No Reform in a Hurry

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India’s economic policy reforms began in 1991. India’s reform programme is similar in many ways to the reforms undertaken in other developing countries, but implemented at a much more gradual pace than elsewhere. This gradualism, which is usually explained in terms of the compulsions of India’s democratic polity, has been criticized for producing a frustratingly slow pace of change.

While the reforms at the Central government level have been implemented in numerous sectors of the Indian economy, only a handful of India’s states have embarked on a significant reform path. Andhra Pradesh, Gujarat, Karnataka, Maharashtra, and Tamil Nadu are more reform-oriented, while states such as Haryana, Kerala, Orissa, Madhya Pradesh, Punjab, Rajasthan and West Bengal have lagged in carrying out state-level reforms. Bihar and Uttar Pradesh are even further behind. States that move against the populist policies and set up regular markets for services, such as power and water, are going to be ahead of the rest in the game. They are likely to garner faster state-level economic growth and job creation, from both domestic and foreign investments.

Currently there are rather significant differences in reform interest and economic performance between a large part of northern India and southern India. Karnataka, Tamil Nadu and Andhra Pradesh are quite dynamic now in trying to improve the physical and legal infrastructure, in order to attract large-scale foreign investment. In Bihar or UP one does not see the same kind of reform dynamism and the results are therefore poor in terms of economic growth. These differences will be noticed politically sooner rather than later, as inequalities between states in their economic performance become glaring. The states that are ahead will be rewarded with better performance while the states that are behind will find that there is the demand to catch up. This kind of interstate competition will spur the overall reform process, as has the inter-regional competition in China.

A slow moving reform process in the Indian states, lack of decentralization in terms of economic policymaking at the state level, stringent labour laws, product reservation for smallscale industry and poor infrastructure in terms of power, ports, roads and telecommunications are some of the crucial reasons why India is unable to attract large sums of foreign direct investment. FDI is seen as an important source of non-debt inflows, and is increasingly being sought as a vehicle for technology flows, and as a means of building inter-firm linkages in a world in which multinational corporations are primarily operating on the basis of a network of global interconnections. MNCs offer the capital, international market access and technology that India lacks, and are therefore vital to India’s change into a strong and rapidly growing economy.

India’s neighbours that are relying heavily on FDI, such as China, Indonesia, Malaysia, and Thailand, have been pulling far ahead of India in economic growth, income levels and productivity, while also increasing their security and geopolitical influence in the world community. India’s continuing ambivalence to FDI exacts a heavy toll on the Indian economy. Undoubtedly, India is ceding billions of dollars of FDI to its neighbours each year, flows that
otherwise would have come to India.

While China achieved actual FDI inflows of around $45.3 billion in 1997, India settled for a mere $3.2 billion. Why is it that India, which provides the largest market after China in the developing world, is unable to attract substantial volumes of FDI? Further, when it comes to comparing China and India, why can India not match or even outpace China in attracting FDI given India’s superior conditions regarding the rule of law, democracy and the widely spoken English language?

There are lots of international investors who would flock to India right now. But, they are put off by the fact that they cannot get reliable power and that the road system is dreadful. Continuing fiscal difficulties that are often linked to the chronic infrastructure difficulties remain a major challenge for India.

The government has set for itself an ambitious target of achieving $10 billion in actual FDI inflows per year. To meet this target, it is essential to undertake some hard reform steps. Of course, additionally, availability of infrastructure services, such as uninterrupted power, good roads and adequate port and telecom facilities are essential.

In order to achieve the government’s goal, it is crucial to raise the FDI approvals to actual ratio. On a cumulative basis, FDI approvals between April 1991 and September 1998 were of the order of $54,268 million, whereas actual FDI during the same period was a mere $11,806 million. Therefore, actual FDI as a proportion of FDI approved was only 21.7 per cent. The same ratio is much higher in China, Indonesia, Korea, Malaysia, Philippines and Thailand.

Statewise approvals of FDI in India suggest differing performances among Indian states. States are now in competition with one another to attract private investment, both domestic and foreign, but this competition is largely confined to Andhra Pradesh, Gujarat, Karnataka, Maharashtra and Tamil Nadu. State-level data on FDI approvals (aggregate FDI approvals between 1991-97) suggest that the relatively fast moving reformers have attracted higher investments, both from foreign and domestic investors.

From the long term development point of view, India has tremendous growth prospects through export-led growth and that export-led growth involves a broad range of sectors, both traditional and new. The most interesting by far of the new sectors is software and information technology. India is becoming one of the most important players of the world in this sector and it is the fastest growing foreign exchange earner for India.

Export-led growth in services is one of the most interesting developments, and export-led growth in manufactures, the more traditional textiles and apparel, in electronics and other labour-intensive operations remains an area where India could do a lot more than it has in the past. India has the resource base, it has the entrepreneurship, has the access to the sea coast, a vast labour force, it has everything that coastal China has had except the interest of the government. But it is a place where one could find tens of millions of jobs over the next few years in real, significant foreign exchange earning private sector activity. This would require a change of attitude.

Greater decentralization of decisionmaking in India is likely to lead to greater competition among
the states and therefore to higher efficiency and productivity in these regions. In India, key fiscal, infrastructure, and regulatory decisions on economic management remain at the Central government level.

A gradual process of decentralization has begun in India as a result of the fact that regional political parties have been lending support in the formation and running of the government at the Centre. This is a healthy development. Also, this is the most plausible scenario in the Indian democracy wherein the Centre is virtually forced to allow greater decisionmaking to be done at the state level.

There are several reasons for being optimistic about India’s future growth prospects — a decade of opening of the economy has produced new dynamism, most dramatically in the IT sector, but in others as well. The new technologies, especially IT and biotechnology, give new opportunities for economic and social development. Demographic trends, especially a slowing population growth rate and a rising share of the population of working age, contribute to rising per capita income.

While rapid economic growth is certainly possible, it could founder for several reasons. First, large and persistent fiscal deficits can endanger sustainability of growth over time. Second, much of India remains mired in illiteracy and exclusion. Unless Indian society, and Indian governments at all levels, truly prioritize improvements in the access of all Indians to education and health services, hundreds of millions of Indians will have little practical prospect of improvement in life conditions.

Third, India must not rest on the laurels of a successful decade of economic reforms. Much was accomplished in the Nineties. But much remains to be done: improvement of infrastructure, in part through privatization and completion of reforms in key sectors; attraction of much greater flows of FDI; liberalization of labour, land, and other factor markets; fiscal reform and consolidation; and finally meeting the great social challenges among India’s poor and excluded groups.

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