Cycles in Indian Economic Liberalization, 1966–1996

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In the 1990s there appears to be a growing disjuncture between India's economic and political performance. The economic news since 1992 has been very positive. Yearly economic growth has been 5–8 percent, inflation has declined dramatically, and India's modern, private sector (electronics, software, and heavy machinery) is doing very well in international competition. Crop yields have also risen, and, in the process, India has become a major grains exporter. However, the political scene has been far more turbulent and increasingly troubling. Regional and ethnic political parties have proliferated, intimidation and violence are widespread, and corruption is pervasive in local, state, and national governments.

In the May 1996 parliamentary elections, for the first time since independence, a communal party, the Hindu nationalist Bharatiya Janata Party (BJP), won a plurality. Although the BJP was not successful at forming a lasting majority in parliament, the electoral results sent a tremor through the Indian body politic. Eventually, a compromise was reached to create a complex coalition of thirteen parties, named the United Front, headed by H. D. Deve Gowda of Karnataka. Not only was Deve Gowda the first southerner to be prime minister, but he was the first member of a minor, regional party to lead the nation. Within eleven months Gowda lost a vote of confidence in the Lok Sabha. The coalition survived, but in tenuous shape, with Inder Kumar Gujral as the new prime minister.

If we step back from this barrage of new developments and try to assess the factors shaping economic policy choice in India, we can see both consistent patterns and interesting anomalies. For almost five decades the dominant mode of economic policy in India has been to rely on the central government for macroeconomic direction (monetary, fiscal, and exchange rate policy) and for the administration of a vast set of controls, subsidies, tariffs, and quotas. Many of these controls were started during World War II under British rule.

The controls were continued and expanded, however, by a sequence of Congress Party regimes that justified intervention on the grounds that "government should control the commanding heights of the economy." By the mid 1960s, the controls were so pervasive and the protection of Indian industry so stifling that a vigorous intellectual debate ensued about the appropriate way to redirect Indian economic
The 1965 Indo-Pakistani war resulted in the cut-off of foreign aid to both belligerents, and the ensuing balance of payments crisis gave foreign donors considerable leverage in pressing for a more open, less controlled, market-oriented economic policy.

In June 1966 Prime Minister Indira Gandhi took the first major step away from the path that her father, Jawaharlal Nehru, had urged. She devalued the rupee and announced a series of steps designed to reduce trade controls and licensing inside India. Although she quickly retreated and never implemented the full range of decontrol measures agreed to with the World Bank, she began the pattern of partial liberalization measures that has recurred in Indian economic policymaking. One of our central objectives is to explain why India seems caught in a recurring cycle of oscillations between controls and attempts to create a more open economy.

In the last thirty-five years Indian real Gross Domestic Product (GDP) has grown on average 4.1 percent per year. GDP growth was slowest in the 1970s (2.6 percent), fastest in the 1980s (5.7 percent), and exactly average in the 1990s (4.1 percent). Nevertheless, because the Indian population has grown at about 2.1 percent per year since the 1960s, real per capita income has increased less than 2 percent on average per year. This slow growth, and the frustration at seeing most of the countries in East Asia improve living standards considerably faster, has led to repeated calls for accelerating growth. Because Indian savings rates have been relatively high, most attention has been focused on how to use capital and labor more efficiently.

The anomalies and complexities of Indian economic policy are striking. The droughts of 1965 and 1966 made India vulnerable to external pressure for policy changes; today, India can feed its population and is a net food exporter. India has a middle class of approximately 80 million, yet the central government still derives 50 percent of its revenues from excise taxes and customs duties (a taxation pattern typical of the poorest developing countries). Despite the creation of a government board of industry and financial restructuring in 1987, not one of the 150 companies that it has recommended for closing has actually been forced to terminate its operations. Although government industries are widely understood to be inefficient, public enterprises in India have grown from 8 percent of GDP in 1960 to about 25 percent of GDP in 1993–94. Because of excess staff and poor management, the public sector enterprises have a gross profit rate that is only one-half the rate in the private sector, and net rates of return are so low in the public sector (averaging only 3 percent) that in many cases the revenues are insufficient even to cover depreciation. India has had three periods when the government has experimented with reducing controls over trade, finance, and industry, yet there is still a bewildering array of central and state regulations on foreign investment and trade in certain sectors. Thus, prodigious energy is devoted to government planning and control of the economy, with decidedly mixed results.
The Indian Economic Policy Dilemma

By 1952 Prime Minister Nehru consolidated the controls regime that he had inherited from the British and put in place an even more extensive set of planning mechanisms. The enthusiasm for government control came from a number of quarters: ideological preference, confidence in the mathematical sophistication of the Indian Planning Commission, the availability of a talented civil service trained by the British, a deep distrust of the business community, the conviction that national security would be enhanced by government direction, and a consensus at the time among academic economists that planning and government leadership would accelerate growth.

The initial results of this highly dirigiste economic policy management style were impressive. Indian GDP in the 1950s grew on average about 3.8 percent per year, faster than the average of other newly independent countries. Nevertheless, by the 1960s the inherent inefficiencies of government micromanagement were beginning to be apparent. GDP growth began to slow, and the frustration with limited performance led Mrs. Gandhi to try her brief experiment with liberalization.

In the mid 1960s, also, development economists began to shift their emphasis from capital accumulation to productivity increases and to stress policies that would improve efficiency. In the early post-World War II period many economists had portrayed growth as a rather mechanical process that would occur as long as the requisite amounts of savings and investment were provided. This view came under scrutiny as it became clear that some countries, India among them, had high savings and investment rates but low GDP growth.

Thus, as India's growth slowed in the 1960s, the international community shifted its focus from how to get more aid to India to how to get India to use its resources more efficiently. Differences over how India should manage its resources have been the nexus of policy debate in New Delhi over the past three decades. There have been limited experiments with liberalization, but the preference has been for controls and extensive government. We will analyze the three periods of liberalization (1966–68, 1985–87, and 1991–94) and answer three questions. Which individuals and which principal factors were responsible for launching these liberalization episodes? What choked off the liberalization efforts? Will the cycle of incomplete liberalizations continue, or are the conditions right for India to move to a substantially more open economy?

The Basic Argument

Liberalization episodes generally involve two related but distinct efforts: creating macroeconomic stability through a mixture of budgetary restraint, monetary policy,
and realistic exchange rates and limiting the role of or terminating government controls, subsidies, and assorted regulations.13

During most of the period between independence and the late 1980s the Indian government followed a relatively conservative monetary policy, stressing low inflation and limited external borrowing. Thus, in the first two liberalization episodes (1966–68 and 1985–87) the principal macroeconomic adjustment was in exchange rate policy, and the extent of reform was far more limited than in 1991–94.

After 1987, however, all four consecutive governments followed a more stimulative macroeconomic policy and were less cautious about foreign borrowing.14 Thus, the scale and complexity of liberalization from 1991 to 1994 were greater than in the first two episodes. Nevertheless, on balance, in all three episodes the real focus of liberalization was to reduce controls, not worry about macroeconomic stability.

The basic argument of this article draws on six propositions. First, the principal motivation in each of the liberalization episodes is not a mystery: the government sought to accelerate the Indian rate of economic growth, implicitly acknowledging that its micromanagement was inhibiting performance. Second, the intricate web of controls created an interlocking set of powerful groups (businessmen, civil servants, and politicians) that each stood to lose if controls were substantially reduced or eliminated. Third, even after thirty years of debate and three attempts at liberalization, the effective rate of protection in India remains very high at 55 percent. Fourth, the persistence of extreme poverty, widespread illiteracy, distrust of business, and a high level of politicization of economic policy in India has made it possible for advocates of controls to present their actions as designed to improve the income distribution. Fifth, each of the three liberalization episodes was launched by a different combination of factors but ultimately brought to a halt by the same opposing forces. Finally, economic liberalization and reform will stall in India without exceptional circumstances. Although the 1985–87 and 1991–94 episodes have each left India less controlled than before, the apparatus of government management is still in place, and there is no self-perpetuating momentum toward a more open economy. India’s regional diversity and hierarchical society have led to a maze of political and social impediments to change.

Theoretical Approaches to Indian Political Economy

E. Sridharan has skilfully summarized the prevailing literature on the political economy of India and suggested that in the past two decades it has been concentrated in three distinct schools: liberal-pluralist, Marxist, and rational choice.15 Here we will draw on Sridharan’s typology of these three schools but present a distinctive interpretation that emphasizes the significance of cycles in liberalization and retrenchment. If a country moves definitely toward a more open economy, the planning and
controls apparatus will be weakened or even discarded. However, in India’s case the
groups favoring central control have a thirty year history of survival despite a gradu-
al weakening of their influence.

Thus, the historical legacy is very important in explaining behavior. Even groups
or individuals who might benefit from openness fear their losses when the pendulum
swings back toward controls. This fear produces a kind of “satisficing” behavior
(that is, cautious, incremental moves when the operating environment is uncertain)
which prevents fundamental structural transformation of the economy. A combina-
tion of this history of repeated incomplete liberalizations and the Indian public’s
deep distrust of the business community makes the process of further liberalization
complex. Added to this mix of cross-pressures has been the Bharatiya Janata
Party’s effort to portray foreign investment as a threat to sovereignty and the viability
of local firms.

The pluralist work on India notes the elaborate rigidity of the country’s social
structure and the manner in which politicians reflect this reality, tending to inhibit
rapid change. It is also significant that India’s constitution grants considerable
authority to the states, which can speed or delay economic reforms depending upon
the orientation of the state governments and legislative assemblies.

The Marxist literature draws attention to the political power of the principal influ-
tential interest groups (landlords, businessmen, professionals, and civil servants).
“Structural” Marxists also hold the view that the state apparatus itself can be semi-
autonomous and pursue its own interests. In this vein, some argue that the 1985–87
liberalization was due to the inability of the central government to raise adequate
revenue. It was thus forced to maintain expenditures for the civil service (necessary
for central control) by reducing subsidies to state enterprises (unpopular but not a
direct challenge to the power of the state).

Rational choice advocates take an even more skeptical view of the state’s actions
and see India’s intricate controls system as merely the latest scheme in a long string
of exploitative moves by government against the private sector. Although the origi-
nal objectives of government may have merit, most analysts using a rational choice
perspective argue that the conferring of specific benefits on a particular industry,
region, or firm will quickly lead to unproductive, rent-seeking behavior.

To analyze the three liberalization episodes we can use elements of these three
theoretical perspectives but in a distinct approach. The pluralist literature is good at
explaining stasis and equilibrium in the Indian political system. By stressing India’s
particularistic features (caste and a plethora of regional and language differences), it
can be argued that policymakers have settled into their own compromises and that
large-scale, intrusive government keeps antagonistic factions in check. The
labyrinthine role of government is therefore a specific solution to the magnitude of
India’s problems. What pluralism does not explain well is the discontent with the
system and the periodic attempts to replace it with a more open policy.
The Marxist tradition is compelling when looking at India’s persistently high rate of illiteracy and the vast divide in income and wealth. But it can not explain the rise of the middle class (the sixth largest in the world), nor is there much confidence now in Marxist approaches to economic management. Also, with the collapse of the Soviet Union in 1991 the parties on the far Left and their intellectual supporters found it harder to appeal to the middle of the political spectrum, as their benefactor and model was such an abject failure.

The rational choice school is persuasive in explaining the reasons why controls persist (that is, the self-interest of those who design, administer, or benefit from them). But it does not adequately deal with why the general public and those who have suffered under the system (exporters, small businessmen, and the more innovative competitive firms) have not formed a coalition that creates sustained momentum for liberalization. One finding of this research is that businessmen are so concerned about the expected swings back to central direction that they are willing to make only modest commitments (in terms of investment and the reorientation of production toward new markets), thus limiting the resource reallocation and improvements in efficiency that would be expected from liberalization.

These episodes should also shed light on the ongoing debate about the most appropriate role for the state in facilitating economic development. In the 1960s many economists and political scientists urged countries to develop a “strong developmental state.” Then, as the evidence grew about the inefficiency and corruption that highly centralized authority could engender, many analysts urged a limited role for the state. A growing literature now emphasizes some balance between markets and state control. The Indian case is a key test of these theories.

Three Liberalization Episodes

The 1966–1968 Episode Indira Gandhi’s decision on June 6, 1966, to devalue the rupee by 36.5 percent and initiate a broad-reaching program to decontrol trade and the industrial sector was due to an exceptional combination of circumstances. The 1965 Indo-Pakistani war resulted in a cut-off of foreign aid; a severe drought in 1965 reduced exports; a balance of payments crisis was looming; and the analytical work for a massive shift in policy had been laid. In addition, several key ministers urged Mrs. Gandhi to take the risk.

The 1965 drought reduced exports sharply, while the cut-off in aid curtailed subsidized imports. The prime minister was left with three main options: to turn to the Left, possibly forfeiting on debt obligations and hoping for increased aid from the Soviet Union and eastern European countries; to tighten import controls and further sell off reserve assets like gold and foreign exchange to pay for imported food; and to move in a “market-oriented” direction and liberalize to provide incentives for...
exporting and to rationalize decisions on importing.

With an overvalued exchange rate, liberalization would have little chance of success, so the market-oriented option had the immediate political disadvantage of forcing a rise in the price of imported goods. Subsequently, much attention was also given to the issue of foreign pressure to devalue the rupee. Despite these clear disadvantages, why did Mrs. Gandhi launch the liberalization effort?

Mrs. Gandhi gave no interviews on the details of her decision, nor did she write memoirs covering the topic. Hence we are left principally with the opinions of her close advisors and the foreign economists and administrators who were directly involved. The two most influential cabinet officers on economic policy were Ashok Mehta, the planning minister, and Subaramaniam, the agriculture minister. Both were convinced that the economic planning bureaucracy and controls established by Nehru needed to be fundamentally reformed.26 They were also essential for Mrs. Gandhi’s political future, as Mehta played the key role in arranging foreign aid and Subramaniam was supervising the “green revolution” which was vital for the Congress Party’s rural base.

Mehta and Subramaniam were assisted by a small group of exceptionally competent civil servants led by I. G. Patel and S. Bhootilingham.27 This coterie of powerful insiders had been dealing throughout 1965 with a prominent team of economists brought to India by the World Bank. The World Bank team, led by Bernard Bell, had produced a ten volume report recommending fundamental changes in India’s economic management.28

Hence a most unusual combination of factors shaped economic policy choice in India in 1966. Prime Minister Shastri’s death in January 1966 brought Nehru’s daughter to leadership of the government; foreign aid was blocked between October 1965 and March 1966, causing a payments crisis; and the management of the World Bank (which was heading the donor consortium for India) clearly lost confidence in New Delhi’s policy direction. Prime Minister Gandhi, ever the pragmatist, saw the immediate need for keeping large volumes of aid flowing, and she was willing to strike a deal.

Ashok Mehta was sent to Washington, where he negotiated an elaborate agreement directly with George Woods, president of the World Bank. The Woods/Mehta agreement committed India to major structural reforms: substantial decontrol of imports, reductions in industrial licensing, increases in private foreign investment, decontrol of fertilizer production and distribution, and reductions in state-owned industries.

In return, the World Bank committed itself to raising the aid flow by $400 million above the 1965 level to an annual level of $1.6 billion. Although a devaluation was clearly necessary (to prevent a surge of imports and to stimulate exports), the size of the parity change was left to the International Monetary Fund to negotiate.

In June 1966, when the devaluation and decontrol package was announced, there
was a hailstorm of criticism, especially from the political Left but also from the civil servants and businesses who recognized that decontrol was going to threaten their interests. For example, the commerce minister, Manubhai Shah, immediately began to undercut Mrs. Gandhi and fought the new regulations issued by the prime minister to move much of the authority for supervising controls to the finance ministry.

In response to the domestic criticism, Mrs. Gandhi chose to tack to the Left. She gave the decontrol package only lukewarm public support and denied in Lok Sabha debates that the rupee had been devalued under donor pressure. She then traveled to Moscow, where she and General Secretary Brezhnev issued a joint communiqué attacking “imperialist forces threatening peace” in Southeast Asia. Not surprisingly, this statement infuriated President Lyndon Johnson, who had been trying to rally Congress to increase assistance to India.

The momentum for liberalization then began to fade as opponents of decontrol in India saw that they had a real chance to block Mrs. Gandhi’s June initiative. The situation was further complicated by a second year of drought, which insured that agricultural exports would be low and scarce foreign exchange would have to be spent on food imports. Ashok Mehta, Subramaniam, and the civil servants committed to liberalization tried hard to weather the storm, and in fall 1966 the donors pressed ahead with their goal of $1.6 billion in aid.

Nevertheless, it was clear both inside policymaking circles in New Delhi and to the foreign donors that the liberalization effort was endangered. Two consecutive years of drought created a recession, and India suffered its own form of “stagflation.” The goal of the reformers had been to accelerate growth by freeing imports, stimulating more competition among businesses, and using the devaluation to provide a substantial incentive for exporters. It was hoped that the extra $400 million in aid would cover any pent-up import demand and that the decontrol process would be less controversial if growth created optimism. Yet the donors lost interest when they saw the political strategy that Mrs. Gandhi was following.

Ultimately, political resistance doomed the liberalization experiment. In the February 1967 general election the Congress Party’s share of the vote declined to 41 percent, and its parliamentary plurality plummeted to a minuscule fifteen seats. The reforms ground to a halt as Mrs. Gandhi changed her political strategy and began to move farther to the Left. She got rid of Ashok Mehta and Subramaniam in short order and made various, highly publicized efforts to improve ties with the Soviet Union. Needless to say, these developments disappointed the donors, and aid levels began to trend down. By 1969 Gandhi had completely reversed course. She took a very populist stance, nationalized the banks, and returned to a state-centric, controls-dominated policy. The bank nationalization reduced efficiency in the banking system and slowed innovation in the financial sector as a whole. In this convoluted fashion the first liberalization episode failed.
The 1985–1987 Episode Except for the Janata government from March 1977 to January 1980, Indira Gandhi dominated the political scene of India from the mid-1960s until her death by assassination in October 1984. Although her popularity appeared to be waning in 1984, when her son Rajiv Gandhi, a former airline pilot, took over the leadership of the Congress (I) Party, her assassination led to a massive victory in the December 1984 elections.

Rajiv Gandhi thus came into office under some very favorable circumstances—low inflation, a current account surplus, and rising GDP growth rates—and the public expected changes in policy. Rajiv Gandhi began with a flourish. He cut direct taxation and liberalized controls on industry and trade. Also, because of sympathy over his mother’s death, his foreign wife, and his life abroad for substantial periods, he was initially treated with a certain deference and made the most of it.

Rajiv Gandhi was urbane, pro-western in manner, and technocratic in style. Because he had not previously been involved in politics, he made no fundamental compromises to become prime minister. He personally launched the 1985–87 liberalization effort, and the usual forces opposing market-oriented policies were temporarily eclipsed.

Joshi and Little summarize the policy changes begun in 1985 as fitting into six broad areas: less restrictive licensing of industrial investments, easing of some import regulations by replacing certain quotas with tariffs, stimulation of exports through duty drawbacks and tax concessions, exchange rate depreciation from 1986, financial market liberalization by raising interest rates on government securities, and lowering of tax rates to increase incentives and reduce evasion.

These moves, pushed by Gandhi, were broader in scope and more significant than those attempted by his mother nineteen years earlier. Moreover, the policy framework was boldly announced and solidly defended. The liberalization took many skeptics by surprise but looked as if it would transform Indian economic policymaking.

Nevertheless, the momentum soon began to slow. The macroeconomic situation turned troubling. Instead of declining, as Gandhi favored, the central government’s deficit surged to over 8 percent of GDP. The trade balance also deteriorated in 1986. The current account appeared better only because the government still received substantial aid flows and began major borrowing from private banks as well.

A combination of factors then directly thwarted the liberalization. Inflation accelerated from an annual rate of 5 percent in 1985 to 8 percent in 1988 (and 11 percent in 1990). External debt more than doubled between 1979–80 and 1989–90, from 13 to 28 percent of GDP. Despite Rajiv Gandhi’s plans, the government sector was not really constrained: public savings went down, while public investment went up during the 1980s from 8.4 to 10.4 percent of GDP. Private savings and investment increased slightly but still hovered at a level 50 percent below the rate of the fast-
growing countries in East Asia like Thailand, Indonesia, and Malaysia.

Then, assorted political factors began to turn against Rajiv Gandhi. His initial progress in averting confrontation in the Punjab stalled. He involved India militarily in suppressing the Tamil insurgents in Sri Lanka. And in 1987 he was charged with involvement in payoffs resulting from India’s purchase of artillery from the Swedish firm Bofors. The Bofors scandal dogged him throughout the rest of his public career and destroyed his positive public image.

By June 1987 the Congress (I) government lost a widely publicized mid term parliamentary election in Haryana. Rajiv Gandhi was clearly on the defensive. Although he continued sporadic efforts at decontrol into 1988-89, he lost the political initiative, and liberalization never regained the lustre it had in 1985.38

What brought the 1985-87 liberalization to a standstill? First, the measures which Rajiv Gandhi pushed were not internally consistent. Although he moved significantly toward decontrolling trade and industry, the surge in government spending and foreign borrowing (which created a business expansion) was profligate and not sustainable. Second, the Bofors scandal hurt the credibility of the “nonpolitician prime minister” so much that few were willing to rally to his support. Third, his highly regarded finance minister, V. P. Singh, who had helped implement the liberalization, resigned over the Bofors issue in 1987.

Then the pendulum began to swing to the Left. V. P. Singh helped meld seven parties together to form the National Front opposition. By 1989, as inflation accelerated, many of the country’s lower income groups felt threatened, and the National Front mounted a broad-scale attack on Rajiv Gandhi personally and on his economic policies.

Although 1989 was actually a stellar year in terms of economic performance, with real GDP growing at 10.5 percent, the National Front was able to portray the Congress (I) as corrupt and unconcerned about the country’s poorest population. The November 1989 general election dealt the Congress (I) Party a resounding defeat, but no other party won a majority. In December 1989 the National Front formed a minority government with parliamentary support from the Communists and BJP. Thus, V. P. Singh came to power as prime minister of a government with parties that had fundamentally incompatible ideologies. Although Singh had earlier favored decontrol of the economy, his new coalition supported government intervention, and the liberalization was quietly interred.39

The 1991–1994 Episode The National Front government was not able to paper over the differences within its coalition and lost a parliamentary vote of confidence after only eleven months. A minority government, led by Chandra Shekar of the Janata Dal Party, took over briefly but collapsed five months later in the midst of a major economic crisis.

Rajiv Gandhi was assassinated during the ensuing election campaign, but the
Congress (I) won a plurality and formed a government with P. V. Narasimha Rao as prime minister. The circumstances were truly bleak, however. The August 1990 invasion of Kuwait by Iraqi forces produced a cascading set of troubles for India. Economic policymakers in New Delhi had long counted on repatriated earnings from Indians working in the Persian Gulf region. Not only did these earnings flows stop in 1990, but there were major costs in rescuing the workers and bringing them back to India. In addition, oil prices soared, further increasing inflation and using scarce foreign exchange. Due to this combination of factors GDP declined by about 1 percent in 1991.

As Prime Minister Rao came into office in July 1991, he faced an annual inflation rate of 13 percent, a current account deficit of about $10 billion (or 44 percent of export earnings), and the first real economic recession since 1980. However, his government, on July 24, 1991, proposed to parliament an even more sweeping set of reforms than Rajiv Gandhi had tried.

The policy package had several key elements. Industrial licensing was dropped for most industries, and limitations on investment by large firms (foreign and domestic) were significantly reduced. These industrial policy changes were linked with measures to stimulate exports. The rupee was devalued a further 22 percent, and an “Exim Scrip” program that allowed exporters to keep 30 percent of their hard currency earnings (to use on imports or to sell privately on the currency market, as they chose) was established.

Why did the Rao government launch the liberalization so expeditiously? One view holds that, in essence, India had no choice. The Soviet Union had just collapsed, so aid from Moscow was out of the question. Hence India had to reduce inefficiency in the industrial sector, generate exports, and attract foreign investment to gain a new source of capital and technology.

According to a related and compatible explanation, the top economists who functioned as civil servant advisors themselves lost confidence in India’s controls system and supported the move toward a market-oriented policy. Certainly Manmohan Singh, who became finance minister and shepherded the reforms through various interministerial committees and parliament, became convinced that centralized management of the Indian economy was a mistake.

The Congress Party also had a political rationale to favor some decentralization of decision making. If the Congress was to revitalize itself, its elected state ministers had to attract foreign capital to demonstrate that they were doing something tangible for the public. Authority for investment approvals had to be taken away from the bureaucracies in New Delhi, and the states had to be allowed to take the initiative.

Critics of the liberalization were less sanguine. Some saw it as poorly conceived “shock therapy with mixed results.” Others stressed that central planning was necessary in India because the “socio-cultural fabric is essentially anti-market.” Others challenged the assumption that freeing markets will increase efficiency and growth.
Nevertheless, early opposition was swept aside, and momentum favored the liberalization, as the Rao government succeeded at getting real GDP growth back above 4 percent in 1992–93 and up to 6.25 percent in 1994–95. The policy changes produced a real transformation in the private sector. The most successful part of the reforms concerned traded goods and services. Imports and exports rose from an average of 15 percent of GDP in the 1980s to 23 percent in 1994–95. A sizable number of firms were thus producing goods meeting world class quality standards and, in turn, were generating sufficient earnings to import top of the line equipment and embedded technology.

In a period of liberalization, attracting foreign capital (both portfolio and direct investment) was substantially easier. The composition of investment also changed. Private investment advanced from an average of 11 percent of GDP in the 1980s to over 14 percent in 1990–94. Conversely, though public investment grew as a percentage of GDP in the 1980s, it declined from an average rate of 10.4 to 9.2 percent in 1990–94. Foreign investment had a particularly stimulative effect in telecommunications, hydrocarbon development, and financial services.

Although the liberalization of the 1990s went further than either Indira Gandhi’s or Rajiv Gandhi’s initiatives, the Rao government’s program began to stall in 1993 when the fundamental weaknesses of the Indian economy had to be addressed. When public sector enterprises produce almost one-fourth of the GDP and are significantly less efficient than comparable firms in the private sector, the country’s long-term growth is mortgaged to the political expediency of maintaining employment in these outmoded companies.

Thus, India’s dilemma is, in many ways, similar to the conundrum facing Russia and the formerly Marxist countries in eastern Europe. How does one transform entities that were never profit maximizing and traditionally served mixed goals of welfare, political patronage, and regional development? Not only are many of these enterprises controlled by the states (and hence only partially subject to central government influence), but elected officials are loath to terminate any economic activity for which they will have to take the blame. As an example of this pattern, it is worth noting that the Board of Financial and Industrial Restructuring has recommended that over 150 public enterprises be terminated, yet by the end of 1995 not one firm on its list had ceased operations. There is no doubt that public enterprises are a considerable drain on the economy and are a negative example that makes it hard for the government to implement efficiencies elsewhere.

There was also a growing concern that the rural poor were being ignored. This debate is long-standing, but, with 80 percent of the Indian population still living in rural areas, neither the Congress Party nor the opposition can ignore it. When the Indian Planning Commission conducted its mid term review in May 1995, it was particularly critical of the agricultural subsidy programs, arguing that government funds mostly went to help well-to-do farmers.
In sum, the reforms of the 1990s lost momentum, but the reaction against them was more muted than in 1966 and 1985–87. It is fair to say that reform has followed a somewhat jagged path in India: advancing, then either sliding back or reaching a plateau, but eventually moving toward greater openness.

Conclusion

Empirical Issues  In the four principal policy arenas—trade, industrial policy, public enterprises, and the financial sector—India still has a highly protected and over-regulated economy. Quotas and licenses for traded goods have been dramatically reduced, but tariffs remain high, and there is still a pervasive government presence (at the center and in the states) when key resource allocation decisions are made.

Two significant steps have been taken, however, which will ultimately push India toward a more open economy. The decision to join the World Trade Organization will bring pressure to free trade further, and the commitment by the Reserve Bank of India in 1997 to remove currency restrictions by the end of the year 2000 will substantially liberalize capital flows and financial markets.

There are certain ironies in the labels that have been used to describe India’s prime ministers. Jawaharlal Nehru was often cited as a brilliant strategist, yet his doctrinaire belief in central planning created the strangulating set of regulations and controls that his successors have tried to curtail. Indira Gandhi was widely viewed as a populist but proved to be very conservative on fiscal policy and would have rued the deficits that her supposedly technocratic son, Rajiv, authorized with abandon. Narasimha Rao was undoubtedly a traditional corrupt, patronage-dispensing politician but ultimately took economic liberalization further than any prior prime minister.

Table 1 summarizes the principal factors which launched, maintained, and then stalled the liberalization efforts in the three reform periods of 1966–68, 1985–87, and 1991–94. Although it is accurate to describe the overall process as an oscillation between controls and a more open economy, it is worth noting that significantly different factors helped launch each of the episodes. Thus, India does not have a stable coalition of supporters of liberalization to balance the remarkably consistent group that opposes decontrol. It is also interesting that two of the three liberalization episodes (1966–68 and 1991–94) were launched after crises, and the 1985–87 effort might not have occurred at all if Mrs. Gandhi had not been succeeded by her son. Thus, the next steps of the United Front government will provide a test of whether reform has been institutionalized or whether India needs to have some extraordinary set of circumstances to overcome the groups thwarting liberalization.

Theoretical Issues  These liberalization episodes have significance for both the theoretical literature on structural adjustment and the writing on Indian political economy.
Table 1 Summary of Indian Liberalization Episodes: Overview of Argument and Cases

<table>
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<tr>
<th>Episodes</th>
<th>What Initiated the Changes?</th>
<th>What maintained the Momentum?</th>
<th>Why did the Liberalization Stall?</th>
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| Mrs. Gandhi 1966-68 | - India-Pakistan War of 1995  
- Foreign aid cut off  
- Drought of 1965  
- Analytic work completed in the Bell Report  
- Mrs. Gandhi's confidence in Ministers Ashok Mehta and Subramaniam | - Only efforts by the senior civil servants and two ministers who were committed to the liberalization  
- Hope of getting increased foreign aid  
- Initial uncertainty among opponents about how to stop it | - Mrs. Gandhi withdrew support when opposition developed on the political left  
- Split within the business community: protectionists vs. those wanting more open trade  
- 2nd drought and donor disappointment with reforms |
| Rajiv Gandhi 1985-87 | - Personal decision of the Prime Minister (PM)  
- Technocratic orientation of the PM and his advisors  
- Public frustration with the slow growth in the 1970's  
- Lack of critics meant the PM had flexibility | - Positive public and press reaction  
- GDP growth rates accelerated  
- Exchange rate depreciation stimulated exports and employment | - "Bofors" corruption scandal  
- Resignation of the Finance Minister, V.P. Singh  
- Formation of the National Front challenge from the Left  
- Inflation increasing worried the middle class |
| N. Rao 1991-94 | - Gulf War led to a balance of payments crisis  
- Oil price increases and inflation from R. Gandhi's 1980's policies  
- Budget deficits: 8.4% of the Central budget and 11% of the consolidated budget | - Growing business community interest in trade  
- Boom in new sectors: autos consumer electronics, aviation and software  
- Capital inflow to equity markets  
- Honest Finance Minister | - Public enterprises, now 25% of manufacturing employment, unable to compete  
- Volatility in financial markets  
- Deep resistance by the Left parties and academic/press commentators |
First, India's attempts at liberalization have never been fully successful because there is no sufficiently powerful coalition willing to push consistently over long periods to achieve a decontrolled economy, whereas a broad coalition of government officials, businessmen in protected industries, and academics and members of the press have always been available to criticize steps toward market-oriented policies.

Second, the backlash against the 1966 liberalization was so severe that Mrs. Gandhi veered far to the Left, nationalizing the banks in 1969 and adopting a populist stance during much of her time in office. Mrs. Gandhi's nationalization of the banks and the insurance industry ostensibly sought to help those with limited means to obtain credit, but it led to widespread inefficiency and the politicization of the financial sector. Although she took steps toward rationalizing economic management in 1981, not until her death in 1984, when Rajiv Gandhi came to power, was real momentum for liberalization reinitiated.

Third, the transition from a tightly controlled to a market-oriented economy involves more than just changes in macroeconomic policy and deregulation. As Przeworski has demonstrated for eastern Europe in the post-1989 era and as McMillan argues in general, making effective use of the market requires a widespread ability within the public to use market data effectively, transfer property rights, enforce contracts, and accept the legitimacy of the "discipline of the market" if one's product is not in demand. If sufficiently powerful groups will not accept the transition, external pressure and even public opinion may not be adequate to achieve liberalization.

Fourth, the three liberalization episodes also shed some light on the puzzle raised by previous analysts of political economy in the subcontinent who tried to explain why Indian savings and investment rates have been comparable to those in East Asia yet India's GDP growth rate has remained much lower. The neoclassical view of this issue simply argues, correctly, that Indians use capital inefficiently. More interesting, however, several rational reasons explain why Indian capital is used inefficiently. First and most obvious, many businesses, especially those in the public sector and those owned by influential private businessmen, receive subsidized credit. Managers in these firms are often far more concerned with maintaining employment or providing services than in using human or financial capital to yield a maximum return. Second and related to this explanation, Indian managers in both the public and private sectors know that the nation's political system oscillates between regimented and more open policies. Savvy operators thus try to be prepared for both types of policies because they cannot predict which will be pursued. Hence private sector managers know that there could well be another turn toward centrally controlled economic policy. Under these circumstances, it makes more sense to protect firms politically and ensure their options in case greater controls are reinstated. Overall, this approach reduces incentives to take risk and innovate aggressively. If this economic environment is well-understood, then it actually rewards suboptimal resource allocation.
Fifth, to achieve major structural adjustment the sequence in changing policy must work to build support for the transition. In 1966, when Mrs. Gandhi devalued the rupee and announced decontrols, liberalization was a shock and provoked immediate rejection, like a bad organ transplant. Rajiv Gandhi’s decontrol efforts in 1985–87 were presented more convincingly, but the accompanying budget deficits and foreign borrowing created serious problems for the successor National Front and Rao governments. If future efforts at decontrol are to succeed, they probably should involve incremental steps that are unthreatening to the major interest groups that have stalled previous reforms.

Finally, India’s neglect of its poorest population is a major barrier to economic liberalization. Deregulation would actually help the poorest in India because it would eventually create more employment and faster growth. Yet the intense fears of liberalization in the lower middle class and among working class employees of the state sector, who are far more powerful than the really poor, pose serious risks in freeing the economy. It might be preferable to introduce liberalization during an economic upswing when the risks of switching jobs is less traumatic.

In sum, the three liberalization episodes in Indian economic policy have followed clear cyclical patterns. Economic policy has swung broadly between controls and greater openness, with a tendency toward decontrolling larger and more important segments of the economy. However, no government since independence has been willing to face the political risks of full-scale liberalization.

NOTES

8. Mahalanobis, the designer of the “Plan Frame,” was a world-renowned mathematician; he used input-output analysis, one of the techniques considered most promising by economists in the 1950s.
9. Although the name of the service was changed from Indian Civil Service to Indian Administrative Service, most of the top individuals remained the same, and standards for admission and promotion were strict.


14. The four governments were the last two years of Rajiv Gandhi’s term, the National Front government, the minority government, and the government of Narasimha Rao.


27. The other members of the group were L. K. Jha, M. Schroff, S. S. Marathe, and V. K. Ramaswamy. See Denoon, *Devaluation under Pressure*, pp. 58–75.

28. Bernard Bell et al., *Report to the President of the I.B.R.D. on India’s Economic Development Effort* (Washington, D.C.: International Bank for Reconstruction and Development, October 1, 1965). The report was so critical that it was kept confidential, even from Indian staff members of the World Bank.


30. Inflation was 18 percent in 1966–67; real per capita income dropped; and real investment declined.

31. In the 1962 elections Congress won 46 percent of the vote and had a plurality of 115 seats in the Lok Sabha.

32. Ashok Mehta was moved out of the planning ministry and was so disillusioned with Mrs. Gandhi that he later helped form a splinter group of the Congress Party, the Congress (O) Opposition. Subramaniam was dropped after criticism of food distribution during the second year of drought.

Comparative Politics  October 1998

May 10, 1972). However, India did not receive the increased aid in the form of general purpose import funding (called program aid), as it had hoped.

34. This optimism in 1985 contrasts sharply with the pessimism that pervaded the last years of Mrs. Gandhi's leadership. See Ashutosh Varshney, “Political Economy of Slow Industrial Growth in India,” Economic and Political Weekly, Sept. 1, 1984, pp. 1511–17, for an overview.


36. See, for example, the white paper entitled Long-Term Fiscal Policy (New Delhi: Government of India, 1985).

37. The states were also running significant deficits of about 2 percent of GDP, so the combined deficit for the first time went over 10 percent of GDP.


39. Furthermore, in an attempt to garner support from the Other Backward Caste (OBC) vote, V. P. Singh reintroduced and advocated the recommendations of the Mandal Commission Report, which urged a highly controversial affirmative action program to require additional set-asides of government positions for disadvantaged groups. This position lost the National Front its support in the middle class.

40. Eighteen industries were still controlled, and polluting industries that wanted to locate plants near major cities were placed under environmental restrictions.


42. Manmohan Singh had held a long series of top economic advisory appointments beginning under Mrs. Gandhi in the early 1970s.


44. Lewis, p. 310.


