

In Conversation With:

Indira Rajaraman

Q1. In a keynote lecture, you mentioned that democracy is one of the major strengths of any country's economy and especially for India. Why do you think so?

Ans. India is an incredibly diverse country in all conceivable aspects. It is a collection of different types of people. In the electoral sense, it is extremely important that people have a chance to change their representation in Parliament. They don't have a right to do anything else, so it is important that they have this basic freedom. For if there were no democracy, a part of the country would feel misrepresented and would have no way to express its displeasure against the government other than by being violent. Most of all, the government would have absolute power over everything including media. So, it is impossible for a country as diverse as India to have any other form of government.

Q2. Considering the present scenario where we have a great dependence on imports, do you think we should take more steps forward for increasing domestic oil exploration?

Ans. Yes, there is a huge controversy raging on this issue and this is a pertinent question. The big oil exploring companies are complaining about the fact that the regime that has been brought in, is what's called the revenue-sharing model. So whatever revenue they earn has to be shared with the government. As students of economics, you know that if revenue-sharing is done, it immediately changes the point on which production will be done, by changing marginal revenue to the producer. The opposing school of thought, which is correct from the production point of view, is that there should not be a revenue-sharing model but instead, a profit-sharing model. In a profit-sharing model, the parameters determining where production stops (where $MR=MC$) are not affected. The generated total profit is shared, which is similar to imposing a tax. This model is as lacking in distortionary aspects as a tax is. Domestic producers complain that they don't have the incentives to go up to the $MR=MC$ point and also about the fact that they are given no incentives to explore. Also, a profit-sharing model somehow gives companies an incentive to falsify their costs and declare a much lower profit so that the government gets part of the under-declared profit. In their defense, supporters of the revenue-sharing model say that they are protecting the people from being cheated on costs. So, I have presented to you both sides of the issue.

Q3. In the current context, India is facing a lot of macroeconomic vulnerabilities. Do you think a higher level of international cooperation could help address that?

Ans. The answer is certainly yes. It is not forthcoming though. The reason being that after the 2008 crash, there was an appearance of immediate global unity under the framework of the G20 and all countries were asked to loosen up fiscally and monetarily, which is actually appealing for the government. But in normal circumstances, fiscal and monetary laxity are considered sins because governments are supposed to tighten them. In this situation, globally governments were encouraged to loosen up and they went ahead with it. But soon after, countries ran into state problems like rising public debt etc. Greece and Italy were worse off than the others. I have sensed that the punishment of loosening up was different among

different countries, with some being punished more sharply than the others. So there is a sense that global unity has not treated the world uniformly because all countries have not been wholly true to the cause of global unity.

Q4. Considering the steps taken by RBI and the central government to tackle the problem of bad loans, how successful do you think these policies have been?

Ans. The fundamental problem is that in India we have a bank-driven financial system, whereas, in other countries, there is more of a corporate bond market. A corporate bond in financial terms is known as a disintermediated market. So, there are no banks. In a corporate bond market, I am the lender. I have the money and I engage directly with the borrower who is the corporate entity. There is no intermediary, I am not putting my money in the bank and making the bank do the lending. Now, I am the ordinary public unaware of the health of the corporate and the project that they wish to undertake. This is where the credit rating agencies come in- they rate the projects 'AAA' or 'BB+', etc. A 'BB+' is going to have a higher return because there exists a risk-return trade off. So a 'AAA' will have lower returns because it's more certain. With more risk, I get a higher return but there is also a higher probability of default. Depending on my risk appetite, I choose whichever bond appeals to me. These agencies are supposed to guide people and tell them about the risk attached to a particular project. But in our country, we have a bank driven financial market and therefore banks have been thrust with this task of doing the due diligence of assessing and basically doing the credit rating agencies' job. Unfortunately, while credit rating agencies are transparent, in banks everything happens internally and non-transparently. This makes way for corrupt politicians to use these policies in a way that is beneficial for them. Moreover, credit rating agencies are by no means perfect but at least they are firm in their convictions.

Q5. Much has been said about demonetisation, whether it was good or bad. A lot of money came back into the system. But how do we effectively chase black money? Is it even possible?

Ans. If you're interested in the economic impact of demonetisation, the Annual Report of RBI could give you a more analytically justified answer. But the other question about how to chase black money? I can respond to that. The big mistake that was made in demonetisation was that it was actually a political decision. But economically, black money is tax avoided income that has accumulated as assets. People think that black money is held as currency but that is not true. A very small portion of black money is kept as held currency because currency generates no income and due to domestic inflation, it steadily loses its value. Most of it is loaned out as currency loans to small businesses. The lender is a tax evader and knows the borrower personally. So there's zero default because if you don't pay the money, he will come after you. It is his enforcement mechanism. Small business owners depend on this kind of money to ensure availability of working capital because they don't have the documentation or collateral to take loans from banks. This is why the main impact that demonetisation had, was on small entrepreneurs who were dependent on such loans of tax evaded income.

Q6. What is your favourite economic theory or model? A theory or model that impressed you?

Ans. I would put a negative sign on that and tell you about the economic policy that I very much dislike. This is something that has had a really negative impact on the economy globally. There is a book by Thomas Piketty on inequality which was a reflection of a larger condition in the world about growing inequality. Inequality throughout the globe has reached monstrous proportions. This has happened because we have failed to use taxation as a

method to reduce post-tax inequalities, which is actually all that matters because, at the end of the day, it is disposable income in the hands of people. Post-tax inequality has gone up since the 1980s for sure. An economist named James A Mirrlees wrote a paper on the optimal rate of taxation on income. His analysis was on the measurement of productive efficiency and argues that a high tax rate would discourage highly skilled labour from doing work. He believed that the whole world would suffer if these highly skilled people were discouraged from work. This is what led to the huge telescoping of rate structure and income taxation after the 1980s. He was very influential in telescoping the income tax schedule resulting in a very high post-tax inequality. This is the only thing that I don't like much. I like everything else.



The Editorial Team with Indira Ma'am (Centre)