Quest for Inclusive Growth

Continuity and Constraints in Indian Economic Policies

Building the Indian nation has required a conscious effort to bring its vast diversity into the economic mainstream. Politically, inclusion has functioned through a claim on fiscal resources for the so-called 'intermediate' classes. In principle, these 'intermediate' groups could have generated economic activity and employment for the larger number of poor to whom direct assistance was unmanageable. In practice, the amorphous intermediate groups have displayed limited leadership, with the important recent exception of the surge in information technology activity. Bold policy initiatives have been constrained because the aspirations to acquire the symbols associated with the intermediate groups have dominated. Major policy changes in India's political context are, therefore, possible only with strong new leadership in politically tranquil periods or under the duress of a crisis. To foster faster growth – while also breaking up the social hierarchies that persist in limiting inclusion – four long-standing challenges remain: undertaking effective decentralisation, raising educational attainments, placing limits on access to fiscal resources through binding fiscal rules, and achieving further discipline through external competition.

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The prospect of inclusion into the economic and political process is the glue that holds together the Indian psyche and sustains its nationhood. The centrality of inclusion grows out of the need to meld a diverse people into a modern nation and to overcome the more egregious and long-standing hierarchies in social relations. Recognising the risks – as well as the potential – of India's diversity, technical approaches to economic policymaking and, more importantly, the political process have made 'inclusive growth' their unchanging focal point.

It is not the intent of this essay to argue that inclusive growth has been achieved. Indeed, the quest for inclusion has remained elusive. However, offering that prospect through real measures and through populist rhetoric has shaped economic policy. The crucial role of inclusion for sustaining nationhood has had six implications for policy formulation and growth outcomes:

– Growth strategies have been designed to cast a wide net over regions of the country, sectors of production, and economic and social groups. Thus, though growth has been viewed as the principal instrument to alleviate poverty, where growth and inclusion have been in conflict, inclusion has prevailed.[1]

– Politically, the objective of inclusive growth came to be embodied in a process dependent on small entrepreneurs, landowning peasants, public sector employees, and, more generally, a middle class seeking upward mobility. Such an 'intermediate' regime was not a necessary outcome of the overarching goal of inclusion but, as K N Raj (1973) observed, it was politically enduring.

– The politics of intermediate regimes, in turn, led to a course of policy actions. Once again, these actions were not the only mechanisms for achieving inclusive growth – and there were time windows during which the actions may have evolved quite differently. However, through historical accident and the power of continuity, they have led the country, at times, not only to a desirable inclusion but also across a fine dividing line, to a dysfunctional populism.

– The abhorrence of macroeconomic instability by the amorphous intermediate groups led, in particular, to a remarkable containment of inflation. Such stability, desirable in itself, possibly also had long-term value for growth. The much derided 'Hindu rate of growth' achieved in the early decades after independence was a substantial step up from the growth experienced during the inter-war period. Absent the efforts at maintaining stability, India could well have been caught up in inflationary populist cycles and violent regime changes. As reforms were instituted in the late 1980s and early 1990s, the dividends were obvious. But the recent dividends also likely to reflect the longer-term investments in stability and nation building.

– However, inclusion and stability did not come without a cost. The question is: could India have had these and more? Those rightly impatient for faster progress have noted the 'strong consensus for weak reform' [Ahluwalia 2002].

– Challenges remain as new fluidities call for continued efforts at new inclusions. In particular, though India has avoided populist instability, populism has been alive and manifested in the large budget deficit, which could generate its own crisis but is, in the meantime, crowding out private investment and entrepreneurial initiative.

The rest of this paper is as follows. A brief overview of the relationship between diversity and development underscores the importance of actively managing diversity to ensure national stability. The next section describes the continuities in the Indian technocratic approaches to inclusion. Then, the logic, endurance, and implications of intermediate regimes are discussed. Following a discussion of the dynamics of economic reform in India, a concluding section speculates on future scenarios.

Diversity and Development

India's most defining characteristic is its diversity. Other countries are large and populous; many are poorer. But in, for example, the complexity of its social arrangements, the variety of its major languages, and the range of ethnicities and religions, India is surely unmatched. As such, an explicit recognition of India's social and economic diversity is crucial to analysing its political and economic dynamics. The news from the academic literature is not good: diversity has been found to hurt growth and, more seriously, to challenge the integrity of the nation itself. However, the lesson also is that diversity needs to be and can be managed and channelled to productive ends. This challenge has been recognised in India, making inclusive growth the central theme for legitimising economic and social policies. Ultimately, whether inclusion is used creatively to build a stronger nation and a better economy – or is hijacked through populist measures to weaken the state – is the outcome of a political process, which continues to unfold.

Inclusion is central to the Indian political process because it is part of the project of nation building and essential to preserving the national identity and democratic institutions. Inclusion has been important to redress the much older and deeper-rooted social hierarchies. These hierarchies, Bhanu Pratap Mehta (2004) has argued, created a strong and debilitating sense of social distance; and nation building would not be legitimate if it did not seek to roll that distance back. In an economy that grew at a relatively slow rate over the 100 years before independence and, with per capita income actually falling between 1914 and 1946 [Roy 2002], it is not surprising that even the modest objective measures inequalities (Table 1) have proved to be onerous. And, yet, bridging the social distance, Mehta notes, is essential to the progress of democracy.

The weight of academic research militates against the success of India as a nation. Easterly and Levine (1993) conclude that greater ethnic diversity is associated with slower growth. A more direct and dire challenge to the concept of India comes from Alesina and Spolaore (2003). Recognising the benefits of large nations (because of economies of scale in providing public goods), Alesina and Spolaore conclude that large nations are ultimately undermined by the high costs of diversity and, hence, with the exception of the US, rich and successful nations are typically small in size with relatively homogenous populations. Even more seriously, they argue that the costs of diversity are higher in democracies where, unlike in dictatorial regimes, diversity is more subversive because it cannot be suppressed. Alesina and Spolaore (2003) further argue that as economies become more open to international trade, the 'optimal size' of a nation becomes smaller as the benefits of being a big nation diminish while the costs of holding together a diverse population remain large. Thus, a democratic India was already on shaky ground as a nation. With its inevitable march towards integration into the global economy, its survival as a nation is placed at further risk.

However, the risk brings forth a response. The UNDP's *Human Development Report*, 2004 rightly points out that diversity can, and should be, managed. Decentralisation of political authority and administration is an obvious approach to managing diversity, with the particular design of decentralisation being crucial for its success. However, decentralisation is a passive approach to dealing with diversity, since it continues to recognise the distinctions while attempting more efficient outcomes within that framework. The *Human Development Report* argues for a more active cultivation of national identities. In particular, the report proposes measures for ensuring political participation, securing religious freedoms, fostering multiple languages, providing for legal pluralism, and promoting policies for socio-economic equality.

While the *Human Development Report* moves the discussion in the right direction, it stops short. The report's analysis assumes a state apparatus motivated by a larger national purpose. But, of course, decisions related to diversity are fundamentally influenced by political processes, actors, and events.

Though guided by a technocratic vision, inclusion in India has functioned politically through a claim on fiscal resources for the so-called 'intermediate' classes. In principle, these 'intermediate' groups could have generated economic activity and employment for the larger number of poor to whom direct assistance was unmanageable. In practice, the amorphous intermediate groups have displayed limited leadership, with the important recent exception demonstrated through the surge in information

Table 1: Selected Indicators, 1960-2000
(Number of Observations in Parentheses)

Variable	India	Latin America [1]/	East Asia	Developing	OECD
Income Inequality					
(Gini coefficient x100)	32.4	49.9	39.1	46.4	35.9
Standard deviation	–	7.2	6.7	8.9	6.1
	–	(19)	(11)	(63)	(21)
External Sector					
External Shocks (standard deviation of terms of trade growth, per cent)	7.6	12.5	8.1	13.3	4.0
Standard deviation	–	4.0	4.6	5.3	1.8
	–	(20)	(12)	(65)	(22)
Openness (Sum of imports and exports, per cent of GDP)	15.9	51.7	96.2	56.2	57.5
Standard deviation	–	19.9	88.4	23.4	25.9
	–	(20)	(12)	(66)	(22)
Relative Investment Price (investment deflator/GDP deflator)	1.6	1.6	1.2	1.8	0.9
Standard deviation	–	0.5	0.3	0.7	0.1
	–	(20)	(12)	(66)	(22)
Financial Sector					
Private sector credit (per cent of GDP)	19.5	22.5	58.9	24.6	65.3
Standard deviation	–	8.6	39.8	21.5	26.3
	–	(20)	(12)	(68)	(22)
Stock market capitalisation (per cent of GDP)	15.3	12.0	57.1	23.4	40.0
Standard deviation	–	11.7	50.1	35.1	23.0
	–	(17)	(11)	(43)	(22)
Policy Indicators					
Primary balance (per cent of GDP)	-6.1	-2.9	-1.4	-3.8	-4.0
Standard deviation	–	3.6	3.3	3.3	2.7
	–	(17)	(6)	(46)	(21)
Fiscal consumption volatility (per cent)	5.7	11.1	7.6	12.7	3.6
Standard deviation	–	3.3	4.1	5.3	0.9
	–	(20)	(12)	(66)	(22)
Average inflation (per cent)	7.5	23.9	8.2	15.2	6.5
Standard deviation	–	20.9	7.9	16.7	3.3
	–	(20)	(12)	(66)	(22)
Inflation volatility (per cent)	3.8	30.5	8.8	17.7	4.4
Standard deviation	–	36.3	12.4	26.1	2.6
	–	(20)	(12)	(66)	(22)
Human Capital					
(average years of schooling)	2.8	4.1	6.0	3.2	8.0
Standard deviation	-	1.3	2.8	1.6	1.8
	-	(20)	(12)	(57)	(22)

technology activity. As such, the main tension in Indian policy-making has been to achieve a desirable inclusion without succumbing to symbolism and, ultimately, a dysfunctional populism to gain the political backing of those who felt excluded.

Technocratic Vision of Inclusion

Post-independence Indian planning process reflected an essential continuity from the early years of the 20th century foreshadowed in the writings of such authors and practitioners as M Visvesvaraya and later in the so-called 'Bombay Plan' (Thakurdas et al 1944 and 1945; see also Srinivasan 1996). Remarkable in these early policy discussions was the importance of inclusion as a prerequisite for nation-building and stable economic growth.

Visvesvaraya's (1920) begins his discussion with, and gives primacy to, a big push in education, showing through international comparisons how backward India was in this regard. His emphasis on education is not surprising. For him, education was thrice blessed. First, an important objective in itself, it provided the foundation for inclusion in the political and economic spheres. Second, a literate labour force was a spur to growth. And, third, he saw education as a prerequisite to the development of a sense of nationhood, in turn necessary for regional balance and consistency in planning for industrialisation.

Beyond educating its peoples, Visvesvaraya (1920) concluded that India needed to pursue an aggressive industrialisation strategy. In this regard, he drew his principal inspiration for state intervention and planning from Japan. He noted (pp 128-29):

> Since all industrial progress in Japan has been achieved in comparatively recent years, she offers to India the most direct and valuable lessons obtainable in material advancement and reconstruction. In Japan, direct relations exist between the government and industry. There pioneer industries were, indeed, set going and, for years, maintained at public cost.

For India, he recommended the constitution of a Board of Industries, relying on foreign and Indian experts and given a free hand "to direct industrial enterprises". Emphasising also, in this context, the importance of decentralised decision-making, Visvesvaraya recommended that funds provided to the board be used to attract local entrepreneurship (p 314):

> Local organisers with directing ability should be sought out and given financial and other facilities and encouraged to start large concerns with the aid of experts. A reasonable measure of protection should be afforded by levying import duties to safeguard the interests of infant industries. Five to ten years of such sympathetic and systematic encouragement would make phenomenal progress possible.

A little over two decades later, 'A Plan of Economic Development of India', the 'Bombay Plan', was authored by prominent industrialists as their vision of Indian growth, achieved with stability and increased equality. In the style of subsequent Indian plans, it recommended a target of a threefold increase in national income over a 15 year period, while also setting out the goal of a minimum living standard. It seemed apologetic about the relatively unambitious growth target, especially in relation to the achievements that had recently been recorded in the Soviet Union, but concluded that India did not have the resources to match Soviet growth and, moreover, could not pay the 'heavy cost in terms of human suffering' (p 23, Part I).

After laying out the extensive role of the public sector in helping achieve the target set, the most remarkable part of the plan is the long discussion on the need for an equitable distribution of income. "An improvement in the general standard of living", the plan notes, "involves both increased production and equitable distribution and although we have dealt with them separately, they are closely interrelated and react on each other" (p 2, Part II). The document refers to a statement by Lord Keynes in which he concludes that while some inequality is good to maintain incentives to save and invest, excessive inequality can be corrosive. Private wealth, Keynes notes in his *General Theory* (p 374), may find outlet in "cruelty, reckless pursuit of personal power and authority, and other forms of self-aggrandisement".

The plan recommends fiscal measures, land reform, encouragement of small and medium firms, widespread distribution of shares in joint stock companies, and state control of public utilities and basic industries to contain inequalities. At the same time, it emphasises the importance of balanced regional development (pp 21-22, Part II).

Other initiatives and events sought to accelerate inclusive growth, with planning as the instrument to achieve this objective (see Srinivasan 1996). However, the two examples presented here highlight some noteworthy commonalities across the various proposals. First, the Soviet model was considered inappropriate. Visvesvaraya does not refer to the Soviet experience and the Bombay Plan regards it as unsuitable.[2] Second, like Visvesvaraya, the Bombay Plan authors viewed education as a crucial vehicle for growth and inclusion. Finally, decentralised decision-making, allowing for efficiencies in regional variations as well as to overcoming historical inequities in development, was part of both perspectives motivated by the goal of nation-building.

These features continued into the post-independence period, when despite superficial similarities, Indian planning had little to do with Soviet-style planning. The dual goals of growth and inclusiveness remained, with a more direct technical focus on poverty reduction. The continuity in Indian planning after independence is usefully summarised by P C Mahalanobis:

> ...the basic strategy of planning in India should be, on the one hand, to increase investments in the heavy industries and also expenditure on services to increase the purchasing power and create fresh demand; and, on the other hand, to increase the supply of consumer goods by increasing investment and production as much as possible in the small and household industries to meet the new demand (Mahalanobis 1955: 15-16).

Thus, investment in heavy industry was intended as a vehicle for increasing productive capacity, incorporating modern scientific achievements. Inclusiveness, however, required the spread of employment in labour-intensive manufactured goods in small- and medium-sized firms and these would also produce consumer goods for the middle-class. For good or for bad, this mix was uniquely Indian. It was quite distant, as the Bombay Plan had earlier recognised, from the Soviet predilection for extreme economies of scale (along with heavy regional specialisation). Smaller, more regionally dispersed production came to characterise Indian industrial production. However, while education remained salient in the post-independence economic and social rhetoric, India lost ground in this respect to both centrally planned economies and to the dynamic economies of east Asia, due to neglect of primary and secondary education. The explanation for this neglect, as discussed below, lies in the political balance of power that emerged.

To the extent post-independence planners departed from their predecessors, it was in emphasising growth over the goal of reducing inequality; instead, poverty alleviation became more integral to the technocratic apparatus of the planning process. There was, for instance, no widely accepted claim in policy-making circles that a reduction in inequality was necessary to spur growth. Indeed, if anything, the opposite was assumed. The logic of post-independence Indian planning, with its focus on raising investment rates, suggested that an increase in inequality may help promote the higher savings needed to finance needed investments [Chakravarty 1987].[3] As such, Indian planners, appropriately more concerned with poverty reduction, concluded well ahead of such recent studies as those by Dollar and Kraay (2000) that a rise in per capita income lifts the income of those in the lower income deciles almost one for one and so does the bulk of the heavy lifting for poverty reduction (Planning Commission 1962). Raj (1973: 1197) cites, in this context, an unpublished paper prepared in 1962 by the Perspective Planning Division of the Planning Commission:[4]

> It is difficult to say a priori what degree of inequality is necessary for growth; but a comparison of the distribution of incomes in different countries is suggestive. It shows that in countries with different levels of development and varying socio-political environment, the distribution of incomes follows a remarkably similar pattern, especially in respect of the proportion of incomes earned by the lowest three of four deciles of the population. If this hypothesis is sustained, the income of the poorest segments as a result of spontaneous economic development may be expected to increase in more or less the same proportion as the total income in any country. The attainment of a specific level of minimum income within a given period becomes purely a function of the rate of development.

Politics of Inclusion: Enduring intermediate Regime

The analysis of Indian policy-making through the lens of 'intermediate regimes' is among Raj's most original and provocative contributions. This lens remains appropriate for assessing how India has managed national integrity while fostering poverty-reducing growth. Intermediate classes include small businesses, large and middle peasantry, and the public sector labour force. They are an amorphous set, distinguished more by who they are not rather than by who they are. Importantly, they do not include big business and the very poor and disenfranchised.[5]

An important alternative perspective on Indian political economy is that of Pranab Bardhan (1984) who proposes that a 'dominant elite', composed of big business, rich farmers, and the government bureaucracy, influences Indian economic policy. Tensions within this elite lead, according to Bardhan, to a dysfunctional race for fiscal resources and hence a loss of policy-making discipline. Thus, while Bardhan is concerned with the same outcome as motivates this paper, his political framework is different in one important respect, namely, that big business is actively engaged in claiming fiscal resources. In contrast, the view from the intermediate regime lens leaves out big business, which was essentially paid off by the rents that accrued from various forms of protection and which, therefore, participated only marginally in key economic policy decisions. Bardhan (1984: 66) concedes as much. Though he refers to "…the loose confederation of the dominant proprietary classes as the 'dominant coalition' for short-hand," this, he notes, "should in no way be interpreted as anything more than a tacit and uneasy alliance of convenience among a motley group of interests". It is the motley characteristic of Indian politics that the intermediate regime emphasises.

One economic implication of the amorphous Indian politics is an abhorrence of inflation, a contrast, for example, to several Latin American countries where political elites dominated and were able to protect themselves from the severe bouts of inflation those countries experienced. Over the period 1960-2000, the average Indian annual inflation rate at 7.5 per cent compares with the 23.9 per cent in Latin America and is even modestly lower than east Asian inflation at 8.5 per cent a year (Table 1). Moreover, the volatility of Indian inflation has been lower than even that in the OECD economies (Table 1). In no decade since independence has average inflation reached double-digits (Table 2). Though less so over time, the dynamics of inflation has been influenced greatly by food prices, of particular concern to the consumers in the intermediate classes. The risk of food price increases spurred the investment in the 'Green Revolution', which alleviated, though did not eliminate, periodic price spikes.[6]

The high priority accorded to stability is also reflected in India's low government consumption volatility (Table 1), implying that government expenditures have not changed erratically from one year to another. Again, the contrast with other developing countries is instructive. Fatas and Mihov (2003) have shown that volatility in discretionary spending severely lowers growth; Mody and Schindler (2004) document that puzzle of Argentina's low growth in the past four decades is largely explained by such fiscal instability. Illustrative growth regressions for India show that when conditioned only its initial per capita income and allowing for its low educational attainment, Indian growth in the 1960-2000 period was about 0.5 per cent higher than would otherwise have been expected. The trade bias against the import of capital goods, measured as the 'relative price of investment' in purchasing power parity terms had only a small impact. However, when account is taken of its low discretionary fiscal volatility, then the Indian growth potential is seen to be much higher and the popular perception that Indian per capita income could have grown faster (by almost one percent a year) is supported by the data.[7] Thus, while achieving stability was a valuable achievement in itself, India failed to further exploit that stability by translating it into more rapid growth.

In this section, I argue that despite the many economic and social changes that have occurred over the past decades, the Indian intermediate regime has endured in its policy-making influence. This is so for two reasons. First, big business, which could have been the strongest counterweight against such a regime, lacked the energy necessary to achieve international competitiveness. Second, granting political strength to intermediate classes was

Table 2: India's Inflation Rates, 1950-2000

Decade	Lowest	Highest	Average
1950s	12.78 (1952-53)	13.80 (1956-57)	1.24
1960s	-0.91 (1968-69)	13.95 (1966-67)	6.34
1970s	-1.13 (1975-76)	25.2 (1974-75)	9.00
1980s	4.40 (1985-86)	18.20 (1980-81)	7.97
1990s	3.30 (1999-00)	13.70 (1991-92)	8.13

a convenient mechanism for generating inclusiveness. It was the expectation that these intermediate groups could generate spillover activity that would reach the truly underprivileged, whose large numbers made tackling their economic and social aspirations beyond the state's immediate capacity. However, reality proved otherwise.

Enervation of Big Business[8]

Indian industry and business suffered a steady decline in fortunes from 1750 to 1900. In 1750, according to Clingingsmith and Williamson (2004), Indian industry accounted for about a quarter of world industrial output but with the disintegration of the Mughal empire and the instability that ensued, economic dynamism waned. Thereafter, with the introduction of factory-based production exploiting new forms of machinery, India's ability to compete fell even further. In the second half of 19th century, Indian businesses did begin to establish factories themselves, but remained in the shadow of European holding companies. In the first half of the 20th century, Indian entrepreneurs gained ground as the Europeans left India and as import tariffs reduced the pressures of competition. Thus, at the time of independence in 1947, Indian enterprise operated in the space provided by British entrepreneurs [Desai 1968; Bagchi 1972], sought and was used to state protection [Gadgil 1944; Hobsbawm 1968], and had scarcely invested in the ability to innovate necessary for rapid productivity gains.

Following independence and up until the early 1990s – scholars continue to debate the end point of this period – big business houses collaborated with the government in sustaining an enervating environment. The government chose to control industrial growth in onerous ways, and big business readily acquiesced in this relationship, choosing to make money through control over scarce licences to operate. Those that played this game well prospered. It is the case that new houses emerged during this period, but whether such emergence can be regarded as an entrepreneurial success in any true sense of the term is open to question.

The most recent period is also the most interesting. A new generation of entrepreneurs has emerged without ties to traditional business groups. Rather than originating from shipbuilders, traders, and financiers, they are typically the children of public sector officials, were trained in highly subsidised engineering colleges, and were ready to exploit the lack of government regulation of a new 'software' industry. Among the big business houses, the Tatas also saw early opportunities in software and developed a successful business, but the sprouting of entrepreneurs from middle-class families with salaried parents is the noteworthy development in the evolution of Indian entrepreneurship. A similar phenomenon has since occurred in the pharmaceutical industry.

The continued dynamism of this new group of entrepreneurs will fashion, to a great extent, the Indian economic outcome of the next few decades. I speculate on some possibilities in the concluding section. For now, I turn to describing how an unenergetic big business combined with an emergent middle-class to sustain a politically stable system, but one which was highly susceptible to bouts of populism.

The Value of Intermediate Classes

In July 1964, two months after Jawaharlal Nehru's death, Raj (1964) wrote of his economic legacy. In Nehru's political framework, Raj argued, the so-called petit bourgeoisie were a central pivot. This was a class that the Congress Party represented but one which Nehru concluded was 'more vocal than vital' [Raj 1964: 1231]. Rendering the petit bourgeoisie a vital instrument for a peaceful economic transition from poverty to prosperity was central to Nehru's economic policy.

Who are the petit bourgeoisie? Raj (1964: 1231) explained:

> …*petit bourgeoisie* is the class which has risen above the level of the proletariat and has developed some interests in property which, though not large in itself, is sufficient to provide a stake in the system of private ownership and blunt the zeal for revolutionary change. Not having the capital or the entrepreneurial background to expand and grow, it is hostile in its attitude to larger capitalists, resentful of the rough and tumble of a competitive system, and therefore conservative in its attitude to programmes and policies which involve direct confrontation. Being nearer in its economic status to the proletariat than to 'big business', it is prepared to champion the cause of the former against the latter, particularly if it is thereby able to protect its own interests, but not to the point where it runs the risk of overthrowing the whole system of private property.

The challenge was to spur this petit bourgeoisie class into a more dynamic role. Several benefits accrued if this transformation was achieved. In the narrow interest of continued political power, an important constituency was strengthened. But the greater gain came from a wider prosperity that reached out to those that state itself could not easily reach. And, finally, costly revolutionary changes were avoided. Raj (1964: 1231) elaborated:

> If the *petit bourgeoisie* could be encouraged to assume the leadership of the numerically large and economically destitute classes against the small strata of large, propertied interests, the objectives of a parliamentary democratic system (one of which is obviously to get elected) and of socialism (which, as generally understood, is to advance the cause of the poor) could be simultaneously furthered. Thereby the extent and the areas of class conflict could also be minimised for some time, and the prospects of a peaceful transition considerably improved.

Almost a decade later, Raj (1973) laid out more formally the political role of intermediate classes in underdeveloped economies, building on ideas that had, in the meantime, been proposed by Michal Kalecki (1972).[9] As Raj (1973) noted, "Kalecki used the term 'intermediate regimes' to describe governments in which the lower-middle class and the rich peasantry could be identified as performing the role of the ruling class". In his 1964 article following Nehru's death, Raj appeared to go along with Nehru on a potentially constructive role for intermediate classes, though he was circumspect in his evaluation. By 1973, he was definitely less optimistic on the implications for economic policy and progress.

Implications for the Conduct of Policy

In practice, economic policy guided by the intermediate classes was directed in their favour, with restricted benefits for the more numerous and less privileged groups. As Raj (1964: 1233) noted, despite numerical strength, the underprivileged class was "…still weak and divided, thanks largely to the *petit bourgeois* leadership on which it still depends even in the most revolutionary parties." Thus, the vocal intermediate classes were able to attract state resources for their own benefit, but turned out not to have any

significant incentives to represent the interests of the less privileged. This was observed in several contexts as, for example, the supply of infrastructure services below the costs of delivery. Low-prices for infrastructure delivery were justified as necessary for provision of essential services to the poor. However, the poor typically lacked access to the services and the subsidies benefited mainly the middle-classes.

The lens of an intermediate regime also helps explain the paradox of Indian education policy. While the spread of primary education remains low (and thus India fares dismally in an international comparison of average years of schooling, as reported in Table 1), Indian entrepreneurs in the software business are renowned for their technical skills. Thus, the education system was geared to the middle-classes, with a range, in particular, of engineering and medical schools from the very exclusive to the more easily accessible. These have been eminently successful. They have provided livelihood to children of middle-class families while also putting India on the international hi-tech map.

Table 3: Growth Determinants

Dependent Variable: Average Real GDP, 1960-2000	(1)	(2)	(3)	(4)
Initial GDP	-0.956	-1.122	-1.249	-1.368
	(0.007)***	(0.001)***	(0.000)***	(0.000)***
Average years of schooling	0.503	0.437	0.258	0.229
	(0.000)***	(0.000)***	(0.015)**	(0.024)**
Fiscal volatility			-0.919	-0.968
			(0.014)**	(0.007)***
External volatility			-0.786	-0.597
			(0.070)*	(0.102)
Relative investment price		-1.262		-0.978
		(0.013)**		(0.010)**
India dummy	0.552	0.302	-0.771	-0.922
	(0.063)*	(0.348)	(0.104)	(0.064)*
Constant	7.219	9.135	14.172	15.172
	(0.002)***	(0.000)***	(0.000)***	(0.000)***
Adjusted R-squared	0.218	0.299	0.362	0.410
Observations	82	82	81	81

Notes: Robust p values in parentheses: *significant at 10 per cent; ** significant at 5 per cent; ***significant at 1 per cent.

Table 4: Changes in Growth Rates

Dependent Variable: 20-Year Difference in Real GDP Growth, 1981-2000 versus 1961-1980	(1)	(2)	(3)	(4)
Fiscal volatility	-0.723	-0.621	-0.879	-0.679
	(0.061)*	(0.120)	(0.010)***	(0.036)**
External volatility	-0.452	-0.438	-0.106	0.079
	(0.364)	(0.387)	(0.822)	(0.865)
Average years of schooling	-0.342	-0.449	-0.286	-0.319
	(0.180)	(0.102)	(0.237)	(0.163)
Initial GDP	-1.881	-1.738	-2.349	-2.537
	(0.001)***	(0.001)***	(0.000)***	(0.000)***
Government size		-1.459		-0.900
		(0.063)*		(0.224)
Trade/GDP			2.456	2.306
			(0.000)***	(0.000)***
Inflation				-0.024
				(0.000)***
India dummy	3.280	3.577	2.252	2.319
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
Constant	-0.251	-0.013	-0.573	-0.108
	(0.576)	(0.980)	(0.159)	(0.809)
Observations	77	77	77	77
Adjusted R-squared	0.279	0.301	0.395	0.497

Notes: Robust p values in parentheses: * significant at 10 per cent; ** significant at 5 per cent; *** significant at 1 per cent.

Much less effort was directed towards primary school education, despite a clear and early acknowledgement of its importance as an economic priority. Dreze and Sen (1995) point out that primary education languished not because of the lack of funds (budgeted resources often went unused) but because politicians and bureaucrats were under only weak pressure to deliver.

The philosophy underlying education policy has remained essentially unaltered despite recent efforts to integrate socially disadvantaged groups into the educational system. Weisskopf (2004) notes that primary and secondary education continue to receive limited attention. Instead, the focus remains on preferential entry into existing colleges and universities, attempting to incorporate the presently disadvantaged into the middle-class and, thereby, maintaining the political framework of the intermediate regime.

Thus, Indian politics settled into a stable equilibrium. Big business, unused to international competition was glad to accept a regime of domestic controls and tariff barriers, which provided for quasi-monopolies. The middle-classes – including small entrepreneurs and peasants with substantial landholdings – received significant state protection and subsidies. The less privileged had few avenues to voice their concerns and demands. Nehru may have viewed the role of the intermediate class – the so-called petit bourgeois – as a constructive one: to raise their own well-being and, in their wake, that of their less privileged fellow citizens. However, that is not how things evolved. Altogether, the system blunted incentives for innovation and productivity growth, though in retrospect higher education geared towards middle-class households had the unintended effect of producing generations of graduates with the skills and incentives to participate in the international flowering of information technology.[10]

In this status quo of interests, the system was not in a position to generate economic reform from within and needed an external impetus. Such an impetus could come from leadership change – and the evidence suggests that a window of opportunity existed in the mid-1960s, but was not exploited. Change, therefore, had to come from an external crisis in 1991. However, the underlying strength of forces generated by the intermediate political regime remained, rendering economic reform a slow and fitful process.

Dynamics of Reform

The dynamics of policy-making in India should be understood to lie along the divide between inclusion and populism rather than between socialism and 'liberalisation' (the coy antonym of socialism). Inclusion is a force for good: it is necessary to achieve the national and democratic agenda and it is compatible with a modern economy integrated into and disciplined by world commerce. Unfortunately, the line between inclusion and populism is often a fine one and the slide into populism is easy in a short-term bid for political power. The political challenge is to create checks and balances that limits corrosive populism.

The difficulty with viewing reform as the tussle between socialism and liberalisation is twofold. First, the term socialism is very much in the eye of the beholder. Second, posing the debate in this manner implies that the process of policy-making is primarily a battle of ideas fought between opposing intellectuals rather a political struggle across multiple interest groups.

Consider, then, the use of the term 'socialism'. It carries various connotations: Soviet-style planning (which has few remaining adherents); the philosophy behind a modern welfare state (which

could apply to much of Europe today); and, as the quote from Raj (1964) above suggests, a concern for the poor (which, in principle, every modern state is committed to). The difficulty, I suspect, is that particular policy instruments, in particular price and quantity controls, are often associated with the term socialism. I argue below that such instruments were, indeed, dysfunctional. But these instruments were not motivated by a higher purpose (socialist or otherwise) and were certainly not necessary to achieve the goal of inclusion; rather, they appeared as ad hoc responses to particular historic events, but once in place had an inertia that has been difficult to dislodge.

At the same time, there is a risk in interpreting the evolution of Indian policy in terms of the tension between ideas. Many of the ideas used today in the international development discourse have been well known in India for at least the past 40 years. But politics and expediency have triumphed. When the state tries to resolve multiple claims on its resources by giving into all claims, that is populism, not socialism. While the state has a legitimate obligation to ensure that all can participate in the political process on equal terms – and, hence, has an obligation to be inclusive – the populist distribution of state largesse to all claimants is not the consequence of an economic principle or ideology.

The tension between inclusion and populism began to play itself out in the second half of the 1950s, though it was not until the mid-1960s that populism took the upper hand. In the first decade following independence, the Indian economy was relatively open to international ideas and capital, with no necessary incompatibility perceived between such openness and inclusive growth. Following the start of the Second Five-Year Plan in 1956, a foreign exchange crisis and the highest inflation rate since independence (Table 1) generated a sense of scarcity, leading to the institution of various external and internal controls. In particular, a control of long-lasting consequence was the reservation of several lines of industrial production for so-called small-scale industries. The promotion of small firms was consistent with the Five-Year Plan, in as much as a stated goal was to produce wage goods through labour-intensive methods in small firms. However, the reservation of production for small firms and the definition of small firms in terms of an absolute cap on the value of their plant and equipment was, at best, a hurried and ill-thought decision, but more likely a populist outcome resulting from the pressures of an intermediate regime.

There was considerable fluidity in policy-making, however, up until the mid-1960s and India's policy stance could, in that period, have evolved quite differently than it did. Policy-making fluidity was possible, in part, because the politics was relatively stable. There were no strong political pressures for redistribution [Raj 1973: 1194]. Similarly, there was considerable recognition that quantitative controls were not integral to the planning process and were not working. In their review of Indian planning between 1951 and 1990, Mohan and Aggarwal (1990) point out that throughout the 1960s, committees appointed by the government, concluded that the system of licensing had failed to achieve all objectives, including regional dispersal, import substitution, and the concentration of economic power, while failing to direct investment into productive channels. Why, then, despite this indictment, did this system continue for so long? Mohan and Aggarwal (1990: 695) conclude: "That the emperor has no clothes has been too painful for the system to acknowledge".

Raj, writing in 1964, recognised a fork in policy-making. He noted the presence of a more 'vital' element in the Congress Party, one that was on the periphery but one that offered an alternative to the stasis that was about set in. This 'new force', he suggested (p 1233):

> …would want to introduce more competition in the economy; let the price mechanism do its allocative function more efficiently without too many administrative controls; allow the expansion of the public sector on a functional and only on a functional basis; permit therefore the public sector to undertake expansion of capital goods or any other industries if such expansion is needed and if private enterprise is not in a position to take it up; improve the efficiency of such state enterprises as are allowed to continue; permit the free entry of foreign private capital; 'rationalise' the tax structure to facilitate larger corporate savings; try and improve the supplies of intermediate goods and credit to small entrepreneurs, but withdraw all subsidies; …and allow 'planning' to go on to the extent, and only to the extent, it facilitates the attainment of these objectives.

This 'vital' wing of the party had an opportunity to change course, according to Patel (2002), but in the early demise of the former prime minister Lal Bahadur Shastri, history, perhaps, once again played a hand. Patel (2002), in his review of Indian economic policy writes that a window of reform was open in the mid-1960s under Shastri (p 98):

> His clarity of purpose and iron will were clearly demonstrated in the 1965 Pakistan war. But his views on economic policy have not received enough attention. He was too shrewd to give the impression that he was out to undo the work of Panditji. But I have no doubt that that is precisely what he would have done if he had lived longer. Already, he had said enough about giving greater importance to agriculture. In the Gandhian tradition, he disliked controls and the corruption they bred. He was not at ease in the company of big industrialists, and his sympathy for the common man made him more willing to give priority to consumer goods industries. At the same time, he was no ideological visionary and understood the connection between defence and modern industry. As was soon to be seen, his stand on the [World] Bank's advice on many occasions would put him in the front rank of modern reformers. I have no doubt that his untimely death changed our recent economic history and delayed economic reform by some two decades.

Patel (2002) goes on to suggest that the elimination of multiple exchange rates that had proliferated to accommodate various interest groups, a devaluation of the currency, and greater uniformity in import tariffs were all possible – reforms that would have opened up the Indian economy to the discipline of international trade.

Reforms, however, did not occur at the time and not only did it become more painful to acknowledge that the emperor had no clothes, the extent of populism increased and became more entrenched. The varieties and size of fiscal subsidies increased, placing an increasing burden on government budgets. It is possible, as Burgess and Pande (2004) have argued, that some initiatives, such as the nationalisation of banks, helped the poverty reduction effort: banks were forced to extend credit through their rural branches. But ultimately, the culture of behest lending, political patronage through the banking system, and resultant non-performing assets, held back economic dynamism.

It was then only the 'exceptionally severe' balance of payments crisis of 1991 that forced recognition of the inefficiencies that had become endemic in the economic system [Ahluwalia 2002:67].

An initial series of reforms exposed Indian entrepreneurs to greater competition from within the country and from the rest of the world. A robust growth response occurred in the early 1990s. Since then, reforms have occurred in fits and starts, with the overall pace a gradual one and much left on the agenda, prompting Ahluwalia (2002: 87) to conclude: "The process can be aptly described as creating a strong consensus for weak reforms".

The framework outlined in this paper suggests that the consensus for 'weak' reforms (euphemistically called reforms with a human face) reflects the continuing pressures of populism, using the metaphors of inclusion.[11] Thus, despite the evident dysfunctionality of reservation for small-scale industries, only limited progress has been achieved in undoing these boundaries. Well after centrally-planned economies of central and eastern Europe have dismantled the vast bulk of stateownership, 'disinvestment' (the polite Indian synonym for privatisation) continues to be contentious, leading to the closing down of the ministry dedicated to the acceleration of the government's withdrawal from productive activities. And debates over the proper role of foreign investment resurface in new guises. Such a reform dynamic follows from the politics of intermediate regimes where, absent a concerted effort, the appeasement of diverse interest groups is achieved at the cost of fiscal discipline.

New Fluidities, New Inclusions: Four Challenges[12]

In recent years, the scope and composition of the intermediate classes and their influence on state policy has undergone considerable changes. The growing assertion of socially disadvantaged groups in the democratic process has changed political configurations. The regionalisation of parties and power centres is, in part, due to this process. At the same time, trade unions in the private sector have become weaker, though they remain a force in the public sector. The relationship between indigenous capitalists and the state has changed during the last decade as the protections have declined. On the other hand, the growing voice of non-resident Indian (NRIs) and foreign investor interests does affect society and politics.

All this points to a new fluidity, possibly with increasing internal contradictions. The most important reflection of this is the tension between of the parlous financial condition of the state alongside the necessity for productive investments in, for example, education and infrastructure. Will this fluidity bring about fundamental change in how economic interests are represented in the policy-making process? Or will the new forces only serve to make the amorphous intermediate regimes even more so, with the new claimants absorbed into the existing structures, leaving policy-making only limited degrees of freedom?

There are no easy answers. While waiting for the next window for strong reforms, forward-looking leadership must institutionalise commitments that reinforce inclusion and limit the scope of populism. Four challenges present themselves.

First, creating an effective decentralisation remains an ongoing enterprise. The 73rd and 74th amendments to the Constitution to decentralise local development functions, though haltingly implemented, have resulted in substantial economic and social gains are also huge. Chattopadhyay and Duflo (2003) document the acceleration in the delivery of water, health and education services when villages are run by women executives. However, without an adequate fiscal structure, which ensures responsibility and accountability, generalisation of these successes will not be easy. Indeed, decentralisation brings its own risks of fiscal indiscipline.

Second, education reforms remain elusive. Despite long-standing recognition of its importance, the state has virtually abdicated its responsibilities in primary and secondary education. Examples around the country demonstrate the potential of non-governmental efforts. Most hopeful is the increase in demand for primary and secondary education as aspirations rise. However, the scale of needs is so massive that the goal of universal education cannot be fulfilled with active state involvement and investment. The risks with respect to higher education are equally serious. India's reputation for effective technical education – and its potential to supply education services to the world – cannot be maintained by the current infrastructure.[13]

Third, stemming the slide into populism will be helped for example, by the adoption of fiscal rules. The domestic fiscal constraint is biting and the bite is getting deeper. That there is huge scope both for improving tax and non-tax revenues, and for more efficient management of public expenditure is well documented. But there is as yet little sign that the severe fiscal constraint will induce corrective action. India has avoided the debilitating macroeconomic instability that populism generated in other developing nations, but large budget deficits have their own corrosive effects, as they suck away private savings from productive private investments and raise the risks of financial crises.[14] The passage of the 2003 Fiscal Responsibility and Budget Management (FRBM) Act marks important progress in this direction. The key question is whether the provisions of this legislation will be implemented or will they be pushed further out. The committee chaired by Vijay Kelkar concludes that, at the current pace, the targets will be missed by a wide margin [Panagariya 2004b].[15]

Finally, India's stronger commitment to the forces of globalisation may complement domestic initiatives to foster inclusive growth. Table 4 describes some cross-country determinants of the change in growth rate during 1980-2000 relative to the previous two decades. India's growth acceleration is, in part, explained by its greater trade openness (a summary measure, in this case, for the wider set of reforms undertaken during this period). It is worth noting that the 'unexplained' portion of the growth acceleration is large (the India 'dummy' remains positive even after accounting for trade openness). As such, it is at least worth considering (though difficult to test and prove) that some part of the growth acceleration reflected the longer-term investments in inclusion, which resulted finally in the availability of stable markets and thus provided the benefits of economies of scale.

The role of external exposure in fostering growth is complex. The focus needs to be on generating external competition, which is important not just to spur productivity growth but also to reduce the oppressive hold of domestic hierarchies as the frequency of international interactions increases. In other words, with national identity and democratic foundations in place, India may be in a position to venture further into the international arena to generate a sustainable and, ultimately, more inclusive growth. Empirical analysis is ambiguous about whether such exposure will increase measured inequalities. Social distance, however, is likely to fall as hierarchies become looser.

This is a moment of high expectation for India. Several Indian businesses have shown themselves capable of competing

successfully in a high-skill international environment. How will these businesses evolve? Will some transform into conglomerates in the Japanese and Korean styles and use internal capital markets to force the pace of growth? Will they persist in setting an ambitious pace of growth or will they relapse into the old-style antagonistic dependence on the state? The challenge to their growth may come from deficiencies in domestic infrastructure, human capital, and regulatory bottlenecks, which will imply a greater role for the government and may imply surrendering the independence that the most innovative firms have enjoyed and which may generate a war of attrition of the type that has stymied Indian business in the past. If they do succeed and visible inequalities of class and region are the initial consequence, will the political process accept that success? EPW

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Notes

[The author is with the International Monetary Fund. This paper was prepared for 'Planning, Institutions, Markets and Development', A Conference in Honour of K N Raj, October 2 and 3, 2004, St Thomas College, Thrissur, Kerala. For comments and suggestions, I am grateful to Swaminathan Aiyar, Anand Chandavarkar, Sonja Keller, Deena Khatkhate, Arvind Panagariya, Narendar Pani, I G Patel, Bhanu Pratap Mehta, Vinod Shanbagh and A Vaidyanathan. The regressions presented are based on joint work with Martin Schindler. The views expressed in this paper are those of the author and should not be attributed to the organisation to which he belongs.]

1 Other societies seek to balance equity and growth. Deppler (2004, pp 8-9) concludes that for Europe: "…postwar developments can be viewed as reflecting two broad-based, ebbing and flowing, and sometimes contrary impulses: toward social solidarity and equity, on the one hand, and financial discipline and economic efficiency, on the other. The historical roots of these preferences run deep. The solidarity dimension stems from a widely shared desire for social peace and cohesion, with roots in the welfare policies inherited from the late 19th century, the political and social upheavals of the first half of the 20th century that culminated in second world war, and the relative homogeneity of Europe's populations. The discipline dimension, perhaps surprisingly, seems to have similar roots. Most cited is the case of Germany, where the deep desire for economic stability can be traced back to the devastating hyperinflation of the early 1920s".

2 The Bombay Plan (p 52, Part I) explains: "Two features of the Russian Plans which caused misery and hardship to the masses were: (i) their overemphasis on heavy industries and indifference to consumption goods industries and (ii) their enthusiasm for building huge industrial plants which took years to come into operation."

3 Despite the passage of about 60 years, the relationship between inequality and growth remains a contentious one. In the most extensive and persuasive study, Forbes (2000) concludes that over time, within a country, a rise in inequality is actually a force for the acceleration of growth. Recent studies, such as Banerjee and Duflo (2003), find a more complex, non-linear relationship. And micro-studies [Banerjee et al 2001 and Kanbur 2002] tend to find that more inequality hurts growth.

4 'Perspective on Development: 1961-1976, Implications of Planning for a Minimum Level of Living', Perspective Planning Division, Planning Commission, government of India, August 1962.

5 In his comment on earlier draft of this paper, Swaminathan Aiyar viewed the analytical breadth of the intermediate class as a disadvantage, possibly because the common interests of this 'class' are difficult to identify. But it is precisely the disparate nature of the intermediate class that leads to the particular form of political competition relevant for policy-making.

6 The rise in inflation in 2004 to just under 8 per cent, led to a peculiarly Indian 'fiscal response'. In other contexts, inflation may have implied a tightening of the budget deficit to reduce inflationary pressures; instead, the easing on duties (and hence fiscal expansion) was undertaken.

7 Fiscal volatility is measured as the volatility of 'discretionary' fiscal expenditures, i e, those expenditures that are not predicted by such determinants of expenditures as country growth rates [for details, see Mody and Schindler 2004].

8 This section draws on Mody (forthcoming).

9 With his usual scrupulousness, Raj traced Kalecki's English language publication of 1972 to a 1964 essay written in Polish language.

10 This process was aided also by limited regulations maintained in the field of information technology by an enlightened bureaucracy in the department of electronics.

11 On the disingenuousness of the term 'human face', see Panagariya (2004a).

12 This section was prompted by an exchange of views with A Vaidyanathan. While the views expressed our mine, I have drawn heavily on the correspondence with him.

13 Panagariya (2002) has a detailed discussion on needed reforms in higher education.

14 Edwards (2003) concludes that budget deficits lower long-term growth by inducing currency crises. Indian policy-makers have largely dismissed this concern because of capital controls, the absence of sovereign external borrowing, and a strong external reserves position. The emphasis in this paper has been on the crowding out of private investment and hence in limiting long-term productivity growth. The fact that budget deficits have not sparked inflation is once again a reflection of a weak private sector. See also Harberger (2003).

15 Kopits (2001) recommends several technical measures, particularly transparency, the discipline of multiyear budgeting, and the inclusion of state budgets within the discipline of the new law, to achieve fiscal responsibility.

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