India’s Economy: From Where to Where?

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For the urban youth today, it would be hard to imagine India just thirty years ago when India Today was launched. It was a miracle if one was allotted a phone, and it took a further act of God and the benevolence of the P&T man for the phone to work after that. Thirty years ago, we had black and white TV, and that too only in a few cities. Urban schoolboys like us had to watch Krishi Darshan for entertainment on the monopoly Doordarshan network, where farmers responded to penetrating questions like “Kya aap khet ko pani dete hain?” Of course, most of the intended audience, villagers, did not have access to a TV or the electricity to power it with.

Within a few years of India Today’s launch, the Indian economy became a veritable dynamo (we are not suggesting cause and effect here), posting an average growth of nearly 6 percent per year over the last twenty-five years. Despite the inevitable unfavorable comparisons with China, very few countries have grown so fast for such a prolonged period of time, or reduced poverty so sharply. We should indeed be proud of what India has achieved, and clearly, many Indians are. There is a buzz today in India, a sense of limitless optimism. But is it justified?

To answer this question, let us start by asking how we got here. The economic policies that our founding fathers conceived for India defy easy characterization. They were an exasperating combination of simultaneously supporting and stifling private entrepreneurship. The barriers erected against foreign competition served to coddle domestic enterprise. But the private sector was simultaneously kept out of large areas of economic activity. In particular, the so-called “commanding heights”, such as steel, petrochemicals, and heavy electricals, were commandeered by the public sector. In yet other sectors, private entrepreneurs were allowed in, but heavily constrained by regulations on how, how much, and what they could do, and where.

An overarching principle animating these efforts was to prevent the concentration of wealth in a few hands. So, licensing regulated the scale of operations of every firm; reservations and other carrots favored small-scale industries; strict labor laws penalized large enterprises; and the Monopolies and Restrictive Trade Practices Act was the final bulwark against expansion. In short, private initiative and growth, except for a favored few, was stymied.

So what were the consequences of this jumble of policies for India’s pattern of development circa 1980? First and foremost, these policies held India’s growth to a low, but not disastrous, level, famously dubbed the Hindu rate of growth. Surprisingly, these policies did not mean that India produced less manufacturing goods as a whole for a country at its stage of development. It did mean, however, that the composition of its manufacturing activity was unusual: India produced more than its share of capital- and

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1 The views expressed here are personal and are not meant to represent those of the IMF, its Management, or Executive Board.
skill-intensive goods (think public sector petrochemical plant), while underutilizing what it had in plentiful supply—its abundant labor. Constrained by regulations and protected from external competition, Indian industry was inefficient and exported very little.

There was a silver lining though. India was highly diversified in its manufacturing even back in 1980. And a portion of its labor force was highly skilled, a clear legacy of Pandit Nehru’s emphasis on science, higher education, and also leading edge technologies for the public sector. How many countries, at India’s then stage of development, could boast of having a space program?

Around 1980, two major changes began to transform the Indian economic landscape. First, attitudes towards the economy, and the private sector in particular, started to change. Under Mrs. Gandhi and then Rajiv, pro-business reforms were set in motion, with liberalized access for domestic firms to capital imports (including, presciently, to computers), technology, and foreign exchange, and the gradual relaxation of industrial licensing. Later, in the aftermath of the foreign exchange crisis in 1990, broader reforms that were more genuinely pro-competition were introduced—barriers to foreign trade were dismantled, inward foreign investment was liberalized, and important services such as telecommunications and finance were opened up.

Second, but no less important, India started becoming more decentralized politically. The decline of the Congress’ power and the rise of regional parties conferred greater political autonomy on the states, translating to autonomy even in the economic sphere. States increasingly prospered, or not, based on what they did rather than because of actions at the center.

What did these changes accomplish? Many things. Above all, the economy responded with the vigor of an uncaged tiger as per capita growth surged from less than 1 percent a year to over 3 ½ percent, not so much by employing more workers and capital but by using them more efficiently. Surprisingly, though, neither the reforms nor the pick-up in growth have altered India’s specialization in capital- and skill-intensive industries. In fact, the fastest growing services – finance, telecommunications, and business services – are also skill-intensive. In many ways, India is building on the capabilities created before the 1980s, with veterans from the state-owned CMC or ECIL seeding the companies that were in the vanguard of the software boom, and alumni from the State Bank of India permeating the financial sector to launch the boom in finance.

These developments are mirrored at the state level. With greater decentralization, better run states, such as Delhi, Gujarat, Karnataka, Maharashtra, and Tamil Nadu, have improved the quality of their infrastructure and business climate, attracted more investment, and surged ahead. The pattern of development in these states has been unusual: they seem to have skipped entirely a phase that most high-growth countries in East Asia, went through -- of specializing in labor-intensive activities (for example, making clothes or leather goods, or assembling consumer electronics). Instead, these states are behaving more like the United States and Europe, exploiting their diversified
skill base and emphasizing skill-based manufacturing (pharmaceuticals, petrochemicals, and auto parts) and especially services.

So what does this mean for the future? Fast-growing states will need more capital and skilled workers (as well as, of course, the necessary infrastructure, a matter on which there is consensus in India). India has a vibrant financial sector and it should have no problem raising and allocating capital but for one impediment – the government appropriates significant amounts of savings to finance its deficit. Not only does this leave less to allocate to private investment or infrastructure, it is also a source of vulnerability if the country were to rely more on foreign capital. The need to force-feed the fiscal deficit to domestic banks also makes it hard for the country to open the capital account (or to privatize banks), a must if India is to achieve its legitimate aspirations of becoming a world-class financial center.

The greater bottleneck will likely be skilled workers. India’s universities have not expanded in a manner commensurate with the growing skill intensity of its production. Even as India redresses its previous neglect of primary education, it needs to multiply institutions like the IITs and regional engineering colleges on which its current success is based. Unfortunately, higher education continues to be one of the last bastions of the license-permit raj.

Despite these concerns, India’s fast-growing states have a certain success-breeds-success dynamic which will be difficult to derail. More worrisome is job creation for India’s growing unskilled labor force and the related problem of the laggard states, where the majority of low-skilled, undereducated Indians still reside. Ideally, of course, the laggard states would reform on their own—scrap archaic labor laws (few realize how pernicious these are because their effects, in terms of the labor-intensive firms that are unborn, cannot easily be seen), improve infrastructure and the business climate —and utilize their vast pools of underemployed low-cost labor to attract investment in labor-intensive manufacturing and agri-business. They would thereby catch up with the leading states in India. Unfortunately, though, there is a reason these reforms have not been undertaken so far – there are few things more persistent than bad governance.

Is the country then likely to face increasing political strife as the populous, politically powerful, but laggard states hold back the economically powerful fast-growing ones? There is a more hopeful scenario – Europe had similar disparities but through various initiatives, prosperous Western Europe offered incentives for laggard European countries to reform. The external pull set reforms into motion, so much so that some of the former laggards like Ireland and Spain are now Europe’s locomotives. If a loosely knit community of nations could do it, why can’t a united nation of states? A reformist center – and India cannot afford to not have one -- could play the role of the European Commission (expanding what the center is already doing on the fiscal side) and offer laggard states more incentives to reform.

For India to pull together better, though, the country has to become more of a common market, with easy cross-state flow of people, goods, and capital. Harmonization of taxes,
standards, and access is necessary. One area where this is critical is education – so that a student from a laggard state can find a place as easily in an engineering college in Mumbai as a student from Nagpur – for returning skilled workers can provide these states both the capabilities and the enthusiasm that has been so instrumental in India’s growth.

Perhaps the defining metaphor for India today is churning, as entrenched interests lose power, as new jobs are created and old ones lost, as people move across states in search of better opportunities, as yesterday’s Bharat becomes today’s India, which becomes tomorrow’s Bharat again. Recall the story of the devas and asuras churning away as the ocean of milk frothed and foamed. Out of the churning, first came poison, but further hard work yielded the divine nectar, amrita. Limitless optimism is justified, but hard work and churning lie ahead.