JCER Working Paper
AEPR series
No. 2018-1-2

This is the pre-peer- reviewed version of the following article:
"India's Economic Reforms: Achievements and Next Steps", *Asian Economic Policy Review*, vol. 14, issue 1, which has been published in final form at
https://onlinelibrary.wiley.com/doi/10.1111/aepr.12239 and DOI: 10.1111/aepr.12239.

India's Economic Reforms: Achievements and Next Steps

Montek Singh Ahluwalia
(Former Deputy Chairman of the Planning Commission of India)

This paper was prepared for the Twenty-seventh Asian Economic Policy Review (AEPR) Conference "India," April 7, 2018, Tokyo.

January 2019

Asian Economic Policy Review
Japan Center for Economic Research

To authors

If you want to introduce the same working paper you wrote and presented at the AEPR conference held in Tokyo on Apr. 7, 2018, in your own/your affiliation's website, please be aware the following requirements.

To ensure that all citations and references to your published article are captured by the SSCI (Social Sciences Citation Index), authors are required to amend the cover page of your working paper as soon as practical after publication in AEPR. The amended cover page should include the full article citation, journal name, volume and issue, and DOI, as well as a hyperlink to the published article. The cover page of JCER Working Paper AEPR series has been already amended after publication in AEPR. The face of this working paper is an example of an amended working paper cover page.

March 25 2018

India's Economic Reforms: Achievements and Next Steps.

Montek S. Ahluwalia

Abstract

This paper reviews the impact of India's 1991 reforms on the performance of the Indian economy in terms of accelerating growth, and considers whether the growth was both inclusive and environmentally sustainable. It shows that the reforms definitely achieved a significant acceleration in growth and also succeeded in some dimensions of inclusiveness, notably poverty reduction. However, it was much less successful in generating good quality jobs. There was progress in providing better access to education, health services and clean drinking water and sanitation, but less that was hoped. The area where performance has been most disappointing is environmental sustainability. The paper concludes by identifying some of the critical policy areas in the years ahead.

JEL classification code: N00, E01, I31

* I am grateful to Utkarsh Patel for extremely careful research assistance. Needless to say any errors are entirely mine.

This paper presents an assessment of India's economic reforms initiated in 1991. Section I describes the main features of the reforms. Section II identifies the areas where reforms have succeeded, as well as those where achievements have fallen short of targets. Section III presents an assessment of the critical policy challenges that need to be addressed if the Indian economy is to realise its full growth potential over the next decade and more.

I The Reforms of 1991

For three decades after gaining Independence in 1947, India followed an economic strategy that was characterised by (a) a strong bias in favour of the public sector with 18 industries reserved exclusively for public sector investment, (b) strict government controls over private sector investment both for new plants as well as expansion in capacity, with investment by large industrial houses being subjected to special scrutiny to prevent concentration of economic power, (c) tight control over imports through a combination of import licensing and high tariffs (d) discouragement of foreign investment, limiting it to so called essential areas, and that too subject to a limit on foreign equity of 40 percent and (e) strict control over import of technology, with limits on royalty payments.

These controls produced a highly protected industrial sector which was uncompetitive in world markets. The inefficiency of the system, and its drag on growth, became evident by the end of the 1970s when it was clear that India was growing much more slowly than other developing countries in East Asia. Some incremental changes in the control regime were made in the first half of the 1980s, under Mrs Indira Gandhi, and then more forcefully in the second half of the decade under Prime Minister Rajiv Gandhi. However, these changes were incremental in the sense that the basic control system remained in place,

but it was made more flexible at the margin. Industrial licensing continued, but some areas were exempted from industrial licensing, and new licenses were given for larger sized plants in order to exploit economies of scale. Approved capacity limits for existing enterprises were also expanded automatically to allow units to undertake debottlenecking. Import licensing continued, but several items were made freely importable and this list was slowly widened. Foreign technology continued to require government approvals, but these were given more freely.

The real change in India's economic policies came in 1991, when the economy was reeling under an exceptionally severe balance of payments crisis. Foreign exchange reserves were run down to $1.1 billion by the end of June 1991, which was barely enough for two weeks of imports. There were fears that India might be forced to default on its external debt payments. A general election in May 1991 produced a new government under Prime Minister Narasimha Rao, with Dr Manmohan Singh as Finance Minister. The new government moved decisively to contain the crisis. The currency was devalued by 19 percent and a macro economic programme of reducing the fiscal deficit over time was announced, along with a programme of structural reforms.

The Reforms of 1991 Were Different

The reforms of 1991 were different from what had been done earlier because they signalled a clear break with the past, moving towards a much more market oriented economy, with a much larger role for the private sector and greater openness to trade and foreign investment. The extent of the structural shift can be seen from the changes summarised below.

There was a major liberalisation of controls over industrial investment. Industrial licensing, which was earlier applicable for all except a defined list was now abolished for all except a handful of industries. The abolition of

licensing also meant that the location of industries, which was earlier specified in the license, was now decided by investors who could locate where they wished, subject to getting the necessary state level approvals for construction, electric power connections, etc. This set the stage for different states to compete with each other to attract private investment. The list of 18 industries earlier reserved exclusively for the public sector was reduced to 8, and this was further pruned later.

The Monopolies and Restrictive Trade Practices (MRTP) Act imposed additional restrictions on industrial houses with total capital in all group companies exceeding Rs 100 crores. These MRTP houses were restricted to invest only in a defined list of high priority industries, and there too subject to the judgment that it would not lead to excessive concentration of power. These restrictions were abolished and the MRTP Act was focussed on anti competitive practices.

Foreign Direct Investment (FDI) was earlier allowed only in a select list of high priority industries, and that too only upto 40 percent of the total equity. It was now freely allowed upto 51 percent of total equity in the defined list, and larger percentages of equity could be considered on merits. The new policy also announced that foreign investment not just be allowed but pro actively sought in areas where it could make a major contribution. Foreign technology agreements earlier needed individual approval but the new policy provided for automatic approval for foreign technology agreements provided royalties and technology fees were within specified parameters as a percentage of turnover.

The reforms included very substantial liberalisation in trade policy moveing away from import licensing to control imports used in production. Some bulk imports eg cement, fertilisers, crude oils and few ores remained "canalised" through state trading agencies to begin with, but all other imports of

capital goods, raw materials, components and other intermediate goods needed for production were made freely importable against tradable import licenses called Eximscrips, which were issued to exporters at 30 percent of the fob value of exports (40 percent for some items). This system was quickly replaced by a dual exchange rate system, and within a year thereafter by a unified foreign exchange market in which all items, that were not explicitly banned could be imported using foreign exchange purchased from the market. However, final consumer goods remained on the banned list and imports of these goods was finally liberalised much later in 2002.

Tax reforms were high on the agenda and a Committee on Tax Reforms was appointed under the chairmanship of Raja Chelliah to make recommendations for reform of both direct taxes and indirect taxes. It submitted its report in December 1991 and called for a switch towards a regime of low tax rates with a broader base, a reduction in the number of indirect tax rates and simplification of the system combined with reforms in tax administration. The broad objective was to increase the contribution of direct taxes, reduce the share of taxes on international trade, and increase the share of domestic consumption taxes, transforming domestic excises over time into a full fledged VAT.

Financial sector reforms were also part of the agenda and a Committee on the Financial System was appointed under M Narasimham to make recommendations on reform of the banks and other aspects of the financial system. This committee outlined a series of steps to (a) liberalise controls over banks in terms of detailed prescriptions of interest rates and high pre-emption of credit via high statutory liquidity requirements (b) introducing tighter prudential and supervisory norms broadly in line with the Basel I requirements that prevailed at the time and (c) abolish government control on capital issues in the

stock market and on pricing of these issues, leaving both to be regulated by a statutorily empowered Securities and Exchanges Board of India (SEBI) .

An important initiative, taken in 1992, was the decision to open the economy to foreign investment in the stock market by qualified foreign institutional investors (FIIs). There was a cap of 24 percent on the total equity in an Indian company that could be held by FIIs. It was a conscious decision to open the capital account to investments in equity, while maintaining strict control over short term capital flows in the form bank debt, which had been the source of destabilising movements in many countries. This led to a steady increase in inflows over the next several years, improved liquidity in the stock exchanges, and helped mid sized companies access foreign funds via the stock exchanges.

Big Bang vs Gradualism

Taken as a whole, the 1991 reforms clearly signalled a system change but the change was not of the "big bang" variety often recommended in those days by advocates of shock therapy. The compulsions off India's democratic polity forced a gradualist pace of change to allow time to soothe fears and weaken resistance.

The fiscal deficit of the central government was reduced fairly quickly from 7.6 percent of GDP in 1990-91 to 5.2 percent in 1992-93. The liberalisation of controls over investment was also implemented in the very first year. However, the implementation of other elements was stretched out over time. As described above, full trade liberalisation including free imports of consumer goods subject only to duty protection occurred only in 2002, a full ten years after the start of the reforms. The agenda for Tax reforms was also implemented gradually over the next several years and this was also true of reforms in the financial sector. Reforms in insurance sector in particular, with

private companies coming into health insurance and pension schemes, only began in 2002 and that too only with foreign equity shares limited to 26 percent.

Reform of the public sector, which was often a key element in many reform efforts in developing countries, was mentioned in 1991 but very little was done. Privatisation was not a part of the policy agenda. The policy only said that public sector undertakings must improve their financial performance, for which they would be given greater managerial autonomy. It was also said that irremediably loss making public sector enterprises (PSEs) would be closed down, but this was never attempted. The only new initiative was the announcement that 20 percent of the equity of profit making PSEs would be sold to mutual funds and other financial institutions with a hope that the induction of non government shareholders would increase the commercial orientation of the managements of public sector units. Policy towards the public sector moved slowly towards genuine privatisation of some public sector units during the first BJP led NDA government but this was soon embroiled in controversy.

An area where liberalisation was needed but was delayed by several years was the reservation of items for production in the small scale sector. India had long followed a policy of reserving certain items to be produced only by the small scale sector, as a means of promoting labour intensive manufacture and by the mid 1980s, as many 876 items had been reserved, including simple consumer goods such as electronic toys, garments, shoes, electric kettles and many household goods. This policy prevented the modernisation of areas which had a strong export potential, and this was pointed out by several expert committees but it was felt to be too sensitive to touch. The process of de-reservation began only in 1997, with 15 items being taken out of the reserved list. More items were de-reserved in subsequent years but it was a very slow process. Garments, which were a potentially an important export item were de-

reserved only in Jan 2001 and leather goods, another item with export potential, in June 2001. Earlier removal from the reserved list would have helped developed strong export oriented companies. Reservation finally came to an end as late as in April 2015, when the last remaining 20 items were dereserved.

Gradualism Helped Ensure Continuity

If India's democratic polity led to a gradualist pace of change, it did ensure a measure of continuity. Democracy is not a consensual form of government. It is a competitive adversarial form, in which political parties will want to differentiate themselves from their opponents, and parties in opposition will criticise those in power, often very heatedly. However, while political competition is essential for democracy, investors and businessmen must have some assurance that policies will not be radically altered when governments change. Most importantly, they must have the reassurance that policies that have worked well, will be continued and indeed even strengthened.

India's experience after 1991 passes this test. The Narasimha Rao government, which started the reforms, was succeeded by several different governments, from different parts of the political spectrum. None of them reversed the direction of reforms, and all carried them forward, though with differences in emphasis. This characterisation also applies to the first four years of the current government under Prime Minister Narendra Modi. The government has faced sharp, and often acrimonious, criticism on social policy, notably for the extreme positions taken by some individual members of the BJP asserting a muscular Hindu majoritarianism, but its economic policy can be broadly described as a continuation of the reforms. Prime Minister Modi's slogan "minimum government, maximum governance" certainly suggests a continued effort to get a private sector led economy to function efficiently.

Perhaps the only new initiative of the government which does not fit into the description of continuity was the surprise demonetisation of the two highest value notes (Rs 1000 and Rs 500) announced in November 2016. About 86 percent of the currency with the public was declared to be no longer [1]legal tender, and holders of the notes were given six weeks to deposit the old notes with the banks and get new notes or add the value to their accounts. Since there weren't enough new notes available, 'there was a cash shortage which lasted for several months. The move was officially justified on the grounds that it would help uncover hidden cash hoards from income that had escaped taxation, discourage counterfeiting and terrorist financing, reduce cash transactions in the economy thus discouraging illegal and tax avoiding activity, and encourage digitalisation. Whatever the limited gains on these accounts, there is no doubt that the move proved much more disruptive than the government expected. The scarcity of cash, affected sectors such as real estate and jewellery, where unaccounted cash payments were widespread, and also the informal sector, including rural markets for agricultural products. The disruption depressed GDP growth in 2016-17, and may also have spilled over into the first quarter of 2017-18.[2]

On all other matters there is substantial continuity although the new government has renamed many earlier programmes, and claimed that it is implementing them more vigorously. For example, it has (i) reaffirmed its commitment to follow a fiscally prudent policy by defining a new time path for reducing the central government fiscal deficit to 3 percent of GDP by 2019-20; (ii) continued the liberal industrial policy in which private investment is encouraged within a competitive market with efforts being made to improve the

[1] Table 1 shows that GDP growth declined from 8.1 percent in 2015-16 to 7.1 percent in 2016-17 and further to 6.4 percent in 2017-18. However, these are preliminary estimates in which the growth of the informal sector is not directly measured but projected based on what happened in the formal sector. If the demonetisation affected the informal sector disproportionately, these growth rates may be revised downwards when the final figures are available. However the final r-figures for 2016-17 will only be available in June 2019

[2]

ease of doing business; (iii) retained the policy of openness to foreign trade though customs duties on a number of items were raised in the 2018-19 budget, and it is to be hoped that the rise of protectionism in the US does not lead to further actions in this area; (iv) strongly welcomed foreign direct investment and expanded the areas where it is allowed, including most notably defence; (v) reiterated the commitment to improve infrastructure through a combination of public investment and public private partnersip (vi) emphasised creating a digital I T infrastructure to promote financial inclusion and improve governance and increase productivity and (vii) started to clean up the books of the public sector banks after full recognition of NPAs has shown a high burden of impaired assets.

There are also some new steps which are consistent with the thrust of policy in the past, but the government can claim credit for substantial forward movement.

The introduction of a Goods and Services Tax (GST) is a major reform of the system of domestic indirect taxes integrating (a) the central VAT (which was only up to the production stage and did not include sales which was the preserve of the states, (b) the central tax on services (c) the states VAT which went up to the sales level and (d) numerous other state taxes, into a single tax, levied on a common base, half of which would go to the states and the other to the centre. The GST had been in the pipeline for several years but it needed a Constitutional Amendment to bring it about. The Amendment Bill was moved by the previous government, but it could not get it passed. The Modi government got it passed in 2016 and the GST became effective in July 2017. There have been problems of implementation, and there is criticism of poor preparation leading to unnecessary problems. However, these problems are being addressed and there is a good chance they will be overcome during 2018.

A second major reform is the introduction of legislation establishing the Insolvency Code under which if the banks and the borrowers cannot agree to a suitable debt restructuring, then 75 percent of the lenders can refer the company to an insolvency process supervised by the National Company law Tribunal (NCLT). If the case is admitted by the NCLT, the management is removed and replaced by a professional insolvency professional acceptable to the lenders who is entrusted with the task of inviting companies interested in taking over the company to submit a bid offering a haircut on the debt. The lenders can then choose the best offer. If the process does not lead to a resolution within 270 days, the company is simply liquidated. Lenders clearly have an incentive to choose a resolution which yields them more then the value in an asset sale. Some companies have now gone through this process and it does create the right incentives for borrowers to face up to the need to repay debt or face the consequences.

A potentially important new initiative on labour market reforms is the introduction of a system of fixed term contracts for employees which allow automatic termination of service at the end of the contract period. It is hoped that this will introduce much needed flexibility in hiring labour, with a possibility of down sizing when market conditions require.

Another new initiative is the decision to privatise Air India by the end of 2018. If successfully completed it would effectively restart a process which had begun under the first NDA government but had become mired in controversy.

II Impact of the Reforms

In this section we assess the impact of the 1991 reforms in terms of its two major objectives: stabilising the economy in the short run and raising the growth rate in the medium to longer term.

Stabilising the Economy

Table 1 presents the major macro economic indicators of the economy in the years following the reforms. The combined fiscal deficit of the central and state governments was reduced from the very high level of 9.1 percent of GDP in 1990-91 to the still high but significantly lower level of 6.8 percent in the next two years after which it rose again. 1991-92.

Table 1

Major Macro Economic Trends

	GDP Growth Rate (%)	Fiscal Deficit (% of GDP)		Current Account Deficit (% of GDP)	Gross Fixed Capital Formation (% of GDP)
		Centre	Centre & States		
1990-91	5.3	7.6	9.1	-3.0	23.8
1991-92	1.4	5.4	6.8	-0.3	22.6
1992-93	5.4	5.2	6.8	-1.6	23.0
1993-94	5.7	6.8	8.0	-0.4	21.5
1994-95	6.4	5.5	6.9	-1.0	21.8
1995-96	7.3	4.9	6.3	-1.6	24.1
1996-97	8.0	4.7	6.1	-1.1	23.1
1997-98	4.3	5.7	7.0	-1.3	23.7
1998-99	6.7	6.3	8.7	-0.9	23.7
1999-00	8.0	5.2	9.1	-1.0	24.0
2000-01	4.1	5.5	9.2	-0.5	22.7
2001-02	5.4	6.0	9.6	0.7	25.1
2002-03	3.9	5.7	9.3	1.2	23.7
2003-04	8.0	4.3	8.3	2.3	24.5
2004-05	7.1	3.9	7.2	-0.4	28.7
2005-06	9.5	4.0	6.5	-1.2	30.3
2006-07	9.6	3.3	5.1	-1.0	31.3
2007-08	9.3	2.5	4.0	-1.3	32.9
2008-09	6.7	6.0	8.3	-2.3	32.3
2009-10	8.6	6.5	9.3	-2.8	31.7
2010-11	8.9	4.8	6.9	-2.8	30.9
2011-12	6.7	5.9	7.8	-4.3	34.3
2012-13	5.4	4.9	6.9	-4.8	33.4
2013-14	6.1	4.5	6.7	-1.7	31.3

2014-15	7.2	4.1	6.7	-1.3	30.1
2015-16	8.1	3.9	7.4	-1.0	28.5
2016-17	7.1	3.5	6.4	-0.7	28.5
2017-18	6.4	3.6	-	-	28.5

Source: National Accounts, Central Statistics Office, 2018

Economic growth in 1991-92 collapsed to 1.4 percent, which is not unusual in stabilisation programmes. The collapse occurred because the economy was suffering from the effects of a severe squeeze on imports in the previous year, which was not relaxed until after the IMF and the World Bank loans were in place in the third quarter of 1991-92. Growth picked up to 5.4 percent in 1992-93, and the current account deficit increased to 1.6 percent. GDP growth accelerated to 5.7 percent in 1993-94 and the current account deficit was a manageable 0.4 percent of GDP.

The stabilisation effort can be judged to have been outstandingly successful. By the end of 1993-94, about two and a half years after the IMF programme began, the balance of payments crisis was over. It was earlier thought that India may need to approach the IMF for an Enhanced Structural Adjustment Facility (ESAF) at the conclusion of the stand'-by arrangement negotiated in 1991, but this was not necessary. What is also impressive is that the economy remained sufficiently robust externally that India has not had to approach the Fund thereafter. It did experience balance of payments problems in 2011-12 and 2012-13 when the current account deficit exceeded 4 percent of GDP, larger than the 3 percent in the crisis year of 1990-91, but it was able to manage the situation on its own without Fund assistance.

The success of the stabilisation effort is a distant event today and therefore may not seem to be too relevant for our narrative but it is important to keep in mind that the success in this area was an important factor that gave strength to the reformers. A failed stabilisation effort would have seriopusly undermined the continuation of the reforms.

Accelerating Growth in the Longer Term

As shown in Table 1, growth recovered quickly after collapsing to 1.4 percent in 1991-92, and averaged 6.5 percent in the 8 years 1992-93 to 1999-2000. Nevertheless, Bradford deLong (2001) raised doubts about whether the reforms really had much of an impact on growth. He pointed out that the incremental reforms in the 1980s produced an average growth rate of 5.6 percent in the period 1980-81 to 1989-90, which was a full 2 percentage points higher than the long term growth achieved before 1980. Against this, the growth rate achieved in the 1990s was only 5.8 percent which represented only a very small improvement over the previous decade. DeLong concluded that the incremental reforms of the 1980s, which consisted mainly of operating the same control system but with a more pro business approach, and without the earlier suspicion of the private sector, had produced a much greater impact on growth than the much hyped reforms of 1991. A few years later, Dani Rodrik and Arvind Subramaniam (2004), built on the De Long critique to suggest that the emphasis on external liberalisation in trade and foreign investment, which was a characteristic feature of the 1990s reforms, though much applauded by international organisations, was actually much less important than operating the domestic controls in a more result oriented manner.

The issues raised are obviously important for evaluating the 1991 reforms. I have argued that the De Long and Rodrik-Subramaniam thesis does not stand up to scrutiny and the main points are worth repeating.[3] First, the high growth of the 1980s, which is used as the base for comparison, was fuelled in part by an excessively expansionary fiscal policy, and was therefore unsustainable. The combined fiscal deficit of the centre and states averaged 6.9 percent of GDP in the first half of the 1980s and increased to 8.6 percent in the second half. This was bound to have a negative effect on GDP growth, and this surfaced in the

[3] See Ahluwalia 2016

form of the crisis of 1991-92. Comparing growth in the 1990s, after including the crisis year of 1991-92, with growth in the 1980s exaggerates the achievement of the 1980s and understates the post reforms performance in the 1990s. If the comparison is made with the post reforms period 1992-93 to 1999-2000, this eight year period yields a fairly robust growth averaging 6.5 percent. This was despite the fact that the economy did suffer from the spillover effect of the East Asian crisis in 1997

Nevertheless, if it has to be conceded that the post reforms period showed higher growth, it can still be said that a growth of 6.8 percent is not very impressive. An important reason for the relatively modest improvement in the initial years is that the reforms announced in 1991 were implemented only gradually, and therefore took time to have their full impact. As pointed out earlier in this paper, the reduction in customs duties, which was a critical component of the external liberalisation strategy, was stretched over several years extending over the two year life of the United Front Government and the subsequent six years of NDA I. The reforms in state indirect taxes took place only in 2005 and the integration of the goods and services taxes of the centre and the state VAT into a common Goods and Services Tax (GST) for the Centre and States together was introduced only in July 2017. The process of de-reservation for small scale production was also considerably delayed as noted above.

The cumulative effect of the reforms is therefore best seen by taking a somewhat longer time horizon. For example, if we take the fifteen year period 2003-04 to 2017-18, the average growth rate of GDP comes to 7.6 percent. This is a full 2.4 percentage points higher than the growth rate of 5.6 percent in the period 1980-81 to 1991-92. This comparison suggests that the economic reforms initiated in 1991 did lead to a significant acceleration in growth, but only after a time lag of several years. India's growth acceleration was not as

marked as that enjoyed by the original Gang of Four (Hong Kong, Singapore, South Korea and Taiwan), or more recently by China which grew at 10 percent per year over a thirty year period! However, growing at 7.6 percent over fifteen years is a remarkable achievement.

Some insight can be gained by comparing India's growth performance in the three sub periods discussed above with the growth rate of China, Other EMs excluding India and China, and the ASEAN group. This is done in Table 2.

Table 2

India's GDP Growth Compared to Other Countries/ Groups of Countries

	1980-1991	1992-2002	2003-2017	2018-2022
Advanced Economies	3.0	2.8	1.7	1.8
All EMDEs	3.4	4.0	6.0	5.0
India	5.2	5.8	7.6	7.9
China	9.2	10.2	9.4	6.2
ASEAN-10	6.1	4.7	5.4	5.2
All EMDEs excl. India & China	2.6	2.6	4.3	3.5

Source: World Economic Outlook, Oct 2017, IMF

In the pre reforms period 1980 to 1991, India grew much more slowly than China and even slower than the ASEAN 10. In the first post reforms period 1991 to 2002, India 's growth edged above the ASEAN 10 but was much slower than China. In the second post reforms period 2003 to 2017, India grew significantly faster than the ASEAN 10, but still slower than China though the gap narrowed. The IMF's projection for the period 2018 to 2022, China is

expected to slow down - an inevitable phenomenon for a country that has grown at an average of 10 percent for 30 years - and India's growth rate will average just under 8 percent overtaking China's.

It is reasonable to conclude that India's reforms, taken as a cumulative process, have unleashed a fairly robust growth process even if they have taken a little too long to do so.

III Has Faster growth Been More Inclusive ?

We now turn to the more difficult question of whether the high growth achieved in the post reforms period is also inclusive. Traditionally, inclusiveness in India has been viewed in terms of the impact on poverty reduction. On this metric the evidence is overwhelming that absolute poverty declined substantially after the high growth effect kicked in. Table 3 summarises the changes in poverty using the national estimates of poverty based on the Tendulkar poverty line, which is actually very close to the international poverty line used by the World Bank. It also reports the growth of GDP and agricultural GDP over the same periods to give some explanation of the difference in performance in different periods.

Table 3

Growth and Poverty in India

	Annual Growth of GDP (%)*		**Population in Poverty**	
	Economy	Agriculture	% in poverty	Millions
1993-94	-	-	45.3	403.7
2004-05	6.2	2.9	37.2	407.1
2011-12	8.5	3.5	21.9	269.8

** The annual averages are for the period preceding the year indicated. Thus 6.2 percent is the annual average growth of GSP from 1993-94 to 2004-05*

Source: National Accounts (2014) and Rangarajan (2014)

The first eleven years of the reforms saw a decline in the percentage of the population in poverty from 45.3 percent to 37.2 percent but it was not sharp enough to offset the increase in total population, so the absolute number of people living below poverty line actually increased marginally. However, in the latest period 2004-05 to 2011-12, the percentage in poverty declined much more sharply, and the numbers in poverty fell by 137 million. The sharper reduction in poverty in the most recent period can be attributed to three distinct factors.

(i) As shown in Table 3, the growth rate of GDP was significantly faster, averaging 8.5 percent per year (about 7 percent per capita), compared with only 6.2 percent (4.2 percent per capita) in the earlier period. A higher growth rate in percapita income can be expected to reduce the extent of poverty provided there is no significant change in the share of income going to the lower income groups. This is the much maligned "pure trickle down" effect.

(ii) The composition of growth in the latter period was inherently more poverty reducing because agricultural growth accelerated to 3.5 percent per years compared with only 2.9 percent in the earlier period. This illustrates the important point that it is not just the rate of growth, but the composition of growth that matters.

(iii) The third factor which could have contributed to a faster reduction in poverty was the increased emphasis on anti poverty programmes from 2004-05 onwards. When the BJP lost the election in 2004, it was commonly said that they had neglected rural areas and been carried away by the growth performance, which was celebrated in the slogan "India Shining". This

reinforced the determination of the UPA to expand a number of anti poverty programmes, including especially the rural employment guarantee, the programme for supply of subsidised food to lower income groups, and various rural livelihood support programmes.

It is important to recognise that all three factors contributed to the fall in poverty. Advocates of poverty reduction strategies tend to focus almost exclusively on programmes directed at poverty alleviation and there is no doubt that these have a very important role to play.[4] However, the other two factors are also important. More research is needed to quantify the relative importance of these three components in different periods of time. One would also expect that the relative importance of these instruments would vary across the different states in the country.

Employment Generation

All over the world, employment has become the critical test of inclusiveness and India is no different. Faster growth is dismissed if it is "jobless growth" and there is a perception that the reforms have not delivered on this front. Part of the problem is that the data available on employment do not permit a completely reliable assessment of what is happening.

Traditionally, employment used to be measured only every five years through the Employment and Unemployment Surveys conducted by the NSSO[5]. This showed unemployment as 3.17 percent in 2004-05, falling marginally to 3.14 percent in 2011-12. There are different definitions of unemployment in the survey and the extent of unemployment varies according to definitions, but whatever the definition, there is relatively little variation over time. A new source of data on unemployment is the Labour Bureau, which has been

[4] See for example Himanshu and Sen (2017)

[5] The NSSO have decided to conduct surveys annually, but no new data are available as yet.

conducting annual surveys. These show an unemployment rate of 3.3 percent in 2011-12 which rose to 3.7 percent in 2015-16, the latest year for which the data are available. Neither of these sources suggest that the unemployment problem is of a scale that amounts to a crisis. This impression may be misleading because in India's economic circumstances, a lack of employment opportunities will not necessarily show up as open unemployment for the simple reason that people cannot afford to remain unemployed for long. In the absence of social security payments. they are forced to take up whatever jobs they can find to eke out a living.

The real problem is that too many people are engaged in forms of employment that do not come up to the expectations of the more educated younger members of the labour force. This problem was moderated to some extent in recent years as children stayed longer in schools, but as these cohorts come to school leaving age, we can expect a sharp increase in the annual accretion to the labour force and the new entrants will be younger people who have gained an education and are hoping to get good quality non agricultural jobs in urban areas. They are unlikely to settle for low productivity self employment and will look for secure employment in the organised sector. Available data do suggest that organised sector employment has expanded by 58 million between 2004-05 and 2011-12, but 84 percent of the increase was in what is called "informal employment" ie contractual employment which does not yield the full benefits of regular employment.

This sobering description of what is happening on the employment front, is perfectly consistent with the very positive picture of a decline in poverty over the same period. A reduction in poverty only requires an increase in farm incomes in agriculture accruing to the self employed farmers, and an increase in real wages for unskilled labour in agriculture and construction. However, the better educated youth entering the labour force are not looking for jobs that will

keep them above the poverty line. They are looking for satisfying jobs in line with what they believe are their superior qualifications.

The slow growth problem of formal sector employment is sometimes attributed to the fact that the manufacturing sector has not grown as rapidly in the post reforms period as was hoped. As shown in Table 4, the manufacturing sector did accelerate from an average of 5 percent per year in the pre reforms period 1980-81 to 1991-92 (including the crisis year in the base period) to 6.6 percent in the period 1992-93 to 2002-03, and then accelerated further to 8.3 percent in the period 2003-04 to 2017-18.

Table 4

Growth Rate of GDP by Industry of Origin

	1980-81 to 1991-92	**1992-93 to 2002-03**	**2003-04 to 2017-18**
Agriculture	3.8	2.7	3.7
Manufacturing	5.0	6.6	8.3
Services	6.3	7.7	9.0

Source: National Accounts, Central Statistics Office, 2018

There are purely accounting reasons why growth in manufacturing may be understated post reforms. The first is that the reduced levels of protection following the reforms would have squeezed the measured value added in industry compared with earlier years where it was artificially high because levels of protection raised the domestic prices of protected industries. This could show up as lower growth in manufacturing value added for some time. A second reason why growth may be understated is that as Indian industry came under pressure to reduce costs, it began to outsource activities such as cleaning, catering for workers canteens, gardening, transport activities, provision security etc to third party service providers. This reduced measured value added in

manufacturing by shifting it to the services sector. The National accounts data do show that service sector GDP accelerated sharply through these years from an average 6.3 percent in the period 1980-81 to 1991-92 to 7.7 percent in the period 1992-93 to 2002-03, to 9 percent in the period 2003-04 to 2017-18. The growth in the services sector would have offset any decline in employment in the manufacturing sector, but the quality of service sector employment would have been poorer with less social security and lower wages.

Apart from these accounting factors, there are good economic reasons why India's reforms failed to achieve the kind of employment growth in manufacturing achieved by East Asian countries. The key point is that India's economic policies were not targeted at developing an export oriented manufacturing sector based on labour intensive industries. As noted above, many of the goods which could have formed the basis for such an export strategy, remained reserved for small scale production in the first ten years of the reforms! India also failed to develop the kind of good quality infrastructure which is essential to support an export orientation. Investments in infrastructure were spread out more thinly over the country, with no special effort to develop high quality competitive infrastructure in selected areas or export zones. Finally, India's labour laws have long been regarded as the culprit, being unduly rigid making it extremely difficult to close down a unit or retrench labour, apart from also being unduly complex. All of this discouraged entrepreneurs from setting up large units employing large numbers of people.

Correcting these weaknesses will be critical for producing adequate growth in good quality employment in the years ahead and I return to this issue later in the paper.

Education, Health Services, Clean Drinking Water and Sanitation

A major failing of the India's development strategy is that it has paid much less attention than other countries to ensuring access to critical services such as education, health, clean drinking water and sanitation. These services have to be delivered by the state and shortfalls in delivery not only impact welfare directly, they also affect the quality of human resources, which are a key determinant of growth. There can be no doubt that India will not be able to develop the momentum of growth needed to take it from the bottom of the middle income category of countries, where it is today, to somewhere nearer the upper end of this group over the next twenty years, without much better performance in delivering essential services to the population.

It is beyond the space constraints of this paper to review all the available evidence on performance in these dimensions, but some general conclusions can be offered.

(i) Indian policy makers have been focussing on improving access to schooling for several years and there is definite improvement in some dimensions. Enrolment of children in Grade I-V is now virtually universal at 99.2 % and for Grade VI to VIII it is 92.8 %. Pupil teacher ratios are also acceptable. However, learning outcomes remain poor. ASER (2016) reported that about 57 percent of Standard VIII students could not do simple division and 25 percent could not read a Standard II text. With such weak foundations, a large proportion of the children in school are bound to fall behind in learning as they progress to higher stages.

(ii) Health outcomes are usually judged by indicators such as life expectancy, infant mortality, maternal mortality, measures of stunting and weight for age of children, etc. All these indicators have been improving, but the rate of improvement is slower than necessary to reach the targets set. As Amartya Sen

and Jean Dreze have often pointed out, India performs worse than many other countries at similar levels of development.

(iii) Sanitation is a major problem area although there is evidence of improvement. In 1993, as many as 88 percent of the rural households had no access to a toilet. Official data show that this had reduced to 50 percent in 2016. However, the incidence of open defecation in rural areas is still around 52 percent, much higher than 32 percent in Sub Saharan Africa or 21 percent in Indonesia[6]. With growing density of population, this is a recipe for spread of infection and disease with children being especially vulnerable. Prime Minister Narendra Modi has set an ambitious target of ending open defecation in India by Oct 2 2019 [7]. However, abandonment of open defecation requires a change in mindsets, including overcoming ritual purity taboos, which discourage people from using community toilets.

Inequality of Income and Wealth.

The degree of inequality in income and wealth is another dimension of inclusiveness which is attracting global attention, and has also surfaced in the public debate in India. There are no official data on the degree of income inequality and discussions on inequality have generally focussed on data on household consumption based on NSSO surveys. These show relatively low levels of inequality but with an increase over time. The Gini coefficient of inequality in consumption was 0.30 in 1993-94. It increased to 0.35 in 2004-05 and further to 0.36 in 2011-12.[8]

The two India Human Development Surveys conducted jointly by the NCAER and the University of Maryland are the only surveys with information

---

[6] Swachta Status Report 2016, National Sample Survey Office and UNICEF-WHO Joint Monitoring Programme 2017

[7] The date is Mahatma Gandhi's 150th birth anniversary.

[8] Oxfam (2017)

on income. They show a Gini coefficient of income distribution of 0.54 in 2005, and 0.55 in 2012. The fact that the degree of inequality is higher than for consumption is exactly what one would expect, but it is also very high, putting India among the countries with the highest levels of inequality. Household surveys suffer from the additional problem of understating the extent of concentration of income in upper income groups because of undersampling and under reporting. Chancel and Piketty (2017) have tried to overcome this problem by combining the results available from household surveys with information from income tax returns data. They do not report Gini coefficients, whihgc are a measure of inequality across the whole distribution but focus on the real growth of income of different income percentile groups ranging from the bottom 50 percent to the top 1 percent and top one tenth of one percent. They claim that the degree of inequality based on these measures has worsened steadily since the mid 1980s and India's performance is comparable with countries showing the greatest increase in inequality.

A related dimension of inequality that has received growing attention is the concentration of wealth. The 2018 Forbes list of billionaires reports 119 billionnaires in India, the largest number after the US, China and Germany. While some of them have created their own fortunes, and added a great deal to the GDP in the process, a very large proportion have inherited their wealth.

Inequalities in income and wealth may be ignored if they occur in an environment of general well being and broad based improvement in living standards. They are bound to become intolerable if there is no sense of broad based improvement. They create sense of unfairness which can greatly weaken the social fabric.

Sustainability

India's growth strategy must also pass the testy of environmental sustainability. This is actually closely connected to inclusiveness. Since many of the negative effects on the environment affect the health and livelihood of poorer groups, failure to integrate environmental considerations into the development strategy directly worsens inclusiveness. Where the effect on the environment is longer term, eg CO2 emissions, it affects the well being of future generations, which can be called a failure of inclusiveness in the inter temporal dimension.

Space constraints do not permit an exhaustive treatment of the environmental sustainability of India's reforms. The positive side is that this aspect is now recognised in policy making. However, we cannot say that we have evolved a credible way of harmonising growth objectives with environmental sustainability. On each of the metrics typically associated with environmental sustainability such as air pollution, maintaining cleanliness of the natural water bodies, preventing excessive drawal of ground water, containing the growth of carbon emissions, and expanding the size as well as quality of forest cover, there is continuing deterioration. The most that can be claimed is that but for the efforts that have been made, the situation would have been worse. In other words, we have made progress in identifying sustainability goals, but we have yet to evolve a workable set of policies to achieve those goals.

VI Prospects for the Future

The government has not formally adopted a medium term growth target, for the future but the three Year Action Agenda, published by the Niti Ayog in 2017, mentioned returning to "8 percent plus" growth trajectory "within two years". An acceleration in growth to this level is definitely needed if the aspirations of the young are to be met.

Since population growth is likely to average about 1 percent over the next twenty years, GDP growth at 8.5 percent would yield a growth in per capita income of around 7.5 percent. At this rate, India could expect to move from the middle of the World Bank's "lower middle income" category, where it is today, into the bottom of "upper middle income" category'. In another ten years, it could get to the middle of that category, approximately where China is today.[9]

The economy did grow at an average rate of 8.4 percent in the eight year period 2003-04 to 2010-11 and it is therefore tempting to conclude that it could easily do it again. However, this is by no means pre ordained. There are many examples of countries can grew rapidly for a while, after some constraints were removed - the effect of what might be called first generation reforms - and then hit another ceiling because other constraints become binding. This is essentially what lies behind the idea of the so called the "middle income trap", in which countries which get to middle income status face new constraints, including the need to develop institutions suitable for handling the more complex problems associated with higher levels of per capita income. The agenda for policy action at any time is therefore not just the accumulated unfinished business of first generation reforms in the pipeline, but also a whole new set of reforms to deal with new problems.

A comprehensive list of the reforms needed to achieve the transition described above would be very extensive. Many of them are currently being attempted and as in the past may be affected by the compulsions of gradualism. However, some of the most critical issues are listed below.

(i) Investment in Infrastructure:

[9] The lower middle income category includes countries with a per capita GDP > $1000 but < $4000 and the upper middle income category is > $4000 but < $12000.

India needs to invest at least another 2 percent of GDP in infrastructure, including infrastructure oriented towards creating a greener economy to start dealing with the challenge of climate change. Since the availability odf resources with the government is limited, a large part of the increase must come from public private partnership (PPP). India made a good start with expanding PPP investments some years ago, and at one stage was commended by the ADB for having the largest number of PPP projects in infrastructure. However, many of these projects ran into a variety of problems, including regulatory ambiguity on many issues. These problems need to be speedily resolved to remove uncertainty for investors.

(ii) Fixing the Banking System:

In 2015, the Reserve Bank of India ordered a the banks to undertake a rigorous asset reclassification exercise and this exercise revealed that banking system, especially the public sector banks, have a high proportion of non-performing assets. A large number of non performing accounts have been referred to the recently established insolvency resolution process. It is expected that the process of resolution will impose large haircuts on the banks, which will erode their capital. Unless the banks are substantially recapitalised, the growth of bank lending will not come up to the level needed to support an early return to rapid growth. This is an ideal time for the government to bring in bank capital from outside, reducing its own stake in public sector banks to less than 50 percent. This will not only reduce the fiscal drain on the government on account of recapitalisation, it will also free the banks from the many constraints that apply to a majority government owned enterprise, thus improving the efficiency of the banks.

Unfortunately there is no support for dilution of government capital below 50 percent among political parties. As a result, a massive capital infusion

will be necessary if the growth of bank credit is not to be jeopardised. And the revival of credit will not be accompanied by any systemic reform.

(iii) Maintaining Macro Economic Balance:

Maintenance of macro economic balance is a precondition for good economic performance, especially for an economy increasingly open to capital flows. Fortunately, the institutional framework for guiding policy in this area has been established with (a) the Fiscal Responsibility and Budget Management Act 2003 directing the central government to fix fiscal deficit targets three years ahead and (b) the establishment of a Monetary Policy Committee chaired by Governor RBI which decides the short term interest rate, with an inflation target of 4 percent, plus/minus 2 percentage points but keeping in mind the requirements of growth.

Hopefully, this institutional arrangement will generate pressure to follow a reasonably balanced combination of fiscal and monetary policy. Maintaining fiscal discipline in the centre will be a major challenge because there are large demands for increased expenditure in a number of areas including infrastructure development and provision of essential services in health and education. It will also be important to ensure that fiscal prudence is also enforced on the states. They have been generally well behaved fiscally because they cannot borrow without the permission of the central government but many states have resorted to announcing loan write offs for farmers in response to signs of rural distress.

(iv) Exchange Rate management:

There is a missing element in the architecture of macro-economic management and that relates to management of the exchange rate. If one takes the view that the exchange rate can be left to be entirely market determined, there is no problem. However, in a world of relatively freer movement of capital, it is possible to envisage large swings in the exchange rate being driven not by

the need to equilibrate the current account deficit, but rather as a response to capital flows. Capital inflows can push a real exchange rate appreciation which discourages exports and encourages imports, in effect generating the current account deficit needed to accommodate the capital flow. There is not enough clarity on what policy should be in these situations. Reserve bank data show that the real effective exchange rate has appreciated by about 20 percent over the past few years. Many critics have linked this to the indifferent performance of exports in recent years. It needs to be considered whether, just as fiscal and monetary policy are being made rule based, similiar rules should not apply for exchange rate management or management of capital flows.

(iv) The Challenge of Urbanisation.

The urban population was 25.7 percent in 1990 and has now increased to 33 percent, and the pace of . urbanisation in India is set to accelerate. However, the existing urban infrastructure in almost all Indian cities is woefully inadequate. A country aiming at 8 percent plus growth must plan to build the necessary infrastructure and deliver the necessary public services to cater to the demands of an expanding and more aspirational urban population. This will not happen unless the financial and the implementation capacity of urban local bodies is drastically overhauled. How to empower city governments to manage the cities is a major challenge.

(v) External economic policy:

The escalation of protectionist rhetoric among the major players in the world economy has created great uncertainty about the external environment in the years ahead and the prospects for an expansion in exports. India's growth is less dependent on exports than many others, and it is possible that India would be less adversely affected than many other emerging market countries because higher growth in India will have to depend largely on the expansion of domestic

demand. The key policy issue that arises is whether India should rethink its position on openness to the world economy, in view of the changing tones of global discussions. The issue is particularly important because domestic protectionist pressures, which are always present in all countries, are likely to intensify, fanned by the new international rhetoric. It will be extremely important for India to resist these pressures and remain an open economy. The global economy may be less welcoming of exports than it used to be, and this may reduce the benefit we would derive from remaining open, but reversing course will not improve the situation.

The issues listed above are only some of the issues that arise as we consider the prospects for India's future policies. There are many others that are not dealt with because of space constraints.

References

Ahluwalia, M. S. "The 1991 Reforms: How home-grown were they." *Economic and Political Weekly* 51.29 (2016): 38-46.

ASER Centre. “Annual Status of Education Report (Rural): 2016.” (2017). Accessible at: *asercentre.org*

Chancel, L. and Thomas Piketty. "Indian income inequality, 1922-2014: From British Raj to Billionaire Raj?." *World Inequality Database Working Paper* N.11 (2017). Accessible at: *wid.world*

DeLong, J. B. "India since independence: An analytic growth narrative." (2001).

Himanshu and Sen A. "In-kind food transfers-I." *Economic and Political Weekly* 48 (2013): 46-54.

IMF. “World Economic Outlook Database, Oct 2017 Edition.” (2017). Accessible at: *imf.org*

Labour Bureau. “Report on Annual Employment – Unemployment Survey (various years).” *Ministry of Labour and Employment, Government of India* (various years). Accessible at: *labourbureaunew.gov.in*

National Sample Survey Office. “Swachhta Status Report 2016.” *Ministry of Statistics and Programme Implementation, Government of India* (2017). Accessible at: *mospi.nic.in*

Oxfam India. “India Inequality Report 2018: Widening Gaps.” (2018). Accessible at: *oxfamindia.org*

Rangarajan, C. "Report of the Expert Group to Review the Methodology for Measurement of Poverty." *Planning Commission, Government of India* (2014). Accessible at: *planningcommission.nic.in*

Rodrik, D. and Subramanian A. "From “Hindu growth” to productivity surge: The mystery of the Indian growth transition.” *IMF Staff Papers* 52.2 (2004): 193-228.

UNDP. "2016 Human Development Report." (2016). Accessible at: *hdr.undp.org*

Central Statistics Office. "National Accounts Statistics (various years)." *Ministry of Statistics and Programme Implementation, Government of India* (various years). Accessible at: *mospi.nic.in*

WHO and UNICEF. "WHO/UNICEF Joint Monitoring Program on Drinking Water, Sanitation and Hygiene (WASH)." (2017). Accessible at: *washdata.org*

The World Bank. "World Development Indicators 2017." (2017). Accessible at: *databank.worldbank.org*