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Ideas, interests, and the tipping point: Economic change in India

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Ideas, interests, and the tipping point: Economic change in India

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ABSTRACT

This paper makes the case for a ‘tipping point’ model for understanding economic change in India. This gradual and largely endogenously driven path calls for the simultaneous consideration of ideas and politics. Exogenous shocks affected economic policy, but did not determine the course of economic history in India. India’s developmental model evolved out of new ideas Indian technocrats developed based on events they observed in India and other parts of the world. A historical case for the ‘tipping point’ model is made by comparing two severe balance of payments crises India faced in 1966 and 1991. In 1966, when the weight of ideas and politics in India favored state-led import substitution, Washington could not coerce New Delhi to accept deregulation and globalization. In 1991, on the other hand, when Indian technocrats’ ideas favoured deregulation and globalization, the executive–technocratic team engineered a silent revolution in the policy paradigm. New Delhi engaged constructively with Washington, making a virtue of the necessity of IMF conditions, and implemented a home-grown reform program that laid the foundations for rapid economic growth in world’s most populous and tumultuous democracy.

KEYWORDS

India; globalization; deregulation; political economy; institutional change.

This paper proposes a ‘tipping point’ model of economic change for India that highlights the explanatory importance of both home-grown ideas and politics. India’s transition to globalization and deregulation is a saga of a government promoting institutions that facilitated competitive markets within a democratic polity while powerful social actors opposed these changes. The literature on developmental states had not been optimistic about India’s growth potential, because the country did not possess the wherewithal of a ‘hard state’ with an authoritarian leadership that could

deal decisively with powerful social actors (Evans, 1995; Chhibber, 2003; Kohli, 2004). India was characterized as a relatively soft state where the dominant political coalition of industrialists, farmers, and the powerful professional middle class was deeply interested in perpetuating a state-led, import-substituting model of development.¹

How did this model of state-led, import-substituting industrialization become transformed into an economic order that stressed deregulation and globalization? The answer to this puzzle lies in the way that ideas about deregulation and globalization evolved within the Indian state – especially among the country's technocrats, who were evaluating the results of different developmental outcomes. The gradual evolution of liberal ideas and policies brought India to a tipping point in 1991, when a balance of payments crisis provided an excellent window of opportunity for India's distinguished technocrats and economists to deal decisively with parts of the dominant electoral coalition at the time of a foreign exchange shock. The tipping point constituted a moment when economic ideas and policies that had been evolving since the mid-1970s had begun undermining state-led import substitution quite significantly. Unlike a punctuated equilibrium model of change, where a sudden exogenous shock at a critical juncture can disrupt old institutions, the tipping point model stresses the importance of slow-moving processes occurring within a system.² The tipping point makes it more likely that a similar or lesser external shock moves the system in the direction of the endogenous changes that were undermining the existing system.

The external element of the shock in 1991 due to the Gulf War was comparable with the oil shock in 1973. And, part of the reason why Moody's called the bluff and discouraged commercial banks from lending to India in October 1990 was because it worried about India's internal fiscal situation. In this sense the severity of the impact of the exogenous factor – the Gulf War – was determined by the extent to which the internal fiscal situation had undermined the existing system. This situation was unsustainable and an exogenous shock was waiting to occur. Even a relatively minor shock stood to engender a severe foreign exchange shortage. Today, by contrast, a globalized and substantially deregulated Indian economy weathers external shocks with relative ease, grows rapidly (Srinivasan, 2011), and is even able to spend considerable sums on welfare.³

Explanations for India's deregulation based on arguments such as external pressure from lending organizations or business lobbying cannot sufficiently account for India's economic transition. First, external pressure alone could not make India adopt new policies.⁴ This paper helps establish that point by comparing the country's two balance of payments shocks in 1966 and 1991.⁵ When Indian politicians and technocrats were unconvinced about the need for globalization and deregulation in the 1960s, they only made a tactical retreat toward reform, then perpetuated the country's

most stringently autarkic institutions after 1969. During the country's balance of payments shock of 1991, on the other hand, technocrats were convinced about the need for a more liberal approach after having experimented gradual policy change during the 1980s. Consequently, they exploited India's dependence on the IMF to deal with parts of the country's dominant electoral coalition, making virtue of the necessity of an IMF loan and its attendant conditions. Had the technocrats dithered or been unconvinced about the fruits of internal and external deregulation during the 1991 crisis, the Indian story would likely have played out very differently. Moreover, the 1991 reforms were a home-grown initiative rather than an IMF-driven approach, at a time when the IMF seemed concerned about the political durability of economic reforms in a democratic polity such as India.

Second, did the business class or the middle class capture the state and force it to deregulate and globalize economic policy (Pederson, 2000; Kohli, 2012)? This paper clearly demonstrates that Indian industry was comfortable with gradual internal deregulation, but did not push towards either promoting substantial internal competition or global competitiveness. The captains of Indian industry were comfortable deriving monopoly rents from the country's over-regulated economy. The state had to persuade parts of professional Indian industry in 1991, and nudge them towards accepting deregulation and globalization when they were hesitant to do so. Therefore the reforms of 1991 cannot be derived from what has been termed as the 'pro-business' orientation of the government in the 1980s (Kohli, 2012). Indian industry acquiesced to the government in 1991 when it had few options, as it was heavily dependent on the IMF for financing the imports that sustained the import-substitution industrialization system in India.⁶ Nor is it particularly convincing to suggest that the capture of the government by the middle class engendered substantial policy changes because the middle class did not suddenly transform itself in the 1991 (D'Costa, 2005). We need an alternative explanation for why policy ideas changed. Class analysis appears tautological if the processes by which the middle class produced change are not clearly spelled out.

My argument is different from Rodrik and Subramanian (2004), DeLong (2003) and Sen (2010), which point to the Indian growth turnaround in the 1980s. I concur with these scholars that ideational and relatively gradual policy changes from the mid-1970s were significant movers of economic change in 1991. But the tectonic policy shifts that reached a tipping point in 1991 need a reassessment of the political economy of the 1980s leading to India's response to the balance of payments crisis. This paper is divided into four sections. The next section will briefly elaborate the paper's theoretical contribution, which lies in the simultaneous consideration of ideas and interests in the explanation of India's economic development path, which reached a tipping point in 1991. The two subsequent sections will

examine the significance of the tipping point by analyzing India's divergent responses to the country's two significant balance of payment shocks in 1966 and in 1991. The final section will conclude by discussing the Indian model of economic change and reflect on New Delhi's relationship with the Washington Consensus.

IDEAS, INTERESTS, AND THE TIPPING POINT

What does a transformation from state-led import substitution to deregulation and globalization have to offer for the literature on institutional change? Economic institutions are normative orders backed by a legal framework that encourage some types of behaviour and proscribe others (North, 1990). Over-regulation of the economy, for example, may restrain entrepreneurship while deregulation may promote it. Institutions have the propensity to persist, and institutional change is fraught with challenges.

Table 1 provides a typology of four paths to institutional change. The argument of this paper is located in quadrant 1, which describes the 'tipping point' model of social change, where endogenous changes driven by ideas and politics build pressures on a system over time. A tipping point can be likened to an earthquake where largely endogenous pressures building up over time produce a shock that only appears to be a sudden and cataclysmic one. It is also comparable to how water begins to boil suddenly at 100 degrees Celsius, even though heat has been continuously supplied to the system over a long period of time (Pierson, 2004; Capoccia

Table 1 Paths to institutional change

	Ideas shape interests	Interests change
Tipping point	(1) British deregulation (Hall, 1993); inter-clan cooperation (Grief, 2006); India's globalization; Single European Market (Jabko, 2006); Keynesianism and monetarism (Blyth, 2006); telecoms and airlines (Woll, 2010).	(2) British democracy (Moore, 1966); state-making (Tilly, 1992); Bank of England (North and Weingast, 1989); Skill development in Germany (Thelen, 2004)
Punctuated equilibrium	(3) Keynesianism (Blyth, 2002)	(4) International pressure and deregulation in the third world (Stallings, 1992; Simons and Elkins, 2003); post-war Keynesianism (Hirschman, 1989)

and Kelemen, 2007). Unlike the cases of economic change in China and Russia, economic change in India was not accompanied by a major upheaval, perhaps because the problems within the system were allowed to surface and were debated during the 1980s.⁷

The 'tipping point' model of economic change is contrasted with the 'punctuated equilibrium' model (quadrants 3 and 4). The punctuated equilibrium model suggests that exogenous shocks characterized by critical junctures can make a significant impact on economic policy. The situation of a punctuated equilibrium can be likened to a meteor that might have led to the extinction of dinosaurs and changed the course of human history. A phenomenon external to the system, according to this kind of argument, produces substantial change to the system (Gould and Eldridge, 1977; Krasner, 1984; Pierson, 2004; Cappocia and Kelemen, 2007; Acemoglu and Robinson, 2012). A punctuated equilibrium is therefore a convenient way for explaining institutional change in social science. It respects the resilience of institutions and enables scholars to deal with change that does not appear to emerge from endogenous sources. According to this model, institutions can be viewed as both quintessentially change-resistant and subject to change because of exogenous shocks.

The narratives in quadrant 1 which accord with the 'tipping point' model deal with changes based on the synchronic consideration of ideas and interests. Game theorists are hard-pressed to explain institutional change. Some have relied on beliefs such as the primacy of balance of power or collective security to explain whether certain political institutions will be self-sustaining or will undermine themselves (Grief and Laitin, 2004; Grief, 2006).⁸ Strategic constructivists have sought to integrate the importance of ideas and interests by arguing that while the availability of ideas is important, players use these ideas for pursuing strategic ends. In the United States, for instance, business groups exploited the inflation of the 1970s to lobby the media and politicians for more fiscally conservative policies. The ideas of economists who advocated fiscal discipline and the efficacy of monetary policy became important during this time (Blyth, 2006).

Historical institutionalists who believe that the social distribution of power matters have acknowledged the importance of ideas as well. For example, Peter Hall's classic paper on the birth of neo-liberal policies in Britain failed to take a specific position on whether to stress the importance of Margaret Thatcher's influence, or to highlight the significance of gradual changes in policy driven by the British technocracy's adoption of liberal policy ideas (Hall, 1993). Was the arrival of Margaret Thatcher a tipping point, or was it a critical juncture associated with the exogenously driven punctuated equilibrium model of change? Mark Blyth has argued that by highlighting two different agendas without seeking to integrate them, Hall wrote an incomplete paper that never became a book (Blyth, 2011). The accounts in quadrant 1 treat history seriously and can be construed as

ones where changes in beliefs that were taking place over a period of time reached a tipping point.

My account of the Indian transformation using the idea of a 'tipping point' demonstrates the salience of endogenous factors that gradually drive economic change during a balance of payments crisis. I demonstrate how liberal economic ideas began emerging in India during the mid-1970s, in response to the dismal results of import substitution, the international demonstration effect of rapid economic growth in Asia, and the economic decline of the Soviet Union. The government and the technocrats increasingly criticized the country's existing policies, and gradual but demonstrable changes in the liberal direction were evident in economic policies during the 1980s. By 1991, India's technocrats knew what had to be achieved, but were frustrated that powerful vested interests stood in the way. The country's balance of payments crisis of 1991, unlike the one in 1966, empowered a convinced executive technocratic team to unleash a series of reforms that changed the course of India's economic history. The exogenous shock alone could not engender an institutional shift in the liberal direction purely by means of international pressure, as the balance of payments crisis in 1966 did not convince the Indian government to abandon its state-led, autarkic development path. Resolving conflicts of interest was as important as ideas in 1991, because new ideas created new interests that had to stage political battles with constituencies in favour of the status quo.

The 1991 case in this paper suggests that the gradual evolution of ideas within the government based on evaluation of India's economic performance in relation to other Asian countries was more central to understanding economic change than external shock or the ad hoc actions of a few individuals. In 1966, state-led import substitution was the dominant paradigm in government and external pressure could not make a dent on it. In 1991, on the other hand, I detail how the government had gradually changed its mind about the old paradigm's capacity to deal with India's economic problems. The financial crisis of 1991 was therefore exploited as an opportunity by the government to deal with powerful vested interests ranged against economic deregulation, globalization and the promotion of competition in India. It is significant that the new ideas had reached a tipping point in 1991 for the government to undertake the tectonic policy shifts in June and July 1991 during a severe financial crisis.

Quadrant 2 includes narratives of institutional change where conflicts between powerful interest groups heated up over a period of time and then reached a tipping point, which drove social change. Material conditions, rather than ideas, tend to play a larger role in these narratives. Different constituencies jockey for power, and this struggle for power produces new institutions over time. Kathleen Thelen, for example, traces the origins of skill-based training in German companies to the authoritarian German

state's need to gain the support of the independent artisanal class as a protection against the radical working class in the late nineteenth century (Thelen, 2004). This was an evolutionary and layered process, where new rules developed alongside old ones, but gradually grew at a swifter pace and rendered the old institutional norms redundant (Mahoney and Thelen, 2010). Douglass North's account of the establishment of the Bank of England in the seventeenth century also falls into this category. The rising power of the capitalists in industrializing Britain was increasingly represented in the English Parliament. Over time, this institution highlighted the conflict between the aristocracy and the emerging rich industrial class. The Parliament secured the interests of the industrialists, while the monarchy represented the aristocracy. This simmering conflict produced the Glorious Revolution of 1688 and gave birth to the Bank of England. The bank became a regulator that protected both the interests of the monarch and the wealthy capitalists by regulating credit (North and Weingast, 1989; North, 1990).

The Indian transition does not sit well with this historical institutional account that relies exclusively on conflicts of interest as a source of economic change. The Indian business class was not the driver of change. Economic ideas about globalization and deregulation that had evolved within the Indian government since the mid-1970s were central to the story of economic change in 1991.

Quadrants 3 and 4 deal with the well-known 'punctuated equilibrium' model of economic change described above. Quadrant 3 characterizes a situation where an economic depression or other unusual economic phenomena with few known parallels create a peculiar kind of uncertainty. Frank Knight's scholarly work has pointed out such possibilities. This involves a situation without precedents, where it is impossible to affix a probability to the success of a particular economic model because of the unique and rather incomprehensible nature of the particular economic crisis. Under these circumstances, policy-makers may be attracted to an appealing idea but are unable to make a rational evaluation of what is likely to succeed. Blyth has argued that Keynesian ideas made just such an ideational impact on policy-makers in the United States during the great depression in the 1930s (Blyth, 2002). The Indian case, however, does not sit well in this quadrant. Even though the paradigm shift occurred in 1991 at the time of the balance of payments crisis, the policies that were pursued aggressively after 1991 had been researched and experimented with since the mid-1970s.

Quadrant 4 characterizes situations where an external shock shifts interests. Such a shock can, for example, produce a critical juncture in a developing country that empowers multilateral donors to coercively change policies in the dependent country during economic hard times.⁹ The ideas held by domestic policy-makers in these situations are less important than the coercive powers of funding agencies. Albert Hirschman offers one

version of this argument in his discussion of the spread of Keynesianism. Keynesianism, according to Hirschman, spread to Europe because of United States financial pre-eminence in the post-Second World War world. American advisors implemented Keynesian principles in Europe while providing needed funds (Hirschman, 1989). Similarly, scholars have argued that neo-liberal economic ideas in the developing world became widespread because of the conditions multilateral agencies imposed on recipients (Stallings, 1992; Haggard and Maxfield, 1996; Simmons and Elkins, 2003).

This paper argues that economic change in India was not the result of an incomprehensible, unpredictable, and external shock. Neither was it driven by the capitalist class nor did it happen because of IMF impositions on the country. The next two sections of this paper describe why 'impositions from above' have never been implemented in India. Rather, endogenous ideational and policy changes in the liberal direction have occurred in India since 1975, driven by Indian technocrats' own reactions to the country's policy puzzles arising from its strategy of over-regulated, autarkic industrialization. Consequently, New Delhi engaged constructively with the Washington Consensus, and engineered a shift in the country's economic policy paradigm towards globalization and deregulation in 1991.

GLOBALIZATION ABORTED – 1966

India's aborted devaluation of 1966 demonstrated Indian technocrats' capacity to defy Washington in no uncertain terms. India devalued the rupee from 4.76 to 7.50 to a dollar, bowing to foreign pressure in June 1966 (Mukherji, 2000; Kirk, 2010). This was considered a humiliating experience at a time when India was in dire need for foreign exchange for import of food-grains. In July 1967, John D. Rockefeller reported to World Bank President George Woods: 'The devaluation was a flop; India did not make the policy changes we expected'.¹⁰ This case demonstrates that external pressure could not engender economic change when the government and its technocrats remained convinced about the utility of import substituting industrialization.

India's technocracy was largely unconvinced about the significance of trade and market orientation in 1966, and only made a tactical policy retreat during this crisis in order to obtain precious foreign exchange for importing food at a time when drought could have turned into famine. The country's young and inexperienced prime minister, Indira Gandhi, had no economic policy experience at this time. Although the United States President Lyndon Johnson teamed up with World Bank President George Woods to coercively push their agenda of globalization and deregulation their project in India faltered very quickly.

India was facing a severe balance of payments situation at the height of the import substitution era. A war with China in 1962 and another war with Pakistan in 1965 had taken a toll. Consequently, India's defence expenditure had doubled from 2 per cent of the gross domestic product (GDP) in 1960 to 4 per cent in 1964.¹¹ India's import-substitution strategy had neglected investment in agriculture. In addition to the wars' negative impact, a drought in 1965 and 1966 led to a 17 per cent decline in the country's food-grain production (Frankel, 2005). Dismayed by India's conflict with Pakistan in 1965, the United States terminated its PL480 program with India, which had supplied wheat almost free of cost.¹² United States President Lyndon Johnson put India on a policy of short-tether, making food stocks available only for a few months and with presidential assent. Non-United States foreign aid donors, including the Soviet Union, either did not have enough grain to help India or were only willing to part with it at commercial rates (Frankel, 2005).

India's foreign exchange situation was extremely fragile at this time. Export earnings were not likely to exceed Rs. 51 trillion against an import requirement of Rs. 53 trillion. Since the country's debt-servicing obligations amounted to Rs. 13.5 trillion, India would face a Rs. 15.5 trillion deficit if no further development activities were undertaken. If the food import requirement was added, this figure would jump to Rs. 26.5 trillion. But the country's Planning Commission asserted that the Fourth Five-Year Plan could be implemented only if an additional amount of Rs. 40 trillion were made available. The foreign exchange crisis could simultaneously exacerbate hunger and bring Indian economic planning to a grinding halt (Paarlberg, 1985).

The United States government and the World Bank wanted to leverage this crisis to nudge India towards greater deregulation and trade promotion. The recently declassified report of the Bell Mission (1965), which is considered to be the origin of World Bank's policy of providing funding with conditions, tells the story very clearly. The report criticized the implementation of India's Third Five-Year Plan (1961–1966). Since India's foreign exchange scarcity was a severe constraint that had to be remedied through foreign aid, India was counselled to adopt an aggressive strategy of export promotion. The report came down heavily on India's neglect of its agricultural sector, which the government had indicated was a top priority, but which had not received the physical and technological inputs it needed (Bell, 1965; Oliver, 1995).

The Bell Mission's key recommendations, which constituted the funding conditions in return for development financing, were (1) devaluation of the rupee; (2) the removal of direct controls on the importation of intermediate goods; (3) population control; and (4) increased investment in agriculture. Export taxes were to be permitted for tea and jute, because it was believed that a reduction in their export prices owing to devaluation

would not increase the demand for these goods. Devaluation of the rupee would promote Indian exports by reducing their price, making separate export incentives redundant. This policy environment was supposed to spur exports, rationalize imports, reduce state intervention, and lead to more efficient allocation of scarce foreign exchange in a poor country (Bell, 1965).

India's executive-technocratic team headed by Prime Minister Indira Gandhi, however, seemed unconvinced about the need to adopt this policy agenda of export promotion and reduced state intervention. Gandhi, the daughter of the late Prime Minister Jawaharlal Nehru, rose to premiership partly owing to the differences over succession within the Congress Party's senior leadership in the aftermath of the sudden death of Prime Minister Lal Bahadur Shastri in Tashkent in January 1966. The group of senior leaders known as the 'Syndicate' opined that Gandhi could serve as a non-threatening prime minister until significant differences within the senior leadership had been resolved (Brecher, 1961; Frankel, 2005). Even though Gandhi was not known to be an ideologically driven person, her political allies were largely in the socialist camp within the Congress Party and among the communist parties.¹³

Gandhi clearly lacked insights into the economic situation and was heavily influenced by the technocrats who advised her. The decision to devalue the currency was a closely guarded secret between the prime minister, finance minister, planning minister, agriculture minister and a few other officials. Finance Minister T.T. Krishnamachari, who disagreed with the World Bank's agenda, resigned in December 1965 and was replaced by Sachin Choudhury.¹⁴ When Gandhi dithered about the decision to devalue, her Ambassador in the United States B.K. Nehru pointed out that she had no other option, if she wanted non-project aid with the blessings of the United States government (Lewis, 1997).

India's technocrats were at odds with the World Bank's agenda for the country. Finance Secretary L.K. Jha, who was considered a liberal among Indian technocrats, prevented the World Bank's Ben King from making a presentation at a meeting of the Aid India Consortium in 1964 (Oral History Program, 1986). Another senior World Bank official reported that the Indian government turned down World Bank funds for financing private sector expansion. India approached bilateral donors instead to finance public sector steel plants (Oliver, 1985). The chief economic advisor to India's Ministry of Finance – I.G. Patel – lamented India's dependence on multilateral agencies. In his memoirs, he wrote that the political environment in 1966 was not conducive to sustaining the devaluation decision (Patel, 2003).

After the onset of the balance of payments crisis in 1966, two significant Indian government reports recommended increased state involvement in economic planning. The first one, published in 1967, advised more detailed planning and industrial guidance for priority sectors (Hazari, 1967). The

second one in 1969 (Hazari, 1969) lamented the concentration of corporate wealth in the hands of a small number of business groups. This report became the precursor of the Monopolies and Restrictive Trade Practices Act (1969). The mood within the government after the 1966 balance of payments crisis was to increase, rather than decrease, regulation.

There was an almost unanimous opposition in Parliament to devaluing the rupee in 1966. Senior leaders of the ruling Congress Party – such as Congress President K. Kamraj, Morarji Desai, former finance minister, T.T. Krishnamachari and Commerce Minister Manubhai Shah – were opposed to the decision to devalue the rupee. Members of the two communist parties and the socialist parties also disapproved of the decision.

Barring a few members of the right-wing Swatantra Party, almost all the members of Parliament seemed convinced that the devaluation would not serve any purpose. The reigning view was that the demand for India's major exports, such as jute and tea, would not respond to a decrease in price. Therefore, the devaluation would make these exports cheaper, but would not earn India a higher level of foreign exchange (Lok Sabha Debates 25 July–5 August 1966; Denoon, 1986; Sundaram, 1972).

The business class, barring a few exporters of tea and iron ore, was also opposed to the decision to devalue the rupee. The majority of Indian industrialists were engaged in import-dependent import substitution and devaluation would raise the price of imports. The Federation of Indian Chambers of Commerce and Industry (FICCI) – the lead industry organization in India – provided public support to the devaluation package, but expressed concerns about the policy in memos to the Ministry of Finance and the Prime Minister's Office (FICCI, 1966; Singhvi, 1968; Kudaisya, 2003).

Why did the Indian government devalue the rupee, despite the reservations of the technocrats, the business class, and a political environment that was largely opposed to it? This question was answered by the Prime Minister's Secretary L.K. Jha in a conversation with a Princeton professor and former United States Agency for International Development (USAID) official John Lewis in 1986. Jha held that the short-lived devaluation was driven by World Bank conditions (Lewis, 1997).¹⁵

India's economic history beyond 1966 bears out this claim in no uncertain terms. Not only did India not pursue export promotion after 1966 – it embarked on an intensive phase of heightened government regulations between 1969 and 1974, which scuttled entrepreneurial initiative to a much greater extent (Ganguly and Mukherji, 2011; Joshi and Little, 1994; Panagariya, 2008). It was the economic fall-out from this phase of dirigisme that sowed the seeds of criticism about India's over-regulation and import substitution after 1975, which is the subject of this paper's next section.

This section has demonstrated that when there is a substantial difference of opinion between New Delhi and Washington, the best that one could expect in terms of economic reform in India was a temporary policy

retreat – not a paradigm shift or a substantial transformation in economic institutions. In the next section, we will describe how policy puzzles that emerged from the import-substitution model of economic development generated new ideas and policies within the Indian government. This internal evolution of ideas and policies brought New Delhi's position much closer to Washington's policy recommendations in 1991 than was the case in 1966.

GLOBALIZATION AND DEREGULATION: THE PARADIGM SHIFT IN 1991

This section will demonstrate how India reached a tipping point during the balance of payments crisis in 1991, building upon ideational and policy changes that had begun around 1975. These gradual and demonstrable changes led to incremental industrial deregulation within the framework of import-substitution industrialization. The politics of institutional change in India during non-crisis periods demonstrates why parts of the country's dominant political coalition, such as the industrial class and the farmers, permitted limited deregulation during the 1980s. The dominant coalition comprising about 20 per cent of the population became quite influential in the 1980s. Indian industrialists wanted the state to protect their monopoly rights, lavish them with subsidies and also impose fewer restrictions on them. Farmers demanded subsidies, assured prices and cheap loans but were unwilling to be taxed. The professional middle class sought cheap higher education, better salaries and lower taxes. Those working for the government enjoyed their regulatory powers. The economy was thus locked in an equilibrium characterized by limited loosening of state controls for domestic investors and protectionism (Bardhan, 1984).

The executive technocratic team challenged parts of the dominant coalition during the balance of payments crisis of 1991. The crisis brought policy puzzles of the 1980s to the fore and empowered a convinced executive-technocratic team in India to pursue a largely homegrown policy agenda. The technocrats' preparation for change during the 1980s was essential, and the mood within the technocracy was quite different in 1991 than it was in 1966. The gradual preparation for change since the mid-1970s is critical for understanding the power of the tipping point model for India.

Indian technocrats' preference for state-led industrialization began to wane in the 1970s, owing to the country's dismal rates of economic growth at a time when various sections of society were clamoring for more subsidies (Bardhan, 1984; Rudolph and Rudolph, 1987). The Indian economy grew at the rate of 3.4 per cent per year from 1956 to 1975 (Nayar, 2006), which was much less than the rapid economic growth experienced in East and Southeast Asia. Moreover, distinguished Indian economists such as Jagdish Bhagwati and T.N. Srinivasan (along with Annie Krueger)

had made persuasive intellectual arguments about the problems associated with over-regulated rent-seeking industrialization (Krueger, 1974; Bhagwati and Srinivasan, 1980). They established a relationship between over-regulation and rent-seeking – a behavior that had come to characterize India's import substitution regime. These rents, these economists argued, were a deadweight loss to the economy (Bhagwati and Desai, 1970; Bhagwati and Srinivasan, 1975).

The Indian government changed its mind from being a votary of import substitution to critically evaluating its performance during the second half of the 1970s. The country's technocrats began focusing on five policy issues: (1) the management of publicly owned enterprises; (2) deregulation of domestic investment; (3) import liberalization; (4) export promotion; and (5) promoting foreign investment. Gradual industrial deregulation became noticeable when Indira Gandhi became prime minister for the second time in 1980. This process accelerated gradually after 1984 when her son Rajiv Gandhi assumed premiership and continued up until 1991.¹⁶

Indian government reports from this period criticized previous policies for a variety of reasons. First, publicly owned companies that had assumed the commanding heights of the Indian economy had been mismanaged. The reports noted government companies' low level of profitability and argued that these companies should have greater operational autonomy. It was suggested that the government should remain involved with strategic decisions but not the day-to-day operation of the firms.

Second, the reports criticized over-regulation of industry. They disapproved of production restrictions under The Monopolies and Restrictive Trade Practices Act (1969) and the limit imposed on foreign equity under the Foreign Exchange Regulation Act (1973). These legislations undermined productivity. It was noted that industrial licensing, which had been initiated in 1956 to regulate production decisions, had become an extensive corruption racket. Licensing had forced private firms to seek permission from the government before making investment decisions. The government, rather than the private entrepreneur, decided where such investment could take place.

Third, freer access to imports was recommended, especially for promoting exports. The dearth of import licenses for capital goods and raw materials was criticized. Foreign technology collaboration and foreign direct investment were seen as ways to help India gain access to modern technology. The Japan External Trade Organization and the Korea Trade-Investment Promotion Agency were described as model institutions that could be emulated in the Indian context.

The rise of Asia's export-led growth strategy was all too evident to policy-makers since the late 1970s. Over time, the decline of the Soviet Union also became quite evident. These events reinforced the views discussed above (Gandhi 1985; Aggarwal and Mukherji, 2008).

However these changes in economic ideas could only be matched by gradual changes in industrial and trade policies for a variety of reasons. First, the Indian business class desired limited domestic deregulation but was not keen on adjusting to economic globalization. Second, even though the weight of economic ideas had begun to shift in favor of economic globalization and deregulation there still remained skeptics within the government (Bhaduri and Nayyar, 1996). Finally, a large number of people within the ruling Congress Party were still steeped in the dogma of dirigisme and socialism (Kohli, 2006).

The most significant area of liberalization was deregulation in the production decisions favoring private business. First, the stipulations of the Monopolies and Restrictive Trade Practices Act were relaxed in 1985. Instead of regulating firms with assets of Rs. 200 million or more, the act now governed companies that were valued at Rupees 1 billion or greater. This released about 50 per cent of the large business houses from the clutches of the act. Second, a few industrial sectors were freed from the requirement of industrial licensing, making it easier for firms in these sectors to make investment decisions. Third, the textile industry was substantially de-regulated. Fourth, income and corporate taxes were reduced. Finally, policies were initiated to promote exports (Kohli, 2006; Tendulkar and Bhavani, 2007; Panagariya, 2008).

If India's industrial class was satisfied with gradual industrial deregulation, the powerful farming community was not. They believed the government had neglected their interests. When Vishwanath Pratap Singh became prime minister as the head of the National Front coalition in 1989, the backward caste groups and the farming community found a greater voice in the policy process.¹⁷ Consequently, Finance Minister Madhu Dandavate called for an agricultural policy resolution for subsidizing the Indian farmer in his budget speech in March 1990. These policies cannot be considered market friendly. Government loans to farmers that cost the exchequer Rupees 40 billion (\$2.34 billion) were waived. The government also raised the procurement price for food-grains, which is the assured price that a farmer gets from the government for producing food-grains (Singh, 1990; Mishra, 1996).

In addition to these reforms of the agrarian sector, gradual industrial deregulation continued during the tenure of the National Front government (December 1989–November 1990). The investment limit for small-scale industry, which was relatively free of government restrictions, was raised. The investment limit for enterprises not regulated by the Monopolies and Restrictive Trade Practices Act was also raised, and industries that were 100 per cent export-oriented were de-licensed (Panagariya, 2008).

These policies both favoring and inimical to the market and pandering to the business class and the farmer's lobby produced an unsustainable fiscal deficit in India, which increased the likelihood that an exogenous

event such as a rise in oil prices owing to the Iraq's invasion of Kuwait and the Gulf War (1990), could result in a balance of payments shock.

Trade and industrial policies favoring the industrial class and the farming community implemented without a strategy of export promotion or attracting foreign investment had increased India's dependence on foreign commercial banks. The increased oil prices during the Gulf War hurt India's current account balance to the tune of 1 per cent of GDP. The impact of this shock on India's economy was similar to the impacts following the first and the second international oil price shocks (1973 and 1979). But this time, when India's fiscal situation was in utter disarray, the external shock almost completely depleted India's foreign exchange reserves. The country's fiscal deficit had shot from 5.4 per cent of the GDP during the period from 1975/1976 to 1979/1980 to 10 per cent of GDP during 1985/1986–1989/1990. In October 1990, the credit rating agency Moody's downgraded India's credit rating, pointing to an unsustainable rise in the country's debt-service ratio, increased exposure to commercial borrowing, the impact of the Gulf War, and a ballooning budget deficit. Non-resident Indians began withdrawing their deposits and India had to pledge gold in return for hard currency to import essential items (Joshi and Little, 1994; Bhaduri and Nayyar, 1996; Mukherji, 2007; Srinivasan, 2011).

India was two weeks away from a default on its debt payments when P.V. Narasimha Rao was selected prime minister of India by the ruling Congress Party, which had formed a coalition government in June 1991. The crisis turned out to be an opportunity to deal with the country's dominant electoral coalition and initiate a paradigm shift favoring deregulation and globalization in India. The Indian government had reached an ideational tipping point after experimenting with gradual policy change during the 1980s. In June 1991, decision-makers were far more convinced about the need for devaluation, globalization, and industrial deregulation than was the case in 1966. Prime Minister Rao understood that the world had changed dramatically after the demise of the Soviet Union and the rise of Asia. A balance of payments crisis at this juncture necessitated a fundamental reshaping of India's economic and foreign policies.¹⁸

Prime Minister Rao, like Prime Minister Indira Gandhi in 1966, was heavily dependent on the economists within the government for charting out the reform strategy in 1991. This time, the presence of a large number of government economists who believed in the benefits of globalization and deregulation was a critical differentiator between the 1960s and the 1990s. These economists who had experienced India in the 1980s took advantage of the crisis and the political support of the Prime Minister to deal with the technocrats and interest groups opposed to industrial deregulation.

Prime Minister Rao invited Manmohan Singh, one India's most experienced technocrat economists, to deal with the crisis as finance minister. Singh had served as finance secretary (1976–1980), governor of the

Reserve Bank of India (1982–1985) and as deputy chairman of the Planning Commission (1985–1987). Significantly, his Oxford D.Phil. (1962), which was published by Clarendon Press in 1964, was an important argument for the merits of devaluing the Indian rupee and promoting exports. In a detailed empirical analysis of various sectors of the Indian economy, Singh had demonstrated that devaluation would reduce both the need for export assistance and the government's administrative burden, and make allocations more efficient. Almost 50 years later, Singh's book reads like a prescient account of the export-led model of economic growth that became famous after rapid economic growth in many parts of Asia starting in the 1960s (Singh, 1964).¹⁹ Singh's recommendations in 1964 were not dissimilar to the Bell Mission's recommendations in 1965.

Finance Minister Singh had the benefit of working with an excellent team of technocrats who had lived and experienced the Indian economy in the 1980s, when the above-mentioned critical reports were being drafted and policies of industrial deregulation were being implemented. Singh was also a college classmate of one of the world's leading trade economists, Jagdish Bhagwati, at Cambridge (Bhagwati, 1998).²⁰ Other technocrats, educated in British and United States universities and exposed to multilateral funding institutions, were well positioned to implement the reform process under Indian conditions. Montek Singh Ahluwalia, a Rhodes scholar, had worked for a group of economists headed by Holis Chenery at the World Bank. This group called for income redistribution along with growth, a view of poverty alleviation that was more respectful of the market mechanism than views held by another group at the World Bank led by Paul Streeten (Ahluwalia, 1974; Streeten *et al.*, 1981). When Prime Minister Vishwanath Pratap Singh was impressed by the economic development in Malaysia after a visit to the country, he sought a paper from Ahluwalia about the policy requirements that would help India attain Malaysian levels of development. In that memo, Ahluwalia formulated the plan that India would execute when it approached the IMF for conditional lending in June 1991.²¹

The other important members of the core team included Palaniappan Chidambaram, a Harvard-trained lawyer and commerce minister; Chakravarthi Rangarajan, the economist and deputy governor of the Reserve Bank; Shankar Acharya, the chief economic advisor to the finance minister; and Rakesh Mohan, advisor to the Ministry of Commerce and Industry. These technocrats had lived in India during the 1980s and had been part of the process economic deregulation, which had the blessings of prime ministers Indira Gandhi, Rajiv Gandhi, and Vishwanath Pratap Singh. The balance of payments crisis in 1991 provided a brief window of opportunity for this technocratic team to drive the Indian economy from import substitution towards deregulation and globalization.²²

This time, unlike in 1966, the Indian team converged with the Washington Consensus on many important issues and convinced the IMF about its

intentions on others.²³ India's technocratic team followed the essence of this strategy, but adapted it to their country's own conditions in a number of ways. In addition, the prime minister gave critical political support to the technocratic team. First, the two-step currency devaluation of 1 July and 3 July 1991 was among the swiftest decisions taken by the team upon assuming office. It was vigorously defended by the key decision-makers.²⁴

Second, the budget and Industrial Policy Resolution of 24 July 1991 demolished the pillars of state-led autarkic industrialization in India. The finance minister affirmed the budget had embarked in an idea 'whose time had come'. It outlined the need to curb expenditure and introduce the forces of competition in the Indian economy. Foreign investment was now considered a safer source of foreign exchange than borrowing from commercial banks. Interest rates were liberalized. Stock market reforms were initiated almost immediately to attract the savings of Indians and foreigners for productive investment in the corporate sector. India's trade regime was liberalized considerably. Even though the devaluation *cum* tariff liberalization did not reduce India's effective rate of protection to a considerable extent, it signaled the primacy of export promotion over import substitution. Industrial licensing was abolished in all but a few strategic sectors. The Monopolies and Restrictive Trade Practices Act was also terminated. This meant that large companies could not only produce wherever they wished, but also that they could produce whatever quantities they wanted without government interference (Lok Sabha Debates, 24 July 1991; Government of India, 1991; Srinivasan 2011).

The consensus in New Delhi had thus moved closer to the Washington Consensus. But New Delhi differed from Washington and provided good reasons for its tailoring its own approach to deregulation and globalization. These concerns were respected. India reduced its fiscal deficit in the first year of its agreement with the IMF, but the deficit was allowed to grow until the government re-imposed self-restraint in the latter half of the 1990s. Both the government and the IMF respected the importance of social spending in India's political system, and India's labor laws could not be re-written.²⁵ There was no significant privatization of government assets. India deregulated the rupee on its current account, but not on its capital account – a factor that saved it from the Asian financial crisis in 1997 (Aggarwal and Mukherji, 2008).

Indian industry resisted the strategy of globalization and deregulation. The Federation of Indian Chambers of Commerce and Industry (FICCI), the lead industry organization till the 1980s, opposed the reform process. Yet the policies earned the support of the part of the manufacturing industry that belonged to the Confederation of Indian Industry (CII). This occurred partly because the professionals within manufacturing industry who were better represented in CII believed in promoting India's competitiveness and in part because the leadership within the organization was

quick to realize that there was no option other than acquiescing to the government and the IMF in 1991. The CII's support for the reform process in the 1980s and in 1991 helped it emerge as India's lead industry organization in the 1990s, overshadowing the FICCI. Despite this support, industrialists within CII voiced their opposition against the entry of foreign companies in 1993, soon after India's dependence on the IMF had ended. Companies within the CII opposed higher corporate taxation, the liberalization of intermediate goods imports and devaluation, which had increased import costs in a manner that was detrimental to Indian industry.²⁶

The Indian government nudged the country's industrialists to embrace deregulation and globalization at a time when they were hesitant to follow this path. This explains why substantial deregulation could not occur in the 1980s, even though Indian technocrats had become convinced about the need for these reforms. The industrialists bowed to the state in this instance because they depended on the IMF for foreign exchange to obtain essential imports when the country was two weeks away from a default in July 1991.²⁷ However, the extent of reforms ultimately depended on the conviction of the executive-technocratic team in 1991. Had reform ideas not evolved to favor deregulation and globalization since the mid-1970s, the balance of payments crisis in 1991 could have been a repeat of 1966.

Like the industrialists, India's Parliament also acquiesced to economic reform. Members of the ruling Congress Party largely supported the proposals made in the budget of July 24, 1991. The right-wing Hindu nationalist Bharatiya Janata Party (BJP), which was the country's second-most important party at the time, was divided. The non-Marxist parties with a socialist inclination, such as the Janata Dal, opposed the devaluation, as did the Marxist parties – the Communist Party of India (CPI) and the Communist Party of India (Marxist). Members of the ruling Congress Party and the opposition parties united in their opposition to a reduction in the fertilizer subsidy, which had been mentioned in the budget. The government respected both these concerns. Ultimately, the major opposition parties abstained from voting, and the historic budget of 1991 passed without much opposition.²⁸

NEW DELHI AND THE WASHINGTON CONSENSUS

In explaining India's experiment with economic change, it helps to simultaneously consider explanations based on ideas and explanations based on political interests. This approach helps us to see that India can best be understood as a 'tipping point' model of largely endogenous economic transformation. Reflecting on this process forces us to integrate the literature that suggests that either ideas (social constructivism) or politics (historical institutionalism) matters (Hall, 2010) in explaining economic or social change. India's own domestically developed ideas, existing policy

puzzles, and gradual policy changes are central to the explanation. India's move towards deregulation and globalization starting in 1991 constituted a shift in the policy paradigm, as the country's economic policy changes in the 1980s remained within the larger framework of state-led import substitution.

Did this paradigm shift reflect the political power of the IMF at the time of a crisis? This paper argues that despite what appears like a sudden and cataclysmic change in India's economic course during 1991, the ideational preparation for the change that occurred during the 1980s was essential. We posit a theory of slow moving gradual ideational and policy change based on the puzzles posed by previous policies and the international demonstration effect of Asia. Slow economic growth till the mid-1970s, the fiscal unsustainability of autarkic pro-business liberalization in the 1980s and developments in Asia and Soviet Union pointed the policy elite towards the need for embracing deregulation and globalization. This ideational tipping point was the necessary condition that enabled technocrats to exploit the balance of payments crisis in 1991 to produce significant economic change in India. When Indian technocrats were not prepared for economic policy changes that occurred during the 1960s, IMF pressure was not able to bend the institutions and policies of import substitution in India.

India's executive technocratic team favoring globalization and deregulation in 1991 had to deal with the country's politics. The paper demonstrates the centrality of a crisis in negotiating far reaching institutional change in a soft state with a powerful dominant coalition of industrialists, farmers and professional middle class. The team had to negotiate both with the IMF and domestic constituencies to chart a politically and ideationally secure path towards a silent revolution. Indian industry had to be nudged toward reform by the technocrats, and the IMF needed to be convinced that areas of divergence between New Delhi and Washington would not derail the reform program. In addition India would not reform its labor laws or reduce fertilizer subsidies, due to the political power of organized labor and the farmer's lobby, respectively. India's fiscal deficit was also allowed to grow after the first year of stabilization, which was not in accordance with the IMF's preferences.

There are numerous other cases that drive home the importance of home-grown ideas and domestic politics for understanding economic change in India. Sectors such as telecommunications in India were deregulated and transformed into one of the most efficient in the world without any support from the World Bank (Mukherji, 2009). This was a politically charged and layered process that occurred more than a decade after the reforms ushered in by the 1991 balance of payments crisis.

Economic change in India is a gradual and evolving process. Perhaps political systems that allow problems to surface and be debated face a lower level of volatility than systems that suppress discussion of policy

problems (Nassim and Blyth, 2011). India did not have a Deng Xiaoping or a Lee Kuan Yew. Nor did India traverse the path from command to market economy. It remained a mixed economy, where state control over economic activity increased or decreased depending largely upon the dominant economic ideas within the country's technocracy and how they became embedded in politics.

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NOTES

- 1 On the extent to which the Indian state was penetrated by social actors, see Bardhan (1984), Varshney (2007), Rudolph and Rodolph (1987), Chhibber (1995) and Herring (1999).
- 2 Among the few clear expositions of the tipping point, see Pierson (2004). On punctuated equilibrium, see Gould and Eldridge (1977), Krasner (1984) and Capoccia and Kelemen (2007).
- 3 This paper on the economic and political roots of India's take-off does not hold that all impediments to India's economic growth have been removed. Moreover, substantial challenges for human development in the form of malnutrition and poor quality of life faced by a majority of Indians pose real challenges for India (Ganguly and Mukherji, 2011).
- 4 On arguments that suggest that external pressure works, see Hirschman (1989), Stallings (1996) and Simmons and Elkins (2003).
- 5 The balance of payments crises of 1966 and 1991 are comparable not because Washington held precisely the same view during both crisis periods. This paper based on critical new primary material finds that Washington wanted India to promote exports, devalue the currency, liberalize imports and assume greater market orientation during both crises periods. Whereas India responded by

- intensifying state control and autarkic industrialization after 1967, it embraced globalization and deregulation after 1991. While perfect controls are impossible in social research, research designs that vary the ideational milieu within the domestic policy elite in comparable cases can provide valuable insights for comparative historical research (Lijphardt, 1971; King, Keohane and Verba, 1994; George and Bennet, 2004).
- 6 I will explain later that the mechanism of change resembled synergistic linkage described in Putnam (1988).
 - 7 For two excellent accounts suggesting that the Chinese and Soviet transitions occurred more abruptly and quickly, see Naughton (1995) and Pei (1994).
 - 8 Game theorists such as H. Peyton Young, on the other hand, model a less than hype-rational world and deploy the punctuated equilibrium model (Young, 1998). Their work would therefore fit in quadrant 3 described below.
 - 9 On economic hard times, see Gourevitch (1986).
 - 10 The Rockefeller Foundation, like the World Bank, worked closely with the US government on India's development in the 1960s (Denoon, 1986).
 - 11 On the war with Pakistan, see Ganguly (2002). On the economic impact of the wars, see Joshi and Little (1994).
 - 12 The Public Law 480 of the US Department of Agriculture had been designed to help politically friendly countries avoid the scourge of hunger during the Cold War (Cullather, 2007).
 - 13 I benefited from interviews with people who advised Indira Gandhi, such as P.N. Dhar (New Delhi, 29 July 1997) and Arjun Sengupta (New Delhi, 20 August 1997). Dhar and Sengupta had served as principal secretary to the prime minister in the 1970s and the 1980s, respectively. This view was also shared by Jagdish N. Bhagwati who was with the Planning Commission in 1966 (New York, 14 November 1997).
 - 14 This information is available from Verghese (2010). B.G. Verghese was information advisor to the prime minister in 1966.
 - 15 John Lewis was part of the team of economists working for the United States Agency for International Development in the 1960s.
 - 16 The variety of documents consulted to discern how the government changed its mind include Alexander (1978), Dagli (1979), Government of India (1980), Hussain (1984), Narasimhan (1985) and Sengupta (1984). For an account of technocrats who presided over the regime of controls but changed their minds over time, see Patel (1987) and Dhar (1990). For a magisterial coverage see Panagariya (2008). Patel was probably the most experienced Indian technocrat who served as director of the London School of Economics in the 1980s, and Dhar was principal secretary to Prime Minister Gandhi in the 1970s.
 - 17 On the rise of the other backward caste groups and the farming community, see Varshney (2000), Jaffrelot (2000), Chandra (2004) and Varshney (1998). On the politics of backward caste groups that helped the coalition win elections, see Butler, Lahiri and Roy (1997).
 - 18 I have benefited from personal interviews with P.V. Narasimha Rao in New Delhi in February 2001. Rao was then a retired politician by then. See also Acharya (2011).
 - 19 I have benefited from a personal interview with Manmohan Singh in New Delhi on 8 August 1997. He was a leader of the opposition at that time.
 - 20 Conversations with Jagdish Bhagwati as a graduate student at Columbia University in 1997.
 - 21 On this paper and Ahluwalia's views before the crisis, see Shastri (1997), Khuroo *et al.* (1990) and Acharya and Mohan (2010).

- 22 I have benefited from discussions with Rakesh Mohan (Mumbai, 3 January 2005) and Shankar Acharya (New Delhi, 6 January 2006). See also Acharya and Mohan (2010) and Rangarajan (2010).
- 23 On the Washington Consensus see the chapter in this volume by Sarah Babb. See also (Williamson, 2000; Srinivasan, 2000).
- 24 This assessment is based on the above-mentioned interviews and various news reports.
- 25 See World Bank (12 November 1991). Finance Minister Manmohan Singh's letter on development policy is also annexed in the same document.
- 26 I have benefited from discussions with Tarun Das (New Delhi, 2 June 2009), D.H. Pai Panandiker (New Delhi, 2 June 2009), Dhruv Sawhney (Teleconference from Singapore, February 2010). Das was the key figure behind the rise of CII; Panandiker was the secretary general of FICCI in 1991 and Sawhney was the president of CII. Various news reports also point to this conclusion. See also FICCI (1991), Kantha and Ray (2006) and Kochanek (2007).
- 27 This dynamic resembles what Putnam called 'synergistic issue linkage'. See Putnam (1988).
- 28 These views are based on various news reports and a reading of the debates in the parliament. See Lok Sabha Debates, 19 July 1991, 24 July 1991 and 30 July 1991.

NOTES ON CONTRIBUTOR

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