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OPINION

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The Narendra Modi government's flagship "Make in India" programme is not the first attempt to goose Indian manufacturing. It will not be the last, no matter who wins the 2019 elections. Scrying the entrails of past policy pushes is helpful. It throws up some constant truths. Import substitution hasn't worked and is unlikely to do so. Industrial policies can introduce significant distortions. Policy decisions made in New Delhi often don't survive the journey to manufacturing plants. A new working paper by Rajesh Raj S.N., Kunal Sen and Sabyasachi Kar, *Unmaking "Make in India": Weak governance, good deals and their economic impact*, provides interesting insights into that last point.

Since its inception in 2003, the World Bank's *Doing Business* report has been perhaps the most popular yardstick by which to measure the state-business relationship. Much was made of India's jumping 30 ranks to 100th position in last year's report. It is a laudable achievement as far as it goes, speaking to the Modi government's attempts to clear up regulatory cholesterol and put new, effective systems in place.

In 2015, however, Mary Hallward-Driemeier and Lant Pritchett had a subversive take on the impact of such policy action in their paper, *How business is done in the developing world: deals versus rules*. Looking at firm-level data from the World Bank's enterprise surveys (ES)—as opposed to the *Doing Business* reports which survey lawyers, consultants, bureaucrats and so on—they found a vast gulf between de jure regulatory frameworks and de facto realities. Corruption and deal-making between the state and businesses meant that across the nations studied, a handful of companies could obtain clearances and permissions far faster than the law suggested, while other companies took far longer than prescribed.

Raj, Sen and Kar mine this perspective further, looking at 2013-14 ES data across Indian states. In line with Hallward-Driemeier and Pritchett, they find a substantial difference between the de jure number of days required for a business to get an operating license or construction permit, and the de facto reality. So far, as expected. In fact, in the majority of states, the mean and median de facto values are lower—sometimes substantially so—than the regulations suggest. Does this mean that governance mechanisms are particularly efficient in these states?

Not quite. They find a wide variance in firms' within-state experiences. For instance, in Bihar, "the 10th percentile set of firms reports obtaining an operating license in one day, while 90th percentile set of firms reports obtaining a license in 90 days." This makes it clear that a company's regulatory experience is a product of its deal-making ability, not of a neutral governance mechanism. Here is where it gets interesting: Raj, Sen and Kar also find that firms in states with weaker capacity and poorer governance, as defined by a handful of proxy measures, are able to secure better deals—and that in most states, good deals go to the least productive firms.

The implications for Indian industry and development are obvious and troubling. For firms, India's administratively weakest states are the most tempting targets for regulatory capture that is likely to skew the inclusive, broad-based growth they need. The natural advantage large companies have over upstart competitors in securing sweetheart deals also means that competition—and the innovation and productivity growth that comes with it—are undercut. There is thus efficiency loss when it comes to business growth pushing broader economic growth and development.

By enriching politicians and bureaucrats, such deal-making and regulatory capture also creates structural disincentives for improving state capacity. In the absence of such capacity, the value of politicians as middlemen who can help firms cut in line or secure public goods for citizens rises. This, in turn, enables more deal-making, perpetuating the cycle.

In *The Republic Of Beliefs: A New Approach To Law And Economics*, Kaushik Basu has written that the effectiveness of laws rests to a significant extent on the belief among citizens of a state's ability to enforce them—that is, buying into a rational expectation of behaviour in accordance with the law. Visible regulatory capture and lack of state capacity make such belief hard to buy into. There is also another factor at play here. To a significant extent, caste and kin networks remain important vectors of social, economic and political activity. This is a reality that doesn't always mesh easily with India's regulatory and legal framework.

These are fundamental problems that define the business-state relationship in India, and extend considerably beyond it. Plainly, improving the regulatory framework is no panacea. Breaking the cycle will take far deeper transformations.

What can the government do to prevent regulatory capture? Tell us at views@livemint.com

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