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SOME REFLECTIONS OF ECONOMIC REFORMS IN INDIAN ECONOMY

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ABSTRACT

Several earlier studies have attempted to analyze the impact of the economic reforms on Indian economy. In one of the earlier studies Nambiar et al. (1999) started from the expectation that trade liberalization "encourages economic activity and hence raises production and employment"; he then asked whether this was also true in the Indian case. Although this expectation may be justified in the long run, it seems somewhat unrealistic to expect immediate benefits since trade liberalization always implies increased foreign competition, which in turn may lead to the closure of less competitive firms and therefore job losses and income reduction in the initial phase following trade liberalization. One may argue, however, that by 1999 it was possible to expect the longer-run impact of increased productivity, competitiveness and accelerated growth. This raises questions about the timing of the reforms and about the time lags necessary to achieve the longer-run changes. Nambiar et al. (1999) concluded that "trade has over the years shrunk India's manufacturing base, both in terms of value addition and employment". Although the authors admit that "this 'high protection-high cost-poor quality' syndrome needed to be corrected by import liberalisation", their assessment of the reform impact is rather pessimistic.

INTRODUCTION

Chauduri (2002) also reported that the "expectations of rapid and sustained growth of output and employment …have not materialized." The author concluded that value added growth in the 1990s was inferior to that in the 1980s, that the industrial base had become smaller, that employment growth in the 1990s was negative in five out of nine years and that the labour productivity stagnated after 1995-96, after having increased in the early 1990s. Here again no attention is paid to the changes in protection, prices and costs that resulted from the reforms.

A much more positive picture was drawn by Panagariya (2004), who argued that growth in the 1990s was more robust than that of the 1980s and that it was achieved through important policy changes. The main policy changes held responsible for accelerated growth are the liberalization of foreign trade, the reduction in industrial licensing and opening to foreign direct investment.

Ahluwalia (2002) characterized the Indian reforms as gradualist, but less so by design than as a consequence of political constraints. He concluded that their cumulative impact was substantial and created the basis for accelerated growth. Although trade and industrial reforms were the most visible, the author cautioned that tariffs in India are still much higher than in China and other countries in Southeast Asia. Similarly, he also found that foreign investment had a much more limited impact in India than in China and Southeast Asia. The one area in which the trade policy reforms were most successful in his view is the sector of information technology-related services. Areas, where the reforms were found to need further progress are the labour market, agriculture, infrastructure and the management of fiscal balance. Any assessment of the policy reform impact on industries has to start with a detailed evaluation and measurement of the incidence of specific policy changes.

Das (2003) attempted such an assessment and computed effective rates of protection and import coverage as well as import penetration ratios for 72 three-digit industries for four sub-periods of the period 1980 to 2000. Although these ratios are useful they do not show the combined effect of tariffs and QRs on output prices. For that it would be necessary to estimate rates of protection based on price comparison, as had been done in the 1980s by Pursell (1988). The author concluded that the Indian level of protection remained high in comparison with several South-East Asian countries.

Pandey (2004) focused on the measurement of several trade reform variables, including the measurement of protection based on price comparisons. As to the impact of trade liberalisation on industry performance he concluded that this link appears to be weak, given the presence of other factors. Among these factors, government controls in form of industrial licensing and public sector investments are singled out, but the author also points to the well-known ambiguity between protection and growth: High protection tends to generate growth in the initial stages, but declining protection may also lead to growth through competition-induced gains in productivity and exports.

One of the expected effects of trade liberalisation is the reduction of profit margins following increased competition from imports. This hypothesis was examined by several authors with differing results. While Srivastava et al. (2001) and Kambhampati & Parikh (2003) did not find substantial evidence of this competitive effect on Indian industries, Krishna & Mitra (1998) and Goldar & Aggarwal (2004) concluded that the tariff reduction and removal of quantitative import restrictions had a significant and profit-reducing impact. However the latter authors also found that the reduction in cost price margins was mitigated by a reduction of labour’s share in value added, which they attributed to declining union power. Closely related to the competitive effect of profit decline is the reform impact on productivity. The longer-run expectation is of course increased productivity and competitiveness, but less dynamic enterprises may also disappear under increased import competition.

While two recent studies (Unel, 2003; TSL, 2003) had found an acceleration of productivity growth in Indian industries, Goldar (Goldar & Kumari, 2003 and Goldar, 2004) re-examined the question by including further determinants, in particular capacity utilization. He concluded that trade liberalization had a positive influence on productivity, but this was counter-acted by a decline in capacity utilization and a declining growth in agricultural production. A somewhat different conclusion was reached by Das (2003a), who found that total factor productivity growth in manufacturing was close to zero over the 1980- 2000 period, that it was positive in capital goods, but mostly negative in consumer and intermediate goods, and that it slowed down from the 1980s to the 1990s. The recession of the mid-1990s as well as the continued labour market rigidity are held responsible for this outcome. Topalova's study (2004), on the other hand, is more supportive of Goldar's findings and also adds a distinction between private and publicly owned enterprises, with the former showing clearly more productivity growth than the latter. Similar conclusions as for productivity were reached for real wages by Goldar (2003), who connected the adverse effect of trade liberalization on real wages with the reduction of rents and the weakening of trade union strength. Banga (2005) also examined the reform impact on wages, but focused on wage inequality. Analysing the impact of three reform targets, FDI, trade and technology, on labour productivity and wage inequality, the author concluded that all three reform components contributed to increased wage inequality.

In a more recent paper Goldar (2005) examined to what extent India's commitments under the WTO have influenced the manufacturing sector and concluded that changes in production, imports and exports are largely not attributable to the commitments arising from WTO membership. He showed that for a number of consumer goods, especially in textiles and clothing, the increase in imports during the early years of 2000 were modest and largely matched by increases in exports.

Kaushik Basu (2004) observed that the actual policy regime that India followed in its early days of independence was a mixture of the two competing visions. A Soviety-style planning system was developed, but without the state having a monopoly of control over the resources. Capitalism was allowed to flourish, but a large bureaucracy was nurtured. Huge investments were made in basic industries, but at the same time several sectors were protected as belonging to the small-scale sector. Capitalism was criticisd but it was also relied upon. Socialism was never practiced, but the rhetoric of socialism was the norm. A burgeoning bureaucracy became the surrogate for socialism.

In the Foreword to the Planning Commission's Macro-Modelling for the Eleventh Five Year Plan (2009), Montek Ahluwalia remarks, "The transition of the Indian economy from a 'planned' economy to a more 'market-based economy', and one more integrated with the rest of the world, has seen the role of planning undergoing a change both in terms of priorities as well as instruments. With the growth of a fairly sophisticated private sector with demonstrable entrepreneurial capacity it is felt that government ned not try to produce products that can be produced just as well by the market, instead it should dvote its scarce resources to providing public goods including especially educational and health services and programmes for social inclusion. Infrastructure development is another priority area since lack of infrastructure is a crucial constraint on the growth of the economy. The role of the government in infrastructure development is obviously critical. The shift to a more open market economy has also created the need to expand modelling capacity to reflect the features of openness including the macroeconomic implications of openness. For all these reasons, the modeling framework needed to undergo a change from being more deterministic and disaggregated to bring more aggregative and indicative.

Bhagwati, Jagdish (2002) stated, "While there is need to push ahead with this in today's India, including a further lowering of tariff barriers and greater mobility of capital, it is not obvious that these reforms, if implemented in the 1960s, would have automatically yielded benefits for the country. There are several laws and institutional features of Indian industry that handicap our domestic producers." For example, there are some industries, such as handicrafts and toys, which are marked as belonging to the small-scale sector. Large-scale factory production is not permitted in these industries. Imagine what would happen if India suddenly opened up the doors to all imports, without liberalising this sector. Foreign producers would manufacture the same goods in large-scale modern factories, lower their per-unit cost of production, and outcompete the Indian producers, handicapped by the Indian laws. This would still cause gains from trade, true, but may inhibit the future development of Indian industry. Moreover, the free flow of capital could cause destabilizing currency crises.

By the mid-20th century, state intervention in the economy and government controls on economic activity were widely accepted and justified across the world, not only on grounds of 'equity' and the need to achieve particular social goals which were not inevitably delivered by the market mechanism, but also theoretically in terms of the possibilities of market failures. The important areas of market failures have typically been identified in microeconomic terms as those of public goods, externalities, industries, characterised by increasing returns to scale, situations of incomplete or asymmetric information, and in macroeconomic terms the persistence of aggregate unemployment and the emergence of sectoral imbalances. For developing economics, which were seen to have structural constraints on growth which had to be overcome, the consensus was that late industrialisation required systematic and planned government economic activity with limited, controlled and directed market functioning.

Subramanian (2007) , after 1980, some clearer patterns become evident. It appears that two sets of factors played a role. First, different states had different pre-existing capabilities. But these remained latent and could not find expression until the economic environment changed. The trigger-the second set-was the liberalization begun in 1980, and especially the decentralization of economic power that was forced by the changing political landscape after 1980. Thus, it was the interaction between pre-existing capabilities and the twin triggers of liberalization and decentralization that explains how the different states fared.

Benerjee et al. (2000) studied that the focused on West Bengal, a state where tenancy reforms were implemented very thoroughly, yields very different conclusions : tenancy reforms improved agricultural productivity. Within a year of being elected in 1977, the left-wing administration launched Opration Barga, a programme designed to implement and enforce the long-dormant agricultural tenancy laws that regulated rents and security of tenure of sharecroppers. Under these laws, if tenants were registered with the Department of Land Revenue, they would be entitled to permanent and inheritable tenure on the land they sharecropped as long as they paid the landlord at least 25 per cent of output as rent. In the decade following the launching of Operation Barga, there was significant improvement in the terms of tenants' contracts and security of tenures.

Athreye and Kapur (2006) examined the level and determinants of concentration in Indian manufacturing before and after the regulatory and trade reforms. They concluded that after liberalization the concentration declined in some industries and increased in others. The expected outcome of general decline was not observed, partially because the penetration of new competitors is a process that may be completed only over longer periods of time and the duration of this process is likely to vary among industries. Our own earlier study of industry competitiveness (Siggel, 2007), which uses ASI data at the two-digit level, revealed that large-scale manufacturing industries have largely benefited from the reforms. The potential effect of import competition leading to strong decline of formerly heavily protected industries thus inducing massive employment loss has simply not happened. Manufacturing employment has continued to grow at an average annual rate of 2.2% over the 1987/88 to 1997/98 study period and most industries have improved their international competitiveness, some of them very substantially. which reports the survey findings on an industry-by industry basis, we compare these findings with the prior findings from the competitiveness analysis.

Srinivasan and Tendulkar (2003) attribute some role to the reforms but they too underplay them when they state: “India’s exports increased over this period [1980s] of piecemeal reforms, but this was more due to a real exchange rate depreciation mostly as a result of exogenous forces than due to an active policy of nominal devaluation or due to explicit policy reforms aimed at reducing trade barriers. Growth performance was also distinctly better in the 1980s than in the earlier period. This surge in growth, however, was supported on the demand side by unsustainable fiscal policies, and it ended with an economic crisis in 1991.”

The main focus has been given on special agencies and extensive discourse. This evolution is illustrated by analysis of the Economic policies of the Indian government from 1991 to 2005. The primary focus of this analysis will be towards the industrial and infrastructural sectors which form the beginning of the gradual liberalization process that was started in 1991. A complete understanding of these two sectors will provide interesting statistics and information regarding trends of FDI. The Concept of Foreign Direct Investment is now a part of India’s economic future but the term remains vague to many, despite the profound effects on the economy. Despite the extensive studies on FDI, there has been little illumination forthcoming and it remains a contentious topic. The paper explores the uneven beginnings of FDI, in India and examines the developments (economic and political) relating to the trends in two sectors: Industry and Infrastructure and sub sector Telecom, to illustrate that.

The far reaching unanimity for FDI within came in 1995-1996 when the government began to showcase the progress made as a result of FDI along with defending the changes to critics.

Statistics had been available for most years, but now FDI entered the mindset of the government. The future of India's growth and output was seen to be connected to FDI and it was deemed necessary for promoting higher growth of output, exports and employment. Furthermore the government also defended FDI by stating that "fears of foreign investment swamping our domestic industry or creating unemployment are unfounded or grossly exaggerated".

The acceptance of FDI was not shared by the opposition, as by the next elections the party positions show some level of variance but the general feelings were similar. The party was able to effectively change its stance by allowing for FDI but stating that it would "strive to minimize dependence of foreign saving" thus elaborating distinctions that would keep India's economic sovereignty. The party elaborated that globalisation is not a synonym for the oliberation of national economic interest. The party was able to change its viewpoint by separating a progressive India open to new ideas, new technology and fresh capital but at the same time not a westernized India.

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

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

The policy environment today is therefore potentially much more supportive, especially if the critical missing links are put in place. However, failure on the fiscal front could undo much of what has been achieved. Both the central and state governments are under severe fiscal stress, which seriously undermines their capacity to invest in certain types of infrastructure and in social development where the public sector is the only credible source of investment. If these trends are not reversed, it may be difficult even to maintain 6 percent annual growth in the future, let alone accelerate to 8 percent. However, if credible corrective steps are taken on the fiscal front, then the cumulative policy changes that have already taken place in many areas combined with continued progress on the unfinished agenda should make it possible for India to accelerate to well beyond 6 percent growth over the next few years.

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

Savings, Investment and Fiscal Discipline

Fiscal profligacy was seen to have caused India's balance of payments crisis in 1991, and a reduction in the fiscal deficit was therefore an urgent priority at the start of the reforms. The combined fiscal deficit of the central and state governments was successfully reduced from 9.4 percent of GDP in 1990–1991 to 7 percent in both 1991–1992 and 1992–1993, and the balance of payments crisis was over by 1993. However, the reforms also had a medium-term fiscal objective of improving public savings so that essential public investment could be financed with a smaller fiscal deficit to avoid "crowding out" private investment. This part of the reform strategy was unfortunately never implemented.

Reforms in Industrial and Trade Policy

Reforms in industrial and trade policy were a central focus of much of India's reform effort in the early stages. Industrial policy prior to the reforms was characterized by multiple controls over private investment that limited the areas in which private investors were allowed to operate and often also determined the scale of operations, the location of new investment and even the technology to be used. The industrial structure that evolved under this regime was highly inefficient and needed to be supported by a highly protective trade policy, often providing tailor-made protection to each sector of industry. The costs imposed by these policies had been extensively studied (for example, Bhagwati and Desai, 1965; Bhagwati and Srinivasan, 1971; Ahluwalia, 1985), and by 1991, a broad consensus had emerged on the need for greater liberalization and openness. A great deal has been achieved in this area after ten years of gradualist reforms. 3 Many countries have increased revenues substantially by switching to an integrated value added tax covering both goods and services. This is not possible in India because of the constitutional division of taxation powers between the center (which can tax production) and the states (which can tax sales). The inability to switch to an integrated value added tax is a major hindrance to tax reform.

Industrial Policy

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

Trade Policy

Trade policy reform has also made progress, though the pace has been slower than in industrial liberalization. Before the reforms, trade policy was characterized by high tariffs and pervasive import restrictions. Imports of manufactured consumer goods were completely banned. For capital goods, raw materials and intermediates, certain lists of goods were freely importable, but for most items where domestic substitutes were being produced, imports were only possible with import licenses. The criteria for issue of licenses were nontransparent, delays were endemic and corruption unavoidable. Removing quantitative restrictions on imports of capital goods and intermediates was relatively easy, because the number of domestic producers was small and Indian industry welcomed the move as making it more competitive. It was much more difficult in the case of final consumer goods because the number of domestic producers affected was very large (partly because much of the consumer goods industry had been reserved for small-scale production). Quantitative restrictions on imports of manufactured consumer goods and agricultural products were finally removed on April 1, 2001, almost exactly ten years after the reforms began, and that in part because of a ruling by a World Trade Organization dispute panel on a complaint brought by the United States. Progress in reducing tariff protection, the second element in the trade strategy, has been even slower and not always steady. As shown in Table 3, the weighted average import duty rate declined from the very high level of 72.5 percent in 1991–1992 to 24.6 percent in 1996–1997. However, the average tariff rate then increased by more *Montek S. Ahluwalia 73* than 10 percentage points in the next four years.4 In February 2002, the government signaled a return to reducing tariff protection. The peak duty rate was reduced to 30 percent, a number of duty rates at the higher end of the existing structure were lowered, while many low-end duties were raised to 5 percent. The net result is that the weighted average duty rate is 29 percent in 2002–2003.

Reforms in Agriculture

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

Infrastructure Development

Rapid growth in a globalized environment requires a well-functioning infrastructure, including especially electric power, road and rail connectivity, telecom- *78 Journal of Economic Perspectives* munications, air transport and efficient ports. India lags behind east and southeast Asia in these areas. These services were traditionally provided by public sector monopolies, but since the investment needed to expand capacity and improve quality could not be mobilized by the public sector, these sectors were opened to private investment, including foreign investment. However, the difficulty in creating an environment that would make it possible for private investors to enter on terms that would appear reasonable to consumers, while providing an adequate risk-return profile to investors, was greatly underestimated.

Financial Sector Reform

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks (Beck, Levin and Loayza 1999; King and Levin 1993; Rajan and Zingales 1998; Demirgüç-Kunt, Asli and Maksimovic 1998; Jayaratne and Strahan 1996).

Privatization

The public sector accounts for about 35 percent of industrial value added in India, but although privatization has been a prominent component of economic reforms in many countries, India has been ambivalent on the subject until very recently. Initially, the government adopted a limited approach of selling a minority stake in public sector enterprises while retaining management control with the government, a policy described as "disinvestment" to distinguish it from privatization. The principal motivation was to mobilize revenue for the budget, though there was some expectation that private shareholders would increase the commercial orientation of public sector enterprises.

Social Sector Development in Health and Education

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

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