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India's economic strides

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Abstract: After decades of stagnation, India is moving forward economically again with ambitious reforms that could transform the country and its standing in the world. India's economic strides are examined.

Full Text: India's vigorous embrace of market reforms after three decades of stifling bureaucratic socialism is an overwhelming irony. Regarded by many in the 1950s as a front-runner in the race for development, India is now catching up instead. What went wrong? And what are India's prospects? ECONOMIC PERFORMANCE India's economic performance prior to the recent reforms was truly dismal. This is manifest in the slow growth of its national and per capita income. Starting with the first Five-Year Plan in 1950, India set the goal of doubling national income by 1967-1968 and per capita income by 1973-1974. But this period turned out to be a disappointment, as did the decade that followed. India's weak performance in increasing national and per capita income not only fell below its own aspirations, but also put India behind many developing countries and substantially behind countries in the Far East. Figure 1 underscores this conclusion. (Figure 1 omitted) Using data for 21 high-income and 88 developing countries since 1960, the figure shows that through 1980 India performed well below Taiwan, South Korea, and Japan, and that it also lost out to the average performance of both middle-and low-income East Asian countries. The Latin American performance was also better, though, as the figure shows, these nations paid dearly for the myopic and excessive borrowing in the 1970s by the debt crises that overwhelmed them in the 1980s. India's disappointing growth rate crippled its ability to reduce poverty with 14 percent of the word's population, India has almost twice as large a share of the world's poor. Recent government estimates suggest that over one-quarter of India's population is considered poor. The argument that slow growth delayed the amelioration of poverty is plausible. But it aroused fierce controversy in India. Left-wing intellectuals contemptuously dismissed the proposition as "trickle-down" economics: My response has always been that growth pulls people into gainful employment, thereby-reducing poverty. It is not "trickle-down" economics but "pull-up" economics. Growth is therefore an active, radical policy, not a passive, conservative option. In India, evidence across the states shows that those with the higher sustained growth were also those that reduced poverty. International experience confirms this too: the superperformers of the Far East have reduced poverty substantially, in large part because of their phenomenal growth rates. The ability to raise revenues to spend on poverty programs that directly reach the poor depends primarily on prosperity: the economics of scarcity leads to the politics of neglect. ADHERENCE TO DEMOCRACY India's economic failure must be balanced, however, by its political success. Almost alone among developing countries, India remained wedded to democracy in the postwar period whereas many (such as Pakistan and Kenya) abandoned it. Indeed, this was what attracted the many intellectuals who consistently supported India's developmental efforts in those early decades. Those who believed that development depended mainly on capital accumulation feared that India would lose out to China, since a totalitarian state would be able to extract greater savings and invest more than a democratic one. Western nations, led by the United States, thus extended foreign aid to India from the 1950s on, not only to reward virtue but also to remove the economic handicap that democracy was thought to bring to its adherents. But the fears that democracy and development would be in conflict were unfounded. Neither the ability to raise savings nor the efficiency of the investments that these savings financed were compromised by democracy. As Figure 2 shows, India nearly doubled its savings to over 20 percent of national income between 1960 and the late 1980s. (Figure 2 omitted) We now also know that democracy usually does quite well in getting the most out of investment. People do not do their best when they lack the freedom that participatory democracy protects. THE WRONG MODEL India's democracy, then, did not cost her the growth that eluded her; the culprit was simply faulty policies. Its misfortune was to choose an economic model that could not and would not work. Under the influence of Cambridge economics and London School of Economics politics, the English-trained Indian intellectuals (such as Prime Minister Jawaharlal Nehru) opted for a development strategy that favored governmental regulation of economic activity and gave top priority to the expansion of the public sector in numerous areas normally the province of private industrial production. In addition, Indian planners carried the prevailing import substitution philosophy absurd lengths. By relying on extensive trade and exchange controls, India created an inwardlooking and sheltered economy. India thus failed to profit from the rapidly expanding world trade that others, especially in the Far East, exploited to great advantage; India also eschewed the benefits that foreign investment could bring to developing countries. An over-regulated, sheltered, inwardlooking, public sector-dominated economy, with little incentive for efficiency and innovation, produced just the sluggish performance that one would expect. A few salient failures illustrate India's afflictions. * Controls. Industrial and trade controls reached kafkaesque proportions by the mid-1950s. Permission became necessary to invest, to diversify production, to increase production over licensed levels (even if this was a result of improved efficiency), and to import components and capital goods. After reading about this situation in The Economist, Maxim Boyko, now overseeing Russia's privatization program, told me, "That could be the Soviet Union!" The result of this extreme centralization was to eliminate flexibility and produce massive inefficiency. * Competition. India killed foreign competition by controlling imports and domestic competition by regulating the entry of new producers. The results were self-evident. The Indian Tariff Commission once noted in exasperation that everything makes a noise in Indian-made cars except the horn. Indian planners had lost sight of Herbert Spencer's eloquent words: "The ultimate result of shielding men from the effects of folly is to fill the world with fools." * Foreign Trade and Investment. The sheltered markets for domestic producers also skewed incentives toward the home market and against exports. The result was abysmal export performance. As Figure 3 shows, India's share of world exports fell almost continually since 1948 and stayed at a low level through the 1980s. (Figure 3 omitted) Its ratio of exports to GNP ratio also stagnated through the mid-1980s even though most countries sowed a substantial rise in this ratio during the same period. Similarly, by the time reforms were undertaken in the early 1990s, foreign investment in India had shrunk to negligible levels. * Public Sector Performance. Equally dramatic, and damaging, was the performance of the public sector enterprises. Employing 40 percent of the workforce in the manufacturing sector and nearly 70 percent in the large-scale nonagricultural sphere, public sector enterprises by 1990 produced an average rate of financial return of only 2.5 percent. And most enterprises in the nationalized coal, steel, fertilizer, power, and transport sectors were posting losses. These inefficiencies created problems elsewhere as well. Since these enterprises supplied critical inputs to other industries, their inefficiencies hurt them too. Thus, for example, power shortages became endemic. A visitor to New Delhi and other cities can still find small power generators in many households, installed to manufacture electricity at great personal and social cost--the equivalent of the absurd Chinese goal of manufacturing steel in backyards during Mao's Cultural Revolution in China. ECONOMIC CRISIS BY LATE 1980S The public sector losses were not merely bad for growth; they also contributed to the budget deficit and hence to a macroeconomic breakdown. The losses being financed by government subsidies were an immediate drag on the budget. Indirectly the public sector losses reflected the inefficiency that hurt the growth of income and hence the growth of revenues. Indeed, the state of Indian public finances had reached crisis proportions by the end of the 1980s. The public debt-to-GNP ratio increased through the 1980s, jumping dramatically toward the end of the decade to nearly 60 percent, a near doubling of the ratio from the 1980 level (see Figure 4). (Figure 4 omitted) The growth of current spending contributed to the debt, possibly reflecting the increased political competition at the national level during the decade: the ruling

Congress party's dominance weakened and the opposition parties took power twice, sapping the will to maintain fiscal prudence when spending could earn votes. The rise in foreign borrowing was also a major component of the fiscal crisis. The external public sector debt as a proportion of GNP doubled during the 1980s to 21 percent, while debt service as a proportion of exports increased more than threefold in less than a decade to 32 percent by 1986-1987. By 1990, India's foreign exchange reserves had fallen drastically, its credit rating in the international capital market was down, and its exposure to short-term borrowing withdrawal was substantial, all of which caused a palpable fear of default. The choice lay between finally initiating long-overdue reforms (as would be demanded anyway by the International Monetary Fund if India were to draw funds under the Compensatory and Contingency Financing Facility), or declaring default and continuing the policies that had been discredited. The newly elected minority government of Prime Minister Narasimha Rao and his remarkable finance minister, Dr. Manmohan Singh (a Cambridge-trained economist whose Oxford dissertation in the 1960s had argued against the pessimistic view that India's export markets were limited and for a new outward orientation), chose the option of initiating reform. And they have been making history. INDIA'S ECONOMIC REFORMS India undertook a cascading set of reforms beginning in June 1991. Industrial controls over most investments and over diversification and expansion were removed almost at once. Import controls (except for most consumer goods) were dismantled, with current account convertibility introduced by 1993. The removal of restrictions on the import of consumer goods has begun as well. Tariffs, still high, will be reduced as part of overall fiscal reform and Uruguay Round concessions. Foreign investment restrictions have also been ended. Indeed, the Rao government has made a substantial effort to attract investment, which is now paying off. Coca Cola and IBM, both virtually forced to leave India earlier, are now back; Pepsi has signed a major agreement with the government; and General Electric and others are actively investing or exploring investments. New investments in 1993 exceeded $1 billion, a substantial increase over the $100 million annual inflow in 1990-1991 prior to reforms. The acceleration is continuing. Financial sector reforms are scheduled, and privatization is commencing. Since the objective of private ownership is greater management efficiency, the government has also sought better management by introducing competition to areas of public sector monopoly by allowing the entry of new private sector firms. New private airlines have been started to compete with the state-owned Indian Airlines, and service has improved. China also eschewed privatization and relied successfully on the rapid growth of private sector enterprises to force the public sector firms to perform better. The macroeconomic balance has also been steadily restored, with the budget deficit reduced on schedule. Inflation is now in single digits, a very different situation than prevails in South America, where high inflations into four digits have flourished with the surreal extravagance found in the novels of Gabriel Garcia Marquez. Indian inflations are considered to be disturbing and are corrected when they cross into just two digits, suggesting an attitude culturally consonant with the tranquility of the Malgudi village portrayed in the novels of the Indian novelist R. K. Narayan. WILL THE REFORMS ENDURE? The reforms can be expected to endure for several reasons: * Both the prime minister and the finance minister know that they are making history with the reforms and are therefore committed to them. Gorbachev once remarked that had he not adopted perestroika and glasnost, he could have lived a quiet life like Brezhnev, but he chose the difficult path. So have the Indian leaders. * The reforms are acceptable, even popular, with the vast middle class and others. The finance minister recently remarked that he now hears criticism for not going far or fast enough, not for going in the wrong direction. The prime minister reacts accordingly: any time he faces a political crisis, he does not shelve economic reforms but he announces further reforms! The government's economic policies have put it on a political roll. * The government's commitment to economic reforms and the enormous popularity of the finance minister were underlined when a parliamentary committee investigating a banking scandal produced a report last December. In the report, the finance minister, who was not involved, was nonetheless held accountable as the chief official of the government. Dr. Singh accepted the responsibility. And he went further; he resigned. But the outpouring of popular and political support for him was such that the prime minister was easily able to reject the resignation. *

Even the return to power of the major opposition party, the Bharatiya Janata party (BJP), would not undermine the reform process. The BJP has carefully kept antireform rhetoric out of its political arsenal. Moreover, in the latest state-level elections this November, it endorsed the reforms fully. In fact, the BJP lost ground and Mr. Rao's government came out stronger from these latest elections, contrary to much foreboding. True, media reports out of India often suggest growing political chaos. But this is not so. These erroneous reports come from a humorless acceptance of the hyperbole common to Indians and from an inability to see that the exaggerated self-criticism is simply a cry for the correction that often follows. Thus, when recent riots in Bombay, where some Hindus and many Muslims were killed, were being condemned, many in India compared them to pogroms and fascism: the comparison is absurd but the anguish behind it is real. Thus while the riots after the destruction of the Ayodhya mosque in December 1992 were thought to be a sign of India's growing disorder and terminal cancer in the body politic, exactly the opposite inference can be drawn. We should not judge a society's strength by whether it can fine-tune politics so as to avoid tragedies, but rather by how it handles them once they occur. After the riots, Indians throughout the nation wrote to the papers, marched in the streets, and organized meetings of condemnation; they did not rush to the streets to loot and massacre on a massive scale. Indeed, the vitality of India's democracy comes through in V. S. Naipaul's beautiful work, India: A Million Mutinies Now (Heinemann, 1990). In it Naipaul shifts from his earlier cynicism about India to great optimism. The tremendous energy now being unleashed by India's reforms also speaks to the vitality of its democracy. The combination of democracy with market reforms gives India a prospect that will outweigh the temporary advantage that economic reforms have given to totalitarian China. The Indian giant is awakening later than the Chinese giant. But it will step onto firmer ground. Jagdish Bhagwati is the Arthur Lehman Professor of Economics at Columbia University and a visiting scholar at the American Enterprise Institute. This article draws an his newly published India in Transition, Clarendon Paperback, Oxford University Press, 1993.

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