



India's Structural Challenges

India has gained more international media attention since Prime Minister Narendra Modi swept into power with a strong majority over a year ago. The victory of this reform-minded leader was expected to kick-start growth. With its large and young population, India no doubt has enormous potential; as China ages, India can emerge as the manufacturing hub of the world. And it is widely expected that India will be the world's fastest-growing major economy.

However, optimism should be tempered with the knowledge that many of India's biggest challenges have deep-rooted origins with no easy solutions. India is in need of sweeping reforms in order to realize the full power of its entrepreneurial talent and to make life easier for its poor and its middle class. This issue of *Asia Insight* seeks to outline the historical context that investors should have in order to hold a more comprehensive view of India's efforts to reform its institutions. By "institutions" we are referring not only to government agencies but also to more abstract concepts such as employment policies and political representation.

The Importance of Inclusive Institutions and Economic Growth

In the book "Why Nations Fail: The Origins of Power, Prosperity, and Poverty," authors Daron Acemoglu and James Robinson discuss how inclusive institutions are crucial for sustained long-term economic growth. We identify inclusive institutions as having well-defined property ownership rights, flexible labor policies and all-encompassing political representation (where political leadership is representative of the overall population). These institutions allow entrepreneurial efforts to flourish, and for these efforts to be rewarded rather than expropriated by bureaucrats and politicians. In addition, the country's institutions must allow new entrepreneurs

to emerge over time, challenging and replacing the existing order.

Failure to develop such institutions tends to depress economic growth not necessarily over the short term but more over the long term. The lack of well-defined property ownership rights in India has led to innumerable delays in land acquisition by corporations. Similarly, rigid labor policies mean that companies are hesitant to hire workers as full-time employees. These labor laws impose restrictions on businesses that in most countries are left to the discretion of management. Paradoxically, instead of these labor laws protecting the workforce, they tend to push workers into informal employment with limited rights. And while India rightfully takes pride in its democracy, several regions still have high levels of illiteracy which cause truly representative governments in those regions to be lacking.

Historical Origins of India's Institutions

In order to understand why these institutions function as they do, it's worth looking at their origins. Many of India's institutions trace their roots back to the country's colonial past. British rule started in a few Indian provinces in the mid-18th Century, and over time expanded across the entire country before finally ending in 1947. The British ruled the Indian subcontinent in two ways—either directly or through native princes. Some believe that native princes felt more connected to their kingdoms and hence tended to take a long-term view. The British officers, on the other hand, knew that they were in for just short stints and were more focused on the short term. Consequently, the prevalence of hospitals and schools was typically greater in regions ruled by native princes. The British-ruled areas tended to have lower literacy levels, and the most oppressive regions were British administered areas where landlords were in charge of revenue collection.

Among India's biggest political challenges is the prevalence of the armed Maoist insurgency (known in India as Naxalism) that emerged in the 1960s. In several regions, landless poor are engaged in an armed struggle against the Indian government. While the Naxalite problem is undoubtedly a sad reflection on the modern Indian



“I believe government has no business to do business. The focus should be on Minimum Government but Maximum Governance.”

—Narendra Modi

state, the roots of the problem go back to the days of British colonial rule. In many areas, the British adopted a landlord based land-tenure system. Here, often absentee landlords would collect taxes from peasants and pass on a portion to the British crown. This led to a system in which the impoverished were exploited, and productive gains were minimal. Researchers have found a strong overlap between such areas and regions impacted by Naxalite insurgency in modern India. Here, class-based conflicts have prevented economic development from reaching these regions, and a vicious cycle of violence has underpinned such populations.

The Naxal-affected districts account for a significant portion of the country’s natural resources, including coal and iron deposits. Hence, violence in these areas poses a drag on overall industrial activity. Impact on coal is particularly troublesome. About one-third of India lacks access to electricity. Worldwide, coal is one of the cheapest and most reliable means of generating power. While India is particularly well-endowed with coal deposits, a significant portion of these deposits are in conflict-prone areas, forcing the government to import expensive coal to meet shortages. Many of India’s coal-based power plants also end up running at less than full capacity.

During its colonial rule, the British set up an administrative arm known as the Imperial Civil Services to oversee a landmass and a population much bigger than its own. At the time of India’s independence, about 1,000 officers with enormous power ruled a population of 300 million. After Independence, India retained core elements of this colonial setup. For a fledging nation, this steel frame of bureaucracy assisted in ensuring unity and integrity of the nation. But, the colonial mindset remained mostly unchanged. Thus, bureaucrats even now rarely look upon the common man as their stakeholders, and more as their subjects. As another instance of this mindset, senior bureaucrats and government ministers live in sprawling estates occupying valuable land within Indian cities, contributing to high land prices in major cities.

Culminating in a Democratic Process that Still Needs Major Improvements

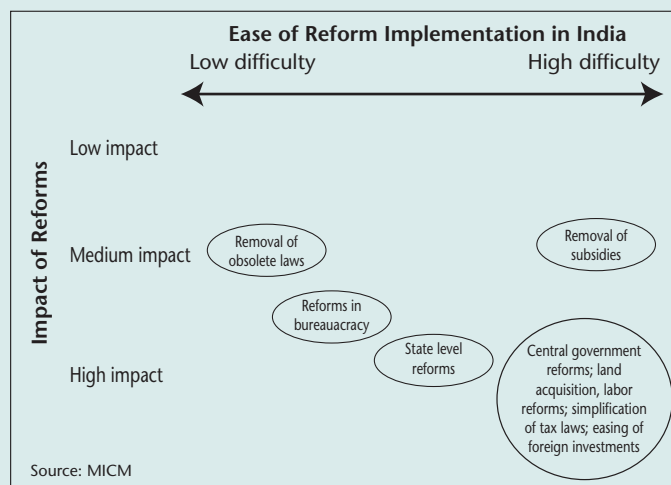
India can take great pride in its democratic institutions. Independent India has had no history of authoritarian rule other than a couple of years in the 1970s. But the *quality* of democracy still leaves much to be desired. Data from the last three federal elections in the past decade shows that more than a quarter of elected representatives

face criminal charges. Even during the 2014 elections that ushered Modi’s government into power, more than one-third of the elected representatives had ongoing criminal proceedings in Indian courts. Contrary to the conventional wisdom that criminal records hurt electoral prospects, in India, candidates with criminal charges actually have a higher probability of winning. A key reason is that criminal records serve to intimidate opposition voters, especially in poorer regions.

Modi is well aware of these challenges. He recently visited the heartland of Naxalism, the first prime ministerial visit in the last three decades where he introduced several development programs. Modi has tried to invigorate and empower the bureaucracy by promoting officials with a reputation for efficiency rather than seniority. Moreover, the prime minister is widely regarded as accessible. But while his availability to rank-and-file bureaucrats is refreshing, without institutional changes, it is difficult to see Indian bureaucracy changing just by force of personality.

A Framework for Reform Plans

Given the historical context of India’s institutions, a key question is: What is the likelihood that a particular reform will overcome opposition and get implemented? We find it useful to look at possible reforms with the framework of this twin perspective: impact versus ease of implementation. While investors typically pay much attention to the impact, not many pay attention to the latter, hence, our previous discussion of the historical context. Our conclusion in simple terms is that any reform that adversely impacts well entrenched organized interests will face more challenges in getting implemented.



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Reforms do not Always Need to be Big Bang Reforms

Modi has articulated a key principle of his government as: Minimum Government, Maximum Governance—a focus on reducing the size and scope of the government. In this spirit, there have been refreshing efforts to reduce the powers of the bureaucracy by scrapping obsolete laws. One of the government’s measures is an attempt to dismantle archaic laws; which, by the government’s conservative estimates, exceed 1,700. These laws, many of them established by the British in colonial times, were conceived in an environment in which the focus was to control the masses and not necessarily to provide services to citizens.

Another instance of reducing chronic red tape is a simple change in documentation requirements. One of Modi’s first acts was to do away with the requirement that photocopies of documents submitted to the government needed to be verified and attested by a government official. This attestation requirement was one of the ways that legacy laws imposed hardships on the ordinary citizens and created opportunities for petty corruption.

In some instances, instead of trying to impose reforms at the center, which given the complexities is challenging, the central government is encouraging states to drive reforms. The state of Rajasthan took the lead in labor reforms, allowing companies to lay off workers without the need for government permission. The earlier law allowed management discretion to lay off workers only in companies with less than 100 employees; this has since been relaxed to include firms with up to 300 employees. Other states such as Madhya Pradesh are in the process of adopting similar reforms. Here, competition among states to attract corporate investments is proving to be a motivation.

“Make in India”

Prime Minister Modi has emphasized his hope of India becoming a manufacturing hub to the world with an initiative called “Make in India.” This national program is designed to facilitate investment, foster innovation, enhance skill development, protect intellectual property and build best-in-class manufacturing infrastructure. This is critical for generating sufficient well-paying jobs for the millions of young people joining the workforce each year. Failure could result in societal failure. While the Make in India intentions are noble, the program requires many parts to click together. It requires the government to implement flexible labor laws, enable easy and fair access of land for industrialization,

ensure reliable supply of power, and curtail powers of bureaucracy and politicians.

While we are rooting for Modi’s success and have high hopes for improvement to India’s democratic process, we realize that the challenges to be overcome are immense. No doubt India has great potential and the wherewithal for rapid economic growth for decades to come. However, long-term investors need to monitor changes in the underlying institutions. Any change from an extractive system to an inclusive system takes time in part because well-entrenched vested interests have to be overcome or co-opted. In any large country such changes are always difficult given the existence of organized, established interests that benefits from the existing arrangements. It is here that Prime Minister Modi will face his biggest challenge. We will watch his next moves with interest.

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