UNIT 24 ECONOMIC REFORMS AND GLOBALISATION

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24.1 INTRODUCTION

The art of policy making lies in reconciling theory with ground realities. Policy has to be adjusted if either theory advances or ground realities change. In this unit, we analyse the changing face of development strategy and policies in India under these twin changes—changes in theory and in political reality. Many of the changes in Indian policy occurred because of balance of payments crises—in 1957, 1965-66, 1973-74, 1980-81, and in 1990-91. Also, over the years there was considerable research both theoretical and empirical-looking at the experience of different countries, and this research influenced the Indian policy makers,

In Section 24.2, we discuss theoretically the issue of whether policy makers should depend on the market or there should be planning and government intervention. Initially the opinion seemed to be that a planned economy could perform better than a market economy. But developments in economic theory and the experience of the socialist economies resulted in a radical change in this view and policy makers came to rely more on the market. In Section 24.3, we discuss Indian planning—its rationale and achievements, and in Section 24.4, we discuss trade policy in India—its role within the Indian planning process and how it was conducted, In Section 24.5, we discuss the 1991 crisis, and the liberalisation and its consequences for economic performance. In Section 24.6, we touch upon the issue of the implications of this liberalisation for Indian democracy, We argue that till the mid-sixties there. was consonance between the objectives of Indian planning, economic theory and the realities of India's economic and political situation. But since the mid-sixties this consonance started to break down; the liberalisation has brought to the fore in a much sharper form the dissonance between these aspects of policy making.

24.2 THEORETICAL DEBATES ABOUT THE USE OF THE MARKET OR PLANNING AND GOVERNMENT CONTROLS

A major preoccupation of economists in the twentieth century, particularly after the establishment of the Soviet Union, has been the question of the relative role of the

government and the marlcet in the management of an economy. This question received increased prominence with the depression of the 1930s bedeviling the capitalist economies and the attempts by newly freed colonies to accelerate growth and improve the living standards of their people, In recent years this debate between the roles of the government and of the market has taken the shape of globalisation and liberalisation. By and large those who favour the market also favour liberalisation, and those who favour a closed economy favour more government intervention, though the lines of battle are not so clearly drawn.

There are broadly speaking three sets of beliefs about inanaging an economy. A group believes that markets lead to a desirable outcome, what in technical language is called a Pareto Optimal (PO) outcome, so there is no need for government intervention. A second group holds that while there are shortcomings in the operation of a market economy, government should not intervene, as it cannot improve the functioning of the economy. The more pessimistic in this group believe that government intervention would actually worsen the operation of the economy. A third group believes that government intervention can improve the operation of the economy, though members of this group may differ among themselves about the extent and nature of the intervention.

We define the basic concept of a PO outcome and its significance in economic analysis before examining these issues in detail.

A situation is said to be PO if nobody can be made better off without somebody being made worse off. If there are two individuals, Vinod and Kamal, &en Vinod cannot be made better off without Kamal being made worse off. We would get a PO better position if both Kamal and Vinod could be made better off. So if a situation is PO we cannot improve upon it by a re-allocation of factors of production or by re-allocating goods between the individuals. But a Pareto improvement does not say anything about how the gains are distributed. For instance if the total production in the economy is 100 then if Kamal gets all the 100 and Vinod gets nothing that is a PO situation as we cannot give anything to Vinod, i.e. improve his situation without reducing the amount available to Kamal. i.e. making him worse off. One of the weaknesses of the concept of PO is that it ignores distributional questions.

What is its strength? Its strength rises from what are called the two fundamental theorems of welfare economics. The first says that the outcome of every perfectly competitive system is PO. So if we have perfectly competitive markets and if consumers try to maximise the satisfaction they get from consumption and producers try to maximise their profits then the outcome will be PO. But the PO outcome that results may be very unpalatable or unwelcome. As we saw above if Kamal gets everything and Vinod gets nothing that is a PO outcome. But few would think that such an outcome is desirable. This weakness is rectified by the Second Theorem, which says that any PO can be reached by a perfectly competitive economy given an appropriate initial income distribution. So society can let the market operate and reach any desirable outcome it wishes for so long as it can adjust the initial income distribution. So selfish behaviour leads to a socially desirable behaviour. The implication of the second theorem is that the government should interfere only to bring about a desirable initial income distribution and then let the market work.

These two theorems provide the basis for much of the belief in the efficacy of the market system that underlies recent liberalisation in many countries. But the problem is that careless analysis ignores the qualification that the market system would reach the desired PO only if the income distribution is appropriate. A second weakness of the market system is that there is no way of guaranteeing an appropriate rate of savings and investment in the economy. Private individuals may save and invest less than is socially desirable leading to slow growth in income and employment so that poverty would persist; furthermore, if savings and investment were not equal, depressions or inflationary episodes would occur. A developing economy needs an appropriate level of savings and investment to raise its rate of growth and improve the living standards of its people.

Would a market economy perform better or worse than a planned economy? This question was first raised in the context of the debates about planning in the Soviet Union. Lange and Taylor, by using the economists' stylised conceptualisation of how a market economy reaches equilibrium, showed that a planned economy could reach equilibrium just as a market economy. An autonomous auctioneer is assumed, and he quotes a price. The people inform him of their demands and supplies at that price. If the demand were greater than the supply he would then raise the price for the next round and if supply were greater than the demand he would reduce the price. People would give their demands and supplies at the new price and again if demand were greater than supply the auctioneer would raise the price and if supply were greater than demand he would reduce the price. The process would continue till a price was reached at which demand and supply were equal, namely equilibrium was reached Actual transactions would occur only after equilibrium was reached. Lange and Taylor argued that the real life Planning Board in a planned economy could play the role of the hypothetical auctioneer in the market case and so ensure that equilibrium was reached. Furthermore, the state in a planned economy could rectify the two shortcomings in the market economy. It would bring about a desirable income distribution. Also the state by its own investments could ensure the socially desirable growth rate. Thus a planned economy would reach a PO situation, and in fact was more likely to reach a good PO position. So the first round seemed to have been won by those who argued in favour of a planned economy.

Later analysis has eniphasised the problem with information flows, The Planning Board can take appropriate decisions only if it has the right information. But it has no way of generating this information on its own. It has to depend on workers and managers in the public enterprise to provide it with the information. They may have no incentive to provide this information. For instance, the planning board may need to set a production target for the enterprise. The workers and managers know much better than the planner what can be produced. But they may understate what can be produced either in order to produce more than the norm in order to earn a bonus or because if they give the higher figure this year they will be expected to produce even more next year and they do not want this higher target for next year. Furthermore, each individual has special knowledge, which cannot be transferred to a central body, and in a centralised system this private knowledge is lost. Only with this was the significance of Hayek's objections against a planned economy better realised (Stiglitz).

The expectatibn was that in a "socialist economy", the individual would behave differently. But for many reasons, the planned economies were not able to eliminate the alienation that

plagued workers under capitalism and build the new "socialist man". And so these economies were not able to overcome the information problem and the system finally collapsed.

To a certain extent these economies created their own problems. As we have seen above, a planned economy can overcome the problems of inappropriate levels of investment and an unsatisfactozy income distribution that plague a market economy. But unfortunately, for reasons not entirely clear, no socialist economy used the market. Instead they relied on quantitative instructions from the Planning Board to various agents. For instance, the state can supply food to all through government shops or can give everyone an income and let them buy what foods they want. In the latter case, the government uses the market to provide everyone with adequate nutrition while in the former case the government would have to find out what foods each one liked or risk that the food supplied may not be eaten. So the market should be looked as one of the many instruments that the government can use to achieve its objectives.

24.3 DEVELOPMENT PLANNING IN INDIA

When India embarked on its planning adventure, the economy was predominantly agricultural with a very small industrial sector limited to mainly the cotton and jute industries, and a low rate of savings of about 10 percent. (For further discussion see Bhagwati and Chakravarty, 1969 and Chakravarty, 1978). In addition, the entrepreneurial class had limited experience with operating industrial enterprises; Indian entrepreneurs were mainly involved in trading activities, and had experience of operating only in the textile industry. A higher rate of growth was needed to reduce the extent of poverty in the country and improve the living standards of the people. But accelerating growth would require higher investments and larger imports of capital goods, as such goods were not produced domestically. These imports could not be paid for by higher exports of agricultural goods, because larger agricultural exports would lead to a worsening of the terms of trade so that export earnings would not increase by much. Furthermore, because of the adverse land-man ratio in India, development had to be based on industrialisation (Chaltravarty). This industrialisation could not be oriented towards the external market, because of fears of a slow going world economy, protectionism in the developed countries (Nurkse) and lack of competitiveness because workers in India were not industrially disciplined and not well trained. Therefore, industrialisation was to be achieved by developing industries by preventing imports. So India's adoption of a policy of impost substituting industrisalisation (ISI) was supported by theory, the Indian economic situation and corresponded to the development policies adopted by most developing countries.

In India the state was the agent for bringing about this industrialisation. (Later in the unit we will discuss the role of government in a more liberalised economy.) This was because India went in for import substitution in basic industries. Theoretical models showed that such import substitution would lead to a higher rate of growth. (For further discussion see Bhagwati and Chakravarty, 1969 and Chakravarty, 1978). Development of basic industries would free the economy from dependence on imports and so support self-reliance, an important objective. In particular, development of a defence industry would be made

easier and so ensure India's self-reliance in defence production. Private capitalists were not keen to invest in such industries as the scale of investments in these industries was large and no output would be produced for many years. Furthermore, state investment in these basic industries would also prevent undue concentration of wealth. Most other developing countries undertook import substitution in consumer goods industries. Investments in these: industries were made by transnational corporations (TNCs) who had earlier been producing these goods in the developed countries and exporting them to the developing countries (see Agaswal Rodrik, 1996 and Ropdrik and Rodriguez, 2001).

For a few years developing countries grew rapidly; then they ran into difficulties–notonly those who had adopted import substitution in consumer goods but also those who had adopted import substitution in capital goods. These difficulties manifested themselves as the countries running large balance of payments (BOP) deficits as their export earnings were much smaller than their import payments and so could not continue to pay for their imports. So developing countries had to adjust.

Most countries made adjustments in their trade policies to lay greater stress on exports. Countries like Brazil and Colombia allowed their exchange rate to periodically devalue so that their exports remained competitive and grew. Others like India provided subsidies to exports in order to encourage exporting. Countries in East Asia, Korea, Taiwan, Singapore and Hong Kong, made more radical departures to encourage exports—and it was later said that they followed an export led development strategy.

24.4 TRADE POLICY IN INDIA BEFORE 1991

India, as noted above, had also opted for an ISI strategy. It faced difficulties in the BOP—there was a crisis in 1957-58 and then in 1965-66. Faced with BOP difficulties Indian policy makers sought new sources for funds and also undertook some adjustment measures. For instance, after the 1957-58 crisis, India approached the World Bank for assistance and the World Bank established the Aid India Consortium. Aid through this consortium financed much of the public investments in the Second and Third Year Plans—about a third. The size of the Plan was also reduced—there was a big debate about how the size of the plan should be adjusted. Subsequently, in the Third Plan (1961-65) the government provided various export incentives in order to increase export earnings.

The 1965-66 crisis resulted in more far-reaching changes. Agricultural policies were changed as one of the causes of the crisis was the increasing import of foodgrains, and the Green Revolution was ushered in. The changes in agricultural policies were successful in rising the rate of growth of agricultural output and make India self-reliant in food production. Trade policies were also changed, including a devaluation of the rupee. But there was much less political support for the changes in trade policies than for the changes in agricultural policies and these were soon reversed. The disputes with the donors resulted in a stoppage of aid by the World Bank and the US. The Indian Government adjusted to this cutback by having a Plan holiday for a few years and undertaking measures to raise the domestic rate of savings (Agarwal, Bowles).

The experience of these years had an enormous influence on Indian policy makers. The adjustment measures, an early experience of structural adjustment, resulted in a decline in

per capita income. As early as 1960 Indian policy makers were concerned that the growth was not generating enough employment and so was leading to a reduction in poverty. A committee was set up to study the situation and recommend policy adjustments. With the slowdown of growth following the 1966 crisis the implications for poverty reduction were stark and the question was how to implement Mrs. Gandhi's promise of "Garibi Hatao".

The technical note to the Fourth Plan examined the options in great detail. They assumed that it would not be politically possible to reduce the consumption of the higher consuming classes. It was assumed instead that the income of the higher consuming classes would be kept constant and all the additional consumption would be granted to the poor: Even under these assumptions they found that a high rate of growth of over 7 percent per year would be required to reduce poverty significantly in a short time. The analysis in the technical note explains why poverty reduction has been so significant in the eighties and nineties as the economy grew at almost 6 per cent a year during this 20-year period.

The BOP crisis of 1973-74 also resulted in a mixed response of seeking new sources o finance and adjustment. Borrowings were undertaken from the oil facility of the Fund and from the Fund's Trust facility. Also investments were made in oil exploration and refining leading to lesser dependence on oil imports. This lesser dependence helped in the management of the economy in the seventies and even more in the eighties when export earnings were stagnant. The BOP crisis of 1980-81 resulted in India borrowing from the Fund and later in the eighties India started tapping Non-Resident Indians and commercial Banks for funds.

But all through this period India continued with its basic policy of ISI. One problem, though, was that with government investment diverted first to agriculture and then to oil exploration and refining, there was a squeeze on investment in the inhastructure sector, which had longer-term consequences, and on investment in manufacturing so that greater reliance had to be placed on the private sector and emphasis shifted from basic industries to consumer industries. Adjustments were made to trade policy in the seventies and eighties to make imports of intermediate goods and components easier as lack of these during the strict import control regime period had prevented better utilisation of installed capacity. More intermediate imports allowed better utilisation of installed capacity and so improved efficiency.

24.5 1991 CRISIS, LIBERALISATION AND ITS ECONOMIC CONSEQUENCES

Since the mid-sixties economists started studying intensively the effect of trade policy on economic performance. Though there is no consensus about the conclusions drawn from these studies, most trade specialists conclude that economies adopting outward oriented policies perform better than countries adopting ISI policies (For a discussion of these issues, see Bhagwati (1978). For an analysis of the Indian case, see Bhagwati and Srinivasan). These studies also identify a number of factors that reduce economic efficiency in countries adopting ISI policies. For instance, in India the foreign exchange control regime had to allocate foreign exchange among companies in an industry for import of raw materials. It

is very difficult to judge efficiency of firms. So the officials tended to allocate the foreign exchange in proportion to production or, more often, capacity. This meant that no effort was made to distinguish between efficient and inefficient firms. If allocation was done on the basis of capacity it encouraged firms to have more capacity so that capacity utilisation was low and capital was being wasted in a country that was short of capital. When decisions about expansion were to be made, the licenses were divided among all the applicants without consideration being given to efficiency. Again therefore efficient and inefficient firms grew at about the same rate. Such allocation rules were a major reason for the slow growth of productivity in Indian industry which has been documented by many researchers.

The broad opinion among economists is that very high rates of tariffs lead to inefficiency and should be avoided. For instance, if a duty of 400 percent is levied on a good in India, it means that Indian producers can be 400 per cent less efficient than foreign producers and the cost is borne by poor Indian consumers. The future benefits, such as becoming more efficient later etc. are rarely large enough to justify this large cost now. But there is no unanimity of what the low level of tariff should be. Some economists would go all the way to free trade, most would opt for 10 to 25 percent, and some may go as high as 35-45 percent. All would favour a few tariff rates. This is purely for administrative reasons. If there me many rates, then considerable time can be wasted in deciding what rate is applicable for a particular good and opportunity for corruption is created. Also economists would by and large not favour use of quotas (QRs).

The result of the considerable amount of research done on the effect of trade policy on economic performance and conditionality attached to Bank and Fund loans has been that most developing countries have abandoned the ISI regime that they had adopted earlier. Most have no QRs—only 7 small countries still maintain QRs. The developed countries have tariffs that average about 4 percent. This is in contrast to the average rate of about 40 percent at the end of the Second World War. Almost 50 percent of the imports into these countries were duty free.

Of course the picture from the viewpoint of developing countries is not so rosy as the developed countries tend to impose higher tariffs on goods exported by developing countries. Developing countries have also reduced the tariffs in imports, Average import tariff in most developing and transition economies is now about 10 percent.

Indian policy makers, tackling the 1991 crisis, took the stance that trade restrictiveness was not an appropriate policy, and that the economy should become more open. Also the industry regulations that had governed entry into an industry and also governed how much a company could produce, had outlived their usefulness. Indian policy makers have drastically reduced the level of protection in the economy, The maximum tariff was reduced from almost 400 percent to about 40-50 percent, the average tariff from about 100 percent to about 20 percent. All QRs on manufacturing imports were eliminated after India lost a dispute before the dispute settlement board at the World Trade Organisation. Earlier all QRs on agricultural imports were eliminated as part of the agreement at the multilateral trade negotiations known as the Uruguay Round. Though, India has liberalised its trade regime considerably, it still has a more restrictive regime than other countries. Internal regulations on industrial investment have also been eliminated and the inflow of foreign capital liberalised.

Economic performance since the liberalisation has not been dramatically different from that of earlier period and this has generated considerable debate. The rates of growth of agriculture and manufacturing as well as total Gross Domestic Product have been about the same. There seems to be no strong evidence that the rate of growth of productivity in Indian industry has increased after the liberalisation. Poverty decreased quite rapidly in the eighties. Poverty has continued to decrease in the nineties after the liberalisation though at a somewhat slower pace (For a detailed discussion of poverty trends in India see Tendulkar, 2003.)

24.6 LIBERALISATION AND DEMOCRACY

The liberalisation has however generated a vigorous debate about its iinplications for poverty reduction, empowerment and democracy. The objective of Indian policy makers since the inception of planning was to achieve what is today called "just growth", namely growth that reduces poverty and leads to a more equal distribution of income and is accompanied by democracy. Democracy and a more egalitarian econoniic system were believed to be connected—political rights could not be guaranteed without econoinic rights. Economic rights consisted both of reducing poverty and reducing inequality. There seemed to be no contradiction between reduced poverty and reduced inequality. Ever since the 1971 "Garibi Hatao" slogan of Mrs Indira Gandhi, the public has been aware of the need to reduce poverty and income inequalities. The constitution had itself recognised this duty and had made provision for reservation to achieve a more just society. Once the notion of state action to help the disadvantaged was accepted, there was increasing number of claimants, and various people formed groups to champion their cause more effectively. The scope for reservation has been increased over the years and many programmes established to improve both the condition of the poor and to provide more power to them.

Increasingly, resources have been diverted towards many explicit and implicit subsidies, One effect of these subsidies has been the increasing budget deficit of the central and state governments. These deficits have left little scope for further employment in the public sector — increasing public sector employment was one of the ways to bring disadvantaged groups into the system.

Though nobody would claim that all disadvantages have been eliminated, considerable progress had been made in reducing poverty. Progress had also been made in empowerment if one looks at the number of representatives from the weaker sections in parliaments or share in ministries or even among chief ministers. But there is a very real question about the sustainability of this progress. Serious constraints have emerged. There is considerable over-manning in the public sector, which has reduced public investment and future growth and employment. The laclc of government investment has resulted in a very poor and outdated infrastructure which is a constraint to faster growth. Education and health have been neglected and increasingly people have to depend on expensive private education and health. There is, at the moment, a very real conflict between the need to grow faster and to have a better distribution. Liberalisation, by raising the rate of growth, could provide the wherewithal for further redistribution. But, unfortunately, investments in infrastructure and in human capital are required to reap greater benefits from liberalisation.

But at the moment that does not seem to be happening. The lack of employment growth is prompting demands for reservation in the private sector also. It is difficult to see how such reservation can be combined with a policy of greater reliance on the market. Society faces serious challenges if it is to succeed in providing just growth.

Just growth could result from globalisation, if that is properly managed. Globalisation is the increasing integration of different national economies; because of liberalisation, the elimination of restrictions has resulted in greater flows of both goods and capital flows. Liberalisation can help in reducing poverty. A more liberal trade policy will help India to export labour intensive goods, namely goods in the production of which considerable labour are employed. There is evidence to suggest that this is happening since the liberalisation. Expansion of labour intensive exports implies growth in employment, and provision of jobs is the surest way to help a poor person overcome poverty. But for the best results the employment that is created should be at high wages. Wages are higher if skilled jobs are created. But for people lo find skilled employment they must be educated. A strong need at this moment is for the government to provide good education. Unfortunately, the standard of public education has been declining, and the cost of private education rising. This situation needs to be rectified urgently if the society is to make the most of the opportunities provided by liberalisation and achieve just growth.

Unfortunately, there is an evidence that globalisation tends to increase income inequality. Therefore, globalisation brings to the fore a possible conflict between poverty reduction and reducing income inequality, a possible contradiction that had been ignored earlier in India.

Globalisation changes the role of the state, though it does not necessarily lead to its reduction. Instead of the state being involved directly in production, the state has to provide both physical and human capital. It also has to act to draw the poor into the economic system and to improve their situation. Furthermore, the state has to act to regulate private enterprise. Instead of increasing the production, the state sets up regulatory institutions. It is not clear that it would be any easier to protect regulatory agencies from political interference and thus leading towards inefficiency. Liberalisation raises new questions about the role of the state to achieve just growth.

24.7 SUMMARY

The beginning of the 1990s saw a major change in the Indian economic policies. The balance of payments crisis led to the policy of economic liberalisation of the Indian economy. A higher growth rate was needed, that required not only higher investments but also larger imports of capital. goods. The policy of import substituting industrialisation that complements the development policies seemed to be a viable option, an option adopted by many developing countries in the earlier years. But with the amount of export earnings remaining relatively low than its import payments, the developing countries had to adjust their economic policies accordingly, The policy makers of India realised the disadvantages of trade restrictiveness. Consequently, the economy was opened up enabling the inflow bf foreign capital and industrial investment.

The focus has shifted to "just growth" wherein an equal distribution of income is ensured in a democratic setup, thereby linking the political and economic rights. Though there have been claims about the advantages of the liberalisation, the lack of government investment has led to an outdated infrastructure thereby stagnating the growth. The elimination of restrictions failed to generate the corresponding benefits. The need of the hour is to make the most out of the opportunities provided by globalisation/ liberalisation. The role of the state, in this context, is crucial in not only improving the existing situation but also thwart moves towards inefficiency. Thus the state can ensure a positive outcome of the liberalisation policies and achieve just growth.

24.8 EXERCISES

1) What is a market economy? Explain its advantages and disadvantages.

2) What do you understand by a planned economy?

3) Write a short note on India's economic scenario prior to 1991.

4) What are the economic consequences of liberalisation in India?

5) How does liberalisation help in ensuring "just growth"?