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Indian Economy: Retrospect and Prospect

Arvind Panagariya

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Foreword

Richard Snape capped a long and distinguished career as Professor of Economics at Monash University with a new and accomplished career at the Industry Commission, and then as Deputy Chairman of the Productivity Commission. In the eight years that he spent at the Commission before his untimely death in October 2002, he played a pivotal role in overseeing our research program, as well as participating in major public inquiries.

This is the eleventh in a series of lectures in memory of Richard Snape. With Richard's own interests and high standards in mind, the lecture series elicits contributions on important public policy issues from internationally recognised figures, in a form that is accessible to a wide audience.

This year's Lecturer, Arvind Panagariya is Professor of Economics and Jagdish Bhagwati Professor of Indian Political Economy at Columbia University. Professor Panagariya has a distinguished academic career and has also served as Chief Economist at the Asian Development Bank as well as holding other positions at the World Bank, the International Monetary Fund, the World Trade Organisation and the United Nations Conference on Trade and Development.

In his presentation, Professor Panagariya provides a critical assessment of policy approaches to economic growth and development in post-independence India – the world's largest democracy. As he points out, the policy lessons from India's experience – such as the importance of outward oriented, pro-market reforms – can apply to all developing countries seeking prosperity within a democratic framework.

I am grateful that Professor Panagariya was able to take time out of his busy schedule to come to Melbourne to deliver the Richard Snape Lecture for 2013.

Peter Harris
Chairman

October 2013

Richard Snape 1936 – 2002

Richard Hal Snape was Deputy Chairman of the Productivity Commission and Emeritus Professor of Monash University. He was a Board Member of the Australian Research Council, Fellow of the Academy of the Social Sciences in Australia and a Distinguished Fellow of the Economic Society of Australia.

Professor Arvind Panagariya

Arvind Panagariya is Professor of Economics and Jagdish Bhagwati Professor of Indian Political Economy at Columbia University. He is also the Director of the Program on Indian Economic Policies at Columbia. He was previously Chief Economist of the Asian Development Bank and has also worked with the World Bank, IMF, WTO, and UNCTAD. He holds a Ph.D. degree in Economics from Princeton University. In March 2012, Panagariya was awarded Padma Bhushan, one of the highest civilian honors India confers in any field.

Professor Panagariya has written or edited a dozen books, including *India: The Emerging Giant* which was listed as a 'top pick' in 2008 by the *Economist* magazine. The *Economist* has described his latest book (with Jagdish Bhagwati) *Why Growth Matters* as 'a manifesto for policymakers and analysts.' His articles have appeared in leading economics journals including the *American Economic Review*, *Quarterly Journal of Economics* and the *Review of Economic Studies*.

Indian Economy: Retrospect and Prospect

Professor Arvind Panagariya*

I feel greatly honoured to be invited to deliver the 11th Richard Snape Memorial Lecture. The list of those who have preceded me in this role beginning with Max Corden and Anne Krueger and ending with Pascal Lamy is both inspiring and humbling. In this lineup of speakers, I perhaps represent a somewhat younger generation. I point this out because for me, Richard was a scholar to aspire to be and to emulate.

Among Richard's many professional attributes, if I were to pick one, it would be that he had a thorough command of theoretical and empirical tools of analysis but for him these were not ends in themselves. Instead, they were the means to promote informed policy discourse and formulation of good policies. Of course, since theory and data rarely give us a unique answer, good economic policy making also requires good judgment. And Richard had this aplenty too.

His conceptual clarity and analytical skills found expression in the development of the classification of services into different modes of delivery, which later became the foundation of the General Agreement on Trade in Services or GATS within the World Trade Organization (WTO).[1] And his good judgment led him to lean in favour of multilateralism in the debate on multilateral versus preferential trade liberalization, the latter being an area in which theory yields ambiguous answers.[2]

* I thank Jagdish Bhagwati for comments on, and Prashant Reddy for many corrections to, an earlier version of the lecture.

1 This work, Sampson and Snape (1985), was done jointly with Garry Sampson. The authors built on earlier work by Bhagwati (1984) who distinguished between services that required the presence of the provider and recipient in the same place and those that did not as, for example, through electronic transmission of a performance across nations. Sampson and Snape divided the former into three sub-categories: those involving the movement of the recipient to the location of the provider, those involving the movement of the provider to the location of the recipient and those involving the movement of both to a third location.

2 See, for example, Snape (1996). In this paper, Richard also demonstrates an uncanny ability to drive home his point with the help of diagrams. He offers an ingenious diagram of the myriad European preferential trade agreements to drive home the point that crisscrossing arrangements of this kind could lead to highly inefficient trade patterns. Jagdish Bhagwati, David Greenaway

In retrospect, it should not be surprising that Richard's first major piece of work immediately caught the attention and imagination of the great trade economist Harry Johnson who himself had an unsurpassed talent for developing theoretical models around policy problems and then taking those models back to policy analysis.

I could go on about Richard's qualities and contributions but that will not do justice to him since at least in the scholarly world such justice comes from taking his work forward.

Therefore, let me turn to the subject of today's lecture. The original title, chosen before I began writing the lecture, promised to explain what India would look like in the next 15 years within the context of the global economy. But as I began writing, I realized that a lecture that merely speculates about the future is unlikely to persuade anyone, let alone this distinguished and critical audience. To be persuasive about the vision of the future, one must first demonstrate a firm grasp of the past. Even good astrologers in India are expected to first tell you the past before they will be believed on their future predictions. So it is with the lecture today: I must first analyse India's past before speculating on its future.

There is, of course, another compelling reason why it is important to look into India's past in some detail. As one of only two developing countries to have had democratic rule for more than six decades and also as by far the largest democracy in the world, India offers a fascinating case study in economic development.[3] Within the same system of parliamentary democracy, India first experimented with autarkic policies coupled with strict state control of domestic economic activity and then with outward-orientation reinforced by increasing reliance on market forces. The country, thus, allows us to sharply contrast the efficacy of a command and

and Panagariya (1998) found the diagram so compelling that we reproduced it in our own paper (with Richard's permission, of course).

[3] I should acknowledge that democracy in India went through a brief period of interruption between June 1975 and March 1977 when Prime Minister Indira Gandhi suspended all civil liberties. I disregard this aberration in the text principally because it was too short a period to seriously influence economic outcomes. The only other developing country to have been governed under a democratic system for six decades or more is Costa Rica, a country of less than five million people in Latin America. Arguably, Sri Lanka could be added to the list but its record is marred by a massive civil war, with the rights of the Tamil minority routinely violated. Even the number of developing countries that gained independence in the 1960s and therefore have had at most five full decades of uninterrupted democratic rule is tiny. These countries include Botswana and Mauritius in Africa and Jamaica, Trinidad and Tobago, and Barbados in the Caribbean. Botswana became independent in 1966, Mauritius in 1968, Jamaica and Trinidad and Tobago in 1962 and Barbados in 1966.

control system of governance with that of a more market friendly policy regime, within a parliamentary democracy.

The tale of the twists and turns of India's policy regime from a mild form of socialism under Prime Minister Jawaharlal Nehru, to a statist regime under his daughter Prime Minister Indira Gandhi, to market-friendly reforms under Prime Ministers Narasimha Rao and Atal Bihari Vajpayee, and then finally a reversion to greater state interventionism under Prime Minister Manmohan Singh offers rich lessons for all developing countries seeking prosperity within a democratic framework. Indeed, India itself could learn much from a better understanding of its successes and failures.

If there is one message that comes out forcefully from the post-independence development history of India, it is that in a country with low per-capita income, growth is central to any meaningful assault on poverty, illiteracy and ill health. While this proposition may seem obvious to many, it is not one that is appreciated widely or accepted readily, especially among the political class who matter the most in determining what policies a country actually adopts.

In India and many countries in Asia, Africa and Latin America, one encounters deep scepticism, even suspicion and hostility, when advocating the centrality of growth to combating poverty, illiteracy, and ill health. The common refrain is that we have tried this before and it has not worked. The fallacy of this argument is that the failure has uniformly been in materializing sustained rapid growth and not in growth failing to deliver poverty eradication. Experiences of countries such as South Korea and Taiwan in the 1960s and 1970s and China and India more recently show that once growth materializes, poverty comes crashing down. Indeed, in the last two decades, if the world has seen by far the largest decline in abject poverty in human history, it is because the developing countries, most notably India and China, have experienced growth as never before.

Why Growth Works

At the outset, it is important to identify two channels through which growth reduces poverty, illiteracy, and ill health:

- Growth 'pulls up' people into gainful employment while also raising real wages throughout the economy. Growth, thus, helps eradicate poverty in a sustainable fashion while also equipping people to better access education and health.

- Growth provides ever-rising tax revenues that additionally allow the government to finance large-scale social expenditures on items such as education, health, and purchasing power transfers to the poor.

Critics often disparage growth by describing its impact on poverty as a passive 'trickle down,' which conjures up the images of the Earl of Nottingham enjoying a sumptuous meal while his serfs down below wait for the crumbs to fall off. In contrast, following the lead of my colleague Jagdish Bhagwati, I prefer to think of growth as an activist 'pull up' strategy that creates well-paid jobs and continuously raises the wages of the poor.[4]

It bears underlining that poverty reduction will be fastest when both growth and social expenditures work in concert with one another. Accordingly, in our recent book *Why Growth Matters*, Jagdish Bhagwati and I argue that to harvest the greatest poverty reduction, the government needs to reform policies along two tracks: Track I reforms that lead to sustained rapid growth in a way that it creates large employment opportunities for low-skilled workers and Track II reforms that enhance the efficiency of social spending made possible by the growth-enhancing Track I reforms. Neglecting Track I reforms would not just hamper employment creation, but also revenue generation and therefore Track II spending, a lesson the current Indian government has learnt the hard way and rather late in its second term.

Why Redistribution Without Growth Cannot Go Far

But let me first subject another common myth to close scrutiny. It is sometimes claimed that growth is really not necessary for a major assault on poverty and that redistribution alone can do the job. During the early 1970s, stimulated by the writings of economist Mahbub ul Haq of Pakistan, who later led the effort to launch the Human Development Report at the United Nations Development Program under the guidance of Amartya Sen, a self-congratulatory cottage industry under the rubric of 'New Economics' grew in India. Contributors to this industry contended that by focusing on growth, India had missed the boat and that it needed to focus on redistribution instead to eradicate poverty. In an influential article entitled 'Let Us Stand Economic Theory on Its Head: Joining the GNP Rat Race Won't Wipe Out Poverty,' Haq (1972) claimed that China had successfully eradicated poverty

[4] The term 'pull up' was first used by Bhagwati (1988) in his magisterial Vikram Sarabhai Lecture originally delivered in Ahmadabad in August 1987. In this lecture, he also identified the two effects of growth on poverty, noted in the text.

through redistribution with only modest growth. Many Indian authors echoed his claim.[5]

We now know, however, that the claim was false. There remained a vast volume of abject poverty in China for Deng Xiaoping to combat when he began opening the Chinese economy in the late 1970s following the death of Mao. Indeed, in total contrast to the assertions by Haq, Mao had struggled hard to achieve rapid growth through the extraction of surplus from agriculture in the countryside for investment in urban-based industries. That effort had actually resulted in neither significant growth nor poverty reduction and had caused millions of Chinese to lose their lives.

The issue of whether India could make a significant dent in poverty through redistribution had been thoroughly debated at the highest political levels.[6] When questions were raised in the early 1960s in the parliament regarding why poverty had not declined, Nehru asked Pitambar Pant, the then chairman of the Perspective Planning Division of the Planning Commission, to take a fresh look at the issue. The resulting document by Pitamber Pant (1962) laid out beautifully the limitations of a poverty eradication strategy that did not have growth at its centre. Pant began by noting that approximately 50 per cent of the population lived in abject poverty on 20 rupees or less per person per month at 1960-1961 prices. He went on to argue:

> The minimum which can be guaranteed is limited by the size of the total product and the extent of redistribution which is feasible. If at the current level of output, incomes could be redistributed equally among all the people, the condition of the poorest segments would no doubt improve materially but the average standard would still be pitifully low. Redistribution on this scale, however, is operationally meaningless unless revolutionary changes in property rights and scale and structure of wages and compensations are contemplated. Moreover, when even the top 30 per cent of the households have an average per capita expenditure of only Rs. 62 per month, it is inconceivable that any large redistribution of income from the higher income groups to the other can be effected. To raise the standard of living of the vast masses of the people, output therefore would have to be increased very considerably (pp. 13–14).

The conclusion Pant reached had also found expression in a more colourful remark by the famous Marxist economist from Poland, Michael Kalecki, who happened to be visiting India in 1962. The problem in India, said Kalecki, was that it had ‘too few exploiters [from whom to redistribute] and too many exploited [to whom to redistribute].’ Redistribution could at best make a minuscule impact, allowing one

[5] For example, see Sau (1972) and Ranadive (1973).

[6] As Nehru (1946) discusses at length, the decision to place growth at the centre of economic policies had been taken after detailed discussions in the Planning Committee that the Congress had appointed for the specific purpose of devising the planning strategy once India achieved independence. Therefore, Nehru had been thoroughly conversant with the limitations of redistribution as the sole or even primary instrument of poverty eradication.

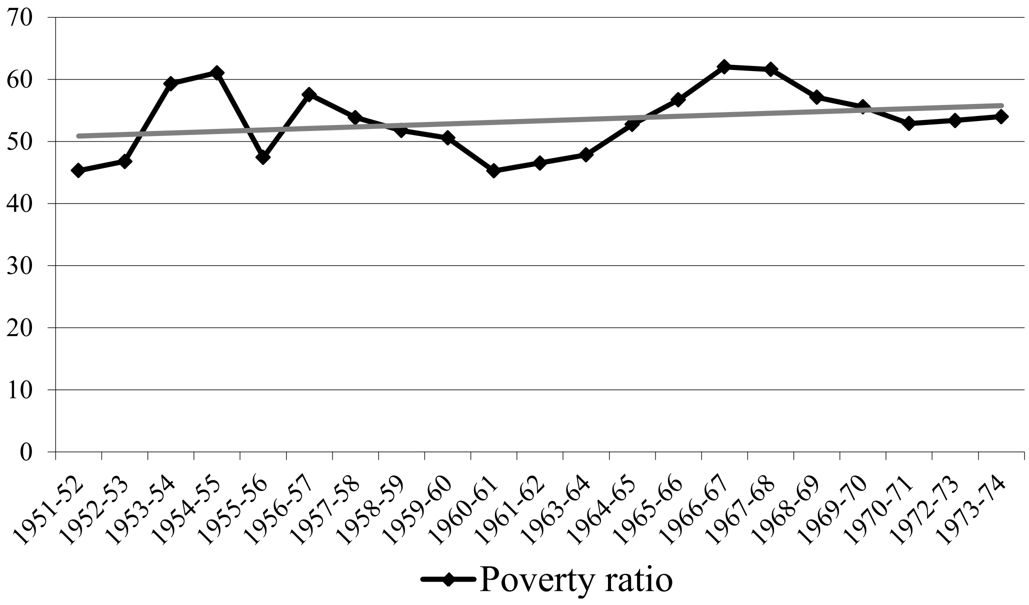
extra chapati at best. As Pant (1962) noted, social spending led to an 85 per cent increase in school enrolment and a 65 per cent increase in the number of hospital beds between 1950-51 and 1960-61. But this was just a drop in the vast ocean of poverty. Ultimately, without growth, even the small gains through redistribution are not sustainable since they would be partially or wholly dissipated by an increase in the population.

The Lost Decades of 1950 to 1980

In the event, India failed to bring down poverty during the first three decades after launching its development program. Figure 1 shows the proportion of people living below the official poverty line, also called the poverty ratio, from 1951-52 to 1973-74 on an annual basis. The solid straight line represents the underlying trend. The poverty ratio fluctuated between approximately 45 and 60 per cent depending on the disposition of the rain god but exhibited no declining trend. Indeed, in so far as there was a trend, it indicated rising poverty.

Figure 1 **Per cent population below the official poverty line in India, 1951-52 to 1973-74**

Poverty ratio: 1951-52 to 1973-74



Data source: Authors' construction using the estimates in Datt (1998, Table 1).

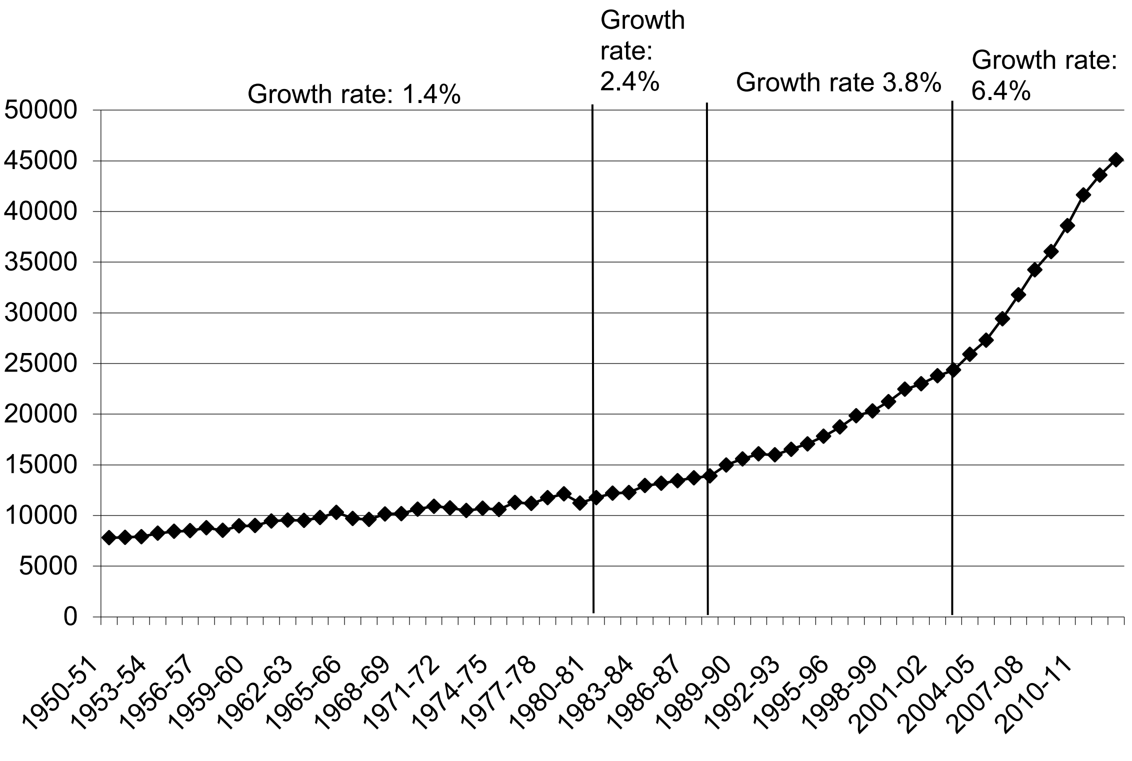
Although many critics contend that this failure represents a failure of India's growth-centred strategy, such a conclusion is unwarranted. Growth did not fail India; instead, it failed to materialize in the first place. India had started with a low per-capita income and absent substantial growth, per-capita income remained low until as late as 1980. Table 1 divides the six decades spanning 1951-52 to 2012-13 into four broad phases and reports the growth rates of GDP and per-capita GDP during each of these phases. Correspondingly, Figure 2 plots the level of per-capita GDP over the same six decades.

Table 1 **Growth rates of GDP and per-capita GDP in India**

Period	*GDP (%)*	*Per-capita GDP (%)*
1951-81	3.6	1.4
1981-88	4.6	2.4
1988-2003	5.9	3.8
2003-2013	7.9	6.4

Figure 2 Per-capita GDP in constant 2004-05 rupees, 1950-51 to 2012-13

Per-capita GDP at factor cost at 2004-05 prices (Rs.)



Data source: Author's construction using the CSO [Central Statistical Office] data.

Table 1 indicates that per-capita income grew a paltry 1.4 per cent per year on average during the three decades spanning 1951-52 to 1980-81.[7] In terms of Figure 2, the per-capita-income line remained virtually flat during these decades. With the initial level being low as well, per-capita income in 1980-81 stood at just 2.4 dollars per day measured in 2005 Purchasing Power Parity (PPP) dollars. If we were to measure the income at the market exchange rate, the income would be less than a dollar!

Why Growth Failed to Materialize

The question we must ask at this point is why India failed to grow faster while some of its neighbours to the east, most notably South Korea and Taiwan, took off in the 1960s and 1970s. In a nutshell, the problem was that India progressively turned inward and replaced Adam Smith's invisible hand by the government's visible hand. Although Nehru had laid the foundation of these policies, under his daughter Indira Gandhi, they acquired real teeth.

As a Fabian socialist, Nehru sought to expand the role of the public sector only gradually by increasing the share of public investment in total investment over time rather than instantaneously through nationalization. He fought hard against radical socialists within his own party and communists outside the party while successfully fending off pressures to nationalize foreign companies. Soon after Independence, he explicitly committed the nation to a policy of no nationalization of foreign multinationals for at least ten years via the Industrial Policy Resolution of 1948. In his many speeches, Nehru argued against using the state's resources for nationalization and advocated investing them to create new enterprises in the heavy industry sectors for which private entrepreneurs lacked resources.

In a similar vein, while Nehru wanted self-sufficiency and therefore minimal dependence on international trade to solidify India's hard-won political independence, he sought to do this by reconfiguring the production basket to the consumption basket and not through blanket protection. Tariffs were generally low in the 1950s. Import licensing, inherited from the Second World War, remained in force but licenses were issued relatively freely. It was only a balance of payments crisis that dramatically changed the scenario by bringing foreign exchange budgeting into existence in 1958. That change meant that the Finance Ministry

[7] India's fiscal year runs from April 1 to March 31. Therefore, a year such as 1951-52 represents the period from April 1, 1951 to March 31, 1952. Throughout the paper, I use a period such as 1951-81 to refer to fiscal years from 1951-52 to 1980-81.

would henceforth clear all transactions involving the use of foreign exchange beforehand.

On the domestic front, Nehru utilized industrial licensing for the private sector to complement his policy of increasing the share of public sector investment and to nudge the former into what the government identified as priority sectors. Under this policy, introduced in 1951, any investments in excess of 2.5 million rupees or approximately half a million dollars at the then exchange rate of 4.8 rupees per dollar required a license. But at least during the 1950s, the licensing regime remained liberal. In contrast to the 1960s and beyond, we find no accounts of complaints by industrialists about difficulties in obtaining licenses.

In broad terms, the story of India until the early 1960s is not dramatically different from that of South Korea. The country grew at the annual rate of 4.1 per cent from 1951-52 to 1964-65. This was a major improvement over the growth rate of less than 1 per cent under the British in the first half of the twentieth century. It was also comparable to South Korea's growth of 4.2 per cent per annum from 1954 to 1962, the immediate post-Korean-war era. But beginning from the early to mid-1960s, the paths of the two countries diverged.

Whereas South Korea and Taiwan, which had both pursued import substitution in the 1950s, turned outward by the early 1960s, India chose to go in the opposite direction. By the mid-1960s, bottlenecks created by investment and import licensing and foreign exchange budgeting had begun to choke the economy. Under pressure from the World Bank and the United States, a modest attempt was made at import and investment liberalization coupled with devaluation of the rupee. But the experiment coincided with two consecutive drought years during which incomes fell. That allowed the dominant left-of-centre politicians to credibly claim that the attempt at devaluation and liberalization had been a mistake.

Nehru died in May 1964 and was immediately succeeded by Prime Minister Lal Bahadur Shastri. Shastri was sceptical of heavy industry and sympathetic to agriculture. He successfully shifted the focus of policy towards agriculture with the launch of the Green Revolution being a major accomplishment of his administration. But his rule was short-lived due to his untimely death in January 1966. Nehru's daughter, Indira Gandhi, succeeded him.

With the exception of three years from 1977 to 1980, Indira Gandhi occupied the office of the Prime Minister from 1966 to 1984. Though she had no particular passion for socialism when she came to the helm, Prime Minister Gandhi had to rely heavily on the political support of the radical socialist wing within the Congress party to seize control of it from her right-of-centre rivals. By the time she finished vanquishing these rivals, however, she had made the cause of her radical socialist allies her own.

The agenda of the radical socialists was spelt out in a ten-point program. It consisted of social control of banking institutions; nationalization of general insurance; nationalization of export- and import-trade; public monopoly over the distribution of food grain; curbs on big business houses and large firms; provision of the minimum needs for all by 1975; limits on urban incomes and property; employment programs and credit without collateral for landless farmers; and an end to privy purses and privileges to the former rulers in the princely states. Having acquired firm control of the party by 1969, Indira Gandhi substantially implemented this agenda and much more in the following years. By doing so, she greatly tightened the state's grip on the economy.

Indira Gandhi nationalized the major banks, the insurance sector, oil industry and coal mines. According to the Monopolies and Restrictive Trade Policy (MRTP) Act of 1969, groups of firms and business houses with just $47 million in fixed assets in land, building and machinery were classified as MRTP firms and confined to investing in nine 'core' industries, which were all highly capital-intensive. With minor exceptions, foreign investment in an enterprise was limited to 40 per cent of the total investment, with foreign companies required to incorporate in India. Virtually all labour-intensive industries from apparel to cosmetics to light consumer goods were reserved for small-scale enterprises, defined as those with a total investment of no more than $100,000 in 1967.

On the trade front, all imports were subject to strict licensing with a red book, describing who could import what and how much, issued every six months. Consumer goods imports were entirely banned and only actual users of raw materials and machinery could import them. The importer had to have one of the ministries as her sponsoring agency, with the latter also willing to certify that the imports were essential and domestically unavailable. Anyone offering to produce an imported product was automatically granted protection from imports. On top of all that, foreign exchange controls were applied with vigour.[8]

The socialist axe also fell on the factor markets. The nationalization of India's banks that together accounted for more than 90 per cent of banking assets had already given the government near-full control over India's bank deposits. In the second half of the 1970s, the government introduced a massive program of priority-sector lending whereby banks were required to lend approximately one-third of their

[8] Pursell (1992), who is one of only a handful of economists to closely follow India's trade policy during these years, provides a careful documentation of how restrictive trade policy had become under Gandhi.

credit to agriculture, small enterprises, and exporters. Subsequently, the government embarked upon a massive bank-branch-expansion program that had little relationship to the commercial viability of the branches. As regards foreign capital, the Foreign Exchange Regulation Act of 1973 more or less put an end to inward as well as outward flows.

In the labour market, the most damaging change was an amendment to the Industrial Disputes Act of 1947. This amendment effectively made it impossible for a firm with one hundred or more workers to layoff any worker for any reason whatsoever. Under the amendment, even if the firm were closed down — a very long-drawn process and therefore a rare occurrence in India even today — the workers had to be paid their wages as if the firm was conducting its usual business. As regards urban land markets, a new law gave the government the right to buy any empty land in excess of a small plot for a pittance. The result was that with recourse to corruption and loopholes in the legislation, landowners withdrew nearly all unused urban land from the market. Urban land prices skyrocketed.

Because strict investment licensing, reinforced by protection against imports, could produce guaranteed monopoly profits, which were anathema within the prevailing socialist norms, price controls followed. The government came to fix the prices of products such as cement, scooters and automobiles so that their licensed manufacturers would not make obscene profits. The price controls in turn produced shortages. The shortages had to then be combated by controls on distribution through permits. So I remember that if you needed a few sacks of cement to fix your house or build an extra room, you had to first get a permit from the government allowing you to pick up the sacks from a manufacturer. And as you transported those sacks to your home in a cart, you could count on an inspector to meet you on the way to harass you. For scooters and automobiles, you had to wait in years-long queues and then receive vehicles of a quality that no customer today would buy. Corruption emerged as the natural response to jump these queues.

The small-scale industries reservation, covering nearly all labour-intensive products in which India with its vast labour force had a comparative advantage, killed all export potential. Enterprises with just $100,000 in investment could scarcely look for customers beyond even a 100-mile radius let alone the world markets. Simultaneously, with imports shut down, consumers became captive to domestically produced low-quality products, which was all that such small enterprises could produce in the first place.

Indeed, product quality fell so low that my own recollection of the fountain pens from the 1960s and early 1970s is that they served mostly as fountains! Shaving with locally made razor blades was so hazardous to the skin that after I migrated to the United States, on each visit to India, I had to bring my father a large enough supply of genuine Gillett blades to last him till the next visit. Then again, in an interesting exchange of letters in the early 1960s, when economist Jagdish Bhagwati wrote from New Delhi to his mentor Harry Johnson in Cambridge, England that he found the craze for everything foreign in India to be offensive, Johnson shot back that if the quality of the paper on which Bhagwati had written his letter was any indication of the quality of Indian products, he found the Indian craze for foreign goods perfectly justified.

Product quality suffered also because the government insisted that manufacturers use locally produced parts thereby indigenizing the product. Moreover, with prices held at low levels and quantity determined by the license, minimizing the cost regardless of quality maximized profits. So the running joke was that in an Indian car, everything made a noise except the horn.

With neither scale nor quality, there was no chance that India could exploit its comparative advantage in labour-intensive products and generate export revenues in vast volumes. Export pessimism, passionately shared by all but two solitary Indian economists of the day — Jagdish Bhagwati and T. N. Srinivasn — thus found justification ex post. In turn, with export revenues so constrained, import controls seemed also to be justified. Those controls in turn gave additional teeth to investment licensing since it was now necessary to ensure beforehand that the foreign exchange required to import machinery and raw materials for the success of the proposed project was available. One distortion, thus, led to another.

The policy regime turned so pernicious that imports as a proportion of the GDP dropped to just 4.1 per cent in 1969-70 after hitting 10 per cent at their peak in the 1950s. The proportion remained below 7 per cent through much of the 1970s. And growth in per-capita income in India plummeted to just 0.3 per cent between 1965-66 and 1974-75. India had witnessed its slowest growth during a decade in which South Korea and Taiwan grew at near double-digit rates.

The 1980s: A Modest Turnaround

By the mid-1970s, the poor performance of the economy and complaints by businessmen had begun to convince at least some within the top rungs of the bureaucracy that the command and control system had gone too far and that it was not delivering the outcomes the government had sought. That realization led to the initiation of a modest process of deregulation. Because no one had the courage to admit openly that mistakes had been made in pushing the control regime too far, no essential change in the policy framework was made and the deregulation was carried out within the existing framework. This process, sometimes called 'liberalization by stealth,' continued into the 1980s with some acceleration, especially in 1985-86 and 1986-87, the first two years of Prime Minister Rajiv Gandhi who succeeded his mother as prime minister following her assassination on October 31, 1984.[9]

Alongside this piecemeal liberalization, India also pursued an expansionary fiscal policy to fuel growth in the 1980s. The stimulus and liberalization together lifted the annual GDP growth rate by one percentage point to 4.6 per cent during the period 1981-82 to 1987-88 from 3.6 per cent during the preceding three decades. Then, in the following three years, the economy accelerated to the average rate of 7.2 per cent. This was truly a major jump but it was also one that could not be sustained without reforms. Let me explain why.

The government had substantially financed the expansionary fiscal policy in the 1980s by borrowing cheaply abroad. Therefore, foreign debt accumulated over the years. Though stimulated by the liberalization and devaluation of the rupee, exports saw substantial growth in the second half of the 1980s, their level being only 5.5 per cent of GDP in 1986-87, in 1990-91, they were still only 7.3 per cent of GDP. As a result, debt service came to absorb almost a third of the export earnings by 1990-91. This left very limited room for even bare minimum imports to sustain growth at the high level of 7.3 per cent.

At this juncture came the Iraqi invasion of Kuwait followed by the United States invasion of Iraq, which led to a large hike in the price of oil. With India being a large importer of oil, the price hike was enough to bring a balance of payments crisis to the doorstep of the country. Maintaining the high growth of the last three years of the 1980s required a much larger export base and that meant faster and more far-reaching reforms.

Reforms Takeoff

Rajiv Gandhi was assassinated during the election campaign in 1991, which paved the way for Narasimha Rao to enter the office of the Prime Minister. By this time, the collapse of the Soviet Union, which India had partially emulated since Independence, the economic success of China following its launch of liberalization policies and India's own policy failures for decades had created a generally favourable environment for a turn to more liberal policies. Rao, the first Congress

9 Details of this liberalization are described in Panagariya (2008).

prime minister without any link to the Nehru family, saw an opportunity in the crisis and launched a major program of systematic and systemic liberalization.

In one stroke, Rao put an end to investment licensing and opened India to foreign investment. Simultaneously, he ended import licensing on all imports other than consumer goods. The latter had to wait another decade when the United States challenged the remaining quantitative restrictions in the World Trade Organization and the Indian government lost in the wake of a compelling panel report written under the guiding hand of Richard Snape, who happened to be the only economist on the panel.

In view of India's past devotion to the command and control regime, many observers had argued that since the reforms had been done under the conditionality imposed by the International Monetary Fund and the World Bank as a part of their loan packages necessary to pull India out of the crisis, the country would return to business as usual as soon as the balance of payment situation had improved. In the event, while the stabilization program was successful and India did quickly accumulate a comfortable level of reserves, the reform process Rao had launched did not come to a halt. He continued to liberalize trade through major reductions in tariffs, introduced major reforms in the financial sector, gave entry to private carriers in the domestic airline business, brought private players into the telecommunications sector and launched a program of dis-investment whereby minority stakes in many public sector enterprises were sold to the public.

Rao was successful in restoring confidence in the economy with GDP growth recovering from 1.4 per cent in 1991-92, the crisis year, to 5.4 per cent in 1992-93 and averaging just under 7 per cent in the subsequent four years. Rao nevertheless lost the election in May 1996 and three short-lived governments followed within the span of less than two years. Luckily, when the nation went back to early polls in March 1998, the Bharatiya Janata Party (BJP) led National Democratic Alliance (NDA) scored a victory and Prime Minister Atal Bihari Vajpayee took charge of the nation's highest office. Vajpayee ruled India the following six years until May 2004 when the NDA lost the election to the United Progressive Alliance (UPA), which has ruled India for the last nine years with Dr. Manmohan Singh as the Prime Minister.

Vajpayee showed true commitment to liberalizing reforms. Unlike Rao, who had been timid in making any public claims of his near 180-degree turn in policies and often characterized the reforms as a continuation of the past policies of the Congress party under Prime Ministers Nehru, Indira and Rajiv, Vajpayee openly and forcefully advocated reforms. With the notable exceptions of higher education and the labour market, he made progress in virtually all policy areas during his six-year rule.

Trade was liberalized in a sustained manner with import licensing on consumer goods imports coming to an end in 2001. Foreign investment caps were liberalized in many sectors. Life and general insurance were opened to the private sector with foreign investment permitted up to 26 per cent. The small-scale industries reservation was substantially ended.

The New Telecom Policy of 1999 revolutionized the telecommunications sector with the tele-density rising from just 2.8 per one hundred people in 1999-2000 to more than 80 today. So successful has been the telecom reform that even rural India boasts of two phones per household on average today. Substantial progress was made in reforming the indirect tax system with a large number of complex excise duties replaced by a central value added tax rate and the principle of the value added tax introduced at the level of the state. Genuine privatization as opposed to dis-investment of minority stakes was undertaken in the case of several public sector enterprises.

In agriculture, reform of marketing of agricultural produce was launched and genetically modified Bt. Cotton seeds were introduced, which led to a sustained increase in the productivity of cotton production. In the social sector, a universal education movement was launched based on the passage of legislation recognizing education for children aged six to fourteen years as a fundamental right. A program to build all-weather roads linking villages to nearby cities and the total sanitation campaign were also launched.

The Vajpayee government had particular success in building the country's infrastructure. It built major highways and worked toward modernizing ports. The golden quadrilateral highway linking Delhi, Mumbai, Chennai and Calcutta was converted to four lanes in record time. According to a recent filing by the government in the Supreme Court, half of the highways built in the last 30 years were built under the NDA government. Above all, the government launched a fundamental reform of the electricity sector that had the potential to modernize and greatly expand India's electricity system. Unfortunately, the successor government all but abandoned that reform.

In the area of macroeconomics, the government freed administered interest rates on many government savings instruments, which had held the rate above market rates. It made a special effort to bring down fiscal deficits and pioneered the fiscal responsibility legislation. The government's success in streamlining the monetary policy was reflected in inflation decreasing to below 5 per cent. On the external front, the current account deficit remained low with the last three years of the NDA rule showing a modest current account surplus. The rupee remained stable with foreign exchange reserves rising from $29.4 billion at the end of March 1998 to $113 billion at the end of March 2004.

Accelerating Growth and Declining Poverty at Last

Contrary to the sceptics who argue that outward orientation and pro-market reforms can deliver precious little in terms of growth and poverty removal, the Indian economy responded to the reforms in a more or less textbook fashion. The initial Rao era reforms stabilized the economy and placed it on a sustainable growth path. For a time, it seemed that the economy had shifted to a 7 per cent per annum growth path but uncertainty due to unstable governments following the defeat of the Rao government, the Asian currency crisis, several sub-normal monsoons and some economic sanctions following the May 1998 nuclear tests by India had an adverse impact on growth.[10] Even then, the economy managed to register 5.9 per cent average growth between 1992-93 and 2002-03. This growth rate was higher than what India had experienced in any prior eleven-year period.

Of course, once the temporary problems of the second half of the 1990s went into remission and economic agents began to respond to the Vajpayee-era reforms, growth accelerated with the economy shifting to an 8 per cent plus annual GDP growth path. The growth rate was 8.1 per cent in 2003-04, the last year of the NDA rule, and averaged 7.9 per cent during the full decade ending in 2012-13. But for the sharp fall in the growth rate in the last two years of this period to the average level of 5.6 per cent, which I will describe in greater detail later, the growth rate during the decade had been even higher: 8.5 per cent between 2003-04 and 2010-11. So robust was this growth that even in the peak year of the global financial crisis, 2008-09, the growth rate remained 6.7 per cent and bounced back to 8.6 per cent in 2009-10 and 9.3 per cent in 2010-11. The acceleration in growth can be readily seen in Figure 2 in which the per-capita GDP curve turns steep in the last ten years, a sharp contrast to its flat shape in the first three decades.

With growth finally materializing, we can return to the question of whether or not it is effective in helping bring poverty down. Using the large household expenditure surveys, conducted approximately every five years in India, we can compare the extent of poverty in India at three distinct points in time in the post-reform era:

[10] See Acharya (2012) for further details on this point.

1993-94, 2004-05, and 2011-12.[11] Drawing on my recent joint paper, Panagariya and More (2013), I show the proportion of the population below the official poverty line in the three years according to four different classifications. In Figure 3, I show poverty in rural and urban areas and both regions taken together. In Figure 4, I show poverty by social groups, identifying separately the historically disadvantaged Scheduled Castes and Scheduled Tribes. In Figure 5, I report poverty figures by religious groups. And finally, in Figure 6, I report poverty ratios for the 21 largest states.

Three important points may be gleaned from these figures. First, whether we look at poverty by region (rural and urban), social groups, religious groups or states, it has steadily declined. Second, the decline has accelerated between 2004-05 and 2011-12 over that between 1993-94 and 2004-05 regardless of the dimension along which we measure poverty. Finally, percentage point declines in poverty among Scheduled Castes and Muslims, who exhibited higher initial levels of poverty, have been larger than in the general population. Therefore, the gaps in poverty across social and religious groups have been narrowed. The Scheduled Tribes remain an exception to this trend perhaps because they are outside the mainstream. Poverty has declined among them as well but at about the rate of the general population.

[11] Two additional such surveys were done in 1999-2000 and 2009-10. I do not report poverty estimates based on the 1999-2000 survey because a change in its design rendered it non-comparable to the rest. I also choose not to report the estimates from 2009-10 partly because it is too close to the 2011-12 survey, which is the latest one available, and partly because being a drought year, it produces several anomalous results ex post. The estimates from the 2009-10 survey can be found, however, in Panagariya and Mukim (2013).

Figure 3 **Poverty in rural and urban India at the Tendulkar poverty line**

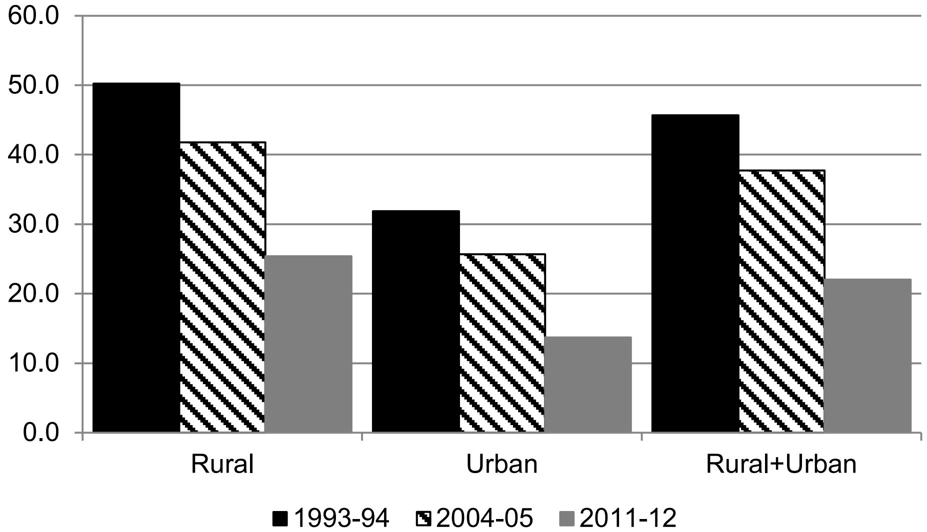


Figure 4 **Poverty in India by social groups at the Tendulkar poverty line**

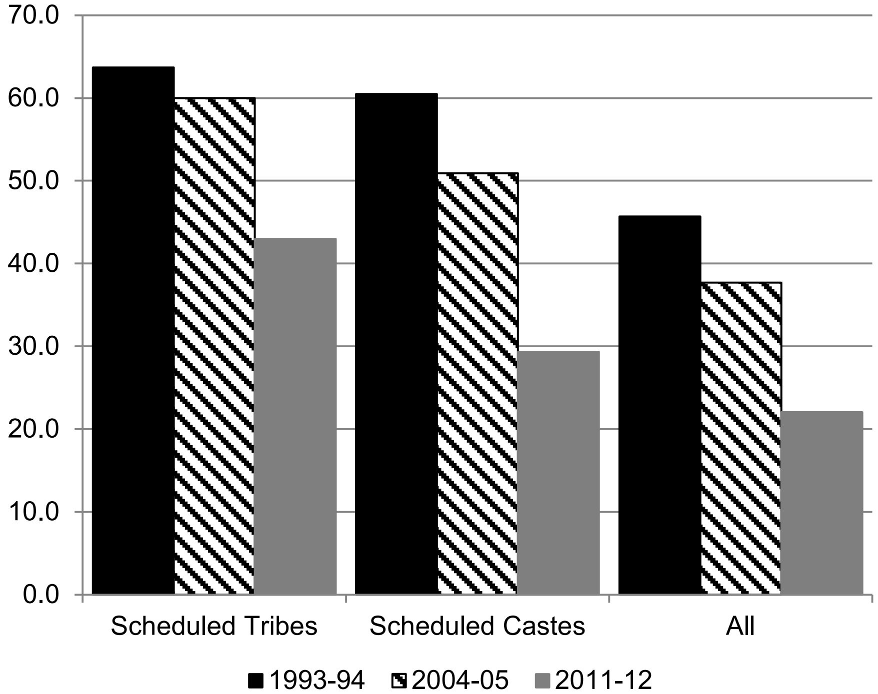


Figure 5 **Poverty in India by religious groups at the Tendulkar poverty line**

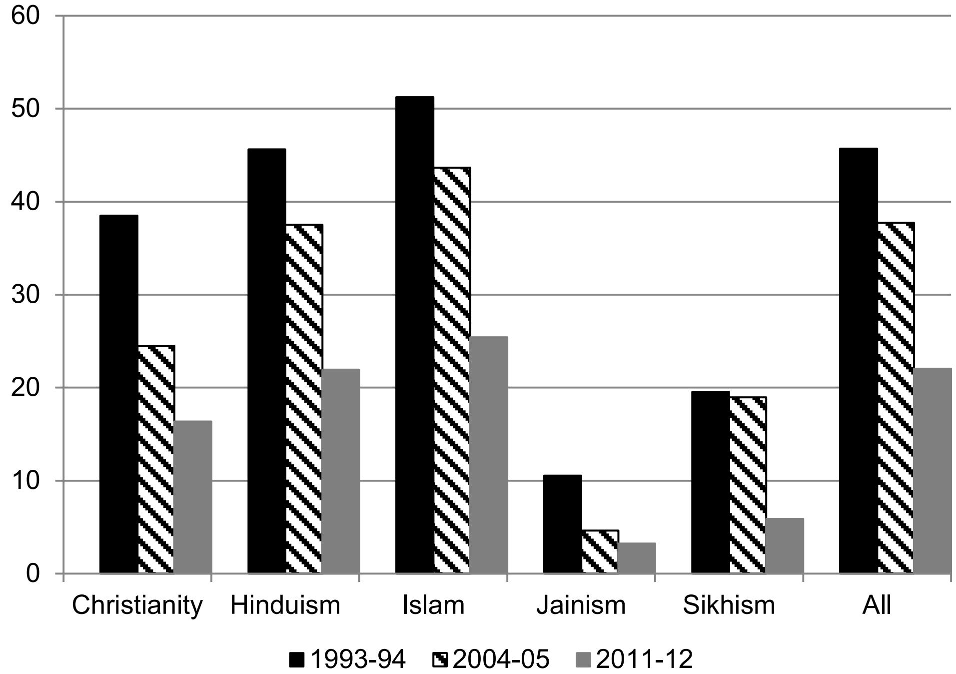
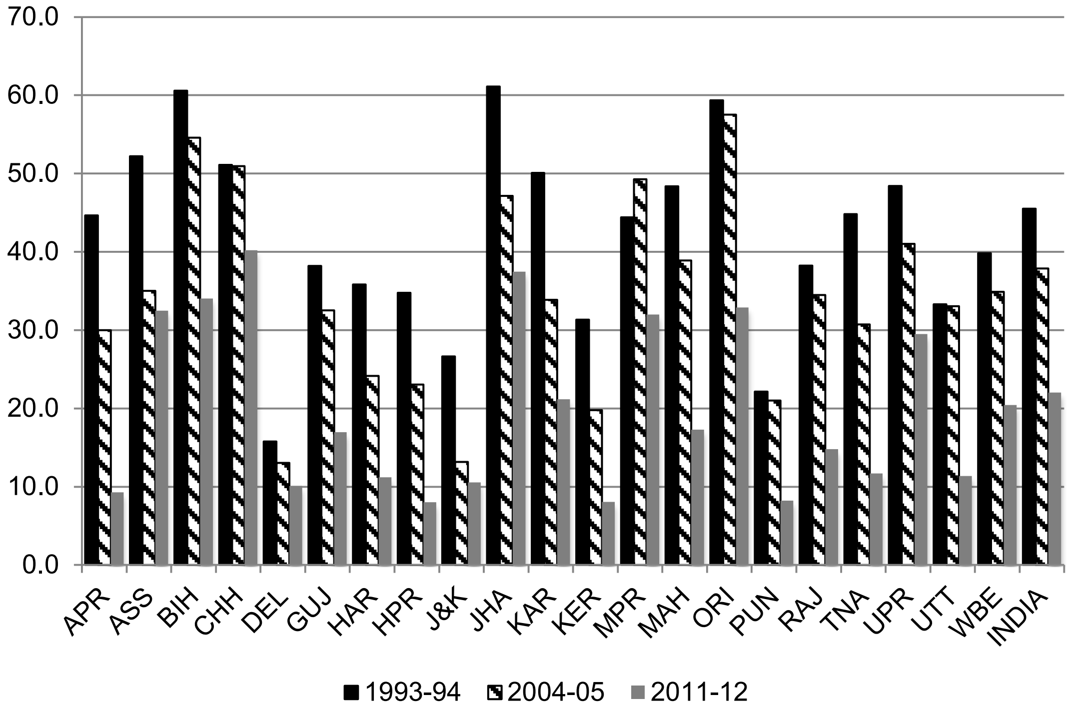


Figure 6 **Poverty by states at the Tendulkar poverty line**



Alas, Reforms Stall and Growth Falters Again

The NDA had contested the 2004 election on a pro-reform platform and lost it. There were many straightforward explanations for the loss but the incoming UPA government, supported from outside by the communist parties, took the view that the reforms had helped only a handful in the urban areas with the poor, especially in the countryside, shortchanged.[12] The incoming Prime Minister, Manmohan Singh, stated in his maiden address to the nation that his government would work towards reforms with a human face.[13] This view was, of course, contrary to the empirical reality. In contrast to the pre-reform era, poverty had declined in the post-reform era so that reforms did have a human face. Indeed, the entire rationale for the reforms had been that the pre-reform policy framework had failed to deliver on both growth and eradication of poverty. A handful of us tried to point this out but had little traction within the left-dominated intellectual environment of the day.[14]

The rhetoric of 'reforms with a human face' translated into the government essentially giving up on growth-oriented reforms or what I earlier referred to as Track I reforms. Sadly, the government even failed to build infrastructure at the necessary pace despite the fact that there was little political disagreement on the need for it. Instead, it focused solely on Track II expenditures, expanding the existing social expenditure schemes and introducing new ones. The foremost among the new schemes was the National Rural Employment Guarantee Scheme that guaranteed one hundred days worth of unskilled employment every year to one member of every rural household.

Initially, the growth momentum from the Rao-Vajpayee reforms was sufficiently strong that discontinuation in Track I reforms seemed not to matter: it was as if the economy was on cruise control. With the NDA having also built the infrastructure that could accommodate the rising demand for it, no serious bottlenecks emerged immediately. But this changed with the elapse of time with serious challenges emerging in the last two years.

[12] One obvious explanation was that the DMK, a party from the southern state of Tamil Nadu, which won 14 seats in the election, had switched its alliance from the NDA to the UPA. That switch alone made a difference of 28 votes, enough to tip the balance in favour of the latter.

[13] In his first address to the nation after being appointed prime minister, Manmohan Singh said, 'Reforms are needed, I've always said that, but economic reforms with a human face that give India's common man a real hope.' See http://www.cnn.com/2004/WORLD/asiapcf/05/19/india.politics/index.html.

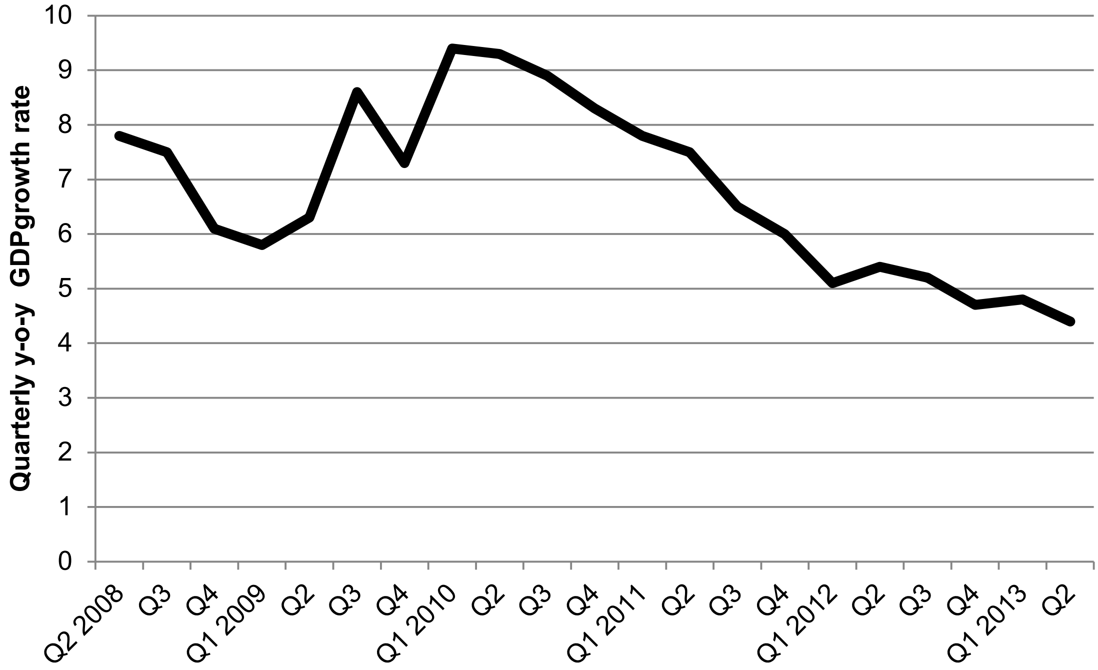
[14] For example, see my op-ed 'It's the Human Face, not Scarface' in the *Economic Times*, June 29, 2004.

In addition to the failure on the reforms and infrastructure front, the greatest shock to the economy came from paralysis in decision making at the highest levels of the government. There were two sources of this paralysis. First, soon after the UPA returned to power in 2009, its hyperactive environment minister began denying environment clearance to project after project. He was later replaced but his successor chose to stay the course. Second, beginning in 2010, a series of corruption scandals broke out that landed a few ministers and several high-ranking officials in jail. That led risk-averse senior bureaucrats to prudentially stop taking decisions on all major projects. While any decision, when taken, can be subject to charges of bribery, inaction is free of such risk. For senior bureaucrats who are on the last leg of their careers, the latter course makes vastly greater sense than the former.

The paralysis had a major impact on new investments, especially by corporations. If the existing projects were not cleared, it made little sense to add more projects to the pipeline. But the paralysis also had an adverse impact on the utilization of existing capacity. For instance, the lack of ready access to coal and natural gas, which are controlled by the government, led to a significant underutilization of capacity in the power sector.

The result has been that Indian growth, which had looked unstoppable even two years ago, is now faltering. This is graphically brought out by Figure 7, which depicts the quarterly growth rates of GDP beginning with the first quarter of the fiscal year 2008-09, which is also the second quarter of the calendar year 2008. As the figure shows, GDP growth saw a sharp drop in the third and fourth quarters of 2008 as the global financial crisis unfolded, but then recovered quickly. The growth rate reached 9.4 per cent in the first quarter of 2010 but then began a downward slide with no bottom in sight. In the second quarter of 2013, the last quarter for which we have data, growth stood at a paltry 4.4 per cent. It is as if India is back to square one with the socialist-era growth rate reinstated.

Figure 7 **Quarterly growth of GDP from the first quarter of 2008 to the second quarter of 2013**



Looking Ahead: India in the Global Economy in the Next 15 Years

We are now in a position to turn to the question: how important will India be in the global economy in the next 15 years?

Let me first reveal my personal biases. I have been and remain upbeat on India and think there is a good chance that in 15 years time, it will be the third largest economy in the world. Lest you conclude that I am looking at a pie in the sky, let me offer a back-of-the-envelope calculation suggesting at least the feasibility if not plausibility of this proposition.

During the past ten years from 2003-04 to 2012-13, GDP in India has grown annually on average at 13.8 per cent in nominal dollars. Going by the Consumer Price Index, the average annual inflation in the United States during this period has been 2 per cent. This inflation rate places the Indian growth rate in real dollars during the last ten years at 11.8 per cent per annum.

In view of this impressive figure, it is not pure imagination to contemplate 11 per cent per annum growth in real dollars in India in the next 15 years. In 2012-13, India's GDP was 1.84 trillion dollars at the average exchange rate prevailing in that year. Assuming an 11 per cent growth rate, thanks to the power of compounding, this GDP would rise to 8.8 trillion dollars in 2012-13 dollars in 15 years. This compares with the 2012 GDP of 6 trillion dollars in Japan, currently the third largest country by GDP. Judging by the performance of the Japanese economy in recent years and the prospects of a shrinking labour force, it is unlikely that the Japanese GDP would surpass the 8.8 trillion dollar mark in the next 15 years.

One can certainly contest my calculation and the claim that India would surpass Japan in the next 15 years, but not the slightly weaker proposition that if the Indian economy can perform on average at the level it has done in the last ten years, it will be one of the most important economies for investors in the forthcoming years. And surely, over a slightly longer time horizon, say 25 years, its prospects of turning into the third largest economy are very real indeed.

Before this conclusion can be secured, however, I must answer the question why the prospects of repeating the performance of the last ten years in the next 15 are realistic even though the current growth rate has dipped below 5 per cent. There are five reasons for my optimism:

- First, the savings rate in India has now risen to more than 30 per cent. The impending demographic change means that this savings rate might rise further. Therefore, capital accumulation necessary to sustain the growth of the past ten years is entirely feasible.
- Second, with its population getting younger by the hour, India will also not face a shortage of labour. Moreover, nearly all six to 14 year old children are now in schools so that the future workforce is likely to be better educated than the past one.
- Third, having opened to world markets, Indian entrepreneurs must now compete against the best in the world. They can no longer produce shoddy goods and still recover a decent price for them.
- Fourth, India has a longstanding tradition of entrepreneurship. Even with their hands as well as feet tied during the heyday of the command-and-control regime, they managed to deliver 3.5 per cent per year growth. They can do far better in the current liberal policy environment.
- Finally, India is still a very poor country. That means it has enormous scope to play catch-up to the global technology frontier. It is not constrained to grow just by the rate of capital accumulation and global productivity growth. It can expect much faster growth in productivity as it moves towards the global technology frontier.

Counteracting these favourable factors are the so-called 'governance' gaps India faces. No economy can flourish over a long period of time without the government doing its part. For instance, rapid growth creates demand for infrastructure, which requires deep involvement of the government. Even if private builders can be counted on to do the building part, it is the government that must acquire land, issue contracts and ensure that contracts are fulfilled. Likewise, the government must supply basic amenities such as electricity, water and sewage. Without them, housing projects essential for urban development cannot be completed. The government also has the responsibility to develop and implement environmental regulation in a way that provides room for the growth of industry. Finally, the government must continuously reform policies that impede development. Today, manufacturers must operate under archaic labour laws — 50 of them legislated by the centre and three times as many by the states — that stifle the growth of labour-intensive manufactures. There is a crying need for the reform of these laws.

Industry versus Services and World versus Domestic Markets

I cannot conclude a lecture on India's prospects in front of a distinguished audience in Australia without briefly addressing the twin issues of the role of industry versus services and world versus domestic markets in India's future growth. Although opening to trade and a rising trade-to-GDP ratio have been important aspects of India's turnaround during the past two decades, it remains true that India's path to-date has been markedly different than that of the miracle economies of Asia.

Whereas growth in South Korea and Taiwan in the 1960s and 1970s, and China more recently, was been driven by a massive expansion of labour-intensive manufactures such as apparel, footwear, light consumer goods and assembly activities, it has been propelled by skilled-labour-intensive services and capital-intensive manufactures in India. Sectors that have flourished in India include skilled-labour-intensive services such as software, telecommunications, transportation and banking and capital-intensive manufactures such as engineering goods, automobiles and auto parts and chemicals.

This pattern has meant that India's share in the world merchandise exports has grown very slowly and despite its large size remains 1.7 per cent today. Domestically, the share of manufactures in GDP has remained constant at the low 15 per cent level since 1991. In turn, job growth in India's urban areas has been considerably slower than in South Korea and Taiwan in the 1960s and 1970s and China recently. The end result has been limited rural-urban migration and hence a slow pace of urbanization.

The million dollar question this raises is whether India can continue to traverse the current course and still transform itself into a modern economy in the next two decades or must nudge its economy towards the road that the successful East Asian countries have taken in the past thereby accelerating the output and exports of manufactures. My unequivocal answer to this question is that India has no choice but to follow the East Asian example. While it must maintain the momentum achieved in services, it is essential to accelerate the growth of labour-intensive manufactures. Let me briefly explain why.

Today, India has a workforce of nearly half a billion. Approximately half of it is employed in agriculture, which contributes less than 15 per cent to the GDP. This is a massive workforce living on a very small income. Of the remaining half of the workforce, only 11 per cent works in the formal economy: 7 per cent in the public sector and 4 per cent in the private organized sector. The remaining 89 per cent of the workers not employed in agriculture toil in the informal, unorganized sector. It is also worth recalling that nearly 70 per cent of the population still lives in rural areas.

Despite average growth of 7 per cent for nearly two decades, why has India progressed so little towards modernizing its economy? The answer as already hinted above is that whereas rapidly expanding labour-intensive sectors massively absorbed workers migrating from rural to urban areas in East Asia during its high-growth phase, these sectors have faltered in India. As an example, today, apparel exports from India are less than one-tenth those of China and less in absolute value than those from Bangladesh, a country less than one-eighth its size. Poor performance of labour-intensive sectors has meant poor growth of formal-sector jobs and therefore limited gains in the real wages of unorganized-sector workers as well.

It is this slow growth of decent jobs for workers that the Indian growth process must overcome. In turn, this requires policy changes that would make it attractive for entrepreneurs to employ labour-intensive technologies and to massively enter labour-intensive sectors. This does not require the government picking winners — in my understanding, that was not the key to the growth of the labour-intensive industry in South Korea and Taiwan, notwithstanding the claims of many to the contrary — but instead reform of policies, especially those relating to labour markets. There is no reason why, as per 2004-05 data, 85 per cent of apparel workers in India are employed in firms of seven workers or less while only 0.6 per cent of the Chinese apparel workers are employed in such tiny firms. India must expand both the output and exports of its labour-intensive manufactures if it is to speed up the creation of good jobs to achieve faster urbanization and modernization. And with China poised to exit the basic labour-intensive sectors such as apparel and light consumer goods, the timing for India could not be better.

In Conclusion

Until a little over a year ago, I did not believe that the growth rate in India could drop below 5 per cent. In view of the resilience with which India had weathered the Lehman crisis and rapidity with which it bounced back to an 8 per cent plus annual GDP growth rate, I had come to believe that a large economy such as India, which was becoming larger by the year, could not be easily stopped. But, alas, India's current government has done what had seemed highly improbable if not outright impossible.

So I must qualify my optimism and say that if a pro-reform government returns in the 2014 elections, India's chances of returning itself to a double-digit-growth path in real dollars and becoming the world's third largest economy in 15 years remain excellent. If the electorate hands a third term to the UPA, however, and the UPA-3 stays the course chartered by the UPA-2, the poor in India will have to suffer a lot longer than they need to. We shall see.

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