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Prospects of Further Reforms in India:

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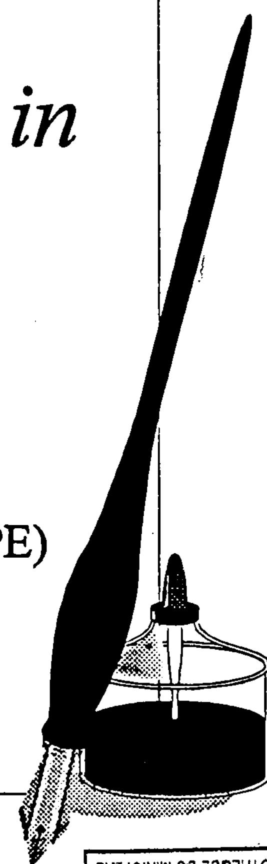

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Prospects of Further Reforms in India

1. Introduction[1]

This note discusses the following question:

- Are economic reforms in India likely to continue or run out of steam?

Ever since India achieved independence in 1947, Nehru-Gandhian socialist philosophy had kept India's economy closed with significant barriers to trade and investment. Government regulation of domestic and foreign trade has been widespread, and controls on the private sector have been tight. Economic inefficiencies at every step kept the annual rate of real GDP growth in India at about four percent from 1955 to 1990. This relatively slow growth, and the policies supporting self-reliance through import-substitution, led to an increasing gap between Indian savings and the country's investment needs.

By the 1980s, policymakers realized that India needed foreign investment to make up the shortfall in domestic saving. In the 1980s, India also set out to attract investment by non-resident Indians (NRIs). Since India's international diaspora is largely made up of professionals, India mostly attracted short-term portfolio investment rather than more stable foreign direct investment FDI.

India, however, did not use new investment to shift the economy to export orientation. State-owned enterprises (SOEs) and India's huge bureaucracy were eating up a substantial share of tax revenues. The fiscal deficit climbed to 8.3% of India's GDP in 1990. As India was unable to reduce its external debt service payments as a proportion of exports, India's credit rating went down. Consequently, in 1991, the international Indian diaspora began withdrawing its portfolio holdings in India. The resulting balance of payments crisis of 1991 forced India to seek help from the World Bank and the International Monetary Fund (IMF).

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[1]Without implicating, for their comments the author thanks Geroge Anderson, Head Policy Staff, Lenord J. Edwards, Assistant Deputy Minister (Asia and Pacific Branch), Ehsan Choudhri, Professor of economics, Carleton University, William Ehrlich, Steven Lavergne and David Weiner, and Suzanne Desjardins for research assistance.

Shortly after Mr. Rao's Congress Party won national elections, his government launched economic reforms in July 1991. The pace of liberalization since then has been gradual. Among other factors, policymakers in India confronted the following circumstances.

- The lack of economic performance relative to other east Asian countries, especially as compared to China.[1]

- The dissolution of the Soviet system and bleak prospects for the nonaligned countries as a group.

- An increasing rejection of the command economy philosophy, which was actually alien to the traditional Indian ethos of an open commercial society. Indian silk, cotton and spices were prized even by the Roman empire. India has had trade links, based on private enterprise, with east Asia and the Middle-east for more than two thousand years.

- The realization that direct investment by non-Indians is essential to attract stable investment that would bring in Western technology. NRI investment, which had the benefit of not upsetting Indian nationalists and Hindu fundamentalists, was neither large nor stable. Consequently, India would have to ease up its nationalistic angle on foreign direct investment. Having lost four decades to the experimentation with the management of the economy via five-year plans, Indian businesses needed to catch up to world-class management skills, which could be learnt through joint ventures with Western firms.

- Given the pace of globalization and spread of the market economy ideology across countries, India's federal government would have to begin reforms to avoid falling behind regional powers such as China and the block of other east Asian countries.

[1]On the latter point, see Jagdish Bhagwati, ***India in Transition: Freeing the Economy***, Oxford University Press, 1993.

2. Reforms from 1991 to 1995

The socialist regulation and import/export license-raj in a democratic India proved to be frustratingly difficult. However, over time there sprang up vested interest groups, including businesses, politicians and bureaucrats. These lobby groups got used to partaking the rents generated in an economy driven by the philosophy of self-reliance and import-substitution.

The deregulation and reform process is aimed at restructuring the Indian economy and make it turn on the basis of private ownership of property and a competitive market system. No other democracy the size of India has attempted such major reforms. The potential scope and extent of reforms in India is as enormous as in China, though India is at an earlier stage. The Communist party in China could simply turn on the reform process in 1979. The democratic process in a developing country, such as India, is bound to be bumpy and take time.

De-licensing. In 1991, the Congress government began by abolishing licensing requirements, except for 15 industries (by 1993). In 1994, industrial licensing for bulk drugs were abolished.

Currency. The Indian currency, the rupee, was devalued by 18% in 1991 and was made partly convertible in the following year before it was floated on current account in 1993. The rupee has further depreciated in 1995. So far, the Indian government has refrained from supporting the rupee.

Foreign direct investment. FDI reforms in 1991 began by raising the stake foreign equity could take in enterprises in India. In 1992, private investment was allowed in the power sector. First private sector power projects came on stream in 1994. Basic telecom and other value-added services were opened to private sector in 1994. In 1995, cellular licenses were awarded and basic telecom services tenders were opened. By 1995, India's central bank had set up a "single window" for almost automatic approval of foreign investments up to 51% of equity in 35 industries that cover the bulk of manufacturing in India.

Trade. Reforms began with the easing of capital-goods in 1991. The highest tariff rate was cut in 1993 from 110% to 85% and then in 1994 to 65%. In 1995, duty-free imports were allowed with the aim of promoting exports of capital goods. Also in 1995, automatic approval became possible for 100% export-oriented units and units in export-processing zones.

Banks, the stockmarket and infrastructure. Major banks are nationalized in India. Beginning in 1992, banks were allowed more freedom to lend money and guidelines were issued for setting up private banks. 1993 saw further easing of restrictions on banks in India. Also in 1993, transactions on the Over the Counter Exchange began. In 1994, the National Highway Act was amended.

3. The Road Ahead

Privatization. The major challenge that the Indian policymakers have yet to tackle concerns the privatization of state-owned enterprises (SOEs) and the restructuring of the huge government machinery. India allowed the creation of major entitlements such as secure jobs in the loss-making public enterprises, and the bloated bureaucracies in state and central governments. Reforms have so far not attacked these entitlements, which continue to bleed the government budget and cast a shadow over the sustainability of the limited reforms underway. China's experience has been to reform around SOEs. But for reforms to go deeper India will have to launch privatization programmes.

Factor market reforms. Although, the land market has been virtually distortion free in India, there still remain major distortions in the market for labour and in the capital market. Concerning the organized sector, India's labour legislation goes back to the 19th century. The antiquated laws and the implicit commitment of a job for life in the government and public enterprises account for an inflexible labour market in India. The reform of labour market in India is urgently needed. Capital markets in India have to work through the nationalized banking sector. The reform of the nationalized banking system is essential to cope with the move from the control and command economy to the market.

FDI-friendly environment. China's experience suggests that creating an environment friendly to foreign direct investment and to exports is essential for India's ability to compete in world markets. India needs to improve access to infrastructure facilities such as electricity, water, transportation, housing and communications. One way India could post the "Open for Business" sign would be to invite tenders for all infrastructure projects by foreign and domestic companies in a transparent fashion.

4. India's Comparative Strengths for Further Reforms

Economy-wide reforms. India turned the reform corner much later than China and other emerging markets. The opening up of India involves reforms that apply to sectors all across India whereas China opened up incrementally, first by creating special economic zones in Southern China then open coastal cities and gradually more inland regions. In India the scope of reforms extends to all parts of the country, though it varies from state to state.

Finance and stock-market. India's central bank and the Bombay stock exchange were established at the turn of the century. India already has 23 stock exchanges. India still needs to reform its financial sector to make it a fully efficient instrument for financial intermediation. Nonetheless, the Indian stock exchange is much more capitalized than, say its Chinese counterparts. India's financial sector is well advanced along the lines of a market economy.

Private property rights. The land market in India has been virtually free of distortions. Similarly, China historically had strong property rights and flexible system of mortgaging and leasing. However, under Chinese communism private property, including private land and individual labour, was socialized. Even today, because the land belongs to the Chinese state it cannot be sold; it can be leased and leases can be transferred or sold. This restriction on property ownership in China puts a limit on the efficient working of the capital market, and consequently of reforms, in China. In India you would not encounter such limitations on private property ownership, which potentially deepens the distance the reforms can go.

The rule of law based on common law. India has a well developed legal system that works, though slowly at times. India's legal doctrines are grounded in common law—a feature also common to the legal system in North America and the U.K.. The case law in India goes back decades. China is struggling to develop its legal system. The combination of clear property rights and the rule of law gives foreign investors an important instrument to enjoy returns and ownership of their investment in India.

Messy and slow, but democracy works. India is the largest democracy in the world, in contrast to China, which remains a dictatorship. Chinese reforms can be introduced by the consensus of the leadership in China and carried out by state dictate. Implementing reforms takes longer in India, but once in place reforms are not easy to repeal as under a dictatorship.

In the long-run, if India can reform its statist regime in favour of a market-based economy, India would be a capitalist democracy—much like the Western economies. In contrast, to fully carry out reforms to establish a market-based economy, China would have to give up its ideology of state socialism, and even then, unless it reforms its political structure, China will be market-based dictatorship.

Overall, if reforms have bright future in China, the institutional set-up in India makes their prospects even brighter.

5. The Political Economy of Future Reforms

India has a long history of maintaining a multi-ethnic society. India has had a decentralized form of social control as embodied in the Indian caste system, and relatively regionally fragmented village communities for two millennium. Historically, over the last two thousand years India has been repeatedly subjected to political instability and changes.

Changing architecture. Broadly speaking, post-1947 India's political structure has been characterized by three planks: secularism, democracy and socialism. In the 1990s India is undergoing a fundamental restructuring and transformation of its economy: away from the rotting socialist underpinning and toward free-market economics. Secularism has always had to struggle against religious forces in the past and caste-based vs. Hindu fundamentalism politics in the more recent years. But tampering with democracy, as Mrs. Indira Gandhi learnt the hard way back in mid 1970s, is unacceptable in modern India.

Reforms in India were initiated in 1991 by the federal government in New Delhi. As elsewhere, globalization and reforms, in a society that is developing an information-based system, have begun to erode the power of the federal government in India. The Congress governments at the centre have historically exerted considerable influence on state governments that have been run by the Congress party.

Since 1991, a number of industrial and high per-capita states, such as Maharastra, Gujarat and Karanataka, and the populous Uttar Pradesh, have elected non-Congress governments. Maintaining socialist state-owned enterprises, regulations and socialist entitlements in these states would require that they remain dependent on getting subsidies from the federal government in New Delhi. Some states have yet to appreciate the enlarged tax base that is made possible by liberalization and deregulation. It is in the interests of state leaders to strike out on their own and use reforms to enhance their clout. A number of provincial premiers are already making friendly noises to attract foreign investment in their province.

Overall, both at the federal level and in the states, the next phase will bring out the conflict between supporters of liberalization and those who want to maintain regulations, socialist state enterprises and entitlements. However, progressive senior civil-servants in India are firm supporters of continued reforms.

Power structure. India has to hold an election by May 1996 to elect a new federal parliament. Most pundits are anticipating a hung parliament, which will force the three large parties, the Congress party, the Bhartiya Janta Party (BJP) and Nation Front-Left Front (NF-LF), to engage in horse-trading to form a coalition government with smaller parties.

Short to medium-term reforms. In the short term, the pace or deepening of economic reforms will depend on which party forms the base of the next government in India. Consider three scenarios.

- The Congress party has traditionally attracted middle and lower classes, Muslim (who are about 12% of the population), and other minority group voters. Its hold over the Muslim and lower class vote-bank has loosened considerably in the early 1990s. To win the lower class vote, Congress, probably will push for the privatization of state-owned enterprises. The Congress party will continue subsidies that are considered pro-poor.

To keep the middle class vote, **the Congress party is certain to continue to sell economic reforms and continued liberalization to attract foreign investment.**

- The BJP is a party which appeals the upper class and upper-caste members of the middle class. The BJP has also attracted a segment of the Indian business establishment that stands to lose monopoly rents enjoyed under the license-raj. The BJP also has strong support among the Hindu fundamentalists and nationalists. The BJP thinks that it has used the Enron case to show that it can stand up to a superpower and defend India's interests.[2]

  The BJP is against the license-raj, favours global tenders for foreign investment more in the capital and service industries than in consumer goods industry. In general, the BJP is not opposed to liberalization of the Indian economy.

- The National Front-Left Front (NF-LF) is a collection of regional parties, which also control a number of state governments. For example, the Communist party (M) runs the province of West Bengal, the Janta Dal governs Karnataka (the province where the silicon and computer city of Bangalore is located), the Telugu Desam party runs Andhra Pradesh and the AIADMK runs the province of Tamil Nadu. The traditional NF-LF vote bank consists of minorities such as the Other Backward Classes, Muslims and Dalits (the untouchables). Like the Congress party, the NF-LF also champions secularism and attacks communalism.

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[2]A Congress government in the industrial province of Maharastra had agreed to a US$2.8 billion deal with the U.S.-based Enron Corporation for a power project in Dabhol. The deal was later scrapped in July 1995 by the new BJP-Shiv Sena government on the pretext that the total project cost and the capital cost per MW was too high. However, in the face of a legal action by the Enron Corp., the Hindu-fundamentalist government in Maharastra, having scored political points against the Congress party, is renegotiating the deal.

LF also champions secularism and attacks communalism.

The views of the NF-LF on liberalization are not coherently articulated except that it seeks more autonomy for the public sector. **In practical terms most of NF-LF provincial leaders, such as Bengal's Communist premier Mr. Basu and Bihar's premier Mr. Laloo Yadav, are keen on attracting foreign direct investment for their provinces.** Karnataka has already enjoyed the benefits of economic reforms. The Communist Basu even promises foreign investors peace from labour-strife in his province.

On balance, in the short to the medium term:

- A Congress majority government or a coalition government around the Congress party would continue economic reforms and liberalization. A Congress government could even begin the privatization process.

- A BJP party centred coalition government is unlikely to reverse the direction of economic reform but could slow the pace, and perhaps narrow the scope for FDI, as the government may pander to nationalists. Reforms would continue and limited privatization is also possible.

- An NF-LF coalition government, though highly unlikely at this stage, can also be expected to continue the reform and liberalization process. The privatization process may not be launched under an NF-LF government.

Long-term prospects. In the long-term, the reform and liberalization process in India can be expected to deepen and widen its coverage.

Overall, economic interests in India, to a large extent, are in favour of further deepening of reforms. The middle class supports reforms because commodity market reforms did away with tariffs and license restrictions on consumer goods. Beyond access to world class consumer goods, the middle class is also enjoying expanded job opportunities created by the current round of domestic and foreign investment in technology-based industries, such as basic and cellular telecoms, tourism, automobile, electronics, computer software and programming.

The lower class and minority caste-groups in India have yet to fully appreciate the potential economic and political benefits of reforms. The new domestic and foreign investment in infrastructure and manufacturing projects will directly create jobs all across India for the lower class and minorities. This change will convince regional leaders in India, as elsewhere, that states can create more wealth by attracting foreign direct investment than by relying on federal government handouts to state-owned enterprises. Regional autonomy can be better realized through economic progress than caste-based politics of horse-trading, which is often dominated by upper-caste and upper-class politicians in India.[4] The debate on the merits of liberalization has yet to fully unfold at the regional level in India. While there will be fluctuations, the trend is for continued reform.

In sum, from the short to long term perspective, the reform process in India can be expected to continue. The pace may pick up or slack off at different turns and twists, depending on the short term political situation in India. But reforms will deepen and spread more widely over time.

6. Concluding Remarks

Will reforms persist in India? The answer depends on socioeconomic and political attitudes toward the market system. This note has argued that there is a tension between economic interests and political forces in how India reforms and adjusts to globalization.

India is currently beginning a historic economic transformation. It is hardly a fully market-based economy yet. Spurred by spectacular economic growth in China and the other Asian countries, and by its own middle class, India has finally moved. That reforms are in India's economic interests is well understood in India and the middle class and business community are committed to the reform process.

[4] The Enron case is an example of how certain upper castes opposed the Dabhol project because it stood to create significant economic opportunities for lower castes (Enron's primary labour pool) in the region. The Hindu fundamentalists and nationalists felt that the spin-offs from the project would undermine their political power. See **International Economic Review**, November 1995, p. 22.

This note has argued that over time regional leaders, the lower class and minorities can be expected to develop strong support for reforms as well. However, in the short-term, reforms in India's slow democratic process are likely to be a messy business. We may even witness some provincial governments finding it expedient to attack or undermine specific elements of the reform programme. Such developments will delay the reform process but not derail, stop or reverse it. Overall, we are likely to see broad support for reforms developing among business, senior Indian bureaucrats, both federal and provincial political leaders, the middle class and increasingly the lower class and other minority groups.

In the medium to long-term, India is a potential economic power house. The reform process has just began in India. The focus is already shifting from consumer goods to India's enormous infrastructure requirements. Reforms in India will continue and new profitable opportunities are going to emerge in sectors where Canada-based companies have comparative advantage.

Annex: The Indian Economy

In 1995, about 200 million people made up the middle-class in India's population of 920 million. India spends about 1.3% of its GDP on health compared with 2.1% spent by China.

GDP. India's nominal GDP in 1995 is estimated to have been about C$465 billion. In 1994, India's GDP was C$406 billion.[4] The real GDP growth rate in 1991—the year reforms were introduced—, dropped to 0.9% from 5.4% in the previous year. Real GDP grew at a rate of 4.3% each year in 1992 and 1993, while in 1994 the Indian economy moved up to a 5.4% growth rate.[5] India turned in a 6% real GDP growth performance in 1995.[6]

Fiscal deficit. The federal government's fiscal deficit as a proportion of India's GDP went up from 6.7% in 1994 to 7.5% in the pre-election year 1995—two percentage points higher than the official target. India's deficit situation is extremely worrisome and the government must reduce the deficit.

Inflation. The wholesale price inflation shot up to 10.5% in 1994 from 8.4% in 1993 and inflation for 1995 is estimated at about 10%. The monetization of federal fiscal deficit often causes inflation. In 1996, inflation is anticipated by the EIU to reach an alarming level of 11%.[7]

Exchange rate. The rupee became convertible on the current account in August 1994. In September 1995, the rupee/US$ exchange rate touched Rs35:US$1 level and in October Rs36:US$1. India's finance minister has avoided intervening in the market to defend the rupee. The high rate of

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[4] Source: DRI/McGraw-Hill, **World Markets Country Summaries**, various issues, including fourth Quarter 1995.

[5] In comparison, the Canadian GDP in 1994 was C$750 and the real GDP growth rate was 4.6%. On the other hand, China had a GDP of C$696 in 1994 and its real GDP grew in 1994 by 11.8%.

[6] Source: The Economist Intelligence Unit (EIU), **Country Report, India and Nepal,** various issues, including 4th quarter 1995.

[7] In comparison, China's wholesale price inflation was 14.2% in 1994 and is estimated to have been 17.7% in 1995 and forecast to be about 15% in 1996. Source: DRI, *op.cit.*.

inflation in India is likely to depreciate the rupee to about Rs40: US$1 by the beginning of 1997.

Trade. India's share of world exports declined from over 2% in the early 1950s to stabilize around 0.5% in the 1980s.[8] The share of trade in GDP has fluctuated in India: until the early sixties it averaged over 12%, only to decline to a low of less than 10% in the early 1970s and to slowly rise thereafter to about 16% in 1979-80.[9] By 1994, the share of trade in India's GDP had risen to about 23%.[10] As has been the case with China, further reforms in India are most likely to increase the share of trade in India's GDP in the 30% to 35% range by the turn of the century.

Imports. Total imports into India in the first four months of the fiscal year 1995/96 (i.e., April-July 1995) amounted to C$15.4 billion, 39% higher than in the year-earlier period, following 21.7% growth in 1994.95. Imports of machinery, chemicals and gasoline grew most rapidly.[11]

Exports. Exports from India in April-July 1995 were C$13.3 billion, 29% higher than in the corresponding period in 1994/95, following annual growth of 18% in 1994/95. There was exceptional growth of garments and engineering goods (a category that includes electronics and computing equipment).

Financing. Moody's upgraded India to investment grade in December 1994. Both private-sector companies and state-owned enterprises can borrow longer-term loans in international capital markets. Without bank or government guarantee, private-sector corporations have paid about 1 per cent over Libor rate, while the state enterprises have paid as little as 0.75% over Libor.

On India's 23 stock markets some 6,000 companies are listed. To

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[8]T.N. Srinivasan, *et al.*, ***Agriculture and Trade in China and India: Policies and Performance Since 1950***, ICEG, San Francisco: ICS Press, 1993, p. 12.

[9]*Ibid.*

[10]Source: DRI, *op.cit.*

[11] The EIU, *op. cit.*.

improve transparency, to restore confidence in the primary market and to provide efficient financial intermediation, further reforms, including better disclosure rules and on-line trading facilities, are required.

Besides the existing nationalized public-sector banks, private banks, including the new foreign banks, have been expanding their deposit base in India. In 1991, state-owned banks still held more than 90% of the total banking assets in the country. However, while the average loan growth in 1994-95 for 31 Indian banks was just under 40%, the big nationalized banks turned in a mediocre growth of about 18%. The new private banks are beginning to offer one-stop total consumer services, including portfolio-management services and on-line access to accounts in India from as many as 35 countries.[12]

Foreign portfolio investment. The Indian diaspora, an estimated 15 million and cumulatively worth some C$55 billion in financial assets, has largely consisted of the professional classes.[13] Following the reforms, foreign portfolio investment in India boomed and India could build-up sizable foreign-exchange reserves, some C$33 billion of which are now locked away in the vaults and could cover about six-month worth of imports. However, this source has dried up in 1995. India has a lot more to do in order to attract more foreign investment.

Foreign direct investment. The Indian government has recognized that trade and investment are interrelated and has eased the restrictions imposed on Indian companies wishing to invest abroad, although some capital controls remain in place. India's FDI in Canada in 1992 rose to C$11 million from C$8 million in 1991 and had declined to C$7 million by 1994.

There is automatic clearance of foreign investment in India below the equity ceiling of 51%. India's industry minister has recently proposed that the equity ceiling be raised to 74%. Canadian direct investment in India increased to C$98 million in 1992 from C$84 million in 1991 and had reached C$126

[12]Source: A study by Jardine Fleming India Broking Private Ltd, September 1995, cited in **India Today,** December 15, 1995, p. 113.

[13]The Chinese diaspora, in contrast, was of entrepreneurs many of whom had migrated, in particular, from Shanghai and Canton to Hong Kong and Taiwan.

million in 1994.

Concerning total foreign direct investment, in 1991 India attracted C$202 million worth. In 1992, FDI in India reached C$596 million level. In 1993, the World Bank estimates that India attracted a huge sum of C$5.64 billion in direct investment.[14] In other words, FDI into India increased by almost 28 times within the two years of the reforms. However, this is still below the FDI inflows into China in recent years.

Savings, investment and productivity. The gross domestic savings in 1993 was 24% of the Indian GDP, up marginally from the savings rate of 23.5% in 1991. The share of gross domestic investment in India's GDP was 24.7% in 1993, up from 22.4% in 1991.[15] Total factor productivity in manufacturing grew at 3.4% in the first half of the 1980s as compared with a decline of 0.3% per annum in the previous 15 years.[16]

Factor markets. Historically, India has discriminated against agriculture by taxing it directly or indirectly. The land market has been virtually distortion free in India. The major factor market distortions are in the market for labour in the so-called organized sector and in the capital market through the workings of the nationalized banking sector.

To go with its population, India has the world's second largest workforce. Wages in India are but a fraction of those in developed countries. India has the third-largest stock of scientific and engineering workforce in the world. However, the productivity as measured by the value added per worker in India's manufacturing sector is low: a fourth of that in Singapore or a tenth of that in Japan. Labour laws in India are such that unions can block work force training and prohibit retrenchment by firms. India must begin to reform its antiquated labour laws to achieve a flexible labour market.

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[14]Source: The World Bank, **World Tables**, 1995.

[15]Source: The World Bank, *op. cit.*.

[16]Isher J. Ahluwalia, ***Productivity and Growth in Indian Manufacturing***, New Delhi: Oxford University Press, 1991.

State-owned enterprises. The share of state-owned enterprises (SOEs) in 1991 was about 13% in India's GDP. The Indian federal government paid out over five times more money in subsidies to SOEs in 1991 than it spent on either education or health. A World Bank study has found that the larger part of the subsidies to SOEs end up being captured by the rich and the middle class.[17] India is trying to reform around SOEs and still maintains industrial licence requirements in 15 industries. For reforms to move any further, the Indian government would have to reduce its holdings in SOEs below 50%. So far, there is little political will to take this step.

[17]The World Bank, **Bureaucrats in Business**, 1995.