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Growth and structural change in Indian Economic

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Abstract: This chapter examines growth and structural change in the Indian economy since independence, focusing on the key drivers and critical junctures that led to changes in economic policies and their consequences for growth and distribution. It then analyzes three central puzzles of Indian economic development: 1) Why, despite a persistent policy and intellectual concern with poverty, has India's record on this score been modest, especially with regard to human capital indicators? 2) Why has India managed reasonably sound macroeconomic policies, in sharp contrast to its innumerable microeconomic inefficiencies? and 3) What explains India's modest growth in the early decades after independence, under good governance, but much more rapid rates of growth in recent decades—second only to China among large economies—even as corruption has mushroomed? The paper concludes with some observations on the Indian Stateand argues that the foremost challenge that India faces is strengthening public institutions andgovernance.

Keywords: India, structural change, economic growth, poverty, governance, State, entrepreneurship
Introduction: If the dizzying transformation of the Chinese economy has been the defining story of economic development in the last three decades, economic changes in India, while considerably less dramatic, have been no less transformative. This paper examines growth and structural change in the Indian economy since independence (August 1947), focusing on the key drivers and critical junctures that led to changes in economic policies and their consequences for growth and distribution.
It then analyzes three central puzzles of Indian economic development: 1) Why, despite a persistent policy and intellectual concern with poverty, has India's record on this score been modest, with several human capital indicators that are not much better than sub-Saharan Africa's? 2) What explains the disjuncture between reasonably sound macroeconomic policies amidst a litany of microeconomic inefficiencies? and 3) Why did India experience only modest growth in the early decades after independence, despite good governance, but much more rapid rates of growth in recent decades, even as corruption has mushroomed?

Historical legacies: The historical legacies of British colonialism are a necessary starting point to understand the trajectory of independent India. At the beginning of the eighteenth century, India's share of world income was between a fifth and a quarter. Over the next 250 years—between the collapseof the Mughal Empire and India's emergence as an independent country—India's share droppedprecipitously to just 3 percent in 1950. It dropped further to 1.7 percent (2.5 percent in purchasing power parity/PPP terms) in 1980 before gradually climbing to 2.6 percent **(5.5 percent in PPP terms) in 2010.**
Given that this period coincided with colonial rule, there can be little doubt that policies that favored colonial interests played an important role in this decline, which was especially marked between the mid-nineteenth and the mid-twentieth century. But the precise reasons are severely contested, ranging from the extractive nature of land revenue systems put into place by the British, to the use of these revenues mainly for security purposes, to the manner of India's insertion in the global economy (favoring British manufacturers). Whether globalization or weak agriculture productivity was the principal cause, the extent

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to which the widening gap between India and the West was due less to India's decline than to rapid increases in productivity in the West (Williamson 2011), or why in the last half century of colonial rule, despite stable property rights, free markets, and openness to trade, growth was so anemic and whether at least some of the onus lay in lndia's social institutions (Roy 2006), was not just a matter of academic debate. It would fundamentally shape the policies of independent India.

At the time of independence India was overwhelmingly rural, largely illiterate, and exceedingly poor. The country lacked a bourgeoisie and a middle-class; its society was deeply stratified and extremely heterogeneous, and the administrative apparatus was geared to serving the controlling interests of the colonial power rather than broader development goals. Yet, compared to many other newly emerging countries, India's colonial legacy had some positive features as well: substantial foreign exchange reserves (arising from its substantial contributions to the Allied war effort) and share in world trade that led India to emerge as one of the founding members and one of the five largest shareholders of the newly formed Bretton Woods Institutions; a meritocratic elite civil service that was rare among bureaucracies in its integrity and competence; an integrative infrastructure in the form of the railways; and a small but solid foundation of legal and higher education institutions.

It was hardly surprising that colonialism left deep cognitive scars on India's nationalist elites which fundamentally shaped the economic policies of independent India, and whose path dependency had significant long-term effects. At the same time economic policies in India had to be consonant and sometimes defer to the multiple political challenges facing the leadership of independent India. As B.R. Ambedkar, the co-author of India's constitution, famously lamented in 1950, "Democracy in India is only a top dressing on an Indian soil which is essentially
undemocratic."3 Although India's political leadership inherited a territorially unified country after independence, it did not inherit a nation in the classical sense of the term. In contrast to virtually every Western democracy, nation building in India followed the introduction of universal franchise. What made India exceptional was the constitutional consensus that resulted in democracy as the principal tool for nation building, which meant accommodating the political aspirations of India's multiple nationalities, weaving them into the fabric of a distinctly "Indian" nation, and granting universal franchise all at once (rather than gradually). Consequently, economic policies had to accommodate these political imperatives, whose yardstick for effectiveness went beyond efficiency and growth to underpinning one of the most audacious political experiments in the modern era.

A critical legacy of colonialism was a deep wariness of global economic integration, be it international trade or private capital flows. After all, it was the then largest multinational trading company—the East India Company, a "great money engine of the [British] state"4—that had spearheaded the British colonial enterprise in India. While the Great Depression had also seemingly shown the benefits of autarchic policies, the visible success of the Soviet Union in the aftermath of World War II was seen as vindicating the logic of central planning in allocating scarce investment resources as well as the need for India to develop its own industrial and technological base. While the political underpinnings of the Soviet model were unacceptable in India, the Fabian socialist policies of the post-war Labor government in the UK, where many of India's nationalist leaders had been educated, appeared to offer a more humane alternative.

Growth and structural change: The economic model that India chose to follow was therefore not surprising: an Import- Substitution Industrialization (ISI) model that was relatively autarchic, with planning and bureaucratic controls rather than markets as the principal tool of resource allocation. The historical legacy, the prevailing gestalt, poorly developed global and domestic markets—all pointed in this direction.

Prior to independence, economic growth in India was meager. Per capita incomes had stagnated over the last half century of British rule (1900–50), although there was some structural transformation with the development of cotton and jute textile industries. At the time of independence India was an overwhelmingly impoverished country, not just in income terms but also in human capital, with the literacy rate just above 18 percent and life expectancy barely 32 years in 1951. Six decades later the literacy rate had increased to 74 percent and life expectancy had more than doubled, to just under 67 years in 2011. In the first three decades after independence (1950–80), India's average annual rate of growth of GDP was a modest 3.5 percent. In the next three decades that figure nearly doubled even as growth volatility declined. Importantly, a decline in the population growth rate meant that per capita income growth tripled in the latter period compared to the earlier period. If one places India's record against the global economy in the longue durée from 1900 to 2010, it lagged global growth for the first eight decades and has only subsequently been growing faster than the world average.

Capital inflows, especially non-debt capital inflows, have been the second important mechanism driving India's integration into the global economy. Inward foreign direct investment (FDI) increased steadily throughout the 1990s, but really took off in the mid-2000s after India partially deregulated its financial sector and started achieving GDP growth rates of 8 percent a year. A new development was the growth of outbound FDI from India, which moved more or less in step with inward FDI, albeit at lower levels. In 2010, inward FDI was around $25 billion and outward FDI around $15 billion. The substantial net capital inflows compensated for the current account deficit, allowing the country to accumulate sizable foreign exchange reserves.

Three central paradoxes:-

The poverty paradox: Independent India's commitment to democratic politics meant that its polity had to grapple with the harsh reality of India's poverty: the sheer number of the poor (who were also now voters), theintensity of poverty and destitution, and a deeply stratified and hierarchical society. Addressing the needs of vulnerable and marginalized groups in society has preoccupied intellectuals and policy-makers, and informed political rhetoric in India, to a degree uncommon among developing countries. Levels, changes, and measurement of poverty have been a major preoccupation of (often contentious) Indian policy debates, in considerable part because the benefits of the large array of redistributive programs deployed by the Indian state have been linked to so-called BPL (Below Poverty Line) status.[8] The puzzle is not that India's policy has been preoccupied with addressing poverty, but that the innumerable number of directed poverty programs that India has put into place over the decades have yielded such modest results. Like Sisyphus, the Indian state appears condemned repeatedly to launch poverty programs, and then,with limited results to show for its efforts, begin the process all over again. What explains these modest outcomes and why does the Indian State persist with these programs?

The salient features of changes in human development in India are provided in Table 1. While clearly there have been improvements in all aspects (except the gender ratio), the changes have been modest, both relative to other comparable countries and in light of India's rapid growth in recent years. Poverty has declined considerably, but for the most part it has been the result of broader growth (including for example the green revolution and the acceleration in growth in recent decades) rather than redistributive programs targeting the poor per se. It should be emphasized that the Indian base line for poverty is extremely low, so that trends over time are a better indicator of progress than absolute numbers, since many millions of people just above the poverty line also have very low incomes.

Innumerable reports on and analysis of India's poverty programs agree on seven broad conclusions. First, the lowest level "front-line" functionaries are poorly trained and often overburdened. Second, a large fraction of the resources in these programs is spent on the administrative costs of the programs or are siphoned off, with their intended beneficiaries receiving only modest amounts. Third, the mismatch between the incentives of the implementation agents on the one hand and the design and funding of these programs on the other ensures that implementation is the Achilles' heel of India's poverty programs. Fourth, the large-scale corruption in these programs stems from the discretionary power of public functionaries. Fifth, to curb these discretionary powers a labyrinth of rules has been put into place, which both slows work and simply redistributes the rents elsewhere. Sixth, these facts are well known to the state functionaries who are supposed to implement and monitor these programs, and to the intellectuals who push for them. And finally, all this persists because there is little accountability in the system. If anything, the accountability is perverse in that punishment is more likely to be meted out to someone who does not participate in the hierarchical systems of corruption than to someone who does.

The macro paradox: The Indian state's noteworthy record in macroeconomic management has long been recognized, whether compared with other developing countries or weak performance in microeconomic policies and ground level implementation. Thus for much of the period prior to the 1991 reforms India's record was the most "conservative" (among seventeen countries studied) with respect to inflation, monetary policy, and external debt (Joshi and Little 1994). India's superior inflation record (at least until the 1990s) owed much to the political aversion to inflation institutionalized by democracy, given the negative impact on the large number of poor voters (largely because the poor do not have access to financial instruments to protect themselves against inflation) and the relatively low levels of income inequality in India. Thus, instead of an independent central bank and monetary targeting, democratic politics has anchored and reined in inflationary expectations.

Despite the lack of conventional statutory independence, the Indian central bank (RBI) has competently conducted monetary policy, albeit within the mandate laid out by the government. Exchange rate management, once the bête noire of Indian macropolicies, has also improved considerably and is an important reason why India has weathered major global crises better than in the past.

The reasons are several. First, the breakdown of the Bretton Woods system depoliticized exchange rate policy in that it allowed the central bank to intervene in ways that led to a gradual depreciation of the rupee (compared to the earlier fixed exchange rate system where the IMF's involvement was inevitable and hence political fodder). Second, an important factor that had undermined the RBI's role in exchange rate management was India's economic model. With macroeconomic policy in India yoked to planning, adherence to the fixed exchange rate was necessary (from the narrow perspective of the planned model) because any change in its level would have upset the careful balance that was part of a plan's design (Khatkhate 2004). As the role of centralized planning ebbed, so did the importance of a fixed exchange rate. Finally, as trade's importance in the Indian economy grew, so did the importance of exchange rate management, since it affected both the competitiveness of India's burgeoning exports (and hence business interests) and inflation (through higher-priced imports), whose adverse effects on India's poor are well known.

The paradox of governance: In the early decades after independence, India's ruling elite was drawn from a narrow social group and by and large its probity was well recognized. Yet the policies it chose ensured that India's growth was modest, even though they did result in a gradual structural transformation of the economy. In contrast, since the late 1970s, as democracy has deepened and Indian growth rates have more than doubled (and in per capita terms, tripled), there is widespread acknowledgment of a sharp deterioration in probity in India's public institutions and manifest corruption at all levels of government. At the macro level, what explains the mismatch between conventional indicators of corruption and economic growth? And at the micro level, why has India persisted with directed poverty programs rather than supplying broad-based public goods whose long-term benefits to the poor are widely acknowledged?

Several explanations have been advanced to address the puzzle on why India has persisted in relying on targeted transfer programs and subsidies while severely under-provisioning basic public services for the poor, such as education, health, water, and sanitation (Keefer and Khemani 2004). Poor farmers might prefer targeted transfers to public services such as education because they have high discount rates (the benefits of transfers are immediate while the returns from education emerge over time). Alternatively, the poor might not matter electorally. However, India is rare among democracies in that the propensity to vote varies little by income, education, or social group—the votes of the poor certainly matter electorally.

Another explanation argues that rather than electoral participation per se, it is the clientelist nature of that participation, which results in materialistic inducements targeted to particular individuals and small groups of people as opposed to the provision of public goods through institutional means. This behavior is due partly to social polarization (itself a cause and consequence of a first-past-the-post electoral system) and lack of credibility of political promises to provide broad public goods (as opposed to private transfers and subsidies). Electoral competition therefore revolves around distributing public resources as club goods (goods with excludability characteristics) rather than providing public goods to a broad base.

Finally, those who have the voice (the middle and upper classes) have de facto exited from the system, preferring market solutions over poor quality and unreliable public services, further reducing pressures to change the system.

Perhaps the biggest driver of India's growth despite poor governance has been entrepreneurship. Although it has long been recognized that entrepreneurs are the central actor stoking the animal spirits of capitalism, conventional neo-classical growth models have little place for them. Behind the dynamism of the Indian economy in recent decades is the sharp increase in the number of entrepreneurs from much wider social groups than in the past (Damodaran 2008).

Conclusion: With a sixth of the world's population, India's economic development has not only important implications for its citizens, but global ramifications. While there is little doubt regarding the substantial economic transformation after 1990, compared to most other large developing countries India has moved more gradually on most measures of market-based reform, be it privatization, trade, or financial sector liberalization. Nonetheless, during this period its growth has been nearly twice the average for developing countries outside Asia and much better compared to its own past. Yet, while all political parties have more or less accepted the broad thrust of the shift to a market-oriented economy (although differing on specific priorities), even after more than two decades reform does not have an overt political constituency.

If India continues to grow at the rate it has achieved in recent years, its global presence will become much more significant. Indeed, it is likely to emerge as the world's third largest economy by around 2030.10 Of course, this outcome is by no means certain: India has significant assets but also major liabilities.

India's recent success has in many ways created new and difficult challenges. Its creditable performance in recent decades notwithstanding, Indian agriculture faces serious long-term obstacles. Excessive use of water relative to supplies and distortions in the application of chemical fertilizers have led to the gradual building up of severe environmental problems. With yields stagnating as the aftereffects of the green revolution take hold, the diversion of scarce agricultural land for urbanization and industrialization, and

India predicted to be one of the countries most adversely affected by climate change, the pressures on Indian agriculture are likely to become more severe over the next few decades and to impose major constraints on future development.

Rapid economic growth is also imposing severe resource constraints, be they land, energy, or water. The allocation of these scarce resources will require a degree of fairness and transparency that has been markedly absent in the non-market discretionary and opaque government actions that have contributed to a range of growing ailments, including a Maoist insurgency in India's central tribal belts, unprecedented levels of corruption, and a policy paralysis from the public backlash.

But perhaps the foremost challenge India faces is strengthening public institutions and governance. Its democratic success and the demographic dividend mean that tens of millions of young people will be joining India's work force with aspirations that their parents couldn't even dream about. Managing their expectations will be no mean task. In the two decades after the onset of economic liberalization India added 364 million people to its population—more than the stock at the time of independence, a stock accumulated over many millennia. Understanding the mass is not easy. Managing it will be even harder.

The challenge India faces is to create a state that enforces laws impartially, rather than simply create new rules at its convenience and enforce them arbitrarily. While in the foreseeable future the expansion and growth of India's private sector and all-too-vibrant civil society will certainly fill in for some of the shortcomings of the public sector, there are a wide range of core functions, from regulation to security and from social inclusion to public goods provision, where the State is—and will be—indispensable. The integrity and responsiveness of the Indian state to the multiple challenges facing the country, both internal and external, will fundamentally determine India's future.

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