1. Details of module and its structure

Module Detail	
Subject Name	Economics
Course Name	Indian Economic Development 01 (Class XI, Semester - 1)
Module Name/Title	Economic Reform Since 1991: Part 1
Module Id	keec_10301
Pre-requisites	Knowledge about Indian Economy 1950-1990
Objectives	After going through this lesson, the learners will be able to understand the following: • What is meant by Economic Reforms • What was the reason behind Economic Reform. • The New Economic Policy • Liberalisation
Keywords	Economic Reforms, New Economic Policy, Liberlisation

2. Development team

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1. Introduction

Since independence, India followed the mixed economy framework by combining the advantages of the market economic system with those of the planned economic system. Some scholars argue that, over the years, this policy resulted in the establishment of a variety of rules and laws which were aimed at controlling and regulating the economy and instead ended up hampering the process of growth and development. Others state that India, which started its developmental path from near stagnation, has since been able to achieve growth in savings, developed a diversified industrial sector which produces a variety of goods and has experienced sustained expansion of agricultural output which has ensured food security.

In 1991, India met with an economic crisis relating to its external debt — the government was not able to make repayments on its borrowings from abroad; foreign exchange reserves, which we generally maintain to import petroleum oil and other important items, dropped to levels that were not sufficient even for fortnight. The crisis was further compounded by rising prices of essential goods. All these led the government to introduce a new set of policy measures which changed the direction of our developmental strategies.

Economic reforms refers to a set of economic policies with the goal of making the economy more market and service oriented and expanding the role of private sector and foreign investment.

Objectives of Economic Reforms

1. To make the economy more competitive.
2. To accelerate the economic growth.
3. To make the industries more efficient and highly productive.
4. To make use of global resources for the development of Indian economy.
5. To rationalise the role of public enterprises and improve their performance.
6. To control fiscal deficit.
7. To reduce current account deficit of BoP

2. Reasons for Economic Reforms

The economic condition of India in the year 1991 was miserable. It was due to the cumulative effect of number of reasons. *Let us discuss the various reasons, for making major economic reforms in the country;*

- **Poor performance of Public Sector:** In the 40 years period (1951 – 90), public sector was assigned an important role to work for the economic development of India. During the initial 15 years, Public Sector Undertaking (PSU) performed satisfactory but thereafter most of them started incurring losses. However, except for few public enterprises, the overall performance was very disappointing. Considering the huge losses incurred by a good number of public sector enterprises, the Government emphasised the need for necessary reforms and greater emphasis on the private sector.

- **Deficit in balance of Payments (BOP):** Deficit in BOP arises when total foreign payments for imports exceed total foreign receipts from exports. Even after imposing heavy tariffs and quotas, there was a sharp rise in imports. On the other hand, there was slow growth of exports due to low quality and high prices of Indian goods in the international market.

  India's BOP deficit has been constantly rising since 1980-81. It was estimated at Rs. 2,210 crore in 1980-81 and rose to Rs.17,367 crore in 1990-91.

- **Inflationary pressures:** There was a consistent rise in the general price level in the economy due to increase in money supply and shortage of essential goods. The rate of inflation reached an all time high of around 17 percent. It further increased the gap between import and export as India's export became uncompetitive in the world market and its export earnings dropped drastically.

- **Fall in Foreign exchange reserves:** in 1991, foreign exchange reserves fell to the lowest level and it led to the foreign exchange crisis in the country. Foreign exchange reserves declined to a level that was not adequate to finance imports for more than two weeks and neither to pay the interest to international lenders.

The crisis became so acute that the Government had to mortgage gold to raise further loans. For availing the loan, these international agencies expected India to libralise and open up the economy. The suggestions given by them were to (i) remove restrictions on the private sector, (ii) reduce the role of the government in the market, and (iii) remove trade restrictions. India agreed to the conditions which were put forth by World Bank and IMF and they announced the New Economic Policy.

- **Huge burden of debts:** The expenditure of the government was much higher than revenue. As a result, government had to borrow money from banks, public and from international financial institutions. In 1991 fiscal deficit was 8.4 percent of Gross domestic production (GDP). IMF decided to advance loan of 7 billions dollars but at the same time insisted that Indian government should introduce economic reforms in the economy.
- **Gulf Crisis:** On account of Iraq war in 1990-91, prices of crude oil shot up. India used to receive huge amount of remittance from gulf countries . In the wake of the war, this took a serious hit and the gulf crisis further widened BoP deficit.
- **Inefficient Management:** The origin of the financial crisis can be traced from the inefficient management of the Indian economy. The government was not able to generate sufficient revenue from internal sources such as taxation, running of public sector enterprises, etc. and simultaneously the government expenditure began to exceed its revenue by such large margins that it became unsustainable. At times, the foreign exchange borrowed from other countries and international financial institutions was spent on meeting consumption needs.

3. The New Economic Policy

The New Economic Policy (NEP) was announced in July 1991. It consisted of wide range of economic reforms. The main aim of the policy was to create a more competitive environment in the economy and remove the barriers to entry and growth of firms.

The New Economic Policy was announced in July 1991. It can be broadly classified into two kinds of measures;

1. **Stabilisation Measures:** They refer to short-term measures which aim at:

   (i) Correcting of the balance of payments deficit by maintaining sufficient foreign exchange reserves; and

   (ii) Controlling inflation by keeping the rising prices under control.

2. **Structural Reform Measures:** They refer to long-term measures which aim at;

   (i) Improving the efficiency of the economy; and

   (ii) Increasing international competitiveness by removing the rigidities in various segments of the Indian economy.

   (iii) Increasing the competitiveness of Indian products internationally.

Main Features of The New Economic Policy

The government initiated different policy changes which fall under three heads:

1. Liberalisation
2. Privatisation
3. Globalisation

4. Liberalisation

Before 1991, there were large number of government restrictions in India in terms of licensing requirement for setting up of industries, import and export trade, dealings in foreign exchange, etc. In July 1991, a package of economic reforms was announced, which marked the beginning of process of “Liberalisation” in India. ***Liberalisation means removal of restrictions on the private sector.*** In other words, it implies liberating the trade and industry from unwanted government controls and restrictions.

Liberalisation contains two things:

(i) Relaxation in the rules and regulations made for the private sector.

(ii) To allow private sector to run those industries which were earlier reserved for public sector.

The purpose of liberalisation was to unlock the economic potential of the country by encouraging private sector and multinational corporations to invest and expand and to introduce much more competition into the economy and provide incentives for increasing efficiency of operations. This would further reduce the debt burden of the country and use the import route for capital goods and machinery from developed countries.

The economic reforms taken by the Government under liberalization include the following:

(i) Industrial Sector Reforms
(ii) Financial Sector Reforms
(iii) Tax Reforms
(iv) Foreign Exchange Reforms
(v) Trade and Investment Policy Reforms

4.1 Industrial Sector Reforms

In order to make necessary reforms in the industrial sector, the Government introduced is new industrial policy on July 24, 1991. *The various measures under industrial policy reforms include;*

1. **Reduction in Industrial Licensing:** The new policy abolished industrial licensing for all the industries, except for a short list of industries (like liquor, Cigarettes, hazaradous chemicals, defence equipments, industrial explosives, etc). No licenses were needed to (i) set up new units; or (ii) expand or diversify the existing line of manufacture. However, license was required for certain industries, related to security and strategic considerations.

2. **Reducing the Role of Public Sector:** One of the salient features was reduction in the role of public sector in the industrial development of the country. The number of industries, exclusively reserved for the public sector were reduced from 17 to 8.

3. **Reforms under small-scale industries:** Many goods produced by small scale industries have now been de-reserved. This was achieved by increasing the investments limit for small scale

industries to Rs. five crores. Market forces were allowed to determine the prices in many industries rather than being decided by the government.

4. **Monopolies and Restrictive Trade Practices (MRTP) Act:** Earlier production capacity was linked with licensing. With the introduction of liberalisation and expansion schemes, the requirement for large companies, to seek prior approval for expansion, establishment of new undertakings, merger, amalgamation, etc. were eliminated. Now producers could expand their business according to their own will depending on market conditions. In 2002, MRTP Act has been replaced by Competition Act 2002 which is more liberal.

4.2 Financial Sector Reforms

Financial sector includes financial institutions such as commercial banks, investment banks, stock exchange operations and foreign exchange market. The financial sector in India is controlled by the Reserve Bank of India (RBI). The role of RBI was reduced from regulator to facilitator of financial sector. For instance, till 1991, RBI was deciding the interest rates for banks on loans and deposits. Thus, financial sector was allowed to take decisions on many matters, without consulting the RBI. The reform policies led to the establishment of private sector banks,Indian as well as foreign. For example, Indian banks like ICICI and foreign banks like HSBC increased the competition and benefitted the consumers through lower interest rates and better services.

The limit of foreign investment in banks was raised to around 50 per cent. Foreign Institutional Investors (FII) such as merchant bankers, mutual funds and pension funds are now allowed to invest in Indian financial markets. Though banks have been given permission to generate resources from India and abroad, certain powers have been retained with the RBI to safeguard the interests of the account-holders and the nation. Banks were given freedom to set up new branches (after fulfillment of certain conditions) without the approval of the RBI. Now banking services are available in almost every corner of the country.

4.3 Tax Reforms

Tax reforms refer to reforms in government’s taxation and public expenditure policies, which are collectively known as its ‘Fiscal Policy.’

Taxes are of two types:

(i) **Direct Taxes** are those taxes where the burden and the imposition is on the same person. It consist of taxes on income of individuals as well as profits of business enterprises. *For example,* Income tax (taxes on individual incomes) and Corporate tax (taxes on profits of companies). Burden of These taxes can’t be shifted.

(ii) **Indirect Taxes** refer to those taxes where the burden and imposition are on two different people. These affect the income of persons through their consumption expenditure. Indirect taxes are generally imposed on goods and services. *For example,* sales tax, VAT, Custom duty, etc. Burden of These taxes can be shifted.

The major Tax Reforms made are:

1. **Reduction in Taxes:** Since 1991, there has been a continuous reduction in income and corporate tax, as high tax rates were an important reason for tax evasion. It is now widely accepted that moderate rates of income tax encourage savings and voluntary disclosure of income.
2. **Reforms in Indirect Taxes:** Considerable reform have been made in indirect taxes to facilitate establishment of common national market for goods and commodities. Efforts are being made to ensure uniform application of GST (Goods and Service Tax) in all states of the country. The GST was finally implemented on 1st July 2017.
3. **Simplification of Process:** In order to encourage better compliance on the part of taxpayers, many procedures have been simplified. Before 1991, taxpayers were reluctant to file tax return because there were lots of formalities and difficult for an individual to file on its own.

4.4 Foreign Exchange Reforms

The important reforms made in the foreign exchange market are;

- **The Devaluation of the Rupee:** Devaluation refers to reduction in the value of domestic currency in terms of foreign currency by the government. To overcome Balance of Payments crisis, the rupee was devalued against foreign currencies. This led to an increase in the inflow of foreign exchange. The Government allowed rupee value to be free from its control. As a result, market forces of demand and supply determine the exchange value of the Indian rupee in terms of foreign currency.

5. Trade and Investment Policy Reforms

Before 1991, a lot of restrictions were imposed on imports to protect the domestic industries. However, this protection reduced the efficiency and competitiveness of domestic industries which led to the slow growth. So the reforms in the trade and investment were initiated to increase the international competitiveness in industrial production, to promote foreign investments and technology into the economy, to promote efficiency of domestic industries and adoption of latest technologies and to give freedom to foreign investors to have a majority of share in equity.

The important trade and investment policy reforms include:

(i) **Removal of Quantitative restrictions on Imports and Exports:** Under the NEP, quantitative restrictions on imports and exports were greatly reduced. For example, quantitative restrictions on imports of manufactured consumer goods and agricultural products were fully removed from April 2001.

(ii) **Removal of Export Duties:** Export duties were removed to increase the competition of Indian goods in the International market.

(iii) **Reduction in Import Duties:** Import duties were reduced to improve the position of domestic goods in the foreign market. Policy of protection to the domestic industries has now been given up. There has been a clear shift in emphasis on export promotion and import substitution.

(iv) **Relaxation in Import Licensing System:** The Import licensing was abolished, except in case of hazardous and environmentally sensitive industries. This encouraged domestic industries to import raw materials at better prices, which raised their efficiency and made them more competitive.

6. Summary

Before 1991, Indian Economy was facing problems of declining foreign exchange reserves, increasing the gap between imports and exports and high inflation. It forced the policy makers to change its economics policies in 1991 due to the financial crisis, and pressure from international organizations like the IMF and World Bank. Major reforms were undertaken in the industrial and financial sectors. One of the major reforms included foreign exchange deregulations and liberalisation. It opened the doors for different kinds of new avenues which proved a benchmark in the Indian economy.