Reforms in India: an appraisal

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Reforms and Growth

- Why do we need "reforms"?
- This question is related to the question why don't most poor countries catch up with the rich ones?
- Or, equivalently to the question Lucas (1990) - "Why Doesn't Capital Flow from Rich to Poor Countries?"

Catch Up

- When a country has low income, and low capital, rate of return on capital is expected to be high
- This would imply capital inflows and high rate of investment
- A low income country will grow rapidly and catch up with the rich countries
- Often, though, that does not happen
- Ratio of output per person in United States and India (data: PWT 7.1) :

1950	21.90
1990	22.01

The Catch

- So, why doesn't capital flow to poorer countries? Why don't we see catching up?
  - Investment not allowed!
  - Realized rate of return on capital too low (in contrast to what it should be)

Hence, reforms

Reforms

- Two aspects of reforms
  - Make investment possible (domestic and foreign)
  - Reduce distortions so as to increase the net rate of return on capital

Have reforms been successful in bringing down these distortions?

Measuring Distortions

- In an economy without any distortion

$$u'(c_t) = \beta u'(c_{t+1})[r_{t+1} + 1 - \delta]$$

- With distortions

$$u'(c_t) = \beta u'(c_{t+1})[r_{t+1}(1 - \tau_{t+1}) + 1 - \delta]$$

τ is the gap between the realized rate of return and the theoretical rate of return in the economy

Figure: gap between the realized rate of return and the theoretical rate of return in the economy

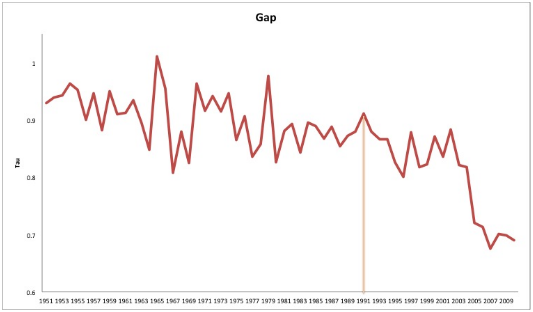


Figure: gap between the realized rate of return and the theoretical rate of return in the economy - Quarterly data

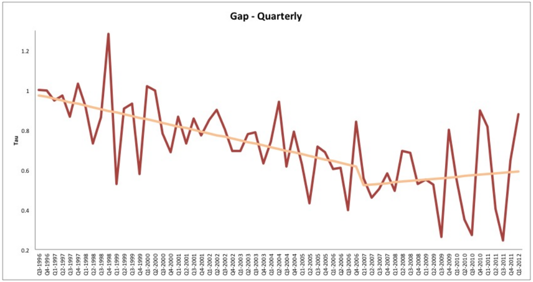
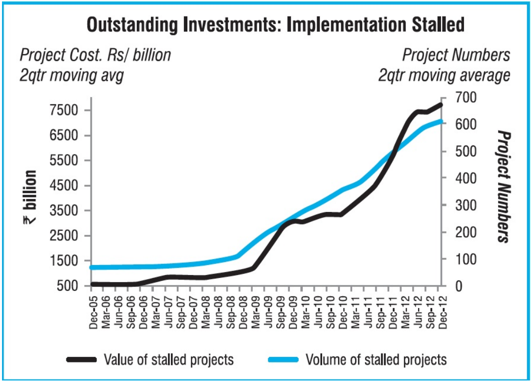


Figure: Stalled Projects (Source: Economic Survey 2012-13)



Policy

- Next stage of reforms will have to focus on reducing the gap further
- Some specific policy announcements made recently might help
  - Infrastructure Debt Funds (IDF) to be encouraged
  - Infrastructure tax-free bond of Rs. 50,000 crore in 2013-14
  - The Cabinet Committee on Investment (CCI) has been set up
  - Companies investing Rs. 100 crore or more will be entitled to deduct an investment allowance
  - Industrial Corridors being set up
  - Clarity about GAAR
- Some stalled policy matters
  - Land Acquisition and Rehabilitation and Resettlement Bill
  - GST Constitutional amendment bill and GST law

Conclusion

- Since 1991 reforms have been successful in enabling investments and increasing the realized rate of return
- This has substantially increased the growth rate of GDP in India and helped close the gap in income per capita between India and rich countries
- Ratio of output per person in United States and India (data: PWT 7.1) :

1950	21.90
1990	22.01
2010	11.9

- Effects of reforms seem to have slowed down in recent times, though some announced and expected policy changes are likely to enhance growth rate