

Policy Regimes & Growth: Government Failure, Entrepreneurial Success

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[Views Are Personal]

Introduction

- Economic Growth, & Policy Regimes:
 - ◆ Indian Socialism: 1950-1 to 1979-80
 - ✦ Poor Growth, Rising Poverty
 - ◆ Market Reforms: 1980-1 to Present
 - ✦ High growth falling poverty
- Market Reforms
 - ◆ Critical Reforms(1980s): ISI to EP
 - ◆ Wider Reforms (1990s): External, Finance
- Growth Prospects: Underlying rate 6.8% to 7%
- Structure Policy Changes & Governance
- Conclusions

Policy Regimes & Growth Phases

- Phase I: Indian Version of Socialism
 - ◆ 30 years from 1950-51 to 1979-80
- Phase II: Experiments in Market Reform
 - ◆ 25 years from 1980-1 to present

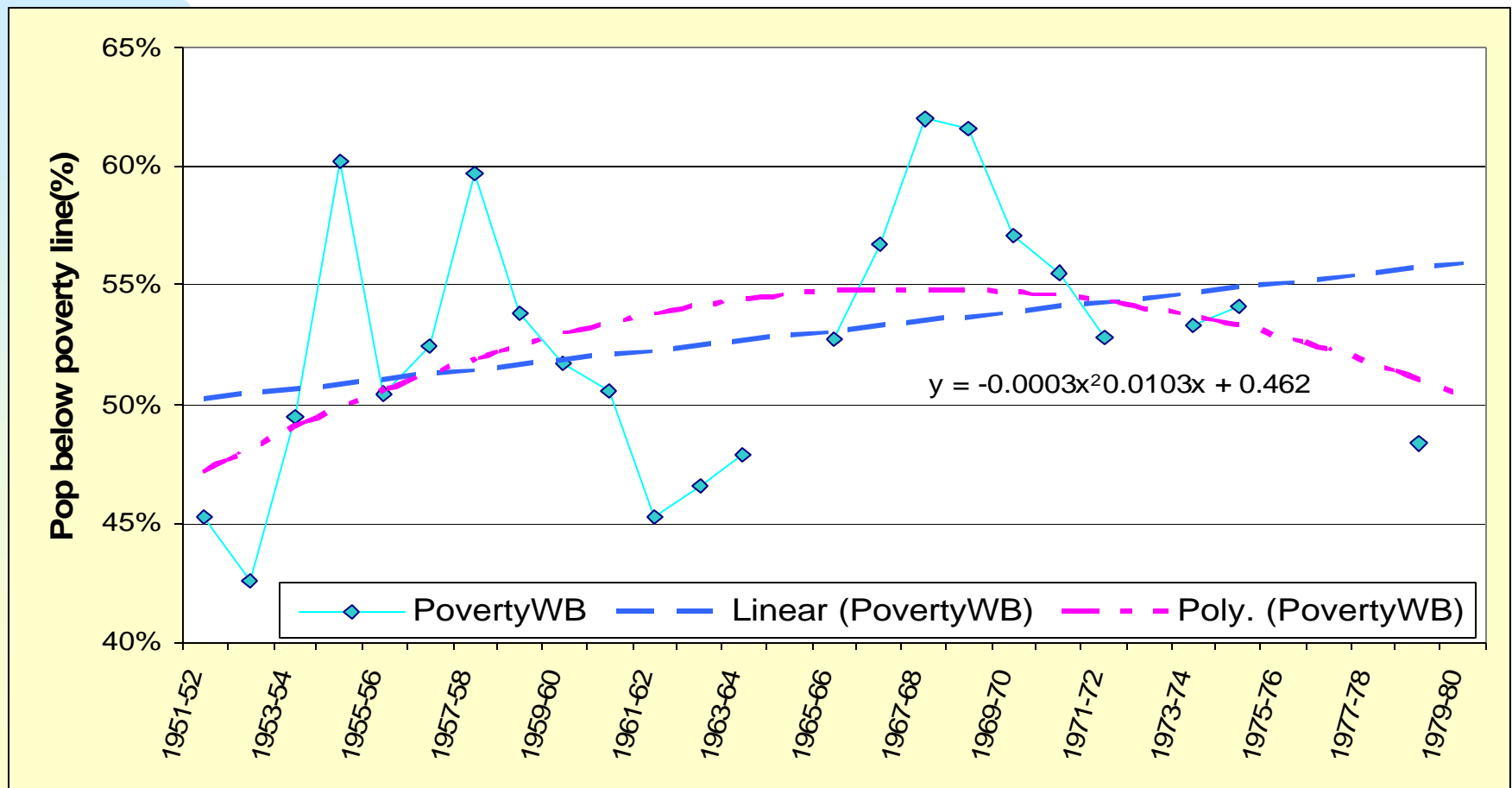
I: Policy Framework IVS

- Introduction and enhancement of the Import substituting Industrialisation strategy (ISI)
- Restriction and elimination of the freedom of economic agents to compete in many industries and sectors.
- Extension of government into more and wider areas of economic and social activity.
- Corresponding and progressive neglect of the fundamental job of government.

Phase I: Results

- Indian Socialist rate of growth
 - ◆ Average Growth Rate: 3.5% per annum
 - ◆ Global Ranking (1960+): Bottom 60/74
 - ◆ Per capita GDP: 1.3% per year
 - ◆ Global Ranking (1960+): Bottom 66/74
 - ◆ Poverty increased by 0.2% per annum

Poverty: Head Count Ratio



II: Experiments in Market Reform

- Move from Import substituting industrialisation to export promotion and from thence to broader import liberalisation
- The restoration of the freedom to compete followed by a move to restore competition in different sectors and markets.

Table: Results - Growth & Poverty

Phase=> I: Indian Socialism II: Market Reform
Period=> 1951-2 to 1979-80 1980-1 to 2003-4

<u>Variable</u>		
GDP at factor cost	3.5%	5.8%
World rank in GDP growth	60/74*	9/88
Per capita GDP	1.3%	3.7%
World rank in per capita growth	66/76*	9/88
Poverty rate (HCR)	0.20%	-0.80%
GDPgr:Co-efficient of Variation	1.0	0.3
Rainfall: Difference from mean	0.5%	-1.8%
Contribution to GDP growth	-0.03%	-0.08%
Total Factor Productivity Growth	0.9%	2.7%

Lessons Level I

- **1.1:** Even with high motivation Govt can fail spectacularly. More commonly it has traits that are opposite of those assumed by those who expect govt to solve every problem.
- **1.2:** The role of Private consumption in economic growth & poverty reduction can be more important than that of Govt Cons.
- **1.3:** Government Investment is neither necessary nor sufficient for Growth.
 - ◆ **1.3.1:** The importance of govt investment as a driver of growth has been overrated and the importance of private investment underrated. Government investment in 'private goods and service' is a substitute for private investment and will have zero direct effect on growth (assuming equal efficiency). The net effect is negative if we take account of tax distortions to raise funds for government investment.
 - ◆ **1.3.2:** The efficiency of investment is critical to growth. Govt investment that is not driven by social benefit-cost considerations can be highly inefficient. A monopolistic govt sector is likely to be highly inefficient (Xefficiency) and can retard growth.
- **1.4:** Though investment is necessary for growth the key driver of total productivity growth (TFPG) and overall growth is investment in machinery

Lessons: Investment, Consumption & Competition

Phase=> I: Indian Socialism II: Market Reform
Period=> 1951-2 to 1979-80 1980-1 to 2003-4

Variable

Investment: Total	6.1%	6.3%
Investment: Public	7.5%	2.4%
Investment: Private	3.6%	8.7%
Investment: Fixed	4.8%	6.2%
Machinery	6.6%	8.8%
Structures	4.4%	4.5%
Private (fixed)	3.6%	8.7%
Consumption: Private	3.2%	4.6%
Consumption: Government	5.8%	6.0%
Real Interest Rate: SBI	-1.7%	7.8%
Real Exchange Rate:Pt/Pnt	0.3%	-0.3%
REER (35 country, trade weighted)	-2.3%	-1.0%
Price of Crude Oil	15.8%	2.4%
Relative Price of Machinery	3.6%	-1.6%

Lessons Level II: Agriculture

- **2.1:** 'Socialist' measures (1967-8 to 1973-4) neither improved per capita income growth nor reduced poverty. Along with deteriorating govt monopolies (created 1950s) may have contributed to increasing poverty.
- **2.2:** Sustainable and efficient systems for water conservation, use and recharge remain essential for minimising the effect of rainfall on agriculture & rural population dependent on it.
- **2.3:** Agriculture has not been a driver of growth in India. May have been a substitute. Productivity growth through diversification & adoption of new technology important. Role of govt. in agro/rural because of information problems.

Lessons Level II: Investment

- **2.4:** Sharp slowdown in public investment in phase IB had no perceptible effect on growth rate. Govt investment neither sufficient nor necessary condition for growth.
- **2.5:** The effect of govt investment depends on (i) Category of goods in which made, (ii) Policy framework (e.g. entry barriers), (iii) Substitutes (legal & illegal). Changes in govt investment in the production of private goods in a competitive industry have no direct effect on growth (assuming ownership neutrality).
 - ◆ **2.5.1** The net effect of a reduction of government investment in private goods on growth could therefore be positive if it is financed by (distorting) tax revenues.
- **2.6:** A slowdown of fixed investment in govt-monopolised Quasi-public services has a negative impact on GDP growth, but the impact is reduced over time (ipso facto). As the monopoly ages, X-inefficiency increases, governance deteriorates and substitutes (legal & illegal) develop.

Market Reform: Sub-Phase IIA Themes

- Move to an Export Promotion (EP) strategy
- Progressive restoration of the freedom of entrepreneurs to compete.
- The gradual nature of these reforms was referred to by us a decade and half ago as “Tinkerisation.”
- Subsequent analysis suggests that the pace of reforms during this decade was not so misaligned with the ‘optimal.’

IIA: Freedom to Compete

- Price and distribution control on cement and aluminium ,removed.
- ‘Broad-banding’ (prod variants, range). Economies of Scope (legally exploit).
- The upper limits on how much an ID&R act licensee could produce, by adding some equipment or replacing old equipment with higher capacity new equipment, was gradually raised (to 5 crore in 1985, 15 crore in 1988). Thus firms could for the first time legally exploit new economies of scale as they emerged (from the technology/supply and demand side).
- Greenfield investment was gradually de-licensed by progressively freeing specified sub-sets of industry from its ambit (i.e. positive list of de-licensed industries) & raising the value limit(no license required).
- Small Scale Sector, investment value limit raised (economies of scale).
- The positive list of MRTP exempt industries was expanded and the investment value limit (above which a licence was required even for industries in the positive list) was raised progressively. As only such MRTP groups had the resources and risk taking ability to invest in large capital-intensive industry, where economies of scale are most critical for competitiveness. These industries were therefore implicitly decontrolled.

IIA(1980 to 1979):Export Promotion

- Availability of imported inputs and capital goods through special schemes (AL, IAL,SIL, IE PBS, EPCG and Tradable REP Licenses).
- Duty free input imports & reduced duty on capital goods.
- Neutralisation of domestic input taxes (e.g. excise) and availability of domestic raw materials at world prices.
- Investment licensing, MRTP, location restrictions exempted. Export obligation reduced.
- More EPZs, simpler admin procedure for duty free import.
- Special facility, lower interest rate on pre/post-shipment credit.
- Reduced income tax on export profit (+professionals).

Initiation of Growth: 1980s

- 32% of all imports were on OGL in 1987-88. Primarily intermediate & capital goods not produced in the country (i.e. high equivalent tariffs).
- Tariff increases on inputs & capital goods closed the gap between the equivalent tariff (arising from QRs) and the nominal tariffs.
 - ◆ Reduced rents improved the efficiency of the remaining rationing.
 - ◆ Tariff collection (non-POL) increased from 30% (late 1970s) to 61% in 1986-87.
- *The real exchange rate (P_t/P_{nt}) depreciated by 0.3% per year (IIA) after appreciating by 0.7% per year (IB).*
- Supply side reforms: Accelerated growth through higher TFPG.
 - ◆ De Long & Summers (1991/92/93) Equipment investment is strongly co-related with long run growth. Hendricks (2000) Effect of relative prices of CG on equipment investment.
 - ◆ Helpman and Krugmen (1985) access to foreign suppliers provides access to specialised capital goods, which by expanding the assortment of capital goods (and inputs) available for production raises TFPG

Market Reform: Initiation of Growth

<u>Variable</u>	Phase=> Period=>	II A: Basic Reform <u>1980-1 to 1991-2</u>	II B: Wider Reform <u>1992-3 to 2003-4</u>
GDP at factor cost		5.5%	6.1%
World rank in GDP growth		12/88	9/107
Per capita GDP		3.2%	4.1%
World rank in per capita growth		14/88	9/107
Poverty rate (HCR-level)		38.0%	35.3%
Co-efficient of Variation of GDPgr		0.5	0.2
Rainfall: Difference from mean		-1.7%	-1.9%
Contribution to GDP growth		-0.08%	-0.08%
Total Factor Productivity Growth		2.6%	2.8%
Investment: Fixed		5.6%	6.9%
Machinery		8.5%	9.2%
Structures		3.7%	5.4%
Real Exchange Rate: Pt/Pnt		-0.3%	-0.4%
REER (35 country, trade weighted)		-2.7%	0.8%
Price of Crude Oil		-1.0%	5.8%
Relative Price of Machinery		-0.8%	-2.6%
Ratio: Export/GDP		4.9%	9.0%

Growth Spurt From IS To EP Policy

<u>Economy</u>	<u>Change Year X</u>	<u>1960 to X*</u>	<u>X+1 to Y</u>	<u>End year Y</u>	<u>Growth Spurt</u>
	1	2	3	4	5=3-2
Indonesia	1966	0.0	5.1	1973	5.1
Singapore	1966	4.8	8.4	1979	3.7
China	1979	4.9	7.7	1991	2.7
India	1979	0.6	3.3	1991	2.6
Korea, S.	1960	3.3	5.7	1970	2.3
Thailand	1980	4.1	6.2	1992	2.1
Taiwan,China	1957	5.0	6.7	1972	1.7
Malaysia	1970	3.5	4.4	1985	0.9

Notes: *=data for S. Korea in this column is for 1960-64 as WDI data is available only from 1960

IIB: Wider Reform: Competition

- Change in direction, emphasis & pace:
 - ◆ The move to an Export substituting strategy in the previous sub-phase was supplanted by and encompassed within an Import liberalisation one.
 - ◆ This was embedded within an overall strategy of eliminating restrictions & barriers to competition and progressively promoting competition.
 - ✦ Static efficiency and welfare gains also received direct attention.
- Why have some reforms worked others not, why same have worked quicker/better than others?
 - ◆ Freedom, Pressure Ability(access) to compete

Dynamic/Schumpeterian Competition

- 3.1: Freedom to Compete is a necessary condition (pre-requisite) for competition & efficiency gains.
 - ◆ 3.1.1: Governance Paradox; A deterioration in governance can increase the freedom to compete and thus lead to increased efficiency/growth.
 - ◆ 3.1.2: A small expansion of freedom to compete can lead to a disproportionate effect on efficiency/growth because of the de-legitimisation of distortionary controls and an increase in evasion-corruption.
- 3.2: Domestic Liberalisation: Reduction of controls on pricing, distribution, production, investment simultaneously increase the freedom to compete & the pressure of competition. Necessary condition for increasing competition and deriving its dynamic benefits.

IMPORT De-Control

- 3.3: A reduction in controls on imports of raw materials, intermediate goods & capital goods increases both the competitive pressure on domestic producers and their access to the means of competition.
 - ◆ 3.3.1: Availability of imported capital goods improves access to embodied technology and thus provides the means to compete. Freedom to import capital goods is necessary for a low income country to obtain the benefits of competition.
 - ◆ 3.3.2: Domestic liberalisation coupled with liberalisation of capital goods imports is necessary and sufficient for increasing competition and obtaining its benefits in terms of efficiency/productivity for the existing set of goods.

Import Liberalization

- 3.4; Intermediate inputs (parts, components) is necessary for introduction of competitive new manufactured products.
 - ◆ 3.4.1: Complements CG liberalisation in promoting productivity improvement.
- 3.5: A replacement of QRs with equivalent tariffs increases the threat of competition on both the output and input side and thus increases both the competitive pressure and the ability to compete (more competitive supply of inputs).
 - ◆ 3.5.1: Average tariff rise cum import de-control can lead to reduced effective protection because of lower transaction costs.=>Efficiency gains from re-allocation of allowed imports
- 3.6: A reduction in import controls on final consumer goods increases the pressure to compete but enhances the ability to compete after a lag. A slower phasing in of consumer goods import liberalisation can therefore be justified.

Access to Means: FDI

- 3.7: The positive effect of FDI is the highest where controls have created the largest gap between the domestic and global technology level.
 - ◆ 3.7.1: In a country that lacks entrepreneurs (perhaps because such entrepreneurs have been eliminated or expelled) FDI is vital for fast growth.
- 3.8: A market sensitive exchange rate policy (foreign exchange supply-demand and market expectations), is critical to the success of market based international trade liberalisation.
- 3.9: The **J curve of Import liberalisation & productivity change**. In a heavily protected economy, a major import liberalisation will initially slow measured productivity growth and result in its acceleration only after a lag.

Credibility of Regime Change

- 3.10: Credibility of Regime Change. A credible change in the policy regime can help magnify the effect of small reforms on (private) investment and growth while a non-credible change can minimize/reduce the effect of large changes.
 - ◆ 3.10.1: It is easier for a single party regime with an unchallenged leader to gain credibility.
 - ◆ 3.10.2: In a democratic system the opposition is expected to question the government's changes and to be critical, but criticism from within the ruling party, its supporting organisations and coalition partners can undermine credibility.

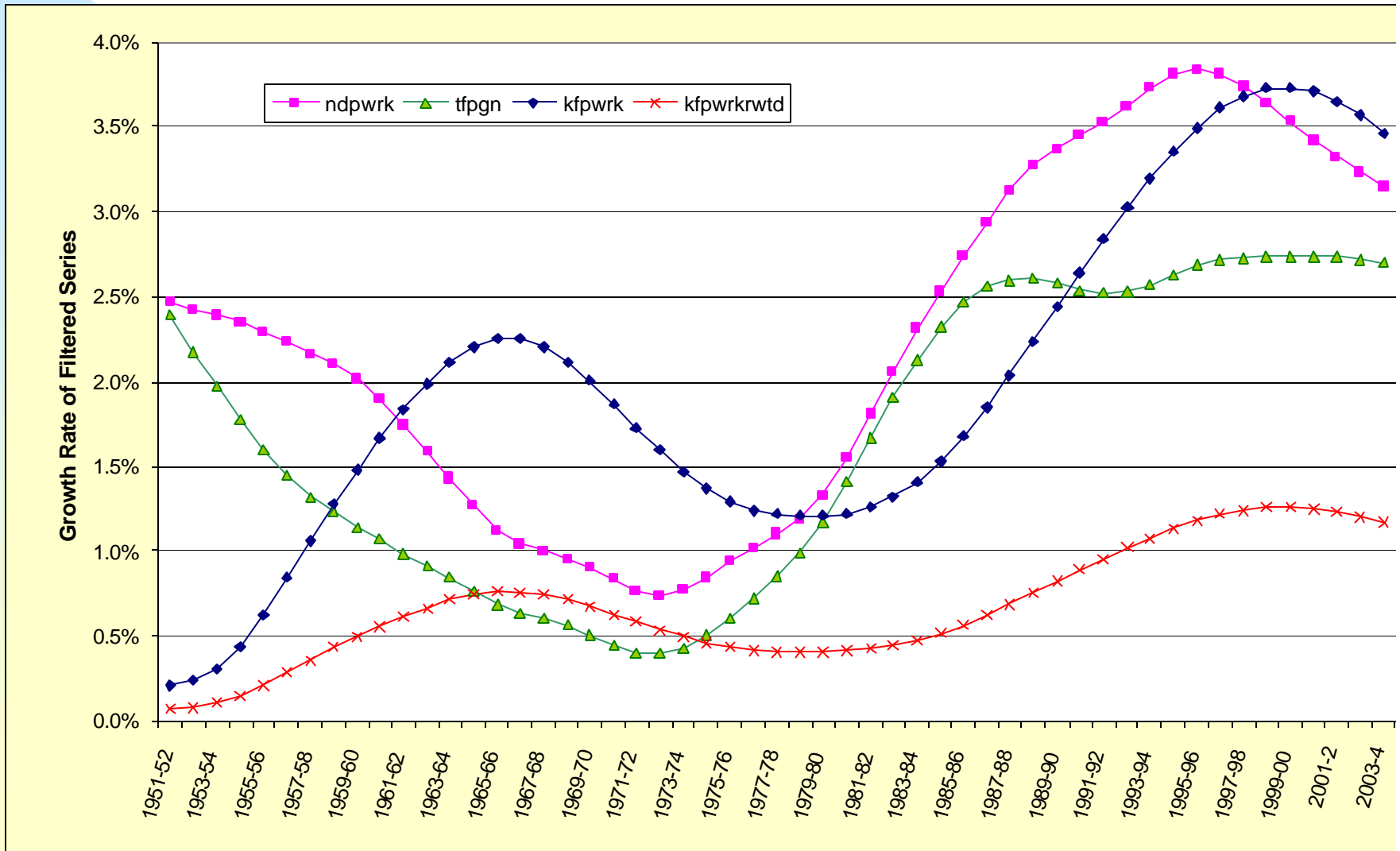
Global Comparison: Equal Society

	<u>Only GDPppp > \$15bd (2003)</u>				<u>Value</u> <u>Year</u>		<u>All countries with data</u>			
	<u>Rank</u>	<u>Nof</u>	<u>%countries</u>				<u>Rank</u>	<u>Nof</u>	<u>%countries</u>	
	India	Countries	Above	Below	India	Countries	Above	Below		
<u>Income</u>										
Per Capita GDP ppp	71	79	90%	10%	636	1980	107	127	84%	16%
Per Capita GDP ppp	80	104	77%	23%	2892	2003	111	165	67%	33%
<u>Income Distribution & Poverty</u>										
Share of Lowest 10%	4	95	4%	96%	3.9	2000*	6	127	5%	95%
Share of Lowest 20%	11	95	12%	88%	8.9	2000*	14	127	11%	89%
Share of Lower 40%	21	95	22%	78%	21.2	2000*	25	127	20%	80%
Ghi Index	29	95	31%	69%	32.5	2000*	32	126	25%	75%
Poverty Head Count Ratio (%)	24	56	43%	57%	28.6	2000*	29	85	34%	66%
Note: * = Poverty And Income Distribution Data is available for different years for different countries										

Govt Failure: (Quasi-) Public Goods

	Rank <u>India</u>	No of <u>Countries</u>	% countries		<u>Value</u>	<u>Year</u>
			<u>Above</u>	<u>Below</u>		
<u>Health</u>						
Mortality Rate Male(per 1000 males)	75	108	69%	31%	250	2000
Mortality Rate female(per 1000 females)	85	108	79%	21%	191	2000
Mortality Rate Infant (per 1000 infants)	84	108	78%	22%	63	2003
Mortality Rate under 5(per 1000 5-)	86	108	80%	20%	87	2003
Life expectancy at birth(per 1000)	87	108	81%	19%	63	2003
<u>Education</u>						
Primary(net) school enrolmnt (%)	82	101	81%	19%	83	2000
Primary(net) school enrolmnt (%)	86	101	85%	15%	83	2001
Primary completion rate (%)	82	100	82%	18%	77	2000
Primary completion rate (%)	81	102	79%	21%	81	2002
Persistence to grade 5(% of cohort)	88	92	96%	4%	61	2000
Labor force with education \geq Primary	69	74	93%	7%	49	1988
Youth(15-24) Literacy (% of youth)	90	98	92%	8%	73	2000
Adult Literacy Rate (% of adults)	100	108	93%	7%	57	2000
Adult Literacy Rate (% of adults)	100	108	93%	7%	61	2001

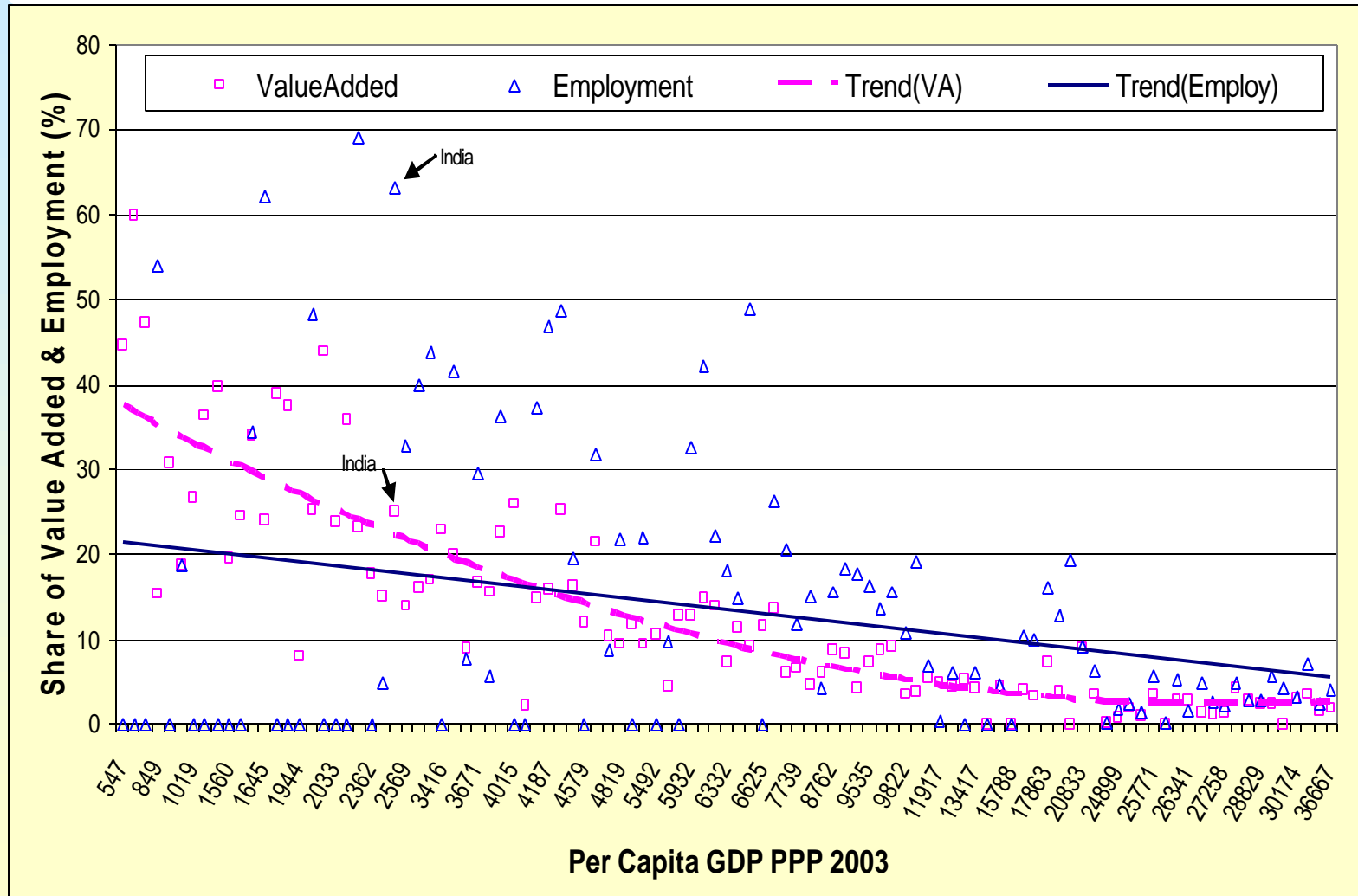
Productivity TFPG



Transformational Policies for Future

- Accelerating Private Investment: Private Goods
 - ◆ Railways, Power, Irrigation, Urban Utilities, Health
- Institutional Reform: Highways/Roads, Urban Inf
- Structural Transformation:
 - ◆ Sectoral GDP. Employment shares
 - ◆ Modern Services & manufacturing
- Education: Policy Framework for Pvt entry
 - ◆ Info asymtry: Mandatory rating, audit, disclosure
- Electricity T&D Mafia: Policy & Regulatory Risk
 - ◆ Vested interest of Dept (monopolist) in Pvt failure
 - ◆ Professional, independent regulation

Agriculture: GDP & Employment



Transformational Policies for Future

- FDI: Global Supply Chain (Retail FDI)
 - ◆ Tariff Rates: Peak- 10%(2006-7), 5% (2008-9)
- Governance: Back To Basics
 - ◆ Corruption of Motivation
 - ◆ Program Overload, Capacity mismatch
 - ◆ Notorious Bureaucracy: Growth orientation

Conclusion: Competition Dynamics

- Govt policy limited competition
- The most important dynamic gains have come from removal of extreme policy distortions
 - ◆ Bans, controls, restrictions on Production, Investment, Import (Capital, Intermediate goods)
- Competition: Freedom, Pressure, Ability (factors):
 - ◆ Vital role in driving TFPG & Gr
 - ◆ Calibrated Balanced; Entrepreneurship
- Government Created Monopolies
 - ◆ X-inefficiency magnified
 - ◆ Monolith: Bundling Policy, Regulation, Magt/Oper
 - ◆ Regulatory Capture: LIC

CONCLUSIONS: 1980s vs 1990s

- Import Substituting (IS) to Export Promotion (EP)
- Competitive Pressure balanced by Competitive Ability (access to means to compete)
- Non-linearity: Glaring/Large distortions tackled
 - ◆ Interaction between law-rules, evasion & corruption
- Large array of reforms: Growth?
 - ◆ Static: Efficiency & equity => Welfare
 - ◆ Change in Pressure > Change in ability (factor market reform lagging)
 - ◆ J curve of Liberalisation: Measured productivity (capital immobility, S curve of tech diffusion)

CONCLUSIONS: Govt Failure

- Government Over-extension, Overload, Failure
 - ◆ Corruption: Motivation (80-90%) vs. financial
 - ◆ Problem =>New law, Govt program/project
 - ◆ Tax & Spend (1960s, 1970s) will not work
 - ◆ Govt Expenditure, Public investment=>No growth
- Poverty: Eliminate through smart card
- Social indicator: Literacy, Mortality rates
- Radical Restructuring of Role:
 - ◆ (Quasi) Public G&S
 - ◆ Get out of Private goods & services
 - ◆ Private or Private-Public partnership

THANK YOU

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