India Twenty Years after Reform

Twenty years ago this summer, India introduced major economic reforms that have led to sustained high growth, reductions in mass poverty, and an ongoing transformation of Indian society. The country is now widely considered a miracle economy, and many analysts predict that India will soon overtake China as the fastest-growing economy in the world. At a Cato Policy Forum held in June, Swaminathan S. Anklesaria Aiyar, research fellow at Cato's Center for Global Liberty and Prosperity; Surjit Bhalla, managing director at Oxus Research and Investments and one of the world's leading experts on growth and poverty; and Arvind Panagariya, the Jagdish Bhagwati Professor of Indian Political Economy at Columbia University, discussed the circumstances that led to these reforms and what the future holds for the world's largest democracy.

SWAMINATHAN AIYAR: When India became independent in 1947, the new socialist government saw free trade as a tool of British colonialism to keep the country poor. To achieve prosperity, they instead emphasized two basic principles: self-sufficiency and public-sector dominance. They created a mixed economy, rather than one based on Soviet-style planning, with licenses required for virtually all economic activity. The government placed onerous controls on what could be produced and imported—and prosperity, they believed, was best achieved when nobody had the freedom to produce or consume. The big, benevolent government was supposed to determine these things.

This planned approach gave India 3.5 percent growth, which in the 1950s was considered fabulous. Under the British, they had barely achieved 1.2 percent growth. It didn't take long, however, for Singapore, Hong Kong, and others to exceed 7 percent—and for these "neo-colonial puppets" to gradually become richer than the British master itself. India, on the other hand, remained poor.

This continued for three decades. Income-tax rates in India went to 97.5 percent—under the false hope that this would abolish poverty—yet poverty rates remained unchanged. Then, in the 1980s, a grudging switch to partial economic liberalization, combined with a public spending boom, helped accelerate growth. Much of this growth, however, was financed by unsustainable borrowing, and in 1991 India ran out of foreign exchange.

After this crisis, a number of things happened. The Soviet Union—which was the model admired by many—was on the brink of collapse. In China, Deng Xiaoping showed that the way forward was not more control, but market-friendly development. In India, Rajiv Gandhi was assassinated, and his Congress Party no longer felt the need to justify a legacy of socialist policies. Conditions were ripe for change, and under political lightweight Narasimha Rao, that change duly took place.

Yet, critics immediately said, "Ah, you guys are in very deep water." India, you see, had taken loans from the World Bank and the IMF—and many believed that similar paths taken by Latin America and Africa in the 1980s had resulted in a "lost decade" of economic growth in these regions. They predicted the same fate for India, warning that the country would become a neo-colonial slave once again.

Almost every one of the skeptics' predictions turned out to be wrong. Far from slowing down, Indian GDP took a few years to stabilize and then took off. Between 1994 and 1997, growth averaged 7.5 percent, and it became obvious that reform had succeeded. Even opposition parties—which vowed to change course—came to power and found that the policies were too successful to reverse.

Now, mind you, liberalization was a very chaotic business—there was no Margaret Thatcher or Ronald Reagan in India—and the process was often two steps forward, one step back. Yet every subsequent government followed roughly the same path. While growth slowed somewhat because of the Asian financial crisis of 1997–1999, two major droughts in the early 2000s, and the recession of 2001, India survived the recent crisis with only minor bumps before returning to 8.5 percent growth. Truly, and very unexpectedly, the lumbering elephant has finally become the Asian tiger.

What were the key achievements of these 20 years? India's per capita income shot up from $300 in 1990 to $1700 today. This not only raised employment directly, but also yielded a public revenue boom that has increased spending on welfare, education, and other programs. India's fast growth, however, did not follow the Asian-tiger model of using cheap labor. Because all of its political parties are labor parties, there was much reluctance to liberalize India's labor laws—which means it was impossible to go the labor-intensive export route. Instead, India has become best known for its brain-intensive manufacturing and service sectors—ranging from auto exports to legal services.

India has become a world leader in "frugal engineering," which means reducing prices not just by 10 or 15 percent, but by 50, 60—even 80 percent. The best known example is probably the Nano: the $2,500 car produced by Tata Motors. Bajaj Auto is about to launch a rival for $3,000 that gives 90 miles to the gallon. Many sectors—from India's telecom industry to its world-class medical services—offer products that are revolutionarily cheap compared to the alternatives.

How else is India different? Unlike some

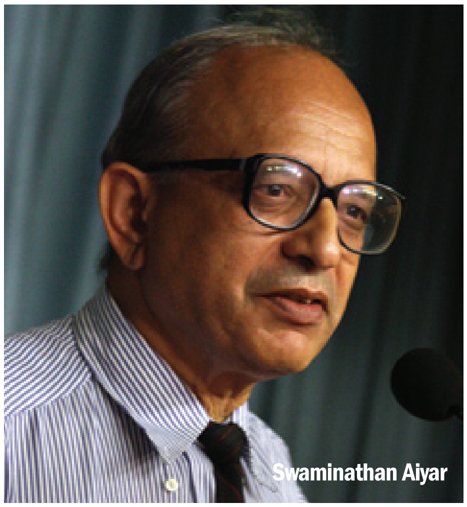
Asian countries—which have rigged their currencies to run up large, mercantilist trade surpluses—India has liberalized its capital controls. Far from being overtaken by multinational corporations—which was once the fear—Indian companies have become multinationals in their own right. In 1991, India was viewed as a bottomless pit for foreign aid. Now it is becoming a substantial aid donor. The country has gradually liberalized its foreign-investment rules. As a result, most of the Fortune 500 companies currently do business there.

There have been many criticisms over what has not been achieved in India as well—the main one being that these reforms have bypassed the poor. However, six poor, backward states, accounting for half of India's population, have grown faster than the national average in recent years. In fact, the country could not have increased its growth rate but for the fact that its poor states almost doubled theirs. The *dalits*—the lowest Hindu caste—have seen dramatic improvements in terms of not only economic indicators, but measures of social status as well. As a whole, poverty has come down from over 45 percent in 1991 to over 32 percent today.

What about the unfinished agenda? The Fraser Institute's Economic Freedom of the World Report rates India 87th out of 141 countries. Yet the economic conditions are only part of the story. India ranks a shocking 182nd of 183 countries in enforcement of contracts, according to the World Bank. Obviously your police, your courts, your systems are not functioning if enforcement is so pathetic. So while both economic and governance problems remain, the latter lag much further behind and are therefore more critical.

SURJIT BHALLA: One important element of the Indian story that is entirely unique is the amount of ideology that pervades policymaking. Before 1991, you couldn't stand in the street without first getting permission by the government. Today, you can do that and a lot more. Yet vast numbers of the intellectuals believe that liberalization has done precious little to alleviate poverty. Basically, they say, the rich have gotten richer and the poor have gotten poorer—and they find support for this from various organizations, including the World Bank. With this in mind, there are three puzzles that make the Indian story much more flavorful.

There are three periods of GDP growth worth looking at. The first is from 1950 to 1980, when growth was around 3.5 to 4 percent per annum. The second is from 1980 to 2003, when growth was 5.5 percent per annum—both before and some time after the 1991 reforms. And the third is from 2003 onwards, when growth averaged more than 8 percent.


Swaminathan Aiyar

"What were the key achievements of these 20 years? India's per capita income shot up from $300 in 1990 to $1700 today."

The first puzzle is: Why did the Indian growth rate suddenly accelerate from 3.5 percent to 5.5 percent in the 1980s? This is the story of the dog that did not bark. What many authors forget is that the 1970s were a disastrous decade for every part of the world, including the United States. Oil prices, for instance, quadrupled in 1973 and then doubled in 1979—and growth rates in the entire world collapsed during that period. In India, growth rates collapsed from about 4.5 percent to something like 3 percent, and the subsequent acceleration is explained by something we learned as graduate students about the reallocation of labor. Just a simple movement of labor—from low-productivity agriculture to high-productivity industry—will provide an acceleration of growth. At the time of independence, agriculture made up around 65 to 70 percent of GDP. The share of agriculture in GDP today is 17 percent. This can't continue forever, but this in my view explains what happened in the 1980s.

In the three years following major reforms in 1991, growth rates in India accelerated to 7.5 percent—but collapsed back down to 5.5 percent once again. The second puzzle, therefore, is this: Why did growth rates stay exactly the same after the mother of all reforms? Well, in 1996, after reforms had taken hold, growth had moved to 7.5 percent three years in a row—and what did our policymakers do? They panicked. "India is overheating," they said, because we'd never seen this before. So they tightened monetary policy, raising interest rates such that real interest rates were 13 percent—*real*. Savings deposit rates were 12.5 percent in 1998–1999. So that killed economic growth, which came down to 5.5 percent.

And the third puzzle: Why did growth rates accelerate from 2003 onward without seemingly any reforms? This decade has seen growth increase from 5.5 percent to 8.5 percent on a pretty sustained basis, and one argument is that a rising tide lifts all boats. World growth expanded last decade, and India went along with it. But a few years ago, the World Bank was merrily forecasting a decline in India's growth because they weren't looking at the big picture. And they were proven wrong. So, what does explain India's acceleration?

Very simply, between 1999 and 2003, active government policy brought down real interest rates by 500 basis points in the space of five years. Now in the United States, there are zillions of trades made on the expectation that there might be a 25-basis-point increase in interest rates. The funny thing is, in India, there's a *500-basis-point* decline in real rates and no one has talked about it. Between 2002–2003 and 2007–2008, investment rates increased from 23 percent of GDP to 38 percent of GDP. Does that explain India's acceleration better than its connection to world growth? I think so. There is a saying: In China, growth occurs because of the state, but in India, growth occurs despite the state. That explains why, without any reforms whatsoever in the last six or seven years, the growth rate has sustained itself.

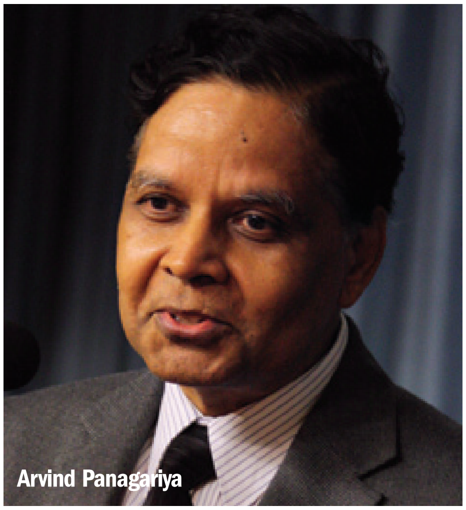
What about India's future? The biggest story emerging is that average fertility levels will reach a replacement rate of 2.1 births per woman by 2015. This will have radical implications. Women in India had a very low labor-participation rate as late as 2000, when only about 15 percent of urban women worked. The participation rate is now 34 percent, and it should eventually reach the historical developed-country norm of 55 to 60 percent. This is the huge advantage India has.

ARVIND PANAGARIYA: By all accounts, India has been growing at about 8 to 9 percent per year in the last eight years. That is the growth rate in real rupees. Yet, during that period, India's inflation rate has been much higher than that of the United States. With nominal exchange rates moving very little, what that means is that, in real terms, the rupee has appreciated. Taking this into account, the growth rate in real *dollars* has been an astonishing 13 percent over the last eight years. That is phenomenal growth.

The Indian economy today is extremely competitive. With the exception of agriculture—if you look at industry and services—the economy is very open. That's the big change that India has experienced. India is competitive. It's starting way inside the global technology frontier. Its capital and labor are both growing rapidly. And therefore I make the conservative assumption that India will grow at least 10 percent per year in real dollars over the next 10 years.

What does this imply? It implies that the Indian economy will go from $1.75 trillion today to $7 trillion by 2025, making it the third-largest economy in the world. That is going to represent a sea change, not only because the global economy will shift towards Asia, but also because we will see massive changes within India. These numbers imply a per capita income of about $5,000 in real terms, which means that poverty as we define it today will be history.

There is a second, very important change on the horizon. By 2025, the developed countries will lose about 37 million people in the 20–49 age group. China will lose about 67 million people from 20–49. Yet India will add 131 million people in this age group. If you think there are too many people like me around today, you haven't seen anything yet!


Arvind Panagariya

"The Indian economy today is extremely competitve. With the exception of agriculture—if you look at industry and services—the economy is very open."

With such a dramatic shift, India will become a very large supplier of the global work force in the years to come.

It is also worth stepping back to consider the dark side of India's growth, which politically the country is completely oblivious to. When countries transform from poor economies to rich ones, one thing that almost always happens is that the share of agriculture in GDP declines. In India, agriculture declined from about 30 percent of GDP in 1990 to 15 percent today. Historically, when agriculture shrinks this way, industry—and manufacturing in particular—grows extremely rapidly, pulling the labor force out of agriculture in the process. This generates gainful employment, rising wages, and declining poverty.

This second step has not happened in India. The share of manufacturing in GDP has been sitting constant, and, more importantly, the share of the labor force employed in agriculture has declined very little. In fact, the absolute number of people employed in agriculture today is still rising. That is rather bad news.

Looking forward, India is facing a number of other problems. One problem is in the labor markets, where a lot of regulations are very industry unfriendly. For example, if you are an employer of 100 workers or more on a regular basis, there are virtually no circumstances under which you can layoff your employees. Even if you go bankrupt, you have to use profits from your other operations to pay the wages of that workforce. That is the kiss of death for the labor-intensive industry today. Many are pessimistic that labor-market reform will ever happen in India. But then there have been a lot of things that I never thought would happen in India that subsequently have, and therefore I remain optimistic.

There are additional problems in areas such as land acquisition and infrastructure, but perhaps the most important is the higher-education system. India is already facing skilled labor shortages, and this is likely to get much worse down the road. Indian higher education had a very good head start: the first three universities were founded in the 1850s, and the rest of their history is uninterrupted. China, by contrast, completely decimated its higher-education system under Mao during the Cultural Revolution—which they didn't start rebuilding until the early 1980s.

Now consider the figures. In 2000, China had 6 percent of its college-aged population enrolled in higher education, while India was at 10 percent. Today, China has zoomed past us to 23 percent, while we remain at 13 percent. This is the other side of the demographic dividend: it is the demographic burden. ■