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India's Trade Policy
The Past, Present and Future

by

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Following the Second World War, a consensus emerged among intellectuals and policy makers on diametrically opposite trade policy prescriptions for the then First and Third World countries. With respect to the former, it was agreed that progressive trade liberalisation would help war-torn economies of Western Europe and Japan to recover faster while also boosting growth in North America. But regarding the latter, the dominant view was that the newly independent nations needed to protect their industries from imports.

Therefore, while the intellectuals and policy makers rallied behind the efforts to build a liberal world trading system under the auspices of the General Agreement on Tariffs and Trade (GATT) immediately following the war, they also provided for protection to industry by the Third World countries within this system. The case for liberal trade order for the First World countries was based on the sound principle of comparative advantage and the highly positive growth experience during the First Globalization lasting from 1870 to 1914. The case for protection in the Third World countries, which were later rechristened as developing countries, on the other hand, was based on neither a sound principle nor positive experience.

Economists rationalized the recommendation of industrial protection in developing countries on a model that conceptualized their economies as consisting of two traded goods sectors: agriculture and industry. They hypothesized that between the two sectors, developing countries enjoyed comparative advantage in agriculture. It then followed that a liberal trade policy would lead these countries to specialize in and export agricultural commodities. But these commodities could not serve as the engine of growth for two reasons.

First, as incomes in industrial countries rise in the future, their demand would progressively shift away from agricultural products and towards industrial products. This was because the income elasticity of demand for agricultural products happens to be low. The shift in demand would in turn lower the relative price of agricultural products in terms of industrial products. As a result, developing Countries exports would fetch progressively lower export revenues per unit of exports.

Second, the effect of low price-elasticity of demand for agricultural products would complement the effect of the low income-elasticity of demand. As developing countries invest in agricultural products and expand their exports, the prices of those products in the world markets would decline disproportionately. The result would be lower export revenues for a larger volume of exports.

The low elasticities, thus, meant that agriculture could not serve as an engine of growth, which then left industry as the only option. And since the developing countries were importers of this industrial product, the recommendation of import substitution and protection as the right policy followed. To give intellectual cover to the recommendation, economists then invoked the flawed infant-industry argument.[1]

The key error in this line of reasoning was the conceptualization of industry as a monolith. In reality, industry consisted of many different products of which some such as textiles and clothing, footwear, toys and furniture were highly labour intensive. While being at a disadvantage in the production of capital-intensive industrial products such as steel, machinery, transport equipment and chemicals, developing countries had a comparative advantage in the labour intensive products. They could, thus,

1 In Panagariya, Arvind, 2019, Free Trade and Prosperity, New York: Oxford University Press, Chapter 3, I show that under plausible assumptions, a logical case for protection on infant-industry grounds cannot be made.

industrialize by initially specializing in and exporting the latter products while still importing the capital-intensive industrial products. These products do not suffer from low income or price elasticities of demand in the world markets and therefore could serve as the engine of growth.

It was this fact that the "tiger" economies of East Asia, most notably Taiwan and South Korea, recognized beginning in the late 1950s and early 1960s. Rather than relying on Import-Substitution Industrialization (ISI), they turned to a policy of export-led and manufacturing-led growth. This policy was supremely successful with these countries transforming themselves into middle-income countries at a pace never observed before. Two of the most populous developing countries, China and India, chose to ignore the lessons of experience offered by these countries until the late 1970s in the case of the former and early 1990s in the case of the latter with unhappy consequences for their prosperity.

The Lost Decades: 1950-80

While this narrative accurately captures the evolution of trade policy in much of the developing world in the early decades following the Second World War, India's protectionism immediately following the independence had a very different origin. Rather than flowing from a desire to industrialize through systematic import substitution, it originated in Prime Minister Jawaharlal Nehru's desire to achieve economic self-sufficiency.

Nehru's Economic Philosophy and Early Liberalism in Trade Policy

As a nationalist who had fought for India's independence side by side with Mahatma Gandhi, Nehru was a nationalist to the core. He wanted India to be economically self-sufficient. For him, economic independence was essential for preserving the country's hard-won political independence. That philosophy, complemented by his conviction to create a *'socialist pattern of society,'* guided his economic policy framework throughout his tenure, which lasted till his death in May 1964. [2]

Nehru felt it necessary that India produce heavy industry items such as railways, airplanes and guns at home because *'to import them from abroad is to be the slaves of foreign countries. Whenever these countries wished they could stop sending these things, bringing our work to a halt; we would thus remain slaves.'*[3]

Symmetrically, he took a skeptical view of exports not because they could not serve as the engine of growth but because he feared they would become a source of conflict with importing nations. *"To base our national economy on export markets might lead to conflicts with other nations and to sudden upsets when those markets were closed to us,"* he wrote in his 1946 book, Discovery of India.[4] For Nehru, the ultimate objective of policy was to reorient the production basket to the consumption basket with trade filling the gap until the two baskets were fully aligned. The alignment was to be done principally through progressive diversification of the production basket.

A most interesting aspect of this strategy was that at least in the initial years, the government did not raise trade barriers. The country inherited modest tariffs, which were first introduced in the 1920s, and import licensing, which was adopted during the 1940s to tackle wartime shortages. These restrictions were maintained with no annual quantitative limits placed on imports. As long as foreign-exchange situation was comfortable, import licenses were issued liberally.

Remarkably, 'Established Importers,' who were licensed to import goods for sale to other buyers, as well as consumer goods imports, were allowed relatively freely until at least 1957-58. *Established Importers* mostly imported consumer goods while producers in need of machinery and raw material imports relied

2 Under his leadership, Indian Parliament had adopted the 'socialist pattern of society' as the objective of social and economic policy.
3 Panagariya, Arvind, 2008, India: The Emerging Giant, New York: Oxford University Press, p. 25.
4 Panagariya 2008, op. cit. p. 25.

on 'Actual User Licenses'. The former accounted for almost one third of the import licenses in value terms until 1957-58. By the early 1960s, this share had dropped to one-tenth, with Actual User Licenses correspondingly gaining in importance.[5]

A Balance of Payments Crisis and Tightening of Import Controls

India had collected substantial sterling balances from Britain as payment for the services it had provided the latter in the Second World War. The British Government placed limits on the rate at which India could draw down these balances but did not enforce them rigidly. Therefore, until these balances were exhausted, India could maintain a liberal import regime at the fixed exchange rate to which it had committed under the International Monetary Fund (IMF) system. But by the end of 1957, the balances had depleted to a level that business as usual could no longer continue.

Had India held serious discussions on evolving a pragmatic strategy aimed at maintaining the flow of imports at a level necessary to advance its development goals, it would have considered measures such devaluation of the rupee and priority to labour intensive manufacturing to accelerate the expansion of exports. But, policy makers had always seen trade as residual activity. Therefore, when sterling balances ran out, the finance ministry instinctively went for the bureaucratic solution of arbitrarily limiting imports to match the availability of foreign exchange. This was done through the instrumentality of foreign exchange budgeting whereby the Finance Ministry would ask each line Ministry and the Chief Controller of Imports and Exports to submit estimates of needed foreign exchange for a specified period and then arbitrarily trim those estimates to match the expected export earnings plus unilateral transfers from abroad, if any.

5 For the sources of information in this article whenever they are not cited, the reader may consult Panagariya 2008, op. cit.

Once foreign budgeting was in place, import-licensing regime tightened progressively. Consumer goods imports fell rapidly with *Established Importer* licenses gradually phased out. By mid- to late-1960s, strict import licensing came to cover all imports. Every six months, the government would issue an import policy with a list of products that could be imported. The policy listed who was qualified to import a given product and in what proportion of the stated requirement. It also named the sponsoring agency that would have to certify the 'essentiality' and domestic non-availability of the product. Any definition of 'essentiality' had to be arbitrary and subject to bureaucratic discretion. Proving domestic non-availability was a challenge as well since the existence of even a remotely substitutable product at home could serve as an excuse for the denial of the import license.

A Model Destined to Fail

In the end, the objective of self-sufficiency which required rapid diversification of production structure, proved fatal to growth and poverty alleviation aspirations of Indian policy makers.[6] There was an inherent conflict between rapid achievement of self-sufficiency and productive efficiency. It is baffling that the policymakers failed to see this obvious contradiction not only in the 1950s but also during the subsequent two to three decades.

In the 1950s, both the level of income and the saving rate were low. The twin facts combined to produce meagre total savings. With ample labour supply available, the key to fast growth was the conversion of these savings into the most productive investment possible. Not just economic logic but even common sense dictated that at least in the early decades the savings be invested in labour intensive products to allow them to achieve the optimal scale and be competitive vis-à-vis their foreign counterparts. This would have helped them create decent employment opportunities for the masses while also generating

6 See Nehru, Jawaharlal, 1946, Discovery of India. New Delhi: Penguin Books India, 2004 edition, pp. 437-8. As the author writes, from the beginning, the objective of Indian planners was to get rid of the appalling poverty of the people. Rapid growth was to serve as the means to this end.

export revenues that could then be exchanged for high-quality components, machinery and other capital-intensive imports. As incomes rose, savings would have risen as well, paving the way for investment into more and more capital-intensive products. Over time, the diversification objective could thus have been achieved while creating gainful employment opportunities for the workforce. This was exactly the strategy that countries such as South Korea and Taiwan pursued.

But immediacy of self-sufficiency required rapid expansion of the economy into a diverse set of products ranging from bicycles to scooters to automobiles to railways to airplanes, their components, and metals and machines required to produce them. With its meagre savings in the 1950s, how was India to achieve this diversification? The planners reasoned that from the viewpoint of allocation of savings for investment, industrial products fell into two categories: capital-intensive products such as steel, automobiles, railways, metals and machinery that only large-scale enterprises could produce and labour intensive products such as apparel, footwear, furniture and numerous other light manufactures that small-scale enterprises, referred to as the 'cottage industry' in the contemporary nomenclature, could produce. It made practical sense to devote the scarce savings exclusively to products in the first category and let the cottage industry produce the products in the second category relying on its internal, household sources of savings.

But this allocation sealed the fate of productive efficiency in almost all its aspects. The compulsion to spread the scarce savings over as many products as possible even within the capital-intensive category meant that each of these products was allocated just enough capital to operate on the minimum technologically-feasible scale. This scale was significantly smaller than the one on which counterpart enterprises in other parts of the world operated. This fact rendered Indian enterprises necessarily uncompetitive against their global counterparts. Therefore, their survival required prohibition of imports. Strict import licensing followed.

Denied access to any savings as well as high-quality imported inputs, labour intensive products fared no better. They too had to be produced in enterprises that were significantly smaller in scale than their global counterparts. Not only did they fail to achieve their export potential, they had to be protected from higher-quality cheaper imports via strict import licensing. Indeed, by the mid 1960s, imports of these products, mostly consumer goods, came to be prohibited.

Markets could not produce this allocation of the scarce savings between capital and labour intensive sectors, and among various capital-intensive products. Instead, the government had to deploy a number of instruments to ensure that they went to only those products, such as steel, automobiles and machinery, which could not be produced on small scale within the cottage industry. For the heavy industry such as steel, railways and power generation equipment, it entered into production activity directly, relying on revenue resources. This was in keeping with Nehru's desire to achieve a socialist pattern of society in which the state was to acquire a progressively larger share in production activity.

For the private sector, the government mandated that any enterprise investing ₹ 1 million or more (the threshold revised to ₹ 2.5 million in 1964, ₹ 10 million in 1969 and ₹ 30 million in 1978) in fixed assets including land, building and machinery must obtain an investment license from a designated government agency. [7] The license specified the product to be produced and its quantity.

To keep the producers of labour intensive products from accessing the scarce savings, the government initially relied on a policy of non-issuance of investment licenses for those products.

7 Panagariya 2008, op. cit.: Chapter 2, footnote 21; Chapter 3, p. 63 and Chapter 4, p. 81.

But beginning in 1967, it introduced what came to be known as the Small Scale Industries (SSI) reservation policy. Under it, the government drew up a list of labour intensive products that were formally reserved for exclusive manufacture by small enterprises defined as those with investment in plant and machinery not exceeding ₹ 0.75 million (later revised to ₹ 1 million but remaining at that level till as late as 1980 when it was raised to ₹ 2 million).[8] The list began with 47 items but expanded steadily to 177 items by February 1974 and 504 items by April 1978.[9]

This regime produced a number of unhappy outcomes:

i. The rule followed to allocate scarce savings created a dualistic structure of the economy. Nearly all capital came to be concentrated in the capital-intensive, formal sector. In parallel, nearly all workforce other than those engaged in agriculture came to be concentrated in the labour intensive, cottage industry, informal sector.

ii. The regime gave rise to three sources of inefficiency. First, the scale of production was typically smaller than what was necessary to minimize per unit cost of production. Second, with imports strictly controlled through licensing and domestic production limited by licensing, all sources of competition were eliminated. Finally, as long as an input was domestically available, no matter how poor in quality, its import was not permitted. That meant that quality-wise, domestic products could be only as good as the quality of domestically available inputs.

iii. Despite the high costs due to these factors, given the restrictions on imports and limited domestic production due to limits placed by investment licenses, products such as scooters, automobiles, steel and cement carried the potential to generate excessive profits. This being anathema

8 Panagariya 2008, op. cit., p. 81.
9 Panagariya 2008, op. cit., pp. 64-65.

within the prevailing socialist ideology, price controls had to be introduced. Price controls in turn produced shortages requiring the introduction of distribution controls. A system of permits was introduced whereby a potential buyer of the products was required to first obtain a permit from a designated government agency. Long waiting queues, sometimes extending to years rather than just months, followed. Those unwilling to wait had to resort to purchases in the black market at higher prices and risk being subject to prosecution.

At the macro, level, these inefficiencies translated into abysmal growth, especially in industry. During 1951-52 to 1964-65, when trade regime was somewhat liberal and bureaucracy was able to give decisions on licensing applications swiftly due to their limited numbers, industry could grow 6.6% annually (**Table 1**). But even this growth rate was low by the standards of fast-growing economies and it fell to just 4.1% between 1965-66 and 1980-81. In parallel, GDP growth rate fell from 4.3% in

Table 1: **Growth Rates in Agriculture, Industry and Services, 1951-52 to 2019-20**

Period	Agriculture	Industry	Services	GDP at FC
1951-65	2.9	6.6	4.9	4.1
1965-81	2.1	4.1	4.2	3.3
1981-88	2.0	6.2	6.0	4.7
1988-91	6.9	8.1	7.2	7.3
1991-92	-2.0	-0.2	4.3	1.5
1992-2003	2.7	6.1	7.4	5.9
2003-20	3.9	7.2	8.5	7.4

Source: Authors' calculations using GDP data by the Central Statistical Office, Ministry of Statistics and Program Implementation, Government of India

Table 2: **Growth Rates of GDP at Constant Market Prices, 1951-52 to 2019-20**

Period	Population	GDP at Constant MP
1951-65	2.0	4.3
1965-81	2.3	3.2
1981-88	2.1	4.9
1988-91	2.1	7.0
1991-92	2.0	1.1
1992-2003	1.9	5.8
2003-20	1.3	7.4

Source: Authors' calculations using GDP data by the Central Statistical Office, Ministry of Statistics and Program Implementation, Government of India.

the first period to 3.2% in the second (**Table 2**). In effect, the economy came to be trapped in a low-growth equilibrium.

A final tragic aspect of the growth experience during these decades was the failure of the economy to create well-paid jobs for the unskilled. The formal sector, which absorbed much of the savings, exhibited limited capacity to create jobs for the unskilled per unit of savings absorbed. Because the growth rate was low, incomes and therefore savings rose slowly over time. That in turn limited the scope for job creation through an expansion of the sector as well.

Labour intensive informal sector exhibited similar limitations in its capacity to create well-paid jobs. Though requiring minimal capital per worker, its productivity was too low to create jobs that could pay well. Moreover, being uncompetitive in the global economy, its expansion was constrained by the domestic demand. The expansion of domestic demand in turn was constrained by the rate of growth of income, which remained low.

The slow growth in well-paid jobs for the unskilled meant that the economy failed to provide incentives to subsistence workers in agriculture to move to industry and services. The transformation of the economy from primarily rural and agrarian structure to an industrial urban one remained a distant dream as a result. As late as 1987-88, 66% of India's workforce was still toiling in agriculture, much of it at subsistence or below-subsistence incomes.

Later, when liberalisation produced some successes in modern services, the dualism that self-sufficiency-driven policy framework had created got extended to services. Skilled labour came to be concentrated in the formal services sectors such as information technology and finance while unskilled labour ended up in informal services sectors such as transportation, tourism and domestic help. This dualism continues to haunt India till today with the pace of rural-urban migration remaining low.

Hesitant Liberalisation: The Transition Decade of the 1980s

Three developments during the second half of the 1970s opened the door, albeit just a tiny bit, to import liberalization. First, as the import-licensing regime tightened alongside increased industrialisation, industrialists found themselves unable to utilize the production capacity fully due to inadequate access to imported inputs. Therefore, they began to lobby for the liberalisation of import-licensing regime.

Second, cartelization of the market in crude oil under the auspices of the Organization of Petroleum Exporting Countries led to a large hike in oil price in 1973, placing vast volume of export revenues in the hands of the member countries. Those revenues gave rise to significant demand for workers from India in the Middle East. Resulting migration brought a steady flow of remittances into India and helped relax the foreign exchange constraint to some degree.

Finally, there was realization among at least some enlightened senior bureaucrats in the central government that the command and control system had gone too far and some backtracking was required. But there was no readiness among the political class to admit that the system was fundamentally flawed. Therefore, only small, piecemeal changes that could be done quietly within the existing policy framework were possible. Hence the liberalisation that followed was done as if by stealth.

Trade liberalisation began with the revival of Open General Licensing (OGL) in 1976. An OGL list of products, for which an import license would no longer be required, was introduced. The reform freed the importer of listed items from the domestic availability condition though she remained subject to the actual user condition and the foreign-exchange-clearance requirement. In 1978-79, based on P. C. Alexander Committee report, the government adopted the policy to place all products not produced domestically on OGL list. It also discontinued the publication of the red book, published biannually, listing the permitted imports and associated conditions. In its place, it created a list classifying all imports into banned, restricted and OGL categories. Goods in the first category were to be banned altogether while those in the second category would require a license. No license or domestic availability condition applied to OGL imports.

Import liberalisation during the 1980s took place through four channels. First, canalized imports, which were a government monopoly, fell from a hefty 67% of total imports in 1980–81 to 27% in 1986–87. The decline eased up the foreign-exchange constraint on non-canalized imports. Factors contributing to this decline included increased domestic production of crude oil following the discovery of oil in Bombay High; elimination of imports of food grains on account of the Green Revolution; and a significant decline in the prices of several canalized imports.

Second, the government steadily expanded the OGL list. In 1976, it was introduced with just 76 capital goods items. The number of these items grew to 1007 in April 1987 and 1329 in April 1990. Alongside, numerous intermediate inputs were also placed on the list with their number reaching 620 in April 1987 and 949 in April 1988. The share of OGL imports in non-canalized imports rose from 5% in 1980-81 to 30% in 1987-88. In most cases, the government also reduced tariffs on OGL items at the time of their inclusion in the list.

Third, several export incentives were introduced or expanded. They helped expand imports directly when imports were tied to exports and indirectly by relaxing the foreign exchange constraint. Particularly important were Replenishment (REP) licenses, which were given to exporters and could be freely traded on the market. Exporters were given REP licenses in amounts that were approximately twice their import needs. The license allowed its holder to import restricted items that were not on the OGL list.

Finally and perhaps most importantly, the Reserve Bank of India allowed the rupee to depreciate significantly in the second half of the 1980s. From ₹ 13 per dollar in 1987-88, the average daily rupee-dollar exchange rate steadily depreciated to ₹ 17.9 per dollar in 1990-91. The depreciation contributed to improved export performance and relaxation of the foreign exchange constraint on imports.

It may be noted that alongside these liberalising developments, tariffs on non-OGL items rose dramatically, especially after 1984-85. An indicator of this escalation is that tariff revenue as a percentage of imports rose from 27% in 1977-78 to 62% in 1987-88. It is important to understand, however, that the objective behind the tariff escalation was to mop up the large quota rents that had existed rather than protection. Some authors have neglected this fact and ended up erroneously arguing that the 1980s were characterized by increased rather than reduced protection.

The 1980s also saw some modest liberalisation of investment licensing, which I eschew detailing here. Coupled with import liberalisation, the change yielded some positive impact on growth. Annual industrial growth, which had fallen to 4.1% between 1965-66 and 1980-81 rose back to 6.2% between 1981-82 and 1987-88 and then jumped to 8.1% between 1988-89 and 1990-91 (**Table 1**). Mirroring industrial growth, GDP growth, which had dipped to 3.2% between 1965-66 and 1980-81, rose to 4.9% during 1981-82 to 1987-88 and then to 7% during 1988-89 to 1990-91 (**Table 2**).

The acceleration in growth during the last three years of the 1980s had been fueled to a considerable degree by large fiscal deficits. In the second half of the decade, the deficits had risen to unprecedented levels. Because they were partially financed by borrowing abroad, foreign-currency debt accumulated. With the economy relatively closed despite some liberalisation and export earnings limited, by 1989-90, interest and principal due on foreign-currency debt came to absorb 27% of export earnings. Given rising import needs due to ongoing economic expansion at the same time, the situation could not be sustained and a balance of payments crisis hit India in 1991.

Systematic Opening and Take-off: The 1990s and Beyond

The balance of payments crisis in 1991 coincided with parliamentary elections that brought the first full-term Prime Minister who was not from Gandhi-Nehru family and hailed from South India, P. V. Narasimha Rao. Taking advantage of the crisis, Rao fundamentally altered the policy framework. With some exceptions, he ended both import and investment licensing in one fell swoop. Consumer goods, accounting for 30% of all tariff lines, constituted the exception in the case of import licensing and 18 narrowly defined products in the case of investment licensing. Alongside, the top tariff rate on industrial products was reduced from 355% to 150% in the budget presented in July 1991 and the rupee was devalued from ₹ 21.2 per dollar to ₹ 25.8 per dollar. The government also adopted a policy of opening the economy to foreign direct investment (FDI).

In subsequent years, Rao ended investment licensing on all but five products for which licensing was justified on health, safety and environmental grounds. Tariffs were compressed from the top each year with the highest tariff rate (with some exceptions) falling to 110% in 1992-93, 85% in 1993-94, 65% in 1994-95 and 50% in 1995-96. When Rao left office in 1996, he had, thus, brought the top industrial tariff down from 355% to 50%. Though no change in the rate took place in 1996-97, it did fall further to 40% in 1997-98.

The next decline in the top rate came in 2000-01 when it fell to 35%. The rate then saw a steady decline in each of the subsequent years until 2007-08. It fell to 30% in 2002-03, 25% in 2003-04, 20% in 2004-05, 15% in 2005-06, 12.5% in 2006-07 and 10% in 2007-08. After 2007-08, no further reductions in the top rates took place though compression in the rates on specific products continued as a part of the policy of rationalization of tariff structure.[10] In the meantime, in April 2001, import licensing on the consumer goods was also ended. That change came on account of a successful challenge in the World Trade Organization (WTO) by the United States to import licensing by India.

Until at least 2002-03, the exchange rate played a highly supportive role in India's quest for outward-oriented development. The average daily rupee-dollar exchange rate steadily moved from ₹ 24.5 per dollar in 1991-92 to ₹ 48.4 per dollar in 2002-03. This depreciation temporarily provided a cushion to import-competing products against the declining tariff rates while also making exports progressively profitable. As discussed below, by 2002-03, the combination of low tariffs and undervalued rupee had set the stage for the take-off of India's exports. Though the rupee remained either stable or appreciated in nominal terms against the dollar in the following eight or nine years, it had been sufficiently undervalued by 2002-03, so that the lack of further depreciation did not hinder export expansion.

By 2006-07, India had gone from a near autarkic to an highly open economy. Import licensing was entirely abolished and the simple average of industrial tariffs stood at 11.9% (**Table 3**). The proportion of tariff lines with rates exceeding 15% had fallen from 93.9% in 2001-02 to just 13.8%. With the process of opening the economy to FDI, initiated by Rao, continuing steadily under all subsequent governments, the economy had also become highly open to foreign investors.

The impact of the reforms is apparent in the vastly improved performance of the economy. During the crisis year, 1991-92, GDP growth had plummeted to just 1.1%. But, supported by reforms, the economy quickly gathered the lost momentum and sustained a growth rate of 5.8% between 1992-93 and 2002-03, compared with 4.9% from 1981-82 to 1987-88. Subsequently, as the reforms during the tenure of Prime Minister Atal Bihari

10 The annual tariff reductions have been compiled from the budget speeches of the finance ministers.

Table 3: **Indicators of protection in industrial products, 1990-91 to 2020-21**

Year	Maximum tariff rate	Simple average of industrial tariffs*	Percent tariff lines with rates above 15%
1990-91	355	126	Not Available
1993-94	85	73	Not Available
1995-96	50	42	Not Available
1997-98	45	35.6	96.6
2001-02	35	30.8	93.9
2006-07	12.5	11.9	13.8
2010-11	10	8.9	11.9
2014-15	10	9.5	13.6
2019-20	10	10.8	24
2020-21	10	11.1	25.4

*For years 1990-91, 1993-94 and 1995-96, the rates relate to manufacturing only and exclude mining

Source: Trade Policy Review: India 1998, 2002, 2007, 2011, 2015 and 2020, World Trade Organization.

Vajpayee began to have their impact, there was further increase in the average annual growth rate to 7.4% from 2003-04 to 2019-20 (**Table 2**). During this last period, spanning seventeen years, industrial growth also saw an increase to 7.2% from 6.1% during the preceding period (**Table 1**).

Trade has been central to these shifts in the growth rate. **Figure 1,** which depicts imports and exports as percentages of GDP from 1950-51 to 2019-20, provides the evidence. Exports fell below 5% of the GDP for the first time in 1958-59 and returned above that threshold only in 1975-76. The proportion remained just above 5% threshold thereafter and did not touch even the 7% mark until 1989-90. These were years of slow growth in India. But, once the 1991 reforms were launched, export growth picked up. By 2003-04, the exports-to-GDP ratio had crossed 15% mark and by 2013-14, 25% mark. In absolute terms, India's exports of goods and services rose from US$ 74.5 billion in 2002-03 to US$ 470.4 billion in 2013-14. As noted, these were the years of significantly faster growth than the prior years. Unfortunately, the year 2013-14 remains the highest peak for exports-to-GDP ratio. By 2019-20, this ratio had fallen to 18.6%. This decline and a generally poor performance of exports in recent years is a matter of great concern.

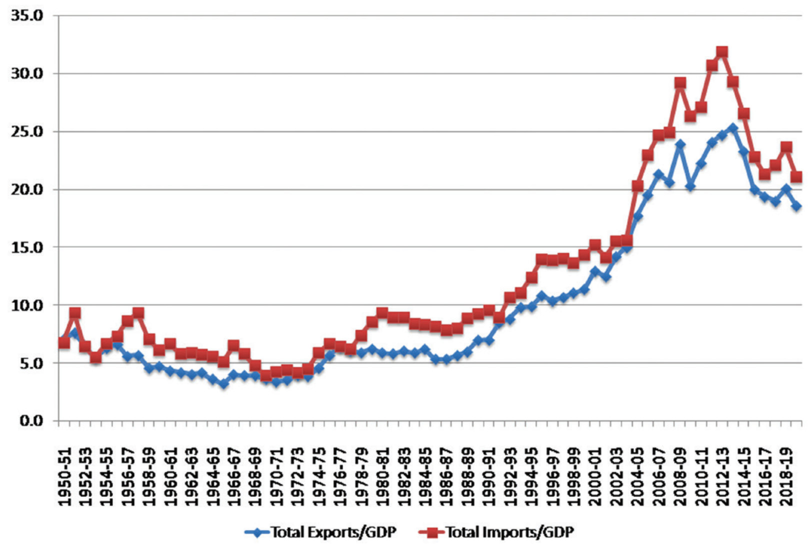

Figure 1: Exports and Imports of Goods and Services as proportion of the GDP.
Source: Author's construction using data from the RBI Handbook of Statistics

Trade Policy Today: Creeping Protectionism

Despite undisputable evidence of benefits of trade openness, India has begun to reverse the process of liberalisation in recent years. Going by the evidence available in the WTO Trade Policy Review reports, published in 2011, 2015 and 2020, protection has seen a steady rise. In the year 2010-11, simple average of tariffs was the lowest on record, 8.9%. That year, the proportion of tariff lines with rates exceeding 15% was also the lowest at 11.9%. Since then, the simple average of tariffs has risen to 9.5% in 2014-15, 10.8% in 2019-20 and 11.1% in 2020-21. The proportion of tariff lines with rates exceeding 15% has risen to 13.6% in 2014-15 and then jumped to 24% in 2019-20. In 2020-21, the proportion stood at 25.4%. The trend of rising tariffs has continued in 2021-22, with the latest budget proposing to raise the custom duties on numerous products.

The tariff increases assume extra significance once we recognize that they have been applied selectively precisely where they have the greatest bite. The explicitly stated objective being import substitution, tariffs have been raised on precisely those products in which substantial imports exist and domestic industry is failing to compete. When high protection applies to products accounting for a large proportion of imports and low protection to products that the country hardly imports, the effect of a given average tariff is more pernicious than when the opposite is the case.

Anti Dumping (AD) duties by India have complemented these tariff increases. The total stock of cases with AD measures such as AD duties and price undertakings by exporting countries in effect as of June 30, 2020 stood at 243 for India. Worldwide, across all WTO members, the total number of these measures on the same date was 1926. With just 2.53% share in the world merchandise imports in 2019, India thus accounted for 12.6%

of all AD measures. Only the United States was ahead of India in the use of this instrument, with 398 measures in place. Brazil and China in that order followed with 156 and 111 measures, respectively.

The use of anti-dumping by India has especially escalated during the latest full year for which anti-dumping data are available. In just one year spanning July 1, 2019 to June 30, 2020, India initiated as many as 98 AD cases. This was the highest number of cases initiated by any country during the year with the United States and Australia in that order occupying the second and third positions with 71 and 15 cases, respectively. All other WTO member countries initiated fewer than 15 cases during the year.[11]

Two further points about AD actions are worth noting. First, these measures are targeted pointedly at the most competitive suppliers of products and AD duties on them can be quite large. As a result, the protective effect that the duties have is often larger than that of tariff hikes of 10 to 15 percentage points.

Second, though China is the country that receives almost all the attention in popular press for 'dumping' its products on the Indian market, it is hardly the only one facing the wrath of the Directorate General of Trade Remedies. Of the 98 cases initiated by India from July 1, 2019 to June 30, 2020, China was the target of investigation in only 18. The remaining 80 cases targeted other countries.

Before discussing the danger that the return to import substitution poses to India’s future growth prospects, it is important to point out that suggestions by some observers that the new protectionism represents a return to pre-1991 days are no more than hyperbole. Unlike pre-1991 India, policy regime today is free of its most restrictive instrument, import licensing. Whereas a near ban had existed on the imports of all consumer goods till as late as March 2001, no such restriction exists today. Simple average of industrial tariffs in 1990-91 was 126%. In comparison, this average in 2020-21 was only 11.1%. The proportion of tariff lines with rates exceeding 15% was 96.6% in 1997-98 compared to 25.4% in 2020-21.

11 Statistics on anti-dumping measures and case are from WTO, Committee on Anti-Dumping Practices - Report (2020) - Adopted 28 October 2020. The report may be downloaded from https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/G/L/1366.pdf&Open=True (accessed on February 4, 2021).

Equally important, India has steadily opened sector after sector to FDI. Even in a sector such as automobile, which is protected by 100% plus custom duties, foreign investment flows freely. The open FDI regime has been particularly instrumental in liberalising trade in services. In pre-reform decades, trade in most commercial services such as banking and insurance was wholly absent. Even while raising tariffs, the present government has relaxed the FDI cap on insurance first from 26% to 49% and then to 74%.

This being acknowledged, it would be a mistake to downplay the damage that creeping import substitution can do to India's growth and jobs ambitions. Of particular relevance is the deleterious effect that this policy can have on growth in labour-intensive manufactures and associated expansion of well-paid jobs for India's vast workforce that has at best limited skills. When industries are promoted on the crutches of protection, they rarely become world-class. India's own successful industries such as information technology, pharmaceuticals and petroleum refining have succeeded on the back of global markets. In contrast, auto industry, which has had 70 years of autarky-level protection, is yet to acquire even 1% share in the world automobile market despite being fully open to FDI.

As an example, India embraced import-substitution industrialization in the electronics industry beginning in 2014. What has this policy achieved in the six years since then? Imports of electronic goods shot up from US$ 32.4 billion in 2013-14 to US$ 55.6 billion in 2018-19, while exports inched up from US$ 7.6 billion to US$ 8.9 billion over the same period. Predictably, protected and subsidized, several mobile phone assembly firms have come up during these years but they have not added up to a vibrant electronics industry. Nearly all locally owned firms are small by global standards, with none that is about to turn into a powerhouse of exports.

The reason for this lack of success is not difficult to see: by its very nature, protection attracts firms that principally want to make quick profits by selling the product in the protected domestic market. With foreign suppliers disadvantaged by tariffs, these firms typically enter business to exploit an assured, almost risk-free domestic market. Lacking global ambition, they also choose to operate on a scale much smaller than their counterparts in the global economy.

There will be less reason to worry if this was all the damage that import substitution could do. The more pernicious effect of the policy, however, is what is not visible to the naked eye. A critical lesson from our own economic history has been that capital is a highly scarce resource in a developing country. In a replay of the history that is discussed earlier in this paper, import substitution channels this resource into high-cost, capital-intensive import-competing sectors while depriving low-cost labour-intensive export sectors of it. The unintended consequence of the policy is a reduction in exports alongside the reduction in imports. The economy thus disengages with the world markets. Going by WTO estimates for 2019, India's share in global merchandise exports is just 1.7%, compared with China's 13.2%. India needs to increase, not reduce, its engagement with the world markets.

A key advantage of maintaining an open trade regime is that it benchmarks the country's firms against the best in the world. A commitment to openness forces the policy makers to ask what changes to domestic policy regime must they make to enable firms to compete against the best in the world. In contrast, when the country gives up on openness and uses import protection to help its firms withstand foreign competition, it leaves the fundamental source of the lack of competitiveness unaddressed.

Looking Ahead: Trade Policy For Tomorrow

I have no doubt that eventually India will transform its predominantly traditional rural economy into a modern, urban and industrial one with no more than 10% of its workforce in agriculture. The critical question is whether it would take 100 or more years to achieve this transformation as nearly every single western industrial economy did or accomplish it in three to four decades as the economies of East Asia have done. If the latter, India needs to rethink its trade policy.

To date, there is no country in the world that has achieved rapid transformation without conquering the world markets. Governments of rapid transformers may have intervened here and there but the broad fact remains that those interventions did not interfere with their expanding trade in any substantive manner. Moreover, careful analysis shows that the net contribution of the interventions was to slow down rather than accelerate growth. These trends are documented at length in my book *Free Trade and Prosperity.*

Today, 42.5% of India's workforce is employed in agriculture. For rapid transformation, approximately half of this workforce must move to industry and services in the next ten to fifteen years. This in turn requires the creation of a large number of jobs in industry and services at the lower-end of skill spectrum that pay attractive wages. The only way this can be accomplished is by creating an environment in which successful export-oriented firms can emerge and flourish in labour-intensive sectors such as apparel, footwear, furniture, toys, kitchenware, stationery, office products and simple electric and electronic devices. These sectors can offer decent jobs to many for limited capital investment. But given the large number of such jobs that India needs, success in export markets is critical. For instance, global apparel market alone is US$ 800 billion worth. If India could capture 15 to 20% of this market in the next decade, it could create millions of jobs at decent wages.

Success in export markets requires first and foremost an open trade regime. Rather than raise tariffs, India must lower them. It must return to its previous ambition of bringing tariffs down to levels prevailing in member countries of the Association of South East Asian Nations (ASEAN). The simple fact we must keep in mind is that when we expand imports in the wake of trade liberalisation, we also expand exports to pay for the extra imports. As the process of import and export expansion proceeds, we replace low-paid jobs in small import-competing firms by better-paid jobs in export-oriented firms.

There are two possible avenues for liberalising trade. First, we may lower tariffs against all trading partners. India successfully deployed this approach from 1991-92 to 2007-08. It is the cleanest approach and an effective one, as India's own experience shows. It is also the most desirable approach. Second, India can enter into free trade agreements with its major trading partners. A good starting point for this would be the United Kingdom and European Union. These are large markets and their agricultural sectors pose no threat to the livelihood of India's farmers.

With some flexibility on liberalising the imports of products such as automobiles and spirits and dropping the insistence on the opening up of their labor market for Indian workers, India can successfully negotiate duty-free access for its exports to these large markets.

With a low corporate profit tax rate, labur law reforms, the goods and services tax and modern bankruptcy law already in place, a massive privatization programme on the anvil, and measures to de-stress the financial sector under way, India is poised to take on to global markets in a major way. But this requires one additional key ingredient: a more liberal trade regime. There is no doubt that given the reforms already in place and those proposed, India can count on growing at 8% rate annually in the two post COVID-19 decades. A more liberal trade regime carries the promise of pushing this growth rate into double-digit range.

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