The Effects of Economic Reforms in India in the Early 1990s

Summary

The aim of this paper is to understand the economic reforms that were undertaken in the late 1980s and early 1990s in India and their relevance today. The study is based on a literature review. The findings from the literature review are validated from data on growth at the national and regional levels. It was found that much of the effects of the reforms are relevant even today in the Indian context. There has been a positive impact on growth due to liberalisation policies. Economic indicators such as GDP and FDI have been on an increasing trend. The removal of trade barriers has had a positive effect on industry. Employment opportunities have increased in both rural and urban areas resulting in a reduction in unemployment. On the negative side, the observed growth is not inclusive. There has been regional a disparity in growth among the different states with some states growing faster than others. Moreover, not all sectors enjoy the benefits of liberalisation.

1 Contribution of authors: Vijay Narayanan (40%), Ike-mefuna Allen (30%), Nahidah Naser (30%).
The agriculture sector, for example, has not seen any or at least very few reforms. Thus to sum up, the government of India needs to continue the reforms and ensure that the benefits of an open market reaches one and all.

**Keywords**

India, reforms, liberalisation, economic growth

**SKUTKI REFORM GOSPODARCZYCH W INDIACH Z POCZĄTKU LAT 90. XX WIEKU**

*Streszczenie*


**Słowa kluczowe**

Indie, reformy, liberalizacja, wzrost gospodarczy

**INTRODUCTION**

The Indian economy has been in recent years one of the fastest growing economies in the world. The factors leading to this transition from the days of the state-led development model to the more liberalized economy is fascinating to study.

The aim of this study is to understand the economy of India pre-liberalisation, the issues that led to the balance in payment crisis, the
subsequent reforms and the restructuring followed by post-reforms and their relevance today. It is important to comprehend the success of the Indian Union which could serve as a model for other growing economies. History shows that the choice and the start of liberalisation was a forced decision due to a balance in payments crisis in the late 1980s and early 1990s. The way economic development has forged the country towards progress and prosperity is worth studying, especially in a period economic crisis, that has engulfed the world, such as the Euro Zone crisis.

One of the reasons mentioned for the imbalance in the Euro Zone crisis was the socio economic differences of the participating countries [Sapir et al. 2015, p. 2]. India, as a country with a population of over a billion people, is many times more diverse than the Euro Zone or the European Union [Stanek, Wach 2015]. Furthermore, the challenges faced by India are complex. The economic success of the Indian union was cited as a case study for European policy makers by Haider in his study for resolving the Euro Zone Crisis [Haider 2014, p. 3]. Different facets ranging from the availability of basic needs like electricity for agriculture to high end IT service sectors have been credited as reasons for development. The truth is that India is so multi-dimensional that there exist an abundant amount of reasons for growth and development. On the negative side, there is so much diversity and issues like poverty, corruption and a lack of good governance etc. that act as deterrents to development. Many authors in the past have contributed to individual topics. One of the main factors that contributed to growth were the reforms undertaken in the early 1990s. There are many studies on individual topics relating to certain policies. Yet there is a dearth of literature having a unified study of many contributing factors done in the recent past. Most of these studies took place either in the last decade of the 20th century or the first decade on the 21st century. This paper is structured in such a way that we begin with the premise of theories on economic development linked to liberalisation and the issues in India leading to a balance of payments crisis followed by the crux of the paper – namely, the literature review of liberalisation policies, contemporary economic scenarios, and finally the conclusion.
THEORIES ON ECONOMIC DEVELOPMENT AND LIBERALISATION

Development economics views the economic development process as one that involves raising the national income level through increasing the rate of capital formation [Thanawala 1994, p. 356]. The roots of Economic development theory can be traced back to the 1930s when Joseph A. Schumpeter published his work titled *Theory of Economic Development* (1934). Schumpeter’s development theory asserts that it is the innovation and creativity of entrepreneurs that determine economic development [Schumpeter 1934, p. 65]. The entrepreneur is described as a creative innovator, whose activities generate an invention that is commercialized, resulting in innovation [Schumpeter 1946, p. 87]. Although Schumpeter’s theory of economic development provides a good basis for explaining the dynamics of the development process, it has several shortcomings. Schumpeter bases his theory on pre-conditions prevalent in developed economies, while failing to provide explanations regarding the development process within less-developed economies. Walt Rostow offered a theory that focuses on how developing economies can achieve economic growth. Rostow’s theory is based on the premise that development involves, in the first instance, the shifting of income from investment in expensive ceremonies and social redistribution to a high investment rate in economic activities [Solvetti 2005, p. 721]. Rostow provides a vital concept to development economics: that the evolution of developing economies in the 20th century is basically similar to that of the 19th century; therefore, past experiences can be used as a guide for national economies trying to develop the preconditions for growth today [Theobald 1961, p. 328].

Arthur Lewis was another economist that focused his theoretical model on the plight of less developed economies. In his Nobel Prize winning work titled *Economic Development with Unlimited Supplies of Labour*, Lewis stressed that less developed countries with a large/ unlimited labour force can achieve economic growth by maintaining low wages in the short-run from which savings will be attained. The resulting increase in the stock of capital will then lead to income growth in the long run [Lewis 1954]. For Lewis, the development process implicates transferring a large mass of underemployed workers
with low productivity from the subsistence sector to the urban capitalist sector [Lewis 1954, p. 141], and in doing so increasing the rate of savings within an economy [Lewis 1954, p. 147]. The assertions made in the Lewis model are still considered relevant today and serve as a guide to policy-makers in countries such as India, China and Bangladesh [Ranis 2004, p. 719], as they attempt to deal with fundamental real world issues of development [Ranis 2004, p. 721]. Since Lewis’s theory, a growing body of literature has evolved that point to economic liberalisation as a driver of economic growth. Proponents of this school of thought see the opening up of an economy, through the enactment of government policy that facilitate international trade and foreign investment, as a means of fostering economic development.

As defined by Woodward (1992), economic liberalisation is the process whereby government enacts a policy to promote free trade, deregulate the economy, eliminate subsidies, privatisate public services etc. In doing so, the government fosters macroeconomic stability by guaranteeing property rights and maintaining the rule of law, while paving the way for economic growth driven by the private sector. Such a free market economy will facilitate economic expansion through labor-intensive export activities, creating employment and improving welfare [United Nations 2010, p. 97]. Supporting this premise is literature that focuses on the positive impacts of trade liberalisation on an economy. The theory holds that trade liberalisation leads to an increase in welfare through better allocation of domestic resources. When trade barriers are removed, a shift of resources occurs from the production of import substitutes to the production of export-oriented goods, thus fueling growth within an economy [Tussie, Aggio 2003, p. 89]. Taking this into account, an economy becomes more efficient due to liberalisation and can focus its vital resources on sectors that will improve the welfare of its citizens. A thought provoking concept highlighting the link between liberalisation and economic growth was brought forth by Mehlum, Moene and Torvik [2005]. Focusing on countries with abundant natural resources, the scholars propagate that the quality of (government) institutions plays a decisive role in fostering economic growth. With producer friendly institutions resources raise income, while institutions characterised by a malfunctioning bureaucracy and corruption have the opposite effect in spite of resource endowment [Mehlum, Moene, Torvik
2005, p. 1]. Modern economic literature cites trade liberalisation as a positive and significant factor impacting on economic growth. Empirically, analyses conducted on Pakistan over the period 1975-2010 found that trade openness was essential in fostering economic growth [Shaheen et al. 2013].

FROM INDIAN INDEPENDENCE TO BALANCE OF PAYMENT CRISIS

The growth of the Indian economy can be seen as rudimentary in the beginning of the twentieth century, slow growth of 3% to 4% post-independence and a rapid growth of 6% in recent years. This has projected India as one of the fastest growing economies in the world. India has achieved this growth while continuing to be a democracy which is contrary to other high growth East Asian countries [Kohli 2007, p. 88]. India’s economic development started on a better note when compared to other countries that were liberated from colonial rule after the Second World War. By 1950, India already had a developed railway network, a disciplined military and well educated-idealistic political class. Offsetting these advantages was the partition of India into two countries, namely India and Pakistan. The partition resulted in the loss of life and property on both sides. The rehabilitation of the victims also resulted in a financial burden. The continuing rivalry and mistrust between India and Pakistan has resulted in a rise in military spending for India as it has one of the largest standing armies in the world. Thus much needed resources for economic development are used in military spending [Thanawala 1989, p. 35].

The planning commission of India was established in the March of 1950 with the Prime Minister acting as chairman. The council and the institutions associated with them, like the National development council, includes – aside from the Prime Minister – important cabinet ministers, eminent politicians, chief ministers of the different states of the Indian Union and a few economists from the academia. The planning council is set up for a period of five years and they develop a plan for social and economic policy, and also a road map with measures for achieving the relevant goals and targets [Thanawala 1989,
p. 36]. Until the end of the 1980s, the Indian economy was a closed economy. In order to attain growth, it has used an “inward looking approach;” that is, support import substitution instead of export promotion. In the beginning of the 1990s, India faced a Balance of Payment crisis with its foreign exchange reserves down to 2.2 billion dollars. To prevent a default, the government of India pledged gold to borrow foreign exchange from the International Monetary Fund. In spite of this crisis, the government introduced macroeconomic stabilization and structural reforms which were later called the New Industrial Policy leading to liberalisation, privatisation and globalisation [Sabade 2014, p. 342]. Various scholars have investigated the interplay between liberalisation and economic growth over the years. In a broader sense, countries that implement liberalisation policies move faster towards steady economic growth [Barro 1991, p. 410]. More specifically, the level of openness within an economy is found to drive the adoption of technology developed in advanced economies, leading to a faster rate of growth than closed economies in both the short- and long-run [Pacheco-López, Thirlwall 2009, p. 21]. It is logical to say that the more open an economy is, the more dynamic macro and micro economic factors become. With the attained dynamism, efficiency gains foster growth that lead to an increase in the overall welfare of people within the economy. The experience of China provides a prime example of how liberalisation drives economic growth. The enacted reforms transformed the Chinese economy from being a highly protected market to one of the most open emerging market economies to date [Lardy 2003, p. 13].

LITERATURE REVIEW

In this section, we will dwell deeper into the policy changes undertaken by the Indian government due to liberalisation and the subsequent effects on the economy. In the first step, we shortlisted journals based on the 2014 ranking for SCR impact factor greater than 1,000. This provided a list of 25 journals for providing quality articles on topics related to economics. The search period was taken from the late 1990s to date to ensure that we studied recent literature in order to understand the current state of affairs.
Table 1. Protocol for identifying relevant literature pertaining to Policy Reforms in India

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Rationales</th>
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<tr>
<td>Publication in peer-reviewed academic journals</td>
<td>We chose economic journals that were top ranked based on a SCR factor greater than 1,000. This provided a list of 25 journals with good quality articles.</td>
</tr>
<tr>
<td>Publication period</td>
<td>The publication period was set to the 1990s to date so that we covered the immediate as well as long-term impact of policy reforms during the liberalisation period.</td>
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<tr>
<td>Publication of full length articles</td>
<td>The articles considered were full length articles.</td>
</tr>
<tr>
<td>Keywords</td>
<td>The keywords used in the search included “policy reforms” in conjunction with “India.”</td>
</tr>
</tbody>
</table>

Source: own study based on the literature review.

Table 2. The reviewed studies on Policy Reforms in India

<table>
<thead>
<tr>
<th>Study</th>
<th>Journal</th>
<th>Method</th>
<th>Research Focus</th>
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<tbody>
<tr>
<td>Anand [1999]</td>
<td>“American Economic Journal: Applied Economics”</td>
<td>Literature Review</td>
<td>This study focuses on the progress made during the reforms period by reviewing 2 books and several World Bank reports written on the progress, positives and negatives towards implementation of the so-called changes.</td>
</tr>
<tr>
<td>Topalova et al. [2011]</td>
<td>“IMF Economic Review”</td>
<td>Case Study</td>
<td>This study focuses on the effect of reforms like trade liberalisation etc. and its effect on firm level productivity. The study confirms that there exists a positive correlation between reforms and firm level productivity in India.</td>
</tr>
<tr>
<td>Kalirajan et al. [2010]</td>
<td>“American Economic Journal: Applied Economics”</td>
<td>Empirical Analysis</td>
<td>An empirical analysis of data before and after reforms which indicates that liberalisation has helped to reduce poverty levels in India.</td>
</tr>
<tr>
<td>Source</td>
<td>Title</td>
<td>Method</td>
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<tr>
<td>Ghosh [2012]</td>
<td>“Handbook of Social Economics”</td>
<td>Empirical Analysis</td>
<td>An analysis of regional disparities among 15 Indian states which showed that post liberalisation, growth has not been uniform across India. The true benefits of liberalisation can be achieved only when growth is inclusive.</td>
</tr>
<tr>
<td>Strom [2003]</td>
<td>“American Economic Journal: Applied Economics”</td>
<td>Empirical Analysis</td>
<td>The evidence shows that Indian reforms are predominantly focused on the manufacturing sector and there has been less emphasis on reforms in the agricultural sector.</td>
</tr>
<tr>
<td>Baddeley et al. [2006]</td>
<td>“American Economic Journal: Applied Economics”</td>
<td>Empirical Analysis</td>
<td>Evidence suggests that regional disparities exist among Indian states and their significant contributors have been analysed.</td>
</tr>
<tr>
<td>Krueger [2008]</td>
<td>“Review of World Economics”</td>
<td>Case Study</td>
<td>The author assesses if the role made towards international trade, capital account transactions and external sector performance is affecting the growth of India.</td>
</tr>
</tbody>
</table>

Source: own study based on the literature review.

India’s economic history can be divided into four phases:

1. The first phase was the Nehruvian era in the period 1947-1965, characterized by a national planning approach to economic policy.
2. The second phase saw the emergence of agricultural policy during the period 1965-1970.
3. The third phase from 1970-1991 was characterized by inward oriented policies.
4. The fourth phase starting from 1991 saw the emergence of economic reforms and openness.

The economic policies of India were shaped either by the macro (structural) or micro (sectoral) views which depended on the political situation and the pressure of coalition politics [Anand 1999, pp. 242-243]. The reforms initiated in the 1990s was concentrated more on addressing the essential fiscal correction [Anand 1999, p. 255]. According to P.B. Anand [1999], the fourth phase lasted for a decade but seeing the current scenario, it is true that India is still in the progress of implementing reforms and openness.

Topalova et al.’s study of Trade liberalisation as an effect of reforms initiated and firm level productivity found that a reduction in trade protection led to higher levels of productivity in industries. Two concepts drove this change. The first is that an increase in competition because of reduced output tariffs pushed companies to improve their efficiencies. Second, the trade reforms also reduced tariffs which led to cheaper imports. This made access to imported inputs cheaper, thus propelling an increase in firm level productivity. It was also found that domestic firms reacted positively to trade liberalisation and reforms with increase in productivity. During this period, India also made additional reforms, such as de-licensing and allowed Foreign Direct Investment (FDI) in many sectors [Topalova et al. 2011, pp. 995-996]. The after effects of FDI and industrialization were studied by Kalirajan and Singh in 2010, and they showed that both these aspects helped in reducing poverty in Indian states. FDI has helped in reducing the gap between potential performance and actual performance by helping transfer modern technology from developed nations. Liberalisation leads to structural changes which in turn attracts further FDI as seen in the case of China. Liberalisation helps to reduce poverty by generating more employment in weaker economies [Kalirajan et al. 2010, p. 26]. In this study, empirical data shows that during the era of liberalisation, 1999-2000, poverty levels dropped from the levels seen in 1993-1994 at the national aggregate level. However it was found that FDI did not directly reduce poverty but indirectly through structural changes in the economy by an increase in industrialization [Kalirajan et al. 2010, p. 40]. Singh et al. in their analysis, found the following [Singh et al. 2011, p. 32]:

- The total FDI globally is dominated by developed countries,
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- The quantum of FDI flows into India has shown a positive trend reinforcing faith in the reforms.
- The outward flow of the FDI from India is on an increasing trend, though much lower than the inward trend.
- The FDI flow inflow in India has been region-specific showing that FDI increases regional disparities.
- The FDI flow into the country is based on few sectors and there is no homogeneity.

A prior study by Baddeley et al. in 2006 found that the economic growth rates appear to have widened as some states tend to grow faster than others [Chatterji 1992; Baddeley et al. 2006, p. 1016]. A study by Ghosh in 2012 analysed the after effects of liberalisation to check for disparities in growth among different Indian states. It was found that disparities among regions have steadily increased and the benefits of growth have not reached all regions of India. This study uses data from 1960-1961 to 2006-1007 among 15 major Indian states and evaluates their economic performance based on divergence of per capita income from the pre- and post-reforms period [Ghosh 2012, p. 191]. It was found that the growth performance of states have improved post reforms, there was divergence in the per capita income among the different states considered. The study identified that the improvements in physical and social infrastructure could greatly help in improving the long term growth potential of the states. It was also seen that the poorer states gave proportionally larger grants compared to better performing states, and the efficient use of these grants in improving physical and social infrastructure would eventually help in improving their growth. The regional differences in per capita income arise because of industries and services. The job opportunities from industries and services play an equally important role as reforms [Ghosh 2012, pp. 210-211]. Baddeley et al.’s study identified factors contributing to growth in some states. State level factors like investment in economic, social and agricultural sectors help in accelerating growth. Also progress made in education across India would help in reducing interstate disparities. This study also suggests that there has been an increase in variation among growth after the onset of reforms indicating that all states have not been able to benefit equally from the change in policies [Baddeley et al. 2006, p. 1016]. Dash et al developed a complex model using investment,
infrastructure stock, export and human capital to explain growth. There exists a strong positive correlation between infrastructure development and growth [Dash et al. 2010, p. 381].

The agricultural sector employs about two thirds of the Indian labour force and since 2003 has contributed to about 30% of GDP. But it is evident that India’s reforms are primarily focused only on the manufacturing sector, neglecting the agricultural sector. It is also evident that policy reforms in agriculture impacts upon the majority of the population, and this alone could serve to substantially increase income levels and the standard of living among the majority of the Indian population [Strom 2003, p. 406]. The study concludes that the net cost of liberalisation of India’s agriculture sector has significant expenses and without any corrective measures this would impact upon the lower strata of society, namely poor landless laborers and small farmers. Extending the liberalisation period would help to reduce the overall effect. Still, in the short to mid term range the effect of liberalisation is expected to be counterproductive [Strom 2003, p. 414].

The Indian economy in the late 2000s bore very little resemblance to the economy of previous decades. It has been seen without reasonable doubt that India can compete in the world market. Although much has been achieved, there is still a long way to go for the complete implementation of the reforms. When a complete transformation is achieved, India will have achieved many of the advantages of having a democracy, strong political system, substantial labour force with successful knowhow, like the IT industry. To achieve this, reforms should continue in the right direction along with efforts to improve infrastructure, education and a reduction in bureaucracy in private business areas [Krueger 2008, p. 281].

OVER VIEW OF ECONOMIC PROGRESS IN INDIA POST REFORMS

It is evident from Figure 1 that the GDP has grown significantly from the 1990s to 2014. As per World Bank reports, the GDP growth at market price is projected at 6.9% in 2014. This is expected to increase to 7.2% in the FY 2015 and further increase to 7.5% in FY 2015-2016. The report further adds that the new government has begun accelerating
reforms to improve the business environment, liberalize foreign direct investment further, boost infrastructure with both public and private funds, simplify taxation and reduce corporate taxes [World Bank 2015]. The reforms in the form of liberalisation, globalisation and privatisation have clearly fuelled growth in the forms of an increase in GDP and an increase in the inflow of FDI.

As seen in the literature review, trade liberalisations and the removal of barriers have helped in steadily increasing the inflow of foreign direct investment in India (Figure 2).

Figure 1. GDP Trend in India from 1990 to 2014.

![GDP Trend Graph]

Source: Adapted from World Bank.

Figure 2. FDI Trend in India from 1990 to 2014.

![FDI Trend Graph]

Source: Adapted from World Bank.

It is also seen that the increasing trend in both GDP and FDI shows a positive correlation that FDI has contributed both directly and indirectly to growth. Figure 3 helps in substantiating the claims of
development and the positive impact of the growing economy and inflow of FDI. The drop in unemployment levels help in understanding the absorption of FDI, and the opportunities it creates in providing jobs for millions of Indians. The figure also poses some serious questions on the downside of the reforms. The majority of the unemployed are from the rural parts of India where agriculture is the primary form of employment. Agriculture as a sector has to date seen no or only limited reforms. This will be the biggest challenge for a growing Indian economy and these questions need to be answered and cannot be ignored by the new government.

Figure 3. Employment among rural and urban India: Unemployment level in 2004-2009 (in millions)

![Unemployment level in 2004-2009](image)

Source: Adapted from Planning Commission of India

Figure 4 shows the employment among sectors accounting for 451 million Indians based on the data from 2009-2010 from the planning commission of India. The employment sectors are broadly classified into 1. Manufacturing, 2. Non-manufacturing, 3. Services and 4. Agriculture. Agriculture clearly dominates as the leading employment provider across India and is still untouched from any form of reforms. The liberalisation has been restricted to the remaining 48% contributed by the manufacturing, non-manufacturing and the service sectors. Undertaking reforms in agriculture will benefit more than 250 million Indians, roughly 25% of the total population of a billion people and a clear majority in the current workforce. Figures 3 and 4 further validate the claim and the seriousness for the push of reforms in the agricultural sector.
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Figure 4. Employment among sectors in the years 2009-2010

Source: Planning Commission of India

Figure 5. Pareto Analysis of State Gross Domestic Product of Indian States & Union Territories (2012-2013)

Source: Planning Commission of India

A Pareto analysis of the regional indicators – namely, the State Gross Domestic Product (GSDP) of 32 Indian states and Union territories – clearly explains the down side of the reforms (Figure 5). It is evident that the effect of reforms has been regional. The 5 states, namely Maharashtra, Uttar Pradesh, Andhra Pradesh, Tamil Nadu and Gujarat, contribute to nearly 50% of the total sum of the GSDP, which is nothing but the GDP of the whole country. It is also seen that the
last 10% is contributed by 18 states and union territories. The bigger and more densely populated states have a higher SGDP. This effect is also explains the regional disparity and absorption of There is a huge population covered by the intermittent states that contribute modestly to growth. It is also interesting to note that the top 10 contributing states have representation from across India – namely, north (Uttar Pradesh), south (Andhra Pradesh, Tamil Nadu, Karnataka, Kerala), east (West Bengal) and west (Maharashtra, Gujarat and Rajasthan) and central (Madhya Pradesh) India – which shows the wide spread of the reforms across the major dimensions of the country. But the level of impact has been more with the southern India having the most representation with 4 states followed by the west with 3 states, with the north, east and central contributing 1 state each.

CONCLUSION

It is evident that the reforms proposed in the early 1990s have had a significant impact on growth and its effects are still relevant today. Trade liberalisation has reduced barriers for both imports and exports making the industry competitive by increasing productivity. An increase in FDI directly and indirectly reduces poverty by generating jobs and increases per capita income among households. It was also found that regional development among states before and after reforms show a significant positive growth, demonstrating that reforms have had a positive impact at the regional level. All the positive claims of liberalisation have been substantiated with data. On the downside, there were some negatives observed as an effect of the reforms and liberalisation. There has been an increase in the disparities among different states. It is evident that some states have grown faster than others, resulting in an increasing gap between them. It is also seen that the benefits of liberalisation has not benefitted all. The government must ensure that growth is uniform and inclusive so that there is no regional disparity. The FDI inflows have also been regional and certain industry/sector oriented. Some sectors, like agriculture, have seen very few or no reforms. With agriculture contributing more than 30% of the GDP, reforms in this area could benefit a huge labour force, which would contribute to tremendous overall growth
in the country. But care should be taken that the interests of small farmers and laborers are protected. The only way forward for India is continuing the reforms and expanding its scope, touching people from all walks of life across all regions and employment sectors.

As with any study, this paper has its limitations as it provides a comprehensive overview about the pros and cons of reforms across India. A detailed region specific and industry specific study is beyond the scope of this paper. As a future area of research, such studies should be continued and a possible analogy with the Eurozone could provide vital patterns in how reforms perform under two different paradigms [Wach 2014]. Such a study could give us an understanding about the workings, benefits and the downsides of a political union (India) compared with a monetary union (Eurozone).

Thus summing up, India has come a long way since the start of reforms. Still much work is left on the path to complete liberalisation and inclusive growth which would cover all spectrums of life. The great journey continues!

Bibliography


