CHAPTER 8

AFTER THE PERMIT RAJ

India's Awakening

MANMOHAN SINGH was due for lunch at friends' in New Delhi on June 21, 1991. That very morning, however, his wife called up the hosts to say that they would have to cancel. "Sudden work" had come up for her husband. Shortly after eight that morning, Singh had received an unexpected phone call from the new prime minister, P. V. Narasimha Rao. So instead of going to lunch, Singh found himself being sworn in as finance minister amidst one of India's worst economic crises. Yet it looked to many as though Singh would soon be free for lunch again, for it was thought that Rao's government was weak and would not last long. Instead, it stayed the full five years, of its term, and in the process fundamentally redirected India's economy away from its state-directed course. The result could well make India one of the most dynamic forces in the world economy of the twenty-first century.[1]

In changing course, this new government would break decisively with the ideas that had governed India since independence and that, indeed, had dominated the Congress Party since the 1930s. Rao had none of the drama or flair of his most famous predecessors. He might well have been expected to be more caretaker than revolutionary, the tail end of a dynasty rather than the man who would overturn the ideas that had knitted it together.

During all those years, India certainly did seem to be governed by a dynasty. The father, Pandit Nehru, had led the nation into independence in 1947 and served as prime minister up to his death in 1963. His daughter, Indira Gandhi, was prime minister for fifteen of the seventeen years between 1967 and 1984, when she was assassinated. In turn her son Rajiv was prime minister from 1984 to 1989. In 1991, he was assassinated while campaigning for a political comeback.

Yet through all of its travails, India remained a democratic country. And

India's continued commitment to democracy stands as one of the great achievements of the second half of the twentieth century. Its free elections, independent judiciary, free press, and free speech were in marked contrast to political realities both in its region and in much of the rest of the developing world, which succumbed for long periods to dictatorship, ethnic wars, and political fission. The accomplishment was all the more remarkable given the size of the country—which comprises almost 20 percent of the world's total population—and its complex multiethnicity. The system was often tested by religious and ethnic strife, corruption, and political ambition, but it had shown remarkable resilience.

When it came to economics, however, the story was quite different. Enthralled by idealism and ideologies, India initially embraced a program that held back development that could have alleviated its massive poverty. And in the process it marginalized itself in a rapidly growing world economy. The great idealist cause was the spirit that had motivated Mahatma Gandhi and captured Jawaharlal Nehru on his car trip into the mud of Rae Bareli in 1920—the conquest of poverty. The problem was not the ideals but rather the means. Their ideas shaped by Fabian socialism and communist central planning, the leaders of the Congress Party distrusted the market. They thought competition was bad, and they had what has been described as "contempt for the price mechanism." Instead, they believed that central planning, strong state control, and government knowledge would do a better job of allocating investment and determining output than would many millions of individual decision makers. Bureaucratic diktats were better than the give-and-take of prices in the marketplace.

There was a great deal of economic analysis—highly persuasive, technically expert, sometimes beautifully argued—to support this approach. As an outstanding Indian economist wryly commented, "It is not entirely wrong to agree with the cynical view that India's misfortune was to have brilliant economists: an affliction that the Far Eastern super-performers were spared." But behind all that was a great sense of urgency. Both natural and economic resources were very scarce in the country. They had to be directed; otherwise, as a government official once explained, they might be frittered away producing nonessentials such as lipstick. The problems facing the country were too immediate, the human suffering too massive, to take that risk. The government would concentrate its resources in the spirit of Soviet central planning, focusing on heavy industry. And, in what turned out to be a crucial mistake of emphasis, the focus was on investment itself rather than on the productivity of the investment and the quality and value of what was produced.[2]

"Up the Marxist Mountain"

The consequence of all this was an economic system that had three self-defeating characteristics. The first was the "Permit Raj"—a complex, irrational, almost incomprehensible system of controls and licenses that held sway over every step in production, investment, and foreign trade. The control system had begun as an emergency improvisation during World War II, but after independence it became far more, with much greater ambitions. What was meant to be the embodiment of the all-knowing allocator and balancer of the economic national interest turned into an endlessly arbitrary bureaucracy. Everything needed approval and a stamp. If a businessman wanted to shift from making plastic shovels to making plastic pails, he had to get approval. A company had to get approval before it could increase output. Indeed, any company worth over $20 million had to submit all major decisions, including the membership of its board of directors, for government assent. Even trivial decisions required stamps. All of this meant hanging around interminably in government offices and seeking to curry the favor of a myriad of officials. But if you had the license and the stamp, there was a consolation—protection against competition from those who did not have the necessary approvals. The result was a host of interests that did not encourage economic growth—"the politicians who profit from the corruption, the bureaucrats who enjoy the power, the businesses and the workers who like the sheltered markets and squatters' rights."

The second characteristic was a strong bias toward state ownership, reflecting what has been described as the Fabians' "measured and slow-paced ascent up the Marxist mountain." The public sector rose from 8 percent of GDP in 1960 to 26 percent by 1991. The central government owned about 240 enterprises, excluding traditional state industries like railways and utilities. Their importance can be seen in their scale. By the end of the 1980s, 70 percent of the jobs in the large "organized" sector of the economy were in state-owned companies. Moreover, it was estimated that half of the 240 firms were in fact terminally bankrupt. Rather than letting "sick" companies fail, the government took them over and ran them. Workers assumed that salaries were the guaranteed "rewards" for being employed while overtime was their pay. Even when their enterprises were closed down, they still expected to be paid the overtime. State-owned companies generally operated in totally sheltered markets, with no discipline from competition. The result was a state-owned sector that had no incentive to be efficient, that did not respond to customers, and that racked up ever-growing losses.[3]

The Hindustan Fertilizer Corporation made for a truly brilliant example. In 1991, at the time of the economic crisis, its twelve hundred employees were clocking in every day, as they had since the plant had officially opened a dozen years earlier. The only problem was that the plant had yet to produce any fertilizer for sale. It had been built between 1971 and 1979, using considerable public funds, with machinery from Germany, Czechoslovakia, Poland, and a half-dozen other countries. The equipment had looked like a great bargain to the civil servants who made the basic decisions, because it could be financed with export credits. Alas, the machinery did not fit together and the plant could not operate. Everyone just pretended that it was operating.[4]

The third self-defeating characteristic was a rejection of international commerce. What has been described as "export pessimism" settled over decision makers. India adopted the inward-looking drive for self-sufficiency that had been so fashionable in the developing world in the 1950s and 1960s. By rejecting foreign trade and foreign investment, it excluded itself from the world economy. India developed a very large cadre of highly talented scientists and engineers, but, as in the Soviet Union, there were major obstacles to deploying new technologies in the marketplace. The hostility toward foreign investment, the severe limits on international trade, and the constraints on competition all closed down the avenues by which innovation moves into nations. India fell behind technologically. Often, technology was frozen at the level at which it had been in the 1950s or 1960s.

The Dynasty

Indira Gandhi did little to adjust the lines of economic policy that her father had established.* Indeed, she had learned power from an early age. Her mother had died when she was eighteen, and as a result it was Indira who became Nehru's confidante, hostess, and travel companion on official visits. As prime minister, she would prove crafty and masterful—and also short-sighted. Charismatic but haughty, she earned considerable personal prestige from India's military successes against Pakistan and from her country's successful explosion of a nuclear device in 1974. At home, however, she centralized political power around herself, straining the limits of India's democracy. She eroded the powers of the states in favor of the federal (or "central") government. And she marginalized dissidents in the Congress Party, causing many to defect and form rival parties. In 1975, the courts accused her of minor voting irregularities in her home district. Enraged, she declared a nationwide state of emergency, suspended civil liberties, and imposed censorship—India's only experiment with authoritarian rule. But the public outcry was too great, and in 1977 she was forced to relent and call general elections, in which she was trounced. But the ragtag coalition that replaced her lost its bearings almost from the start. Its economic policies proved incoherent, and it was during this time that many international companies, fearing nationalization, decided to leave India. The coalition foundered on its endless squabbles. By 1980, her reputation tarnished but her charisma intact, "Mrs. G." swept back into power.

But politics had changed. No longer invincible and infallible, the Congress Party was losing ground in the states—to regional interests. Mrs. Gandhi's stubborn, uncompromising response only exacerbated tensions, fueling separatism in some areas, notably among the Sikh community in the

*Indira Gandhi, Nehru's only daughter, was briefly married to Feroze Gandhi—no relation to the mahatma.

northern state of Punjab. In June 1984, she ordered the army to storm the Golden Temple, the holiest of Sikh shrines, where extremists had taken refuge. It was her fatal mistake. The following October, her bodyguards, who were Sikhs, took revenge; they opened fire on her while she strolled in the prime ministerial garden, killing her.

It had been very clear that Mrs. Gandhi expected Sanjay, her younger son and closest adviser, to succeed her—despite damage to his reputation during the emergency years, when he was found to have promoted a program that rounded up villagers and forced them to undergo medical sterilizations in exchange for transistor radios. But Sanjay was accidentally killed in 1980 while flying a light plane. Mrs. Gandhi had then turned to her older son, Rajiv. He stepped first into Sanjay's place, and then, after his mother's death, into hers, becoming leader of the Congress Party. Then, riding on a great wave of sympathy, he became prime minister. Rajiv was the quiet son, unassuming, married to an Italian, and much more passionate about flying than about politics. He had been a pilot for Indian Airlines, the domestic carrier. In the course of the normal in-flight pleasantries, he would simply announce himself over the PA system as Captain Rajiv.

By the time he became prime minister, mounting losses by state-owned enterprises turned into steadily increasing government deficits. As public debt soared, the government tried to catch up by borrowing, both domestically and internationally. Rajiv Gandhi pledged to reform the Permit Raj. He and his relatively young advisers, known as the "computer kids," talked about the importance of innovation and freer markets. Gandhi also had an intuitive feel that India needed to change. Why? After all, he was the grandson of Fabianism. The reason, it has been suggested, was that he was "the first prime minister to have done honest work outside politics. He thus had seen for himself, and through his friends, the system that he sensibly deplored and would seek to change."

But there was no broad consensus to support reform. The various proposed measures were scorned and attacked as "against the common man." And after his initial burst of enthusiasm, Gandhi himself seemed to lose conviction, especially as his government became immersed in a weapons-purchase scandal involving a Swedish arms maker. The drive to reform dissipated and Gandhi was turned out by the voters in 1989. But there were two consequences of his government that would directly affect reform—one positive, one very negative. The first was the surfacing and discussion of a set of reform ideas, however mild. The second, and more important, was the turn—in the face of soaring deficits—toward borrowing, which was what ultimately led to the crisis. As the end of the 1980s approached, the government's deficit was mounting and it was harder and harder to service the debt. Meanwhile, because of the growing debt burden, it had to cut investment, which meant reducing spending on infrastructure, which, in turn, further choked back growth.[5]

Gandhi's successors, riven by political conflicts over religion and caste, were unable to keep their grip on power. Rajiv launched a comeback campaign. But in May 1991, he too was assassinated—at a village campaign stop, by a Tamil suicide bomber seeking revenge for Indian intervention in the Sri Lankan civil war.

Some in the Congress Party once again looked instinctively to the Nehru-Gandhi dynasty. But both Rajiv and Sanjay were now dead, Rajiv's children were too young, and his Italian wife, Sonia, although now an Indian citizen, promptly ruled herself out of the race. Thus the elderly P. V. Narasimha Rao was elected president of a shocked Congress Party.

The Crisis

Rao looked to be at best a caretaker. For many years he had been a faithful servant of the dynasty. A Congress Party functionary and a sometime speechwriter, he had held a host of senior positions—from foreign minister to home secretary. He had always done what he was supposed to do. Even at a time when several of his children were living in America, he would deliver the ritualistic attacks on the United States that Mrs. Gandhi demanded of him. Yet he was not only a shrewd politician but also a man of considerable personal accomplishments. He knew a dozen languages and was also a translator and a poet. He came from a small Brahmin subcaste from the state of Andhra Pradesh. The members of the caste were known both for their talent for survival and for their intellectual achievements, and many of them lived in the United States.

At the time of Rajiv's assassination, Rao was seventy and had been preparing for retirement. As he had lived his entire political career in the shadow of the dynasty, he was going with certain mixed feelings, perhaps because he had not received the recognition that he felt he deserved. If he had bitterness, it was toward Mrs. Gandhi, who had abused and belittled him, as was her habit with many around her. Rajiv, by contrast, had treated him with respect and civility. Later, the walls of Rao's private quarters would be adorned with informal photographs of Rajiv but with none of Rajiv's mother.

Owing to Rajiv's assassination, Rao postponed his planned retirement. Although he had never been elected to a national office, he was chosen to lead the Congress Party in the elections—not because he was a bold and charismatic leader, which he certainly was not, but because he was a conciliator, a balancer, a compromise candidate, who did not seem likely to challenge the other party barons. When, as the newly designated prime minister, he unveiled his cabinet, it was dismissed as "old wine in old bottles." His government, it was said, would not last long. That seemed a reasonable expectation, since it was a minority government. As events turned out, however, it stayed the full five years. In the first hundred days of his term Rao would launch a full-scale attack on the state-controlled economy—the first assault in what would prove to be a protracted war.[6]

Circumstances drove it. Rao and his colleagues did not have the luxury of debating or dallying, for India was in severe economic straits. On August 2, 1990, Saddam Hussein had invaded Kuwait. The sharp increase in the price of oil hit India's already fragile balance of payments very hard. In addition, Indian workers in the Persian Gulf states stopped sending their earnings home, further weakening the balance of payments. On the edge of a financial crisis, India was virtually bankrupt.

Although the country's turmoil was triggered by the Gulf crisis, it was fundamentally homegrown. Entangled in the Permit Raj, India was prevented from reaching anything close to its potential.

"No Head for Figures"

Over a matter of weeks in the summer of 1991, a small group responded to the crisis by changing India's direction. Indeed, the most important decisions that Prime Minister Rao made were in the ministerial portfolios. Not all, in fact, were old wine. Along with all the familiar figures, he deliberately selected some men who would break with the past. One of the key decision makers was Rao himself, the old Congress Party hand and the wily politician. He had no intention of trying to be a Margaret Thatcher—or, for that matter, a Lee Kuan Yew. He saw himself very much as a social democrat. "I do not believe in trickle-down economics," he emphatically declared. As a politician, he would not be rushed; he would think things through deliberately, carefully, and, to the frustration of some, exhaustively. He also recognized how the Congress Party had weakened and fragmented over the years. Once, he compared the party to "a railway platform where all sorts of people come and go as they like." And although he had looked weak and tired when he took over—he had already had open-heart surgery in Houston—he turned out to be more vigorous, and much more in command, than had been expected. It was the consequence, one of his aides wryly remarked, of his absorbing the most important vitamin of all—vitamin P, as in *power.*

The second figure was the finance minister, Manmohan Singh. A Sikh, Singh had been born into a poor family in a drought-prone village in the Punjab region that is now part of Pakistan. Talent and scholarships had carried him far. In the tradition of India's brilliant economists, he had earned his undergraduate economics degree at Cambridge and then his Ph.D. at Oxford. Subsequently, he had made a considerable career in India as an economic bureaucrat; he held a senior post on the all-important planning commission. Although no one doubted his economic acuity—after all, he had won the Adam Smith Prize at Cambridge—he was modest and understated; when he wanted to avoid a question, he would somewhat implausibly murmur, "I have no head for figures."[7]

The third key figure was P. Chidambaram, the commerce minister, a member of a leading industrial family from Madras, with an MBA from Harvard. Singh would deal with macroeconomics, while Chidambaram would battle down in the nitty-gritty of trade policy, the Kafkaesque world of licenses and permits. Reserved and rather austere in style, he knew exactly what he intended to do, which was to deconstruct the Permit Raj. His reaction was more visceral than Singh's, the response to fifteen years spent practicing administrative law and grappling with the system on a daily basis: "It became clear to me that both the public sector and the private sector were being mollycoddled by a protectionist environment. The poor quality of goods and services was so apparent. I saw how intrusive, oppressive, and inefficient government had become, stifling entrepreneurial spirit, killing every idea, and not delivering anything in turn."

Each of these men, confronting the impending economic wreck, recognized that four decades of policy making had steered the country badly wrong. They were, however, in a minority. Within the dominant Congress Party, there was still no broad support for change. But there was a clear set of ideas that served as a critique of the old policies and guided the new. And when he and the other reformers examined the workings of the economy, they saw it had not delivered growth. Productivity was low, government spending was uncontrolled, and high-minded planning had degenerated into mindless control. All these ailments could be traced back to overwhelming government intervention. "The left had been dominated by the idea of market failure," said the economist and civil servant Vijay Kelkar. "Yet government failure had over time become very well documented. We could see all the data that was piling up. We responded to experience."[8]

Waking Up

Data were also coming from outside the country. The collapse of Soviet communism had a decisive impact on India's redirection. Central planning, with its appearance of rationality, had long ago captured the imagination of intellectuals and officials. Even before independence Nehru had written that "communists and socialists point with confidence to the way of socialism" because "they have science and logic on their side." Indians wanted to emulate the Soviet economic system (even as Russians craved, when they went to India, the opportunity to go shopping). "We tried to implant a Soviet economic model on a Western parliamentary system on an Indian social system," said Jairam Ramesh, one of India's new technocrats. "It was a heady cocktail." It also created a massive hangover. The failure of the Soviet economic model destroyed conviction in the ability of government to manage the economy. The ignominious end of the USSR meant not only the extinction of India's leading trading partner; it also undermined confidence in the system of central planning. India, the elite came to realize, had hitched its future to the wrong star.

To make matters worse, Indians awoke at the same time to what was happening in East and Southeast Asia. For decades they had ignored the emerging

"Asian economic miracles," first Japan and then the tigers, all of which were much smaller than India and many of which were allied with the United States. "We tended to dismiss those countries as lackeys of the United States, running dogs of American imperialism," said one economist, "and closed our ideas to their performance, to how amazing it was what they had done in one generation."

By the end of the 1980s, the reality could no longer be denied. These countries, on a consistent basis, were growing much more rapidly than India, which, it was said apologetically, seemed consigned to a lower "Hindu rate of growth." The annual differences in growth rates had now added up to a huge gap, a fact that was vividly demonstrated for Manmohan Singh when he made a trip to the Far East. Singh had reasonable socialist credentials, which had made him acceptable to the Congress Party as finance minister in 1991. (He had previously served as the secretary of the South Commission, very much a repository for believers in third world state intervention. Indeed, the chairman of the South Commission was Julius Nyerere, whose commitment to altruistic socialism had been ruinous for the economy of Tanzania, the country he had led to independence.) But in 1987, Singh made his trip to East Asia. He was stunned. The comparisons were astounding. South Korea and India had been at the same economic level in 1960. Now South Korea's per capita income was ten times that of India, and it was applying for membership in the OECD.

Singh struggled to understand what had made the difference. Certainly, all the accouterments of the Permit Raj—the controls and licenses—had held back the economy. But two things really struck Singh. In East Asia, the governments engaged in what he called "promotional activities" supporting business, whereas in India the emphasis was on regulation. But perhaps the most striking difference of all was the degree to which the East Asian countries had oriented themselves toward international trade and captured its benefits, while India had insisted upon turning inward. The numbers spoke for themselves. In 1990, the OECD countries imported just $9 billion of manufactures from India—and $41 billion from South Korea, whose population was one twentieth the size of India's. East Asia was not the only international influence. "What happened under Mrs. Thatcher was an eye-opener, a revelation," said Chidambaram. "After all, we had gotten our Fabian socialism from Britain."

One more factor reinforced the conviction that India was on the wrong track. Many Indians had emigrated, moving to North America and Western Europe in the 1960s and 1970s. The first wave may have started off poor, but they worked very hard, and by the late 1980s, they—and their children—had established themselves as successful businesspeople and professionals in their adopted countries. Indians owned 46 percent of the budget-motel rooms in the United States. They were responsible for much of retail trade in Britain. They had also built large industrial and commercial firms overseas. Known as NRIs—nonresident Indians—they were now coming back to visit their families and rediscover their roots. Their impact was considerable, and raised an endlessly fascinating sociological question: Why are Indians such a success outside India? It couldn't be the drinking water. It had to be the economic systems under which the NRIs flourished. Their achievements outside the country became another indictment of the Permit Raj within.[9]

"A Functionless Capitalism"

Rao was sworn in as prime minister on June 21, 1991. The next day, his new finance minister, Manmohan Singh, briefed him on the state of the economy, going through all the numbers. The central government's deficit was 8 percent of the GDP, while its internal public debt amounted to 55 percent. Interest payments on just the domestic debt consumed another 4 percent, while interest payments on foreign debt amounted to 23 percent. At the conclusion of this dismal recitation, Rao said, "I realized the position was bad but I did not realize that it was this bad." The nation had just a few hundred million dollars' foreign-exchange reserves left, enough to pay for imports for only two weeks. The nonresident Indians, panicking, were pulling out their deposits. There was even desperate discussion about selling off the Indian embassies in Tokyo and Beijing to raise quick money. Rao and Singh knew they would have to go to the International Monetary Fund for loans; but as it turned out, the IMF's conditions would reinforce rather than define the ensuing agenda for reform. Indeed, the Rao government ended up going far beyond the terms the IMF would have required.

The crisis gave Singh and Chidambaram the opportunity to force a change that would cure the fundamental ailments of the economy—too much regulation and control and not enough competition. India suffered, Singh would say, from what he called a "functionless capitalism"; that is, "people can make a lot of money without any concern for technical progress, quality, and cost reduction." As much as anything else, the change would mean a change in ideas. "India needs to think afresh on many fronts," Singh said just after his appointment. "The old methods of thinking have not taken us anywhere." He added, "You must not underestimate the force of ideas."

Singh and Chidambaram realized that they had an audience of one. They would have to convince the cautious prime minister to push as much reform as possible as quickly as possible. Rao would admit that his knowledge of economics was less than encyclopedic, and his view of the world had been shaped within the confining walls of the Congress Party, which had for so long heralded the preeminence of the public sector. Chidambaram understood what he was up against. "For 20 or 30 years," he told the prime minister, "you were raised on a diet of controls and regulations which you thought was the right thing. To suddenly say that we want to decontrol and delicense can be quite traumatic."

"Yes," replied Rao, "for some of us it is difficult because it is not an easy thing to make a break with what we thought was the right course."

Rao had continuing moments of doubt as reforms got under way. After

Singh made a controversial decision not to reduce the price of kerosene, a fuel of critical importance to farmers, Rao put his head in his hands and moaned, "What am I to do with these technocrats?" But finally Rao made the break with the past. His government, he said in a nationwide radio broadcast, was committed "to removing the cobwebs that come in the way of rapid industrialization."[10]

The decisions for reform were made by a small circle of officials working, it seemed, almost around the clock. In presenting the emergency budget in late July 1991 in a speech to Parliament, Singh could not help but note that his wife was very unhappy with his long hours. "The House will agree," he said, "that it is not good for the health of our economy if the finance minister of the country has strained relations with his own finance minister at home." He took that occasion to propose lower taxes on kitchen utensils.

Singh's budget speech was an extraordinary document, not only as a definition of new policies, but also as a penetrating and incisive diagnosis of what had gone wrong. Its overall message was that India was in dire straits and that its only hope was massive reform. The country was "at the edge of a precipice," Singh told Parliament. "There is no time to lose. . . . The room to maneuver, to live on borrowed money or time, does not exist anymore." Again and again in the speech, he showed how performance had fallen very far short of ideal and expectation. India had the third-largest number of scientists and engineers in the world, but that was hardly reflected in the country's technology. He came back to what had hit him in 1987 in East Asia—it was imperative that India become "an internationally competitive economy." He invoked the dynastic pantheon—Nehru and Indira and Rajiv Gandhi—to bless the efforts. But there was no question that he was using the crisis to try to break with the past.

Both bureaucrats and Congress Party members kept sniping away at the reformers, warning them that they were going too far too fast, that they were denying the heritage, the beliefs, that were at the heart of the party. "We're in the business of making changes," Singh told one group of officials. "Anyone who has reservations should speak up." When he was criticized for spurning Nehru's legacy, Singh invoked Mahatma Gandhi's vision of *swadeshi*—self-reliance—and shot back, "No, no, it follows from self-reliance. Self-reliance means trade and not aid."

In a matter of weeks, the Rao government did succeed in changing course: It devalued the rupee. It cut subsidies for domestic products and for exports. It reduced tariffs and trade barriers, eliminated licenses for 80 percent of industry, and did away with the requirement that larger firms get advance approval to expand or diversify. It even dared to reopen the door to foreign investment. And it began a process of disinvestment—that is, selling off some of the government shares in companies.

With such rapid-fire reforms pressing so hard against four decades of government policy, a firestorm of strong opposition might have been expected. But the circumstances of the crisis and the clarity of the reformers somewhat mitigated the opposition. The crisis gave them a freer hand than they had any reason to anticipate, and the worst they got were protests over reductions in subsidies for fertilizers. In the meantime, they started a process that would gather momentum and prove surprisingly durable.[11]

"A Vastly Different Role"

"The economic reforms since mid-1991 have," in the words of two Indian scholars, "signaled a vastly different role for the government in the Indian economy." But there have been many upsets and controversies since. In March 1998, after fifty years of almost uninterrupted rule by the Congress Party, India's voters brought to power the country's growing political force, the Bharatiya Janata Party (BJP), with Atal Behari Vajpayee as prime minister at the head of a coalition that grouped regionally based parties from India's southern and middle regions. BJP was widely known for espousing so-called Hindu nationalism—a revivalist emphasis on rolling back minority privileges in favor of India's Hindu majority. Many, too, felt the BJP's economic agenda to be suspect—the party's platform had long promoted *swadeshi* economic self-reliance and distrust of many aspects of foreign investment. But part of the BJP's electoral support came from the merchant classes inhabiting the densely populated northern Indian cities—India's so-called Hindi Belt. These voters, hostile to bureaucrats and to bureaucratic prerogatives, brought visceral support to the economic rationale for greater liberalization and less government intrusiveness. Vajpayee himself had never swerved from his own dedication to the free market and hostility to the Permit Raj, a mainstay of the Congress Party's patronage system. His first brush with politics had come in his student days, when he had joined the Quit India movement in 1942, which hastened the end of British colonial rule. Following a brief stint as a journalist, he decided to do politics full-time and became one of the founders of the BJP.

Controversy erupted in the early months of rule by a BJP-led coalition. Activating a campaign promise that not everyone had taken seriously, the new government revived India's nuclear-weapons program, detonating a series of underground test devices in May 1998. The event set off countertests by Pakistan and considerable international concern and some economic sanctions—sanctions that were, however, not widely endorsed. At home, the tests sparked considerable support, which provided the political capital for the government to pursue its economic goals.

When the time came to announce its economic policy, the BJP surprised its critics with a platform that, although largely grounded in the *swadeshi* approach, included measures that were unmistakably reformist in spirit. It began by setting up a regulatory agency charged with fixing electricity tariffs—a welcome, albeit politically controversial, step in a country where electricity rate cuts and subsidies had long become the centerpiece of every politician's election campaign, causing electricity boards to lose billions of dollars each year. The government also lifted quantitative restrictions on more than three hundred import items, abandoned its initial opposition to allowing foreign investment in insurance companies, and announced measures designed to encourage entrepreneurial activity.

The BJP-led coalition won an improved mandate in 1999, one that eliminated the need to rely upon parties in the south of the country that had made balancing interests almost an impossible task. Vajpayee's new government established its reformist credentials early on by explicitly putting privatization and foreign direct investment at the forefront of its economic agenda. In an attempt to cut back further on the red tape stifling private initiative, the government simplified excise tax procedures. The limit for foreign ownership in an Indian company was raised to 40 percent. And favorable tax incentives were developed to attract venture capital. By many standards, the changes were not radical. Still, as they continued, India's economy showed a steady climb. The 6 percent growth achieved in 1999 made India one of the fastest-growing economies in the world. By late 2001, in the aftermath of deepening recession following the terrorist attacks on the United States on September 11 of that year, India was one of the very few countries among the Asia-Pacific economies to continue to register 5 to 7 percent annual GDP growth rates. The country's mounting debts, however, are a big problem. Still, the fiscal deficit, which at the end of 2001 stood at 10 percent of GDP, and the growing levels of domestic indebtedness (more than 70 percent of GDP) are major threats to future economic progress.

At the heart of India's current economic platform is a certain view about growth: in order for the reform to achieve the ultimate goal that has driven India's politicians since independence—the eradication of the crushing poverty that continues to plague one third of India's population—India has to grow at a 9 to 10 percent annual rate over the next two decades. Achieving this goal will not be easy. In contrast to the first stage of reform, which was crisis-driven, the second stage will have to be driven by consensus. Measures that so far have proven politically untenable will have to be taken simultaneously on many different fronts. They include eliminating the debilitating subsidies—particularly in the power sector—and allowing companies to charge market rates for their products and services. The government is looking to significantly broaden the taxpaying base. Its other priorities include stepping up the rate of privatization; passing legislation that would allow further foreign ownership in Indian enterprises—including the so-called strategic ones; passing new, more flexible labor laws that would allow enterprises to become more competitive. All of these measures are seen as crucial in helping India eliminate the severe fiscal deficit (the highest as the percentage of GDP among the less developed countries), while at the same time freeing up cash to invest in the badly needed infrastructure—reliable electricity supplies, clean water, telephone lines, usable roads, railways—and in health and education. And greater emphasis on participating in international trade would help promote growth and technological progress.

The need for reform is made all the more urgent by India's demographics. India's population has been growing at a rapid rate over the past half century, climbing from less than 400 million in 1951 to more than 1 billion at the turn of the millennium. Over the next two decades, the country will have the largest share of working population it has ever had. Vijay Kelkar, a distinguished Indian economist who has held senior economic positions in the government, describes India's situation thus: "Just like a satellite when it is put to orbit requires high velocity to ensure exit from the Earth's gravitational force, if our economy is to exit from the gravitational pull of poverty, it requires a high exit velocity of double-digit growth rate over the next two decades. We cannot afford to lose this unique opportunity."

Sunset of the Permit Raj

Throughout the tumult of domestic and foreign politics of the last ten years, India has succeeded in maintaining a slow, sometimes halting, but still steady course of reform. When all the changes are added up, they have been quite considerable. The licensing and approvals of the Permit Raj have been mostly eliminated. Foreign trade has opened up. So has foreign investment, which rose from close to zero to well over $2 billion a year as foreign and domestic private firms were allowed to invest into such infrastructure areas as electric power, ports, and telecommunications. India's share of world exports grew. Its foreign-exchange reserves stood at more than $55 billion by the end of 2001, the equivalent of a year's worth of imports. Quantitative restrictions on imports of consumer goods and agricultural products have been removed in their entirety. The end of state monopoly on long-distance telephone services and improved access to Internet bandwidth have created further opportunities for India's burgeoning information-technology sector. However, high tariff protection still shelters India's hardware manufacturers, hindering the sector's—and the country's—competitiveness.

Crucially, and in radical contrast to the past, change is coming from below—from the state capitals, and no longer just from "the center," New Delhi. The loosening of the central government's controls is accentuating a shift of economic power to the states. The state governments are taking the initiative more and more. The state of Andhra Pradesh was the first ever to negotiate a World Bank loan disbursed directly to an Indian state. It has also been a pioneer in reforming electricity, transferring control of water usage to farmers, and computerizing the issuance of government documents, which cuts down on corruption. The shrewd business policies of the government of Karnataka have turned its once-sleepy capital of Bangalore into one of the world's premier centers of information technology. Kerala has the highest levels of literacy and life expectancy and one of the lowest poverty rates in India. And Tamil Nadu has been a leader in promoting computer education and laying fiber-optic cable.

Nor is this rise in state activism limited to India's southern states. Madhya Pradesh, in the middle of the country, has an innovative education guarantee scheme that has helped its literacy rate climb from 45 percent in 1991 to 64 percent in 2001. And even West Bengal—once a byword for socialist-minded policies—has been active in developing policies that encourage investment. Perhaps the surest sign of vitality from below is the new role of regional parties in federal politics. The rise of power brokers steeped in regional politics and guided by a focus on regional development reflects a powerful change in Indian government toward giving more voice to state-level experiments and results.

Although the bulk of Indian industry remains state-owned or state-controlled, there is a considerable private sector, most notably the powerful conglomerates built up in colonial days by a group of legendary entrepreneurs and their heirs. These houses—such as the Tatas, the Modhis, and the Birlas—retained their assets after independence because Nehru wanted to set up new state-owned firms, not nationalize existing private industry. Around the old conglomerates a new private sector is also on the rise, particularly in technology and services. Efficiency and entrepreneurship no longer face the range of impediments characteristic of the Permit Raj era, even though the bureaucratic red tape remains tenacious. In the words of Yashwant Sinha, India's finance minister, "In the initial years and even subsequently, the Permit Raj stifled the spirit of entrepreneurship in this country. It led to too much dependence on government and to the evolution of a system where corruption was built in. It led to people depending on the state for everything: the state was the father and the mother, and that had created a bad mind-set in the Indian people." But the economic disconnection between rigid government controls and the powerful commercial traditions of the Indian people, which has been one of the oddest things about India since independence, is gradually becoming a thing of the past. "The springs of entrepreneurialism run very deep in India," observed Vijay Kelkar. "That's not the problem. Bad policies are the problem." But those policies are being changed, and nowhere has it been more evident than in India's Silicon Valley—Bangalore.

Drawing on Its Best Brains

More than any other Indian city, Bangalore has come to symbolize India's new engagement with the world economy. Yet, contrary to the way it may have looked from the outside, Bangalore did not become one of the world's leading centers in information technology overnight. Bangalore is a multifaceted phenomenon, a product of vision, good public investment, and the supportive policies of the government of Karnataka—the southern state of which Bangalore is the capital. But it was the overall economic liberalization of the 1990s that provided the ultimate nurturing of the seeds that had been sown almost four decades earlier.

In some ways, the vision was Nehru's—in some ways, definitely not. To be sure, Nehru could not have foreseen the high-rise, high-tech campuses of Bangalore in the 1950s; at the time, it was a low-key provincial capital that had grown out of a British cantonment town to become known, postindependence, as "pensioners' paradise" thanks to its mild salubrious climate and lush gardens. Nor did Nehru begin to envision the kind of economic policies that would mature in Bangalore. What he did see was the great potential of science and technology to transform a society and put it onto a path of progress. It was on his orders that Bangalore became the center of India's electronics and military research industries. The choice had been determined by several things. One was the city's tradition of learning, which went as far back as the maharajah of Mysore. Another was Bangalore's remoteness from borders. A third, which would grow more important with time, was the relatively dust-free environment, particularly important for the electronics industry.

With these industries established in Bangalore, Nehru prophetically referred to it as India's "City of the Future." But who was to staff the newly minted research laboratories? In the example of the United States, with its wide and well-endowed system of higher education, Nehru saw a model of fostering the technical elite that would push the country's development forward. In 1952, Nehru established the first campus of IIT—the Indian Institute of Technology—in Kharagpur, West Bengal. Built on the model of the Massachusetts Institute of Technology, over time the IIT would provide its students with competitive, demanding education and produce some of the world's brightest scientists and engineers, who would not only fill the domestic research institutes and growing electronics and high-tech firms of Bangalore but would become prized items in the world's best universities and corporations. They would also come to play a major role in the prospering of California's Silicon Valley. Bangalore now contains the largest number of fully developed tertiary engineering institutes—twenty-three—of any city in the world.

Given the synergies between the electronics and software industries, it was only natural that India's first computer and software development firms were drawn to Bangalore. The initial investment in higher education paid off handsomely in providing India with world-class professionals in the increasingly important field of information technology. But the government of Karnataka also did something else important—it crafted a hands-off policy vis-à-vis the software industry. Once the industry's potential became apparent, the government made it its priority to foster the development of the sector and actively pursue foreign investment, while at the same time making sure to interfere as little as possible in day-to-day operations. Over the years, this approach remained a constant in the Karnataka government's policy, providing the additional benefit of a stable and continuous policy environment—a rare gift in India.

In 1985, the arrival of the first multinational—Texas Instruments—finally put Bangalore on the map. Encouraged by the success of Texas Instruments as well as by the package of incentives provided by the state (which included a guaranteed supply of electricity and water), other technology companies followed. In Bangalore, they discovered a large army of world-class, English-speaking software professionals who could be hired at a fraction of the cost, and a city with a rich academic culture and a pleasant climate that was not unlike Silicon Valley's. Over time, a further advantage became apparent: with the 9-to-12-hour difference with the United States, an American corporation with an office in Bangalore could provide its customers with twenty-four-hour customer service, an advantage that led to Bangalore becoming a major world center of so-called back office services—the work that involves billing, debt collection, personnel records, and the like.

The changes that came with 1990s reforms catalyzed the software industry's development, sending growth numbers through the roof. Favorable tax policy, the easing of import restrictions, the lowering of the entry barrier for foreign corporations, the encouragement of exports, the devaluation of the rupee, the lowering of telecommunications costs—all these helped domestic players and made India more attractive for the world's top high-tech firms. Prior to reform, it took Narayana Murthy, founder and CEO of Infosys, one of India's foremost IT firms and the first Indian company to list shares on the U.S. stock market, two years and fifty trips from Bangalore to Dehli to get permission to import a computer worth $1,500. Things are different now: "Ever since 1991, there has not been a single instance when I went to Delhi for any license for any business of Infosys. Today I can import a computer worth millions of dollars" without having to see a single bureaucrat or apply for any license. The results have been extraordinary: India's software exports have been growing at a 50 percent rate. Info-tech services, broadly defined, now account for almost 3 percent of India's total GDP. Even China's Huawei company has set up in Bangalore and sends hundreds of computer engineers each year to learn software engineering skills from Indian colleagues. Chidambaram is succinct in summarizing the key lesson of Bangalore's success: "The lesson to be learned there is, the less the regulation, the further the government is away from business, the better it is for business."

There are other lessons as well. Bangalore's success did not come out of an explicit policy decision the way much of India's industry had under Nehru; if anything, it shows that no one can easily predict new sources of economic growth. Instead, it demonstrates what can happen when a government invests in its human resources, creates the right business environment, and trusts that the business sense and entrepreneurial spirit of the people will lead to unexpected and spectacular results. Bangalore is a lesson in how a developing nation can become a competitor in the global marketplace by identifying and developing its competitive strengths and unleashing their potential. One of the unforeseen and most important results of reform has been that the brain drain that has long been lamented in India—the loss of its best and the brightest to the West—is, in fact, beginning to pay off. Over the decades of stagnation at home, the Indian diaspora has become a powerful and affluent force in Silicon Valley. With liberalization and reform creating new opportunities within India itself, the IIT graduates are finally coming back home, bringing with them money, knowledge, and skills they accumulated abroad.

But Bangalore reflects both the strengths and the weaknesses of India today. Together with other high-tech cities, it remains an enclave amid an ocean of poverty and illiteracy. Its pristine campuses with Domino's Pizza outlets, golf courses, state-of-the-art gyms, and elite school graduates armed with the latest in mobile technology stand in stark contrast to the surrounding countryside, where the average Indian still washes his clothes in a nearby creek and has never made a telephone call. If India is to fully capture the catalytic potential of Bangalore, it needs to turn the latter from something of an offshore phenomenon into a regular pattern of development. The good news is that the pattern seems clear: Invest in human resources, create a favorable environment for entrepreneurship, and let the markets do their work—the rest will follow.

The Hindu Rate of Growth

So has the change been dramatic? "Dramatic is a very strong word," said Chidabaram. "But clearly India's whole economy has opened up, and the whole vocabulary of political dialogue has changed. Nobody now talks in terms of massive investments in the public sector. Nobody now questions private enterprise, private wealth, big industry. All that is gone now. The whole mind-set has changed."

To be sure, problems persist. Foreign direct investment still ignites some visible controversies. A Kentucky Fried Chicken restaurant in Bangalore was besieged by opponents, who included a religious faction that attacked it on dietary grounds. Of larger importance are the legal challenges that have afflicted the $2 billion power plant project at Dabhol in the state of Maharashtra (which includes India's commercial capital, Mumbai). Reluctant to raise electricity prices to consumers, the government of Maharashtra has refused to pay the amount it owes, pressuring for reductions in the price of the plant's electricity, even though the price has already been renegotiated. The project's difficulties are an unambiguously negative signal to other potential foreign investors. The highly complex and somewhat mysterious approval process for new investment, involving multiple federal and state agencies, and the legal loopholes that continue to plague projects even after the signing of contracts, are at the root of India's chronic shortage of foreign investment. It remains negligible given the size of India's economy—$2.1 billion in 2000, compared to $41 billion that went into China (not including Hong Kong) in the same year.

The complexity of politics in the world's largest democracy has been slowing things down. As the regions become more empowered, the risk of conflict and stalemates increases. Religious sectarianism has been on the rise. And the social structure, built around the caste system, is creating conflict over access to opportunity. Yet the changes to date suggest that India will become an increasingly important participant in the world economy in the future—as both a market and a competitor. India is not expected to be a dragon or a tiger. Instead, some Indians suggest that the appropriate zoological analogy is the elephant—slow to rise and get up to speed but, once in motion, fast and steady, moving through thicket after thicket. Despite controversies and frequent political stalemates over specific measures, there seems to be a broad intellectual consensus: liberalization and integration in the world economy remain the only way to significantly reduce poverty and bring the country to a more widely shared prosperity and a position of influence in the world. Anything else will only throw India further back. "The transition is here in thought," said Chidambaram. "People accept it. The difficult part is always to deal with the lobbies and the established interests that are blocking the process of changes. This is the time when we should not lose nerve or direction. The last mile of reform is indeed the most difficult."

During the 1991 crisis that began the reforms, Manmohan Singh quoted Victor Hugo: "No power on earth can stop an idea whose time has come." He went on to say, "The emergence of India as a major economic power in the world happens to be one such idea." During the dismal days of 1991, that might have sounded like a rhetorical flourish or even a dream. A decade later, in the first years of the twenty-first century, it is a realistic prospect.[12]