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**From the Hindu Rate of Growth to the Hindu Rate
of Reform¹**

by

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Policy reform in India is conventionally dated from the time of the macroeconomic crisis in 1991, in response to which the Indian government initiated a range of liberalizing microeconomic reforms in addition to a (temporary) tightening of fiscal policy and a devaluation of the rupee. But, as Table 1 reveals, the significant acceleration in economic growth occurred a decade or so earlier. Aggregate growth in the 1970s was even lower than what used to be termed the “Hindu rate of growth”, at an average of 2.4 percent per year. India was in fact the slowest-growing of the five countries and regions whose performance is shown in Table 1, much below not just East Asia² and China but also Latin America and even Sub-Saharan Africa. But in the 1980s Indian growth accelerated

—not as much as in China, but enough to place India securely in the middle of the country groups identified in Table 1. The 1990s brought only a very modest further acceleration, although India’s performance again looked relatively better as a result of the slowdown in East Asian growth that resulted from the 1997 crisis.

The preceding paragraph already reveals that we are conventional in judging the success of reform primarily in terms of its impact on a country’s growth rate. But primarily does not mean exclusively. If one takes the view that the living standards of the poor are of particular importance, then one will favor growth because empirically it has a close relationship to the rise in the income of the poor (Dollar and Kraay 2001), but one will also recognize that income distribution matters (World Bank 2000). If one cares about social variables like health, literacy, longevity, and infant mortality, then one will favor growth because empirically it improves those variables, but one will also recognize that there is a lot of scope for them to vary independently of income (Sen 1999). If one recognizes that welfare depends (negatively) on fluctuations in consumption as well as (positively) on its level, then one will care about the emergence of disequilibria that may

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² East Asia is here used to refer to the aggregate of Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

provoke a future crisis, like fiscal and balance of payments deficits and their cumulative consequences, high levels of external or domestic debt.

The paper starts by sketching the situation in India prior to reform, and then provides a broad-brush description of the reforms that took place in the 1980s. This is followed by a description of the Indian reforms in the 1990s, and then a discussion of the unfinished business of reform. We conclude by examining the principal policy issue posed by the Indian story: the old question of gradualism versus shock treatment.

While India's reforms are cumulatively impressive, and have been relatively successful in nurturing growth (and were spectacularly successful in inducing a rapid return to growth after the 1991 crisis), the dominant feature of India's reform program is that it has been gradual. We therefore ask whether such "a Hindu rate of reform" (with the exception of the period 1991-93) is necessarily a bad thing. We argue that India's gradual reforms have enabled it to give attention to planning reforms more carefully than has sometimes happened elsewhere. Gradualism has allowed India to give effect to such conclusions as the sequencing literature reached. India's politics has surely delayed reforms as compared to any concept of the optimal speed, but it may be that the final outcome was better than a shock treatment would have yielded. That is not to promulgate some Law of the Optimality of Procrastination, but it is to suggest that we should try and identify the circumstances in which big bangs are justified and those in which gradualism is better, and that the latter is not an empty set.

The License Raj

At Independence India had already developed all the institutions of a modern market economy. The financial system was well developed, including a twenty years old central bank and Bombay's stock market, one of Asia's oldest and largest. The Indian civil service was renowned for elite recruitment, and freedom from political interference. There was a modern legal system, which recognized property rights, independent courts, and a well-trained legal profession. At the same time, however, India's industrial development stalled during the later part of the colonial period; the economy stagnated. Agriculture was unable to feed the country's population; famines were frequent and malnutrition was pervasive. Life expectancy was one of the world's lowest, only a small proportion of the adult population was literate, school enrollment rates were abysmally low, and population growth was accelerating. Gunnar Myrdal captured the tragedy of India's human condition in his *Asian Drama* (1968). For Gandhi and much of India's intelligentsia, the elimination of deprivation had long been the critical issue that an independent India would need to address. Technological catch up, rapid industrialization, growth, and poverty reduction were major themes in the writings of India's founding fathers, already in the economic platform of the Congress Party in the 1930s, and crystallized into what Waelbroek (1998) termed the "Indian Congress Consensus" by Nehru in his writings while in jail in 1944. These doctrines were prominent in the early reports of the Planning Commission.

When it came to the means to reaching such objectives, the state was seen as the main agent towards more rapid development, taking the “commanding heights” of the economy. In the first four decades of India’s history as a nation, “economic reform” meant something entirely different to what is meant in our days (Williamson, 1999). Extensive government control began right after Independence in 1947. An Industrial Policy Resolution adopted in 1948 created state monopolies in “core sectors” of the economy, from which the private sector was excluded. In 1954, the Parliament passed a resolution committing India to a socialist pattern of development. And in 1956 a second Industrial Policy Resolution increased the number of sectors reserved for public sector investment. Since then, for about three decades, new regulations strengthened the role of the state, and the share of the country’s GDP generated in the public sector increased persistently, while a web of mutually reinforcing controls over the private sector further increased the Government’s influence over resource allocation. Industrial licensing controlled how much and for what purpose private firms could invest. Industrial regulations determined how existing capacity was to be utilized, and where and at what price production was to be sold. Nationalizations in the late 1960s and early 1970s—of banks, coalmines, and foreign enterprises in selected sectors—further increased government control over resource allocation. Firms in the formal economy became ever more dependent on government approvals for the most basic business decisions. Hence, while India had all the institutions for a free market economy, including a large and talented entrepreneurial class, the government chose to direct resource allocation for the goals of a centrally planned growth process.

Regulations in one area interacted with those in another to give teeth to the regulatory system. For example, without an industrial license from the Ministry of Industry allowing new investment to take place, the Ministry of Commerce would not provide a license to import capital goods, and the RBI would not authorize the sale of foreign currency to buy them. And even if the capital goods could be purchased domestically, banks would not provide financing, and the Comptroller of Capital Issues would not allow equity to be issued. Public sector monopoly over key industrial inputs such as steel, power, petrochemicals, and coal provided an added influence over private sector business decisions. Misguided as the ultimate objective might have been, considerable intellectual energy and even creativity went into designing controls, and making them effective. The sections below provide an indication, far from exhaustive, of the complex regulatory and licensing environment in which private entrepreneurship operated in India, focusing on industrial licensing, international trade, financial markets, agriculture, and labor. This also gives a sense of the complexity of the task of reforming India’s economy—India’s reforms have not been just a matter of freeing prices and trade. It has been a task of undoing a complex system of controls that moved the economy far away from allocational efficiency, created numerous rents and vested interests, and was grounded in numerous pieces of legislation and institutions.

Prior to the reforms started in July 1991, India had one of the world’s most controlled *investment regimes*. There was a list of sectors reserved for public sector investment (coal, power, telecommunications, insurance, mining, oil, etc), while private investment in any registered industrial firm (which accounted for three-fourths of India’s

manufacturing output) was subject to government approval. There was a “Small Scale Industry” reservation list of 830 goods that could only be produced by firms below a certain size, including garments for export, lamps, and some agricultural machinery. Private investment was regulated even in sectors where it was permitted. Private investment in housing in urban areas was regulated by the Urban Land Ceiling Act of 1976, which subjected all sale of urban land to state government approval. In agriculture, private investment in storage was controlled indirectly by ceilings on the amount and in some states the period for which commodities can be stored (the remnants of legislation aimed at curbing hoarding during food shortages and famines), bans on future and forward trading of agricultural commodities, and directly by licensing requirements for investment in agro-processing. Foreign investment was particularly restricted, and banned from some sectors. Firms with more than 40 percent foreign equity could only access domestic financing, or acquire assets with central bank authorization.

India’s *trade regime* was likewise one of the world’s most complex, characterized by severe licensing restrictions on imports, and very high import tariffs—with an average of 87 percent. Draconian foreign exchange regulations (for example, possession of foreign exchange was a crime) complemented restrictive trade regulations. The import licensing regime was based on 26 lists classifying all importables. Each list had its own approval procedures. Imports on some lists, notably of consumer goods, were simply banned. The licensing regime was complemented by a variety of special import schemes that increased its complexity. The Actual User Policy banned resale of imports bought under more permissible lists. Phased Manufacturing Programs allowed otherwise restricted imports by firms committed to increasing the local content of their production following a pre-agreed schedule. “Canalization” policies reserved imports of specified items to designated State trading agencies. Basic duties were as high as 355 percent; there were surcharges up to an additional 95 percent. These high tariffs were somewhat diluted by exemptions which reduced the effective tariff to below the nominal rate. Exemption notifications were changed frequently, and often varied among different users. Notwithstanding the exemptions, average effective rates were extremely high for all categories of imports.

Since nationalizations in the late 1960s and early 1970s, the public sector has dominated India’s *financial system*. The financial saving rate was 13 percent of GDP when liberalization started in 1991, indicating that the financial system was unusually well developed for a country at India’s income level, but it suffered from four serious problems. The first was government ownership and lack of competition. The government and the domestic private sector owned 28 banks each, while foreign investors owned another 24. The public sector also owned several specialized development finance institutions, several of which were particularly large—ICICI (Industrial Credit and Investment Corporation of India), IDBI (Industrial Development Bank of India), the National Bank for Agriculture and Rural Development (NABARD) and the Housing and Urban Development Corporation (HUDCO). While not large in absolute numbers, public sector banks accounted for 90 percent of commercial bank deposits. They ran most of the country’s extensive network of 60,000 bank branches; supplied loans and equity to specialized finance institutions; and ran subsidiaries for

leasing, mutual funds, merchant banking, and other corporate services. Government policies discouraged the entry of new banks, and controlled the expansion, closure and location of branches. Before it was opened to the private sector in 1992, the central government-run Unit Trust of India monopolized the mutual fund industry, managing 50 different funds. The Government also owned the only two insurance companies in the country.

The second problem was the control of interest rates and terms at which to access capital markets. Except for interest rates in the inter-bank market, the government regulated all basic interest rates, on loans and deposits. Wide differentials existed for lending rates depending on the sector and the size of loan. Banks could issue certificates of deposit (on which interest rates were unregulated) only up to 5 percent of their deposits. Besides approving any issue of debentures or equity, the Comptroller of Capital Issues also approved their terms.

The third problem was regulation of the direction of credit and other forms of financial savings, which left little room for market forces. There were severe restrictions on commercial banks' use of funds. In July 1991, 63.5 percent of every increase in demand and time deposits had to be set aside for investment in government securities: 25 percent as Cash Reserve Requirement and 38.5 percent to meet the Statutory Liquidity Ratio, both generally at below market rates. Of the remaining 37.5 percent, 40 percent had to be extended as credit to priority sectors such as agriculture, small scale industries, small scale enterprises, housing, village artisans, etc, with sub targets for each, at subsidized rates differentiated by purpose, size of loan, and borrower. There were 50 such rates in 1989. Even the free portion of banks' resources were subject to "credit norms" which set inflexible limits to loans according to sector, purpose, firm's financial ratios, and security. In addition, the RBI set sector-specific credit targets; and through the Credit Authorization Scheme, approved any loan or advance to India's thousand largest firms. Detailed guidelines governed loan approvals for other firms. There were strict eligibility criteria governing the issuance of commercial paper by firms, and firm level limits on the maturity and outstanding amounts of these securities. Similarly severe restrictions on investment of their funds applied to insurance companies, which had to hold over half their portfolio in government designated securities.

Fourth, while government interventions in the financial system served its objectives of channeling credit to the sectors it considered priority, the emphasis on direct controls meant, for the commercial banks, insufficient attention to loan appraisal and assessing risks and returns, and, for the regulators, insufficient attention to developing adequate prudential regulations and supervision. Capital adequacy norms, and prudential regulations for asset classification, income recognition, provisioning for bad debts and financial disclosure did not meet international standards. While bank inspection procedures were adequate, inspectors were in the contradictory role of having to maintain the safety and soundness of commercial banks, while forcing them to comply with government regulations. Obviously, both regulators and banks gave priority to what they would be most directly held accountable for, which was compliance. There was equally inadequate institutional support and oversight of capital markets.

Similarly complex regulations applied to *agriculture*. Restrictions were based on the 1955 Essential Commodities Act, which was created to prevent anti-competitive practices when India was vulnerable to food shortages. While the Act was successful at preventing anti-competitive practices and hoarding, it also provided central and state governments with sweeping powers to issue notifications or Orders, and to control and regulate the production, supply, distribution, and prices of virtually all agricultural commodities. In particular, this legislation imposed licensing requirements for wholesale trade, storage, and processing of most agricultural commodities. It also enabled states to impose state-specific restrictions such as licensing requirements for exports to other states, e.g. rice out of Tamil Nadu or Andhra Pradesh, edible oil out of Gujarat, or cotton out of Maharashtra. States were also enabled to impose storage restrictions, including cold storage restrictions in major fruit and vegetable producing states. And there was a general ban on futures and forward trading. Coming on top of distortions induced by the trade regime, which implicitly taxed agriculture through high protection of manufacturing and overvaluation of the exchange rate, such interventions distorted agricultural incentives and were the cause of large efficiency losses.

Exit of labor and capital from where no longer competitively deployed was another tightly regulated area. Resource mobility in India has been constrained by restrictions on the discretion of firms to contract their work forces, or close plants. Several pieces of legislation aimed at strengthening unions, increasing wage outcomes, and enhancing job security in the formal economy had the result of making layoffs difficult, even during periods when demand contracted. The 1947 Industrial Dispute Act required state government permission for layoffs in any firm with more than 100 employees, permission that was seldom granted. Similar restrictions prevented exit of capital. India's bankruptcy procedures provide no protection to firms facing poor economic prospects or even default; emphasize rehabilitation, even when the cost is high to creditors and tax authorities; and bankruptcy-like procedures (managed by the Board for Industrial and Financial Reconstruction) give a higher premium to continuity and rehabilitation than to longer run solvency. These restrictions have prevented mobility of resources, and increased risks associated to hiring and investment decisions.

Reform in the 1980s

In a recent paper, Chaudhry, Kelkar, and Yadav (2002) have discussed the genesis of the IMF loan to India in 1981. They contrast the failure of the previous Indian engagement with the IMF, at the time of the 1966 devaluation of the rupee, with the success of the 1981 program. In 1966, the IMF (along with the United States and the World Bank) brought strong pressure to bear to devalue the rupee and move away from import-substituting industrialization, a strategy change about which the Indian authorities were at best ambivalent. When the details of the Indian program became public, and even though the Indian authorities claimed that they had avoided making any significant policy change in order to obtain the loan, there was a strong critical political reaction. The last straw was when only about half the aid that had been promised actually materialized. The government thereupon withdrew critical components of the reform package, the donors

withdrew their support, and India muddled on with its dirigiste policies and consequent low growth for another 15 years.

When India's terms of trade deteriorated in the late 1970s as a result of the second oil shock, the Indian authorities concluded that they were going to need IMF financial support in order to spread out and thus limit the costs of adjustment. This time round, they went to great pains to prepare a program that could be sold to the IMF as "home-grown", so as to avoid the threat of a political reaction similar to that which ended all hopes of a program in 1966. Both the conditions and the performance criteria of their program were based on India's Sixth Five-Year Plan, and the IMF accepted these as providing a legitimate basis for a loan from the Extended Fund Facility. The conditions essentially committed India to maintaining its longstanding policy of macroeconomic responsibility, rather than doing anything much to liberalize the economy. Although the Exchange and Trade Relations Department of the IMF (the precursor of today's PDR Department, often referred to as the Fund's thought police) objected that such a program was "a farce", they were given as a sop only a commitment to increase public savings a bit more. The IMF basically allowed India to have a loan on conditions that it had itself designed, which is what many of us have always thought the Fund should regard as ideal, whenever the policy stance is sufficiently solid to permit it.

Nonetheless, a number of reforms were implemented during the 1980s. While they pale in comparison with the reforms of the 1990s, they were important not only because of their positive efficiency impact, but also because they gave confidence and credibility to the reformers. Relaxation of controls over capacity utilization ("broadbanding", whereby firms could diversify production into non-authorized products provided they utilized the same basic inputs), and over imports of capital goods and spare parts, enabled much better utilization of installed capacity. Efficiency gains were also achieved by dismantling price controls over key industrial products such as cement and aluminum. The liberalization of the trucking industry in the second half of the 1980s was particularly important—and ended a complex allocation system whereby the Ministry of Transport set prices, issued licenses to truckers, and centrally allocated freight to licensed transporters. Liberalization reduced prices and transport times, and led to the emergence of a highly competitive trucking industry. These successful price liberalizations--and the fact that competition drove prices down whereas anti-reformers expected the end of controls to push prices up—was important in establishing that competitive market forces did not imply impoverishment of consumers. There was also some deregulation of the financial sector, an accelerated depreciation of the exchange rate, and increases in export incentives, which corrected some of the anti-export bias inherent in India's import policies. The government financed a large expansion of the public investment program—including investments in power, steel, chemicals, refineries, telecoms, and other basic industries. As a result, the growth rate of the private sector more than doubled in the 1980s, primarily because of a dramatic decline in its previously astronomical ICOR (Table 2); and overall GDP growth doubled. And, contradicting decades of export pessimism, merchandise exports grew at real rates in excess of 10 percent during 1985-90.

At the same time, however, the central government fiscal deficit increased rapidly, to 8.5 percent of GDP at its peak in 1986-87, a level never reached since. And the debt to GDP ratio reached levels from which it has not yet recovered. These macroeconomic imbalances, and a gradual depletion of reserves, raised questions about the sustainability of the growth rate and made the economy particularly vulnerable to shocks.

Indian Reforms, 1991-2001

A stronger and more radical impetus for reform came in the early 1990s when a decade of gradual increases in macro imbalances, amplified by the high oil price caused by the 1990 Gulf War, and domestic political instability combined to push India to the verge of default. A new Government came to power on June 21, 1991 and its most important short-term priority was to avoid defaulting on India's external obligations. For the first time since independence, however, there was a Finance Minister (Manmohan Singh) who believed market forces would help India address its development challenges more efficiently than government controls. In a radical break with past thinking, in a historical Budget speech on February 29, 1992, the new Finance Minister eloquently summarized the new government vision: "To realize our development potential, we have to unshackle the human spirit of creativity, idealism, adventure and enterprise that our people possess in abundant measure. We have to harness all our latent resources for a second industrial revolution, and a second agricultural revolution. Our economy, polity and society have to be extraordinarily resilient and alert if we are to take full advantage of the opportunities and to minimize the risks associated with the increasing globalization of economic processes. We have to accept the need for reform if we are to avoid an increasing marginalization of India in the evolving world economy."

In addition to devaluation and fiscal contraction, therefore, the government started a program of reform focused on freeing the investment regime; liberalizing the trade regime; reforming the financial system; modernizing the tax system; and divesting public enterprises. This was the start of ten years of reform that gradually but persistently expanded to other areas—such as agriculture, pensions, insurance, capital markets, infrastructure, and full-blown privatization--and is transforming the nature of India's economy.³

The outcome of ten years of reform is that India has opened to the world economy. Trade barriers have declined further than anyone thought possible when reforms started in 1991, both on exports and imports—virtually every year since 1991 has seen reductions in import tariffs and relaxation of import constraints (Table 3). There are no quantitative restrictions left. The last February Budget introduced a further reduction of maximum tariffs from 35 to 30 percent, and established a plan to reduce custom slabs

³ Details on the process of change and the reforms introduced over the last ten years are provided in the Ministry of Finance annual Economic Surveys, and the RBI annual Reports on Currency and Finance. These provide cogent reviews and analysis of the changes introduced as well as insights on government thinking on economic management priorities and challenges.

to two by 2004—with a rate of 10 percent for raw materials and intermediate goods, and a maximum of 20 percent for final products.

Foreign direct investment has likewise been liberalized continuously and, except for restrictions on foreign investment in retail, India now has a competitive foreign investment regime. A recent ranking of attractiveness of foreign investment regimes in Asia by the Economic Intelligence Unit places India just behind Thailand, Malaysia and the Philippines, and ahead of China, Sri Lanka, Indonesia and Vietnam. Restrictions on domestic investment have been essentially eliminated—there is hardly an area left where investment requires any government authorization other than the usual municipal and environmental clearances. With the last budget's removal of 50 items, the number of items reserved for small-scale industries has been reduced from 830 before the beginning of reform to less than 300 at present.

The financial sector has likewise seen the introduction of numerous reforms. Most of the reforms took origin in the report of a high level Committee, the Narasimham Committee appointed in August 1991, which a few months later made a wide range of recommendations intended to improve the soundness of the banking system, and increase its competitiveness. Many of these recommendations were implemented immediately while the implementation of others was more gradual, particularly in the case of recommendations related to: (i) improving the functioning of capital and money markets; (ii) enhancing capital adequacy requirements and prudential regulations; (iii) reducing directed investment in government securities; (iv) reducing high cash reserve requirements; (v) liberalizing interest rates; (vi) reducing priority sector lending; and (vii) promoting private sector participation in the financial sector, including foreign banks.

A new impetus to reform came in 1998 when a second Narasimham high level Committee was appointed to make further recommendations in light of the results achieved by then (Hanson and Kathuria, 2000). Together with the 1998 Khan Committee Report on harmonizing banks and development finance institutions, the 1998 Gupta Committee Report on rural credit, and the 1997 Tarapore Committee Report on capital account convertibility, the Narasimham II report provided the basis for a new round of reforms. While recommendations in these reports were in the direction of strengthening recommendations already in Narasimham I (further deregulation of interest rates, further deregulation of credit allocation, abolishing the Statutory Liquidity Ratio, more stringent classification of non-performing assets, tougher capital adequacy requirements including raising bank capital to 10 percent of risk-weighted assets with mark-to-market and a 5 percent risk-weight for government securities that were formerly zero-weighted, stronger supervision, and increasing competition), these reports were also more explicit regarding structural changes in the banking industry. In particular, Narasimham II and some of the other reports recommended reducing government ownership in public banks to 33 percent, and a move towards universal banking with a progressive elimination of differences between banks and development finance institutions.

Many of the recommendations in the Narasimham I and II and other reports have been implemented and have addressed several of the four problems mentioned earlier —

government ownership and lack of competition, regulation of interest rates, controls over the allocation of financial savings, and weak supervision of the financial system. Government ownership remains a major problem, however, and one with possibly serious repercussions on the soundness of the banking system. In 2001 the Government proposed legislation to bring public sector equity in public banks to 33 percent as recommended by Narasimham II, but this has not yet been approved, nor even debated (as discussed in more detail later in this paper). Another issue that remains to be addressed is the lack of RBI supervision of specialized development finance institutions, HUDCO and NABARD in particular, two among the country's largest financial institutions.

While government ownership of banks and other financial institutions continues virtually intact, competition has increased. The number of foreign banks increased from 24 to 42, and private banks are now 31 (from 28). Indicative of increased competition, even though branch expansion of private banks is still constrained, the public sector banks' share of deposits declined from 90 percent at the beginning of the decade to 70 percent at present. The profitability of the public banks has been a problem. Notwithstanding margins that are wide by international standards, and the source of high profits for competing private banks, many of the public sector banks have required public funds for recapitalization. Over the decade the government transferred close to 2 percent of GDP for the recapitalization of banks. This is only a part of the cost since banks also approached capital markets for recapitalization. Another source of competition has come from non-bank financial institutions (financial institutions engaged in consumer finance, investment finance, and leasing that can take only time deposits and have no check writing facilities), a vibrant segment of the financial services industry, with no insurance on deposits—either explicit or implicit, as closures of some of these NBFIs has demonstrated. In the insurance industry the end of government monopoly in the sector is recent, and as yet there are no signs of erosion of profitability, but they are likely to emerge as competition becomes fiercer. In the mutual funds industry, there is now considerable competition from domestic and international institutional investors, a fact that may have contributed to the need for UTI to go through two costly recapitalization exercises.

Banks' discretion over the allocation of funds has increased, and incentives for the efficient use of funds improved. The Cash Reserve Requirement has been gradually reduced over the decade from 25 percent to 5 percent at present. The Statutory Liquidity Ratio has been reduced to 25 percent. Priority sector lending has been rationalized and its cost to the banks reduced through an across the board increase in rates. With few exceptions, interest rates are now set freely. And the system of prudential regulation and supervision of the banking system has been completely reformed with the creation of a Board of Financial Supervision and a revamping of supervision operating procedures. More stringent criteria for asset classification, provisioning for Non Performing Assets, and capital requirements that have gradually increased and now exceed Basel criteria have helped increased the soundness of banks, and helped India weather the East Asia crisis. The Government abolished the Comptroller of Capital Issues in February 1992. This allowed firms not only to decide for themselves when they wished to raise capital

but also to price their issues freely, subject to the disclosure norms of the Securities and Exchange Board of India (SEBI). Also, since February 1992 Indian firms have been allowed to issue equity and bonds abroad, subject to approval of the Ministry of Finance. In parallel, stock markets were considerably strengthened in 1992, when SEBI was elevated to a full-fledged capital markets regulator with statutory powers. Over the past decade, and often in response to market turmoil, key steps have been taken to modernize India's stock markets, including creation of the National Stock Exchange in competition with the Bombay Stock Exchange, the move to electronic trading, creation of a clearing corporation, dematerialization, improvements in settlement procedures, and introduction of trading in equity derivatives. Along the same lines, the RBI has considerably improved its supervisory capacity.

There was also significant progress in reforming taxes, although here also there is a large unfinished reform agenda. When liberalization began in 1991 India's tax system yielded a respectable 16-17 percent of GDP of revenue for the central and state governments combined, but in terms of allocational efficiency and compliance it was possibly one of the most costly systems in the world. Revenue from customs, a full one-fourth of revenue when reforms began, was based on high and distortionary tariffs. Excises, another fourth of tax revenue, were based on high and highly differentiated rates on manufacturing products; numerous specific taxes; very partial rebating which created serious cascading effects; and collections not based on invoices but on notional prices agreed with the central government. Together with several hundred exemptions, this system complicated tax administration, encouraged litigation, and increased compliance costs. With rates as high as 52 percent for widely held companies and 58 percent for the others, corporate taxation discouraged corporate investment and encouraged evasion. Similar problems existed for personal taxation. States' sales taxes, states' most important source of revenue, suffered from similar problems and, in addition, were eroded by tax competition between states and widespread exemptions. Sharing of tax revenue with the states at different rates depending on the taxes was another source of distortions—because it encouraged the Central Government to focus on taxes on which states had little claim. For example, over three decades during which successive Finance Commissions increased the states' share in personal income taxes to 85 percent, yield from that tax declined by half in relation to GDP. Most of these problems have been addressed. Corporate and personal income taxes have been brought down to internationally competitive levels. The indirect tax system has been rationalized with more generalized rebates, less differentiation of rates, and a wider base. The government has announced its intention to introduce a value added tax both at the national and state levels, but serious coordination and administrative problems need to be addressed for successful implementation. But while there has been significant progress in establishing minimum floor rates and reducing wasteful interstate tax competition through exemptions, most states have still to modernize their tax system.

Another area where reform has been distinctly gradual involves the exchange rate of the rupee and the liberalization of capital flows. After a sharp devaluation in July 1991 shortly after it came to power, the new Government announced a floating exchange rate regime in March 1992. Initially, however, for one year, to mitigate the impact of the

further devaluation, 40 percent of export receipts were converted at the old official rate to finance the import of some crucial commodities, notably food, drugs, and oil. The rates were unified in 1993. In the case of the capital account, despite two occasions when there were pressures for much faster change, the government has taken a very gradual approach to liberalization. In the early 1990s controls on non-debt creating capital inflows (FDI and portfolio investment) were relaxed: foreign investment up to a 51 percent shareholding was approved automatically in most industries, while foreign institutional investors were allowed to invest in listed securities and bonds subject to registration with SEBI. At the same time, debt-creating inflows were discouraged by withdrawing the exchange guarantees previously given to bank deposits by non-resident Indians, with the object of reducing the probability of a recurrence of the sort of vulnerability that led to the 1991 crisis. In 1997 there was further liberalization of both FDI and portfolio inflows. Later on there was also some relaxation of the restrictions on FDI outflows, with the objective of enabling India's (few) nascent multinationals to expand.

The first occasion when there was pressure for more rapid liberalization was in 1993-94, when India encountered the novel problem of excessive capital inflows. At the time the IMF had started to put pressure on a number of countries to liberalize their capital account and pressed for further liberalization and for allowing a relatively free float of the rupee, which would at that time have appreciated. The Indian authorities resisted this pressure, possibly aided at the margin by the fact that the Bretton Woods institutions did not give unanimous advice on this topic. The second occasion was in 1997, when the corporate sector was champing at the bit to be allowed to borrow more cheaply (it thought) in dollars. The government responded by setting up a powerful committee (as it has done on many similar previous occasions), in this case chaired by S.S. Tarapore, a former Deputy Governor of the RBI. The committee recommended what it described as a gradual strategy to achieve capital account convertibility over three years, subject to the satisfaction of three preconditions: fiscal discipline, bank solvency, and trade liberalization. The committee reported in April 1997, less than 3 months before the Asian crisis broke, an event that effectively killed its recommendations even before it could become clear that the preconditions laid down were pipe-dreams. India still retains one of the most closed capital accounts in the world (see the excellent discussion in Joshi 2002), not to mention gigantic fiscal deficits, public sector banks in need of recurrent recapitalization, and one of the world's most protected economies.

As a result of all the measures taken over the decade, India now has a much less regulated economy. Admittedly privatization has proven laborious and slow—not unlike privatization experiences elsewhere in the world—and has only gained momentum at the national level in the last two years. Only two enterprises of significance have been privatized so far, with two others in the final stages. In the case of the two national airlines, potential investors withdrew after prolonged and inconclusive discussions. But while public ownership of major productive assets—from banks and utilities, to manufacturing and transportation—has remained largely unchanged, the market environment has become markedly more competitive, because of both external and domestic liberalization. There are no significant barriers to entry left in any sector; the

recent deregulation of oil and oil product prices has addressed one of the three last remaining serious pricing distortions (the other two being excessive minimum agricultural support prices that have led to unnecessarily large official stocks, and fertilizer subsidies). Agriculture has been significantly deregulated; restrictions on domestic trade of agricultural products have been lifted, as have licensing restrictions on food storage, and forward agricultural markets in several commodities are operating again. After several false starts, the telecommunications industry is now one of the most open and competitive in the world, with the recent end of state monopolies on a variety of services. International trade has become an increasingly important part of the economy, and in many respects the globalization of India's economy is accelerating.

The Agenda of 2002

India's inability to bring fiscal deficits to a sustainable level is generally seen as the country's largest policy failure in the 1990s. Since the early 1990s, the Ministry of Finance annual Economic Surveys, the RBI annual Reports on Currency and Finance, the World Bank and IMF reports and assessments, have all raised alarm on the size of the fiscal deficit and its sustainability. In more recent years the *India Development Report* produced by the Indira Gandhi Institute in Mumbai has joined the chorus. After initial contraction, fiscal deficits started rising again in the mid-1990s. After declining by 13 percentage points of GDP between 1992 and 1996, the consolidated center and state debt rose again, by 12 percentage points of GDP, to reach 81 percent of GDP at present (Table 4). The fiscal deficit is now close to being the biggest of any major country. In addition, the recent decline in inflation has considerably raised the real interest rate to a level that is high by both historical and international standards (Figure 1), which has significantly increased the fiscal deficit adjusted for inflation (Figure 2, and Favaro, 2002).

Given the current strength of the external position, this is unlikely to spill over into a macroeconomic crisis any day soon. India's external situation is vastly stronger than it was at the beginning of the 1990s. The current account deficit is around 0.2 percent of GDP (about \$1 billion), as against an average of 3.1 percent in 1990-91. This is more than covered by the inflow of FDI, which is running at about 0.7 percent of GDP (\$3 billion). International reserves are some \$49 billion, equal to about 11 months of imports, as against under \$2.4 billion (1 month of imports) in 1990. Total external debt is only \$100 billion, about 21 percent of GDP. Only some 6.2 percent of the external debt is short-term, one of the lowest proportions among the emerging market economies.

The danger is not that the fiscal deficit will provoke an external collapse. But that does not mean that it can be ignored. In the words of Charles Schultze (1989) about the US fiscal deficit of the 1980s, the danger is not of a wolf at the door, but of termites in the basement. The deficit crowds out development spending in the public sector and investment in the private sector, and in those ways limits the possible growth rate. And the longer the country delays launching a program of fiscal adjustment, the greater the danger that it will one day find itself in a debt trap, where the debt rises faster than GDP despite a primary fiscal surplus because interest rates are pushed up by investor resistance to increased debt holdings.

India has a number of severe structural impediments preventing faster growth, in addition to the fiscal deficit. We discuss three of these in the present section: difficulties encountered in the reform of India's power sector; the fiscal relations between the central and state governments; and those illuminated by a recent McKinsey report on India's competitiveness.

The Power Sector. Before the Electricity Supply Act of 1948, which made power generation, transmission, and distribution into a state monopoly, private companies supplied and distributed four-fifths of the power consumed in India. As a result of the Act, every state government created its own State Electricity Board in charge of generation, distribution, and tariff setting. By the early 1990s, the State Electricity Boards (SEBs) controlled 70 percent of all generation in the country, and virtually all distribution. Central government generation accounted for most of the remaining 30 percent. There were a small number of private distribution companies in some cities, including Calcutta and Bombay, constituted before the Act and never nationalized; they largely purchased power directly from the SEBs. The legislation expected the SEBs to function commercially and earn a 3 percent minimum rate of return on assets. These institutional arrangements were initially successful. Between 1948 and 1991 generation capacity increased at 9 percent per year. Much of the expansion in manufacturing and agriculture can be attributed to the growing availability of power. For example, where water was available, high-yielding varieties enabled multi-cropping and large increases in agricultural productivity from the 1960s on. Many of the irrigation projects were large, publicly funded projects for surface irrigation, but groundwater pumping became increasingly popular, leading in some regions of the country to highly developed water markets. Irrigation had broad political appeal because it helped both achieve food security and increase farmers' profits.

In 1977, for the first time, electricity entered the world of Indian politics, which it has not left since, when the Congress-led southern state of Andhra Pradesh made an election promise of flat-rate tariffs based on pump capacity rather than measured consumption (Dubash and Rajan, 2001). This had a demonstration effect in Tamil Nadu, where a non-Congress party came to power in an unstable coalition and offered free power to poor farmers to secure its leadership. In following years, politicians extended power subsidies to farmers in Maharashtra and Karnataka. Today there is not a state that does not subsidize agricultural consumption. While in many states a flat tariff rather than free electricity was offered, meters were in either case no longer monitored or simply removed and returned to the SEBs. By the mid-1990s, less than half of all electricity generated was metered, all SEBs were facing severe financial problems, operational efficiency eroded with increasingly unreliable supply, and power shortages became an important constraint to the expansion of industry and economic activities in general. Consumers receive low-quality power, but those who pay are forced to pay tariffs above cost to cross-subsidize others. Industrial tariffs in India at US 7-10 cents are among the highest in the world—and not surprisingly an increasingly large number of industries are leaving the grid and relying on captive generation, hence further eroding SEBs' finances. Annual economic subsidies for power are around 2-3 percent of GDP. SEB arrears to

central government generation and transmission utilities amount to US\$10 billion, which is over 2 percent of GDP.

The 1990s have seen a number of reform initiatives at the level of the central government, and in some states. In the early 1990s, because of its concern with the inability of state utilities to invest in needed expansion of capacity and distribution, the power industry was one of the first that the central government opened to private and foreign investors. To increase the attractiveness of investment in the industry, the new legislation offered minimum rates of return on equity, to be guaranteed by the states and counter-guaranteed by the central government. Interest from domestic and foreign investors in generation was strong, and very soon there was a long pipeline of generation projects awaiting guarantees—a policy that wisely the central government soon discontinued (although the guarantees were maintained to those already granted in the early days of liberalization). Notwithstanding doubtful economics, the well-known Enron investment in Maharashtra (Dabhol) was seen as a success for the new opening, and precursor of a large wave of private investment in power. Potentially high rates of return could not overcome, however, the financial realities of SEBs, and the fact that there were a large number of non-paying consumers. Few projects reached financial closure, and Dabhol is now facing acute financial problems. A second impetus for reform came from the state of Orissa's experience in the mid-1990s when the power industry was unbundled, and an independent regulator established. In 2000, this model was made part of national legislation with a view to de-politicizing tariff setting. By 2001, only 9 states had already set regulators and unbundled their power industry. Notwithstanding a 1996 agreement at the highest political level—Prime Minister and Chief Ministers—to introduce a minimum agricultural tariff, few states have implemented it.

Reform has stalled because of enormous political opposition to increases in tariffs for a service that is not reliable. Tariff increases in 1999 in Andhra Pradesh were met with widespread agitation, hunger strikes, a State Legislative Assembly paralyzed for one month, and several deaths. Similarly strong opposition emerged when tariff reforms were first introduced in Haryana in 1998. The strength of the opposition comes not only from consumers reluctant to pay for unreliable supply, but also, and perhaps more importantly, from mafias that steal power from the grid for distribution to local neighborhoods or villages, and retain payments from consumers. These are the source of huge rents, and it will take considerable political commitment and persistence to overcome them. At the same time, there are some encouraging signs emerging in Karnataka, Rajasthan and AP, where regulators mindful of the importance of not passing the costs of inefficiencies on to tariffs have pushed state governments to universalize metering, reduce losses from theft, and increase operational efficiency. This progress notwithstanding, the sector remains in crisis—financially and operationally, and power shortages are a recurrent problem in India.

The power sector problems illustrate several of the macro-economic consequences of India's micro-economic distortions. The first is on the efficiency costs stemming from under-pricing, which not only leads to over-consumption of power, but also of water. Environmentalists are concerned with the subsidization of pumping that

depletes underground water reservoirs faster than they can be replenished. Efficiency costs also come from duplication of capacity because of captive generators present in virtually any factory above a certain size, and even middle-class households, as well as from the cost of interrupted production and large fluctuations in voltage. Second, a number of activities, particularly small-scale enterprises in rural areas, are thwarted for lack of access to reliable power. In manufacturing survey after manufacturing survey, availability and reliability of power supply is one of the most important factors guiding private firms industrial location decisions. Third, after the pay and size of the civil service, the power sector is possibly the single largest source of fiscal pressure on state finances. And last, the financial conditions of the sector help explain why foreign investment in the sector has been negligible compared to its potential.

Fiscal Federalism. It is important to realize that India is a Union of 29 States—the largest 15 of which would be considered sizable by the standard of nation-states (with populations between 20 million in Haryana and 160 million in UP). The Constitution gives the states considerable autonomy to define their development policies. The states are responsible for the provision and regulation of key infrastructure and social services, including primary education and health. State governments, and local governments subordinated to the states, are responsible for 60 percent of all government spending in India, and a much higher proportion (some 90 percent) in the case of public spending on health, education, and roads. State governments also have a major role in the regulation of agricultural, land and labor markets, and also in the regulation of some utilities—power and water in particular. Before reforms started in 1991, India's states could not utilize private capital for their development. National policies excluded it from important sectors and, even where permitted, central licensing authorities, not the enabling environment, determined the volume and composition of private investment. Consequently, across India, states' development policies focused on expanding public investment, often in commercial areas more suited for private sector investment. For this expansion the states relied on transfers from the central government or on resources borrowed with central government guarantees.

India's system of intergovernmental transfers has two basic resource transfer mechanisms. The *first* consists of transfers recommended by the Finance Commission. The Constitution requires the President of India to appoint such a Commission every five years to advise the Central Government on how to share the revenue from tax collections, and on the desired levels of other forms of financial assistance to the states. There have been 11 Finance Commissions so far; the most recent one completed its work in 1999. Finance Commissions command considerable respect, and their recommendations have invariably been implemented. A major objective of successive Finance Commissions has been to achieve a better match between expenditure and revenue assignments. Until the early 1990s, successive Finance Commissions recommended levels of financial assistance on the basis of states' per-capita income, and the projected gap between current revenue and current expenditure ("gap filling"). Fiscal performance or indicators of tax effort were not taken into account. This changed starting with the Ninth Finance Commission (1990-95), which based its recommendations on normative current account deficits rather than those projected by the states.

The *second* source of financial support for the states are the transfers recommended by the Planning Commission, which also commands considerable respect in India. This Commission was established soon after Independence, and is chaired by the Prime Minister. While in recent years its role has evolved from detailed central planning to providing a framework for policies and policy reform, the Planning Commission is still responsible, in consultation with the states, for formulating five-year development plans for the central and state governments and identifying corresponding financing plans. Resources for financing states' development plans come from five sources: (a) central government support for specific projects in the form of 30 percent grants and 70 percent loans (currently with an interest rate of 12 percent and a maturity of 20 years); (b) "Centrally Sponsored Schemes", development programs conceived by the central government and made available to the states with a grant element varying between 50 and 100 percent depending on the scheme; (c) "market borrowings", which designate captive sources of finance such as placement of state-issued bonds with banks as part of their SLRs, insurance companies, and pension funds mandated to invest in "designated securities"; (d) official external development assistance; and (e) 75 percent of the increase in saving deposits with the postal system in that state. Other sources of finance have been lending from HUDCO and NABARD, and other financial institutions. Another, less conventional, source has been arrears with central government utilities.

India's system of intergovernmental transfers has a number of positive features. The Constitution bars the states from borrowing abroad, and requires central government authorization for domestic borrowings. This has established an element of conservatism that has helped maintain India's overall prudent macro-economic policies. The current system also provides a rule-based transparent framework and hence predictability.

However, the system has discouraged fiscal discipline by the states in several ways. *First*, starting in the early 1970s and until the early 1990s, the Finance and Planning Commissions recommended gradually but persistently increasing levels of transfers to the states—from 3 percent of GDP in 1970-71, to over 8 percent in the mid-1980s. In addition, "market borrowings" provided an additional and increasing source of financing of state deficits. These developments built expectations that the states need not be overly concerned with mobilizing resources since ever-expanding and politically more expedient financing would be forthcoming. As a result, throughout the 1970s and 1980s, the states expanded investments in physical infrastructure (power, roads, irrigation, ports, roads) and provision of social services, without establishing mechanisms for cost recovery or maintenance of these assets. Under-pricing for the services provided by these assets is at the origin of subsidies of about 7 percent of GDP for non-social services. *Second*, until the mid-1990s, successive Finance Commissions based their recommendations for financial support on projected rather than normative current account deficits, thus penalizing states' savings and resource mobilization. *Third*, all borrowings being on the same terms (despite being called "market borrowings") eliminates a potentially powerful discipline for good fiscal performance. *Last but not least*, through lending the central government plays the role of a commercial bank without the prudential safeguards—credit risk evaluation, project implementation

monitoring—that typically accompany project lending. India is possibly the only country in the world in which the central government plays the role of a development bank. Numerous analyses in India have shown that there is ample diversion of resources—with capital formation generally well below what is expected *ex ante*, and hence central government resources for investment often ending up in government consumption.

By the second half of the 1980s, it became evident that the states were experiencing considerable fiscal difficulties. They had created infrastructure and expanded social services without establishing adequate mechanisms or prices to recover costs, finance maintenance, and ensure needed expansion. They had expanded employment; contracted debt; and launched programs they could not sustain in the long run. Fiscal stress became evident in the 1980s, when wages, interest payments, and pension obligations started to absorb an increasing proportion of state revenue, often in excess of two-thirds. The situation worsened in the late 1990s following a large pay increase decided by the central government, which state governments followed. Net of interest payments to the central government, central government transfers to the states have now declined to 3 percent of GDP in the last three years, from about 7 percent in the mid 1980s. As a result, virtually all Indian states are now faced with three crises—fiscal, infrastructure, and social. In most states resources for education and health have been declining rather than increasing, and the maintenance of infrastructure is well below norms, often resulting in serious disrepair. The worsening fiscal situation (Table 4) has helped create a consensus for reform in some states, notably AP, Karnataka, and Rajasthan, but the situation is likely to take the best part of a decade to resolve, even if measures are begun expeditiously.

The McKinsey Report. Two years ago, McKinsey's Global Institute undertook a country study to determine why India's performance had been weaker than is widely believed to be possible (<http://www.mckinsey.com/knowledge/mgi/India/index.asp>). Based on a detailed 18-month review of firms in 13 sectors (two in agriculture, five in manufacturing and six in services, which together account for 26 percent of India's GDP), the study brought a fresh perspective on the constraints on India's growth. It did not refer to fiscal deficits, and their impact on stability or the cost of capital. Nor did it see transportation and other forms of infrastructure as the major constraint to increased productivity and expansion of Indian firms. It also concluded that labor laws and the restrictions they impose on contraction of the labor force are of secondary importance. The study identified three other barriers as the primary impediments to India growing at rates in excess of 10 percent per year. These are: (a) over-regulation of product markets within the country; (b) distortions in the real-estate market; and (c) widespread government ownership of businesses. Examples of over-regulation were the small-scale industry reservation of 830 products (already reduced to less than 300) and numerous impediments to agricultural marketing and processing (also significantly reduced after the study). Examples of distortions in the real-estate market are inflexible zoning, rent and tenancy laws that freeze land-use in city centers and thus preclude real estate development. The study rightly highlights that this artificial regulation-made scarcity means less competition among housing developers and retailers, which has helped make Indian land prices the highest among all Asian nations relative to average incomes, and has kept housing's

share in GDP well below what is normal in countries at India's level of development. As examples of how government ownership can promote inefficiency, the study examines the case of SEBs. While some of the conclusions of the McKinsey study can be questioned, they provide a useful perspective on constraints as seen and experienced by the private sector.

While the 1990s brought progress in improving allocational efficiency by dismantling restrictions on the free functioning of markets and private entrepreneurship, there was limited progress in reducing the size of government, improving the efficiency with which it uses resources, and strengthening its enabling role. Policy needs to complete the task of dismantling remaining restrictions, and increasing the efficiency and strengthening the enabling role of government. Each one of these objectives has its own reform agenda.

Regarding the dismantling of remaining restrictions to entrepreneurship and productivity, the most gross and obvious distortions have gone, but subtle and less obvious ones are still important. For example, one of the reasons why restrictions on the rational use of land persist, as highlighted in the McKinsey report, is unclear separation of responsibilities between state and local governments. Even in large urban metropolitan regions, state government agencies rather than elected municipal governments are responsible for regulating land use. Decentralization in India has generally meant political decentralization, unaccompanied by corresponding fiscal and administrative responsibilities, and as a result elected local governments have little to be accountable for. Remedying and restoring appropriate incentives and aligning responsibilities will take more than a few changes in legislation—above all it requires good diagnostics and clear analysis first.

Reducing the role of government is a less subtle but politically much more complex task. Our review of the power sector illustrates the difficulty of privatization ahead of fundamental governance reform enabling full recognition of property rights; power sector reform is a police as much as a policy matter. Even recognizing that privatization is not always an issue of policy implementation, there are a number of areas where privatization is technically straightforward. This is true of all public enterprises producing contestable goods, while public sector banks and public financial institutions are other priority areas for privatization, since the necessary regulatory mechanisms already exist (Virmani 2002). It is not a matter that public enterprise cannot be efficient—there are examples in India itself of competently and efficiently run public concerns. But the incentives for performance are inherently weaker than they are with private ownership, as demonstrated by events from the implosion of socialism in the former Communist bloc to the history of India's power sector. Reliance on the honesty and integrity of civil servants and the commitment of politicians not to succumb to short-term gains is sensible only in special situations, where individuals can be expected to sacrifice for a clearly perceived and pressing common good. While difficult to quantify, the gains from transferring to the private sector assets now being run commercially by the public sector are (according to the McKinsey Report) simply enormous. While the bulk of public-sector assets are owned by the central government, state governments are also

important. For example, state governments own and operate bus companies employing close to one million employees, which are widely known to be much less efficient than their private counterparts. One must therefore hope that the momentum for privatization will continue to build.

Strengthening the enabling role of government at all levels—central, state, and local—and increasing the efficiency with which public resources are used is another complex agenda that will take time to implement but that potentially offers enormous productivity gains. There is not enough time or space to develop this agenda here, but it has been widely discussed in India. The Bangalore Public Affairs Center (web site address: www:/pacIndia.org) has recently conducted a survey on the delivery of public services in India, mostly provided by state and local governments. It shows that governments are providing very inefficiently the most basic public services like education, health, availability of water and sanitation, title registration, and security. The survey provides ample evidence of a lack of responsiveness of government agencies in the inevitable encounters between citizens and the public administration—from waiting times for delivery of essential services, to shortfalls in quality (stemming especially from a pervasive lack of teachers and health personnel in attendance at schools and health centers in rural areas). And the McKinsey study highlights the consequences of these shortcomings in shaping the business environment and firms' investment decisions. While generalizations are dangerous, and even recognizing that there are large differences between Kerala and Bihar, or between Delhi and Calcutta, in general the Indian public is not getting appropriate returns for the taxes it pays.

Redressing this situation requires a complex reform agenda that has yet to be articulated, to align incentives and accountabilities with performance. We sketch below some of the elements that may be expected to figure on such an agenda. The central government and a few states have recently passed Freedom of Information legislation, and this is already inducing more responsibility in civil servants. The 2000 Public Expenditure Commission has produced a large body of recommendations on how the central government could reduce the level and increase the efficiency of its expenditure. While its recommendations are being implemented very gradually, they provide a blueprint of a possible program of reforms for both the central and state governments—from contraction of the civil service, to rationalization of public expenditure programs. In terms of oversight functions, at the level of the central government, there are a number of areas that need strengthening—from stronger emphasis on the quality of corporate governance and bank supervision, to modernizing labor laws and legal and judicial services. The reform of the central-state system of transfers also requires re-examination. In particular, states need to face the discipline of financial markets in their spending and financing decisions—not an invariably accommodating stance of the central government. The central government's unusually large role in lending to the states needs to be shifted to proper financial intermediaries. Virmani (2002) develops several other ideas, including subsidiarity, transparency, and accountability.

Outcomes

As shown in Table 1, the result of the decade of reform has not been any dramatic acceleration in the growth rate. Growth was indeed exceptionally high for several years in the middle of the decade, roughly from 1993 to 1997, but over the decade as a whole it was only slightly higher in aggregate terms (though with somewhat lower population growth the increase was a little more in per capita terms) than in the 1980s. Perhaps the results are slightly better than this comparison would suggest, for three reasons:

- The growth of the 1980s was clearly unsustainable, as was shown by the macroeconomic crisis of 1991.
- The statistics of the 1990s include the low growth of the crisis year 1991, which weighs down the growth rate of the decade.
- Growth in other parts of Asia was much weaker in the 1990s than in the 1980s, so performance improved in relation to India's most obvious comparators (other than China).

Nevertheless, the sustained growth slowdown after 1997 has disappointed those who thought that the reforms had shifted India to a higher long-run growth path. Rather surprisingly, the public sector contribution to growth has barely declined (Table 2), presumably reflecting not just the slow pace of privatization but also the public sector wage increases resulting from the Pay Commission award (Acharya 2001). But other indicators suggest that the policy changes of the 1990s have transformed the economy in a positive direction. For example, Table 5 shows that over the decade the share of trade in GDP has increased by a significant 12 percentage points (or 14 percentage points of GDP if workers' remittances are included), bringing it to 30 percent (32 percent with workers' remittances). Foreign investment increased from a negligible 0.1 percent of GDP to a still low but no longer derisory 1 percent of GDP. In response to stronger competitive pressures which eroded firms' ability to pass on to workers rents established in less competitive markets, and notwithstanding absence of labor law reform, the nature of industrial relations has changed as well. Table 6 indicates that the new more competitive environment, and greater openness to international trade, has not been translated into an increase in industrial disputes in the formal labor market. On the contrary, the number of industrial disputes has in fact declined during the 1990s to reach a four-decade low in recent years; the decline in workers' initiated disputes has been particularly rapid, whereas the decline in employer initiated disputes is less pronounced.

As expected, the growth of the 1990s has had a positive effect on the incidence of poverty (Figure 3). This was the subject of some debate last year when the new official poverty estimates for 1999-2000 were released in February 2001. In contrast to surveys earlier in the 1990s, the new estimates indicated a rapid decline in poverty—from 37 percent of the rural population in 1993-94 to only 27 percent in 1999-2000 and from 32 to 24 percent of the urban population. However, changes in the design of the survey (related to the recall period) raised questions on the comparability of the figures. There was soon a heated controversy, with anti-reformers claiming that a decade of reforms had had no impact on poverty and reformers claiming that the questioning of the

methodology reflected vested interests from development agencies in maintaining analytic work and dialogue on poverty measurement and monitoring. Work by Angus Deaton (2001) suggests that the reduction in the incidence of poverty has been substantial, albeit at a somewhat lower rate than indicated by the official statistics. However, the work of several Indian economists suggests that the decline may have been even more rapid than the official figures suggest. The debate is likely to continue, but with a presumption that the issue will be how much, rather than whether, poverty is declining.

Contrary to most reform experiences in the world, India was able to introduce major policy changes without large fluctuations in income or consumption, and in fact maintained almost continuous improvements in living standards throughout the decade. As Figure 3 suggests, the decline in poverty has been as rapid in low-income as in high-income states, despite the fact that income differentials between high, middle, and low-income states have widened over the decade (Figure 4). Inflation has declined to its lowest level in decades, and the real exchange rate has been reasonably stable (Figure 5). Social indicators like illiteracy and infant mortality have continued to improve.

Did India's Gradualism Make Sense?

On the whole, India should be regarded as a successful reformer. But it was also a determinedly gradualist one (Montek Ahluwalia's recent paper on Indian reform is entitled "Economic Reform in India: A Decade of Gradualism"), as indeed our own title emphasizes. We conclude by examining whether it can reasonably be claimed that India was wise to have embraced such a gradualist strategy.

The sequencing of reforms was unusually coherent in India. The liberalization of product markets (through the dismantling of the licensing that regulated investment and trade) preceded the liberalization of factor markets, which is still incomplete. A sharp devaluation (in July 1991) preceded the lifting of quantitative restrictions on imports of intermediates and capital goods, which in turn preceded reduction in tariffs. In reforming the banking system, prudential regulation and banking supervision were strengthened ahead of recapitalization, to reduce the likelihood of recurrent needs for further recapitalization later on. The deregulation of interest rates was introduced in steps, which avoided the problems that sudden financial decompression created in some Latin American countries. The capital account has been only marginally liberalized. All this is pretty much in accord with such conventional wisdom as exists.

The speed of reform raises more difficult questions. Some of the first authors to argue in favor of abandoning the dirigiste framework of early development economics, notably Little, Scitovsky, and Scott (1970) and McKinnon (1973), argued explicitly in favor of a gradualist reform strategy (in respect to trade and the financial sector respectively). This was reinforced by the fiasco of the collapse of the Southern Cone stabilization programs of the late 1970s, in which strong appreciations of the currency combined with rapid reduction in tariffs to create an adverse shock to industry, which ultimately derailed the programs. Most analysts soon blamed the collapse on excessive speed leading to faulty sequencing of the reform program: premature capital account

liberalization, without waiting until fiscal probity had been established and both trade and the domestic financial system had been successfully liberalized.⁴

But in the course of the 1980s the economics profession began to be infected by the enthusiasm of certain leading politicians of the day for “the magic of the market”, and arguments in favor of “big bangs” and “shock treatment” became prominent (starting with Mussa 1982). It became increasingly clear that a gradual approach to stopping hyperinflation made no sense. Perhaps the most high-profile conversion was that of Jeffrey Sachs, who argued the need to stabilize before liberalizing in Bolivia, but then became the apostle who took the gospel of the big bang to Poland after seeing the opponents of the party he had been advising in Bolivia implement a comprehensive program of both stabilization and adjustment in 1985. By the time that the transition to a market economy got under way in the former socialist economies, a belief in gradualism had almost become tantamount to a confession of a lack of reforming virility. For a while the evidence seemed to suggest that the more rapid reformers had returned to growth more quickly (see, for example, Aslund, Boone, and Johnson 1996), but the comparisons have begun to look less favorable to shock treatment as the comparators have been extended beyond Eastern Europe and the former Soviet Union to include China and Vietnam. The addition of India to the list of comparators would seem at first blush to reinforce the case for gradualism. Should we all become gradualists now?

Perhaps one reason that the literature on this topic has remained inconclusive is that many different issues have been rolled up together, as though the optimality of gradualism or shock treatment in one context implies that it must also be preferable in all others. The initial pro-gradualism arguments were in favor of gradual approaches to certain specific problems: to gradual trade liberalization, and to delaying liberalization of the capital account until certain specific preconditions had been fulfilled. These should surely be treated as discrete issues, as should the big issue of designing a strategy to transition from a planned to a market economy, the question of how to stabilize, and the discrete issue of how rapidly to privatize. We proceed to discuss each of these five issues in turn, including whether Indian policy appears to have been expedient given what the theory says, and whether Indian experience throws any light on the state of the debate.

Trade Liberalization. The most influential early work favoring shock treatment was that of Mussa (1982) in the context of trade liberalization. Mussa “made the important point that the costliness of adjustment to major structural reforms does not necessarily imply that the adjustment of *policy* should be gradual. He showed that, in a world of frictionless markets and rational expectations, and in which all costs of adjustment are internalized by the private sector, it is optimal for the government immediately to adjust the previously distorted policy instrument to its first-best level, while allowing the private economy to adjust gradually in response to the incentives generated by the reform.” (Gavin 1996) In other words, under the ideal conditions favored by economic model-builders, the private sector will determine optimally whether the frictions and delays inherent in reallocating

⁴ See McKinnon (1982) and Ardito Barletta, Blejer, and Landau (1983) for early discussions on sequencing, and Edwards (1984), Krueger (1984), and McKinnon (1991) for more considered treatments of the issues.

resources will lead to gradual or rapid resource reallocation. The mere fact that resources cannot be reallocated instantaneously does *not* constitute an argument for gradual reform.

Michael Gavin (1996) constructed what is perhaps the most telling critique of Mussa's analysis, by building an explicit model with a simple structure but persuasive properties where it can be shown rigorously that gradual withdrawal of a subsidy that is unambiguously welfare-reducing is preferable to its precipitate abolition. The model posits that unemployed workers search for new jobs in one of two industries, and that the rate at which they exit unemployment is a positive but decreasing function of the number searching for new jobs in the industry (rate of new hires = $f(U)$, with $f' > 0$ but $f'' < 0$). This implies an externality: workers are excessively ready to quit their existing jobs and search for new ones, because they do not take into account the impact that their addition to the pool of unemployed will have in increasing the time spent unemployed by other workers. The "first-best" way of remedying this would be to tax the unemployed so as to make them less ready to quit their jobs and search for better ones, but this would have undesirable distributional consequences since the unemployed are unambiguously the poorest section of the population in his model. An alternative is to withdraw the subsidy gradually.

At the level of high theory, therefore, there is no presumption that shock treatment is optimal. Most applied economists have long felt that Chile ordered things well in its stage-by-stage post-1974 liberalization. As summarized by McKinnon (1991, pp. 177-78), this involved the following sequence:

1. Unify the exchange rate so that all exporters and importers transact at the same rate.
2. Convert all quota restrictions into rough tariff equivalents.
3. Establish current account convertibility.
4. Reduce the highest tariffs, in pre-announced small steps, to converge over time to a modest uniform import tariff.

The step that India did somewhat out of this sequence was to delay the elimination of quantitative restrictions. While quantity restrictions on imports of intermediate and capital goods were eliminated right at the beginning of reforms, they remained on consumer goods. Their elimination in phases started in 1998, and was concluded in 2001, and that soon only because of foreign pressure exerted through the WTO. The fact that India remains the most highly protected emerging market (Table 7) suggests that trade liberalization was too gradual in practice.

Capital Account Convertibility. The literature on the sequencing of capital account liberalization (see note 4 above and also Williamson 1991a) has argued that it is mistaken to open the capital account until several conditions have been satisfied:

- Non-traditional export industries are well-established, so that any induced appreciation of the real exchange rate will not be too damaging to export performance.

- Fiscal discipline has been established, so that the government's fiscal needs will not push up interest rates and attract a capital inflow without building assets to service the debt.
- Trade has been liberalized, so that the capital that flows in will not be invested in the wrong industries, where growth might be immiserizing.
- The financial system has been liberalized and is solvent, so that imported funds will not build up vulnerability to a financial crisis.

Williamson (1991a) pointed out that these are essentially conditions needed to support the liberalization of capital *inflows*. He argued that liberalization of outflows needs other preconditions, notably a policy regime that investors regard as permanent (so that the country will be able to borrow even in the face of adverse circumstances), the ability to manage demand by a measure of fiscal flexibility, and arrangements to limit erosion of the tax base.

The preconditions for capital account convertibility identified by the Tarapore Committee covered three of the four conditions for liberalizing capital inflows that are listed above, and it can be argued that the missing one, the presence of non-traditional export industries, is already more or less satisfied in the Indian case. Thus it might have made sense to liberalize capital inflows on the Tarapore timetable had the preconditions been satisfied. However, the Tarapore Committee recommended something much more radical than liberalization of capital inflows, namely full capital account convertibility, meaning the liberalization of capital outflows as well as inflows. None of the preconditions for that were either identified or satisfied. Hence India was fortunate that the Asian crisis happened before it could expose itself to the vulnerabilities that would surely have made it a candidate for contagion. The subject is now on the back burner, where it should remain for the moment.

Transition. The most exciting debate on gradualism versus big bangs has occurred in the context of countries making the historic change from a socialist economy to a market economy. The major argument made there in favor of a big bang is that a number of the critical reforms needed to establish a market economy are interdependent:

The transition process is a seamless web. Structural reforms cannot work without a working price system; a working price system cannot be put in place without ending excess demand and creating a convertible currency; and a credit squeeze and tight macroeconomic policy cannot be sustained unless prices are realistic, so that there is a rational basis for deciding which firms should be allowed to close. (Lipton and Sachs, 1990, p.99.)

In that spirit, one of the authors of the present paper once tried to spell out the set of reforms to a non-market economy that needed to be undertaken simultaneously if the reform program was not to be sabotaged by the second best⁵ (Williamson 1991b). Of the

⁵ Anecdotes abounded of the wasteful activities that were undertaken by decentralized, profit-maximizing enterprises faced with arbitrary prices, like exporting semi-tropical flowers from Poland or feeding bread to

25 reforms identified to construct a fully functioning market economy, it was argued that 8 were preconditions for liberalization; another 8 ought to be undertaken simultaneously as a package (“the minimum critical bang”); 5 should be delayed until after the bang; and the remaining 4 were not critically dependent upon their timing.⁶ Many of the preconditions, as well as some of the reforms that were envisaged as coming after liberalization and also some of those where the timing is flexible, involve difficult investments in institution-building. The need to build institutions (or to undertake second-generation reforms, in the language used in Latin America) is perhaps the most basic of the reasons as to why it is unrealistic to think of all reforms being undertaken in one big bang.

India already had the institutions of a functioning market economy in 1991, when its liberalization began. It therefore had no need for packaging measures like allowing enterprises to decide what to produce rather than obeying the planners, imposing hard budget constraints, allowing enterprises to spend their own money balances, and eliminating the monetary overhang. Nor was there any role for a dual-price system. The nearest that it came to such measures was to abolish the system of industrial licensing that had previously required firms to seek planning permission to undertake investment, and that was indeed abolished overnight, as the analysis suggests it should have been.

On the other hand, two of the preconditions for moving to a market economy that were identified by that paper were not present in India in 1991, and indeed are still absent today. One is fiscal discipline, the other is the right of enterprises to fire workers when the need arises. The absence of both was, and remains, costly.

A quite different type of argument in favor of rapid reform asserts a political need to act rapidly when circumstances permit before opposition can emerge and consolidate. Others, however, assert the advantages of careful planning and consultation in the context of a complex system where it is difficult to foresee all the consequences. They point to the benefits of being able to limit mistakes and take account of unanticipated reactions while limiting the costs. They claim that this gives a chance to build support for bigger initiatives by showing benefits from the initial steps.

India made extensive resort to expert advice, and made a practice of exposing this advice to different constituencies. Numerous high level expert committees were appointed by successive governments during the last ten years to examine virtually every dimension of the policy framework and to offer recommendations— on taxation, the financial sector, banking, tariffs, opening of the capital account, labor market regulations, corporate governance, privatization, and oil pricing. The Government has generally accepted the recommendations of these committees, which became part of policy papers

pigs. For all their failings, no central planner would have ordered such wasteful activities. These are classic illustrations of the way in which a single reform can reduce welfare, as the second-best theory postulated.

⁶ A particularly interesting analytical question is whether a dual-price system such as that used in China (in which each state enterprise has to deliver a basic quota of its output to other state enterprises at controlled prices while being free to sell the excess on the market at uncontrolled prices) can materially reduce the size of the minimum bang.

and other official documents, and were amply discussed among political, academic, policy and business circles. This approach helped clarify the government's policy goals, built consensus around economic reforms, enabled the government to anticipate reactions to reforms, helped calibrate the pace at which to introduce reforms, and may explain why there have been virtually no reversals in India's reform process--reversals that in other countries have been frequent, and have sometimes derailed entire reform programs. (For example, in Argentina the trade liberalization of the late 1970s was reversed after 1982, and in Brazil one of the reactions to the oil shocks of the 1970s was to raise import barriers and start a new cycle of import substitution focused on substitution of capital goods. It remains to be seen how the present crisis in Argentina will end, but the progress made in liberalization during the 1990s appears to be in jeopardy.)

Stabilization. The literature argues that gradual disinflation is the appropriate treatment for gradual inflation but that shock treatment (such as the use of a fixed exchange rate as a nominal anchor) is better suited for dealing with very rapid inflation, when the mechanisms that give rise to inflation inertia have broken down. When the whole economic system is in jeopardy, economic policy needs to overshoot to regain market confidence.

Since India never allowed its inflation to get out of hand, it was not a candidate for that type of program. Where a somewhat similar issue arose was in dealing with the balance of payments crisis of 1991. Many countries have suffered prolonged recessions when they were faced by a need to secure balance of payments adjustment. In contrast, India suffered one year of recession, in 1991-92, before bouncing back to near its previous trend growth rate (5.3 percent in 1992-93) and then accelerating to over 7 percent in the mid-1990s. This impressive outcome would seem to be attributable to the combination of microeconomic liberalization that raised the underlying growth rate and an eminently sensible macroeconomic policy stance that allowed increased productive potential to be brought into use. The sharp devaluation of 1991 had expansionary expenditure-switching effects that rather quickly came to outweigh the contractionary effects of the fiscal tightening and (given that the economy is fairly closed and had almost no private sector foreign-currency denominated debt) the minimal expenditure-reducing effect of the devaluation. When India chose to allow the rupee to float in 1993, it continued to manage its exchange rate with a view to maintaining competitiveness (Figure 5). Thus it chose to accumulate reserves, it adopted a fiscal-monetary mix biased (at least initially) toward fiscal discipline and monetary ease, and it maintained controls on capital inflows. The results were good for both growth and the balance of payments.

Privatization. The main argument in favor of privatizing rapidly in the economies in transition was that so many enterprises needed to be privatized that a gradual approach would last forever. It turned out that doing it rapidly meant using vouchers, or allowing insider privatization, neither of which led to the robust corporate governance and resulting efficiency improvements that were envisaged as the main benefits from privatization. Hence India can take comfort in the fact that it does not have so many state enterprises as to rule out the careful process of selling these off one by one that enables

the state to get a fair price for its assets and be reasonably sure that they are going to owners who will manage them effectively.

The fact is, however, that Indian privatization has gone much more slowly than those considerations could have rationalized. Indeed, for a long time the word privatization was taboo. The PC term was disinvestment, meaning the sale of minority shareholdings, which is a formula that has minimal impact on corporate governance or efficiency, and that virtually guarantees that the state will not get a good price for its assets. There is a school of thought that argues that the state should retain a substantial minority shareholding for several years after sale of a controlling interest to a strategic investor in order to maximize its financial return, but it seems awfully difficult to rationalize a policy of selling minority shareholdings and retaining state control. This is a field in which reform has surely been too half-hearted and slow.

Concluding Remarks

The discussion above suggests that gradualism has yielded two enormous benefits to India. First, the avoidance of premature liberalization of the capital account prevented India being exposed to contagion in the Asian crisis. Second, the Hindu rate of reform has allowed time for the magnificent but somewhat cumbersome Indian democratic polity to buy into the reform program.

If faster reform could have been achieved only by jeopardizing those benefits, then gradualism must surely be judged in a highly positive light. But we have argued that this sort of all-or-nothing attitude to reform, or the speed of reform, is misguided. India could (and can) move faster to put its fiscal house in order, to rid itself of remaining small industry reservations, to liberalize the labor market, to fix the power sector, and to privatize its state-owned industries, without allowing capital account convertibility or thwarting democratic debate. Its failure to move faster in these areas slows growth and unnecessarily perpetuates poverty.

Will reforms continue in the future? Since serious reform started in 1991, a cycle of three elections has been completed at both the center and state levels. In the process, virtually every party has had a chance to be in the central government, but all the governments have pursued basically the same economic agenda, regardless of political orientation. All have experienced similar pressures stemming from fiscal distress, and been subject to the influence of lobbies with a wider perspective (such as industry, foreign investors, senior bureaucracy, and think tanks). The commitment of the state governments to reform has been more varied—strong in Andhra Pradesh, Rajasthan and Karnataka, but more tentative in Maharashtra and Uttar Pradesh. Even in Punjab, known for its populist policies, the new Chief Minister has been highlighting the need for reform and a reduction of subsidies.

Political forces seem to create incentives for governments in power to embrace reforms. They respond pragmatically to difficult fiscal situations, they feel a compulsion to be responsive to pressures wider than those from their own party (reinforced in recent

years by the fact that no single party has obtained an absolute majority, all governments have been coalitions), and they see benefits in producing concrete results. Parties in opposition tend to oppose the very same reforms they had supported while in government. For example, legislation to reform the insurance industry was introduced in Parliament in 1994 by a Congress Government, but was passed only in 1999 by a BJP government, with Congress opposition. Privatization was supported by the Congress Government in the first half of the 1990s, but Congress opposed it when the BJP government started implementing it in the last few years. One explanation as to why parties in opposition are anti-reformist is that they do not expect to benefit from successful reforms whether or not they support them, while they can expect to pick up support from the losers, whether or not the reforms prove to be in the general social interest, so long as they oppose reform.. A fixed economic ideology has no political pay-off where, as in India, each political party's main purpose is to secure a share of power for its supporting group: those of a particular caste, class, or region.

With these political dynamics, the implementation of reforms is bound to remain vulnerable to the varied pressures of India's complex political life. A good example is the February 2001 Budget, which announced path-breaking reforms—from legislation to reduce government equity holding in public banks to 35 percent and reform labor legislation, to a proposed fiscal responsibility act, and acceleration of privatization. Shortly after the Budget was presented, a corruption scandal broke, after journalists caught top civil servants accepting bribes for defense deals. This provided the opportunity to the opposition to stall Parliament for several weeks, demanding the resignation of the Prime Minister. The budget could not even be debated, and there was no question of approving legislation introducing the reforms. A scam on the Mumbai stock market occurred at the same time, further detracting from the Government's ability to push any reform. The situation continued in May when elections were held in four major states, all of which were lost by the coalition in power. Following this, the UTI scandal broke—the country's premier government-run mutual fund was found to have been mismanaged. To make matters worse, the privatization of Indian Airlines and Air India became a fiasco, when foreign investors withdrew expressing doubts about the government's commitment to privatize. Following this, the failed July summit with Pakistan's President, the events of September 11 and their aftermath, the attack on the Indian Parliament of December 13, the subsequent stand-off with Pakistan, and new state elections in some key states, all resulted in reforms being put on hold. Only in the weeks preceding the new Budget did the Government attempt to give new life to the reform agenda, with pre-Budget agricultural liberalization and privatization.

So political dynamics suggest that reforms in India will proceed, with lots of stops and starts, with strong ownership by the parties in power, but political maneuvering by parties in the opposition. Let us hope that it will continue to be successful, even if it proceeds at no more than a Hindu rate.

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