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India's Industrial Policy Missteps in Retrospect

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Three reform-era missteps have held India below its growth potential: tariff cuts that exposed small-scale manufacturing to imports, gradual abandonment of PSUs, and neglect of development finance institutions. Policy should rest on India's realities, not on either free-market or statist mantras.

Economic reforms have been an ongoing process after the major transformation of our development policy paradigm in July 1991, with a broad consensus in their favour and the belief that our economic performance was getting better as a result. The conceptual framework and the specifics of reform ideas came largely from the English-speaking West, whom we have looked up to as thought leaders and exemplars of good practices.

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The "Washington Consensus"-based policy prescriptions from the World Bank, the Asian Development Bank (ADB), the United States Agency for International Development (USAID), and consultancy firms have been central to the policy discourse in the country. Belief in the intrinsic superiority of the private sector and of global free markets were at the core of this worldview.

History is full of instances of policies made with good intentions turning out to be ineffective, suboptimal, and sometimes even harmful. We now have the experience of 35 years of ongoing reforms. With the benefit of hindsight, it would be worthwhile to see where there were mistakes and errors of judgement, which made the Indian economy underperform and grow below its potential. Three major ones are discussed in this piece.

1. Small-Scale Reservation after 1991

The most damaging misstep at the outset led to our failure in labour-intensive manufacturing. The causation, however, is neither obvious nor easily apparent.

In the pre-reform era before 1991, there was a policy of reserving production of notified items for small-scale industrial units. Products notified for reservation could only be made by small-scale units. Large firms producing these items could continue with their existing production levels but could not increase output. The objective was to widen entrepreneurship and disperse manufacturing with job creation.

The political constituency for this policy grew. The number of items reserved for the small-scale sector kept growing and became more than 800 by 1991. All labour-intensive manufacturing ranging from TV sets to sports goods to bus bodies were reserved for the small-scale sector. The domestic market, which was closed to imports, was growing. To meet this rising demand, the number of small-scale units, their production, and job creation grew. The 1980s was a good decade for manufacturing.

The key pillars of the reforms of 1991 were the end of industrial licensing, the opening up to foreign direct investment (FDI), and trade liberalisation with a reduction of import duties. In the World Trade Organisation (WTO) agreement of January 1995, Indian negotiators had worked hard and succeeded in getting policy space with reasonable headroom in the bound rates to which we committed to bring down our import duties.

The success in the first few years of getting the economy out of the woods and on to a stable growth path generated more confidence in reformers. In the quest for greater international appreciation and to appear as an attractive destination for investment, import duties were brought down drastically in 1995-96 to well below the bound rates committed under the WTO.

The consequences for Indian manufacturers of the more than 800 items reserved for the small-scale sector were neither adequately understood nor properly analysed. Small-scale enterprises were not free to expand to acquire economies of scale and modernise. Large Indian firms, or foreign firms through FDI, were not free to invest and build production facilities for items reserved for small-scale production.

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Imported goods had better technology and quality. The Indian consumer, whose purchasing power was rising, naturally went for imported items, which began to increase their share in the domestic market. Beginning with the 2000s, cheap Chinese goods began to flood our market and now dominate it. The relative decline of labour-intensive manufacturing in India has continued inexorably.

The gradual process of de-reserving more than 800 items was taken up in the late 1990s with little appreciation of what was happening in the market and the need for urgent remedial action. In 1997, 15 products were taken off the reserved list, and 51 in 2001. The process then gathered momentum, and was completed in April 2015 when the last 20 items were de-reserved.

Preserving market share is always challenging. But reversing a drastic loss of market share is far more difficult and it rarely happens. Labour-intensive manufacturing firms of the reservation era have by and large been unable to enter a higher growth trajectory with better technology and scale. Locks from Aligarh to fireworks from Sivakasi are illustrative examples of this decline. The government did not think of putting in place sector-specific, practical, and viable revival packages, presumably as it believed that markets should be left free.

The US had by then succeeded in convincing the rest of the world, barring East Asia, that "industrial policy" was not a good idea. Though there have been programmes to assist micro, small, and medium enterprises (MSMEs), these have yet to result in rapid growth of labour-intensive manufacturing. The crisis of jobs is the outcome. India is sui generis in being unable to benefit from the abundant supply of low-wage young workers willing to work hard, learn, and upgrade their skills to become globally competitive.

2. Public Sector's Conundrum

India built a very large and growing public sector from the 1950s. This began with planned development and its emphasis on heavy industry, along with the decision to keep the "commanding heights" of the economy in the public sector. By 1991, Indian public sector undertakings covered almost all sectors of economic activity, ranging from banking and insurance to steel plants and power plants, to airlines and hotels, and to the Super Bazaar, a retail outlet, in Connaught Place, New Delhi. The public sector dominated the economy. Technologically, India was on a par with China in 1990, though it is difficult to imagine today. These national technological capabilities were nurtured in the public sector.

Then came the 1991 reforms. That the private sector was more efficient than the public sector, and wholesale privatisation should be undertaken was a major pillar of the "Washington Consensus". Our reformers had been wanting large-scale privatisation. They have been successful, in varying degrees, in persuading the political leaderships of the country's two main political parties.

Successive governments, however, have had to contend with the contradiction between their intention to privatise and ground realities, which made actual privatisation politically very difficult. As a result, privatisations till date have been very few. Even closure of bankrupt enterprises whose revival is just not possible has proved politically too difficult for all governments.

The public sector continued to be managed by the line ministries concerned. Larger profitable undertakings were given greater autonomy through Navratna and Maharatna status to become professional board-run companies. Many have become listed companies with progressive disinvestment over time, with the government retaining majority shareholding. They continue to be instruments of the government.

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In practice, informal political directions rather than formal orders of the government have become the reality; a sub-optimal arrangement. However, public sector undertakings became progressively less central to the strategy of government for India's development. Their commercial and long-term interests ceased to be important. Their salience diminished in the government's larger vision of the future. They were just legacies of the past, which could not be wished away.

As privatisation was not politically feasible, private sector entry was gradually permitted and supported in areas where there was only the public sector. Each such step was seen as a major reform. Competition would benefit consumers, and it did. The long-term

consequences were, however, not foreseen nor analysed. Perhaps these could not have been fully anticipated. With the benefit of hindsight, outright privatisation would have been far better for the economy in many cases than the gradual decline that followed.

A common pattern emerged over time. Its common features were:

? The hollowing out of talent. As a new private sector entrant could pay very high salaries, which the public sector was not free to match, it was able to choose and employ more talented and competent persons at senior levels. This impoverished public sector undertakings of their most valuable asset, human resources, which had been nurtured over time and at considerable cost. Overnight, a formidable lean private firm emerged to compete with the incumbent, which was not free to downsize to cut costs.

? While formally giving more autonomy, finance, audit, and vigilance functions in the public sector were progressively made to mirror what was happening in government. This created a dysfunctional, cautious, risk-averse management culture, with a declining ability to act commercially with speed and dexterity. To illustrate, major procurement decisions for anything new, which was not repetitive, moved at a snail's pace when technology was evolving rapidly in the world. Procurement often became a game of snakes and ladders, with retendering mandated in the case of a single bid, or to play it safe in cases of complaints or complexity.

? Capture of decision-making in the ministries at the behest of new private entrants helped them grow at the cost of the government's own enterprise. To illustrate, private banking entrants had no obligation to open branches to serve communities with lower incomes. They have succeeded in taking the business of the wealthy and are highly profitable while public sector banks have experienced a relative decline.

The cumulative impact on the economy has been huge. Air India is a good example. Profitable routes and landing rights were given to other airlines by the government. It began to accumulate losses and became so sick that government felt that it had no option but to privatise. The Tatas took it back for emotional reasons as they had created it as a globally admired airline in the 1950s, before the government took it over.

The financial condition of the airline was so bleak that the Tatas bid only Rs 18,000 crore. They paid Rs 2,700 crore in cash and took over Rs 15, 300 crore of the airline's debt. The government had to retain the rest of the debt of over Rs 46,000 crore, an unprecedented but unavoidable decision. The Tatas are still struggling to turn around the airline, which is losing money.

Much more than financial costs, the far bigger loss has been in opportunities foregone. To illustrate, Bharat Heavy Electricals Limited (BHEL) was the best power equipment manufacturer in the global south. Instead of growing into a leading global supplier of thermal power plants with government support, it is now looking at its inevitable decline as the age of thermal power plants ends.

It had the potential to diversify and become a leading manufacturer of solar panels, railway engines, and even jet engines. It had the money to buy European companies facing decline but could not even contemplate such decisions while the Chinese were systematically buying such companies. Then BHEL took World Bank loans for transmission and accepted their international competitive bidding guidelines, when we as a country were not short of money or foreign exchange. As a result, BHEL could not become a manufacturer of high-voltage 700 kV and high-voltage direct current (HVDC) lines, where the domestic market is now fully with multinational corporations (MNCs).

The contrast with China is telling. Starting from a weak position, China has been taking clear strategic decisions with the aim of making their efficient public sector enterprises global champions. Huawei is the best example. They have, in parallel, closed a very large number of inefficient enterprises. In the Fortune list of top 500 companies for 2025, there were 130 Chinese companies, 91 of them public sector enterprises.

3. Winding up Development Finance

In the pre-reform era, our development financial institutions (DFIs), supported by the government, provided long-term financing for large, capital-intensive, industrial investments through the Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI). The advice of the World Bank that these institutions were no longer needed after the reforms was accepted in the early 1990s. The flow of concessional financing from the Reserve Bank of India (RBI) to them ended and they had to became banks.

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Long-term debt naturally became a problem in the years that followed. The solution was supposed to emerge from a long-term bond market, as in the US. The government and the RBI, despite good intentions, were unable to nurture such a market.

In the first decade of this century there was broad acceptance that a mistake had been made and development financial institutions were a necessity. But to fulfil its objectives, development finance needs implicit and explicit support from the government, depending on the circumstances and the need. New institutions such as the Infrastructure Development Finance Corporation (IDFC) in 1997 and the India Infrastructure Finance Corporation (IIFCL) were created in 1997 and 2006 respectively.

But they had difficulty in living up to the high expectations with which they were set up because they had to raise money in the market on their own and discharge their responsibilities without government backing-something that DFIs need. The problem of long-term development finance persisted.

In a fresh start in 2015, a National Investment and Infrastructure Fund was set up. Then the National Bank for Financing Infrastructure and Development (NaBFID) was created by legislation in 2021, marking the "return of DFIs in the country after decades", according to its website.

It is worth noting that the Japanese, and now the Chinese, give long-term tied project loans at very low interest rates to get orders and business for their firms. Our Delhi metro, the Delhi-Mumbai freight corridor, and the bullet train are good examples. In the absence of government support, our Export-Import (EXIM) Bank has been unable to find resources to finance major projects in Africa. These include large mining projects and related highway, railway, and port development, as well as power plants.

It is useful to look at the experience and outcomes of major policy decisions, draw the right lessons without being doctrinaire, and learn how to make better and more pragmatic policy choices and course corrections. The key lesson is that we should not be prisoners of any economic mantra, whether of the free market or the state, and should craft our policies based on our own realities and what will work best in our circumstances.

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