Reforms: unsound assumptions

India's reform strategy has erred on the side of too many pat assumptions in market worship, ***Deepak Nayyar*** says.


Expectation and reality

There are some important assumptions implicit in the reform strategy adopted by the government in India. It is necessary to highlight and to evaluate these underlying assumptions. Stated in caricature form, the assumptions are : (a) the market mechanism would be a substitute for State intervention; (b) private investment would be a substitute for public investment and direct foreign investment would be a substitute for other forms of foreign capital inflows: (c) imports of technology would be a substitute for domestic technological capabilities; and (d) the agricultural sector would, somehow, take care of itself. In my judgement, these assumptions are only heroic in nature but also suggest an inadequate understanding of reality. Consider each in turn.

The first assumption that State intervention does not matter, or is counterproductive, in the process of industrialisation, is ahistorical. Our experience in the second half of the twentieth century suggests that the guiding and the supportive role of the State has been at the foundations of successful development among late industrialisers.

In the earlier stages of industrialisation, State intrvention creates the conditions for the development of industrial capitalism by etablising a physical infrastructure through government investment, developing of industrial capitalism. In the later stages of industrialisation, State intervention is functional or strategic rather than conducive but remains crucial.

At one level, functional State intervention may seek to correct for market failures, whether general or specific. At another level, strategic State intervention, interlinked across activities or sectors, may seek to attain broader, long term, objectives of development.

It is possible to cite several examples. Exchange rate policy is not simply a tactical matter of getting-prices-right but may turn out to be a strategic matter if deliberately undervalued exchange rates, maintained over a period of time, provide an entry into the world market for differentiated manufactured goods. The structure of interest rates is not just about allowing market forces to determine the price of capital, but may be a strategic method of guiding the allocation of scarce investible resoures. Restrictions on the use of foreign brand-names is not so much an inward-looking attitude, if it is perceived as a strategic means of buying time to develop national brand names.

It is the nature and the form of State intervention that matters. The experience of excessive State intervention associated with government failures, however, should not lead to the conclusion that minimal State intervention is the best or that market failures do not matter. We appear to have moved from a widespread belief, prevalent in the 1950s, that the State could do nothing wrong to a gathering conviction, fashionable in the 1990s, that the State can do nothing right. These are caricature perceptions.

The reality is more complex than simplified paradigms that may be in or out of fashion. In a world of uneven development, the role of governments in the industrialisation process remains vital and could account for the difference between success and failure. For industrialisation is not only about getting-prices-right; industrialisation is also about getting-state-intervention-right.

The second assumption has two components, both of which are open to question. For one, most of the evidence available in India suggests that the level of public investment in the economy has been an important determinant of the level of private investment in the economy.

This is particularly so for the industrial sector where public investment crowds in, rather than crowds out private investment. Thus, a scaling down of public investment would squeeze supply responses in the medium term not only because it would cut back on infrastructure but also because it may dampen private investment.

For another, given the relative magnitudes, it is most unlikely that direct foreign investment could substitute for other forms of foreign capital inflows at least in the medium term. The open door policy may stimulate large inflows of direct foreign investment as compared with the recent past, but we must recognise that policy regimes are permissive and not causal. The perceptions of transnationals are variable ones.

The third assumption emphasises the importance of access to imports of technology and neglect the significance of doemstic development of technology at the present stage of industrialisation in India. The liberalisation of technology imports would lead to a multiplicity of imports by the same firm over a period of time.

The discipline of the market would, of course, place some limits on this process, but it is possible that domestic technological capabilities may be stifled. Yet, an economy that industrialises should be able to move from importation to absorption and adaptation of technology through to the stage of innovation, at least in some sectors.

The industrialisation experience of India suggests that there are a number of sectors where the level of technological development is just not adequate. There are several examples of situations where technologies were imported for particular sectors at a point of time and the absorption of such technologies has been followed by stagnation rather than adaptation, diffusion and innovation. At the same time, in many cases, indigenous development of technology has not led to widespread diffusion let alone technological upgradation. The underlying reasons are complex. It is clear, however, that market structures and government policies have not combined to provide an environment which would accelerate the absorption of imported technology and foster the development of indigenous technology, or create a milieu which would be conducive to diffusion and innovation. Indeed, the R&D effort in the private corporate sector has been minimal.

It needs to be stressed that, at a macro-level, the role of the government is crucial for planning technological development across sectors and over time. This means planning for the acquisition for technology where it is not needed.

The fourth assumption is perhaps the most curious. It is striking that the entire discourse about structural reform proceeds as if the agricultural sector does not exist, or if it exists it does not matter. This is indeed puzzling in an economy where the agricultural sector contributes one-third of GDP and employs more than two-thirds of the work force. And it is not as if the agricultural sector is without structural rigidities or structural imbalances. The process of macro-economic stabilisation combined with fiscal adjustment and structural reform would, of course, be constrained by what happens in the agricultural sector. But this process would also have a significant impact on Indian agriculture in as much as it reduces fertiliser subsidies and priority sector lending, or in so far as it moves domestic prices of inputs and outputs closer to world prices.

The increase in fertiliser prices and the possible increase in the price of credit are a cause of concern because, given the stagnation and decline of public investment in the agricultural sector which began in the late 1970s, the use of fertilisers and the availability of credit have been the most important determinants of the increase in yields per hectare and, hence, agricultural output. The trade policy reform in India, in the sphere of agriculture, which seeks to dismantle restrictions on trade other than tariffs and to bring domestic prices closer to world prices, represents a fundamental departure from the past. It may set in motion a sequence of changes large enough to reshape the parameters not simply for the agricultural sector but for the economy as a whole.

The impact would not be confined to trade flows. It would extend to output and prices.The changes in the distributio of agricultural output and incomes between regions may accentuate inequalities, which would have political implications. Inreases in domestic prices of wage goods produced in the agricultural sector are bound to erode food security, which,in turn, would have social consequences. There may not be much confort in the balance of payments either.In so far as the volume of India's agricultural imports or exports would affect world prices, terms of trade are likely to worsen.The possibilities would be constrained further in as much as structural rigidities in the agricultural sector inhibit supply responses.