Economic Reforms in India since 1991: Has Gradualism Worked?

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India was a latecomer to economic reforms, embarking on the process in earnest only in 1991, in the wake of an exceptionally severe balance of payments crisis. The need for a policy shift had become evident much earlier, as many countries in east Asia achieved high growth and poverty reduction through policies which emphasized greater export orientation and encouragement of the private sector. India took some steps in this direction in the 1980s, but it was not until 1991 that the government signaled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of government.

India's economic performance in the post-reforms period has many positive features. The average growth rate in the ten year period from 1992-93 to 2001-02 was around 6.0 percent, as shown in Table 1, which puts India among the fastest growing developing countries in the 1990s. This growth record is only slightly better than the annual average of 5.7 percent in the 1980s, but it can be argued that the 1980s growth was unsustainable, fuelled by a buildup of external debt which culminated in the crisis of 1991. In sharp contrast, growth in the 1990s was accompanied by remarkable external stability despite the east Asian crisis. Poverty also declined significantly in the post-reform period, and at a faster rate than in the 1980s according to some studies (as Ravallion and Datt discuss in this issue).

However, the ten-year average growth performance hides the fact that while the economy grew at an impressive 6.7 percent in the first five years after the reforms, it slowed down to 5.4 percent in the next five years. India remained among the fastest growing developing countries in the second sub-period because other developing countries also slowed down after the east Asian crisis, but the annual growth of 5.4 percent was much below the target of 7.5 percent which the government had set for the period. Inevitably, this has led to some questioning about the effectiveness of the reforms.

Opinions on the causes of the growth deceleration vary. World economic growth was slower in the second half of the 1990s and that would have had some dampening effect, but India's dependence on the world economy is not large enough for this to account for the slowdown. Critics of liberalization have blamed the slowdown on the effect of trade policy reforms on domestic industry (for example, Nambiar et al, 1999; Chaudhuri, 2002).[1] However, the opposite view is that the slowdown is due not to the effects of reforms, but rather to the failure to implement the reforms effectively. This in turn is often attributed to India's gradualist approach to reform, which has meant a frustratingly slow pace of implementation. However, even a gradualist pace should be able to achieve significant policy changes over ten years. This paper examines India's experience with gradualist reforms from this perspective.

We review policy changes in five major areas covered by the reform program: fiscal deficit reduction, industrial and trade policy, agricultural policy, infrastructure development and social sector development. Based on this review, we consider the cumulative outcome of ten years of gradualism to assess whether the reforms have created an environment which can support 8 percent GDP growth, which is now the government target.

Savings, Investment and Fiscal Discipline

Fiscal profligacy was seen to have caused the balance of payments crisis in 1991 and a reduction in the fiscal deficit was therefore an urgent priority at the start of the reforms. The combined fiscal deficit of the central and state governments was successfully reduced from

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9.4 percent of GDP in 1990-91 to 7 percent in both 1991-92 and 1992-93 and the balance of payments crisis was over by 1993. However, the reforms also had a medium term fiscal objective of improving public savings so that essential public investment could be financed with a smaller fiscal deficit to avoid "crowding out" private investment. This part of the reform strategy was unfortunately never implemented.

As shown in Table 2, public savings deteriorated steadily from +1.7 percent of GDP in 1996-97 to –1.7 percent in 2000-01. This was reflected in a comparable deterioration in the fiscal deficit taking it to 9.6 percent of GDP in 2000-01. Not only is this among the highest in the developing world, it is particularly worrisome because India's public debt to GDP ratio is also very high at around 80%. Since the total financial savings of households amount to only 11 percent of GDP, the fiscal deficit effectively preempts about 90 percent of household financial savings for the government. What is worse, the rising fiscal deficit in the second half of the 1990s was not financing higher levels of public investment, which was more or less constant in this period.

These trends cast serious doubts on India's ability to achieve higher rates of growth in future. The growth rate of 6 percent per year in the post-reforms period was achieved with an average investment rate of around 23 percent of GDP. Accelerating to 8 percent growth will require a commensurate increase in investment. Growth rates of this magnitude in east Asia were associated with investment rates ranging from 36-38 percent. While it can be argued that there was overinvestment in East Asia, especially in recent years, it is unlikely that India can accelerate to 8 percent growth unless it can raise the rate of investment to around 29-30 percent of GDP. Part of the increase can be financed by increasing foreign direct investment, but even if foreign direct investment increases from the present level of 0.5 percent of GDP to 2.0 percent -- an optimistic but not impossible target -- domestic savings would still have to increase by at least 5 percentage points of GDP.

Can domestic savings be increased by this amount? As shown in Table 2, private savings have been buoyant in the post-reform period, but public savings have declined steadily. This trend needs to be reversed.[2] Both the central government and the state governments would have to take a number of hard decisions to bring about improvements in their respective spheres.

The central government's effort must be directed primarily towards improving revenues, because performance in this area has deteriorated significantly in the post reform period. Total tax revenues of the center were 9.7 percent of GDP in 1990-91. They declined to only 8.8 percent in 2000-01, whereas they should have increased by at least two percentage points. Tax reforms involving lowering of tax rates, broadening the tax base and reducing loopholes were expected to raise the tax ratio and they did succeed in the case of personal and corporate income taxation but indirect taxes have fallen as a percentage of GDP. This was expected in the case of customs duties, which were deliberately reduced as part of trade reforms, but this decline should have been offset by improving collections from domestic indirect taxes on goods and by extending indirect taxation to services. This part of the revenue strategy has not worked as expected. The Advisory Group on Tax Policy for the Tenth Plan recently made a number of proposals for modernizing tax administration, including especially computerization, reducing the degree of exemption for small scale units and integration of services taxation with taxation of goods (Planning Commission, 2001a). These recommendations need to be implemented urgently.[3]

There is also room to reduce central government subsidies, which are known to be highly distortionary and poorly targeted (e.g. subsidies on food and fertilizers), and to introduce rational user charges for services such as passenger traffic on the railways, the postal system and university education. Overstaffing was recently estimated at 30 percent and downsizing would help reduce expenditure.

State governments also need to take corrective steps. Sales tax systems need to be modernized in most states. Agricultural income tax is constitutionally assigned to the states, but no state has attempted to tax agricultural income. Land revenue is a traditional tax based on landholding, but it has been generally neglected and abolished in many states. Urban property taxation could yield much larger resources for municipal governments if suitably modernized, but this tax base has also been generally neglected. State governments suffer from very large losses in state electricity boards (about 1 percent of GDP) and substantial losses in urban water supply, state road transport corporations and in managing irrigation systems. Overstaffing is greater in the states than in the center.

The fiscal failures of both the central and the state governments have squeezed the capacity of both the center and the states to undertake essential public investment. High levels of government borrowing have also crowded out private investment. Unless this problem is addressed, the potential benefits from reforms in other areas will be eroded and it may be difficult even to maintain the average growth rate of 6 percent experienced in the first ten years after the reforms, let alone accelerate to 8 percent.

Reforms in Industrial and Trade Policy

Reforms in industrial and trade policy were a central focus of much of India's reform effort in the early stages. Industrial policy prior to the reforms was characterized by multiple controls over private investment which limited the areas in which private investors were allowed to operate, and often also determined the scale of operations, the location of new investment, and even the technology to be used. The industrial structure that evolved under this regime was highly inefficient and needed to be supported by a highly protective trade policy, often providing tailor-made protection to each sector of industry. The costs imposed by these policies had been extensively studied (for example, Bhagwati and Desai, 1965; Bhagwati and Srinivasan, 1971; Ahluwalia, 1985) and by 1991 a broad consensus had emerged on the need for greater liberalization and openness. A great deal has been achieved at the end of ten years of gradualist reforms.

Industrial Policy

Industrial policy has seen the greatest change, with most central government industrial controls being dismantled. The list of industries reserved solely for the public sector -- which used to cover 18 industries, including iron and steel, heavy plant and machinery, telecommunications and telecom equipment, minerals, oil, mining, air transport services and electricity generation and distribution -- has been drastically reduced to three: defense aircrafts and warships, atomic energy generation, and railway transport. Industrial licensing by the central government has been almost abolished except for a few hazardous and environmentally sensitive industries. The requirement that investments by large industrial houses needed a separate clearance under the Monopolies and Restrictive Trade Practices Act to discourage the concentration of economic power was abolished and the act itself is to be replaced by a new competition law which will attempt to regulate anticompetitive behavior in other ways.

The main area where action has been inadequate relates to the long standing policy of reserving production of certain items for the small-scale sector. About 800 items were covered by this policy since the late 1970s, which meant that investment in plant and machinery in any individual unit producing these items could not exceed $ 250,000. Many of the reserved items such as garments, shoes, and toys had high export potential and the failure to permit development of production units with more modern equipment and a larger scale of production severely restricted India's export competitiveness. The Report of the Committee on Small Scale Enterprises (1997) and the Report of the Prime Minister's Economic Advisory Council (2001) had both pointed to the remarkable success of China in penetrating world markets in these areas and stimulating rapid growth of employment in manufacturing. Both reports recommended that the policy of reservation should be abolished and other measures adopted to help small-scale industry. While such a radical change in policy was unacceptable, some policy changes have been made very recently: fourteen items were removed from the reserved list in 2001 and another 50 in 2002. The items include garments, shoes, toys and auto components, all of which are potentially important for exports. In addition, the investment ceiling for certain items was increased to $1 million. However, these changes are very recent and it will take some years before they are reflected in economic performance.

Industrial liberalization by the central government needs to be accompanied by supporting action by state governments. Private investors require many permissions from state governments to start operations, like connections to electricity and water supply and environmental clearances. They must also interact with the state bureaucracy in the course of day-to-day operations because of laws governing pollution, sanitation, workers' welfare and safety, and such. Complaints of delays, corruption and harassment arising from these interactions are common. Some states have taken initiatives to ease these interactions, but much more needs to be done.

A recently completed joint study by the World Bank and the Confederation of Indian Industry (Stern, 2001) found that the investment climate varies widely across states and these differences are reflected in a disproportional share of investment, especially foreign investment, being concentrated in what are seen as the more investor-friendly states (Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu) to the disadvantage of other states (like Uttar Pradesh, Bihar and West Bengal). Investors perceived a 30 percent cost advantage in some states over others, on account of the availability of infrastructure and the quality of governance. These differences across states have led to an increase in the variation in state growth rates, with some of the less favored states actually decelerating compared to the 1980s (Ahluwalia, 2002). Because liberalization has created a more competitive environment, the pay off from pursuing good policies has increased, thereby increasing the importance of state level action. Infrastructure deficiencies will take time and resources to remove but deficiencies in governance could be handled more quickly with sufficient political will.

Trade Policy

Trade policy reform has also made progress, though the pace has been slower than in industrial liberalization. Before the reforms, trade policy was characterized by high tariffs and pervasive import restrictions. Imports of manufactured consumer goods were completely banned. For capital goods, raw materials and intermediates, certain lists of goods were freely importable, but for most items where domestic substitutes were being produced, imports were only possible with import licenses. The criteria for issue of licenses were nontransparent, delays were endemic and corruption unavoidable. The economic reforms sought to phase out import licensing and also to reduce import duties.

Import licensing was abolished relatively early for capital goods and intermediates which became freely importable in 1993, simultaneously with the switch to a flexible exchange rate regime. Import licensing had been traditionally defended on the grounds that it was necessary to manage the balance of payments, but the shift to a flexible exchange rate enabled the government to argue that any balance of payments impact would be effectively dealt with through exchange rate flexibility. Removing quantitative restrictions on imports of capital goods and intermediates was relatively easy, because the number of domestic producers was small and Indian industry welcomed the move as making it more competitive. It was much more difficult in the case of final consumer goods because the number of domestic producers affected was very large (partly because much of the consumer goods industry had been reserved for small scale production). Quantitative restrictions on imports of manufactured consumer goods and agricultural products were finally removed on April 1, 2001, almost exactly ten years after the reforms began, and that in part because of a ruling by a World Trade Organization dispute panel on a complaint brought by the United States.

Progress in reducing tariff protection, the second element in the trade strategy, has been even slower and not always steady. As shown in Table 3, the weighted average import duty rate declined from the very high level of 72.5 percent in 1991-92 to 24.6 percent in 1996-97. However, the average tariff rate then increased by more than 10 percentage points in the next four years.[4] In February 2002, the government signaled a return to reducing tariff protection. The peak duty rate was reduced to 30 percent, a number of duty rates at the higher end of the existing structure were lowered, while many low end duties were raised to 5 percent. The net result is that the weighted average duty rate is 29 percent in 2002-03.

Although India's tariff levels are significantly lower than in 1991, they remain among the highest in the developing world because most other developing countries have also reduced tariffs in this period. The weighted average import duty in China and southeast Asia is currently about half the Indian level. The government has announced that average tariffs will be reduced to around 15 percent by 2004, but even if this is implemented, tariffs in India will be much higher than in China which has committed to reduce weighted average duties to about 9 percent by 2005 as a condition for admission to the World Trade Organization.

Foreign Direct Investment

Liberalizing foreign direct investment was another important part of India's reforms, driven by the belief that this would increase the total volume of investment in the economy, improve production technology, and increase access to world markets. The policy now allows 100 percent foreign ownership in a large number of industries and majority ownership in all except banks, insurance companies, telecommunications and airlines. Procedures for obtaining permission were greatly simplified by listing industries that are eligible for automatic approval up to specified levels of foreign equity (100 percent, 74 percent and 51 percent). Potential foreign investors investing within these limits only need to register with the Reserve Bank of India. For investments in other industries, or for a higher share of equity than is automatically permitted in listed industries, applications are considered by a Foreign Investment Promotion Board that has established a track record of speedy decisions. In 1993, foreign institutional investors were allowed to purchase shares of listed Indian companies in the stock market, opening a window for portfolio investment in existing companies.

These reforms have created a very different competitive environment for India's industry than existed in 1991, which has led to significant changes. Indian companies have upgraded their technology and expanded to more efficient scales of production. They have also restructured through mergers and acquisitions and refocused their activities to concentrate on areas of competence. New dynamic firms have displaced older and less dynamic ones: of the top 100 companies ranked by market capitalization in 1991, about half are no longer in this group. Foreign investment inflows increased from virtually nothing in 1991 to about 0.5 percent of GDP. Although this figure remains much below the levels of foreign direct investment in many emerging market countries (not to mention 4 percent of GDP in China), the change from the pre-reform situation is impressive. The presence of foreign-owned firms and their products in the domestic market is evident and has added greatly to the pressure to improve quality.

These policy changes were expected to generate faster industrial growth and greater penetration of world markets in industrial products, but performance in this respect has been disappointing. As shown in Table 1, industrial growth increased sharply in the first five years after the reforms, but then slowed to an annual rate of 4.5 percent in the next five years. Export performance has improved, but modestly. The share of exports of goods in GDP increased from 5.7 percent in 1990-91 to 9.7 percent, but this reflects in part an exchange rate depreciation. India's share in world exports, which had declined steadily since 1960, increased slightly from around 0.5 percent in 1990-91 to 0.6 percent in 1999-2000, but much of the increase in world market share is due to agricultural exports. India's manufactured exports had a 0.5 percent share in world markets for those items in 1990 and this rose to only 0.55 percent by 1999. Unlike the case in China and southeast Asia, foreign direct investment in India did not play an important role in export penetration and was instead oriented mainly towards the domestic market.

One reason why export performance has been modest is the slow progress in lowering import duties that make India a high cost producer and therefore less attractive as a base for export production. Exporters have long been able to import inputs needed for exports at zero duty, but the complex procedure for obtaining the necessary duty-free import licenses typically involves high transactions cost and delays. High levels of protection compared with other countries also explains why foreign direct investment in India has been much more oriented to the protected domestic market, rather than using India as a base for exports. However, high tariffs are only part of the explanation for poor export performance. The reservation of many potentially exportable items for production in the small scale sector (which has only recently been relaxed) was also a relevant factor. The poor quality of India's infrastructure compared with infrastructure in east and southeast Asia, which is discussed later in this paper, is yet another.

Inflexibility of the labor market is a major factor reducing India's competitiveness in exports and also reducing industrial productivity generally (Planning Commission, 2001). Any firm wishing to close down a plant, or to retrench labor in any unit employing more than 100 workers, can only do so with the permission of the state government, and this permission is rarely granted. These provisions discourage employment and are especially onerous for labor-intensive sectors. The increased competition in the goods market has made labor more willing to take reasonable positions, because lack of flexibility only leads to firms losing market share. However, the legal provisions clearly remain much more onerous than in other countries. This is important area of reform that has yet to be addressed. The lack of any system of unemployment insurance makes it difficult to push for major changes in labor flexibility unless a suitable contributory system that is financially viable can be put in place. The government has recently announced its intention to amend the law and raise the level of employment above which firms have to seek permission for retrenchment from 100 workers at present to 1000 while simultaneously increasing the scale of retrenchment compensation. However, the amendment has yet to be enacted.

These gaps in the reforms provide a possible explanation for the slowdown in industrial growth in the second half of the 1990s. It can be argued that the initial relaxation of controls led to an investment boom, but this could have been sustained only if industrial investment had been oriented to tapping export markets, as was the case in east Asia. As it happened, India's industrial and trade reforms were not strong enough, nor adequately supported by infrastructure and labor market reforms to generate such a thrust. The one area which has shown robust growth through the 1990s with a strong export orientation is software development and various new types of services enabled by information technology like medical transcription, backup accounting, and customer related services. Export earnings in this area have grown from $100 million in 1990-91 to over $6 billion in 2000-01 and are expected to continue to grow at 20 to 30 percent per year. India's success in this area is one of the most visible achievements of trade policy reforms which allow access to imports and technology at exceptionally low rates of duty, and also of the fact that exports in this area depend primarily on telecommunications infrastructure, which has improved considerably in the post-reforms period.

Reforms in Agriculture

A common criticism of India's economic reforms is that they have been excessively focused on industrial and trade policy, neglecting agriculture which provides the livelihood of 60 percent of the population. Critics point to the deceleration in agricultural growth in the second half of the 1990s (shown in Table 2) as proof of this neglect.[5] However, the notion that trade policy changes have not helped agriculture is clearly a misconception. The reduction of protection to industry, and the accompanying depreciation in the exchange rate, has tilted relative prices in favor of agriculture and helped agricultural exports. The index of agricultural prices relative to manufactured products has increased by almost 30 percent in the past ten years (Ministry of Finance, 2002, Chapter 5). The share of India's agricultural exports in world exports of the same commodities increased from 1.1 percent in 1990 to 1.9 percent in 1999, whereas it had declined in the ten years before the reforms.

But while agriculture has benefited from trade policy changes, it has suffered in other respects, most notably from the decline in public investment in areas critical for agricultural growth, such as irrigation and drainage, soil conservation and water management systems, and rural roads. As pointed out by Gulati and Bathla (2001), this decline began much before the reforms, and was actually sharper in the 1980s than in the 1990s. They also point out that while public investment declined, this was more than offset by a rise in private investment in agriculture which accelerated after the reforms. However, there is no doubt that investment in agriculture-related infrastructure is critical for achieving higher productivity and this investment is only likely to come from the public sector. Indeed, the rising trend in private investment could easily be dampened if public investment in these critical areas is not increased.

The main reason why public investment in rural infrastructure has declined is the deterioration in the fiscal position of the state governments and the tendency for politically popular but inefficient and even iniquitous subsidies to crowd out more productive investment. For example, the direct benefit of subsidizing fertilizer and underpricing water and power goes mainly to fertilizer producers and high income farmers while having negative effects on the environment and production, and even on income of small farmers.[6] A phased increase in fertilizer prices and imposition of economically rational user charges for irrigation and electricity could raise resources to finance investment in rural infrastructure, benefiting both growth and equity. Competitive populism makes it politically difficult to restructure subsidies in this way, but there is also no alternative solution in sight.

Some of the policies which were crucial in promoting food grain production in earlier years, when this was the prime objective, are now hindering agricultural diversification. Government price support levels for food grains such as wheat are supposed to be set on the basis of the recommendations of the Commission on Agricultural Costs and Prices, a technical body which is expected to calibrate price support to reasonable levels. In recent years, support prices have been fixed at much higher levels, encouraging overproduction. Indeed, public food grain stocks reached 58 million tons on January 1, 2002, against a norm of around 17 million tons! The support price system clearly needs to be better aligned to market demand if farmers are to be encouraged to shift from food grain production towards other products.

Agricultural diversification also calls for radical changes in some outdated laws. The Essential Commodities Act, which empowers state governments to impose restrictions on movement of agricultural products across state and sometimes even district boundaries and to limit the maximum stocks wholesalers and retailers can carry for certain commodities, was designed to prevent exploitive traders from diverting local supplies to other areas of scarcity or from hoarding supplies to raise prices. Its consequence is that farmers and consumers are denied the benefit of an integrated national market. It also prevents the development of modern trading companies, which have a key role to play in the next stage of agricultural diversification. The government has recognized the need for change and recently removed certain products -- including wheat, rice, coarse grains, edible oil, oilseeds and sugar -- from the purview of the act. However, this step may not suffice, since state governments may be able to take similar action. What is needed is a repeal of the existing act and central legislation that would make it illegal for government authorities at any level to restrict movement or stocking of agricultural products (Planning Commission, 2001).

The report of the Task Force on Employment has made comprehensive proposals for review of several other outdated agricultural law (Planning Commission, 2001b). For example, laws designed to protect land tenants, undoubtedly an important objective, end up discouraging marginal farmers from leasing out nonviable holdings to larger farmers for fear of being unable to reclaim the land from the tenant. The Agricultural Produce Marketing Acts in various states compel traders to buy agricultural produce only in regulated markets, making it difficult for commercial traders to enter into contractual relationships with farmers. Development of a modern food processing sector, which is essential to the next stage of agricultural development, is also hampered by outdated and often contradictory laws and regulations. These and other outdated laws need to be changed if the logic of liberalization is to be extended to agriculture.

Infrastructure Development

Rapid growth in a globalized environment requires a well-functioning infrastructure including especially electric power, road and rail connectivity, telecommunications, air transport, and efficient ports. India lags behind east and southeast Asia in these areas. These services were traditionally provided by public sector monopolies but since the investment needed to expand capacity and improve quality could not be mobilized by the public sector, these sectors were opened to private investment, including foreign investment. However, the difficulty in creating an environment which would make it possible for private investors to enter on terms that would appear reasonable to consumers, while providing an adequate risk- return profile to investors, was greatly underestimated. Many false starts and disappointments have resulted.

The greatest disappointment has been in the electric power sector, which was the first area opened for private investment. Private investors were expected to produce electricity for sale to the State Electricity Boards, which would control of transmission and distribution.

However, the State Electricity Boards were financially very weak, partly because electricity tariffs for many categories of consumers were too low and also because very large amounts of power were lost in transmission and distribution. This loss, which should be between 10 to 15 percent on technical grounds (depending on the extent of the rural network), varies from 35 to 50 percent. The difference reflects theft of electricity, usually with the connivance of the distribution staff. Private investors, fearing nonpayment by the State Electricity Boards insisted on arrangements which guaranteed purchase of electricity by state governments backed by additional guarantees from the central government. These arrangements attracted criticism because of controversies about the reasonableness of the tariffs demanded by private sector power producers. Although a large number of proposals for private sector projects amounting to about 80 percent of existing generation capacity were initiated, very few reached financial closure and some of those which were implemented ran into trouble subsequently.[7]

Because of these difficulties, the expansion of generation capacity by the utilities in the 1990s has been only about half of what was targeted and the quality of power remained poor with large voltage fluctuations and frequent interruptions.

The flaws in the policy have now been recognized and a more comprehensive reform is being attempted by several state governments. Independent statutory regulators have been established to set tariffs in a manner that would be perceived to be fair to both consumers and producers. Several states are trying to privatize distribution in the hope that this will overcome the corruption which leads to the enormous distribution losses. However, these reforms are not easy to implement. Rationalization of power tariffs is likely to be resisted by consumers long used to subsidized power, even though the quality of the power provided in the pre-reform situation was very poor. The establishment of regulatory authorities that are competent and credible takes time. Private investors may not be able to enforce collection of amounts due or to disconnect supply for non-payment without adequate backing by the police. For all these reasons, private investors perceive high risks in the early stages and therefore demand terms that imply very high rates of return. Finally, labor unions are opposed to privatization of distribution.

These problems are formidable and many state governments now realize that a great deal of preliminary work is needed before privatization can be successfully implemented.[8] Some of the initial steps, like tariff rationalization and enforcing penalties for non-payment of dues and for theft of power, are perhaps best implemented within the existing public sector framework so that these features, which are essential for viability of the power sector, are not attributed solely to privatization. If the efforts now being made in half a dozen states succeed, it could lead to a visible improvement within a few years.

The results in telecommunications have been much better and this is an important factor underlying India's success in information technology. There was a false start initially because private investors offered excessively high license fees in bidding for licenses which they could not sustain, which led to a protracted and controversial renegotiation of terms. Since then, the policy appears to be working satisfactorily. Several private sector service providers of both fixed line and cellular services, many in partnership with foreign investors, are now operating and competing with the pre-existing public sector supplier. Teledensity, which had doubled from 0.3 lines per 100 population in 1981 to 0.6 in 1991, increased sevenfold in the next ten years to reach 4.4 in 2002. Waiting periods for telephone connections have shrunk dramatically. Telephone rates were heavily distorted earlier with very high long distance charges cross-subsidizing local calls and covering inefficiencies in operation. They have now been rebalanced by the regulatory authority, leading to a reduction of 30 percent in long distance charges. Interestingly, the erstwhile public sector monopoly supplier has aggressively reduced prices in a bid to retain market share.

Civil aviation and ports are two other areas where reforms appear to be succeeding, though much remains to be done. Two private sector domestic airlines, which began operations after the reforms, now have more than half the market for domestic air travel. However, proposals to attract private investment to upgrade the major airports at Mumbai and Delhi have yet to make visible progress. In the case of ports, 17 private sector projects involving port handling capacity of 60 million tons, about 20 percent of the total capacity at present, are being implemented. Some of the new private sector port facilities have set high standards of productivity.

India's road network is extensive, but most of it is low quality and this is a major constraint for interior locations. The major arterial routes have low capacity (commonly just two lanes in most stretches) and also suffer from poor maintenance. However, some promising initiatives have been taken recently. In 1998, a tax was imposed on gasoline (later extended to diesel) , the proceeds of which are earmarked for the development of the national highways, state roads and rural roads. This will help finance a major program of upgrading the national highways connecting Delhi, Mumbai, Chennai and Calcutta to four lanes or more, to be completed by the end of 2003. It is also planned to levy modest tolls on these highways to ensure a stream of revenue which could be used for maintenance. A few toll roads and bridges in areas of high traffic density have been awarded to the private sector for development.

The railways are a potentially important means of freight transportation but this area is untouched by reforms as yet. The sector suffers from severe financial constraints, partly due to a politically determined fare structure in which freight rates have been set excessively high to subsidize passenger fares, and partly because government ownership has led to wasteful operating practices. Excess staff is currently estimated at around 25 percent. Resources are typically spread thinly to respond to political demands for new passenger trains at the cost of investments that would strengthen the capacity of the railways as a freight carrier. The Expert Group on Indian Railways (2002) recently submitted a comprehensive program of reform converting the railways from a departmentally run government enterprise to a corporation, with a regulatory authority fixing the fares in a rational manner. No decisions have been announced as yet on these recommendations.

Financial Sector Reform

India's reform program included wide-ranging reforms in the banking system and the capital markets relatively early in the process with reforms in insurance introduced at a later stage.

Banking sector reforms included: (a) measures for liberalization, like dismantling the complex system of interest rate controls, eliminating prior approval of the Reserve Bank of India for large loans, and reducing the statutory requirements to invest in government securities; (b) measures designed to increase financial soundness, like introducing capital adequacy requirements and other prudential norms for banks and strengthening banking supervision; (c) measures for increasing competition like more liberal licensing of private banks and freer expansion by foreign banks. These steps have produced some positive outcomes. There has been a sharp reduction in the share of non-performing assets in the portfolio and more than 90 percent of the banks now meet the new capital adequacy standards. However, these figures may overstate the improvement because domestic standards for classifying assets as non-performing are less stringent than international standards.

India's banking reforms differ from those in other developing countries in one important respect and that is the policy towards public sector banks which dominate the banking system. The government has announced its intention to reduce its equity share to 33-1/3 percent, but this is to be done while retaining government control. Improvements in the efficiency of the banking system will therefore depend on the ability to increase the efficiency of public sector banks.

Skeptics doubt whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise. The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share.

If privatization is not politically feasible, it is at least necessary to consider intermediate steps which could increase efficiency within a public sector framework (see for example Ahluwalia 2002). These include shifting effective control from the government to the boards of the banks including especially the power to appoint the Chairman and Executive Directors which is at present with the government; removing civil servants and representatives of the Reserve Bank of India from these board; implementing a prompt corrective action framework which would automatically trigger regulatory action limiting a bank's expansion capability if certain trigger points of financial soundness are breeched; and finally acceptance of closure of insolvent public sector banks (with appropriate protection for small depositors). Unless some initiatives along these lines are taken, it is highly unlikely that public sector banks can rise to the levels of efficiency needed to support rapid growth.

Another major factor limiting the efficiency of banks is the legal framework, which makes it very difficult for creditors to enforce their claims. The government has recently introduced legislation to establish a bankruptcy law which will be much closer to accepted international standard. This would be an important improvement but it needs to be accompanied by reforms in court procedures to cut the delays which are a major weakness of the legal system at present.

Reforms in the stock market were accelerated by a stock market scam in 1992 that revealed serious weaknesses in the regulatory mechanism. Reforms implemented include establishment of a statutory regulator; promulgation of rules and regulations governing various types of participants in the capital market and also activities like insider trading and takeover bids; introduction of electronic trading to improve transparency in establishing prices; and dematerialization of shares to eliminate the need for physical movement and storage of paper securities. Effective regulation of stock markets requires the development of institutional expertise, which necessarily requires time, but a good start has been made and India's stock market is much better regulated today than in the past. This is to some extent reflected in the fact that foreign institutional investors have invested a cumulative $21 billion in Indian stocks since 1993, when this avenue for investment was opened.

An important recent reform is the withdrawal of the special privileges enjoyed by the Unit Trust of India, a public sector mutual fund which was the dominant mutual fund investment vehicle when the reforms began. Although the Unit Trust did not enjoy a government guarantee, it was widely perceived as having one because its top management was appointed by the government. The Trust had to be bailed out once in 1998, when its net asset value fell below the declared redemption price of the units, and again in 2001 when the problem recurred. It has now been decided that in future investors in the Unit Trust of India will bear the full risk of any loss in capital value. This removes a major distortion in the capital market, in which one of the investment schemes was seen as having a preferred position.

The insurance sector (including pension schemes), was a public sector monopoly at the start of the reforms. The need to open the sector to private insurance companies was recommended by an expert committee (the Malhotra Committee) in 1994, but there was strong political resistance. It was only in 2000 that the law was finally amended to allow private sector insurance companies, with foreign equity allowed up to 26 percent, to enter the field. An independent Insurance Development and Regulatory Authority has now been established and ten new life insurance companies and six general insurance companies, many with well-known international insurance companies as partners, have started operations. The development of an active insurance and pensions industry offering attractive products tailored to different types of requirements could stimulate long term savings and add depth to the capital markets. However, these benefits will only become evident over time.

Privatization

The public sector accounts for about 35 percent of industrial value added in India, but although privatization has been a prominent component of economic reforms in many countries, India has been ambivalent on the subject until very recently. Initially, the government adopted a limited approach of selling a minority stake in public sector enterprises while retaining management control with the government, a policy described as "disinvestment" to distinguish it from privatization. The principal motivation was to mobilize revenue for the budget, though there was some expectation that private shareholders would increase the commercial orientation of public sector enterprises. This policy had very limited success. Disinvestment receipts were consistently below budget expectations and the average realization in the first five years was less than 0.25 percent of GDP compared with an average of 1.7 percent in seventeen countries reported in a recent study (see Davis et.al. 2000). There was clearly limited appetite for purchasing shares in public sector companies in which government remained in control of management.

In 1998, the government announced its willingness to reduce its shareholding to 26 percent and to transfer management control to private stakeholders purchasing a substantial stake in all central public sector enterprises except in strategic areas.[9] The first such privatization occurred in 1999, when 74 percent of the equity of Modern Foods India Ltd. (a public sector bread-making company with 2000 employees), was sold with full management control to Hindustan Lever, an Indian subsidiary of the Anglo-Dutch multinational Unilever. This was followed by several similar sales with transfer of management: BALCO, an aluminium company; Hindustan Zinc; Computer Maintenance Corporation; Lagan Jute Machinery Manufacturing Company; several hotels; VSNL, which was until recently the monopoly service supplier for international telecommunications; IPCL, a major petrochemicals unit and Maruti Udyog, India's largest automobile producer which was a joint venture with Suzuki Corporation which has now acquired full managerial controls.

The privatization of Modern Foods and BALCO generated some controversy, not so much on the principle of privatization, but on the transparency of the bidding process and the fairness of the price realized. Subsequent sales have been much less problematic and although the policy continues to be criticized by the unions, it appears to have been accepted by the public, especially for public sector enterprises that are making losses or not doing well. However, there is little public support for selling public sector enterprises that are making large profits such as those in the petroleum and domestic telecommunications sectors, although these are precisely the companies where privatization can generate large revenues. These companies are unlikely to be privatized in the near future, but even so, there are several companies in the pipeline for privatization which are likely to be sold and this will reduce resistance to privatizing profit-making companies.[10]

An important recent innovation, which may increase public acceptance of privatization, is the decision to earmark the proceeds of privatization to finance additional expenditure on social sector development and for retirement of public debt. Privatization is clearly not a permanent source of revenue, but it can help fill critical gaps in the next five to ten years while longer term solutions to the fiscal problem are attempted. Many states have also started privatizing state level public sector enterprises. These are mostly loss making enterprises and are unlikely to yield significant receipts but privatization will eliminate the recurring burden of financing losses.

Social Sector Development in Health and Education

India's social indicators at the start of the reforms in 1991 lagged behind the levels achieved in southeast Asia 20 years earlier, when those countries started to grow rapidly (Dreze and Sen, 1995). For example, India's adult literacy rate in 1991 was 52 percent, compared with 57 percent in Indonesia and 79 percent in Thailand in 1971. The gap in social development needed to be closed, not only to improve the welfare of the poor and increase their income earning capacity, but also to create the preconditions for rapid economic growth. While the logic of economic reforms required a withdrawal of the state from areas in which the private sector could do the job just as well, if not better, it also required an expansion of public sector support for social sector development.

Much of the debate in this area has focused on what has happened to expenditure on social sector development in the post-reform period. Dev and Moolji (2002) find that central government expenditure on towards social services and rural development increased from 7.6 percent of total expenditure in 1990-91 to 10.2 percent in 2000-01, as shown in Table 4. As a percentage of GDP, these expenditures show a dip in the first two years of the reforms, when fiscal stabilization compulsions were dominant, but there is a modest increase thereafter. However, expenditure trends in the states, which account for 80 percent of total expenditures in this area, show a definite decline as a percentage of GDP in the post-reforms period. Taking central and state expenditures together, social sector expenditure has remained more or less constant as a percentage of GDP.

Closing the social sector gaps between India and other countries in southeast Asia will require additional expenditure, which in turn depends upon improvements in the fiscal position of both the central and state governments. However, it is also important to improve the efficiency of resource use in this area. Saxena (2001) has documented the many problems with existing delivery systems of most social sector services, especially in rural areas. Some of these problems are directly caused by lack of resources, as when the bulk of the budget is absorbed in paying salaries , leaving little available for medicines in clinics or essential teaching aids in schools. There are also governance problems such as nonattendance by teachers in rural schools and poor quality of teaching.

Part of the solution lies in greater participation by the beneficiaries in supervising education and health systems, which in turn requires decentralization to local levels and effective peoples' participation at these levels. Nongovernment organizations can play a critical role in this process. Different state governments are experimenting with alternative modalities but a great deal more needs to be done in this area.

While the challenges in this area are enormous, it is worth noting that social sector indicators have continued to improve during the reforms. The literacy rate increased from 52 percent in 1991 to 65 percent in 2001, a faster increase in the 1990s than in the previous decade, and the increase has been particularly high in the some of the low literacy states such as Bihar, Madhya Pradesh, Uttar Pradesh and Rajasthan.

Conclusions

The impact of ten years of gradualist economic reforms in India on the policy environment presents a mixed picture. The industrial and trade policy reforms have gone far, though they need to be supplemented by labor market reforms which are a critical missing link. The logic of liberalization also needs to be extended to agriculture, where numerous restrictions remain in place. Reforms aimed at encouraging private investment in infrastructure have worked in some areas but not in others. The complexity of the problems in this area was underestimated, especially in the power sector. This has now been recognized and policies are being reshaped accordingly. Progress has been made in several areas of financial sector reforms, though some of the critical issues relating to government ownership of the banks remain to be addressed. However, the outcome in the fiscal area shows a worse situation at the end of ten years than at the start.

Critics often blame the delays in implementation and failure to act in certain areas to the choice of gradualism as a strategy. However, gradualism implies a clear definition of the goal and a deliberate choice of extending the time taken to reach it, in order to ease the pain of transition. This is not what happened in all areas. The goals were often indicated only as a broad direction, with the precise end point and the pace of transition left unstated to minimize opposition—and possibly also to allow room to retreat if necessary. This reduced politically divisive controversy, and enabled a consensus of sorts to evolve, but it also meant that the consensus at each point represented a compromise, with many interested groups joining only because they believed that reforms would not go "too far". The result was a process of change that was not so much gradualist as fitful and opportunistic. Progress was made as and when politically feasible, but since the end point was not always clearly indicated, many participants were unclear about how much change would have to be accepted, and this may have led to less adjustment than was otherwise feasible.

The alternative would have been to have a more thorough debate with the objective of bringing about a clearer realization on the part of all concerned of the full extent of change needed, thereby permitting more purposeful implementation. However, it is difficult to say whether this approach would indeed have yielded better results, or whether it would have created gridlock in India's highly pluralist democracy. Instead, India witnessed a halting process of change in which political parties which opposed particular reforms when in opposition actually pushed them forward when in office. The process can be aptly described as creating a strong consensus for weak reforms!

Have the reforms laid the basis for India to grow at 8 percent per year? The main reason for being optimistic is that the cumulative change brought about is substantial. The slow pace of implementation has meant that many of the reform initiatives have been put in place recently and their beneficial effects are yet to be felt. The policy environment today is therefore potentially much more supportive, especially if the critical missing links are put in place. However, the failure on the fiscal front could undo much of what has been achieved. Both the central and state governments are under severe fiscal stress which seriously undermines their capacity to invest in certain types of infrastructure and in social development where the public sector is the only credible source of investment. If these trends are not reversed, it may be difficult even to maintain 6 percent annual growth in the future, let alone accelerate to 8 percent. However, if credible corrective steps are taken on the fiscal front, then the cumulative policy changes that have already taken place in many areas, combined with continued progress on the unfinished agenda, should make it possible for India to accelerate to well beyond 6 percent growth over the next few years.

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Table 1

India's Growth Performance
(Percent per year)

	Total GDP Growth	Sectoral Growth of GDP .		
		Agriculture	Industry	Services
1970-72 to 1980-81 (average)	3.2	2.0	4.0	7.2
1981-82 to 1990-91 (average)	5.7	3.8	7.0	6.7
1991-92	1.3	-1.1	-1.0	4.8
1992-93	5.1	5.4	4.3	5.4
1993-94	5.9	3.9	5.6	7.7
1994-95	7.3	5.3	10.3	7.1
1995-96	7.3	-0.3	12.3	10.5
1996-97	7.8	8.8	7.7	7.2
1997-98	4.8	-1.5	3.8	9.8
1998-99	6.5	5.9	3.8	8.3
1999-2000	6.1	1.4	5.2	9.5
2000-01	4.0	0.1	6.6	4.8
2001-02*	5.4	5.7	3.3	6.5
1992-93 to 1996-97 (average)	6.7	4.6	8.0	7.6
1997-98 to 2001-02 (average)	5.4	2.3	4.5	7.8

Source: Economic Survey 2001-02, Ministry of Finance, Government of India, 2002. Growth rates for 2001-02 are projections of the Ministry of Finance based on partial information.

Table 2

Major Macro-Economic Indicators
(percentages of GDP)

	Combined Fiscal Deficit of Central and State Govts.	Gross Savings		Gross Capital Formation	
		Private Sector	Public Sector	Private Sector	Public Sector
1990-91	9.4	22.0	1.1	14.7	9.3
1991-92	7.0	20.1	2.0	13.1	8.8
1992-93	7.0	20.2	1.6	15.2	8.6
1993-94	8.3	21.9	0.6	13.0	8.2
1994-95	7.1	23.2	1.7	14.7	8.7
1995-96	6.5	23.1	2.0	18.9	7.7
1996-97	6.4	21.5	1.7	14.7	7.0
1997-98	7.3	21.8	1.3	16.0	6.6
1998-99	8.9	22.6	-1.0	14.8	6.6
1999-00	9.4	24.0	-0.9	16.1	7.1
2000-01	9.6	25.1	-1.7	15.8	7.1

Note: Public sector capital formation minus public sector savings does not equal the fiscal deficit because the definition of public sector for estimate of savings and capital formation includes non-departmental enterprises. Estimates of public sector savings and capital formation distinguishing general government from non-departmental enterprises are not readily available for recent years.

Table 3

Weighted Average Import Duty Rates in India

	All Commodities	Peak Customs Duty 1/	No. of Basic Duty Rates 2/
1991-92	72.5	150	22
1992-93	60.6	110	20
1993-94	46.8	85	16
1994-95	38.2	65	16
1995-96	25.9	50	12
1996-97	24.6	52*	9
1997-98	25.4	45*	8
1998-99	29.2	45*	7
1999-00	31.4	40	7
2000-01	35.7	38.5	5
2001-02	35.1	35	4
2002-03	29.0	30	4

Source: Report of the Task Force on Employment, Planning Commission 2000. Estimates for 2002-03 have been provided by Archana Mathur of the Planning Commission.

1/ Includes the impact of surcharges in the years indicated by *. In 2000-01, duties for many agricultural products were raised above the general peak in anticipation of the removal of QRs. This explains why the average for all commodities exceeds the peak rate in 2001-02.

2/ Refers to *ad valorem* duty rates. Some items attract a specific duty and these are not included as separate duty rates.

Table 4

Public Expenditure on Social Sector and Rural Development
(Percentage of GDP)

	Central Government	State Government
1990-91	1.42	5.98
1991-92	1.25	5.85
1992-93	1.29	6.72
1993-94	1.49	5.57
1994-95	1.49	6.27
1995-96	1.54	5.33
1996-97	1.56	5.13
1997-98	1.60	5.18
1998-99	1.67	5.41
1999-00	1.59	6.06
2000-01	1.58	5.46

Source: Dev and Moolji (2002).

[1] This approach reflects to some extent the revisionist view of the role of trade policy reforms being expressed internationally as for example by Rodrik (1999). For a critique of the revisionist view, see Bhagwati and Srinivasan (2001).

[2] An increase in public savings will have some negative effect on private savings as for example, when higher tax revenues lead to a reduction in disposable income in the private sector which in turn reduces private savings but the net effect will still be positive.

[3] Many countries have increased revenues substantially by switching to an integrated value-added tax covering both goods and services. This is not possible in India because of the constitutional division of taxation powers between the center (which can tax production) and the states (which can tax sales). The inability to switch to an integrated value-added tax is a major hindrance to tax reform.

[4] The sharp increase in average duty rates in 2000 – 01 reflects the imposition of tariff on many agricultural commodities in anticipation of the removal of quantitative restrictions. Since these items were protected by quantitative restrictions in the mid-1990s, the combined protection provided by tariffs and quantitative restrictions was probably higher in the mid-1990s.

[5] India's reforms are often unfavorably compared with the very different sequencing adopted in China, which began with reforms in agriculture in 1978, extending them to industry only in 1984. The comparison is not entirely fair since Chinese agriculture faced an extremely distorted incentive structure, with virtually no role for markets, which provided an obvious area for high priority action with potentially large benefits. Since Indian agriculture operated to a much greater extent under market conditions, the situation was very different.

[6] Underpricing of water and fertilizer leads to excess usage and waterlogged soil. Free electricity enables larger farmers to pump water from deep wells at relatively low cost. This encourages a much more water using cropping pattern than would be optimal and also leads to overexploitation of ground water and lowering the water table, which in turn hurts poorer farmers relying upon shallow wells.

[7] The best known of these was the Dabhol project of the Enron cooperation which became mired in controversy because of the high cost of power from the project especially as a consequence of a pricing arrangement which meant that most of the tariff was U.S. dollar denominated and that the risk of rupee depreciation against the dollar was borne by the buyer.

[8] These problems surfaced in a recent effort to privatize the distribution system in Delhi. The terms offered were publicly criticised as being too generous because tariff setting was based on a relatively modest pace of reduction in transmission and distribution losses. Nevertheless, all bids received were below the reserve price set by the government. This was a consequence of several factors: information on the quality of assets and the financial position of the system was very poor; private investors were expected to take on the responsibility of excess staff with inadequate information on the costs of retrenchment; enforcement of payment and disconnection for non-payment can create law and order problems in parts of the city; and there was lack of regulatory certainty about the way tariffs would be set in future. These deficiencies inevitably led to very low bids.

[9] The definition of strategic for this purpose covers enterprises related to defense, atomic energy, and the railways. This would exclude only a handful of the 232 public sector enterprises of the central government.

[10] The Ministry of Disinvestment in its website (http://www.divest.nic.in) has made a valiant effort at explaining the case for privatizing even profit making companies on the grounds that government ownership makes it impossible to achieve commercial efficiency.