5

Conclusions and the Tasks Ahead

India's decades-long pursuit of an inward-oriented development strategy—rationalized both by a wary, if not an altogether hostile, attitude toward foreign trade, technology, and investment and by pessimism about export markets—inevitably marginalized the country in world trade and private foreign capital flows. India's share of world exports declined from 2.2 percent in 1948 to a low of 0.5 percent in 1983 and then recovered to 0.7 percent in 2000 (WTO, *International Trade Statistics 2001*, table II.2). India shared only modestly in the phenomenal growth of private capital flows in the 1980s and 1990s to the so-called emerging-market economies. The economic reforms of 1991 abandoned the inward-oriented development strategy and initiated a process of reintegration of the Indian economy with the world economy. But challenges remain.

The inward-oriented development strategy was implemented through an extensive system of discretionary, rather than rules-based, state controls over economic activity. Over time, the coverage of the system of controls was expanded and became more intrusive. The scope and discretion embodied in the controls also fostered administrative and political corruption.

With the exception of a brief period of liberalization after the macroeconomic crisis of 1966,[1] attempts to moderate the rigors and unintended

1. This liberalization was abandoned by then-Prime Minister Indira Gandhi in part because of strong political opposition from her own party, let alone from parties in the opposition. The failure of the World Bank to deliver the substantial nonproject assistance that was promised in support of liberalization (because of pressure by the United States, which was unhappy with India's opposition to the war in Vietnam) played a role in the demise of this reform effort.

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side effects as well as distributional consequences of the control system generally involved additional government interference. Export incentives were introduced in an effort to alleviate the penalty imposed by import controls on exporters. Import tariffs were often raised to mop up the premiums accruing to import licensees.

Some liberalizing actions were taken, particularly in the 1980s, on the basis of the recommendations of several government committees that looked into various functional aspects of the control system. There was increasing use of the market mechanism to allocate critical materials such as steel and cement; these two were completely decontrolled in the 1980s.

With Rajiv Gandhi's succession as prime minister after his mother's assassination in 1984, a number of young economists were appointed at senior levels of economic ministries and in the prime minister's office. They were open to experimenting with the liberalization of economic controls. Though these liberalizing actions and tendencies did not amount to significant departures from the development strategy, when combined with an unsustainable fiscal expansion financed by costly domestic and external borrowing, they delivered a relatively rapid growth of GDP at 5.8 percent a year in the 1980s (World Bank, *World Development Indicators 2002*, table 4.1).

By the end of the 1990–91 period, the fiscal deficit of the central and state governments together exceeded 9 percent of GDP and, as was discussed in chapter 2, serious imbalances in external accounts gave cause for concern. The ensuing crisis, coupled with the collapse of the centrally planned economies of the Soviet Union and Eastern Europe in 1991, led to a reexamination of the development strategy and the associated centralized industrial planning. Moreover, the spectacular growth after the late 1960s of the open East Asian economies, and particularly China after its opening in 1978, undermined the other foundation of India's economic policy, namely, inward orientation. The reexamination of the strategy led to major policy reforms in 1991 toward greater integration with the global economy, greater reliance on private initiatives, and the use of market-based instruments in economic management.

The First Generation of Reforms: Achievements and Problems

The economic reforms removed policy-induced entry barriers, relaxed constraints on private-sector initiatives, and led to the emergence of domestic as well as external competition. The reforms resulted in several favorable outcomes. The composition as well as direction of imports and exports shifted away from barter trade with the former Soviet bloc. Shares of exports in domestic production increased. Output and employment in the factory segment of the manufacturing sector expanded. Finally, the

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GDP growth rate in the first 3 postreform years exceeded 7 percent for the first time since Independence.

The beneficial effects on the economy, though significant, have been modest. Still more reforms are needed to put India on a path of sustained, rapid growth. For example, although the postreform Indian export performance was superior to that of the prereform era, it was vastly outdone by that of both small economies (in terms of population) like Malaysia, South Korea, Taiwan, and Thailand, and large economies like China and Indonesia. After reaching a peak of 7.8 percent in 1996–97, the growth rate fluctuated between 4 and 6.6 percent in the subsequent 5 years.

Political and external factors played a role in the slowdown. However, the failure to bring the overall fiscal deficit of the central and state governments, as well as those of nonfinancial public enterprises, significantly below what it was as a proportion of GDP in 1990–91 just before the crisis was a major contributing factor. The persistent deficit led to a rise in real interest rates on borrowed capital and crowded out private investment.

The burden of the fiscal adjustment that has occurred since the reform has fallen in large part on public investment, particularly in infrastructure. The lack of adequate investment in additional capacity, and the poor maintenance and inefficient operation of infrastructure facilities and services, have acted as a drag on growth. Although there have been improvements in the performance indicators in power, telecommunications, railways, road transport, and ports, concrete progress has been too slow to meet the progressively demanding requirements of the globalizing economy.

Two factors constrain investment for creating needed additional capacity. The public sector, as a whole, has become a net dissaver. More public borrowing at market rates, not only for investment but also to sustain public consumption, would exacerbate the already serious issue of fiscal solvency besides crowding out private investment. The alternative—attracting significant private investment (domestic and foreign) into infrastructural sectors—is impossible as long as investors have to absorb, in effect, the cost of subsidized sales to privileged users. Besides adding capacity through investment, the efficient operation of already existing capacity is essential.

The regulation of the infrastructure sectors is also a key concern. Scale economies and network externalities are clearly significant in infrastructure sectors. Atomistic competition among price-taking enterprises is unlikely, because there are few (private and/or public) firms of significant size relative to the market in such sectors. Regulation of their operation is common around the world, although the nature and scope of regulation have changed.

In these circumstances, a well-formulated and effectively enforced competition law could be better social policy than regulation. India's experience with regulation is very recent. The Telecom Regulatory Authority of India had to be reconstituted twice within its short life. The states and the central government have set up regulatory agencies for electricity, but the

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legislation defining their functions and interrelation was approved by the Central Cabinet only in August 2001. Whether the newly created regulatory agencies will resist political pressures and escape capture by those regulated remains to be seen.

Tasks Ahead

It is evident that the series of reforms initiated in 1991 (the so-called "first-generation" reforms) are yet to be completed. Several problems had arisen as they were being implemented. Further, the first-generation reforms have to be extended to other areas and deepened.

Completing the First Generation of Reforms

Even after substantial reductions in import tariffs, and the removal on April 1, 2001, of all quantitative restrictions (QRs) on imports, there is still a long way to go before India's trade barriers are as low as those of its neighbors. All finance ministers in the postreform era have declared their intention of bringing down average tariff rates to the levels prevailing in East Asia. *The Mid-Term Appraisal of the Ninth Five-Year Plan* argues for a clear time frame for a phased reduction of import tariffs to 10 percent (GOI-PC 2000, 1120). The report of the Prime Minister's Economic Advisory Council suggests a 5-year phased transition, from 34 to 12 percent (GOI-PM-EAC 2001, 14).

The more quickly these intentions are translated into concrete actions, the more quickly will Indian industry become internationally competitive and better placed to receive the benefits of expanding trade opportunities. Unfortunately, by replacing the QRs that were removed with high tariffs and by imposing antidumping duties on some imports from China, the government seems to have taken a step away from acting on its intentions.

The first generation of reforms is also not complete with regard to the power sector. Draft legislation for the power sector allows for the unbundling of generation, transmission, and distribution and also permits private enterprises to undertake some of these functions. The unbundled functions of state electricity boards (SEBs) should be corporatized as an interim measure, because privatization is unlikely anytime soon. This would formally distance them from government and may be expected to improve the efficiency of operations, rationalize the structure of tariffs, and bring revenues in line with costs. The finance minister, in his budget for 2001–02, has provided central assistance to states with a clearly monitorable agenda for restructuring SEBs.

The progressive deterioration of the fiscal situation of the central government and states after some correction in the initial year of reform is a

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third major concern. The introduction of a Fiscal Responsibility Act in Parliament in 2001 and the central government's intention to adhere to its provisions even before it is passed are welcome steps. The provisions include the elimination of the central government's revenue deficit and the reduction of the overall deficit to 2 percent of GDP in 5 years.

Launching the Second Generation of Reforms

The first generation of reforms, which were initiated in 1991 and are still in various stages of completion after a decade, attracted broadly based, though by no means universal, political support. As such, although there is some resistance to their completion, it is unlikely they will be reversed. The second generation of reforms are those yet to be undertaken in any significant measure but which are critical for restoring and sustaining rapid growth. Unfortunately, they do not command as much political support. Not only do the policy preferences of the National Democratic Alliance (or NDA, the central government's ruling coalition) differ from those of the main opposition Congress Party but there are also differences even among members of the NDA, some of which are regional parties.

There are four critical second-generation reforms of domestic policies and institutions: reform of the labor laws; privatization of enterprises that have no compelling social rationale to be in the public sector; reform of laws for bankruptcy and liquidation, so as to allow for an orderly exit of failing private enterprises; and restructuring of center-state economic relations, by amending the Constitution if necessary. There is synergy among the four, so that failure to enact one could detract from the benefits accruing from enacting the others. In addition to these four, there is the as yet barely begun task of integrating India's agriculture sector with world markets.

The Labor Market

An overwhelming majority (60 percent) of the Indian labor force is engaged in agriculture. The inefficient functioning of the market for land constrains the movement of labor out of agriculture into more productive activities. The labor market has a dual structure: a few large enterprises have a dominant share of output and a much smaller share of industrial employment, and a large number of small enterprises have a large share of employment but only a small share of output.

Productivity per worker between the two segments differs significantly, being higher in large enterprises due to their use of more capital per worker. Large enterprises substituted relatively cheap capital for labor as labor laws increased the cost of hiring and firing. Although large private corporate enterprises managed to get around the provisions of the labor laws (albeit at some cost), public-sector undertakings (PSUs) could

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not do so. Their high labor costs have contributed to their poor financial performance.

Although reforming the labor laws has been on the agenda since 1991, not much has happened. The proposal offered by the finance minister in his 2001–02 budget is a notable exception: to increase compensation to retrenched workers while restricting the requirement of mandatory prior government permission for layoffs, retrenchments, and closure to large units employing 1,000 or more workers. It appears very unlikely, however, that the legislation amending the labor laws to implement this proposal will be passed by Parliament, if it is introduced at all. Trade unions that are affiliated with the ruling NDA and the opposition comprising the Congress Party and the left-wing parties all are adamantly opposed to it.

Entry, Exit, and Privatization

The first generation of reforms freed PSUs from intrusive government interference, but their parent ministries still effectively control them. They can no longer count on budgetary support for financing their operating losses and investment, even as they face competition from leaner and more efficient domestic and foreign PSUs. Although such competition provides a desirable impetus for PSUs to become more efficient, the ability of their managers to act on the impetus is severely constrained by bureaucratic controls, political interference, and inhibitions arising from their being subject to auditing by the comptroller and auditor general of India and oversight by Parliament.

What is needed is a thorough examination of the social rationale for existing enterprises to continue to be in the public sector. Those for which there is no such compelling rationale should be privatized, regardless of whether they are making profits. The policy of disinvestment—consisting for a long time of a sale of a part of the equity in an enterprise (not necessarily to private agents)—has not been a meaningful substitute for a well-thought-out policy of privatization. The percentage of disinvested equity has typically not been enough to give buyers control over operations and management and thus has not brought in market incentives.

Political support for privatization is unlikely, however, until the labor laws are reformed and workers that would be likely to be laid off from overstaffed PSUs after privatization are reasonably confident that they can secure alternative and equally remunerative employment in a rapidly growing economy. But as we noted in chapter 4, the successful privatization of Bharat Aluminum Company, and the sale of significant shares of equity in Videsh Sanchar Nigam Limited as well as Maruti Udyog Limited and other firms to private investors, appears to have significantly changed the climate for privatization. As a recent observer notes: "Long a source of controversy, privatization is rapidly becoming a matter of routine. Since the start of the year, India has sold more government-run firms

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than it did in the previous decade. No fewer than 17 companies—some large, some small—have moved from public to private hands, bringing the government an expected $2 billion" (J. Slater, "Privatization Is Routine in Once Socialist India," *Wall Street Journal*, July 5, 2002).

The policy environment for efficient and rapid restructuring needs to allow not only entry into potentially profitable activities but also exit from activities that have become unprofitable and are likely to remain so in the future. First-generation reforms have removed entry barriers to domestic and foreign private capital and introduced greater competition. Yet as was discussed in chapter 4, exit on reasonable terms still continues to be very difficult, if not impossible. It will remain so until there is a serious overhaul of the Sick Industrial Companies Act of 1985 (which deals with the reorganization of failing firms) and the Companies Act of 1956 (which deals with bankruptcy and liquidation).

Center-State Economic Relations

Unstable coalitions of national and state political parties have been in power since the defeat of the Congress Party in the parliamentary elections of 1996. The ruling NDA, which came to power after the 1999 elections, is a coalition consisting of a single national party, the Bharatiya Janata Party, and several state-level parties. Clearly, this shift toward coalition rule has meant that the states have gained a much greater say in policymaking at the center. The first-generation reforms, by abolishing central controls on investment and imports, have also greatly expanded the role of policy action by states in influencing their own industrial development. It is fair to say that the Central Planning Commission has lost its raison d'être in the postreform era despite getting the approval of the National Development Council on September 1, 2001, for its paper on the approach to the Tenth Five-Year Plan (2002–07).[2] The plan has much less meaning as an operational document, even for the public sector, than it had in the prereform days.

The states' increasing influence on their own development in the postreform and coalition politics era could have a profound effect on their own development as well as on India's integration with global commodity and financial markets, for several reasons. First, the reforms provide an enabling environment for better performance that at least some states appear to be taking advantage of. Actual performance depends on the response to reforms. The response, in turn, depends on the initial conditions, such as the skills and discipline of the labor; the cost and quality of the infrastructure; and, most important, the quality of governance. States that are better endowed in these dimensions initially (partly because of

2. See http://planningcommission.nic.in/plans/planrel/appdraft.pdf.

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their policy choices in the prereform era) appear to respond more effectively and quickly to the opportunities opened up by reform. Coastal southern and western states have been growing faster since 1991 than the large interior states. In principle, this could induce lagging states to invest in human capital and infrastructure to a greater extent, improve their governance, and thus catch up with the faster-growing states.

Conversely, one cannot rule out inadequate, if not perverse, policy responses by the laggard states. Were this to happen, disparities among states could increase and threaten the stability of India as a federal nation.[3] The evidence regarding the extent of catch-up and convergence is at present ambiguous. Different researchers come to different conclusions.[4] The fact that the poorer and more slowly growing states also happen to be the ones with a sizable share of India's population and electorate is disturbing; if they fail to catch up with their richer counterparts, the stability of India's federal polity could be threatened.

Second, the states are actively competing to attract domestic and especially foreign investment. If the policy instruments used in this competition consist of concessions in taxes and the subsidized provision of infrastructure rather than better-quality and less-expensive infrastructure or a better-skilled and -disciplined labor force relative to other states, the competition could take the form of a race toward the bottom. Competition that involves each state offering more and more tax concessions in a futile effort to attract investment will merely transfer public resources to investors without influencing the final locational decisions of investors.

Third, the states' fiscal situations not only affect their ability to provide public goods and services to their residents but could also affect their (as well as the rest of India's) attractiveness to foreign investors. At present, the states cannot borrow, even at home, without the permission of the central government—though this requirement has been evaded by state enterprises resorting to borrowing from the market. Just as credit agencies now rate India's creditworthiness in part on the basis of the central government's fiscal situation, states' debt will also be subject to credit rating if they access capital markets at home and abroad. Such agencies not only

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3. Apart from the response of state governments, there is also the response of individuals, households, and enterprises to opportunities opened up by reform. Again, these responses could be heterogeneous and dependent on their initial endowments. The policy environment, including the actual response of each state to the postreform environment, could either help or hinder initially lagging private agents in catching up. It is possible that disparities among private agents within states, as well as those between the average performances of states, would increase in the postreform era, at least in the short to medium run. Indeed, this also happened in China after its opening in 1978.

4. Marjit and Mitra (1996); Abler and Das (1998); Bajpai and Sachs (1996); Cashin and Sahay (1996, 1997); Ghosh, Marjit, and Neogi (1998); Nagaraj, Vroudakis, and Vganzones (2000); Iyer (2001).

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look at governments' actual liabilities but also at their contingent liabilities arising from their guarantees of private debt and implicit commitments to bail out failing large (particularly financial) enterprises.[5]

The states also create contingent liabilities for the central government when foreign investors insist on guarantees that the enterprises they invest in will be paid in full and on time for the output they sell to state enterprises. Enron Corporation's experience in India is a prime illustration of this. Because the Maharashtra State Electricity Board (MSEB), the sole buyer of power generated by the power plant in which Enron invested, was fiscally weak, Enron insisted that Maharashtra State, the owner of MSEB, guarantee that it would pay if MSEB failed to pay. Because Maharashtra State itself was in dire fiscal straits, Enron insisted on and got a counterguarantee of payment by the central government, in case Maharashtra State was unable to fulfill its guarantee.

It is clear that the existing center-state economic relations relating to tax and expenditure assignments, as well as responsibilities regarding social and physical infrastructure and regulation, need to be reexamined (Singh and Srinivasan 2002). This would partly involve rethinking constitutional provisions for revenue sharing and transfers, as determined by quinquennial Finance Commissions, and also for transfers, as determined by the Planning Commission. If India is to succeed in achieving rapid growth through greater interaction with a more and more competitive world economy, such a reexamination is imperative.

Integrating India's Agriculture with World Markets

We noted above that in their declaration after the Doha meeting of the World Trade Organization (WTO), the world's trade ministers committed to negotiate substantial reductions in major distortions of agricultural trade, such as export subsidies and domestic support. The extent of those distortions as of 2001 was large:

> Support to agricultural producers accounted for 31% of farm receipts in the OECD [Organization for Economic Cooperation and Development] area, compared to 32% in 2000 and 38% in 1986–88. Three-quarters of support to producers in OECD countries distort production and trade, and prices received by farmers in 2001 were still an average of 31% above world prices, compared with 58% in the mid-80s, shielding farmers from world market signals.
>
> Significant differences nevertheless remain across countries and commodities. Producer support levels range from 1% of farm receipts in New Zealand . . . to

5. We do not wish to exaggerate the analytical capabilities of these agencies, particularly in anticipating problems. After all, they failed to downgrade the debts of South Korea and Thailand, for example, until they were in the middle of the Asian financial crisis. Conversely, they rushed to downgrade Japanese debt in 2002, even though Japan's large stock of foreign assets and high savings rates would suggest that its chances of defaulting on its debt are rather low.

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over 60% in Iceland, Japan, Korea, Norway and Switzerland. Producer support is 21% of farm receipts in the US and 35% in the EU. Rice, sugar, milk and wheat are the most supported commodities. (OECD 2002a)

It is unfortunate that US President George W. Bush recently signed a farm bill that will further add to trade-distorting domestic support in the United States. But as we noted above, there have been some encouraging signs in recent US proposals at WTO negotiations on agriculture.

India and other developing countries rightly criticize the excessively distortionary agricultural subsidies in rich industrialized countries. However, the fact that rich countries subsidize their agricultural exports is cited as an argument, particularly by Indian policymakers, for developing countries to adopt similar distortionary policies. This is a non sequitur. Adding another distortion to an existing distortion will not improve the situation, particularly in world markets where India does not have market power. It is true that there are difficult adjustment problems in integrating India with world agricultural markets, but maintaining or increasing distortions and insulating Indian agriculture from world markets is not the right response to agricultural protection and subsidization in rich countries. The right response is to address the adjustment problems in a serious way.

The Political Economy of Reform

Reforms of any significance affect the welfare of various socioeconomic groups differently, with some gaining and others losing from the reforms. Moreover, the relative political clout of each group influences the content and pace of the reform process in a multiparty democracy such as India's. As we noted above, there were relatively few losers in the reforms of the first decade. But the situation does not appear to be so conflict free for the remaining reforms. In assessing the prospects for these reforms being undertaken, it is useful to identify four significant interest groups. The first three are large industrialists, bureaucrats, and large farmers, as identified by Bardhan (1984) in his celebrated study of India's political economy. The fourth group, organized labor, has been vocal in its opposition to several major items on the reform agenda.

Large Industrialists

The reforms of the first decade are unlikely to be reversed because most of them did not involve significant political costs for the reforming governments of the Congress Party, the coalitions that succeeded it, or the opposition parties. There is no agreement, however, among political parties on whether—and if so, how—to proceed further with reforms.

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In analyzing the attitudes of political parties toward reforms, we have to analyze the reforms' impact on their supporters, the interest groups. Limited but imaginative liberalization of industrial capacity licensing (initiated by the Congress Party regime of Rajiv Gandhi in 1985–86) allowed firms to diversify into related products within their overall licensed capacity and to produce 25 percent above their capacity. Firms with sales of less than Rs10 billion, in contrast to the earlier limit of Rs1 billion, were exempted from the requirement to obtain government approval for expansion. These measures were welcomed by industrialists and indeed resulted in an industrial boom in the period 1985–88. After this experience, industrialists were receptive to a virtual abolition of capacity licensing in the reforms of 1991.

Abolition of licensing of imports other than of consumer goods once again did not run into opposition. This was primarily because domestic producers did not immediately face increased competition from imports. The devaluation of the rupee in July 1991 and high tariffs still restricted imports.

The progressive reduction of tariffs before 1995 and appreciation of the rupee in response to substantial increases in flows of foreign capital have eroded protection margins. Thus it is not surprising that producers of import substitutes oppose further trade liberalization. The unrestricted availability of cheaper intermediates and capital goods benefited user industries. In particular, with imports of consumer goods (especially consumer durables) still banned, effective protection for the producers of substitutes for such imports rose even above the already high levels that existed before the reforms. The increased profitability of the QR-protected production of automobiles resulted in significant flows of foreign direct investment (FDI) to the automotive sector.

India's reluctance to phase out the QRs on consumer goods imports until forced to do so by a ruling of the WTO's Dispute Settlement Body can, to a certain extent, be attributed to the pressure of the vested interests of producers of import substitutes—which include the PSUs and organized trade unions entrenched in the PSUs. With the removal of QRs and with greater penetration of competitive imports, in particular from China, domestic producers demanded the imposition of antidumping duties against such imports rather than face the task of becoming internationally competitive. Their response to import competition is no different from their counterparts in the US steel industry and elsewhere. Unfortunately, the government caved in and imposed antidumping duties on some imports from China.

This outcome illustrates the well-known worldwide phenomenon that governments accord greater weight to producer than consumer interests in such decisions. Even the Bush administration, which ideologically is against trade restrictions, ordered an investigation to determine whether

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steel producers have been injured by import competition and, having satisfied itself that they have been, has provided tariff protection.

The Indian government's ambivalence about the reforms and the slow pace of liberalization of FDI could be in part attributed to the conflicts within the group of large industrialists. Liberalization benefited some by enabling them to increase their market share with foreign participation. Others faced a loss of market share due to competition from foreign producers. In any case, large industrialists in India have been traditionally against foreign investment.

Desai (1998, 38) argues that the liberalization of foreign portfolio investment in 1992 was a compromise between the industrialists' fear of competition from FDI and the pressure from the IMF to expand opportunities for non-debt-creating foreign capital inflows. By allowing foreign institutional investors to buy equity in Indian companies—but restricting any individual investor initially to 5 percent (and later to 10 percent) of the equity of a company, and in the aggregate to 24 percent—India opened the door to foreign investment, but not wide enough for foreign investors to take over Indian companies. At the same time, Indian companies were allowed, subject to government approval, to tap foreign capital markets by selling equity through global and US depository receipts. Because such equity did not have voting rights, there was once again no threat of foreign control.

Much FDI came in through the discretionary and nontransparent channel of approvals by the Foreign Investment Promotion Board (FIPB). Desai (1998, 29) points out that the FIPB, consisting of the secretaries of the economic ministries, was set up to override the Secretariat for Industrial Approvals (set up in the 1970s) because this body had approved very few of the proposals that had come before it. The FIPB made its recommendations to the ministers in the Foreign Investment Coordination Committee. In response to increasing opposition from domestic industry to its liberal attitude toward FDI, the FIPB was transferred to the Ministry of Industrial Development in 1995. This institution simply filed applications received without acting on them.

After the election of 1996, however, the newly appointed minister for industries resumed the liberal grant of approvals. Although FDI for up to 51 percent of equity was given "automatic approval" by the Reserve Bank of India in 34 "priority" industries, Desai (1998, 31) suggests that foreign companies preferred the flexibility of negotiating terms face-to-face with the FIPB rather than the rules-based approval process of the Reserve Bank. This process involved inflexible conditions on the priority status of the industry and the proportion of equity held by foreigners.

The substantial initial enthusiasm among foreign investors for portfolio investment in India subsided once they became sufficiently informed to assess the potential of different Indian firms and their own vulnerability to malpractice by players in the Indian equity markets. This disenchant-

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ment was naturally greater among those who invested in equity in Indian firms through Global Depository Receipts. These factors led to a decline in portfolio investment by the mid-1990s and to a shortage of equity funds among Indian companies, which forced some that had formed joint ventures to reduce their share of equity or sell out to foreign partners. It is not surprising, as Desai notes, that large industrialists became averse to foreign investment. Desai also correctly suggests that the incomplete, ill-planned liberalization of foreign capital inflows while the domestic capital market was still riddled with imperfections and malpractices has given rise to xenophobia, even among those powerful industrialists who initially supported opening up (Desai 1998, 47–48).

Farm Interest Groups

It is a complex task to assess the impact on large, medium-sized, and small farmers, tenants and agricultural laborers, and consumers of integrating Indian agriculture with world markets. In India, as in most countries, government interventions in markets for agricultural outputs and inputs are extensive and nontransparent. Not only is it virtually impossible to assess the net impact of the myriad interventions (and changes in them following trade liberalization) on different groups, but these groups also overlap and the same person could be in different groups at various times during a year.

For example, small farmers sell food grains at harvest and buy them later because they have a limited capacity to store them. As such, they would benefit (or lose) from high (or low) prevailing market prices at harvest times when they sell their produce, but lose (or benefit) from high prices when they buy. Integrating domestic markets for agricultural outputs (both raw and processed) and inputs with world markets is most likely to have significant, but not easily estimated, distributional effects.

Intervention in agricultural markets affects several groups. They include large farmers who are primarily sellers of produce, consumers (particularly poor people), suppliers of inputs (e.g., seeds, fertilizers, electricity and petroleum products, and irrigation), and user industries (e.g., textiles). Rural poor people—who are mostly tenants and landless agricultural laborers, many of whom belong to socially disadvantaged groups such as the scheduled castes and tribes—have not been politically influential except in the states where the communists rule (West Bengal) or have ruled or shared power (Kerala) and more recently in Uttar Pradesh, where the Bahujan Samaj Party of lower caste members is in the ruling coalition.

The large farmers are politically well represented in all parties except those on the extreme left. Large farmers have received subsidized supplies of inputs—namely, fertilizers, electricity, petroleum fuels for irrigation pumps, and credit from nationalized banks—since the introduction in the late 1960s of high-yielding varieties of rice, wheat, and a few other crops

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that for profitable cultivation require irrigation and the use of chemical fertilizer. Electricity was supplied free to agriculturists in some states, and charges for canal irrigation did not even cover the cost of maintenance.

In addition to subsidizing inputs, the government intervened in output markets, particularly of food grains. Foreign trade in agricultural commodities was canalized through state trading agencies. The net effect of the insulation from the world markets on the one hand, and various domestic subsidies on the other, appears to have been one of implicit taxation of agriculture as a whole, and also of a number of commodities, especially some food grains. Because the cropping pattern naturally varies across states, reflecting differences in agroclimatic conditions and in the extent of irrigation, the removal of all state interventions from agriculture and fully integrating it with world markets will affect different states differently.

Self-sufficiency in food grains and other essential agricultural commodities has long been a national-security-motivated objective of Indian policymakers. Their interest in it was reinforced by the country's searing experience with imports of food grains from the United States under Public Law 480 when India faced serious food shortages caused by the harvest failure of 1965–67. President Lyndon Johnson threatened to withhold food aid in an attempt to change India's opposition to the Vietnam War.

In part because of this experience and the coincidental availability of Green Revolution technology, India devoted greater resources to agricultural production. A policy of domestic price support, insulation from world markets, and subsidization of inputs was instituted. The policy succeeded in making India self-sufficient in food grains. Therefore, both the removal of QRs on agricultural imports and the integration of Indian agriculture with world markets are seen as threatening this hard-won "food security."

This view is unfounded, however. If food security is appropriately redefined as ensuring that poor people have access to food at prices they can afford, nothing in the Uruguay Round Agreement on agriculture would preclude the Indian government from reforming the Public Distribution System for food grains and maintaining the buffer stocks necessary to achieve security.

Integrating Indian agriculture with world markets will necessarily involve comprehensive reform, which will have to be sold to diverse groups of large farmers and consumers across states. Large farmers do not appear to be united on the issue. Although Sharad Joshi, a leading farm lobbyist, has been strongly in favor of eliminating subsidies and integration with world markets, such other leaders as M.D. Nanjundaswamy in the South and Mahender Singh Tikait in the North have not been. Some farm lobbyists have also been opposed to India signing the Agreement on Trade-Related Aspects of Intellectual Property Rights, the opening up of the seed industry to multinationals, and the entry of foreign fast food chains. The conflict of interest between farmers supplying agricultural inputs to

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industry (e.g., over the price of raw cotton) and industries supplying inputs to agriculture (e.g., fertilizers and pesticides) also has to be resolved.

Bureaucrats

Bureaucrats' resistance to reforms is understandable. Cabinet ministers who are politicians make policy decisions, but the distribution of any rents associated with the decisions remains in large part in the hands of bureaucrats. Although ministers can exercise control through their power over the appointment, transfer, and promotion of bureaucrats, this power is not absolute and is constrained by civil service rules and by the judiciary.

Moreover, bureaucrats have held the top management positions in public enterprises, giving them yet another source of patronage. The system of foreign trade and other controls have provided sources of income (outside of their regular pay and perquisites) that bureaucrats and politicians stand to lose with liberalization. Bureaucrats have been the major losers from the dismantling of the direct discretionary control regime in the first-generation reforms. They have been trying to regain their discretionary powers under the guise of "regulating" natural monopolies.

Labor Unions

Finally, there are the politically important labor unions of workers in government and the organized manufacturing enterprises (both private and public). These unions represent a microscopic minority of aristocrats in the labor force. They enjoy high wages, security of employment, and other perquisites that are not available to the vast majority of workers. All unions have opposed privatization and any reduction in public employment, because private management will almost surely reduce the bloated payrolls of public enterprises once they are privatized.

This fear is understandable given the slow growth in employment outside the public sector in the past. Workers have to be convinced that with further reforms the economy will grow faster and the demand for labor will grow much faster than in the past. Being retrenched from one enterprise, then, need not necessarily mean becoming unemployed. The reform of the labor laws should provide suitable assistance for retrenched workers for retraining and job searches.

To sum up, the domestic political economy of the reform in the Indian context is very complex. There is continuing pressure from the World Bank and the IMF to push reforms further. India has also undertaken many commitments as a signatory of the Uruguay Round Agreement and will almost surely undertake others as a signatory of any future agreements. By imaginatively using these external commitments and pressures as levers, as China is apparently doing successfully, it is to be hoped that the government, whatever its party affiliation, will be able to push the reforms further.

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India and the Global Trading Environment

Most of the actions needed to integrate India's economy fully with the world economy are domestic. India would reap significant benefits from globalization by unilaterally taking these actions even if there is no further liberalization of the world trading and financial systems.

The benefits of integration will be significantly higher, however, if the global trading environment becomes more liberal and the growth of market demand in the industrialized world is sustained. For this reason, India needs to engage constructively in the negotiations to set the agenda for the next round of multilateral trade negotiations. As was discussed in chapter 3, the country's inward-looking development strategy has not in the past precluded such involvement in international economic negotiations. Now, after a series of domestic reforms to enhance integration, India has even fewer reasons to eschew political engagement. The country's interests will be better served if, through such engagement, it can enhance the chances of including on the agenda those items that potentially will benefit it and excluding those that potentially will cause harm (e.g., the social clause in the WTO).

India has a vital interest in seeing that the incentives for preferential liberalization are eliminated in the post-Doha negotiations for multilateral liberalization. There is a real danger that the already evident and unfortunate rush to enter into bilateral and regional preferential trade agreements (e.g., the Free Trade Area of the Americas and expansion of the European Union) could turn into a stampede. Notwithstanding some loose talk about an India-United States free trade agreement, it is unlikely that India will be assiduously sought out by many countries to join in forming a new agreement or to become a member of an existing one.

Moreover, the attempt to form a South Asian Free Trade Area (SAFTA) also is unlikely to succeed, given the political reality of the conflict between India and Pakistan. As an indicator of relations between the countries, Pakistan has obtained a waiver—permitted first under the rules of the General Agreement on Tariffs and Trade (GATT) and now under those of the WTO—to the granting of most-favored-nation status to India on national security grounds. Even if SAFTA were to be implemented, the resulting gains from the liberalization of South Asian trade would be limited compared with the liberalization of trade with all global regions on a multilateral, MFN basis.

Antidumping measures (ADMs) constitute another area of concern. Unlike safeguard measures permitted by the GATT and later the WTO to deal with temporary surges of imports, ADMs do not have to be applied on a nondiscriminatory basis to all suppliers of imports and with compensation to them. ADMs can, in contrast, be targeted at imports from individual countries and even at individual suppliers within such countries.

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ADMs are, therefore, very attractive and handy tools for protectionists everywhere, whether they be perpetually whining US steel firms or their more recent counterparts in India that have succeeded in having ADMs imposed on imports from China.[6] In our view, India should not only cease using ADMs—which in effect coddle internationally noncompetitive domestic producers at the expense of users of imports—but should also go further and urge WTO members to exclude ADMs from the list of permissible trade policy instruments under WTO rules.

India has a vital interest in ensuring that world markets remain open both for its traditional exports and also for new goods and services, such as software and other kinds of information technology, in which it has an apparent comparative advantage. It is in the country's interest to unilaterally reduce tariffs and nontariff barriers. This is so even in the absence of the adoption of a suggested negotiating rule that would give credit at the next round of trade negotiations for unilateral liberation undertaken after the conclusion of the Uruguay Round. Even in the traditional negotiating process of exchanging concessions in the form of reducing one's own barriers if reductions are made in the other's barriers, India would be in a stronger position to demand reduced barriers to its exports (including information technology) in other markets if it reduced its own barriers.[7]

It is also in India's interest that the WTO continue to be a forum for negotiations. However, there is increasing evidence that the WTO is overextended and in danger of losing its legitimacy as an apolitical, rules-based organization. Paradoxically, this is a result of the Uruguay Round's success in extending the WTO's mandate far beyond that of the GATT. In particular, the General Agreement on Trade in Services, involving rules for trade in services of banks, insurance firms, telecommunications, and so

6. Although the announcement in 2002 by the US government of its intention to impose tariffs on certain categories of steel was preceded by an inquiry, as required under the safeguard clause, to establish that imports have caused material injury to domestic industry, the facts that some exporters have been exempted and that no compensation has been offered to any affected exporter suggest violations of the provisions of the clause. The US intention has been challenged by the European Union and others in the WTO's Dispute Settlement Mechanism. Regardless of how the WTO's panels and its Appellate Body rule on the challenge, it is unfortunate that the United States took this step as the Doha round of negotiations continues. It sends the wrong signal about the US commitment to free trade.

7. Mattoo and Olarreaga (2000) argue that the effect of such a credit rule would be primarily distributional, in favoring those that have undertaken such liberalization, and that its acceptance would depend on the generosity of those that have not liberalized. They argue in favor of a rule that would be part of an agreement at the conclusion of a round and that would grant credit in the next round for any further unilateral liberalization beyond what is included in the agreement itself.

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on, requires the WTO to delve deeply into the economic and social structures of its member states.

There are also serious concerns that the WTO's purely legalistic Dispute Settlement Mechanism will sooner or later become politically unsustainable (see Barfield 2002 for an incisive analysis). As we noted in chapter 3, the WTO's Appellate Body is also, in effect, beginning to legislate. The difficulty of amending WTO rules creates a great temptation to bypass the need to renegotiate rules and to reinterpret them and even use domestic law in member states as a precedent. A case in point is the Appellate Body's decision to overturn the panel decision against the United States and to decide in favor of Thailand and India in the Shrimp-Turtle case, essentially by overly expanding the scope of Article XX(8).

Moreover, the Appellate Body has decided on its own to accept amicus curiae briefs offered by individuals and nongovernmental organizations. India's minister for commerce and industry, Murasoli Maran, raised his objection to this at a February 22, 2001, Round Table in Delhi on the Dispute Settlement System on the grounds that such a decision is beyond the competence of the Appellate Body and that only the WTO's General Council is competent to deal with it (*The Hindu*, February 23, 2001; http://www.hinduonnet.com/2001/02/23/stories/01230002.htm). Whether or not acceptance and consideration of amicus briefs improve the quality of the decisions of the Appellate Body, Maran's objection about the process by which the decision to accept was arrived at needs to be addressed. His concerns reflect the more serious argument that the political sustainability of the WTO system itself will be seriously threatened unless the decision-making processes of the system become more transparent and participatory.

India could and should take the initiative in increasing the effectiveness with which less-developed countries can participate in WTO decision making. To the extent that the old GATT convention of consensus decisions for all important matters has lost its force in the WTO, the WTO's weaker members have lost some of their bargaining power. They now have to be persuaded that their views get a hearing so that they get a sense of involvement in the decision-making process of the organization.

One caveat is that conceding the demand for participation to any and all groups around the world is not in India's best interest. Not only would the WTO become paralyzed and nonfunctional as an institution if such broad participation were allowed, but conceding such participatory rights would certainly destroy the fundamental character of the WTO as an intergovernmental organization. We discussed this controversial matter in more detail in chapter 3.

Finally, the introduction of a social clause on labor standards into the mandate of the WTO—as well as any expansion of the consideration of environmental standards in the WTO beyond the Committee on Trade and Environment—would be against India's interests. In the absence of

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multilateral agreements on these matters, they have been incorporated in some form into preferential trade agreements such as the North American Free Trade Agreement and the United States-Jordan Free Trade Agreement. While resisting the introduction of a social clause, India should make it clear that it is willing to discuss labor and environmental standards at relevant forums, such as the International Labor Organization for labor standards and the United Nations Environment Program for environmental standards.

Conclusion

Indian economic policy since Independence has had many obvious flaws, but lack of ambition has not been one of them. The closure of the economy over the four decades from Independence in 1947 to the macroeconomic crisis of 1991 was an integral part of a planned effort to force rapid growth and industrial development. A complex series of controls, regulations, and detailed five-year plans were based on volumes of statistics that are perhaps more comprehensive than those collected by any other developing country. India's interaction with the world economy through international economic forums such as the GATT reflected its inward-oriented development strategy, one that most developing countries also pursued to varying degrees. It is no surprise that India's leaders often acted as spokespersons for developing-country interests in such forums.

The current move toward market opening is an equally ambitious development plan, not the least because it will require dismantling an intentionally created economic infrastructure as well as constructing a new set of market-supporting institutions. The combination of international economic events, such as the collapse of the Soviet Union and the rise of China, with internal market pressures from entrepreneurs has done much to weaken the old economic regime. But there are still many who cling to the protection that Indian economic policy offered.

Removing the remaining components of the old economic regime will require a concerted effort with regard to both international and domestic policies. On the international level, we argue that India should become more actively engaged in further multilateral trade negotiations through the WTO to offset the resurgence of protectionism in industrialized countries. On the domestic level, policies to improve the physical and regulatory infrastructure for investment are at the top of the list.

We are cautiously optimistic, however, about the reforms. The removal of tariffs, the relaxation of industrial policies, and the extrication of the government from the business sector have been slow and subject to political obstacles and bureaucratic inertia. But the cumulative changes during the past decade have had a noticeable impact on job growth and productivity. The efforts to attract foreign investment have been hampered by an

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inadequate physical infrastructure, but they nevertheless led to a tenfold increase in FDI from the 1980s to the 1990s. The pace of reform slowed in the multiparty governments of the early 1990s, but it has resumed as political conflicts have lessened since 1999.

We have been evaluating India's economy from the vantage point of just one decade after the beginning of a new economic trajectory; the achievements thus far are promising, and the future prospects are bright—provided that the reform process is extended and deepened, particularly in its international dimensions. It is heartening that the need for this extension and deepening is being realized by the parties in power and by the opposition.

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