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Summary of ICA Institute Study Group
held on April 30, 2005

Discussion leader:
Dr. Anupam Srivastava, Director
Asia Program, Center for International Trade and Security
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Economy

During the period from 1947-1985, the Indian government introduced 5-year plans based on the Soviet model out of necessity. The economy was completely distorted because it was a colony of the British serving as a source of raw materials and then a market for British products. The government decided a strong state (central government) was needed to reallocate resources and policy priorities to build basic strengths. The federal government put in a lot of resources to build up manufacturing and heavy engineering capabilities; they invested in education and infrastructure.

In a country with a large population, you have just a few centers where all industry will happen (e.g., Mexico City, London, Taipei). India distributed industry to four metropolises: Calcutta, Delhi, Chennai and Mumbai. The MRTP (Monopolies and Restrictive Trade Practices Act) antitrust law in 1969 capped the size of companies so they would not enjoy monopolistic price and market share. The government also nationalized banks (1969).

Why did nationalization happen and what was the underlying fear the government had about banks?

Ms. Gandhi, as the Information Minister in 1966, had already begun to articulate some of these fears. When she came into power, she began to feel that the power of big money was creating an industrial complex that would dominate India. This was

inherently antithetical to the kind of state driven, gradual growth of India as an economy where the private sector was deliberately circumscribed in how much access and influence they could have. Nationalization of banks was to make sure there was transparency and accountability in government control of bank resources for the nation's development. But what happened was that while these steps were necessary up until the early 70's, they began to go wrong. There was too much state planning, too little space for the private sector. Ms. Gandhi imposed a state of national emergency for two years which was a very undemocratic move. What happened was the birth of "License Raj", the rule of licensing system, which means that in India you were looking at a very large domestic market (about 750 million people) and very high tariff walls. Both state and private sector industry started making the argument that were not competitive enough to face international competition at home and therefore tariff walls should be raised (300-350%). This happened in the late 60's but mostly in the early 70's.

Was the gov't influenced by its advisors to do this? Who were the people who believed in this system?

A whole range of people, including Prof. Prasanta Mahalanobis, advisor to Nehru who wrote the economic blueprint in the late 50's. Mahalanobis was the world's top statistician at the time. He founded the Indian Statistical Institute. Statisticians from around the world went to India to study with him. CR Rao was his disciple. Somebody once summarized that India borrowed the best brains to create the worst mix of capitalism and socialism. That is why the government, for example, supported ISI, import substitute industrialization. This is a strategy where you say you will stop importing from the outside, invest your meager resources internally to industrialize and create a self-sufficient economy, and industrialize your way out of poverty. Sadly, this only works if you are very rich country to begin with because otherwise there aren't enough government and private resources. This was tried in a number of Latin America and African countries and failed.

Do you think the government leaders, for whatever reason, hijacked the brain power of India and steered them in one direction or was it the brain power that influenced the gov't?

For one thing, the intellectual capital that was driving policy was too schooled and steeped in the socialist mindset to have the basic mistrust of the western-capitalist model. The License Raj was an example. With a 300% tariff system, it meant that a foreign product with a \$2 cost plus \$6 tariff added would sell in the Indian market at \$8. This also meant that the Indian produced product could sell in the Indian market as long as its cost was under \$8. You could be 3 or 4 times more inefficient and still sell in the Indian market. That is why there was no reason for these companies to not continue to pass along their inefficiencies to the domestic market. The people who benefited began to grease the hands of the bureaucrats who were in charge of these things. That's why

there was a nexus of bureaucracy, big state owned enterprises and a few family owned businesses.

Some people argue in the case of China that import substitution and similar policies help in some ways such as learning by doing, they help develop the capabilities of production, even if it's not efficient production, and indigenous technologies that many countries don't have. Were there some positive aspects of this historical period in this respect?

Yes. Because of technology embargoes, India did not really have a choice of an open system at that time. Therefore, the domestic production that happened on the defense side created a pool of technology that is now fundable. This industry is now scaling up and innovating. It was not what the government did in the 50s and 60s it was the late 60s and 70s (high tariff walls) that caused the problem. They could have started trading with Southeast Asia as a way to break into international competition. Even today, about 82% of Southeast Asia's economy is India's economy so there isn't much that isn't India's economy.

What percentage of the people who led India's economic planning in the first 40 years are still around?

By 1991, when we come to the first generation of reforms, these guys were still very strong and didn't want the barriers to come down. They made a very political argument that when an economy opens up you will have growth in some sectors and a widening income inequality. In a country like India, with a large population below the poverty line, this is not a good argument. In the mid-1990s, the government grew prosperity but also drove it into certain sectors in a way that absolute poverty decreased in absolute terms. This bolstered the argument that you can reduce poverty much faster through growth. You can keep dividing and subdividing the pie in egalitarian ways but the pie must grow for it to mean more. By late the 1990s, the political spectrum, including the Communists, began to argue over who could grow the economy the most. Both of the major parties are now economics driven.

What is the current political balance of power? Do you have two parties that are controlling everything?

At the federal level, you have a right of center occupied by the BJP and its group of forces, you have a left of center occupied by the Congress Party and the Communist Party. The Communists are to the left of the Congress Party. The other right parties are to the right of the BJP. At the federal level there is no fundamental difference in economic policy. At the state (province) level the political alignments are different. The U.S. was formed as a federation from below (states), India was formed as a federation from above but that is changing and now you have states that are asserting themselves. The government is becoming more of a facilitator rather than a controller.

What happened in the 1985-1991 time frame was that all of these protectionist things came to a head. Rajiv Ghandi tried to institute reforms but the controllers (the

isolationists) fought it off. And so a return to a subsidy type of model had started. But it also meant that the federal government had to borrow heavily at very high rates in the domestic and foreign markets. This led to a foreign exchange crisis. It took a non-politician, Manmohan Singh, who was finance minister, and others to create a fundamental change in the Indian economy that has driven the system through growth. Growth started averaging 6-6.5% in the 90s, administrative reforms began to happen, a lot of infrastructure development began to happen, and a whole range of exports grew. In 1991, India's exports were \$6 billion and \$9 billion in imports. As of last week, India exports were \$80 billion and imports are \$90 billion and they will easily cross \$200 billion in the next three years. The export-import portfolio has changed. The largest exports to Germany are leather and machine tools, which is not what you would expect. Its top imports from Germany are capital intensive machinery, not textiles or chemicals.

Another factor of the change was the 1990 Gulf War, which hit India the third hardest because Iraq was India's major oil supplier and the war severely limited their oil supply. There were over 600,000 India workers in Kuwait who were providing almost a billion and a half cash flow back to India. At one point, India reserves went below 2 billion. This resulted in a credit ban by commercial banks. You could not import anything without getting a letter of credit from an exporter viewpoint.

Moving to the Current Economy

Incremental Capital Output Ratio (ICOR) shows how efficiently you are using capital in a country. Until a few years ago, the ICOR in India was as high as 4, meaning that it will take four units of capital to produce one unit of output. As of yesterday, it was 3.6.

Investment in India has been around \$2.5-4 billion in the last two years compared to at least \$25 billion in China. China is growing around 9% and India is growing around 6%. With 1/10 of China's investment, how can India continue to grow at this pace? Some have concluded that China has become less efficient. If India has to grow at 9% it would need 36% investment. India's saving rate is only at 25% now so it does need outside investment and that is why the government is compelled to continue with market friendly policies.

On the other hand, there is a viewpoint that the Chinese government is saying they are flush in investment, but this is only in a few sectors and in a few cities and this has caused them to become inefficient in those areas. They need to drive the investment into other provinces.

What you have now is 10 years of the first generation of reform leading up to 2000 resulting in an economy that is much more open, restrictions on the operations of the private sector have mostly been removed, and the number of licenses and requirements have been simplified. The fact that the economy is exporting more in one month than it used to in a year shows that this is happening.

In the second generation of reforms, the federal government realized it had a number of disincentives for province level exports. One of these was that when an entity from an individual, province-owned enterprise exported something, the revenue would go to the federal government and then the federal government would distribute this to the provinces based on need and merit. So there was no incentive for province-owned companies to export. This has changed. The federal government now wants to nurture a big brother relationship but essentially as a way to delegate more decisional latitude to the provincial government.

The central government has also started working on major projects. For example, most analysts believe that if India would fix its infrastructure problems the GDP would grow by at least 2%. Power structure reforms alone could grow it by 1 to 1-1/2 %. The central government has laid out in its financial for the next 20 years, and are planning half a trillion dollars in investment in infrastructure development. Typically, the problem in infrastructure in the last ten years is that return on investment is low and takes a long time to mature. The government has realized that it must have at least a 25% stake in each of the infrastructure projects to ensure domestic and foreign investors that the project will go forward. They have a series of programs. One on the highway side is BOLT (Build On Lease Transfer) in which they are incentivizing foreign companies to invest in roadways and then they can make them toll roads to recover their investment. Civilian aviation, ports, and electricity have also been the subject of these kinds of deals.

The World Bank, which had almost ceased lending to India 4 or 5 years ago, came back this year and said they not only wanted to resume investments but also wanted to increase them, to the total amount of \$3.5 billion, particularly in infrastructure. The federal government has said do not give the money to us, it should be given directly to the projects that are going on and do it in installments based on the World Bank conditions as the project is successfully completed. An example is the building of the national highway system. The government calculates how much of the highway is passing through each district. To the district magistrate (bureaucrat) they are given identical specifications and then telling them to invite tenders and build their part of the highway. This was a way to allow the building of the system without starting at one point and working to the end. It allows the simultaneous building of the system. Quality tests are done to ensure that it is all of the same quality.

Is the money coming from the World Bank for specific projects or sectors?

85% of the WB's \$3.5 billion this year is going into infrastructure projects that are different from the highway project, such as in power structure reforms. NGOs in those sectors are identifying what projects are available and the World Bank is providing the money. The Indian government is telling the World Bank to choose which projects meet their criteria and put their money there. It's a more market based approach going through NGOs.

Is there any tendency to contract out projects with the preference for internal production within a province?

These are being contracted out to other provinces and other countries. The Delhi and Mumbai airports are being built by the company that built the airport in Singapore because they feel that is the best airport model in the world. The metro system in Delhi is being built by the South Koreans. The Japanese are going to build a magnetic levitation train. There is a conspicuous absence of American and European companies in a lot of these projects. These contracts are being steered to certain companies just as Iraq contracts are being steered to certain companies by the U.S.

What is the latest development regarding social barriers, such as the caste system, in labor mobility or upward mobility? Does the caste system still function?

If you see India as a spectrum from metropolises to satellite townships to remote villages, within this spectrum this is still true. But in metropolises and satellite townships this is not the case. For those who grew up in the 70s and 80s even, there was not a class problem regarding who you went to school with, whose house you ate in, etc. In the more remote villages there are still caste issues with marriage and property. Where property rights are not well defined, it makes land transactions difficult because it is hard to prove who owns the land. It used to be that when you wanted a land certificate you went from bureaucracy to bureaucracy for weeks and lost thousands of rupees to bribe bureaucrats to make the transfer. An e-governance system was created so all land, property and other data is uploaded at the district level to Hyderabad where it is stored and managed. A farmer can now go to the sub-punch (village head's place) where there will be a computer and he can access the data he needs and print it out. He can essentially take care of the job in a half hour or hour instead of the weeks that it used to take. This is not the practice in all provinces but this is the direction it is headed.

Between the states in India, is there a federal law like the interstate commerce act in the U.S., (which is sorely lacking in China), that keeps states from preventing cross state economic relations in international markets?

India does not have a law that prevents interstate commerce and does have some that encourages it, but they have not worked very well. There were a number of taxes, from taxes by the central and provincial down to licenses at the district level. From April 1 of this year, the government implemented a VAT system. 17 of 25 states have adopted it. There is still confusion in how this will be done but it essentially sets up one tax system across the country. The federal government will take the levy and give the state's portion back quickly in the accounting process. There will not be guesswork or double taxation.

Closing

Summing up, this is an India that had a colonial background, distorted factors of production and a distorted economy, used a strong central role to create the basic

infrastructure. But the aggressive state role that was used very successfully in the Southeast Asian case--strong state intervention to promote exports, to promote aggressive growth-- was only used in backward way. The government controlled a lot. So the government was partially right in the 50s and 60s and started going wrong in the 70s. Because of necessity and the intellectual leadership of a few economists, it did start on a process of economic reform. It did allow private sector investment and the criteria therefore for measuring a policy became much more pragmatic than ideological.

A good example to illustrate this is Miruti, a government run automobile company. Three years ago, Miruti's workers asked for a wage hike. The Minister at the federal level immediately drew some data on how much Miruti's wages were vs. their productivity and then compared it to foreign and private domestic auto companies. He said they did not deserve a raise, and actually deserved a wage decrease. This had never been done in India, so the government has finally moved to that level.

What is the quality and complexion of the economists who are driving Indian economic policy going forward?

The economists that are today influential in India are not ideologues. They are very substance oriented in their arguments and analytical and are saying let the market sort out the inefficiencies, and do not go with either/or propositions such as either the U.S. or China. You can look at India's foreign trade balance and its still first with the EU, then the U.S. The U.S. wants a full FTA with India. Tariffs that used to be 350% are now down to a peak of 15% (average around 13%) and will soon be down to 10% or 5%.

Doesn't a drop like this wreak havoc?

It did. But the companies that survived acted smartly and shaped up. Those companies are now among the world market leaders. Prades Forge is the world market leader in tractors and Reliance is the third largest petrochemical company in the world. Infosys is the most productive IT company in the world. They have shaped up to the point where they don't mind foreign competition, in fact they are shopping globally to get closer to other markets. These companies have been acquiring property in the U.S. to set up operations with American employees. They are forming their own American-based companies like Toyota or Honda have done.

What the Indian government has done is adjust its basic production function so it is economizing on all of these. So instead of putting in too much technology and capital to improve production, they are increasing use of what they have more of, which is the labor force. It's more labor units into the production function. That is an influence that the economists are having.

Another major battleground is the small scale sector. Ghandi's idea was that the more you keep small companies managing businesses the better. But their scale makes them inefficient. They are unorganized, offer junk products, and labor is exploited. Now the government is looking at actively abolishing the small scale sector.

This has been seriously debated for the past 3 years. An example being used is China. One of the keys to China's success was to allow investment, and particularly foreign investment, to go into these small sector businesses. So the foreign investment goes into a small business to make lighters at 23 cents that can be sold worldwide for 50 cents or a dollar. The Indian government's fear has been that if you scale up production and allow foreign investors, they will assert managerial control and then not use local labor or mechanize production so you end up losing local crafts. But the Indians are now looking at the Chinese model of setting conditions such as having a certain percentage of labor from the region and only then allowing an outside labor force.

There is a lot of overt admiration and competition with China. China is now the benchmark for competition in each of these sectors. But this competition is not a zero sum game. It's more like two world class athletes challenging each other to get the best out of themselves. It's not that China should beat India or the reverse.