The Four Pillars Of Industrial Policy, And Why They're All Bad

Episode 08 |FED Dialogues

Rahul Ahluwalia, Ajay Shah

Transcript

August 6, 2026

Ahluwalia, Rahul, and Ajay Shah. "The Four Pillars Of Industrial Policy, And Why They're All Bad." XKDR Forum, August 6, 2026. Video, 15:21:49. https://www.xkdr.org/viewpoints/the-four-pillars-of-industrial-policy-and-why-theyre-all-bad

Abstract

Ajay Shah, whose intellectual formation came from watching his father walk from communism to a deep understanding of the failures of Indian socialism, argues that India's economic story reduces to a bumper sticker: too much central planning and too little rule of law. He points out that India's great growth episode from 1991 to 2011 happened without state capability or strong rule of law, which means growth does not require first becoming Norway. It requires unleashing the private sector and removing the fear of expropriation that comes from arbitrary state power.

The conversation moves into a detailed dissection of industrial policy, which Ajay breaks into four pillars: subsidies, ethno-nationalist protection of national champions, government control of technical standards, and government-built monopolies. He argues against all four, drawing on public finance concepts like the marginal cost of public funds, on public choice theory, and on the epistemic humility that no individual or official can predict which technologies will win. He extends this analysis to China, Japan, and South Korea, arguing that China's current macroeconomic collapse is tied directly to Xi Jinping's turn toward central planning, that Japan's MITI successes are overstated and cherry-picked, and that South Korea's dictatorship-era chaebol strategy worked because it was tied to export discipline rather than subsidy-seeking.

The discussion closes on exporting as the cleanest path to productivity growth, because global markets do not allow the political capture and domestic rent-seeking that distort protected economies. From here, the notes move chapter by chapter through Ajay's arguments on tax policy, FDI, China's specific export crisis, and the comparative lessons from Japan and Korea.

Supplementary Resources

- **Why firms in the country need to prioritise Japanese engagement more** by Ajay Shah (Resource) [1]

- **Graduating to Globalisation** by Ajay Shah and Amit Varma (Resource) [2]
- **Many roads lead to a sound GST** by Vijay Kelkar and Ajay Shah (Resource) [3]
- **The China Model is Broken** by Ajay Shah and Amit Varma (Resource) [4]
- **Beware of Industrial Policy** by Ajay Shah and Amit Varma (Resource) [5]
- **In Service of the Republic: The Art and Science of Economic Policy** by Vijay Kelkar and Ajay Shah (Book) [6]

Contents

Introduction and personal connection to growth **4**

Too much central planning, too little rule of law **6**

The four pillars of industrial policy **9**

Debating PLI subsidies and the Apple example **14**

Learning from China's industrial policy collapse **17**

Japan's MITI and the limits of central planning **20**

Exporting, multinationals, and the path to productivity **20**

Introduction and personal connection to growth

Rahul Ahluwalia: The way I've been starting this for a few times is just I ask everyone about their personal connect to economic growth.

Ajay Shah: So my father walked the entire arc of the twentieth century. Like all thinking people of the mid-twentieth century, he turned himself into a communist. He joined the Communist Party. He was a full-time party carder all the way till 1955.

Ajay Shah: And then through the years, he turned around, and he also was understanding how the Indian experiment with socialism was going terribly wrong.

Ajay Shah: I got my formative years with him and I got the books. So I got to read Milton Friedman's Free to Choose. I got to read Capitalism and Freedom. I got to read Essays in Positive Economics.

Ajay Shah: I got Hayek's Socialism: The Fatal Conceit. These are all things I read when I was in my half pants.

Ajay Shah: What is wrong with India? Too much central planning. The government is meddling in the economy in thousands of details. There was a great growth episode in India, 1991 to 2011.

Ajay Shah: There was a growth collapse after that.

Ajay Shah: I want to always remind all of us that when India got a great growth episode, 1991 to 2011, it wasn't like there was any state capability. It wasn't like there was much rule of law. It was a pretty horrible Indian state. So we should not have rosy visions about becoming Norway and then you'll get growth.

Ajay Shah: There is right now a very prominent narrative about industrial policy, about government actually taking a more active role in promoting certain industries.

Ajay Shah: You want to place bets about the nature of technology in the next ten years and twenty years? You will know it well. I will know it well. Who are we?

Ajay Shah: We are pygmies. No individual knows it. It is the market economy that discovers this.

Ajay Shah: I just want to question the arrogance of the people who believe that, "I'm the secretary of this department, I'm going to take a call about this technology or that technology. And this technology is strategic and we're going to support it," on ethno-nationalism. I'm really not there. It's not right.

Ajay Shah: It's not wise.

Ajay Shah: There's a little too much cockiness and a little too much arrogance. The fact remains that we celebrate good Indian firms and we're very proud of Indian firms, but the best Indian firms are far behind the best global firms. [00:02:12] [Music]

Rahul Ahluwalia: Hello everyone and welcome to another episode of Fed Dialogues. I'm very happy to have with us Ajay Shah, who is one of the best thinkers on public policy in India and also author of one of the best books on the subject, In Service of the Republic. If you haven't read it already, I highly recommend it.

Rahul Ahluwalia: Ajay has been at the forefront of many policy reforms in India and I'm very pleased that we're able to discuss the subject of economic growth and what goes into it with him. Thank you for joining us, Ajay. Let's get started.

Ajay Shah: Thank you, Rahul. It's my pleasure to be here.

Rahul Ahluwalia: Great. Okay, so let's jump right in. The way I've been starting this for a few times is I ask everyone about their personal connect to economic growth. What brought it home to you?

Rahul Ahluwalia: How did you first notice it? What are the anecdotes around growth that really connect you to it?

[00:03:07] Ajay Shah: I have a very odd answer. This is just what I got out of growing up with my father. So my father walked the entire arc of the twentieth century. He ran away from boarding school and came into Gandhiji's Quit India Movement in 1942.

Ajay Shah: He came ticketless from Karachi to Bombay, slept at the railway station, that kind of madness.

Ajay Shah: Then, like all thinking people of the mid-twentieth century, he turned himself into a communist. He joined the Communist Party. He was a full-time party carder all the way till 1955. And so he fully knew that way of thinking.

Ajay Shah: And then through the years he turned around. Khrushchev's speech in 1953 made a very big impact. And then he thought deeply about the world.

Ajay Shah: And he also was understanding how the Indian experiment with socialism was going terribly wrong. So these are all the stories I heard in my childhood, that really growth is the story and growth is built in the private sector. It is built in firms. And the Indian state is a cancer of central planning and lack of rule of law.

Ajay Shah: These are the stories I heard when I was in my half pants. So I kind of got this for free.

Rahul Ahluwalia: Wow, that's amazing, right? Because for many of us, for me at least, it was 1991 that did it.

Ajay Shah: Yeah, so I was in this well before. My father was one of the economists of India who was early in understanding how broken the main paradigm of socialism was. He died far back, he died in 1984.

Rahul Ahluwalia: So he didn't get to see the cancer being treated, unfortunately.

Ajay Shah: Correct. But I got my formative years with him and I got the books. So I got to read Milton Friedman's Free to Choose. I got to read Capitalism and Freedom.

Ajay Shah: I got to read Essays in Positive Economics. I got Hayek's Socialism: The Fatal Conceit. These were all things I read when I was in my half pants.

Too much central planning, too little rule of law

Rahul Ahluwalia: Amazing. So from all that, and I've heard some of this, but I still want to ask you, what according to you is the road to growth? What is the most important thing that India should be doing, should have been doing, to grow?

Ajay Shah: The closest I get to a bumper sticker is that what is wrong with India is too much central planning and too little rule of law. The government is meddling in the economy in thousands of details, and there's too little rule of law. Government meddling is characterized by a personalized force that is not controlled by rules and procedures. It has arbitrary power in the hands of people.

Ajay Shah: And when you put these two together, we have created too much of a risk of expropriation in the eyes of the private sector, and that has given us a collapse of investment. In the data, we see the investment collapse at about 2011. There are a couple of different ways to measure it. I'm happy to discuss them.

Ajay Shah: But my view is that there was a great growth episode in India, 1991 to 2011. There was a growth collapse after that.

Ajay Shah: You will notice that I do not talk that much about a constructive agenda of addressing market failure and building public goods and building state capability. It's all there, it's true, because there's no way to solve the bumper sticker without doing these. But I want to always remind all of us that when India got a great growth episode 1991 to 2011, it wasn't like there was any state capability. It wasn't like there was much rule of law.

Ajay Shah: It was a pretty horrible Indian state. So we should not have rosy visions about becoming Norway and then you'll get growth. Growth has to be ignited in a poor country with a ramshackle, shambolic capability of the state. And you will get to Norway later.

Ajay Shah: So I don't think of state capability and addressing market failure as the soul of it — meaning you do need to go down these routes. Let's talk further in a few moments.

Ajay Shah: But when I think of what made 1991 to 2011 happen, it was a messed up state. There was low state capability, and it wasn't like they were doing a whole lot about addressing market failure. But there was growth. There was a miraculous growth episode for twenty years, and it behooves all of us as a community to understand that, to think deeply about that, and wonder how we might recreate conditions to do another twenty years.

Ajay Shah: But my views have shifted on that, about sprinting versus jogging, and let's talk further about that later.

Rahul Ahluwalia: Sure. So to address, what you're saying is — I want to spell out what you're not saying. Is it more about unleashing the private sector? Is it just removing the shackles?

Ajay Shah: Correct. Too much central planning and too little rule of law. You've got to make private people safe. At present, what has gone wrong in India is private people are afraid that there will be some government change, some central planning scheme.

Ajay Shah: The government will announce some monopoly which is being built by the government, some new PSU, some rule will change. The private sector will not have even a modicum of consultation.

Ajay Shah: There is central planning of a deep, intrusive nature, spread far and wide over India. In many ways, there is more central planning in India today than there was in 1991. And that just creates enormous risks for private people. Private people put their heart and soul to build companies, for the companies to do well.

Ajay Shah: And when they are presented with this level of fear — and of course then there are the problems about the income tax and the FEMA and the Enforcement Directorate and all that —

Ajay Shah: there's just outright fear in terms of expropriation, but also in the normal mainline business regulation — regulators, government PSUs, new government PSUs, government policies, government monopolies, government bans. A sudden government rule that today evening you get a legal instrument which says by tomorrow morning your entire enterprise IT system has to change. That stuff has just left the Indian private sector a bit bewildered and unhappy, and it has inhibited the optimism and the confidence. Or, I want to say this differently:

Ajay Shah: there's been a Darwinian selection where the optimists got destroyed and you've got more quiet, stodgy people manning the industry.

Rahul Ahluwalia: Okay, but what you're saying — skipping ahead a little bit to where I want to go later, but I'll go there now because I think it fits very well — one part is that this Darwinian selection is not just selecting for the quiet, stodgy people, but it's also selecting for people who optimize for government and not for performance.

Rahul Ahluwalia: So it affects competitiveness as applied internationally, because competitiveness in India ends up being about optimizing for government. Competitiveness everywhere else is optimizing for price and quality of your product. So that's one, I think, unanticipated side effect of this.

The four pillars of industrial policy

Rahul Ahluwalia: The other thing, and this is what I wanted to get to, is that there is right now a very prominent narrative about industrial policy, about government actually taking a more active role in promoting certain industries. And everything you're talking about — how does that square with this vision that you can micromanage, or at least give a substantial boost to certain parts of your economy, and have that result in a net positive? Because that's very important. So, since it's coming into this flow, I want you to talk about how that fits with what you're saying.

Ajay Shah: So there's a spectrum of possibilities around industrial policy. The government may like to give subsidies to certain industries because they believe this is good for the country. And there's a variety of shades of gray about how the subsidies can be done. It can be an explicit payment of a subsidy — fifty percent of the money required to build a semiconductor fab is paid for by the government.

Ajay Shah: Or it can be like a PLI, or it can be tax breaks.

Ajay Shah: So there's a variety of different ways to do it, but that's not important. I just classify it under the bin of subsidies — that we take hard-won taxpayer resources and put it into subsidies for certain chosen, favored industries. Or it can include protectionism, where we go anti-foreigner and start saying that foreigners are a bad thing, and then you get into the concept of defining what is an Indian firm.

Ajay Shah: If Sundar Pichai is the CEO of Google, does that make it an Indian firm? So then you get into the question of a certain racist view that certain skin colors are good and certain skin colors are bad. That is pillar two — you start saying that we will support Indian firms. The earlier version, the subsidies, can potentially be done in a neutral way — if Samsung will build a fab in India, will you still pay fifty percent to them?

Ajay Shah: And currently the answer is yes — any company that chooses to produce in India will get the PLI, will get the fab subsidy. So pillar one is a neutral treatment for Indian firms and foreign firms in the world of subsidies. Pillar two is the idea that somehow Indian firms are better. And then you get to the definition of what is Indian.

Ajay Shah: And then the person's got to look like you and me. Is that person the CEO?

Ajay Shah: Will I hire a foreigner as a CEO? No — then the owners, or the board of directors. But I have foreigners as shareholders. ICICI Bank is ninety percent owned by foreigners.

Ajay Shah: You go down that malaise — but that's pillar two. And then pillar three is that the government will control the technology. You can do whatever you want, you can be foreign, we won't particularly subsidize you, but we will use the coercive power of the government and control the technology.

Ajay Shah: We will tell you how something has to be done. It often originates under the guise of technical standards, but there is more than a whiff of central planning going on in pillar three. And finally, pillar four: the government will build monopolies — they'll build an Air India. So these are the four levers that are in play.

Ajay Shah: And I feel this is a fair description all over the world — if you look around, you'll be able to classify these.

Ajay Shah: Pillar one, subsidy. Pillar two is protection of national champions and a certain definition of ethno-nationalistic values. Pillar three is technical standards — the government will tell you about technology, that we believe X is right, we believe diesel is good, or we believe green hydrogen is good. And finally the fourth is the government will just say, look, let's skip this whole pretense of going through a market economy, we'll just build the company ourselves.

Ajay Shah: So these are the four forms of industrial policy. And all this is predicated on a couple of ideas. First, that the government is able to see better than the financial system in allocating resources. So for every optimist around central planning and industrial policy, on pillar one, subsidy, I would say isn't that the job of the financial sector?

Ajay Shah: Some mad venture capitalist, some mad private equity guy is supposed to see the possibility and invest in an Uber and a Google when they were still a glint in somebody's eye.

Ajay Shah: And if this is about the working of the financial system, then I would generally say it's safer, better, cheaper to do it through the financial system. Now you can come up with a layer-two argument that the Indian financial system is deeply broken. And yes, the Indian financial system is deeply broken, and I've spent half my life figuring out how to fix that, and a lot can be done. It's not too hard.

Ajay Shah: It's downside cheaper to fix the financial system as opposed to making the government a venture capitalist and placing bets.

Ajay Shah: When a government places bets, there are many, many things wrong with it. Thing one: public money comes at a high cost. There is a very sweet concept of public finance that I think everybody in the world of public policy needs to know more about. Kelkar and I have nurtured this idea for a very long time — it's called the marginal cost of public funds.

Ajay Shah: When a government spends one rupee, it's not at the cost of one rupee in the economy that got grabbed and put into public hands and got spent.

Ajay Shah: In fact, it comes at a whole range of expenses in the economy. It comes at the expense of the economic distortion of how people change their life in order to reduce the burden of taxes. It comes at the cost of the record-keeping and compliance work by people in complying with taxes and in minimizing taxes.

Ajay Shah: And it comes at the cost of all the complexity and inefficiency and further burden of implicit taxation, where the government is borrowing — because in India, the government borrows very badly. It is ninety-five percent done by force. So there's another tax there — government borrowing is a tax upon the financial system. So all this drives up the marginal cost to society.

Ajay Shah: In OECD countries, this MCPF, the marginal cost of public funds, has opinions and estimates of about 1.6 to two — that is, for one rupee of government spending, it's a cost to society of 1.6 to two. And in India, the range of distortions and difficulties associated with government fundraising and government borrowing are much worse than anything we see in advanced countries.

Rahul Ahluwalia: And you estimated it at three.

Ajay Shah: Yeah, Kelkar and I hypothesized that the value is more like three. So when a venture capitalist uses one rupee, it's a cost of one rupee. When a government uses one rupee, it's a cost of three rupees. It's just better for society that things should be done by the financial system.

Rahul Ahluwalia: And one way of seeing this for Indians is the higher cost of capital, as you're saying.

Ajay Shah: The high cost of private capital is a better environment compared to the high cost of government money. Government money is the scarcest thing.

Rahul Ahluwalia: I completely agree. I'm just saying the high cost of private capital is partly a reflection of the failure of financial and macroeconomic policy, because roughly speaking, as a first approximation, there is infinite capital in the world economy and the cost of capital in the world economy is abysmally low. So all the screw-ups we see in India about the high cost of capital are to be laid at the doorstep of bad performance by financial policy and other elements of macroeconomic policy, including debt management and monetary economics.

Ajay Shah: But it's better to go through the financial system rather than through government, because capital in the hands of government is a very scarce thing. The second problem with the government using money is that you get to public choice theory. Why will an official, why will a government scientistdo the right thing? It's very difficult.

Ajay Shah: The incentives are not there. A venture capitalist is well incentivized.

Rahul Ahluwalia: I think I completely agree. The public choice aspects of government are, like you were saying earlier, much more likely to give it to a crony, or someone they like, or someone who is out there being...

Ajay Shah: There'll be all kinds of political compulsions. Somebody shouts on Twitter saying pro-government things, they're more likely to get money from the government — those kinds of things. So it's not an efficient allocation.

Ajay Shah: And finally, I just want to appeal to common sense. You want to place bets about the nature of technology in the next ten years and twenty years? You will know it. I will know it well.

Ajay Shah: Who are we? We are pygmies. No individual knows this. It is the market economy that discovers this.

Ajay Shah: I just want to question the arrogance of the people who believe that, "I'm the secretary of this department, I'm going to take a call about this technology or that technology, and this technology is strategic and we're going to support it." And I just feel very nervous when people say these things, because you couldn't do it, I couldn't do it, Nehru couldn't do it, Mahalanobis couldn't do it. These were the best people. And we expect our government departments today to do it.

Rahul Ahluwalia: Yeah, which is also why I think it's a very common fallacy to find amongst particularly intelligent people. I think particularly intelligent people have a good sense for the world and a good sense for themselves, and they somehow feel that good sense is going to be transposed onto whichever bureaucrat or politician is going to make these decisions.

Ajay Shah: And I would say to those intelligent people, dude, go trade the stock market. Be a speculator on the stock market. Put your money where your mouth is. Don't put public money where your mouth is.

Ajay Shah: That is not fair.

Rahul Ahluwalia: Or, I think it's worse than that. It's don't imagine that public money will be put where your mouth is. They imagine that public money will be managed with the same sort of foresight or speculative intelligence that they possess, whereas public money is...

Debating PLI subsidies and the Apple example

Ajay Shah: But also, the moment we've gone down this conversation — the foresight and speculative intelligence in the hands of a venture capitalist is a very scary, tentative, risk-taking thing. We know and love Ashish Dhawan. He has so many amazing achievements to his credit, where he made calls ten years, fifteen years before the rest of the world understood it. But Ashish has had dozens of fails, and he approaches it with that humility and that skepticism.

Ajay Shah: In government, the power goes to your head. So all this is my shooting down pillar one — let's not bring public money into this. I'm happy to discuss the other three, but let's keep public money out. Next, on ethno-nationalism: I'm really not there.

Ajay Shah: It's not right, it's not wise. We love India, we dream for India. You and I are the purest Indian patriots. We voted with our feet.

Ajay Shah: We love this country.

Rahul Ahluwalia: We've dedicated our lives to...

Ajay Shah: We've dedicated our lives to this country. But high productivity, high capability are in global firms. The great Indian IT industry — the greatest industry, the one thing India does right — was seeded by the likes of Texas Instruments, who built their first software development facilities here, and then started hiring people in India, and that knowledge went into people in India. I recently wrote a column about FDI where I felt impelled to put a paragraph of argument from scratch, once again, about why FDI is important, because sometimes people forget.

Ajay Shah: There's a little too much cockiness and a little too much arrogance. The fact remains that we celebrate good Indian firms and we're very proud of Indian firms, but the best Indian firms are far behind the best global firms. The best knowledge is in the advanced economies. Let's not lose sight of the development journey.

Ajay Shah: Infosys is a really good firm, but Infosys does not hold its own when compared with a Google or a Meta or an IBM, and so on.

Ajay Shah: And so they're different, and there is a lot to learn, and that learning happens when global firms choose to operate in India. So we should be focused on Indian people here in India. For example, I am very pro work visas and expats living in India. Why?

Ajay Shah: Because when an Indian firm takes the trouble of bringing in somebody from abroad and putting them to work in India, it's because they have special knowledge, they have special skills, and that knowledge percolates into our coworkers.

Rahul Ahluwalia: Everyone who works with them.

Ajay Shah: Everyone who works with them learns more. And they seed the Indian landscape, and that's the way we should approach it. So I want to shoot down pillar two — let's not get into ethno-nationalism. And then some people will say national security, and I always say wall off national security from economics.

Ajay Shah: The best foreign policy is eight percent GDP growth. So yes, the Ministry of Defense should figure out national security. If I was them, I would worry about it.

Ajay Shah: But there are ways to do it without distorting the economy. You need the economy to work. A strong, robust, fast-growing economy is the greatest strength of any country, and we should decouple these two. If the economy does well, if GDP is strong, taxation will be strong, there'll be a chunk of money to give the Ministry of Defense, and I'm very happy to sit and discuss military affairs and how geopolitical questions can be addressed in that.

Ajay Shah: So they should be worrying about chips sourced in China which may have a back door. If I was them, I would be absolutely paranoid about sourcing any equipment from China.

Rahul Ahluwalia: I think that's a very strong argument for economic growth that doesn't get made often enough — that the best defense strategy is a good economic policy.

Ajay Shah: Correct. And then you should not use defense considerations to contaminate the growth journey with this ethno-nationalism. So that's pillar two, and I just say I'm skeptical.

Ajay Shah: Next, we come to pillar three, technical standards and central planning. Let's first start at a different wording, because words matter so much.

Rahul Ahluwalia: Would all these quality control orders of late fit under this for you?

Ajay Shah: That is just protectionism. I didn't even bring protectionism into this, because protectionism is rather obviously a bad idea. I don't even need to...

Rahul Ahluwalia: It's still been used to a very great extent, so I think we should talk about it at some point.

Learning from China's industrial policy collapse

Ajay Shah: Yeah, I'm happy to. But that's really worse. No — let's start, step one: central planning is a bad idea. The government does not know technology.

Ajay Shah: Let's treat that as a dharma — that firms, inside their business, know technology. The subtlety, the sophistication of production in a modern environment is known to private people, and only to private people, and governments will never know this. You've just got to deeply internalize this proposition.

Rahul Ahluwalia: And even private people get it very wrong. The way we ultimately converge to technologies that make sense is through many, many private people getting it wrong and failing.

Ajay Shah: And making mistakes. It's a process of discovery, not design. It's never a top-down imposition of one answer. Let's start at that foundation — that you really don't want a government.

Ajay Shah: Once again, it's a bit like a venture capitalist. Here the counterpart is the senior management of the company and the board of the company. The senior managers of the company, the board of the company, sit and look into the unknown and place bets — "We could go do this, we could go do that.

Ajay Shah: We really don't know, but net-net, we feel this will be a good idea, but let's run a small pilot because we can't be really sure." And as you correctly say, fifty firms in the industry place bets on different things, and some of them work, and then others copy them. And there is the ceaseless FOMO of "Oh my God, we placed our bet on this, but those guys, they're actually doing very well with that process."

Ajay Shah: That is how technical change happens. Let's make a military analogy. There is a huge mistake in the world where people mix up the cool tech — what I affectionately call the toys — and... I don't mean any harm by it, I love all the high-tech, I love all the toys.

Ajay Shah: For me, the act of touching a CNC lathe is the closest I get to a spiritual experience. So I love the toys, but now let's talk military terms. When you get the tanks, you actually don't get the effectiveness to wage war. It took ten years in the hands of geniuses like Marshal Tukhachevsky and Heinz Guderian and Erwin Rommel to figure out the doctrine under which a tank will be used — which is military speak for all the management processes and everything else that has to be orchestrated to make tanks work.

Ajay Shah: So when the first tanks showed up in the First World War, there was a very limited tank doctrine, they did some simple things and they did not work too well. It took ten, fifteen years for people to think deeply about what this tank is and how you use it. So I want to elevate and respect the management that surrounds the technology. High productivity firms are not just a creature of the technology in a hard science sense.

Ajay Shah: High productivity firms are management. They are the genius of that choreography — the dance of people and how they work with the machines, and the systems and institutions.

Rahul Ahluwalia: My example would be ancient China had all the science and technology known to them — they had gunpowder, they had paper, they had steamships, they had everything. Why were they not...

Ajay Shah: Never did anything with it.

Rahul Ahluwalia: Correct.

Ajay Shah: So inside private firms, the journey to productivity is rich and subtle. If you will just parachute in some toys into the hands of private firms, it won't particularly deliver great things. To flip it around, this is the hardest of the knowledge. It is soft knowledge, it is tacit knowledge, it is not transferable.

Ajay Shah: You can go to a global trade show and buy the latest and greatest CNC machine. What you can't buy is the amazing knowledge present inside the German engineering firms.

Ajay Shah: And that, again, is inside the foreign firms. It is not there inside the Indian firms. And any top-down imposition of technology will go wrong, because if the senior managers of the firm and the engineers in the firm are groping in uncertainty, how dare some official or some central planner tell the country, "This is the right technology, thou shalt use this."

Rahul Ahluwalia: I have so many questions buzzing around in my head. I don't know which one — and time will ultimately be a constraint. But even on this — where is the most egregious thing that we're doing right now on this? Because it's not even something I think about, honestly.

Rahul Ahluwalia: I am much more stuck in the public subsidy and tariffs space.

Ajay Shah: This is happening a lot in the world of high technology. It began at the UIDAI, then the UPI, then Bharat Bill Pay. Now there's a unified lending interface, and so on. In each of these, some individuals design a technology, it is imposed upon the entire country, coercive power is used to make sure everybody uses it, foreign companies are blocked from entering India.

Ajay Shah: I just want to say — not wise. That's pillar three.

Ajay Shah: Finally, pillar four: government setting up monopolies. That's like NPCI. And again, I want to say the essence of the journey of growth comes from a process of discovery, not design — from competition, from the unpredictable nonlinearities of the market economy. And we should respect that, rather than the clean, tidy — what looks good on a whiteboard is seldom effective.

Ajay Shah: So what looks good on a whiteboard is seldom effective in the field. This is a bit like Jane Jacobs and the ballet of the street, in her understanding of urbanism — that the top-down design of Chandigarh is seldom a way to get to a great city. A great city has an element of chaos and unpredictability, and the streets look a little chaotic, things don't look perfect. A city that is instantly comprehensible to a visitor is not often a great city.

Ajay Shah: Great cities are messy, but that's because the human mind is messy.

Japan's MITI and the limits of central planning

Rahul Ahluwalia: Gurgaon versus Chandigarh is a classic example, right?

Ajay Shah: So these are the four pillars of industrial policy, and I'm just unenthusiastic about all four.

Rahul Ahluwalia: Yeah, that's fair enough. But I want to ask you, because there are serious people considering — and I think pillar one is the one that most people think of. So I'm grateful to you for expanding into all these different realms.

Rahul Ahluwalia: But I want to dig a little deeper on pillar one, or a few others. So one argument you made is that government funds are not best used for this purpose. One objection I've heard is: the government throws away its money on all kinds of ineffective things, but if they spend their money incentivizing, let's say, Apple to come to India, is that a bad thing?

Ajay Shah: So let me now give a better version of the PLI argument. There's a part of my heart that does not disagree. There's a part of my heart that grieves. There is more wit in PLI than meets the eye.

Ajay Shah: The argument is the Indian tax system is broken. There is plenty of stupidity in the Indian tax system, and we're just refunding the money to Apple that should never have been taken from them in any reasonable indirect tax system.

Exporting, multinationals, and the path to productivity

Ajay Shah: A, I agree. B, it bothers me — why Apple, why not everybody? And that takes me to C — you've had an overwhelming majority in the parliament and the ability to get legislation through the Lok Sabha, why was it so difficult to fix those mistakes of tax policy and tax administration? I can even understand it as a three-week, six-week initiative to get things going.

Ajay Shah: But if the government agrees that Indian indirect taxation is broken — and I do too, and I'm happy to discuss that at length — Ila, Ila Patnaik is the one who has really opened my eyes to the fact that these are not second-order issues, these are first-order issues that fundamentally contaminate the ability of manufacturing to operate in India. I didn't know how deeply this stuff matters and how deeply it's broken. Maybe we should discuss this on another day — Ila and I are writing a paper on this.

Ajay Shah: She's really woken up my eyes to the fact that this stuff is not second order, it's first order. I used to think, look, basically we got our GST, no? And in GST you get zero rating of exports, no? So aren't we pretty much done?

Ajay Shah: And only in the recent two years, Ila has carried me to a modified position — no, the list of mistakes of indirect taxation in India are first order, and they fundamentally frustrate a lot of globalized manufacturing from happening in India.

Ajay Shah: And I've shifted positions in response to her arguments, and as I said, I'm in the process of building a paper with her. So if Apple comes along and says this makes no sense at all, it's a nice temporizing move to say to them, "Yes, I'll refund it to you," even though it's not my law — meaning my law is stupid, but this is a special case and I'll refund it to you.

Ajay Shah: But it's been years. So why would you do this indefinitely? I would think of this as six weeks. I would say to Apple, "I will gather the best public finance minds in India.

Ajay Shah: I will get them to write a committee report on what has to be fixed in indirect taxation. I will put it through an FSLRC process to draft a high-quality law, and I will enact the law, and until I enact the law, I will refund it to you."

Ajay Shah: And if that was the game plan — again, in temporizing — I would buy the PLI thing. Where I'm unhappy is that this has just stabilized. It's been normalized that this will go on indefinitely. Tax policy in India will keep on being badly done.

Ajay Shah: We will keep on having a failure of economics knowledge being brought to bear on tax policy.

Rahul Ahluwalia: A slightly different dimension — I think it was initially very much sold as, "We have competitive disadvantages," not just tax policy — although again, I think I also need to learn about how that's more important — but a whole bunch of other things: infra, logistics, etcetera.

Ajay Shah: So again, in fairness to the PLI guys, that's not what they are refunding. I've seen some calculations — they're just doing careful calculations around taxation. Everything else, in my opinion, is fair and square. Whenever people say, "But electricity in India is expensive," I say, "But people in India are cheap." Beyond that, it is the zone of capitalism — every production question is some combination of land, labor, capital, enterprise.

Ajay Shah: And it is for firms to choose — if I am in remote parts of Chandrapur district, what is optimal there in terms of the prices of land, labor, capital, enterprise, and the logistics costs of moving there? Firms should choose, and they should never complain, "But I'm finding the price of clean water expensive." Fine, then don't do business there. You've got to figure it out yourself. So there is an immense operational advantage in India, which is cheap labor.

Ajay Shah: And again, to the extent that government policy — namely labor law — is interfering with the ability of firms to do voluntary contracts with workers at lower prices, it is the Indian law that needs to change. You should not be subsidizing the firm, you should be fixing the law. We should be going to the root cause and solving things.

Rahul Ahluwalia: Remove the distortion. Don't try and introduce another distortion on top of it.

Ajay Shah: But in fairness to what is being done as PLI, at least my understanding is it's only indirect tax calculations. The other things are not being paid for by subsidies.

Rahul Ahluwalia: Got it. And it was time-limited in the initial conception of it, right? I think it remains to be seen whether it stays time-limited. But what you said is an echo of what I often also say — that as part of a comprehensive strategy to attract investment and improve the business environment of India, it makes sense.

Rahul Ahluwalia: Sure, you may want people to come in while you fix stuff.

Rahul Ahluwalia: But I don't see a lot of the stuff being fixed. And I think that's shortsighted. I also think it's shortsighted to say, "Just don't do it," or completely take it away from your menu of options. But to have it be your sole option is also, I think, a big mistake.

Ajay Shah: Now, in this I want to say two things. One is that Apple is a storied firm — one of the world's most recognized and respected brands, and rightly so. Apple is a great firm, I'm not at all dissing on them, it's an absolutely wonderful firm. It is a deeply resourced firm, multi-trillion dollars of market cap.

Ajay Shah: And they are able to work the public policy process of India, get meetings with the right people, get the right conversations for designing the PLI, and manage to get paid on time.

Ajay Shah: There are tens of thousands of important, capable global firms who don't have that ability to work with the Indian state and solve their problem. The really important thing about solving things through policies rather than through individual deals is that it throws open a vastly greater universe of entrepreneurship and imagination and risk-taking — some bloke in Finland that you haven't even thought about, who has an idea, and who has one friend that he went to college with who lives in Hyderabad, and they make the call and say, "Let's try this."

Ajay Shah: And they'll build a small firm initially with two hundred people, it'll work well, it'll grow to two thousand people. Then it'll attract four other firms. That's how capitalism works. So this big-firm-centric view of creating policy environments that work for the largest firms is also limiting in terms of the scale of its impact.

Ajay Shah: And finally, I just want to babble on the nature of the policy process. The first thinking on the GST originated at NIPFP in the early — in the late nineties. There was a Govind Rao report on service tax, where while writing a report on service tax, he started saying, "Look, guys, you've got this all wrong, you need to integrate everything into one unified tax." Then after that, Kelkar, Arvind Modi and I were part of an FRBM implementation task force report commissioned by Jaswant Singh,

Ajay Shah: where we proposed that the best single way to deal with the problems of indirect taxation is to fuse it all into a single GST, and we did a first working design of the GST. This report was 2003. So the idea came from the intellectual community in the late nineties and early two thousands, and it turned into the GST in 2016, 2017. These are the kind of time lags about how ideas are incubated — many, many people get persuaded, and then gradually it goes closer to implementation.

Ajay Shah: So if Ila was educating me on the extent to which errors in indirect tax are of first-order importance for the possibility of globalized manufacturing in India — partly I am a little clueless and came late to the party and didn't understand this, but partly we've got a ten-year story in front of us of the journey of building these ideas, getting twenty papers out, socializing them in seminars and conferences, securing a mainline consensus amongst economists and other writers, and then future governments will do them.

Rahul Ahluwalia: Yeah, at least ten years. Okay. Another argument that gets spoken of very often is that to compete with China, it's not enough to have standard economics work — that competitiveness is not enough, that they are being subsidized to an extent that you need to do the same. How do you think about that?

Ajay Shah: It's a fair question, it's an important question. All of us need to think deeply about it. China is one of the most important phenomena of the last thirty years, and we should all spend more time and effort thinking deeply about China, and we should worry about the question you've just described. I want to take you back further into history.

Ajay Shah: In the eighties, there was a problem known worldwide as Japan Inc., where firms that operated in normal market economies felt that the collaboration between Japanese firms — which is violative of any normal competition law —

Ajay Shah: for example, the Indian Competition Commission would not allow firms of the same industry to make deals of certain kinds. But that's how Japan was working, orchestrated and synchronized by the Japanese MITI. And it was felt that that was unfair. I want to talk about today's Chinese problem under a couple of different heads.

Ajay Shah: There's one part that is just outright IP theft. They have resorted to cybercrime and stolen knowledge.

Ajay Shah: And that, I think, just crosses a line. Nobody wants to go there — running cybercrime and stealing software and stealing technical designs from elsewhere in the world is just not on. I seem to remember there were some Cisco routers that appeared as the releases of some Chinese company, and it was a cybercrime coup — the entire firmware of the router and the entire designs of the router were stolen by Chinese gangs, to some extent with government support.

Ajay Shah: This is just not on. No civilized country should accept that. And now you get to the problems of how state-to-state enforcement will happen. If Cisco is an American company and they work through the United States government asserting that such IP theft has happened, will there be enforcement in China?

Ajay Shah: If there isn't, then I think we are in a different place, and we need to think more about how to deal with the China problem.

Ajay Shah: So this is one kind of problem, which is outright theft. And a variant of this problem is that many, many global companies have found that they get a factory built in China, and without their knowledge, under the cloak of the Chinese language, five hundred kilometers away, an identical factory springs up. Because all the drawings and designs and engineering details of that factory are there in the hands of some Chinese people or the other. And it is a business model in China to then obtain all those secrets and commission the same engineering vendors — the same L&T equivalent — to build an identical factory in the hands of some other entrepreneur.

Ajay Shah: And suddenly the global company producing in China has lost its entire IP, and it's got first-class counterfeits coming out under a different Chinese brand name. This also I think of as just basic police action — you need to be part of the civilized world enough to respect the claims of foreigners. And this comes under the head of ethno-nationalism — if foreign firms don't get equal treatment, then you've really lost the ability to participate in globalization.

Ajay Shah: The third problem in China is about the subsidies, where there is cheap energy and cheap land and cheap finance. This is again a story we've seen in Japan before, where in Japanese finance there was an evergreening of loans which led to zombie firms. Zombie firms were like dead men walking. In any reasonable world they ought to be bankrupt, but they're just propped up with government hinting to the banks, "Please support this guy, we don't want this big firm to go bankrupt."

Ajay Shah: And from the viewpoint of the competitive dynamics of an industry, it is a unique agony for you and me to be running a sophisticated, high-productivity firm and watch our profits being destroyed, or even turned into losses, because some loser who doesn't know how to run a factory is competing with us in the market, charging low prices while running a negative operating profit for several years, propped up by the government, propped up by the banking system.

Ajay Shah: And this also is a very uncomfortable problem with the behavior of many Chinese firms. Finally, there is a here-and-now. There is a very unique moment in Chinese history — right now, in the last few years, there is a macroeconomic collapse going on in China. Many people have scoffed at some of these claims for many years — I have been criticized by people saying, "China pessimists have been forecasting that the China model would peter out for thirty years, and I've been wrong every time." And people like me have said, "No, but we are right this time." So something important has changed.

Ajay Shah: We have to go back into the history so we can see more deeply, and we can see it wasn't that the collapse of China happened out of thin air. It happened because there were major changes in China. And the major change was the rise of Xi Jinping. Xi Jinping concentrated power into himself.

Ajay Shah: So Deng Xiaoping's project of becoming a more open political system with dispersion of power was broken down by Xi Jinping.

Rahul Ahluwalia: And reversed.

Ajay Shah: And reversed by Xi Jinping — power was concentrated back to Xi Jinping and his cronies. What little political system liberalization had happened was reversed. Many more people were sent to jail, freedom of speech in China went down, and China—

Rahul Ahluwalia: They almost destroyed their entire tech industry, right?

Ajay Shah: He destroyed their tech industry. China went back from being a country on a long journey to learning freedom — whether economic freedom or political freedom — to a reversal, where political freedom went down, more central planning came, the rule of law declined, arbitrary state power could be fired through the barrel of various guns against private people, and the private sector got disenchanted, lost its optimism, and the entire economy got messed up.

Ajay Shah: On top of that, Xi Jinping went into an arrogant nationalism, taking on the West. He started getting angry against the West, started making claims that the West is hostile to China and will not accept the rise of China — "but now we are big enough, so we will take you on," in a variety of ways, including most notably supporting Russia's invasion of Ukraine and promising that any day now he reserves the right to invade Taiwan, and so on.

Ajay Shah: Now, as a consequence of all that, all hell broke loose in the Chinese economy. My five-minute narration sounds like a script out of hell for how to mismanage an economy — everything wrong all at once. So from 2018 onwards, the Chinese economy has been in absolutely terrible shape, and they are facing zombie firms, zombie banks. They have built entire cities' worth of real estate which have no buyers, and there is a great deal of production capacity ripe for bankruptcy.

Ajay Shah: And now you come to the political decisions of China — it would be a political catastrophe for Xi Jinping if there was a thirty percent decline in per capita GDP, which is the sort of adjustment required for the Chinese general equilibrium to come back to balance. Xi Jinping is not willing to accept that. So there is a vast scale of financial and other subsidies to firms, where firms are being told, "Don't close down.

Ajay Shah: Just get enough revenue to pay your direct operating cost, and everything else we'll figure out." Now, if you're going to produce widgets and sell them at direct operating cost, they are very, very cheap. And there is a tremendous push by the Chinese government in important Chinese industries to try to export those things as a way of keeping those jobs and the capacity utilization of those factories going. In many industries, a lot of the world economy has put up trade barriers against China,

Ajay Shah: which creates a bit of a hydraulic effect — if you're going to export to four countries and two of them put up trade barriers, then the pressure of exports on the other two countries gets even worse. The Chinese macroeconomic crisis involves an amazing thing, which is deflation. Their aggregate prices are going down because the economy is in such bad shape. Think of the CPI as the price that clears aggregate supply and aggregate demand — things are so bad in China that the CPI is going down.

Ajay Shah: When deflation happens, it also means you're exporting at very low prices. So there's a very unique moment in global macroeconomic history where a systemically important country is leading a policy regime of bad macroeconomics that will generate large-scale destruction of industrial capacity and unemployment in trade partners. We are not in a normal world of trade policy anymore. So for the first time in my life, I have written a protectionist article about the crisis of Chinese exports coming into India.

Ajay Shah: Ila and I have co-authored this, and we think there is a case for some limited, very careful non-tariff barriers against certain situations. I'm happy to talk about that. But that's a response to this very narrow here-and-now — 2022, 2023, 2024. That's all, it's not the larger story.

Rahul Ahluwalia: But here's a pushback, in some respects, to taking these measures — why would you not want to profit from this?

Ajay Shah: Yeah, it's a fair question. In the article, we say that the case for protectionism in India is only when there is a significant Indian industry which has institutional capabilities, which has management knowledge, which has high technology worthy of protecting. If there is no such industry, no meaningful industry, then you should just be saying thank you to the Chinese and buying up this stuff and sticking it in a warehouse.

Rahul Ahluwalia: Because they're subsidizing your production and your consumption.

Ajay Shah: Your consumption. Yeah. We should be building warehouses to store this stuff and buy it while you can, because this will not last indefinitely. I don't want to make sweeping statements — there is a need for limited, careful kinds of non-tariff barriers, done with great care.

Ajay Shah: And as you read that article, you will wince thinking of the level of state capability and political economy required to get this right.

Rahul Ahluwalia: That's — and you are your own greatest critic on that article, right? Because one of the—

Ajay Shah: It is very difficult to do it right.

Rahul Ahluwalia: It's very difficult to do it right. And this is one of the — you put out four pillars, and this is one of the horizontal issues with implementing correctly on any of those pillars — it's state capability and incentives.

Ajay Shah: It's a choke point everywhere.

Rahul Ahluwalia: Yeah. And I want you to talk about that.

Ajay Shah: So let me just finish on China. It is not unconnected that there is a Chinese macroeconomic collapse and Chinese industrial policy. Xi Jinping, consolidation of power, central planning, industrial policy, Chinese collapse — these are five of a piece. It is not correct to single out electric vehicles and say, "China industrial policy is so great." That same industrial policy attempt in many other fields has actually led to this overall destruction of the China model.

Ajay Shah: Deng Xiaoping and his successors had done something miraculous, and Xi Jinping has wrecked it. So I think that also should be laid at the doorstep of the central planners and the industrial policy.

Rahul Ahluwalia: And in the real estate space, it's very much industrial policy that's done this, right? And I think this is one of the classic — you see the thinkers that promote industrial policy are very much cherry-picking the few successes.

Ajay Shah: So many things went wrong. I could argue that it was Chinese industrial policy that did ridiculous levels of promotion of the real estate sector. If you just read the rules, you will see — my God, this government really wanted the construction sector to triumph, for a ridiculous number of millions of houses to get built. And you know what, they did it.

Ajay Shah: There are few bigger blunders in world history than Chinese industrial policy around the construction sector and real estate. So you should not cherry-pick that Chinese EV has done rather well and call that the achievement of Chinese industrial policy. Chinese industrial policy has played out in many fields, and I would argue that this kind of approach represents the destruction of the successful China model that ran all the way from Deng Xiaoping to the rise of Xi Jinping.

Ajay Shah: It was there in milder versions earlier. Chinese economic policy made more sense earlier, and I'm happy to discuss that.

Rahul Ahluwalia: It was more across the board — it was just more general.

Ajay Shah: I think Ricardo Hausmann has been the best thinker in understanding China's rise. He has emphasized the importance of the Chinese conception of FDI. The approach was: China has bad institutions, and for a long time China will have bad institutions, because they're not even a democracy. Institutions goes with the word rule of law — you can't separate the word rule of law from the word institutions, and that's not China's thing.

Ajay Shah: They have a constitution which doesn't happen, and the judges are deferential to the Communist Party.

Ajay Shah: So rule of law is not their thing. It would be very hard for China to build institutions — even worse than India, if that is possible. So the Chinese approach to FDI was: look, you're a foreign company, you don't need to know anything about China, you don't need complex contracts and sophisticated activities in China. You just want a piece of land, we will give you the logistics ability to move raw materials into China, you will hire Chinese people, they will do work on an assembly line, you will re-export the work.

Ajay Shah: So it's a sterile engagement with globalization, and that's what powered the Chinese model for a long time. It is a very wise approach — an FDI-led model where you did not need to engage with the complexities of a company's act, accounting, a stock market and stock market regulation. And it's no surprise that for all the beauty of Chinese high growth and its emergence into middle income, the Chinese stock market has been doing very badly for a long time.

Ajay Shah: Because a stock market depends on subtle institutions like accounting. India has accounting traditions that go back to the seventeenth century. It is very difficult to recreate accounting traditions after you've been through the cauldron of the Cultural Revolution. So there's a soft infrastructure of the modern economy — rule of law, institutions, commercial contracts, the concept of a company.

Ajay Shah: The concept of a company is only thinly established in China.

Ajay Shah: There are all kinds of horror stories about — you thought you owned the company, but actually it was not quite the company.

Rahul Ahluwalia: This is what they did in the special economic zones. They just...

Ajay Shah: The special economic zones — here's a piece of land, it's a special economic zone, there'll be no labor law. And I believe we in India should do it too. It's a good idea. It's not the only idea, because in India we have—

Rahul Ahluwalia: It's one of the things we are trying at—

Ajay Shah: Yeah, so it's not the only game in town — meaning the entire gigantic success of the Indian services exports industry has come without SEZs. So I think India has the institutional maturity to create corporations. Infosys, TCS — these are incredible achievements. There is a wisdom and a richness, there are norms.

Ajay Shah: There are bad actors too — individuals who do horrible things — and we hope that over time they get winnowed out of the body economic of the Indian economy.

Ajay Shah: But I live in Bombay, and I'm very aware of business culture in Bombay. There is such a thing — business culture, norms, oral contracts, people doing business with friends, not going to court. One of the sure red flags is a company that litigates a lot — then you know they're doing something wrong. Or individuals who litigate a lot — you know these are bad actors, and effectively they get shunned, and nobody will do business with them.

Ajay Shah: We do oral contracts because we don't trust the courts. We are routing around the malfunctioning of the Indian courts.

Rahul Ahluwalia: Reminds me of the Greif paper on Maghribis versus the Genoese — the culture...

Ajay Shah: No, I don't know this.

Rahul Ahluwalia: Oh, it's a really nice paper, I highly recommend it.

Ajay Shah: Okay, tell me about it later. But just to finish — there is wisdom in that Chinese model, saying, "Here's a piece of land, we will give you the logistics and we will exempt you from all the laws." And by the way, I also want to say to every friend from the Department of Revenue who's hearing this: it is perfectly good to give tax breaks to foreigners, because they generate salaries and incomes, which is consumption, and they give business to counterparties in India.

Ajay Shah: So the fundamental concept — you do not tax foreigners — remains. Like the Vodafone story, where a foreigner is doing a trade with a share in India with foreigner two — it's not the Indian tax base, and it's a fundamental failure of public finance knowledge when the Indian tax authorities want to say "this is my tax base." Similarly, any stinginess in refunding the comprehensive burden of indirect taxes to an exporter — it's a simple rule: the high-seas prices of goods and services are immune to all taxation. You've got to just grok that. India will become rich, people will get salaries, other firms in India will get contracts, and they will generate the tax revenue.

Rahul Ahluwalia: I think the story that this monumental mistake was possible should warn us against trying to do industrial policy in India.

Ajay Shah: Yes.

Rahul Ahluwalia: It's such a shortsighted, incredibly poor policy measure that somehow made it all the way through the Indian parliament at one point.

Ajay Shah: And the Supreme Court, and so on. It's a monumental failure of the institutions of India, and it has scared off a lot of foreigners. Note the dates carefully — 1991 to 2011. The dates line up correctly.

Ajay Shah: But back to China. Ricardo Hausmann, in my opinion, has the best insights — that Chinese institutions sucked and were going to suck for a long time, because emergence into a democracy and rule of law takes a very, very long time. In the best of times, in India, we should have no illusions that there is a very long journey for India to get to rule of law.

Ajay Shah: It will come gradually. It's not like we magically got to state capability and rule of law from 1991 to 2011. We should think deeply about the nature of elite capability in India, and how disputes got resolved, and how the business world had recourse to policymakers to solve individual mistakes in the 1991-to-2011 era. In China, there was a phase of more comfortable FDI-led growth where there was not that much attempt at industrial policy.

Ajay Shah: When we got to Xi Jinping and a whole radical change in course, and full-blown central planning arrogance — "we will have this payment standard, we will build China Pay" — basically UPI is China Pay. "We will build China Pay, we will block Mastercard and Visa from operating in China," same as what was done in India, and so on. Those kinds of approaches actually torpedoed the China model.

Ajay Shah: So I'm not convinced that industrial policy has done that well for China. It has, in restricted areas, but when you zoom out a little and take that whole philosophy of too much central planning and not enough rule of law, it actually screwed up the whole development trajectory initiated by Deng Xiaoping.

Rahul Ahluwalia: Yeah.

Rahul Ahluwalia: So that's China. But what about the story of Japan, and how that worked? That's another classic story, and there's stuff I've been hearing about Taiwan too, so if you know something there, I'd like to hear about it.

Ajay Shah: I've not studied Taiwan adequately, but Japan is a very, very interesting story, and I've read about this all my life and argued with myself and with everybody I could find. There is no question that the early decades of MITI — MITI is the industry ministry of Japan — were quite a success. In field after field, they centrally planned that there shall be the rise of a Japanese industry in steel, a rise of a Japanese industry in electronics and automobiles, and so on.

Ajay Shah: They did it several times, and it was an important part of powering the early rise of Japan. There's no question that happened. So we should wonder what worked.

Rahul Ahluwalia: Why did it work? Does it scale?

Rahul Ahluwalia: I mean, give me a second — you're saying there's no question that it worked, but I have come across narratives that do question it. Soichiro Honda, no less, is supposedly a big critic of MITI, saying Honda could have grown faster and more had it not been for...

Ajay Shah: It's about which period you look at. By the—

Rahul Ahluwalia: Sorry, at what point was...

Ajay Shah: By the eighties, MITI was fumbling and failing. But I'm discussing the fifties, sixties, seventies.

Rahul Ahluwalia: Fifties, sixties — but the period I'm talking about is the early sixties, when automobiles were starting to grow. Honda had to really sneak into automobile production. Sony was banned from acquiring transistor technology, even initially. So I'm not one hundred percent sold on the idea — but even if we buy that, I think what you were getting to is still important.

Ajay Shah: So let me tell my story, and how I understand it.

Rahul Ahluwalia: Absolutely.

Ajay Shah: Point number one — you have to look at their level of state capability and the ethos and national cohesion. Japan got to the Meiji Restoration in 1869, and from that point onwards they had begun a determined journey of rising up to the levels of the advanced economies. We all famously know the stories that in 1869 they sent boatloads of young people from Japan to go study the world.

Ajay Shah: And they brought back scientific knowledge, they brought back institutional knowledge. I think there were debates in Japan about whether they should take British law or French law or German law, and they decided Germany is the most advanced country in the world, so we're going to take German-style law — things like that, where they systematically took knowledge from the European frontier and said, "We're going to reinvent the country like this."

Ajay Shah: Everybody likes to point to the milestone of 1905. In 1905, Japan won a war against Tsarist Russia, where Tsarist Russia was halfway there to accessing the knowledge and institutional capabilities of the West. Russia has never been up at the level of the capabilities of Germany and France and the UK, but it was a semi-Western nation.

Ajay Shah: So it was not like Japan invading Korea or China or Formosa, where they would face lower levels of capability. The Russian Navy had British technology, and despite that, the Japanese, with an entirely home-made navy, without purchasing ships from Britain, fought a naval war against Tsarist Russia and won — this is 1905.

Ajay Shah: So by 1905, there was an advanced capability in Japan. Japan is not a developing country. So when we come to questions of state capability, by 1905 there was significant state capability.

Ajay Shah: Then we get to the Second World War, and there was an amazing Japanese process of truth and reconciliation, of understanding and accepting the guilt of what Japan did in the Second World War. It is all too easy for a nationalist to whip up hatred against the Americans, saying the Americans used atom bombs at Hiroshima and Nagasaki, and the Americans ran a colonial occupation of Japan, and the Americans imposed a constitution on Japan — all of which are true things.

Rahul Ahluwalia: All of which are true.

Ajay Shah: And yet in Japan after the Second World War, there was a very humble recognition that "we screwed up big time and we were wrong, and the burden is on us to rebuild this country and make it good." So there was a very high level of national morale and a sense of guilt that we've got to do this right.

Ajay Shah: And that's the context in which you see the working of the bureaucracy of Japan in the fifties, sixties, seventies — they were really recruiting the best people in the country, and they already had high state capability for generations, because in 1905 they were able to win a naval war against Russia, which is not a small matter. For generations they had very high levels of bureaucratic capability.

Ajay Shah: I remember when I read about the Second World War, the Americans were shocked, after the war, at the level of industrial capability and the sheer output of planes and ships they found in Japan during the Second World War — the best estimates by American intelligence had significantly underestimated Japan during the war. It's only after they occupied Japan that they understood, "My God, we were up against something far more capable than we ever dreamed."

Ajay Shah: So this is not a developing country, this is not a poor country. This is a country rising out of the ashes of the Second World War with a deep sense of guilt and the need to show the world and themselves that there is something great inside them and they can do this right. In those situations, there were some wins by the Japanese MITI. But you have to see the particular circumstances.

Ajay Shah: And also, then there's a cherry-picking problem. In the eighties, MITI famously went after the semiconductor industry and came to naught — it just didn't matter, because CPUs happened in America, and Japan just did not get to the party when it came to building CPUs. So all the industrial policy of MITI did not work when it came to the semiconductor industry, which was supposed to be their next wave.

Ajay Shah: I remember as a child there was a big supplement inside Scientific American, an ad by MITI — a forty-page ad to the scientific and engineering talent reading Scientific American, saying, "We are MITI, we are so cool, we are an industrial policy, we shall guide the Japanese industry, and we are building the world's greatest semiconductor industry. Come live in Japan, come work with us," etc. But it didn't work.

Ajay Shah: And then, as you correctly say, a whole bunch of people inside Japan started questioning MITI. So this is one view of MITI. And then, once again, just like we did with China, I want to take the second view — that all this central planning in Japan actually worked out badly. Japan rose like a phoenix from 1945 to 1985, for forty years.

Ajay Shah: And then after that they had a terrible time.

Ajay Shah: If you actually level it out, average the growth of Japan from 1945 to 2025, it's good, but not great. So I feel it's better to nurture the ways of the market economy, the ways of capitalism, which is a ceaseless churning and low growth rates maintained for a long time, rather than some quick spurt in a relatively artificial way, which will then peter out, and then you'll get ten, twenty, thirty years of retrenchment where you're trying to figure out what to do.

Ajay Shah: And you lose institutional capital, you lose people, you lose the memories. You need the knowledge transfer from the previous generation to the next. When you have an entire generation-long fail, like what is shaping up in India, we've lost a generation of the capabilities...

Rahul Ahluwalia: Several generations, right, like...

Ajay Shah: Of what was happening in the earlier world. So I feel that's a very costly way to proceed. For Japan also, I would say the jury is out on whether a counterfactual of a pure market economy from 1945 would have worked better.

Rahul Ahluwalia: Yeah. And the other example that's coming to me, and maybe we don't discuss it in too much depth, but I do want to get to it, is South Korea. They seem to have somewhat better made that transition — they are still a competitive, dynamic, vibrant economy relative to the others we're discussing here, and they never very heavily got into industrial policy in the first place, and maybe that's what saved them.

Rahul Ahluwalia: I was discussing with Dr. Panagariya in one of our earlier episodes, and he said they tried it for a small time, did badly, and managed to exit quickly, and that's what saved them. I don't know if you have views.

Ajay Shah: I don't know enough about South Korea. Lant Pritchett has told me a high-level story which runs like this — there were some fourteen business houses, called chaebols. There were fourteen business houses, and the dictator somehow got one good idea, that he wanted them to export. Now that's a difficult piece of good fortune to have — one such dictator, and to have these fourteen business houses.

Ajay Shah: And he basically would run meetings with them every day and say, "We want you to export." And then the whole Anne Krueger, T.N. Srinivasan, Jagdish Bhagwati type argument kicks in — that exporting creates a correct political economy inside the country, because you're not trying to grab from each other, you're not trying to grab from the local economy. In fact, you are aligned in everybody's interest to create high productivity, because you want to compete in the global market.

Ajay Shah: So you want a small country like Korea, and fourteen business houses, and a single-minded focus on exporting. That worked well, and over a twenty-five-year period, from the Korean War to becoming an OECD member, South Korea arrived. Also, it was very lucky and good for them that they managed the democratic transition.

Ajay Shah: The Olympics in 1988 basically put them irrevocably on the path to becoming a beautiful democracy. Today they have complete freedom of speech, freedom of politics, freedom of elections.

Rahul Ahluwalia: Freedom of economics...

Ajay Shah: No arbitrary power, freedom of economics. So they really graduated to the full package of freedom, which is what kept it going after 1988. Otherwise my counterfactual would be that you may have got a more dictatorship-type economic model with fourteen business houses which worked from 1960 to the late eighties, but then it would have run into trouble.

Ajay Shah: Unlike China, they actually got a big political system reform at the right time. By the late eighties they were turning into a democracy, and so they got the whole machinery of the liberal package of freedom, freedom, freedom — of the true ability of individuals at self-expression and living their own lives, which really brings out the best for all of us.

Rahul Ahluwalia: Yeah, this is a fantastic note to end on, but I don't want to end, because I think one very cool thing that you said — and you said this to me before — I want you to take a little time to talk about it. It's very connected to what you just said, right? What they happened to just get right is that exporting was critical.

Rahul Ahluwalia: It's critical for industrial policy, but as we've discussed before, it's also critical if you want to grow as a poor country — and over time you've come around to this view, that exporting is one of the most important things. If you can just summarize your views, I think after that we'll call it an episode.

Ajay Shah: Okay. So exporting is a great place to be, because the only way to compete in the global market is to be good. There's no cheating — you can't do the domestic political economy of one firm screwing another, and we've seen plenty of that in India. All of Indian finance is a warfare of one firm against another, implemented through the regulator — firm one wants a certain kind of rule, firm two wants another kind of rule, and it's a very toxic environment.

Ajay Shah: So the beauty of exporting is you're competing outside. And there is an intimate connection between exporting and FDI. A good slogan to remember is that fifty percent of world trade happens intra-firm — they're not firm-to-firm arm's-length transactions, they're happening within multinationals.

Ajay Shah: So the only way to succeed in exporting is to become a host to multinationals, which includes foreign multinationals and Indian multinationals. I've watched with great excitement the emergence of Indian multinationals — hundreds of big Indian companies are true multinationals today. They operate all over the world, and that is the right way to proceed.

Ajay Shah: Exporting and the emergence of multinationals with FDI also goes with the removal of trade barriers and capital controls. There India has fumbled and failed, and we still have plenty of trade barriers and capital controls, but that's the logical future to go into. And that's where you learn how to be high productivity.

Ajay Shah: Foreign and Indian firms in India participating in global supply chains learn how to run one firm at a time. It could be ten people, it could be a hundred people, it could be ten thousand people, it could be a hundred thousand people. But the growth of a country happens in the rise of productivity of one firm at a time, and exporting is the game under which that happens.

Ajay Shah: And once I've said all this, I straight away want to say, let's not get into a Goodhart's Law situation with this. You can always produce fake exports — this is a term that Ila and I coined. You can always get fake exports through government distortions of the exchange rate, through government subsidies on exports, and that just makes no sense.

Ajay Shah: So you should not be foolish in how you seek exports — meaning when the dictator sat with the fourteen business houses, they didn't turn around and say, "Give us a fake exchange rate, give us subsidies, then we'll export." The dictator said, "No, shut up, I want you to export." So...

Rahul Ahluwalia: "What's getting in your way, we'll clear your way," but we are not going to like...

Ajay Shah: We're not going to give you a subsidy, we want you to perform. Performance is defined as exports.

Rahul Ahluwalia: Yeah, and these Park meetings famously had — you tell me who's stopping you and what's stopping you, and I'll get them out of your way.

Ajay Shah: Yeah, and...

Rahul Ahluwalia: But I'm not going to give you subsidies.

Ajay Shah: Yeah, and I think if we can just get stuff out of the way for Indian firms —

Ajay Shah: but there you get to rules and deals and the problems of India. All in all, South Korea was a small country — a minor population compared with even North Korea — and you can imagine the span of control and the personal conversations of a Park or a Lee Kuan Yew pretty much spanning the business environment. That's not feasible in India.

Ajay Shah: In India we have to go much more into rules, because there are tens of thousands of firms spread all over India. If you go towards that world of deals — "you tell me what is wrong and I'll solve it" — then you're coming back to the bad old world of India, where the business leadership of Bombay would have to get on a plane all the time, come to Delhi, and plead with one JS or another, where managing Delhi was central to the success of the firm. We should not go there.

Ajay Shah: For a country the size of India, we're far better...

Rahul Ahluwalia: No, let me reframe that — tell me what rule is problematic, and maybe it's not the business houses to ask that, maybe it's the broader intellectual community as well. But let's fix the rules of the game in a way that makes Indian firms, and multinational firms in India, competitive enough to export. And that's the way to growth.

Ajay Shah: I think that's fantastic.

Rahul Ahluwalia: Thank you, Ajay, for talking to us. I learned a lot, as always.

Ajay Shah: Thank you for being here.

Rahul Ahluwalia: Happy to be here.

Ajay Shah: Thank you.

Rahul Ahluwalia: Thank you. [15:21:49] [outro music]

References

[1] Shah, Ajay. "Why firms in the country need to prioritise Japanese engagement more." Business Standard, Opinion/Columns, 5 10, 2026. https://www.business-standard.com/opinion/columns/why-firms-in-the-country-need-to-prioritise-japanese-engagement-more-126051000734_1.html.

[2] Shah, Ajay, and Amit Varma. "Graduating to Globalisation." Episode 48, *Everything is Everything*, XKDR Forum, May 24, 2024. https://www.xkdr.org/viewpoints/graduating-to-globalisation-episode-48-everything-is-everything.

[3] Kelkar, Vijay, and Ajay Shah. "Many roads lead to a sound GST." Business Standard, October 17, 2022. https://www.mayin.org/ajayshah/MEDIA/2022/sound_gst.html.

[4] Shah, Ajay, and Amit Varma. "The China Model is Broken." Episode 16 of *Everything is Everything*, XKDR Forum. Podcast/video, 1:28:51, October 13, 2023. https://www.xkdr.org/viewpoints/the-china-model-is-broken-episode-16-everything-is-everything.

[5] Shah, Ajay, and Amit Varma. "Beware of Industrial Policy." Episode 89 of *Everything is Everything*, podcast and video, XKDR Forum, March 7, 2025. https://www.xkdr.org/viewpoints/beware-of-industrial-policy-episode-89-everything-is-everything.

[6] Kelkar, Vijay, and Ajay Shah. *In Service of the Republic: The Art and Science of Economic Policy*. Penguin, 2022. https://www.penguin.co.in/book/in-service-of-the-republic/.