Chapter 3

Grassroots Capitalism Thrives in India

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India, among today's fastest growing economies, averages over 6 percent annual growth. Its potential to emerge as an economic giant is now acknowledged, as is its rise in the arena of information technology (IT). The present debate over outsourcing only emphasizes India's enormous human capital and its ability to compete with the best in the world. We've come a long way.

There is still some distance to be covered, though. India remains a poor country, with a per capita income of around US$550 (around US$3,100 in purchasing power parity). At the same time, however, it is rich in potential—a potential that is fueled by the real stars of the Indian economy, the ordinary Indians who have survived the heavy hand of government that has sought to control almost every aspect of economic activity since the 1950s.

Ingenuity, a spirit of enterprise and innovation, has helped most Indians, particularly those at the bottom of the socioeconomic ladder, survive strangulating economic policies. Being a pluralistic democracy has actually helped to moderate some of these economic policies, allowing people to bend oppressive regulations.

Reinforcing the pluralist democracy is a free press. Notwithstanding the ideological fervor of the intelligentsia and the rhetoric of the political class, there is a point beyond which the government cannot impose rigid economic regulations. Where such regulations are indeed laid down, there is a point beyond which enforcement agencies cannot implement the laws on the ground.

That is the way it has always been. While the dominant political party adopted the doctrine of a "socialistic pattern of development" in the mid-1950s and sought to implement Soviet-style five-year plans, a large part of the Indian economy continued to function virtually outside the scope of the law. Today, 15 years after economic liberalization, experts estimate that 30 percent–40 percent of the Indian economy continues to be in the informal sector. This informal economy reflects India's true economic potential.

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SPINNING WHEELS

If the world is impressed with India's success in outsourcing, it would be fascinated by the extraordinary lengths to which entrepreneurs in India have gone to escape oppressive government regulations in the manufacturing sector.

Almost a century after Henry Ford revealed the economic power of the assembly line, Indian grassroots entrepreneurs have shown that their hand-made automobiles can and do beat the competition from more modern counterparts in rural India.

In the 1930s, India became one of the first countries in the developing world to manufacture automobiles. However, since the 1950s, the automobile has been viewed as a luxury item by Indian policymakers, and the automobile sector has been heavily licensed, controlled, and punitively taxed. The duties on imported vehicles, even second-hand ones, continue to be prohibitive. Indeed, the latest scam in India's automobile sector is the import of luxury cars, supposedly as tourist taxis, which attract significantly less import duty, but actually for use by the rich and powerful.

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The automobile sector has seen gradual deregulation over the past two decades, and about a dozen international car manufacturers now operate in India. In a country of one billion and counting, the annual sale of automobiles is around 900,000 vehicles, around three-quarters of them in the small-car segment. Of the 65 million vehicles on Indian roads today, two-thirds are two-wheelers; the rest include cars, buses, and trucks.

India has one of the lowest vehicle densities in the world. Most Indians still cannot afford cars. In addition, the public transport sector is dominated by loss-making public-sector corporations, which are a further burden on the taxpayers. Consequently, there is a tremendous and largely unfulfilled demand for transportation, particularly in rural areas.

Over a third of Indian households do not own any form of private transportation; over 43 percent of people own just a bicycle. Draught animals continue to play a huge role in the transportation sector. The gap between the bullock cart and formal-sector transportation is filled by a unique breed of village mechanics. Having learned the trade of maintaining and repairing various kinds of farm equipment over the past three decades, these mechanics are now in a position to assemble a motorized mini-truck in about two weeks' time. Operating from small workshops, they can assemble a whole vehicle from scratch right under the roadside tree. In many parts of north India, these homemade vehicles are called *jugaad*, slang for "quick fix."

The flourishing auto-parts market in Delhi generally provides used car parts like gearboxes, radiators, wheels, and steering wheels. The mechanics start with an 8–12 horsepower agricultural diesel engine of the sort typically used to drive a water pump or other farm equipment. Then the chassis is welded, the engine is mounted, and the gearbox is connected to power the rear wheels. With a rudimentary bench as seat, the vehicle is ready to chug along at around 20 kilometers an hour, carrying around 25 people. To save on fuel, electric lights and horns are often eliminated. The vehicle costs from US$1,000 to US$2,000. Compare this to the price of a basic small car (800 cubic centimeters), which seats only four and costs about US$5,000.

Out in the countryside, these unorthodox vehicles easily hold their place between bullock and camel carts at one end and regular cars and trucks at the other. Meeting the short-haul needs of small towns and villages within a radius of 50 kilometers, these vehicles ferry children to school, carry produce or farmers and local traders to nearby markets, or carry cows to the local veterinarians.

And now a farmer-turned-innovator has designed an award-winning, low-cost small tractor that is ideally suited for the small land holdings of a typical Indian farmer. He has sought to patent it and would like to send the vehicle for conventional road testing so that he can manufacture it commercially. Unfortunately, he has been unable to raise the money necessary to get the tests done, which could cost quite a bit more than the US$2,000 he has spent on assembling one of his prototypes.

None of these vehicles currently qualifies for registration, and under the law, none can run on public roads. Nevertheless, keeping to the Indian tradition, law enforcement agencies tend to look the other way, since the economic and political costs of actually stopping these vehicles are too high for the government.

VIRTUAL HARDWARE

India's manufacturing revolution extends beyond the low-tech production of home-made vehicles. There is also the Indian IT revolution—a revolution that might not have been possible without the informal-sector technicians who assemble computers.

India's IT services sector is among the fastest-growing in the world. One estimate holds that while IT services revenue increased less than 2 percent from 2000 to 2003 worldwide, India's IT services industry experienced a 22 percent revenue growth, a pace comparable to that of Hong Kong's electronics industry during the 1970s.[1] Over 80 percent of India's IT services is exported.

However, this sector stands on a shallow foundation. The official number of personal computers sold in the country in 1997 was just over 500,000; today, it stands at 3.6 million. The level of PC penetration jumped tenfold between 1997 and 2005 but stands today at barely 12 per 1,000 people. Internet subscriptions are only 6.6 million, although the total number of users stands at over 52 million.[2]

These numbers have to be viewed within the context of Indian reality. Just as in the automobile sector, the success of Indian IT has come about in large measure despite efforts by the government to curb it. Typically, during the 1980s, tariffs on PCs were set at 300 percent to 400 percent, stifling the growth of the hardware sector.

Enter the informal PC assemblers: skilled technicians who maintain and repair the country's small but high-value PCs. By the late 1980s, there was an army of technicians assembling lower-cost PCs for a large number of consumers. Increased demand naturally led to the rise of a huge network of traders who smuggled components into the country, avoiding tariffs. Whole markets developed in major Indian cities that specialized in supplying imported components needed to assemble the PCs.

Even today, 60 percent–70 percent of PCs are assembled by this "grey" market. Typically, an assembled PC sells at 25 percent less than its branded equivalent. Today, when import duties on PCs are down to zero and the hidden tax burden on branded PCs is down to about 10 percent–15 percent, the informal sector continues to hold its ground.

The competitive informal-sector assemblers have ensured that most first-time buyers invariably buy a locally assembled PC. The biggest advantage that the informal-sector assemblers have is their flexibility to assemble a PC tailored to the customer's needs and financial constraints. For almost every major component, they provide a range of options, balancing quality and price. And, of course, they also provide on-site repair options.

Hewlett Packard (HP) is the largest seller of branded PCs in India today, holding 12 percent of market share. Senior executives at companies like HP acknowledge that the informal sector has played an enormous role in expanding the market. By familiarizing their customers with personal computers, the informal assemblers have paved the way for these customers to buy branded computers the second time round.

As noted, however, government policies have generally been inimical to the spread of IT in India. Sabir Bhatia, the Silicon Valley entrepreneur and co-founder of Hotmail, says:

> In my travels around the world, I am often asked a question: "Could you have done Hotmail in India?" And my answer has inevitably been, "No!" Had I attempted to create Hotmail in India, somebody would have come to me claiming that I was taking away the revenues of phone or fax companies![3]

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PEOPLE POWER

The major impediments to economic growth in India are in the infrastructure sector, where one finds glaring shortcomings in the state of roads, ports, electricity, and the like. There is also a crying need to improve the social infrastructure, such as the country's education and health facilities.

Per capita consumption of electricity in India is 1/20th of per capita consumption of electricity in the United States. Over half of India's nearly 200 million households do not have electricity. Around 70 percent rely

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on traditional, non-commercial fuel such as firewood, cow-dung cakes, and other agricultural waste to cook their food. Most Indians experience power outages as routine blackouts, either for a few hours every day or for days at a time.

Electricity is still considered a natural monopoly in India. Most of the generation and distribution is controlled by public-sector organizations. Typically, rather than looking at growing demand as a potential business opportunity, these service providers tend to blame consumers for their insatiable appetite. Here too, Indian entrepreneurs, particularly those in the informal sector, have stepped in to answer the demand.

In Delhi, private entrepreneurs provide the electricity needs of consumers. At the top end, many households, housing societies, and whole neighborhoods have installed backup electricity generators to supply the energy when the utility fails.

Officially, private generation of electricity stands at 18 percent, but this captures only installations of over one megawatt. If all the household, commercial, and small industrial installations that have their own power backup are counted, it is between one-fourth and one-third of all power in the country—again, despite all manner of regulations against such generation and taxes on installing and generating private power.

Even more interesting is the local parallel grid being run in many parts of urban India. Shop owners have set up businesses along roads and, without the sanction of the civic administration, collaborate to set up kerosene or diesel generator sets to supply lighting during the evening shopping hours. Typically, an entrepreneur wires 50 to 100 shops or vendors in one neighborhood or at an informal marketplace. The fee charged is usually based on the number of light bulbs that are connected for a certain number of hours each evening. While the cost of electricity is much higher than it would be if it were available from the grid, the vendors have the flexibility to decide whether the benefits of attracting customers during peak shopping hours outweigh the high unit costs.

At the top end, the arrangements are quite sophisticated. Recently, for example, the government declared as unauthorized a whole upper-income neighborhood in Delhi. This area houses many of the city's rich and powerful; as a result, for all its illegal status, no houses have been demolished. The government, however, does not provide amenities like electricity. Consequently, every house in the area has installed a generator. Over time, service providers have come into the picture, installing larger generation units to power whole blocks. Typically, the cost of electricity in this area is about four times the rate charged by the public utility.

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Perhaps the best example of private-sector entrepreneurialism in wiring is cable television. Since the early 1990s, cable TV in India has been dominated by independent private entrepreneurs in almost every urban locality. In 10 years, they connected 30 million urban households—much more than the public-sector telephone companies had managed to connect during the previous 50 years. In fact, India today has the unique distinction of being perhaps the only country in the world where more homes have cable TV than telephones.

Nor are these informal infrastructure services restricted to electricity or cable TV. Urban waste recycling is mostly in the hands of a million men who make a living gathering and sorting waste material. Virtually nothing that can be recycled or reused is left behind. Even in the case of water supply, there is evidence of a flourishing and diverse water market in rural and urban India. Naturally, all of this operates peacefully outside the purview of the law.

MASS EDUCATION

Perhaps the most unrecognized phenomenon in India is the role of the informal sector in providing basic education. Since the 1950s, education has truly been a sacred cow; the role of the state in providing primary, secondary, and higher education has never been questioned. For instance, in Delhi, to set up a school recognized by the government, almost 40 permissions are required to satisfy the authorities that the education being provided meets the best standard.

The record of public education, however, particularly at the primary level, has been anything but credible. Almost 60 years since India gained its independence from British rule, literacy rates have barely exceeded 60 percent. The number of illiterate Indians today exceeds the total population of the country in 1950. The paradox is even greater when one considers that while some Indians are carving out a niche in the Information Age, many more are deprived of the three R's of education.

The definition of literacy itself has undergone some changes. Just being able to sign one's name is considered adequate to qualify one as functionally literate. While the education bureaucracy and budget have inflated, and while the number of children enrolled at primary levels has reached 95 percent, the number of children slipping through the official education net has remained high. The probability of dropping out increases as the child moves through higher grades.

As can be expected, entrepreneurs have entered education in a big way too. India always had some of the world's best private schools, but what has not been appreciated is the scale of educational service provided by the informal sector. According to some estimates, about 50 percent of the poorest children in urban India are attending private neighborhood schools, some run by charitable organizations and the majority run by local entrepreneurs.

The Indian experience forces one to draw the conclusion that many of the poorest families not only value education, but also are willing to pay for that service. And they have a reason: Independent studies have shown that students in these informal private schools routinely outperform those in government schools.[4]

State-sponsored schooling is virtually free in India. The government provides the books, often the school uniform, and often one meal as part of its effort to induce parents to send their children to schools. On the other hand, numerous surveys have pointed out the serious problems with public schooling in India. Lack of facilities, lack of accountability, teachers' absenteeism, and truancy all constitute part of the problem.

Thus, even when a public school is within easy reach and free, many impoverished parents prefer paying around US$1 to US$2 a month to send their children to informal private schools in their neighborhoods.

Typically, these informal schools are run by families from the community. They will have 50 to 100 students—often students in different grades attending a common class under a common teacher—and are frequently operated in two or three rooms of a house owned by the principal teacher. They may hire local boys and girls who may have completed high school or even have a college degree to act as additional teachers. More often than not, they operate under extreme competition from other educational entrepreneurs in the vicinity, so there is some accountability.

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ALL THAT GLITTERS?

The world finds the Indian love affair with gold perplexing. A poor country with an apparent shortage of capital, India is the world's largest consumer of gold. At current market values, gold accounts for 10 percent–15 percent of the Indian household balance sheet. Therefore, while Indian GDP is about 1/20th that of the United States, India's gold consumption is one-and-a-half times that of the U.S. India accounts for a huge 18 percent of the annual global gold demand, while India's share of nominal global GDP is only 1.6 percent.

According to some estimates, Indians hold over 15,000 tons of gold, most of it in private hands. The total value of this gold equals roughly a third of India's approximately US$750 billion GDP. Interestingly, this enormous private asset has been built despite government efforts to persuade people to give up their gold through a series of carrot-and-stick policies.

Last year alone, the demand for gold in India increased by more than 17 percent to about 643 metric tons. Some analysts believe that the growth in demand came from investors in other assets, such as real estate and equities, booking their profits and shifting to gold. It is estimated that about 15 percent of gold is for investment, with the rest being used for jewelry and coins.

This involvement with gold is not new. In the economically challenged 1960s, the government instituted a draconian Gold Control Act in an attempt to discourage people from accumulating a nonproductive asset. Imports of gold were prohibited, and the price differential between domestic and international prices of gold widened. Not surprisingly, from the 1960s to the 1980s, Indians turned gold smuggling into an art form. Smuggling became the theme of countless Bollywood films showing the exotic ways the yellow metal was being brought into the country. In the 1980s, 150 to 200 tons of gold were smuggled annually into India.

As import bans created a vast network of smugglers and illicit dealers, restrictions on gold ownership turned virtually every Indian household into *de facto* violators of the law, and this widespread breach of an unsustainable set of laws corrupted law enforcement agencies. Fortunately, the trade in gold and a wide range of commodities was significantly liberalized in the 1990s. One can only imagine what catastrophic effects such a criminal–corrupt official nexus would have in today's world where terrorists could leverage the existing criminal networks.

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Yet, after all the deregulation and liberalized trade, roughly 40–50 metric tons of gold continues to be smuggled into India annually. One corollary of India's insatiable demand for gold has been that jewelry making has become a vast cottage industry. The skills of Indian artisans have attracted the attention of the world. In 2003, gold accounted for 21 percent of India's non-oil imports, and jewelry accounted for 18 percent of total merchandise exports.

Given that the opportunity cost of investing in a nonproductive asset like gold can be huge, why does the average Indian household not replace even part of its gold holdings with financial assets? The answer is that gold provides basic economic security, even to the poor. Two-thirds of the demand comes from rural India, where the formal banking sector's reach has been very limited.

Additionally, gold has been an attractive asset in the face of inflation, which has often surged well past the rate of return on any financial assets. For the poor Indian who has no access to banking, the easy liquidity of gold, provided by jewelers and pawnshops in the smallest towns, has made it a highly prized asset. In other words, gold often replaces financial services, such as savings and loans, or other investments that are difficult to access.

MONEY TRANSFERS

When people find barriers in their path, they usually find a way to circumvent or reduce the impact of those barriers. This also creates unintended consequences.

The demand for gold in India bumped against one of the world's most restrictive barriers: controls on the foreign exchange market that are intended to stem capital flight. India's huge appetite for gold needed a foreign exchange market. For gold to be brought in, money had to be sent out. So, despite the restrictions, capital flight still characterized the Indian economy until the early 1990s.

This example illustrates one of the biggest paradoxes faced by many poor countries: national economies need productive investment to climb out of endemic poverty, yet economic policies are rarely conducive to attracting investment. Rather than reassessing the wisdom of policy instruments affecting investments, most governments prefer instead to go after the miscreants.

It was in such an economic climate that the informal *hawala* system of international money transfers was born and perfected in the 1960s, particularly in South Asia. In Urdu, a language spoken primarily by the Muslim population in India and Pakistan, hawala means "in the air." In Arabic, it generally translates as "transfer." In other words, hawala is an invisible transfer of money from one country to another.

Hawala also leveraged the gap between the market and official exchange rates that is caused by government restrictions on foreign currency transactions. But hawala is not money laundering. Money laundering is an attempt to camouflage the source of funds by processing them through a number of international transactions, almost always through banking and other formal-sector financial channels, while hawala is based primarily on a private network of dealers operating across countries and continents and working mostly outside the formal banking system.

Initially, it was a response to rigid foreign currency regulations in South Asia and the very high transaction costs of dealing in foreign currency. The rapid, worldwide spread of South Asian expatriate communities that wanted to send money home reinforced the need.

Assume, for instance, that a taxi driver in New York wants to send some money home to his mother. He approaches a hawala agent in his neighborhood, who decides on a simple commission, typically about 0.25 percent, or offers an exchange rate that is 10 percent to 15 percent higher than the official rate. The agent then informs his counterpart in India about the transaction, and the counterpart ensures that the money is delivered within 24 to 48 hours to the mother, usually in cash, since the recipient probably does not have a bank account.

Despite economic liberalization and the spread of communication technologies, a wire transfer from one bank to another takes days. Relying on trust, the network, and using simple codes, the telephone, fax, e-mail, and now SMS text messaging, the hawala system is able to provide faster service at a lower cost. There are about 20 million Indians living abroad, and it is believed that most of them have used the hawala system at some point.

Countering hawala would mean figuring out ways to lower the transaction costs of foreign exchange transfer so that the 90 percent of transactions now taking place through hawala are absorbed into the formal system. For that to happen, however, the formal banking channels must be able to compete with the low-cost hawala network. Even though most hawala transactions involve relatively small amounts, legitimately earned and saved, being sent by ordinary people to their family and friends, the banking sector's ability to provide such low-cost service is hindered by India's high regulatory costs, restrictions on foreign exchange, and resultant low level of competition.

POOR MAN'S BANK

According to the 2001 census, barely 50 percent of urban households and only 30 percent of rural households avail themselves of banking services in India. The paperwork involved in opening a bank account, coupled with low income levels and the fact that most Indians operate in the informal cash economy, mean that maintaining a bank account is not an attractive proposition for most people.

The banking sector's ability to provide such low-cost service is hindered by India's high regulatory costs, restrictions on foreign exchange, and resultant low level of competition.

Microfinance is the new mantra for the governments and banks because it provides them a high-visibility scheme, showcasing their intention to deal with poverty. However, very little has been done to make formal-sector banking accessible to the large population in the informal economy. Consequently, the informal sector has improvised to provide its own credit and savings facilities.

For instance, at almost every commercial complex in Delhi, people at the lowest income levels have tried to band together in small groups, led by a reliable coordinator. The members are typically 10 to 100 people working in the vicinity, or people who have known each other for a long time. They agree on various savings schemes in which the members may put in, say, US$1 a week or US$5 a month. The coordinator acts as a mobile bank, carrying the cash in his pocket and ready to disburse a loan on the spot. Every member has the opportunity to withdraw his contribution or to take a loan. The interest rate is determined by the members of the group themselves and is typically 2 percent–5 percent per annum.

Members join these groups for different reasons. Some want to save in a simple and convenient way so that they can buy something that they want, perhaps a TV or a refrigerator. Others join so that they can get a loan to help meet the cost of a child's education or a daughter's marriage. Such independent groups, operating outside the scope of microfinance institutions, are quite common in rural as well as in urban India. Shopkeepers in low-income neighborhoods often provide daily or weekly savings schemes to help their clients buy goods from them. Women in villages often join such groups in order to save small amounts, which they can then withdraw in rotation to meet family expenses.

No one actually knows the precise number of such independent schemes operating in India, but they far outnumber the 100,000 or so recognized microfinance schemes. This is another example of grassroots entrepreneurship in the informal sector.

One reason why formal banks have not stepped forward to cater to this segment is that they have not figured out how to lower the cost of processing clients who transact in low amounts of money yet have higher frequency of transaction. This indicates that the level of competition in the banking sector is not high enough to motivate banks to innovate and reach out to new clients. In addition, the banks do not yet have the freedom to charge higher interest rates to compensate for the higher perceived risks associated with informal-sector clients.

If these grassroots capitalist entrepreneurs were freed from the shackles of bureaucratic economic regulations, they could well take India to the top of the development ladder.

GRASSROOTS ENTREPRENEURSHIP

These are only a few examples of the all-pervading spirit of enterprise, particularly among people at the bottom of the economic ladder, in India today. They exhibit an uncanny ability to identify an unmet need and then find a way to supply that demand. Relative lack of formal education and training, or of capital and technology, are not obstacles.

The biggest obstacle faced by Indian grassroots entrepreneurs is the government's attempts to outlaw their businesses or impose regulations. The World Bank's annual "Doing Business 2006" survey, which measures the ease of doing business in a country, ranks India 116th out of 155 countries surveyed. New Zealand leads the rankings, followed by Singapore.[5]

Despite recent economic reforms, starting a formal business in India requires 11 procedures and 71 days (down from 89 last year). In addition:

- Dealing with licenses requires 20 procedures and 270 days;
- Export procedures take 36 days;
- Import procedures take 43 days;
- There are 59 taxes, compliance with which takes about 264 hours; and
- Overall, some 40 procedures and 425 days are required for a contract.

The "rigidity of employment" index, which relates to difficulties in hiring and firing workers, ranks India 62nd on an index of 100—by far the highest in the region. And while starting a business is obviously difficult, closing a business is likely to be even more so. According to this report, bankruptcy procedures take 10 years in India.[6]

Some formal-sector competitors complain that those who are involved in the large informal sector in India have an edge because they avoid paying taxes and do not bear the full cost of economic regulations. On the other hand, the single biggest obstacle to the informal sector is its vulnerability to extortion from law-enforcing agencies. Strictly enforcing some of the regulations would gravely affect some of the poorest sections of society who are engaged in the whole range of informal economic activities. Political upheaval would inevitably follow. Because India is a democracy, its government has to maintain a balancing act.

The other cost that the informal sector has to bear because of its extra-legal status is the inability to raise the capital necessary to expand businesses even if they are competitive and have successful products or services. This inability to capitalize assets, and the consequent underutilization of capital for economic development, has been well researched by Peruvian economist Hernando de Soto in his book *The Mystery of Capital*.[7] A corollary to this problem is the formal sector's difficulty in taking advantage of successful informal-sector players' managerial and technical expertise by integrating them into their operations.

This brief survey provides a glimpse of the culture of entrepreneurship that prevails in India. If these grassroots capitalist entrepreneurs were freed from the shackles of bureaucratic economic regulations, they could well take India to the top of the development ladder. It would not be too far-fetched to suggest that there is hardly any country in the world today where informal-sector economic activity is as diverse and as widespread as it is in India. This activity is an unrealized potential just waiting to be harnessed.

Endnotes

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