

# David Finch Memorial Lecture at Melbourne University, Australia on September 22, 2005

## India's Experience with Globalisation

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### 1. Introduction

It is a privilege to be invited to deliver the David Finch Memorial Lecture. I spent about 11 years in Washington, DC between 1968 and 1979 as a staff member of the World Bank but never met David Finch in this period, though he was well known to us by reputation as one of the most influential senior staff members of the International Monetary Fund (IMF). It was only after I returned to Washington, DC in 2001, as the Director of the new Independent Evaluation Office of the IMF, that I came into personal contact with David. He took the initiative to get in touch with me to say that he thought it was very important that the work of the IMF be subjected to independent evaluation.

He was particularly concerned about the need to ensure that shareholders of the IMF did not interfere with technical work of the staff. He recognised of course that all shareholders, as sovereign governments, had the undisputed right to press their position at the Board, but they should not interfere at the stage where technical assessments were being made by the staff. Those familiar with David Finch's career know that he resigned from the position of Director of the Exchange and Trade Relations Department of the IMF in 1987 in protest against what he felt was pressure from the major shareholders on the staff to support weak programs in Egypt and Argentina. This was particularly interesting for me because one of the first evaluations we undertook was of the role of the IMF in managing the East Asian crisis where the IMF was criticised for being too tough and many observers claimed that tough conditionality was being imposed at the instance of the shareholders. The wheel had clearly come full circle since then. Whereas David had protested against being pressured to be soft, 10 years later the complaint was that influential shareholders wanted the IMF to be too tough!

My initial purely professional contact with David became more personal when I persuaded him to lend me a copy of his unpublished autobiographical memoir 'From Werribee to Washington'. I was particularly struck by his description of his childhood in a farm in Werribee, not far from here, where he lived in a house which did not have any electricity or running water. It struck me as remarkable that a top official of the IMF, from a now industrialised country, had a childhood which would have made him at least a little bit aware of what conditions were like in the developing countries he dealt with. I venture to suggest to the organisers of this lecture that they should consider publishing this memoir. I have no doubt it will attract interested readers.

The subject of my lecture —India's experience with globalisation—appears to depart somewhat from the guidelines for the lecture which state that it must be on 'evolving practices and principles and related issues pertaining to international, monetary, financial and trade cooperation'. Earlier lectures in this lecture series have followed the guidelines scrupulously and focused on the functioning of the international system and not on individual countries. And yet, many of the questions that have come to the fore in recent years relate to whether the international trade and financial system functions in a manner which gives the developing countries a fair chance or not, and these can only be examined by looking at individual cases. This lecture is therefore devoted to examining India's experience in the transition from a relatively closed economy to one that is much more open to trade and financial flows and especially to considering how far some of the fears and criticisms that are typically raised about the dangers of globalisation are valid in India's case.

The remainder of the lecture is divided into four parts. Section 2 comments very briefly on the nature of India's reforms and some commonalities and differences with other countries. Section 3 presents an overview of the effectiveness of the reforms in various dimensions, particularly growth, poverty reduction, employment generation etc. I will argue that India did reasonably well during this reform period on most relevant dimensions, but not in all and also not as well as it had targeted. Section 4 provides some explanation of why there were shortfalls in the reforms compared with expectations. Finally, Section 5 considers what this implies about India's future prospects.

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## 2. India's Economic Reforms

I do not propose to provide a full account of all the reforms undertaken in India—a detailed exposition is available in Ahluwalia (2002). However, the principal areas in which reforms were initiated are listed in Table 1 and the point I wish to emphasise is that the reforms were multidimensional. It was necessary to make changes on many fronts to break away from the earlier approach which was characterised by extensive government control over private sector activity, a preferred position for the public sector over the private sector, high levels of protection to encourage domestic production and a restrictive approach to foreign investment.

The change occurred because it had become obvious by the mid-1980s that India's growth performance in the two decades from 1960 to 1980 was disappointing. India grew at about 3.5 per cent per annum against the target of 5 per cent. Countries in East Asia were seen to be doing much better by following somewhat different policies. These countries provided a less rigidly controlled environment for the private sector and instead of relying on import substitution for an extended period as India did, these countries were taking advantage of the tremendous opportunities provided by world trade to expand exports of labour-intensive manufactured goods. It was evident that India could also reap these benefits but to do so it would have to initiate domestic decontrol and also move to greater trade openness. Domestic decontrol and openness to foreign trade and foreign investment are two different things because one can imagine an economy that is domestically deregulated but shielded from the outside world by high levels of protection. The reforms involved movement in both areas with domestic decontrol generally occurring earlier and being completed faster than external liberalisation. Trade liberalisation was accompanied by a movement to a flexible exchange rate which allowed a gradual exchange rate depreciation to offset the effects of import liberalisation and tariff reduction.

Liberalisation of policies towards foreign direct investment (FDI) was an important part of the strategy of opening up the economy. Prior to the reforms, foreign investment was viewed with some suspicion, and was permitted only very selectively. This changed dramatically in the 1990s, with foreign investment being welcomed and later actively sought in a wide range of sectors. A distinction was made between FDI, which involved setting up new capacities, and portfolio investment, which involved buying equity in existing companies through the stock market. FDI was generally viewed as a preferred form and these inflows were liberalised early in the reform, while the liberalisation of portfolio flows took place a little later.

The reforms also brought about a change in perceptions about the role of the public sector. Areas that were previously reserved exclusively for the public sector (for example, steel, petroleum, air transport, telecommunications and certain types of mining) were thrown open to the private sector. However, unlike many other developing countries, India did not enthusiastically adopt the policy of privatising existing public sector enterprises in the sense of handing over management control. Instead, privatisation was limited to selling minority stakes in public sector enterprises, while retaining management control. In 1999, the National Democratic Alliance (NDA) government that was then in power did announce a policy of privatising public sector units by handing over management control, and indeed some units were sold in the next two years. However, there was strong resistance even within the NDA government to selling off profit-making public sector units and none of these was actually privatised. Subsequently, the Congress-led United Progressive Alliance government, which came to power in 2004, announced that it would not privatise profit-making public sector units.

Parallel with reforms in the real economy, there was also a fairly broad agenda of reform in the financial sector, including reforms in banking, non-bank financial intermediaries, the capital market and insurance and pension funds. In each of these areas, the general strategy of reform was to proceed on two fronts. One was to promote efficiency by liberalising controls and providing a greater role for the private sector and market forces. The other was to promote financial stability through the introduction of prudential norms with independent financial regulation. These efforts at financial sector reforms were to be underpinned by an effort to reduce the fiscal deficit in order to create a macroeconomic environment that would be conducive to financial stability and would also encourage investment.

An area of reform which was recognised as important, but in retrospect can be said to have received less attention than it deserved in the initial stages, related to economic infrastructure—that is, roads, airports, ports, electric power, telecommunications, railways etc. These sectors produced essential inputs for growth which were non-tradable and therefore could not be imported and had to be produced domestically in sufficient quantity and quality. The scale of investment needed in Indian infrastructure development was massive and it was recognised that this could not be done solely through public investment. The strategy therefore relied upon attracting private investment but the complexity of what needed to be done was

underestimated, with the result that progress in this area has been inadequate. I shall return to this point later in the lecture.

### **Table 1 The Reform Agenda**

#### **Domestic deregulation**

- (i) Abolition of industrial licensing as an instrument of control over private investment.
- (ii) Abolition of the restriction on investment by large industrial groups.
- (iii) Drastic reduction in the list of industries reserved for the public sector.
- (iv) Elimination of price control on several industrial items.
- (v) Reduction of the list of items reserved for production in the small-scale sector.

#### **Opening the economy**

- (i) Elimination of quantitative import licensing.
- (ii) Reduction in import tariff levels.
- (iii) Adoption of a flexible exchange rate regime.
- (iv) Opening the economy to FDI and to portfolio equity flows.

#### **Financial sector reforms**

- (i) Reforms in the banking sector: liberalisation of interest rate controls and controls over bank credit allocation: introduction of prudential norms and improved supervisory standards; liberalisation of entry for private banks; and introduction of minority private share holding in public sector banks.
- (ii) Reforms in the capital market: elimination of government control over the issue of capital; establishment of an independent regulator for the securities market; and opening the mutual funds sector for private mutual funds.
- (iii) Reforms in insurance: opening the sector to new private sector insurers but with a cap of 26 per cent in foreign equity.

#### **Infrastructure development**

- (i) Adoption of a general strategy for public-private partnership in developing infrastructure.
- (ii) Efforts to open up the following sectors under varying regulatory structures: power, telecommunications, roads, ports, airports and, most recently, railways.

#### **Fiscal reforms**

- (i) Reducing the fiscal deficit of both the central and state governments.
- (ii) Tax reforms at the central and state government levels including moderation of rates of tax, simplification and introduction of VAT principles in domestic indirect taxation by the central government and more recently by state governments also.
- (iii) Sale of minority equity in public sector organisations to mobilise resources for the budget.

In broad terms, the reforms undertaken in India were similar in many respects to those attempted in other developing countries as they sought to integrate more fully with the world economy. However, they were not entirely in line with what is usually characterised as the Washington Consensus. On privatisation for example, they were distinctly different. More generally, they were also much more gradual in implementation than in most other countries, and I will have more to say on this a little later.

### **3. Outcomes of Reform**

I now turn to assess the outcome of India's reforms. It is relevant in this context to note that the ongoing debate on globalisation in the world has generated considerable scepticism in many quarters about the policies of liberalisation associated with globalisation, and also a suspicion that these policies in many developing countries have not had the favourable results expected, and in many cases they have actually had a negative impact. Is this true of India? To address this question it is useful to highlight the objectives against which performance should be

judged.

I can discern at least six distinct objectives which a political leader in India would want to endorse. First, he or she would want the growth rate of GDP to accelerate since that is a necessary requirement to transit from India's current very low level of per capita income to levels consistent with improving the material conditions of the bulk of the population and 'catching up' with the levels of well-being experienced in the more developed parts of the world. Second, in a very large and regionally diverse country like India, a political leadership wishing to deliver broad-based support would also want to ensure that growth accelerates in all, or at least most of, the major states. Third, poverty reduction is bound to be viewed as a prime objective given that around 45 per cent of the population—and therefore also of voters—were below the poverty line in the mid-1980s. Fourth, employment generation is a major issue in any assessment of performance. Fifth, policy makers are inevitably also concerned about inequality. The international development community often defines development objectives exclusively in terms of poverty reduction and this sometimes leads to the implicit suggestion that inequality per se is not important. In actual practice, however, policy makers cannot ignore inequality, at least not beyond a point. Finally there is the elusive concept of 'fairness'. Policy makers have to be able to claim that the development outcome, which may fall short on many counts, was on the whole 'fair'. I have said that these are distinct objectives and indeed they are since it is perfectly possible to imagine some of these being met while others are not. Let us consider briefly how India's growth experience appears on each count.

### 3.1 GDP Growth

It is perhaps easiest to assess what happened to economic growth. Table 2 presents available data on GDP growth for the 1980s and for the period from 1990 to 2005 for India and a group of emerging market countries. I have already mentioned that in the two decades prior to 1980, India's average economic growth rate was only 3.5 per cent. In the 1980s, when the reforms began, there was a substantial jump in the average growth rate to 5.8 per cent. This was followed by a mixed pattern in the next 15 years. If we take the five-year period 1992 to 1996 after the reforms, the growth rate averaged a respectable 6.7 per cent. It slowed down to an average of only 5.5 per cent in the next five-year period 1997 to 2001, after which it picked up averaging about 6.7 per cent again in the period 2002 to 2005 (assuming 7.5 per cent growth in the fiscal year 2005-06).

**Table 2 Growth Rates of GDP**

<i>Country</i>	<i>Average 1980-1991</i>	<i>Average 1992-2005</i>	<i>Country</i>	<i>Average 1980-1991</i>	<i>Average 1992-2005</i>
India	5.4	6.3	Philippines	1.9	3.7
China	9.2	9.7	Argentina	0.0	3.1
Malaysia	6.5	6.1	Colombia	3.4	2.9
Chile	3.9	5.6	Mexico	2.8	2.9
Thailand	7.8	4.4	Hungary	0.0	2.8
Poland	-1.1	4.2	Brazil	2.2	2.7
Indonesia	6.0	4.2	South Africa	1.8	2.6
Pakistan	6.1	4.2	Czech Republic	0.9	2.1
Peru	0.3	4.1	Venezuela	1.5	1.8
Turkey	4.3	4.0	Russia	2.8	-0.1
Egypt	4.8	4.0			

*Source: IMF Database.*

An interesting difference between the 1980s and the subsequent period is that India's ranking compared with other countries improved substantially in the second period. China was the clear leader in the growth league in both periods and by a very large margin, but India's performance improved substantially in the second period and is better than all the other

emerging market countries.

While India's growth performance improved in the second period, it is also true that it fell short of expectations. This is because the acceleration in growth in the initial post-reforms period led to more ambitious growth targeting. The achievement of 6.7 per cent growth between 1992 and 1996 led the government to target 7 per cent growth in the next five years, and the target was raised further to 8 per cent for 2002-2007. However, these growth rates were not achieved. Disappointment on this score is understandable, but it needs to be sharply distinguished from the pessimistic assessments of anti-globalisers who argue that reforms in developing countries have had negative effects, including a collapse in growth. This may have happened in some developing countries, but it was clearly not the case in India. India's growth performance was disappointing only because the targets set were higher and not in comparison with the past.

### **3.2 Interstate Growth Performance**

Was the growth process equally strong across all states? This is an important question in a country where politics is increasingly regionalised and the short answer is that it was not. Several states experienced accelerated growth but some accelerated much more than the average.<sup>1</sup> Interestingly, it was not the richest states that experienced the fastest growth. Two of the richest states, Punjab and Haryana, actually experienced a deceleration of growth in the 1990s compared with the 1980s. Some of the middle ranking states in terms of per capita incomes were the ones that benefited most from the new regime and these states actually reduced the gap between their per capita incomes and those of the richest states. The real weakness in performance in this dimension was that some of the poorest and most populous states actually decelerated. The political implications of this phenomenon in a democratic polity can be easily imagined.

It is not difficult to understand why liberalisation and economic reforms led to this outcome. The pre-reforms policy regime effectively controlled both private and public investment, and could direct investment into areas that were deemed to be economically backward in the hope that this would help industrialise backward areas. However, since these were typically areas that did not have adequate infrastructure, connectivity and human resources, this policy led to a loss in productivity and therefore potentially higher growth. In effect, a more regionally balanced growth was obtained at the cost of lower growth for the economy as a whole. With the removal of such controls over investment, one would expect a reallocation of investment towards the better endowed states and the higher productivity of such investment could lead to faster overall growth but with less regional equity.

This is not to say that liberalisation necessarily means a reallocation of investment in favour of better placed states. While initial favourable endowments could help, investment would also flow towards states which respond to the liberalised environment by creating a more favourable investment climate. There is little doubt that individual states have responded differently to the economic reforms and this has been reflected in their ability to attract investment. There are examples of states that were not favoured earlier, but where state governments have worked actively to create a more investment friendly environment, and have been able to attract more investment. Andhra Pradesh and more recently Orissa and West Bengal are examples of states that have successfully changed their image in the eyes of investors.

It is interesting to note that several of the leading industry organisations and think tanks now undertake annual exercises ranking states according to their investor-friendliness, or infrastructure quality, etc. This has helped raise consciousness among the states of the need to present an investor-friendly picture and many states are competing actively in this dimension; a change of attitudes which could lead to a more even spread of benefits in future.

### **3.3 Poverty Reduction**

The third dimension in which India's performance needs to be evaluated relates to poverty reduction which has long been recognised as a core objective in India. The view is often expressed, both internationally and in India, that liberalisation has done little for the poor, and may even have made things worse. Is there any basis for such a conclusion?

India is in some ways very well endowed for making assessments of trends in poverty over time because of the existence of a remarkable database in the form of a series of periodic broadly comparable household consumption surveys conducted by the National Sample Survey Organisation over several decades. Unfortunately, this abundance of data is accompanied by an even more generous endowment of economists keen to interpret it in different ways. This has led to a large number of studies, each differing from the other in some respects and coming to somewhat different conclusions. I will not go into all the interesting points that have been made in the debate on trends in poverty in India, on which the interested

reader is best referred to Deaton and Kozel (2005). The main point I wish to make is that there is now a consensus that poverty in India, as conventionally measured in terms of a fixed poverty line measured in real consumption per capita, has clearly declined. From 45 per cent of the population below the poverty line in 1983, the percentage declined to 36 per cent in 1993 and further to 26 per cent in 1999<sup>2</sup>—a 20 percentage point decline in 17 years, or a little over one percentage point per year. The decline in poverty was not as fast as the government had targeted, but that should not be a surprise because (i) the growth rate was also less than what was targeted and (ii) growth in the agricultural sector, in particular, was well below target, indicating a sectoral policy failure which needs to be corrected. On both counts, the failure to reduce poverty was at least in part due to failure to achieve growth.

Despite these data, the perception remains widespread that there has been relatively little progress in poverty reduction and it is relevant to ponder why. One reason could be that the definition of poverty used in various studies differs widely from that in people's minds for the purpose of public debate. The poverty estimates are based on a narrow definition of poverty, in terms of a poverty line fixed in 1971 in terms of real consumption per head. This poverty line represents a bare nutritional minimum and a poverty level that was reasonable in 1971 may not appear reasonable today when per capita incomes have risen substantially.

The extent of poverty based on a broader definition of poverty relating to the percentage of the population deprived of access to essential services is likely to be much larger than 26 per cent. For example, malnutrition among children below 5 years of age is as high as 47 per cent. This figure may be quite consistent with poverty based on per capita consumption being only 26 per cent if there is intra family inequality (for example, neglect of nutrition for children especially the female child). It is also possible that inadequate access to other essential services, notably clean drinking water and sanitation, perpetuates health problems such as diarrhoea, which contribute to malnutrition even when food intake is otherwise sufficient.

There are other forms of deprivation which are also relevant for defining poverty. For example, although school enrolment rates have increased to about 95 per cent, as many as 35 per cent of children do not complete primary school. In another dimension, more than 60 per cent of women give birth to children without the benefit of a skilled attendant. The percentage of households with access to latrines is only about 30 per cent. If we define poverty more broadly in terms of these dimensions the percentage of the population in poverty will be much higher than 26 per cent. This is not to deny that the decline in the percentage of the population below a consumption level fixed in real terms is a very substantial achievement. It is only to state that it is not enough, and similar improvement is needed in other relevant indicators also to claim that progress is being made in poverty reduction. In other words, rising income and consumption levels may not be enough. They need to be supplemented by specific strategies that would ensure that essential public services reach the poor, and although there is progress in this dimension also, the percentage of the population that is deprived is larger than that below the poverty line.

### **3.4 Growth of Employment**

A fourth dimension of performance that is relevant is what has happened to employment growth. While the data on poverty indicate a clear decline in poverty, the data on unemployment show a more mixed picture. In fact, the unemployment figures in India in the 1990s show a very marginal increase from about 6 per cent in 1993 to about 7 per cent in 1999. However, the data suggest that real wages in rural areas increased at about 3.6 per cent per year in the same period, more or less comparable with the growth rate of GDP per capita. In other words, over a 10-year period, real wages increased by around 42 per cent. It is difficult to take a firm position on employment outcomes based on such a marginal increase in unemployment especially when it is accompanied by a fairly respectable increase in real wages.

A feature in employment trends which is a legitimate cause of concern is the deceleration in employment growth in the so-called 'formal sector'. This sector accounts for only about 8 per cent of total employment, but it represents the pool of high quality employment, with an element of job security and social security benefits. This is the type of employment which the increasingly educated new entrants to the labour force aspire to get and inadequate growth in this type of employment is bound to be seen as a negative feature. Employment in the government was expected to decline, reflecting gross overmanning, and a decline was also expected in public sector corporations which had excess labour and are now under competitive pressure from private sector producers to reduce costs. However, shrinkage of employment in these areas was expected to be offset by an expansion of employment in the private organised sector. This has not happened as much as was expected, especially in the past few years when the deceleration in growth of organised sector employment has been converted into an actual decline in absolute terms.

As in other countries, the fear of 'jobless growth' is a problem that needs to be addressed urgently.

It is interesting to note that although much of the public debate focuses on the need for a different growth strategy, it can be argued that the solution actually lies in accelerating growth. Had GDP grown at 8 per cent as targeted after 2002, employment growth would have been higher. The failure to achieve higher growth is to a substantial extent due to the failure to achieve more rapid growth in manufacturing. Instead of growing at 10 per cent per year as targeted, manufacturing sector growth has been only around 7 per cent. Later in this lecture I shall examine some of the reasons why this may have occurred, but the point to note at this stage is that faster growth in manufacturing would have generated faster growth in organised sector jobs.

### **3.5 Trends in Inequality**

The fifth dimension of performance which needs to be assessed is whether inequality increased. Unfortunately, we do not have reliable data on the personal distribution of income. The only reliable time series data available are on the distribution of consumption and this shows only a marginal increase in consumption inequality in the post-liberalisation period. According to available data, the Gini coefficient in China is 0.42 whereas in India it is only 0.32. Of course static measures of ex post inequality tell only one side of the story. One can argue that what is really important is the equality of opportunity which measures ex ante equality. On this view the same ex post inequality may be much more acceptable if it arises from a situation where there is more ex ante equality of opportunity. Unfortunately, we have no reliable measures of these important dimensions of performance.

### **3.6 Fairness of the Development Process**

Finally, it is relevant to assess the quality of the growth process in the post-reform period in terms of an omnibus criterion: is it seen to be fair by the public at large? This is obviously the most difficult question to answer because it is very difficult to measure such perceptions and while all the quantifiable indicators discussed above are obviously relevant they are not exhaustive. In the aftermath of the general election in India in 2004, which led to a change in government, there was much discussion on why the NDA government lost the mandate. One view was that it campaigned under the slogan 'India Shining' implying that India was doing very well, whereas the electorate clearly thought otherwise. It was commonly said that the growth process was seen as favouring the elite, and ignoring rural areas.

It is obviously difficult to analyse the reasons for any particular election outcome. The electorate in a democracy is moved by several considerations and in a large country there would be regional differences also. Besides, in a multiparty contest, the final outcome in terms of parliamentary seats also depends critically upon election alliances. However, it can be argued that there were aspects of economic performance which created a perception of unfairness in large sections of the population. Agricultural GDP, which grew at an average rate of 3.6 per cent between 1980 and 1996, slowed down thereafter to a trend rate of less than 2 per cent in the next eight years up to 2004. Since 60 per cent of the population depend on agriculture as their major source of livelihood, it should not be surprising if such a marked deceleration of growth in agriculture, without any large shift to non-agricultural income sources, leads to resentment in rural areas. The fact that some of the poorer and more populous states did not fare well under the reforms and also the fact that younger voters perceive inadequate growth in organised sector employment would only add to the sense of unfairness.

### **3.7 Summary**

Let me now present a summary assessment of India's experience in its transition to globalisation over the past 15 years or so. India's experience was clearly very different from the pessimistic perceptions and projections of the anti-globalisers. The overall growth performance improved significantly and poverty as conventionally measured also declined. But it is also true that the achievements in these dimensions were less than was expected and there were distributional problems. The benefits of growth were not seen to be evenly distributed among different states and some of the poorer and most populous states actually experienced a deceleration in growth. The picture on employment levels is mixed. There was a marginal increase in unemployment but a very robust increase in real wages. However, growth of organised sector employment decelerated and in recent years even declined. There is evidence that rural areas did not share adequately in growth as agriculture decelerated significantly after the mid-1990s.

## 4. Reasons for the Shortfall in Performance

I now turn to the issue of why performance fell short of expectations in some respects. Three different types of explanations are relevant: first, the reforms were implemented too slowly, leading to a less than expected impact; second, the reforms in some areas were not well designed, leading to ineffectiveness; and third, some of the reforms that were essential were not undertaken. I will touch briefly on each of these.

### 4.1 *The Pace of Implementation*

The issue of the pace of implementation of reforms in India has been much discussed in the Indian literature. It is reasonable to argue that the reforms listed in Table 1 are so comprehensive that if they had been implemented effectively in a relatively short time, the growth rate should have been even higher than it was, which in turn would have led to greater poverty reduction and a faster growth in employment. However, the pace of reforms in India was inevitably affected by India's democratic polity. India is a very large and very diverse country, with a highly pluralistic and very participative democracy and this is not an environment in which policy changes can be mandated from above on purely technocratic grounds. They require a process of political consensus building which often takes time. This is especially so since parliamentary democracy is an adversarial form of government in which political parties in opposition have no incentive to support the consensus. A slower pace of implementation in turn delays the flow of benefits.

The point can be illustrated by the pace at which trade policy reforms were implemented. This is perhaps the area where there was a wide consensus in technocratic circles but, nevertheless, changes occurred only slowly. In 1991 the government announced its intention of removing import licensing as a method of import control and shifting to tariffs, and also bringing tariffs down gradually. However, while import licensing for raw materials and even for capital goods was abolished within the first two or three years, it remained in place for all consumer goods for many years thereafter.

India's potential competitiveness in world export markets was primarily in the simpler manufactured consumer goods, but because India had in the past deliberately followed a policy of encouraging small scale producers in large parts of the consumer goods sector, there was reluctance to expose this sector to import competition and a corresponding delay in its restructuring to gain competitiveness. It was only in the year 2001, fully 10 years after the reforms began, that licensing control on the import of consumer goods was removed. The process of tariff reduction was also gradual. We began with an average tariff level of 128 per cent in 1991. This was brought down to 30 per cent by 1997, but this was followed by a slight reversal after a change of government at that time and average tariff levels increased to about 32 per cent by 2000. Thereafter, the trend of reducing tariffs was resumed, reaching 18 per cent in 2005. This is much higher than the average tariff level in East Asia, which is our declared objective. The slow pace of trade reforms meant that domestic industry was slow to restructure and this was all the more so because there was no predetermined schedule for the pace of opening up. The broad direction of change was clearly stated but no precise time schedule was announced. Instead, the approach was opportunistic — changes were made, generally in the right direction according to the perception of political feasibility.<sup>3</sup>

It can be argued that the slow pace of change had the effect of reducing the flow of benefits from the reforms in the early years. This certainly seems to be the case if we look at what happened to exports as a percentage of GDP. Exports of goods and services as a per cent of GDP increased from a very low level of only about 7 per cent of GDP in 1990 to about 11 per cent in 1998 and then increased more sharply to approximately 14.5 per cent by 2003. A faster pace of implementation, even within a gradualist framework, might have brought the benefits of expanding export markets earlier in time.

This is not to suggest that a faster pace of implementation is always better. The financial sector provides an example where India's decision to liberalise capital flows only at a gradualist pace proved to be a sound strategy. There was a conscious sequencing of reforms with FDI flows being liberalised first, followed by long-term external debt and portfolio investment in equity, all the while maintaining relatively tight control over short-term debt flows which have proved to be the principal source of instability in many developing country crises.

The government was often criticised for opening up the capital market far too slowly, but we felt that until the domestic banking system became strong enough, and the fiscal deficit had been brought under control, it would be dangerous to open the economy to short-term capital flows which could be potentially destabilising. The East Asian crisis in 1997, when many East Asian countries were seriously affected while India was not, vindicated the government's approach. The growth rates in Table 2 show that whereas India's growth performance in the

period 1980-1991 was distinctly lower than Thailand, Indonesia and Malaysia, the situation changed after 1997. If the post-1997 years are included, India's growth rate in the period 1992-2005 was higher than Thailand, Indonesia and Malaysia.

## **4.2 Deficiencies in the Design of Reforms**

Part of the explanation for shortfalls in performance can also be traced to deficiencies in the design of reforms. This was most evident in the area of infrastructure development. It was clear at the start of the economic reforms that to globalise successfully India needed to upgrade its infrastructure—that is, electric power, roads railways, ports, airports and telecommunications, all areas where India lagged behind East Asia. This upgrade required massive investments and, since the resources needed could not be provided by the public sector alone, the government needed to evolve a strategy for attracting public investment in these areas as much as possible.

While this strategy was readily endorsed, it can be said in retrospect that the complexity of the policy challenge was underestimated, leading to results that were disappointing. Most infrastructure sectors are limited monopolies in some respects and therefore have to be subjected to some regulation. For private investment to take place in these areas it is necessary to create an environment in which the regulatory structure is fair to investors in the sense of (i) reassuring them that they have a reasonable chance of getting a decent return provided they reach expected levels of efficiency and (ii) assuring them of fair treatment in the event of disputes between the investors and the government and also between competing suppliers, some of whom may be public sector organisations. It must also have credibility with the consumers in the sense of reassuring them that their interests are adequately protected. It is not easy to devise a policy framework that will balance all these considerations and there is no doubt that we had our share of problems.

An example of bad policy design is the power purchase agreement signed in 1993 by the Maharashtra State Electricity Board with the Enron Corporation on the Dabhol Power Project. The Dabhol project ran into problems on several counts. It was financed almost entirely by foreign debt and foreign equity and the entire foreign exchange risk was shifted to the purchaser. It was also a gas-based plant in which the price of gas was a pass through and as it happened gas prices rose sharply several years later. The power proved to be extremely expensive and the State Electricity Board, which was financially weak, in any case was unwilling to pay the high prices. It also claimed non-performance in terms of power availability. The project was embroiled in disputes almost as soon as it started producing power, leading to a triggering of guarantee claims and counterclaims, a shutdown of the plant and a long period of idling. The dispute was finally settled in 2005 with the foreign investor being bought out at a negotiated price which included a haircut.

In later years, the government realised that the priority in power sector reforms must be with addressing the financial unviability of the distribution segment since unviable distribution companies could not be viewed as credible purchasers of power even if power costs were reasonable. Efforts have now shifted to reforms aimed at improving efficiency at the distribution end. Some states are trying to do this within a public sector framework while some have experimented with privatisation. It is too early to judge whether these reforms will succeed.

Faulty policy design was also evident in telecommunications when it was first opened to the private sector in the mid-1990s. The sector was initially opened to private sector cellular operators who obtained licences based on competitive bidding for licence fees that proved to be too high since revenue generation was much lower than expectations. The private players were also not happy with the regulatory system claiming it did not ensure a level playing field especially vis-a-vis the incumbent public sector service provider. The government had to restructure the policy in 1999 in several ways. The licence fee arrangement was changed to a revenue-sharing arrangement and this modification in favour of the incumbent private players was combined with a decision to allow one more private competitor in each circle. The powers of the regulator were also strengthened. These decisions were criticised at the time for changing the rules of the game. After an initial shake-out, telecommunications services have expanded rapidly since then and the industry has a few financially strong private players who are investing heavily. Most important of all, telecommunications costs have fallen markedly.

## **4.3 Missing Elements**

Performance was also less than expected because of missing elements in the reform agenda. I have already mentioned that agriculture slowed down after the mid-1990s. The Ninth Five Year Plan, which covered the period 1997-2001, had targeted a 4 per cent growth of agriculture but by the end of the plan it was clear that agricultural growth was only 2 per cent.

In retrospect, this should have sounded a warning note calling for a basic change in agricultural policy but the opportunity was missed. The Tenth Plan, covering the period 2002-2006, simply targeted 4 per cent growth again, based more or less on a "business as usual" policy. It has now become clear that a more fundamental rethinking of policy in this area is needed.

We need to act on several fronts. It is necessary to increase public investment in irrigation in those areas where irrigation is possible and in watershed management where assured irrigation is not possible. Rural road connectivity is also poor in many parts of the country and greater public investment in this area is needed to help stimulate agricultural growth. It is also necessary to revamp the agricultural research system and agricultural extension systems which have become over-bureaucratized and dysfunctional. More generally, we need to move from an agricultural strategy based on the foodgrain economy, aimed at achieving self-sufficiency in foodgrains, to a more diversified agriculture in which horticulture, poultry, dairying etc. have a much larger role to play. This requires a completely different type of marketing with much greater emphasis on post-harvest facilities including cold chains, transport logistics and development of modern marketing. The corporate sector has an obvious role to play in strengthening the link between the farmer and the market, and in this context contract farming is being explored as a way of providing the linkage. These missing elements are now being put in place.

A second missing element was the inadequate focus on health and education. India's primary education and health indicators compare poorly with East Asia and this is an area where the existing gaps must be filled as quickly as possible. Easier access to basic education and health services is essential not only because it contributes directly to human welfare but also because it is essential as an investment in human resources needed for faster growth in the medium term and for ensuring that the growth process is more inclusive. The government has launched a major effort in both areas with a substantial increase in public expenditure in primary education and a similar increase planned in health in rural areas. It will be necessary to increase the scale of public expenditure in education and health by at least 2 to 3 per cent of GDP over the next five years. This will be difficult and will call for reprioritisation of public expenditure.

Even more difficult than mobilising additional resources is the need to ensure that these resources are well spent. A major institutional innovation in this regard is the attempt to devolve financial responsibility and accountability to local elected bodies in rural and urban areas. Essential services such as primary and secondary education and also primary health often suffer from poor accountability of service-delivering agencies. This is best corrected by making them responsible to local elected bodies.

Finally, a critical missing element in the reforms undertaken thus far is reform in the labour market. Indian labour laws are widely regarded as being unduly rigid because employers cannot resort to retrenchment, or close down a unit, without government permission which is rarely given. Many employers achieve the necessary flexibility through voluntary retrenchment schemes, but these typically involve expensive compensation packages, which are manageable in capital-intensive activities but are prohibitive for labour-intensive industries. The net result is that employers are reluctant to expand employment especially in labour-intensive industries where the wage bill is a large proportion of value added. Yet these are precisely the industries where India has a comparative advantage. China's remarkable success in expanding exports of simple labour-intensive manufactured goods, and generating large employment opportunities in the process, shows that India may have missed some very valuable opportunities for positive outcomes on the employment front.

Reforming labour laws is a difficult exercise in most countries and one that depends as much on politics as on economics. The government recognises that this is an area where action is necessary, but the approach being adopted is one of first building a working consensus with representatives of labour interests. This process has only just begun.

## **5. Prospects for the Future**

What can we say about India's economic prospects based on this review of the past? On balance, India has clearly managed the transition from a relatively closed to a more open economy fairly well. The change has been slow, but the cumulative effect of the reforms that have already taken place is to put the economy in a much better position today than it was 10 years ago.

The macroeconomic environment is broadly favourable for growth. India has been able to increase its savings and investment rates steadily. The investment rate is nowhere near the 40 per cent of GDP achieved in China, but it has increased to around 26 per cent and is rising.

FDI has risen from virtually nothing in 1990 to about 1 percent of GDP, and there is a distinct possibility of increasing it to 2 or even 3 per cent of GDP. Investor interest in India is definitely increasing and 200 of the Fortune 500 companies are now operating in India. Many potentially big investors—Microsoft, Intel, Dell, Toyota and POSCO, to name only a few — have announced their intention to increase investment in India.

Perhaps the most important structural change that has taken place, which augurs well for the future, is a change of mindset on the part of Indian business persons, which has given them confidence to cope with globalisation and the challenges it throws up. In the last two or three years, they have begun to look beyond India and invest abroad. There is more Indian investment in Australia than the other way around. Indian companies are also investing in China, Europe and the United States to acquire a foothold in these markets. This globalisation of Indian companies is going to have a very powerful effect on how they conduct themselves at home.

The new confidence evident in India is in part born out of the realisation that India has produced some winners in a world that is globally integrated. Areas such as software development, IT-enabled services, pharmaceuticals, auto components and biotechnology all have Indian firms that are doing extremely well. These are areas that require relatively high skill levels and India's educational system does produce impressive numbers of people with the right skills.

There is reason to believe that India's potential is yet to be fully realised. Some indication of what is possible can be obtained by comparing FDI flows into China with those into India. China attracts annually about \$60 billion in FDI whereas India's level is currently only around \$5-6 billion. China's economy is three times larger than that of India, so one should expect China would attract three times the investment levels that India does, but even on this basis India's FDI inflow could be three times higher than it is now.

There are of course important gaps in the policy environment which need to be addressed. Policies towards agriculture need to be restructured, infrastructure gaps need to be bridged and a major effort is needed to improve the delivery of essential services in health and education. Assuring steady progress in these areas, there is a very good chance that India can accelerate its growth rate of GDP from between 6.5 and 7 per cent per year, to 8 per cent and more. Most international observers— whether they are investment banks or multilateral institutions such as the World Bank, the IMF or the Asian Development Bank — share the assessment that if India were to continue the reform effort and act quickly to fill in some of the critical gaps, it would be possible to achieve 8 per cent growth.

What would 8 per cent growth achieve? It will not transform India into an industrialised country in a short time, but in 10 years time it will certainly get rid of absolute poverty as we know it today. In 25 years time, it will make India the country with the third largest GDP in absolute terms after the United States and China. Combined with the steady pace of opening the economy that is clearly under way, India is well positioned to be an increasingly important player in the global economy. That is a big transformation. Indians are increasingly aware of it and are determined to ensure that it happens.

*January 2006*

### **Endnotes**

1. See Ahluwalia (2002) for a more detailed exposition.
2. These are Planning Commission estimates.
3. See Ahluwalia (2002) for elaboration of this process.

### **References**

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