1 The Indian Economy: Up to 1991 and Since

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1.1

With the exception, perhaps, of the years immediately following India's independence, never before has there been as much optimism about the Indian economy as in the last decade. But India is notorious for blowing its chances, not only in cricket, but also vis-à-vis the economy. The hope, in the immediate wake of this country's independence, was firmly belied. In the late 1970s, with foreign exchange reserves beginning to build up, the savings rate crossing 20 percent for the first time, and the economy running a food surplus, many felt that the time for India's economic takeoff had come. But India remained stubbornly rooted to the tarmac. Hence, there is reason to view the current buzz with caution. Is the recent growth spurt of the 1990s sustainable? How has the growth been shared among India's different regions and different people? Is the optimism founded too excessively and exclusively on India's celebrated success in information technology? How successful, in fact, has India been in information technology? Given the surge of interest in the Indian economy, it is natural for such questions to arise. This book is an attempt to provide answers to some of these issues and to offer perspectives on India's recent performance and future prospects from a group of people who have been on the cutting edge of research, policymaking, and industry building in India.

In this introductory chapter I cover some of the ground addressed in the subsequent chapters but do not confine myself to those issues. Subsequent chapters are written by independent and prominent commentators, with their own distinctive views. Hence, while on some of the most fundamental policy matters they share a common approach —remarkably so—the chapters have different foci and, often, different perspectives. Hence, one purpose of this introductory chapter is to give a general, overarching account of India's economic performance, recounting not only what happened in the 1990s but also filling in some of the background story leading up to the past decade. I hope this overview helps readers better appreciate the essays that follow, which have their own themes and, with a few exceptions, are concerned with India's post-1991 economic experience.

But I cannot resist going beyond this editorial task to put on record my own views on the Indian experience and, in particular, to argue that, as soon as one takes a slightly longer view of an economy's performance it becomes important to understand the social and cultural setting in which this occurs.[1] I argue that economic performances, good and bad, may owe a lot to the cultural underpinnings of the economy in question.[2] There is also reason to study the social, cultural, and political environment in itself. As Amartya Sen argues in chapter 2, economics is not the only yardstick with which to evaluate a nation's performance. And, on the political and social front there is much concern about India's recent experience,[3] even though its *economic* prospects look encouraging. Democracy and secularism were two basic tenets behind the vision of an independent India. Sen assesses how India has figured in terms of these two larger political and cultural aims and alerts us to the possibility of these being endangered. Moreover, it is arguable that economic success in the long run may depend on such political and cultural factors.

In explaining the economic success or failure of a nation, economists and others study the kind of macroeconomic policies in effect—openness to trade, the size of the fiscal deficit, and the nature of the exchange rate regime—and the hard structural features of the nation in question—such as its geography, topography, and natural resources. However, it will be argued that the roots of India's prolonged economic stagnation and the glimmer of hope that one notices today cannot be fully understood if one ignores the variables that conventional economic analysis has taught the public to ignore—the social norms, culture, beliefs, and fabric of social interaction.

To say that the cause of a nation's overall stagnation lies in its culture or its collective beliefs does not mean to deny the importance of its economic policy, just as the assertion that the spilled fuel on the floor caused the fire does not exonerate the smoldering cigarette stub thrown carelessly into it. Also, culture and social norms must not be taken as immutable features of society. These norms evolve and change, often responding mechanically to the altering global environment and the inexorable advance of technology, but also at times consciously, through the will of the people to adopt a norm that may seem valuable or to discard values that may have become an anachronism.[4] Public intellectuals, writers, and Keynes's academic scribblers of yesteryear play a crucial role in this.

One can find many historical accounts of a nation's changing culture and norms. In 1950, Alec Adams, the British Charge d'Affaires in Korea, described Koreans as follows: "[Foreigners] who live here mostly entertain the lowest opinion of Korean intelligence, mores, ability and industry. It is hard to believe, I gather, that [Koreans] will ever be able to successfully govern themselves." (qtd. in Clifford 1994, 29). It seems impossible to square this perspective with our contemporary view of Koreans, who are known for their intelligence and industry. It is possible that Adams's opinion was shaped in part by racism, but he was not the only one to hold such a view (see Clifford 1994). It also seems possible to argue that Korean mores have changed during these last fifty years; while Adams's perspective may have had some validity then, it has no validity now.

Thus, an understanding of the role of culture and collective beliefs in the life of a nation can help analysts and policymakers design better and more appropriate economic policy. In the case of Russia it is now recognized that standard economic policies designed to speed transition did poorly because they amounted to a change that Russian society was not prepared to accept—the requisite culture and norms for the market economy were not in place. But this is true not just for Russia. When economists propose their favored economic policy agendas and fret that they are not immediately adopted, or get aborted, after adoption, because of social instability, one reason for the policy failure and economists' frustration is the lack of understanding of the social and political context in which the policy was implemented (Platteau 1994, 2000). Hence, the focus on the politico-cultural underbelly of an economy does not have to be founded in skepticism of economic policy, but in recognition of the fact that this is a complement of it and so should assist in the design of better and more appropriate economic policy.

But before going to that it is convenient to begin with a brief recounting of the statistical context of the subject matter of this chapter and also the book. Both occur in the next section.

1.2

A broad picture of where India stands today in cross-sectional terms is captured in table 1.1. The numbers tell a lot. It is a country that remains

Table 1.1
Selected cross-country development indicators, 2000–2001

	Average annual % growth in GDP (1990–2001)	Gross national income (GNI), per capita dollars (2001)	PPP Gross national income (GNI), per capita dollars (2001)	Gross capital formation, % of GDP (2001)	Life expectancy at birth, years (2000)	Under-5 mortality rate, per 1,000 (2000)	Adult literacy rate, % of people 15 and older (2000)
China	10.0	890	4,260	39	70	39	84
India	5.9	460	2,450	24	63	88	57
Mexico	3.1	5,540	8,770	21	73	36	91
Pakistan	3.7	420	1,920	15	63	110	43
South Africa	2.1	2,900	9,510	15	48	79	85

Source: The World Bank, *World Development Report 2003*.

crushingly poor but has had a decade of fast growth. As is evident from tables 1.2 and 1.3, in terms of pure growth the 1990s was India's best decade since gaining its independence, and, from what little one knows of her earlier experience, perhaps the best performance of the last century. In per capita income terms, with or without purchasing power parity (ppp) correction, India has now outperformed Pakistan, where political turmoil has taken its toll on economic performance. On the other hand, China, whose economic performance even a decade ago was very close to India's, has now surged ahead and has nearly double India's per capita income. Arguably, India's growth performance in the last decade has been second only to China's, but the gap between the two nations is, nevertheless, substantial.

On an examination of indicators that reflect the standard of living, such as life expectancy at birth or literacy or under-5 mortality, India does poorly but perhaps not quite as poorly as one might expect from her per capita income. South Africa, for instance, is several folds richer than India but has a life expectancy of 48 years, way below that of India's 63. It has a mortality rate close to India's. India's literacy rate of 57 percent, as reported in table 1.1, is bad by any standards, though it must be pointed out that, one year later (i.e., in 2001), the national census showed that literacy had actually risen to 65 percent.

As far as performance over time goes, these are summarized in tables 1.2 and 1.3, which show that, going by pure growth rates, there is some reason for optimism for the Indian economy. India's average growth rate, which was close to 3.5 percent in the fifties and sixties, went up to over 5 percent in the late seventies and stayed that way for a decade. After the economic depression of 1991, growth picked up even more, clearing the 6 percent mark on average and actually seeing a GDP growth rate of over 7 percent for three consecutive years starting from 1994.

With this brief statistical sketch in the background, we are now in a position to go into the causes of the Indian economy's poor performance for so many decades after independence and its seeming improvement in the last decade.

1.3

One of the most celebrated battles in Indian history was fought between Robert Clive and Siraj ud Daula in June 1757 in Plassey, West Bengal. Siraj's defeat would be a milestone in the establishment of

Table 1.2
Gross domestic saving (GDS) and growth rate in India, 1950–2001

	Rate of gross domestic saving (GDS)	Annual growth rate of GDP at factor cost		Rate of gross domestic saving (GDS)	Annual growth rate of GDP at factor cost
50–51	8.9	.	76–77	19.4	1.2
51–52	9.3	2.3	77–78	19.8	7.5
52–53	8.3	2.8	78–79	21.5	5.5
53–54	7.9	6.1	79–80	20.1	−5.2
54–55	9.4	4.2	80–81	18.9	7.2
55–56	12.6	2.6	81–82	18.6	6
56–57	12.2	5.7	82–83	18.3	3.1
57–58	10.4	−1.2	83–84	17.6	7.7
58–59	9.5	7.6	84–85	18.8	4.3
59–60	11.2	2.2	85–86	19.5	4.5
60–61	11.6	7.1	86–87	18.9	4.3
61–62	11.7	3.1	87–88	20.6	3.8
62–63	12.7	2.1	88–89	20.9	10.5
63–64	12.3	5.1	89–90	22	6.7
64–65	11.9	7.6	90–91	23.1	5.6
65–66	14	−3.7	91–92	22	1.3
66–67	14	1	92–93	21.8	5.1
67–68	11.9	8.1	93–94	22.5	5.9
68–69	12.2	2.6	94–95	24.8	7.3
69–70	14.3	6.5	95–96	25.1	7.3
70–71	14.6	5	96–97	23.2	7.8
71–72	15.1	1	97–98	23.5	4.8
72–73	14.6	−0.3	98–99	22	6.6
73–74	16.8	4.6	99–00	22.3	6.4
74–75	16	1.2	00–01	.	5.2
75–76	17.2	9			

Source: Reserve Bank of India (2001).

Table 1.3
Annual average growth rate in India across plan periods

		GNP at factor cost, 1993–1994 prices
First plan	1951–1956	3.7
Second plan	1956–1961	4.2
Third plan	1961–1966	2.8
Fourth plan	1969–1974	3.4
Fifth plan	1974–1979	5.0
Sixth plan	1980–1985	5.5
Seventh plan	1985–1990	5.8
Eighth plan	1992–1997	6.8
Average	1951–2000	4.4

Source: National Accounts Statistics 2001, Ministry of Statistics, Government of India.

the British Empire in India. The battle was bizarre and brief. Siraj ud Daula's force was some 60,000 strong. This included close to 20,000 cavalry and 40,000 infantry. Clive, on the other hand, commanded an impossibly small force of 3,000 soldiers. Even the firepower was mismatched. Siraj's army had nearly fifty guns, most of them 24- or 32-pounders. Clive's men had eight field guns and one howitzer. The balance of resources was overwhelmingly in favor of India.[5] But within moments of the start of the battle, the Indian side was in disarray.[6] Panic, lack of coordination, and betrayal made the forces look not so much like a defending army as a wild rioting mob. The battle was won by Clive, within hours of its start. The defeat cannot be understood in terms of the balance of resources or individual human capital. It was essentially a failure of organizational capital or what in business schools today would be called a failure of managerial coordination.[7]

Consider an economy where some people control all the water, some all the food, and some all the energy. Even though the total amount of water, food, and energy may be very large, if this society does not learn how to exchange and trade, it will be a very poor society—indeed so poor that all its members may die. In a modern nation, it is not enough for there to be a lot of knowledge about medicine, engineering, and information technology. If the nation does not have the organizational ability to share and exchange this knowledge and to combine each with other kinds of knowledge and harness it where it is needed, it will be a miserable and poor nation. Since one does not typically think of organizational skill and the ability for coordinated action as a resource or capital, it is easy to overlook their importance. But in the case of India, to overlook these abilities and issues is to seriously handicap thorough analysis. It may not be entirely a matter of chance that India has so much individual talent in classical music but no orchestral tradition.

This situation is, in part, a consequence of the social norm not to submit to authority, whether it be the conductor's baton or the government's order. There are not too many cities in the world, where, as in Delhi in the early eighties, bus seats with the prominently displayed label "Ladies Seat" often required another beseeching sign: "Please let ladies sit on Ladies Seat." And, based on my own limited observation (from the precarious foothold that I would have—on lucky days—on the bus, while traveling between home and the Delhi School of Economics) of passenger behavior, even this meta-order had little effect.

It is worth emphasizing here, by way of a digression, that what I am calling organization or organizational capital[8] is quite different from education or human capital. The latter resides in individuals whereas organizational ability (and coordination) is a property of *collectivities*. A society of high human capital and poor organization is like a society where lots of people have computers but no Internet exists to link the information in these computers. It is clear that the same society with the same number of computers becomes vastly more efficient if people are able to use the information in one another's computers. Likewise, the benefits of ample human capital are large, but would nevertheless be severely underutilized without a network of organization and coordination.[9]

By the same token, the "success" of the early European colonizers in India is impossible to understand without examining this mysterious resource—organizational capital. It is the development of the managerial technique, whereby a small number of Europeans could not only coordinate their own actions but use large numbers of locals to control the locals, that led to the advancement of the empires. The British Empire was the crowning example of this method of management.

The rise of the British offers another lesson in management—the importance of learning. It is arguable that this technique was not their own but that of the Portuguese, developed during the viceroyalty of Alphonso d'Albuquerque in Goa from 1509 to 1515. Albuquerque mastered the technique of using a very limited number of his own people, the Portuguese, to control masses of the local population through a carefully designed system of incentives and disincentives, instead of the age-old practice of bringing in large occupying armies from the conquering nation to establish control over the new territories. It was a managerial system par excellence, which the British emulated.

People learn most easily from those with whom they identify. It is not surprising that Albuquerque's technique was mastered by other Europeans and facilitated the spread of colonialism but had little effect on the *nawabs* and the indigenous civilians.

In the case of India the British would soon edge out the Portuguese, who were deflected from their original mission of trade and commercial plunder by their zeal to convert and kill the heathens, in particular the Muslims of India. The British, on the other hand, offered the natives protection and won over their trust; soon they were using the same method of offering small incentives and punishments to commandeer the local population against the larger interests of the local population.

1.4

While the Indians did not learn the amorphous art of control and management from their colonial rulers, they did learn one thing from the colonial experience that would get etched as a belief in the country's collective psyche.[10] The British came to India not to rule but to trade. The initial contact that India had with Britain was not with the Crown but with one of the earliest multinational corporations of the world, the East India Company. But the trading interests of the company increasingly intertwined with the ruling interest of the nation from where the company originated. Commercial interest merged with political interest and gradually, without any serious resistance, a huge subcontinent had passed into the control of the British Empire. Thenceforth, the Indians would be relieved of their resources not just through asymmetric trade and exchange but also taxation and state-sponsored extortion. The fear of multinationals and a mistrust of business and trade would become part of India's collective memory. And if their memory ever tended to fade, incidents such as the U.S. interference in Allende's Chile to make Latin America "safe" for U.S. business would restore it to vigor. Independent India would design its economic policy in the shadow of this memory.

One can see manifestations of this commercial distrust in all walks of Indian life, trivial and momentous. The mistrust of business and profit has been woven into songs and into the remonstration of parents to children who refuse to study hard that they will end up having to do business when they grow up. One can see this sentiment in advertisements. In India there is a disproportionate effort to couch business in morality, to show that the low price or the big sale is not a business stratagem but an act of honor. I have some newspaper clippings of advertisements from a 1984 price war among sellers of hosiery goods—undergarments, vests, and "baba suits" (suits for little boys, to the best of my knowledge)—who took out a series of advertisements in the *Indian Express*. These are funny because they are so blatant; but they are also significant because they illustrate the need of entrepreneurs to counter the widespread Indian mistrust of business. The first of these is an advertisement from 22 March, which shows the picture of a kindly looking man, Bal Krishan Khurana, and gives details of the sale that he is organizing, including the fact that all items are being sold at the low price of 30 rupees each. Just below Mr. Khurana's picture and above those details, a bold caption reads: "If I am asked about my last wish, I would pray to God to send me again to the great land of India, so that I can give more hosiery service to my country men."

Virtually all advertisements and commercials in every country have manufacturers and traders professing concern and care for the consumer's welfare. What is noteworthy in this advertisement is that it goes beyond pandering to the consumer. It appeals to morals beyond the marketplace; it appeals to the seller's patriotism.

A few days later, on 26 March, came a challenge to Mr. Khurana in the form of an advertisement taken out by Mr. Ramesh Arora, a person sporting a beard in a manner befitting holy men. He is selling similar hosiery items at lower prices than Mr. Khurana's, but that information is dwarfed by the moral message in bold, which reads: "Today Ramesh Arora is going to sell Hosiery items worth up to Rs. 200 [for] only 25 Rupees because I am the son of that respectable mother who did not desire Bungalows from me, but desired the service of my nation. Just imagine can any one on this divine Earth compete with me in selling Hosiery items."

Some weeks later, on 20 May, Mr. Khurana did what Bertrand competition in oligopoly would lead economists to expect of anybody who has bought a disproportionately large inventory of hosiery. He cuts the price to Rs. 5 and appeals again not to good business or concern for consumer welfare, but this time to revolutionary fervor. The advertisement has a large-font caption that reads: "The person who fights with Nations enemies is called REVOLUTIONARY. The person who sells Rs. 150 worth export quality goods [for] Rs. 5 is called BAL KRISHAN KHURANA."

The other side of this same phenomenon—namely, the consumer's apprehension that businesses are always out to cheat[11]—has had more significant consequences for India. It led to the creation of a large bureaucracy to control and monitor business and to set up barriers to foreign goods and investment. The tariffs on imports rose steadily, as successive finance ministers fell over one another to demonstrate their resolve not to allow foreigners to exploit Indians. Foreign direct investment (FDI) was discouraged, and this was done so successfully that the amount of FDI that was coming into India by the late 1980s was less than what was going to its much smaller neighbor, Bangladesh.

Growing disillusionment with the economy, a gradual drift of opinion the world over (away from planning and control to recognizing the importance of incentives and openness), and, on top of this ready soil, a major crisis in the early 1990s would shake India out of her policy stupor and make possible changes that earlier would have met with enormous popular resistance. But I come back to that shortly.

India's failure was, more than anything else, an intellectual failure. Many contemporary writers, charged by the euphoria of economic reform and the mantra of government withdrawal, have written at length about the goodness of big business and the nobility of man's acquisitive urge. This is a distortion of history and contemporary reality. And it is not as if one needs it to make a case in support of economic reforms and market liberalization. India needs to move more vigorously toward a modern, market economy. But as several of the essays in this book illustrate, this cannot be achieved through the relatively easy route of rolling back government. There is no escape from the need for purposive, intelligent action from government. Government, or good governance, is a concomitant of efficient markets, not a substitute.

It is my opinion that a suspicion of the big and the powerful (be it government, corporations, or individuals), at any time, is a sign of good judgment. The mistakes Indian policymakers made lay elsewhere. First, they failed to realize that the global business ethos had changed, not only from the mid-eighteenth century when Robert Clive had plundered India on behalf of a business concern but even through the 1970s and 1980s. Corporations are still hungry for profit, but emerging global norms do not allow them to use the kind of plundering strategy that they earlier employed. Second, the policymakers lacked pragmatism. They made the erroneous deduction that if X is interested in only his own profit, then we cannot benefit from interacting with X and so should not have any truck with X. This deduction is invalid because it presumes that, if an agent does something in his own self-interest, then that action cannot have beneficial effects on others. But "collateral benefits" in economics can be as ubiquitous as collateral damage in war. Despite this mistake the decisions of the policymakers would be fine if, other than such X's, there were Y's, who were noble and effective business partners. Maybe these Y's will come to exist in some future time, but there are few such Y's around now. So, while guarding our own interest, we must at the same time be prepared to deal with businesses that may have no interest in human welfare at large. Pragmatism requires us to decide on the course of a particular action on the basis of how good its consequences are, and not on the basis of whether it requires us to run with the hounds.

1.5

Economists keep telling the public about what is the "obviously" right policy. "If only," they say, "India had done this or that . . ." it would not be a nation in such poverty. But a study of history and an open mind shows that, in crafting policy, there is virtually nothing that is *obviously* right or wrong. I do believe that India's persistence with a closed economy system—a direct byproduct of her history and beliefs—hurt her, and it is the opening up of the 1990s that has been the basis of the economic progress that has been witnessed since, providing hope for the future. But, as I demonstrate, there are counterexamples, which would make a view different from mine not outrageously wrong or obviously false. Regrettably, economics and the study of society are doomed to this innate ambiguity.

One can see the glaringly paradoxical nature of economic policy in India's most celebrated industry—information technology and software.[12] The numbers are quite stunning. The volume of India's software exports was $2.7 billion in 1998–1999, over $4 billion in 1999–2000, $6.2 billion in 2000–2001 and exceeding $8 billion in 2001–2002. This trend has been present for the last ten years—an annual growth rate of approximately 40 percent, despite the slight slowdown last year caused by the global recession. Given the compounding involved, this means that in the 1990s, India's exports virtually doubled every two years. In 1999 a study by NASSCOM and McKinsey[13] had predicted that India's exports would reach $50 billion by the year 2008. Since India's *total* current exports are less than $50 billion,[14] and nothing like this has happened in any other sector in India in anybody's living memory, these estimates and predictions have given rise to much skepticism. I was initially skeptical myself, but having checked and compared different sources I am convinced that, give or take a margin of 5 percent, the estimated volume of exports is right. No matter what one thinks of the forecast and even if one, quite reasonably, believes that it errs on the side of optimism, the sector's performance thus far has been outstanding.

What is interesting is that India's software success has resulted from policies that were commonly viewed as defective. First and foremost, it was a consequence of India's "over-investment" in higher education. For a long time Indians were used to seeing a glut of engineers in search of jobs and many economists criticized the policymakers and, more generally, government for this oversupply. Then came the admittedly unexpected breakthroughs, mainly in the United States, in the information technology (IT) sector, and suddenly the idle engineers were gone, boosting the Indian economy and sending entrepreneurs scampering to set up institutes and colleges to cope with the excess demand for higher education.

Second, brain drain had for long been criticized for many of India's ills. Yet it is arguable that it is the brain drain to Silicon Valley that made Bangalore possible. As Indian computer professionals migrated to the United States, ideas flowed back to India and the Indian industry took off. The NASSCOM-McKinsey study, mentioned earlier, has estimated that the larger the outflow of computer professionals to outside India, the greater the software exports from India. So the brain drain in this instance played greatly to India's advantage.

Third, it would be a denial of reality if one did not recognize that it was an act of closing the economy that spurred India's domestic IT sector. In 1977 the Janata government asked IBM to leave India, since they refused to dilute their ownership of 100 percent of the subsidiaries. As Infosys's CEO, Narayana Murthy, has written elsewhere, "This was in some sense a blessing in disguise," encouraging the production "of smaller, state-of-the-art but cheaper minicomputers and microcomputers" (2000, 215). But after this, the boost to this sector came, as Murthy acknowledges in the same paper and discusses in greater detail in chapter 9, from the opening up of the economy in the nineties.

One sobering experience comes from Russia. It has long been believed that privatization leads to efficiency. But as Russia privatized, it was soon recognized that, if the supporting institutions are not there, it may not be in the interest of the entrepreneurs to work to maximize the long-run value of the firms. Instead they could serve their own interest best through asset-stripping or "self-dealing." The anarchy that ensued in Russia is now well known. As Black, Kraakman, and Tarassova (2000, 1752) wrote, "The weak legal and institutional framework was no secret to the privatizers. But writing good laws can take years and building good institutions decades. The privatizers weren't willing to wait" (see also Hoff 2000). Some argued that privatization would result in a demand to reform the institutions and bring in the rule of law. But that did not happen, or happened with so much time lag that the damage to the economy in the interim period was great.

I believe that there is need now for India to move more strongly forward with the reforms, allow private firms to enter sectors earlier kept reserved for state-owned enterprises (this is more important than privatization), open the economy further, and, in particular, allow Indian companies to go for larger acquisitions abroad. But one must be aware that there are no panaceas in economic policy. One has to be prepared for flexibility, to experiment with policy but be ready to adjust, alter, and on occasion even do a U-turn, depending on the evidence coming in. To stick with one policy, unbendingly, is to make the same mistake of policy stubbornness that led India to its present predicament.

Take openness, for instance. While there is need to push ahead with this in today's India, including a further lowering of tariff barriers and even greater mobility of capital, it is not obvious that these reforms, if implemented in the 1960s, would have automatically yielded benefits for the country. There are several laws and institutional features of Indian industry that handicap our domestic producers. For example, there are some industries, such as handicrafts and toys, which are marked as belonging to the small-scale sectors. Large-scale factory production is not permitted in these industries. Imagine what would happen if India suddenly opened up the doors to all imports, without liberalizing this sector. Foreign producers would manufacture the same goods in large-scale modern factories, lower their per-unit cost of production, and outcompete the Indian producers, handicapped by the Indian laws. This would still cause gains from trade, true, but may inhibit the future development of Indian industry. Moreover, the free flow of capital could cause destabilizing currency crises. And, not surprisingly, prominent economists such as Jagdish Bhagwati have advised against full convertibility on the capital account for developing countries, observing that "the optimal speed at which one liberalizes is not necessarily the fastest" (2002, 90).[15]

The same is true for globalization, which creates great opportunities. But to maintain that it has no costs is to make the same mistake of overconfidence that served India so poorly in the past. For one, globalization is likely to bring prices of the weaker economies into alignment with prices in the industrialized nations. Given that the price of illiterate labor is close to zero in industrialized nations, this means that the illiterate population of developing nations will tend to become extremely impoverished if there is globalization without complementary government intervention.[16] In a country like India where 35 percent of the people are illiterate, globalization can contribute to increasing poverty and inequality.[17] It is important to recognize this not in order to thwart globalization but to prepare for and benefit from it.

1.6

To understand contemporary India's economic problems, I find it useful to travel back a little in time and research the roots of India's own experience. This is especially important to me because of my skepticism about history being amenable to theory or being codified in a law so that we can dispense with the details. It is a tragedy when great minds spend inordinate amounts of time to unearth the laws of history, and an even greater tragedy when they find them. This can mislead ordinary mortals into an illusion of knowledge, into a false confidence about what lies ahead, and make them shed skepticism. And skepticism is the mainspring of not just enquiry and true knowledge, but also civil society.

Many see no redeeming feature in India's performance during the first thirty or forty years of independence. But if one compares whatever data are available from pre-independence India with post-1947 data, it is clear that independence has been good for India, not just for the nation's democracy, morale, and self-respect, but for its economy and standard of living. Take literacy. Despite Britain's avowal to educate the Indians,[18] India's literacy rate in 1951 was 17 percent. In the next ten years, it would double. Thereafter the rise would be slow, reaching a level of 65 percent in the current year. But no matter how one measures it, it is clear that the performance during the first fifty years of the last century was far outstripped by the second fifty years.

The same is true for per capita income. From 1900 to 1947 India's national income grew at slightly less than 1 percent per annum, which amounted to a per capita income growth rate of 0.1 percent per annum.[19] In comparison, the notorious "Hindu rate of growth" of national income of just over 3 percent per annum, at which India was stuck from 1947 to 1975, and the 5 percent per annum that was achieved during 1976–1991 are significantly higher. And of course the period 1992–2001 with an annual growth rate of 6.5 percent looks positively bullish.[20] Indeed in terms of virtually all measures of standard of living that one can think of, independence turns out to be a dummy variable of significance, with performance clearly better after it than before it.[21]

The frustration with India is not that nothing happened since 1947, but that more did not happen, that rhetoric and achievement diverged so widely. In some sense this was inevitable because India's policy was born out of two conflicting systems of beliefs and ideas—those of Gandhi and Nehru—held together precariously, and often with the differences denied, because this was one difference that Indians found too difficult to confront.[22] The differences had roots that go back to well before 1947. They can be found in Nehru's education at Harrow and Cambridge, and his commitment to Fabian socialism and in Gandhi's grassroots struggle, experiments in alternate living, and innate convictions. As early as 1933 Nehru had confided to his diary, "I cannot understand how [Gandhi] can accept . . . the present social order [and] how he can surround himself with men who are . . . the beneficiaries of this social order." Nehru was more radical, in a conventional sense of the word, than Gandhi. This was clear from his diary entry: "In many ways I have far more in common with English and other non-Indian socialists than I have with non-socialists in India" (qtd. in Wolpert 1996, 150).

Gandhi lived a life with a minimum of material trappings, but did not believe in socialism—certainly not of any known variety. He viewed Nehru's difference of opinion with tolerance and understanding. Thus in 1937 he would tell some foreign visitors: "[Nehru's] enunciation of scientific socialism does not jar on me. I have been living the life since 1906 that he would have all India to live. To say that he favors Russian Communism is a travesty of truth" (qtd. in Wolpert 1996, 215). Gandhi was right in his assessment of Nehru. But the economic policies they envisaged for India were very different. In the 1930s and even the early 1940s Nehru was quite enamored by Marx and Lenin (though not by Russian Communism) and referred to their works repeatedly in his diary entries and in letters to friends. He had shed his Marxism-Leninism and even socialism by the time India attained its independence, but his faith in megaplanning, heavy industry, modern science, and technology would persist. Along with Prasanta Mahalanobis, he would try to give shape to those ideas in the form of what came to be called the Mahalanobis-Nehru strategy of development.[23]

The actual policy regime that India followed in its early days of independence was a mixture of the two competing (and almost contradictory) visions. A Soviet-style planning system was developed, but without the state having a monopoly of control over the resources. Capitalism was allowed to flourish, but a large bureaucracy was nurtured. Huge investments were made in basic industries, but at the same time several sectors were protected as belonging to the small-scale sector. Capitalism was criticized but it was also relied upon. Socialism was never practiced, but the rhetoric of socialism was the norm. A burgeoning bureaucracy became the surrogate for socialism.

Ideas played a major role, and in this case the dominant ideas were those of Nehru. Nehru was of course an outstanding intellectual, with a flair for writing that put him in the class of a very limited number of national leaders in world history. But he was not obsessive about economic growth in the way some other twentieth-century leaders have been, such as Park Chung Hee of Korea or Lee Kwan Yew of Singapore. Nehru did participate in the economic planning process; but his interest was not so much in the plans as in the prose of the plans. Not surprisingly, while Korea produced some of the most effective policy plans, India produced some of the most well-*written* policy plans.

Advisers from Washington, DC, and many economists recommend that Third World nations must have democracy and must open up their economy and privatize, oblivious to the fact that to ask for a democracy and then to insist what the democracy should choose amounts to a contradiction. Since most developing countries are not democracies, they did not face the problem, but India did. Once people's opinion had been shaped (and Nehru was instrumental in this), there was no way that policies could be easily dictated to them. Opinion would have to be molded before major policy shifts were possible. Or at least policymakers had to catch people in a moment of doubt or vacillation to usher in changes.

1.7

That is exactly what Manmohan Singh set out to remedy as the newly appointed Finance Minister in 1991. In that year India had run into its most major economic crisis. The Indian economy had always lived on the edge of a foreign exchange crisis. According to Bimal Jalan's (1992) count, for thirty out of the thirty-six years since the start of the second Five-Year Plan in 1956 the economy had faced some kind of a balance-of-payments crisis. In 1991, because of a combination of factors, including the Gulf War, a burgeoning fiscal deficit, and large international debt, a foreign exchange shortage occurred and India came closer to defaulting on its international debt commitments than ever before. Major policy initiatives were needed, and from 1991 to 1993 major and bold changes in policy were effected. An account of the basic features of the reform and the crisis that prompted it is given by Mihir Rakshit in chapter 5.

The effects of these reforms are quite apparent. The most important policy initiatives were in the international sector and the major successes have been in that sector.[24] India's foreign exchange balance has grown rapidly. Thanks to the economy's openness, the information technology sector has expanded at record rates. Of the total amount of software produced in India, two-thirds is exported. So the global trade interaction has been crucial to this sector.

The 1990s was also the time when India's draconian licensing laws were dismantled. It is easy now to forget the absurdity of the bureaucratic hurdles that had been built up in India. As Narayana Murthy, one of the architects of India's software revolution, explains in chapter 9, India's software success may not have been possible even if all the other propitious factors were present but the reforms had not occurred.[25] Despite all this, the license-raj could have been justified if it helped the disadvantaged. But as Amartya Sen (1995, 28) pointed out, "Four decades of allegedly 'interventionist' planning did little to make the country literate, provide a wide-based health service, achieve comprehensive land reforms, or end the rampant social inequalities that blight the material prospects of the underprivileged" (Dreze and Sen 1995).[26]

The economy's overall post-reform growth rate, with the partial dismantling of the license-raj, has been very good. As stated earlier, from 1994 to 1997 Indian national income grew at over 7 percent per annum, and during the entire last decade the growth rate has been around 6.5 percent. Specific sectors, such as the consumer durables industry, have done well. A study by K. V. Ramaswamy (2001) has shown that growth in the post-reform period has been significantly higher than in the pre-reform period, and, more important, firms have responded to the reforms by going in for technological improvements.

Elsewhere I have taken the view (Basu 2001a), and continue to maintain it, that an economy has to be evaluated, ultimately, in terms of what happens to the poorest and the dispossessed. Everything else, such as a nation's income growth rate, is of *instrumental* value. Not all economists concur with this view. To many, efficiency, growth, and *aggregate* welfare are the ends that they wish to pursue. Yet it is worth putting on record that Amartya Sen has consistently taken a normative stand where these are merely of instrumental value (see, e.g., Sen 1999, chap. 2). Jagdish Bhagwati has argued vigorously for free trade and raising growth, but unlike some other economists, who take such a line, he has been categorical: "As regards the *objective* of development, I should emphasize, as I always have, that growth was seen by me . . . , from the early 1960s, as simply an instrumental variable, as a means to an end, and the end was clearly the elimination of poverty" (1985, 1). Empowerment of the poor and poverty reduction also is the central concern of Manuela Ferro, David Rosenblatt, and Nicholas Stern in chapter 7. Given such a normative stand, it is important to look at indicators that relate to the lives of the poor.

On matters of basic needs and development of the most disadvantaged, India unfortunately still has miles to go. Over the last few decades, inequality has been rising, regional disparities have been growing, and poverty and illiteracy continue to be high. Ferro, Rosenblatt, and Stern's chapter provides a comprehensive account of what is happening to poverty and what should be done. Two other chapters that directly address what is happening to the disadvantaged, without going into matters of macro aggregates, are the ones by Renana Jhabvala and Ravi Kanbur (chapter 12) and by Barbara Harriss-White (chapter 11). Jhabvala and Kanbur look at the especially vulnerable, including women, from the field experience of Self Employed Women's Association, better known as SEWA. Globalization creates new vulnerability, they argue, while not denying that globalization also creates enormous potentials for advancement. Harriss-White, who is also concerned with matters of gender, looks at India's informal economic sector, in which most of the poor participate and which typically gets very little attention in economic analysis.

On the overall magnitude of poverty there was, initially, a lot of very confusing data coming in and it was not clear what was happening (see Datt and Ravallion 2002, for discussion). Much of the confusion was caused by a change in the nature of the questions adopted by the National Sample Survey (NSS) of India. Regarding consumption, the NSS was trying to switch from asking people how much they had consumed in the last thirty days to the last seven days, which many believed elicited more accurate answers from people with fallible memories. This caused certain contaminations in the data that allowed analysts to make claims in keeping with their predilections, without really fussing about what the data really said, which in any case was very difficult to interpret. The most scientifically convincing study is the one by Deaton (2001), which establishes fairly clearly that poverty, after remaining steady through the early 1990s, went in for a definitive dip by 1999. Though the fall in the percentage of people below the poverty line was not as sharp as the government claimed (27.1 percent for rural areas and 23.6 percent for urban areas in 1999), it was sufficiently sharp (down to 30.2 percent and 24.7 percent in rural and urban areas, respectively) to cause the absolute number of people below the poverty line to fall.[27] This augurs well, but it must not be forgotten that the level of poverty in India continues to be unacceptably high.

Literacy has risen from 52 percent in 1991 to 65 percent in 2001. This is not so much a consequence of government policy as people's changing view of the value of education (caused by the greater exposure to the world out there), which has led to parents demanding better education for their children and often willing to pay for that at the expense of great personal hardship. Again, while this trend is heartening, it is tragic that a nation with so much policy devoted to higher education and scientific work still has 35 percent of its population unable to read and write.

On these fundamental indicators therefore there is reason to be both disappointed at where the nation stands and optimistic about the changes that have taken place. The reforms of the early 1990s, luck (as in the rise of IT in the United States) and history (such as the overinvestment in higher education) seem to be going in favor of the Indian economy. One question that arises is that, if the IT sector, and more generally, services, turn out to be one of the major powerhouses of the Indian economy, will this be a reliable powerhouse and will the benefits of this sector be shared widely?

There has recently been concern expressed about this sector based on the observation that the global situation has changed since 1999 in ways that beckon economists to revise the forecast downwards. First, there is the downturn in the U.S. stock market, especially in the IT sector. This is indeed a matter of some concern, since so much of India's exports end up in North America. However, what must be realized is that the stock market tends to correlate with the *profitability* of the industry, and this need not be correlated with the *size* of the industry. And India's exports depend mainly on the size of the U.S. industry. One reason why the technology stocks are doing badly is precisely because the IT sector in the United States is such an attractive industry and growing so rapidly. As the number of firms increases, profits go down; and so the stock market does poorly—especially so since market players did not understand this and had over-invested in technology stocks. So this in itself should have only a small effect on India's exports. If, however, the U.S. economy goes into a major slump and U.S. growth stops or becomes negative, then the projections can go wrong.

The second worry pertains to the supply side in India. With the large flight of computer professionals out of India, there is going to be a supply bottleneck forming in India's software production. This problem was exacerbated by increases in the U.S. quota of H1B visas, that is, visas for professional migration, which currently stands at approximately 200,000 professionals each year. Typically, about 45 percent of these visas go to Indians (the second largest category being the Chinese, at 9 percent) and 53 percent of the ones who get H1B visas are computer professionals. This means that roughly 50,000 computer professionals have been leaving India for the United States each year. When one adds to this the (admittedly smaller) flows to Germany, Sweden, and even Japan, it is evident that the out-migration problem is quite serious for India, even though the numbers slacked off last year because of the slowdown of the U.S. economy. In chapter 10 Nirvikar Singh goes into many of these issues related to the software sector.

While this out-migration is reason for some concern, it must be recognized, as I mentioned earlier, that IT is one sector in which India has actually benefited from the brain drain. So this increased demand for Indian computer personnel should be treated as a blessing, and government should simply work hard to educate a larger numbers of Indians appropriately.

What are the consequences of this sector for the well-being of people at large in India? The concern, often expressed, is that the IT sector is not labor-intensive enough. Currently, approximately half a million people are employed in this sector. This is not a small number;

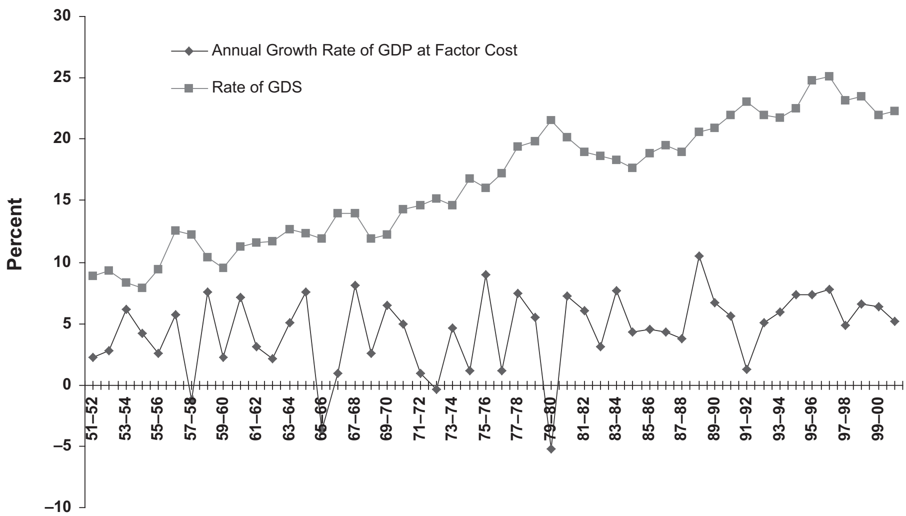

Figure 1.1
Gross domestic savings (GDS) and growth rate in India, 1950–2001. *Source:* See table 1.2.

moreover, simple projection, based on the growth of this sector as predicted by the NASSCOM-McKinsey study, suggests that employment will grow to 3 million by the year 2010. Most important, these calculations ignore the fallout on other sectors. India has an IT-enabled sector (such as call centers and data-processing units) that is growing more rapidly than the IT sector itself. The IT-enabled sector currently employs 100,000 people but has enormous potential.

Turning to more general matters, we observe that one worry for India's development prospect concerns the recent movements in the savings rate (and investment rate). After rising sharply through the 1970s, and slowly through the 1980s and early 1990s, this has declined suddenly in the late 1990s. It was 22 percent in 1998–1999, having climbed to over 24 percent in the mid-1990s (see table 1.2 and figure 1.1). While the relation between savings and investment rates and growth is a long-run one and therefore easy to overlook, reason and evidence suggest that to have sustained high growth a nation needs high investment and savings. This may not be obvious by looking at figure 1.1, but India's growth rate, averaged over a few years, has generally mirrored its savings rate, with a time lag. Until 1965, India's growth rate averaged below 4 percent per annum and the savings rate was below 14 percent—see table 1.2. Savings crossed the 20 percent mark by the late seventies, and by the early eighties India's growth

Table 1.4
Major macroeconomic indicators in India (% of GDP)

	Combined fiscal deficit of central and state governments	Gross savings	
		Private sector	Public sector
1992–1993	7.0	20.2	1.6
1993–1994	8.3	21.9	0.6
1994–1995	7.1	23.2	1.7
1995–1996	6.5	23.1	2.0
1996–1997	6.4	21.5	1.7
1997–1998	7.3	21.8	1.3
1998–1999	8.9	22.6	−1.0
1999–2000	9.4	24.0	−0.9
2000–2001	9.6	25.1	−1.7

Source: Ahluwalia (2002).

rate had moved to over 5 percent. And there were further increases in both these rates until the early nineties. Looking at cross-country experience, one sees the East Asian economies achieving growth rates of 8 percent while saving well over 30 percent. As Montek Ahluwalia (2002) points out, to have a growth rate of 8 percent it will be essential to have an investment rate of between 29 and 30 percent. Even if one achieves a part of this from foreign direct investment, India can ill afford to fall back on the savings front.

Why is India's savings rate falling? It is difficult, as yet, to tell all the reasons behind this, though it is certain that the worsening fiscal situation and declining public-sector savings are major contributory factors.[28] Ahluwalia (2002) provides some compelling numbers and argument supporting this, some of which are reproduced in table 1.4. He also points to what has been known for a while, namely, that the finances of the Indian states are in poor shape. This is the subject matter of detailed inquiry by Govinda Rao in chapter 6. He suggests reforms that can arrest this deterioration, something that is essential for the long-run health of the economy.

Much has been written about the next round of reforms, but what is not talked about enough but is important to develop is the institution of contracts, without which no modern market can function. This is one more way in which government is important: It can play the crucial role of the third party that helps enforce contracts. But contracts are partly a matter of culture. Without this culture it is difficult to develop crucial long-term markets, such as the market for mortgage and long-term investment loans, and to take full advantage of globalization. And these, in turn, are key ingredients of fast growth.

There are, fortunately, enough strengths in the Indian economy for it to be a net beneficiary of globalization. The economy has gone past that critical level where to open up is to risk being cheated and impoverished. Though there are still innumerable important reforms to undertake, the fundamentals of the Indian economy are probably strong enough for it to be able to implement and benefit from another round of market reform and further (though gradual) opening up of the economy.

Globalization and modern markets bring with them many ills. But, on balance, and given the new strengths of the Indian economy, these changes will open up rather than close windows of opportunity for India. The modern global economy is beginning to change the nature of management of Indian firms and to encourage "clean business," which, historically, used to be considered a contradiction in terms and will hopefully influence the organization of government. It is bringing in new ideas on how to organize and how to govern the market. It is changing beliefs about what is good and what is bad for the economy. These beliefs may be right or wrong, but they will have a bigger impact on the economy than most people realize. There are huge inequities and injustices in the world to remedy. It is not always clear how this can be achieved and whether this can at all be achieved by a single nation. When crafting policy, it is important for the policymaker to recognize the features of the world that must be taken as given, and try to do as much as possible *subject* to those constraints. To craft policy *assuming* that the features of the global economy and the rules of the global game that one does not like can be wished away is to court failure.

Notes

For helpful comments and criticisms, I am grateful to Alaka Basu, Gayatri Koolwal, and Elizabeth Murry.

1. In doing so, this essay draws heavily on my previous work: Basu (2001b) and Basu and Pattanaik (1998).

2. This point is compellingly made for a context that goes much beyond India in Platteau (2000). In chapter 3 of this volume, Pranab Bardhan conducts an analysis of India's economic performance that is rooted in "political sociology." See also Bardhan (1984).

3. There is, in particular, reason to be worried that plurality, secularism, and cultural openness, which were historically India's strength and distinctiveness, have witnessed threats in recent times (see Sen 1996 and chapter 2).

4. For an illuminating analysis of the general role of social and cultural norms in economic development, see Platteau (2000). For a model of how cultural norms need not be immutable, see Basu and Weibull (2003).

5. Some may argue that from Siraj's forces the 20,000 or so soldiers who were under Mir Jafar's charge and did very little to defend Siraj should be deducted. The nonfunctioning of those 20,000 soldiers or, more accurately, their betrayal, corroborates the point I am about to make.

6. Accounts of the Battle of Plassey and Robert Clive's strategies are legion. The numbers I quote here are from Chaudhuri (1975).

7. Thus Harvey writes: "To comprehend the campaign at Trichinopoly, and indeed later in Bengal, it is necessary to understand the nature of the colorful, shambling circuses that were the Indian armies of the time.... The forces of an Indian prince much more nearly resembled a travelling township than an army" (1998, 91).

8. I deliberately avoid the term *social capital* for it has been used in so many different senses in recent times, though its original meaning does have overlaps with the concept being used here. In addition, I am not confident that I fully understand what it means and fear that there are others who do.

9. Bardhan (2003) has recently made a similar observation about *contemporary* India, arguing that some of India's failures are rooted in the nation's inability to resolve "collective action problems." He maintains that China's recent retrenchment of large numbers of workers from overmanned public-sector enterprises is founded in China's relative greater skill for putting the "collective resolve" into action.

10. For a discussion of the relation between beliefs and economic progress, and a classification of growth-enhancing and growth-hindering beliefs, see Basu (2000b, chap. 4).

11. The consumers' belief is not necessarily false. I have argued in Basu (2000b) that this belief can be self-fulfilling, in the sense that, given such a collective belief, the kind of business practices that come into existence reinforce the belief, and the belief then is fully justified.

12. Two chapters in this volume, those by N. R. Narayana Murthy (chap. 9) and Nirvikar Singh (chap. 10), evaluate in detail the experience of India's IT industry and its relation to the Indian economy and polity at large.

13. See ⟨www.indianembassy.org/indiainfo/india_it.htm⟩.

14. According to the Mid-Year Review released by the Ministry of Foreign Affairs in November 2002, the April–June exports were $11,757 million. Multiplied by four this gives us $47,028 million. While it is true that the growth in exports has been high at times, it is unlikely to cross the $50 billion mark this year.

15. The role of international trade, openness, and technology transfer in the context of the East Asian economies has been recently studied and modeled by Van and Wan (1999). They construct the model specifically with an eye on how the experience can be emulated by other nations such as India. In their analysis the crucial benefit of trade is the technology transfer that results with it.

16. Research by Wood and Calandrino (2000) suggests that, as India's foreign trade increases, this raises the demand for educated workers but lowers the demand for illiterate workers.

17. The subject of inequality and poverty is an important one for global policy. I have discussed some of the measurement issues involved in Basu (2001a). I believe that, left to the market, global inequality will tend to grow. However, there is very little that a single developing country can do about this. To try to control inequality too aggressively within one's own territory is likely to drive capital away, causing greater poverty. What is needed is a concerted global plan. There is much that can be done by way of controlling inequality, without hurting incentives and entrepreneurship, but this has to be a global effort and is a subject matter that lies beyond the scope of this chapter.

18. In the case of some viceroys, the commitment to India was genuine. This was most notably so for Louis Mountbatten.

19. The figures are from Sivasubramonian (1997). For discussion and comparison of growth rates before and after independence, see Roy (2001, 2002), and Majumdar (1997). Table 1.3 gives the average annual growth rates for successive five-year plan periods and demonstrates clearly its rising trend.

20. For a discussion of this growth history and the breakup of independent India's economic history into these three periods, see Basu (2000a).

21. An interesting recent paper by Iyer (2002) investigates the more general question of whether colonial rule has desirable long-run effects. She studies this by looking at the conditions today of regions of India that were under British colonial rule and of regions that remained under Indian rulers. Given that the British did not annex regions randomly but chose them according to some criterion, Iyer's analysis is crucially sensitive to weeding out this endogeneity problem. Once this is done, she shows that there is strong evidence that colonial rule tended to significantly lower the level of public goods in the long run. Abhijit V. Banerjee's essay (chapter 8) starts from a similar framework, and then allows for the fact that history, geography, and many other variables can affect the level of public goods in different regions of India. The study is a comprehensive one conducted for a list of thirty-three public goods and across a large number of India's districts spread over sixteen states.

22. See Basu and Pattanaik (1998). Cohen (2001) discusses how the influence of Nehru and Gandhi went beyond economic policy to all dimensions of strategic thought, including foreign policy, in contemporary India.

23. See Ashok Rudra (1996), especially chapter 11 by T. N. Srinivasan.

24. What is not always noted is that there have also been significant changes in monetary policy. Since 1992 there has been a conscious effort to lower interest rates and encourage greater lending. In 1993 the minimum lending rate was lowered from 17 percent to 15 percent and the SLR was lowered from 30 percent to 25 percent, open market operations being used simultaneously to neutralize money supply increases and control inflation. For a discussion of monetary policy see Rangarajan (2001). See also Reddy (2002, chap. 4). A comprehensive account of monetary reforms, along with an account of the institutional setting for the possibility of such reform, occurs in chapters 4 (Y. V. Reddy) and 5 (Mihir Rakshit).

25. Similarly, Das (2001, chap. 13) uses the story of Dhirubhai Ambani to illustrate how Reliance may never have become a world-class enterprise under the labyrinthine laws

that controlled Indian industry between 1965 and 1991. It is noteworthy, however, that Dhirubhai Ambani had not done badly under the license-raj. As Das's own account illustrates, some of Dhirubhai's initial success was, there can be no denying, because he managed to exploit the protective system of India's bureaucratic government to his advantage. It should therefore be noted that one important contribution of the reform is that it constituted a step toward making "clean" business possible.

26. See also Dreze and Sen (1995).

27. For an analysis of inequality in India based on the same data sources, see Deaton and Dreze (2002).

28. Policymaker-analysts of the Indian economy seem quite unequivocal on this: see, for instance, Lahiri and Kannan (2001), Kelkar (2002), and Mohan (2002).

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