*Development through Planning, Markets or De-centralisation**

Shyamala Gopinath

It gives me great pleasure to inaugurate the seminar on, 'Development through Planning, Markets or De-centralisation' during the Golden Jubilee of IIT. The subject of the present seminar is extremely important at the present stage of Indian economic development. This three-day seminar I am sure, will provide useful insights into various issues relevant for policy-making to guide India successfully through paradigm search and paradigm shift. There are divergent views on theme of the present seminar and I believe the illustrious scholars participating in this seminar will touch upon them. The seminar would provide an important outlet for sharing and discussing rich experiences on such a relevant topic. I congratulate the Humanities and Social Sciences Department of IIT Bombay for organising this seminar on an important topic.

The reform process of the mid-1980s and 1990s has been successful in gradually establishing the pre-conditions for smooth functioning of the market. However, concurrently, the Eighth, Ninth and Tenth five year plans provided the overall direction to the economy. The outcome of such an experience has been encouraging on several fronts though there exists a large unfinished agenda. On the positive side, the Indian economy has entered a high growth phase since 2003-04 breaking the lacklustre performance what late Prof. Raj Krishna described by the catchy phrase "the Hindu rate of growth". While the real GDP growth for the Tenth Plan period (2002-03 to 2006-07) averaged 7.6 per cent per annum, during 2005-06 and 2006-07, the

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growth rate has been above 9.0 per cent level. The major issue facing the Indian economy at this point is whether this high growth phase can be sustained. It is in this context that the debate on planning versus decentralisation versus market becomes crucial. One thing is very clear that right combination of strategy would be required to steer India through from a developing economy to a developed economy.

Rethinking on economic policy in India has not been an exclusive and distinct process, but has been derived from the international thinking. The broad outline of the reforms that were initiated in the mid-1980s was not very different from the reforms undertaken by many developing countries around that time. The limitations of a development strategy based on import substitution, public sector dominance and extensive Government control over the private sector had become evident by then, and there was no choice other than changing the system itself in a fundamental way. The broad characteristics of the system change involved liberalisation of Government controls, a larger role for the private sector and greater integration with the world economy. India's reforms differed from rest of the world in that it was implemented at a much more gradual pace keeping in view the Indian context and Indian specific circumstances, and the gradualism strategy paid off in warding off any financial crisis of sorts witnessed in East Asian economies or Latin American economies.

After giving a historical background of planning in India, I would touch upon the policy changes as a part of the structural reforms in different sectors of the Indian economy. I would also review the achievements in terms of the performance of the economy in the post-reform period. The concluding observations would delineate some of the challenges that lie ahead.

I. Historical Background

The Planning Commission was set up in March 1950 with the objectives of promoting a rapid increase in the standard of living of the people by efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community. The Planning Commission was entrusted with the responsibility of making assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilisation of resources and determining priorities. The evolution of India's development policy over the past fifty years is a unique illustration of change with continuity - though the underlying objective has been the same, the emphasis of each plan varied in accordance with the evolving situation. During the first three Five Year Plans India's process of development consists of the following three elements: (a) modernisation of the economy; (b) self-reliance; and (c) socialism or, more correctly a socialist pattern of society with equity and social justice. For the following two decades, policies were

adjusted to the changes in the objective conditions of the economy. For the first eight plans, the emphasis was on a growing public sector with massive investments in basic and heavy industries. Among the prominent features of public policy, licensing regulated the scale of operations of every firm; reservations and other incentives favoured small-scale industries; strict labour laws constrained large enterprises; and the MRTP Act was the final safeguard against concentration. In short, private initiative and growth, were to that extent stymied although it has to be accepted that the impressive growth performance since 1990s was possible due to the strong foundation of an industrial base and the knowledge enhancing institutions. Since the launch of the Ninth Plan in 1997, the emphasis on the public sector has become less pronounced and the current thinking on planning in the country, in general, is that it should increasingly be of an indicative nature.

II. Economic Reforms of the 1990s

The economic reforms of the 1990s included: significant industrial and trade liberalisation; financial deregulation; improvements in supervisory and regulatory systems; and policies more conducive to privatisation and foreign direct investment. One of the major initiatives in the reforms spectrum was in the area of industrial and trade policy.

Industrial Reforms

The pre-liberalisation industrial policy was characterised by several restrictions on private investment on subjects like, areas allowed for investment, scale of operations, location of new investment and even the technology to be used. As a result, the Indian industrial structure was highly inefficient as documented by a number of empirical studies. In order to protect this inefficient industrial structure, the trade policy necessarily had to be restrictive and protective. Considering all the costs these restrictive policies inflicted on the economy, there was a near consensus amongst economists and policy makers about the need for reforms in the industrial sector.

Before the reforms, around 18 industries were reserved for sole operation by the public sector. This list has been reduced over the period and at present only three industries - defence aircrafts and warships, atomic energy generation and railway transport, are reserved for the public sector. Another major area of reforms was the industrial licensing. Currently industrial licensing by the Central Government is restricted only for a few hazardous and environmentally sensitive areas. The MRTP Act has been diluted. The list of items reserved for production by the small scale sector has been pruned substantially. Some of the most crucial items which were removed from the reservation list included highly export-oriented items like garments, shoes, toys and auto components.

Trade and Investment Reforms

Prior to the reforms, the trade policy was characterised by high tariff and pervasive import restrictions. Import of manufacturing commodities was completely banned. In order to import capital goods, raw materials and intermediaries, where indigenous

substitutes were available, licenses were required. This made imports not only cumbersome and time consuming, but also resulted in inefficient industrial production as mentioned earlier. The aim of reforms in the trade policy was to phase out import licensing and rationalisation of import duties. The requirements of import license for capital goods and intermediaries were relaxed as early as 1993. Removal of restrictions on import of manufactured consumer goods and agricultural products was a more lengthy process as the number of domestic producers affected by this change was large. The quantitative restrictions on imports of manufactured consumer goods were finally removed in 2001.

Prior to 1991, there were several restrictions on foreign direct investment in India, making it almost impossible for foreign entities to operate in India or collaborate with Indian companies. There was a growing understanding that liberalisation was needed on this front in order to increase the total volume of investment in the economy, improve production technology, increase access to world market and also improve efficiency in the domestic production processes by introducing an element of competition. Owing to the reforms in this direction, 100 per cent/majority foreign ownership is now allowed in a number of industries with a few exceptions. Procedures for obtaining permission were greatly simplified by listing industries that are eligible for automatic approval up to specified level of foreign equity (100 per cent, 74 per cent and 51 per cent). In order to get the required permission, the foreign investors only need to register with the Reserve Bank. In case of foreign direct investment in areas other than that covered by the automatic route list and also in case higher than automatically permitted investment proposals, the interested parties are required to go through the Foreign Investment Promotion Board. Since 1993, investments in Indian equities by Foreign Institutional Investors (FIIs) are permitted and presently the FIIs as a class has become a dominant player in the Indian stock markets. The reforms in trade and industrial policy had a deep rooted impact on the industrial sector in India. The Indian companies became more efficient thanks to the competitive pressures. The domestic players reaped the benefits of upgraded technology and expanded to more efficient scales of production to withstand the competitive pressure. Many domestic players also had to restructure their business activities through mergers and acquisitions. Others refocused their business strategies to concentrate on their areas of core competency.

Infrastructure Reforms

Rapid growth of the economy can be sustained only if there are no infrastructural bottlenecks. In fact, infrastructural facilities like electricity and telecommunications, connectivity through water, roads, railways and air transportation, are the backbone of an emerging economy. The State Governments have taken some initiatives by instituting independent statutory regulators, which are expected to set tariffs at a level which is fair to

both consumers and producers. Privatisation of power distribution has also been affected by some states, though implementation of these reforms has been met with some resistance. Comparatively, India's performance in the telecommunication sector is much better. There are several private sector service providers operating in fixed line and cellular services. As a result, while the tele-density has improved substantially over the period, waiting period to get new connections has come down drastically. The most striking impact was on the long distance charges, which have been reduced substantially. In the case of civil aviation, the entry of private players has introduced competition and this has resulted in lowering tariff rates across the spectrum. While there have been some remarkable initiatives in the case of road transport, the railways have also witnessed winds of change in recent years. Tariffs have been rationalised and newer avenues of earning revenue are being explored extensively.

Agricultural Reforms

As compared with the industrial policy and trade policy, the reforms in agricultural sector were slow. Some economists have suggested that the reform process indirectly benefitted the agricultural sector as the reduction in protection to industry and the accompanying depreciation in exchange rate tilted the relative prices in favour of agriculture and agricultural exports. The Government stepped up efforts to improve agricultural productivity through regionally differentiated strategies under the macro management mode of planning and implementation, introduced in October 2000, subsuming all earlier Centrally Sponsored Schemes. Agriculture has, however, suffered due to decline in public investment in areas which are crucial for agricultural growth, *viz.*, irrigation, soil conservation, water management and rural roads. Some studies have suggested that this decline in public investment was more than offset by the increase in private investment in agriculture. However, the fact remains that initiatives which can kick-start the growth process are likely to be undertaken only by the public sector. Thus a lot remains to be done in the area of agricultural reforms.

Financial Sector Reforms

Financial sector reforms, which are an important institutional underpinning for real sector reforms, have also made considerable progress. A modern and efficient financial system is necessary not only to provide a conducive environment for private saving, but also to ensure that these are channelled into the most productive investment opportunities. The principal objective of financial sector reforms was to improve the allocative efficiency of resources, ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. With a view to making the reform measures mutually reinforcing, the reform process was

carried forward through analysis and recommendations by various Committees/Working Groups and extensive consultations with experts and market participants. One of the special features of the reforms was that these were carefully sequenced in terms of instruments and objectives. Thus, prudential norms were introduced early in the reform cycle, followed by interest rate deregulation and gradually lowering of statutory preemptions. The more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place. While the focus of the first generation of reforms was to create an efficient, productive and profitable financial services industry, the second phase of financial sector reforms, beginning from the second-half of the 1990s, was aimed at strengthening of the financial system and bringing of structural improvements.

The need to prepare the financial system in a more globalised environment and to promote financial stability in the face of domestic and external shocks was on the top of agenda of reforms. With increasing globalisation of the Indian economy, the reform process witnessed a significant move towards adoption of international best practices in several crucial areas of importance such as prudential norms, banking supervision, data dissemination and corporate governance. The desired reforms to align with what are considered appropriate global practices, in financial sector, in terms of timing and redesigning to suit our conditions must recognise the status and developments in the real sector, especially flexibilities, fiscal health and overall governance standards.

With a view to increasing competition in the banking sector, new private sector banks were licensed. A prerequisite for grant of the licence was that these banks had to be fully automated from day one. The results are self-evident as these banks have become high-tech banks. This has had a 'demonstration' effect on the entire system. The Government ownership in nationalised banks and State Bank of India was brought down by allowing them to raise capital from the equity market up to 49/45 per cent of paid-up capital. A unique feature of the reform of public sector banks, which dominated the Indian banking sector, was the process of financial restructuring. Banks were recapitalised by the Government to meet prudential norms through recapitalisation bonds. The mechanism of hiving-off bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard. The overhang of non-performing loans had to be managed. The divestment of equity and offer to private shareholders was undertaken through a public offer and not by sale to strategic investors. Consequently, all the public sector banks, which issued shares to private shareholders, have been listed on the exchanges and are subject to the same disclosure and market discipline standards as other listed entities. Banks were also allowed to diversify into various financial services and are now offering a whole range of financial products like universal banks.

Active steps were also taken to improve the institutional arrangements, including the legal framework and technological system what is referred to as financial ecology. To tackle the issue of high level of non-performing assets (NPAs), Debt Recovery Tribunals (DRTs) were established consequent to the passing of Recovery of Debts Due to Banks and Financial Institutions Act, 1993. To provide a significant impetus to banks to ensure sustained recovery, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was passed in 2002. While transfer of NPAs of public sector banks to separate asset management companies was not considered, an institutional mechanism to deal with distressed assets of banks and financial institutions has been created. Asset Reconstruction Companies have been allowed to be set up which are in the private sector and operate as independent commercial entities to acquire non-performing assets from any financial entity and restructure and rehabilitate or liquidate them within a definite time frame. This has created a market for distressed assets in India.

The Government securities, money and forex markets have significant public policy implications for an emerging market economy. These have developed during the reform period with impressive diversification of participants and instruments.

The smooth functioning of the payment and settlement system is a pre-requisite for financial stability. The introduction of Real-time Gross Settlement (RTGS) system and setting up of the Clearing Corporation of India Limited (CCIL) which acts as a central counterparty for securities and forex transactions and guarantees both the securities and funds legs of the transaction have enhanced the efficiency and stability of the payments mechanism.

There has been a constant rebalancing of reform priorities predicated upon the domestic and global business environment, institution of prudential practices, upgradation of the regulatory and supervisory framework, institution of appropriate institutional and legal reforms and the state of openness of the economy. In retrospect, the key success of financial sector reforms in India since they were instituted in the early 1990s has been the maintenance of financial stability through a period marked by repeated financial crises across the world. The process of reforms is noteworthy not only for the absence of turbulence in its path but also for the sheer dimensions of the change achieved from the position where we started.

III. Impact of Economic Reforms of the 1990s

These changes introduced across several sectors of the economy gave a sharp boost to growth. The impressive growth performance since 1990s was possible due to as stated earlier strong foundation of an indigenous industrial base, domestic entrepreneurial class, knowledge enhancing institutions and improvements in vertical social and economic mobility during the decades 1960s to 1990s. The recent growth dividend is not just a miracle of

marketisation but is built on decades of conscious nation building since independence and extension of the Reserve Bank's mandate during the period *inter alia* to building institutions and improving their delivery capabilities. Some of the major achievements have been:

i. Annual real GDP growth averaged 5.7 per cent for the 1990s and 6.9 per cent for the period 2000-01 to 2006-07. The high real GDP growth during recent years was led by both industrial and services sector.

ii. Poverty has fallen significantly. Poverty rate is estimated to have fallen from 37 per cent in 1993-94 to 28 per cent in 2004-05, clearly establishing the link between faster growth and poverty reduction. Measures of income inequality also declined during this period.

iii. Other social indicators have shown similar improvements over the last two decades or so: life expectancy has increased from 53 in 1980 to 63 years during 1999-2003; the infant mortality rate has dropped from 110 in 1981 to 58 per thousand live births in 2005; and literacy has risen from 44 in 1981 to 65 per cent in 2001.

iv. The external position has also strengthened: since the 1991 balance of payments crisis, official reserves have risen steadily and now stand at around US $282 billion (as on January 11, 2008). Although the current account deficit has remained modest, averaging one per cent of GDP since the early 1990s, the integration of the Indian economy with the global economy has increased significantly over the same period. This can be seen in the steady rise in the current receipts-GDP ratio from around 8 per cent in 1990-91 to 27 per cent in 2006-07. Over the same period, current receipts and current payments combined together increased from 19 per cent to 54 per cent. Gross capital inflows and outflows constituted 46 per cent of GDP in 2006-07 as compared with only 12 per cent in 1990-91.

v. External debt has declined to around 18 per cent of GDP.

vi. It is important to note that not only has there been a steady upward shift in India's growth path, but this has also been accompanied by enduring stability. A remarkable feature of India's growth experience has been its resilience to both global and domestic shocks.

vii. The fiscal reforms through the Fiscal Responsibility and Budget Management (FRBM) is a significant measure. Overall, the fiscal reform process spanning both the Centre and States has been wide ranging of which the important ones are: (i) unique features in the management of public debt which impact stability - States have no direct exposure to external debt and almost the whole of public debt is in domestic currency and held mostly by residents; (ii) The Reserve Bank cannot subscribe to primary issues since April 1, 2006, thereby providing safeguards to

monetary policy from the consequences of expansionary fiscal policy.

However, there are several challenges of reforming the public sector enterprise, improving agricultural productivity and efficiency, financing public infrastructure, reducing poverty, expanding access to education and environmental, *etc.* From a central banking perspective, in the Indian context, the principal challenge for public policy is to ensure a smooth transition to higher growth path, accompanied by low and stable inflation and well anchored inflation expectations. For the Indian financial system, the biggest challenge is how to extend itself and innovate to meet the new demands for financial inclusion and respond adequately to new opportunities and risks. Innovative channels for credit delivery for serving the new credit needs have to be developed, perhaps with greater use of information technology and intensified skills development in human capital. Notwithstanding the substantial improvement in the domestic banking system, it will need to be further strengthened to face greater external competition and introduction of financial innovations and fuller capital account convertibility. It will require action on several fronts like introduction of greater competition; convergence of activities and supervision of financial conglomerates; induction of new technology; improvement in credit risk appraisal; encouragement of financial innovations and improvement in internal controls. The role of the Reserve Bank in this context amounts to promoting safety and soundness while allowing the banking system to compete and innovate. There exist well functioning fairly deep and liquid markets for bonds, currency and derivatives. However it needs further development to enhance the efficiency of the transmission mechanism, along with the development of the corporate debt market and exchange traded interest rate futures. The Reserve Bank has already placed in public domain draft guidelines on currency futures and credit derivatives. Over and above, price stability and financial stability would continue to be the main challenges with expected increase in credit expansion and global integration.

India's social indicators at the start of the reforms in 1991 lagged behind the levels achieved in south-east Asia around twenty years ago when these countries started growing rapidly (Dreze and Sen, 1995). While privatisation in all other sectors of the economy were initiated with the reform process, there was a growing understanding that in order to bring about improvement in social sector, a stronger Government initiative is required. While the Central Government expenditure on social sector as percentage of GDP has shown an increasing trend in the post-reform period, *albeit* with some exceptional years, the State Government expenditure on social sector has declined. On the whole, taking Central and State expenditure together, social sector expenditure has more or less remained constant. Thus while the social indicators have shown some improvements in post-reform period,

these can be associated with the indirect effect of economic growth and not to any directed effort. It is almost a consensus that the challenges in this direction are enormous. The UNDP's global Human Development Report (HDR) for 2006 ranks India at 126 out of 177 countries, being lower by two compared with 2000. Reprioritisation of expenditures towards social sectors and improvement in public service delivery are essential. Higher public spending on social services, coupled with a focus on quality, would improve the social infrastructure and provide productivity gains. For the current growth momentum to be entrenched on a durable basis, there is a need for a significant enhancement in capacity building and in the availability of public services that cannot be adequately provided by the private sector. Fiscal empowerment would allow higher outlays for boosting infrastructure and social sector spending, which will have a beneficial impact on domestic productivity, growth and employment.

State Governments

There is evidence to suggest that availability of funds is a necessary, but not a sufficient condition for tackling the problems of poverty, backwardness and low human development in India. Successful implementation of development programmes also requires appropriate policy framework, formulation of suitable plan schemes, and effective delivery machinery on the part of funding Ministries/State Governments. The State Governments in India are responsible for most public expenditures relating to the provision of social services including health and education, as also most infrastructure services except telecommunications, civil aviation, railways and major ports. They are also responsible for law and order. The ability of the States to spend on social services and infrastructure, thus, has important implications for the overall economic development.

As widely documented, the deterioration in the fiscal position of States was reflected in the decline in developmental expenditure of the States in the second half of the 1990s compared with that during 1990-95, which had a significant deleterious impact on the States' social expenditures including education and health. With active initiatives of the States towards fiscal correction and consolidation in the recent period, there has been a reversal of the trend of developmental expenditure and social expenditures as well. The State Governments in their budgets for 2007-08 proposed higher allocations to social sector expenditure in order to ensure improved quality of human resource development. In view of the priority given to infrastructure development in the Eleventh Five Year Plan, the State Governments have envisaged implementation of various projects, especially power and roads. Many State Governments have proposed to implement the infrastructure projects through the framework of public-private partnership (PPP) and development of urban infrastructure under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM).

Furthermore, it is found that the economically less developed States are also the ones with low human development index (HDI) and economically better-off States are found to have relatively better performance on HDI. However, the relation between the HDI and the level of development does not show any correspondence among the middle-income Indian States. For example, among medium-income States, Kerala had high HDI, while Andhra Pradesh and West Bengal did not show high HDI values.

IV. Conclusion

The old paradigm of Indian development based on the active involvement of the State for economic development and poverty removal, was used to justify intervention in and entry of the State into every sphere of economic activity, gradually substituting the position occupied by the private sector, co-operatives, individuals and social groups. This was accompanied by a gradual but pervasive deterioration of governance, as also distortions in the attitudes and operations of business, workers and farmers. Though this deterioration started with specific areas of government operations and specific regions of the country, it spread over almost every field of activity in which Government was involved. This led to the end of the old paradigm and the emergence of a new approach.

The new paradigm is based on a clear and non-ideological recognition of the strengths and the weakness of the State and the people. A democratic society has enormous potential for entrepreneurship, innovation and creative development. The people, their diverse forms of activity and association such as companies, co-operatives, societies, trusts and other NGOs must be allowed and encouraged to play their due role. The State must focus on what only it can do best and shed all activities that the people can do as well or better. Economic theory also tells us that under certain conditions market competition produces results that are the most efficient. The State will have to manage the economy so as to accelerate employment and income growth in a self sustaining manner, ensure that all citizens receive their entitlements of basic public goods and services and empower the poor so that they have equal rights (and responsibilities) with the better off citizens. Similarly given the large infrastructure requirements of the country the public sector will have to play a large role in providing infrastructure funding. The Government is actively pursuing PPPs to bridge the infrastructure deficit and several initiatives have been taken to promote PPPs in infrastructure development. The appraisal mechanism of the PPP projects has been streamlined to ensure speedy clearance of the projects, removal of red tape, adoption of international best practices and bringing uniformity in guidelines. The awareness of concerns and issues relating to PPP however is still lacking and not evenly spread across different states.

Decentralisation of governance was ushered in the early 1990s through the 73rd and the 74th constitutional amendments raising hopes for better

delivery of public services, sensitive to local needs. The argument in favour of decentralisation of planning is based on the fact that as the distance between the action point at which information is generated and the point at which decision is made increases, the information cost increases. In the Indian case, the wide regional variations in natural endowments, and levels of development, a single strategy may prove to be inappropriate justifying decentralisation of the planning process. The advantage of decentralised planning lies with the possibility of tapping local resources by ensuring greater participation of the people in the development process given the possibility of centralised planning and implementation machinery being delineated from the public.

Any new approach must correct the incentives for productivity and efficiency. Laws, rules and procedures are such that they minimise the time and money cost of compliance to relatively honest economic agents. Any process of sustained economic reform and investment requires a framework of long-term policy to which the Government can credibly commit itself. Reforms anywhere can be popular if they are oriented to aspects of human development (education, health, child nutrition, drinking water, women's welfare and autonomy, *etc.*). Reformers usually are preoccupied with problems of the foreign trade regime, fiscal deficits, and the constraints on industrial investments, and they believe that once these are handled right, trickle-down will take care of the issues that concern the masses. In the age of financial globalisation, the Indian economy cannot remain insulated from international developments. This makes it all the more important that India adopts the right strategy and takes the right steps now to boost long-term growth, and to fulfill its economic potential. To quote Governor Reddy[1] : 'One of the determining factors in India, for moving forward, would be the reforms in governance, that are critical to strengthen State capacity to perform its core functions more effectively and equitably. The business community has a vital stake in the improvement of the quality of governance by empowering the public institutions, since good governance can prevail only when public institutions function fairly and efficiently'.

[1] Some Perspectives on the Indian Economy, Address by Dr. Y.V.Reddy, Governor, Reserve Bank of India at the Peterson Institute for International Economics, Washington D.C., USA on October 17, 2007.