Political Economic Digest Series 18

Dear Political Economic Digest Series Participant,

Welcome to the eighteenth series of Political Economic Digest Series. In the last issue of Political Economic Digest Series we discussed about one of the basic principles of economics- invisible hand, in this issue we will be discussing about the how economic reforms in India made an impact in the economic growth of India.

The first reading "A Brief History of 20 Years of Reform (1990-2010) " contains the brief history of India mainly focusing on the economic reform made from 1990-2010 . This reading explains the process of liberalization initiated by the then Prime Minister Narasimha Rao and Finance Minister Manmohan Singh.

The Second reading "How Reforms Benefited the Poorer Half" talks about how economic reform of 1990 not only helped rich get richer but also helped poor get richer.

The third reading "How India's Liberalization Shaped a Generation of Entrepreneurs" talks about how the process of liberalization helped India create more entrepreneurs who accumulated wealth from India and other countries . It further talks about how India from a poor country before 1990 has emerged to become a possible super power in the future.

The fourth reading "The myth of India's liberalization" talks about the myth that prevailed in India about liberalization. This reading explains to the critics of liberalization on how it contributed positively to the economy of India.

A Brief History of 20 Years of Reform (1990-2010)

After independence in 1947, India followed a socialist pattern of development, emphasizing self-sufficiency and public sector dominance. It was inward looking and skeptical of markets and international trade. In the 1970s, marginal income tax rates went as high as 97.75 percent, on top of which a wealth tax of up to 3.5 percent was levied to promote the garibi hatao (abolish poverty) policies of Indira Gandhi. Yet poverty did not fall at all in the three decades after independence, and GDP growth averaged just 3.5 percent per year (the so-called "Hindu Rate" of growth), just half of what had been achieved by Asian tigers with outward-looking, market-friendly policies.

Some economic liberalization plus runaway public spending helped accelerate GDP growth to 5.5 percent in the 1980s. But this was based on unsustainable borrowing, and it ended in tears when India ran out of foreign exchange in 1991. Rajiv Gandhi was widely expected to win the general election in June 1991 but was assassinated by a Sri Lankan terrorist. No party won an absolute majority in that election, and the Congress Party formed a fragile minority government headed by a political lightweight, Narasimha Rao.

So, both economic and political conditions were highly unfavorable. The Soviet Union was collapsing, making it clear that more socialism was not the answer. Meanwhile Deng Xiaoping had revolutionized China, showing that the market was the way to go. And so, more in sorrow than ideological triumph, India turned away from socialism to half-baked liberalism. There was no Ronald Reagan or Margaret Thatcher in India: reform was a very pragmatic process.

Opposition parties accused India of having sold out to the International Monetary Fund and swore to reverse the reforms when they came to power. But within two years the reforms restored India's finances, and in the three years from 1994 to 1997 India averaged 7.5 percent GDP growth, a new record. This was too successful to reverse, and so India continued down the reform path even when other political combinations came to power. The reform process was halting, inconsistent, and sometimes partially reversed, yet the overall direction remained unaltered. No party dared liberalize very restrictive labor laws, and so India failed to make its mark in labor-intensive industries. But, to everybody's surprise, it emerged as a major power in brain-intensive industries ranging from computer software and medical tourism to auto exports and research and development (R&D).

The Asian financial crisis of 1997–99 was the first test of the resilience of Indian reforms. Growth took a hit, yet—in part because it was a relatively closed economy—the country survived without serious damage, without imposing new controls on capital inflows, and without having to go hat in hand to the IMF like so many other Asian neighbors. Indeed, this was the period when India's computer software industry rose to prominence, playing a leading role in developing software to thwart the so-called Y2K problem. The recession of 2001 led to greater outsourcing of software and business services, and India built on that opportunity. In the next decade it marched up the value chain, moving steadily into higher and higher levels of technology, proving that India had not just cheap labor but world-class skills.

In 2000 India was seen as globally competitive in services but not industry, where the Chinese juggernaut crushed all opposition. India's restrictive labor laws made it virtually impossible to shed workers in any company with over 100 workers. Labor inflexibility meant India could not follow the path set by the other Asian tigers, of export-led growth based on labor-intensive industries. Indian entrepreneurs were wary of setting up large labor-intensive factories for exporting items like garments, and so suffered the ignominy of being overtaken by Bangladesh in this sector. But, after taking time to adjust to liberalization and globalization (which was opposed by an influential quasi-protectionist section of industry called the Bombay Club), Indian industries greatly improved their productivity and in many areas became globally competitive.

One measure of how far India has come is that in 1991 Finance Minister Manmohan Singh's first budget brought the maximum import duty down—to a still whopping 150 percent. Earlier it was as high as 300 percent. Today the standard import duty is down to 10 percent, and the effective rate for many items is around 7 percent, close to the average for Southeast Asian countries. Back in 1991 more than 800 items were reserved for production by small-scale industries, and several more for the public sector. These reservations were whittled away gradually over more than a decade. Controls on industrial production, imports, technology, and foreign exchange have been abolished or hugely relaxed.

The financial sector used to be a virtual government monopoly but has now been liberalized with the entry of several private and foreign players, though the sector remains heavily regulated, and 70 percent of banking is still in government hands. Foreign investment has been liberalized in most areas, though much remains to be done in service industries like retail, banking, and insurance. Privatization has been very limited, but private investment in infrastructure and other areas previously reserved for the government has transformed the country, especially in telecom.

When India started down this reform path 20 years ago, skeptics abounded. Leftist critics predicted that India was going down the World Bank-International Monetary Fund (IMF) path that had supposedly resulted in a "lost decade" of economic growth in Africa and Latin America in the 1980s and warned that India would suffer a similar fate. They predicted that opening up and cuts in import duties would cause massive unemployment and de-industrialize India. They warned that multinational giants would rapidly take over the Indian economy and that Indian companies would go bust or become subservient underlings of foreigners. They also warned that the fiscal stringency imposed by the IMF would strangle social spending and safety nets, hitting the poor.

Every one of these dire predictions turned out to be wrong. Far from suffering a "lost decade," India became a miracle economy averaging 8.5 percent growth in the 2000s. Far from getting de-industrialized, Indian industry rose to new heights with the abolition of controls, and many new Indian giants emerged. A few Indian companies were indeed taken over by multinational corporations, but most Indian companies comfortably held their own, and dozens became multinationals in their own right, acquiring companies across the globe. Indeed, India began to rival China in making acquisitions abroad.

Far from suffering a fiscal squeeze on social spending, such spending rose to new heights, financed by booming revenues that accompanied booming GDP growth. However, failure to reform service delivery meant that much of the additional revenue was wasted or diverted to the undeserving, while corruption flourished. Despite such waste, India enjoyed a record increase in literacy in the two decades of reform, and poverty fell substantially. However, some social indicators did not improve quickly, and India's proportion of underweight children—a measure of malnutrition—was the third-worst in the world at 46.7 percent. This is one reason India remained far down in the Human Development Index of the United Nations.

Twenty years after reforms began, the Indian public is angry at high corruption arising out of crony capitalism, often a product of half-baked reform. Many analysts also worry that inequality is rising, the poor have not benefited enough, and poor states are getting left behind even as Maoist insurrection in many states worsens. These criticisms are mostly exaggerated or plain wrong. There is plenty of evidence that poor people, states, and castes have benefited substantially. But the unfinished agenda remains large.

How Reforms Benefited the Poorer Half

There has been widespread criticism that the reforms of the last 20 years have bypassed poor regions; have bypassed poor sections of the population like dalits (formerly called untouchables); that poor people have in desperation taken to Maoism, which now affects almost a quarter of all districts; and that social and poverty indicators have not improved fast enough. These criticisms are mostly exaggerations or falsehoods.

Poor regions. Many critics assert that poor regions have been bypassed by fast-growing GDP. For instance, James Lamont wrote a news story in the Financial Times headlined “High Growth Fails to Feed India’s Hungry.” 17 This is false. The proportion of people claiming to be hungry in some or all months has fallen from 17.3 percent in 1983 to 2.5 percent in 2004–05. Six poor, backward states accounting for half of India’s population— Uttar Pradesh, Bihar, Madhya Pradesh, Orissa, Chhattisgarh, and Jharkhand—have grown exceptionally fast in recent years, many faster than the national average. India’s western and southern states have historically been dynamos, with the northern and central ones lagging far behind. But in the five years from 2004 to 2009, the mean growth rate surged in the poor northern and central states —Bihar (12.4 percent), Chhattisgarh (9.7 percent), Jharkhand (8.5 percent), Madhya Pradesh (6.6 percent), Orissa (10.2 percent), and Uttar Pradesh (6.7 percent).18

Critics have asked rhetorically, “When will growth trickle down to the poor regions?” The question is meaningless in the Indian context. In some small mineral-rich nations, income is concentrated in a few hands, so mineral-based fast growth can bypass the bulk of the population. This is not possible in a large, diversified country like India with a relatively egalitarian Gini coefficient of 0.37 (this coefficient is a measure of income inequality, and ranges from 0 for complete equality to 1 for complete inequality). Growth of 8.5 percent in such a country is possible only if the bulk of the population improves its productivity, as is the case in India. This fast growth of poor states trickled up to create record GDP growth at the national level. India is mainly a case of trickle up, not trickle down, though of course fast national growth also produced more revenue that was shared with the states.

Maoist travails. Many critics think slow growth and lack of development have led to the rise of Maoist insurrection in some poor states. However, insurrection in India is correlated closely with ethnic and religious divisions, not with poverty or deprivation. From 1978 to 1993 Punjab, India’s richest state, had an insurrection led by the richest community (Jat Sikhs), while the poorest (Mazhbi Sikhs) remained loyal to India. Kashmir has the lowest poverty rate of all states, yet it has suffered insurrection by Kashmiri Muslims wanting independence, with a death toll of approximately 70,000 since 1988. In Assam a secessionist insurrection has been led by upper-caste Hindus, mainly against poor Bengali immigrants. Maoist violence has been concentrated in tribal areas of central India and is best seen as ethnic conflict between tribesmen and nontribesmen (though poverty adds fuel to ethnic tensions).19 the poor states with the most Maoist violence (Bihar, Orissa, Jharkhand, and Chhattisgarh) has recorded exceptionally fast growth in GDP and in literacy. Industrial growth has averaged an impressive 15 percent in Orissa, Jharkhand, and Chhattisgarh, and is based not simply on mining (which can deprive tribesmen of their land) but on manufacturing.

Dalits, the poorest of the poor. Critics believe that the economic liberalization has benefited just small elite and left behind the poor, especially the lowest Hindu caste of dalits. Their condition is worst in northern states like Uttar Pradesh, India's biggest state, with almost 200 million people. But a recent authoritative survey in two districts of Uttar Pradesh revealed striking improvements in living standards of dalits in the last two decades. Television ownership was up from zero to 45 percent; cell phone ownership up from zero to 36 percent; two-wheeler ownership (of motorcycles, scooters, and mopeds) up from zero to 12.3 percent; children eating yesterday's leftovers down from 95.9 percent to 16.2 percent.

Even more striking was the improvement in dalits' status. Cases where dalits were seated separately at weddings were down from 77.3 percent to 8.9 percent; cases of non-dalits accepting food and drink at dalit a house up from 8.9 percent to 77.3 percent; halwaha (bonded labour) incidence down from 32 percent to 1 percent; dalits using cars for wedding parties up from 33 percent to almost 100 percent; the dalit proportion running their own businesses up from 6 percent to 37 percent; and proportion working as agricultural laborers down from 46.1 percent to 20.5 percent. The dalits themselves say the improvement in status matters more than income improvement. Some dalits have become millionaire businessmen, and have also established a Dalit Chamber of Commerce and Industry. Dalits are still at the bottom of the income and social ladders, but they have gained substantially in the reform era.

Literacy. Literacy is a problem of the poor, not the elite, so it is heartening that in the two decades since 1991, India's literacy rate has shot up by a record 21.83 percentage points to 74.04 percent . In the earlier two decades, it rose only 17.8 percentage points. This figure would be even less if we adjusted for the fact that before 1991 the literacy rate referred to people aged 5 and above, and from 1991 onward referred to people aged 7 and above.

In the last decade, the improvement in all-India literacy (9.7 percentage points) was vastly exceeded by several poor backward states—Bihar (16.82), Uttar Pradesh (11.45), Orissa (10.37), and Jharkhand (16.07). Female literacy improved even more dramatically, by 11.8 percentage points across India, and at still higher rates in Bihar (20.2), Uttar Pradesh (17.1), Orissa (13.9), and Jharkhand (15.3).

Poverty. The poverty headcount ratio, calculated from data from the National Sample Survey Office (NSSO), has declined from 45.3 percent in 1993–94 to 32 percent in 2009–10.

Some will say this is not fast enough. However, NSSO surveys now capture only 43 percent of consumption measured by GDP data against 87 percent in the 1970s. Poor people may understate their living standards for fear of losing benefits targeted at the poor. Hence the poverty headcount ratio may actually be much lower than suggested by the official data. The proportion of people saying they have been hungry in some or all months has declined sharply in the poorest states and has fallen overall from 17.3 percent in 1983 to 2.5 percent in 2004–05.

Booming revenues in the reform era have enabled the central and state governments to greatly increase outlays on subsidies and employment programs aimed at the poor. These programs are notorious for fraud and leakages, but nevertheless something is getting through. However, casual labor wages have risen with fast growth, and labor shortages are being felt everywhere, even in agricultural and construction labor (traditionally viewed as unskilled labor). Agricultural wages in the 35 months to December 2010 were up by 106.5 percent and 84.4 percent respectively in rich agricultural states like Andhra Pradesh and Punjab, and were up sharply even in poor states that normally suffer outmigration, such as Bihar (58.3 percent), Orissa (62.9 percent), Uttar Pradesh (62.4 percent) and Madhya Pradesh (56.2 percent).26 Rapid growth has done more to combat poverty than welfare schemes.

(Extract from "The Elephant That Became a Tiger" 20 Years of Economic Reform in India by Swaminathan S. Anklesaria Aiyar, CATO)

How India's Liberalization Shaped a Generation of Entrepreneurs

Since India began liberalizing its economy in 1991, entrepreneurship in the country has been on the upswing. Some of the most respected companies in the business community today are considered children of liberalization. Take information technology firm Infosys: In the first decade of its existence, from 1981 to 1991, Infosys grew to less than $5 million. In the 20 years since liberalization began, the company has grown to become a $6 billion-plus entity, and one that is well established in the global arena.

N.R. Narayana Murthy, co-founder and chairman emeritus of Infosys, is categorical that the company would not have seen this kind of success had India not set forth on the liberalization path. He has often said, "If there is one great example of the success of liberalization, it is Infosys." Indeed, at the 16th Wharton India Economic Forum held in Mumbai earlier this year, keynote speaker K.V. Kamath, chairman of ICICI Bank and Infosys noted that liberalization "has allowed a whole new generation of entrepreneurs to flower, execute their vision and add tremendous value."

In a recent study, Kaustubh Dhargalkar, professor of business design and head of the innovation lab at the Center For Innovation and Memetics at the Mumbai-based Welingkar Institute of Management Research and Development, and his research assistant Rudra Desai, have examined the role that liberalization has played in shaping successful entrepreneurs in India. Dhargalkar's study focuses on companies listed in Group A of the Bombay Stock Exchange (BSE) from 1995 to 2011. He says that it typically takes three to four years for policy decisions to reflect on firm performance at the ground level; Dhargalkar chose this particular category for the study because it represents the elite, high-performing and sought-after firms. "The listing of a company in this group is an indicator of the success of the company," he notes. "These are blue chip firms."

According to Dhargalkar's study, the number of first generation companies listed in Group A has grown from nine in 1991 to 30 in 2011. That number does not include those start-ups that moved out of Group A for various reasons, such as being acquired by another firm. "If we were to consider the total number of first generation companies getting listed, as well as going out of, Group A on the BSE then 32 more companies would be added to the list," the researchers write. "In simple terms, 62 different first generation companies got listed in Group A of the BSE [from] 1995 to 2011." That's an increase of 588%.

But even if one were only to consider the 30 companies that were listed on Group A and did not move out during the period studied, the increase in percentage terms since liberalization is still significant. In 1995, first generation companies accounted for 9.78% of the firms listed on Group A. In 2011, they constituted 15.08%. According to the study, moving forward "the gap in numbers between the first generation companies and older established companies will gradually reduce, though not get bridged…. If reforms are pushed by the government in an orderly manner, the Indian entrepreneurs would continue to create big-ticket successes."

But given the current state of Indian politics, where the government has been reduced to a state of policy paralysis due to charges of corruption, what will be the effect on entrepreneurship? "There will be some impact," Dhargalkar says. "But the power of entrepreneurship in India has been unleashed by the liberalization process and even if the pace of reforms is slow, entrepreneurs will find a way to move ahead."

Dhargalkar lists four key reasons for the increased influence of first generation companies in the post-liberalization era: Technology has substantially reduced the costs associated with niche marketing; stock markets have become more efficient and transparent and made it easier for entrepreneurs to access money; the costs of starting up an enterprise have fallen because of access to angel investors and venture capitalists; and Indians have opened up to entrepreneurship.

Pointing out that entrepreneurs are important in any economy because they create employment, generate new ideas and implement new techniques in management functions, Dhargalkar notes: "Over time, entrepreneurs will increasingly contribute to India's GDP and also have a greater impact on the socioeconomic fabric of the nation."

Posted in Knowledge@ Wharton Today. http://knowledgetoday.wharton.upenn.edu/2012/02/how-indias-liberalization-shaped-a-generation-of-entrepreneurs/

The myth of India's liberalization

Indian Prime Minister Manmohan Singh is due to visit Washington in a few weeks, and editorialists and commentators have already started writing about the emerging economic power of India. New Delhi's decision to start liberalizing its economy in 1991 is touted as a seminal event in India's history, the moment when it threw off the shackles of Fabian socialism and embraced free markets. It is the stuff of myth--and to a large extent, it is exactly that.

While part of India has benefited from being opened up to foreign products and influences, most of the country is still denied access to free markets and all the advantages they bring. India opened its markets in 1991 not because there was a political will to open the economy, but because of a balance-of-payments crisis that left it with few options. The liberalization was half-hearted and limited to a few sectors, and nowhere near as broad as it needed to be.

One would have expected India's growth to be driven by labor-intensive manufacturing but, almost by default, it instead came in the poorly licensed area of services exports. The manufacturing sector, ideally placed in terms of labor and raw material to compete with China, never took off. India's restrictive labor laws, a remnant of the socialist infrastructure that India's first Prime Minister, Jawaharlal Nehru, put in place in the 1950s and 1960s, were politically impossible to reform. It remains excruciatingly difficult for most Indians to start a business or set up shop in India's cities.

This is painstakingly illustrated in "Law, Liberty and Livelihood", a new book edited by Parth Shah and Naveen Mandava of the Center for Civil Society in New Delhi, which documents the obstacles in the way of any Indian who wishes to start a business in one of India's big cities. Messrs. Shah and Mandava write: "Entrepreneurs can expect to go through 11 steps to launch a business over 89 days on average, at a cost equal to 49.5% of gross national income per capita." Contrast the figure of 89 days with two days for Australia, eight for Singapore and 24 for neighboring Pakistan.

But often, even this figure is just a notional one, and entrepreneurs find it next to impossible to get a legal permit to start a business at all. Street hawkers and shop owners in the cities often cannot get a license at all. (Even those who do have to comply with draconian regulations that offer so much discretion to the authorities that corruption is inevitable.) They survive by paying regular bribes to municipal authorities and policemen, which are generally fixed in such a way by this informal market that they can barely survive on what they earn, and cannot, expand their business or build their savings. They are trapped in a cycle of enforced illegality and systematic extortion by authorities, which results in a tragic wastage of capital. It serves as a disincentive to entrepreneurship, as well as to urbanization, the driving force of growing economies.

Another disincentive to urbanization is how hard it is for poor people to get legal accommodation in the big cities. In Bombay, for example, an urban land ceiling act and a rent-control act make it virtually impossible for poor migrants to rent or buy homes, and they are forced into extralegal housing. The vast shantytowns of Bombay--one of them, Dharavi, is the biggest slum in Asia--hold, by some estimates, more than $2 billion of dead capital. For most of the migrants who live in these slums, India hasn't changed since 1991. As that phrase from India's pop culture goes, "same difference."

India's policymakers are aware of these anomalies, but it is an acute irony in India that any proposal to reform the bureaucracy has to first wind its way through the bureaucracy. Arun Shourie, a former disinvestment minister and a respected journalist, wrote in his recent book "Governance" that, "proposals for reforming [the] system are adopted from time to time, and decrees go out to implement the measures 'in a time-bound manner.' But in every case, the proposal is put through--some would say, it has to be put through--the same mill."

It is in the nature of bureaucracies, Mr. Shourie points out, to endlessly iterate. He charts how the apparently simple task of framing a model tender document took the government more than 13 years, as drafts of it circulated between different committees and ministries. Anything even slightly more complicated, and with pockets of political opposition to it, like economic reforms, becomes almost impossible to implement. Dismantling state controls is only possible if there is political will and a popular consensus. None of these exist. On the contrary, there is a popular belief that the economic inequalities in India are caused or exacerbated by free markets.

The socialist left, a natural proponent of such views, believes that free markets are the problem and not the solution. India's communist parties have blocked labor reform, opposed foreign investment and prevented privatization of public-sector units. They naturally have a vested interest in the "license-permit-quota raj," as the web of statist controls is called. On all these issues they are supported, surprise surprise, by the religious right.

The Hindu right wing, led by the Bharatiya Janata Party and collectively known as the Sangh Parivar, also fears globalization. Its sustenance comes from identity politics, the impact of which is diluted by the opening up of the cultural mindspace to "foreign influences." If people are busy chasing prosperity and gaining Western liberal values, they will naturally have less time to focus on "the Hindu identity," and suchlike. Rabble rousers need the masses to be disaffected.

In between the socialist left and the religious right is the Congress, a party which occupies the center of the political space almost by default. Its position on issues is always malleable, and although it is currently the party of government, it leads a coalition that depends on the left for survival. The pace of reforms has not increased since it came to power last year, and is not likely to do so anytime soon. While the world focuses on the metaphorical bright lights of Bangalore, most of the country--indeed, much of Bangalore itself, which has been plagued by power and infrastructure problems recently--remains in darkness.

Posted in India Uncut By Amit Varma . http://indiauncut.com/iublog/article/the-myth-of-indias-liberalization/

Questions to think about

Contrary to the economic reforms process of India, Nepal's liberalization process did not yield as much results as expected. What do you think are the primary reasons for the failure of liberalization in Nepal?

Do you think liberalization will work in Nepal? If yes, what do you think are the necessary conditions?