

## **India: Reform and the Politics of Gradual Accommodation**

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### **Introduction:**

India's "Great Transformation" seems to be finally underway. During the last four years it has experienced growth rates of almost eight percent, and many analysts believe that this growth is sustainable. India has averaged a growth rate of six percent for almost two decades. While this seems less impressive in comparison to China, it is a considerable achievement in light of India's own recent history. There is some dispute over the data, but it is generally agreed that the number of people living below poverty line fell to about twenty six percent and are expected to further fall by a percentage point each year. India's human development achievements have been less impressive: it lagged behind China considerably in both health and education indicators. Although the state of public health remains a cause for concern, India may finally be on the verge of a transformation in primary education. India always had a significant tertiary education sector, but its primary education enrollments are now up to ninety three percent. Although the quality of education remains a concern, India is finally waking up to the need to create human resources. But in many other respects, India's economy is extremely dynamic: the rise of India's service sector, particularly, Information Technology, has been spectacular. While India has not yet made its presence felt in mass scale manufacturing of consumer goods, there are signs of progress in this sector too, particularly automobiles. India's private sector capital output ratios are extremely impressive. India's economy has become considerably globalized. While the total share of FDI remains low, foreign institutional investment is rising pushing the stock market to dizzying heights; peak tariff rates are down from 155 percent in 1991 to less than 15 percent, and there is more openness to trade. Its foreign exchange reserves, though not spectacular, stand at a comfortable one hundred and fifty billion dollars. But India is firmly committed to globalizing its economy. India's saving rate has also been creeping up to thirty percent. But perhaps the most important change is aspirational: India finally has come to believe that it can compete with the best in the world, and its identity is increasingly going to be premised upon that aspiration.

Despite challenges, it is difficult not to have an acute sense that this is a momentous occasion in India's history. This sense is palpable in India, which is now considerably more confident in its dealing with the rest of the world than a decade ago; the world is also beginning to recognize India's potential as great power. A unique combination of factors is in play that could usher in a golden era of growth in India. Such factors would include, India's demographic advantage, a vibrant enterprise culture, robust financial markets, a large domestic market, a good human capital and managerial base, a stable and transparent democratic system, and potentially competitive labor cost advantage. But whether India takes full advantage of these propitious conditions will depend upon the policy choices it makes, which in turn will depend upon its politics.

How does one assess India's development trajectory and what are going to be its consequences? What are the drivers of growth and what are its challenges? Before we answer this question three preliminary remarks are in order.

First: Neither India nor China have followed a text book model of development. Both countries have improvised their strategies: India emphasized services over manufacturing, the development

of domestic business capacity over foreign direct investment, the development of financial markets over state investment. It's globalization and economic reform have been gradual, rather than based on a "ideologically driven" big push. It's currency policy has been marked by a similar gradualism, that allowed it to escape the East Asian currency crisis. This pattern of gradual improvisation is likely to continue, with the government responding to challenges as and when they arise.

Second: Like most countries India's trajectory of economic reform has to manage political constraints. I will describe these political constraints later in the paper. But the important point that cannot be overemphasized is that development strategy is an outcome of a number of political negotiations, not a product of a simple unfolding plan. This is particularly true of a large and diverse democracy like India. Indeed, it can be argued that India's future will not depend upon some over determined structural factors, but by the capacity of its institutions to devise creative solutions to its problems.

Third: International Relations in the global system are at an interesting conjuncture where two competing dynamics are at work. On the one hand most countries of the world, including China and India seem to extol the virtues of economic interdependence; they are enhancing their power, not through isolation but by creating webs of interdependence: financial, trade and economic. In this scenario, international relations is a peaceful win – win situation. In this liberal internationalist vision countries that are interdependent are likely to work together to secure a stable international order, old territorial rivalries are passé, and a web of institutional affiliations in the international system is likely to triumph over standard nationalist ambitions. On the other hand there is a version of the world where traditional great power rivalry continues to be a trope around which international discourse is organized: in this view power is a zero sum game, nationalist great power aspirations are likely to more enduring than international interdependence and military rivalry of as equal importance as trade. So we have the paradox, where great powers are encircling each other with trade agreements, in a competitive frenzy for FTA's, but simultaneously they are encircling each other by political influence and military spending. The world seems delicately poised and it is not clear which of the two versions of international relations will win out. For the version of liberal internationalism to win our countries will have to look upon their states rather instrumentally: as the provider of certain public goods but not the source of a historical mission or the locus of a strong identity. They will be more like what Robert Kagan described as post historical nations. It is, however, very likely that India, China and the United States will remain three historical nations, who not only have a strong sense of national identity but seek recognition of their status in the international system. Although on the face of it, it is highly likely that this nationalism will not take an ominous form, the presence of nationalism as an autonomous force in the politics of these countries cannot be ruled out.

### **A Brief History of India's Reform**

India embarked on a process of globalization and economic liberalization during the nineteen nineties. India's push towards economic reform was largely in consonance with worldwide trends. An external balance of payments crisis, a worldwide ideological shift towards free markets, and the collapse of the socialist model were the immediate drivers of reform. But the building blocks of economic reform were largely an outcome of India's own internal crisis of the state that began in the late seventies. Although the Indian state has done moderately well in keeping inflation low, avoiding any episode of mass starvation, and creating a base for industrial production, its positive achievements were less than impressive. The regulatory structure imposed by the state on industrial production had stifled growth, the state itself was not able to mobilize

savings into public investment, its social sector record was abysmal. But India's conversion to a liberal economic system was gradual and far from complete.

The first stage of reforms was two fold: deregulating domestic business and gradually cutting down tariffs to integrate India into the global economy. Indeed, the main driver of liberalization in India was not so much a commitment to pro market ideologies as the emergence of a pro domestic business attitude. What is the difference between pro business and pro market attitudes? In a pro market ideology, there would have been a greater emphasis on opening the bottlenecks that stand in the way of creating a truly competitive market. The Indian state has by and large not made radical moves in that direction. The obstacles that it refuses to confront are a) reservation of a large number of sectors for the small scale sector. Many argue that this has impeded the emergence of manufacturing capacity in India b) labor laws that prevent companies from hiring and firing labor. Although Indian companies have become adept at circumventing these laws, they still remain something of an obstacle to generate large scale employment in the manufacturing sector c) the public sector still remains a dominant source of production. In 1991-92 62.3 percent of the production of all large firms in India came from the public sector; after a full decade of reform that number had dropped only to 57 percent. In other words, the public sector still dominates large scale production. Therefore it would be premature to argue that the penetration of market forces has been as deep or as complete as it looks from the outside. The most striking achievement of reforms however was the create a pro business climate in the sectors that were not reserved for small scale industry and create a robust culture of private entrepreneurship and some impressive companies. This liberation of business, coupled with small scale entrepreneurship is likely to sustain growth in the 6—7 percent range; but accelerating growth will require more radical measures. This sector is now confident enough to push for more reform, but its power should not be overestimated.

The core weakness of India's reform program, its inability to create the conditions for a large manufacturing sector, is likely to remain in place for the near future, since the left parties draw their support from the small group of workers (30 million) in the organized sector who want to preserve the privileges of the existing workforce at the cost of its expansion.

The second feature of India's economic success has been that it is more pronounced in the "skills" sector. Not only does India's success in services and IT depend upon skills, even the areas of manufacturing where India is beginning to show success are high skill intensive industries. These are typically high value added industries requiring knowledge workers more than a traditional labor force. As a result India's high growth rate has been relatively "jobless", with employment elasticity of growth actually declining during the nineties. This emphasis on high skill sectors is a consequence of three factors: archaic labor laws which direct investment into "white collar" industries, India's historically high investment in tertiary education, and the regulatory structure which left the services sector free of regulation. These three advantages for high skills are likely to continue. Despite high value added, the resulting India's transition from an agrarian to an industrial economy in terms of the workforce will be slower.

The third feature of India's reform program has been its inability to make a serious impact on the agrarian sector which is still growing at only two percent annually and remains a cause for serious concern. Although the government is now laying stress on agro processing industries and investment to boost agrarian output, the outlook for this sector remains bleak. This is in part because no one is quite sure of the employment elasticity consequences of high value added agrarian production. Second, the government is also not sure of the policy instruments that can improve agrarian income. Even in areas where high value added agriculture is practiced there

is considerable agrarian distress that will cast an intermittent violent shadow on India's otherwise optimistic growth trajectory.

### **Taxation and Finance**

Economic growth has had an enormously beneficial impact on India's financial position. While total consolidated public debt to GDP ratio remains at a worrying eighty percent the last couple of years have seen a turnaround in the India's fiscal position. The fiscal deficit to GDP ratio of the Central Government has declined to 3.8 percent, and even more significantly, state finances are beginning to show a great deal of improvement overall. The Indian State remains cautiously optimistic about India's financial future for a number of reasons. First, India's financial system, including its banking system is considered extremely transparent, so there are unlikely to be any significant unaccounted for financial vulnerabilities. Second, India's tax over GDP ratio remains low at around twelve percent, so there is considerable room of raising more revenue. Indeed, it is for the first time that India is in the process of not only introducing a Value Added Tax, that has already improved the financial position of the state, it is also introducing a more efficient tax collection system. Provided the Indian State gets its administrative machinery in order, India's fiscal deficit is unlikely to pose a significant threat to India's prospects. India's best hope is to emphasize efficiency gains. One key aspect of this will be the creation of a single unified market that allows free and easy mobility for labor and capital and goods and services across the country. By some estimates of the barriers to internal mobility, especially of goods and services, India is even less of a common market than the European Union. India's big challenge will be to create an efficient integrated goods and services tax that facilitates rather than impedes mobility across India's various jurisdictions.

### **Finance and Human Development**

But India's improving financial position also suggests that India is unlikely to engage in more radical reform. Fiscal pressure was one of the drivers prompting the government to undertake disinvestment or privatization. With the easing of the fiscal pressure, the government is unlikely to undertake radical disinvestment. But much of the improving financial gains are going to be committed to stitching a new social coalition, through social sector spending. For example, it is not insignificant that the expenditure on defense and subsidies has fallen slightly as a percent of GDP under the present government, while outlays on education and employment programs have increased. While some this expenditure, especially in education, was long overdue, analysts fear that an easing fiscal situation may lead the government to craft more populist coalitions. Instead of fixing the roof while the sun is shining, the imperatives of populism will push the government into frittering away what could be a potential advantage, by spending on social programs that are not very productive. But on balance, it can be said that even if this is not the optimal course of option, India can now withstand the costs of a little fiscal profligacy on the social sector side.

Where should India spend? There is general consensus that given India's growth trajectory, India's only option is to spend a great deal on education and health. It is very likely that the key to India's future success will be its ability to invest in high quality education at all levels. Although India has had great success in high skill intensive areas of the economy and has a large tertiary sector in education, the rate of growth in services is already outpacing the supply of skilled labor. The real question for the twenty first century will be whether India can create the framework for producing large quantities of highly skilled labor to retain its cost advantages.

The difficulty in India spending patterns is more political than financial. It is estimated that only twenty percent of the money allocated for social sector spending actually reaches its intended beneficiaries. Accountability systems in public institutions, whether it be schools or universities, are on the verge of breaking down. The power of entrenched vested interests in these sectors, including teachers Unions make it difficult to introduce institutional reform that can give India's education sector an edge. My own view is that the battle over this sector will determine India's growth prospects considerably. Indeed, India's most significant challenge will be the reform of mechanisms by which public services are delivered: these mechanisms remain immensely inefficient and ineffective.

## **Decentralization**

India will have to more radically decentralize and strengthen its system of local governance, both urban and rural. India's federalism is a very complex and paradoxical institution. On the one hand, especially in matters of culture, language and identity, the Indian State has been extremely accommodating of regional and sub-regional aspirations. Indeed, it could be said that whenever the Indian State has tried democratic incorporation of regional aspirations, for instance Tamil Nadu during, the sixties, it has succeed; whenever it has tried repression it has failed. Arguably, state subverting secessionism is a product of the authoritarian moments of the Indian State; whenever it has allowed genuine self governance, it has succeeded.

But in matters of economics and governance India's federalism is undergoing three transformations. On the one hand, because of coalition politics, regional parties and leaders now exercise more power at the Centre; Indian federalism is becoming more inclusive by turns. On the other hand the trend in the economy is that the share of Central Taxes as proportion of total taxes is rising, so that arguably, the fiscal power of the Center is increasing. The challenge for federalism is going to be this. So far, the way in which the Center distributes finances to the state has followed, with some exceptions, a fairly stable formula. The advantage of this was that fiscal allocations from the Center to the State were not overtly politicized. The disadvantage was that the Center could exercise very little disciplining power against states that were financially profligate or inefficient since their allocations were fixed by formulas. Arguably, growing inequalities between states will require the Center to pressurize laggard states into performing better, but it has very few levers by which to do so. On the other hand, well of states are going to resist what they see as transfer of resources to less well off states. While the potential of regional inequality producing tension exist, in practice these are unlikely to produce serious threats for the Indian Polity for two reasons. First, the existing institutional framework is likely to have enough flexibility to provide for interregional transfers as are necessary for human development. Second, in practice states leverage concessions individually rather than in regional blocks, so are unlikely to collectively resist the center. But given the divergences in growth rates amongst states, the politics of regional equality is likely to become a more significant issue in Indian Politics.

But there is another level of decentralization that may turn out to be crucial to India's future. This is decentralization below the level of the state, to towns and villages. Although the 73<sup>rd</sup> and 74<sup>th</sup> Constitutional Amendment, devolved powers to local bodies, these remain considerably weaker than their counterparts elsewhere. For instance, few local bodies have financial powers, or powers to override the state bureaucracy. Without more radical decentralization is difficult to seem the delivery of public services improving in a sustainable way over the long run.

## **A Political Cure**

Ironically, the cure for India's governance problems will be more rather than less democracy. Many of the bottlenecks it faces in development can be directly traced to institutional devices that impede the process of democratic negotiation. The best example of this is India's party system, which is characterized by the following features:

India has a large number of political parties. While these parties give many sections of the population voice in the political system, they impede the process of democratic negotiation in three ways. First, in coalition politics small parties can come to exercise veto power over policy. Second, the proliferation of parties makes preference aggregation more difficult. Third, most parties are themselves undemocratic structures. They have no clear rules of recruitment, nomination or contestation. They are very oligarchic structures in which a few people control the finances, the agenda setting power, and the choice of personal selection within parties. This has the following consequences: a) it makes the party system less responsive to the people. This partly explains why the Indian system can be representative without being responsive. The party systems are oriented towards protecting incumbent leaders within parties b) the undemocratic character of different political parties leads to the proliferation of parties. Any newly mobilized social group or leader usually has two options: it can either join an existing party and try and reorient its agenda, or it can form its own party. It is likely to do the former only if there are clear rules within parties about how its ideological agenda gets oriented; if there are no such procedures or mechanisms, new groups have an incentive to create their own parties. This is precisely what is happening in India, adding to another layer of complexity to India's negotiations. Current party leaderships have no incentives to reform their party structures because their power is derived from the existing system. Therefore, the current fragmented party system is likely to continue, making policy making hostage to a million negotiations and several small vetoes.

But it is precisely this ability to negotiate with a million contending interests that gives India enormous depth, resilience and stability, even if the pace of change is somewhat slower. India's pluralism, an ability to negotiate across all kinds of cultural divides; and its democracy that allows for an openness and gradual accommodation may yet prove to be its greatest strengths rather than weaknesses. The key to its future prosperity will lie in serious institutional reform. Even if the unfolding story of India's rise is slow, it is sure footed and robust.