

# India's Economic Reforms

## What Has Been Accomplished? What Remains to Be Done?

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**T**hough economic liberalization in India can be traced back to the late 1970s, economic reforms began in earnest only in July 1991. A balance of payments crisis at the time opened the way for an International Monetary Fund (IMF) program that led to the adoption of a major reform package. Though the foreign-exchange reserve recovered quickly and ended effectively the temporary clout of the IMF and World Bank, reforms continued in a stop-go fashion.

What has been accomplished and what remains to be done? Is the glass half full or half empty?

### **The Good News: Achievements Thus Far**

India's reforms have been piecemeal and incremental, giving the casual observer the impression that nothing has been happening. If one takes the totality of reforms over the last decade, however, the change is unmistakable. The analogy is with the hour hand of the clock, which looks completely static, and yet completes a full circle every 12 hours.

To get an idea of the accomplishments, begin with the industrial policy prevailing prior to the launching of the reforms. The heavy industry was a state monopoly. Other industries were either subject to strict industrial licensing or reserved for the small-scale sector. The tight control of the government on industry was aptly captured by a leading cartoonist in a 1980s comic strip showing the industry minister tell his staff, "We shouldn't encourage big industry—that is our policy, I know. But I say we shouldn't encourage small industries either. If we do, they are bound to become big..."

The reforms of the last 10 years have gone a long way toward freeing up the domestic economy from state control. State monopoly has been abolished in virtually all sectors, which have been opened to the private sector. The License Raj is a thing of the past. The

small-scale industry reservation still persists but even here progress has been made. Apparel, with its large export potential, was recently opened to all investors.

In the area of international trade, in 1991, import licensing was pervasive with goods divided into banned, restricted, limited permissible, and subject to open general licensing (OGL). The OGL category was the most liberal but it covered only 30 percent of imports. Moreover, certain conditions had still to be fulfilled before the permission to import was granted under the OGL system.

Imports were also subject to excessively high tariffs. The top rate was 400 percent. As much as 60 percent of tariff lines were subject to rates ranging from 110 to 150 percent and only 4 percent of the tariff rates were below 60 percent. The exchange rate was highly over-valued. Strict exchange controls applied to not just capital account but also current account transactions. Foreign investment was subject to stringent restrictions. Companies were not permitted more than 40 percent foreign equity unless they were in the high-tech sector or were export-oriented. As a result, foreign investment amounted to a paltry \$100-200 million annually.

Today, import licensing has been completely abolished. This includes textiles and clothing, which remain protected in developed countries through the multi-fiber arrangement. The highest tariff rate has come down to 45 percent (including the tariff surcharge and the so-called Special Additional Duty) with the average tariff rate declining to less than 25 percent. The foreign investment regime is as liberal as in other developing Asian countries.

Ten years ago, telecommunications services were a state monopoly and constituted a major bottleneck on the conduct of business activity. So callous was the attitude of the government that when a Member of Parliament complained about poor telephone service in Delhi during the early 1980s, the then telecommunications minister went on to remind him that in a poor country like India, the telephone was a luxury. The minister then added that if the Member was unhappy with the service, he could return his phone since many customers had queued up for it for years!

Today, the private sector has become an active participant in the telecommunications sector, and the New Telecom Policy issued in 1999 sets the target of providing telephones on demand by the year 2002. In many cities, this goal has already been achieved. The provision of cellular mobile as well as fixed service is now open to the private sector including foreign investors. As a result, the telecommunications services in India are mushrooming.

Progress has also been made in many areas that were previously off limits to reforms. Insurance has been opened to private investors, both domestic and foreign. Diesel oil and gas prices have undergone some increases. At least symbolic reductions have also been made in fertilizer and food subsidies. The value-added tax has undergone substantial rationalization.

These reforms have paid handsomely. The economy has grown at more than 6 percent coupled with full macroeconomic stability. This compares with a growth rate of 3.5 percent during 1950-1980. The rate of inflation has been low and foreign exchange reserves are sufficient to finance imports for more than eight months. Rising incomes have helped bring down poverty. According to official figures, the proportion of poor in total population has declined from 40 percent in 1993-1994 to 26 percent in 2000.

But, perhaps, the greatest change in the last 10 years has been in the attitude toward reforms. Whereas the vocal supporters of reforms within India were rare during the 1980s, virtually every political party today recognizes the need for continued reforms. Differences on which reforms to undertake first and at what pace still exist, but few disagree that reforms must continue. Initial fears that changes in governments will bring the reform process to a halt or even reverse it have proven to be without foundation.

### **The Bad News: Still a Long Way to Go**

The accomplishments of the past decade are dwarfed only by what remains to be done. To begin with, the fiscal deficit is in a dire state. The combined deficit at the center and states exceeds 10 percent of GDP. Given an already high debt-to-GDP ratio of

nearly 60 percent, this deficit is unsustainable; it is also crowding out private investment.

From the viewpoint of long-run growth, the “old economy” must be further unshackled. A key deficiency of India’s growth process has been the failure of the conventional industry to pull workers out of agriculture into gainful employment. Today, in contrast to virtually all successful developing economies, approximately 60 percent of India’s workforce still remains in agriculture. The revival of conventional industry requires reforms in four key areas. First, a large number of highly labor-intensive products remain reserved for small-scale producers. As a result, the labor-intensive industry has been scuttled in India and, with trade liberalization, will find it almost impossible to survive. This reservation must end with small-scale producers given assistance through alternative measures rather than a total ban on large-scale entry. Second, labor laws must be reformed so as to restore the employer’s right to layoff workers upon adequate compensation to them. At present, firms with 100 or more workers have no legal way to exit since they cannot lay off their workers. This works as a major barrier to entry of new firms on a large scale: they hesitate to enter into a world that has no exit doors. Third, privatization of public sector enterprises needs to be speeded up. With almost two thirds of the industrial output of the organized sector in these enterprises, it will be difficult to stimulate industrial growth in the short to medium run without faster privatization. Finally, trade liberalization must proceed apace with all tariffs brought down to 15 percent or less in the next three years. Again, this is necessary to reallocate production toward labor-intensive products in which India has comparative advantage. It will also be salutary for poverty reduction.

Infrastructure is another important area of reforms. Roads, railways, and ports all need expansion as well as improvement in the quality of service. The government has recently taken steps in this direction, particularly in the area of roads, but the pace remains slow.

The most important area of reforms is perhaps India’s power sector. Virtually no sector of the economy—industry, agriculture, or

services—can achieve successful transformation without adequate supply of power. The power sector has been a government monopoly at the state level and suffers from proverbial inefficiency including large-scale thefts of electricity in almost every state. Reforms involving privatization of power generation and distribution have been undertaken in several states recently but no spectacular successes have emerged as yet. This is the area with highest payoffs for imaginative reforms.

Fertilizer and food subsidies pose yet another challenge. As much as 0.7 percent of GDP goes into fertilizer subsidies. Contrary to popular impression, much of this subsidy goes to support the inefficient domestic fertilizer industry rather than farmers. In the last five years, the prices for fertilizer paid by farmers have been close to the world price. Guaranteed rates of return to fertilizer manufacturers have allowed firms with costs two to three times the price in the world market to stay in business. Likewise, the bulk of the food subsidy has failed to reach the poor. Between food and fertilizer subsidies, there is scope for generating savings worth more than 1 percent of GDP.

Economic reforms of the last decade have virtually bypassed agriculture. Besides fertilizers among others, farmers need adequate supply of water and electricity. Currently, these are provided free of charge but their supply is highly unreliable. Farmers must also be able to reap the full market price for their product rather than be subject to a procurement price below the market price. Further, export restrictions must be phased out.

The need for the expansion of primary education is well recognized. But needed as well are reforms in the area of higher education. Universities in India also remain a state monopoly. With the need to cut the fiscal deficit, the state has no resources to spare. Therefore, like most other countries including Bangladesh and People's Republic of China, India must allow the entry of private universities.

Financial sector reforms, particularly the reform of banking, remain a distant goal. While foreign banks are now allowed freely

to open branches in India, they have not yet moved in aggressively. Banking sector privatization will take time but large efficiency gains could be achieved if labor laws are reformed to restore the hire and fire policy. Layoffs in banks have been very difficult, and voluntary retirement schemes extremely costly.

Finally, the reform of bureaucracy is essential. The problem of a bloated bureaucracy and the need for downsizing it is well recognized. But with policy making becoming an increasingly sophisticated and specialized activity, it is necessary to open the top bureaucracy to outside specialists. One proposal, made by the present author, is to open the positions at the level of Joint Secretary and above to outsiders rather than limiting competition to the existing bureaucracy as is the current practice.

### **Conclusion**

If India grows at 6 percent per annum on a sustained basis, it will take 14 years to reach the current level of per capita income of People's Republic of China, 36 years to reach Thailand's, and 104 years to reach that of the United States. Thus, the need for accelerated growth can hardly be overemphasized. At the same time, the task of implementing reforms in a democracy is complex. Therefore, those wishing for rapid reforms will need to be patient. The good news, however, is that the experience of the past decade shows that change can occur. Moreover, the success of the reforms in delivering growth and poverty reduction must make the road to future reforms less bumpy. The support for reforms today, though far from universal, is fortunately much stronger than it was 10 years ago.