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India's states can be laboratories for policy innovation and reform

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While there is a lively ongoing debate on the merits of the Centre's attempt to increase the FDI limit in multi-brand retail, the most important innovation of the proposed policy may not be about retail at all, but rather the provision that it will be up to the states to decide if they want to allow it. In other words, the Centre is not imposing a policy as much as getting out of the way and allowing states that want to experiment with FDI in retail to do so, while states happy with the status quo are not forced to make any changes.

This is an important landmark in policymaking in India. It points the way forward on many contentious policy issues where there is lack of consensus at the national level. Inevitably, any major policy reform will have reasonable arguments both for and against (regardless of whether it is reform of labour laws, cash transfers, or public-private partnerships to improve service delivery). Reforms also create winners and losers, and it is not surprising that the losers will oppose these reforms, even if they improve aggregate welfare. The combination of plausible public-spirited reasons for opposing reforms, the interests of prospective losers in opposing them, and a governance system with multiple veto points creates a strong bias in favour of the status quo.

The question of whether a specific reform is welfare-enhancing is typically an empirical one. But how do we generate data on the impact of reforms if it's politically risky to try them in the first place? One option is to reduce the risk of making a mistake, by reducing the size of the jurisdiction where innovations are tried out. If debates in Delhi are going to decide policy for over a billion people, the stakes are very high: opposition is more entrenched, and the high level of risk-aversion to mistakes magnifies the status quo bias.

Using the states as laboratories for policy innovation makes sense for several reasons. The first is simply that this provides 28 settings for experimentation as opposed to just one, allowing a greater diversity of ideas to be tried out at lower risk. Second, Indian states are large (the 10 most populous would be among the 25 most populous countries in the world) and have enough scale to be autonomous policy-making entities on many issues.

Third, there is great diversity among states' political leaders, and corresponding variation in their priorities and their abilities to build coalitions for specific reforms. Thus, while most reforms might not take place in all states, each state will likely attempt at least some reforms — and each major sector will see some reforms somewhere. Finally, the locus of political accountability is increasingly shifting to the states, which provides an incentive for states to copy good ideas and compete for investments and jobs.

The central role of competition among political jurisdictions and the imitation of successful ideas in long-term growth is illustrated by a powerful historical example.

Consider the case of China and Europe in the 15th century and the question of where we should have expected greater technological progress. Surely China had the advantage: not only was it already more advanced then, but it also was a unified political entity. Resources weren't being wasted on internal wars — unlike in highly fractured Europe. Yet research by economic historian Joel Mokyr suggests Europe had a key advantage — the possibility for experimentation across political jurisdictions, with rapid imitation of successful ideas, whereas the uniformity across China limited the scope for experimentation, making mistakes much more costly.

A striking example of this is the history of seafaring. The Ming dynasty decided to ban ocean-going ships to limit smuggling. Of course, this had several unintended consequences, including limiting China's exposure to the rest of the world and its ideas. Columbus, meanwhile, looking for patrons to fund a westward sea journey to the east was turned down by Portugal (where he went first), but found favour in Spain, enabling the discovery of the New World by Europeans. Of course, all leading European powers (including Portugal) then quickly embarked on their own westward sea voyages. China on the other hand, stayed isolated from the world for centuries after the decision to ban oceangoing ships.

The lesson is that well-intentioned policy mistakes are inevitable, but making these mistakes in one big country is much more costly. Not only do you make a mistake for a larger jurisdiction, but the lack of a self-correcting mechanism means that it takes much longer to figure out that you may have made a mistake. The Portuguese mistake was less costly than China's because the Spanish got it right — and it was easy to learn and adapt from a neighbouring country.

The implications for India are obvious. Not allowing FDI in retail may be correct, or may be a big mistake — but deciding to not allow FDI at the all-India level means that we will never really find out if this is an error. A more promising approach is to reduce the structural risks of reform, and for the Centre to support experimentation by states to better understand the impacts of specific reforms, and to then facilitate knowledge transfers across states that enable scaling up successful reforms. Proceeding with second-generation reforms in this manner is both economically and politically prudent.

The Government of India's approach to FDI in retail should set a precedent for providing an enabling environment for states to drive the next generation of reforms. The NDA, which has a stronger tradition than the Congress of supporting greater autonomy for states, as well as state leaders, should take this opportunity and work with the Government of India, in the national interest, to evolve a structure that lets states lead on reforms.

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