

## ECONOMIC REFORM AND THE POOR

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It is a great pleasure indeed to be here again in Bombay, almost exactly five years after I had the honor of presenting a public lecture in the Reserve Bank. The topic then was the dangers of excessive budget<sup>2</sup> deficits and I am happy to report that the Governor of the Reserve Bank found my views on the issue to be totally sound.

A year later India was in the grip of one of the most serious financial crises in its history. Thanks to the resolute actions of the Government, which were backed by the IMF and other multilateral and bilateral creditors, India rapidly surmounted that crisis—and seized the opportunity to begin a process of change that, if sustained and deepened, will enable this country to fulfill its potential as a major economic power in the global economy. Four years since the crisis, India has emerged stronger than before. The external position is now much more robust, economic growth has been restored, industry has become more dynamic and competitive, and foreign investors have been eager to participate in India's emerging success.

If during this lecture I emphasize what still needs to be done, rather than what has been achieved, you will understand that is because it may still be possible to change the future, rather than because of a lack of appreciation of the achievements of the last four years. A visitor returning after four years cannot fail to be greatly impressed by the changes in the approach to economic policy and by changes in the Indian economy that may be more evident to the outsider than those who live here.

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1. First Deputy Managing Director, International Monetary Fund. This paper was prepared for presentation at the tenth Exim Bank Commencement Day Lecture in Bombay on March 27 1995. I am grateful to P.R. Narvekar, Charles Collyns, Ajai Chopra, Richard Hemming and Karen Parker of the IMF for substantial assistance, and to Guy Pfeiffermann of the IFC and Roberto Zaha of the World Bank for helpful comments.
  2. The substance of the lecture appears in Fischer and Easterly (1990).

When I spoke here last, I was at the World Bank. Now that I have moved to the Fund, it would be natural to re-emphasize the message of my previous lecture, that large fiscal deficits endanger macroeconomic stability. Nothing I have learned in the last five years has changed my views that fiscal policy is key to macroeconomic stability, and that macroeconomic stability is essential if growth is to be sustained and permanent progress made in the attack on poverty. This time I would add that advantage should be taken of a period of sustained growth to reduce the deficit decisively, and then I would go on to describe the supporting structural policies, among them privatization, continued trade and domestic deregulation, and financial sector reform, that are needed to ensure that the growth process takes permanent hold. However, there are three reasons not to pursue this topic: first, I do not have the privilege of speaking in India often enough to justify saying the same thing again—however crucial and correct the message is; second, I suspect that the arguments are well known and increasingly accepted by most in the audience; and third, the argument was convincingly laid out in last year's Exim Bank Commencement Day Annual Lecture by Dr. Vijay Joshi.

Alternatively, at this point, three months after Mexico devalued its currency, I could use the occasion to draw the lessons of Mexico for market-oriented reform. Interesting as that might be, let me only summarize my views by stating that Mexico has been in most respects a model reformer—in balancing its fiscal accounts, in liberalizing trade and entering NAFTA, in privatization and in aspects of domestic deregulation—but that it made the critical mistake of allowing the exchange rate to become so overvalued that the current account deficit reached and was expected to remain at eight percent of GDP. The adverse effects on confidence of the devaluation that became unavoidable, in part because of the credit policies pursued in 1994, were compounded by the structure of the government debt. Despite the setback suffered by Mexico, I have no doubt that the market-oriented approach will continue to be the only road to development and growth, albeit with variations that reflect countries' individual histories and political economies.

The Mexican case also illustrates the remarkable speed and power of private capital flows in the emerging global markets. You will not be surprised to learn that the IMF is devoting a considerable amount of thinking to adapting its role and the instruments at its disposal to enable it to help its members deal with the world of the twenty first century, whose shadow has cast itself before us in Mexico.

The topic I have chosen today, "Economic Reform and the Poor", lies at the heart of the political economy of the market-oriented approach to economic reform. The question is often posed whether such reforms have benefitted, or can benefit, the common person. The concern is entirely legitimate, for the ultimate objective of growth is to raise the living standards and the well-being of virtually everyone. This is particularly so in India, which contains a substantial portion of the world's poorest people, and where literacy, sanitation, and nutrition standards rank among the world's lowest.

In talking about economic reform and the poor it is important to get the focus correct. *The prime aim of policy must be to achieve sustained growth, for there can be no permanent improvement in the living standards of the great bulk of the population without continuing growth.* When per capita GDP is as low as it is in India, no amount of redistribution can raise the living standards of most people to the levels that have been attained elsewhere in Asia by countries that at one time were as poor as India. The question is not redistribution versus growth, but rather how to ensure that growth reduces poverty, and preferably also reduces the inequality of income.

This is a complex issue, and there is much that we, in the international agencies, in governments, and in the academic world, still have to learn about the links among adjustment, growth, poverty reduction, and income distribution. Early research by Simon Kuznets and others pointed to a worsening of income distribution in the initial stages of development, leading economists to think there was a tradeoff between growth and equity. However, both East Asia's dramatic progress over the past two decades and further academic research has made it clear that there is nothing

Before moving on to these four lessons, let me note briefly that direct poverty relief schemes also play a key role in the fight against poverty, and that India has pioneered in creating many of the most successful of such schemes. Indeed, the budget for 1995/96, announced on March 15, includes several measures aimed at poverty alleviation and spreading the benefits of reform<sup>6</sup>.

I will not discuss these and other direct poverty relief and social safety net measures in any detail, not because they are not important in reducing the social costs of adjustment, but because their scope is necessarily limited by the overall resource constraint on the economy, and because the focus of this lecture is those aspects of pro-growth policy that can help ensure that growth reduces poverty and improves income distribution.

### 1. Developing human resources

The issue of the role of government is often posed by asking whether government is too big, and the expected answer in the case of India would be yes. But that answer is at best partial, and it is certainly highly misleading. In certain areas, particularly in regulating economic activity, the tentacles of the Indian Government reach too far, and help stifle the potentially creative private sector. In other areas, including infrastructure, education and the provision of health and other social services, the Government (central and state together) is doing too little, or is misdirecting its activities.

Empirical research has consistently demonstrated the importance of accumulating human capital as a prerequisite for rapid, sustained growth in living standards. The acquisition of formal education and improvements in health standards definitely increase labor productivity. Extending educational opportunities and healthcare to the least-advantaged also empowers them to escape poverty through their own efforts. The East Asian experience shows how this can be done.

6. Specific measures include a social assistance program for the poorest, larger spending on rural housing schemes, and subsidies for life insurance for poor households.

inevitable in the relationship between growth and income distribution, and that what happens to poverty and income distribution during growth is determined in large part by policy<sup>3</sup>.

More important, the evidence suggests that rapid growth is not only compatible with, but is likely to be enhanced by policies—such as investing in primary and secondary education—that also improve income distribution and reduce poverty<sup>4</sup>.

A growing body of research indicates that the key to rapid poverty reduction is high quality growth, that is, sustained, broad-based growth that generates employment, improves the quality of human capital, and is outward oriented. The challenge is to identify the right mix and sequencing of policies so that the benefits of reform are felt quickly, and by as many people as possible. The right approach improves the human resource base and brings down the rate of population increase, as well as generating support for further reforms. Thus, a virtuous circle of rapid growth and improving living standards can be created—and has been created in many countries on this continent.

Within this general framework, I will focus on four key lessons that are particularly relevant to India's reform strategy. *First*, the most important investment a country can make is in its people. This is not a slogan, but a fact that should drive policy: the development of India's human resources is key to achieving rapid, sustained growth<sup>5</sup>. *Second*, flexibility in labor markets helps to foster employment generation and facilitates the process of industrial restructuring. *Third*, agricultural reform is critical to boosting growth and improving living standards for the majority of the population. *Finally*—and here I turn to macroeconomics—a concerted effort should be made to establish price stability, for inflation imposes a heavy burden on the poor and saps India's growth potential.

3. Alesina and Perotti (1994) contains a survey of the recent literature.

4. See Persson and Tabellini (1994).

5. This point is convincingly made in Anartya Sen's 1994 Lakdawala Memorial Lecture.

East Asian countries have devoted considerable public resources to education over a prolonged period of time. The early decision to do so was important. This is because as soon as economic growth began to take off, real spending per pupil could be increased without raising the share of such spending in GDP. Improved education and health standards also fostered a decline in fertility rates, which implied a slower growth of the school-age population, thus again allowing higher spending per pupil. In 1989, the East Asian economies spent an average of 3.7 percent of GDP on public education. Many other developing economies spent the same share or more. However, with larger and faster growing populations to provide for, and with slower economic growth, they could not achieve the levels of spending per pupil typical in East Asia.

The second principal lesson from the East Asia experience is the importance of the *structure of education spending*. Other than Singapore, all the successful East Asian economies have devoted 80-90 percent of education budgets to primary and secondary schooling. As a result, primary and secondary school enrollment rates are high and the goal of universal primary education is close to being achieved. One important benefit has been a rapid narrowing of the gender gap in education, which has not only increased the skill level of the female labor force but also has enhanced the home learning environment and helped to lower the population growth rate. These policies not only contributed to growth: they were also instrumental in promoting equality. Moreover, since education enrollment rates increase with both income and equality, the whole process has been self-reinforcing. Not surprisingly, therefore, recent research in the World Bank and elsewhere has shown relatively high direct and indirect returns to women's education<sup>7</sup>.

India has always attached a high priority to education, and many key indicators of educational attainment have shown a sustained improvement. This year's budget—incorporating higher outlays on education and greater emphasis on primary education—is a further indication of the Government's commitment. Yet the

fact remains that enrollment rates and literacy lag far behind those in East Asia. Moreover, the improvement in educational attainment reflects mainly increased secondary education, remarkably enough, the proportion of the population that has completed primary school actually declined over the last 30 years. In addition, educational opportunities are not as readily available to the poor and to women as to others. Consequently, the better off derive much of the benefit from public education, preserving and possibly exacerbating existing inequalities. Part of the problem is that India spends some 15 percent less, relative to GDP, on education compared with the East Asian average.

Low female enrollment rates are critical not only because they deny opportunities to individuals, but also because they deny the country the direct economic returns of the education. Moreover, they matter because there is a strong link between female educational attainment and fertility rates. Per capita growth in India, and the quality of economic growth, would benefit from lower population growth. Both improved access to education, particularly for women, and increased spending on family planning, would help reduce population growth.

A similar story can be told with regard to healthcare. India has achieved high standards in its best medical facilities. But a high proportion of budget outlays on health are absorbed by curative healthcare and urban hospitals, leaving inadequate allocations to primary and preventive healthcare, including family planning. Health standards would also benefit from increased attention to improving nutrition, particularly for children; broadening access to clean drinking water; and extending sanitation facilities in rapidly expanding urban areas.

Increasing and redirecting resources to primary education and basic healthcare will not be easy in view of both budgetary constraints and the political economy of educational and health reform. Moreover, reorienting spending patterns will undoubtedly be resisted by those with a vested interest in the existing structure. Change will also be complicated by India's federal system of government. The states are responsible for the provision of virtually all primary and secondary public education and healthcare. Unfortunately, it is at the decentralized level that

7. See Summers (1994).

budgetary change has proved most difficult to accomplish and pressure group politics have their greatest influence. The wide disparities in education and healthcare spending across states are a consequence. Reforming center-state relations, and improving governance more generally, therefore have a role to play in a growth-oriented education and health strategy.

## 2. Making labor markets more flexible

Flexible labor markets contribute importantly to achieving high quality growth. This point is well illustrated by the experience of the East Asian countries. Wages and employment in these countries have been largely determined by the interaction of labor supply and demand, rather than by government legislation, public sector leadership, or union pressure. The result has been a powerful virtuous circle. Flexible labor markets have encouraged efficient allocation of workers across sectors, higher investment, and use of more labor-intensive technologies. This process has contributed to more rapid output growth, which in turn has enhanced labor demand, employment, and wages. The cycle has been reinforced by high levels of education, vocational training, and healthcare that have allowed the pattern of employment to become gradually more skill-intensive, again supporting rising wages and living standards.

India's experience has been very different. Employment in the organized private sector has stagnated since the mid-1970s, while the capital-intensity of production has grown rapidly. The passage of legislation in the mid-1970s (the Industrial Disputes Act), which required firms to obtain government permission before retrenching workers, has surely been an important factor behind this outcome. Firms do not want to take on new workers if they are uncertain whether and when excess labor can be cut back in response to changing market conditions. Thus, paradoxically, policies designed to protect Indian workers in fact do them a disservice by foreclosing valuable employment opportunities.

Of course, this pattern, of high firing costs generating high rates of unemployment, has also been observed in Europe, most notably in Spain where the current unemployment rate exceeds 23 percent and the natural rate of unemployment is estimated to be about

18 percent. European economists also rely on the insider-outsider model of labor markets to explain real wage rigidity and other labor market phenomena associated with high and persistent unemployment. In these models, wages and work conditions are determined mainly by the insiders whose employment is likely to continue, rather than by the outsiders who could potentially benefit from changes in the terms of employment. This pattern is visible too in India, where present policies protect a small, highly visible segment of the labor force (about 8 percent of the total). Conversely, they discriminate against the vast majority of workers who are employed in the lower wage informal sector, where they receive minimal legal protection of their working conditions.

It is sometimes argued that because the informal sector in India is so large and flexible, the costs of restrictions in the formal sector are overestimated. That is of course to some extent true. Nonetheless, restrictions in the formal sector and the segmentation of labor markets have direct economic costs. Segmented labor markets result in an inefficient allocation of resources and generate pressures on the public sector to hire more workers, resulting in substantial overmanning. Moreover, labor market rigidities interfere with the adjustment of the economy in response to changing economic conditions, technologies, and external shocks, as the European experience confirms. It is important that India avoid this European trap.

Let me venture some general suggestions on what can be done in this area. A more effective employment policy for India needs to move on two fronts simultaneously: to increase the flexibility of the employer-employee relationship, and to support the effective redeployment of labor. The key element is to change the role of government in the labor markets. It should no longer be required to vet any labor force reduction before it can occur. Instead, such decisions should be left to free bilateral negotiation between management and workers. The Government should focus on ensuring that fair labor legislation is applied uniformly and that workers who need to look for new jobs are given adequate support. In this latter respect, the minimum compensation required for laid-off workers could be raised (it is now 15 days' wages per year of service); and the funds available in the National

Renewal Fund could be deployed more effectively for retraining and placement services for retrenched labor.

### 3. Reforming agriculture

Any strategy to achieve rapid growth and make significant inroads on poverty must tackle the low productivity that continues to plague India's farm sector. The reasons are clear: some 80 percent of India's poor reside in rural areas, where they are predominantly engaged in farm activities. Farming employs 70 percent of India's labor force and accounts for 32 percent of its GDP. Thus, the most direct means of combating poverty is to boost employment, productivity, and wages in agriculture.

Further, the benefits do not end with poverty reduction. Agricultural development provides a strong foundation for growth in the rest of the economy. It is no coincidence that the most successful countries of East Asia have achieved rapid rates of farm productivity growth, generating sharp increases in agricultural output in a context of stable food prices and rising rural wages. Most notably, and notwithstanding the recent stagnation in agricultural output, China's spectacular growth in the last 15 years started with radical and extremely rapid reforms in the agricultural sector—incidentally, a fact that should qualify the common view that China has pursued a gradualist reform strategy. Because land ownership and usage patterns in India differ from those in East Asia, such rapid reforms could not be duplicated in India. But it remains true that progress in agriculture would support economic growth, reduce poverty, and could help to improve the distribution of income.

A basic reason for the successful agricultural development of the East Asian economies is that they did not promote industry at the expense of agriculture. They generally avoided the taxes, food price controls, and pro-industry allocations of credit that have been common in other developing economies. Equally important, they refrained from taxing agriculture indirectly through industrial protection and exchange rate overvaluation. Agricultural productivity was also enhanced by public sector investment in rural infrastructure, by programs to disseminate new technologies, inputs and know-how to farmers, and by effective land reform.

India has also devoted considerable resources to agricultural and rural development over the past three decades. The spread of irrigation, fertilizers, and high-yielding seed varieties across the country has boosted food production, contributing to the ending of famines in India<sup>8</sup>.

However, despite the success of the adoption of Green Revolution technologies, there remain significant distortions created by India's protected trade regime, industrial regulations, and controls on internal and external trade in agricultural products. Moreover, rural infrastructure remains inadequate and yields are well below international levels. In part for these reasons, labor productivity in India's farming sector has grown on average by just 1/2 percent per year over the past two decades, compared with productivity growth in East Asian farming of over 2 percent per year. Most of the increases in food production have come through the intensification of cropped areas in a few regions of the country, supported by extremely costly subsidies (for power, irrigation, and fertilizers) which are no longer sustainable. Low productivity has constrained farm wages, contributing to persistent poverty in rural areas.

What can India do to promote agricultural development and thereby tackle poverty, especially rural poverty, head on? Here I am once again at a comparative and absolute disadvantage, and I shall venture only general suggestions. The key is to untangle the complex web of distortions that reduce incentives for producers and inhibit productivity growth. There are three requirements. First, the agricultural sector should be liberalized—as was the industrial sector in 1991—by dismantling the pervasive controls on commerce in agricultural products. This would involve eliminating licensing requirements for wholesale trade and storage of virtually all commodities, phasing out the remaining elements of compulsory public procurement, abolishing the remaining controls on imports and exports of many agricultural items, ending the licensing of agro-processing industries, and—with safeguards—

8. The qualification "contributing" takes into account the striking fact made well-known by Amartya Sen that there has never been a famine in a democracy (see Dreze and Sen, 1989).

lifting the ban on futures and forward trading. Many of these controls were set up in the 1950s under the Essential Commodities Act, at a time when the centralized management of agricultural supply and prices was considered necessary to prevent acute shortages. Such an approach no longer seems necessary in an India where basic supply conditions are much stronger and a robust private sector exists to do the job well.

Second, the system of price incentives facing the farmer needs to be brought into line with market realities, while providing adequate infrastructural support. In recent years, progress has been made toward raising procurement prices toward international levels, but the link needs to be more systematic. In addition, the enormous distortions implied by heavily subsidized fertilizers and electricity for farmers need to be addressed. While there can be no doubting the political difficulties of dealing with this issue, it would be far more productive to phase out these subsidies and redeploy the budgetary resources toward increased investment in rural infrastructure, particularly transportation and storage facilities needed to get products to the market, and in strengthening rural credit systems.

Third, it will be necessary to look again at the public distribution system. Increasing the role of markets and international trade in agricultural supply may raise price volatility and imply significant increases in the prices of some commodities. In a country such as India, making available certain essential foodstuffs at subsidized prices does provide significant protection for the poor. However, the present public distribution system is extremely inefficient and does not do a particularly good job of delivering cheap food to the poor. The system needs to be overhauled to reduce its costs and ensure a much more effective targeting to the truly needy.

#### 4. Tackling inflation

Inflation is sometimes referred to as the cruellest tax of all, because of its heavy incidence on the poor, and because it is to a considerable extent invisible to most of those who bear its burden. The poor in India seem particularly vulnerable to inflation. Their wages are set in nominal terms in an economy

with minimal indexation. Moreover, most of their limited financial savings is held in the form of currency.

Beyond its adverse distributional effects, inflation also directly reduces growth and slows the rate at which poverty is reduced. Much research, including Fischer (1993), has demonstrated the negative association between inflation and growth<sup>9</sup>.

There are many reasons for such a negative relationship: among them that inflation creates uncertainty, reduces the efficiency of resource allocation (in part through its interactions with the tax system), lowers investment, and thus reduces the rate of productivity growth. Inflation in the double digits, or in the upper single digits, serves no useful purpose, often threatens to rise further, and should be fought and reduced.

How can inflation be brought down while minimizing the short-term impact on growth? An effective inflation reduction program requires measures both to contain aggregate demand and to enhance aggregate supply. To complement these measures, institutional reforms to establish a policy-making framework with a clear commitment to price stability would reduce the potential costs of inflation reduction

On the demand side, sustained fiscal adjustment supported by monetary policy is the lynch-pin of successful price stabilization. Reducing inflation without choking off growth will depend crucially upon substantial further fiscal consolidation. First, deficit reduction would reduce the pressures for monetary financing of the deficit by the RBI. The RBI has successfully resisted these pressures in recent years, but has allowed the foreign exchange inflow to affect money growth. A further reduction in the deficit would give the monetary authorities more room to offset the effects of the capital inflows. Second, fiscal adjustment would ease pressure on interest rates and allow a greater share of

9. Based on their recent research, Michael Bruno and William Easterly (1995) claim that the negative association between inflation and growth becomes significant only at inflation rates in excess of 40 percent. This result is different from those reported in Fischer (1993), so that the issue of the inflation-growth relationship at low inflation rate remains open.

resources to be made available to the private sector. A tight monetary policy without supporting fiscal policy could be effective in bringing down inflation in the short run. However, it would raise real interest rates, tend to promote a real exchange rate appreciation, and thus discourage the investment and exports needed for sustained growth.

This is not the occasion to go deeply into the question of how to continue reducing the deficit and ensure that the debt-to-GDP ratio begins to decline<sup>10</sup>.

What is needed are measures that would unambiguously establish the direction and durability of reforms. In particular, continued tax reforms and improvements in the structure of government spending programs are essential. Well-designed expenditure reforms would leave room for necessary spending on infrastructure and human capital and help to foster confidence in the sustainability of adjustment.

On the supply side, the combination of a rapidly growing economy and a relatively inefficient distribution system is likely to lead to bottlenecks and capacity constraints in the period ahead, which would add to inflationary pressures. To relieve such pressures, high priority should be given to further import liberalization, taking advantage of the present high level of international reserves. Lifting internal restrictions on trade in agricultural products and improving facilities for the distribution and processing of foodstuffs would also help. Perhaps most importantly, India's infrastructure (particularly its power supply, ports, and roads) need to be modernized rapidly. In view of the resource constraints faced by the Government, this will require finding effective ways to involve private capital.

Finally, let me stress the importance of making inflation an explicit policy target and establishing an institutional structure for policy making that demonstrates a clear commitment to price stability. A number of countries have acted recently to achieve price stability after years of tolerating moderate rates of inflation—

10. For an analysis of the sustainability of India's fiscal stance, see Butler and Patel (1995).

including Chile, Canada, New Zealand, and the United Kingdom. Innovations have included publicized "policy target agreements" between the minister of finance and the central bank governor and legislation to increase central bank autonomy. Last year's agreement between the Reserve Bank of India and the Ministry of Finance regarding the phasing out by 1997/98 of the RBI's ad hoc financing to the Government is important in this regard. Its effective implementation — and implementation is so far on track — would enhance the central bank's ability to run an independent and anti-inflationary monetary policy.

## 5. Concluding remarks

To sum up, the main message I would like to leave with you is that economic reform can directly and rapidly reduce poverty at the same time as it increases growth. The stabilization and reform program pursued since 1991 has provided a sound base that is beginning to transform India, but further bold steps are still required for India to emulate the rapid growth and sustained progress in poverty reduction achieved in East Asia. Continued and deepened structural reforms in the areas of trade and industrial liberalization, privatization, and financial sector reform, conducted on the foundation of macroeconomic stability, are essential to sustaining and increasing the growth rate. I do not in any way underestimate the profound political difficulties involved in effecting these changes, but their long-run benefits will be enormous.

In focusing on those policy decisions that can help ensure that growth directly reduces poverty and improves the distribution of income, I have emphasized four areas: building up human capital and in general improving the quality of government spending, encouraging employment growth by making labor markets more flexible, developing agriculture, and bringing down inflation. These reforms would all serve to strengthen the positive linkages between growth and poverty reduction. Of course, it will also be important to ensure that adequate steps are taken to protect the poor and disadvantaged who might be adversely affected in the short run, through appropriate targeting of food subsidies and the provision of effective safety nets for redeployed workers. But the essential ingredient in sustained poverty reduction is achieving high quality economic growth.

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