Interview with Business Standard

Rakesh Mohan

By

Asit Mishra

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Q: What was the rationale for the licence-permit raj before 1991, and was it in sync with what was happening around the world?

There was a clear view after independence, in India and elsewhere and generally in the 1950s and 60s, in the global post-colonial environment, that we had to break off the shackles of colonialism and increase our growth rate. In the 50 to 100 years before independence, our per capita income growth rate was near zero, and the savings-investment rate was around 10-12 per cent. To attain a higher growth rate, you had to increase savings and investment. So, there was an agreement that we had to do some kind of planned development. Sitting in the 1950s, the successful example available was of planning in the Soviet Union, which had attained higher growth through it, relative to their past. It was also higher than what then developed countries had experienced during their long development phase. The USA, World Bank — everyone at the time advocated setting up planning commissions in almost every developing country. The analogy available today is that of the high growth period of East and Southeast Asian countries, which other countries now seek to emulate.

One difference in our case, which I have not seen elsewhere, is the invention of the licence-permit raj. To set up an industry, in as large a country as India, you had to go to the central government to get a licence. In the Soviet Union and China, all industry was in the public sector, so the question of the private sector setting up an industry didn't arise — but we were a mixed economy. Trade restrictions and import substitution were common everywhere. They were seen as measures against the past ills wrought by colonialism. We had been suppliers of raw materials to the colonial centre which used them made the final goods that they exported to us. What people forget is that this was also the era of fixed exchange rates under the IMF, until the 1970s. When exchange rates don't adjust, the only adjustment available is tariffs or trade controls.

I investigated the origin of the licence-permit system when I was Economic Advisor in the Industry Ministry, before the 1991 reforms. What I found was that its origin was not socialism — it was the Defence of India Act of 1939, a response to the Second World War. All the controls on imports, foreign exchange, industrial permits, capital issues, capital flows, came through that. And in the three years right after independence, 1948 to 1951, all that machinery was re-enacted, as laws, culminating in the Industrial Development and Regulation Act of 1951.

Public sector reservation, which came in 1956, had three backdrops: the licence-permit apparatus, the UK's post-war nationalisation of coal, electricity and gas under the Labour government, and the general view that with such a low savings rate, the private sector lacked resources, so the government had to squeeze resources through taxes and invest itself.

Two further inventions were entirely our own: small-scale industry reservation, which came in the 1970s and exists nowhere else in the world, and the Urban Land Ceiling Act of 1975, which also has no real parallel — I checked this myself as a World Bank intern in 1973-74 and found only one small example, in Bolivia!

Q: The 1991 reforms were triggered by the balance-of-payments crisis. What prompted the licence-permit regime to be abolished simultaneously?

What is interesting is that right through the 1960s, ‘70s and into the early ‘80s, there was a whole succession of government committees on industrial licensing. Each one showed how badly it was working — and each one concluded that we had to tighten control to make it work better!

What led to 1991 was that the world had moved on: East and Southeast Asia had broken through in the 1970s and ‘80s, keeping planning but opening their economies and pushing export promotion. Discussion had started here too, through committees — the Abid Hussain Committee on trade, the Arjun Sengupta Committee public sector reforms, the L.K. Jha Committee on Economic Administration Reforms. Apart from the crisis itself, three other things happened: the Soviet Union broke down, there was a demonstration effect from Asia's success, and the Kuwait war pushed up oil prices at a time when we already had a huge fiscal expansion from the late 80s. All of this combined into a real crisis in 1991.

What most people don't know is that in 1990, in the Ministry of Industry — where I was Economic Advisor and A.N. Varma was Industry Secretary — we had, entirely Suo moto, prepared a full industrial policy reform paper. This was approved by the cabinet, and laid before Parliament under the V.P. Singh government, which as the first non-Congress government in a long time and was keen to break from the licence-permit legacy. Ajit Singh, the Industry Minister, was very receptive. Then the government fell — and it was on that very industrial policy that Chandra Shekhar had rebelled, apart from political reasons. Yet when Chandra Shekhar became PM and took the industry portfolio himself, he came personally to the Ministry and told us to continue our work regardless of his earlier rebellion.

So, when Narasimha Rao came to power and Manmohan Singh became Finance Minister, the document already existed. Chandra Shekhar had earlier brought Manmohan Singh into the PMO as Economic Advisor (with cabinet rank) on his return from the South Commission. He had knowledge of the reform paper, and knew me personally, having called me back from the World Bank years earlier when he was Deputy Chairman of the Planning Commission in the Rajiv Gandhi government. A.N. Varma, who owned the document, became Principal Secretary to the PM. That whole constellation — the ready document ready, Varma at the PMO, Manmohan Singh at Finance — is why the reforms could be done within six weeks, by July 24, 1991. The industrial policy reform itself had nothing to do with the World Bank or IMF; it was entirely our own.

Q: In hindsight, what were the biggest achievements, and then the biggest failures, of the 1991 reforms?

On the achievements side: the opening of the economy demonstrated confidence that we could compete. Crucially, Manmohan Singh and Rangarajan did an ex-ante devaluation, which meant the huge tariff reform that followed — average tariffs came down from about 110 per cent in 1991 to less than 15 % over the next 15 years — could happen without much damage to industry. Then came the domestic deregulation, which released far more entrepreneurial energy than even we in government expected. We also removed controls on foreign technology imports, released most areas that had been reserved for the public sector in areas like steel; abolished the MRTP Act (which had barred large companies from entering many sectors); abolished the Directorate General of Technical Development (DGTD) which was the nerve centre of most industrial controls; abolished the Cement Controller; the Controller of Capital Issues, the finance ministry official who used to control every IPO and its pricing; abolished the Chief Controller of Imports and Exports, replacing it with the Director General of Foreign Trade (DGFT). Most import controls were lifted in the following years. Over the 1990s we also built institutions of economic governance — SEBI replacing the Controller of Capital Issues, TRAI for telecom, TAMP for tariff regulation for major ports — and later, civil aviation deregulation and private entry into power. MRTP was replaced by a modern competition law, governed by the newly formed Competition Commission of India (CCI). These reform directions have continued, without political argument, across every government since. The whole tax structure was reformed over time: personal income tax and corporate tax rates have been greatly reduced and rationalised; the very complex indirect tax regime has been greatly simplified and rationalises, first through the institution of MODVAT, which finally gave way to GST.

Now the disappointments. The biggest is that industrial growth has simply tracked overall GDP growth, and not led it, as we had expected. So, manufacturing's share of the economy has not risen at all — even though development experience elsewhere says it should rise at this stage. The single biggest omission was the failure to de-reserve small-scale industry until around 2010 — twenty years too late. It was bizarre: even as we cut tariffs and let in imports of the very items reserved for small industry, we continued to deny our own manufacturers the right to produce them at scale. This mattered enormously because labour-intensive, low-technology industries were exactly where Japan, Korea, Taiwan, and later China succeeded first — and we denied ourselves that path.

Tied to this is the failure of labour reform. In 1992-94, we designed something called the National Renewal Fund, approved by Cabinet in 1993, funded partly through a World Bank loan I personally negotiated. The idea was that every worker laid off would get 45 days' pay per year worked from the Fund, financed by a permanent 4 per cent-of-wages contribution forever, split between government, employer and employees. We had calculated that this would become self-sustaining forever if there were no withdrawals for the initial ten years, during which it would have to be funded by the government. We piloted it with the Textile Labour Association in Ahmedabad — sick mills would shut, workers would be compensated, owners would get nothing, and the land would be redeveloped, funding the whole scheme. The union agreed. And then — I still don't know why — the whole thing died within the Finance Ministry even though the original idea had been floated in the Dr Manmohan Singh's initial path breaking budget speech. I was so angry I took a year's leave and went off to Maastricht to study European industrial policy! We are still suffering the consequences: without labour flexibility, employers rely heavily on contract labour instead — some industries are up to 100 per cent contract labour — and there is no incentive to train workers whose tenure is uncertain. Had we implemented this scheme overall labour reform would have become much easier, and labour-intensive industries and exports could have boomed.

A related, less discussed failure is R&D. In 35 years, R&D as a share of GDP has stayed flat at about 0.7 per cent, less than half of it from the private sector — even though rising domestic and external competition should have pushed firms to innovate. It remains a puzzle to me.

Q: People say India has missed the manufacturing and export bus. Do you agree?

No. Southeast Asia and China succeeded because developed-country demand was rising during their period of high growth, and they could fuel their rapid industrial development by fulfilling this demand. Now that demand is slowing as those economies age. What we've missed, because of a colonial mindset, is looking East. China plus ASEAN plus Japan, Korea and South Asia have over 4 billion people, still urbanising, with rising incomes — that's where the demand is now. We made a major error not signing RCEP and haven't even applied to CPTPP. The fear that China will "overrun" us ignores that we already import $130-140 billion from China against exports of about $20 billion — that gap won't suddenly widen from an FTA. The real question is why an Indian company can't make what China makes: Chinese manufacturing wages are now three to four times ours, yet we still can't compete on a basic cotton shirt. That's not a wage problem; it's a management and efficiency problem. On security concerns with China, I have no argument — we must remain vigilant and do whatever is necessary to ensure our territorial security. This cannot be compromised. But economically we only hurt ourselves by restricting our economic relations with China, and restricting investment in areas like labour-intensive manufacturing. We have demonstrated our self-confidence by entering into FTAs with the UK, EU and other groupings. We could reap much greater fruit from these FTAs if we could become fully part of the Asian supply chain enabled by RCEP and/or CPTPP.

Q: What about PLI (Production-Linked Incentive) schemes?

I don't fully agree with them as designed. Telling industry "You suffer from many handicaps, so I'll give you money" is itself a confidence issue and it leads to licence-raj of another kind. If government itself says that Indian industry is handicapped, they believe it, and then every sector wants subsidies. I'd support PLI fully if it is done to support technological advancement of Indian industry across the board. It could be tied to conditions such as enhanced R&D spending, greater technical development, continuous training of labour, which would also, for instance, reduce reliance on contract labour. Otherwise it's just free money. I would also prefer such incentives designed to strengthen Indian companies, rather than to large foreign companies.

Q: Do we need a new industrial policy?

No, but industrial and trade policy need to be in sync rather than requiring a grand new framework. What we need is evidence-based, problem-specific intervention. Urban land is too expensive, so it's difficult to set up industries in towns and cities, thereby foregoing essential agglomeration economies. There may also be urban regulation issues preventing high-rise factories — in Bangladesh, for instance, garment factories run have 15-20 floors, with crèches for children of their women workers built in. We should be asking, sector by sector, what the actual bottleneck is, the same way we'd approach trade facilitation — much more directed, much more evidence-based, rather than one big sweeping policy.

Q: Does it mean our industrial subsidies are misdirected?

Absolutely. They should go toward labour-intensive sectors and toward giving ordinary trades — carpenters, plumbers — better tools and training, not to the world's biggest companies. A carpenter here is entirely self-trained, from a father or an uncle, working out of a small bag of tools; a plumber in the US comes with a belt of fifteen tools. Even construction workers' children are sitting on site with nothing to do while their parents work — those are all skills that could be upgraded for the modern economy, and we haven't thought about it that way.

There is concern of duopoly in many sectors in the economy.

It isn't good for the economy, and we do need to encourage other large players. But it follows from strong network effects inherent to those industries — telecom is the same story — so competition policy must actively work at encouraging entrants, even though the underlying industry structure pushes toward concentration. That said, infrastructure built through private concessions — airports, ports — has genuinely worked well: Delhi, Mumbai and Bangalore airports are as good as or better than most in the world, which shows the model itself isn't the problem.

Q: Are you happy with the pace and quality of urbanisation?

This is the area that we've paid least attention to. Unlike China, which gives cheap or free land around cities to build industry and housing, we haven't; and basic urban governance — transport, sanitation, walkable streets, urban health centres — remains poor even as more people urbanise. Better cities are what make labour want to come, stay, and become more productive. It connects back to everything else: without liveable, well-governed cities, the rest of the growth story runs into a wall. Consequently, contrary to popular belief, Indian urbanisation has been slowing down over the last couple of decades.