, legislation goes through Select Committees, which comprise the more qualified and interested MPs, and which can engage and consult experts. Throughout the process of law-making, the MPs are helped by the Lord Chancellor’s office; although the Lord Chancellor himself is a politically appointed minister, he is always a lawyer, and has a qualified permanent staff of draftsmen. In India, the replacement of indifferent civil servants by lawyers taken on contract into the law ministry would help. But ultimately the solution is to elect some of the MPs on a new basis – either on the basis of a vote given to income tax payers in proportion to the tax they pay, or on the basis of minimum professional qualifications.

The Law Commission is quite wasted in the present context. It is generally headed by a retired judge of the Supreme Court and manned by equally venerable colleagues, it works on laws for years and years, and then its work is forgotten. It would be a great improvement if it were directly associated with Parliament, and had the power both to vet all legislation brought before Parliament and suo moto to take to Parliament any other legislation, including amendments to aged laws.
The Bharatiya Janata Party is keen on a review of the Constitution. The motives are infamous: some want to ensure that once it forms government, it should be impossible to vote the BJP out of power, whereas others want to disqualify Sonia Gandhi. But the idea is unexceptionable. Now that the Constitution Commission has been set up, it should set up three working groups. One would work on legislatures, another on the quality of the civil service, and a last one on judicial appointments and court procedures. That is the way to develop a robust solution to our legal problems.

The political establishment

The last BJP government handled the civil service with great lack of success. It came to power with considerable sympathy within the civil service; it has more or less won over the middle class, of which the civil service was a part. But the relations between ministers and senior civil servants deteriorated rapidly, and the politicians handled the conflicts crudely; in the end, the average civil servant was no fonder of the BJP ministers than of their predecessors. Instances of conflicts are well known. In the Bhagwat case, George Fernandes was at least guilty of overreaction, and the suspicion that he acted out of unhealthy political considerations was never removed. Ram Jethmalani’s conflict with his secretary was largely the result of his intemperate behaviour. And the removal of Vijay Kelkar, soon after he delivered a first-class budget, remains an unexplained mystery.

With the wilful changes in secretaries, the BJP has brought to the centre a practice which was confined to the states till recently. There the chief minister moves about civil servants as he likes. The practice is a bit more orderly in better run states like Gujarat and Maharashtra, whereas arbitrariness rules the roost in the northern states. The manipulation of civil servants’ careers to make them malleable is bad for both politics and administration. Politically, it concentrates power in the chief minister and his favourites. As a result, too many people want to become chief ministers; the Congress at one time ran a game of musical chairs in the states to accommodate aspirants. Still, not every one can be accommodated; so ambitious politicians split away from the major parties; this is how the welter of parties has been created. Thus the roots of political instability are to be found in the fact that politicians exercise powers that are not theirs by manipulating civil servants’ appointment. Some chief ministers buy stability by decentralizing the power to move civil servants; in MP, for instance, even MLAs have the power to select district collectors. This only results in collectors who do not administer, but instead concentrate on pleasing politicians.

On the other side, the practice of moving about civil servants at will brings to the top civil servants whose only qualification is malleability; they command no respect in the bureaucratic hierarchy, and hence cannot be effective. The point of having a hierarchy is to make large numbers of employees subject to
commands from the top; but where the top officials do not command respect or authority, the hierarchy
does not function. The objectives of such a bureaucrat become schizophrenic: he wants to last out his time
without getting into trouble, and tries to use the time for personal advantage. Thus malleable civil servants
are more often corrupt and cautious. Politicians’ selection of civil servants for senior posts, and their
interference in selection and promotion processes, have been the major causes of administrative
deterioration.

One only has to apply this to the police to see why law and order is so unsatisfactory. The BJP got
everseous bad publicity for attacks on Christians. Its involvement in many of the events is unclear and
doubtful. But the fact is that the police in India today are virtually incapable of catching criminals and
taking their prosecution to the correct conclusion. Vast amounts of criminal litigation go on with very
little result. The bending of the police to politicians’ will has destroyed their effectiveness.

The same goes for the developmental bureaucracy; whether it be in education, health care, transport or
energy, the government achieves so little development with so much expenditure. Large parts of the
bureaucracy are driven by short-term, personal objectives; and the politicians who control or influence
appointments to critical posts often share in their spoils. The result is that much development expenditure
disappears in the enrichment of contractors, bureaucrats and politicians; little is actually translated into
real development.

This was a bit less true of the central government than of state governments. The last BJP government
brought the centre slightly closer to the abysmal state practice. If it is interested in good government, and
in being reelected for good government, it should be thinking of reforms in two directions – political and
bureaucratic. Of the two, political reform must come first, for without honest politicians, an honest
bureaucracy is impossible, and without competent politicians, bureaucrats cannot be controlled.

If politics is to be cleaned up, two things are necessary. First, the parties must be so well funded that they
can employ politicians; and second, the only way to success for politicians should be through a rise up the
party bureaucracies. In India, parties have so little money that they pay their employees a pittance; at
election time they hunt around for candidates who can win – and those are politicians who have money or
muscle of their own. In this way, corrupt politicians dominate parties.

Most politicians become rich by misusing state power. The point of privatization and liberalization is to
reduce opportunities for such self-enrichment. But generally, politicians cannot be corrupt on their own;
they need the cooperation of bureaucrats, who share in the booty. Their resistance has defeated reforms in
India; before reforms can come, a way must be found to strengthen parties vis-à-vis politicians, and to strengthen party finances.

I believe the way to do this is to go over to proportional representation based on the list system. This arrangement confines competition to parties; individuals cannot win unless they get into the list put up by a party. Proportional representation is supposed to be less conducive to the emergence of majorities in legislatures than our present first-past-the-post system. But the present system has in fact failed for over a decade to produce decisive majorities; in our circumstances, proportional representation will not produce less decisive results. And proportional representation can be made to produce decisive results by putting a cut-off point below which parties would get no seats. It is 5 per cent of the vote in Germany; the higher it is fixed, the greater the likelihood of a decisive majority. If the threshold is 1/3, there will be at most two parties; if it is ½, there will be only one party.

Reform of the electoral system will go far towards solving the funding problem. For people give money to parties that have a chance of winning. But if that is not enough, parties should be funded out of state funds in proportion to their votes. The funding should be generous enough to enable them to maintain bureaucratic establishments down to the district level at all times.

The greatest benefit of PR is that it will bring up politicians who have a nationwide or statewide reputation. At present a politician has to have a hold on a single constituency to become a player – just pour state resources into the constituency, or get jobs for his constituents. This is how a Laloo or a Jayalalitha gets elected, which is the first step to becoming a leader. PR would devalue money and patronage, and favour ideology and achievement.

The bureaucracy

The uneasy relationship between the BJP ministers and the civil servants goes back to the root of our administrative system. In all countries other than the United States, the bureaucracy came before representatives of the people. All organized states right into the eighteenth century were monarchies. Monarchs needed a bureaucracy to collect taxes, to fight wars and to maintain order; but they did not need democracy. Democracy was forced upon them; and even then, the first parliaments represented particularly influential subjects, such as army commanders, landlords and merchants. These parliaments were consultative, not decision-making bodies. They enabled the monarchs to judge the degree of support or resistance their plans might face, and sometimes let some people let off steam.
That system was first overturned in the United States, where the settlers said that they could not be taxed by the British king without being represented, and won the point. So it came about that the representatives wrote into the US Constitution that they would approve most administrative decisions, and not only be consulted. That is how they approve appointments of senior civil servants, import restrictions, health care regulations, treaties with foreign countries, etc etc.

India inherited the British system, in which the Viceroy in Council decided everything. It was a monarchical – a viceregal - system. The British had envisaged only a consultative role for elected representatives; and they represented influential subjects, such as property holders, rather than “the people”. So when popular government was elected after independence, the politician ministers had little to do. Nehru used habitually to deal with secretaries of ministries instead of ministers, and to admonish ministers who “interfered” in the administration. That was the administration to which Paul H Appleby gave such high marks in the 1950s.

That is all past now. Today, ministers routinely manipulate the appointments and transfer of civil servants, and thereby control them. They have thereby created a docile and compliant civil service. One of my most vivid impressions of my time in the government is how civil servants sat watching their minister in meetings, guessing what the minister wanted, not uttering a word until they knew the minister’s mind, working out how each minister could be handled. Most ministers had simple agendas: for instance, “Push up agricultural support prices,” or “Get the central government to take over the bankrupt mills nationalized by the Maharashtra government,” or “Make the banks give loans to Jat farmers”, or “Give favourites licences to set up petrol pumps”. The civil servants satisfied the ministers’ agenda and made them happy; in return, the ministers let the civil servants run their rackets. Both exploited and cheated the people.

As long as the ministers have the powers of appointment and transfer of civil servants, you cannot get a clean civil service without a clean political system. But clean politicians by themselves will not lead to a clean bureaucracy; for that a number of other things are necessary: exit of the state from commercial activity, rule of law instead of rule of functionaries, a reward system for bureaucrats based on honesty and competence instead of pliability, and easy entry and exit from the civil service based on performance.

The government needs to get out of commercial activity – production and trading – because law, in the sense of rules based on some concept of justice, is inapplicable there. In these activities, competition is good for consumers. In competition, some businesses will prosper, some will suffer; some people will get jobs, some will lose them; some will get orders, other will not. These decisions will be driven by costs
and profits. If ideas of justice derived from government are applied to competing businesses, weird results follow. The solution is not to let government businesses flout rules of justice derived from administration; it is for government not to be in business at all.

The function of law is to constrain the executive: to limit its discretion and compel it to serve the guiding principles of the state. But language is a highly flexible instrument; it can be used to create discretion as much as to restrain it. In the British system that we follow, the bureaucracy has considerable power to create law; typically, the legislature passes only an enabling law, leaving it to the government to make “rules”. This power is systematically misused; the bureaucracy makes masses of rules that are vague, non-transparent, and inconsistent with the guiding principles, and uses them to harass the people. These rules are tabled in legislatures, but politicians are too ill educated to read them, let alone understand them. In France, the judiciary is closely woven into the bureaucracy, and participates in the formulation of rules, which thus have a strong judicial basis. In the US, Congressmen are backed by strong secretariats, and many, especially in the Senate, are highly trained; they write into laws much that in India would go into rules. In India, the legislatures are incompetent for vetting the rules, or even the laws; we need judicial commissions to go through all laws and rules, make them transparent and consistent with the principles of justice, publish them, and weed out junk. Legislation should be initiated by these judicial commissions, and should go to legislatures only for approval.

The British gave permanent jobs to civil servants in the expectation that they would thus be made less susceptible to politicians’ whims. But politicians have found in promotions and transfers the whip to bend the bureaucracy to their will. In the process they have destroyed the bureaucracy as an organization; its command consists of sycophants, and its troops are ill trained. If this is to be changed, the government’s labour force needs to be tailored to the work done, and its choice, promotion and dismissal need to be related to performance. The present non-gazetted staff should be replaced by young persons under the age of 30 who would serve on short-term, non-renewable contracts, the present gazetted staff or senior officers should be replaced by people selected by examination from the non-gazetted staff on renewable contracts of 5-10 years, and the present records need to be completely computerized. With these changes, it would be possible to get rid of babus before they become corrupt or useless, the number of superior officers can be cut down to the work to be done, and the work itself considerably cut down once files are abolished. Movement of files is an extremely poor way of administration; it immobilizes information in nonretrievable forms and makes it unavailable to most people who need it most of the time. Private businesses are rapidly moving from paper-based systems to intranets and electronic information systems. So are many governments. For India, which boasts of a world class IT industry, the changeover should be particularly easy.
Defence, law and order

Amongst the growth industries of independent India, the police and the armed forces must be leaders. The army today probably has ten times as many soldiers as it did in the 1930s; and the police, including paramilitary forces and the central police, has probably grown about sevenfold. (The population, in comparison, has grown less than threefold.) Since we no longer have to fight for independence, the demands on the army and the police should have gone down. And yet, it is doubtful if any of us feel more secure today than our grandparents. The external security environment is definitely worse; and if we exclude the frequent and often massive agitations launched by the Congress before independence, the domestic law and order situation is also worse.

The reason why external security has worsened is that before independence, we were part of the British empire. After it, we joined the Soviet empire; it gave us arms, and bailed us out at crucial points. But it did not have the overarching global presence of the erstwhile British empire and the successor American empire to give us low-cost defence; so we had to expand the armed forces manifold. With the collapse of the Soviet Union, we were cast adrift. In the 1990s, successive governments have tried to get closer to the United States, but both our historical amour propre and US disinterest have prevented us from joining the US camp.

A US umbrella would only be worth while if it gave us better security vis-à-vis Pakistan and China at a lower cost. Mr M L Sondhi has pleaded in a recent book for a rapprochement, with the US, in the form of an alliance of democratic nations. However, the US is at present suffering from weak leadership, and its historical groundswell of isolationism is resurfacing. This is a bad time for forging any strong relationship with it.

In the absence of such an option, the strategies I earlier suggested of increasing foreign trade and investment, of bringing our Indian Ocean neighbours closer by buying more from them, and of forging an alliance with Australia and South Africa, remain the best available. With China we had reached the best possible understanding in the early 1980s, of putting the border question on ice and expanding economic relations; that strategy remains the best available despite George Fernandes's earnest efforts to upset the apple cart.

Thus, foreign policy is easy because the options are few. The difficulties lie in the design and deployment of security forces. They exceed 2 million men, but they do not perform either of their tasks - internal or external security - well. Earlier I suggested that the bureaucracy should be cut down so as to meet the demand for work. To achieve this, I proposed that the junior (non-gazetted) civil service of lifelong babus
should be replaced by clerks on short-duration contracts who would permanently leave the civil service at the age of 30; and I proposed a maximum of three successive 10-year contracts for gazetted civil servants, which would permit the construction of a pyramidal structure in consonance with the number of jobs available.

Strangely enough, the only part of the government that comes at all close to my model is the armed forces. Soldiers are taken in on 10-year contracts, and retrenched at the end unless they are promoted and made non-commissioned officers. Traditionally, officers were dismissed unless they were promoted to the next rank by a certain maximum age. Thus of all the civil services, the British made an exception for the armed forces and avoided life-long employment in them. The reason was that the forces had to be sharply expanded during wars and abruptly contracted after them; a structure that allowed flexible employment was required. But also, the British Indian army had to perform better than its rivals and hence its personnel had to be selected on the basis of fitness and fighting quality.

The inherited organizational structure has been under strain. As employment prospects in the civilian economy have improved, young men of requisite physique have come to find the short army service unattractive; so the army is short of soldiers. Officers' salaries are low, and possibilities of personal enrichment poor; hence the intake of officers has also been insufficient. Their educational level has sadly declined. And army officers no longer get so easily absorbed in the civilian economy. Under their pressure, the army now retains a lot of officers without having operational responsibilities for them.

Does this mean that my model is wanting? No; the labour shortage in the army is due to salaries that lag badly behind those in the private sector, and not to the fact that soldiers and officers do not have lifelong employment. For my model to work, salaries in the private and the public sector - including the armed forces - have to be comparable.

But my model also requires that personnel released by the government should be absorbable in the private sector. This is certainly true of clerks. If they all had the standard BA degree in five subjects - English, mathematics, accountancy, economics and the law - and they all got basic training in information processing and management that working in the government should involve, they would find a ready market outside the government. Similarly, senior officials should get sufficient management training in government to be prized in the private sector.

But this is not necessarily true of the armed forces. Soldiering is basically a physical job with a modicum of engineering; comparable work in the private sector is scarce. And managing soldiers is a relatively
easy task; it does not equip officers for civilian personnel management. Finally, loyalty, teamwork and esprit de corps are important in any fighting force, and they require that turnover should be minimized.

Hence I would suggest that the paramilitary forces and the police should be formed out of released soldiers and officers of the army. A soldier should serve for ten years in the army; then, unless he proves himself unfit, he should be absorbed into the paramilitary forces. He may serve there for another ten years, after which he should be sent into the police, where he may serve till he retires. Similarly, officers who are not promoted within the army should be transferred to the paramilitary forces and the army.

Why does this not happen now? The reason is that the government wants a number of forces under divided control, so that if one or the other rebels or stages a coup, another part of the forces can be used against it. Thus we have three sets of managers: the defence ministry for the armed forces, the home ministry for the paramilitary forces, and the state governments for the police. But this divided control is immensely wasteful of skills, and has in fact given us substandard forces of all three kinds. We must devise new forms of civilian control over the security forces, which would work primarily through financial control, and leave internal management to the forces themselves.

**Removing corruption**

International organizations such as Transparency rate India as one of the most corruption-ridden countries in the world; this matches the perception of most people in India, and is responsible for their sense of shame.

In this respect, the 1990s started with much hope. The Havala scandal brought high-level corruption into the limelight; and the way the Supreme Court took control of the Central Bureau of Investigation and strove to unravel the web of corruption engendered hope that, just as the courts in Italy had cleaned up its political system, our courts would rescue ours. But the hope proved false. The CBI did a poor job of investigation. And then the Supreme Court itself abandoned the mission with its verdict in the Captain Satish Sharma case, when it reversed its own verdict that he was personally responsible for his malpractices as central minister and had to pay a fine. With this, it is unlikely that the judiciary, on which so much hope rested, can curb corruption. This is why I seek more indirect, structural remedies for corruption.

Probably, 90 per cent of corruption in India is bureaucratic, and ten per cent at most is political. But in a democratic system, politicians are bosses; they can move around civil servants and bend them to their will. With the new norms that the BJP introduced, even MLAs can now influence the appointment of civil
servants; so the latter must cooperate with politicians, or face a very uncomfortable career. The same element of political discretion was present when Manmohan Singh put Rs 1 crore at the disposal of each MP for spending in his constituency; the BJP raised it to Rs 2 crore. Hence political corruption must be tackled first.

The corruption of politicians can be curbed by political parties. This is why I earlier proposed a system of proportional representation based on the list system; such a system would be open only to candidates who belong to parties. Under our present first-past-the-post system, a Sukh Ram can be discovered possessing a lot of unexplained cash, be expelled by his party, and still remain a successful politician because some constituency somewhere elects him. This would become impossible under proportional representation.

The corruption of parties can be punished by the electorate. But a party will mind being so punished only if it has a good chance of coming to power; a party that survives on coalitions and deals can survive forever with a small proportion of the vote. This was the bane of Italian politics; proportional representation distributed seats in such a way that only coalitions could rule, and parties entered coalitions only to make money. The way to prevent this is to ensure that only two or three parties get seats. Either a party should have to get a high proportion of the votes – 20-30 per cent – to get any seats at all; or the two parties that get the highest proportion of the votes should get all the seats.

Indian politicians are keen to get the government to fund election expenses. Doing so would be a useless expense, for they would still be free to raise other money in corrupt ways. What is worth funding, however, is a minimum administrative infrastructure for the parties that enter Parliament.

I also advocate the election of half the members of parliament by individual income tax payers, who should have votes in proportion to the tax they pay; the MPs they elect should have a veto over all money matters – government revenue, expenditure, borrowing, and audit. These voters would have an interest in ensuring that their money is not wasted or siphoned off.

Even if there are few enough parties for each to have a high chance of coming to power, and even if the government funds them, they can still be corrupt. The scandal unraveling just now in Germany, which has all the institutional devices I advocate, is instructive. Helmut Kohl, who ruled Germany as Chancellor for 16 years, privately received millions of Marks from arms dealers and other obscure businessmen, and used it to buy the loyalty of party politicians. A political system that cannot be corrupted is yet to be invented. But what can be done is to limit the damage corruption does to good government. The smaller the reach of the government, the fewer the areas in which it exercises arbitrary power, the smaller the potential for corruption. This is the argument for liberalism – for minimum government intervention. It
implies that all productive activities should be privatized, and that competition should be introduced and maintained in every industry where this is possible. It also implies the replacement of discretionary by automatic, nondiscretionary controls – for instance, of licences by auctions or import controls by a uniform tariff, which may be zero.

Honest politicians are not enough to eliminate bureaucratic corruption. Governments are big organizations; for them to be honest, it is necessary that their managers are honest, and that they have sufficient control over their subordinates. In India, lifetime employment in government ensures that managers have no control over subordinates. To restore that control, I proposed earlier that the junior civil service should have a maximum age bar of 30. Clerks should be recruited and selected by senior civil servants according to work requirements. A clerk who joins the government should lose his job at 30 unless he gets selected into the senior civil service. This will ensure turnover in the junior civil service and prevent the emergence of corrupt cliques.

The juniors will not be honest unless their managers are honest. Hence I proposed that managers should be paid market-based salaries – that the salaries of the senior civil service should be comparable to those in big business. They cannot be unless the size of the senior civil service is pared down to what the work to be done requires. Hence I suggested selection at or before the age of 30 on the basis of previous employment in the junior civil service and an examination in only five useful subjects – English, accountancy, law, economics and mathematics – and a maximum of three ten-year contracts; that would permit the continuous adjustment of the size of the civil service. The surplus of senior civil servants at present means that if a civil servant does not please his political bosses, he can be relegated to a rubbish bin. Once this surplus is eliminated, the hold of politicians will be much weaker. The entry and exit of civil servants at various points in their career and the comparability of their and private sector salaries will also ensure that they will be far less daunted by the displeasure of politicians.

**Government enterprises**

The bureaucracy defeated the reforms of the 1990s. By the bureaucracy I not mean, not the Indian Administrative Service, but the 12 million minions who run the machinery at the centre, in the states, in municipalities and in public enterprises. Of this bureaucracy, the majority is today employed by productive enterprises, both departmental and corporate.

But that was only the latest and most famous instance; the bureaucracy has won many more battles. The biggest is the one over telecommunications. As telephone users will testify, low-level corruption is rampant in the telephone services. The earnings of corruption would disappear if there were competition;
so the Department of Telecommunications and its daughters have fought a dirty battle to prevent competitors from emerging, and when they emerged, from succeeding. When the politicians decided to introduce private operators, the DoT ensured that their number would be the smallest possible. Then the DoT enlisted MPs – including those of BJP – to argue that the interest of the government lay in extracting the highest licensing fees from private operators – which meant from their customers. They extracted such a high price that it took the operators five years of politicking, at who knows what price, to have the regime changed to revenue sharing. And even then the DoT fought in courts till the end. It defied with impunity the one institution that could have ensured a level playing, namely Telecommunications Regulatory Authority of India. Any bureaucracy that wants to protect its turf has much to learn from DoT.

In 1992, when Manmohan Singh decided to license new banks, bank staff and workmen organized lightning strikes. They never go on a protracted strike, for that might invite retaliation. They always strike one or two days at a time; that way they maximize inconvenience to the public at minimum cost to themselves. Thanks to their pressure, Reserve Bank issued only a handful of new bank licences, many of them to institutions within the government family; it just filed the rest of the applications, and continues to sit on them till now. This sequence is about to be repeated in insurance. After deliberating for seven years, the government piloted a bill making it possible to introduce private competitors in insurance. Immediately the staff of LIC and GIC threatened to go on strike. To pacify them and protect their portly employers, the BJP government has ensured that foreign insurance companies, the only companies with any experience, can have only a 26 per cent stake in Indian companies; they will each have an inexperienced Indian gatekeeper to usher them in and share in their profits, exactly as in telecommunications. And the insurance regulator will do the rest: he will keep up the premiums so that LIC and GIC may not be hurt too much, and he will limit the number of new competitors to the minimum.

We bear these excesses in silence lest we might be victimized. But the cost is enormous. Government enterprises have high costs both because they use more resources than necessary to produce whatever they do, and because their employees cost more than their value in a competitive market. Although the top salaries in government enterprises are below those in the private sector, the average wages are considerably higher than in comparable jobs in the private sector.

The standard solution offered to the tyranny of public enterprises is to privatize them. But this has proved virtually impossible in India, for three reasons. First, the opposition of employees. They find their present condition enviable – they have lifetime jobs with no obligation to deliver. They prevent any adverse change in it. Second, the absence of a market for public enterprises. Many of them could fetch very high
prices – provided their fat could be removed. It is a matter of religious faith with our politicians that no one should be dismissed; so no one can be removed, and the value in the enterprises cannot be unlocked. Even if it could, our labour laws would make it very expensive to persuade surplus staff to leave. The government has chosen the worst alternative of voluntary separations; these are not only expensive, but they get rid of precisely the best employees, who have the greatest value to the enterprise. And finally, the nexus between bureaucrats and politicians. The big corporations – for instance the DoT, or the oil corporations – can easily befriend 50 or 100 MPs, and use them to block any changes they do not like. Unless we clean up politics, we can never clean up the bureaucracy.

Employees are a liability to a greater or lesser extent in all government enterprises; if they are to be privatized, this liability must be taken off their books. If the BJP is serious about privatization, it would have to separate the enterprises to be sold from the employees. For each enterprise it should pass a privatization bill. It would stipulate that the enterprise would be sold without its employees. Those employees whom the buyer retains beyond one year would get no compensation; in that year they would be expected to work out employment conditions with the new owner, or leave and be compensated. The compensation should be such that it would give the younger employees enough time to seek new careers, and old employees enough to retire on – it would vary between a year’s and eight years’ wages. The enterprise would go to the highest bidder, who would be free to strip it and sell it off piece by piece if he wants. Most would be kept as going enterprises, but by allowing them to be stripped, the government would be maximizing their sale value, and hence the difference between it and the liability to workers.

This is the way to remove the millstone of manpower from the neck of a potential buyer of a government enterprise. But there is one more millstone in the case of government financial enterprises, such as the financial institutions and banks – namely, bad debts. The principle to follow in their case is the same as in the case of employees; they should be taken off the institutions books before selling them. But whereas employee compensation can be laid down in advance, the value of bad debts cannot: it depends partly on the effort made to collect them. The buyer should be given some time – a year to three years after purchase – to ascertain the quality of loans. The price of the bank should be fixed at the end of the period, and the value of the assets found bad by the buyer should be deducted from it.

In every case, the object should be to maximize the sale value of the enterprise. That sale value depends on what the buyer can do with it; hence the aim should be to remove the constraints on what he can do. Unwilling labour and bad debts are the major such constraints; but there may be others. Whatever they are, the government must unbundle the enterprises and remove their historical encumbrances, so that their essential value can be realized.
Natural monopolies

The BJP has striven to be taken seriously as a party of reforms. It inserted a number of what it thought were reforms in the President’s speech to Parliament. Much legislation has been put through or introduced into Parliament in the name of reforms. And yet, the party’s efforts lack credibility because it has no liberal economic ideology, no sense of purpose and no conceptual clarity. Let me illustrate this by its approach to the railways, telecommunications, and electricity.

In the railways there is a tradition of ministers who fiddle with purchase contracts, pack the railways with employees from their own state or constituency, and start trains to the same. Jaffer Sharief is the most notorious in present times; he spent the budget meant for purchase of wagons on conversion of meter gauge to broad gauge. Much money was spent and little conversion achieved. Ram Vilas Paswan packed the railways with new and unnecessary employees. Nitish Kumar was the first decent minister in decades; the Prime Minister removed him as soon as was convenient to bring in Mamata Banerjee, an incorrigible populist.

Telecommunications had Sukh Ram, the minister who was caught with crores stashed in his prayer room. He was thrown out of the Congress and started his own party – which later became the BJP’s ally. Sukh Ram had auctioned telecom licences to highest bidders; the BJP had then given him a hard time with allegations that he had favoured certain bidders. Later it became clear that the licence fees were unrealistically high; there had either to be retendering or the licence fees had to be reduced. Under Vajpayee, the Prime Minister’s office took a commendable initiative to change lump sum to revenue-based licence fees. Then inexplicably, Vajpayee brought in Jagmohan as telecommunications minister; he completely overturned the PMO’s initiative, and did his best to screw the private operators.

In electricity, the Congress government had the stupid idea of giving new private entrants guaranteed return which it immediately regretted; thus began the travails of the private entrants which continue to this day. Then the World Bank moved in to help state governments with three ideas: trifurcation of State Electricity Boards into companies for generation, transmission and distribution; privatization; and price regulation. Even if these plans were implemented they would fail. Impecunious state governments, lured by World Bank money, have tried to implement them, and in the process have introduced their own convolutions to make failure doubly sure. In the meanwhile, Vajpayee has installed as central minister Rangarajan Kumaramangalam. He dreams of megaplants under the ownership of the central government – in other words, of more socialism.
These three industries are the touchstone of the BJP’s commitment to reforms. If it means to be taken seriously as a liberal party, as the party that seeks to overturn the socialist heritage of the Congress, it must not merely make announcements, do something different for the sake of difference, make gestures of activity without direction. It must articulate a liberal, anti-statist ideology, and work out its implications for these industries, as well as others.

I have chosen these industries to point out a common feature: they all have a component that would be too expensive to replicate. In the case of railways it is the stations and tracks. If we were today to build a competing railway system, so much valuable real estate would have to be destroyed that the cost would be prohibitive. The same with telephone lines and power lines. (Or water pipes, or sewage pipes.) The high costs of replication rule out competition.

From this the Neanderthal socialists concluded that the monopolist owners of these industries would make excessive profits. These industries should be for social benefit, not private gain. So they nationalized these industries to run them for the society. The managers of the industries could not see how they were less deserving than the society, and made sure the industries made no profits. That made the industries dependent on the government for investment funds. The worse the government’s finances, the more the industries were starved of investment. And nationalization means giving free play to a Jaffer Sharief, a Sukh Ram or a Kumaramangalam. Even private monopolists cannot be as bad as these irresponsible politicians.

The capitalist solution was price regulation: the government should prevent the monopolists from making excessive profits – it should specify the maximum rate of profit that could be made. Now, capital goes where it gets the highest profit, not where the government tells it. So regulated industries found it difficult to raise equity, and raised most of their requirements as debt. Debt cannot be serviced unless there are steady returns, and returns cannot be guaranteed if there is competition. In addition, politicians saddled the regulated industries with “social obligations” – subsidize second-class fares, give cheap electricity to the poor, take telephone lines to villages – which had to be paid for out of profits somewhere else. Hence the regulators themselves developed an interest in keeping up profits and in perpetuating monopolies.

Both the socialists and the capitalists have realized their errors in the last two decades and tried out new solutions. But the solutions have worked in some countries and not in others. It is not much good plumping for slogans; solutions have to be worked out studying both the experience abroad and the conditions in India. Let me take up some of the basic ideas.
**Competition:** Competition is the key: it is a substitute for regulation. The aim should always be to create a market – for calls, for power, for train seats – to allow firms in to compete in the market and to make them compete in a level playing field.

**Privatization:** Privatization cannot work without a large private sector and a competitive capital market; both conditions are absent in India. If the government still forces privatization, it will be pseudo-privatization – the government will pay someone to take over the industries – or cronyism – the politicians will pass on the enterprises to cronies. The best that can be done in India is to turn over government’s shares in the public sector to a mutual fund, to set up independent managements in public enterprises, and to let them raise capital in any form and from any source they like.

**Regulation:** I have already written earlier in this series about our shameful record of regulation. We need to have much fewer regulators, to replace committees of regulators by single regulators, to remove the government’s power to instruct or replace them, and to give them much clearer terms of reference.

**Vertical disintegration:** Vertical disintegration actually increases transaction costs; and the replacement of a monopoly by a set of interdependent monopolies is no improvement. The only point of vertical disintegration is to isolate that part of an industry in which there cannot be competition: tracks and stations in railways, transmission and distribution lines in power and cables in telecommunications. These components should be subject to price control and common carrier and non-discrimination obligations. Other components – trains in railways, generation in power and message transmission in telecommunications – can certainly support competition, and competition should be deliberately introduced in them.

### Geographical ailments

Large states contain diverse populations and have trouble in integrating them, some more than others. The US has been the most successful; the USSR was such a failure that it split up. The US and Brazil are constructed of immigrant stock, which they have drawn from relative narrow confines of Europe, and on which they have imposed a single culture drawn from British and Portuguese roots respectively. China has similarly tried to integrate its several “nationalities” into the dominant Han culture. India is far less integrated than any other large nation. Its linguistic, religious and caste groups retain greater differentiation; the Indian fabric is woven distinctly looser.

It was first torn by linguistic tensions. Nehru was initially inclined to leave the states as the multilingual entities that had accidentally emerged under the British, and to use English as the binding medium. But
the Samyukta Maharashtra agitation negated his plans. Finally the suicide of Potti Sriramulu forced the
formation of linguistic states.

The linguistic states have been extremely unfair to tribes; in Gujarat, Madhya Pradesh, Bihar, Orissa,
Andhra and West Bengal, the tribals have been largely excluded from power and reduced to serfdom.
Those near the borders, however, were able to acquire arms and stage violent revolts. Agitations continue
in Jharkhand and Telengana. The Bhils have forborne for long. But if the Bajrang Dal has its way in
Gujarat, a Bhil revolt is inevitable.

The rulers’ formula has been to suppress these movements as long as possible, and when suppression no
longer works, to concede a state. Mrs Gandhi conceded states to every major tribe in the northeast. (The
Kashmiris, who are different enough from the Indian Bhadralok to constitute a tribe, came to India with
their own state.) The central government gives these peripheral states liberal aid. An elite group intercepts
much of it. Where that group distributes the aid wisely, it manages to keep peace in its state; where the
rulers are too greedy as in Kashmir, insurgency resurfaces. In either case, the state remains undeveloped,
and the gap between it and mainstream India progressively widens. This will also be the fate of any new
states that the BJP may now choose to create, such as Jharkhand and Uttarakhand.

India has border problems and tribal problems; but since these peripheral populations are small, it has
been possible to keep the problems from boiling over except in Kashmir. Still, the feeling of alienation
and discrimination is very strong– even in Assam and Manipur, whose populations are better integrated
into the mainstream. Tribals have been poorly served by the linguistic states, and every concentration of
tribals is a powder keg.

But the problem they pose is trivial compared to the rift that has emerged in mainstream India. Even
during the days of socialism, western India developed much faster than the rest; Gujarat, for instance,
which was poorer than West Bengal at the time of independence, is vastly more prosperous today. But the
schism began to widen much faster in the 1990s. Once industrial licensing was removed, even the
industry that was forcibly located in the east did not have to go there; and with the liberalization of
foreign trade, the maritime states did much better than the inland states.

Thus the geographical configuration of advanced and backward states is changing. Earlier, Gujarat and
Maharashtra were way ahead in the west, and Punjab and Haryana were far ahead in the north. Now states
are competing for investment. Of them, Karnataka has become the home of the new industries, and Tamil
Nadu has pulled up after Jayalalitha left. Chandrababu Naidu may still manage to retrieve Andhra
Pradesh. Rajasthan and Delhi also have attracted sizeable investment. But Madhya Pradesh, the north and
the northeast have done miserably; their poor performance is beginning to show in deteriorating law and order, which will make them even less attractive for investment. It is no longer the cow belt vs the rest; it is more the maritime states vs the rest. If the rift continues to widen, it will tear India apart.

The BJP is, in a sense, the only nationalist party today; as such, it has an approach to these problems. Its answer is Sanskritization. Its politicians take oath in Parliament in Sanskrit, and speak only in pidgin Sanskrit. I see the Prime Minister’s east-west and north-south highways as another attempt to unify India. Forcible cultural homogenization has been tried elsewhere. It succeeded in China; but the sinification of China took centuries, if not millennia, and nowadays, proselytizers such as the Hindu joint family do not get even decades to accomplish their work. It failed in the Soviet Union with dire results; today the nationalities unified centuries ago by the Czars are separate, but have inherited economies that cannot survive separately. It worked in the US and Brazil, but these nations have been artificially forged out of settlers by selective immigration and unilingual schooling.

It would be far less wasteful of national energies, far less divisive, far less violent, to preserve and encourage the diversity that we have in India. The present states have failed to serve the geographical minorities; we should have far more states – 50 or 100. The smaller the states, the more interdependent they will be. A state should consist of a large town surrounded by its hinterland; every city in India should become a state. In the process, suppressed languages and tribes will find new expression.

All barriers that obstruct the movement of goods and people between such states should be banned, including differences in commodity taxation, different regimes for alcohol, sugar or cigarettes, and roadside checkposts. In particular, no state should be allowed to impose the language of instruction within its boundaries; any minority should have the right to be educated in the language of its choice, including Japanese or Swahili.

The growing rift between the maritime states and the inland states is due to excessively high transport costs. Today it is cheaper to import granite into Bombay from Italy rather than from Rajasthan, or to import wheat for southern millers than to bring it from Punjab. Removal of state-imposed barriers will bring down transport costs. But to reduce them significantly, two things are necessary. First, railways should be taken out of the hands of ministers like Jaffer Sharief, Ram Vilas Paswan or Mamata Banerjee, and privatized, and three-quarters of its work force should be given a VRS. Railways need massive investment to move larger volumes of goods, and they will attract it only if their flab is cut and they are made profitable. Second, the existing roads should be repaired, widened, straightened out, and fenced to keep out jaywalkers, cattle and buffalo carts. Highways are just like railway tracks; they serve much
better if access to them is restricted. And finally, all agricultural price support should be removed, especially support for wheat, rice and cane prices; if the north and the east produce these more cheaply, they will sell more of them to the south and the rest of the world.

**Making the federation work**

The British designed the Indian federal system in 1935. The provinces were soon to have popular elections and the Congress was likely to win most. Hence the government reserved most powers to the centre. Mrs Indira Gandhi later used this structure to great advantage. It could be so used as long as the Congress ruled the centre without being dependent on state satraps; she ensured this by decapitating all satraps who threatened to establish a power base. She was the real beneficiary of the British design of strong centre and dependent states.

This structure lasted only as long as the Congress won absolute majority at the centre. Once its majority crumbled in 1977, power passed to coalitions in which state-level politicians had a powerful role. With this shift in the balance of power, the structure of public finance also changed. Till 1979, the centre had a healthy fiscal surplus; after that, as the state satraps began to milk it, it began to run deficits. The states stopped repaying their loans from the centre and the banks; the centre began to transfer enough to them every year to meet the repayments. Indian economists regard the centre as primarily responsible for fiscal profligacy, and point out that the constitution forbids the states from issuing money or borrowing abroad. But there is no limit to what the states can borrow from the centre or the banks; and most have borrowed enough to make themselves financially unviable.

As they have raised their expenditure, financial control on it has deteriorated. If the Comptroller and Auditor General at the centre is ineffective, his counterparts at the state level are moribund. There is no financial control worth the name left at the level of the states; the politicians who rule them raid government treasuries at will. The real problem of Indian public finances is not control of the fiscal deficit; it is the fact that the government does not spend on public services, but on whatever benefits the parties in power. The control that the BJP has given its party men in the states it rules over the appointment of civil servants has this aim: to remove obstacles to the use of government funds for party political purposes. And the BJP is not unique in this respect; it is only following precedents of other parties in other states.

Government as it is understood in well governed countries has progressively declined in India. Good government is administration by bureaucrats following rules that are the same one, and politicians who make the rules. As I have seen in Parliament, our politicians on the whole do not have the competence
even to understand the reams of rules that are placed before them, let alone make them. They choose bureaucrats who help them use or bend the rules to their benefit. The government is no longer for the people, but for those who get into power. As people have lost confidence in the fairness of the government, they have spawned movements that subvert the government. Power is shared between the governments and militants in the north-east and Kashmir; the same pattern is now emerging in more central parts of the country, for instance, Bihar and Andhra Pradesh. This is the most visible sign of the failure of our brand of democracy; less obvious but equally sinister signs are to be found in what the common man thinks of the average politician, policeman or tax official.

The present states have no rational basis. They are supposed to be linguistic. But there five Hindi-speaking states; soon there will be eight. People speaking tribal languages have no state of their own. It is an advantage for a state to have a common language, but language is an insufficient criterion. There can be many states speaking the same language.

The economic basis for a state would be a central city surrounded by a hinterland. The present state governments have extensively used their powers of supersession to emasculate urban local authorities; states based on principal cities would revive them, and eliminate one tier in the vertical hierarchy of government. If we think in these terms, Gujarat should be divided into at least three states centred on Rajkot, Ahmedabad and Baroda, Maharashtra into states centred on Bombay, Nagpur, Poona and Sholapur, and so on; India would be reorganized into 50-60 states. With such a reorganization, the present Rajya Sabha should be reorganized into a much smaller body, with just one directly elected representative from each state. The lower house would be elected on the basis of proportional representation based on the list system, with a high cut-off point; it would be entirely free of regional pressures. Half its members would be elected on universal franchise as now, and half by individual income taxpayers with votes in proportion to the tax they pay.

The present transfers from upper to lower tiers of government should be given up; let each level of government fund itself. So should the present division of powers of taxation. There is no reason why two levels of government should not levy a tax, with two exceptions. First, no subnational government should have the power to tax, or indeed to prevent in any way, trade or interstate movement of goods, services or people. And second, taxes on immoveable assets should be given over entirely to the lowest level of government. This lowest level may be the village or neighbourhood council. Since the state government would not be subsidizing this local authority, it should have no leverage on such a council. Any neighbourhood may decide by a three-quarters majority of all its adults to set up its own council, with powers of taxation. Private auditors appointed by the CAG should audit all governments, including the
central. Only the central government may borrow abroad; all the other governments can borrow within the
country without limit. They may go bankrupt, in which case they should be placed under receivership by
a court, just like a private business. Only the central government could not go bankrupt, since it would
have the power to issue money.

In this scheme of things, the centre may spend in any state and a state may spend in any neighbourhood,
but not through the government of that state or neighbourhood. Thus it would spend on building up
infrastructure - roads or water supply facilities for instance. It may also subsidize or otherwise promote
privately owned infrastructure such as power, railways or electricity. It would promote the development
of poorer states, not by subsidizing its people or politicians, but by improving their infrastructure, social
services and links with the rest of the world. Similarly, the local government would be able to do what it
chooses for its people without the interference of the state government. The forced marriage between the
various levels of the government involved in our present constitution would be dissolved, and each level
would be able to do what it is best at.

III Policy

In the previous section I outlined how the state should be reformed to make it a flexible instrument of
public service. Once it is redesigned, it begins to make sense to discuss what are rational economic
policies. The policies in major spheres are dealt with next.

External economic policy

Economic policy must govern foreign policy, its aim should be to increase flows of foreign trade and
investment, especially with neighbouring countries, and we should stop being touchy, ill-manned and ill-
tempered in our relations with other countries and interfering in matters that do not concern us. What does
this mean in terms of external economic policy?

Foreign trade is the way to expand the market available to Indian goods beyond the Indian market. The
world market is about thirty times as large as the Indian market; if India can produce anything more
cheaply than others, exports can give it a far larger market than home sales. It is with exports that country
after country has transformed itself and become a world power – Holland, Britain, Germany, Japan, and
most recently, China. It is India’s general failure as an exporter that has set it back.

A country will be able to export only if it imports; countries export value added, not goods or services. A
free import regime is good for exports. It is also good for consumers. Some producers, those who are
afraid of foreign competition, will think otherwise; and they will always find politicians whom they can
bribe to take their side. This is the BJP’s greatest economic weakness. It is close to industrialists, and in its one year’s rule, it has yielded repeatedly to pressure from high-cost producers for protection.

Commodity-wise protection is wrong: it favours some commodities against others, some producers against others, and producers against consumers; it is the outcome of an unholy alliance between certain producers and certain politicians. There will be times when protection to producers must be increased, for instance when the majority of them are in trouble. But such protection should be extended in such a way that it does not favour one producer against another. There are only two ways of doing it: either by putting a uniform import duty on all imports, or by devaluing the currency.

Import duties discriminate against value-added exports. They raise the cost of imports above what producers in countries with lower duties pay, and handicap our exporters against their competitors in other countries. Our import duties have always been high; despite the considerable reduction in the 1990s, they continue to be high. This is why the range of India’s exports has remained so narrow despite import liberalization. Gems remain our largest export because their value is high and difficult to estimate, so underinvoicing and overinvoicing are easy. Textiles are exported because export restrictions keep domestic cotton cheap. Most other exports are made out of indigenous inputs; true value-added exports are small. China, whose exports were no higher than ours 20 years ago, exports six times as much as us today; it exports the widest range of consumer goods to industrial countries. The reason is that it imports raw materials, adds value to them and exports them.

To make this possible, we have various arrangements like advance licensing, duty drawback and the passbook scheme. But they have done little to diversify exports. They are available only to exporters of goods whose input-output norms have been worked out by the DGFT and approved by the Customs. The rigmarole of doing so is just too great for exporters of new goods. And the corruption in the two departments hampers exports of even those goods with approved input-output norms. Today, these two departments are the biggest obstacle to exports.

This is why I advocate that import duties should be brought down to zero; if there are no import duties, no duty drawback will be necessary. To make duty reductions painless, the rupee should be devalued at the same time. This was the device tried in the early 1990s; it doubled exports. It can be tried again with even greater results. The finance minister should over the next three years reduce the maximum import duty to 30, 20 and 10 per cent respectively, and adjust the exchange rate so as to protect industry. Import licensing has to be dismantled by 2001 anyway; and if the maximum duty is reduced to 10 per cent or less, advance licensing will become largely unnecessary.
Another vexatious barrier to trade is the multiplication of import and excise duties. For instance, if a product bears an import duty of 40 per cent and an excise duty of 40 per cent, its imports are taxed at the rate of 98 per cent. This multiplication is quite unnecessary; it is far simpler to simply add the two duties to 80 per cent.

Another matter on which the BJP and Indian industrialists have conspired together is foreign direct investment; under their dual influence, the policy on foreign investment has become so arbitrary and complicated that direct investment is negligible. After the reforms of 1991, Indian industrialists had rushed abroad welcoming foreign investors. But they wanted foreign companies to come in as partners. But earlier, foreign companies preferred joint ventures because it was easier to get industrial licences for them than for subsidiaries, and because import licensing made producing in India full of indigenization hassles best left to Indian partners. With the removal of industrial and import licensing, foreign companies no longer need gatekeepers, and prefer to set up subsidiaries. Under the influence of the erstwhile gatekeepers, the BJP has instituted a highly non-transparent policy to make foreign investors take on Indian partners.

Foreign subsidiaries do not only create competition for domestic producers; they also create jobs for Indian workers, and markets for Indian suppliers. Not all Indian producers are afraid of foreign competition; there are some, like Reliance and Telco, who welcome it. But there are terrified producers and they have political influence; the workers and the suppliers do not come into existence and cannot have political influence unless the subsidiaries are allowed.

It is unrealistic to ignore the domestic producers’ influence; at the same time, to give them a veto over the entry of foreign competitors would be arbitrary and against consumer interest. What is needed is a transparent policy devoid of ministerial discretion. A number of alternatives are available; they are not mutually exclusive.

One is to make foreign companies announce their intention to set up a subsidiary, and to allow them to do so three years after the announcement. In this way, their Indian competitors will have three years to prepare for the competition. The other is to let them set up subsidiaries as companies registered in India with a minimum 40 per cent of the capital held by Indian investors or by mutual funds investing in such subsidiaries; that will give Indians a share in their success – or failure. A third alternative is to exempt such subsidiaries from restrictions provided that at least 40 per cent of the capital is held by nonresident Indians. These are not the only options; the BJP can work out its own. The important thing is to remove discretion and arbitrariness from its policies, for it can only bring the party a bad name.
Financial policies

The government comes into the financial picture in three ways. First, it has a monopoly of currency supply. Second, it is a substantial borrower. Finally, it regulates financial markets.

In all these three respects, the Indian government’s influence on the economy has been negative. It borrows too much; and its borrowing agent, Reserve Bank, wants to keep down the cost of borrowing. So it borrows as much as possible by issuing currency, which are zero-interest bonds that have never to be repaid. Reserve Bank routinely raises money supply by 16-17 per cent a year – about 10 per cent more than the growth of real production. Even if we add a couple of per cent for increasing monetization, Reserve Bank, plans for a high rate of inflation. Inflation was 7 per cent till the 1970s, then it went up to an average of 11 per cent. In the past year it has come down to 2-3 per cent; nothing has changed in monetary policy or in the government’s policy of pushing up foodgrain policies. There is no change in the Reserve Bank’s rate of money creation, so sooner or later inflation is likely to return to its trend level of 10-12 per cent.

When it comes to regulation, the government’s ownership of banks and financial institutions leads it to favour them. Thus all of them have high levels of bad debts, and are in effect bankrupt. The correct thing to do with bankrupt firms would be to close them down. But because they belong to the government, it has done everything except close them down. The Bank of Karad was milked by sharebrokers who were later caught in the Bank scam; the government merged it with another bank. Then Manmohan Singh poured new capital into bankrupt banks – capital which ultimately had to be financed by taxpayers in the form of higher taxes or by the general population in the form of higher prices. When the UTI bankrupted its US-64 by injudicious speculation, Yashwant Sinha bailed it out by giving massive tax concessions to investors in shares and in mutual funds. These are not poor people. If they pay less tax, someone else must pay more – or there must be more inflation, or both.

Reserve Bank has worked actively to ensure that they do not have to face competition. In the first flush of reforms, Manmohan Singh asked Reserve Bank to license new, private banks. It did license some; quite a few of those were owned by government financial institutions. It received over a hundred applications; it is still sitting on them. Then arose a new threat to government banks – non-banking financial companies. Starting with the report of the A C Shah committee, Reserve Bank has seen to it that only a handful of the 40,000-odd NBFCs survived; it has effectively contained their threat to the banks.

Apart from the tax concessions on dividends and capital gains, the government has not tampered too much with the equity market; in fact, the market has greatly improved over the 1990s. Two influences
have been important: the setting up of the National Stock Exchange, owned by government financial institutions, and the transfer of regulatory powers from the finance ministry to Securities and Exchange Board of India. Both have turned out to be highly positive developments.

Thus, policy mismanagement lies largely on the side of debt, and concerns the government’s handling of banks and lending institutions. Here there has to be more, fairer and more equal competition; and there will not be as long as they remain under government ownership. Hence their privatization must be the first priority of reforms.

However, privatization must steer clear of two dangers. First, the banks and financial institutions must not pass under the control of major borrowers – for instance, industrialists. In many countries – including Pakistan – government banks were sold to industrialists, who borrowed from them and made them bankrupt, and then went back to the government for a bailout. It is possible to minimize this possibility by ensuring that a shareholder or a group of them does not dominate a bank; there can also be rules about who may not own bank shares. Reserve Bank knows all about such restrictions, and would have no difficulty in introducing them. But there is another way: namely, to pass on the ownership to depositors. This is the principle of mutual societies, which predate companies. Mutual insurance companies and mortgage banks in the west are being demutualized and turned into corporate institutions under the pressure of their owners; the owners prefer to own saleable shares instead of illiquid units. But mutualization may be a good first step to ensure that the banks do not immediately fall into the hands of powerful borrowers.

Second, the market structure is all wrong. There are four huge long-term financial institutions. Of them, two – IDBI and ICICI – are too large; they need to be demerged into at least half a dozen institutions. One – IFCI – is bankrupt; it should be wound up. The last, UTI, is at last facing healthy competition from private mutual funds; although it is too large, it will cease to be so under the force of competition. Amongst the banks, the State Bank is too large, and should be demerged into half a dozen smaller banks. Of the rest, the bankrupt ones like the United Commercial must be sold off piece by piece; those that are not can be left alone.

But the most important point is to introduce open structures – structures that allow that entry and exit of new banks, financial institutions and insurance companies. Reserve Bank finds this idea highly unwelcome; it would rather limit the numbers in the hope that it can thereby contain competition and stave off bankruptcies. The insurance regulator is equally against competition. But as I have earlier written, the way to stave off bank bankruptcies is not by limiting competition, but by insisting that every
bank writes off doubtful debts out of deposits as soon as they arise. Banks would in effect provide two separate services. One would be to hold cash for depositors; on these cash accounts, the banks would pay no interest at all, and may even charge interest. But they would also offer to invest the deposits for their clients, and offer various options of lending them out to borrowers that vary in risk, and of investing the deposits in marketable securities. Thus banks would offer customers a number of investment options just like mutual funds, and like mutual funds, the banks would pass on the capital risk, including the risk of bad debt, to the investors. An investor who wants safety can keep his money in a cash account; if he wants a return, he must take risk, just like an investor in equity. That would eliminate the risk of bank failure – and the need for Reserve Bank to restrict competition. All it would have to do is to ensure that banks keep proper accounts and promptly write off losses. The banks’ depositors, who would bear the losses, would take their money out of inefficient banks and make sure those banks close down.

Fiscal policy

Fiscal policy involves five things. First, tax rates and tax collection machinery should be such that the taxpayers regard them as fair and taxes are paid with the least oppression. Second, the government should spend on such goods and services of benefit to the community as the private sector cannot equally well supply, and the benefits should be distributed fairly. Third, the balance between government revenue and expenditure should be determined by the public’s need for state-issued money and by the requirements of macroeconomic stability. Fourth, services should be provided by that level of government which can provide them most efficiently; and its powers of taxation and borrowing should be commensurate to what it needs to provide those services. Finally, the overall activity of tax collection and spending should serve the general interest, and not that of dominant political lobbies. These five criteria make it obvious how deficient our fiscal policies are.

Fiscal policy has seen the greatest activity in the 1990s. Manmohan Singh did the most: he reduced income tax from its punitive level, brought down the maximum import duty from 300 to 55 per cent, and also reduced the more egregious excise duties. P Chidambaram reduced income tax further, but also introduced service taxes which are the reverse of reforms – they have introduced fresh complications and harassment without raising the revenue much. Yashwant Sinha, after his disastrous first budget in which he rewarded friends and punished enemies, drastically reduced income tax on investment income in his last budget. He also reduced the number of excise and import duty rates. The net result has been that income tax revenue has gone up as a proportion of GDP despite the massive reduction in rates. The ratio of customs revenue has not fallen despite the considerable reduction, largely because the import ratio has
gone up. The ratio of excise revenue, on the other hand, has declined because the excise collection machinery has not geared up to the extension of VAT.

Of all these changes, income and excise tax reductions are a reform only insofar as the rates were too high and encouraged evasion. Thus Manmohan Singh’s reductions were called for; Chidambaram’s and Sinha’s less so. On the other hand, import duties should be largely abolished. We are still far from there; tariff reductions have got quite stuck under Chidambaram and Sinha. Sinha has actually made quite a few ad hoc duty increases.

All this action, reformist or otherwise, has been on the revenue side. Manmohan Singh abolished export subsidies; but that apart, there have been no reforms on the expenditure side at all. On the contrary, the quality of expenditure has worsened considerably: senseless subsidies have gone up, and capital expenditure has come down. Matters are even worse in the states. There have been no reforms on the revenue side; and as central subsidies have come down, the quality of expenditure has deteriorated. So the overall fiscal story is pretty sordid.

Now that a commission on constitutional reforms is to be set up, it should be possible to think of more fundamental reforms. The present states are obsolete. State boundaries need to be withdrawn; there should be 50-100 states, each centred on a major city. In this way it would be possible to reduce the three-tier hierarchy of centre, state and city into a two-tier one. At the same time, it should be possible for any neighbourhood to set up its own local government by a majority vote of its inhabitants.

How should powers of taxation be divided between the three levels? Local community governments should have automatic and exclusive power to tax immovable assets. Of other taxes, the states should be deprived of the power to impose taxes that fall on the movement of goods and people between states. That means an end to the present state sales taxes.

On the other hand, if the centre imposes a tax, there is no reason why the states should not tax the same base. Thus Canada has a two-part income tax. The centre collects it; but each state adds its own surtax. This is what we should do in India as well. Devolution of taxes should be given up. Once states are given the power to impose the same taxes as the centre, there is no reason why the centre should give them money or vice versa.

The same principle should be applied to indirect taxes. Yashwant Sinha says he is moving towards a single-rated value added tax. So he should. But state sales taxes should be replaced by a surcharge on the
central VAT. The surcharge would be uniform across all states, and should be decided by the upper house where all states will be represented.

A value added tax can be collected just like income tax; in fact, the same accounts that generate income for taxation also give one value added. Historically, VAT has arisen from sales or output taxes in all countries, and is for that reason collected on each transaction. But this is only a historical anomaly. VAT collection may be spread out over the year for the sake of management of money supply. But it does not have to be collected on transactions. Excise and sales tax departments are unnecessary, and can be abolished.

Tax reform would be defeated if corruption in revenue departments siphons off revenue to officials and taxpayers. To reduce corruption, it is necessary to reduce the size of the revenue bureaucracy, and to raise its salaries sufficiently to remove temptation. I have earlier shown how the size of the bureaucracy should be tailored to the work done, and how its pay should be comparable to pay in the private sector; as I wrote, “The present non-gazetted staff should be replaced by young persons under the age of 30 who would serve on short-term, non-renewable contracts, the present gazetted staff or senior officers should be replaced by people selected by examination from the non-gazetted staff on renewable contracts of 5-10 years, and the present records need to be completely computerized.” With this automatic turnover, government salaries will have to be made comparable to private sector salaries. But with the abolition of indirect taxes, there will be considerable savings on the size of the revenue bureaucracy.

The fiscal deficit is high, and the need to reduce it has been accepted by all finance ministers since Manmohan Singh, but none has made much dent in it. For operational purposes, it is better to think of the absolute deficit – say, Rs 1500 billion for the centre and the states – and to plan its reduction to zero over five years. In the meanwhile, the SLR should be immediately abolished, and all governments should have to compete in the open market for funds. Thereafter, the government should aim to reduce the total debt, as the British and American governments are doing already. The government may borrow or repay for the purpose of cyclical stabilization or for building lumpy infrastructure; but that apart, there is no justification for build-up of public debt.

The design of regulators

Regulators have been an important part of the reforms of the 1990s. One of Manmohan Singh’s earliest acts was to transfer the regulation of stock markets from the finance ministry to SEBI. This regulator, which had been set up in 1987 but given nothing to do, was suddenly woken up from slumber and loaded with considerable responsibility. The insurance regulator was appointed long before there was anything to
regulate. TRAI was set up when licences were given to private telecom operators. More recently, the CERC has been set up to regulate the power industry; and as if one is not enough, every state is being cajoled into setting one up.

However, there are other, older regulators; the only reason why they are not recognized as such is because the term did not exist then. Reserve Bank is the oldest regulator. Set up in 1934, it was explicitly set up to manage currency and regulate banks. Comptroller and Auditor General is also a regulator: he is supposed to keep government accounting straight.

These old regulators were set up before 1950; the new ones have come up after 1990. Why was there such a long drought in the creation of regulators? The reason is that the executive arm of the government came to be conceived as a super-regulator. Thus, industrial licensing was introduced in 1956; it could have been given to a regulator. Instead, a ministry administered it. Import licensing too could have been treated as a regulatory function; instead, it was given to a Chief Controller of Imports and Exports. In fact, what is called a regulator today was called a controller by the British: there was and is a Controller of Drugs; and the Controller of Capital Issues was meant to be a regulator. Thus, both the British and the Congress socialists freely confused regulation and administration; but their reasons for doing so were very different.

The British political theory was and is that government is the application of law to administrative decisions. The decisions may be numerous and repetitive, and may not therefore require such elaborate procedures as employed in courts; but they must be taken in the same fashion as a court would. They must apply the law fairly, without regard to whom it is being applied to. The theory is that Parliament lays down the law and the government only applies it. There are, of course, exceptions to this mechanical application of law. In foreign policy, for instance, a government pursues national interest, and gives little weight to justice or precedent. In immigration policy, governments blatantly discriminate against particular types of immigrants. Taxation is levied on principles that have only a tenuous basis in fairness. These are the areas that are decided on the basis of majority. A party gets to power by virtue of majority in parliament, and takes such arbitrary decisions as long as it holds majority. Thus one can imagine a variety of administrative decisions involving law and discretion in different proportions. The entirely discretionary decisions would be taken by or in the name of a minister; a controller would take the entirely mechanical decisions. Where the line was drawn was arbitrary; but whether a minister took a decision or a controller, it was supposed to be taken in a judicial spirit.

The Congress socialists, on the other hand, absorbed regulators into the government because they believed in revolutionary justice. They thought it fit to punish British industrialists because they were
British, and later, the big business houses because they had backed the wrong side in the struggle between Indira Gandhi and the old Congressmen. They thought it fit to favour those born in scheduled castes and tribes because the higher castes had been unjust to them. They denied licences to established importers because they indulged in sinful importing without doing any virtuous manufacture. Revolutionary justice aims at correcting historical injustice. But those to whom history was unjust are long dead; the compensation and the retribution are visited upon quite another set of people. And the quantum of either bears no relation to the historical injustice. Hence revolutionary justice creates fresh grievances and discredits the government that dispenses it. Its revolutionary rule discredited the Congress; people did not trust it any more.

That is why the Congress started appointing regulators – to give new policies a semblance of independence and objectivity. But appointing a regulator is not enough; a regulator has to be independent and objective. For this, five things are necessary.

First, the task of a regulator must be clearly defined. Elsewhere, regulators are set up in industries where competition is inadequate, and are expected by law and custom to mimic competition. In India there is no general commitment to competition. This is why the courts have allowed DoT and MTNL to ride herd over TRAI, and why the overriding aim of the insurance commissioner is to push up premia, on the excuse that insurance companies should be solvent; the fact that high premia reduce competition and help the government companies is incidental.

Second, the authority of a regulator should be commensurate to the task. In India, there are too many regulators, and they have been set up without proper division of territory. Thus Reserve Bank and SEBI fight over who is to regulate bonds; DCA holds on to powers which it cannot properly use and which were best given to SEBI. Having separate SERCs from CERC is a sure way to conflicting decisions.

Third, a regulator comes into being because the government cannot be trusted to be fair or objective; it comes about as a compromise between the party in power and the opposition. It is the function of the opposition to ensure the independence of the regulator. The house committees of US Congress routinely hold discussions with the chiefs of regulatory organizations; in India, the government does not permit it, and Parliamentarians do not ask for it. They are more interested in what benefits them than in what benefits the country.

Fourth, a regulator must not be beholden to the government. This is almost never true of Indian regulators. They are almost all civil servants, active or retired. Either way they have expectations of the
government; they expect extensions or further plum jobs. In Britain, the power regulator is a professor of economics; in America, the chief of SEBI is a financier. Regulators must be expert, not red.

Finally, the regulator must have powers of instant punishment. The SEC in US is all the time debarring brokers from business, or fining financial agents for misdemeanour. In India, powers of punishment and deterrence are inadequate and often ill defined, and few regulators use the powers they have.

Before we set up any more regulators, we should set up a commission to deliberate on a general enabling law covering all regulators, which would give them authority, autonomy and clear objectives, govern the appointment of regulators, and give them protection from government. We have far too many regulators doing too little regulation; this is a clear sign that the government does not know what regulators are for.

**Sectoral policies**

Socialists are fond of sectoral policies, since their world is inhabited by angels – that is, workers and peasants – and devils – that is, all others, and since they believe in rewarding and punishing people right and left. They also suited the Congress well because rewards and punishments can be lucrative. Most of its sectoral policies still continue; this has been the greatest failure of Congress-led reforms. And the BJP continues sectoral policies for much the same reasons.

A number of reasons are given to justify sectoral policies. First, *national insecurity*. If a country feels insecure, it will want to favour such activities as make it feel more secure. Thus it may set up government-owned defence industries. It may prevent the country from becoming dependent on imports of goods that can be used to put pressure on the government.

Second, *absolute shortage*. If the supply of something cannot be increased, then it has to be allocated. Its owner will allocate it, but he will try to make the most money out of it, and the government may think that unfair. Absolute shortages are impossible amongst goods and services that can be imported; they can arise only amongst non-tradables. The most important example is land. Any piece of land can be held only by one entity, and an authority – a government – has to decide who that entity is, and help it enforce its property right. It has also to regulate the sharing of land use – for instance, oil pipelines or power transmission lines will not be built unless the government enforces their right to cross others’ land. And it has to ensure that some land does not belong to anyone – for instance, roads. Other scarce goods may also require central allocation – for instance, radio frequencies, or water.

Third, *monopoly power*. This is a more general variant of absolute shortage. It involves goods for which there are no close substitutes, and whose markets new producers cannot easily enter. Electricity is an
example. Because electricity cannot be supplied to a consumer without a cable connection, the number of distributors will be limited. If the consumer does not have a choice of distributors, his relationship with his distributor may need to be regulated.

Finally, economic crimes. For instance, one producer cannot be allowed to use another’s brand name, or to spread unjust calumny against him. Law has to be applied to the relationship between producers and consumers or producers and producers; often the law has to be developed. Although some antique government departments such as the Department of Company Affairs continue to play this role, the modern tendency is to hand over such economic policing to independent regulators.

Let me begin with national insecurity. The chief consequence of insecurity is our stress on self-sufficiency in food. In the name of self-sufficiency we justify protection and subsidies to agriculture. Even if we insist on feeling insecure about food, that does not require licensing of agricultural exports and imports, agricultural price support, or the PDS. All that is required is to ensure that total agricultural imports are below a certain proportion and domestic stocks are above a certain proportion – say, 10 per cent – of domestic consumption. Just now agricultural imports are negligible, and absolutely no agricultural protection or subsidy is justified. If they came to exceed 10 per cent, it might then be appropriate to impose a small tariff, but we are far from it. And the way to ensure a minimum level of food stocks is to give cheap loans for storing grains. The entire present machinery for procuring and distributing grains is unnecessary and costly. It should be replaced by a central subsidy to interest paid to banks on funds borrowed by private parties against the security of foodgrains.

Insecurity also leads us to produce a lot of military and nonmilitary equipment under government ownership, and to spend on research and development within the government. This entire sector of government is extremely inefficient. It produces tiny quantities of obsolete trucks at great cost. Tanks and fighters it is supposed to design have never been designed, let alone produced; forget the cost of failing to make them. Because of the delays, cost overruns and poor quality, the armed forces press for imports and generally get them; the result is that they are extremely dependent on imports, making a mockery of self-sufficiency. They do not always get the equipment they want; their civilian controllers see to that. That is how they lack snowmobiles and parkas in Kashmir. And because military procurement is so centralized, big crooks home in on it. Bofors is only the most conspicuous example; but if Admiral Nadkarni is to be believed, the same kind of thing goes on under George Fernandes; the ties of Harinder Singh, whom he favoured, with arms dealers received good publicity in the press. The solution is to push down the authority to purchase as far down the operational hierarchy as possible; every fighting formation should have the freedom to buy the equipment it considers best. There should be no compulsion to buy from
anyone, whether it is government-owned ordnance factories or Indian-owned enterprises. If the
government has any explicit preferences – such as reluctance to depend on a particular supplier or country – it should spell them out in specific embargoes.

The cases of absolute shortage or natural monopoly are few, and in many of those cases, it does not matter if the producers extract monopoly rents. It happens with television channels all the time, and no one gives a thought to the profits they make. The unconscionable profits being made by software and internet companies at present are another instance. The stock market has been booming in India as well as the US on the basis of those profits. But no one thinks of controlling or reducing them. So monopoly is no longer a sufficient reason to control an industry. Unfair practices can be. But the standard model today for controlling them is a judicial one – a regulator with a judicial outlook, and not an executive agency of the government.

Still, there will be a handful of natural monopolies that will have to be regulated: for instance, electricity, telephone or cable connections to households. The controls required on them are of two types. The first is the common carrier principle: the owner of those connections must offer to carry the services of any supplier, and must not favour one or the other. Thus it is quite wrong for the Department of Telecommunications to own the last mile of telephone cables to the consumer, or for the SEBs the last mile of electricity cables. Distribution in these cases ought to be separated and hived off into an independent company. The second is an obligation to fair pricing on such companies. What that price might be is for a regulator to decide. But the regulator – and the government – should never decide how many suppliers there should be, and should not prevent the sale and purchase of such supplying companies.

**Education as empowerment**

There was a time, no more than two decades ago, when every economic discourse in India began with an incantation to poverty. Today, poverty is hardly ever mentioned except in Plan documents; and they are the least read documents in the country. The amnesia is not entirely unjustified; the poverty ratio began to fall almost as soon as concern about poverty ceased. If poverty can be removed by ignoring it, so much the better.

But although poverty has slipped out of public discourse, the policies ostensibly instituted to combat it in the socialist regime still continue. The public distribution system continues, and was considerably expanded by the Narasimha Rao government. Subsidies to agriculture, which continue, were once justified on the ground that people who lived on agriculture were poorer. Free education and government
health services continue on the grounds that they serve the poor. Even the World Bank, when it funded structural adjustment in 1991, insisted on a “safety net”; the National Renewal Fund was set up on such grounds.

None of these policies helped or help the poor. The public distribution system subsidizes people in the metros and in northeastern states, but few others; it is quite untargeted. Subsidies to agriculture go to the rich as well as poor. Free education and health services do probably reach more poor than other policies, but they are quite undiscriminating, and their quality is abysmal. And the NRF arbitrarily handed out largesse to workers in a few government enterprises.

Hence there is a case for dismantling all the supposedly pro-poor policies. But pro-poor policies will not go away. Even the BJP will grope around for a New Health Policy and a New Education Policy, for Houses for the Millions and a Crore Jobs Each Year. Redistribution pays political dividends; the most reactionary parties will be attracted to it. If we cannot get away from redistribution, we might at least make it efficient.

Even conservatives admit the case for subsidies that enhance the opportunities and capabilities of the poor – that build up “human capital”. These are basically subsidies for education and health. In both, reforms are urgent. Here I deal with education.

Murli Manohar Joshi, the erstwhile professor of physics, thinks education is about Saraswati Pooja. Actually, Saraswati showers her blessings, not on those who adorn themselves with red dots and worship her, but on those who master useful knowledge. It is not the fervent Hindu nationalists whom she blesses, but the whiz-kids who devote themselves to computers. Saraswati Pooja, singing of Vande Mataram, and sermons on the great Indian civilization are all waste of children’s time. The time they spend in educational institutions is valuable; it should be entirely devoted to useful arts.

In education, the Indian governments give excessive subsidies to tertiary education and spend too little on primary education. Colleges were the first device discovered by Congress politicians to siphon off public money into their own pockets; in the past 50 years, many other racketeers have trodden this path to easy money. But colleges get subsidies only if they submit to the dead hand of university administrations; and universities have become progressively less capable of providing quality education. The result is the growth of private colleges. Today, software is almost entirely the preserve of south Indians, especially Andhras, Tamils and Kannadas; and they are largely products of private colleges.
These private colleges demonstrate what can be done to education if the dead hand of the government is removed. All that the government needs to do is to ensure that standards are set. It does not have to set them; for instance, standards are set in accounting by private bodies whom the government has given a monopoly. This model can be followed at all levels of education. What we need is examining bodies that give standardized examinations and grade those who take them without favour. I have been arguing for a standard bachelor’s examination, which would replace the IAS examination; it would consist of five subjects – English, accounting, law, economics and mathematics – and would set nationwide standards in them. Graduates in these subjects would find a ready market, not only in the government, but also in business and professions. Similar qualifications can be set up at other levels – at the end of primary and secondary schooling – and in more specialized subjects.

If standard, nationwide qualifications are set up, the government can get completely out of teaching. The sooner it does so, the better; for its exit is necessary for fair competition to emerge in education, and only fair competition will give us better standards at a lower cost. The lowest cost would be achieved if education were imparted by satellite. BJP’s information and broadcasting ministers have been sitting on the licensing of direct-to-home television in the hope that they can use it to make huge profits for Door Darshan. It is an old socialist misconception that fattening government institutions is good. If the BJP gives it up, it has in DTH the most powerful tool available for improving the standard of education at the lowest cost. The government should give a licence for direct-to-home television on the condition that half of the 200 channels would be devoted to imparting education all the way from primary to tertiary.

A subsidy to education would still be advisable. Ideally, it should be a subsidy to students; vouchers are the best means of subsidies. Any child that reaches the age of 4 should get vouchers that it can use to pay for five years of schooling. If it passes a certain statewide examination, it should get vouchers to pay for another five years’ schooling. It should not have to wait for five years to take the examination; it should be free to accelerate its rate of learning. The examinations should be only in useful subjects, such as English, mathematics and engineering; Sanskrit, Persian and Latin should be entirely relegated to universities, for study in which no student should get a subsidy. In addition, prizes should be given to all who achieve a minimum standard in examinations; the better they do, the higher the prize. To encourage children to compete, there should be so many prizes that a high proportion of successful students would get one. Thus education will become a lottery of talent.

Subsidies should not go beyond ten years of education. As students approach the age when they must seek employment, their education must be geared to meet the demands of the market; and the best way to do so is to make the market pay for it. Employers should be allowed to sign contracts whereby students
whose education they finance would have to work for them for a certain number of years. Companies should be allowed to go into the business of tertiary education. Useful education, as imparted by the private colleges, has become an industry; if industrial enterprises enter it, they will bring innovation and efficiency to an industry that for too long has been the preserve of indolent educators.

Bodily concerns

Although millions of poor people have nothing else to fall back on, the state of government medical facilities in India is execrable. There are a handful of elite government hospitals, generally attached to medical colleges whence they get cheap medical manpower. They attend hand-and-foot to politicians in power, bureaucrats and others who have influence with either. But for the rest, no one who can afford private care would choose to go to a government hospital or clinic. The facilities are overstretched and the waits are long. The doctors are overworked and hence often callous. The wards are overcrowded and patients lie on the ground. Medicines are scarce and patients’ relatives are asked to go and buy essentials abroad. Maybe government medical institutions work better in some states; the exemplary record of the southern states in birth control and child care cannot be entirely accidental. But it is only by geographical accident that Indians get good medical care from the government.

The state provides medical care in many industrial countries. It is looked upon as, and is often called, a form of insurance: illness is an accident that can befall anyone, its costs can be unaffordable, and it seems unfair that someone should not receive medical care because he cannot afford it. Some countries provide it through a nationalized medical system; others pay for medical insurance, which is provided by private insurance companies. The insurance companies then contract with clinics and hospitals for the actual medical service.

Thus in the US, the government compels employers to cover their employees’ medical needs. Employers make contracts with insurance companies, and insurance companies enter into agreements with collectives of medical practitioners to provide the medical services. The system works fairly well for those who are employed; but 44 million Americans, mostly poor and without secure jobs, remain uncovered by any kind of medical insurance. In Britain, the government nationalized the medical facilities soon after World War II, employed most of the doctors and took over the hospitals, and provided everyone with comprehensive medical care paid out of a tax on employers and employees. This system became too onerous. In the 1990s the British government has begun to allocate a fixed subsidy to each doctor. Physicians are thus forced to allocate the money amongst those in need of treatment, and to haggle
with hospitals about the cost. In Germany, the system works as in the US except that insurance is paid for out of taxes.

They are such a shoestring operation that they can only provide extremely substandard services; and they face such excess demand that they can never do a good job. Equally undesirable is the government-owned insurance system. The insurance companies issue medical insurance policies, but the benefits are limited, and there is not much certainty that the promised benefits will be delivered in the case of illness, especially in the event of expensive illnesses. Consequently, the number of medical insurance policies sold is minuscule. It would be best to privatize government-owned hospitals and clinics, and to use the private sector to provide broader and more subsidized medical services. Similarly, if the government’s insurance monopoly goes, competition will lead to the provision of greater and better medical insurance.

But insurance is based on the principle of calculable risk. The risk of illness increases with age, and with a history of previous illness. The probability of old age is extremely high – in fact, close to one. Hence there is virtually no element of insurance in old age insurance; old age insurance policies are just schemes in which the insurance company invests the insured’s premium payments and holds them in trust. It is in general interest that people should save for their old age and not become dependent on others. Hence there is a case for subsidizing old age insurance.

Rather, the case is for subsidizing all long-term savings. This is the idea behind the Public Provident Fund, on which the government gives absurdly high interest provided the money is held for at least 15 years. But the case is for subsidizing savings that are held till old age befalls a person – in other words, that are held till the age of 60 or more. And the savings should not have to be given to the government; they may equally be invested in private sector bonds or equity. This is the principle behind the PEPs and the new ISAs in Britain, and the 401(k) funds in the USA: the holder qualifies for tax rebate provided he does not withdraw the money till he reaches a certain age. Till then he can reshuffle the money between investments, but he cannot consume it. This is the way we should go; such savings for old age should get not just a tax rebate, but a subsidy.

There are other catastrophes which, though not as probable as old age, are highly probable: for instance, a person who has had one heart attack is highly likely to have another; a cancer patient must always fear recurrence. These are cases which insurance companies avoid like plague; they shun offering medical insurance to anyone with a past record of certain diseases. But these cases are analogous to old age; although the high probability of illness makes them inappropriate for insurance, saving for the likely
illness is highly desirable. The subsidies that apply to pension policies should also be available for medical policies for people who are highly likely to suffer from ailments.

Health and old age insurance in industrial countries involves a cross-subsidy from the young and the healthy to the old and the infirm. As their population ages, this cross-subsidy grows, and so does the resistance to it. In Holland, the old have formed a political party; at least one prime minister lost power because he did not heed the old. This cross-subsidy is best avoided.

But there is one cross-subsidy that has everything in its favour: a subsidy from a young person to himself when he gets old. Such a subsidy would be subsumed in a life-long health insurance policy that is taken at an early age – say, before the age of 30. The government should compel all insurance companies to offer such a policy – and should subsidize its premia. The best way to give such a subsidy would be to pay the first few years’ premia; then it would be up to the insured to continue the policy.

Just as the government should offer every child that is born a subsidy equal to the first five years’ school fees, it should offer every person a lump sum when he reaches the age of 25 which he may only use towards a life or a medical insurance policy. The sum may be spread out over any number of years. The poor will take a small policy and spread the sum over more years, the rich will take a big policy and use up the subsidy in the first year. The way to better health is not through health services, but through the design and promotion of appropriate insurance products.

IV Conclusion

An improved design of government and rational economic policies are what we need today. But to continue to prosper, we will need something more – we will need mechanisms whereby the government and policies continue to adapt to changing circumstances. There is no eternal wisdom. But learning organizations can encompass the government just as much as firms. To create a government that listens, analyses and learns should be our final ambition.

Towards a self-improving polity

We pride ourselves on our democracy. But it is nothing great. Democracies are a dime a dozen. By now, over a hundred countries in the world have democracy of one sort or another; about the only large country that is not democratic is China. Democracy is useful insofar as it allows the citizens of a country to settle their differences peacefully – by talking in parliaments, which literally mean talking shops. But it is debatable how far our democratic institutions promote peace. Parties represented in the legislatures have no qualms about taking to the streets; and there are plenty of groups not so represented who take to arms.
This is the condition in a time of prosperity; what would happen if India underwent a major crisis? Look at Indonesia where, since the economic collapse, locals have been killing the Chinese, Muslims have been attacking Christians, and the army has been attacking the East Timorese; this is the kind of mayhem that imperfect democracies can degenerate into. This is what could happen to us. We need a more representative democracy, for which I have earlier made suggestions—proportional representation with a high cut-off, the right of any neighbourhood to form its own local government, and a civil service that can be hired and fired.

But there is another role democracies have increasingly adopted in industrial countries; their elected representatives use the power bestowed on them to make continual improvements in administration, policies and social order. And to do so, they have modified their political structures, and taken them far beyond the primitive democracy that we know in our country. Just as competition in productive activities delivers better products at a lower price to consumers, so democracy is supposed to deliver better public services—law and order, justice, traffic management, disaster relief—to the people at a lower price. This is why the more vigorous democracies have been changing their practices with experience gained.

First, they refer more questions directly to the electorate. Switzerland has an old tradition of putting major questions to referendum; that is how the Swiss decided, for instance, that they did not want to join the European Union. In recent decades, California has increasingly taken to putting propositions before electors and asking them to vote on them. Thus it recently put to popular vote alternative proposals to ease traffic problems in San Francisco, involving a motorway vs an underground railway. The Labour government has similarly promised to put to direct vote the question whether Britain should adopt the euro. Referenda were impractical till recently because of their enormous cost and inconvenience. But electronic technology has considerably brought down their cost. In India itself, electronic voting machines have got rid of the enormous paperwork and counting effort in elections. We should install an ATM in every post office, and allow everyone to open an account free; the ATM can then be used to take impromptu votes as well.

Second, they try to equip elected representatives better for their task. We give our MPs gas allocations and money to spend in their constituencies. The US gives them big offices and money to support a sizeable staff; Congress arranges courses that teach newly elected legislators about the business of lawmaking. And British ministers liberally employ outside advisers to help them formulate policy; right now, some 70 such advisers, who do not belong to the civil service, are working in the Labour government. The US government recruits bright, successful young people to come and work for a year at
a time. In India, the finance minister brings in an outside adviser once in a while. Then it is news; but soon the line bureaucrats intrigue against and undermine him.

Third, the better run countries have supplemented their parliaments with forums where outside viewpoints and intellectual inputs can be brought to bear on policy. Thus in Britain, major policies are debated in select committees, and not in Parliament itself. The select committees routinely call outside experts, commission studies from them, and take them on as consultants. In the United States, with its presidential system, it is perfectly normal for an expert to be appointed to the top ministerial posts. Thus Larry Summers, the current Secretary of the Treasury or finance minister, made a name as an academic economist before he entered government. Stanford abounds with professors who have served in the US government in various line posts. Not for them the Indian Administrative Service; not for them bureaucrats who have crammed all they can while they do their graduation and who stop learning the day they join the government. Here, learning is welcome at all levels of government, embodied in people of all ages.

Finally, something that is peculiar to the US. Elsewhere, politicians make promises to the electorate. Thus some six weeks before the general election, Indian parties issue manifestos which they promptly forget. So do European parties; but their manifestos are shorter and more specific, and are often implemented if a party comes to power. It is the parties that decide what issues to address in the manifestos; and they cannot be grilled on the manifestos. But in the US, a presidential candidate does not issue a manifesto. He has first to run in primaries for eight months; then, if nominated by his party, he has to fight a presidential campaign for four months. During that year, he may be asked questions not only by the press, but also by his electorate during the primary campaigns, and by his opponents in televised debates. The questions will not be on issues of his choice; in fact, it can be taken for granted that if there is a question that will embarrass him, it will be asked. It will not necessarily be on grand policy; but there will invariably be questions on the issues that stir the people, however petty others may think them to be – on tobacco, on abortion, on immigration, on anything. In other words, it is the people who set the agenda, and the candidates have to take positions whether they like it or not. In this way, a much better definition of the issues and the protagonists emerges than it ever does in parliamentary systems.

Whether to go presidential is a boring and not so important question. But how to create a political system that will continually improve itself and serve the society is an important question, and we in India have not even begun to answer it. I hope that Justice Venkatachalaiah will take it up in the Constitutional Commission. But it would be wrong to expect that a single commission should answer it once and for all. It would also be a mistake to think that the Constitution is all that needs to be changed. We should have
institutions that concern themselves with it all the time. Our ramshackle democracy needs a lot of reform; we need to create institutions that will steadily churn out ideas and governments that will try them out. And for that we need more effective competition in our political market.