Endogenous Origins of Economic Reforms in India and China

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The Role of Attitudinal Changes: India (1980-1984) and China (1978-1982)

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Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work.

Abstract

'Attitudinal change' in the context of economic reforms has been referred to in Rodrik and Subramanian (2005), DeLong (2003), Kohli (1989), and Panagariya (2004, 2008). The dissertation provides empirical support for this literature, establishing an earlier start for India's economic policy liberalisation than presented in stylized accounts. It demonstrates the endogenous nature of the origins of these policy shifts. 'Attitudinal change' literature had directed attention to the need for further research into India's policy changes of the early 1980s and for studying broader comparability issues in other developing countries. This research makes a contribution towards filling these gaps.

This dissertation shows that India started its economic liberalisation under the Indira Gandhi administration from 1980 to 1984. These findings depart from the conventional view that India's economic policy changes were initiated by the Narasimha Rao government in 1991, or by the Rajiv Gandhi administration in the mid to late 1980s. The dissertation establishes that policy shifts of the early 1980s had endogenous origins in the political leadership's attitudinal changes. The Indira Gandhi administration of the early 1980s revisited the statist policies of its previous tenure from 1966 to 1977. The new approach entailed more openness towards private enterprise, scaling back the role of the public sector, and starting India's integration into the global economy.

The dissertation also discusses the comparable role of attitudinal changes at the start of China's policy liberalisation led by Deng Xiaoping from 1978 to 1982. It focuses on the significance and challenges faced by China's political leadership in bringing about societal attitudinal change. It concludes by drawing comparisons between India and China, developing a linkage between their endogenous attitudinal changes and economic policy liberalisation.

This book is dedicated to my father, Anna

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CONTENTS

Glossary of Terms and Acronyms

Aam Admi	Common man
Assocham	Associated Chambers of Commerce & Industry of India
Bharat	India
BJP	Bharatiya Janata Party
Canalised	Foreign trade channelled through STC
CCP	Chinese Communist Party
Congress (I)	Congress (Indira) – the majority faction within Congress
Congress (R)	Congress (Ruling) – synonymous with Congress (I)
CPSU	Communist Party of the Soviet Union
Fang	'Opening up' of China's economy
FERA	Foreign Exchange Regulation Act
FICCI	Federation of Indian Chambers of Commerce & Industry
Gang	The Gang of Four
Garibi Hatao	Banish Poverty campaign launched by Indira Gandhi
IMF	International Monetary Fund
Kai-fang	China's 'Open-Door' policies to open up the economy
Lok Sabha	Lower House of Indian Parliament
MRTP	Monopolies and Restrictive Trade Practices Act
NRI	Non-resident Indians
OGL	Open General Licence
PLA	People's Liberation Army
Rajya Sabha	Upper House of Indian Parliament
RBI	Reserve Bank of India
Red Guards	Youth groups organised during Cultural Revolution years
Sarvodaya	People's movement launched by Jayaprakash Narayan
Shou	'Tightening' policies in China's economy
STC	State Trading Corporation (India)

Part I. Introduction

In the early years of the twenty-first century, India and China have been acknowledged variously as rapidly developing economies, 'Asian Giants,' emerging economic superpowers, or key players in an integrated global economy. Both countries have made significant progress over the past three decades in economic development, adoption of market economy principles, and integration into the global economy. This progress since the late-1970s or early-1980s becomes even more pronounced when compared to the first three decades following India's Independence in 1947 and the establishment of the People's Republic of China in 1949. In the 1950s, 1960s and 1970s, political leadership in both countries sought to achieve their respective objectives of social justice and economic development through largely insular economic policies, adopting a statist approach which favoured a 'commanding' role for the state in the economy while repressing private enterprise and material incentives to varying degrees.

Both countries changed this approach between the late-1970s and early-1990s, moving towards a market economy and a diminished role for the state. Broad liberalisation measures announced by the government of Narasimha Rao in its Statement of Industrial Policy of July 1991, and Finance Minister Manmohan Singh's budget speech of February 1992, in which he sought to realise India's development potential by "unshackling the spirit of enterprise," are considered milestones marking the start of India's economic liberalisation; Rajiv Gandhi's 'pro-business' policies during the 1984-89 period are also acknowledged as major turning points. Deng Xiaoping's reinstatement in July 1977 followed by the introduction from 1978 of various market oriented initiatives mark comparable milestones in China's economic development.

When did India's economic liberalisation really begin? How did it begin? Was India unique in the timing and origin of its reform process? This dissertation presents evidence to show that India's policy changes commenced during the 1980-1984 tenure of Prime Minister Indira Gandhi. This starting point precedes the generally accepted stylized view that India started its economic liberalisation in 1991 under the stewardship of Narasimha Rao and Manmohan Singh. It also pre-dates the 'pro-business' policy changes attributed to the Rajiv Gandhi government between 1984 and 1989.

A strand of existing literature on the origins (often described as the 'decisive shift') of India's economic liberalisation has pointed to the 1980s as the appropriate starting point. Within this strand, there is some discussion attributing this decisive shift to 'attitudinal changes' among the political leadership. However, there is insufficient clarity in this literature whether these references are to the years of Indira Gandhi's leadership (1980-1984), or that of Rajiv Gandhi (1984-1989). Even in instances where the start of economic liberalisation is ascribed to the 1980-1984 period, the underlying 'attitudinal change' arguments are not supported by empirical evidence documenting such policy changes. This dissertation seeks to fill these gaps in existing research.

The constancy of key actors in India as compared to a regime change in China with the death of Mao Zedong and the end of power of the Gang of Four mark important differentiators between India's and China's start of economic liberalisation. Despite the pivotal role of Deng Xiaoping in China's policy shift, he had to bring about considerable attitudinal changes in a society that had witnessed the disruptions of the Great Leap Forward and the Cultural Revolution and thirty years of ideological domination. China's political leadership saw the imperatives of persuading broad sections of society to embrace attitudinal changes towards a more market-oriented economy. Comparable policy discussions surrounding these persuasive efforts provide some insights into experiences of the two countries in their initiation of economic liberalisation.

This dissertation thus has three drivers: First, to show that India's economic liberalisation had started in the 1980-1984 period under the leadership of Prime Minister Indira Gandhi. Second, to show that these policy changes had endogenous roots in the attitudinal changes of the political leadership. Third, to examine the economic liberalisation initiated by Deng Xiaoping in China in 1978, drawing out comparable attitudinal changes in surrounding policy discussions between India and China.

Chapter I.

The Stylized View of Economic Reform in India and China and Comparator Evaluation

A. The Stylized View

The conventional view of India's economic development in the second half of the twentieth century describes the country setting 'social justice' goals of rapid agricultural and industrial development, the removal of poverty and socio-economic disparities, and the attainment of self-reliance. Independent India's political leadership post-1947 consisted mainly of key actors from the Congress party who had played leadership roles in the long drawn out freedom movement against British rule. Jawaharlal Nehru had been Prime Minister for 17 years, from 1947 until his death in 1964. His daughter, Indira Gandhi was elected Prime Minister in 1966 and remained the leading political figure until her election defeat in 1977. Following a brief Janata party government, she had been returned to power in 1980, and remained Prime Minister until her assassination in 1984. The periods of Indira Gandhi's tenure as Prime Minister, 1966-1977 and 1980-1984, are the focus of this dissertation.

India enunciated its post-Independence development goals in the Industrial Policy Resolutions of 1948 and 1956. While a 'mixed economy' was provided for, the state's role was considered preeminent in achieving these goals. Macro-economic planning by the state through Five-Year Plans had established output targets and allocated resources across the economy; the private sector was to play a supporting role. The state's dominance in matters economic manifested itself in the 'Commanding Heights' public sector, often leading to the establishment and growth of several inefficient industries under state ownership and management.

The state became increasingly activist over the 1960s and 1970s following food shortages, balance-of-payments crises, and a general deterioration of the economic situation in the mid-1960s. The foreign exchange crisis of the 1960s had led to the adoption of an increasingly insular approach with emphasis on 'self-reliance'. There was increasing disengagement from global market economies into the 1970s coupled with growing economic ties with the Soviet Union and the Eastern Bloc countries. The Cold War and India's declared 'non-aligned' posture in international affairs provided the political backdrop. Soviet economic assistance often came on a state-to-state basis, complementing the development needs of the public sector.

The commanding role of the state also led to the growth of bureaucratic controls over private enterprise in the form of licence requirements, approvals for setting up or expanding production capacity, controlled prices for food and other essential commodities, high rates of corporate and personal taxation, regulation over business activities of large businesses and foreign investors, and state control over the allocation of credit to the economy through its ownership of major financial institutions. Inefficient public sector enterprises coupled with a discouraged private sector had led to generally poor economic performance, high levels of unemployment, rising inflation and shortages of essential commodities throughout the 1970s and 1980s. The cumulative effects of this economic deterioration had precipitated the balance of payments and macro-economic crisis of 1991.

Spurred by this crisis, India's policy makers had turned to technocrats and started liberalising the economy. 1991 has been widely described as a "watershed" year when trade barriers began to be dismantled, doors were opened to foreign investment, bureaucratic controls such as capacity licensing and investment restrictions began to be repealed. The stylized view typically attributes the start of economic liberalisation to Prime Minister Narasimha Rao and his Finance Minister Manmohan Singh in 1991.[1]

In the Statement of Industrial Policy issued by the Ministry of Industry on 24th July 1991, the Narasimha Rao government initiated considerable departures from previous economic policies covering domestic deregulation, opening the economy to foreign investment and global integration, financial sector and fiscal reforms, and pro-

[1] For example, Das, Gurcharan, *India Unbound: A Personal Account of a Social and Economic Revolution* (New York, 2000).

vided for infrastructure development.[2] It also formalised several ad hoc liberalisation measures that had been introduced over the past decade.[3] This policy statement removed investment licensing and several entry restrictions applicable to large firms covered by the Monopolies and Restrictive Trade Practices Act (MRTP), ended public sector monopolies in various sectors, and initiated automatic approval for foreign direct investment in domestic companies up to a limit of 51%. Reversing previous policies of requiring industrial licensing in all cases unless specifically exempt, the 1991 policy abolished such requirements across the board with the exception of specified industries. This denoted a shift in approach towards positivism by making industrial licensing an exception rather than the rule. A similar shift was made in external trade, replacing the previous 'positive list' approach for permissible imports through the Open General Licence (OGL) scheme with a 'negative list' approach; any item could be imported unless specifically excepted. Certain exchange controls on current account flows were lifted, coupled with a 22% Rupee devaluation. The public sector was clawed back by limiting state-owned monopolies to eight sectors only; all other sectors were now opened for the private sector.[4] The bias against large firms covered by the MRTP restrictions was largely eliminated; pre-entry scrutiny of their investment decisions was no longer required. The emphasis had shifted towards controlling and regulating monopolies and unfair trade practices rather than governing them through absolute size limits or prior approval of their activities. On foreign in-

[2] *Statement on Industrial Policy: 24 July 1991* (1991). For a list of policy changes in the Industrial Policy Statement, 1990, see Panagariya, Arvind, *India: The Emerging Giant* (New York, 2008). For further discussion, see Ahluwalia, Montek S., 'Economic Reforms in India since 1991: Has Gradualism Worked?' *The Journal of Economic Perspectives* 16, no. 3 (2002), 67-88; Ahluwalia, Montek S., 'India's Experience with Globalisation', *The Australian Economic Review* 39, no. 1 (2006), 1-13; Panagariya, Arvind, 'India in the 1980s and 1990s: A Triumph of Reforms', *IMF Working Papers* 4, no. 3 (2004).

[3] These policy changes are further discussed in Kumar, Nagesh, 'Economic Reforms and Their Macro-Economic Impact', *Economic and Political Weekly* (2000), 4 March 2000, 803-812; Jenkins, Rob, *Democratic Politics and Economic Reform in India* (Cambridge, 1999); Frankel, Francine R., *India's Political Economy, 1947-2004: The Gradual Revolution* (New Delhi, 2005).

[4] Public sector monopoly continued in eight sectors on strategic or security grounds.

vestment, the policy abolished the 40% foreign equity ceiling previously stipulated in the Foreign Exchange Regulation Act. Instead, the Reserve Bank of India initiated automatic approval for such foreign investments including proposals for 100% foreign participation in Special Economic Zones.

Another liberalisation watershed was Finance Minister Singh's budget speech of 29th February 1992, where he stressed the need to "unshackle [the] spirit of enterprise" and accept reform to avoid marginalisation from the world economy. This budget introduced further liberalisation measures, and when coupled with the earlier Industrial Policy Statement of July 1991, constituted the milestones for India's economic liberalisation.

The conventional account of China's stylized economic development in the second half of the twentieth century starts with the establishment of the People's Republic of China in 1949. Political leadership was consolidated in the hands of Mao Zedong and the monopoly political power of the Communist Party of China.[5] The leadership's objectives of egalitarianism underpinned by Marxist-Leninist ideology made for a protracted 'class struggle' against bourgeois elements in society. Economic policies were introduced to reverse any trace of free markets, material incentives, private ownership of farms, or private enterprise. The 1950s had seen China borrow from the Soviet model of collectivisation of agriculture and complete the takeover of private industry and commerce; central planning tools had also been adopted from the Soviet Union. The Great Leap Forward campaign (1958-1961) saw a further push into communalisation of agriculture. A mixed economy was of no relevance as economic power was concentrated in the hands of the state. The failure of the Great Leap Forward was acknowledged in the 1960s, leading to a partial reversal of some of its policies, including collectivisation of agriculture. Nevertheless, state control over the economy remained complete. Economic assistance and technology

[5] There were eight other political parties operating for "political consultation … under the leadership of the Chinese Communist Party": China Revolutionary Committee of the Kuomintang, China Democratic League, China Democratic National Construction Association, China Association for the Promotion of Democracy, Chinese Peasants' and Workers' Democratic Party, China Zhi Gong Dang, Jiusan Society, and the Taiwan Democratic Self-government League. See *White Paper on China's Political Party System* (2007). For a discussion on these political parties, see Shih, Wen, 'Political Parties in Communist China', *Asian Survey* 3, no. 3 (1963), 157-164.

transfers from the Soviet Union to China had been withdrawn in the 1960s following ideological differences between the two countries, setting China on a firmly insular path, adopting policies of self-reliance and import substitution, to pursue its economic development. Economic policies during this period had been the proximate cause of more than 30 million famine-related deaths; a general deterioration of economic well-being had been observed.

The Cultural Revolution decade (1966-1976) had unleashed ideological warfare led by Mao, the Gang of Four and the Red Guards. Bourgeois liberalisation, tendencies to 'go it alone,' and any sort of material incentives had come under severe criticism; the Communist Party of China itself had been a victim of these attacks. Opponents of the Gang had been portrayed as 'deviants' for suggesting bourgeois liberalisation. The fear of decision-making amongst policy makers had led to a decade of economic policy stasis with politics dominating economics. Key 'revisionists' who had been purged in the Cultural Revolution decade included Deng Xiaoping who had been labelled as a "capitalist roader;" amongst Deng's faults had been his suggestion of "material incentives" and "going it alone." Deng had been removed from power in 1969; his banishment had been representative of those who opposed dominant thinking during the Cultural Revolution decade. Mao Zedong's death in 1976, followed by the fall of the Gang of Four and a brief power struggle, had seen the return of Deng Xiaoping to political leadership in 1977.

Deng set about his agenda of economic reforms in 1978, placing the economic well-being of the people as his top priority. The thrust of policy changes from 1978 consisted of the modernisation of agriculture through application of scientific methods; rapid catch-up in industrial production by importing the necessary technology; financing these imports by developing an export sector, thus removing the insular bias of the past thirty years; developing scientific and management skills to increase productivity; focusing on quality; making people responsible for their actions through a 'responsibility system,' and introducing of material incentives to create a reward structure of "to each according to his work." Deng has been generally described as a 'reformer' who 'opened the door' for China to start its integration into the global economy. The policy liberalisation of the post-1978 period encouraged foreign direct investment to rapidly modernise the country. Efforts were made to reduce the role of the state in the economy by opening several sectors to private enterprise, domestic and foreign. In changing the course of China's economic policies after 1978, Deng and his cohorts had faced varying degrees of opposition from domestic groups in state-owned enterprises and from within the Communist party, fearing loss of their 'iron rice-bowl.' Over time, this resistance was chipped away as liberalisation introduced a market economy and policy changes became more firmly entrenched through the 1980s.

B. Comparator Evaluation: Why India and China?

Given the emphasis in scholarship on a 'sharp break with the past,' the endogenous origins of India's and China's economic policy changes have largely been neglected. Significant research has been done over the past three decades looking at various aspects of policy changes and outcomes in both countries. Stylized accounts of the commencement of their respective policy liberalisations often point to economic compulsions in the face of deteriorating economic circumstances, the end of the Cold War and therefore the need to shed statist Soviet-style policies, or an emulation effect following the rapid rise of the South-east Asian 'Tiger' economies.

The endogenous origins of India's and China's economic policy changes, especially attitudinal changes on the part of the political leadership leading to these policy changes, have been an under-researched area. In both countries, the start of economic liberalisation was not precipitated by exogenous pressures. There was no deep economic crisis or external conditionality from multilateral agencies to initiate reforms during the period reviewed. In both countries, the political leadership had options; they could have opted to remain on the statist path which they had espoused during the 1960s and 1970s. However, they did not. Policy changes did not result from a 'new dawn' or a fresh new generation of leaders. Instead, policy changes in India and China were initiated by many of the same individuals who had been in power in the statist era.

The political leadership in both countries had undergone a period of reflection providing time and space for a critical review of past policies. This had resulted in a re-think of their approach. The new approach called for dialogue rather than unilateralism in policy-making, a lessening of the role of ideology, compromise and cooperation with groups that could assist in promoting economic development and social justice. There was recognition in both countries of the limitations of the role of the state in promoting these goals; it had lacked capacity. Results of a commanding public sector coupled with suppression or elimination of private enterprise had not been favourable. This re-think on the part of the political leadership was its attitudinal change. Political leaders in both countries had come to a similar realisation.

This realisation and accompanying attitudinal changes had occurred in both countries around the same time – in the late 1970s to early 1980s. The similar timing was more than coincidental. There had been general deterioration in both economies; original lofty goals of improving people's lives had been underachieved. The central planning model adopted from the Soviet Union had shown weaknesses even in that country. Other Eastern Bloc countries in Comecon under the Soviet economic umbrella were facing similar pressures by the early-1980s. South-east Asian Tiger economies had been the rising stars of that time; significant pressures to emulate their success would be expected. Old Cold War antagonistic relationships were changing. The United States and Soviet Union were engaging in détente and discussing contentious issues more openly. The war in Vietnam had ended and American troops in that theatre had withdrawn by 1975. China had joined the United States in boycotting the Moscow Olympic Games in 1980 to protest at the Soviet invasion of Afghanistan. India had nuanced its foreign policy to distance itself from the Soviet Union over its Afghanistan policies around the same time. There were few advantages in aligning completely with either superpower or in continuing insularity. The 'conditions were now right.' Both political leaderships concluded that a more nuanced approach would be beneficial.

Some coincidence did exist in this pattern. In both countries, an *ancien regime* had collapsed around the same time. The political hegemon, Mao Zedong, who had dominated China's political economy, passed away in 1976; the Gang of Four had been arrested shortly thereafter. Indira Gandhi, who had had near paramount stature on the Indian stage, had lost the general election in 1977 and had been relegated to the Opposition benches. There had also been coincidentally similar periods allowed for introspection in both countries. Deng Xiaoping had six years for soul-searching during his political exile from 1969 to 1975, while Indira Gandhi had three, from 1977 to 1980. Besides these two leaders, many of their cohorts had also been sidelined during the Cultural Revolution or the Congress party's eclipse around the same time.

Policy changes introduced in both countries resulted in more open economies and led to a decline in the role of the state along with increased participation for private enterprise. Both India and