ECONOMIC DEVELOPMENT AND TRANSITION: INDIA

by

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Paper presented at the, Tokyo Dialogue on Alternatives to the World Bank-IMF Approach to Reforms and Growth, (organised by) Economic Planning Agency, on December 7, 1997 in Tokyo, Japan.[*]

[*] Draft: October 1996

1 INTRODUCTION

Since Independence, Indian economic development has gone through three broad phases. These can be termed (a) Public Infrastructure (b) Industrial Control and (c) Reform & De-control. These phases are distinguished by two important policy variables: The degree to which policy favoured the public sector vis-à-vis the private sector, and the degree to which industrial policy was control oriented rather than market oriented. The first phase was characterised by and large by the desire to identify market failure and missing markets and to use the Public sector to fill the gaps in Physical Infrastructure.[1] The second phase was characterised by an increasing distrust of the private sector & corresponding view of the Public sector as a panacea for all ills, and the suppression of market responses through quantitative controls. The final phase was characterised by a slow but steady recognition of the problem of government and Public sector failure, and the need to remove the distortions created by government policy itself. This phase underwent quantum change in 1991-92, with a much clearer articulation of the reform philosophy and acceleration in actual economic reform measures.

In the first phase, which ended around 1964-5, the rate of growth of Gross Domestic Product at factor cost averaged 4.2% per annum. The second phase, starting from around 1965-6 is characterised by a slowing of the rate of growth to an average of 3.5% per annum. This phase lasted till about 1978-9, when the Reform phase started. The Reform phase has seen a reversion of growth to higher levels, which despite the BOP crises of 1990-91 to 1991-92 averaged 4.8% per annum. This paper will focus on the last two phases of development.

2 GROWTH PHASES

Determining the end points of different phases of economic development in India is a hazardous process, because GDP from agriculture, which still forms about 30% of the total value added, has been very dependent on the monsoon. Selecting an end point which is either a very good or very bad monsoon year can provide very mis-leading estimates of the underlying trend growth rate, and also distort the choice of the cut-off year for a particular phase. It therefore becomes imperative to adjust for the effect of rainfall variations. The best method would be to use a rainfall index. However such a rainfall index going back to 1950-1 is not currently available. We therefore construct two different indices based on the effect of rainfall on agriculture. These indices are then used to purge the effect of rainfall on short-term variations in growth, so as to get a more accurate picture of the kinks in growth trends, which define different phases of economic development in India. To avoid simultaneity bias we also use trends in non-agricultural GDP (total GDP minus agricultural GDP) to define the end points of the different growth phases of the economy.

Stability tests are used to define break points. These show that the first phase of development came to an end and the second phase started around the middle of the sixties. This phase in turn came to an end towards the end of the seventies. The following equations summarise the conclusion of this exercise:

GrGDPna = 5.87 + 0.17 RAINidx - 1.34 Dummy

(1) (19.3) (3.67) (-2.48) R = 0.33

Where RAINidx is the rainfall index derived as a residual from the following equation,

[1] The ratio of public to private investment rose steadily through this phase to exceed one in 1965-6(8.5% of

$$\text{GrGDPag} = 5.23 - 0.55\ \text{GrGDPag}(-1) - 0.33\ \text{GrGDPag}(-2)$$

(2) (4.8) (-3.7) (-2.2) R = 0.26

and GrGDPag is the rate of growth of GDP from agriculture, GrGDPna is the rate of growth of GDP from the rest of the sectors(i.e. non-agricultural), and dummy takes the value 1 from 1965 to 1978 and is zero otherwise. We can conclude from this exercise, that the Indian economy was in a low growth phase between 1965 and 1978, and that the trend growth rate was about 1.3% lower during this phase. Alternative formulations of the rainfall index etc., yield the same broad conclusions with respect to both the end points of the phase as well as the decline in growth rate.

Before moving to an analysis of the policies which resulted in movement of the economy into a lower growth trend, it is useful to look at a simple measure of productivity in the Indian economy, the incremental capital output ratio.[2] Because of the rainfall variation problem we have to use a smoothed ratio based on a three year moving average of growth rates and investment rates. The stability analysis as well as the following equation shows that productivity has gone through the same three phases indicated above:

$$\text{ICOR} = 4.65 - 0.21\ \text{RAINidx} - 0.28\ \text{RAINidx}(-1) + 2.62\ \text{Dummy}$$

(3) (9.6) (-2.9) (-3.9) (3.2) R = 0.48

The above equation shows that productivity of capital as measured by the average ICOR of the economy deteriorated by about 50%(2.6/4.7) during the middle phase of Indian economic development.

GDP). By 1960-1, public investment as % of total was 100% in railways, 95% in Telecom, 97% in electricity.

[2] Being a traditional, “labour surplus” economy, this is not as inadequate a measure as it might be in a “full employment” economy.

There is a possibility that a new growth phase has started around 1991-2 or 1993-4. There are not, however, enough data points available to confirm this possibility as yet. It is however, clear that within the last phase there are two sub-phases, with the latter sub-phase resulting from the economic reforms initiated in 1991-92.

3 INDUSTRIAL CONTROL

The severe drought in 1966 followed by the oil crises of 1971 and a number of other exogenous shocks led to a re-evaluation of existing policies and a re-orientation of development policies. There were both positive and negative features of this re-orientation. The former included a renewed recognition of the importance of agriculture and the initiation of the “Green revolution”, and conservative and successful management of the macro-economic imbalances created by the oil shock. The negative features included; a) a number of laws, such as the Monopolies and Restrictive Practices act and the Foreign Exchange Regulation act designed to control the private sector. b) Nationalisation of Banks and General insurance, designed to supplant private sector by the public sector. c) An increasing resort to licensing and controls to direct industrial investment, imports and agricultural exports, and d) the spread of the public sector into a variety of areas such as constancy and consumer goods. The public sector share in Investment in resource based industries such as coal, petroleum & basic metals, and in fertiliser, chemicals & pharmaceuticals rose.[3]

Even at its worst, Indian economic planning remained far removed from comprehensive Soviet Planning, as most of agricultural, trade, cottage & small industry, remained beyond the reach of the government, while constitutional autonomy of states(provinces) preserved their independent action in a large number of sectors. There was, however, increasing resort to the rhetoric and methods of “State Socialism” during the second phase of India’s development.

In a country in which fairly sophisticated markets for commodities and finance (hundi system) had existed for centuries, in which there were three well developed stock exchanges and forward markets for commodities at the turn of the century, this represented something of a contradiction. Given the individualistic religious/cultural ethos of the people, this approach was a contravention of the economic systems approach adopted by Japan, for which a considerable cost was paid in terms of lower economic growth and efficiency.[4]

4 DE-CONTROL

The third phase of development, which started around 1979-80, can be divided into two sub-phases: In the first sub-phase, which lasted till 1990-1, the process of reform was very selective and case by case. The basic approach was however to correct the glaring and most obvious distortions introduced by government intervention, on which there was broad consensus among economic analysts. Thus the cement and aluminium industries which were subject to price, distribution and investment control were de-licensed. The scope for large industrial groups was expanded over time by a gradual rise in the limit below which MRTP clearance was not required for investment. The scope for diversification and expansion of capacity for the industries under investment licensing was gradually expanded. Imports of capital goods were made procedurally easier through licensing of imports for modernisation and export industries. Intermediate imports were gradually moved from licensing to tariff protection, and made available for export production at lower or zero duty.

Despite these limited and selective reforms the rate of growth of Gross domestic product(at factor cost) averaged 4.9% per annum during the first sub-phase[1979-80 to 1990-1]. As 1979-80 was a very bad monsoon, the average

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3 The proportion of public to total investment in manufacturing, however fell.

4 It should be noted however that with the exception of trade & foreign exchange controls which applied across the board, all other controls were directed against the large organised manufacturing sector which constituted a small part of the economy.

rainfall index was only 0.6 compared to 1.9 for the period 1980-1 to 1990-1 or 1.6 for the eighties.[5] It is therefor interesting to note that even the world bank data for the eighties shows that during the eighties the average rate of growth of the Indian economy at 5.8% was the eleventh highest in the world. This was just behind Indonesia with an average growth of 6.1% per annum(WDR 1996), while Thailand was at fifth position with an average growth rate of 7.6%.[6] The ICORs derived using the same comparative data set, suggest the reasons: The Indian ICOR for the eighties at 3.8 was the same as China's, but lower than that of Indonesia(4.3) and Thailand(4.5). An analysis of total factor productivity in organised manufacturing by Ahluwalia (1991, 1995) shows that while between 1960 and 1980 it declined by 0.5% annum, in the 1980s it has grown by 2.8% per annum. Thus higher productivity and economic growth appear to be the direct results of the policy of decontrol set in motion at the end of the seventies.

This sub-phase of gradual de-control, however, culminated in a Balance of Payments crises, because it was accompanied by an increase in the fiscal deficit.

The gross fiscal deficit rose from 4.1% of GDP to 6.2% in 1980[7] and a peak of 8.4% of GDP in 1990-1, making the macro-economic situation vulnerable to external shocks. The proximate trigger for the BOP crises was the Iraq crises and the consequent disruption of oil supplies & cost of oil, coupled with political uncertainty.[8] It can therefore be concluded that even though economic growth during the eighties was quite high, it was not sustainable without a correction of the growing fiscal imbalances. Though such a correction may have happened in a gradual manner in the absence of the

[5] The average growth rate was 5.86% during 1980-1 to 1989-90, and 5.82% during 1980-1 to 1990-1.
[6] China is in second position with a growth rate of 10.2% per annum.
[7] It may be recalled that the minor oil shock in 1979-80, in addition to the drought mentioned above.
[8] A substantial portion of India's oil imports was directly or indirectly sourced from Iraq.

external and internal shocks, the BOP crises facilitated a thorough re-evaluation and recasting of the entire development policy framework.[9]

5 COMPREHENSIVE REFORM

Three broad themes have under-pinned the economic reforms initiated in 1991. These are Competition/Ability to Compete, the Role of the State/Private sector and Globalisation/Self reliance. The control mentality of the second development phase focused almost exclusively on the destructive/resource wasting effects of competition and firm failure, and not enough on the positive creative aspects of competition.

5.1 COMPETITION and ACESS

The current phase of the reforms is driven by the need to promote competition as a motivating force for improving the efficiency and quality of production. At the same time firms must be given access to inputs, technology, capital and services of international quality and competitive price if they are to meet the challenge of competition. Thus de-licensing of investment, and imports of capital & intermediate goods effects both sides of this equation, and were deliberately carried out right at the beginning of this sub-phase of reforms. The restrictions on investment by large industrial groups(MRTP) were also removed at this time given the scale and size of global competitors. Technology import regime was also made automatic up to a royalty limit of 5% on domestic and 8% on export sales, and a limit on fixed up-front fees(currently $1 million). All special restrictions on foreign owned(FERA) Indian(registered) companies were removed(subsequently) so that they now operate on a completely level field.

A radical reform of the entire foreign exchange control regime was initiated in the first year and completed within three years. Till 1991 the foreign

[9] As in other countries the crises allowed radical reforms to be taken much more quickly than is possible under normal government/bureaucratic procedures.

exchange system was heavily controlled with virtually every payment linked to a licence or specific permission to remit foreign exchange. In early 1992 a dual exchange rate system was introduced which retained a fixed exchange rate for certain government transactions and shifted all other import transactions to a market based and determined exchange channel.[10] In early 1993 this dual exchange rate system was integrated into a single market determined exchange rate. The central Bank declared that they would confine themselves to smoothing sharp movements(arising for instance from thin markets) and dampening excessive volatility unrelated to fundamental changes. Despite dire forecasts of depreciation by critics of the policy, the exchange rate of the rupee vis-à-vis the US $, after an initial adjustment period(month) showed remarkable stability despite minimal Central bank operation in the market. The process was completed in 1994 with the declaration of Current account convertibility, and formal accession to the IMF article. This has transformed the speed and quality of the economy's access to foreign goods, services(including travel) and information, thus putting industry in a better position to meet competition.

Reform of the extremely diverse and multifaceted financial system is designed to improve the efficiency & quality of intermediation so as to channel savings into the most productive uses at the lowest cost. A Securities and Exchange Board(SEBI) was set up to regulate the capital market, and subsequently given statutory status and independent authority.[11] SEBI has drawn up norms and rules, for the regulation of primary & secondary market participants and Stock exchanges. These are directed and ensuring the flow of information to small investors, transparency in new issues, and reduction of the risks involved in secondary market transactions for all participants. Among these are the reduction in the settlement period, setting up of Clearance

[10] Exports had a mixed (40:60) regime with part of the remittance bought at the controlled rate and the rest at the market rate.

[11] i.e. under the constitution rather than as a subordinate agency of the government. The Controller of Capital Issues, which earlier determined the price, and amount of new issues was abolished.

corporations and Depositories. Other developments include introduction of Screen based trading and a debt market segment in major stock exchanges, starting of private Mutual funds, permission for Money market and gilt security funds, and announcement of a take-over code. The Banking system has similarly moved gradually from a system of controls to a system of regulation based Income recognition and capital adequacy norms, concurrent and statutory audits and annual supervisory inspections by the Central banks supervisory system.

5.2 ROLE OF STATE

One of the major changes has been the recognition by academic intellectuals and the political elite that the possibility of Government failure is as real as, if not more so, than that of market failure. That the government does not (can not) have the resources or the ability to solve all problems, nor is government intervention or the public sector necessarily the solution to all problems. That government policies rather than solving the problem, in many cases have created economic distortions and new problems. This practical conclusion, which has long been familiar to unbiased practitioners operating at ground level is also underpinned by the new public and institutional economics. That electoral processes may not reflect the general public interest in all situations/cases, and the objectives of an organisation(government) may not be translated into correct and effective actions by its staff(bureaucracy) because of problems of incentive compatibility.

The industries reserved for the public sector are now effectively only, arms & ammunition, atomic energy, atomic minerals and railways. Mining of specified minerals was removed from this restriction in 1993. The remaining two items, Coal and Mineral oils has been partially opened up to private, including foreign, investment and are consequently not exclusively reserved for the Public sector. A completely new development has been the opening up of what were once considered(even in OECD market economies) as natural monopolies/public utilities to the private sector. India was among the earliest countries in opening Electricity generation and basic Telecommunication to both private and foreign capital, even though operationalisation of this decision has been slower than in E & S.E. Asia.[12] Electricity generation was opened to 100% private/foreign ownership in the first year of reform itself. In telecommunication 49% direct foreign investment is permitted even in basic services, but his can go up to 74% by owning 49% of an Indian company which holds the 51% direct share.[13] The electricity act is in the process of being changed to allow private entry in transmission and generation, and an Independent Regulatory authority is to be set up to deal with national/inter-state issues. The legal and procedural changes necessary to give a push to private investment in highway construction & operation are currently under preparation. The setting up of an Independent regulatory authority for the Port sector along with transparent rules and procedures for private entry into the 11 major ports have been approved in principle. The minor ports under the individual states have already been thrown open to the private sector by several states.

The state has also re-focused its attention on macro-economic management, social welfare for the poor, and reform of tax and fiscal reform. An unprecedented capital inflow of $6 billion into the capital market between October 1993 and September 1994 was successfully managed. Expenditure policies are being re-oriented towards controlling general expenditure and improving the effectiveness of social programs through innovative schemes(e.g. hospitalisation insurance for the poorest). Tax reforms have aimed at simplifying the system, reducing exemption, reducing tax rates and widening

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[12] This is due to delays arising from the very strict constitutional and legal procedures which need to be followed in India given the respective powers of the Central and state/provincial governments.
[13] This could perhaps be the most liberal regime in the world.

the base, so that the environment in which business operates is positive. Customs tariffs have come down from a maximum of 300% to a maximum of 52%. The central excise tax has been largely converted to a VAT type system. Corporate and Personal income tax rates have been reduced with the maximum marginal rate of the former down to about 43% and the latter to 40%. As result revenue collections from income taxes have shown remarkable buoyancy.

Globalisation

The strategy of Globalisation of the Indian economy is based on the recognition that the gap between the international and domestic production possibility frontier(PPF) has widened over the years. One of the lessons from the success of the NIEs has been that foreign trade provides a critical link between the domestic and international PPF. The shift from licensing to tariffs is a crucial part of this exercise, even though the phasing out of controls on consumer imports is being carefully phased to give industry time to adjust to the new environment. Similarly the lesson of ASEAN success has been that Direct Foreign investment provides an even more important link between the two Production Possibility Frontiers in today's world. In addition to the Infrastructure sectors mentioned earlier, an automatic route provides approval for up to 51% foreign equity(i.e. more like a registration). Sectors not contained in this list require approval of the foreign investment Promotion board, which is open to foreign investment proposals in all sectors. Two independent studies which compared the speed and effectiveness of the FIPB with the Foreign Investment approval process in China and other countries in E Asia found it as liberal and expeditious as China which was recognised at that time to be the best.[14] Foreign investors can also invest in Indian companies through Global Depository Receipts (GDRs) and FCCBs, which are subject only to first point

[14] One by IFC, World Bank and the other by a well-known international accounting firm.

clearance. There is complete freedom to liquidate and take out the proceeds from it.

6 RESULTS

The second sub-phase of the Reform phase started in 1991-2. The mean growth rate for this period at 4.7% is however quite misleading because of the problem of rainfall fluctuations. The mean rainfall index for this period is -0.28 compared to a mean of 1.87 for the first sub-phase. We must therefore either adjust for the low rainfall during 1991-92 or focus on the period 1992-3 to 1995-6. The average growth rate during this period was about 5.7% per annum, while the mean rainfall index was 0.88, both of which are lower than in the first sub-phase. As there is a standard problem of separating the after effects of a crisis from the effects of the new policies it is instructive to look at the pattern of growth. After a sharp fall in growth in 1991-2 to less than 1% growth averaged around 5.1% in the next two years, and about 6.3% in the subsequent two years.

A set of economic indicators such as export growth and current account deficit is summarised in Table 1 below. These suggest that the macro-economic adjustment and structural adjustment carried out after the Balance of Payments crises in 1991-2 was quite successful.