

Model That Couldn't

The Telegraph, Calcutta, June 23, 1997

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During the past 30 years, India's performance in raising living standards has lagged behind most of east Asia. This is in terms of economic growth per capita as well as various measures of development, such as improvements in life expectancy, literacy and infant mortality. China and Indonesia, both populous and agrarian like India, have also outpaced India.

It is now widely understood India's poor performance is related primarily to the choice of economic strategy followed since independence. The Nehruvian socialist strategy of state led industrialization-based on high protectionism, planning and detailed domestic regulation of the economy-did not succeed. It not only failed to deliver the goods in purely economic terms, it contributed to the spread of corruption in politics and administration.

At the end of the Forties, India initiated the trend among newly independent nations of choosing the state led economic strategy. This model became the favourite of post-colonial countries, even among the long independent Latin American states. Variants were adopted by Indonesia's Suharto, Tanzania's Julius Nyrere and Argentina's Juan Peron. Most of these countries identified their policies as socialist, and often identified them as a "third way" between capitalism and communism. A couple of dozen countries followed the Soviet Union's stricter Marxist-Leninist model.

The choice of state led industrialization in India and the developing world is understandable given the choices facing their leaders at the end of World War II. At the core, this policy was a defensive reaction against the capitalist first world's governments and multinationals. The former colonies had experienced years of depredation at the hands of imperial powers. Often the *de jure* colonial power was not even a government but a firm. In India's case the original colonial power was the East India Company. The notion of foreign multinationals as helpful or benign forces for development was considered ludicrous.

Extensive engagement in foreign trade also seemed dubious. Not only did it appear to mean subservience to former colonial masters, trade itself had collapsed between 1914 and 1945, crushed by two world wars and a depression. By 1949, when India was first choosing the state led model, only a handful of countries had convertible currencies. Global trade was bilateral and represented a tiny percentage of national income. There was widespread skepticism that multilateral trade would be reestablished as a vibrant force in the world economy.

Neither foreign capital nor free trade seemed sensible paths to national economic development for fragile states in what seemed to be a hostile world.

At the same time, economic theory and the alleged lessons of Soviet industrialization seemed to point to a model of rapid development based on state ownership and extensive trade barriers. Even, John Maynard Keynes concluded at one point that capitalism was inherently unstable and needed the strong hand of government to preserve full employment. Other economists also felt some

planning was needed to avoid fluctuations in unemployment and take advantage of economies of scale in industry. Simplistic development planning models seemed to offer a scientific base for state leadership in the economy. Soviet successes now known to have been exaggerated and achieved with horrific loss of life-seemed to say that planning worked.

Only a few developing countries chose an open market system instead of state led industrialization or Marxism-Leninism. A study shows that fewer than 20 developing countries were always open to international trade in the postwar period or from the time of their independence.

India, of course was far from open: its import tariffs were well above 40 per cent and import licensing covered nearly all its overseas trade until the Nineties. In east Asia, Malaysia, Singapore and Thailand were among the few that maintained open trade. Indonesia, South Korea and Taiwan pursued state led policies in the Fifties. They opened up by the Sixties following severe economic failures in the form of inflation. There were also pressures and inducements from the United States. If there is one overriding reason why these six countries chose market oriented strategies, it would be national security. They looked to the US for defence and the US nudged many of them becoming more open to trade.

The choice of state led industrialization in India and elsewhere might be understandable, but the results were very poor. Closed, state led economies fared very badly in the past 40 years, lagging far behind open, market based economies.

The results were worse than just low average growth rates. Almost every country that pursued the state led model ended up with a severe macroeconomic crisis in the Eighties or Nineties. Typically, governments pursuing the state led model looked to foreign borrowing as the way to speedy growth, or to forestall recessions. These governments borrowed heavily in the Seventies and Eighties, and ended up with a fiscal crisis by the end of the Eighties. Of the 17 developing countries that had an open economy in the Seventies only Jordan succumbed to a macroeconomic crisis. Of the 73 developing countries that were closed, a remarkable 59 experienced an extreme macroeconomic crisis in the Eighties. Several more succumbed in the next decade.

India avoided an extreme crisis, But just barely. Like other state led economies, India borrowed heavily from abroad, a lot in the late Eighties. Most of these loans were from commercial banks. A large part was non-resident Indian deposits: short term capital at high interest. One person wrote, "Rajiv [Gandhi's] was a policy of accelerating growth by borrowing, but without any drastic restructuring of the economy."

In 1990 and 1991, increased political risk, overly expansionary macroeconomic policies, and a drop in overseas remittances following the Kuwait war, led to outflows of short term capital, putting extreme pressure on India's foreign exchange reserves. By mid-1991 India's reserves could cover only two weeks of import. This near miss with a serious balance of payments crisis was the proximate cause of India's reforms in 1991.

It is interesting that almost all countries which embarked on state led industrialization in the Fifties and Sixties stuck with this model until hit by crisis. One might have expected many would

undertake economic reforms in time to avoid a severe crisis. But this rarely happened. India at least acted swiftly. Nipped in the bud, its 1991 macroeconomic crisis was rather modest.

The lesson: while state led industrialization began in most countries on the basis of economic and political ideology it was sustained on the basis of powerful vested interests that fought within the political system for the preservation of state benefits and protection. The policies nurtured entire sectors of inefficient import competing enterprises and trade unions whose survival depended on the continuation of state support and protection. In India both enterprises and unions became key campaign financiers of political parties. No party dared speak too radically about trade liberalization, privatization or downsizing lest the party find itself without campaign funds.

Even though a strong majority of interests might benefit from liberalization, such potential winners tend to be politically disorganized and often unaware of the potential gains from liberalization, and therefore incapable of mobilizing an effective political opposition. The incumbents use their incumbency including control over state revenues to ward off challenges from any potential opposition. Generally, only when the budget is in extreme crisis are the advantages of incumbency reduced sufficiently to allow a challenge to the prevailing state led system.

Since 1991 India has partially dismantled the state led system. Selective progress has been made, mainly in ending the licensing of trade and domestic investment. Yet reforms have remained limited. They have gone far enough to lift India's medium term growth rate to five or six per cent per year, but not to achieve the rates of eight to 10 per cent per year that India's neighbours in east Asia have been achieving.