Economic Reforms in India: 1991

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Introduction

- For three decades after gaining Independence in 1947, India followed an economic strategy with a strong bias in favor of the public sector, strict government controls over private sector investment, and insulating the economy from the rest of the world.
- Through a combination of import licensing and high tariffs. Foreign investment was discouraged, and the import of technology was strictly controlled. The economy performed reasonably well under this control system in the first 15 years 1950–1951 to 1964–1965, when the rate of growth of gross domestic product (GDP) (at factor cost) averaged 4.1% per year.

- India was a latecomer to economic reforms, embarking on the process in earnest only in 1991, in the wake of an exceptionally severe balance of payments crisis. The need for a policy shift had become evident much earlier, as many countries in east Asia achieved high growth and poverty reduction through policies that emphasized greater export orientation and encouragement of the private sector.
- A process of liberalizing the control regime had started in the first half of the 1980s, under Prime Minister Indira Gandhi, and was intensified in the second half of the decade under Prime Minister Rajiv Gandhi. However, these changes were incremental rather than structural.
- India took some steps in this direction in the 1980s, but it was not until 1991 that the government signaled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of government.

Reasons behind 1991 crises

- Collapse of Soviet Union that was India's major trading partner
- The gulf war of 1991 spiked prices of oil
- Expansionary policies of 1980s --> money was used for consumption rather than investment --> no productivity enhancement
- Restrictive industrial licensing --> low of efficiency and lack of competition --> low return on investment and less expansion opportuinities

India between 1991 - present

- The real break with the past came in 1991, when a new Congress led coalition government, under Prime Minister Narasimha Rao, with Dr Manmohan Singh as Finance Minister, had to deal with an exceptionally severe balance of payments crisis.
- Foreign exchange reserves had run down to $1.1 billion by the end of June 1991, barely enough for 2 weeks of imports, and there were widespread fears that India might be forced to default on its external debt payments.
- The new government moved decisively to contain the crisis through a classic stabilization program consisting of a reduction in the fiscal deficit and a currency devaluation.
- To support these efforts it negotiated a International Monetary Fund (IMF) loan in 1991, along with structural assistance loans from the World Bank and the Asian Development Bank.

Summary of the major changes

1. Industrial licensing, which was earlier applicable for all industries except a defined list, was now abolished for all but a handful of industries. This meant investment in new plants and capacity expansion in existing plants could now be undertaken for a very wide range of industries without any approval from the central government. Since the location of industries was previously specified in the license, the abolition of industrial licenses meant that location was left to investors to decide, setting the stage for different states to compete with each other to attract private investment.
2. The list of 18 industries earlier reserved exclusively for the public sector was reduced to 8, and this was further pruned later. This effectively ended the earlier perception that the public sector must "occupy the commanding heights of the economy".
3. Earlier, the Monopolies and Restrictive Trade Practices (MRTP) Act provided that all investments by companies with total assets exceeding Rs 1 billion needed special scrutiny to ensure that it would not increase concentration of economic power. These restrictions were abolished and the MRTP Act was to be used to check anticompetitive behavior.
4. Foreign Direct Investment (FDI) was earlier allowed only in a defined list of high priority industries and each application needed to be cleared on a case-by-case basis, with foreign equity limited to 40%. FDI was now freely allowed up to 51% in this list and higher limits were considered on the merits of each case. The government also announced that it would seek foreign investment pro-actively in areas where it could make a major contribution

5. Foreign technology agreements, which earlier needed individual approval, became eligible for automatic approval provided royalties and technology fees were within specified parameters.
6. There was a very substantial liberalization in trade policy. Capital goods, raw materials, components and other intermediate goods needed for production were made freely importable against tradable import licenses called Eximscrips.
7. A Committee on Tax Reforms was appointed, under the chairmanship of Raja Chelliah, to make recommendations for the reform of both direct and indirect taxes. It recommended a switch towards a regime of low tax rates with a broader base, a reduction in the number of indirect tax rates, and a gradual reduction in customs duties to expose Indian industry to competition from abroad.
8. Financial sector reforms were seen as an essential accompaniment to industrial liberalization, and a Committee on the Financial System was appointed under M. Narasimham to make recommendations in this area.
   – It recommended liberalization of controls over the interest rates charged by banks for different types of loans
   – and the introduction of tighter prudential and supervisory norms in line with the Basel I requirements that prevailed at the time.
   – It also recommended abolishing government controls on capital issues in the stock market and on pricing of these issues, leaving both to be regulated by a statutorily empowered Securities and Exchanges Board of India.
9. In 1992, qualified foreign institutional investors (FIIs) were allowed to bring in capital to purchase shares in listed companies through the stock exchange. There was a cap of 24% on the total equity in an individual company that could be held by FIIs.

Principal driver behind 1991 reforms

- There was much speculation at the time on whether the reform agenda was thrust upon the Indian government by the IMF as part of its assistance program.
- As per Montek Singh Ahluwalia (2016), the ideas implemented in the reform had been extensively discussed domestically, well before the crisis, and while they figured in the conditionality associated with the Fund's assistance, the IMF was not the principal driver.
- It would be more accurate to say that reformers in the government saw the crisis as an opportunity to implement changes that were being discussed earlier, but were politically not acceptable.
- The fact that the IMF program ended in 1994, but the reforms continued is proof that the reforms were home grown.

Gradualism

- India’s reforms have often been called gradualist rather than of the “big bang” variety.
- Gradualism had the obvious disadvantage that the reforms took a long time, and the flow of benefits was therefore delayed. However, they had the advantage of making small changes to begin with and allowing time to build a broader consensus across parties.
- Making policy changes in a democratic polity poses special challenges. Democracy is not a consensual form of government. It is an intensely competitive and adversarial form, in which political parties in opposition will engage in heated criticism of those in power

The Narasimha Rao government(1996-98)

- The United Front (UF) government, which followed the Narasimha Rao government which initiated the reforms, was in power from 1996 to 1998. It was a coalition which included the Communist Party of India.
- The UF government pushed for opening the insurance sector to new private players, with foreign insurance companies allowed to have up to 26% foreign equity.
- The government started the process of reducing the number of items reserved for the small-scale sector by taking out 15 items in 1997.
- It also tried to introduce a more rational approach to public sector reform by setting up the Disinvestment Commission and asking it to recommend transparent ways of selling off PSEs, including the possibility of handing over some PSEs entirely to the private sector

Manmohan Singh's Government 2004-2014

- Since Manmohan Singh was the architect of the 1991 reforms, it was expected that reforms would continue and they did, albeit in a gradualist manner.
- A major signal of continuity was that the government undertook a commitment to fiscal consolidation implied by the Fiscal Responsibility and Budget Management Act, which was passed by the previous government a year earlier. The combined fiscal deficit of the central and state governments declined sharply between 2003–2004 and 2007–2008 which created a supportive macroeconomic environment for private investment.
- The scope for FDI was expanded to increase the percentage of foreign equity in Telecom from 49 to 74%, and in airlines from 26 to 49%. FDI in retailing was also opened up, initially for "single brand retail". Department stores engaged in multibrand retailing were opened up much later, but subject to onerous conditions.
- The UPA also launched an ambitious program of infrastructure development through Public Private Partnerships (PPPs). The infrastructure deficit had become a major constraint holding back India's economic performance, and a massive increase in investment was needed. This could not be done using budget resources alone, because there were too many other claims on the budget. The strategy adopted was to rely on PPP wherever possible. The effort was very successful for several years, with PPP projects in roads, ports, airports, and power generation.

- Another important initiative of the UPA was the creation of Aadhar, a biometric identity verification system to cover all residents. This was to be used to promote financial inclusion and facilitate direct transfer of benefits in government subsidy schemes. This was started by the UPA, but has been greatly expanded by the NDA government that followed.
- The UPA government also began the process of getting the states to agree to an integrated goods and services tax(GST) in which both the center and the states would tax goods and services with full provision of input tax credit.

Narendra Modi's Government 2014 to present

- The current government under Prime Minister Narendra Modi took office in 2014. There are sharp differences between the government and opposition parties on social issues, most especially on growing incidents of violence against minorities and the dalits, which are widely attributed to aggressive Hindu nationalism and majoritarianism. However, the economic policy of the government is not very different from the gradualist reforms attempted by earlier governments.
- Perhaps the only initiative which does not fit into the description of continuity was the surprise demonetization of the two highest value notes (Rs 1000 and Rs 500) announced in November 2016. The move was officially justified on the grounds that it would help uncover hidden cash hoards from income that had escaped taxation, discourage counterfeiting and terrorist financing, reduce cash transactions in the economy and thus would discourage illegal and tax-avoiding activity. There is now a growing consensus that this initiative has proved to be much more disruptive than the government expected and has not contributed much to the other stated objectives.

On other economic issues, there is a high degree of continuity especially on the following

- Reaffirmation of the commitment to follow a fiscally prudent policy, but with a new time path for reducing the central government fiscal deficit to 3% of GDP by 2020–2021.
- Continuation of the liberal industrial policy with efforts being made to improve the ease of doing business
- Continuation of the policy of openness to foreign trade, though customs duties on a number of items were raised in the 2018–2019 budget.
- Continued openness to FDI with an expansion of the areas where it is allowed, including most notably defense, and also raising the equity cap in insurance from 26 to 49%.
- Reiterating the commitment to improve infrastructure through a combination of public investment and PPPs.
- Creating a digital IT infrastructure, based on Aadhar, the biometric identity system introduced by the UPA government, and using it to achieve financial inclusion and direct benefit transfers.

- The most important new step taken by the Modi government is the introduction of a Goods and Services Tax (GST). This major reform of the system of domestic indirect taxes was initiated by the UPA government and was opposed at the time by the BJP ruled states.
- However, the government can legitimately claim the credit for having got the Constitutional amendment done and introducing the system from mid-2017 onward. There are criticisms of the implementation of the GST. There are too many rates, too large a set of commodities has been excluded, and the system is more complex than it needs to be especially in the matter of crediting taxes paid on inputs and providing refunds to exporters.
- The government has acknowledged many of these problems and hopefully, they will be addressed over time. Once that is done, India will have a state-of-the-art domestic indirect tax system.

The Insolvency and Bankruptcy Code

- A second major reform is the Insolvency and Bankruptcy Code which is expected to speed up the process of debt recovery from companies defaulting on debt payments.
- The first few companies are now emerging from this process, with large haircuts for the banks and a complete loss of the company for the defaulting owners.
- Hopefully, as more successful resolutions emerge, it will create the right incentives for bankers to accept haircuts that are transparently determined and for borrowers to repay debts or face the consequences.

GDP rate of India

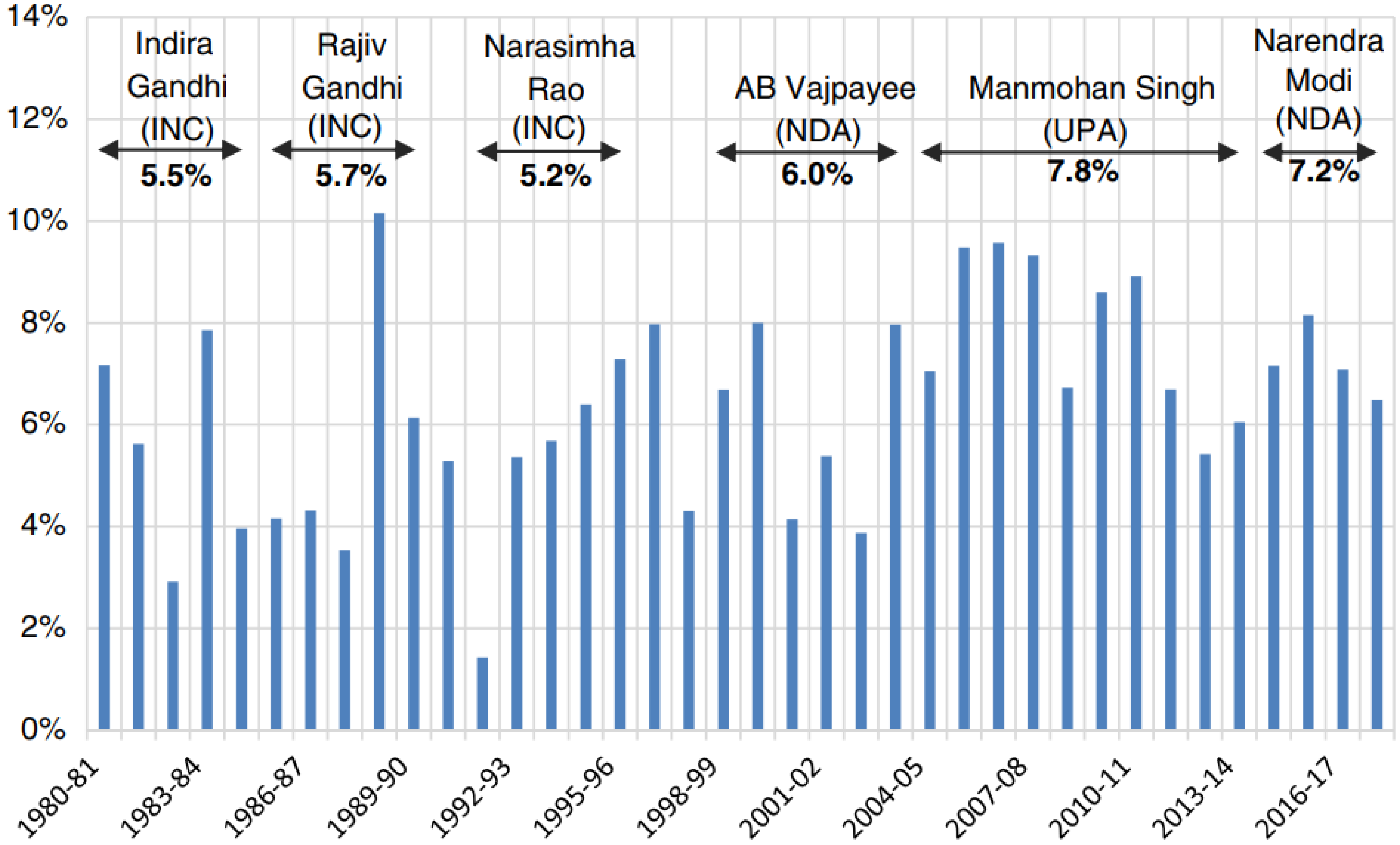

Figure 1 Growth rates of GDP.

Source: CSO (various years).

Were the reforms inclusive?

- Traditionally, inclusiveness in India has been viewed in terms of the impact on poverty reduction.
- The first 11 years of the reforms saw a decline in the percentage of the population in poverty from 45.3% to 37.2%. However, this decline was not sharp enough to offset the increase in total population, so the absolute number of people living below poverty line actually increased marginally

Table 2 Growth and poverty in India

	Annual growth of GDP (%)		Population in poverty	
	Economy	Agriculture	% in poverty	Millions
1993–1994	—	—	45.3	403.7
2004–2005	6.2	2.9	37.2	407.1
2011–2012	8.5	3.5	21.9	269.8

Note: The annual averages are for the period preceding the year indicated. Thus, 6.2% is the annual average growth of GSP from 1993–1994 to 2004–2005.
Source: Central Statistics Office (2014) and Rangarajan (2014).

The sharper reduction in poverty in the most recent period can be attributed to three distinct factors

- Faster growth rate
- Composition of growth rate (Growth rate of Agriculture)
- Government scheme to alleviate poverty(Like rural employment guarantee)

Education, health services, clean drinking water, and sanitation

- Access to schools has improved considerably, with the enrolment of children in primary school now being virtually universal. Gender gaps in enrollment have narrowed and pupil teacher ratios have also improved. However, learning outcomes remain poor. ASER Centre (2017) reported that about 57% of Standard VIII students in rural India could not do simple division, and 25% could not read a Standard II text.
- Health outcome indicators such as life expectancy, infant mortality, maternal mortality, measures of stunting, and weight for age of children have all shown improvement, but the rate of improvement is too slow.
- Sanitation is directly linked to health status, especially for children, and this has long been a problem area. However, the situation is improving. In 1993, only 12% of the rural households had access to a toilet. This has increased to 50% in 2016 (NSSO, 2017). The government's Swatch Bharat program has emphasized the provision of toilets for every rural household, and there is evidence that it is making a difference.

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