"Powerful political interests still stand in the way of India's realizing its economic potential."

A Tiger Despite the Chains: The State of Reform in India

RAHUL MUKHERJI

India's rapid and sustained economic growth since 1991 has occurred in an environment in which industrialists, trade unions, bureaucrats, farmers, and nongovernmental organizations wield considerable political power. Two decades ago, India was stereotyped as a "soft" state, quite unlike the fast-growing "tiger" economies of East Asia. India was deemed incapable of disciplining powerful social actors in order to promote its competitiveness.

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This perception seemed confirmed when the economic growth that the country enjoyed in the 1980s, which was fueled by greater opportunities for private companies in a closed economy, became unsustainable in 1991 amid a balance of payments crisis. That crisis was driven by fiscal profligacy, a rise in the price of oil during the Gulf War in 1990, and India's heavy dependence on foreign commercial borrowings.

And yet, substantial economic reforms did occur after 1991, and they helped transform India's economy. How did this happen? New policy ideas gradually replaced old ones, which had emphasized economic self-sufficiency and trade pessimism. Also, reforming statesmen such as Prime Minister P. V. Narasimha Rao and Finance Minister (now Prime Minister) Manmohan Singh, along with reforming technocrats like Montek Ahluwalia and Chakravarthy Rangarajan, took advantage of the balance of payments crisis to alter fundamentally the rules of economic engagement in India.

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Since 1991, the Indian economy has experienced an average growth rate in excess of 6 percent per year. Between 2003 and 2007, the economy grew at an average rate of 9 percent. It weathered the recent global financial crisis with greater ease than most countries' economies, and it continued to grow at a 6.7 percent clip in 2008–2009. India's current finance minister, Pranab Mukherjee, expects the figure to be 7.2 percent in 2009–2010. After the global downturn has ended, a return to a 9 percent growth rate seems likely.

But why does the Indian economy not grow at double-digit rates like China's does? It is because numerous political challenges still get in the way. Powerful constituencies such as trade unions, rich farmers, and politicians and bureaucrats still pose substantial obstacles to investment.

In addition, economic reform has not yet benefited enough Indians for the country to harness the potential of its youthful workforce. Substantial resources have been pledged in areas such as literacy promotion and employment generation, yet the government so far has been unable to reach targeted populations efficiently. For India, which has more poverty than any other nation in the world, improvement in the human condition is not just an end in itself—it is a means toward sustaining a high-growth trajectory.

REFORM AND REJUVENATION

The government's response to the foreign exchange crisis in July and August of 1991 constituted a watershed in India's economic history. A number of significant policy decisions taken at that time subsequently improved the country's competitiveness in the global economy.

First, India devalued the rupee by about 20 percent, thereby making Indian exports cheaper in the world market. (In 1994, the rupee was made fully convertible in the capital account, which meant that exporters could easily access foreign exchange at the market rate.) Second, the government overturned an intrusive regulatory framework that had evolved since 1951, a framework that required industrialists to seek state permission before embarking on commercial enterprises. Third, the government abolished stringent regulations on capacity expansion in any company worth more than 1 billion rupees. Fourth, the foreign investment limit in most sectors was raised from 40 percent to 51 percent.

India's growth story owes a great deal to entrepreneurs who took advantage of the new industrial deregulation and export orientation of the 1990s. The country's ratio of trade to gross domestic product (GDP), which had been constant at about 16 percent between 1980–81 and 1990–91, jumped to 54 percent by 2008. Information technology exports surged from $194 million in 1991–92 to $6.54 billion in 2001–02, and to $50.4 billion in 2008–09.

The information technology service company Infosys, which began with an initial investment of $250 in 1981, was worth $4 billion in 2008. Tata Steel retrenched its workforce and invested $2.5 billion to transform itself from a top-fifty steel company in the world to one of the leading five. The Tata Group, in search of technology and markets, bought the Anglo-Dutch steel maker Corus Group in 2007 for $12.1 billion.

Predatory propensities within the government hinder the development of roads, railways, and airlines.

Successful companies have generated substantial personal wealth for a few individuals. Mukesh Ambani, a tycoon in several industries, is the fourth-richest person in the world, with a fortune of $29 billion. According to the latest rankings in *Forbes*, four other Indian entrepreneurs rank among the top fifty billionaires.

Linking domestic competitiveness with global acquisitions has become characteristic of many of India's best companies. These include Bharat Forge (automobile parts), Tata Motors (cars), Wipro (information technology), Dr. Reddy's (pharmaceuticals), and Tata Tea (fast-moving consumer goods).

In 2006–07, Indian companies spent $12.8 billion on acquisitions of overseas companies, compared with China's $16.1 billion. This represented a substantial amount, considering that the Chinese economy is two and a half times the size of the Indian economy. Moreover, a large share of Chinese investment was accounted for by state-owned companies pursuing natural resources, whereas India's investments were made by private companies in search of technology, brand names, and markets.

FINANCIAL RETURNS

The government also successfully reformed India's banks and stock markets to create the financial environment necessary for growth. The Reserve Bank of India improved the supervision of banks and systematically subjected them to international best practices. This led to a substantial reduction in bad debts and an improvement in profitability. Indeed, India's banking system is today better regulated than China's.

The government viewed stock markets as critical for raising resources for Indian companies. So, when the brokers of the Bombay Stock Exchange refused to accept international best practices, the Ministry of Finance in 1993 created a modern and computerized national stock exchange. Competition from the national exchange forced the Bombay exchange to acquiesce to the reforms suggested by the Ministry of Finance. Substantial reforms in trading norms followed, in 2003.

The booming markets quickly became an attractive investment proposition for Indians and foreigners alike. India's stock markets attracted $24.2 billion from foreign institutional investors between 1992–93 and 2002–03. This figure was a little higher than the foreign direct investment ($24.1 billion) registered during the same period.

Foreign investment was impaired because the business environment for multinational companies was more hostile in India than in China. India had enormous entrepreneurial potential waiting to be unleashed in 1991, whereas China had no private sector when it initiated its economic reforms. Partly as a result, India's government and companies were more cautious than China about allowing foreign investment. In 1993, an informal group of industrialists calling themselves the Bombay Club made the case that foreign investment was detrimental to India. Many a productive investment was blocked by regulations governing joint ventures with foreign partners and by the need for state-level intervention in matters related to obtaining land, water, electricity, road infrastructure, and a variety of such amenities.

This business environment for foreign investors is changing gradually. Successful Indian businesses that began as relatively small entrepreneurial endeavors have needed foreign capital and technology to compete with larger companies. For example, the Hero Group, a bicycle manufacturer, partnered with Honda to become a leading producer of motorized two-wheelers. Bharti's partnership with SingTel helped it become India's leading telecom service provider. Whereas India attracted $24.1 billion in foreign direct investment between 1992–93 and 2002–03, in a single recent year (2008–09) it attracted $27.3 billion.

THE TELECOM BOOM

It is well known that India's telecom boom has contributed substantially to the country's growth. Less widely known perhaps has been the impact of government actions on telecommunications. India has more than 500 million telephone lines and is adding between 8 and 10 million lines every month, in what is considered the world's fastest-growing telecom market. Indian companies offer the cheapest rates in the world. But it was the Indian state's response to the balance of payments crisis of 1991 that created conditions favorable for private sector participation and growth in the telecom field. The government proved it was serious about withdrawing from commercially viable sectors in order to reduce substantial fiscal deficits.

Trade unions, rich farmers, and politicians and bureaucrats still pose obstacles to investment.

In the early 1990s, private sector activity in the absence of appropriate regulation sowed the seeds for companies to experience investment crises later in the decade. This could have driven telecom service providers to bankruptcy. But the government again responded, first in 1997, by creating the Telecom Regulatory Authority of India, then in 2000 by further empowering the regulators.

The success of Indian telecommunications owes much to the spread of wireless telephony. By 2008, 90 percent of the Indian market was using wireless technology. Two principal factors made this possible. First, the sector's transformation from a government monopoly in 1991 to one in which 80 percent of the market is now served by private companies drove telecommunications providers to become more efficient. Technological advances in mobile technology further fueled growth. (Private companies enjoyed the first mover's advantage in cellular services because the government had not predicted the potential of this technology in the early 1990s.)

Second, competent regulation promoted competition among service providers, which exerted downward pressure on tariffs. Today the penetration of mobile telephones in the smaller cities and villages holds great promise of opening up new opportunities for the poorer people of India.

REMAINING FETTERS

Notwithstanding India's economic performance over the past two decades, powerful interest groups—in particular, trade unions, wealthy farmers, and government bureaucracies—continue to present substantial challenges to the promotion of the nation's competitiveness and overall development. They constitute the principal reasons that India is unable to grow as rapidly as China.

India's labor unions, thouth they represent less than 10 percent of the workforce, have successfully thwarted a social contract that would benefit the majority of Indian workers and boost the country's productivity. Trade unions in many European countries, with memberships that protect more than 70 percent of the labor force, have promoted a business environment in which labor is productive and contributes to the industrial sector's competitiveness. Labor laws in India, on the other hand, protect a minority of workers and turn a blind eye to the majority in the unorganized sector who work under exploitative conditions.

Legal protection for labor, moreover, increases with the size of the enterprise. The government's regulatory framework thus forces industrial enterprises either to reduce their scale or become more capital-intensive. This is a disincentive for reaping economies of scale in a labor-abundant economy like India's.

The political power of the unions can be judged from the fact that even severe economic crises and fiscal and external pressures have not made an impact on laws that create perverse incentives. India is in dire need of more widely inclusive unions that pledge productivity in return for

social protection. This represents a significant challenge for promoting competitiveness in labor-intensive activities, an essential condition for generating more employment.

India's rich farmer lobby is another potent political force and hindrance to growth and development. This lobby benefits from fertilizer and power subsidies that do not help marginal farmers and that crowd out public investments in areas such as irrigation and rural roads. The subsidies also contribute handsomely to India's fiscal deficits.

To be sure, public investment is essential in a sector that constitutes less than 20 percent of GDP yet employs a majority of the population. Average annual growth in the country's agricultural sector dipped from 3.4 percent in the 1980s to 2.9 percent in the 1990s. The sector witnessed zero or negative growth in three of the first four years of the new millennium. Policy makers have tried to give agriculture serious attention since 2004.

But the political power of the wealthy farmers has stalled reforms, particularly in the power sector. Farmers in many Indian states do not pay electricity bills. In states such as Andhra Pradesh and Tamil Nadu, the agricultural lobby can bring down governments that seek to impose even a subsidized tariff. Consequently, the losses of state-owned power companies have increased from $4.8 billion in 2005–06 to $7.1 billion in 2008–09.

Growth has made welfare more affordable, and democratic pressures are making it essential.

The private sector hesitates to play an enthusiastic role in a business environment in which obtaining revenues is a major challenge. And the power sector's losses not only impose a burden on the public treasury; they also increase costs for industry, which has to subsidize the free power delivered to farmers.

India's poorer farmers, meanwhile, are unable to benefit from these subsidies because their farms depend on canal irrigation and diesel pumps. Farmers who consume free electricity to run electric hand pumps pay a price anyway, in the form of poor power quality and frequent transformer burnouts.

Land acquisition can also be a major bottleneck for productive investment in India. Political mobilization at the local level often impedes acquisition of land for industrial enterprises. To give one example, Tata Motors faced a slew of challenges when it wanted to make an iconic investment in the world's cheapest car, the Nano. Such was the level of politically motivated opposition to the setting up of a Nano factory in Singur, in the eastern state of West Bengal, that one of the most highly respected captains of Indian industry, Ratan Tata, had to shift the location of the factory from Singur to Pantnagar, in the northern state of Uttarakhand.

Laws that govern the acquisition of land contain serious flaws. The colonial-era Land Acquisition Act gives the government absolute power to acquire any piece of land. But protests in places like Singur and Nandigram in West Bengal point to the need to win the consent of the local population. The government needs to devise a regulatory framework that allows for adequate compensation and makes the acquirers of land work toward improving the living conditions of those who will be displaced as a result of commercial activity.

Within an appropriate regulatory framework, productive investment can be a win-win situation for the investor and for displaced people. Investment-friendly states such as Gujarat, Tamil Nadu, Haryana, and Andhra Pradesh have found ways to win consent for land acquisitions in the absence of a national regulatory framework; as a result, they have been able to attract more investment and grow rapidly.

GOVERNMENT IN THE WAY

Even more than trade unions and obstructive rural interests, the government itself is often the worst enemy of competitiveness in India. For example, the ports that carry 95 percent of the country's trade by volume could benefit from better regulation of private investment. India's ports charge higher fees and take a longer time to provide services than do ports in Dubai, Colombo, and Singapore. Larger vessels often dock in other countries' more efficient ports and use smaller vessels to ship merchandise to India because of the inadequacy of that nation's port infrastructure. Indian ports thus lose business, and Indian exports and imports face higher transaction costs.

The government's regulation of private sector participation in ports is primitive compared to its regulation of the telecom sector. Bidding procedures regarding ports, for example, encourage private players to make unreasonably high bids to secure contracts that may not be commercially viable. Tariff-making procedures do not aid the realization of scale economies. And the governance of most major ports is controlled by port trusts, which are run by government servants who do not respect commercial considerations. The terminal charges for private operators are competitive, but high port costs result from additional charges levied by the port trusts.

The government has dragged its feet in other areas as well. The civil aviation sector lacks an independent regulator, and Air India continues to lose money. The United Progressive Alliance government, in office since 2004, has been averse to the privatization of a loss-making airline. As a consequence, precious taxpayers' money is diverted from developmental projects. The case of Air India reflects a trend in which disinvestment in loss-making public companies has taken a back seat in recent years.

In contrast, allowing a greater role for commercial considerations in Indian Railways six years ago catapulted the rail system from bankruptcy to substantial profits. Yet the populist inclinations of the government's new railway minister may overturn this legacy. Likewise, the development of national highways and private sector participation in roads have also slowed in recent years. These infrastructure areas are vital for India's economic growth, and the government is constricting their development.

SHARING GROWTH

India's rapid economic growth needs to involve a larger proportion of the citizenry. The government's inattention to areas such as literacy promotion and employment generation has helped produce unacceptable levels of absolute poverty. Most economists believe that about 26 percent of the Indian people in 1999 lived below the poverty line, under unacceptable conditions, when the same figure for China was about 10 percent.

The economic reforms of the early 1990s clearly reduced poverty levels from what they would have been without the reforms. But it is also apparent that the benefits of rapid economic growth trickle down too slowly in India. Moreover, it may not be politically feasible to sustain a social environment in which a few of the richest individuals in the world coexist with a vast population that lives on less than $2 a day.

India produces more engineers than the United States, but its literacy rate in 2001 was 61 percent, far lower than in China—or, for that matter, in Sri Lanka, where more than 90 percent of the population is literate. India's policy elite during the 1990s ignored the need to abolish child labor and promote literacy. The prevailing view was that poor people could keep their children at work to augment their family incomes, and that literacy for such Indians was not critical.

This view has changed over time. India's Supreme Court linked the right to education and the right to life in 1993. In the new millennium, the government has pledged substantially greater resources for literacy promotion, a commitment that was evident in the Right to Education Act of 2009. More than 96 percent of Indian children aged 6 to 14 years were enrolled in school in 2006–07. This suggests that the literacy picture in India is undergoing a belated transformation.

The major challenge facing literacy promotion is the low quality of government schools. Teacher absenteeism rates in India's public schools are among the highest in the world. And the children of poor parents have no exit options. Cheap private schools serve the lower middle class and the relatively better off among the poor. Policy makers are debating whether school vouchers for the poor may be a better option than spending large sums of money on government schools that are largely dysfunctional. States like Madhya Pradesh have been able to reduce teacher absenteeism by involving village governments in the governance of schools and by keeping teachers on renewable contracts.

High levels of unemployment and underemployment also pose a significant challenge for poverty alleviation. The Mahatma Gandhi National Rural Employment Guarantee Act (NREGA) of 2005 is the most ambitious welfare program in India. It guarantees 100 days of paid work to all who seek employment. Employment is generated by the creation of public goods such as water tanks, roads, and schools, especially in rural areas. Public works are monitored by local village governments.

According to NREGA, 47.2 million families have benefited so far from this scheme, over 50 percent of whom are from socially and economically marginalized castes and tribes, and 48 percent of the beneficiaries are women. Rajasthan has the best implementation record, and India's poorest states—including Bihar, Chhattisgarh, and

Madhya Pradesh—are among NREGA's top five beneficiaries. This program seems to be making a dent in poverty, notwithstanding some corruption problems.

Corruption has been the bane of India's poverty reduction efforts. Funds provided for employment generation schemes are often siphoned off to benefit richer families. In 2003–04, over $90 million out of a $158 million food subsidy did not reach a single family whose economic status was considered below the official poverty line. Meanwhile, teacher absenteeism impairs literacy initiatives, and health worker absenteeism weakens health programs.

The current government has taken two significant steps in an effort to improve service delivery for Indian citizens. First, the Right to Information Act of 2005 replaced the Official Secrets Act of 1923, which had made it legally impossible to obtain information vital for punishing corruption within the government. Social activists such as Aruna Roy helped bring about this reform. Roy had resigned from the civil service and started a "social audit," whereby poorer people who were supposed to benefit from public services began to assess government programs. The Right to Information Act is a powerful weapon that has been successfully deployed to catch corruption in high places.

Second, the Unique Identification Authority of India, initiated in 2009, will provide every resident with a card that will carry essential data about the individual. The card is designed to empower citizens such that they should easily be able to access essential public services. The authority is headed by Nandan Nilekani, who gave up his chief executive's job at Infosys to help devise the system. The new card will eliminate the need for multiple identification cards, such as one card for NREGA employment benefits and another that certifies a person's status as living below the official poverty line.

THE ROAD AHEAD

India's growth story has largely been driven by the gradual development of new policy ideas—ideas whose value became more apparent during financial crises, which facilitated their consolidation. Gaining political support for new ideas has taken time; indeed, ideas such as autarkic development and public control over the economy could not be quickly or easily replaced by ones that emphasize the role of private companies and international trade. New ideas have also been resisted by political constituencies that benefited from the old ideas.

The transformation of policy ideas and politics has made India's corporate sector more efficient. It has engendered better service provision in appropriately regulated areas such as telecommunications, banks, and stock markets. In these arenas, the government's role has contributed to India's rise as a rapidly emerging economy.

But powerful political interests still stand in the way of India's realizing its economic potential. The country's trade unions have successfully opposed a legal framework that could benefit more workers and spur labor-intensive industrialization. Rich farmers make unreasonable demands for power and fertilizer subsidies that crowd out essential public investment in rural areas. The predatory propensities of politicians and bureaucrats prevent India's ports from achieving their potential. Similar predatory propensities within the government hinder the development of vital infrastructure such as roads, railways, and airlines.

India's growth has preceded the creation of a welfare state. Growth has made welfare more affordable, and democratic pressures are making it essential. In advanced industrial welfare states, capitalism arrived before democracy. The welfare state was born because of democratic pressures on the propertied classes after substantial surplus accumulation had already occurred. A similar phenomenon is occurring now in India.

Legal and institutional developments such as the Right to Education Act, the Mahatma Gandhi National Rural Employment Guarantee Act, the Right to Information Act, and the Unique Identification Authority of India point to the pressures from below that are today demanding redistribution of wealth and consolidating the idea that the Indian citizen has certain rights to services, which the state is obliged to provide. Going forward, efforts to reduce poverty could have a significant impact, not only in spreading the benefits of growth more widely, but also in sustaining India's rapid economic development. ■