ECONOMIC REFORMS IN INDIA SINCE 1991

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India was a latecomer to economic reforms, embarking on the process in earnest only in 1991, in the wake of an exceptionally severe balance of payments crisis. The need for a policy shift had become evident much earlier, as many countries in east Asia achieved high growth and poverty reduction through policies which emphasized greater export orientation and encouragement of the private sector. India took some steps in this direction in the 1980s, but it was not until 1991 that the government signaled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of government.

India's economic performance in the post-reforms period has many positive features. The verage growth rate in the ten year period from 1992-93 to 2001-02 was around 6.0 percent which puts India among the fastest growing developing countries in the 1990s. This growth record is only slightly better than the annual average of 5.7 percent in the 1980s, but it can be argued that the 1980s growth was unsustainable, fuelled by a buildup of external debt which culminated in the crisis of 1991. In sharp contrast, growth in the 1990s was accompanied by remarkable external stability despite the east Asian crisis. Poverty also declined significantly in the post-reform period, and at a faster rate than in the 1980s according to some studies (as Ravallion and Datt discuss in this issue).

However, the ten-year average growth performance hides the fact that while the economy grew at an impressive 6.7 percent in the first five years after the reforms, it slowed down to 5.4 percent in the next five years. India remained among the fastest growing developing countries in the second sub-period because other developing countries also slowed down after the east Asian crisis, but the annual growth of 5.4 percent was much below the target of 7.5 percent which the government had set for the period. Inevitably, this has led to some questioning about the effectiveness of the reforms.

Opinions on the causes of the growth deceleration vary. World economic growth was slower in the second half of the 1990s and that would have had some dampening effect, but India's dependence on the world economy is not large enough for this to account for the slowdown. Critics of liberalization have blamed the slowdown on the effect of trade policy reforms on domestic industry. However, the opposite view is that the slowdown is due not to the effects of reforms, but rather to the failure to implement the reforms effectively. This in turn is often attributed to India's gradualist approach to reform, which has meant a frustratingly slow pace of implementation. However, even a gradualist pace should be able to achieve significant policy changes over ten years.

Fiscal profligacy was seen to have caused the balance of payments crisis in 1991 and a reduction in the fiscal deficit was therefore an urgent priority at the start of the reforms. The combined fiscal deficit of the central and state governments was successfully reduced from 9.4 percent of GDP in 1990-91 to 7 percent in both 1991-92 and 1992-93 and the balance of payments crisis was over by 1993. However, the reforms also had a medium term fiscal objective of improving public savings so that essential public investment could be financed with a smaller fiscal deficit to avoid "crowding out" private investment. This part of the reform strategy was unfortunately never implemented.

The central government's effort must be directed primarily towards improving revenues, because performance in this area has deteriorated significantly in the post reform period. Total tax revenues of the center were 9.7 percent of GDP in 1990-91. They declined to only 8.8 percent in 2000-01, whereas they should have increased by at least two percentage points. Tax reforms involving lowering of tax rates, broadening the tax base and reducing loopholes were expected to raise the tax ratio and they did succeed in the case of personal and corporate income taxation but indirect taxes have fallen as a percentage of GDP. This was expected in the case of customs duties, which were deliberately reduced as part of trade reforms, but this decline should have been offset by improving collections from domestic indirect taxes on goods and by extending indirect taxation to services. This part of the revenue strategy has not worked as expected. The Advisory Group on Tax Policy for the Tenth Plan recently made a number of proposals for modernizing tax administration, including especially computerization, reducing the degree of exemption for small scale units and integration of services taxation with taxation of goods.

The fiscal failures of both the central and the state governments have squeezed the capacity of both the center and the states to undertake essential public investment. High levels of government borrowing have also crowded out private investment. Unless this problem is addressed, the potential benefits from reforms in other areas will be eroded and it may be difficult even to maintain the average growth rate of 6 percent experienced in the first ten years after the reforms, let alone accelerate to 8 percent.

Reforms in industrial and trade policy were a central focus of much of India's reform effort in the early stages. Industrial policy prior to the reforms was characterized by multiple controls over private investment which limited the areas in which private investors were allowed to operate, and often also determined the scale of operations, the location of new investment, and even the technology to be used. The industrial structure that evolved under this regime was highly inefficient and needed to be supported by a highly protective trade policy, often providing tailor-made protection to each sector of industry. The costs imposed by these policies had been extensively studied (for example, Bhagwati and Desai, 1965; Bhagwati and Srinivasan, 1971; Ahluwalia, 1985) and by 1991 a broad consensus had emerged on the need for greater liberalization and openness. A great deal has been achieved at the end of ten years of gradualist reforms.

Trade policy reform has also made progress, though the pace has been slower than in industrial liberalization. Before the reforms, trade policy was characterized by high tariffs and pervasive import restrictions. Imports of manufactured consumer goods were completely banned. For capital goods, raw materials and intermediates, certain lists of goods were freely importable, but for most items where domestic substitutes were being produced, imports were only possible with import licenses. The criteria for issue of licenses were nontransparent, delays were endemic and corruption unavoidable. The economic reforms sought to phase out import licensing and also to reduce import duties.

The impact of ten years of gradualist economic reforms in India on the policy environment presents a mixed picture. The industrial and trade policy reforms have gone far, though they need to be supplemented by labor market reforms which are a critical missing link. The logic of liberalization also needs to be extended to agriculture, where numerous restrictions remain in place. Reforms aimed at encouraging private investment in infrastructure have worked in some areas but not in others. The complexity of the problems in this area was underestimated, especially in the power sector. This has now been recognized and policies are being reshaped accordingly. Progress has been made in several areas of financial sector reforms, though some of the critical issues relating to government ownership of the banks remain to be addressed. However, the outcome in the fiscal area shows a worse situation at the end of ten years than at the start.

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