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INDIA'S ECONOMIC REFORMS: THE STEPS AHEAD

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Abstract

In this paper we suggest further steps that India needs to take in the process of her economic reforms. While the reform measures undertaken during 1991-96 have led to considerable deregulation and liberalization of the Indian economy, a lot still remains on India's unfinished reform agenda. The experience of East Asian countries along with that of China is taken into account in suggesting relevant lessons for the future course of India's economic reforms. Among other things, we highlight the need for much greater openness of the economy, deregulation of the private sector, exit policy, and reform of the labor and land laws. Besides, in our view, the government needs to focus its attention to and provide larger resources for primary health and primary education. The main quantitative conclusion is that India can expect per capita economic growth of a mere 3.5 percent per year under current policies, but could raise the overall per capita growth rate to as much as 7 percent per year under extensive market reforms that delivered a national saving rate and efficient market institutions similar to those of East Asia.

INDIA'S ECONOMIC REFORMS: THE STEPS AHEAD

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India's performance in raising living standards has lagged far behind most of East Asia during the past thirty years. The laggard performance is evident in terms of economic growth per capital as well as various measures of human development, such as, improvements in life expectancy; literacy, literacy, and infant mortality (see Table 1). Perhaps, the most relevant comparisons for India are China and Indonesia, the two hugely populous and heavily agrarian economies of the region. Both of these countries have substantially out paced India in economic growth and reductions in the incidence of poverty in the past two decades. The case of china will be considered in some detail below. A recent account of Indonesia's successes may be found in Woo, Glassburner, and Nasution (1994).

It is now widely understood that India's relatively poor performance is related primarily to the choice of economic strategy of State-Led Industrialization (SLI), based on high protectionism, planning, and detailed domestic regulation of the economy, did not succeed. Not only did it fail to the spread of corruption throughout the political and administrative system.

After some three decades of high growth in East Asia, and a multitude of studies on comparative economic growth, the roots of rapid economic growth are fairly clear, even though particular aspects of the East Asian experience remain hotly debated. Some important lessons for India based on the East Asian experience are also clear. This paper summarizes those lessons, and applies a cross-country growth equation to estimate India's economic potential under alternative policy choices in the future. The main quantitative conclusion is that India can expect per capita economic growth of a mere 3.5 percent per year under current policies, but could raise the overall per capita growth rate to as much as 7 percent per year under extensive market reforms that delivered a national saving rate and efficient market institutions similar to those of East Asia. An increase in per capita annual growth from 3.5 to 7 percent per year would lead to nearly a cumulative 100 percent increase in per capita GDP in the course of 20 years, that is almost a doubling of per capita GDP from the current trajectory

II. The Legacy of Nehruvian Socialism

At the end of the 1940s, India initiated the trend among newly independent nations in choosing the economic strategy of state- led industrialization, or SLI, characterized by economic planning, high protectionism, and extensive state-regulation of the economy. This combination of policies, became the favored strategy of most of the

[1] This work draws upon, in parts, on a research project with Dr. Andrew Warner of HIID, on the comparative growth performance of developing countries, and on our comparative research on china and India with Dr. Tianlun Jian of HIID.

post-colonial countries of the world and even among the long-independent developing countries of Latin America. SLI was adopted, in one variant or another in most parts of the developing world, such as, Indonesia under Suharto, Tanzania under Nyerere, Egypt under Nasser, Argentina under Peron, and Brazil under Getulio Vargas. Most of these countries identified their policies as Socialist, but not as Marxist-Leninist. Indeed, the SLI policies were often explicitly identified as a "third way" between the capitalist first world and the communist second world. Another couple of dozen countries, constituting fully one third of the world's population, followed the Soviet Union in imposing a much stricter Marxist- Leninist model, based on nearly complete state ownership of industry and a rigorous one-party Marxist-Leninist dictatorship. In the People's Republic of China, and many countries of Africa, the Marxist-Leninism model was imposed by a revolutionary government, with the support and aid of the Soviet Union. In Central and Eastern Europe, the model was imposed directly by the Soviet Union.

The choice of SLI in India and elsewhere is understandable given the choices facing the leaders of developing countries, and especially of new post-colonial nations, at the end of World War II. At the core, SLI was a defensive reaction against the capitalist "First World," including both governments and multinational enterprises. The former colonies had experienced a century or more of depredations at the hands of the imperial powers. Often, the effective or even *de jure* colonial power was not even a foreign government, but actually a foreign corporation. In India's case, of course, the original colonial power was the East India Company, and it was only in 1858 that the British Government itself became the *de jure* colonial authority. Thus, the notion of foreign multinational enterprises as helpful, or even benign, forces for economic development was considered ludicrous. Extensive engagement in foreign trade also seemed to be a dubious proposition. Not only did foreign trade appear to threaten the subservience of the new nation to the former colonial masters, but foreign trade itself had collapsed between 1914 and 1945, under the weight of two world wars and a Great Depression. By 1949, when India was first choosing the SLI model, only a handful of countries had convertible currencies. Global trade was managed through state-to-state settlements, and at a very low level as a percent of national income. There was widespread skepticism that multilateral trade would be re-established as a vibrant force in the world economy. In summary, neither inflows of foreign capital nor a development strategy based on free trade seemed a sensible approach to national economic development for fragile, newly independent states in what seemed to be an essentially hostile world.

At the same time, economic theory and the alleged lessons of industrialization of the Soviet Union seemed also to point to a model of rapid development based on state-ownership and extensive barriers to trade. John Maynard Keynes had concluded that capitalism was inherently unstable, and therefore needed the strong hand of the government to preserve full employment. In the depths of the Great Depression in 1933, in a famous speech in Dublin on "National Self Sufficiency," Keynes (1933) preached the need for experimentation with new economic systems, and even the desirability of relatively autarkic economic development, though by the end of World War II Keynes was again championing, and helping to design, a new international monetary system based on open, multilateral trade. Many other economists had concluded that some form of planning was needed not only to avoid extreme fluctuations in unemployment, but also to take advantages of the economies of scale

of modern industry. P.N. Rosenstein-Rodan (1943), for example, wrote of the need for a Big-Push in industrialization, presumably led by the state. Development planning models, based on input-output models and simple dynamic equations for economic growth, seemed to offer a scientific base for state leadership in the economy. And the apparent success of the Soviet Union in industrialization (now known to have been greatly exaggerated by the official data, and in any event achieved with horrific cruelty and loss of life) seemed to demonstrate that effective planning was possible.

Only a handful of developing countries chose an open market system instead of SLI or Marxism-Leninism. In a recent study of the postwar histories of more than 90 developing countries, Sachs and Warner found fewer than 20 developing countries that were always open to international trade in the post-War period or from the time of their independence (if that is more recent). Sachs and Warner classified a country as "open" if it satisfied four criteria: (1) average import tariff rates of 40 percent or less on intermediate and capital goods; (2) import quotas and licenses covering 40 percent or less of total imports; (3) a black market exchange rate premium of 20 percent or less on average; (4) and no state monopolization of trade in the leading exports. Of course, India failed these criteria by a wide margin, since import tariffs were well above 40 percent and import licensing covered virtually all of international trade until the 1990s. In East Asia, Malaysia, Singapore, and Thailand were among the few countries that maintained open trade (though Thailand just squeezed in under the 40-percent-tariff threshold). Indonesia, South Korea and Taiwan pursued SLI policies in the 1950s, but then opened in the 1960s, well before most other developing countries. The switch from SLI to a more open, market-oriented strategy was related to severe economic failures (very high inflation in Korea and Taiwan in the 1950s, and in Indonesia in the mid-1960s), as well as pressures and inducements from the U.S. If there is one overriding reason why all six of these East Asian countries chose more open, market- oriented strategies, while most of the rest of the developing countries did not, the best answer would probably lie in the area of national security. All six countries looked to the U.K. and U.S. for military defense and internal security. The U.S. in particular, through foreign aid and technical assistance, helped to nudge Korea, Taiwan, and Thailand into relatively open trading regime.

The choice of SLI in India and elsewhere might well be understandable, but the results were very poor indeed. Closed, state-led economies fared very badly in the past forty years, lagging far behind the economies that maintained open trade and market-based strategies. Figure 1, reproduced here from Sachs and Warner (1995) shows the worldwide experience in simple terms. Here we see the average growth rate of 40 developing countries that chose a "closed" model, and 8 developing countries that were always open economies grew much faster then the closed economies in every year. In tow years, 1974-75, when the major increase in world oil prices temporarily reduced the growth of the open economies the closed economies, by contrast, tended to absorb the oil shock by greater internal subsidization of energy prices, together with high foreign borrowing. This protected growth in the short term, but eventually contributed to a fiscal crisis in most of these countries.

The results of SLI were even worse than indicated by low average growth rates. Almost every country that pursued SLI, or a more extreme Marxist-Leninist approach, ended up with a severe macroeconomic crisis in the 1980s or

1990s.Typically, governments pursuing SLI looked to foreign borrowing as the way to speed growth, or to forestall recessions (as in 1974-75). These governments borrowed heavily in the 1970s and 1980s, and ended up with a fiscal crisis by the end of the 1980s. Table 2 gives some evidence on this point. Sachs and Warner (1995) define an "extreme macroeconomics crisis" as one of three events: (1) inflation in excess of 100 percent per year; (2) a rescheduling of foreign debt; or (3) a default on foreign debt. We see from Table 2 that of the 17 developing countries that had an open economy in the 1970s only one (Jordan) succumbed to an extreme microeconomic crisis. Of the 73 developing countries that were closed economies, however, a remarkable 59 experienced an extreme macroeconomic crisis in the 1980s (and several more of the 73 succumbed to extreme crisis in the early 1990s).

India, thankfully, avoided an extreme macroeconomic crisis, but just barely. Like other SLI economies, India borrowed heavily from abroad, particularly in the late 1980s. Much of the borrowing was from commercial banks and large part was the so-called Non-Resident Indian (NRI) balances, which were short-term capital inflows at high interest rates. As Desai (1995, p.82) has described it, "Rajiv's [Gandhi's] was a policy of accelerating growth by borrowing, but without any drastic restructuring of the economy." In 1990 and 1991, increased political risk, overly expansionary macroeconomic policies, and sharp decline in remittances from overseas Indian workers in the wake of the gulf war, led to outflows of short-term capital, putting extreme pressure on India's foreign exchange reserves. By mid-1991, India's foreign exchange reserves had declined to just two weeks of import coverage. This near-miss with a serious balance of payments crisis was the proximate cause of the start of India's market liberalization measures in 1991, led by Finance Minister Manmohan Singh.

It is an interesting feature of political economy that almost all countries that embarked on SLI arrangements until hit by a severe macroeconomic crisis. One might have expected that many countries would undertake economic reforms in time to *avoid* a severe crisis, but this rarely happened. (In Fact, on this account, India acted rather swiftly, since the 1991 macroeconomic crisis was rather modest, and was nipped in the bud). The lesson, it appears, is that while SLI began in most countries on the basis of economic and political *ideology*, it was sustained on the basis of powerful vested *interests* that fought within the political. SLI nurtured entire sectors of inefficient, import-competing enterprises and trade union, whose survival then depended on the continuation of state support and protection. Both the enterprises and the union because key campaign financiers of the main political parties, both to government and opposition. No party close to power dared to speak too radically about the need for trade liberalization, or privatization, or downsizing of industry, lest the party find itself bereft of needed campaign funds (see Ramaswamy, 1995, for a trenchant analysis). Even though a strong majority of interests might benefit from liberalization, the potential winners from liberalization tend to be politically disorganized and often even unaware of the potential gains from liberalization, and therefore incapable of mobilizing an effective political opposition. The incumbents, moreover, use their incumbency, including control over state revenues, to ward off challenges from any potential opposition. Generally, only when the government budget is in extreme crisis are the advantages of incumbency reduced sufficiently to allow a challenge to the prevailing SLI system.

Since 1991, India has been undertaking the partial dismantlement of the preceding SLI system. (During the second half of the 1980s, some very small steps were also taken in this direction, but they did not add up to overall liberalization). Considerable progress has been made in certain areas of reform, mainly in ending the extensive system of licensing of international trade and domestic investment. Yet, India's reforms have remained limited. They have probably gone far enough to lift India's medium-term growth rate to 5-6 percent per year, but not to achieve the rates of 8-10 percent per year that India's low-income neighbors in East Asia have been achieving. We now turn to an analysis of the policies that have underpinned the rapid growth in East Asia, in order to assess the areas of priority for future reforms in India.

III. Factors in Achieving High Economic Growth

In this section we investigate the factors that have contributed to the rapid economic growth of the fastest-growing market economies of East Asia. Our main comparison group is Indonesia, Korea, Malaysia, and Thailand. In the following section, we take up the case of China, which has several unique features worth emphasizing. By identifying several common features of these five fast growing economies, we can identify the priority areas for India's future economic reforms. We stress that while India made substantial progress in market reforms during 1991-96, much remains to be accomplished by the new government taking office in mid 1996.

Economic theory teaches that economic growth is based on three main factors: (1) the accumulation of the factors of production, including both human and physical capital; (2) the efficient allocation of resources within the economy; and (3) the improvements in technology over time. The theoretical and empirical debate centers around the choice of economic institutions (e.g. markets versus government allocation, open trade versus protectionism, etc.) that can most effectively deliver these three components of growth. One general implication of economic theory, confirmed by experience, is that poorer countries following appropriate policies can expect to grow more rapidly than richer countries. In the current economic jargon, the poorer countries can expect to "converge" with the richer countries in per capita income levels. Convergence occurs mainly because of the first and third factors in growth. Poorer countries tend to accumulate capital more rapidly (in terms of percentage growth of the capital stock) than do richer countries, because poorer countries tend to have lower capital-labor ratios and higher rates of return on new investments, both of which promote a rapid increase in the capital stock. With regard to technology, poorer countries tend to have the advantage that they can make use of the technological advances of the richer countries, without having to reinvent these technologies.

These tendencies towards convergence have clearly played an important role in the rapid growth in East Asia. But convergence can be achieved only when there are effective economic and governmental institutions supporting rapid capital accumulation, the efficient allocation of resources, and the rapid diffusion of technology from the more advanced economies. Worldwide experience, interpreted by economic theory, suggests that the following institutional arrangements have been key to East Asia's rapid growth.

Openness of the Economy

The quintessential feature of East Feature of East Asian development has been the rapid growth of manufacturing exports, shown in table 3 for the period 1985-92. The rapid growth of manufacturing exports has been supported by trade policies which have allowed manufacturing exporters to operate at (nearly) world prices, both for inputs of capital and intermediate goods, and for the sale of exports on world markets. East Asian economies have avoided the kinds of trade policies that undermine the capacity of manufacturing exporters to obtain necessary inputs at world prices, or that penalize exporters trough heavy taxation of exports (effective taxation of exports can arise through: tariffs and quotas on inputs, inconvertibility of the currency, state monopolization of exports on unfavorable terms for exporters, or explicit taxation of exports). The exact from of the trading regime has differed across countries, bur the following elements have been common features in East Asia: (1) convertibility of the currency for current account transactions; (2) zero or low tariffs (and the absence of licensing) for capital goods and intermediate inputs, and modest tariffs for most consumer goods; (3) implicit or explicit subsidization of exports; and (4) other institutions supportive of manufacturing exports (e.g. export processing zones, state guarantees on export credits). In general, the East Asian economies have been quite open to trade both for imports and exports, especially in comparison with other developing countries. Industrial policies, where they exist, have supported manufacturers not mainly through the protection of the home market, but through the implicit and explicit subsidization of export activities.

Openness, and the orientation to manufacturing exports, has made several contributions to growth. First, it has helped to ensure the efficient allocation of resources, through specialization, comparative advantage, and dynamic learning by doing. Second, openness has promoted domestic competition by limiting the market power of domestic firms, and by providing a rigorous international yardstick of performance. Third, openness has promoted the rapid accumulation of capital through foreign borrowing and foreign direct investment, which is then serviced by the rapid expansion of exports. Fourth, openness has promoted the rapid improvement of technology through the importation of foreign technologies. Technology may be imported directly through merchandise trade (e.g. in the form of machinery embodying a new technology), or it may come via foreign direct investment. In either case, openness has greatly enhanced the domestic economy's awareness of, and access to, technological advances in the rest of the world.

Table 4 shows some indicators of trade and financial openness comparing the fast-growing East Asian economies with India. We see, for example, that India's average tariff rate of 33 percent vastly exceeds the average tariff rates of the other economies. India also displays continuing high barriers to foreign direct investment in contrast to most of the fast-growing Asian economies. It is true that not all of East Asia relied heavily on foreign direct investment to achieve rapid growth: Japan and Korea are the two main exceptions. But most of the region, especially in Southeast Asia, has relied heavily on FDI, and the East Asian countries tend to have much simpler rules for FDI, and the East Asian countries tend to have much simpler rules for FDI approvals than are now in place in India.

Promotion of Saving through Fiscal Policy

East Asian economies all have high rates of national saving, as shown in Table 5, considerably in excess of India's saving rate. These high saving rates contribute to rapid capital accumulation, and thereby to rapid economic growth. The high saving rates were not always the case in East Asia. The general pattern is that saving rates rose in the course of growth, from modest levels in the 1960s to rates exceeding 30 percent of GDP in the 1990s. National saving is the sum of government saving and private saving. Government saving, in turn, is the excess of current government revenues over current government expenditure. The largest difference between India and the East Asian economies in overall saving rates lies in government saving rates. The East Asian economies all have sizeable government saving as a percent of GDP, while India's government saving has been close to zero. (Mechanically, India's overall budget deficit of around 6 percent of GDP is approximately equal to the level of government investment as a percent of GDP. Therefore, *current* spending approximately equals current revenues, so that government saving is very small).

In many East Asian countries, private saving rates are also unusually high. This is partly a result of rapid growth itself rather than a cause, since high rates of growth stimulate private household saving and retained earnings by firms. High private saving rates also partly reflect the development of financial market institutions that are effective in mobilizing household saving, such as the micro- finance institutions in Indonesia (e.g. Bank Rakyat Indonesia) which mobilize the saving of millions of rural households. More generally, throughout East Asia, households are responsible for their own retirement saving, and can not expect large budgetary transfers from the state. Cross-country evidence suggests that generous pay- as-you-go state pensions, as in Western Europe, tend to depress household saving rates, while household responsibility for retirement tend to raise household saving rates.

High Degree of Internal Competition

The East Asian economies promote an efficient allocation of labor across sectors through a variety of market-supportive policies, some of which stand in sharp contrast to India's policies. First, the engine of growth in East Asian industrialization (and especially manufacturing) has been the private sector. While most of East Asia experienced a brief phase of import-substituting growth in the 1950s, often dominated by state-owned enterprises, the rapid growth of manufacturing since the 1 960s is almost entirely due to private enterprises. As shown in Table 6, the role of state-owned enterprises as a proportion of overall industrial production, investment, and employment, is low. These private firms, unlike typical state enterprises, operate according to hard budget constraints. If they do not survive the market competition, they are pushed in bankruptcy and out of operation.

Second, as noted, in one way or another these private firms are exposed to the rigors of international competition, either in competition against imports, or as exporters on world markets. Even when firms receive protection on the domestic market (mainly in the case of final consumer goods, such as automobiles), the

protected enterprises tend to be *exporting* firms which receive protection in the home market but which are still disciplined by competition in foreign markets. Protectionism, when it exists, is almost always in the service of export promotion (as in Krugman, 1987) rather than for the protection of the domestic market *per se*.

Third, the private firms operate in a regulatory environment which offers high flexibility for wage setting, and the hiring and dismissal of workers. In almost all of East Asian, union bargaining, when it exists, takes place at the level of the enterprise, rather than at the regional or sectoral level as in many cases in Western Europe. Therefore, the terms of collective bargaining agreements are set according to market forces felt at the enterprise level. Union power tends to be low. Workers have few guarantees of long-term employment, with the partial exceptions of Korea (since the late 1980s) and Japan. In most of East Asia, firms can reduce their workforces with short notice and modest severance payments.

India stands as the extreme outlier in this case, since workers in large firms in the formal sector have a virtual guarantee of continued employment according to the industrial disputes act. For firms of 100 employees or more, reductions in the workforce must be upon the permission of local government, which is almost never granted. Remarkably, loss-making firms are also not even allowed to close their operations without government consent. As Ramaswamy (1995,p.118) stresses, these guarantees are extensive, applying not just to industry but to virtually any undertaking that employs 100 or more people, including nonprofit activities such as universities, hospitals, and charitable organizations. The results of India's highly regulated labor markets have been devastating. Formal-sector employment India is shockingly low, in large part because so much urban employment is carried on outside of formal registration. Out of an economically active population of some 506 million, formal sector employment was a meager 27.4 million in 1994, or just 5.4 percent! Of this, 19.3 million worked in the state sector (state enterprises and public administration), and just 8.1 million worked in private firms with formal employment.

Social Policies Targeted to Human Capital Accumulation

The East Asian economies have not undertaken extensive social welfare spending, and as a result have been able to maintain relatively low rates of government expenditure and taxation as a percent of GDP. Particular, these governments have not pursued large-scale redistributive transfers via state pensions, welfare spending, or heavy budgetary subsidization of particular sectors of the economy. This restraint in government expenditure has helped the East Asian Governments to preserve high rates of government saving while also avoiding highly distortionary rates of taxation. On the other hand, the East Asian governments have made major commitments to human capital accumulation in the from of spending on primary education and health. The most notable success has been to achieve high rates of literacy, in comparisons with India where literacy rates lag far behind (see Table 7).

Small Government and Low Marginal Tax Rates

Since the East Asian economies have eschewed heavy government spending on transfers and social programs, they have avoided the fiscals burdens of heavy government spending. As seen in table 8, total government spending as a percent of

GDP tends to be rather low, typically between 15 and 30 percent of GDP, in contrast with many developing countries in which government spending is well above 30 percent of GDP, India's overall government spending, indeed, is around 35 percent of GDP, on the very high end of the East Asian economies. The counterpart of relatively low government spending as a percent of GDP is relatively low rates of taxation. For example, corporate tax rates in East Asia are generally in the range of 15-30 percent, compared with a rate of 55 percent in India (combining the base tax rate with the 15 percent surcharge). These high corporate tax rates are surely a disincentive to domestic and foreign corporate investment in India.

Industrial Policies?

East Asian growth has been marked by its private-sector orientation high rates of national saving, and intense competition in product and labor markets. It is often claimed that in addition to (or even instead of) these market forces, the key to rapid industrialization in East Asia rests on special industrial policies of the government. Amsden (1989) and Wade (l990) are widely cited advocates of this position. What is the evidence in favor or against the role of industrial policies?

The starting point for analyzing industrial policies in East Asia should be the recognition that there is no single East Asian model. The extent of government intervention in industry has differed markedly. Korea has surely been the most interventionist, rather closely modeling its industrial policies on Japanese institutions. Taiwan probably comes next in the extent of government intervention in industry, though with considerably more market orientation and reliance on small, family businesses as opposed to the large industrial conglomerates (*chaebol*) supported by state policies in Korea. Southeast Asia, by contrast, has shown considerably less government intervention in industrial policies than has Northeast Asia (Japan, Korea, and Taiwan). Hong Kong, for example, has maintained completely free trade, with zero tariffs, quotas, and licences on merchandise trade. Singapore as well has essentially maintained open trade, though with more government intervention via tax policies and other incentives. Indonesia, Malaysia, and Thailand have also pursued rather modest programs of industrial policy in comparison with Northeast Asia. All three have maintained relatively open trade since the 1970s, based on convertible currencies, modest tariff rates, and relatively free markets for capital and labor. While these three Southeast Asian economies have all engaged in some efforts to identify and promote industrial "winners," most of industrial growth, and especially the export growth, has taken place outside of these government-led attempts.

Despite this wide variety of industrial policies, there is much less variety in outcomes: all of the countries succeeded in export- led manufacturing growth. The evidence suggests that it is the common features in East Asia—currency convertibility, moderate tariffs, strong private sector orientation—rather than specific industrial policies, that are behind the widespread successes in the region. This conclusion is supported by several recent studies which have analyzed industrial policies on a more detailed sectoral basis. Most of these show modest or negative contributions of sectoral industrial policies to productivity growth. For example, a comparison of growth of free-market Hong Kong with moderately interventionist Singapore finds higher productivity growth in Hong Kong (Young, 1993). A detailed study of sectoral productivity growth in Korea finds that sectors targeted by industrial

policy incentives (e.g. subsidies, tax benefits, etc.) experienced lower, not higher, rates of productivity growth. A study of the most interventionist period in Korea, the so-called Heavy and Chemical Industry drive of 1973-79, finds a mixed record of industrial policy (see Stern, Kim, Perkins, and Yoo, 1995). The authors conclude that many of the successful government interventions in Korea were in fact needed to offset other distortions in the Korean economy, and that the interventionist policies would not have been needed at all if Korea had been more thoroughly market oriented from the start. In other words, Korean industrial policy in the I970s should be viewed as a "second- best" policy, to overcome other existing distortions in the market, rather than to supersede the market. Recent work on the Japanese economy, allegedly the original site of successful industrial policy, has also turned up negative conclusions about the productivity effects of industrial targeting (Weinstein, 1995).

While East Asian economies have differed widely in the scope and ambition of industrial policy, it is true that a few institutions of industrial policy have been widely applied, and deserve a sympathetic look. Most importantly, virtually all of the East Asian countries have utilized Export Processing Zones (EPZs) or other Special Economic Zones (SEZs), to help attract foreign investment and to initiate the process of manufacturing export-led growth. These zones have not aimed to pick "winners" in the classic sense of industrial policy. Rather, they have attempted to carve out a geographical zone in which export-businesses can conduct profitable export-oriented activities, exempt from costly regulations, tax laws, and labor standards that apply more generally within the country. More generally, the relatively successful industrial policies have had a few common characteristics: (1) they have aimed to promote exports, rather than to protect the domestic market; (2) they have provided subsidies on the basis of successful performance (e.g. the growth of exports) rather than to cover losses; and (3) they have been temporary rather than permanent subsidies (e.g. a five- year tax holiday for new export firms).

Is East Asia Really a Model for Rapid Growth?

A widely read article by Paul Krugman (1994) has called into question the growth performance of the East Asian economies. Krugman argues that East Asia's growth has resulted from capital accumulation, rather than from improvements in productivity. He goes on to compare this growth with the growth of the Soviet economy, which was similarly based on the rapid accumulation of capital. His implicit conclusion is that East Asian growth is neither a model for other countries, nor sustainable. Krugman misses the essential point of East Asian growth. Unlike Soviet capital accumulation, the accumulation of capital in East Asia has been carried out mostly under market forces, and especially under international market forces. The investments are therefore tested repeatedly by the marketplace. The Soviet economy eventually collapsed in part because the structure of production drifted farther and farther away from the needs of the society. In the end, the Soviet Union was producing nearly twice the steel of the United States, for an economy roughly one-seventh the size in terms of purchasing power. It was not surprising, therefore, that when the bureaucrats stopped demanding the steel after 1991, market demand for steel could not compensate, and the steel sector suffered a very sharp decline. There is absolutely no reason to suspect that East Asia would similarly be subject to a collapse of demand, since industrial production has been responsive to market demand on an ongoing and intensive basis.

IV. Chinese Growth and Lessons for India

If market competition and openness are a *sine qua non* for rapid growth, then China's experience in the past 17 years—since the onset of Deng Xioaping's market reforms in 1978—cries out for explanation. How is it that a country still pursuing a socialist model, albeit one with "Chinese characteristics," has achieved such rapid growth? Unlike the other East Asian economies, China has maintained a major role of the state in guiding investment, and a major role of state-owned enterprises in the economy. Is China an exceptional case in East Asia, or an exception that proves the rule? Since China is enormously relevant to India as the world's only other billion-plus population country, we must have a special look at the Chinese experience for possible lessons for India.

Our interpretation of China's recent growth experience is as follows (see Sachs and Woo, 1994, for a more detailed discussion). While China has indeed protected its large state-owned industrial sector, the source of dynamic growth in China lies in the *non-state sector*, which has operated much closer to market forces. Indeed, outside of the state-enterprise sector, the Chinese economy has much in common with the other East Asian economies, especially when these other economies were at an earlier stage of development. While the non-state Chinese economy operates without many of the legal underpinnings of a more advanced market economy, it is at least subject to the strong market forces, international trade, and low taxation that are the hallmarks of the fast-growing market economies of East Asia. Despite appearances, India is probably less market oriented than China at this point, despite the fact that China's state sector is somewhat larger than India's. In China, the non-state sector is relatively unconstrained by government regulation while in India, the non-state sector continues to be tied down by extensive regulations that hinder in dynamic development.

The key, then, to understanding China's economic success lies in understanding the scope, and limitations, of the socialist (or state-owned) sector. When Deng Xioaping began market reforms in China in 1978, state-enterprise employment was approximately 18 percent of the total Chinese labor force. Approximately 71 percent of the population was engaged in peasant farming, and another 10 percent or so operated in various non-state activities outside of agriculture, especially urban collective enterprises attached to state enterprises, and industrial township and village enterprises (see Sachs and Woo, 1994, for details on this breakdown of the labor force by type of activity). The Chinese "gradual" reforms after 1978 have involved the liberalization of the non-state part of the economy, while preserving the socialist character of the pre-existing state-owned enterprises. Thus, in terms of the labor force, roughly 20 percent of the labor force has been maintained in the socialist sector, while a little more than 80 percent of the labor force has operated in the non-state part of the economy.

China's boom has come in three main ways. First, agriculture boomed as soon as the commune system was dismantled, and peasant farming resumed on the basis of household plots of land (leased from the state) and markets for agricultural output. This return to household plots and agricultural markets led to greatly improved incentives on the farms and to a one-time boost in productivity between 1978 and

1985. After 1985, however, agricultural productivity returned to a lower long-term trend growth rate. Second, rural industry was greatly liberalized after 1978, especially in the form of Township and Village Enterprises (TVEs), which are a mix of collective and privately owned enterprises in the rural areas. These TVEs operate outside of the state plan, and largely without funds from state banks. Therefore, they are subject to quite rigorous market competition and hard budget constraints. Third, urban export- oriented enterprises were encouraged by the designation of a growing number of Special Economic Zones (SEZs),coastal open cities, and Economic and Technological Development Zones (ETDZs), all designed to encourage manufacturing exports. These special areas received various kinds of favorable tax and regulatory treatment, such as tax holiday, and duty-free access to imported inputs and capital goods needed for export production. Thus, the SEZs and other special areas were akin to the export processing zones that had been used in other parts of Asia as part of their initial export- led growth.

A major aspect of China's dynamism is the low rate of taxation of non-state enterprises. As already noted, many non-state enterprises are exempt from taxation as the result of special tax privileges associated with special economic zones. Moreover, Chinese government spending is a remarkably low 14 percent of GDP (compared with 33 percent in India), so that China can maintain very low tax rates on average throughout the economy. In China, for example, an individual taxpayer earning $4,000 pays a 10 percent marginal tax rate, compared with a 40 percent marginal tax rate on the same income in India.

China's labor markets are also highly flexible in the non-state sector. While workers in the state sector are accorded generous job guarantees in both China and India, workers in the non-state sector do not receive guaranteed employment. One result has been the rapid growth of employment in China, since firms can hire workers without fear of being stuck with unwanted labor in the future due to restrictions on dismissals. Formal sector employment has increased dramatically, from 95 million in 1978 (9.7 percent of the economically active population) to 148.5 million in 1994(19.2 percent of the economically active population). India, by contrast, has experienced a mere increase from 22.9 million in 1978 (just 6.8 percent of the economically active population) to 27.4 million in 1994 (a mere 5.4 percent of the economically active population).

Considerable evidence confirms that it is China's non-state sector, largely operating under free-market rules, rather than China's state sector, that has been the source of China's dynamism. First, the state-owned sector has continued to make large losses, despite more than 10 years of active experimentation by the government with alternative incentive schemes for management and workers. Second, the productivity growth in the state-owned sector has lagged far behind the productivity growth of the non-state sector, and according to some calculations, total factor productivity growth of the state sector has been close to zero. Third, the non-state sector accounts for the explosive rise of Chinese manufacturing exports. The share of TVE exports in total exports has grown from 16.4 percent in 1980 to around 44.4 percent in 1993. Fourth, overall GDP growth has been much faster in regions with a high proportion of employment in non-state enterprises (see Xiao, 1991), and in the special economic zones (Wei, 1995).

One key institutional support for rapid growth has been the *decentralization of economic policy making in China*. One of the reasons that state control on the non-state sector has been limited is that the power of the central bureaucracy in Beijing has been substantially weakened in favor of provincial and local governments. In particular, the coastal provinces have been relatively free to pursue market-oriented policies in support of export-led growth without being blocked by planners in Beijing. The provinces have a significant control over government expenditure and taxation; infrastructure projects; and even the policies regarding foreign direct investment. Indeed, the provinces have been competing actively with each other to attract foreign direct investment and to upgrade the infrastructure. The relative decentralization of economic policy making among the Chinese provinces contrasts markedly with the continued strength of the Indian Federal Government in Delhi in setting the overall economic agenda for India, including most major decision over infrastructure expenditure and foreign investment.

The solution to the economic paradox of rapid growth in "socialist China" is therefore threefold: (1) the socialist sector is a limited part of the economy, perhaps some 20 percent as measured by employment; (2) the non-state sector has been given ample freedom of economic activity, including favorable incentives such as in the SEZs, so that China could emulate the export-led manufacturing growth of the rest of East Asia; and (3) the political decentralization of decision-making has strengthened the hand of regional governments relative to the central government, to the benefit of market reforms relative to state planning.

V. What is Left to be Done in India?

India has experienced massive deregulation, especially regarding international trade, since mid-1991, under the leadership of Minister of Finance Manmohan Singh. The results of market liberalization have been encouraging, both in the growth of GDP and especially in the rise in exports, as shown in Table 9. This has been accomplished while preserving moderate rates of inflation and sustainable levels of foreign exchange reserves and the balance of payments. Thus, the first stage of India's market liberalization must be judged a success. When evaluated by the standards of the fast-growing East Asian economies, however, it is clear that there is still much to accomplish if India is to achieve sustained high rates of economic growth. India's growth rates fall short of those of East Asia, despite the fact that India is a much poorer economy, and therefore should be able to achieve even faster growth than the East Asian neighbors in view of the tendency towards economic convergence (or "catching up") among market-oriented economies.

The relatively slow growth is most likely the result of continuing shortcomings in India's market institutions. India continues to be trapped by preconceptions of the 1950s, and especially by the vested interests fostered by SLI, rather than by the global economic realities of the 1990s. Key political parties continue to resist foreign direct investment along nationalist lines, despite the fact that greater foreign investment is critical for India's rapid growth, and despite the clear evidence from East Asia that even substantial flows of foreign direct investment do not threaten national sovereignty or national culture. Similarly, trade unions, which provide campaign contributions to the major political parties, continue to exercise a veto power over important reforms of labor law and exit policy. Many new regional

and caste-based political movements support populistic platforms calling for large increases in government expenditures on behalf of the poor. Given that India's government spending as a percent of GDP is already high, and that the government deficit is already large, programs based on increased overall public spending are likely to be highly destabilizing.

One simple gauge of India's growth prospects on the basis of current policies is a cross-country growth equation, which relates a country's per capita economic growth to its initial income level and, several policy indicators, including: the national saving rate, an index of openness to trade and financial flows, an index of labor market flexibility, and the level of government expenditure as a percent of GDP. We expect to find that growth is higher for poorer countries, and for: higher saving rates, greater openness, more labor market flexibility, and lower government expenditure as a percent of GDP. (See the Appendix for details of the regression results and the underlying variables). On the basis of this regression estimates, we find a predicted per capita growth rate for India of 3.6 percent per year on the basis of current policies. Now, suppose that each of the key policy variables were to take on the average values of the East Asian economies. Given India's initial income level, the predicted per capita growth on the basis of "East Asian policies" on saving, tariffs, labor market flexibility, and government spending, would be 7.2 percent per year. While these results are admittedly crude, they help to establish that further reforms would have significant effects on raising India's growth rate in the medium term.

We would underscore the following eleven priority areas for further reforms.

1. *Openness*. India's tariff rates are still among the highest in the world, and continue to block India's attractiveness as an export platform for labor-intensive manufacturing production. Restrictions on foreign investment are still pervasive. Highly publicized controversies over specific foreign direct investment projects (e.g. the Enron power project in Maharashtra state) and over foreign investments in consumer goods sectors (e.g. Kentucky Fried Chicken outlets) seriously hinder the inflow of foreign direct investment. Policy recommendations towards greater openness would include further reductions of tariff rates to averages in East Asia (between 0 and 20 percent); the implementation of export processing zones on a much wider scale within India; and the deregulation of FDI in industry, and simplification of FDI procedures in infrastructure.

The very modest contributions of India's export processing zones to overall export development also call for a revision of policy. China's five economic zones (Shenzhen, Zhuhai, Santou, Xiamen, Hainan) exported $6.99 billion in 1991 (9.7 percent of nationwide exports), compared with exports of just $478 million (2.6 percent of nationwide exports) in India's six export processing zones (KAFTZ, SEEPZ, NEPZ, MEPZ, CEPZ, FEPZ). India's export processing zones have lacked dynamism because of their relatively limited scale; the Government's general ambivalence about attracting foreign direct investment; the unclear and changing incentive packages attached to the zones; and the power of the central government in the regulation of the zones, in comparison with the major responsibility of local and provincial government in China.

2. *Fiscal reform*. With India's rate of government saving near zero India's overall national saving rate is around 23 percent, rather than the 30 percent or higher seen in the fast-growing countries of East Asia, and the astonishing 43 percent seen in China in 1994. Government saving could be increased by reductions in government spending on subsidies to agriculture and industry. A more efficient tax system (e.g. based on value added taxation rather than turnover taxes, high external tariffs, and inefficient internal trade tax as the Octroi) could also raise tax revenues while lower effective tax rates. Moreover, the receipts from the privatization of state assets could help to pay down India's substantial government debt, and thereby reduce the heavy debt service burden (interest – payments alone amounted to some 5.4 percent of GDP in 1994-95). Cuts in government spending as a percent of GDP would also permit a reduction of tax rates to more competitive levels.

3. *Deregulation and privatization of state monopolies*. India's state-owned enterprises (SOEs) do damage in two ways. First, many of the SOEs are inefficient and loss-making firms. Second, these firms tend to be protected by grants of state monopoly, especially in areas of finance, such as commercial banking and insurance, and infrastructure, in areas such as telecommunications, port facilities, and road building. An end to the state monopolization of these sectors is crucial to permit new, privately owned firms to introduce competition and higher productivity into these sectors. Privatization of these enterprises is also desirable in most cases, since the government has no particular comparative advantages in running these enterprises, and many severe disadvantages (especially the politicization of key investment and employment decisions of the enterprises)

4. *Labor Law Reform.* The greatest irony of Indian economic policy is that a desperate shortfall of job creation in the formal economy is combined with highly restrictive labor legislation that substantially raises the costs of hiring new workers. As we have noted, formal sector employment is a shockingly low 6 percent of the economically active population. Most importantly, the continuing barrier to the dismissal of unwanted workers in Indian establishments with 100 or more employees paralyzes firms in hiding new workers.[2] Labor-intensive manufacturing exports require competitive and flexible enterprises that can very their employment according to changes in market demand and changes in technology, so India remains an unattractive base for such production in part because of the continuing obstacles to flexible management of the labor force. Small steps could be taken by designating a significant number of export processing zones in which the restrictive labor legislation would not apply. A more general approach would be to give continued protections to formal-sector workers that are already employed, while liberalizing the hire and dismissal of new workers in the future. The third, and most desirable kind of change, would be to abandon the general restrictions on hire and dismissal in the Industrial Disputes Act, and instead allow hiring and dismissal decisions to be made at the level of the enterprises as part of the collective bargaining agreement between enterprises and enterprise- level unions, without the interference of government.

[2] According to the industrial Disputes Act (IDA), 1947, if a firm employs 100 or more workers, then workers cannot be laid-off without the prior permission of concerned state government. Besides, the Act prohibits closure unless of course the state government has granted approval to do so.

5. *Decentralization of Economic Policy Making*. India's Constitution was designed to give primary economic policy making responsibility to the central government. The Constitution, of course, designates three kinds of policy areas: those of exclusive provenance of the central government; those to be shared between the center and the states; and those that are the exclusive provenance of the state governments. In practice, the key fiscal, infrastructure, and regulatory decisions on economic management remain at the, central government level. Recent political trends (the decline of the Congress Party, and the rise of regional political movements) suggest that economic and political authority will be more decentralized in the future. International experience, most notably that of China, suggests that such a trend will be desirable from the point of view of economic growth. Regional decentralization of economic policy making would tend to: (1) promote deregulation, especially as regions compete with each other to attract domestic and foreign investment; and (2) foster a choice of infrastructure more closely attuned to regional and local needs.

6. *Exit Policy for Enterprises*. An exit policy needs to be formulated such that firms can enter and exit freely from the market. While the reforms implemented so far have helped remove the entry barriers, the liberalization of exit barriers has yet to take place. While it would be incorrect to ignore the need and potential merit of certain safeguards, it is also important to recognize that safeguards, if wrongly designed and/or poorly enforced would turn into barriers which may adversely affect the health of the firm. The regulatory framework which is in place does not allow the firms to undertake restructuring. Besides, there are legislative barriers, namely the legal provision for job-security and the land laws. Large firms in India are not allowed to retrench or layoff any workers, or close down the unit without the permission of the state government. While the law was enacted with a view to monitor unfair retrenchment and layoff, in effect it has turned out to be a provision for job security in privately owned large firms. This is very much in line with the job security provided to public sector employees. Importantly enough, India needs to put in place a straightforward bankruptcy code.

7. *Social Policy*. The central government and state governments need to provide larger resources for primary education and primary health. Primary education should be made compulsory. Existing subsidy programs, especially on higher education, should be retargeted to support enhanced primary education. Food subsidy programs can be re-targeted towards this end, for example, through a much more extensive program of nutritious school meals for poor children. The mid-day meals program for school children announced by the Finance Minister in the budget for 1995-96 is an encouraging step in this regard. However, the proposed scheme does not yet envisage any re-targeting of existing subsidies, and so remains at too small a scale. We should also stress that expenditure on girls' education has an especially high social return, since female literacy supports better family health, lower infant mortality, lower population growth through reduced fertility rates, greater labor market Productivity of woman, and generally higher status of woman in society. The central government might provide enhanced transfer payment to the states on a matching-grant basis, so that state government are given an incentive to increase their own efforts in health and education expenditures.

8. *Infrastructure*. Serious infrastructure constraints can only be overcome if the government creates a regulatory and economic environment conducive to large-scale

inflows of foreign investment in critical areas. Most importantly, the central government needs to empower the state government to negotiate infrastructure projects with prospective foreign investors according to basic norms, but without central government interference that now contribute to long and cumbersome approval procedures.

9. *Urban Land Use*. The Urban Land (Ceiling and Regulation) Act of 1976 prevents enterprises from selling surplus land in major cities without the permission of the state government. In some particularly publicized cases, a large number of sick textile mills in Bombay and Ahmadabad, and jute mills around Calcutta, are in possession of surplus land which could be sold to raise funds for restructuring, and to free up land for more efficient utilization. Nonetheless, the state governments have systematically denied permission to sell the land.[3] The Urban Land Ceiling Act further undermines the rational utilization of land by specifying an upper limit on the size o landed property that an individual, a group of people, or a company can own. In the major metropolitan cities, like Bombay and Calcutta, the limit is 500 square meters. In minor cities, like Ahmadabad, it is 1,000 square meters. Firms in possession of surplus land must inform the state government of the amount of surplus land, which then buys the excess land at a pre-specified rate, significantly lowers the market value. These arbitrary limits, and effective confiscation of property, obviously hinder modern property development.

10. *Agricultural Sector Reform*. Deregulation of pricing and procurement of agricultural commodities is necessary in order to raise farm-gate prices to farmers, in order to stimulate productivity growth in agriculture, and to provide income to sustain rural investments in industry. Similarly, the government needs to relax restrictions on agricultural land-use so that rural areas can shift flexibly from agricultural activities to smell-scale rural industry. China's dynamic township and village enterprises (TVEs), we noted earlier, have played an important role in China's economic boom since 1979. India must similarly unleash its rural industrial potential.

11. *Financial Market Reform*. India's banking and insurance sectors were nationalized more than two decades ago. While a number of other countries also undertook such action in the 1970s and early 1980s, for instance Mexico, France, and Chile, the other countries have by now completely, or almost completely, reversed this policy. India, nearly alone among market economies, still relies on a state-owned banking sector and insurance monopoly. The results are heavy losses in state banks, and growing inefficiency in the delivery of financial services. The banking sector needs, on an urgent basis, a green light for new entry of domestic and foreign private firms; the demonopolization of insurance, and new entry of new domestic and foreign firms as in the banking sector; and the privatization over time of financial enterprises currently in the state sector.

[3] As an exceptional case, according to an order of the Maharashtra government, issued in March 1996, the National textile Corporation (NTC) mills have been granted permission to sell their excess land. The land is being sold to raise fund for the revival of the chronically sick mills and for their modernization.

VI. Prospects and Conclusions

The prospects for continued reforms in India are perplexing. On the one side, India has already opened the economy substantially, and eliminated a vast number of deleterious internal regulations. The results have been positive: growth has been restored while macroeconomic stability has been enhanced, even if not yet guaranteed. All major political parties deem themselves to be adherents to continued market reforms. No political party calls for turning back the clock to planning, self sufficiency, or other standards of the previous SLI system. On the other hand, the precise commitment of the various political alignments to real market reforms is less than clear. In the election in 1996, much of the electoral offer of the parties dealt with increased social spending, protections for the poor, reservations of jobs for scheduled castes, increased subsidization of agriculture, and other rather populistic campaign pledges.

There were mixed results, therefore, in the 1996 elections, with implications still hard to fathom. On the one side, democracy worked, and worked well. The ruling Congress Party was punished for extensive corruption and the public reaffirmed its desire for the rule of law. This wake-up call for cleaner politics and administration can't help but be a positive sign. Efficient market economies rely on the rule of law and relatively clean government. (Mauro, 1995, has shown empirical evidence that corruption lowers long-term growth; Barro, 1995, among others has shown that the rule of law is a significant contributor to economic growth). The weakening of the national parties in favor of regional parties might also have the salutary effect of decentralizing economic policy making authority in the country. We have argued that decentralization of economic decision making is needed, not only to reduce the stifling regulation of the central government, but in order to stimulate inter-regional economic competition, which would tend to lead to policies more favorable for long-term investment, foreign capital inflows, and infrastructure development.

On the other hand, the splintering of political authority, and the populist appeals to the electorate, auger for more pressures on the budget, and perhaps movements in the wrong direction regarding overall government saving and expenditure. If Indian politics becomes a bidding war for an increasingly fragmented electorate, the orderly process of economic reform would be jeopardized. As of mid1996, the directions of needed change are rather clear. Once again, the challenges in India are mostly political rather than strictly economic.

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Appendix

Based on recent cross-country growth models, we estimate a rudimentary cross-country growth equation in which per capita economic growth is a function of initial per capita income, the national saving rate, and an index of market efficiency based on data from the World Economic Forum's (WEF) Global Competitiveness Report. The efficiency index is the sum of three indexes jointly prepared by the Harvard Institute for International Development and the World Economic Forum. The three indexes measure: openness of the economy to trade and financial flows; the size of government in the economy; and labor market flexibility. We add the three indexes for openness, government, and labor markets to create an overall index of market efficiency. The index is created to give a higher score for: *more* openness, *smaller* government (as measured by government expenditure as percent of GDP, and various rates of taxation), and *more flexible* labor markets. To give a sense of India's relative ranking in competitiveness, in a sample of 49 countries, with a rank of 1 being the best performance and 49 the poorest performance, India ranks 49th on openness; 20th on size of government; and 33rd on flexibility of labor markets. The East Asian economies rank much higher on all counts. If we take the average score of the East Asian economies, the "average" East Asian economy would rank 25th on openness; 3rd on size of government; and 9th on flexibility.

The ranking of 25th (out of 49) on openness might look surprisingly low for East Asia. We note the following. First, on average, East Asia is much more open than the developing countries in the overall sample of 49. The higher ranked countries are, generally, the more advanced economies. Second, East Asia is generally more open on trade than on financial flows (though there are exceptions). Thus, the modest ranking on openness reflects, in part, the relative capital market closure of some of the East Asian economies. Third, What really distinguishes East Asia as a group among developing countries was the very early date in which the economies were opened to trade, typically in the 1960s if not before. Thus, these countries are not only open to trade on current measures, but have been open to trade for decades.

The basic regression is shown in Table Al. As expected, initial income enters with a significant negative coefficient: poorer countries tend to grow more rapidly, all other things being equal. Also, as expected, more efficient economies (i.e. those with a higher score on the efficiency index) tend to grow more rapidly. According to this equation, India's growth is held back by its relatively poor ranking on the various components of market efficiency. To estimate the growth consequences of India's efficiency index, we use the regression estimates to calculate two growth rates: (1) the predicted growth for India given current income levels (GDP per capita at purchasing power parity in 1993) and current market efficiency; and (2) the projected growth rate for India for current income levels but an improved market efficiency index equal to the average for the East Asian economies. According to the regression estimates, the improvement in market efficiency to East Asian standards would raise annual per capita growth by some 3.6 percent per year, to an overall predicted rate of 7.2 percent per year. The calculations are shown in Part II of Table A2

Table A1
Regression Estimates

Dependent variable: Real per capita GDP growth 1992-95

Independent variables:	
Log initial income	-1.17 (-2.58)
Saving rate (1995)	0.098 (2.20)
Efficiency Index	2.75 (3.17)
Constant	4.59 (2.18)
R^2	.404
N	42

Table A2

Growth Counterfactuals

Part I

	India	Seven Asian economies
Log initial income	1.65	3.67
Saving rate 1995	22.43	35.01
Efficiency Index	-.734	+.563
Growth 1992-95	3.57	6.33

Part II

India's actual growth rate 1992-95: 3.57

Predicted growth if India had the efficiency index of the seven Asian economies : 3.57 + 3.57 = 7.14

Predicted Growth if India also had the savings rate of the seven Asian economies : 7.14 + 1.23 = 8.37

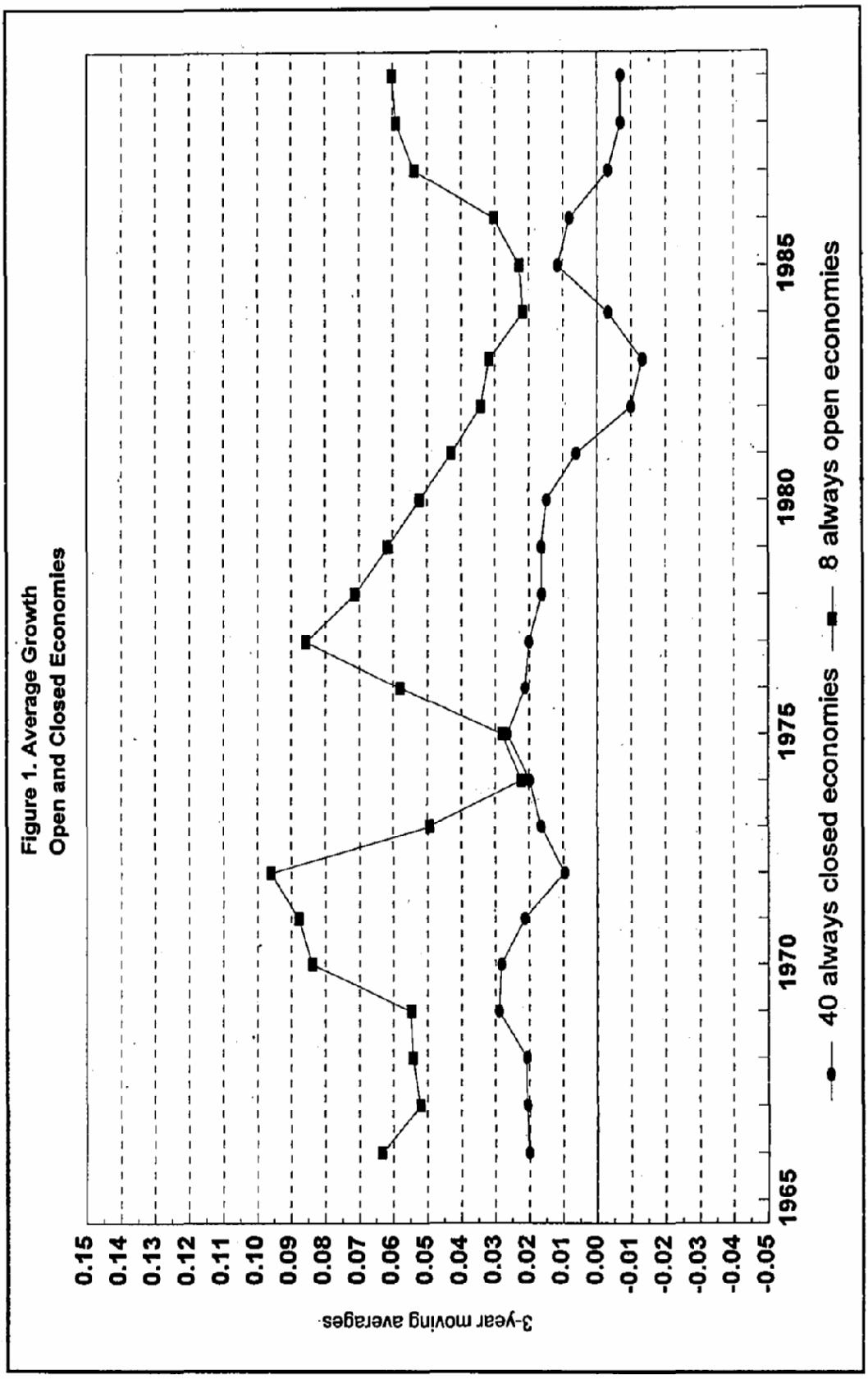
Figure 1. Average Growth
Open and Closed Economies
3-year moving averages
0.15
0.14
0.13
0.12
0.11
0.10
0.09
0.08
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0.00
-0.01
-0.02
-0.03
-0.04
-0.05
1965
1970
1975
1980
1985
40 always closed economies
8 always open economies

Table 1. Rates of Growth and Social Indicators of India and selected East Asian economies

	GNP per capita annual growth rate	Life Expectancy at birth		Infant Mortality per 1000 births		Adult Literacy rate	
	1980-93	1960	1992	1960	1992	1970	1992
Indonesia	4.2	41	62	139	66	54	84
Republic of Korea	8.2	54	71	85	11	88	97
Malaysia	3.5	54	70	73	14	60	80
Thailand	6.4	52	69	103	26	79	94
India	3.0	44	60	165	89	34	50

Source: United Nations, Human Development Report, 1994 and World Development Report 1995.

Table 2. Developing Country Openness and Macroeconomic Crisis

Openness	Macroeconomic crisis in 1980s	No macroeconomic crisis in 1980s
Open in 1970s	1	16
Not open in 1970s	59	14

Source: Sachs and Warner 1995, p. 56

Table 3. Growth in Manufacturing Exports of India and selected East Asian economies

	Growth in Manufacturing Exports – Average annual Growth rate		
	1960-70	1970-80	1985-92
Indonesia	3.5	6.5	9.3
Republic of Korea	35.2	22.7	16.8
Malaysia	6.1	3.3	15.3
Thailand	5.2	8.9	24.4
India	3.1	5.9	10.5

Source: World Bank, World Development report, 1980 and 1995, and World Data, 1995

Table 4. Measures of openness to Trade-India and Selected East Economies

	Openness of economy 1994	Quota	Average tariff rates 1994	Foreign Direct Investment US $ Mn	% of GDP 1993	Index for openness to financial flows 5-high and 0-low
Indonesia	55	3.00	6	2004	1.4	5.00
Republic of Korea	55	2.00	4	516	0.2	3.50
Malaysia	171	2.00	9	5206	8.0	4.50
Thailand	80	4.00	9.3	1715	1.4	4.50
India	25	58.00	33	574	0.3	2.50

Note: The index for openness to financial flows takes into account eight aspects of financial opening. For resident of a country, it considers whether thee are restrictions in acquiring foreign exchange or other foreign assets, whether there are export surrender requirements, or restrictions on opening foreign currency denominated bank accounts. For foreigners, it considers restrictions on acquiring domestic assets, such as equity in domestic companies, government bonds and FDI.

Quota: Fraction of 6-digit import categories covered by some form of quantitative restriction. The data is for the years between 1992-94.

Openness is defined as imports + exports/GDP

Source: trends in Developing Economies, World Bank, 1995; IMF Occasional Paper no. 134; and 1996 Index of Economic Freedom, the Heritage Foundation, and UNCTAD-Trade Analysis and Information System data, 1995, and various issues of World Development report, The World Bank.

Table 5. Savings Rates in India and Selected East Asian Economies

	Gross domestic savings percent of GDP			
	1960	**1970**	**1980**	**1993**
Indonesia	8	14	30	31
Republic of Korea	1	15	23	35
Malaysia	27	27	32	38
Thailand	14	21	22	36
India	14	16	20	24

Source: World Bank, World Development Report, 1980, 1992, and 1995.

Table 5 (b) Public and Private Savings of India and selected East Asian Economies

	Public savings	**Private savings**	**Total**
Indonesia			
1981-88	7.7	14.0	21.7
Japan			
1981-88	5.1	15.8	20.9
Malaysia			
1981-90	10.3	19.1	29.4
Singapore			
1981-90	18.5	24.0	42.5
Thailand			
1980-85	14.3	4.7	19.0
India			
1980-83	4.1	15.9	20.0
1983-86	3.1	15.9	19.0
1986-89	2.3	18.1	20.4
1989-91	1.3	21.7	23.0

Source: World Bank, East Asian Miracle - A policy Research Report, 1993 and Economic Survey, Government of India, 1994-95.

Table 6. Share of Employment, Output, and Investment in State-Owned Enterprises : India and selected East Asian economies, 1990

	Employment	Output	Investment
Indonesia	1.2	13.0	5.0
Republic of Korea	1.9	10.2	3.3
Malaysia	na	na	3.9
Thailand	0.9	5.4	4.9
India	8.3	14.1	8.5

Note : Output for Indonesia is for 1989.

Source: Bureaucrats in Business, World Bank Policy Research Report, Oxford University Press, 1995.

Table 7. Indicators of Literacy by Gender—India and Selected East Asian Economies, 1992

	India			Indonesia			Korea			Malaysia			Thailand		
	Male	Female	Total	Male	Female	Total	Male	Female	Total	Male	Female	Total	Male	Female	Total
Adult literacy rate as % of age 15+	64	35	50	91	77	84	99	95	97	89	72	80	96	92	94
Mean years of schooling 25+	3.5	1.2	2.4	5.3	3.1	4.1	11.6	7.1	9.3	5.9	5.2	5.6	4.4	3.4	3.9
Illiterate-adults 15+ in millions	102.5	169.3	271.8	4.8	13.7	18.5	0.2	0.8	1.0	0.6	1.6	2.2	0.7	1.6	2.3

Source: United Nations, Human Development Report, 1994.

Table 8. Government Spending as percent of GDP: India and Selected East Asian economies

	1995
Indonesia	17.1
Republic of Korea	20.3
Malaysia	30.6
Thailand	22.1
India	31.7

Source: Government Finance Statistics Yearbook, International Monetary Fund, 1994.

Table 9. Growth of GDP and Exports in India

	1985-90	1991-92	1992-93	1993-94	1994-95	1995-96
GDP growth	6.6	0.9	5.1	5.0	6.3	6.2*
Export growth	9.6	-1.5	3.8	20.0	18.4	24.2**

Note: * Advance estimate;
**April-December, 1995.

Source: Economic Survey, Government of India, Various issues.