

30 YEARS OF 1991 ECONOMIC REFORMS

FROM ONE REVOLUTION TO ANOTHER

INTRODUCTION

Our understanding of events refines with time. New developments reframe the issues, and prompt reassessment of the solutions applied, their design and outcomes. Same remains true for the economic policy reforms that were undertaken by the then Government of India in 1991, in the form of Liberalization, Privatization and Globalization.

The stocktake of the economic reformation becomes even more important as the world is grappling with an economic crisis which has raised serious questions over the current economic policy paradigm. The lessons learnt from an experience of 30 years of policy change may serve as a guide to tide over the present crisis and utilize this opportunity to chart out a more effective economic policy for the future.

In this backdrop, it becomes important to understand what was the scenario that prompted the 1991 reforms? How did the Indian Government respond to the situation? What has been the impact of these reforms? What are the 'chinks in the armor' that remain unaddressed? How can we chart out the future of economic policy reform? In this edition, we will try to answer these questions.

What was the scenario that prompted the 1991 reforms?

The 1991 crisis was not a sudden blip in the Indian economy, but a culmination of multitude of factors ranging from global failure of socialism as an economic policy to inward looking domestic policies and a consequent foreign exchange crisis in the country.

Indian economic policy after independence was influenced by the colonial experience (which was seen by Indian leaders as exploitative in nature) and by those leaders' exposure to Fabian socialism. As a result, the economic policies tended to move towards protectionism, a strong emphasis on self-sufficiency with limited role of international trade, industrialization under state monitoring, state intervention at the micro level in all businesses especially in labour and financial markets, a large public sector and business regulation.

The manifestation of this ideology resulted in the following policies-

- **License raj:** The "License Raj" or "Permit Raj" was the elaborate system of licenses, regulations and accompanying red tape that were required to set up and run businesses. The same was executed through Monopolistic and Restrictive Trade Practice (MRTP) under MRTP Act, 1969 which controlled the qualitative as well as quantitative aspects of businesses.

- For instance, permissions from a large number of regulatory bodies (at times their conditions being contradictory in nature) were needed before a firm could be granted a 'license' to produce and the state would decide what was produced, how much, at what price and what sources of capital were used.

- **Policy of import substitution:** This policy advocated replacing imports with domestic production. It is based on the premise that a country should attempt to reduce its foreign dependency through the local production of industrialized products and was intended to promote self-reliance.


- But this led to the monopoly of Indian industries and lack of incentive for them to improve the quality of products which hampered consumer interests.

- **A closed economy:** The rupee was inconvertible and high tariffs and import licensing prevented foreign goods reaching the market. The overinvolvement of bureaucracy often led to absurd restrictions. This can be seen in strict regulation of foreign exchange via the The Foreign Exchange Regulation Act, 1973.

The long-term repercussions of these policies were combined with immediate factors like complacency caused by Bombay High Oil discoveries, collapse of Rupee-Rouble trade following the dismantling of the Soviet Union and crude oil price hike due to the Gulf War. This resulted in a **Balance of Payment (BoP) crisis** which unfolded in the following manner-

What is an economic policy?

Economic policy refers to the actions that governments take in the economic field. It covers the systems for setting levels of taxation, government budgets, the money supply and interest rates as well as the labor market, national ownership, and many other areas of government interventions into the economy.



1985	● By 1985, India started to have BoP problems due to persistent deficit between income and expenditure.
1990	● By 1990, the Government was close to default on its foreign payments and the Central Bank refused to issue more credit.
1991	<ul style="list-style-type: none">● The foreign exchange reserves, maintained to import petroleum and other important items, dropped to levels that were not sufficient to last even for a fortnight.● The crisis was further compounded by rising prices of essential goods.● This forced the Government to look for external aid in order to ward off this crisis.

For external aid, India approached the International Bank for Reconstruction and Development (IBRD), World Bank and the International Monetary Fund (IMF).

India received 7 billion dollars as loan from these agencies to solve the crisis. In lieu of that, India had to pledge collectively 67 tonnes of Gold. In addition, as part of the bailout, **IMF expected India to liberalize** i.e., open the economy and remove trade restrictions between India and other countries.

"There is no time to lose. Neither the Government nor the economy can live beyond its means year after year. The room for manoeuvre, to live on borrowed money or time, does not exist any more.... We need to expand the scope and the area for the operation of market forces."

Dr. Manmohan Singh.
Budget Speech,
July 24, 1951.

Why did World Bank and IMF nudge India towards liberalization? *The Neo-imperialist narrative of the opposing forces*

The then Government of India was presented a stark choice by the two institutions- It will either have to undertake reforms that will promise the needed external support or brace itself for a disorderly and painful transition that will significantly reduce growth for years to come. India chose the former.

Although, in hindsight, effecting forced structural reforms seems a better choice, but at that time it faced significant opposition.

The opposition was based on the prevalent **communist-capitalist debate and the neo-imperialist perception of the international financial institutions** especially the Bretton Woods Institutions. The IMF and World Bank largely controlled by the Western powers (particularly USA) were seen as proxies of these countries.

It was feared that opening the economy to the external world would pave the way for western interventions in the economy which was seen as a threat to economic sovereignty and consequently to strategic autonomy of the country.

The opening of the economy did lead to a more globally connected Indian Economy but the fear that this would lead to loss of strategic autonomy turned out to be a misconception.



How did the Indian Government respond to this crisis?

The **reform process had already started earlier in the late-1980s** which included export incentivization, creation of a Securities and Exchange Board of India in 1987 and recognizing the importance of consumer goods vis-à-vis India's emerging middle class. **The 1991 reforms represented the watershed in this reform process** and with the advent of the crisis, following reforms were initiated-

- **Liberalization:** Liberalization was done in various sectors in the following ways:

- **Deregulation of industrial sectors:** Industrial licensing was abolished for all but product categories - alcohol, cigarettes, hazardous chemicals, drugs, explosives etc.

- Many goods produced by small-scale industries had been dereserved.



■ As a corollary of supply deregulation, markets were allowed to determine the prices of commodities through free-market dynamics.

■ The MRTP Act paved the way for a more liberal Competition Law in 2002.

➤ **Financial sector reforms:** The role of RBI was reduced from regulator to facilitator of financial sector. Thus, paving the way for establishment of private banks and increased foreign investment in the sector.

■ **Tax Reforms:** Corporate tax rate was gradually reduced. Also, tax procedures were simplified with number of tax slabs being reduced to 3 instead of 11 earlier.

● **Privatization:**

➤ **Expanding the 'dereserved' list:** Many industries which were reserved for public sector had been "dereserved". Only railways, defence equipment, atomic power generation had been reserved with the public sector.

➤ **Disinvestment:** The reforms recognized the importance of policy of disinvestment in transitioning from a controlled and planned economy to a market driven economy.

● **Globalization:**

➤ **Trade and Investment Policy Reforms:** Following restrictions were removed to encourage foreign trade and investment-

■ **Dismantling of quantitative restrictions** on imports alongside reduction of tariff rates (taxes on imports).

■ **Removal of licensing procedures** for imports except in case of hazardous and environmentally sensitive products.

■ **Export duties were progressively decreased** to promote exports.

➤ **Foreign Exchange Reforms:** The rupee was devalued against foreign currencies which led to an increase in inflow of foreign exchange. Also, market has been allowed to determine the foreign exchange rates.

■ The restrictive FERA, 1973 was replaced with a more accommodating Foreign Exchange Management Act, 1999.

The immediate and medium-term objective of these reforms was to ward off the prevailing Balance of Payment (BoP) crisis. But the structural reforms that were initiated had a long-term impact on the nature as well as the magnitude of the Indian Economy.

● **Dereservation** implies opening up of those industries for the private sector that were exclusively reserved for the government sector.

● **Deregulation** means reduction or elimination of government control (restrictions and regulations) in a particular industry, usually enacted to create more competition within the industry.

● **Disinvestment** means sale or liquidation of assets by the government, usually in Central and State public sector enterprises, projects, or other fixed assets. The aim of this exercise is to reduce the fiscal burden on the exchequer, or to raise money for meeting specific needs, such as to bridge the revenue shortfall from other regular sources. In some cases, disinvestment may be done to privatise assets. However, not all disinvestment is privatisation.

For example in case of drugs and pharmaceuticals (D&P) industry, If government says that drugs and pharmaceuticals can be manufactured only by a public sector company, it is called a **Reserved Industry**.

Later, if government says that anyone having licence can manufacture drugs and pharmaceuticals in the manner as decided by the government, it is called **Dereservation**.

Now if the government says that if anyone wants to manufacture drugs and pharmaceuticals, it does not require any licence to do so and can operate without worrying about restrictions and regulations, it is called **Deregulation**.

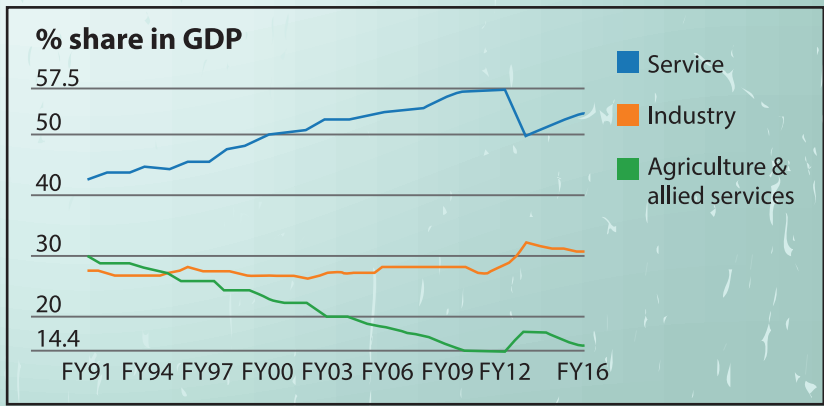
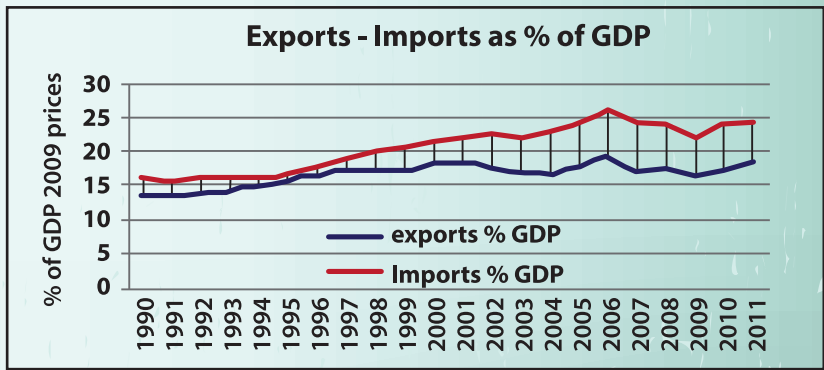
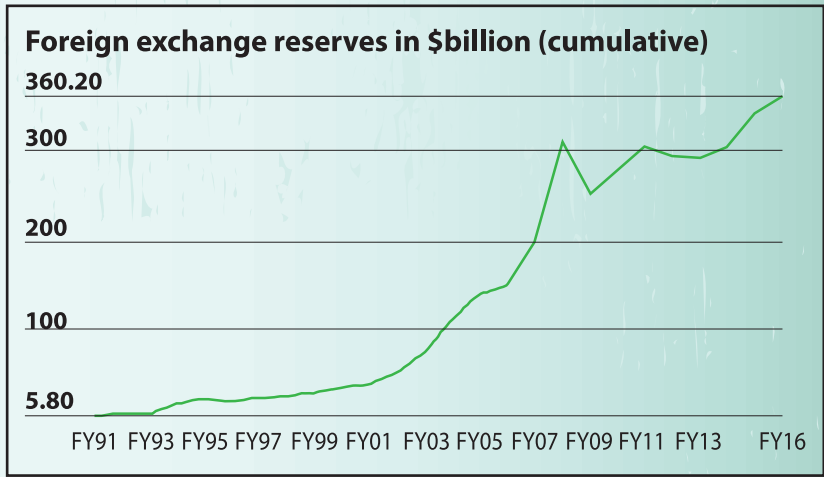
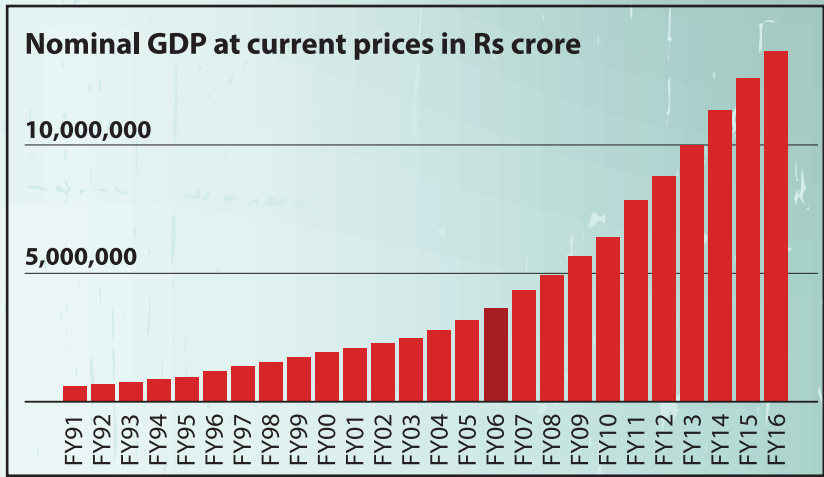
After some years, when government decides to sell its stakes in one of its drugs and pharma company, it is called **Disinvestment**.



What has been the impact of these reforms?

The ideological change sparked by the reforms has culminated into following impacts:

- Size of the Economy:** The size of the Indian Economy has grown from about Rs. 6 lakh crore to about Rs. 140 lakh crore (although the effect of inflation and currency devaluation needs to be discounted).
- Foreign investment:** Before 1991, foreign investment in India was negligible. With continuous liberalization in the Foreign Direct Investment (FDI) and Foreign Indirect Investment (FII) regimes, the collective investment of the two have crossed \$ 100 bn.
- Forex Reserves:** The dismal state of forex reserves was the tipping point which forced the Government towards reforms. Since 1991, the forex reserves of India have seen significant growth. The reserve in 2021 reached a record high crossing the \$ 642 bn mark.
- Growing trade:** Since 1991, India is seen as a successful exporter of auto parts, pharmaceutical goods, engineering goods, IT software and textiles.
 - Although, opening the economy has also increased the extent of imports thus affecting the overall Current Account Deficit (CAD) and the level of external debt.
- Services sector:** With IT sector becoming the torch bearer of the growth of the Indian Economy, the services sector showed significant growth post-1991. This altered the proportions of sectoral contribution in the economy.
 - Growing consumption can be proxied on variables like growing electricity consumption and telecommunications.
- Capital and Financial market:** The liberalization of the Indian economy alongside encouragement to private sector led to development of a vibrant capital and financial market. This was further aided by strengthening of the Securities and Exchange Board of India (SEBI). Growth in the Sensex index can be seen as a proxy to capital market development.
- Price stability:** The corollary of the BoP crisis in 1991 was growing inflation and instability in Government finances. Since 1991, barring some instances, price volatility has remained largely under control.
- Consumption and rise of middle-class:** Opening of the economy removed the supply constraints which simultaneously created demand from an average citizen. This demand-supply dynamic has led to increased consumption resulting in rise of the middle-class, which was earlier a miniscule part of the Indian Economy.
 - Growing consumption can be proxied on variables like growing electricity consumption and telecommunications.



Impact of the 1991 Reforms beyond the Economy

The economy of any country does not operate in a silo but is enmeshed with its social, political, cultural, and technological spheres. Similarly, the 1991 economic reforms not only impacted the economic structure of the country but influenced other aspects as well-

- **Health and Education:** The corollary of privatization in the economic sphere was its percolation in the sphere of health and education as well. Privatization allowed creation of schools, universities, clinics, and hospitals alongside the public institutions.
- **Nature of Politics:** The 1991 reforms changed the country's political economy from politics of control to politics of regulation and facilitation. The idea of liberalization has spilled over to other areas of polity as well, leading to an ideology of 'minimum government and maximum governance'.
 - As a corollary of changing nature of politics, the **role played by the bureaucracy also became less intrusive and restraining and more facilitative.**
- **Intermingling of cultures:** The advent of globalization and liberalization has enabled intermingling of culture in the music, language, food, and clothing among others. For instance, the glocalized innovation of 'Paneer-tikka burger' would have been difficult without opening the economy.
- **Technological growth:** The opening of the economy to the world and allowing the market to blossom incentivized innovation. This has led to relatively faster technological growth in India in the past 3 decades.

What are the 'chinks in the armor' that remain unaddressed?

- **Limited inclusivity and jobless growth:** Though the GDP growth rate has increased in the reform period, it has been pointed out that the reform-led growth has not generated sufficient employment opportunities in the country.
 - Also, acceleration of growth has not dented and in some cases accelerated the extent of economic inequality in the country.
- **Complicated taxation framework:** Although, the 1991 reforms had significantly reduced the taxation levels, the taxation framework remains complicated and regressive with almost half of the tax revenue coming from indirect taxation.
 - The issues in the framework include low Tax-to-GDP ratio despite high taxation rates, overuse of cesses and surcharges and rationalizing the taxation structure for agriculture among others.
- **Several areas remain untouched by reform:** The reforms have largely been in the formal sector of the economy, while the agriculture, urban informal sector, and forest dependent communities have not seen major reforms. This has led to uneven growth and unequal distribution of economic freedom among people.
 - For instance, there has not been much difference in the growth trajectory of the agriculture sector pre and post the 1991 reforms.
 - Also, this has resulted in development of a large unorganized sector which makes it even more difficult to regulate the economy or initiate reform.
- **Policy flip-flop:** Surprise changes, lack of consistency at policy level especially in areas like industrial policy, external trade etc. makes the Indian market volatile and as a result limits its potential as an investment and business arena.
 - For example, unanticipated changes in the import tariffs discourage businesses to engage in long-term trade agreements.
- **Inadequate infrastructure:** Chronic inadequacy in infrastructure in the form of under-development of roads, railway, airline, port infrastructure, digital infrastructure and social infrastructure among others affects all areas of the economy.



- The limitations posed by the infrastructural bottlenecks are estimated to reduce India's GDP growth by 1-2 per cent every year.
- **Small size of the financial sector:** Although the size of the financial sector has grown since the 1991 reforms but when compared to the size of the economy, the financial system is still at a nascent stage. This can be seen through the size of largest banks in India and through the level of financial penetration in India.
 - Also, other areas like development of bond markets, forex markets etc. have remained underdeveloped due to issues like lack of regulatory clarity and limited capital account convertibility.
- **Lack of emphasis on human resource development:** The economic reforms have always been looked at from the perspective of economic entities. This masks the role that education and development of human resources play in the economic development.
 - For instance, incentivizing industry through monetary and policy incentives will have a limited impact if it is not accompanied with requisite attention to skill development.

Along with the above-mentioned areas, the biggest hole in the 'armor' is lackluster execution and slow pace of reforms. There have been several efforts to overcome these challenges like employment generation programmes, Good and Services Tax, deliberations on Direct Taxes Code, National Infrastructure Pipeline (NIP) etc. But the same has not materialized due to slow pace of reforms.

How can we chart out the future of economic policy reform?

The 1991 reforms averted the crisis and had a significant socio-economic impact on the country. The crisis and the impact that the reforms created changed the perspective of the government and the citizens alike towards economic reforms. A public acceptance has emerged now that reforms should be undertaken. The critical question has shifted from 'Should reforms be undertaken' to 'How reforms should be undertaken'.

The current economic policy flux created by COVID-19, though unfortunate, has provided us the ground to use the current situation and acceptance of economic reform to create an economic policy for the future. Such a policy could entail the following-

- **Diversified Privatization:** The idea of diversified privatization aims to complement privatization with policies which prevent concentration of wealth and thus encourage inclusiveness in growth.
 - For example, encouraging collaborative structures such as cooperatives which despite of lying outside the public purview enable sharing of wealth.
- **Shareholder capitalism to stakeholder capitalism:** Stakeholder capitalism is a system in which corporations are oriented to serve the interests of all their stakeholders. Among the key stakeholders are customers, suppliers, employees, shareholders, and local communities.
 - Under this system, a company's purpose is to create long-term value and not to maximize profits and enhance shareholder value at the cost of other stakeholder groups. For instance, the development and growth of SHGs can act as a guiding light in furtherance of such an economic model.
- **Integrated and progressive taxation system:** With the advent of digital economy and emergence of unconventional assets such as cryptocurrencies, Non-fungible tokens etc., it becomes important that deliberations be started to create an integrated taxation policy.
 - Also, efforts need to be made for simplification of the overall taxation system and gradual transition towards a direct-tax dominated taxation system.
- **Clarity in the role public sector envisages to play in the economy:** As the economy transitions towards a more market-oriented economy, it is important that role of public is clearly defined. This will enable value maximization from the resources of the economy as well as result in generation of larger and more planned revenue for the Government.

" I do not minimise the difficulties that lie ahead on the long and arduous journey on which we have embarked. But as Victor Hugo once said, "No power on earth can stop an idea whose time has come". I suggest to this august House that the emergence of India as a major economic power in the world happens to be one such idea. Let the whole world hear it loud and clear. India is now wide awake. We shall prevail. We shall overcome."

—
Dr. Manmohan Singh.
Budget Speech,
July 24, 1991

- **Holistic reforms to streamline the economic climate:** Keeping the economic framework i.e., the rules and regulations in line with the changing needs of the society and economy. Also, simplification of the business climate by addressing issues like the 'Exit problem' of the Indian economy, delays in permissions, high compliance cost etc. must be addressed. The areas highlighted by the World Bank's 'Ease of doing business' ranking can act as a good starting point.
 - A good example in this regards is the codification of all labour laws into 4 labor codes which is expected to have a holistic impact on labor welfare, ease of compliance, increasing business activity, increasing formalization among others.
- **Integrated approach to financial sector:** An approach which integrates financial education, financial inclusion, banking sector, FinTech agencies and markets such as bond markets, commodities markets, forex markets etc. could be envisaged for the future.
 - An integrated approach will not only ensure development of nascent areas like community markets but also enable creation of sophisticated instruments which could satisfy the need of all customers as well as deepen the financial sector.
- **States need to be a part of the reformation process:** The political economy of the country has evolved from being a centrally planned economy towards ideas like 'cooperative' and 'competitive' federalism. In this context, it is important that states are provided significant weight and space vis-à-vis policy changes at the national level.
 - Also, the primary reason of slow progress of reforms is lack of consensus at the political level. Thus, it is important to create a culture of economic policy debate. This would accelerate the pace of deliberations and bring more dynamism in the reformation process.
- **Economic policy inclusive of the larger picture:** The current pattern of economic growth in both India and abroad has proved to be myopic in nature with issues such as climate change remaining unaddressed. In this context, it is important that the economic policy reform takes into account the ideas and targets propagated by the Sustainable Development Goals (SDGs).

CONCLUSION

The year 1991 is a milestone in the history of independent India. The economic reforms initiated in 1991, followed by further measures undertaken by successive governments, have helped our country emerge as one of the fastest growing economies in the world. While India has continued to reform its policies since the early 1990s, including recent tax reforms, the pace of reform is disquietingly slow, red tape continues to stifle the economy and insufficient attention has been paid to the pressing problems of disease control, pollution, rural poverty, and inadequate social services, such as education and health care.

Furthermore, the COVID pandemic that battered the economy has reset the reforms debate. It is therefore time to outline a credible new reform agenda that will not just support the revival of the economy but also ensure growth rates higher than it had when it entered the pandemic.



TOPIC AT GLANCE

Background of the 1991 reforms

Underlying causes for the crisis

- **License raj:** The “License Raj” or “Permit Raj” was the elaborate system of licenses, regulations and accompanying red tape that were required to set up and run businesses.
 - This was largely executed through the MRTP Act, 1969.
- **Policy of import substitution:** This policy advocated replacing imports with domestic production. This led to the monopoly of Indian industries and lack of incentive for them to improve.
- **A closed economy:** The rupee was inconvertible and high tariffs and import licensing prevented foreign goods reaching the market. The overinvolvement of bureaucracy often led to absurd restrictions.

Immediate unfolding of the crisis

- The immediate causes of the crisis included complacency caused by Bombay High Oil discoveries, collapse of Rupee-Rouble trade following the dismantling of the Soviet Union and crude oil price hike due to the Gulf War. This resulted in a BoP crisis-
- **1985:** BoP problems started due to persistent deficit between income and expenditure.
 - **1990:** The Central Government was close to defaulting on its foreign payments.
 - **1991:** The foreign exchange reserves dropped to a dangerous level alongside rise in prices of essential goods. This led to a situation where India was seeking help from external bodies i.e., IMF and World Bank.

Response of the Indian Government to the crisis

- **Liberalization:** Liberalization was done in various sectors in like **deregulation of industrial sectors, financial sector reforms** like establishment of private banks and increased foreign investment and **reforms related to taxation**.
- **Privatization:** This included **expansion of the ‘dereserved list’** thus inviting private participation and disinvestment which helped in transition towards a market driven economy.
- **Globalization:** The idea of globalization manifested in **Trade and Investment Policy Reforms** like dismantling of quantitative restrictions, removal of import procedures and lowering of export duties. It was also accompanied with **Foreign Exchange Reforms** such as devaluation of rupee.

Impact of these reforms

- **Size of the Indian Economy** has grown from about Rs. 6 lakh crore to about Rs. 140 lakh crore.
- With continuous liberalization in the **FDI and FII, the collective investment of the two have crossed \$ 100 bn.**
- Forex reserves in 2021 reached a **record high crossing the \$ 642 bn mark.**
- India has become a **successful exporter of auto parts, pharmaceutical goods, engineering goods, IT software and textiles.** As a corollary, **the services sector has showed significant growth** post-1991.
- Encouragement to private sector led to **development of a vibrant capital and financial market.**
- Opening of the economy has shifted the demand-supply equilibrium upwards thus resulting in **increased consumption and rising middle class.**

The reforms have also impacted areas like Health and Education, Nature of Politics, Culture and Technological Development.

Challenges that remain unaddressed

- **Limited inclusivity and jobless growth** as GDP growth remains uneven and does not create proportionate level of employment.
- **Taxation framework is complicated and regressive** with half of the tax revenue coming from indirect taxation.
- **Several areas** like agriculture, urban informal sector and forest communities **remain untouched by reform.**
- **Surprise changes, lack of consistency at policy level** makes the Indian market volatile and less attractive.
- **Chronic inadequacy in infrastructure** has a negative multiplier effect on almost all areas of the economy.
- **Small size of the financial sector** including banks and development of bond, forex markets etc.
- **Lack of emphasis on human resource development.**

Way forward for the future of economic policy

- **Diversified privatization** to complement privatization with policies which prevent concentration of wealth.
- **Moving from shareholder capitalism to stakeholder capitalism** to make growth more inclusive.
- Focusing on creating an **integrated and progressive taxation system.**
- **Clarity in the role public sector envisages to play** in the economy.
- **Holistic reforms** in areas ranging from industry to labour to streamline the **economic climate of the country.**
- **Integrated approach to financial sector** including banks, FinTech sector, financial markets among others.
- With the evolution of India’s political economy, the **states need to be an integral part of the reformation process.**
- **Economic policy** reform should **take into account** the ideas and targets propagated by the **SDGs.**