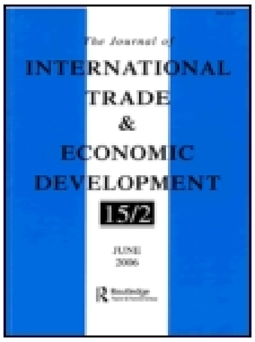

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India's economy and the reforms of the 1990s: genesis and prospect

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1. INTRODUCTION

We have two purposes in writing this essay, which is intended to serve as an introduction to this issue of the *Journal of International Trade and Economic Development*. First, since many of the readers may not be familiar with the recent history of the Indian economy, we have tried to provide a brief sketch of the background against which the reforms of the 1990s occurred. We believe that some knowledge of the general historical background is useful in understanding the forces that led to the reforms. Secondly, we identify some basic questions that have recurred in recent debates about the economic reforms in India and we briefly comment on the eight papers in this issue.[1]

2. THE BACKGROUND

In this essay, we shall treat 1991–96 as the reform years, although the reforms did not really get under way until 1992. Some important policy changes had indeed taken place in the late 1980s[2], but it is arguable that these were only piecemeal attempts to restructure the economy, motivated more by an urban, middle-class restlessness than by a concerted economic concern. It was only in 1991–92 that there was an attempt at systematic change, backed by professional economic thinking and a reasonably consistent, economy-wide agenda. It is true that the immediate fillip for reforms came from the economic crisis of 1991 but, once they began, the reforms acquired a momentum of their own. However, in assessing the reforms it is useful to begin earlier.

The roots of India's economic policy are a source of much debate and even more misunderstanding. India's lackluster performance is often put down to her alleged socialism or centrally planned economic system. For instance, Friedman and Friedman (1980, p. 181) lump together Russia, China and

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'India since independence' as examples of centrally planned economies.

In truth, India's economic system was born out of an uneasy compromise between two disparate aims – Mahatma Gandhi's dream of a simple village-based economy, and Jawaharlal Nehru's Fabian ideals of the welfare state and his belief in the importance of a heavy-industry foundation. Nehru had confided his growing distance from Gandhi's ideology to his diary as early as 1933: 'I am afraid I am drifting further and further away from him mentally. His continual reference to God irritates me exceedingly ... he does not encourage others to think ... What a tremendous contrast to the dialectics of Lenin & Co.. More and more I feel drawn to their dialectics' (Wolpert, 1996, p. 150). However, there is some evidence that, by the time India became independent, Nehru was disillusioned by Lenin's method as well. He still believed in planning and heavy industries, but his commitment to socialism had become feeble.

Out of deference to the Gandhians and to Nehru's own ideals at the time of India's independence, the Indian government began subsidizing small-scale industries and handicrafts, and also building large steel plants and dams. Prasanta Mahalanobis gave shape to some of these ideals through the five-year plans. The welfare part of Nehru's dream was never adopted and socialism became a word that had to be used repeatedly to make up for its absence. The lacuna was also made up by nurturing a large bureaucracy that had been inherited from the British Raj and by setting up an elaborate system of controls over the economy.[3] Several features of these instruments of *surrogate socialism*, which multiplied over time and tended to throttle the economy, may be worth noting. First, the government intervened extensively in the private sector and such intervention often took the form of discretionary, direct controls. The industrial licensing system under which investments above a certain level required a licence from the government, and the Industrial Disputes Act, under which a firm with 100 or more workers could not retrench workers and could not resort to closure without prior permission from the government, are just two examples of such control. Secondly, the government installed, in addition to tariff barriers, an extremely complex system of quantitative restrictions over international trade. Lastly, whatever might have been the original rationale for many of these regulations, often their cumulative effect was to reduce competition drastically and to generate monopoly rent.

Ironically, while, in the name of socialism, the state was undertaking these massive interventions in so many spheres of economic life, it neglected to intervene on behalf of the poor by providing schooling and basic medical facilities. As a consequence, India failed miserably in removing poverty, illiteracy and illness. In 1992, the adult literacy rate in India was 50% while the corresponding figures for the republic of Malaysia and Thailand were 80% and 94%, respectively (see Table 1 in Bajpai and Sachs' paper here). Again, in 1992, the infant mortality rate in India was 89 per thousand births, while the figures for Malaysia and Thailand were 14 and 26, respectively (see Table 1 in Bajpai and Sachs' paper). In brief, India's was a case of government intervention (and non-intervention) in the wrong places.

The contrast shows up most dramatically if one compares India with Korea. Both countries were comparably and abysmally poor when they both became independent nearly 50 years ago. The prospect looked a little better for India. India saved 10% of her income, Korea 6%; India exported a larger share of her income than Korea (Krueger, 1996). In 1950, Alec Adams, the British charge d'affaires in Korea spoke of how he and other foreigners living there entertained 'the lowest opinion of Korean intelligence, mores, ability and intelligence. It is hard to believe ... that they will ever be able to successfully govern themselves' (quoted in Clifford, 1994, p. 29). A widespread land reform, government action to raise standards of health and literacy and select intervention in industry, and a reliance on economic openness soon had the Korean economy surging forward and by the 1990s acute poverty and illiteracy had virtually vanished from Korea and, in per capita terms, Korea was at least 15 times as well as off as India no matter how one measures income.

During the first 30 years after independence, India did poorly in terms of economic growth; the average annual rate of growth of GDP over 1953–54 to 1966–67 was only 3.5% and, over 1967–68 to 1980–81, it was 3.8%. But contrary to widely held opinion, India's growth performance has not been bad since the 1980s. India's savings rate had risen sharply through the early 1970s and, with a little time-lag, India's growth began picking up in the 1980s. The Indian national income grew through the 1980s at the respectable rate of 5.8% per annum.[4] This was quite remarkable not only in terms of India's earlier performance, but even in cross-country terms.

Some Asian countries, such as China, Thailand and Malaysia, grew even faster, but a rate of 5.8% per annum was twice as high, or even more, than the fastest growing developed countries, such as the US (3%) or Germany (2.2%), and much faster than growth rates in most developing countries – Brazil, for instance, grew at the rate of 2.7% per annum during the same period. These statistics are summarized in Table 1. During 1988–89, India's growth rate had spiked to 10.2%. But this was brought about by a very good year for agriculture with agricultural output growing at the rate of 16.3% in that year, as shown in Table 2.

By the late 1980s the good performance was accompanied by gathering clouds. Some people argued that India was growing by mortgaging her future. Indeed, India was borrowing very heavily by the late 1980s. Her international debt-to-GDP ratio was at an all time high, and, more worringly, the debt-service ratio had broken through the 30% mark. In addition, India's fiscal deficit was very high. By 1990–91 it was at 8.3% of the national income.

The crisis which had to come, came in 1991. The trigger was the Gulf War. It raised petroleum prices, curtailed remittances from the Middle East, and, by

Table 1 Cross country performance

	Annual growth rate of GDO 1980–90	*GNP per capita in 1994, US$*
India	5.8	320
China	10.2	530
USA	3.0	25 880
Germany	2.2	25 580
Malaysia	5.2	3 480
Brazil	2.7	2 970
Thailand	7.6	2 410

Source: World Development Report, 1996 World Bank

Table 2 Performance of the Indian economy over time

	GNP growth rate (%)	*Agriculture & allied activities growth*
1986–87	4.0	-1.0
87–88	4.1	0.5
88–89	10.2	16.3
89–90	6.9	2.0
90–91	5.2	4.2
91–92	0.5	–2.0
92–93	5.0	5.8
93–94	4.5	3.3
94–95	6.7	4.9
95–96	7.2	2.4

Sources: Economic Survey, 1995–96, Government of India; *Economic Survey, 1995–96, An Update*, Government of India

fuelling apprehension among India's creditors, resulted in a sudden drying up of India's foreign reserves (Basu, 1993). A new government that had taken office in June 1991 initiated some drastic policy changes to stave off default and bankruptcy. By the time the government came to present its second Budget in 1992 the nation was in a mood to review and restructure its economic policy. And, from 1992, the then Finance Minister, Manmohan Singh, ushered in a series of major reforms.

3. THE REFORMS AND AFTER

In 1991, the government introduced two major policy changes. Except for 18 specified industries, industrial licensing was dismantled. Also in July 1991, the government initiated a programme of liberalization of the foreign trade regime. The ceiling on tariff was lowered steadily, and it now stands at 50%.

The complex import licensing system was drastically pruned in April 1992. Foreign exchange was decontrolled, starting in 1992 and, through a succession of measures, in the following years. Although exchange of foreign currency still has to occur through authorized foreign exchange dealers, the dealers are now free to choose the exchange rate.

While one can argue about the details of this policy, it seems difficult to deny that some such change was long overdue. Economic openness has always been viewed with suspicion in India. The collective memory of the East India Company has continued to colour our thinking. There has been an implicit adherence to a zero-sum view of the world. If a foreign government considered exporting to India beneficial to it, then, it was presumed, that this must mean that such export was harmful to India. The fact that multinationals consider it profitable to invest in India has been inverted in the common perception to the belief that India must *therefore* be worse off as a consequence of multinational investment. The fallacy of such a viewpoint was articulated most brilliantly in the following passage written in 1853:

> I know that the English millocracy intend to endow India with railways with the exclusive view of extracting at diminished expenses the cotton and other raw materials for their manufacturers. But when you have once introduced machinery into the locomotion of a country, which possess iron and coals, you are unable to withhold it from its fabrication. You cannot maintain a net of railways ... without introducing all those industrial processes necessary to meet the ... wants of railway locomotion and out of which there must grow the application of machinery to those branches of industry not immediately connected with railways. The railway system will therefore become truly the forerunner of modern industry.

The person who wrote these lines, assuring us that no matter what the motivation of the investor, an investment can be beneficial to the recipient economy, happens to be Karl Marx (1853, p. 661). One has to view India's recent move to attract foreign investment and have a more open economy in this light.

The first response of the market to the many changes of the early 1990s was lukewarm. Growth rate in 1991–92 was only 0.5%. Industry stagnated. In 1992–93 growth picked up a little, but for the fortuitous reason that agriculture grew rapidly in that year. Since 1994 the economy has been the cause of much optimism. In 1994–95 the growth rate was 6.7% and in 1995–96 it was 7.2%. The latter was accompanied by an industrial growth rate of over 12%. A number of questions naturally arise in this context. Has India moved on to a higher growth path? Can an annual growth rate of 7% be sustained or even bettered in the future? Most importantly, will the policy changes ultimately bring relief from the grinding poverty that has been the lot of so large a segment of the Indian society for so long? Or, will they unleash forces that will increase poverty and inequality? Since 1996, India has given new meaning to 'multi-party democracy' – its government is a coalition of 13 parties! Despite this, and despite the fact that the reforms had anyway slowed down by 1995, the economy is growing well. In 1996–97 it is expected that the income growth will once again exceed the 6% mark. Indeed, according to some forecasts recently put out (IEG-DSE Team, 1996) the Indian economy is expected to perform in this way all the way to 1998. Does all this suggest that the economy is beginning to be politics-proof?

These questions will be debated and, like all good debating questions, yield no easy answers. The papers published in this issue of *The Journal of International Trade and Economic Development* contribute to such debate by providing intellectual fodder. They express both optimism and scepticism but backed with evidence, data and institutional detail.

The paper by Bajpai and Sachs takes on a wide canvas. It starts by commenting on the roots of independent India's economic strategy; in particular, Nehruvian socialism. Then the authors go on to examine the factors primarily responsible for rapid growth in the East Asian economies, examine India's reform experience and finally comment on the relative experience of India and China. They comment on how China's greater decentralization has been a catalyst in China's progress.

Decentralization in India is the central concern of Singh. In the burgeoning literature on India's reforms very little attention has been paid to the subject of governance. Singh is concerned about 'the institutions of governance' and, although he discusses the broader theoretical debates on the subject, his immediate interest is driven by the 73rd and 74th amendments to the Indian constitution, which occurred in 1992 and which grant local governments greater control and authority. Singh treats the amendments as first steps towards a greater federal structure than has prevailed until now.

While Singh looks at the structure of panchayats and their economic role, Rao also studies the subject of federalism but at the level of the states and their fiscal policies. In India, the state governments have been under tremendous fiscal strain. Not only has this contributed to the overall fiscal deficit in the country, but it may have adversely affected spending on the social sector, which includes health and education, since India's social sector spending is largely the responsibility of the state. In 1991–92, for instance, 85% of India's public spending on social services came from state governments. While much has been written about reorienting the Union government's budget, relatively less is available on reforming fiscal policy in the states and this is the subject matter of Rao's paper.

Bajpai and Sachs also note in their paper how, in China, labourers in the state sector are well-protected but, in contrast to India, firms in the private sector do not have to fear that once they set up shop they will not be able to close down or downsize. The consequence of this has been that firms have been more eager to set up shop in China than in India. In consequence, it is, ironically, the Indian workers who have suffered. This is a matter that has been much discussed in the context of India (Datta Chaudhuri, 1994; Basu, 1995).

There is indeed a great need to amend India's labour laws. Indian labourers, *in the organized sector*, have lots of rights but not the right to waive many of these. Many of these laws are to the benefit of workers, but laws that make it difficult to retrench workers have in all likelihood been responsible for dampening the demand for Indian workers *ex ante* and thereby kept wages down. Legislation, such as the Industrial Disputes Act, 1947, needs to be amended. Unlike some commentators on the Indian scene, we do not agree that employers should be granted the right to fire workers, but that there should be much more scope for free contract. Thus, some workers could choose to take a low wage but have the right not to be laid off, whereas others may insist on a higher wage but give the employer the freedom to retrench them.

Cheap labour is India's comparative advantage. Amendments in the labour law can make India an attractive destination for foreign and domestic capital and so this should be treated as a priority area. The reason we are interested in this is because it is labourers who stand to benefit most from such reforms.

It is true that India's financial sector also needs reform. It is too easy to overlook this sector in our concern for the 'real' side of the economy. But the availability of credit is the essential lever for investment and, with a lag, economic progress. In addition, a smoothly functioning stock market can allow the benefits of progress to be shared by a large section of the population. In India, insider trading and other forms of manipulation of the capital market have prevented the common person to benefit from the purchase of stocks and mutuals. This is one area where government needs to intervene more actively and to have laws that prevent such manipulation. Till this happens firms will want to raise more funds abroad than considerations of comparative advantage require.

One difference between China and India that deserves more attention is with regard to primary education. China is ahead of India by quite a large margin in terms of literacy. Also, while in both countries female literacy lags behind male literacy, the gap is larger for India. Dreze and Sen (1994) have noted these differences and, in addition, draw our attention to the fact that much of China's literacy achievements occurred before it undertook wide-ranging economic reforms. It is true that the opening up of the economy increases opportunities for labourers but unless labourers possess basic skills and education they may not be able to take advantage of the opportunity. Given that the beneficial effects of literacy tend to occur with a lag, politicians, with their eye on the next election, have tended to neglect this sector. Studies across the world show that primary education is of utmost importance, both in itself and also as an instrument of economic growth. It is therefore the responsibility of economists, journalists and the public at large to bring pressure on government to direct more resources and energy into education.

Savings and investment are similar to primary education in that they have some gestation before they yield results. Not surprisingly, India has lagged behind many other nations in this regard. India's current rate of savings, as a percentage of GNP is at around 22%. This is good in comparison to developing countries in Africa and Latin America and also in comparison with her own performance up to the early 1970s, but all the Asian economies which are performing well, without exception, save more than 30%, with China and Singapore saving close to 40%. Government needs to rethink its policy of how to boost savings and investment.[5] This has to be a many-sided policy but a large part belongs to better fiscal management. Currently, more than one-third of the Union government's expenditure goes into repayments on past borrowing. Such heavy borrowing by government has tended to drive out productive investment. In addition, government's own spending on infrastructural investment has been slack. In 1990–91, the total central allocation for power, transport and communication was Rs. 6700 crores. In 1995–96 it was Rs. 6300 crores.[6] Given that, in normal terms, the economy had approximately doubled between these two periods, in the normal course the allocation should have doubled. In other words, in real terms the allocation has fallen sharply.

One infrastructural investment which aroused a lot of interest as well as ire in India is Enron Corporation's offer in June 1992 to build a 2015 MW plant at a cost of approximately US $2.8 billion. The broad outline of the Enron saga is well-known in India. Enron and the Maharashtra State Electricity Board signed an agreement in 1993. Then the new Maharashtra government that came to power in 1995 cancelled the agreement and, after a period of vacillation, renegotiated the contract once again and gave a green signal to the project. Perhaps such ups and downs are natural during the first steps towards opening up the economy[7], but the Enron case raised lots of questions about bargaining and social cost–benefit analysis for infrastructural projects. Parikh's paper goes beyond what has appeared in the popular press on the subject and provides a detailed economic analysis of the 'Enron story'.

So far in India, no comprehensive reforms have been undertaken that target the agricultural sector directly. However, it has been sometimes argued that, in so far as the reduction in tariffs and the removal of quantitative restrictions on imports make the industrial goods relatively cheap and hence render the domestic terms of trade more favourable to agriculture, they will stimulate investment in agriculture and promote growth of agricultural output (see, for example, Bhagwati and Srinivasan, 1993). However, on the basis of his computable general equilibrium analysis of trade liberalization, Storm concludes that the scope for stimulating agricultural investment and output through such price incentives resulting from trade liberalization is rather limited. Gokarn's paper deals with movements of relative prices from the perspective of the 'supply shock' approach. On the basis of his study of changes in prices over the period 1983–95, Gokarn arrives at the conclusion that the reforms generated virtually no positive supply shocks in the short run.

In any economy where there has been a prolonged regime of high tariffs and quantitative restrictions on imports, trade liberalization inevitably raises questions regarding its possible unfavourable impact on employment. In India also, when substantial trade liberalization was initiated in 1991, there was considerable apprehension that it could adversely affect the import-competing sector, and, given the labour market frictions, this, in turn could result in cutbacks in employment, at least in the short run, in import-competing industries. The paper of Kambhampati, Krishna and Mitra is of much interest in this context. Using panel data for firms in five import-competing industries, they examine the effect of the trade liberalization on employment. The effect on employment, overall, and also in each of the five import-competing industries, turns out to be small and insignificant.

How has all this affected the conditions of the poor? In the context of the Indian economy, this is clearly of fundamental interest. Patnaik argues, using some indirect evidence, that rural poverty has increased in the 1990s. The head-count ratio of poverty did seem to rise in 1992. But given that the reforms began in earnest only in 1992, this is more likely the effect of the crisis rather than the reforms. Moreover, poverty has declined in 1993–94 (Sen, 1996). Essentially, it is still too early to be able properly to assess the impact of these policies on distribution and poverty. Also, given that India's record of battling poverty has been quite unremarkable over the 1960s and 1970s, we feel it was time to move away from the old policies, and the reforms are a move in the correct direction. But to the extent that growth, in our view, is important only as an instrument for helping raise the standard of living of the poorest classes, we will have to analyse the impact of the reforms of the poor once systematic data become available. Through the 1980s India's index of inequality, as measured by the Gini coefficient, remained more or less unchanged (see Dreze and Sen, 1995) – although some recent estimates by Ravallion and Subramanian (1996) show a slight decline in equality. On the other hand, poverty seems to have declined more definitely. The percentage of population below the poverty line in 1977–78 was 54.5% in rural areas and 43% in urban areas. The corresponding figures for 1987–88 were 44.9% and 36.5% (Dreze and Sen, 1995). While there is no way of knowing whether this decline in poverty was caused by the faster growth in the 1980s, it is heartening to see that the faster growth occurred alongside the decline in poverty.

4. CONCLUDING REMARKS

With virtually all major political parties agreeing to the broad idea of economic reforms, the current trend of structural changes is probably irreversible. What makes this more hopeful is that there seems to be a general change in perception across the population that, despite the rhetoric, the Indian government was for decades doing too little for the poor and the disadvantaged. This was all too evident in India's enormous poverty, mass illiteracy, underemployment and lack of basic amenities such as housing, drinking water and electricity for the poor. This has at last given rise to an awareness that the old policies were not working and we must cast for change.

However, a desire for change is by no means sufficient for bringing about the correct policy regime. In today's complex world one needs a lot of research to determine what exactly needs to be done. What, on the face of it, seems like a desirable policy may not always be so. This is, in fact, one of the reasons India was doing badly. The collection of these papers, whether they commend or criticize the economic reforms, is best viewed as an effort towards a more rational and pragmatic economic policy.

NOTES

1 For recent evaluations of India's economic policy, see, for instance, Bhagwati (1993), Desai (1996), Dreze and Sen (1995), Jalan (1996), and Joshi and Little (1996).
2 For a wide-ranging account of India's economic and social policy till the early 1980s, see Sen (1982).
3 When John Galbraith came to India as an ambassador, Nehru had told him, perhaps not entirely in jest: 'I am the last Englishman to rule India' (Wolpert, 1996, p. 379).
4 This is the World Bank estimate. There are other estimates which put the figure down to just over 5%.
5 The important role of savings and investment, both theoretical and in the East Asian experience, has been examined by Majumdar (1997).
6 These figures are from Government of India (1995).
7 This is especially so for a democracy. But democracy, combined with an efficient legal system, is likely to be an advantage in the long run.

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