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Distance Learning Programme (DLP)

INDIAN ECONOMY - I

(UPSC PRELIMS)

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INDIAN ECONOMY-I

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ECONOMIC REFORMS & LIBERALIZATION

Introduction

The Indian economy is one of the fastest growing major economies in the world. Since its independence in the year 1947, a number of economic policies have been framed and implemented which have led to the gradual economic development of the country. On a broader scale, India's economic reforms have been a blend of both socialist and liberal policies.

India was a latecomer to economic reforms, embarking on the process in earnest only in 1991, in the wake of an exceptionally severe balance of payments crisis. The need for a policy shift had become evident, much earlier as many countries in East Asia achieved high growth and poverty reduction through policies which emphasized greater export orientation and encouragement of the private sector. India took some steps in this direction in the 1980s, but it was not until 1991 that the government signaled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of government.

Several economic reform measures got initiated during the 1980s with exchange rates adjusting continually for differences in the inflation rates, change in the approach of monetary policy to monetary targeting, instituting new institutions in the financial sector, announcement of long-term fiscal policy, reducing quota requirements in selected commodities, focusing on telecom and IT sector, etc.

Planning and Economic Reform

State led planning and state control over the economy was seen as a way ahead by most of the newly independent countries. India also adopted the state led planning model based on the lines of the USSR. For a significant period of time, economic policy in India was guided by 5-year plans. A major shift in policy from agriculture towards industry, and then once again to agriculture due to the food crisis and other geopolitical implications, were some striking features of the state controlled economy in India.

Washington Consensus

Till the late 1970s, the world had recognised the limits of a state dominated economy, thus market, i.e., the private sector, was promoted emphatically. Many countries shifted their economic policy, arguing for a minimal role of the government in the economy. Such a development strategy was regarded as being inspired by the Washington Consensus.

The Washington Consensus refers to a set of free market economic policies supported by prominent financial institutions such as the International Monetary Fund, the World Bank, and the U.S. Treasury. A British economist named John Williamson coined the term Washington Consensus in 1989. The ideas were intended to help developing countries that faced economic crises. In summary, The Washington Consensus recommended

structural reforms that increased the role of market forces in exchange for immediate financial help. The ten specific principles originally set out by John Williamson in 1989:

- Low government borrowing to discourage developing economies from having high fiscal deficits relative to their GDP.
- Diversion of public spending from subsidies to important long-term growth supporting sectors like primary education, primary healthcare, and infrastructure.
- Implementing tax reform policies to broaden the tax base and adopt moderate marginal tax rates.
- Selecting interest rates that are determined by the market. These interest rates should be positive after taking inflation into account (real interest rate).
- Encouraging competitive exchange rates through freely-floating currency exchange.
- The adoption of free trade policies that would result in the liberalization of imports, removing trade barriers such as tariff and quotas.
- Relaxing rules on foreign direct investment.
- The privatization of state enterprises. Typically, in developing countries, these industries include railway, oil, and gas.
- The eradication of regulations and policies that restrict competition or add unnecessary barriers to entry.
- Development of property rights.

Mixed Economy and Economic Reform

By the mid-1990s, it was significantly comprehended that neither the Washington Consensus (complete privatisation) nor the state-led planned economic model were the best strategies of development. Thus, the focus shifted to a decent blend of both the socialist and capitalist model, i.e., mixed economy model.

The Macroeconomic Crisis

- Macroeconomic crisis is a situation in the economy experience a falling GDP, a drying up of liquidity and rising/falling prices due to inflation/deflation etc.
- Although the Indian economy grew more swiftly during the 1980s than it had during previous decades, the proportion of the central government's fiscal deficit grew over the decade as well. By the mid-1980s, the fiscal deficit was approximately 8% of GDP, and it continued at that volume through the remainder of the 1980s. Inflation also grew over the course of the 1980s, and stood at 10% at the start of the 1990s.
- The public sector continued to absorb much of the country's investment capital without contributing to the economy proportionately. Iraq's invasion of Kuwait in August 1990 and the ensuing Gulf War strained the economic conditions.
- The World Bank pronounced that India, along with several other South Asian and East Asian countries, was among the most adversely affected due to the escalation in oil prices, loss of foreign exchange earnings of workers in the Gulf region, displaced workers, and a reduction in export profits.
- During the mentioned crisis, India found itself with foreign exchange reserves adequate to finance only two weeks of necessary imports, a lowered investment rating that made additional loans costlier, and the prospect of defaulting on its international debt payments. The immediate task of the government was to re-establish macroeconomic

stability, prevent a default on debt payments, and bring down inflation, all of which the government accomplished despite being one of the most fragile governments since independence.

Mandatory Reform

During the BOP crisis, India under the Extended Fund Facility (EFF) programme of the IMF got external currency support to mitigate the BoP crisis, but such supports have some obligatory terms or conditions put on the economy to be fulfilled. The IMF conditions for India during the 1980s BoP crisis were:

- Devaluation of the rupee by 22%.
- Drastic reduction in the peak import tariff from the prevailing level of 130% to 30%.
- Excise duties to be hiked by 20% to neutralise the revenue shortfalls due to the custom cut.
- All government expenditure to be cut down by 10%, annually.

The ultimate goal of the IMF was to help India bring about equilibrium in its BoP situation in the short-term and go for macroeconomic and structural adjustments so that in future, the economy faces no such crisis.

Macroeconomic Reforms

In response to the internal economic crisis of 1990–91, and the changing international situation, the Narasimha Rao government decided to introduce economic reforms or the New Economic Policy (NEP). The NEP clearly reflected certain global trends, like the collapse of the socialist economy and growing acceptance of economic globalization across the world.

Although the reforms as a part of the process of liberalization and globalization were revolutionary in nature, these were launched within the democratic framework of the country. They marked a shift from the Nehruvian consensus of the 1950s to a new consensus around reforms.

The reform programme consisted of macroeconomic stabilization and structural reforms. Macroeconomic stabilization is a short term programme to overcome the macroeconomic crisis by regulating the total demand in the economy while structural reform was a medium- and long-term programme dealing with sectoral adjustments and the problems on the supply side of the economy by bringing in the dynamism and competitiveness to the economy. Structural reforms included liberalized trade and investment policies with emphasis on exports, industrial deregulation, disinvestment and public sector reforms, and reform of the capital markets and the financial sector. Focus areas of 1991 Economic Reforms were LPG:

- **L:** Liberalization (Reduction of government control)
- **P:** Privatization (Privatization is the transfer of control of ownership of economic resources from the public sector to the private sector)
- **G:** Globalisation (It means integration of the national economy with the global economy).

Liberalisation

- Objectives of Liberalization
  - To increase competition amongst domestic industries.

- To encourage foreign trade with other countries with regulated imports and exports.
- Enhancement of foreign capital and technology.
- To expand global market frontiers of the country.
- To diminish the debt burden of the country.

■ **Major Reforms**

- **Foreign Exchange Reforms**
  - The first important reform in the external sector was made in the foreign exchange market. In 1991, as an immediate measure to resolve the balance of payments crisis, the rupee was devalued against foreign currencies.
  - This led to an increase in the inflow of foreign exchange.
- **Deregulation of Industrial Sector**
  - Regulatory mechanisms in India were enforced in various ways, i.e., industrial licensing under which every entrepreneur had to get permission from government officials to start a firm, close a firm or to decide the amount of goods that could be produced; the private sector was not allowed in many industries; some goods could be produced only by small scale industries, etc.
  - The economic reforms introduced in and after 1991 removed many of these restrictions. Industrial licensing was abolished for almost all but product categories — alcohol, cigarettes, hazardous chemicals, industrial explosives, electronics, aerospace and drugs and pharmaceuticals.
  - Many goods produced by small scale industries have now been dereserved. In many industries, the market has been allowed to determine the prices.
- **Financial Sector Reforms**
  - Financial sector includes financial institutions such as commercial banks, investment banks, stock exchange operations and foreign exchange market. The financial sector in India is controlled by the Reserve Bank of India (RBI).
  - One of the major aims of financial sector reforms is to reduce the role of RBI from regulator to facilitator of the financial sector.
  - Foreign Institutional Investors (FII) such as merchant bankers, mutual funds and pension funds are now allowed to invest in Indian financial markets.
- **Tax Reforms**
  - Tax reforms are concerned with the reforms in government taxation and public expenditure policies which are collectively known as fiscal policy.
  - Since 1991, there has been a continuous reduction in the taxes on individual incomes as it was felt that high rates of income tax were an important reason for tax evasion.
- **Trade and Investment Policy Reforms**
  - India was following a regime of quantitative restrictions on imports through tight control over imports and by keeping the tariffs very high. These policies reduced efficiency and competitiveness which led to slow growth of the manufacturing sector.
  - The trade policy reforms focused at dismantling of quantitative restrictions on imports and exports, reduction of tariff rates and removal of licensing procedures for imports.
  - Import licensing was abolished except in case of hazardous and environmentally sensitive industries.

- Export duties have been removed to increase the competitive position of Indian goods in the international markets.

Privatisation

- Privatisation is the transfer of control of ownership of economic resources from the public sector to the private sector.
- Disinvestment is selling off part of the equity of PSUs to the public.
- Objectives of Privatization
  - Raise funds from disinvestment.
  - Improve the financial situation of the government.
  - Increase the efficiency of government organizations.
  - Provide better and improved goods and services to the consumer.
  - Create healthy competition in the society.
  - Encouraging foreign direct investment (FDI) in India.

Globalisation

- Globalisation is the outcome of the policies of liberalisation and privatisation.
- It is generally understood to mean integration of the economy of the country with the world economy.
- It involves creation of networks and activities transcending economic, social and geographical boundaries.
- It is a process of turning the world into one whole or creating a borderless world.

Outsourcing

- In outsourcing, a company hires regular service from external sources, mostly from other countries, which was previously provided internally or from within the country (like legal advice, computer service, advertisement, security — each provided by the respective departments of the company).
- This is one of the important outcomes of the globalisation process.

World Trade Organisation (WTO)

- It is a precursor organisation for promoting globalisation and integrating the local economy with the global economy.
- The WTO was founded in 1995 as the successor organisation to the General Agreement on Trade and Tariff (GATT).
- The WTO is expected to establish a rule based trading regime in which nations cannot place arbitrary restrictions on trade.
- The WTO agreements cover trade in goods as well as services to facilitate international trade (bilateral and multilateral) through the removal of tariff as well as non-tariff barriers and providing greater market access to all member countries.

Indian Economy Since Reforms

- The economic reforms have led to considerable liberalization and freeing of international trade, and to some replacement of what used to be called the 'Licence Raj' (with pervasive bureaucratic control over private economic initiatives). This has greatly added to

business opportunities in India and has also helped to consolidate India's faster economic growth.

- Liberalisation has helped to free Indian entrepreneurs to seek global trade, and the success has been especially large in specific sectors such as information technology.
- The telecom sector is a success story of India's economic reforms. The telecom sector underwent a revolution in the Indian growth story. The rate of growth of GDP from telecom accelerated from an average of 6.3% per annum (during 1980–81 to 1991–92) to 18% per annum during 1992–93 to 2002–03.
- In the case of ports, private operators have been introduced and then the Tariff Authority of Major Ports was formed. In the civil-aviation sectors, new private airlines, new private airports and the beginning of an open skies policy are evident.
- Relaxed entry of foreign firms in the services sector was also directly attributable to the growth in the services sector as the share of services in foreign direct investment increased. Due to economic reforms, the tertiary sector has been the main gainer of the shift in employment. Yet the increase in its employment share has not been in accordance with the increase in its share of GDP.
- The share of secondary sector in employment has increased at a relatively faster rate while its share in GDP has remained constant at around 25%. The economic reforms were more radical as far as industries were concerned. Changes in the policy framework gave a big boost to industries. The major reforms were the abolition of licenses for a wide range of industries. Licenses are now only required for some industries.
- The economic reforms have also contributed to the rise in competition among states to attract private investment. This has promoted the feeling of cooperative federalism.

Other Positive Impacts of Economic Reform

- The growth of GDP increased from 5.6% during 1980-91 to 6.4% during 1992-2001.
- Foreign investment increased.
- Foreign exchange reserves increased.
- The growth of the service sector has increased.
- The economic reforms in India since 1991 have also brought changes in trade and industrial policies which have led to competition for production with cheap labour, which led to a reduction in cost of production.

Negative Impacts of Economic Reforms

- Basic problems of employment, agriculture, industry, infrastructure development, and fiscal management could not be solved through New Economic policy (NEP).
- The agricultural growth decelerated in the economic reform period (commencing in 1991). Between 1991 and 2016, agricultural growth has stagnated at around 1%. The rate of growth of production of food grains fell from 2.9% per annum in 1980s to 2.0% per annum in 1990s and stood at 2.1% per annum in the first decade of the 21st century.
- Since the Economic Reform of 1991, both public sector and private sector firms are downsizing workers with greater pace, there is subcontracting and outsourcing of the work which has also added to informal sector employment.
- FDI attracted towards industrially developed States like Gujarat, and Maharashtra was more than under-developed States like Jharkhand, and Orissa. Hence, it has led to regional disparity.

Redefining the Role of the State vis-à-vis Economic Reforms

- The adoption of the NEP (New Economic Policy) based on liberalization and privatization has given rise to a debate on the nature of the link between state and market.
- The NEP does not imply a retreat of the state. The state and the market are not substitutes for one another, but they complement each other. Further, these two actors provide mutual checks and balances in such a way that one can correct the failures of the other. The state needs to formulate policies to bring about improved transparency and greater accountability, which forms the basic pillars of good governance.

India vs China

1978 China's Economic Reforms

- Agriculture was transformed first and then reforms were taken to the industrial sector. China's economic growth has also benefited from a very large net inflow of foreign direct investment, a sign of confidence in the Chinese economy by outside investors.
- The overall performance of the Indian economy may not have matched that of post-reform China (with its sustained growth rate of 8 to 10% a year), but India's move from the rigid box of a 3% growth rate to the 5 to 8% arena is certainly not a negligible development.
- India's reduction of poverty has been far less rapid than what has occurred in China since the economic reforms.

Economic Reforms and Vulnerable Sections

The proportions of the Indian population with incomes below the standard poverty lines have fallen over the 1980s and 1990s. Economic Reforms enabled greater access to technological advancements in agriculture, including high yield varieties, genetically modified crops (GM crops) and micro irrigation techniques. Foreign investment in agriculture in contract farming, cold storage and food processing have helped farmers. Access to foreign markets has greatly boosted Indian agricultural exports.

Period after economic reforms has also been marked by an increase in the level of inequality in the country. According to a study, "in both the early 1990s and the early 2000s, the wealthiest 10% of wealth-holders held at least 50% of total assets, while the least wealthy 10% held at most 0.4% of total assets". In case of land, it is more unequally distributed than wealth.

After the new economic reforms, the trade unions in the country have lost their edge and militant spirit to sustain the workers' rights and further, the size of the trade unions has also reduced and is not able to maintain pressure on the government. The Central trade unions did not perform an effective role for the informal sector workers, rather they never considered them as workers. Today organised sector workers are also struggling to retain existing rights.

Unsustainable agricultural practices post economic reforms and the inability to compete against cheaper imports contributed to the distress migration of rural farmers, destroying rural agrarian societies and traditional family structures. The dependency on MNC seeds resulted in farmers losing touch with indigenous seeds and farming methods.

The Next Round of Reforms

Three generations of reforms as a way forward to 1991 reform have been announced till date, although some experts have suggested the fourth generation, too.