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Indian Reforms

Jagdish Bhagwati

Perhaps the most appropriate way to start my tribute to Meghnad Desai, who has been in the forefront of discussions on Indian public policy for many years, is to discuss Indian reforms.

Today, there are two contrasting ‘narratives’ about India’s reforms: one superlative and dramatically congratulatory, the other apocalyptic and hypercritical.

Perhaps the most dramatic, optimistic view of India has come from the once skeptical magazine, *The Economist*, which famously wrote nearly twenty years ago that India was a tiger that had been crouched for a long time but was unable to leap; the danger was that *rigor mortis* had set in. But the magazine wrote a raving cover page story 10 September 2010, abandoning its reservations and arguing that India’s steadily accelerating growth rate since the 1991 pro-market, liberal (or ‘neoliberal’ if you wish to make them sound sinister) reforms was not a flash in the pan. Apparently throwing caution to the wind, it speculated that India’s growth rate ‘could overtake China’s by 2013, if not before’.

But then, the naysayers, among them the socialists in the currently ruling Congress Party, have rejected the ‘miracle’ produced by the reforms by asserting darkly that the growth ‘lacks a human face’, that it is not ‘inclusive’, that the gains have accrued to the rich while the poor have been immiserized, that inequality has increased, and that India stands condemned before the world. Perhaps the most articulate critics are the ‘progressive’ novelists of India, chief among them Pankaj Mishra whom the op-ed page editors of *The New York Times* regularly and almost exclusively invite to write about the Indian economy, a privilege they do not seem to extend symmetrically to American novelists to give us their profound thoughts on the US economy.

Mishra’s latest *Times* op-ed 2 October 2010, writes of the ‘alarmingly deep and growing inequalities of income and resources in India’, ‘the waves of suicides of tens of thousands of overburdened farmers over the last two decades’, ‘a full-blown insurgency ... in central India’ to defend tribals against depredations by multinationals, ‘the pitiless exploitations of the new business-minded India’, and much else that is allegedly wrong with India.

While economic analysis can often produce a yawning indifference, and Mishra’s narrative is by contrast eloquent and captivating, the latter is

really fiction masquerading as non-fiction. The fact is that several analyses show that the enhanced growth rate has been good for reducing poverty while, measured meaningfully, it has not increased inequality and that large majorities of virtually all underprivileged groups polled say that their financial situation has not worsened and significant numbers say that it has improved.

Abysmal growth prior to reforms

The enhanced, and increasing, growth rate since the reforms followed a period of abysmal growth rates in the range of 3.5 to 4.0 per cent annually for over a quarter of a century, starting in the 1960s. The cause of the low growth had to do, not with our efforts at raising our investment rate, but with the fact that we got very little out of the investment we undertook. The reason was that we had a counterproductive policy framework whose principal elements were:

- 1 Knee-jerk intervention by the government through a maze of Kafkaesque licensing and regulations concerning investment, production and imports, prompting the witticism that Adam Smith's Invisible Hand was nowhere to be seen;
- 2 Massive expansion of the public sector into many areas other than utilities, with occasional monopoly granted to public enterprises by excluding entry by the private sector, with predictable inefficiencies that multiplied through the economy; and
- 3 Autarky in trade and inflow of equity investment which was so extreme that the Indian share of trade to GNP had fallen while it had increased in most countries, whereas the inward flow of equity investment had been reduced to minuscule levels.

This policy framework had been questioned, and its total overhaul advocated, by me and Padma Desai in writings through the late 1960s which culminated in our book, *India: Planning for Industrialization* (Bhagwati and Desai, 1970) with a huge blowback at the time from virtually all the other leading economists and policymakers who were unable to think outside the box. In the end, our views prevailed and the changes which would transform the economy began, after an external payments crisis in 1991, under the forceful leadership of Prime Minister Manmohan Singh who was the Finance Minister at the time.

It is often suggested by populist anti-reformers in India and their ideological friends abroad (such as my colleague Joseph Stiglitz), that the policy changes were imposed from outside, reflecting what has come to be known as the

Washington Consensus – a phrase that has the advantage of harnessing anti-Americanism in your cause – in favour of liberal reforms at the Bretton Woods institutions. But that is no more true than to argue that the Soviet *perestroika* under President Gorbachev and the Chinese economic reforms starting in the late 1970s were imposed by Washington. In all three cases, the driving force was endogenous, a realization by the leadership that the old, counterproductive policy model had run their economies into the ground and that a change of course had to be undertaken. In fact, if the contention of the populists was correct, one would have expected the reforms to be reversed once the 1991 payments crisis was over. Instead, successive governments have only intensified the reforms: no serious analyst wanted to turn the clock back and back into the future, embracing a failed policy model.

The early reforms were primarily focused on dismantling the licensing regime (known popularly as the ‘permit Raj’) which freed up the animal spirits of the private sector. The economy was also steadily opened up: the average import tariff on manufactures, at virtually 113 per cent in 1990–91, was reduced steadily, avoiding the folly of ‘shock therapy’, and now stands at 12 per cent. While privatization would prove politically difficult, its intended effects in terms of efficiency of management were sometimes achieved by opening up entry by private firms into the sectors that had been reserved for public sector enterprises: the entry of these firms, plus unwillingness to provide ever more subsidies to absorb losses, was like a pincer movement that meant ‘shape up or ship out’.

The old policy architecture could not be demolished in one fell swoop. The leadership had to negotiate minefields of ideological opposition, bureaucratic intransigence, and the lobbies (called ‘interests’ by political scientists) that had fattened on the rents (i.e. monopoly profits) attending sheltered markets that they were earning. The ‘three Is’ – ideas, institutions and interests – of the old regime had to be confronted. Then, again, the post-1991 reformers felt that their task was akin to cleaning up after a tsunami. Hastening slowly was their only choice.

Substantially enhanced growth after the reforms

Still, as the reforms gathered steam, the effects on the growth rate were palpable. The growth rate, rising to roughly 6 per cent, nearly doubled in the 1990s, increased still further in the following decade and has recently been close to 9 per cent. The sense that India was now an ‘emerging superpower’ was a heady experience for Indian elites who had seen their country marginalized by policies that had become a laughing stock in the world while smaller nations in the Far East had emerged as the much-admired star performers.

The poor and the underprivileged have also benefited

But are the opponents of the reforms right to complain that the reformers have been focused on growth to the neglect of the underprivileged; and that the latter have been bypassed or immiserized?

It has become fashionable to say that this must be so because the Human Development Index, produced by the United Nations Development Program (UNDP), put India at the bottom, in 135th place, in 1994. But this is a nonsensical index which reduces, without scientifically plausible weights, several non-commensurate elements like literacy and diverse health measures to a single number. It is a fine example of how bad science gains traction as a result of endless repetition by the media: it must be dismissed as rubbish. There is no substitute for hard, scientific answers to the questions concerning what has happened, during the period of reforms and enhanced growth, to the poor and the underprivileged: and these answers, as I will presently sketch, are more benign.

To begin with, however, let me remind you that the common criticism that Indian policy was interested in growth for growth's sake is not even true if we go back to the early 1950s when planning took formal shape. In fact, my first job in the Indian Planning Commission half a century ago was to devise a strategy to bring the bottom 30 per cent of India's poor above the poverty line so they would enjoy a 'minimum standard of living'; and I came to the view, often expressed by the leaders of the Independence movement, that we had to grow the pie to do so: redistributing wealth in a country with 'many exploited and few exploiters' as the visiting Marxist economist Kalecki put it graphically to me in 1962, was not a strategy that could produce sustained impact on poverty. Growth was therefore regarded as a principal 'instrument', a strategy, for pulling the poor out of poverty through gainful employment, not as an end in itself. Growth was seen as what I have called an activist, radical 'pull up' strategy to reduce poverty. In no way was it viewed as a passive, conservative 'trickle down' strategy to reduce poverty, as illustrated by the film *Robin Hood* where the Earl of Nottingham and his vassals are eating legs of lamb and venison at the high table and crumbs fall below to the dogs and serfs underneath the table.

The growth strategy of pulling the poor up from poverty however did not work because growth itself did not materialize because of the counterproductive policy framework that I sketched above. But now that growth has actually been produced by the post-1991 reforms, what can we say about the wisdom of the growth strategy? Let me sketch some of the studies that seem to affirm it.

After a considerable debate, it is now generally accepted that the enhanced growth over nearly twenty-five years was associated with lifting nearly 200 million of the extreme poor above the poverty line. In contrast, and consistent with commonsense, the abysmal growth rate of the preceding quarter

century saw no perceptible, beneficial impact on poverty. At a narrower level, the political scientist Devesh Kapur and associates have studied the fortune of the *Dalits* (untouchables) in India's most populous state, Uttar Pradesh, between 1990 and 2008, to find that 61 per cent of those surveyed in the east and 38 per cent in the west said that their food and clothing situation was 'much better' (Kapur, Prasad, Pritchett and Babu, 2010).

Most striking is the finding of the political scientist Al Stepan, drawing on polling data produced by the Center for the Study of Developing Societies in Delhi, that for every disadvantaged group including women, the response to the question 'Has your financial situation improved, worsened, or has remained the same' posed in 1996 and again in 2004, shows that every group has overwhelmingly remained the same or improved: those who claim to have worsened are invariably less than 25 per cent of the respondents (Stepan, 2011).

As for the relative economic outcomes of the disadvantaged groups, the economist Amartya Lahiri and associates have studied India's 'scheduled castes' and 'scheduled tribes', two particularly disadvantaged categories, and conclude that the last twenty years of major reforms 'have seen a sharp improvement in [their] relative economic fortunes'. Then again, using household expenditure data for 1988 and 2004, the Johns Hopkins economists Pravin Krishna and Guru Sethupathy conclude that inequality, using a well-known measure invented by the Dutch econometrician Henri Theil, while showing an initial rise, had fallen by 2004 back to the 1988 levels: a straight rise in inequality cannot be asserted (Krishna and Sethupathy, 2011).

I should also add that many reforms help the poor more than the rich because the rich can cope with the results of inefficient policies better than the poor. If the public sector generation and distribution of electricity is inefficient, and the electricity goes off in the middle of the night in Delhi's summer, the rich turn on their private generators and their air-conditioners continue working. But the poor man on his charpoy swelters as his small Usha fan is not working. Those who object to letting in Coke and Pepsi forget that the common man derives his caffeine from these drinks while the well-off critics get theirs from the Espresso and Cappuccino coffee in the cafes.

The most interesting political implication of the success in finally denting poverty significantly, though nowhere near enough, is that poverty is now seen by India's poor and underprivileged as erradicable. India is witness finally to what I have called the 'Revolution of Perceived Possibilities'. Aroused economic aspirations for betterment have led to political demands for the politicians to deliver yet more. This suggests, as my Columbia University colleague Arvind Panagariya and I have hypothesized, that voters will look to vote for the politicians who can deliver growth, and we would expect growth before the vote to be correlated with vote now. In an important paper, Poonam Gupta and Panagariya have recently tested this hypothesis and indeed found that it works (Gupta and Panagariya, 2011). Politicians should, therefore, be looking

to augment reforms, not reverse them as misguided anti-reform critics urge. In fact, the recent dramatic success of Chief Minister Nitish Kumar, who had successfully delivered on prosperity, only underlines the lesson that the electorate will reward the politicians who have delivered and therefore are credible when they promise more.

So, politicians would do well to strengthen the conventional reforms, which I call Stage 1 reforms, by extending them to the unfinished reform agenda of the early 1990s. In particular, further liberalization of trade in all sectors, substantial freeing up of the retail sector, and virtually all labour market reforms are still pending. Such intensification and broadening of Stage 1 reforms can only add to the good that these reforms do for the poor and the underprivileged.

But these conventional reforms have also generated revenues which can finally be spent on targeted health and education so as to *additionally* improve the well-being of the poor: these are what I call Stage 2 reforms which were, let me remind you, in the minds of our earliest planners (as demonstrated by their inclusion in our Five Year Plans since 1951 and Programme Evaluation reports at the time) but have been handicapped principally by revenue constraints. When 'progressive' critics argue that Stage 2 reforms must replace Stage 1 reforms, because they appear superficially to be more pro-poor, they forget that Stage 2 reforms have been made possible only because Stage 1 reforms have been undertaken and have produced the necessary revenues.

This response applies equally to distinguished economists like Amartya Sen, whose policy prescriptions implicitly or explicitly supported the disastrous pre-reforms policies, and who is often quoted as saying about the post-reform policies that it is wrong to celebrate high growth rates when there is so much nutritional deprivation. Does he have a magic wand that would have improved living standards and increased nutritional intake without the high growth rates? Talking about hunger is different from providing policy prescriptions that will reduce it: talk is cheap but it also costs dearly in a country such as India where it is often mistaken for effective action.

How to get the most bang for your buck from programmes under Stage 2 reforms is where we also need to be turning our attention. Stage 2 reforms tend to involve 'social engineering' and are, therefore, inherently more difficult than Stage 1 reforms. If you want to reduce trade barriers, except for political difficulties, it's easy: you just slash them. But if you want to improve education, for example, you have to worry about the best classroom size, the issue of teacher absenteeism, the question of how to get poor children to the school when their parents might want to have them work instead, whether you should be using school vouchers, and so on. There is little doubt however that, once we have put our minds to work and our shoulders to the wheel, we will move ahead on both Stage 1 and Stage 2 reforms.

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