

# India's Economic Development

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## Abstract

This chapter examines growth and structural change in the Indian economy since independence, focusing on the key drivers and critical junctures that led to changes in economic policies and their consequences for growth and distribution. It then analyzes three central puzzles of Indian economic development: 1) Why, despite a persistent policy and intellectual concern with poverty, has India's record on this score been modest, especially with regard to human capital indicators? 2) Why has India managed reasonably sound macroeconomic policies, in sharp contrast to its innumerable microeconomic inefficiencies? and 3) What explains India's modest growth in the early decades after independence, under good governance, but much more rapid rates of growth in recent decades—second only to China among large economies—even as

corruption has mushroomed? The paper concludes with some observations on the Indian State and argues that the foremost challenge that India faces is strengthening public institutions and governance.

**Keywords:** India, structural change, economic growth, poverty, governance, State, entrepreneurship

## **Introduction<sup>1</sup>**

If the dizzying transformation of the Chinese economy has been the defining story of economic development in the last three decades, economic changes in India, while considerably less dramatic, have been no less transformative. This paper examines growth and structural change in the Indian economy since independence (August 1947), focusing on the key drivers and critical junctures that led to changes in economic policies and their consequences for growth and distribution.<sup>2</sup>

It then analyzes three central puzzles of Indian economic development: 1) Why, despite a persistent policy and intellectual concern with poverty, has India's record on this score been modest, with several human capital indicators that are not much better than sub-Saharan Africa's? 2) What explains the disjuncture between reasonably sound macroeconomic policies amidst a litany of microeconomic inefficiencies? and 3) Why did India experience only modest growth in the early decades after independence, despite good governance, but much more rapid rates of growth in recent decades, even as corruption has mushroomed?

The paper concludes with some observations on the Indian State and why its health will be critical for the country's economic future.

## **Historical legacies**

The historical legacies of British colonialism are a necessary starting point to understand the trajectory of independent India. At the beginning of the eighteenth century, India's share of world income was between a fifth and a quarter. Over the next 250 years—between the collapse of the Mughal Empire and India's emergence as an independent country—India's share dropped precipitously to just 3 percent in 1950. It dropped further to 1.7 percent (2.5 percent in purchasing power parity/PPP terms) in 1980 before gradually climbing to 2.6 percent (5.5 percent in PPP terms) in 2010.

Given that this period coincided with colonial rule, there can be little doubt that policies that favored colonial interests played an important role in this decline, which was especially marked between the mid-nineteenth and the mid-twentieth century. But the precise reasons are severely contested, ranging from the extractive nature of land revenue systems put into place by the

British, to the use of these revenues mainly for security purposes, to the manner of India's insertion in the global economy (favoring British manufacturers). Whether globalization or weak agriculture productivity was the principal cause, the extent to which the widening gap between India and the West was due less to India's decline than to rapid increases in productivity in the West (Williamson 2011), or why in the last half century of colonial rule, despite stable property rights, free markets, and openness to trade, growth was so anemic and whether at least some of the onus lay in India's social institutions (Roy 2006), was not just a matter of academic debate. It would fundamentally shape the policies of independent India.

At the time of independence India was overwhelmingly rural, largely illiterate, and exceedingly poor. The country lacked a bourgeoisie and a middle-class; its society was deeply stratified and extremely heterogeneous, and the administrative apparatus was geared to serving the controlling interests of the colonial power rather than broader development goals. Yet, compared to many other newly emerging countries, India's colonial legacy had some positive features as well: substantial foreign exchange reserves (arising from its substantial contributions to the Allied war effort) and share in world trade that led India to emerge as one of the founding members and one of the five largest shareholders of the newly formed Bretton Woods Institutions; a meritocratic elite civil service that was rare among bureaucracies in its integrity and competence; an

integrative infrastructure in the form of the railways; and a small but solid foundation of legal and higher education institutions.

It was hardly surprising that colonialism left deep cognitive scars on India's nationalist elites which fundamentally shaped the economic policies of independent India, and whose path dependency had significant long-term effects. At the same time economic policies in India had to be consonant and sometimes defer to the multiple political challenges facing the leadership of independent India. As B.R. Ambedkar, the co-author of India's constitution, famously lamented in 1950, "Democracy in India is only a top dressing on an Indian soil which is essentially undemocratic."<sup>3</sup> Although India's political leadership inherited a territorially unified country after independence, it did not inherit a nation in the classical sense of the term. In contrast to virtually every Western democracy, nation building in India followed the introduction of universal franchise. What made India exceptional was the constitutional consensus that resulted in democracy as the principal tool for nation building, which meant accommodating the political aspirations of India's multiple nationalities, weaving them into the fabric of a distinctly "Indian" nation, and granting universal franchise all at once (rather than gradually). Consequently, economic policies had to accommodate these political imperatives, whose yardstick for

effectiveness went beyond efficiency and growth to underpinning one of the most audacious political experiments in the modern era.

A critical legacy of colonialism was a deep wariness of global economic integration, be it international trade or private capital flows. After all, it was the then largest multinational trading company—the East India Company, a “great money engine of the [British] state”<sup>4</sup>—that had spearheaded the British colonial enterprise in India. While the Great Depression had also seemingly shown the benefits of autarchic policies, the visible success of the Soviet Union in the aftermath of World War II was seen as vindicating the logic of central planning in allocating scarce investment resources as well as the need for India to develop its own industrial and technological base. While the political underpinnings of the Soviet model were unacceptable in India, the Fabian socialist policies of the post-war Labor government in the UK, where many of India's nationalist leaders had been educated, appeared to offer a more humane alternative.

The lessons of the Bengal famine of 1943, in which millions of people died because of the colonial government's inaction, further underlined the limitations of market forces in addressing the acute poverty and deprivations of the majority of the country's population.

For all these reasons it was almost inevitable that the Indian State would seek not only to occupy the “commanding heights” of the Indian economy, but to camp out in the lower valleys where the Indian masses lived and toiled.

## **Growth and structural change**

The economic model that India chose to follow was therefore not surprising: an Import-Substitution Industrialization (ISI) model that was relatively autarchic, with planning and bureaucratic controls rather than markets as the principal tool of resource allocation. The historical legacy, the prevailing *gestalt*, poorly developed global and domestic markets—all pointed in this direction.

Prior to independence, economic growth in India was meager. Per capita incomes had stagnated over the last half century of British rule (1900–50), although there was some structural transformation with the development of cotton and jute textile industries. At the time of independence India was an overwhelmingly impoverished country, not just in income terms but also in human capital, with the literacy rate just above 18 percent and life expectancy barely

32 years in 1951. Six decades later the literacy rate had increased to 74 percent and life expectancy had more than doubled, to just under 67 years in 2011. In the first three decades after independence (1950–80), India's average annual rate of growth of GDP was a modest 3.5 percent. In the next three decades that figure nearly doubled even as growth volatility declined. Importantly, a decline in the population growth rate meant that per capita income growth tripled in the latter period compared to the earlier period. If one places India's record against the global economy in the *longue durée* from 1900 to 2010, it lagged global growth for the first eight decades and has only subsequently been growing faster than the world average.

Initially the economy grew reasonably well until the mid-1960s; it then slowed down until around 1980, then accelerated in each subsequent decade (see Table 1). While agriculture was not neglected, the thrust of the first decade and a half was on capital goods—capital-intensive projects such as dams, power plants, and heavy industrialization—rather than consumer goods. This created a savings and foreign exchange gap and India soon ran through its foreign exchange reserves, necessitating greater reliance on foreign aid (Lewis 1962). In this regard India undoubtedly benefited from the Cold War, with the Western alliance seeing it as a democratic model for the countries emerging from decolonization and a counter to the possible attractions of Communist China. While the United States was the largest donor until the 1960s, multilateral

lending became more important in subsequent decades and by 2010 the only significant bilateral source of official financial flows to India was Japan. India would continue to face chronic foreign exchange shortages and periodic foreign exchange crises, and it was not until 1994 that India finally accepted its Article VIII obligations (on current account convertibility) with the International Monetary Fund (IMF).

The mid-1960s saw the first major shift in Indian economic strategy. With back-to-back failures of the Indian monsoon in 1966 and 1967, India's dependence on the United States for food aid was seen as a national humiliation and led to a major change in agriculture policies. The new strategy relied less on the earlier efforts at institutional change, such as land reforms which had been only modestly successful, and more on new "green revolution" technologies, including new seed varieties and intensive use of water, fertilizer, and pesticides. In the first phase (mid-1960s–early 1980s), agriculture growth rates were moderate and confined to the northwest and parts of the coastal south. Growth accelerated in the 1980s with the adoption of the new technologies in eastern and central India, but then ebbed from the early 1990s onwards, especially in foodgrains (Bhalla and Singh 2012). More recently, Indian agriculture growth has come mainly from the non-cereal sector (horticulture, poultry, and dairying) and cash crops, especially cotton.

The green revolution was successful in sharply raising foodgrain production from 82 million tons in 1960 to 197 million tons three decades later. The specter of famine that had haunted India for centuries was laid to rest. However, the law of unintended consequences gradually began to make its presence felt as the policies that underpinned the success of the green revolution began to have major effects on the political economy.

Distributing water required irrigation, and with canals expensive to build and maintain (especially as dam building began to meet more and more resistance from displaced peoples), tube wells proliferated, and with them the demand for highly subsidized if not free power for farmers. This had cascading effects on India's power sector, which continues to be one of its biggest infrastructural constraints. And with water virtually free, overuse was inevitable, resulting in declining water tables across many parts of India. Similarly, with farmers hooked on chemical fertilizers whose costs were determined by increasingly expensive hydrocarbon feedstocks, fertilizer subsidies ballooned to about one percent of GDP by 2011. Thus, despite the high rates of return on public investments in rural roads, irrigation, and agricultural research and development (R&D), short-term electoral exigencies inexorably pushed public spending towards input subsidies (especially fertilizer and power). Moreover, the increased use of inputs led to

greater demand for credit and, in turn, periodic political demands for farm loan write-offs that undermined the rural credit and banking system.

Ironically, pressures arising from the political economy of agriculture grew even as the share of agriculture declined, from two-thirds of GDP in 1950 to one-sixth in 2010. However, agriculture's share in employment declined much more gradually, accounting for about half of all employment even by 2010. Thus with rural incomes stressed and rural voters continuing to matter electorally, the political economy pressures were not surprising.

On the external front, the economic and balance of payments crisis of 1966–67 precipitated a major intervention by Western donors (especially the U.S.) and the Bretton Woods institutions. As was the practice in the years preceding the breakdown of the Bretton Woods system, India's exchange rate regime operated as a fixed nominal exchange rate. By the end of the 1950s and in the first half of the 1960s, mounting inflation led to an appreciation of the Real Effective Exchange Rate (REER), and despite severe trade and capital controls and foreign aid, India's Balance of Payments (BOP) problems mounted. In June 1966, under pressure from the United States and the Bretton Woods institutions, India undertook a large nominal devaluation

(36.5 percent) but because of a complex tax regime and high inflation, the REER depreciation was only about 7 percent (Joshi and Little 1994).

The devaluation of 1966 was widely regarded as a political disaster and significantly impacted India's macroeconomic policies over the next two decades. India had signaled that along with the devaluation, it would liberalize domestic industrial licensing as well as trade policies and change tack on its agriculture policies in return for substantial increases in external support. In the end that support did not materialize. While India drastically changed its agriculture policies, the government, confronted with mounting economic pressures, instituted even more stringent administrative controls on both trade and industrial licensing and launched a wave of nationalizations (from banks to mines). State controls not only adversely affected the economy directly but created a new political economy of rent-seeking whose effects proved even more pernicious (Bhagwati and Srinivasan 1975).

The *license-raj* and autarchic policies that dominated the 1960s and 1970s, and external shocks—including three wars (in 1962, 1965, and 1971), major droughts (especially 1966 and 1967), and the oil shocks of 1973 and 1979—all contributed to the two worst decades of the Indian economy. While domestic savings and public-sector investment continued to gradually

rise, productivity growth was negligible. By the end of the 1980s, the collapse of the Soviet Union fundamentally undermined the intellectual legitimacy of central planning, while the widening gap between East Asian countries (including China) and India had become painfully evident. And when the balance of payments crisis of 1990–91 struck, leading India to humiliatingly hock its gold reserves to stave off external debt default, India had little option but to change course.

While there is little dispute that India's economic policies changed sharply after 1991, there is also no dispute that India's growth rate accelerated a decade prior to that pivotal year, from around 1980. However, there is much less agreement on the causes of growth and its sustainability. One view attributes this to modest trade and investment licensing liberalization and higher levels of public expenditure funded by a sharp increase in external and internal borrowings (Panagariya 2008). Others argue that reforms in 1980s were less pro-liberalization than pro-business in that they helped boost profits of existing business without threatening them with real competition (Rodrik and Subramanian 2005; Kohli 2012). But were the attitudinal changes a necessary precursor to the later policy changes, and if so, why did they occur? Yet another explanation puts the onus on the "output gap" and "credibility" of reforms (Virmani 2004). Since the mid-1960s the Indian economy had underperformed, increasing the

gap between potential and actual GDP. The policy changes during the 1980s provided an opportunity to catch up and in particular make better use of underutilized capital. In addition, politically credible signals of the intent to reform failed policies gave greater confidence to the private sector to invest, and reassured policy-makers that economic liberalization could deliver results.

Although economic growth between the 1980s and 1990s differed little with the passage of another decade, three facts stand out.<sup>5</sup> First, fiscal expansion and foreign borrowing were responsible at least in part for raising growth rates in the 1980s and the unsustainability of this approach precipitated the balance of payments crisis at the end of the 1980s. Second, if the post-reform period is extended into the first decade of the new millennium (which recorded the fastest growth rates ever), the growth story is perceptibly better (and even more on per capita terms). Third, productivity rose markedly in the post-reform era, especially in services, whether because of access to new technologies, greater competition, or the growing role of the private sector (Bosworth, Collins, and Virmani 2007).

But perhaps the most significant change was the transformation in India's engagement with the global economy.<sup>6</sup> In 1990, India had one of the world's most closed economies, with a trade-to-

GDP ratio lower than in 1950. The reforms instituted in 1991 aimed to move the economy toward greater market orientation and external openness. Dismantling the Maginot Line that had been built over four decades to safeguard India from the threat of international trade and foreign investment was critical. From that point on, quantitative import controls on manufactured goods were almost entirely eliminated while tariffs were drastically cut (from 145 percent in 1990 to 9 percent in 2010), although agriculture (as in most countries) still remains fairly highly protected (the average agricultural tariff has come down from 134 percent in 1990 to 33 percent in 2010). Restrictions on inward and outward foreign investment were also significantly reduced.

These changes brought about a pronounced increase in the openness of the economy, manifest in a radical change in the structure of the balance of payments. Exports of goods and services tripled between 1990 and 2010, from just 7 percent of GDP to 22 percent, while imports increased even further. The decades of autarchic development policies had resulted in a sharp drop in India's share of world exports, from 2 percent in 1950 to barely 0.5 percent in 1990. The pendulum gradually swung the other way, and by 2010 India's share in global merchandise exports had tripled (to 1.5 percent) while in services it climbed to 4.5 percent.

However, it must be kept in mind that over the same period China's share of global exports increased sixfold. The principal reason was India's failure to rapidly expand labor-intensive manufacturing exports (such as garments, footwear, and electronics assembly). India's labor laws, ostensibly meant to protect the interests of organized labor, simply discouraged industries that could harness its principal comparative advantage, an abundant supply of low-skilled labor. Infrastructure deficiencies, weak human capital, and the high transaction costs in starting and running a manufacturing unit in India due to innumerable bureaucratic obstacles have further impeded labor-intensive manufacturing. As a result, unlike China, India has not become closely integrated into global manufacturing networks (the automobile sector is an exception) while it is deeply integrated in global networks in information technology (IT)-related services.

Indeed, India emerged as an outlier among emerging markets in that it bypassed the normal sequence of economic development where low-income economies are dominated by the primary sector (agriculture), middle-income by the secondary sector (manufacturing) and high-income by the tertiary sector (services). In India's case, services came to dominate the economy even when it was still a lower middle-income country. The success of India's services sector is epitomized by the remarkable success of the IT sector, which rose from less than \$1 billion in 1990–91 to over \$100 billion in fiscal year 2011–12 (7.5 percent GDP). With nearly 80 percent of its

revenues derived from exports, the IT sector more than any other epitomized the goals of the historic shift of the 1991 economic reforms: a private-sector-driven economy that was much more globally integrated.

Yet the limitations of this shift have also been evident. By the end of 2011 the IT sector provided direct employment to 2.8 million people and indirect employment to around 9 million people, which, while substantial, still represents only a small part of India's burgeoning work force of nearly half a billion people. The failure of India's rapid growth to create substantial numbers of jobs in the formal sector for India's rapidly expanding labor force remains one of the biggest weaknesses of the Indian economy.

The greater importance of trade for the Indian economy led to a considerable change in India's attitudes to international trade negotiations, from reluctant participant to a proactive role. Before 2000, India had signed just one inconsequential preferential trade agreement (with the Maldives). It negotiated another three between 2000–05. With the Doha Round stalemated, it followed up with another sixteen in the next five years, and in 2011 was negotiating another seven agreements (including, significantly, with the EU). In contrast to its earlier protectionist stance in

the pre-reform era, from about a decade after the onset of economic reforms, domestic business became a major lobby for greater global integration, reflecting India's growing self-confidence.

Capital inflows, especially non-debt capital inflows, have been the second important mechanism driving India's integration into the global economy. Inward foreign direct investment (FDI) increased steadily throughout the 1990s, but really took off in the mid-2000s after India partially deregulated its financial sector and started achieving GDP growth rates of 8 percent a year. A new development was the growth of outbound FDI from India, which moved more or less in step with inward FDI, albeit at lower levels. In 2010, inward FDI was around \$25 billion and outward FDI around \$15 billion. The substantial net capital inflows compensated for the current account deficit, allowing the country to accumulate sizable foreign exchange reserves.

International migration has been the third leg of India's growing engagement with the world economy, in addition to trade and capital movements.<sup>7</sup> Outward migration from independent India was initially driven by the large demand in the United Kingdom for unskilled and semi-skilled workers, following the end of the Second World War. From the late 1960s onward, two major streams of migration emerged. The first, to the Middle East, was dominated by unskilled or semi-skilled temporary workers; nearly four-fifths of these labor flows were to just three

Middle Eastern countries (Saudi Arabia, the United Arab Emirates, and Oman). The second stream, comprising skilled professionals, migrated to OECD countries, especially the United States, where the Indian-born population grew from around fifty thousand in 1970 to 1.8 million in 2010.

Unlike China, the economic effects of international migration from India have not yielded much in the way of FDI. Instead, the Indian migrants have been an important source of financial flows into India in the form of remittances. Remittances emerged as an important component of the country's balance of payments in the mid-1970s and increased dramatically after the onset of economic liberalization in 1991, growing from \$2.1 billion (0.7 percent of GDP) in 1990 to \$53 billion (3.1 percent of GDP) in 2010.

The fears of influential sections of Indian elites notwithstanding, greater integration into the global economy has been transformative for the country. An important reason was the decision of Indian policy-makers to eschew the "big bang" approach, opting instead for a more gradual transition, especially with regard to capital account and financial sector liberalization. As a result India has avoided the sort of major financial crisis that has engulfed many industrialized and emerging market economies (Joshi and Kapur, forthcoming). However, in contrast to the strong

and positive effects on growth and macro-stability, the effects of greater global integration on poverty and distribution are more ambiguous. It is this subject that we now address.

## **Three central paradoxes**

### ***The poverty paradox***

Independent India's commitment to democratic politics meant that its polity had to grapple with the harsh reality of India's poverty: the sheer number of the poor (who were also now voters), the intensity of poverty and destitution, and a deeply stratified and hierarchical society. Addressing the needs of vulnerable and marginalized groups in society has preoccupied intellectuals and policy-makers, and informed political rhetoric in India, to a degree uncommon among developing countries. Levels, changes, and measurement of poverty have been a major preoccupation of (often contentious) Indian policy debates, in considerable part because the benefits of the large array of redistributive programs deployed by the Indian state have been linked to so-called BPL (Below Poverty Line) status.<sup>8</sup> The puzzle is not that India's policy has been preoccupied with addressing poverty, but that the innumerable number of directed poverty

programs that India has put into place over the decades have yielded such modest results. Like Sisyphus, the Indian state appears condemned repeatedly to launch poverty programs, and then, with limited results to show for its efforts, begin the process all over again. What explains these modest outcomes and why does the Indian State persist with these programs?

The salient features of changes in human development in India are provided in Table 1. While clearly there have been improvements in all aspects (except the gender ratio), the changes have been modest, both relative to other comparable countries and in light of India's rapid growth in recent years. Poverty has declined considerably, but for the most part it has been the result of broader growth (including for example the green revolution and the acceleration in growth in recent decades) rather than redistributive programs targeting the poor per se. It should be emphasized that the Indian base line for poverty is extremely low, so that trends over time are a better indicator of progress than absolute numbers, since many millions of people just above the poverty line also have very low incomes.

There is considerable variance in outcomes of India's poverty programs across both states and types of programs. Self-targeting programs like the National Rural Employment Guarantee Scheme (which guarantees one hundred days of wage employment annually to a rural household

whose adult members undertake unskilled manual labor) have performed better than the Public Distribution System, which has been notorious for leakages.

The mainstay of India's anti-poverty programs have been specific purpose transfer schemes, designed to address issues of categorical equity. Most of these schemes have been launched by the central government, even though actual implementation is undertaken by state and local governments. Initially these schemes focused on area development (backward areas, arid areas, hilly regions), wage employment, and promoting self-employment (by transferring a productive asset).

The first area development program, the Community Development Program, began in the early 1950s and sought to involve the rural community in a specific location in development. However, while the pilot projects were promising, weaknesses became evident as the program expanded. A critical review by the Indian government in 1957 placed the blame on the acute administrative burdens imposed by the program on ill-trained and ill-equipped local bureaucracy. Little has changed since.

Over the years, other types of schemes came into being, particularly new forms of transfers, such as old age pensions and housing and basic services like education and health. Their numbers grew from the 1980s as a weakening federal government sought to route funding directly to the local level, bypassing the states. These schemes grew especially in the post-reform era, and in part served as a compensatory mechanism for the central government to exercise influence within states, after instruments such as industrial licencing were abolished, and in part for intellectual and policy elites who could exercise more influence on the central government than in the states.

Innumerable reports on and analysis of India's poverty programs agree on seven broad conclusions. First, the lowest level "front-line" functionaries are poorly trained and often overburdened. Second, a large fraction of the resources in these programs is spent on the administrative costs of the programs or are siphoned off, with their intended beneficiaries receiving only modest amounts. Third, the mismatch between the incentives of the implementation agents on the one hand and the design and funding of these programs on the other ensures that implementation is the Achilles' heel of India's poverty programs. Fourth, the large-scale corruption in these programs stems from the discretionary power of public functionaries. Fifth, to curb these discretionary powers a labyrinth of rules has been put into

place, which both slows work and simply redistributes the rents elsewhere. Sixth, these facts are well known to the state functionaries who are supposed to implement and monitor these programs, and to the intellectuals who push for them. And finally, all this persists because there is little accountability in the system. If anything, the accountability is perverse in that punishment is more likely to be meted out to someone who does not participate in the hierarchical systems of corruption than to someone who does.

Nonetheless, there have been some striking successes, with the “Kerala model” the best known example (Drèze and Sen 2002). In general, the anti-poverty effort in the southern and some of the northern and western states has been better than in the central and eastern states (where the bulk of the population and the poor live). While poverty did continue to decline in the post-1991 era, the elasticity relative to growth was less, with the lack of expansion of labor-intensive manufacturing an important reason. In contrast, the demand for skilled labor has risen, and with it the wage premium for skills, which is one reason why income inequality has increased over this period. While pressures for redistributive policies have grown, the large growth in government spending has had a limited impact on India's substantial inclusion deficit, which has deep historical roots.

At the time of independence India was a highly unequal country, and so it remains six decades later. However, the characteristics of inequality have changed. Most accounts of inequality focus on the simple Gini coefficient. In reality India simply does not capture data on income distribution, and the Gini measures used for India are simply household expenditure distributions acting as a surrogate for income distribution. The Gini based on household expenditure was 35.6 in 1951 and gradually dropped over the next two decades to 30.4 in 1960. Over the next two decades it was reasonably steady, then began climbing upwards in the early 1990s, reaching 36.8 in 2004. By 2010 it was 30.6 in rural and 40.2 in urban India, which implied that urban income inequality in India is probably close to levels in Latin America, long regarded as an outlier.

With India's population overwhelmingly rural in the early decades after independence (82.7 percent in 1951), the critical factor affecting inequality was land ownership. This was especially true in Eastern India, where the British land revenue system had created a small rentier class of large landlords (*zamindars*) and millions of small and marginal farmers and landless laborers. While the *zamindari* system was abolished, overall attempts at land redistribution were at best modest, and reform of the land tenure system was only slightly better. For half a century Indian intellectuals have lamented the absence of meaningful land reform, imagining it as the magic elixir to alleviate both rural poverty and inequality. The reality is that drastic land reforms

have occurred only in the aftermath of revolutions or external occupation, never under a democratic regime. An even harsher reality is that there just isn't that much arable land in India relative to its rural population. The net sown area per rural household was less than three hectares in the 1950s and less than one hectare six decades later. If anything, a major problem facing Indian agriculture is extreme land fragmentation rather than land concentration. Asset inequality in land over the decades was less about a few having a lot and more about many (namely, landless laborers) having nothing.

The insistence on land reforms as the pathway to reduce inequality meant that policies that could have done much more to help cultivators and small peasants—such as rights of tenants on lands they had been cultivating (the states of Kerala and West Bengal were exceptions), transparent and low transaction land registration, and titling—were largely ignored. But most egregiously, the only other viable instrument for addressing the roots of inequality in India, namely, a sound and egalitarian primary education and primary health system, was given short shrift.

Under the Indian Constitution, primary education and public health are state subjects.

Consequently it is not surprising that that in the early decades the federal government left this issue to the states. Since the politics of most states was dominated by upper-caste males, it has

been argued that they had little interest in educating the lower castes and women (who formed the majority of the population), preferring to maintain their historical social advantages (Weiner 1990). However, over time the iron law of numbers inherent in universal franchise led to the middle and lower castes' capturing power in most states; yet even this did not lead to a reorientation of priorities. India has had powerful women politicians, but there is little evidence that they gave greater emphasis to girls' education. The fact that the state of Kerala is an outlier on social indicators and has had a strong Left tradition may lead one to conclude that political ideology was the key. However, the communists held power in West Bengal for twice as long as in Kerala and the record there is much weaker, while the small northern state of Himachal Pradesh, where the Left never had a presence, has a record second only to Kerala. The major impetus for a substantial increase in central government spending on primary education came in 2001, with the launch of a multi-billion-dollar education *Sarva Shiksha Abhiyan* program for universal elementary education, and in 2009, when the right to primary education was given constitutional status with the passage of the Right to Education Act.

These efforts notwithstanding, India has a long way to go in fulfilling this most basic instrument of empowerment and social mobility. While the quantitative goals of enrollment have been reached, the quality of education is still severely deficient. The principal reason for this lies in

the multiple weaknesses of the country's basic administrative systems. Despite reams of evidence that public teachers and health workers have very high absenteeism rates (despite being paid substantially more than their private-sector counterparts), Indian intellectuals and politicians are reluctant to press for firing them—the interests of powerful public unions are better protected than those of powerless children.

It is arguable, however, that the inequalities that matter for the daily lived experience of most people in India are not changes in the Gini but rather the complex and deep social inequalities that have been a pernicious feature of Indian society, with gender and caste being salient examples. The former has been most manifest in intra-household inequality. While the Indian constitution and as subsequent legislation have sought to eliminate gender-based discrimination in matters such as inheritance, divorce, sexual discrimination in the workplace, etc., social institutions have proved tenaciously resistant to change. While on some indicators (such as education) the male-female gap has been narrowing, on others (such as employment) this is less the case. The most troubling aspect has been the decline in sex ratio, falling from 972 females per 1,000 males in 1901 to 933 in 2001, before slightly recovering to 940 in 2011. More disturbing is the decline in the child-sex ratio, from 945 in 1991 to 927 in 2001 to 914 in the

2011 census—an indication of how, despite being illegal, son-preferences have been amplified with new wealth and technologies that allow sex-selective abortions.

The biggest change in inequality in India has been a more subtle but profound change, namely, a significant decline in the deep social inequities that were a hallmark of the stratified and hierarchical Indian caste system. At the time of independence, large parts of rural India were feudal in character, with labor relationships akin to serfdom. Many of the specific features that characterized these stratified social relationships, such as commensality (rules of purity and pollution), the correspondence between caste and occupation, servility, and social exclusion, have considerably weakened in recent years, although they have by no means been eliminated. While multiple causal factors—the direct and indirect effects of economic growth (the latter manifest in significant circulatory migration), the ascendancy of lower caste political parties, technological change, and lagged effects of prior public investments—make precise attribution difficult, it does point to the wrenching role of markets in driving social change. Finally, there is strong evidence of convergence in human capital (years of schooling, life expectancy) and occupations across social groups, an indicator of gradually improving inter-generational mobility.

### ***The macro paradox***

The Indian state's noteworthy record in macroeconomic management has long been recognized, whether compared with other developing countries or weak performance in microeconomic policies and ground level implementation. Thus for much of the period prior to the 1991 reforms India's record was the most "conservative" (among seventeen countries studied) with respect to inflation, monetary policy, and external debt (Joshi and Little 1994). India's superior inflation record (at least until the 1990s) owed much to the political aversion to inflation institutionalized by democracy, given the negative impact on the large number of poor voters (largely because the poor do not have access to financial instruments to protect themselves against inflation) and the relatively low levels of income inequality in India. Thus, instead of an independent central bank and monetary targeting, democratic politics has anchored and reined in inflationary expectations.

Despite the lack of conventional statutory independence, the Indian central bank (RBI) has competently conducted monetary policy, albeit within the mandate laid out by the government. Exchange rate management, once the *bête noire* of Indian macropolicies, has also improved considerably and is an important reason why India has weathered major global crises better than in the past.

The reasons are several. First, the breakdown of the Bretton Woods system depoliticized exchange rate policy in that it allowed the central bank to intervene in ways that led to a gradual depreciation of the rupee (compared to the earlier fixed exchange rate system where the IMF's involvement was inevitable and hence political fodder). Second, an important factor that had undermined the RBI's role in exchange rate management was India's economic model. With macroeconomic policy in India yoked to planning, adherence to the fixed exchange rate was necessary (from the narrow perspective of the planned model) because any change in its level would have upset the careful balance that was part of a plan's design (Khatkhate 2004). As the role of centralized planning ebbed, so did the importance of a fixed exchange rate. Finally, as trade's importance in the Indian economy grew, so did the importance of exchange rate management, since it affected both the competitiveness of India's burgeoning exports (and hence business interests) and inflation (through higher-priced imports), whose adverse effects on India's poor are well known.

If the Indian state's handling of exchange rate policies has been reasonably adept, this is also true (albeit to a lesser extent) on one side of the fiscal ledger, namely, tax revenues. As a fraction of GDP, tax revenues increased slowly but steadily from 1950 to 1990 and then declined somewhat

in the 1990s before again increasing after 2000 to nearly 15 percent of GDP in 2010–11 (Table 1). The increase in the first four decades was due mainly to increases in indirect taxes (such as excise and trade taxes), which have more distortionary effects. India's complex fiscal federalism, with assignments of tax powers and tax sharing arrangements at different levels of government, has influenced the incentives for revenue mobilization and made it difficult to enact and implement comprehensive tax reforms. Selectivity and discretion, both in designing the structure and in implementing the tax system, contributed to erosion of the tax base and created powerful special interest groups (Rao and Singh 2006). Nonetheless, there has been a sharp reduction in the rates and dispersion of trade taxes and a shift to direct taxes driven in part by the introduction of the value added tax (VAT) in 2005. At the time of writing, India was attempting to integrate taxes on goods and taxes on services into a common goods and services tax (GST), which if implemented will anchor India's fiscal federalism in the foreseeable future.

Government expenditures, on the other hand, have had much less discipline, especially in recent decades, and India's persistently high fiscal deficits—reflecting innumerable microeconomic inefficiencies—have been a major drag on the Indian economy. Predictably, these expansionary fiscal policies have had monetary consequences, notably higher interest rates and (to the extent that the deficits get monetized) greater inflation or an external debt problem (if financed

externally). It is this interconnectedness between microeconomic inefficiencies and macroeconomic problems that fed the growing fiscal crisis in India by the late 1980s and soon spilled over to the balance of payments.

Why has India fared better with its monetary and exchange rate policies than with its fiscal policy? Explanations for India's large fiscal deficits put the onus on the fragmentation of the Indian polity, with weak coalition governments more susceptible to distributional conflicts and the growing limitations in the state's capacity to mediate and moderate the many demands being placed on it. Even by the early eighties it was argued that India's public economy had "become an elaborate network of patronage and subsidies. The heterogeneous proprietary classes fight and bargain for their share in the spoils of the system and often strike compromises in the form of 'log-rolling' in the usual fashion of pressure groups" (Bardhan 1986: 65–6). With no group hegemonic, as each group sought to grab more public resources, fiscal deficits grew. However, these distributional compromises may have contributed indirectly to the maintenance of democratic processes. The increasing political assertiveness of socially marginalized groups who have been politically empowered—by the emergence of regional and identity-based political parties and by greater representation in public offices at all levels—has forced the Indian state to manage these pressures through a range of instruments that seek to give something to each

pressure group, ranging from agricultural subsidies to efforts to extend the scope and duration of affirmative action programs.

In the mid-2000s the fiscal deficit began to decline, primarily because of an increase in tax revenues (rather than a cut in expenditures) due to technological upgrading of the country's tax infrastructure. However, despite unprecedented growth India's fiscal situation deteriorated again, because of the failure to deepen and broaden the tax base, massive increases in expenditures in new social programs, and a political unwillingness to rein in subsidies. However, while the growth of subsidies has been driven by a political logic, the expansion of social programs has been strongly influenced by small groups of activists. The net effect has been an increase in government spending directed towards consumption rather than investment. Paradoxically, this has led to greater de facto privatization in much-needed public infrastructure as cash-strapped governments turned to public-private partnerships, the very change some of this consumption spending is trying to stem.

***The paradox of governance***

In the early decades after independence, India's ruling elite was drawn from a narrow social group and by and large its probity was well recognized. Yet the policies it chose ensured that India's growth was modest, even though they did result in a gradual structural transformation of the economy. In contrast, since the late 1970s, as democracy has deepened and Indian growth rates have more than doubled (and in per capita terms, tripled), there is widespread acknowledgment of a sharp deterioration in probity in India's public institutions and manifest corruption at all levels of government. At the macro level, what explains the mismatch between conventional indicators of corruption and economic growth? And at the micro level, why has India persisted with directed poverty programs rather than supplying broad-based public goods whose long-term benefits to the poor are widely acknowledged?

Several explanations have been advanced to address the puzzle on why India has persisted in relying on targeted transfer programs and subsidies while severely under-provisioning basic public services for the poor, such as education, health, water, and sanitation (Keefer and Khemani 2004). Poor farmers might prefer targeted transfers to public services such as education because they have high discount rates (the benefits of transfers are immediate while the returns

from education emerge over time). Alternatively, the poor might not matter electorally.

However, India is rare among democracies in that the propensity to vote varies little by income, education, or social group—the votes of the poor certainly matter electorally.

Another explanation argues that rather than electoral participation per se, it is the clientelist nature of that participation, which results in materialistic inducements targeted to particular individuals and small groups of people as opposed to the provision of public goods through institutional means. This behavior is due partly to social polarization (itself a cause and consequence of a first-past-the-post electoral system) and lack of credibility of political promises to provide broad public goods (as opposed to private transfers and subsidies). Electoral competition therefore revolves around distributing public resources as club goods (goods with excludability characteristics) rather than providing public goods to a broad base.

Finally, those who have the voice (the middle and upper classes) have de facto exited from the system, preferring market solutions over poor quality and unreliable public services, further reducing pressures to change the system.

Perhaps the biggest driver of India's growth despite poor governance has been entrepreneurship. Although it has long been recognized that entrepreneurs are the central actor stoking the animal spirits of capitalism, conventional neo-classical growth models have little place for them. Behind the dynamism of the Indian economy in recent decades is the sharp increase in the number of entrepreneurs from much wider social groups than in the past (Damodaran 2008).

Historically, traders and merchants had a none-too-respectable status in India. In Kautilya's *Arthashastra*, the classic Indian treatise on governance, traders and merchants are seen as "persons to be regulated, taxed and kept under watch for sharp practices."<sup>9</sup> While social stratification kept out much of the lower castes, many of the educated upper castes who controlled India's policy making apparatus regarded business and entrepreneurship as somewhat dubious activities. While the loss of political power by the upper castes certainly made the private sector and entrepreneurship more attractive to them, the sheer demographic pressures relative to available employment opportunities, from agricultural labor to government jobs, have made entrepreneurship a virtue out of necessity despite numerous infrastructural bottlenecks and government obstacles. Writing of the United States in the nineteenth century, the American historian Walter McDougall referred to the country as "a nation of hustlers," capturing the spirit

of a people relentlessly on the make—and doing whatever it takes. In many ways this is an apt metaphor of the raw capitalism unleashed in India.

But unlike the scenario in the United States a century or so ago, the contemporary Indian version is inextricably intertwined with a state that while weak in its implementation capacity has remarkably strong rent-seeking abilities. India's economic reforms unleashed market forces and capitalism, but the parallel strengthening of the institutions that underpin a market economy did not occur. The resulting crony capitalism has been especially potent in sectors with high regulatory intensity, especially in natural resource-related sectors (such as land, mining, spectrum, water, and forest resources). This has undermined both competition and the very legitimacy of capitalism, and poses the single biggest challenge to India's long-term growth.

## **Conclusion**

With a sixth of the world's population, India's economic development has not only important implications for its citizens, but global ramifications. While there is little doubt regarding the substantial economic transformation after 1990, compared to most other large developing

countries India has moved more gradually on most measures of market-based reform, be it privatization, trade, or financial sector liberalization. Nonetheless, during this period its growth has been nearly twice the average for developing countries outside Asia and much better compared to its own past. Yet, while all political parties have more or less accepted the broad thrust of the shift to a market-oriented economy (although differing on specific priorities), even after more than two decades reform does not have an overt political constituency.

If India continues to grow at the rate it has achieved in recent years, its global presence will become much more significant. Indeed, it is likely to emerge as the world's third largest economy by around 2030.<sup>10</sup> Of course, this outcome is by no means certain: India has significant assets but also major liabilities.

India's recent success has in many ways created new and difficult challenges. Its creditable performance in recent decades notwithstanding, Indian agriculture faces serious long-term obstacles. Excessive use of water relative to supplies and distortions in the application of chemical fertilizers have led to the gradual building up of severe environmental problems. With yields stagnating as the aftereffects of the green revolution take hold, the diversion of scarce agricultural land for urbanization and industrialization, and India predicted to be one of the

countries most adversely affected by climate change, the pressures on Indian agriculture are likely to become more severe over the next few decades and to impose major constraints on future development.

Rapid economic growth is also imposing severe resource constraints, be they land, energy, or water. The allocation of these scarce resources will require a degree of fairness and transparency that has been markedly absent in the non-market discretionary and opaque government actions that have contributed to a range of growing ailments, including a Maoist insurgency in India's central tribal belts, unprecedented levels of corruption, and a policy paralysis from the public backlash.

But perhaps the foremost challenge India faces is strengthening public institutions and governance. Its democratic success and the demographic dividend mean that tens of millions of young people will be joining India's work force with aspirations that their parents couldn't even dream about. Managing their expectations will be no mean task. In the two decades after the onset of economic liberalization India added 364 million people to its population—more than the stock at the time of independence, a stock accumulated over many millennia. Understanding the

implications of this immense demographic change in such a short period of time and limited land mass is not easy. Managing it will be even harder.

The challenge India faces is to create a state that enforces laws impartially, rather than simply create new rules at its convenience and enforce them arbitrarily. While in the foreseeable future the expansion and growth of India's private sector and all-too-vibrant civil society will certainly fill in for some of the shortcomings of the public sector, there are a wide range of core functions, from regulation to security and from social inclusion to public goods provision, where the State is—and will be—indispensable. The integrity and responsiveness of the Indian state to the multiple challenges facing the country, both internal and external, will fundamentally determine India's future.

Table 42.1: The Indian economy, 1900–2010

	1900–50	1950–60	1960–70	1970–80	1980–90	1990–99	2000–10
Growth rate (%) (annual average)							
World	2.1	4.2	5.3	3.6	3.2	2.5	3.7
India	0.5–1.0	3.7	3.6	2.8	5.8	6.1	7.3
Population growth rate (%)	1.0	2.3	2.3	2.3	2.1	1.8	1.5
Population (millions)	361	439	548	683	846	1 028	1 210
Tax/GDP (%)	6.2	7.8	10.3	13.7	15.4	14.5	14.7
Gross domestic capital formation/GDP (%)	8.4	14.0	15.1	19.9	26.0	24.3	35.1
Exports/GDP (%)	6.2	3.9	3.6	4.6	5.8	9.9	14.5
Agriculture as share of GDP (%)	65.4	49.8	43.9	38.3	33	25.3	16.7
Rural population (% of total)	82.7	82.0	80.0	76.7	74.3	72.2	68.9
Per capita net national product (Rupees constant 2004–2005 prices)	5 708	7 121	8 091	8 594	11 535	15 172	35 993
Total public sector employment (millions)		7.1	11.1	15.5	19.1	19.1	17.9
Life expectancy	32.1	41.3	45.6	50.4	58.7	62.5	67
Literacy rate (%)	18.3	28.3	34.4	43.6	52.2	64.8	74.0
Infant mortality rate (per 1,000 live births)	146	129	134	104	80	68	47

Sources: RBI, *Handbook of Statistics on Indian Economy*; Census of India; Planning Commission; Economic Survey.

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<sup>1</sup> I am grateful to Galileu Kim for his research help in putting together this chapter.

<sup>2</sup> For a comprehensive understanding of almost all aspects of the Indian economy, see Basu and Maertens (2012).

<sup>3</sup> Quoted in Pankaj Mishra, "How India Is Turning Into China," *New Republic*, December 21, 2012. (<http://www.newrepublic.com/article/politics/magazine/111367/how-india-turning-china>, accessed February 18, 2013)

<sup>4</sup> Stephen R. Brown (2009). *Merchant Kings: When Companies Ruled the World, 1600–1900*. Vancouver: Douglas & McIntyre, 314.

<sup>5</sup> Variations in the period covered in different studies lead to differing growth rates when comparing pre-reform and post-reform or 1980s and 1990s. The discussion in this section draws from Kapur (2010a).

<sup>6</sup> The following discussion draws on Joshi and Kapur (forthcoming).

<sup>7</sup> This section draws on Kapur (2010b).

<sup>8</sup> Poverty estimates in India are based on monthly per capita consumption expenditures based on national household surveys, with official poverty lines defined in terms of a threshold monthly per capita expenditure linked to minimum calorific intake. For an excellent overview see Deaton and Kozel (2005).

<sup>9</sup> The *Arthashastra* (4<sup>th</sup> century BCE) is an ancient Indian treatise on statecraft, economic policy, and military strategy which identifies its author by the names "Kautilya" and "Viś hṇ u Gupta," both traditionally identified with Chāṇ akya (c. 350–283 BCE), a teacher and scholar.

<sup>10</sup> This would be so at both market and purchasing power parity (PPP) exchange rates, although India's per capita income will be well below those of industrialized countries. Currently India is the world's fourth largest economy based on PPP exchange rates.

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