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**ARVIND PANAGARIYA \***

## **The Indian Growth Miracle: What Are the Lessons? \*\***

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Mr. Narasimham, Dr. S. K. Rao, distinguished guests:

It is a real honor and privilege for me to be invited to give the K. L. N. Prasad Memorial Lecture. It is befitting that we celebrate K. L. N. Prasad by discussing economic reforms and what they have helped India accomplish. Mr. Prasad was an entrepreneur, a journalist, a public figure and a philanthropist. So much accomplished within a lifespan of less than 60 years!

Turning to the subject at hand today, let me begin on a lighter note. A little less than two decades ago, in 1989 or perhaps 1990, I recall attending a lecture at the World Bank by the then Indian ambassador to the United States, Dr. Abid Hussain. Dr. Hussain began his lecture by noting that economists who worked on India could be divided into those who were pessimists and those that were optimists. The pessimist would say that there is so much wrong with India that he could not imagine things being any worse. And, the optimist would respond, he could!

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That little anecdote captures how bleak the future of India looked even less than 20 years ago. In a similar vein and on a personal note, I remember that when I came to Princeton to do my Ph.D. in economics in 1974, I had initially thought I would write my thesis on India. But I very quickly learned that partly because the relations between India and United States had been on a real low, but largely because the Indian economy had done rather poorly, interest in the study of India in the United States had plunged from the high levels of the 1950s and early 1960s. In the 1950s, US policy-makers and scholars saw India as the poster child of development. Most development economists around the world eagerly sought a visit to India in general and to the Delhi School of Economics in particular. In those days, such a visit was a necessary part of the credentials of a legitimate development economist. Yet, by 1974, when I arrived at Princeton, India was seen as having decisively failed in fulfilling its promise, and few US economists were keen on it. That observation led me to shift my own interests to trade theory, and I ended up writing my thesis on the theory of international trade in the presence of economies of scale. Nevertheless, now that India has turned its economy around, it is on everyone's radar screen. Studying the country's economy is back in fashion, allowing me to return to the subject with my recent book, *India: The Emerging Giant*. The debate between optimists and pessimists is no longer whether things can go from bad to worse but instead whether India can accelerate to a double-digit growth rate.

### **India: The Emerging Giant**

As Mr. Narasimham mentioned in his introductory remarks, today India is growing at 9 per cent per annum. This is the average growth rate of the GDP during the last five financial years. That is to say, if you take the average of annual growth rates in terms of real rupees between 2003–04 (1 April 2003 to 31 March 2004) and 2007–08, you get a figure of 9 per cent. The growth rate looks even more dramatic in real dollars. Thus, taking the 6 per cent per annum real appreciation of the rupee against the US dollar into account, India has been growing at 15 per cent per annum in real dollars. That is an

incredibly remarkable growth. To get an idea of how rapid this growth is, suppose this growth rate could be sustained for 20 years. I am not suggesting that this will actually happen but only trying to bring out the implications of the 15 per cent rate of growth. At 15 per cent growth in real dollars, India's GDP would rise from its current level of US\$ 1.2 trillion to approximately US\$ 20 trillion in 20 years. In comparison, the current GDP of America is a little less than US\$ 15 trillion. That is how fast we have grown in the last five years! Of course, there remains the issue whether the present growth rate can be sustained.

Before I address this issue of sustainability, let me first address a more fundamental issue that is sometimes raised: Are the data telling us the truth? Could it not be that we are measuring the GDP progressively inaccurately? This issue acquires some salience when we consider the fact that a very large part of our growth is driven by informal sector services whose measurement may be subject to substantial errors. To at least partially dispel these doubts, let me briefly point to the impressive growth in a number of sectors that we can measure with reasonable accuracy. The Indian economy has also undergone a transformation in recent years that is highly unlikely without rapid growth.

One of the things you expect in a fast-growing economy is very rapid growth of international trade. For the first time in our recent history, since Independence, that has happened. The simplest and commonest measure of openness is the proportion of the GDP that is accounted for by international trade. This measure is obtained by taking the ratio of the sum of imports and exports of goods and services to the national income. This ratio rose from about 17 percent in 1990–91 to approximately 46 per cent in 2007–08. Considering that the GDP, which is in the denominator, has itself been growing at 6 to 7 per cent in real terms during this period, trade has to be growing extremely rapidly in real terms for the ratio to have almost tripled.

Next, consider foreign investment. In the early 1990s, foreign investment—both direct and portfolio—coming into India was below US\$ 300 million. By 2002-03, it had risen to \$6 billion. In the following five years, it rose and got multiplied by a factor of 10 rising to a staggering \$62 billion in 2007-08. Remittances by overseas Indians, people like me who work abroad and may be sending part of their income to the home country, used to be in the range of US\$ 2–4 billion in the early 1990s. In 2007–08, the latest year for which we have data, they had risen to US\$ 40 billion. Outward investment, which is a relatively new phenomenon for India because of the restrictions we imposed in the past, has expanded rapidly. The volume of Indian firms acquiring foreign firms in dollar terms was worth anywhere between US\$ 30 to 35 billion last year. Some of the most visible acquisitions include the takeover of Corus Steel by Tata Steel, Arcelor Steel by Mittal Steel and Jaguar also by Tata. Indian firms are showing unprecedented confidence internationally and acquiring the most prestigious firms around the world.

The tales of the dramatic rise of the IT industry are much too well known to be recounted here. As recently as 1995, India's software exports were less than a billion dollars. In 2006–07, they reached US\$ 30 billion and in 2007–08, US\$ 40 billion. Software exports are again an item we can measure with reasonable precision.

As a trade economist, I regard the opening up and the enormous expansion of trade as one of the most important stories emerging out of India's economic reforms. Yet, the biggest story of the reforms is actually domestic: The rise of the telecommunications sector. The transformation in this sector has been breathtaking. Many Indians think that India's success in this sector owes much to the developments in the second half of the 1980s—when Rajiv Gandhi was Prime Minister and we had these STD booths pop up everywhere. But that greatly overstates the progress made in the 1980s and masks the achievements of the economic reforms, especially in the late 1990s and early 2000s. Some like to attribute the telecommunications success to the technological change that brought out the cell phone technology. While this certainly played an important role, I

think reforms were crucial to our ultimate success. There is little doubt that despite the availability of cell phone technology, the explosion in the use of the phone would not have happened without the implementation of the New Telecommunications Policy, 1999.

Those who have experienced the 1970s and 1980s India can testify to the poor quality of telecommunications services. The running joke in those days was that you had to wait for a few years to get the phone. Once you did get it and picked up the receiver, there was a 50 per cent chance that you would get the dial tone. And when you did get the dial tone and dialed, there was a 50 per cent chance that you would end up getting the wrong number! The picture in quantitative terms was not more encouraging either. While the advent of STD booths in the late 1980s undoubtedly made an important contribution to consumer welfare, all said and done, as late as 1991, the total number of telephone lines in India was 5 million. This absolute number translated into a tele-density—number of phones per 100 individuals—of less than 1. This was the achievement of more than 40 years of development efforts! Today, as I am sure all of you know, the headline news is that India is adding 8 million telephones every month. This is not per decade or even per year but per month. The tele-density in India has gone up from less than 3 as recently as 1998 to approximately 30 currently. On the average, every three individuals out of ten have a phone today. In urban areas, tele-density is a whopping 70 per cent. I think in terms of improved productivity, this is perhaps the single most important development. With most of our workforce employed in the informal sector, the cell phone has become a critical ingredient in productivity growth. Because of low levels of education, the penetration of the broadband Internet is likely to be slow. But since almost anyone can use a phone, the use of cell phones can rapidly spread to the entire population.

Growth of the automobile industry, which can also be measured with a reasonable degree of precision, offers another major success story of the economic reforms. On the quality front, we again know that the Ambassador and Fiat models sold in India in the 1980s

were virtually identical copies of their counterparts sold in the 1950s. These models did not change in India until liberalization began. Today, not only have these models undergone dramatic change, virtually all major auto manufacturers in the world have a presence in the Indian market. In terms of quantity, automobile production has been rapidly expanding. The number of passenger vehicles produced has risen from 723,000 in 2002–03 to 1.8 million in 2007–08. These figures tell you how rapid the growth is: not only has the number become quite large, growth itself is extremely rapid.

The final index of rapid growth I wish to cite is the number of billionaires in India. The last list of billionaires in India that the *Forbes Magazine* put out was in November 2007. On that list, there were 54 billionaires. This number was larger than the number of billionaires in either China or Japan. So in Asia, India has the largest number of billionaires. This figure derives its significance from the fact that since India is a competitive economy, you cannot become a billionaire in it without creating significant amount of wealth. These billionaires have not become wealthy by grabbing other people's wealth. Instead, they have largely accumulated their billions by creating wealth. Thus, wealth creation is very much a part of India's success story. I have no doubt that being the entrepreneur he was, if K. L. N. Prasad were alive today, he would be on the *Forbes* list of billionaires.

### **Poverty Has Declined and Inequality Is a Lesser Problem**

Thus, the story of India's growth is real. Once this point is driven home, reform critics return with the complaint that the growth may be real, but it has not done very much for the poor. Some uninformed observers even go so far as to assert the poverty has actually gone up. But this too turns out to be a false claim. A very substantial literature has grown around the issue of poverty in India in recent years. I document the twists and turns of this debate in chapter 7 of my book. The essence of that chapter is that no matter how you manipulate the available data, you cannot escape the conclusion that significant

reduction in poverty has accompanied the acceleration of growth. You can argue about the precise extent of the reduction and its pace during various phases, but the fact that the proportion of the population living below the poverty line has significantly declined cannot be disputed. Only those on the extreme left, with methodology that no other scholars seem to endorse, reach the conclusion that poverty has not come down with growth. Rather than go into the details of various estimates, let me just cite those officially provided by the Planning Commission: The proportion of those living below the poverty line was about 46 per cent in 1983; it fell to 27 per cent in 2004–05.

With the issue of poverty and reforms thus largely settled, critics have predictably changed the subject to inequality. They now argue that even if reforms and growth have brought poverty down, they have raised inequality. Once again, the evidence fails to give comfort to the critics: If you go by the conventional measures of inequality, like the Gini coefficient, you do not see it rise by more than 2 or 3 per cent between 1983 and 2004–05. So the change in overall inequality at the national level has remained well within the margin of error associated with the estimates.

But two other forms of inequality—regional and urban versus rural—have gone up. If you compare the state-level per capita incomes, they are much more unequal today. Urban-rural differences in per capita incomes are also much larger. I have devoted an entire chapter—chapter 8—to the discussion of inequality in my book. I argue in this chapter that increased regional and urban-rural inequality need not alarm us. I offer many reasons for this conclusion, but let me offer you just one of them here. Rather than focus on fighting inequality, focus on combating poverty. When you do that, you will naturally focus on improving incomes in the poor states, such as UP, Bihar and Orissa. But these are precisely the states whose low per capita incomes significantly contribute to high regional inequality. Thus, as you fight poverty to do good to the poor, you will also reduce regional inequality. A similar argument applies to urban-rural inequality since the

poor concentrate more in the rural areas and lower average rural incomes contribute to urban-rural inequality.

The reason why it is risky to concentrate policies on combating inequality directly is that this is likely to lead to the adoption of measures that level incomes at the top. We did this for many decades with devastating effects on growth and poverty alleviation. You do not want to go after those that create wealth to combat inequality. Wiping out billionaires will also lead to the wiping out of some of the gains achieved in poverty reduction. Our efforts to combat the so-called concentration of wealth in the 1970s, which included the exclusion of the most successful firms from all but a handful of 'core' sectors, marginal income tax rates in excess of 95 per cent and reservation of all labor-intensive products for small-scale enterprises, cost us dearly in terms of forgone growth and poverty alleviation.

## **Rapid Growth Can Be Sustained**

Let me next turn to the question whether we can sustain the current growth. There are at least four reasons why I believe that the current growth is likely to be sustained. To explain, let me first note that growth depends on how efficiently we allocate the existing resources among various goods and services, how rapidly we augment them and how rapidly we increase their productivity.

Consider first the efficiency and productivity. Thanks to the reforms, India is now a highly competitive economy. As Mr. Narasimham said, the reforms have slowed down lately. Nevertheless, the reforms done to date are there: Thankfully, there have not been any serious reversals. I think with the possible exception of a handful of the politicians and economists on the extreme left, there is now virtual consensus in India that these reforms have been good for the country. Therefore, the fear of reversal is not serious.

Given this fact and the numerous changes I just described that have altered the initial conditions—India is now much more confident, it is more competitive, and it is more open to the world markets—prospects for the efficient use of resources and productivity growth remain excellent.

Second, let's turn to the prospects for augmenting capital stock—another necessary ingredient in sustaining and accelerating growth. The savings rate, and therefore also the investment rate, has risen at a remarkable pace in recent years in India. From the 20–23 per cent range in the early 2000s, the savings rate is now approximately 32 or 33 per cent. This high savings rate implies India is well positioned to augment its capital stock in the forthcoming years.

Third, we must also consider the other factor of production, labor. India is a relatively young country and is predicted to grow younger in the next 10 to 15 years. The proportion of the young in the population or, stated slightly differently, that of working to total population is going to be rising. This has two important implications. First, with a larger part of the population working, more output per capita is produced. Second, a proportionately larger working population means a higher savings rate. Therefore, the savings rate has the potential to rise even further. Thus, you have the ingredients for productivity growth, you have got faster capital accumulation, and you have more rapid growth of labor—all the three factors necessary to maintain a high rate of growth are in place.

Finally, in re-emphasizing the importance of reforms for productivity enhancement, I should like to mention the important role of entrepreneurs. I have often said that India's entrepreneurs are absolutely top-class. K. L. N. Prasad, whom we are celebrating today, offers a shining example of great Indian entrepreneurial spirit. Even in the 1960s and 1970s, when policies had more or less placed them in a straitjacket, these entrepreneurs managed to deliver a growth rate of 3 to 4 per cent. Today, having been freed up and

given the necessary space in which to operate, it is no surprise that they are doing wonders. Nani Palkiwalla famously said in the 1980s that the spirit of Indian entrepreneurs is not easily suppressed. But, as he went on to add, our bureaucrats have the necessary talent to do so. Luckily, the reforms to date have lifted the bureaucratic hand off the entrepreneurs on whom India can count to continue to deliver the rapid growth of the recent past. Recent entrepreneurial successes have dramatically changed the ethos among the young. Not long ago, in 2000, when Bill Gates first visited India, young Indians were in awe of him. They saw him as an icon they could touch and, if lucky, whose hand they could shake. But they did not think they could *be* him. But now that India has itself produced a large number of billionaires, awe has given way to high aspirations and ambition. The young no longer see a challenge in becoming a millionaire; they want to be billionaires: If Narayana Murthy can do it, so can they!

## **What Went Wrong in the 1970s?**

Let me next step back and ask what mistakes led to the low levels of growth in the '60s and '70s.

The first mistake on my list is the adoption of autarkic trade policies. India's trade regime during these decades was very, very restrictive. For example, in contrast to the experience of most growing economies, the imports-to-GDP ratio between the 1950s and mid-1970s actually fell in India. From around 6 to 8 per cent in the 1950s, the ratio fell to below 4 per cent in the early 1970s. Korea, which started at approximately the same level of imports as India in the 1950s, saw its imports-to-GDP ratio rise to 25 to 30 per cent by mid-1970s. The story in terms of exports is similar.

Autarkic policies that discourage competition from abroad have a very harmful effect on growth and productivity. An analogy from cricket helps put the matter in perspective. If

you want to produce world-class cricket players in large numbers, you have got to play test cricket. As a nation, if you say that you will only play state-level or college-level cricket until your players are ready to face the test players, you can be sure that they will remain uncompetitive on the world scene. When you play against the best in the world, not only does it make you work harder because you face tough competition, you also learn from your rivals. Competition also forces you to devise new techniques and strategies. The story with entrepreneurs is similar. If you are only going to compete domestically, you will not only miss out on the latest production and marketing techniques and products, but also the intense competition that forces you to be most efficient. That to me, in a simplistic sort of way, is the reason why being open is extremely important. By closing ourselves off from the world markets, we failed to achieve high productivity as well as product quality. If I think of product quality in the 1960s and 1970s, I am often reminded of the fountain pens that functioned more as fountains and less as pens, and soap bars that would peel the skin before cleansing it.

Let me divert a little and tell you an interesting story to illustrate what happened to our product quality during these decades. Jagdish Bhagwati came back to India after studying in Cambridge in 1961. Though ground reality would soon change his mind, turning him into a passionate advocate of free trade, at the time, he shared the sentiments of nationalism that had shaped India's trade policies. As a result, he happened to write to his professor at Cambridge in England, Harry Johnson, that he found the craze for foreign goods among young Indians rather disturbing. Harry Johnson, a quick wit, shot back by return mail that if the quality of the paper on which Bhagwati's letter was written was any indication of the quality of Indian-made goods, the craze for foreign goods seemed quite rational to him! Adopting autarkic trade policies was one of the major mistakes we made.

The imposition of a variety of restrictions on the entrepreneurs even when producing for the domestic market was another of our major mistakes. While the foundation of these restrictions was laid down in the 1950s, they became truly stifling in the late 1960s and

first half of the 1970s. From a political standpoint, Mrs. Gandhi was a great Prime Minister: courageous, decisive and wholly nationalistic in outlook. But on the economic front, she seriously damaged India. On the one hand, she introduced the small-scale industries (SSI) reservation whereby all labor-intensive products such as apparel, footwear, toys and light manufactures were reserved for exclusive production by small-scale enterprises. On the other hand, she also restricted successful, large enterprises to a selected set of sectors. She was instrumental in getting enacted the Monopoly and Restricted Trade Practices (MRTP) Act in 1969, under which firms and business houses with US\$ 27 million or more in assets were classified as large firms or big business houses. These firms were then restricted to investing exclusively in 19 highly capital-intensive 'core' industries.

Thus, we excluded large-scale production in labor-intensive products in which a labor-abundant country such as India had comparative advantage. Small-scale enterprises, which were then restricted to less than US\$ 100,000 in assets, could not be expected to look for export markets. Indeed, most of them probably could not afford to look beyond 100 miles of their own location. Simultaneously, we took our most successful entrepreneurs—the large firms and big business houses—and told them that they could not invest in anything outside of the 19 core industries that were largely capital intensive. A cartoon that appeared in the *Economist* magazine in the late 1980s captured this straitjacketing of the entrepreneurs aptly: It showed the Industries Minister telling his staff that he understood that it was the national policy not to encourage large firms, but it was his view that the country should not encourage small ones either. For if they encouraged small firms, reasoned the minister, one day they would definitely become large!

## **Towards the Reforms**

These restrictions stifled both investment and its efficiency. As I document in my book, by mid-to-late 1970s, some thoughtful individuals in the government began to appreciate that the restrictions had gone too far. Businessmen who found they could not import raw materials to operate at full capacity or could not expand capacity to meet the demand also began to lobby for some relaxation of the regulations. This led to the beginning of some small steps towards liberalization. Of course, no one explicitly wanted to admit that a mistake had been made. Therefore, any changes had to be introduced within the existing policy framework, as if by stealth. This process continued in the early 1980s.

In late 1984, her Sikh guards assassinated Mrs. Indira Gandhi. Her son, Rajiv Gandhi, succeeded her as Prime Minister. Rajiv Gandhi was a different kind of Prime Minister. He was a modern man: Having studied and spent some time in the UK, he had seen first-hand the accomplishments of a major Western nation. In his maiden speech immediately after assuming the reins of power, he spoke of the need to prepare India for the twenty-first century. He started off very well, accelerating the process of liberalization in the 1985–86 and 1986–87 budgets.

Rajiv Gandhi had a three-fourths majority in Parliament. Therefore, he was well positioned to implement reforms, including even those that would have required constitutional amendments. But unfortunately for the country, after two years, he was distracted by such events as the Bofors controversy and the casualties that the Indian Army bore in Sri Lanka while fighting the Tamil insurgents. The result was a deceleration rather than acceleration of reforms. Some progress was made but not nearly enough.

The piecemeal reforms of the 1980s, coupled with expansionary fiscal policies, returned India more or less to the growth rate achieved during 1951–64. India had grown at 4.1

per cent during that period. The growth rate during 1965–80 dipped to 3.2 per cent. During 1981–87, India grew at 4.8 per cent per annum, a hair above that achieved immediately after the launch of development planning. The recovery in the 1980s had been partially fuelled by a progressively expansionary fiscal policy with a large chunk of the deficit financed by borrowing abroad. As a result, the foreign debt accumulated. India's exports-to-GDP ratio at 6 to 7 per cent was not very large so that debt servicing became a serious problem by the end of the 1980s. By 1990, nearly 30 per cent of the export earnings were going into servicing the foreign debt. That left very little foreign exchange for imports. Then came the first Iraq War and a steep rise in oil price, which led to a balance-of-payments crisis, opening the door to more systematic reforms.

### **Systematic and Systemic Reforms at Last**

Rajiv Gandhi was assassinated while campaigning for the June 1991 parliamentary elections, which resulted in Narasimha Rao assuming the reins of the Congress Party. Congress emerged as the party with the most seats in Parliament and, with the outside assistance of the Left Front parties, formed the government. Narasimha Rao became the Prime Minister and, taking advantage of the crisis, decided to set the house in order. He appointed a technocrat, Dr. Manmohan Singh, as his Finance Minister and provided him the necessary political cover to proceed with systematic reforms. Perhaps for strategic reasons, Rao himself rarely made any claims to having carried out the most significant economic reforms in the country's history. The only public statement relating to economic policies by him I recall is that he wanted to be remembered as the development Prime Minister. Most authors attribute the reforms of the early 1990s almost solely to Dr. Singh. Yet it is highly unlikely that such important policy decisions could have taken place without the Prime Minister playing an active role behind the scenes. One specific reform surely points in this direction. It is often stated that the New Industrial Policy, 1991 was the key to the transformation of domestic and foreign investment policies. But

few analysts know that the policy came out of the office of Prime Minister Narasimha Rao rather than Finance Minister Manmohan Singh: It so happens that the Prime Minister himself had held the Industry Ministry at the time. For strategic reasons, he probably did not want to be seen as the primary mover and therefore announced the policy on the same day that Dr. Singh presented the first budget of the government.

In the following two to three years, mega reforms took place. We often like to say in India that our reforms have been gradual. While there is considerable truth in this claim, it is not entirely uncontested: The reforms of the early 1990s took place within a very short time span and transformed the policy regime quite dramatically. Thus, they ended the investment licensing in the vast majority of the sectors and permitted imports of all goods except consumer goods without a prior license; they brought down industrial tariffs considerably; and, based on the recommendations of the first Narasimham Committee, carried out major financial sector reforms. Some other reforms, like those relating to the entry of private players into the airlines and telecommunications industries, also started during this period.

Unfortunately, the reform process lost steam during the last two years of Prime Minister Rao's tenure. Despite a growth rate in excess of 7 per cent, he lost the 1996 general election. Prime Ministers Deve Gowda and I. K. Gujral who followed had to depend on the outside support of the Congress, which kept them on a short leash. They together lasted for less than one and a half years. Elections were once again called in March 1998. The National Democratic Alliance (NDA) won and formed the government under Prime Minister Atal Bihari Vajpayee. Mr. Vajpayee began moving forward with the reforms, but his government also lost its mandate in April 1999 after AIADMK withdrew its support.

Elections were held yet again in October 1999. This time around, NDA won a clear majority and Prime Minister Atal Bihari Vajpayee returned to preside over a full five-

year term. Like Prime Minister Rao before him, Prime Minister Vajpayee implemented far-reaching and systematic reforms during these five years. I recall writing several columns in the *Economic Times* complaining about the slow pace of reforms during this period. Yet, when I began researching the accomplishments of the Vajpayee government in the course of writing my book, I was astonished by how much progress the government had made. These accomplishments are now carefully documented in the book. The telecommunications revolution to which I previously alluded is only a part of the full story of reforms during this period. Mr. Narasimham has already mentioned several of the reforms that took place on the macro and micro fronts—privatization, trade liberalization, deregulation of interest rates and monetary reform. The government even tried to reform the much-maligned Industrial Disputes Act, 1947 but was unsuccessful in bringing the legislation to the floor of Parliament.

The acceleration of growth during the last five years (from 2003–04 to 2007–08), which I discussed in detail at the beginning of the lecture, owes much to the Vajpayee era reforms. Prior reforms, principally under Prime Minister Rao, had given rise to sustained growth at 6 per cent. But without the reforms under the NDA government, we could not have accelerated this rate to 9 per cent.

Let me finally turn to the biggest challenge India faces going forward and conclude with the lessons that can be drawn from our experience.

## **The Challenge India Faces**

India's big challenge is the following: Today, if we consider core agriculture (excluding forestry and fishing), it contributes only 15 per cent of the GDP. Approximately 55 per cent of the workforce is employed in agriculture. So we have this massive workforce that generates and lives on only 15 per cent of the income. Naturally, more than half of

India's workers, engaged in farming, are not doing very well despite the 9 per cent growth.

India's challenge is to transform this primarily rural, agricultural economy into a modern, industrial one. What this requires in the short run is lots of reforms in agriculture, many of which I outline in chapter 14 of my book. There is no doubt that a second green revolution is possible. But the task in this sector is not easy. We are constrained by the fact that agriculture is largely a state subject; therefore, until and unless the state governments take the initiative, not much can happen. Punjab is one of the few progressive states, which has done well in carrying forward the reform agenda in agriculture. Other states could learn from its experience.

But reform in agriculture is far from a sufficient response to the challenge India faces. In the long term, you cannot have a modern economy with 55 per cent of the workforce in agriculture. Any developing economy that grows rapidly—you can go back and study the experience of the United States and United Kingdom or consider the more recent successful experiences of South Korea and Taiwan—does this by expanding labor-intensive manufacturing at an accelerated pace. Such expansion rapidly pulls the workforce out of agriculture into well-paid jobs in manufacturing. Unfortunately, the share of manufacturing in the GDP in India has remained very low at about 15 per cent since 1991. This is unprecedented: You almost never see the manufacturing share stagnant in a rapidly expanding economy and within manufacturing, labor-intensive activities performing most poorly. If you look at India's exports, for example, products that we are exporting are either capital intensive or skilled-labor intensive. You have got things like IT and gems and jewelry that are skilled-labor intensive; or you have petroleum and engineering goods that are capital intensive. What we need is for the labor-intensive sectors to grow far more rapidly. China is beginning to exit the textiles sector; and as the wages there rise, it will also begin to exit the apparel sector. As such, the timing could not be more opportune for India to massively expand its share in the

world markets for these products. This is why the reform of labor laws, the foremost constraining factor for labor-intensive sectors, is so crucial. Thankfully, the small-scale industry reservation has effectively ended. But labour laws are still binding. In sectors where labor costs account for 80 per cent of the total costs, firms are reluctant to enter on a large scale under the existing draconian labor laws. India urgently needs to tackle this reform. Sadly, the UPA government has pre-committed itself in its Common Minimum Program not to reform the Industrial Disputes Act, 1947 to give firms the right to fire workers.

The second very important constraint facing manufacturing is electricity. Power is extremely expensive for our industry, and that sector again needs to be reformed. This is entirely feasible since we have an excellent law—the Electricity Act of 2003—in place. But unfortunately, its implementation has been slow with some reversals under the current UPA government. The fact that this too is largely a state subject has not helped.

Then there is the issue of transportation infrastructure. Here I am generally optimistic. The new airport in Hyderabad provides a basis for this optimism. While the UPA government has failed to maintain the momentum the NDA government had achieved, India has now at least learned to build state-of-the-art roads, ports, airports and bridges. Therefore, in the not-too-distant future—perhaps within five to seven years—this frontier can be won.

Therefore, I will place priority on the reform of labor laws and the power sector. Additionally, we need to pay greater attention to the social sector: education, health, and water supply and sanitation. These are areas in which the government is seen as the principal supplier. Unfortunately, the government has proved itself virtually incapable of delivery. To give you just one quick example, after almost 50 years of investment in primary health centers and community health centers in the rural areas, 80 per cent of the rural people go to private rural medical providers (RMPs) for out-patient care. This is an

astonishing figure, a true example of the failure of the state governments to deliver. Even the poor people have to go to RMPs, who are not real doctors but individuals with a small bit of medical knowledge acquired by observing doctors or working with them. RMPs have no formal qualifications, and many of them do not even have a high school diploma. There is a big challenge here.

## **Lessons Learned**

Let me now conclude with some of the lessons that can be gleaned from India's experience. First and foremost—and Mr. Narasimham has already touched on this—our experience clearly shows that democracy is not a barrier to rapid growth. Until recently, people would have said that you could achieve growth rates of 4–6 per cent under democracy but not much higher. Even Chile, which is also a democracy and is doing very well on almost all fronts, has not grown more than 6 per cent on a sustained basis. But India is now growing at 9 per cent and, given all the things I have said, it can easily raise this rate to the 11–12 per cent range. What is needed is another round of bold reforms of the kind Prime Ministers Rao and Vajpayee introduced. So, for sure, democracy is not in the way of rapid growth.

Second, reforming a highly distorted economy is a long-drawn process. Some analysts are saying these days that you should look for one or two policies that constrain your growth the most and concentrate on changing them. India's experience demonstrates otherwise: The reform process extends to decades. You initially solve some problems, good things begin to happen; but then you have to solve more problems to make things even better. So, it is a process that must be sustained over a long period of time.

Third, gradualism is not a barrier to policy reform. There are those who say that we must do a big-bang reform when the opportunity arises because otherwise the opponents of

reform will get the time to block and reverse the process. But India offers an example of reforms in waves with, at worst, rare reversals. It is rare that a single, big-bang reform will be feasible within a democratic form of government.

Fourth, there are some clear policy lessons for other countries. India's experience greatly reinforces the view, held by most economists, that low or declining barriers to trade are extremely critical to rapid growth. Likewise, domestically, you have to give the entrepreneurs space in which they may freely operate. Reforms that give entrepreneurs the necessary space may be different depending on the circumstances of the country. But, at the end of the day, you have to find ways to make the necessary space for them to be able to carry out their profit-making activities without undue restraints.

Ownership of policies is extremely important as well. Forced policy reform by the World Bank and the IMF in the 1980s in many countries was not going to work, and it did not work. When governments themselves do not own reforms, they will sabotage it at the implementation level or reverse it once the loan has been disbursed. In contrast, India's reforms were home grown. At most, one could argue that the first set of reforms in 1991–92 were carried out under the terms and conditions of the IMF and the World Bank loans. But even this is contestable, as I point out in chapter 5 of my book. Everything else that followed was initiated and executed by India. After its initial program in 1991–92, the IMF became irrelevant to India. Likewise, after the first structural adjustment loan by the World Bank, India was firmly in the driving seat. The World Bank remained engaged only because it wanted to loan money to India *following* the policy actions India had been taking. Without ownership, reforms would not have been sustained. Nor would they have been credible to the entrepreneurs.

Finally, we should acknowledge that a country also needs some good luck for the success of its reforms. We do not understand everything about what triggers and sustains growth. And we cannot derive a formula from India's experience that will work everywhere.

What remains unexplained may be called “good luck”. I am glad that starting in 1991, India has had good luck. As an optimist economist, I think this luck will stay with us for some time to come. We must capitalize on it by undertaking the remaining key reforms and accelerating further the process of growth and poverty alleviation.

Thank you very much.