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Introduction

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HISTORICAL PRECEDENTS

After independence from Great Britain on August 15, 1947, and following the trauma of the partition of colonial India into India and Pakistan and the death and cross-border movement of millions, India embarked on its development. After extensive debate, a Constituent Assembly drafted a Republican constitution for the Indian Union that was adopted on January 26, 1950. Soon thereafter, on March 15, 1950, the Union Cabinet, through resolution No. 1-P(C)/50 established the Planning Commission to, *inter alia*, "make an assessment of the material, capital and human resources of the country, including technical personnel, . . . [and] formulate a plan for the most effective and balanced utilization of resources." The very first sentence of the Cabinet Resolution referred to the need for planned development as a means of raising the country's standard of living. This belief resulted in the appointment in 1938 of the National Planning Committee (NPC) under the chairmanship of future Prime Minister Nehru. The Commission has since put together five-year (and also annual) plans for national development, starting with the first for 1950–51 through 1955–56 (Srinivasan 2000). Currently, the eleventh five-year plan for 2007–08 through 2012–13 is under implementation.

The overreaching objective of development planning in India even long before independence has been the eradication of mass poverty. Concern about massive poverty and its adverse impact on the welfare of the people had been widespread since the submission of a note by Dadabhai Naoroji, Indian member of the British Parliament, to its Committee on Indian Finance in 1872. This note was included and eventually published in 1899 in the now-classic study of Naoroji entitled *Poverty and Un-British Rule in India*.

This history is important for several reasons. First, the NPC clearly recognized that rapid growth of income and national product (although the term it used was *wealth*) at around the then historically unprecedented average annual rate of 7 percent combined with more equitable distribution were instrumental for achieving the intrinsic objective of poverty eradication. Variations of the phrase "rapid and well-distributed growth for poverty eradication" have been used successfully in electioneering slogans, first and famously in Indira Gandhi's campaign for 1971 Parliamentary election as "Garibi Hatao" or "Remove Poverty" and most recently in the May 2009 elections by her party, the Indian National Congress Party, now headed by her daughter-in-law, Sonia Gandhi, as "inclusive growth." However, a well-designed strategy for eradicating poverty has yet to be the driver of the five-year plans. During the first three decades of planning (1950–80), the annual average rate of growth was 3.75 percent, by no means rapid, and the proportion of the population below India's modest national poverty line (even more austere than that defined by Naoroji) fluctuated around 50 percent with no trend. Only after the hesitant and piecemeal reforms of the mid-1980s and systemic reforms after 1991, including most importantly opening the economy to domestic and global competition, did growth accelerate and the poverty ratio begin to decline, with the latest official estimate being 27.5 percent in 2004–05.

The pre-reform development strategy was focused on industrialization with a heavy emphasis on machine building and other capital-intensive industries; the dominant role of the state in the economy and state ownership of key industries were envisaged. Employment growth was to be left to low-capital-using small-scale and village industries. The strategy was articulated in the second five-year plan (1956–61). Its analytical foundation and its focus on long-run growth were provided by a two-sector (consumer and machine-building sectors) model of growth with capital as the only scarce factor of production. It completely excluded foreign trade possibilities by assuming the economy to be closed to foreign trade and investment. The model had been published by the Soviet author Grigor Feldman in 1928 and was independently envisioned by Professor P. C. Mahalanobis, the author of the second plan. In this model, the long-run rate of balanced growth of consumption and investment is an increasing function of the share of the machine-building sector in total investment.

The potential contributions of foreign trade to the efficient allocation of domestic resources and the acquisition of technical knowledge, from both trade in goods and inflows of foreign direct investment, were completely neglected. This neglect reflected the historical association in colonial India of free trade and the network of foreign capital flows as tentacles of imperialism, as well as from pessimism about India's export prospects. The dominance of the state in the Indian economy was incomplete, unlike in the Soviet Union or China, because such important sectors as agriculture, commercial banking, insurance, and large-scale manufacturing remained in private hands. Ostensibly to ensure that the private sector followed the output targets and sectoral priorities of the five-year plans, an elaborate system of controls on private decision making was put in place.

At its most expansive and intrusive, the system involved the following: *industrial licensing* under which the scale, technology, and location of any investment project other than relatively small ones were regulated, and permission from the government was needed to expand, relocate, and change the output or input mixes of operating plants; the *exchange control system*, which required exporters to surrender their foreign exchange earnings to the Reserve Bank of India at the official exchange rate and allocated the exchange earnings to users through *import licensing*; *capital issues control* under which access to domestic equity markets and debt finance was controlled; *price controls* (complete or partial) on some vital consumption goods (for example, food grains, sugar, vegetable oils) and critical inputs (for example, fertilizer, irrigation water, fuel); and *made-to-measure* protection from import competition, granted to domestic producers in many "priority" industries, including, in particular, the equipment producers. The agricultural sector was insulated from world markets, subjected to land ceiling and tenancy legislation, and forced to sell part of the output at fixed prices, but it also received subsidies on irrigation, fertilizer, and electricity. Large commercial banks, which were nationalized in 1969, were subject to directed and selective credit controls and controls on deposit and lending rates, and in effect had to lend more than half of their loanable funds to the government through the operation of reserve requirements of various kinds. Insurance had been nationalized earlier.

The controls taken together were far more restrictive than each of them individually. For example, grant of an industrial license did not imply grant of a capital goods import license so that the capacity licensed could not be operational if the intended imports were essential. In addition, all regulations were accompanied by uncertainty about their fair implementation because they were essentially *discretionary* rather than *rule-based* and *automatic*. Although some principles and priorities governed the exercise of these regulatory powers, these were largely nonoperational for two reasons. First, it was impossible, even in theory, to devise a set of principles or rules for all the myriad categories of regulations that were mutually consistent and in consonance with the multiple goals of the industrial policy framework, which in themselves were not entirely consistent. Second, the problem of translating whatever rules there were into operational decisions was one of Orwellian dimensions. The allocative mechanism was largely in the form of quantitative restrictions unrelated to market realities. A chaotic incentive structure, rapacious rent-seeking, and political corruption were the inevitable outcomes. Indeed, the discretionary regulatory system instituted in the name of planning for national development instead became a cancer in the body politic (Srinivasan 2000).

It is widely, although not universally, agreed that the insulation of the economy from world markets and from domestic competition cost India substantially. Notwithstanding the development of a diversified, albeit internationally uncompetitive, industrial structure and the successful ushering in of the green revolution, the average annual growth rate of 3.75 percent during 1950–80 was extremely slow when compared to the growth of the so-called newly industrializing countries. South Korea, for example, which was somewhat but not much richer than India in the mid-1950s, opened up its economy in the early 1960s and grew rapidly; by 1980, its real per capita income was six times that of India.

In the mid-1980s, India hesitantly began reforms that were aimed at moving away from the development strategy and policies of 1950–80. The commitment to reform was broadened and intensified after a macroeconomic crisis in 1991. By the 1990s, a return to the 1950–80 policies that had been inspired by Soviet central planning was unimaginable both because of the collapse of the Soviet system and because China, after abandoning its own Soviet-style central planning and insulation from world markets in moving toward a market economy, grew very rapidly. Thus, when India's crisis occurred in 1991, there was no realistic alternative to systemic reforms.

Since 1999, the Stanford Center for International Development (SCID) has hosted conferences at Stanford and selected sites in India evaluating Indian economic policy and proposed reforms to enhance India's prospects for sustained and rapid economic growth. The period since SCID initiated its conferences has coincided with the acceleration of India's growth rate and a burgeoning confidence in India's ability finally to realize its great economic potential. The impact on Indian policy of the debates on policy issues at the Stanford conferences has been enhanced by the participation of members of the major political parties of India combined with their growing conviction that India's economy will flourish if the uneven progress in economic reform that began in 1991 is pursued more systematically.

Recognition has grown, as well, that India's economic goals will be well served by embracing the opportunities afforded by globalization, as has been done to such good effect by India's East Asian neighbors. The advantages of engagement with the international economy through the adoption of policies of openness to international trade and capital flows became apparent initially in the dramatic growth performance of the newly industrializing countries of East Asia in the 1960s, 1970s, and 1980s. More recently, the extraordinary economic performance of China, although beginning from what appeared to be exceptionally unfavorable initial circumstances, also has owed much to its firm commitment to integrate with the international economy. Indeed, China's success in adapting the "East Asia Model" to its own circumstances might have served as an important spur to changing the mindset of Indian policy makers, thereby contributing to the welcome acceleration in India's growth.

The collection of papers in this volume, one in a series of volumes that reports on the deliberations at SCID's Stanford conferences,[1] recognizes the contributions that improved policy making has made to the Indian growth outlook. At the same time, they point the way – in selected important areas of the Indian economy – toward further reforms that can help to sustain and even accelerate growth. In four sections – the first dealing with aspects of the macroeconomy; the second, with agriculture and the social sectors; the third, with jobs and how the labor markets function in agriculture, industry, and services; and the fourth, with infrastructure services for development, specifically those of electricity, telecommunications, and transport – the volume analyzes key development issues in papers authored by highly regarded scholars of the Indian economy. Their contributions indicate the extent to which Indian policy reform still needs to progress in many vital areas if India's improved performance is to be sustained through the early decades of the new century.

THE MACROECONOMY

The first paper in the macroeconomic section is a far-reaching assessment of federalism and economic development in India by **Nirvikar Singh** and **T. N. Srinivasan**. They acknowledge the recent improvements in India's

[1] Krueger, Anne O., Editor, 2002, *Economic Policy Reforms and the Indian Economy*, The University of Chicago Press, Chicago 60637. Krueger, Anne O. and Sajjid Z. Chinoy, Editors, 2003, *Reforming India's External, Financial, and Fiscal Policies* (Stanford, CA: Stanford University Press).

economic policy-making and development outcomes, as well as the efforts that have been made to transform positively the country's federal institutions. However, much remains to be done to improve the structure of India's budgets, taxes, and the overall fiscal system. Singh and Srinivasan investigate the approaches of individual states and regions of India and indicate how widely differentiated performance is affected strongly by pronounced differences in the way in which they conduct fiscal policy. They find much to criticize in the quality of fiscal governance in India – at the center and at the level of the states – and reserve particular criticism for the way in which the Planning Commission and the Finance Commission interact. They support policies to simplify the internal transfer systems in India, and they compare Indian with Chinese experience to argue that a better alignment of political and bureaucratic interests at the central and local levels within India could enhance overall performance. One of their major, and certain to be controversial, recommendations is to do away with the Planning Commission in its current form and to replace it with a Fund for Public Investment. As well, they have some preliminary suggestions on how to limit subsidies and entitlement programs, which dissipate so much of India's fiscal resources in wasteful expenditure, and improve their efficiency.

In the next chapter, **Arvind Panagariya** emphasizes the transformation in India's thinking about its ability to compete internationally and the extent to which "an open trading environment can help catalyze and sustain faster growth." He acknowledges India's widely acclaimed success in boosting its exports of services, especially in the impressive accomplishments of an increasingly confident information technology industry. Nevertheless, by reference to the extraordinary performance of China in raising its share in a host of international markets as it has emerged as a trading power to rival the "big three" developed trading nations (the United States, Germany and Japan), he reveals that India still punches far below its weight class in the international markets for most goods.

He goes on to review the trade and domestic policies of both countries over the past two decades recognizing that they have to be mutually supportive and reinforcing, for reforms to be successful. This recognition leads him to note, that, beginning in the early 1990s, Indian policies towards international trade and investment have been catching up with China's. India's policies towards the external sector are now reasonably open across the board: in goods, services, and foreign investment. India is only slightly less open than China in trade in manufactures and is probably more so in services trade and in foreign investment. However, there is, relative to

China, a vast difference in trade performance of India due to deficiencies in India's domestic policies. In particular, the failure to export labor-intensive manufactures in amounts that are in any way comparable to China's are a legacy of dirigist policies that have proved resistant to two decades of sustained reform in other parts of the Indian economy. India's domestic policies prevented large, well-capitalized firms from establishing labor-intensive manufacturing at an appropriate scale, and many products suited to large-scale production were "reserved" for production by "small-scale" units. Unlike China, almost all foreign ownership was restricted to forty percent of a firm, and when exceptions were made they favored heavy industry. Finally, the catastrophic restrictions on the ability of firms hiring more than 100 workers to fire any of them created labor market rigidities that were anathema to the emergence of a dynamic export sector.

The way forward must be marked by more enlightened labor policies, along with essential improvements in the quality of supporting infrastructure. That means, in particular, reliable power supply and efficient transportation services. Panagariya notes as well the need for reforms in many more areas that affect trade: further reduction in protection, restraint in recourse to anti-dumping actions, introduction of foreign investment in such areas as retail trade in India, and the negotiations of beneficial trade concessions in both multilateral and bilateral forums. His chapter ends with his views on the considerations that should shape India's position if the Doha round proceeds; and the issues involved in negotiating a free-trade agreement with China.

The third macroeconomic contribution (in Chapter 4), by **Rakesh Mohan**, at the time of writing the Deputy Governor of the Reserve Bank of India, considers the extent and impact of what he documents as the extensive reforms of the Indian financial sector and the mechanisms for conducting monetary policy. His paper describes those reforms; assesses them in terms of economic outcomes, including the resulting health of the financial sector; and, finally, draws some lessons from the Indian experience – for participants in the financial sector and, more importantly, for the Indian monetary authorities. Mohan's chapter may surprise those observers of the Indian scene who might not have noted that India is no longer the almost classical example of financial repression that it was. At least until the 1990s, monetary policy subserved fiscal policy, with the largest requirement of the banking system being to direct monies to various causes supported by India's governments and of the central bank to monetize fiscal deficits.

Since then, there has been remarkable progress in deregulating the Indian financial system and in introducing institutional reforms that have equipped India – if not with financial institutions that are perfect in every respect – certainly, with institutions that are much better positioned to support fast growth of an emerging market economy that is increasingly better integrated with the global economy. Mohan maintains that, through a measured, gradual, cautious and steady process, India's financial system has undergone substantial transformation. It has become a reasonably sophisticated, diverse, resilient system due to well-sequenced and coordinated policy measures, which have succeeded in making the Indian financial sector more competitive, efficient and stable. The management of monetary policy also has become increasingly sophisticated, which has enabled price stability largely to be maintained, while ensuring the better allocation of credit to support investment demand and growth. However, as the Indian economy grows beyond the trillion dollar mark, and as greater opening subjects the Indian financial system to further strains from integration with global markets, then more needs to be done to modernize regulations and to make India's monetary institutions more robust.

INSTITUTIONAL REFORMS: AGRICULTURE AND EDUCATION

The reforms of the 1980s and 1990s changed institutional arrangements in vital sectors of the economy, providing actors with the incentives necessary to make the investment choices that generate growth. But ensuring further rapid growth, particularly in the agricultural and rural sector, and deeper reductions in poverty will require a more difficult set of institutional reforms. Which institutional changes are likely to be successful in enhancing rural and agricultural development? And, what are the institutional arrangements most likely to improve the quality of public goods such as schools and colleges? The chapters in the volume's second section tackle these issues. The first two chapters focus on the rural and agricultural sectors; the second two turn to educational institutions, widely acknowledged as amongst the most important for economic growth.

The Rural and Agricultural Sectors

Pranab Bardhan and **Dilip Mookherjee's** paper provides evidence on two institutional reforms widely believed to be essential for improvements in agricultural productivity and rural incomes: land reforms and the decentralized administration of programs for the delivery of agricultural inputs, investments in local public goods and infrastructure, and general welfare. Recent research in institutional economics argues that a realignment of property rights in favor of small cultivators and tenant farmers can help solve incentive problems that otherwise lower investment rates for these households. Decentralized delivery of local public goods may also enhance efficiency through a variety of channels, including the greater accountability of local governments to village households.

The authors study the case of West Bengal which, under the Left Front Government, initiated a set of sweeping institutional reforms intended to promote greater equality. The reforms, initiated in the 1970s, included a land reform program and the introduction of a system of decentralized governance. The land reform program involved the implementation of land ceilings, and enforcement of legislation, which had been enacted earlier but not effectively implemented, governing the distribution of surplus land to the landless and the regulated registration of tenancy contracts.

The research of this paper is based on a unique data set for 89 villages, with detailed farm records of inputs and output for three successive five-year periods spanning 1981 to 1996, as well as data on the composition and activities of local governments spanning 1978 to 2004. Using these data, Bardhan and Mookherjee probe two questions. First, how accountable were local governments and what is the evidence as regards the capture of the local political process by village elites? Second, is there evidence to show that these reforms, which pushed towards greater socio-economic equality within the state, were instrumental in improving agricultural productivity and farm incomes?

Their research emphasizes that the functioning of institutions is context specific – the same institutional arrangements will generate different results in different settings. They find, for example, that the pervasiveness of local capture varies with such characteristics of the region as the extent of local inequality and political competition.

They also find evidence that equality-enhancing land reform does boost agricultural productivity. However, it is the tenancy registration program that was important; the land distribution program had an insignificant effect. Moreover, other agricultural programs implemented by village governments, such as a program that provided farm households with "mini kits" of agricultural inputs and that invested in local irrigation works, were more effective than land reform in increasing productivity. Finally, their results suggest that decentralized delivery of agricultural inputs generated village-wide benefits to both small and large farms, with substantial trickle down to landless agricultural workers in the form of higher wages. This suggests that reforms that improved productivity in general had a larger effect on the productivity of a sub-group of rural households, than equality-enhancing reforms.

While land reform and changes in the institutional arrangements to deliver key agricultural inputs can affect changes in agricultural productivity, the challenges in this sector require policy changes in many other areas as well. **Peter Hazell, Abhijit Sharma** and **Laurence Smith** argue, in Chapter 6, that the need for improved productivity in agriculture is crucial, since it continues to provide employment to 60 percent of India's workforce. As Krueger observes in Chapter 9, one reason for this is the policies that inhibited the growth of labor-intensive production in India's manufacturing sector. Hazell, Sharma and Smith believe, however, that there is considerable potential for generating greater employment in the agriculture sector by diversifying into high-value crops, livestock, and processing activities. Although income growth has generated a demand for these products, the authors contend that the failure to expand into these activities reflects supply-side constraints. These in turn stem from institutional arrangements that fail to provide farmers the incentives required to diversify into new activities. The authors substantiate their hypothesis using conditions in Punjab and Rajasthan, two previously progressive states that are now lagging in adjusting to the challenges facing their agricultural sectors.

A key institutional feature inhibiting increases in foodgrains acreage is the system of assured prices and guaranteed purchases put in place by the government – a system unavailable for other crops. The authors note that, in comparison, alternative crops suffer from greater output variability. Perhaps because of their lower profitability, there has also been little investment in the infrastructure required for the storage and marketing of these crops, such as processing units, cold storage and dry freezing plants.

A second institutional constraint comes from canal irrigation systems. Both states utilize the *warabandi* system, whereby water is allocated across farms in proportion to farm area and is supplied on a predetermined rotational schedule. Available data suggest the high degree of wastage associated with this system, particularly in tail-end fields, the problems it gives rise to as regards maintenance and upkeep, and its negative effect on agricultural productivity. Yet, there appears to be little effort to change the system. Instead, farmers are increasingly turning to tubewell irrigation. However, in the absence of good institutional arrangements to properly price scarce water and electricity, extensive tubewell irrigation is causing a critical shortage of ground water.

Improvements in agricultural productivity, absolutely essential for the employment of the rural work force, require attention to these institutional issues. There is little evidence, however, that proper policy attention is being given to reform of these arrangements. In this regard, an important area for