

Preface to the Paperback Edition

We believe that India has a chance for a tremendous breakthrough in economic development in this first decade of the twenty-first century. There are several reasons for this view. The current government enjoys a reasonably strong electoral mandate. A decade of opening of the economy has produced a new dynamism, most dramatically in the Information Technology sector which gives fresh opportunities for economic and social development. Demographic trends, especially a declining population growth rate and a rising share of working population, contribute to higher per capita income. The world is waking up to India's crucial role as the largest democracy and as a vibrant economy, even though a low-income one. GDP growth rates can be raised and sustained beyond 6 to 6.5 per cent, should certain critical reforms be implemented soon.

India's economic reforms have played a critical role in the performance of the economy since 1991. It is important to note that despite the slowdown in 1997-8, the average growth rate in the four years, 1994-5 to 1997-8 was 6.9 per cent, significantly higher than the growth rate of 5.6 per cent achieved in the 1980s. Moreover, the growth in the 1980s was not sustainable without further reforms, as the lack of export dynamism contributed to a balance of payments crisis at the end of the decade. In 1998-9, the GDP is estimated to have grown at 5.9 per cent. The positive trends currently being seen in most sectors of the economy have been able to more than neutralize the debilitating effects of two general elections in two years, the crisis in East Asia, the nuclear explosions and the US sanctions that followed, and Kargil operations.

Two significant measures were taken by the BJP-led NDA government in 1999 that indicated the Government of India's

continued commitment to the economic reform process. These were: the passage of the Insurance Regulatory and Development Authority (IRDA) Act 1999 in parliament and a substantial increase in the administered prices of diesel despite fierce opposition from several quarters, including a long drawn strike by truckers in October 1999. The passage of IRDA Act by the parliament was a major milestone in India's on-going economic liberalization process as it opened the way for the private sector in the insurance business, which had been a government monopoly for decades. These factors, among several other initiatives, led one to believe that the union budget for 2000-1 might usher in some hard reform measures, especially with regard to the fiscal situation. However, that did not turn out to be the case.

Keeping in view the fact that the fiscal deficit runs very high, the process of fiscal consolidation was not pursued as vigorously in the budget as would have been ideal. Large and persistent fiscal deficits in India are a serious cause for concern. Considering the excessive preemption of the community's savings by the government, the potential for crowding out the requirements of the private sector, the pressure on interest rates, and rising interest payments on government debt, it is extremely essential to reduce the fiscal deficit, mainly by lowering the revenue deficit. The process of fiscal consolidation needs to be accelerated through more qualitative adjustments to reduce government dis-savings. Expenditure reform in India is critical in view of the fact that India's government dis-saving and overall level of government spending remains high. There is probably little room to further reduce capital expenditures, for they have already been squeezed to a mere 3.3 per cent of GDP in 1998-9. Of course, in the future, it is the private sector rather than the government that should meet most of the enormous infrastructure needs of a growing economy. Still it is hard to imagine that rapid growth can be accomplished with public investment at less than the current rate relative to GDP.

We believe that deficits should be brought under control mainly by cutting down government expenditure relative to GDP rather than by raising revenue relative to GDP. It is the current expenditure that needs to be reduced significantly. Current expenditures at the central level are predominantly made up of interest payments, grants to states, subsidies, and defence

expenditure. In all these areas, there will be higher levels of spending relative to GDP as per the budget for 2000-1. Interest payments will go up substantially. In the year 1999-2000, the net borrowing requirements, that is, the fiscal deficit is going to be over Rs 1,00,000 crore. The fiscal deficit is thus likely to increase to 5.6 per cent of GDP from the budget target of 4 per cent. In terms of interest payments in the year 2000-1, this implies an additional expenditure of Rs 10,000 crore. Grants to states will go up under the interim award of the Eleventh Finance Commission. Allocation of funds for defence expenditure, of course, has been hiked by Rs 13,000 crore more than in the budget estimate for the year 1999-2000, and this will weigh heavily on the budget and on the economy. Expenditure under food and fertilizer subsidies may go down marginally should the government be able to withstand the pressure from its allies. With respect to internal public debt, privatization of public enterprises could raise significant funds as a per cent of GDP, which could then be used to buy down the public debt. By announcing disinvestment to the tune of Rs 10,000 crore only, of which, a mere Rs 1000 crore is proposed to be used for retiring debt, the budget takes a very small step in the direction of privatization.

As with the central government, the financial condition of the state governments in India has also been a cause for concern. Over the years, the consolidated financial position of the state governments has shown a marked deterioration in some of their major deficit indicators. One of the fundamental weaknesses of state government finances in India can be attributed to the increases in non-developmental expenditure, particularly the revenue component of the non-developmental expenditure, and interest payments as a proportion of revenue receipts. These problems have been greatly aggravated over the past few years for a variety of reasons. The resource constraints in state finances have been accentuated by a near stagnant tax-GDP ratio, a rising share of non-developmental outlay in the total expenditure, large volumes of hidden or implicit subsidies and increasing financial losses of state enterprises.

A growing pressure on state finances has also stemmed from the rising demand for public services. Furthermore, the fiscal situation in the states is likely to come under much greater pressure with the acceptance of the report of the Fifth Pay Commission by

several state governments in India. The slow growth in revenue mobilization at the state level has posed serious difficulties for the state governments to meet their expenditures. Be that as it may, the critical problem in state finances is not only one of high levels of expenditure, but also one of increasing distortions in the pattern of expenditure.

In the final analysis, fiscal control will require an overhaul not just in budgetary patterns, but in the basic functioning of the public sector in the economy. For example, privatization is an important means to reduce the overhang of public debt. Similarly, privatization of infrastructure services is a key method to relieve the growing burden on state budgets, which are weighed down by losses of State Electricity Boards (SEBs) and other parastatal institutions. Greater autonomy for local and state-level governments in infrastructure reform and investment priorities will similarly allow the central government greater freedom in cutting back on transfer payments to the states, which will be in a better position to prioritize and economize on state spending.

A few of the Indian states have been more reform-oriented, such as Andhra Pradesh, Gujarat, Karnataka, Maharashtra, and Tamil Nadu, while states such as Haryana, Kerala, Orissa, Madhya Pradesh, Punjab, Rajasthan, and West Bengal have lagged in carrying out state-level reforms. Bihar and Uttar Pradesh are even further behind. States that move against the populist policies and set up regular markets for services, such as power and water, are going to be ahead of the rest in the game. They are likely to garner faster state-level economic growth and job creation, from both domestic and foreign investments.

Broadly speaking, there are currently rather significant differences in reform interest and economic performance between a large part of northern India and southern India. Karnataka, Tamil Nadu, and Andhra Pradesh are quite dynamic now in trying to improve the physical and legal infrastructure, in order to attract large-scale foreign investment. In the north especially in Bihar and Uttar Pradesh, one does not see the same kind of reform dynamism and the results are therefore poor in terms of economic growth. We believe that these differences will be noticed politically sooner rather than later, as inequalities between states in their economic performance become glaring. The states that are ahead will be rewarded with better performance while the states that are behind

will find that there is the demand to catch up with the states that are growing. This kind of inter-state competition will spur the overall reform process, as has the inter-regional competition in China.

We would like to highlight India's growing capacity in service-sector exports based on Information Technology. India is becoming one of the most important players of the world in the IT sector and it is the fastest growing foreign exchange earner for the country. Several US and European companies have located their back office operations in Bangalore, Chennai, and Pune. Abundant supply of labour, low wages, cheap satellite communications and the internet have been instrumental in the decision of foreign firms to establish their back office operations in India. Such operations create job opportunities in Indian cities and help lower costs for the foreign companies. These range from billing to payroll handling, from credit appraisal to airline reservations, and from inventory management to answering customer complaints. Data transcription and transmission for hospitals in the US and telemarketing for US firms is also being undertaken by Indian companies based in various Indian metropolitan cities.

We believe that the government could do more for this industry, not necessarily through direct subsidies, but mainly by liberalization of telecommunications, which would allow new entry of major domestic and international players in the business, thus resulting in lower priced services. These companies could lay down a widespread fibre optic network in India and increase the bandwidth available for Indian business and put the country even more centrally on the international scene. Moreover, the government needs to support basic science and R&D in this sector to some extent because India has world-class engineers and scientists that have already brought it ahead in an important way and could keep it in the very forefront of this new technology.

The engine of growth of the booming Indian IT sector is the software industry, which has grown at an estimated average annual rate of 60 per cent between 1992 and 1999. India's software industry has also achieved a worldwide reputation for providing excellent quality: many local software firms have earned ISO 9000 as well as SEI-CMM certification, with five of them having reached Level 5 (only 9 firms worldwide have reached this level). India has achieved this feat by leveraging its most valuable resource: highly

skilled manpower. The country today boasts of the second-largest English-speaking pool of scientific manpower in the world and 70,000 computer professionals every year, in addition to the graduates from the prestigious Indian Institute of Technology (IIT). We are of the view that the Indian IT Industry, by intelligently leveraging its inherent strengths, can secure a decent share of the lucrative internet software market and eventually emerge as an e-commerce leader.

The Indian software industry, which employed 160,000 professionals in 1998-9, has zoomed from a mere US \$ 20 million 10 years ago to US \$ 4 billion in 1998-9, of which US \$ 2.6 billion was exported. This industry has clearly emerged as a major export earner for the country, contributing to 8 per cent of total merchandise exports. The union budget for 2000-1 proposes to phase out exemptions from income tax for export earnings over a five-year period: 20 per cent from the financial year 2000-1, and by 20 per cent each subsequent year till they reach a zero level. This budget proposal may well end up hurting India's exports.

We feel that some of the initiatives announced by the government in the Exim policy for 2000-1, such as establishing, as in China, SEZs, in different parts of the country, and fully involving the state governments in the export efforts are welcome steps. While these measures will undoubtedly provide great impetus to India's export efforts, it is critical for India to abolish product reservation for the small-scale industry and to liberalize labour laws if India is to attain and sustain high rates of export growth.

Let us now turn to the politics of economic reforms. Except for the emergence of a greater political stability at the central level, an important development in its own right, little has changed since we wrote last. In the political chapters of the book, a distinction was drawn between mass politics and elite politics. The argument was that even though economic reforms had a tremendous potential to remove mass poverty, their value was understood and debated only in India's elite circles. In electoral and mass politics, we argued, economic reforms were yet to become a factor, and the link between reforms and mass welfare was not brought out clearly in electoral campaigns and political rhetoric. Hotly debated in the English-language press and metropolitan circles, reforms were

practically irrelevant to elections, where identity politics far outweighed reform politics.

The national elections of 1999 have further confirmed this insight. Celebrated in India's intellectual and elite circles as well as outside the country, two of India's major reformers, Manmohan Singh and P. Chidambaram, were defeated in the parliamentary elections of 1999. Reforms, to be sure, were not the reason for their defeats, but their association with India's reforms did not electorally help them either. The elections were simply won or lost on other issues.

Some commentators have argued that the state-level victory of Chandrababu Naidu, Chief Minister of Andhra Pradesh and an enthusiastic reformer at the state-level, has signaled a shift in Indian politics, showing that a politician closely identified with economic reforms can also get a mass mandate in elections.

A careful political analysis of election data shows this argument to be wrong. First, Naidu benefited immensely from the alliance he made with the BJP. Compared to the previous elections, the Congress party, opposed to Naidu's party, the TDP, achieved a remarkable 4.3 per cent vote increase in the state. As against this, the BJP-TDP alliance increased its share of popular vote by a mere 0.5 per cent increase. However, as is often true in first-past-the-post election systems, the vote swing in favor of the Congress party was nullified by the combined power of the TDP-BJP alliance. The TDP's election victory was thus an artifact of alliance politics, not the result of a substantial swing in popular vote. The TDP's performance would have been worse if the Congress had had a superior alliance-making strategy. Without an alliance with the BJP, the TDP in all probability would not have been able to form a government.

Second, in an interview to the *New York Times* just before the elections, Naidu himself denied that a pitch for reforms was the main plank of his election strategy.¹ He argued that while reforms undoubtedly enhanced mass welfare in the long run, their short run impact was not unambiguously clear, and since elections were fought in the short, not the long, run, 'he must also deal with the reality that voters want government to help them now... people need something today'.

¹ Celia Dugger, 'Even the Poor Pay Heed to the Esoterica of India's Riches', *New York Times*, 10 September 1999.

It is thus wrong to read the election victory of Naidu as a popular mandate for reforms. But there is no doubt that, by providing political stability, Naidu's triumph gives him a remarkable new opportunity to push reforms and show positive results before the next round of elections is fought. This can, in turn, generate a new political dynamic at the state-level. If reforms in Andhra Pradesh succeed, other states will almost certainly compete with it and try to attract investor attention. Since states will not get substantial private investment—foreign and domestic—if their economic policies are not reformed, the likely consequences of Naidu's victory are positive for economic reforms, even though reforms were not the cause of his victory.

The 1999 elections and developments since then continue to call for a new political imagination. Politically speaking, market-oriented economic reforms in India, though highly economically desirable, did not emerge from below, which is where the masses are located. As is true of many other countries outside the former Communist bloc, India's reforms also emerged from above. The breakthrough was made by the government in 1991—during a moment of economic crisis that demonstrated the exhaustion of statist and inward-looking economic strategies. The 1991 elections, however, were not fought on alternative economic strategies. The masses may have felt an acute dissatisfaction against the excessive and abusive powers of the state under the older economic regime, but a desire for lesser state interference in everyday life does not necessarily translate into a support for economic reforms. It would be an awful mistake to interpret the turn towards economic reforms as a sign of vigorous mass support for them. Indeed, if India's reforms fail to deliver mass welfare before long, a political backlash against India's continuing liberalization and globalization cannot be ruled out. As of now, democratic politics and market-oriented economic reforms are quite awkwardly aligned. It is not a happy and permanent marriage.

In normative terms, this political interpretation of economic reforms presents a challenge as well as suggests a possible danger. The challenge, as we argued, is simply that reformers must produce a political language and rhetoric aimed at creating a mass constituency for reforms; show how reforms can make life better for the masses, not simply for the middle class and the rich; and think of ways to make reforms politically attractive for politicians.

Otherwise, because of political reasons, deeper reforms such as privatization, a change in labour laws, dereservation of the small industrial sector and a greater deregulation of agricultural sector—all of which are desirable and will almost certainly make reforms better serve the masses in the long run—may be either too slowly implemented, or may come later than sooner. The sooner they are put in place, the greater is likely to be the impact of reforms on mass welfare.

The danger is also quite simple. In the absence of a clearer understanding of what economic reforms can potentially do for mass welfare and rhetoric and policies that reflect that understanding, any significant short- to medium-run downturn that makes the masses precipitously worse off can take the shine off reforms in politics, and create a constituency for disciplining the uncertainties of markets through the agency of the state. It has to be more clearly demonstrated that reforms are not only about economic efficiency, but also about enhancing mass welfare, especially that of the poor. Only the latter can be the primary political rationale for economic reforms in a poor democracy. Politically speaking, greater economic efficiency must serve the larger purpose of greater mass welfare. If reforms must be pursued in a democratic framework, an imaginative integration of the political and the economic remains quite necessary.

Let us conclude by stressing that while there are many reasons to be optimistic about India's economic future, there is nothing guaranteed about India's development success in the first decade of the twenty-first century. Rapid economic growth and substantial alleviation of poverty is certainly possible, but it could founder for several reasons. First, increased military expenditures related to instability in South Asia will put an enormous threat on achieving vital fiscal gains. Second, despite India's excellence in high technology, much of India remains mired in illiteracy and exclusion. Unless Indian society, and Indian governments at all levels, truly prioritize improvements in the access of all Indians to education and health services in addition to pursuing efficiency-enhancing economic reforms, hundreds of millions of Indians will have little practical prospect of improvement in life conditions in the coming years. Third, India must not rest on the laurels of a successful decade of economic reforms. Much was accomplished in the 1990s, especially when viewed from the perspective of the opening years

of crisis of that decade. But much remains to be done: improved infrastructure, in part through privatization and completion of reforms in key sectors; attraction of much greater flows of foreign direct investment; liberalization of labour, land, and other factor markets; fiscal reform and consolidation; and finally meeting the great social challenges among India's poor and excluded groups.

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