

## **Understanding India's Reform Trajectory: Past Trends and Future Challenges by Montek Singh Ahluwalia\***

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The May 2004 elections in India provided a dramatic demonstration of that core element of democracy - voters can change governments. This has important implications for whoever is managing the process of policy change in India. It must be done in the context of a very genuine democratic process operating at both the state level and the national level. This means that reforms must have a sufficient consensus to ensure continuity and they must be seen to have benefited a sufficiently large percentage of the population if governments are to receive electoral endorsement from time to time. These considerations explain a great deal about the nature of policy reforms in India and also the nature of the political debate which typically heats up before and after election. They are relevant to understand some of the debate on economic policy associated with the May election.

Let me first comment briefly on the nature of policy reforms in India. I have written elsewhere - and one of the papers prepared for this symposium mentions this - that the pluralistic character of Indian politics led to the choice of gradualism in the implementation of reforms. Gradualism has both advantages and disadvantages. The advantage is that it enables the government to build a consensus on reforms which moderates opposition to the reform and also helps assure continuity. The disadvantage is that the process of reform is stretched out over time. This leads to a delayed flow of benefits which weakens the perception of benefits flowing from the reforms. Besides, gradualism in India has been of a special type. It was not gradualism in the sense of a process in which there is a clear indication of the transition being planned - say from point A to point B — combined with a conscious decision that in order to ease the pain of transition, and to allow various actors to adapt, the transition will be accomplished not in one year or two years, but over a longer period say five to ten years. That is not the way gradualism has actually worked in India. Instead it took the form of first signalling the broad direction of reforms, which has usually been very clear, but leaving the detailed implementation to a more opportunistic process whereby the reforms are implemented at a pace that is politically feasible. The absence of a specified time table leads to lack of clarity about how fast the change is going to take place and this has often slowed down the process of adjustment to change since the actors involved are often not very clear about what policy changes are likely to happen and when.

This problem is well illustrated by what has happened in the area of external trade liberalization. The government clearly signalled the need to lower tariffs and it was often said that India must lower tariffs to the levels of Asean countries. But a phased sequence for the lowering of particular tariff lines was never announced. This made it difficult for investors to plan for tariff changes, and may have led many not to do so. Those in favour of building a political consensus argue that the political process is better able to build a consensus on the broad direction of reform if it does not have to specify policy announcements which might generate a build up of opposition to the general thrust of reform. The lack of a clear signal however does lead to delays in adjusting to the reform process which also postpones problems rather than solving them. The particular example of tariff reduction can be multiplied in other areas. For example, on the issue of removing items from the list of industries reserved for the small scale producer, there was an indication that dereservation will take place progressively but no advance warning about what sectors will be dereserved when.

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\* Revised text of the introductory remarks made by Mr. Montek S. Ahluwalia while inaugurating the SAIS symposium on the politics of India's next generation of reforms, held in Washington, DC, on May 17, 2004. At that time Mr. Ahluwalia was the Director of the Independent Evaluation Office of the International Monetary Fund. He subsequently returned to India and is currently serving as the Deputy Chairman of India's Planning Commission.

Let me now turn to some of the specific issues that have been discussed in India in the context of economic reforms. First, there has been active debate on the impact of the reforms on various aspects of economic performance, and a considerable diversity of views has been expressed based on judicious choice of statistics. In the prelude to the elections, those who wanted to argue that the Indian economy was doing well, focused on short term performance. The economy was even described as growing at an annual rate of 10.3%, when this was the growth rate in only one quarter in a year in which the economy was recovering from a bad monsoon. Analysts in the financial sector, whose weekly proprietary letters go out to clients, and are often copied to a huge range of people, including me, have been at the forefront of presenting such upbeat views.

Those who focus more on longer term averages, saw quite a different picture. In the 1980s there was a clear break from what had been a very long trend of low growth. Depending on the period considered, the increase was from about 3.5% to 4% annual growth in the pre-1980 period, to approximately 5.7% in the 1980s. This acceleration has often been attributed to the beginning of economic reforms in the 1980s. The economic reforms were intensified in 1991. Initially economic growth in the post 1991 reforms period accelerated beyond the 1980s rate but in the second half of the 1990s it decelerated again. I will return to this point later, but first let me focus on certain aspects of India's reforms which differentiate them from those in other countries.

Unlike the case in Latin America or Sub-Saharan Africa, reforms in India were not driven by a response to a crisis. The changes that took place in the 1980s were the result of a process of considerable internal rethinking. Further, unlike reforms in Russia and Eastern Europe, India's reforms were also not driven by a loss of political confidence in the larger political system. In those countries, the process of change in economic policy was being driven by a desire to bring about a political revolution. That was not, and is not, the case in India.

Some observers have put forward the view that the economic reforms, especially in 1991, were thrust upon India by the international financial institutions. I do not subscribe to this view. It is true that the direction of India's reforms was broadly consistent with what the international community - and by this I do not mean only the Bretton Woods institutions - thought was the right way to go. However, the reforms were basically homegrown, and a genuine domestic response to developments in the rest of the world, including especially in South East Asia where the benefits of more open economies was evident. It is important to note that Indian reforms did not come to an end once the immediate crisis was over. This reflects the fact that there was an autonomous internal process of reform that had been taking place and indeed gaining momentum.

One of the reasons why there is a backlash against globalization in parts of Africa and Latin America is that during the long period over which reform has taken place in these countries, economic performance has not improved significantly. Brazil's growth rate in the last ten years probably does not average more than 2.5% annually, and this is a country that in the 1960s grew at 9%. In this respect too, the experience with reforms in India has been quite different. As I have already said, reforms in the 1980s led to a definite improvement in comparison with the previous two decades. The reforms were intensified in 1991 and this raises the question, did the more systemic reforms produce better results? In the immediate aftermath it certainly did: the Indian economy grew at 7.5% annually for three consecutive years between 1993-94 and 1995-96. That was an impressive performance and it generated the expectation that with these new reforms, India had broken away from the 5.7% growth of the 1980s. However in the second half of the 1990s the economic growth rate decelerated. The much "headlined" figure of a three year average growth rate of 7.5% was slowly eroded in the second half of the 1990s so that the average growth rate in the 1990s was more or less the same as the growth rate in the 1980s.

The fact that the average growth rate in the 1990s is not very different from that in the 1980s has led some researchers to argue that the reforms of 1990s were in fact not very important, and that it was the reforms of the 1980s that accounted for most of the improved growth performance across *both* decades. Personally, I do not subscribe to that view. The

acceleration to 7.5% in the mid-1990s was a real acceleration and could have been sustained had the momentum of reforms been maintained. This did not happen because the gradualist approach led to a loss of momentum partly because the economy entered into a phase when much more difficult second generation reforms were necessary. These were more complex and required more sustained effort. Besides, the growth rate of 5.7% achieved in the 1980s was probably unsustainable without further reforms. This is because the growth of the 1980s was financed by a build up of external debt and was not accompanied by the change in competitiveness that was necessary to make the growth self sustaining. In other words, if the reforms of 1991 had not occurred, we would not have been able to maintain the 5.7% growth witnessed in the previous decade.

The deceleration in growth in the second half of the 1990s contributed to some disillusionment with reforms and this was evident before the last election. This disappointment was accentuated by the high expectations that had been raised. The growth of 7.5% achieved after 1991 had raised expectations that the economy was ready to transit to a higher growth path, which in turn would imply a faster growth of employment in the organized sector. This did not happen. Sanjaya Baru who is a participant in this conference, has written very persuasively about the role of expectations, 2. There is no doubt in my view that the expectations generated by the reforms, and possibly also the hype associated with them, were important factors which led to disillusionment on the part of the electorate. Actual growth was far below the target, and employment growth slowed down. Poverty declined, but it did so much more slowly than projected. Television also projected an exaggerated picture of urban prosperity, largely because it was driven by advertisements aimed at the middle class which typically presented a glamorized picture of rising consumption levels. This picture bore little relation to the experience of ordinary people in rural areas, or even the experience of the lower half of the city population.

It is important to note however that this was not just a failure arising from a pre-occupation with growth to the neglect of equity. The fact is that the strategy faltered on delivering growth itself as is evident from the deceleration in the second half of the 1990s.

It is now generally recognised that many of the things that people want - a marked improvement in the rate of poverty reduction, an increase in the rate of employment generation, and so forth - cannot be achieved if the economy does not accelerate to something like 8% growth. One consequence of this is that the new government will have to set ambitious growth targets. Nobody expects to achieve the target completely and consistently, but if you set a target of 8% and you achieve 7%, or a little over 7%, you can reasonably expect to be able to go back to the electorate and say that the target -was realistic and the performance was very good. The new Planning Commission will have to work out new growth targets and I would not want to pre-judge its efforts. But as an economist I would certainly say that continuation of the 5.6% growth that we had in the 1990s is not consistent with making a significantly better or more rapid impact on poverty and is not consistent with achieving a significantly better rate of employment generation. I assume, therefore, that the new government will want to set a growth target at something close to 8%. Can it be done? I have no doubt that it can.

There is a lot of research that has been reported in the academic and other literature, particularly in the last two years - and I am referring entirely to material produced outside India - that India's economy has reached the stage that if the government gets a few more things right, it could reach the "tipping point" where it could accelerate from 5.6% growth to say 7.5%, or even a bit higher. This raises the question: What are the "things" that need to be gotten right? Everybody has their own list, so let me list the three things that I would emphasize.

The first concerns agriculture. Agriculture is clearly an important sector of the economy accounting for about 25% of GDP and even more important, providing the principal livelihood for well over half the labour force. I do not think that the economy can achieve 8% GDP without agriculture achieving about 4% growths or thereabouts. This 4% is not going to be easy, especially since agriculture has actually decelerated in recent years. It was

growing at around 3.3% upto the mid 1990s but since then growth has averaged less than 2 percent per year. Accelerating to 4% will call for intervention at several levels but some of the main components of what needs to be done are known. We need to reverse the decline that has been taking place in public investment in agriculture and related sectors such as irrigation and rural roads. The extension system needs a thorough revamping and the agricultural research system also needs to be revitalized.

The strategy for agricultural growth also needs to be changed. We cannot rely solely on the earlier food-grain oriented strategy. We have to move towards diversification of agriculture which poses complex marketing challenges. Horticultural crops are perishable and their marketing requires the development of an entire cold storage chain. The active involvement of the corporate sector is necessary for this stage of agricultural development. The set of policies that is necessary to bring that about needs to be elaborated and implemented.

The second requirement is infrastructure. It is absolutely clear to everybody, both inside and outside India, that the country suffers from a huge infrastructure deficit. It is a testament to the creativity of Indian entrepreneurs that they have been able to accomplish what they have with the insufficient quantity and quality of infrastructure provided. Therefore, improving infrastructure must be at the absolute top of anyone's list of necessary reforms over the next five years.

Infrastructure includes power, telecommunications, roads, railways, ports, airports, etc. and in the rural areas, irrigation and watershed management. In the last five years, with the exception of telecommunications, where I think there has been a significant change in the volume, scale, and quality of service delivered, we have not made much less progress than we should have. The resource requirement for upgrading infrastructure is very large. Private investment can fill some of the gaps but I do not think anyone believes that all of India's infrastructure needs can be met by private sector investment. Areas such as rural roads and irrigation will have to involve a substantial volume of public investment. In other areas also, the scope for private investment is not limitless.

In the mid-1990s, it became evident that the public sector could not mobilize the resources required to meet the infrastructure needs of faster growth and these sectors should therefore be opened to private investment. However, the expectations from private investment were exaggerated. The past several years have seen a return to more realistic assessments. It is now recognised that even if governments want to attract private investment the preconditions for success in this area are complex and it may not be easy to establish them in all areas. It is quite clear that the private sector can play a much bigger role in certain areas such as telecommunications, ports and airports. But in other areas, such as rural electricity distribution - and rural infrastructure more generally - improvements will have to be driven by the public sector's capacity to invest in infrastructure. In other areas such as generation and distribution of power in urban and industrial areas, private investment is possible provided radical structural reforms are undertaken. The tariff structure allowed must be consistent with financial viability and the regulatory structure must provide credible reassurance to private suppliers that they will get a fair deal.

As far as the public sector is concerned, its ability to play an effective role in developing infrastructure will depend critically on how the fiscal position evolves. This will be the biggest challenge facing both the new government and the new politics. The Finance Commission is scheduled to present its report by the end of 2004. I have no idea what it is going to recommend, but the pressure clearly will be to transfer more resources to the states. However, the fiscal position of the centre is not particularly comfortable. Therefore, a balance must be struck between, on the one hand, the need for more resources for infrastructure and, on the other, the need to stabilize the strained fiscal situation, both at the central and state levels.

A third important area which the new government must address is the huge deficit India faces in the social sector, i.e., education and health, especially in the rural areas. This will require determined action on two fronts. First, it will be necessary to increase expenditures in these sectors. Although the responsibility for these areas is that of the States, the fact is

that the States do not have the financial capacity to respond. The burden of finding resources will therefore fall disproportionately on the Centre. Second, resources are not the only problem. There are serious problems relating to the efficiency of resource use in these areas which need to be addressed. This calls for far-reaching changes in governance especially greater involvement of local governments and representative bodies including NGO's.

Finally let me comment on the prospects for growth at the State level. I think both economic theory and empirical evidence suggest that as the economy is further liberalized, the performance of individual states is going to vary. This is a problem in China also but there is a big difference between China and India in this respect. In China, the way liberalization unfolded has meant that the benefits flowed to the most heavily populated regions, the coastal areas. In India, however, the most populous states are in the hinterland and have not been the main engines of growth.

One of the interesting features of the Indian case is that states in which GDP growth has been faster have not necessarily benefited from political stability. This may be because the "revolution of expectations," which has made it difficult for governments even in these relatively well-performing states to retain political power. At the same time, many states - representing a large proportion of the country — have not actually responded in a manner that would enable the states to derive the full benefits of liberalization. I think there will be a tension between the political logic, which tends towards the transfer of resources to poorly performing states, and the economic logic, which says that the best thing the central government can do for weak states is to improve their infrastructure, and then to let the state governments themselves take action to improve the investment climate. How to manage this tension in the context of a democratic political system is the challenge which the new government will face.

#### **NOTES**

1. See the essay by Rob Jenkins in this special issue, "*Labour Policy and the Second Generation of Economic Reform in India.*"

2. Sanjaya Baru, "*No, Don't Blame the Laptop, It Was a Revolt of Rising Expectations,*" *Indian Express*, May 12, 2004.