

Lessons from India's Economic Reforms Montek S. Ahluwalia*

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IT IS A GREAT HONOR TO HAVE BEEN ASKED TO GIVE THIS LECTURE, JOINING A SERIES of extremely distinguished practitioners in development policy. It is also a pleasure to be doing so at the World Bank, where I had my first job after graduating from university. I have many pleasant memories of my days at the Bank and especially the many friendships I formed at the time.

The lecturers in this series have been asked to provide personal reflections rather than deep analyses—to draw lessons from their experiences and discuss what they would have done differently had they known then what they know now. That seems simple enough, but of course it is not. In my current position, which involves conducting ex post evaluations of International Monetary Fund (IMF) programs, I am very conscious that it is extremely difficult to determine what constitutes a valid lesson. A lesson necessarily implies some kind of statement about counterfactuals—that if things had been done differently, outcomes would have differed as well—and establishing sound counterfactuals is extremely difficult. Having gennected before this qualification, I propose to get into the spirit of these lectures by skirting analyses and simply asserting my perceptions, leaving it to scholars to test whether these perceptions, and the lessons drawn from them, are valid.

India's Economic Performance and Reforms since the 1970s

Before attempting to draw lessons, let me first summarize India's economic performance over the past three decades. When I returned to India in 1979, after a decade at the Bank, the country was generally regarded as a growth laggard. In the 1970s its GDP growth averaged just 3.2 percent a year—lower than in Sub-Saharan Africa, East Asia, Latin America, and the global average for developing countries (table 1). India also fared poorly relative to other large developing countries, ranking 17 in a sample of 20 (table 2). Its growth performance improved considerably in the 1980s, rising to an annual average of

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Ahluwalia left the Indian government in 2001 to become the first Director of the Independent Evaluation Office at the International Monetary Fund (IMF). There he oversaw the IMF's self-evaluation of its role in Argentina's financial crisis. When he left the position in 2004, the IMF Executive Board commended him by saying, "Mr. Ahluwalia has successfully established independent evaluation as an essential element for the effective functioning of the Fund with respect to its surveillance, program, and technical assistance activities in support of its members." In mid-2004 he began a Cabinet-level position as Deputy Chairman of India's Planning Commission. Ahluwalia cowrote (with Hollis Chenery and others) ***Redistribution with Growth: An Approach to Policy*** (Oxford University Press, 1975). He has also written extensively for professional journals on India's economic reforms and global financial architecture.

5.7 percent and causing its rank to rise to 7 among the sample of 20 countries. Growth rates improved further in the first half of the 1990s.

The acceleration of growth in the 1980s was associated with a process of policy rethinking and (very partial) reforms. This rethinking was spurred partly by mainstream thinking about development policy but mainly by the example of the superior performance of many East Asian countries. The World Bank is the principal source of data on comparative economic performance among developing countries, and it should be a source of satisfaction to those who collate and publish these data that the picture they present has an impact on policy-making.

The main lesson that Indian policymakers learned from this comparison was that India's economic system needed to be redesigned. The system was characterized by extensive government controls over private sector activity in the form of investment licensing and price controls, high levels of tariff protection combined with quantitative restrictions on imports, restrictive controls on foreign investment, and so on. This system came to be regarded as dysfunctional and in need of change.

Nevertheless, the control system was not fundamentally altered in the 1980s. It remained in place, but was operated more liberally. Controls were relaxed in marginal ways by removing some industries from licensing controls, allowing some automatic expansion in licensed capacity, and removing some imports from controls. More important, the controls in place were generally operated more permissively, in the sense that there was less suspicion of private sector activity and permissions needed were more freely given.

As this process of incremental liberalization proceeded and produced good results in the 1980s, many technocrats were convinced that deeper, more systemic changes were needed. Several committees were appointed to review various aspects of the economic management system, and these committees recommended further liberalization. Many of these recommendations were implemented in the 1990s.

The reforms of the 1990s were triggered by the fact that India experienced a severe balance of payments crisis in 1991. The new administration, headed by Prime Minister Narasimha Rao, appointed a technocrat and economist, Manmohan Singh, as minister of finance. Singh (who is now prime minister) unveiled a comprehensive program of economic reforms, including:

- Abandoning the earlier predisposition in favour of a dominant role for the public sector and recognizing the importance of the private sector as a leading engine of growth.
- Placing much greater reliance on market forces and competition as the primary means of increasing efficiency.
- Opening the economy to international trade, foreign investment, and foreign technology.

Because reforms were implemented at a time of crisis, when the economy also had to resort to IMF financing and a structural adjustment loan from the World Bank, they were criticized as being driven by the IMF and World Bank. But the fact is that the package of reforms was the outcome of considerable internal thinking. Although the reforms were broadly in line with what was considered sensible policy by international institutions, this was more a reflection of a genuine convergence of views on development policy than of pressure exerted by the IMF and the Bank. One indication of the extent to which the design of the package was home-grown is that in many areas — especially privatization and the pace of external liberalization India's reforms differed significantly from those in typical IMF-Bank programs. Another indication is that the reforms were continued even though the crisis was overcome relatively quickly.

The initial response to the reforms was an impressive acceleration in annual GDP growth, which averaged 6.7 percent in the first half of the reform period (1992—97). This acceleration was widely viewed as vindicating the government's approach. But in the second half of the reform period (1998-2003) the growth rate decelerated to an average of about 5.7 percent. Not surprisingly, there has been a great deal of concern in India about this deceleration.

TABLE 1**Average Annual GDP Growth in India, China, and Developing Regions, 1971-2003**

<i>Country/region</i>	<i>1971-80</i>	<i>1981-90</i>	<i>1992-97</i>	<i>1998-2003</i>
India	3.2	5.7	6.7	5.7
China	6.3	9.3	11.5	7.7
Sub-Saharan Africa	3.3	2.2	2.3	3.0
Developing Asia excl. China and India	5.8	5.0	6.2	2.7
Middle East and North Africa	6.3	2.4	3.3	4.3
Latin America and Caribbean	6.1	1.5	3.9	1.3
All developing countries	5.5	4.1	6.3	4.5

Source: IMF, *World Economic Outlook*.

TABLE 2**Average Annual GDP Growth in 20 Large Emerging Economies, 1971-2003**

<i>Region/country</i>	<i>1971-80</i>	<i>1981-90</i>	<i>1992-97</i>	<i>1998-2003</i>
South Asia				
India	3.2	5.7	6.7	5.7
Bangladesh	1.8	3.7	4.8	5.2
Pakistan	4.8	6.0	3.6	3.8
East Asia				
China	6.3	9.3	11.5	7.7
Indonesia	7.8	5.4	7.1	0.5
Korea, Rep. of	7.7	8.7	6.6	4.3
Malaysia	8.0	6.1	9.2	2.7
Philippines	6.0	1.8	3.8	3.4
Thailand	6.9	7.9	6.5	1.8
Vietnam	3.9	5.9	8.8	5.0
Middle East and North Africa				
Egypt	5.8	5.2	3.0	4.0
Turkey	5.5	5.2	5.1	1.9
Sub-Saharan Africa				
Nigeria	4.4	2.2	2.7	2.7
South Africa	3.5	1.5	2.1	2.4
Tanzania	3.7	3.3	2.5	5.2
Latin America				
Argentina	2.9	-1.1	5.5	-1.7
Brazil	8.6	1.6	3.4	1.6
Chile	2.8	3.3	8.3	2.5
Mexico	6.9	1.9	2.6	2.9
Venezuela	4.1	1.0	2.4	-4.2

Source: IMF, *World Economic Outlook*.

The deceleration can be explained by two factors. First, global economic growth slowed in the wake of the East Asian crisis and the collapse of the technology boom in the United States. Among the 20 comparator countries mentioned earlier, India's rank in 1992-97, when growth accelerated, was 6 out of 20. But in 1998-2003, when India's growth decelerated, its rank rose to 2 (see table 2). Second, there was a weakening in the pace of reforms. I will touch on this issue and its implications at various points in this lecture.

Lessons from India's Experience

The above description suggests that India's reforms may not have been as successful as we would have liked. Still, India's growth was higher than that of many comparator countries in recent decades. What can be drawn from this experience? Six lessons seem to me to be of special relevance.

The first lesson relates to the importance of a home-grown approach for reforms to take hold. The second relates to the inevitability of gradual implementation in a pluralist, highly participatory democracy. The third is that implementation of complex reforms involves a process of learning and discovery, which means that there will inevitably be some false starts and midcourse adjustments in the implementation process. The fourth is that when dealing with multiple reforms on several fronts, careful attention must be paid to sequencing. The fifth relates to India's federal political structure and the increased importance of policy action at the subnational level in an environment where the central government is liberalizing controls. Finally, India's experience yields important lessons about poverty alleviation.

A homegrown approach

The broad direction of India's reforms was by no means unique. I have already mentioned that the reforms implemented in the 1980s, and especially in the 1990s, reflected the emerging consensus on development policy in the international community. The difference from many other countries that took the same path is that India's reforms were not dictated from the outside. Although the reforms were supported by financial assistance from the IMF and the Bank—which implies that they met with the approval of these institutions—they were not an externally designed blueprint thrust on an unwilling government.

On the contrary¹, the broad direction of reforms had been extensively discussed internally, and there was fairly wide domestic consensus that changes along these lines were needed. This is not to say that the reforms were universally accepted, but democracies are not given to encouraging universal acceptance. Indeed, they put a significant premium on adversarial debate. The point is that the reforms had substantial homegrown support.

Several committees had recommended reforms well before they were introduced. I recall a discussion with the prime minister in 1989 on why and how so many East Asian countries were doing so well, and why India was lagging behind. I argued that the main reason was that India's economic policies were not conducive to rapid growth and needed wide-ranging reforms. I was asked to write a paper on the subject, which I did and which was discussed internally in the government. I mention this incident only to illustrate that we were not operating in completely virgin territory: the intellectual foundation for the reforms was already in place. Had that not been the case, it would have been extremely difficult to make many of the changes that were made in 1991 because resistance would have been too strong, and it would have looked like they had been imposed by technocrats cut off from the mainstream.

A gradual approach

The second lesson that emerges from India's experience is that the pace of reforms is dictated by economic and political forces, and it is difficult to force that pace beyond a certain point. In India, with its highly pluralist and participatory democracy, this meant that reforms were gradualist. The more impatient of my friends often argued that it was more like glacialism, because you could barely see the movements taking place. The process was often compared unfavourably with Latin America, where similar reforms were adopted much more vigorously and with much greater speed.

There were two somewhat different reasons why India's reforms were implemented in a gradualist fashion. First, there were areas of reforms where there was broad technocratic and political consensus on what needed to be done, based on established theoretical and empirical work. But implementation was deliberately stretched out due to a desire to avoid sudden changes and spread the costs of adjustment over a longer period. Second, in certain areas gradualism arose because there was consensus that change was needed, but no consensus on how far it should go. In such cases some steps were taken but it was never clear whether further steps would be taken.

An example of the first type of gradualism is the conduct of reforms involving external liberalization. In the late 1970s India suffered from a grossly overvalued exchange rate as a result of tight import controls as well as a varied, but generally very-high, tariff structure. There was considerable agreement in technocratic circles that quantitative restrictions on imports were dysfunctional and should be phased out. In addition, tariffs had to be reduced over time and the exchange rate had to be devalued to provide incentives for domestic production as tariffs were cut.

The 1980s saw some partial steps to address this problem. The exchange rate was managed in a way that achieved a steady depreciation in real terms, eroding the impact of quantitative restrictions. There was also some limited relaxation in quantitative restrictions, but little progress on tariffs. In fact, where quantitative import licensing was reduced, tariffs were actually raised as a way of shifting from quantitative restrictions to tariffs.

The reforms of the 1990s envisaged a systemic change on all three fronts but at a graduated pace. In 1991 the fixed exchange rate was devalued by 25 percent (in two successive steps) to a more reasonable level. Since import controls were to be liberalized, it was logical to shift to a system that allowed greater exchange rate flexibility. This was done in two stages. In 1992 a dual exchange rate was introduced, with one fixed rate at which exporters were expected to surrender 30 percent of export earnings (which were then used to finance essential imports such as petroleum and to meet government debt servicing obligations) and a floating rate at which all other transactions took place based on the demand and supply of foreign exchange. There was no indication at the time on how long the dual exchange rate system would be kept, but the government clearly intended it to be a transitional measure, and internally we were clear that if the market exchange rate did not get pushed to unreasonable levels, the two rates would quickly be unified. In 1993 the dual exchange rate was replaced by a single exchange rate that was effectively market-determined.

Gradualism was also evident in phasing out import licensing. Licensing was phased out fairly quickly for all non-consumer goods (intermediate goods and capital goods), but it remained in place for consumer goods until as late as 2002. Throughout this period a steady effort was made to cut tariffs, and the weighted average import tariff fell from more than 80 percent in 1991 to about 30 percent in 1997. There was a reversal in 1997, partly because Indian industry began to feel the pressure of competition after the East Asian crisis, but the process of reducing tariffs resumed in 2000. India's weighted average tariff is now about 24 percent. Though definitely an improvement relative to 1991, it is three times as high as that in East Asia, and that is despite the fact that for the past five years a declared objective of government policy has been to approximate East Asian tariffs.

Looking back, I have no doubt that we were too cautious and we should—and probably could—have moved faster. The case for gradualism was that a slower pace would evoke less opposition, and this was probably true. But there are two somewhat obvious disadvantages to this type of gradualist approach. First, although it minimizes pain in the short run, it also postpones benefits and to that extent does not build a strong enough constituency for reforms. For example, the export response normally associated with trade reform was slow to materialize in India. It has emerged in the past four or five years, but it would have occurred much earlier if we had been bolder on this front. A second disadvantage is that gradualism gives more time for opponents of reform to mobilize, and all the

more so because the benefits of reform are necessarily muted. The reversal of tariff cuts in 1997 was to some extent a concession to growing protectionist pressures from industry.

The second type of gradualism refers to situations where there was consensus on the need for policy change, but no consensus on how far to go. That was the case with privatization. Unlike in Eastern Europe, where privatization was politically attractive because it was part of a structural change that was generally supported, in India there was little public support for privatization. The pressure for change came from the technocracy, which recognized that too many loss-making public enterprises imposed a drain on the budget. But even among this group there was no conviction about the need for wholesale privatization as an ideology. Rather, there was a desire to privatize all loss-making units, in the belief that private entrepreneurs would do a better job, and to privatize units in sectors where no strategic interests were being served and private ownership was clearly more appropriate (hotels and simple consumer goods were the most obvious candidates in this category).

Even this limited approach had little support outside the technocracy when reforms began in the early 1990s. The process was driven primarily by the need to raise resources for the budget and was limited to selling minority shares in public enterprises (described as "disinvestment" rather than privatization). While the primary motivation was to raise revenue, there was also a belief that by bringing in private shareholders, management of public enterprises would take on a more commercial orientation.

The Congress government, which began the process of disinvestment, was succeeded after the 1996 elections by a left of centre government that was not expected to favour privatization. It is an interesting example of the way gradualism helped build consensus that the new government did not reverse policy. Instead it focused on process issues, criticizing the earlier process as one in which the choice of which public enterprises would be privatized was arbitrary and non-transparent.

To remedy this problem, the government created a Disinvestment Commission to examine the issue, hold hearings, talk to all stakeholders, and then make recommendations. The government did not endorse any particular policy; it simply established a commission to make recommendations on which units should be privatized and to what extent or in what manner. The commission held consultations and submitted reports recommending different courses of action for different public sector units, including full privatization in some cases.

Since the government was in office less than two years, it collapsed before it had to make any decisions on these recommendations. Following the elections of 1997, it was succeeded by a right of centre coalition led by the Bharatiya Janata Party (BJP). The new government decided to accept the recommendations on privatization, and in 1998 announced that it would transfer management control of all nonstrategic public enterprises. A new Ministry of Disinvestment was created to push the process more vigorously.

The first two privatizations involving a change in management occurred in 1999 and 2000 and created tremendous controversy. Company workers took the matter to court, saying that privatization was illegal. Numerous nongovernmental organizations (NGOs) also opposed the government's efforts, as did a variety of other individuals and institutions, with many filing petitions accusing it of doing something wrong. The Supreme Court considered the matter and pronounced that the government was perfectly within its rights to sell public enterprises. But while the principle was established and some units were privatized, the government was unable to overcome internal resistance to privatizing some of the most attractive public units in the petroleum sector, despite its declared intention to do so.

Relative to Latin America, where privatization was pushed enthusiastically, India looked uncertain about its intentions and slow in its decision-making. Indeed, investment bankers often commented that India's approach was difficult to understand and that it looked as if we did not know what we were doing. But the fact is that privatization did not command sufficient public support. The government took a series of partial steps and encouraged active public debate, giving many voices a chance to be heard. This approach was aimed at building sufficient consensus before moving forward. In general, changes

were made opportunistically, with the government moving forward when it sensed an opportunity—but being just as willing to hold back when there was opposition.ⁱ

India's experience with privatization shows that ensuring debate on a policy does not guarantee that consensus will emerge. The essence of democracy is that it is adversarial, and parties participating in a democratic process do not have a compulsion to reach an agreement. On the contrary, opponents will remain opposed even after an issue has been extensively debated, at least until public opinion changes very broadly.

This point is important in the context of the push by the IMF and World Bank for various types of participator)- processes in formulating Poverty Reduction Strategy-Papers (PRSPs). There is often an unstated assumption that if all stakeholders are involved in such discussions, it will be possible to reach agreement. But that is by no means certain. Debate is an essential part of the political process, and while it helps ensure participation, it does not guarantee convergence. Indeed, it can sometimes even sharpen conflicts that might have remained muted in the absence of debate. In short, public debate does not eliminate the need for political leaders to make decisions in areas where full support may not be forthcoming. In the end, politicians still have to take risks—and if they fail, their opponents will obviously try to capitalize on those failures.

Complex reforms

The third lesson relates to the special challenges posed when attempting second generation reforms, which are much more complex. This was evident in India's experience with reforms aimed at introducing private participation in infrastructure sectors such as electricity generation and distribution, telecommunications, and roads. It was evident in the early 1990s that India had huge infrastructure gaps and that the gaps could not be filled through a strategy based purely on public investment. Infrastructure services had traditionally been delivered by government-owned suppliers that charged very low user fees and so did not generate adequate resources within the system. The government's fiscal situation did not allow it to cover the resources shortfall, making the system inherently unsustainable. Thus a change in policy was essential.

One way of solving these problems was to end the public sector monopoly and open these sectors to private investment. This approach was readily accepted, but the complexity- of the reforms needed to achieve it was not recognized. There was a tendency to think that if only private entry were allowed, India would be flooded with new investors setting up infrastructure projects. The technocracy was aware that enabling reforms would be needed, but in retrospect I do not think that we appreciated the extent and complexity of the preconditions needed to attract private investment in infrastructure.

Let me illustrate by describing what happened in the case of electricity. Initially, the policy aimed at attracting private investors into the generation of electricity without addressing the lack of financial viability of the distribution segment. Distribution, which was a public sector monopoly, suffered from an unviable tariff structure that charged some consumers far less than the cost of power. Public distribution companies also suffered from large-scale under-collection due to a combination of operational inefficiency and corruption in the form of deliberate under-billing. The effort to attract private investors to sell power to financially bankrupt monopoly buyers could succeed only if the government guaranteed power purchases, and there was a flood of applicants seeking to set up plants backed by such guarantees.

Although state governments were willing to provide guarantees, their weak financial positions typically made investors seek counter-guarantees from the central government, which initially resisted giving them. In the end some limited guarantees were given, but many of these plants ran into other problems.

The World Bank Group—especially the International Finance Corporation (IFC)—was actively involved in this process, and it pushed for the structural changes needed to allow private players to operate in the power sector. But I think it is fair to say that the Bank Group also underestimated the complexity of such reforms. For example, I remember being told

on many occasions that India was insufficiently sensitive to the needs of private actors in the power sector, and Pakistan's Hub River Project was frequently cited as a model of effective private participation. Yet that project has since become an example of everything that can go wrong with project design.

Even when the focus shifted to privatizing electricity distribution under the supervision of a statutory regulator, there were unexpected problems. In Delhi, for example, when a regulator was finally put in place, it laid down regulations for determining power tariffs on the basis of a cost-based tariff structure. Although such structures are not perfect, they are quite common. But the initial regulations did not generate confidence among private sector players. The regulations listed the various factors to be taken into account in determining costs—but they also stated that in exceptional circumstances, regulators could depart from any of them. Such omnibus clauses giving governments a great deal of power are readily accepted in a public sector framework, since public utilities can appeal to the government to take a reasonable view. But when a private utility is expected to provide \$1 billion in investment—\$800 million of which is going to be borrowed—tariff regulations containing such large potential for arbitrariness are unlikely to be acceptable.

India also had problems introducing private participation in telecommunications, but with somewhat different results. Again, the initial policies for attracting private investment did not take adequate account of the complexities involved. In telecommunications, low tariffs were much less important than in electric power because long-distance telephone charges were too high to start with, and private investors were quite willing to enter the market because they knew that consumers would be willing to pay for their services.

But there were other problems. First, investors wanted a regulatory environment that would ensure interconnection with the incumbent service provider on reasonable terms. A regulator was established, but it did not have sufficient powers to enforce a level playing field for private investors relative to the incumbent. Second, investors initially bid unrealistically high fees for telecommunications licenses and soon complained that revenue streams would not support such high payments. This led to demands to renegotiate the license fees, because otherwise the new system would not be sustainable. Not surprisingly, there was severe criticism that changes were being made in response to lobbying by the private sector—which they were. But the government felt that enforcing the original conditions was impractical, because it would lead to prolonged legal wrangles as well as service interruptions for many consumers.

In the end the problem was resolved by restructuring the regulatory authority, increasing its powers and converting the payments to be made by licensees into a share of revenues instead of fixed license fees. The evolution of policy in this area can be described as a kind of learning by doing, adjusting policies that were not quite right in a series of steps. This was obviously not ideal, but unlike with electric power, private participation in telecommunications succeeded. Capacity expanded considerably, and there were visible improvements in the quality and supply of services, as well as a reduction in their cost.

To summarize, reforms in infrastructure development were generally much more complex than we had expected, and the results therefore varied across sectors. In some sectors, such as electric power, we faced problems from the very beginning that continue even today. In others, such as telecommunications, there was a process of periodic adjustments in policy that were controversial at the time but appear to have worked in the end. It is tempting to think that by anticipating sufficiently, one could ensure a policy design that would avoid problems subsequently. In practice however, it is difficult to hold back initiatives because their design is imperfect—especially if many participants are keen on making progress. Some learning by doing is therefore unavoidable, and it is important to retain flexibility in policy to allow for such improvements.

The importance of sequencing

Because reforms in some areas are essential to success in others, broadly based reforms require that careful attention be paid to sequencing. This becomes even more important

when a gradual approach is used, because gradualism inevitably reduces the effectiveness of other reforms. If gradualism means fitful progress, as was the case in India in many areas, then correct sequencing is that much harder to achieve because reforms in some areas may be held up by unexpected opposition. In hindsight, Indian policy toward sequencing got it right in some cases and wrong in others.

An interesting example of sequencing problems relates to the need to remove domestic distortions before, or at least at the same time as, lowering external barriers. India got this sequencing right in one sense, because domestic industrial liberalization was implemented much earlier than external liberalization. However, there were important exceptions. The policy of reserving certain items for production by small-scale industries was a domestic distortion that should have been eliminated well before external liberalization. But doing so proved politically difficult, and all that could be achieved was a progressive reduction in the list of reserved industries. Over 10 years the reserved list was cut from about 800 to 500.

A faster pace would have been more logical and would have helped these industries adjust sooner to the new, more competitive environment. To realize the competitive potential of exports such as garments, toys, and leather goods—areas where China has done incredibly well—Indian producers should have been allowed to produce on larger, more credible scales. Technocrats recommended such changes in the mid-1990s, but political constraints prevented the government from making them. Indeed, only in 2002 were significant adjustments made in this area.

An area where India got sequencing right was liberalization of the capital account. Many countries have liberalized capital flows before developing a strong financial sector, and suffered as a result. India avoided this problem. It had traditionally followed restrictive policies toward external debt. The government never borrowed abroad, and commercial organizations could not incur external debt without government permission—and the government was very restrictive in granting such permission. It also did not allow commercial organizations to take on short-term loans, only long-term, and even those were subject to a global limit determined by the minister of finance.

In the mid-1990s, when there was ample liquidity in world markets, there was a lot of pressure from domestic businesses to liberalize policies on capital flows. That is pretty much what happened in East Asia, and a lot of the instability that arose there in 1997 was the result of huge amounts of short-term external debt having been incurred. India avoided that problem because its decision to liberalize the capital account remained essentially cautious.

This caution did not stem from a desire to avoid change. Indeed, in late 1996 the government appointed an expert committee, headed by a former deputy governor of the Reserve Bank of India, to examine how the capital account should be liberalized. The committee's report, submitted before the East Asian crisis, recommended that India liberalize the capital account in a gradual manner, with appropriate sequencing. The sequence proposed was to first liberalize foreign direct investment, because it is the least volatile, and portfolio investment, because such investment is a little more self-regulating. Investors are less likely to make sharp reversals in portfolio equity flows because stock markets are likely to collapse if they do. The report was emphatic that short-term flows should not be liberalized until the fiscal deficit was brought under control and the banking system was made much stronger. This was good advice that was followed by the government.

Liberalization and State governments

The next lesson involves the extent to which the role of sub-national governments becomes more important in a liberalized environment. Earlier, the central government's control over private investment decisions enabled it to spread resources thinly across Indian states. But in a liberalized environment, resources will flow to states where conditions are considered most favourable for private investment.

This tendency was heightened by the fact that state governments responded very differently to

liberalization. More enlightened states aggressively adopted investor-friendly policies, trying to attract both domestic and foreign investors. Less enlightened states were laggards in this respect. Some of the poorest states, which have the largest populations, grew slower in the 1990s than in the 1980s. So, while India as a whole experienced faster growth, many important states saw a deceleration. This was not because the central government followed a discriminatory policy. Unlike in China, India's liberalization was not geographically selective. But states responded differently, causing an increase in inequality between states.

This outcome had predictable consequences. It generated pressure on the central government to adopt a more proactive approach to ensure more egalitarian growth processes. Although this objective was widely supported, it was not entirely clear what the central government should do. It could provide more money to slower-growing states, but its resources were limited. Another question was whether additional resources provided to poorly performing states should be unconditional transfers, on equity grounds, or whether they should be linked to efforts that would improve performance. Implicit in the latter approach is the notion that additional transfers to poorly performing states should be linked to greater conditionality. This is a controversial issue, and hard decisions of this type cannot be avoided indefinitely.

The key lesson in this area was that economic liberalization implies that unless state governments actively engage in reforms, the potential benefits of liberalization may not materialize—and that state governments that do not change their approach will actually see a deterioration in economic performance, because of the competitive environment created by reforms. This simple fact took time to sink in, though I am happy to say that it is now much more widely recognized.

Implications for poverty reduction

Finally, India's experience provides some useful lessons on poverty alleviation. It shows that growth is good for poverty alleviation. Poverty did not decline in India in the 1970s, when growth was weak, but it did decline in the 1980s and 1990s, when growth was strong. India is blessed with a wealth of survey data on consumption levels—and an even larger endowment of people willing to analyze it! As a result there is a rich, diverse literature from which you can probably prove whatever you want if you choose your data and analyst appropriately.

That said, a general consensus has emerged. Most experts who have thoroughly examined the issue—including independent international experts such as Angus Deaton—have concluded that not only did poverty decline in India in the 1980s and 1990s, but also that the decline was greater in the 1990s. Poverty did not decline as much as was targeted, but growth also did not reach the levels associated with those targets.

An important issue in the Indian debate is how much reliance should be placed on poverty reduction induced by growth as opposed to poverty reduction resulting from targeted antipoverty programs. India has used both strategies. It has relied heavily on growth and, furthermore, on growth of a particular quality, with an explicit emphasis on the need to accelerate income generation in agriculture. This is not to say that it has achieved this goal. In fact, one of the disturbing facts about India's recent economic performance is that the momentum of agricultural growth was lost in the second half of the 1990s, and this slowdown is part of the reason why there has been dissatisfaction with the equity' aspect of recent reforms. However, while this surfaces as an equity' issue, it is as much a failure of the growth component of the strategy.

India has also relied on a wide variety- of targeted antipoverty programs. These programs are limited in scale but play an important supporting role—because there can be little doubt that the bulk of the reduction in poverty has occurred because the benefits of growth have spilled over sufficiently to poor people.

The main lesson I draw from this experience is that growth helps poverty- alleviation and should be as pro-poor as possible. In India, where a large portion of poor people are in rural areas, this means paying special attention to policies that stimulate agricultural growth and non-agricultural economic activity - in rural areas. The poverty-reduction strategy has not been very effective in this respect in recent years given that agricultural

growth slowed in the mid-1990s.

Although it is beyond the scope of this lecture to provide answers on why this has happened, there is growing consensus on many issues relevant in this context. India's approach to agriculture has depended on a combination of subsidies and public investment. Over time, subsidies have expanded while public investment has fallen. This approach should be reversed, with fewer subsidies and more public investment, especially in irrigation and rural roads. In addition, policies should encourage agricultural diversification and agro-processing. I am not sure that we have all the answers yet. Careful analysis is needed to devise a workable package of reforms, some the responsibility of the central government but many requiring action by state governments.

While on the subject of poverty; I would like to comment on some aspects of poverty" reduction as a policy objective where there are interesting differences of perception between policymakers in developing countries and international institutions such as the World Bank and other multilateral development banks. The international institutions focus on poverty- alleviation as the overriding objective of policy and are often inclined to view all policy choices from the perspective of what they do for poverty-alleviation. This is understandable because the mandates of these institutions, as defined by the development community" in industrial countries, define poverty' alleviation as the principle international public good that the institutions are meant to promote. Allocation of public resources to these institutions is justified largely on this basis. But policymakers in developing countries necessarily have multiple objectives. Poverty alleviation is clearly one of the most important in low-income countries, but other objectives—such as economic development and achievement of middle-income and ultimately industrial country status—are also important. And these go beyond poverty alleviation, narrowly defined.

This has a number of interesting consequences. First, an exclusive focus on poverty alleviation can lead to a bias in favour of interventions that directly affect poor groups in the short run in a measurable manner, compared with other interventions that have either an indirect (and so not easily measured) impact or a positive impact but over a long time horizon. Since resources are scarce, it is important to recognize the opportunity costs of direct interventions. In India, for example, investments in land development, irrigation, and rural road connectivity may not appear to affect poverty directly because their benefits accrue to the rural population generally. But the net results in terms of impact on poor people may be substantial. It is important that broader infrastructure investments not be short-changed by an excessive concern with targeting.

Another area of difference between multilateral development banks and practical policymakers is that distributional concerns cannot be limited to the issue of the impact on poverty. Multilateral development banks tend to treat this issue as the only relevant distributional concern. But this does not reflect the compulsions of practical politics: policymakers have to be concerned with broader distributional concerns. It is perfectly possible to envisage a growth process that reduces poverty- but increases relative inequality, or the urban-rural divide, or regional inequality; Any of these could become a political problem and would need to be addressed.

Consider a situation where a policy change has no impact on poor people, or is even marginally favourable, but has a churning effect on the distribution above the poverty line—with some groups that were higher up in the distribution pushed down and some lower down pushed up. This may leave the distribution statistically unchanged, but the "impoverishment" of some groups above the poverty line would entail a political price.

All this suggests that politicians have to work with complex objective functions. Ideally, a politician would like to claim that policy reforms have helped poor people, and indeed that every group and region has also benefited.

These are some of the lessons uppermost in my mind as I reflect on India's experience over the past two decades. Some are certainly relevant for policymaking in India in the years ahead.

Note

ⁱ The change of government in 2004 has brought a further modification. The new government has indicated that it will not privatize profit-making public enterprises. But privatization of loss-making enterprises remains an option, as does the sale of minority holdings in profit-making enterprises.