India's Reform Experience – Some Lessons

The year 1991 is an important landmark in the post-Independence economic history of India. The country faced a severe economic crisis, triggered largely by a serious balance of payments problem. The crisis was converted into an opportunity to effect some fundamental changes in the content and approach to economic policy. The response to the crisis was to put in place a set of policies aimed at stabilization and structural reform. While the stabilization polices were aimed at correcting weaknesses that had developed on the fiscal and the balance of payment fronts, the structural reforms were meant to remove the rigidities that had entered the various segments of the Indian economy.[*]

Genesis of Reforms

In the 1950s and 1960s, the dominant view in the literature on development economics was that the government had an important role to play, and that it should undertake activities that would compensate for 'market failure'. 'Market failure' was perceived in its inability to optimally allocate resources over time, that is, for investment because of the 'myopic' nature of markets. The literature also emphasized the benefit of a coordinated and consistent set of investment decisions. It is this line of reasoning that led most developing countries, including India, to formulate economy-wide plans. However, four decades of development experience have shown that there can be 'government failure' as well. The regulatory state in many countries has resulted in economic losses not only due to the misallocation of resources arising from faulty investment decisions but also from the diversion of resources to rent-seeking activities

[*] This and following two paras are taken from my article 'Two Episodes in the Reform Process' included in Acharya and Mohan (ed.), India's Economy and Challenges.

because of the very regulations themselves. One of the reasons for the emergence of skepticism regarding the benefits of state intervention has been the growing perception that government failures on account of political factors and bureaucratization may, in many cases, exceed market failures. Given the importance of the incentive-reward system in achieving consistent improvement in efficiency, it is felt that markets provide a better incentive framework for many activities. Closely related to these institutional factors is the belief that a competitive environment tends to crease a better climate conductive to enhancing efficiency. In other words, while there can be some doubt as to the capacity of the competitive market structures to determine the ends, there is more confidence in competition as a means of achieving the desired ends. Thus, if there is a lesson to be drawn from the development record of the last four decades, it is that there can be both 'government failure' as well as 'market failure', and that the critical issue is not so much the presence or absence of state intervention, as the extent and quality of that intervention. The new economic policy builds on this experience.

There is a common thread running through all the measures introduced since July 1991. The objective is simple: to improve the efficiency of the system. The regulatory mechanism involving multitudes of controls has fragmented capacity and reduced competition even in the private sector. The thrust of the new economic policy is towards creating a more competitive environment in the economy as a means to improving the productivity and efficiency of the system. This is to be achieved by removing the barriers to entry as well as the restrictions on the growth of firms. While the industrial policy seeks to bring about a greater competitive environment domestically, the trade policy seeks to improve international competitiveness, subject to the protection offered by tariffs which are themselves coming down. The private sector is being given a larger space to operate in, as some areas earlier reserved exclusively

for the public sector are now also allowed to the private sector. In these areas, the public sector will have to compete with the private sector, even though the public sector may continue to play the dominant role. What is sought to be achieved is an improvement in the functioning of the various entities, whether in the private sector or the public sector, by injecting an element of competition in them. There is, however, nothing in the new economic policy which takes away the role of the state or the public sector in the system. The New Economic Policy of India has not necessarily diminished the role of state; it has only redefined it, expanding it in some areas and reducing it in others. As has been said, somewhat paradoxically, more market does not mean 'less government' but only 'different government'.

Trends in Growth

That the economic reforms India undertook have been on the right track is vindicated by the performance of the economy since the launch of reforms. In the post-reform period beginning 1992-93, the economy has grown at an average rate of 6.8 per cent per annum (Table 1), a significant improvement over the pre-reform period.

India's annual growth rate between 1952 and 1980 averaged to 3.5 per cent (Table 2). With population growing almost at 2.2 per cent, the average annual growth rate of per capita income was 1.3 per cent. It is true that the Indian Economy grow between 1980 and 1990 at 5.6 per cent (Table 3). But the economy faced the worst crisis in 1991-92 and the growth rate fell to 1.0 per cent. It is extremely doubtful if without a change in the strategy of development, growth would have picked up again.

Coming to the more recent period, as mentioned earlier, economic growth in the ten year period beginning 2005-06 despite the crisis affected year of 2008-09, is at an average of 7.7 per cent. This clearly represents an acceleration in the pace of growth. Per capita GDP grew at an average of 6.2 per cent in these ten years. An examination

of the high growth phase of 2005-06 to 2007-08 when the economy grew at an average annual rate of 9.4 per cent clearly indicates that this period was marked by high domestic savings and investment rates and a low current account deficit. In these three years, agriculture growth averaged 4.5 per cent while manufacturing grew at 11 per cent. Capital flows were large. As CAD averaged only 1.1 per cent of GDP, the accretion to reserves amounted to $144 billion. On many dimensions, the growth rate was robust. It was not just fuelled by financial availability. The external environment also provided good support. The growth performance of the period shows what the potential rate of growth of the economy is.

Under the severe impact of the global crisis, the Indian economy registered a growth of 6.7 per cent in 2008-09. By any standard, the Indian economy was able to protect itself reasonably well in the turbulent conditions of the financial crisis.

The recovery from the impact of the global crisis was swift and sharp. The economy achieved a growth rate of 8.6 per cent in 2009-10, despite a severe drought.

The growth rate rose further to 8.9 per cent in 2010-11. The manufacturing sector grew by 8.9 per cent and the services sector by 9.7 per cent. Had we anticipated correctly this sustained rise in growth, we could have withdrawn some of the stimulus measures a little early. That could have moderated the inflationary tendencies. However, the fact remains that as late as the fourth quarter of 2010-11, the economy was growing at 9.2 per cent and manufacturing was growing at 7.3 per cent.

Economic activity moderated quite substantially in 2011-12. The overall growth rate came down to 6.7 per cent. Growth in the last quarter was a low 5.1 per cent. Agriculture grew at 5.0 per cent, which came on top of a sharp increase in the previous year. The manufacturing sector whose growth rate was originally estimated at 2.7 per cent was revised to 7.4 per cent. The service sector showed some deceleration. The

sub sector which suffered most was ‘Trade, Hotels and Restaurant’. The overall decline in growth rate was caused by supply side bottlenecks, price shocks and weak investment demand. Coal output fell. So also did several other minerals. International commodity prices remained high despite the poor performance of the advanced economies. The investment sentiment was affected by various factors including non-economic which created an element of uncertainty in the minds of investors. The external environment was also not hospitable.

In 2012-13, according to the earlier estimates agricultural growth remained modest at 1.4 per cent. Manufacturing failed to pick up. Over the year, manufacturing sector showed a growth of 1.1 per cent. The growth rate of the year was placed at 4.5 per cent. According to the revised estimates with the base as 2011-12, the growth rate is 4.9 per cent with manufacturing growing at 6.2 per cent.

In the fiscal year 2013-14, growth continued to remain modest according to the 2004-2005 basis. The growth rate was estimated at 4.7 per cent. An important contributor to growth was agriculture. Monsoon was extremely favourable and the result was a good growth of 4.7 per cent in agricultural GDP. Manufacturing growth rate was estimated at -0.7 per cent. However, the revised estimates with the new base year puts the growth rate at 6.6 per cent with manufacturing growing at 5.3 per cent and Trade, Hotel, Transport and Communication growing at 13.3 per cent. The new numbers have provoked a big controversy. Many analysts remain skeptical about the new numbers mainly for the reason that these new numbers are not in sync with ground realities. The new numbers however, tell us that the slowdown was short-lived and that the recovery was swift.

India’s growth rate in 2014-15 is estimated at 7.3 per cent. Agricultural growth is modest at 0.2 per cent, Manufacturing growth is estimated at 7.1 per cent, “Trade,

Hotels, Transport and Communication" is estimated to grow at 10.7 per cent. These are reasonably good numbers. Concerns about credibility continue to haunt these numbers. In any case, we need a much stronger growth to kick start a virtuous cycle of high growth and high investment.

Potential Rate of Growth

In the light of India's economic performance in recent years, a frequently asked question is whether India has the potential to grow at 8 to 9 per cent in a sustained way. In 2007-08, India's domestic savings rate was 36.8 per cent and the investment rate was 38 per cent. Since then, these rates have come down significantly. Nevertheless, recent data indicate that in 2012-13 the gross fixed capital formation rate, a measure of the accumulation of fixed assets by business, government and households, was around 30.4 per cent (and 31.4 per cent according to new estimates) as against 32.9 per cent of GDP in 2007-08. In normal situations, keeping in view the recent trends in ICOR (the Incremental Capital Output Ratio) which is around 4, this should have given us a growth rate close to 7.5 per cent but the actual rate turned out to be below 5 per cent. Economic growth has in fact declined much more steeply than what is warranted by the decline in investment. This may be because projects have not been completed in time or complementary investments have not been forthcoming. In some cases, this could also be due to non-availability of critical inputs such as coal and power. Going ahead there are issues relating to land acquisition and environment which need to be addressed. These are critical issues which need attention, if we have to maintain a high growth over the medium term. The fact that even today, savings and investment rates are at high levels re-assures us that if we are able to find ways to complete projects speedily, we shall be able to usher in rapid growth in income even in the short run. Thus while the existing level of investment rate should enable us to grow at 7.5 per cent in the

short run, provided action is taken to implement projects speedily, only a return to higher level of savings and investment can take us back to the very high levels of growth which we had seen earlier.

Stability Parameters

For sustained high growth, stability is important. Macroeconomic stability has three components – low inflation, low current account deficit and modest fiscal deficit. In all these areas, we are approaching some degree of stability after having gone through some years of serious imbalances. It is important to sustain it. The domestic policy framework must be tuned to achieve these goals. This may also call for several policy decisions which may not be popular.

Other Dimensions of Development

Discussions so far have centred around growth and factors that contribute to growth. An equally important issue relates to how far the benefits of growth have accrued to different deciles of population. Eradication of poverty has been one of the objectives of economic policy. What has been the impact of growth on Social Development? To what extent, the goal of ensuring to every citizen a certain minimum standard of living has been achieved?

Obviously the growth in national income and per capita income is reflected in a number of social performance parameters such as rise in the literacy rate, the availability of medical and health facilities, expansion in education etc. The literacy rate has gone up from 30.7 per cent in 1951 to 73.0 per cent currently. Similarly, expectation of life at birth for males has increased from 37.1 years to 62.6 years during this period and for females from 36.1 years to 64.2 years.

Social Development Indicators

As measured by the social indicators, the performance of the country is less impressive. India ranks low in the Human Development Index. As per the Human

Development Report 2014 of UNDP, India's rank was 135 among a total of 187 countries. It is, however, to be noted that India, with the Human Development Index value at 0.586, is included among the Medium Human Development countries. Admittedly, the computation of these indices is debatable. The HDI also does not take into account many other aspects of social development as well as institutional dimensions like the freedoms enjoyed by people in making political and economic choices. The index may thus understate somewhat India's achievements. However, the deprivation in India in terms of health and education facilities has been documented by several studies.

Interaction between Growth and Human Development[*]

At a fundamental level there is no conflict between economic growth and social or human development. Economic growth implies improvement in the material well being of people which necessarily includes better health, education and sanitation. However, there are two possible routes to achieve the end of social development. One is to let the economy grow and expect the consequential benefits to accrue to all segments automatically. This process is often described as 'trickle down'. However, for this to happen, the economy needs to grow strongly. A good example is South Korea. Any moderate rate of growth, as we have had in this country particularly in the first three decades after independence, is unlikely to have had a significant impact on the bottom deciles of population. The alternative strategy of development is to focus directly on social infrastructure facilities such as health, education, sanitation and drinking water. No country including India has adopted an exclusive approach. Poverty alleviation

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[*] For a more detailed discussion, see C.Rangarajan, 'Economic Growth and Social Development: Synergic or Contradictory' in Economic Development in India, Vol. 198, Academic Foundation.

programmes of various types were introduced from time to time, besides focusing on providing basic facilities like primary education and health.

Growth leads to improvement in social development. This can happen through two possible routes. As a country grows particularly at a faster rate, there happens the percolation effect and all sections of the society do benefit, even though, perhaps, some sections may benefit more than others. As the saying goes, a rising tide lifts all boats. But the effect may be stronger or weaker depending on the rate of growth and the pattern of growth. Second, in a fast growing economy more resources are available for the Government to provide for various kinds of social safety nets. Therefore, the ultimate impact depends on the pattern of government expenditures as well.

The period 1993-94 to 2011-12 provides some interesting insights into the question of the relationship between growth and reduction in poverty ratio which is taken as a summary indicator of human development. The annual rate of growth in per capita income in the period 1993-94 to 2004-05 was 4.3 per cent and the growth rate for the period 2004-05 to 2011-12 was 6.7 per cent. The annual rate of decline in the poverty ratio in the first period was 0.7 per cent and 2.18 per cent in the second period. This has happened in the backdrop of an unchanged inequality in rural areas and somewhat of an increase in inequality in urban areas. Perhaps, it is not farfetched to draw the inference that the faster decline in poverty ratio was mainly due to the faster growth of income. It may also be noted that the period 2004-05 to 2011-12 saw also a sharp increase in the growth rate of agriculture. The average annual growth rate in agriculture during this period was 3.61 per cent. A State wise analysis confirms a similar trend. Without exception, in all States the decline in poverty ratio is much stronger in the second period than in the first period.

The impact of higher growth on poverty reduction can also be seen from the decile-wise growth in per capita consumption expenditure. In the period 2004-05 to 2011-12 an increase in per capita consumption had taken place across all the ten deciles of the population both in rural and urban areas as compared to the period 1993-94 to 2004-05 (Table 4). It is true that the average growth of per capita consumption of the top five deciles is more than that of the bottom five deciles. However, the ratio of the average growth rates of the two periods is higher for the bottom five deciles as compared to the top five. It implies that the expansion of consumption of the lower deciles of the population was more than the upper deciles.

Future Reforms

In the first phase, reforms were introduced in the industrial sector, external trade and investment sectors, exchange rate management, fiscal policy and financial sector. Later, communications and other key infrastructure sectors were covered. We need to extract the full potential of the reforms we have already introduced. However, reforms must form part of a continuing agenda.

Given the favourable impact of reforms on growth, what should be the focus of reforms in the coming years? The objective of reforms is to improve efficiency through enhanced competition. The introduction of GST will be a step in the right direction, as it will help to enhance efficiency. 'Acquisition' is against the spirit of competition and the scope of any Land Acquisition Act must therefore be limited. At the same time, we should avoid fixing the price of land. Farmers have become fully conscious of the value of their land. They are unlikely to sell them at throwaway prices. There are still some segments of the industry which are subject to a number of controls of the pre-1991 type. A typical example is the sugar industry. Molasses are subject to a type of control which results in subsiding the liquor industry! The basic principle of liberalization of creating

competitive markets with minimal barriers to entry and should be extended to all sectors. Pricing of natural resources has become an issue. In the absence of competition, transparent mechanisms for fixing the price must be followed which will be fair to producers and end-users. Among the sectors that have remained untouched by reforms, the most important is agriculture. Even as much remains to be done to improve the productivity of agriculture through scientific research and improved dissemination of knowledge, there are areas like marketing where reforms are badly needed. The present marketing arrangements particularly with respect to vegetables are archaic. Barriers to movement of trade across the country must be brought to an end. The other area that demands attention and that will have a big pay-off immediately is the improvement in the administrative structure. Reform of the Government's delivery system not only in terms of the distribution of subsidies but also all other services will have the most immediate impact. Cumbersome rules and procedures must be done away with.

Sequence

Sequencing of reforms is equally important. It is often argued that factor markets have largely remained untouched by reforms. People have in mind particularly labour market. Flexible labour markets always help in generating faster growth. For example, in the post 2008 crisis period, U.S. has done better than Europe because of the more flexible labour markets in US. Nevertheless, the time for modifying labour markets is when the economy is booming, that is, when the economy will be able to absorb easily the disruptions, if any, caused in the labour market. Labour will then realize that it stands to gain more by a fast growing economy than by legislative constraints. It is only in a growing economy, new entrants join the labour force in a big way. It avoids the trap of the employed becoming the enemy of the unemployed. Thus while some reforms of

the labour market are necessary; they should wait till the economy gathers momentum and moves on to a much stronger growth path. The low hanging fruits are clearly in the area of administrative reforms. In fact, closely related to it is the improvement in the functioning of various public enterprises. The infrastructure is still dominated by the public sector.

Growth and Reforms

For sustained high growth, reforms are imperative. Reforms, however, by themselves do not result in growth. They only create the necessary environment. There has to be a proper response to reforms from the private and public sectors. For example, the policy framework was similar between the period 2005-06- 2007-08 and past 2011. But the growth rate was strikingly different. May be some of the constraints in the early high growth phase which were non-binding became binding later. The key to growth lies in building a proper investment environment. This is dependent on both economic and non-economic factors. Reforms are only an important first step.

Reforms are not ends in themselves. Even growth is not an end in itself. Ultimately, growth triggered by reforms must benefit all segments of society. Equity and efficiency should not be posed as opposing considerations. They must be weaved together to provide an acceptable pattern of development. Equity will remain only a dream, if it is not accompanied by growth and reforms.

Table 1: Growth rate between 1992-93 and 2013-14		
Year	**GDP at factor cost**	**Per capita net national income**
1992-93	5.4	3.4
1994	5.7	3.7
1995	6.4	4.3
1996	7.3	5.3
1997	8.0	6.2
1998	4.3	2.2
1999	6.7	4.6
2000	8.0	6.0
2001	4.1	1.7
2002	5.4	3.3
2003	3.9	2.3
2004	8.0	6.5
2005	7.1	5.0
2006	9.5	7.8
2007	9.6	7.9
2008	9.3	8.1
2009	6.7	4.7
2010	8.6	6.8
2011	8.9	6.8
2012	6.7	5.1
2013	4.5	2.1
2013-14	4.7	2.7
AVG	6.8	4.8

Source: Economic Survey 2013-14

Table 2: Growth rate between 1951-52 and 1979-80		
Year	**GDP at factor cost**	**Per capita net national income**
1951-52	2.3	1.2
1953	2.8	1.4
1954	6.1	4.8
1955	4.2	3.6
1956	2.6	0.9
1957	5.7	3.6
1958	-1.2	-3.5
1959	7.6	5.3
1960	2.2	0.0
1961	7.1	5.5
1962	3.1	0.6
1963	2.1	-0.4
1964	5.1	2.8
1965	7.6	5.2
1966	-3.7	-6.5
1967	1.0	-1.4
1968	8.1	5.8
1969	2.6	0.1
1970	6.5	4.3
1971	5.0	2.2
1972	1.0	-1.6
1973	-0.3	-2.9
1974	4.6	2.3
1975	1.2	-1.4
1976	9.0	6.9
1977	1.2	-1.3
1978	7.5	5.5
1979	5.5	3.4
1979-80	-5.2	-8.2
AVG	3.5	1.3

Source: Economic Survey 2013-14

Table 3: Growth rate between 1980-81 and 1990-91		
Year	GDP at factor cost	Per capita net national income
1980-81	7.2	5.0
1982	5.6	3.5
1983	2.9	0.0
1984	7.9	5.9
1985	4.0	1.3
1986	4.2	1.7
1987	4.3	1.9
1988	3.5	0.7
1989	10.2	8.1
1990	6.1	3.9
1990-91	5.3	2.7
AVG	5.6	3.2

Source: Economic Survey 2013-14

Table 4
Decile-wise Growth in Per Capita Consumption
(Per cent per year, compound)

Decile	1993-94 to 2004-05		2004-05 to 2011-12	
	Rural	Urban	Rural	Urban
1. First Decile	0.70	0.66	2.91	2.96
2. Second Decile	0.49	0.54	3.00	3.28
3. Third Decile	0.56	0.66	3.15	3.39
4. Fourth Decile	0.55	0.91	3.17	3.42
5. Fifth Decile	0.54	1.00	3.17	3.41
6. Sixth Decile	0.55	1.24	3.30	3.35
7. Seventh Decile	0.52	1.36	3.40	3.30
8. Eighth Decile	0.61	1.35	3.45	3.40
9. Ninth Decile	0.71	1.47	3.48	3.45
10. Tenth Decile	1.61	2.30	3.71	4.52
A. Bottom Five Deciles	0.57	0.75	3.08	3.29
B. Top Five Deciles	0.80	1.54	3.47	3.60

N.B.: The growth rates are in real terms and derived from URP consumption data.