The Politics of Economic Reform in India

I

After Independence the policymaking elite in India launched a project of economic development with a heavy involvement of the state and a democratic polity. In the first three decades since then, in the 50's, 60's and 70's, there were many successes and at least as many failures of this developmental project. In terms of economic success, this particular project led to the foundation of a complex industrial economy, though some parts of the economy are highly inefficient and not very cost effective. This project also led to a fairly reasonable rate of agricultural growth, with publicly provided or subsidised irrigation and chemical fertilizers, sometimes at the cost of a heavy fiscal burden and some environmental degradation. In terms of the democratic experiment, apart from consolidating a massively diverse polity into some unified political and administrative framework, over time ripples of democratic equality spread out as if in concentric circles to ever increasing numbers of hitherto subordinate groups and castes.

Many of the failures of the project we are now all familiar with. The major failure at the overall macro-economic level was that the growth rate in national income was very slow, particularly in per capita income. A colossal and highly inefficient public sector became a drain on the resources mobilised by the government. There was rampant corruption, both political and bureaucratic; some of this corruption flowed from the regulatory structure of the economy, particularly the nightmarish maze of controls and regulations that the government imposed. The sluggish growth could not match the growing aspirations of the up-and-coming subordinate groups. In that sense there was a chasm between the political and the economic development. The political mobilisations gave rise to aspirations of groups that now came up from below overcoming a long history of social inequality and oppression, but the economy could not match those aspirations. Due to the slow growth, the elite that controlled the economy did not have adequate state resources to placate those who were banging at the gates with increasing assertiveness; this obviously led to economic and political frustrations and social fragmentation all around. This was beginning to be widely felt by the middle 70's.

Partly in response to this rising frustration, the elite in India over the last two decades launched a process of economic reform with a view to unleashing the entrepreneurial forces from the shackles of controls and regulations, hoping that some of the ensuing economic growth would trickle down to the clamouring masses. The changes introduced, particularly since the early 90's, were dramatic by past standards in India, but quite unremarkable by the standards of many other developing countries, particularly in East Asia and Latin America. The major elements of changes in policy over the last decade include:

(a) delicensing and deregulation of investment and production in most industries, and the introduction of a general regulatory framework in the case of monopolies (rather than case-by-case discretionary control);

(b) discontinuation of exclusive reservation of many key industries for the public sector and of budgetary subsidies to public sector enterprises, with some small steps towards privatisation in more recent years;

(c) gradual abolition of quantitative restrictions on imports (except for some consumer goods);

(d) movement towards a market-determined exchange rate (within limits) and current account convertibility;

(e) reduction of average levels of direct and indirect taxes and some streamlining and rationalisation of the tax structure;

(f) some reform in the financial sector (abolition of control of capital issues, more competition among banks and insurance companies, deregulation of some interest rates, insistence on capital adequacy norms, etc.).

In some sectors of the economy significant reforms have yet to be started, for example, in storage and movement of commodities in agriculture, labour regulations, reservation in small-scale industries (except very recently in some industries like garments). In other sectors reforms have started but the pace is sometimes erratic and slow. A recent international survey of business environment by the World Bank indicates that in India 16 per cent of manager's time is still spent in dealing with the bureaucracy, as compared to 5 per cent in Latin America. Some of the obstructive regulations by state governments (in matters like electricity and water supply and land acquisition and registration) are still in place. Government-controlled financial institutions still dominate the financial markets. Import-weighted tariff rates are still relatively high at 30 to 35 per cent on average. There is strong opposition from organised labour to privatisation, and from politicians and bureaucrats to giving any genuine autonomy to public enterprises. Jenkins (1999) has pointed to some accomplishments of 'reform by stealth', for example in the matter of some state governments looking the other way as the stringent labour laws are evaded or diluted by factory owners in practice. But some of the major political blocks to reform are difficult to surmount this way and the constellation of interest groups that lock in the system in a low-level equilibrium (for an elaboration of this argument see Bardhan (1984, 1998)) is still quite powerful. Nowhere is this as evident as in the case of the continuing fiscal crisis of the state.

The various (implicit and explicit) fiscal subsidies of the central and state governments to a plethora of interest groups (mostly relatively rich) and the interest burden on borrowing to cover current expenditures contribute to a fiscal deficit of about 11 per cent of GDP (as large as at the time of the crisis in early 90's), and the more alarming feature is that the revenue deficit as per cent of GDP is now much larger. Many state governments are near bankruptcy after paying the large recurring bills of salaries and pensions. The contingent liabilities of state governments (in the form of borrowing by the public enterprises under their control) are not counted in the estimates of fiscal deficits, and already run to about 6 per cent of GDP. The central government has also various ways of parking their additional deficits in the public financial sector. Large public dissavings (in the form of fiscal deficits and public enterprise losses) keep the interest rates high, and that cripples the credit-starved small-scale industries (who do not have much access to the equity markets).

This kind of fiscal profligacy has also its obvious adverse consequences in the form of the state governments' diminishing share in social expenditure, and the central government's diminishing involvement in public investment (not adequately compensated by rise in private investment). Capital expenditure (of central and state governments together) as a percentage of GDP declined from about 6.6 per cent at the end of the 80's to 3.4 per cent at the end of the 90's. India's creaking infrastructure (ports, railways, power, irrigation, etc.) has become a crucial bottleneck to industrial and agricultural growth. The resultant high real costs for Indian business make it uncompetitive internationally in many branches of manufacturing. Even in agricultural products it has been observed that it is cheaper to import wheat in south India from Australia than from Punjab. The largest single contributor to fiscal deficit for the country as a whole is the staggering burden of losses in the state electricity boards. The massive investments in these enterprises over the years have yielded a *negative* return of 17 per cent by a current estimate. The corporatization of the state electricity boards with independent regulatory bodies has been very slow in most states. The problem of cross-subsidisation of agricultural and residential users by over-charging industrial users is now being somewhat mitigated by reform in some states. But the losses due to theft and illegal connections (with complicity of electricity board employees in collaboration with politicians and criminals) keep on mounting (in U.P. alone there are about 2 million illegal-- *katia*--connections, and the total annual loss due to so-called transmission and distribution losses run to about Rs. 30 billion). Unless and until the problem of charging market prices and user fees for infrastructural services is resolved, the chances of substantial foreign investment to relieve the infrastructure bottleneck are low.

II

An analysis of many of the fundamental problems besetting Indian reform requires an exercise in political sociology. In the rest of this Chapter we shall briefly focus on the various kinds of disjunctures that have appeared in the Indian scene between the policy of economic reform and the political and administrative processes. Economists often ignore these and are surprised when things do not proceed in the way they want. We need to have a better understanding of why reform is so halting and hesitant, why there is no substantial political constituency for reform (outside the small confines of India's 'pink press' and sections of the metropolitan elite), why even the few supporters of reform underplay it at election time.

(a) Any process of sustained economic reform and investment requires a framework of long-term policy to which the government can credibly commit itself. But the political process in India seems to be moving in the opposite direction. While becoming more democratic and inclusive in terms of incorporating newer and hitherto subordinate groups, it is eroding away most of the structures of institutional insulation of long-run economic management decisions against the wheeling-dealing of day-to-day politics. There are very few assurances that commitments made by a government (or a leader) will be kept by successive ones, or even by itself under pressure. A political party that introduces some reforms is quick to oppose them when it is no longer in power.

(b) With the extensive deregulation of the last two decades it was expected that corruption that is associated with the system of permits and licenses would decrease. There are no hard estimates, but by most anecdotal accounts corruption has, if anything, gone up in recent years. Some of the newer social groups coming to power are quite nonchalant in suggesting that all these years upper classes and castes have looted the system, now it is their turn. This has implications for the milking of the remaining obstructive regulations, particularly at the level of state governments. As elections become more and more expensive, the demands on business from the politician-regulator are unlikely to relent.

(c) Much more than economic reform, the major economic issue that captures public imagination is that of job reservation for an increasing number of 'backward' groups, which is accepted by all parties. In the last decade of market reform more and more of the public sector job market has been carved up into protected niches. Cynics may even argue that the retreat of the state, implied by economic reform, is now more acceptable to the upper classes and castes, as the latter are losing their control over state power in the face of the emerging hordes of hitherto subordinate groups, and opting for greener pastures in the private sector and abroad. As subordinate groups capture state power, they are not likely to easily give up the loaves and fishes of office and the elaborate network of patronage distribution that goes with it, whatever the rhetoric of reform they mouth when they entertain visiting dignitaries from the Western countries. This is more acutely the case at the state government level where these groups are more secure in power.

(d) As we have mentioned above, there have been few substantive reforms in the agricultural sector, and the non-agricultural informal sector has been hurt by the credit crunch. Yet these two sectors constitute 93 per cent of the total labour force. No wonder they are not enthused by the reforms carried out so far. In fact even organised farm lobbies (with the exception of some small sections under leaders like Sharad Joshi or Bhupinder Singh Mann) are not very active in demanding reforms of agricultural controls like those on storage and on domestic and foreign trade. They may be worried that the dismantling of the existing structure of food, fertilizer, water and electricity subsidies, in exchange of receiving, say, international agricultural prices, may be too complex and politically risky a deal. In any case the high administered procurement prices for grains have now eroded India's earlier (largely unexploited) competitive advantage in world grain markets.

(e) Political power is shifting more to the regional governments and regional parties, which makes national coordination on macro policy more difficult. For example, fiscal consolidation in general and a substantial reduction in the subsidies in particular are difficult when the national government depends on the support of powerful regional parties that assiduously nurse their parochial interest lobbies with a liberal use of subsidies (implicit or explicit). As the logic of economic reform and increased competition leads to increased regional inequality, it is not clear how the Indian federal system will resolve the tension between the demands of the better-off states for more competition and those of other states (which a weaker Centre can ill afford to ignore politically) for redistributive transfers. Can, for example, a shaky coalition government at the Centre, dependent for its survival on the large number of MP's from weak states (like Bihar or Uttar Pradesh), ignore their redistributive demands to compensate them for losing out in the inter-state competition for private investment? It is also the case that a large number of entry taxes on goods imposed by governments even in otherwise leading states in economic reform (for example, Maharashtra, Tamil Nadu) are making the goal of reformers to unify an integrated all-India market that much more distant.

(f) Another anomaly is that while the political power of regional governments is increasing, at the same time their fiscal dependence on the Centre is also increasing. (Between the middle 1950's to middle 1990's, the fraction of states' current expenditures financed by their own revenue sources declined from around 70 per cent to around 55 per cent.) A significant part of the central transfers is discretionary (examples are the numerous central sector and centrally sponsored schemes); these and discretionary subsidized loans are often used by the Centre more for political influence in selected areas than for the cause of fiscal or financial reform or of poverty removal.

(g) Reform would have been more popular if it was oriented to aspects of human development (education, health, child nutrition, drinking water, women's welfare and autonomy, etc.). Reformers usually are preoccupied with problems of the foreign trade regime, fiscal deficits, and the constraints on industrial investments in the factory sector, and they believe that once these are handled right, trickle-down will take care of the issues that concern the masses. Among other things, the reformers have paid little attention to the crucial problems of governance in matters of achieving human development, which will be inexorably there even if trade, fiscal and industrial policy reforms were successful. If the administrative mechanism of delivery of public services in the area of human development remains seriously deficient, as it is today in most states, chances of constructing a minimum social safety net are low, and without such a safety net any large-scale program of economic reform will remain politically unsustainable, not surprisingly in a country where the lives of the overwhelming majority of the people are brutalised by the lack of economic security.

(h) Of course, decentralisation of governance which the 73rd and the 74th constitutional amendments in the early 1990's ushered in most of the country (around the same time as serious economic reforms were also launched) has raised hopes for better delivery of public services, sensitive to local needs. But so far the progress in this respect has been disappointing in most states, both in terms of actual devolution of authority and outcome variables. [Let me quote from one such general evaluation, by Mahi Pal in EPW, September 8, 2001: "With some exceptions in Kerala, Madhya Pradesh, Tripura and West Bengal, nothing worthwhile has been devolved to the panchayats. The bureaucracy at all tiers of panchayats is holding the balance."] Note also that in Kerala and West Bengal decentralisation with regular panchayat elections started long before the constitutional amendments. In many states not just the bureaucracy (which often has overlapping functions with the panchayats) has been reluctant to let go, the local MLA's, in order to protect their patronage turf, have hijacked the local electoral and administrative process (even in otherwise better-run states like Tamil Nadu). In Andhra Pradesh, a state supposedly at the forefront of economic reform, the Chief Minister is reportedly using information technology to further centralise (and personalise) the administrative process. Even in the relatively successful case of West Bengal, the major role of panchayats has been in identifying beneficiaries of government programmes and the management and implementation of local infrastructure projects like roads and irrigation, funded by tied grants from the Central or state government. There is no serious involvement of the panchayat in the management or control of basic public services like primary education, public health and sanitation or in raising local resources. Of course, prior land reforms in Kerala and West Bengal have made the panchayats somewhat less prone to capture by the village landed oligarchy as in large parts of north India.

(i) Another potential link between economic reform and decentralisation largely unutilised in India relates to small-scale, particularly rural, industrialisation. (In fact rural non-farm employment grew at a much slower rate in the 90's than in the 80's.) The Chinese success in the phenomenal growth in rural industries is often ascribed to decentralisation, by which the Central and provincial governments gave 'positive' incentives to the local government-run village and township enterprises (by allowing them residual claimancy to the money they make) and 'negative' incentives to keep them on their toes (in the form of refusing to bail them out if they lose money in the intense competition with other such enterprises). In India decentralisation is usually visualised only in terms of delivery of welfare services, not in terms of fostering local business development, and yet if this link could be established, economic reform would have been much more popular, as local informal-sector industries touch the lives of many more people than the corporate sector. A programme of economic reform that involves curbing the petty tyranny and corruption of the small industry inspectors (who currently act as serious barriers to potential entry), encouraging micro-finance and marketing channels, and providing the 'positive' and 'negative' incentives of Chinese-style decentralisation, has the potential of opening the floodgates of small-scale entrepreneurship in India. Examples of successful cooperative business development with the leadership of the local government, though rare in India, are not entirely absent. Take the case of the Manjeri municipality in the relatively backward district of Malappuram in north Kerala, with not much of a pre-existing industrial culture. In this area the municipal authorities, in collaboration with some NGO's and bankers, have succeeded in converting it into a booming hosiery manufacturing centre, after developing the necessary skills at the local level and the finance. This and other award-winning panchayats in Kerala (often CPM-controlled) dispel the common presupposition that civic bodies in the villages and small towns of India do not have the capability to take the leadership in developing and facilitating skill-based small-scale and medium-scale industries.

(j) Finally, it is anomalous to expect reform to be carried out by an administrative set-up that for many years has functioned as an inert, arbitrary, heavy-handed, corrupt and uncoordinated monolith. Economic reform is about competition and incentives, and a governmental machinery that does not itself allow them in its own internal organization is an unconvincing proponent or carrier of that message. Yet very few economists discuss the incentive and organizational issues of administrative reform as an integral part of the economic reform package. We have an administrative structure dominated by bureaucrats chosen on the basis of a generalist examination (rank in that early entry examination determines the whole career path of an officer no matter how well or ill suited s/he is in the various jobs s/he is scuttled around, each for a brief sojourn) and promotions are largely seniority-based, not merit or performance-based. There are no well-enforced norms and rules of work discipline, very few punishments for ineptitude or malfeasance, and there are strong disincentives to take bold, risky decisions. Whether one likes it or not, the government will remain quite important in our economy for many years to come, and it is difficult to discuss the implementation of economic reform without the necessary changes in public administration including incentive reforms, accompanied by changes in information systems, organizational structure, budgeting and accounting systems, task assignments, and staffing policies. In these matters there is a lot to learn from the (successes and failures of) innovative administrative reform experiments that have been carried out in many developing countries in the last decade or so (see, for example, the account on reforms in tax administration in Mookherjee (1997)).

References

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