India — Reform on Hold

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Abstract. *In 1991, India embarked on economic reforms that have the potential to transform its future economic development. This paper is an evaluation of these reforms. It analyzes the progress made in the last seven years, considers the likelihood of its continuance, and suggests an agenda for the future. The authors conclude that while there has been significant movement in some areas, the reforms, as a whole, have been slow and unbalanced and are as yet highly incomplete. They are fairly pessimistic about the political feasibility of the reforms and sceptical about greater devolution of powers and responsibilities to the States as the way forward.*

The Ancien Regime and the Need for Reform

On the economic front, India's post-independence history has been one of disappointed hopes and expectations. Performance has been inadequate as regards both growth and poverty alleviation.[1] India has lagged massively behind the East Asian superperformers in both respects; indeed she has lagged behind even the average of middle and low-income countries of East Asia. From 1950 to 1980, India grew at around 3.6 percent per year (per capita 1.3 percent per year), dubbed the "Hindu rate of growth" in view of its seeming resistance to economic policies. Growth did speed up to 5.7 percent per year (per capita about 3.5 percent per year) in the 1980s but on the basis of unsustainable macroeconomic policies that resulted in a crisis in 1991. Nor was there much compensation for slow overall growth in the form of improvement of the standard of living of the poor. Even now, India has about 350 million people below the poverty line—more than one third of India's population and a similar percentage of the

[1] For an excellent overview of India's economic performance and causes thereof see Bhagwati (1993).

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world's poor. As regards broader indicators of welfare such as literacy and health, notwithstanding some improvement, the absolute levels remain disturbingly low.[2]

Growth Performance

We focus here on the causes of India's growth performance because high growth is a necessary condition for poverty alleviation.[3] We can divide the sources of growth schematically into the rate of saving and investment and the productivity of investment (see Table 1).

Table 1: **Investment and Savings as Percentages of GDP**

	1950/51	**1960/61**	**1970/71**	**1980/81**	**1989/90**
Investment (current prices, % GDP)	10.2	15.7	16.6	22.7	24.1
Investment (constant 1980/81 prices, % GDP)	14.7	18.1	18.7	22.7	21.8
Domestic Savings (% GDP)	10.4	12.7	15.7	21.2	21.7
GDP growth (% p.a., 10-year averages)		3.6	3.3	3.7	5.7

Note: Investment figures are those that are adjusted to equal the estimates of domestic plus foreign savings in the national accounts.
Source: Government of India, C.S.O. National Accounts Statistics.

From 1950/51 to 1980/81, India's growth rate was roughly constant but saving and investment (at current prices) rates more than doubled. In the 1980s, the growth rate increased significantly without any increase in saving and investment rates but that was for special reasons. Liberalization of India's highly controlled economy began in a small way in the 1980s with favorable effects on efficiency. High growth

[2]While we would stand by the overall thrust of the above paragraph, it should not be taken to imply that our assessment of India's post-independence performance is entirely negative. Per capita incomes did grow faster than they did in the pre-independence period. Self-sufficiency was achieved in foodgrains, albeit at a very modest level of consumption. The share of manufacturing in GDP increased from one sixth in 1950/51 to one fifth in 1990/91 and the country acquired a diversified and in some ways quite sophisticated industrial base. Over the same period, life expectancy rose from 32 years to 60 years; infant mortality fell from 175 per 1,000 live births to 100; and the literacy rate increased from 17 to 52 percent. The proportion of people below a modest poverty line fell substantially. Nevertheless, India's progress is clearly dismal in relation to the hopes held and targets set at independence and in relation to the achievements of successful developing countries. For example, life expectancy and infant mortality are not much better in India now than they were in Republic of Korea in 1960 and adult literacy is significantly worse.

[3]High growth by itself is not enough. It is important, if the poor are to benefit, that growth be labor-demanding.

in that decade was also the result of the strong (and eventually unsustainable) pressure of demand created by fiscal expansion. Thus, considering the four decades from 1950/51 as a whole, we can justifiably conclude that the low productivity of investment rather than the low rate of saving and investment is the principal explanation for India's slow growth.[4,5]

In our opinion, the low productivity of investment in India was mainly the result of its "planning strategy" whose intellectual underpinnings came from Fabian Socialist ideas and Soviet planning models. The strategy was characterized by a distrust of the price mechanism, a preference for administrative solutions to economic problems, a belief in "self-reliance" that negated the efficient use of foreign trade and technology, and an emphasis on a dominant and expanding public sector to spearhead saving and investment. Such ideas were generally fashionable in the 1950s and may even have had some merit at the time.[6] What is remarkable is that India's policies did not adapt to reality until the 1980s.

Recent economic writing has called attention to the importance of primary health care and education in generating fast growth. India's slow progress in improving health and literacy may be regarded as an independent cause of low productivity, though it must also be emphasized that such improvements cannot contribute

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[4] It will be seen in Table 1 that while saving and investment (at current prices) rates more than doubled from 1950/51 to 1980/81, the rate of investment at constant prices increased by only about 50 percent, the difference being explained by an increase in the relative price of capital goods. The decline in the productivity of investment is obviously sharper if the investment rate is measured at current prices. We think that is the correct interpretation as we are ultimately interested in the return to consumption sacrificed. The rise in the relative price of capital goods was partly a product of India's inward-looking, "heavy industry" strategy and is more properly captured in the falling productivity of investment.

[5] Empirical studies that decompose India's growth into the contributions of factor accumulation and total factor productivity (TFP) support the above observations. TFP growth was negligible until 1980 but increased markedly after that (see Ahluwalia 1991 and Chopra et al. 1995). Ahluwalia attributes the rise in TFP in the 1980s to the (mild) liberalization that began in the late 1970s. Note also the calculations of Joshi and Little (1994, ch.13), which are in the spirit of endogenous growth theories. Joshi and Little estimated rates of return to investment in two periods, 1960/61-1975/76 and 1976/77-1986/87. They found that the rates of return to public investment, especially in manufacturing, were very low in both periods. In contrast, rates of return to investment in private manufacturing nearly doubled from the first period to the next, to a level comparable to those in industrial countries. Joshi and Little attribute the increase in GDP growth to (i) greater aggregate demand pressures; (ii) the rise in public infrastructure investment which, by reducing bottlenecks, contributed to raising productivity; and (iii) the limited liberalization that had some favorable effects on efficiency.

[6] It may well have been right at the time to assign the state a major role in creating "the inducement to invest" by fostering Rosenstein-Rodan style balanced growth. As Bhagwati puts it, "...Rosenstein-Rodan focused on balanced growth in an ingenious argument for coordination of decentralized investment decisions, each held up in a Nash equilibrium but made feasible through governmentally contrived cooperative equilibrium.…" (see Rosenstein-Rodan 1943, Bhagwati 1993). But after the First Five-Year Plan, Indian planning went far beyond the above strategy in the direction of physical planning, strict control and regulation of private sector activities, and extensive public ownership of industry. At the same time, the proper role of the state in the provision of primary health and education was neglected.

much without an increase in the demand for labor. Table 2 details India's inadequate comparative performance with regard to relevant social indicators.[7]

We comment below on the two pillars of Indian planning, controls, and extensive public ownership.

Table 2: **Social Indicators of India and Selected Countries in East Asia**

	Life Expectancy (at birth)		**Infant Mortality Rate (per 1,000 births)**		**Adult Literacy Rate (Age 15+)**	
	1960	**1992**	**1960**	**1992**	**1960**	**1992**
India	44	59	165	79	28	50
China, People's Rep. of	47	69	150	31	n.a.	78
Korea, Rep. of	54	71	85	13	71	97
Thailand	52	69	103	26	79	94

Sources: United Nations *Human Development Reports,* World Bank *World Development Reports,* and Drèze and Sen (1995).

Controls

The origins of controls lay in the collectivist and statist philosophies that had a special resonance in many post-colonial societies. Once controls were established, the dynamics of rent-seeking took over and grew to permeate every aspect of business activity (for further details, see Joshi and Little 1994, ch.2).

Industry

Industry was regulated by three sets of licensing policies that controlled the entry and growth of firms—capacity licensing, monopoly control, and small-scale industry reservations—and, in addition, by foreign trade controls (dealt with below), location controls, and price and distribution controls. Capacity licensing was originally undertaken mainly as an instrument of planning, supposedly but wholly unrealistically to ensure that supply matched demand. Prior clearance in the form of a license was required for routine business decisions such as setting up a plant, expanding or relocating production, or introducing a new product. Firms frequently put in bogus applications simply to forestall competition. No consistent economic criteria

[7]Primary health and education are direct constituents of welfare as well as major requisites of economic progress. Some Indian States like Kerala have made big strides in these areas but most States have failed miserably (see Drèze and Sen 1995).

were ever employed. First come, first served and lobbying by large industrial concerns were the most important determinants of licensing decisions.

Monopoly control was introduced to prevent the concentration of economic power and to curb restrictive practices. Under the Monopoly and Restrictive Trade Practices Act of 1969, firms with assets above a certain threshold (defined in nominal rupee terms and altered very infrequently) had to receive clearances before entering or expanding any line of production. The effect of this regulation was to limit the growth of firms and thus to prevent the realization of economies of scale and to discourage expenditure on research and development. In many cases, by limiting the exercise of countervailing power, competition was reduced, not increased.

Concessions to small-scale industry were introduced principally to promote employment on the doubtful theory that small-scale firms are labor-intensive. Assistance was given to them in various ways, including tax and interest rate concessions, but the most important method was the reservation of a large number of activities for the small-scale sector. This served to curtail competition from and expansion of large firms; indeed, even the expansion of small firms was limited since they stood to lose concessions as soon as they reached threshold size.

In addition to licensing controls, industry also faced full or partial price and distribution controls, for example in petroleum products, coal, electricity, fertilizers, iron and steel, cement, and a range of other items. (Some of these controls still survive.) The objectives of these policies were to provide poorer groups with certain basic necessities cheaply and to provide key inputs for the development process at low prices. These controls have had various deleterious effects, e.g., shortages of several commodities, low profitability that prevented modernization, the survival of inefficient producers, mounting government subsidies, and blackmarkets that indirectly reduced the government's tax revenue.

Industry also bore the brunt of various regulations that interfered with the working of factor markets. The labor market was (and is) characterized not only by wage regulations but by stringent regulations on hiring and firing. The Industrial Disputes Act makes it very difficult to dismiss workers even for clear cases of misbehavior. The Act also requires companies to seek the permission of the government (normally the State government) to retrench workers. For political reasons, this is seldom given. The introduction of the government into labor management in medium and large firms reduces the flexibility of the labor market and can only be to the detriment of the whole workforce, which outnumbers those protected by 20 times or more. It should also be noted here that exit in Indian industry was as difficult as entry or expansion. Both labor retrenchment and bankruptcy procedures were extremely cumbersome and politicized, making it almost impossible to close down a business legally.

Foreign Trade

Imports were comprehensively controlled as will be described below. Before 1980, controls were usually the binding constraint on imports and internal prices were higher than landed cost. This tendency was partially reversed in the 1980s when Indian tariffs were raised to very high levels. The above system produced an internal market for manufactures that was highly protected. This protection was only weakly counteracted by a haphazard system of export subsidies; in general, the tendency was for the effective rate of protection of exports to be much lower than that of domestic sales, and often negative. In addition to the standard "static" resource allocation costs, the system led to delays, corruption and rent-seeking, monopoly, and retardation of technical progress due to isolation from global competition. The effect was to reduce the growth rate not only of exports—India's share of world exports fell from 2 percent at independence to 0.4 percent by the end of the 1980s—but also of GDP since the latter became effectively constrained by the growth of agriculture. In addition, by increasing the capital intensity of techniques and products, this regime reduced the demand for labor and impeded the attack on poverty.

India's attitude to foreign investment was equally isolationist. The Foreign Exchange Regulation Act passed in 1973 restricted foreign ownership in Indian companies to 40 percent, and introduced many other wide-ranging impediments to the activities of foreign investors. The consequence was that inflows of foreign investment were reduced to a trickle (about $100 million per year).

Financial Markets

Government intervention in this sector had its origin in pre-independence nationalist thinking. Colonial banking was perceived to be biased in favor of working-capital loans to trade and large capitalist enterprises, and against rural areas and "the common man". This legacy, combined with socialist ideology, culminated in the nationalization of all banks in 1969. After that, the banks (and the financial system generally) were heavily regulated. There were nevertheless some notable achievements. There was a dramatic expansion of banks throughout the country, which contributed to increasing financial savings. The worst elements of "financial repression" were avoided, largely because inflation remained reasonably low and real interest rates were only mildly negative. But while performance was satisfactory in resource mobilization, it was very unsatisfactory as regards resource allocation. The low productivity of investment in India has many causes but inefficient credit allocation by the banking sector was undoubtedly one of them.

By 1991, the country had erected an unprofitable, inefficient, and financially unsound banking sector.[8] What led to this state of affairs? The following list contains some external and some internal causes, a distinction that is convenient but superficial as most of the internal shortcomings were a natural response to the institutional and regulatory environment:

(i) *Preemption of Bank Resources*. High reserve requirements were imposed on banks, to be held in investments whose yield barely covered the cost of funds.[9] In 1991, an average of 50 percent of deposits was captured in this way; the marginal preemption was even higher, a staggering 63.5 percent.

(ii) *Directed* Credit. Banks were required to allocate up to 40 percent of their lending to certain "priority" sectors at concessional rates of interest.

(iii) *Administered Interest Rates.* Virtually all interest rates offered and charged by banks were stipulated by the government.

(iv) *Lax Regulation and Supervision*. The supervisory system was lax, though ironically the degree of micro-interference was high. There was an absence of clear, internationally comparable accounting norms for banks, so that the essential elements of financial discipline were missing.

(v) *Lack of Competition.* There was a large number of banks but little competition between them.

(vi) *Low Internal and Organizational Efficiency.* Banks had high operating costs. Contributory factors included rampant overmanning, strong unions, bad industrial relations, and inadequate incentives for managerial competence.

vii) As with any system of controls, bank credit was subject to political manipulation.

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[8] A few facts will suffice. The average return on assets in the second half of the 1980s was about 0.15 percent, an extraordinarily low figure by world standards. Return on equity was higher (about 9.5 percent) but that was simply a reflection of the low capitalization of Indian banks. In the same period, capital and reserves averaged about 1.5 percent of assets, compared to 4-6 percent in other Asian countries (World Bank 1990; see also Joshi and Little 1994, 1996).

[9] There are two reserve ratios in India: the cash reserve ratio (CRR) and the statutory reserve ratio (SLR) stipulating the proportion of bank deposits to be held in the form of cash and government securities, respectively.

The result of the above factors was a steady deterioration in the quality of bank portfolios. By 1991 reform of the system was urgent as the banking system was virtually bankrupt and ill-suited to the task of allocating credit or even performing ordinary banking functions efficiently.

Banks are at the heart of the financial system but an efficient financial sector also needs other financial institutions such as insurance companies, mutual funds, and primary and secondary debt and equity markets. Government intervention was pervasive in all these areas but again of the wrong kind in the sense that there was no attention to efficiency, financial soundness, or probity. Debt markets remained undeveloped. The development finance institutions that were established to make up for this lack suffered from all the problems of the banks. Insurance markets were also monopolistic and suffered from excessive premia, inadequate variety of cover, overstaffing, and poor customer service. Primary and secondary equity markets were heavily controlled but nevertheless suffered from nontransparent trading methods and offered poor investor protection (for details, see Joshi and Little 1996).

The Public Sector

In theory, it can be argued that efficiency and productivity are ownership-neutral. In practice, this has proved not to be so because the agency problem in the public sector is far more serious than in the private sector. There is an insoluble problem of reconciling managerial autonomy and public accountability. Some countries have achieved a better compromise than others. India is among the worst.

The domain of the Indian public sector has been extensive and went beyond utilities and "commanding height" industries to include consumer goods production. Many "sick" private sector units were also taken over by the government. The share of the public sector in GDP rose from 8 percent in 1960/61 to 24 percent in 1990/91. It also absorbed a lot of investment but gave little back, e.g., in the 1980s it accounted for about 50 percent of investment while producing about 25 percent of GDP. The inefficiency of the public sector has been well documented. For example, the returns to investment in public sector manufacturing from 1976/77 to 1986/87 have been estimated as 3-5 percent compared with 17-23 percent in private sector manufacturing.[10] A large number of public enterprises made losses. A good many of these loss-makers were technically "sick", i.e., had negative net worth.

Public sector inefficiency was the product of a dual process. On one hand, the public manager's freedom to manage was far more severely constricted than that of his private sector counterpart. On the other hand, his incentives to be efficient (and penalties for being inefficient) were also much weaker. Lack of managerial freedom and autonomy followed from public ownership as this entailed being directly under

[10]For methodology and details of the calculations, see Joshi and Little (1994, ch. 13).

the supervision of a minister and his civil servants who were formally accountable to Parliament. The practical results of this were:

(i) Public enterprises were expected to achieve a wide variety of noncommercial objectives, e.g., employment maximization.

(ii) Since members of Parliament and ministers had electoral aims, public enterprises tended to become instruments of political leverage.

(iii) Accountability to Parliament took the form of extraordinarily intrusive monitoring through parliamentary questions and detailed audits. Since these processes emphasized rigid rules, managers tended to become ultracautious and adopted a "don't rock the boat" attitude.

(iv) All except the most minor decisions regarding investment and recruitment of senior personnel were made by or required the approval of higher-level bodies such as the Public Investment Board and the Public Enterprise Selection Board.

Public enterprises were "compensated" for these restrictions on autonomy by preferential treatment vis-à-vis private sector companies and by soft budget constraints. But these practices merely exacerbated managerial slack and x-inefficiency.

The 1991 Crisis

In the 1980s, particularly in the second half of the decade, the interventionist style of government gradually began to change. There was some dilution of controls, especially those affecting industry, and exchange rate policy became more flexible after 1986. Growth of exports and industrial production increased substantially. Unfortunately the decade also witnessed a sharp reversal in India's erstwhile fiscal prudence resulting in large fiscal deficits and current account deficits. The resulting fragile macroeconomic situation led to a full-scale crisis at the end of the decade triggered by a minor temporary increase in the price of oil that followed the Iraqi invasion of Kuwait.

The economy grew rapidly in the 1980s. GDP growth rose from the long-standing rate of 3.5 percent per year to 5.7 percent. Some of the growth was unsustainable, being the direct result of the fiscal deficits; but part of it was the product of desirable policy changes, in particular the deregulation of controls. These reforms, half-hearted and piecemeal though they were, were proving to be effective, but

foundered in the macroeconomic crisis at the end of the decade.[11] More comprehensive reforms were needed but in a stable fiscal setting.

A program of reform was initiated in July 1991 by the minority Congress government headed by Narasimha Rao, with Manmohan Singh, a distinguished economist civil servant as Finance Minister. This government ruled for almost five years, to be succeeded by another minority government led by the United Front coalition.

Macroeconomic Stabilization

Table 3 presents the salient macroeconomic indicators for the recent past.

Stabilization was essential in 1991 because there was a severe macroeconomic crisis. The need for stabilization was further increased by the fact that structural reform could itself be expected to produce macroeconomic pressures.[12] Short-term stabilization was carried out in an orthodox manner by means of expenditure reduction and expenditure switching policies. Fiscal and monetary contraction were undertaken, combined with a 19 percent devaluation of the rupee, supported by a stand-by credit from the International Monetary Fund.

Table 3: **Growth, Inflation, Fiscal Deficits, and Balance of Payments**

	1985/86-89/90	**1990/91**	**1991/92**	**1996/97**	**1992/93-96/97**	**1997/98***
GDP (% p.a.)	6.0	5.4	0.8	7.5	6.8	5.0
Agriculture	3.4	3.8	-2.3	7.9	3.9	-2.0
Industry	7.5	7.2	-1.3	6.4	8.0	5.7
Services	7.4	5.2	4.9	8.1	7.9	8.9
Inflation (% p.a.) (WPI)	7.1	12.1	13.6	7.3	8.1	5.0
Public Sector Gross Deficit (% GDP)	12.5	12.3	9.6	9.2	9.5	10.0
Primary Deficit		6.3	3.5	2.7	3.0	3.5
Current Account Deficit (% GDP)	2.9	3.2	0.4	1.1	1.2	1.5

*Figures for 1997/98 are provisional and in the case of the public sector deficit are authors' estimates.
Source: Government of India, Ministry of Finance, *Economic Survey 1997-98.*

[11] For a detailed review of the causes of the crisis, see Joshi and Little (1994, ch.7).

[12] Examples are trade reforms that reduce revenue and financial reforms, which raise the cost of government borrowing. Admittedly, other structural reforms help the macroeconomic problem. For instance, a reform of public enterprises can affect the budget favorably. But in the short run, the adverse effects may outweigh the favorable effects.

Output performance has been satisfactory. After a sharp slowdown in 1991/92 as a result of the contractionary policies (and erratic weather), there was a recovery, at first intermittent, then strong and broadbased. From 1992/93-1996/97 (i.e., leaving out the crisis year 1991/92), overall growth was 6.8 percent per year and industrial growth 8 percent, evidently a much better performance than in many other developing countries embarking on post-crisis reform programs. The growth rate was not much higher than in the second half of the 1980s but with an important difference. Growth in the 1980s was based on a mountain of borrowing. Post-reform growth has been accompanied by some fiscal correction and by moderate current account deficits. Even so, as discussed below, the long-run fiscal position is not satisfactory.

Inflation has proved to be rather stubborn, averaging about 8 percent per year from 1992/93 to 1996/97. It has fallen sharply since 1995/96 but we doubt if that is an enduring improvement. The balance of payments has improved dramatically. In 1991/92, the current account deficit fell from 3.5 percent to 0.4 percent of GDP but this was almost entirely because of deflation and import compression. The improvement was sustained, however, and the current account deficit has been about 1.5 percent of GDP or less in succeeding years despite the recovery of output. Until 1995/96, this was mainly the result of strong export growth. In 1996/97 however, export growth fell sharply to 4 percent and the current account deficit stayed low due to buoyant invisible current inflows, particularly private transfers. In addition to the current account turnaround, there was a large surge in private capital inflows starting in 1993/94, resulting in a sizeable accumulation of foreign exchange reserves ($22 billion at the end of 1996/97 as compared to $2.3 billion at the end of 1990/91).

The rate of growth of 5.7 percent per year achieved in the 1980s could not be sustained without major reforms. After a slowdown caused by essential crisis measures, output has again grown by more than 6 percent per year from 1992/93-1996/97. The critical question is whether the stabilization measures, together with the structural reforms already made, make this rate of growth sustainable. We discuss the relevant macroeconomic issues under the headings of fiscal adjustment, inflation, and balance of payments management.[13]

Fiscal Adjustment

In 1991, India was quite evidently in an unsustainable fiscal position. Since then, the fiscal deficit has been reduced but it is still too high from a long-run standpoint.

The primary deficit of the nonfinancial public sector was 6.3 percent of GDP in 1990/91. It has since been reduced to about 3 percent (see Table 3). If the real interest and growth rates are assumed to be 6 percent, then fiscal sustainability (taken to

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[13]For a detailed assessment of stabilization policies since 1991, see Joshi and Little (1996, ch.2).

mean stabilizing the debt-GDP ratio at the current level) requires that the primary deficit should be no higher than about 1 percent of GDP, approximately equal to the inflation tax at an acceptable inflation rate of about 5 percent per year. Sustainability is not a particularly ambitious aim. It would be desirable to raise the growth rate by reducing the debt-GDP ratio and crowding in private investment.[14] This implies a sharper fiscal adjustment. India should aim at eliminating the primary deficit of the public sector and reducing interest payments by privatization.[15]

If we assume that the Center has to bear the entire fiscal adjustment, its primary deficit of about 1 percent has to be converted into a primary surplus of 2 percent. (This in turn is roughly equivalent to a reduction in the Center's overall deficit to 3 percent of GDP and in its revenue deficit to zero.) But it is surely to be desired that the States and the public enterprises should also contribute to fiscal adjustment. So far they have not done so. The deficits of the States have remained in the region of 3-4 percent of GDP. The performance of the public sector enterprises (PSEs) continues to be dismal: neither the profits of the profit makers nor the losses of the loss makers have shown any significant change.

As important as the quantity of fiscal adjustment is its quality. It is vital that the reduction of the fiscal deficit be achieved without cutting capital expenditure or expenditure on social sectors. It is significant in this context that such fall as there has been in the fiscal deficit since 1990/91 has come principally from a reduction in public investment, particularly in infrastructure. Social sector expenditures have been protected (apart from the crisis year of 1991/92) but there is a strong case for increasing them.

In our judgment the following measures are critical in securing the needed fiscal adjustment:

(i) widening the base of direct taxes, possibly by presumptive taxation;

(ii) reducing food and fertilizer subsidies, the former by better targeting, the latter as part of a package to free agricultural prices and close down nonviable fertilizer plants;

(iii) arresting the growth of the wage expense in government administration by a freeze on new employment and by pay restraint;

[14]The transition to a lower fiscal deficit is a task of some delicacy since it has to be dovetailed with the use of fiscal policy for short-run stabilization. It is obviously important to speed up fiscal adjustment during an upswing when there is a natural tendency for the budget to improve. In this context, it is clear that India wasted the opportunity for deficit reduction opened up during the strong recovery from 1994/95-1996/97.

[15]For a discussion of the above calculations and their underlying assumptions and methodology, see Joshi and Little (1996, ch.2).

(iv) eliminating the massive hidden subsidies in the provision of publicly provided goods and services such as water and electricity; and

(v) selling off public enterprises and prime urban land owned by the government.[16]

These measures will require action at all levels of the public sector. The Center is in a strong position because it can harden the budget constraints of both the States and the public sector enterprises by reducing budget support (through direct grants and loans) and restricting their market borrowing. But there are obvious political limits to doing so. Moreover, a crude squeeze on State and public enterprise finances would be counterproductive if it reduces capital formation and social sector spending. In the long run, therefore, addressing the fiscal problem requires an overhaul of Center-State financial relations to give proper incentives to resource mobilization and expenditure control by both tiers of government.

In sum, India's fiscal problem is not insoluble. The extent of soft budgets and hidden subsidies is so large that the required adjustment could be achieved quite rapidly without compromising efficiency and equity. Of course, the political constraints are severe. But unless they are overcome, the reform process could grind to a halt.

Inflation

A disturbing feature of inflation in the 1990s is that it remained high despite a run of good harvests. While a broadly monetary explanation of inflation makes sense, one other contributing factor deserves mention. The growing strength of the farm lobby has resulted in procurement prices for food being raised even in good years. This has led to mounting food stocks with high carrying costs and further to higher issue prices out of concern for the fiscal deficit. As indexation is increasing, this has added a pronounced cost-push element to the inflationary process. Moderation of the inflationary process in India would thus seem to require unwinding the distortionary interventions of the government in the food market, in addition to pursuing responsible fiscal and monetary policies.

Inflation has fallen below 8 percent since 1995/96. This was the result of monetary tightening but also of a freeze on all administered prices including food and fuel in anticipation of the 1996 elections. Tight money also drove up interest rates creating the dilemma considered below.

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[16]Subsidies are dealt with below. Privatization would give a fiscal benefit because public enterprises could be sold at prices significantly above the present value of their profits in public ownership. Further details and analysis of these measures can be found in Joshi and Little (1996) and Joshi (1998).

Keeping the trend of inflation low clearly requires firm control over the rate of monetary expansion. If, however, fiscal deficits are high, real interest rates are driven up and private investment is squeezed. If high rates of private investment are necessary for rapid growth, this in effect means that low inflation becomes incompatible with high growth. This is not a new problem in Indian policymaking. Monetary policy in India has for a long time been guided by the objective of "making room" for fiscal deficits without letting the money supply get out of control. What has happened after reform is that the inflation/growth tradeoff has sharpened because of financial sector liberalization, which has both raised real interest rates and increased their sensitivity to changes in fiscal deficits for any given rate of monetary expansion. The above considerations underscore the need for fiscal consolidation if rapid growth and low inflation are to be successfully combined.

Balance of Payments Management

In 1991, India had an unsustainable current account deficit that had its roots in the fiscal slippage of the 1980s. This was brought down by using orthodox policies. The new problem that India has had to get used to, in common with many other reforming countries, is the volatility of capital flows. From 1993/94 to 1996/97, India had by its previous standards, a very large inflow of portfolio equity capital (about $3-4 billion annually). This was handled without nominal exchange rate appreciation, by a mixture of sterilized and unsterilized intervention. This was a sensible decision since an immediate nominal and real exchange rate appreciation would have hurt export competitiveness. Some real appreciation did take place over short periods as a result of the increased money supply growth that was caused by unsterilized intervention. But such changes were reversed by exchange rate depreciations engineered or allowed by the authorities.[17]

Without doubt, the balance of payments position in 1996/97 constitutes a large improvement over that five years earlier: the current account deficit is moderate despite rapid growth and the external debt position has improved both quantitatively and qualitatively. An important question concerning future balance of payments policy is whether the size of the current account deficit should be an object of policy concern. The Common Minimum Programme of the United Front government estimated the infrastructure investment requirements of the country to be in the region of $200 billion over five years, some of which would have to be met from foreign savings (see United Front 1996). The Programme also asserted that "the nation needs and has the capacity to absorb at least $10 billion a year as foreign direct investment". If we allow for portfolio inflows and assume the annual net capital inflow to

[17]We think that India has the appropriate exchange rate regime for its circumstances, viz. a managed float. For further discussion, see Joshi and Little (1996).

build up to $20 billion per annum in 5 years, and project GDP forward at 6 percent per annum over the same period, we get an implied current account deficit of about 5 percent of GDP in 2000/01, a much higher level than would traditionally be regarded as safe.

There is a fashionable view that the size of the current account deficit should be a matter of indifference so long as it corresponds to a private rather than a public deficit. The rationale is that the former would be self-correcting since the private sector can be expected to respect its intertemporal budget constraints. But India's public accounts are not yet in good order; and international experience, for example in Chile in the early 1980s and East Asia in 1997, shows that unsound private borrowing and lending followed by crises and crashes can and do occur. Experience also shows that the pool of internationally mobile net long-term funds is limited and that countries that have successfully run persistent current account deficits of 6 percent of GDP or more are the exception rather than the rule (see Feldstein and Horioka 1980).[18]

We suggest that India should be wary of running current account deficits higher than say 3 percent of GDP unless long-term real export growth can be stepped up significantly above 10 percent per year. This is so even if capital inflows are not debt-creating. While the latter have better risk-sharing characteristics than bonds, they require a considerably higher rate of return, taking one year with another. It follows from the above that India cannot safely rely on foreign savings alone to secure a substantial increase in the rate of investment—an increase in the domestic savings rate will also be necessary.

Financial Sector Reform

Until 1991, India suffered many of the features of financial repression. This did not impede the mobilization of savings because inflation was low and there was a rapid spread of banks. But financial repression manifested itself both in the highly inefficient allocation of savings and in the unsound condition of many financial institutions. Since 1991, India has made a good start with financial sector reform. But

[18]Canada, Australia, and Argentina ran large current account deficits in the 19th century but long-term capital then was not constrained by exchange risk. Some East Asian countries are currently running current account deficits in the region of 6-8 percent of GDP but they have considerably higher growth rates of exports than India. They are also far more open: in their case a deficit of 6-8 percent of GDP corresponds to 25-30 percent of exports; in India's case it would correspond to 60-80 percent of exports. Moreover, these deficits are probably too high and make these economies vulnerable to capital account volatility. The Feldstein-Horioka paper has been subject to critical scrutiny (see for example Artis and Bayoumi 1990) but its central insight has been amply confirmed by the experience of Mexico and East Asia in the 1990s.

there is still a long way to go in creating an efficient financial sector suitable for a sophisticated modern economy.[19]

The Banking Sector

The reform strategy in the banking sector has been guided by the aim of removing financial controls while simultaneously restoring the health of the banking system and instituting systems of prudential regulation.

Prudential regulation is necessary to deal with the moral hazard problem inherent in the provision of lender of last resort facilities, and this is so *a fortiori* during the process of financial liberalization when increased competition for deposits and loans increases the incentive of banks to take risks. In India, prudential regulation has taken two forms. First, banks have been subjected to internationally agreed accounting norms regarding income recognition, provisioning, and capital adequacy. Secondly, a supervisory authority, the Board of Financial Supervision (BFS), has been constituted. Understandably, the new authority still has a long way to go in devising the information and monitoring structures appropriate for an increasingly complex financial environment. Our main criticism concerns the fact that the BFS has been made part of the Reserve Bank. It would have been better to set up a separate institution as this would have given it a better chance of being independent and not crossing wires with the RBI's monetary policy functions.

The application of the new accounting norms in 1992 exposed the true state of the banking system. Nonperforming assets amounted to 25 percent of the total loan portfolio. Half of the banks had negative net profits and/or negative net worth. It was recognized that restoring the health of the banking system required both a "stock" solution (i.e., a restoration of net worth) and a "flow" solution (i.e., an improvement in future profitability that could only follow from financial liberalization). Restoration of net worth was achieved by capital infusions from the budget. By 1995, most banks had achieved positive net profits and were on the way to achieving an 8 percent capital adequacy ratio. The critical question is whether this represents a durable and fundamental improvement. We remain to be persuaded. The overall level of nonperforming assets is still in the region of 20 percent of the banks' total portfolio. Debt recovery is inadequate and the debt tribunals set up for the purpose are barely functioning. A substantial proportion of bank credit is still locked up in sick industries. There is little evidence of cost-cutting. The weakest banks still remain a serious problem.

We now turn to financial liberalization. A key change has been to reduce the high level of the SLR, which led to low profitability and high spreads. The average SLR has now been brought down from 38.5 percent to 29.5 percent, the near-term

[19]For a detailed assessment of post-1991 financial sector reform, see Joshi and Little (1996, ch.4).

objective being to reduce it further to 25 percent. The change has been achieved fairly smoothly since interest rates on government securities have been increased in tandem, thus increasing the banks' incentive to voluntarily hold these securities. There is obviously an associated fiscal cost, so further rapid progress in this direction depends on the success of fiscal adjustment.

There have been significant moves toward interest rate deregulation. First, in the key market for government borrowing, most long-term securities and a growing proportion of treasury bills are now sold by auction. Secondly, commercial bank interest rates have been substantially liberalized. The lending rate for loans larger than Rs 2 lakhs (approximately US$5,000) has been completely freed though two concessional rates are still in place for loans of smaller size. The deposit rate has also been freed for deposits with maturity longer than one year. There is still some way to go in reducing the involvement of the RBI in the primary market for government debt. But further moves in this direction are now dependent on the success of fiscal consolidation.

While there has generally been progress in interest rate deregulation, this cannot be said of the system of directed credit, which remains largely unreformed. Formally, banks are supposed to direct 40 percent of their credit to "priority sectors", notably agriculture and small-scale industry; in addition, there are various subtargets, e.g., 18 percent of bank credit should be loans to agriculture. Though in the last five years there has been some benign neglect as regards the banks' achievement of these targets, there has been no systematic overhaul.[20]

The record of directed credit in promoting efficiency and equity is discouraging. The efficiency case for directed credit rests on arguments such as breaking the monopoly power of rural money lenders, informational imperfections, and externalities in the provision of financial infrastructure. The financial viability of directed-credit institutions within a reasonable time horizon is surely one test (though obviously not a decisive one) of their success in overcoming these market imperfections. On this test, the record of the last 25 years has not been encouraging. Commercial banks have met directed credit targets but only at the cost of continuing and large cross subsidies and above-average incidence of bad debts. Most regional rural banks and cooperative banks are in a state of financial collapse.[21] Econometric studies of the impact of directed credit on efficiency have also produced disappointing results (see Binswanger and Khandker 1992).

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[20]Note that agriculture and small-scale industry are served not only by the directed credit of commercial banks but also by other special-purpose institutions such as regional rural banks (RRBs) and cooperative banks. Our criticism covers the directed credit system broadly construed.

[21]In 1994, there were 196 RRBs (with 15,000 branches). Of these, 170 were making losses and 150 had negative net worth. Overdues were 60 percent of debt-service due. A similar story applies to cooperative banks except in a few States such as Punjab, Kerala, and Maharashtra. In 1992, their overdues amounted to 34 percent of advances and 50 percent of debt service.

The equity-based argument for directed credit has also not withstood the test of experience. It has proved very difficult to prevent cheap credit being captured by rich farmers. This applies also to credit-based poverty alleviation programs such as the Integrated Rural Development Programme (IRDP). A further important problem with IRDP is that the income generated is insecure and risky. Since poor households do not have the required debt capacity, IRDP borrowing often gets them deeper into debt than they were to start with (see Drèze 1990a). Experience shows that poverty alleviation objectives are likely to be more effectively furthered by other types of intervention, for example, public employment programs (which have the merit of incorporating a self-selection element), social security schemes that target vulnerable groups, and policies to improve primary health and education.

Concessional credit to small-scale industry comes from banks (as part of their priority sector targets) and various development finance institutions.[22] The direct evidence of the relative efficiency of small firms is discouraging (see Little, Mazumdar, and Page 1987; and Goldar 1988). Not only that, the share of institutional credit in total borrowing has been found to be negatively correlated with total factor productivity (see Goldar 1988). We think that subsidized directed credit to small-scale industry should now be discontinued for the following reasons:

(i) small firms, particularly in urban areas, are served by the urban informal credit market, which is both large and efficient;

(ii) the small-scale sector contains many modern enterprises that are commercially on all fours with medium-scale and large-scale firms;

(iii) the portfolio quality and financial viability of many State-level development finance institutions (DFIs) have been severely compromised by concessional lending to small firms; and

(iv) the measures to overcome informational asymmetries by means of institutional credit create more problems than they solve.

An important aspect of financial sector reform in India concerns moves to increase competition among banks. India has a large number of commercial banks but in practice there is very little competition between them. This has now changed to some extent as a result of interest rate deregulation, softening of consortium lending arrangements, and opening up of the banking sector to entry by new private banks (with appropriate restrictions as regards initial capital size). Even so, in our

[22]Many of these DFIs are controlled by State governments but receive subsidized refinance from either the RBI or the Small Industries Development Bank, which is itself a subsidiary of the Industrial Development Bank of India.

judgment, stronger policies to promote competition are required, for example, greater freedom for new banks in opening branches and fewer restrictions on the operations of nonbank financial intermediaries. But the most important change that is required to promote competition and efficiency is privatization. In theory, publicly owned banks could compete vigorously with one another and with private banks and the pressures of competition would bring managerial autonomy in their train. In practice, this is far-fetched. Given the inherited advantages of public-sector banks in terms of branch coverage and customer base, the competitive threat from private banks is too distant to deter interference by politicians and bureaucrats.

The Nonbank Financial Sector

The Capital Market

Development of the capital market required reduction in intrusive micro-intervention on the one hand and regulation to ensure investor protection on the other. A regulatory body, the Securities and Exchange Board of India (SEBI) was set up in 1988 and given statutory powers in 1992. In the primary market for equity, statutory control of the floatation and pricing of issues was abolished in 1992, subject to appropriate disclosure rules. Since then SEBI has concentrated on enacting and enforcing these. Another of SEBI's principal tasks has been to improve the trading and settlement procedures in the secondary market for equity. The Bombay Stock Exchange (BSE), the premier exchange in the country, was well-known for its opaque trading practices. Settlement procedures were equally deficient, and the registration of stock took several months due to bad deliveries or deliberate delay on the part of company registrars.

Improvement has been slow but significant. The transparency of trading practices has improved as a result of the introduction of screen-based trading and the establishment of the National Stock Exchange that competes with the BSE. Another important recent development is acceptance of the principle of setting up a central depository for securities, thus paving the way for their eventual "dematerialization", so that all transfers of shares can be made electronically.

Progress in developing the debt market has been even slower. Changes such as the deregulation of interest rates and reduction in government preemption of funds have revived the debt market to some extent. Nevertheless, demand for corporate debt is still constrained by the portfolio restrictions imposed by the government on domestic insurance and provident fund institutions as well as on foreign institutional investors. Since financing India's infrastructure requirements will call for substantial long-term finance, revival and development of the debt market must be regarded as an urgent priority.

Development Finance Institutions

The DFIs share several features with commercial banks that have resulted in making both themselves and the companies that borrow from them financially weak. First, until recently, they faced little competition as borrowers or as lenders. As borrowers, they shared in the allocation of the funds captured from banks by the government. As lenders, they operated on a consortium basis, leaving their clients little choice. Since 1991, some competition has been introduced. Their privileged access to funds has been withdrawn and consortium requirements have also been significantly diluted. Secondly, the DFIs, particularly those at the State level, face severe governmental constraints on their autonomy. As with banks, privatization would be desirable. Thirdly, like banks they have suffered from soft accounting norms and lending practices. The consequence was the creation of many weak, highly leveraged firms and a deterioration of DFI portfolio quality. Recently, accounting norms similar to those for banks were imposed on the major national term-lending institutions. But the clean-up of their portfolios also depends on changes in the practice of keeping "sick industries" alive. The State-level DFIs remain a serious problem. Finally, as a result of soft accounting procedures combined with signals from the government that existing promoters should be left undisturbed, DFIs have not performed the corporate governance role that might be expected of them as major shareholders. In this regard, there has been no change since 1991.

Insurance

The insurance industry in India consists of two nationalized monoliths, the Life Insurance Corporation of India and the General Insurance Corporation of India, which are both pure monopolies in their respective segments. A government committee has reported on insurance reform (see Government of India 1994). Its recommendations, while not in our opinion going far enough, were sensible. It suggested opening up the sector to domestic and foreign competition, diluting the government's holding to 50 percent of equity, reducing mandated investments in government securities by insurance companies from 75 to 50 percent of their portfolio, and setting up a regulatory agency. With the exception of some moves toward setting up a regulatory agency, nothing has been done, probably because of the threat of trade union unrest.

Liberalization of Portfolio Capital Flows

The Indian government's attitude to capital account liberalization has been cautious.[23] Outflows by residents are still forbidden or heavily controlled. India has always been fairly liberal as regards repatriation of capital and dividends by nonresidents but in the past there were stringent restrictions on nonresident inflows. The latter have now been substantially deregulated so long as they come through recognized foreign institutional investors consisting mainly of broad-based funds such as investment trusts and pension funds. Offshore borrowing by Indian companies is controlled by the Ministry of Finance. There are also strict controls on the foreign asset and liability positions of domestic banks. We think that this cautious stance is justified in view of the problems that can arise due to the volatility of capital flows. Experience in reforming countries suggests that excessive capital inflows can cause real exchange rate appreciation and harm export growth, and lead to maturity mismatches and deterioration in the quality of bank portfolios. Acute difficulties can result if the funds are pulled out, something that can happen not only due to domestic mismanagement but also for exogenous reasons. We thus agree with those who believe that full capital account liberalization should come later in the reform process after trade liberalization, financial regulation, and fiscal consolidation are well advanced.

Fiscal and Trade Policy Reform

Throughout much of the developing world since the mid-1980s there has been an important policy reversal in favor of eliminating most trade controls. India has shared in this movement though to a lesser degree than many other Asian countries. Once controls are eliminated, trade is influenced only by tariffs and subsidies. Tariffs are used both to raise revenue and to protect certain domestic activities. Mainstream economic theory suggests that any such protection should normally be by domestic subsidy. However, the Indian tariff, though reduced, remains highly protective.

Reform of Trade Controls

Prior to 1991, most imports were licensed or prohibited. Licenses were generally granted only on proof that there was no source of indigenous supply, and they were granted only for own use, i.e., not to commodity traders. All "bulk" items (e.g., cereals, petroleum, ores, metals, fertilizers) were "canalised", that is they could be imported only by a government monopoly. Controls rather than tariffs limited

[23] We confine ourselves to portfolio investment here. Direct investment is discussed below.

imports. The balance of payments crisis of 1991 necessitated a temporary increase in the stringency of these controls. But at the same time the intention of moving from a regime of quantitative restrictions to a price-based mechanism was announced. So far as the import of producers' goods is concerned, this has been largely achieved, though most petroleum products and fertilizers remain canalised. But a virtual ban on consumer good imports has remained with only a few recent concessions. (About 75 percent of value added in manufactured consumer goods is still subject to quantitative controls.) This exception to liberalization defies all economic logic, and stems from the Swadeshi movement under which the embargo or destruction of foreign goods was an expression of nationalistic fervor. The other main exception is that a good many restrictions remain on exports of agricultural and livestock products, and ores and minerals.[24] In a few cases the reason is to prevent sensitive food price rises. But the main reason has been to keep indigenous raw material prices low, and to protect some domestic industries. Cotton is one of the most important examples, to protect handloom weaving.

While some exports are restricted, others are promoted. There is a panoply of complicated export promotion schemes. These were intended to mimic Republic of Korea and Taipei,China's trading regimes that created virtual free trade for exporters while maintaining a protected home market. They are probably essential, but only until such time as India has (if ever) very low protection and a domestic fiscal system under which exports are exempt from all domestic indirect taxes.

Reform of Tariffs: Protection and Revenue A spects

In 1990-1991 the unweighted average nominal tariff was 125 percent with a peak rate of 355 percent. There were a great many different rates and dozens of exemptions, resulting from years of lobbying. By 1995/96 the peak rate was further reduced to 50 percent, probably bringing the average to 40 percent, close to the recommendations of the Tax Reforms Committee (Government of India 1992). The big devaluations of 1991 meant that Indian industry could weather both liberalization and these duty reductions without too much pain. The July 1996 budget made some further reductions in customs duties, especially on inputs for the textile and electronics industries, probably increasing their effective protection. However there was a general increase of two percentage points in all duties, probably resulting in a small rise in the average rate.

The Tax Reform Committee recommended a structure of seven rates, rising roughly with the degree of processing, though consumer goods would pay the highest rates of 30-50 percent regardless of the degree of processing. This structure (which would leave India as one of the most protected of all countries) bears no relation to

[24]Quantitative restrictions still apply to four fifths of valued added in agriculture.

any of the static or dynamic arguments for protection.[25] Indeed, the infant industry argument was advanced for yet additional protection.

Our own views are that India should opt for a low uniform protective tariff of about 10 percent (plus countervailing duties for domestic excise and sales taxes).[26] But the strong political economy arguments for uniformity were brushed aside, although important simplifications have been made. The Committee argued in the manner of an old-fashioned tariff commission, whereby comparatively disadvantaged industries get most protection. This may have been necessary for an interim period of adjustment, but not for the long run. The United Front government eventually established a Tariff Commission to consider tariffs product by product—a most regressive idea.

It is not clear whether it has been the political need to reduce protection slowly, or whether it was the loss of revenue that governed the speed of reform. The Budget speeches have reflected both concerns. But the ban on consumer goods imports, a rise in which would have increased the revenue, suggests that protectionism may have outweighed the fiscal argument. Customs revenue stood at 3.9 percent of GDP in 1990/91, and 3.3 percent in 1995/96 (revised budget estimates). This small fall in the face of large reductions in tariff rates is explained by rapid import growth in the previous two years and the elimination of many exemptions. It could be easily offset by other desirable tax changes, for instance a rise in direct taxation. In the long run a low uniform tariff would imply a much lower revenue from protective duties. But "countervailing" duties—the counterpart of domestic indirect taxes—which are not protective, could raise the total taxes collected on imports close to the 3.9 percent of 1990/91.

Domestic Tax Reform

An efficient national system of taxation must involve reform at both the central (federal) level and that of the states. Such a reform requires agreement of the states, and this is complicated by the revenue sharing of the different taxes.

The taxation powers of the Center and the States are laid down in the Constitution. Broadly speaking, the taxes assigned to the States are land tax, agricultural income tax, alcohol excise, and sales taxes. The rest belong to the Center, and consist of customs and central excise, and personal and corporation income tax. The Center retains all customs and corporation tax revenue, but must share central excises and personal income tax with the States in proportions decided by quinquennial Finance Commissions. Currently the rates are 47½ percent of central excise, and 77½ percent of personal income tax. It is not surprising in view of these perverse incentives that

[25] For further discussion of India's trade restrictions and tariff protection see Joshi and Little (1996).

[26] The rationale of our views is fully discussed in Joshi and Little (1996, ch.3).

customs revenue as a proportion of GDP more than trebled in the 20 years before 1990/91, while personal income tax stagnated. The latest Finance Commission has sought to end this absurdity, proposing that the States get a percentage, to be revised only after 15 years, of the pooled total of all central taxes. But this highly desirable change would require a constitutional amendment, and it has not yet been enacted. Because of increasing inefficiency, evasion, and corruption (itself perhaps a function of the Center's lack of concern) the yield of direct taxation in India is very low, about 15 percent of total taxation.[27] The yield in 1990/91 reached a low of 2.3 percent of GDP. The Tax Reform Committee made many suggestions for reform,[28] and the yield has subsequently improved a little: to 3 percent of 1995/96 GDP. This was either despite, or partly because of, a reduction in peak marginal personal and corporation tax rates to 40 percent and 46 percent, respectively.[29]

The Central excises (about 4.1 percent of GDP in 1990/91) consisted of an extremely complex maze of more than a hundred different tax rates on (mainly) industrial products, whether current inputs, capital goods, or final consumption goods. The multiplicity of rates and exemptions bore no relation to any social or economic purpose; and the extensive cascading taxation of inputs, both current and capital, constituted a serious bias against both investment and exports. Much the same applies to State sales and excise taxes (4.2 percent of GDP in 1990/91). They fall predominantly on the same base, and except in a few states are not rebated at subsequent stages of manufacture or distribution. Interstate sales are also taxed at a rate of 4 percent, so that India is not a common market.

Since 1990/91, a good deal has been done to simplify central excises. Specific rates have been changed to ad valorem, and many reduced. The number of rates have also been greatly reduced (to ten). A limited form of VAT introduced in the late 1980s, called MODVAT, under which some but not all excise taxes were rebated, has been extended. At the same time many exemptions have been eliminated. The yield has fallen only a little (to 3.8 percent of GDP).

It is now accepted policy (in New Delhi at least) that the Center and the states should work toward some form of VAT to replace both excise and sales taxes, except for the excises on alcohol, gasoline, tobacco, and possibly a few other luxury consumption goods that are prevalent in all countries. Much good work has been done by the National Institute for Public Finance and Policy (1994) on the difficult problem of devising the best system that

(i) preserves the fiscal autonomy of the States;

[27] Another reason is that the Center cannot tax agricultural income, and the States do not want to.

[28] See Government of India (1992, part I, chapters 5 and 6).

[29] In the 1997 budget, these rates were further reduced to 30 and 35 percent, respectively.

(ii) permits some interstate redistribution;

(iii) preserves the desirable economic qualities of the VAT; and

(iv) is administratively efficient, discouraging leakages and corruption.

In most federations VAT is levied and controlled by the Center, though administration and proceeds are shared. Examples include Argentina, Austria, Germany, and Mexico. This is certainly the best option. However, all observers argue that there is no possibility of getting the States' agreement to the constitutional changes that would be required. Though a radical solution under which the Center gives up all domestic indirect taxation might be possible in the long run, the most negotiable solution is probably a dual system under which the Center would continue with an extended and simplified MODVAT, while each State would institute its own VAT with some agreed harmonization to create a common market within India. Unfortunately little progress seems to have been made in achieving this reform.[30]

The Reform of Expenditure and Reduction of Subsidies

Subsidies are negative indirect taxes. The explicit central subsidies in 1990/91 were about 2 percent of GDP. Export subsidies were easily eliminated after the large devaluation. But almost no progress has been made in reducing the other two main subsidies, on fertilizers and food. They constituted about 1.3 percent of GDP in 1990/91 and 1.1 percent in 1995/96.

Fertilizer subsidies are partly subsidies to the fertilizer industry, and partly to farmers, very roughly half and half depending on the c.i.f. price. There is no sound economic argument for special protection of fertilizer plants: there is only a short-run argument that otherwise, probably half the industry would collapse. But the subsidy should certainly be reduced, and a beginning made with closing high-cost plants. There is also no good argument for subsidizing fertilizers to the farmer. This is discussed further below when we consider agricultural trade.

Food subsidies represent the difference between the procurement prices paid by the Food Corporation of India and the issue prices of the public distribution system (PDS). For 1995/96, Rs 5250 crores was budgeted—about one-half percent of GDP. The justification for food subsidies is poverty relief. However it is widely acknowledged that the PDS has proven to be a very cost-ineffective way of relieving poverty (for example see Parikh 1994, 1998). This problem is discussed below.

[30] On all this see Joshi and Little (1996, ch. 3).

The above explicit subsidies are the tip of an iceberg. In the case of public services or products that could be sold to persons or firms, one should include as subsidy the difference between cost and what is recovered. A calculation of subsidies along these lines has recently been made for the year 1994/95 (see Table 4) by Srivastava and Sen (1997), building on the pioneering paper by Mundle and Rao (1991). The calculation distinguishes between subsidies on "merit goods" (defined, rather unconventionally, by these authors as goods with significant positive externalities, e.g., primary health, primary education, R&D) and "nonmerit goods". The subsidy on merit goods is about 4 percent of GDP, that on nonmerit goods a massive 10 percent of GDP, a figure that is comparable to the overall public sector deficit. This includes the notorious subsidies on power, irrigation water, and other agricultural inputs many of which are the responsibility of State governments. None of these subsidies accrues significantly to the poor.

Table 4: **Subsidies in India**

	Center	**States**	**(% GDP)** **Total**
Subsidies			
Merit Goods	0.7	3.0	3.7
Nonmerit Goods	3.8	6.9	10.7
Social Services	0.3	2.9	3.2
Economic Services	3.5	4.0	7.5
Total	4.5	9.9	14.4

Sources: Government of India, Ministry of Finance (1997), and Srivastava and Sen (1997).

The efficiency and cost of supply of government services are also matters of concern. In general government departments are grossly overstaffed, and pay rates are relatively high, and have grown excessively. From 1974/75 to 1989/90 pay per government employee rose by 5.4 percent per annum while per capita income rose by 2.5 percent per annum. Even if direct retrenchment is ruled out, pay restraint and a freeze on new employment are essential.

Agricultural Trade and Incentives

The fertilizer subsidy is only a small part of the total massive subsidization of agricultural inputs, much of which is the responsibility of State governments. The farmer pays only a small fraction of the cost of the water and electricity that he uses. These subsidies, although politically influenced to a high degree, are an essential part

of the agricultural economy. The prices of all major agricultural products are determined by the central government's control of trade. The price of cereals and cotton has been held below world prices in most years. Farmers pay more than world prices for machinery and pesticides. Although sugar and edible oils are protected, agriculture on balance has been heavily disprotected.[31] The input subsidies offset this partially.

If the input subsidies, which are not only a fiscal strain but also cause production inefficiencies such as an excessive use of water, and nitrogen relative to phosphates, are to be eliminated, agriculture clearly must be compensated. Free trade would more than compensate, though there would be problems of adjustment, suggesting it should not come overnight.

The rise in the price of food consequent on free trade in farm products would imply that antipoverty programs should be strengthened. This is discussed below. Even if the whole of the fiscal savings from eliminating subsidies was spent on such programs the economic and social gains would be great. First, these programs would be far better from a distributional point than input subsidies. Second, agricultural incentives would be changed in such a way as to greatly improve the efficiency of production and the value of output. Cereals and cotton production would be favored relative to the overprotected oilseeds and sugar.

The reform of agricultural trade policy and pricing is as important as that of industrial policy and pricing, and financial reforms. But it has attracted little attention. Much less has been done, and there is no accepted framework of reform. Although there has been some derestriction, for example, exports of rice, trade remains highly controlled. To some extent this is because agriculture is a State subject. Nevertheless the broad lines of agricultural policy are determined by the Center's control of agricultural trade, and by its fertilizer policy.

Industrial Policy Reform

The strategy of Indian industrialization did not change much from Independence to 1990. As described earlier in the first section, it emphasized heavy industry, public ownership, and import substitution. This went along with contempt for the price mechanism, and a belief that competition was harmful. The result was an almost incredible maze of controls. Big private business, both domestic and foreign, was feared and distrusted. Special obstacles were put in the way of expansion by "dominant" companies, and those with significant foreign ownership. Yet at the same time the political support of private industry was needed. So businesses were

[31] In the 1970s, the ratio of nominal protection in agriculture to that in manufacturing was 0.4; in the 1980s, it was around 0.6. This calculation comes from Pursell and Gulati (1995). The same source estimates the ratio of effective protection in agriculture to that in manufacturing as 0.64 in 1986/87.

protected in many ways from both foreign and domestic competition. Their incumbent workers, like those in the public sector, were doubly protected as it was made illegal to sack anyone without permission, or even to vary the kind of work.

Deregulation

Most controls over production and investment by domestic enterprises are now gone, and private enterprises can in principle compete in nearly all industrial sectors. Foreign direct investment has been made much more welcome, though it is still restricted and controlled. This all adds up to an important change of regime and outlook. Foreign ownership up to 51 percent is now "automatically" approved for a wide range of industries deemed to be of national importance. Proposals up to 100 percent are considered by a Foreign Investment Promotion Board. There has been some response. Direct foreign investment rose from $150 million in 1991/92 to $2 billion in 1996/97, still small compared to People's Republic of China, Indonesia, or Thailand. Most observers agree that the combination of increased competition and reduction of controls is making Indian industry more efficient and more enterprising, though there is as yet no hard evidence. But there is still a great deal that is wrong. It stems largely from the continued importance of public industry, especially its dominance of the nontradable goods or infrastructural sectors.

The Public Sector and Privatization [32]

There has been a wave of privatization in the world, largely resulting from the fiscal burden imposed by loss-making public industries. In India, the central nondepartmental public enterprises produce mainly tradable goods, and are important or dominant in heavy industry: basic metals, heavy machinery, oil, and fertilizers. Except in the oil industry, returns are very low, and over 100 enterprises were actually making losses in 1992/93. Half of these had been referred to the Board for Industrial and Financial Reconstruction by end-1994 (see below). The situation is likely to get worse, now that imports have been liberalized and private competition is permitted. It is very unlikely that their efficiency can be greatly improved without privatization, which, however, is not on the political agenda. Yet these industries are not natural monopolies, and freedom to import can ensure competition.

Infrastructural services are dominated by central departmental enterprises (telecommunications and the railways) or by State enterprises (power, water, and other transport). The problem here is not merely losses, but inadequate services. Infrastructure is in poor shape. Rail freight services are inadequate, and many main roads

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[32]For a more extended treatment see Joshi and Little (1996, chapter 5, especially section 5.2.1); and Ahluwalia (1998).

are highly congested. Ports are also congested, and delays endemic. Telephones are scarce, and connections erratic. Parts of the irrigation system are falling into disrepair. However, power shortages are probably the most threatening for economic growth. The state electricity boards (SEBs) are notoriously inefficient and corrupt, and cannot be relied on to pay their bills. This makes investment in new generating capacity difficult. However, one State (Orissa) has taken the plunge into privatization cum regulation. It is hoped that others would follow suit. One way or another, drastic reform of the SEBs is essential.

Infrastructural deficiency results from a long history of undercharging and underinvestment. The undercharging comes from political control of pricing, and the fact that politicians at both the Center and in the States are unable to resist the short-term popularity of subsidizing rail and bus travel, and giving farmers subsidized, even free, electricity and irrigation water. The underinvestment stems from the waste of public revenue on subsidies, and on investments in manufacturing projects with very low returns.

The massive investment now needed far exceeds public sector financial resources. The urgent need to infuse private investment, both domestic and foreign, into infrastructural projects on a large scale is accepted in principle. In practice the modalities for doing so, thus permitting competition with the public sector, do not seem to have been fully researched, let alone settled. The same is true of the problem of regulating natural monopolies where adequate competition cannot be ensured. It took over three years of negotiation to agree on the first major foreign investment in electricity (the Dabhol project in Maharashtra).

The Legal Framework for the Private Industrial Se ctor[33]

Privatization and introduction of private competition into infrastructural services should be the most burning issues in industrial policy. But there are also a good many legal impediments to the efficient private use of productive resources. Indian businessmen have long been harassed by restrictive regulations, but also protected from competition. These features have been reduced, but not eliminated. Company Law, Labor Laws, and Urban Land Law have combined to create the Indian phenomenon of “sick” industries—firms that are bankrupt but cannot be closed down. Creditors cannot sell the assets and labor is unpaid. The waste of assets that should be redeployed is considerable. These laws were enacted with good intentions but without understanding of economics. Civil servants and legislators seldom understand, or refuse to recognize, that protection of incumbent workers in larger firms reduces their demand for labor, and thus by exclusion harms the poor outsiders; nor that company laws protecting incumbent management often preserve an inefficient

[33]See also Joshi and Little (1996, chapter 5, especially sections 5.3 and 5.4); and Goswami (1996).

use of assets. As long ago as 1985 the Board for Industrial and Financial Reconstruction was set up under the Sick Industries Companies Act to deal with "sickness" in both the public and private sectors. But its own bias in favor of reconstruction, together with excessive legal delays and impediments, have meant that it falls very far short of resolving the problem.

Another interference with the free working and efficiency of manufacturing industry is the reservation of many products for exclusive production by small firms. This, together with excessive fiscal favors, distorts the natural growth of firms, and impedes technical progress and exports. No doubt this legislation was intended to promote employment. But research has shown that small firms are not reliably labor-intensive nor efficient.[34] However, the small enterprise lobby is strong, and nothing has been done.

A thorough revision of all the legislation that affects the ownership and use of industrial assets is needed. Labor legislation that favors only a tiny minority of the workforce must be received with discretion. The scope for appeal to the law also needs to be reduced. The courts are overburdened, and delays too long, for justice to be dispensed. More generally, some critics have maintained that the once proud Indian legal system has degenerated to the point that it can no longer fulfill its essential commercial role of impartially administering property laws and enforcing contracts.

The Social Sectors: Poverty and Reform

Expenditures on health, education, and welfare can be considered to be quite largely, but not wholly, poverty-related. Rural development expenditures include mainly rural employment schemes which, in intention at least, are primarily intended to relieve poverty.

India lags behind many other poor countries in educational standards, and health and health improvement (see Drèze and Sen 1995). Expenditure was inadequate and the programs have also been much criticized for relative neglect of primary education and primary health care. We agree with the criticisms but will not go into the details of policy in these sectors, for reasons of both space and knowledge. We concentrate rather on what may be used to soften some of the possibly adverse effects of structural adjustment on the poor.

The crisis of 1990/91 resulted in a reduction in central social sector and rural development (SSRD) expenditure for two years. There was probably some increase in rural poverty in this period. The reforms were much criticized at the time as causing poverty. This criticism was essentially a confusion—deliberate no doubt on the part of conservative antireformers—in the reduction of expenditure needed to restore

[34]See Little, Mazumdar, and Page (1987, chapters 7 and 16); and Goldar (1988).

external viability with the long-term program of structural reform. Since 1992/93 there has been a remarkable rise in SSRD expenditures. The provision in the budget of 1995/96 was 63 percent greater than expenditure in 1992/93, a period in which inflation was about 30 percent. The profile of the programs has also been slanted much more toward poverty relief, both immediately and in the longer run. For instance, budgeted primary education expenditure has risen by 129 percent and expenditure on rural development by 148 percent. Estimates of the extent of poverty are contentious. Under the Narasimha Rao Government, the Planning Commission estimated a very sharp drop between 1987/88 and 1993/94 in the percentage of people below the poverty line, from 30 percent to 19 percent. Under the United Front Government, the Planning Commission has estimated no change, about 39 percent in both years.[35] 1993/94 is the latest year for which estimates can be based on a full National Sample Survey. But a comparison of 1987/88 and 1993/94 tells one nothing about the relationship of poverty after 1991/92, the first year of reform. However it seems clear that there was a rise in poverty in 1992/93 as a result of the stabilization measures, and that this had been reversed by 1993/94 (Joshi and Little 1996, ch. 6; and Tendulkar 1998). This was still too early for structural reforms to have had any measurable effect.

One can expect the liberal reforms to reduce poverty as compared with the old policy regime. Growth should be faster. The demand for labor will rise not only because of this, but also because the pattern of output growth should be more labor-demanding. Freer trade certainly works in this direction, both for industry and agriculture. The reduction in interest rate subsidization, and in public sector investment in tradeables, will also help. However, there are two potential by-products of reform that may offset the favorable effects, if no compensating action is taken. The first is that increasing industrial efficiency, especially in the public sector, may require widespread redundancy before the favorable effects on employment take effect. The second is that freedom of agricultural trade, and elimination of agricultural input subsidies, implies a rise in food prices that would hurt poor consumers, and also subsistence farmers.

The industrial employees who would be made redundant are not poor. Also, most of them would quite quickly find new employment, as the demand for labor grows. However, redundancy would nevertheless result in hardship for some, if not well compensated. But since the potentially redundant are being paid full wages to produce little or nothing, the public sector can make both generous redundancy payments and save money. The problem of redundancy was recognized with the establishment in 1992 of the National Renewal Fund supported by IDA contributions. It has been used mainly for public sector voluntary retirement schemes, in particular for

[35] Independent researchers have estimated a drop in the headcount index of poverty from 38 percent in 1987/88 to 35 percent in 1993/94.

75,000 workers who have been retired in the textile sector. But it is too small to cope with the full extent of the problem, and the fear of creating redundancy was a factor inhibiting public sector and other reforms from 1990/91 to 1995/96. There are probably 2 million redundant workers in the public sector alone. Even if one allows a 10-year horizon, the release of redundant labor needs to be accelerated.

A rise in farm input and output prices is a rather more difficult problem. The knee-jerk reaction would be to increase the food subsidies via the Food Corporation of India and the Public Distribution System (PDS).[36] But it has been convincingly shown that the PDS is a grossly inefficient instrument for reaching the poor (see Parikh 1994, 1998).[37] Various suggestions have been made to improve the poverty targeting of the food subsidies, e.g., by limiting them to cereals, and denying ration cards to those with overt signs of wealth, More radical would be the replacement of the PDS by a system of food stamps.[38] This would be a more economical and flexible way of subsidizing food consumption, but the targeting problem would remain.

Public Employment Schemes can almost certainly be more effective instruments of poverty relief than food subsidies. The two main central public Employment Schemes are the Jawahar Rozgar Yojana (JRY) and the employment-assurance Scheme (EAS). These schemes are modelled on the Maharashtra Employment Guarantee Scheme, which was highly successful in preventing destitution and death during the drought years of the early 1970s. The needy targeted themselves because wages were very low, and the drought meant that there was almost no alternative employment (for a general assessment, see Drèze 1990b). Later it became much less well targeted, and probably ceased to be a genuine guarantor of employment, because the official minimum wage was raised and it was illegal to pay less (see Ravallion, Dutt, and Chaudhri 1993). Its most important clone, the JRY, is also rather poorly targeted on poverty, only about half of those finding employment falling below the poverty line (see Neelakantan 1994). Other leakages result in only a small percentage of the expenditure reaching the poor (see Guhan 1995). Hence, these schemes, in

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[36]The basic structure of the PDS is as follows. The Food Corporation of India buys specified commodities (mainly foodgrains) at "procurement prices" and then supplies them at "issue prices" that are lower than open market retail prices through "fair price shops". The setting of procurement and issue prices is a complex exercise. On one hand, if procurement prices are too far below market prices, the government cannot procure. If procurement prices are too low and also act as support prices, the incentive for farmers to grow foodgrains is adversely affected. On the other hand, if procurement prices are too high, issue prices have to be raised, which goes against the objective of protecting the poor. If issue prices are not raised, the budgetary burden goes up. Note also that the difference between procurement and issue prices is not a straight subsidy to consumers because the operations of the Food Corporation of India involve enormous wastage and corruption.

[37]An earlier study using a general equilibrium model was Parikh and Srinivasan (1993).

[38]Food stamps are essentially a second currency doled out to the needy that can only be spent on certain food items. The licensed food retailer is reimbursed in cash by the issuing agency. One could not fully ensure that the retailers sold only food in exchange for stamps: but neither this leakage nor the fact that the stamps could be sold for cash would matter. The recipient of the stamps still gains. Food stamps can do everything the PDS can do, and do it more flexibly and cheaply. There would be no need for public distribution and government shops. Government buffer stocks could still be operated, if desired, with purchases and sales being made through normal commercial channels. The problem of targeting would however remain. Food stamps are commended in Bhagwati and Srinivasan (1993).

times and places of normal rainfall, cannot be advocated for poverty relief alone, especially if the going agricultural wage or more has to be paid. The works created must be valuable, and there is some doubt about how valuable they are. More research, improved design and implementation, and careful monitoring is needed.

Direct transfers for the disabled, for the old and for widows; and allowances for sickness and maternity benefit are likely to be better targeted to poverty than existing public employment schemes (but are not competitive with them). Tamil Nadu has used such transfers since 1989/90. The 1995/96 budget assumed for the Center for the first time a role in helping the States with direct transfers, by instituting the National Social Assistance Scheme. These transfers, unlike public employment schemes, should not be regarded as interim measures whose need will hopefully vanish with the success of labor-demanding growth policies, but as permanent features of a good society.

Prospects for Growth and Reform

The rate of growth of India's national income will depend very much on a continuation of the reform process of 1991-1996, toward an open, liberal, and stable economy in which the incentive structure directs individual action toward the general welfare. If the reforms made so far go no further, or are even in some respects reversed, then the growth rate of 5-6 percent per annum achieved in most years since the early 1980s may sink back to the average of 3-4 percent per annum that prevailed earlier.

The bearish facts that could have this result are:

(i) The growth rate since 1980 has been supported by unsustainable borrowing. The central government can no longer safely enjoy a primary deficit.

(ii) The very small improvement in the fiscal deficit since 1990-91 has been achieved by a fall in public investment.

(iii) The material infrastructure is under greater strain than ever before, and without major economies in current expenditure, public investment in the infrastructure will continue to be inadequate.

(iv) Excessive public borrowing results in very high interest rates, discouraging private investment.

(v) The economy has been enjoying an exceptional run of good monsoons.

The above makes it clear that the maintenance of 5-6 percent growth requires a very substantial reduction in public sector deficits, both at the Center and in the States. This must not be achieved by cutting investment, but mainly by reducing implicit and explicit subsidies. The State Electricity Boards must be radically reformed (or abolished), and the problems associated with private, including foreign, investment in power, transport, and telecommunications must be solved.

We believe that the more exciting prospect of growth in the region of 8 percent per annum requires the rapid fulfillment of most of the other reforms that we have discussed. This is necessary for an improvement in the use of existing resources to continue, and to ensure that new investment has a high social yield. Further strengthening of financial institutions is a high priority. The banks are still inefficient, and weighed down by nonperforming assets. The cost of intermediation is high by international standards, discouraging private investment. A further large reduction in protection over the next few years is needed to ensure a high social return to investment, both domestic and foreign. It is impossible to assign priorities to the other reforms; all are needed to increase the efficient working of the economy.

We have argued that the prospect for growth depends on reform. What are the prospects for reform? It is now clear that the 50 years of almost unbroken Congress government is likely to be succeeded by evanescent coalitions including a large number of small parties with limited regional, and communal or caste, support. This might in theory be consistent with stable rather liberal and open economic policies.[39] This, however, is too optimistic. India still lacks the strong consensus in favor of relative laissez-faire and the open economic policy that is required for such a scenario. Certainly in the past 10-15 years a consensus has formed among policymaking elites that the highly restrictive *permit-raj* economic regime must be reformed. But a consensus is still far off at both the Central and State levels, favoring the very liberal policies we espouse and believe to be essential for achieving growth rates of over 6 percent per annum. Moreover, despite the consensus in favor of some unravelling of red tape, the reforms of 1991-1996 would not have been achieved without the leadership of a small, dedicated body centered on the Finance Ministry. We fear that the force of this leadership may now decline.

Increasing the Power of the States

One reform that will surely be pressed forward is a devolution of powers and responsibilities to the States. The growth in the strength of political parties with a following in only one or two States will ensure this.

[39] Italy and (until recently) Thailand are, perhaps, examples of unstable polities and stable economic polices, combined with good economic performance.

Some believe that such a devolution and decentralization of powers is a reason for optimism. It has been suggested that State governments may now show greater stability than the Center, and also that some may be more reform-minded than the Center. We have little faith in such arguments. In the past, State governments have generally been unstable, the long term Communist government of West Bengal being an exception (its economic performance was also exceptionally bad). A few have admittedly shown themselves more willing to privatize than the Center, and have even welcomed Coca Cola. But this does not add up to any convincing movement.

One should in any case ask what the States can do, independently of the Center, which would promote higher growth for themselves and for India as a whole. In any federation the Center or Federal Government must hold the main keys that govern the influence of policy on the economic growth of the nation. Apart from defense, it must be responsible for macroeconomic stability; this in turn entails regulation and control of banking and the monetary system, and the borrowing of State and municipal governments. It must also be responsible for the international trade regime, and for all matters affecting members of different states including interstate trade and justice. Economies of scale and externalities also make large parts of the economic infrastructure a natural central preserve, for example, railways, trunk roads, and telecommunications. Finally, the Center has a comparative advantage in raising most taxes, either because the tax base is mobile or because of economies of scale.

How then may the States help given a relative increase in the devolution of powers and responsibilities? The general economic argument for devolution is that subnational governments are closer to the people whose wants and needs vary from region to region. It is supposed that they will therefore more efficiently deploy public resources in accordance with local tastes. This is an *a priori* argument that may not be realized in practice, since State or local governments may be more corrupt, nepotistic, and inefficient than the Center.

The above argument for devolution concerns only expenditure. The comparative advantages of the Center in raising revenue are such that there is always a fiscal imbalance in federations. The States depend on the Center for much of their revenue (in India it is about 40 percent). This means that full fiscal independence, and the advantages in terms of discipline and responsibility that go with it, is undesirable if not impossible. There would be grave difficulties in the way of increasing the States' own tax revenue. Sales taxes, which account for about 60 percent of their own revenue, are already a serious source of economic inefficiency.[40] Nevertheless, there could be some benefit from increasing both the responsibilities of the States and the revenue they derive from the Center, provided that the latter accrues on an "objective" basis, i.e., a basis that does not depend on the States' own expenditure. In the

[40]We have briefly discussed above the problems associated with introducing States' VATs. See also Joshi and Little (1996, section 3.11) and references given there.

past the awards of the Finance Commissions have been too much concerned with filling the States' budgetary gaps. A major reform of the manner in which the central revenues are shared with the States is in any case highly desirable (see above), and is essential if the responsibilities of the States are to be increased.

The Center must certainly continue to regulate the borrowing of the States, both domestic and foreign. In a good many countries, excessive borrowing by subnational governments or other institutions (often to finance current expenditure) has been a major cause of national crisis. The national or Federal government cannot credibly maintain that it will never bail out bankrupt states (or major banks). It is therefore compelled to regulate in the national interest.

Further devolution of responsibilities to the States, together with a clearer demarcation of some of these responsibilities as between the Center and the States, is a politically essential reform that could also be beneficial from a welfare and efficiency point of view. The latter must depend on how well the devolution is done, and is any case far from certain. Success requires agreement on quite radical fiscal reforms on the part of the Center and the States. Finally, one must remember that the States have been responsible for the worst populist measures of heavily subsidized rice and bus fares; and free electricity and irrigation water for farmers.

The greater freedom for private investment, both domestic and foreign, already in place implies greater freedom for the States to compete for this investment. Obviously their own budgets must limit the attractions they can offer in terms of facilities or reduced taxation (this increases the importance of hard budgeting by the Center). Nevertheless this competition could help to increase private investment. And some of the most progressive states may be able to go ahead still faster.

One can conclude only by saying that the effects of increased devolution on the welfare of the country and the prospective rate of growth are highly speculative. Devolution thus cannot itself be counted as one of the reforms we regard as essential for raising the rate of growth of the Indian economy.

Conclusion

India grew fairly steadily at about 3.6 percent per annum for 30 years after Independence until 1980. As the rate of population growth was about 2.3 percent, the growth per capita was a disappointing 1.3 percent per annum. During this long period the rate of saving doubled. Therefore the growth productivity of savings halved. This was partly due to a relative rise in the price of capital goods. But there was also a large fall in the productivity of investment, which in real terms rose by about 50 percent as a percentage of GDP.

In the 1980s the growth of GDP rose to about 5½ percent per annum, while savings and investment remained on a plateau of about 22 percent of GDP. What

explains this jump? One reason is that the boom was based on an unsustainable level of borrowing, resulting in a fuller use of existing resources. The other reason is a rise in the efficiency of the use of resources, especially private investment.[41] This in turn may be attributed to the mild, liberal reforms that began in the late 1970s.

In the 1990s the higher rate of growth was restored after a sharp drop in the crisis year of 1991/92. Savings and fixed capital formation remained on the previous plateau. During 1996/97 signs of industrial recession were becoming apparent probably due to the high real interest rates arising from monetary attempts to contain inflation in the face of the government deficit. 1997/98 is likely to show a reduced rate of growth.

The big question is whether a growth rate of 6 percent can be sustained, let alone increased to 8 percent or more as some optimists predict. We have given a number of reasons why a fall back to the Hindu rate of growth is not difficult to imagine. To prevent this, domestic investment in the infrastructure, much of it public, must be increased at the same time as the public deficit is reduced, so that private investment in agriculture and manufacturing has both the room and the incentive to expand. This at least is necessary to sustain the present rate of growth of about 6 percent per annum.

Still higher rates of growth depend on continuing liberal reforms that will encourage investment in labor-intensive activities, resulting in a more effective use of India's labor force. While these include, of course, both agriculture and services, the export of labor-intensive manufactures remains the most promising way ahead. It was the high road for Hong Kong, China; Republic of Korea; Singapore; and Taipei,China for at least the first 15 years of their astonishing growth. It will not be so easy for India, which now has People's Republic of China to compete with. Meanwhile, the industrialized countries of the West may react unfavorably to labor-intensive imports now that they themselves have a problem in employing unskilled labor. Against this, in the long run, India could look forward not only to markets in the Far East, but also to large foreign direct investments from these increasingly high-labor-cost countries, provided that exports are not regulated or taxed, and employment conditions are not discouraging.

We see no other *deus ex machina* that might result in very high growth rates, or an acceleration of income per capita. The plateau of savings and investment is already high for a very poor country, and higher rates such as prevailing in the "miracle" countries are likely to come only as a result, and not as a cause, of very rapid growth.

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[41] Joshi and Little (1994, 327-8) provide a fuller discussion of the reasons for the rise in growth rate.

A demographic miracle is also unlikely. India has not reached the standard of living and education at which a rapid fall in the birth rate is predictable.[42]

Since we do not believe that the political conditions are favorable for rapid liberal reform, we would not predict growth rates of 7 percent or more. We think that 5-6 percent will continue, provided that the fiscal and infrastructural problems are surmounted. But a relapse toward the Hindu rate of growth has to be feared.

Postscript

We wrote this paper in early 1997. We see no reason to alter the judgments made. As we anticipated, growth of GDP fell to 5 percent in 1997/98 with the growth of industrial production down to 4.2 percent. Three factors were responsible: (i) high real interest rates caused by tight money policies undertaken for anti-inflationary reasons; (ii) increasing infrastructural bottlenecks; and (iii) very disappointing export growth (2.6 percent) for a second year in a row. These factors are a warning of major underlying problems and confirm our view that the potential growth rate of the economy does not as yet exceed 6 percent.

We maintain our judgment that sustained growth of over 7 percent requires the rapid fulfillment of the radical reforms outlined in this paper. We can illustrate this with reference to export promotion, which is clearly of central importance in achieving rapid, labor-intensive growth. The limited reforms since 1991 undoubtedly contributed to the healthy growth of 20 percent per annum in the dollar value of exports from 1993/94 to 1995/96. But the sharp slowdown in export growth to only 3 percent since then also indicates the shallowness of the improvement. There is still no sign of an East Asian or Chinese style export boom in labor-intensive goods that would accelerate poverty reduction.[43] To this end, deeper reforms are necessary along with the maintenance of a competitive exchange rate. Firstly, the process of trade liberalization must be carried further. This includes elimination of import controls on consumer goods and reduction in tariffs to a low uniform level. Secondly, agricultural trade must be freed. India could then become a substantial exporter in many agricultural commodities (see Pursell and Gulati 1995, and Gulati 1998).[44] Thirdly, reservation of products for small-scale industry must be rolled back. Exports of mass consumer goods such as shoes and garments may require production in factories employing large numbers of people. Often the technique of production is the same in a

[42]There are some signs that India's population growth is slowing. Even if this is confirmed, it remains true that the labor force will continue to grow rapidly in the next two decades. The implied increase in the ratio of working-age adults to children will have a favorable effect on the growth of incomes but only if the adults find productive employment.

[43]A penetrating analysis of India's export performance is given by Srinivasan (1998).

[44]The poorest consumers would have to be protected from the consequential rise in the price of staples. This issue is discussed above.

small as in a large firm but the large firm saves capital by lower building costs and smaller inventories per unit of output. There are many examples of this in People's Republic of China and East Asia generally. Fourthly, direct foreign investment must be encouraged in labor-intensive goods.[45] India does not currently provide a welcome environment for foreign investment in these sectors, partly because many of these are reserved for small-scale industry. Finally, infrastructural constraints must be broken if India is to compete in world markets.[46] Thus, sustained export growth requires reforms across a broad front. The same goes for other reforms: the strong interdependencies between them imply that success depends on pursuing them as a package.[47]

We were rather pessimistic about the future of reform, because it was likely that India's political future would consist of a series of unstable coalitions. The United Front minority coalition government, which was in power for only a few months, has been replaced by an equally fragile Bharatiya Janata Party (BJP) minority coalition government. The BJP government has also declared itself in favor of reform, but in terms that betray the nationalist and protectionist sentiments that are known to be strong within the party. The first full budget of the new government embodies a marked return to protectionism, which invites and often succumbs to the demands of every producer of every item in the tariff nomenclature. There are promises in the matter of public enterprise and industrial and labor market reform; and the urgent need for infrastructural reform and investment is recognized. It will be heartening when and if serious progress can be reported. The same goes for the fiscal deficit that increased in 1997/98 and which the government promises to reduce. In fact, the deep fiscal reform that is required to reduce subsidies while simultaneously increasing government expenditure on infrastructure and the social sectors is nowhere in sight.

The 1997 Asian financial crisis adds to India's difficulties. While the current account deficit (1.5 percent of GDP) is moderate; reserves are comfortable (around $25 billion); and external debt is low (20 percent of GDP) and very little of it is short-term, the crisis will be very bad for exports in 1998/99. Although India exports relatively little to East Asia (about 15 percent of total exports), she will face strongly increased competition in third markets.

The BJP government also appears to be taking India down the road of nuclear weapons development. Whatever the political rights and wrongs of this move, its economic consequences promise to be adverse. As of now, it is not possible to estimate the rise in the defense budget, the direct effect of international sanctions on aid

[45] Multinationals have played a significant part in the export growth of People's Republic of China, Malaysia, and Thailand. This investment, much of it Asian, has been mainly in labor-intensive goods, sometimes as part of a vertical intra-industry chain. It has transferred technology (mainly low-tech) but also importantly, management and marketing skills.

[46] Port capacity is just one example among many. The turnaround time for ships in the Bombay and Calcutta ports is 5-6 days in contrast to only a few hours in ports in Southeast Asia.

[47] The only exception is capital account liberalization, which should come later in the reform process. In this respect, India has shown appropriate caution.

and loans, and the indirect effect on foreign and domestic investment of the resulting uncertainty in the economic climate. But early signs are not encouraging. The government could perhaps have neutralized the effect on investment by a radical proreform budget but it let the opportunity slip.

Our view of the prospects for growth have not changed since we wrote the paper. We think that 5-6 percent growth may still be achieved but our fears of a relapse to the "Hindu rate of growth" remain.

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