

# Development Discussion Papers

## **Strengthening India's Strategy for Economic Growth**

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## Strengthening India's Strategy for Economic Growth

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### Abstract

We suggest a *three-pronged approach* to an enhanced growth strategy for India. The first prong is export-led growth. Here the lessons of China are particularly instructive, since China achieved in the past fifteen years the kind of export-led growth that India could have achieved, but failed to do so, because of poor public policies. The second prong is rural improvement, especially in the vast population of the Gangetic valley. India needs a specific strategy to bring modern economic growth to rural India, through a concerted campaign of infrastructure upgrading and appropriate re-design of state policy. The third prong is the maintenance of macroeconomic stability, to avoid the kind of crisis that pushed East Asia into economic collapse. The macroeconomic stakes have obviously been raised in the past year. India's macroeconomic policies will be under scrutiny as perhaps never before following the onset of the East Asian financial crisis.

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## Strengthening India's Strategy for Economic Growth

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India has great potential to achieve rapid economic growth in the next twenty years. In fact, it is in many ways poised to match or even exceed China's overall growth performance. This is partly because China is likely to slow down compared with its own rapid rates of economic growth during the past decade, and partly because India is likely to speed up.<sup>1</sup> Yet sustaining high economic growth is not easy. Rapid growth can easily be derailed, as the East Asian crisis has reminded us yet again. For India, one key requirement to achieve sustained high growth is an appropriate growth strategy, one that recognizes India's unique situation in the world economy, and that best positions India in the emerging global division of labor.

Our analysis of India's situation suggests a *three-pronged approach* to an enhanced growth strategy. The first prong is export-led growth. Here the lessons of China are particularly instructive, since China achieved in the past fifteen years the kind of export-led growth that India could have achieved, but has so far failed to achieve because of poor public policies. The second prong is rural improvement, especially in the vast population of the Gangetic valley. India needs a specific strategy to bring modern economic growth to rural India, through a concerted campaign of infrastructure upgrading and appropriate re-design of state policy. The third prong is the maintenance of macroeconomic stability, to avoid the kind of crisis that pushed East Asia into economic collapse. The macroeconomic stakes have obviously been raised in the past year. India's macroeconomic policies will be under scrutiny as perhaps never before following the onset of the East Asian financial crisis.

We begin to lay out our three-pronged approach by first taking a look at the results of a recent global survey of business attitudes, the **1998 Global Competitiveness Report of the World Economic Forum**, in which India is ranked relative to 52 other countries. These business surveys are revealing: they lay bare in a realistic way India's strengths and weaknesses for future growth, and they help to delineate the priorities in the period ahead. After reviewing the survey results, we then proceed to analyze each strand of our three-pronged approach.

### *India's Business Environment: Comparative Survey Results*

The World Economic Forum, in conjunction with the Harvard Institute for International Development, carries out an annual survey of business leaders in 53 countries of the world, to explore the comparative business environments of the major economies. The various economies

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<sup>1</sup> In *Economic Growth in Asia*, a background paper for the Asian Development Bank's 1997 *Emerging Asia* study, co-authors Steven Radelet, Jeffrey Sachs, and Jong-Wha Lee estimate that India can achieve a sustained growth of 5.5 percent per capita during the period 1995-2025, compared with just 2.2 percent during the period 1965-95. The rise in projected growth is the result of improved policies (especially deregulation and opening of the economy), and favorable demographic trends, including falling fertility rates, a rising proportion of the population in the working ages, and rising life expectancy. Readers will of course appreciate that such long-term forecasts are purely indicative, and fraught with large uncertainties.

are ranked on eight broad dimensions of the economic environment; based on dozens of detailed questions each scored on a scale of 1 (bad) to 7 (favorable). The eight dimensions are: openness of the economy to international markets; fiscal policy management; financial markets; quality of infrastructure; level of technology; performance of enterprise management; functioning of labor markets; quality of public institutions. The survey results are combined with other quantitative data (e.g. objective measures of infrastructure, saving rates, financial market depth, educational attainment, etc.) to produce an overall assessment of international competitiveness, which the study defines as the ability to achieve rapid growth over the medium term.

In the 1998 Global Competitiveness Report, India ranks a relatively disappointing 50<sup>th</sup> out of 53 countries in overall competitiveness, little changed from the rank of 49<sup>th</sup> in the 1997 report. Table 1 summarizes several sub-categories in which India stands out either as especially strong, or as especially weak. Regarding areas of strength, business respondents note four areas. First, the Indian stock market is seen as an important avenue for new enterprise financing, in contrast with many other countries with smaller and less effective stock exchanges. Second, India is regarded as having strong science and engineering capabilities, with a large pool of competent scientists and engineers, and strong education in basic science and math. Third, India is highly ranked for its relatively strong business schools and its vast labor force. Fourth, India is given high marks for judicial independence, including the government's compliance with court orders and the ability to challenge government decisions in court.

There are, alas, many more areas of weakness than strength, and these areas of weakness point implicitly to the most urgent points of the reform agenda. First, despite the importance of the stock exchange, India's financial markets were generally viewed as deficient. The overall sophistication of the financial system is regarded as low, a danger point in view of the East Asian financial crisis. Venture capital, which is key to the start up of new industries, is also viewed as particularly weak. Second, public administration is given especially low marks, in several notable areas: administrative regulations are viewed as strongly constraining business activities (the license raj continues); state subsidies are viewed as inappropriately protecting old industries; the civil service is viewed as unduly politicized; and tax evasion is judged to be rampant. Third, and perhaps most strikingly, the quality of infrastructure is judged to be abysmal. This was true in all areas: roads, ports, power, and telecomms. India was ranked 53<sup>rd</sup> out of 53 countries in overall infrastructure. Fourth, the research and development nexus is judged to be very weak, with little collaboration between business and academia, and little success in commercializing or adopting new technologies. This poor outcome is ironic in view of the praise for India's science and engineering prowess. Fifth, labor markets are judged to be ineffective, perhaps the most ineffective in the world. Business respondents not surprisingly point to the severe restrictions on hiring and firing. Finally, business respondents point to the high prevalence of irregular payments, i.e. bribes, connected with permits and licenses.

If we summarize, India shows the advantages of a vast labor force with a skilled engineering and scientific community. It also shows, however, deficiency in both the hard infrastructure, such as roads, ports, and power, as well as the soft infrastructure of public administration, labor market practices, and financial market depth. We now turn to our three-pronged approach to high and sustained growth, seeking to turn India's advantages to best use,

while overcoming the most extreme liabilities. However, we would like to stress that we are not trying to be comprehensive, for example, we don't discuss social policy, but rather attempt to highlight some of the missing aspects of current policymaking.

### *The first prong: export-led growth*

If there has been one lesson of recent development experience, it is that rapid overall economic growth depends on rapid export growth. The strategy of inward-looking development, in which exports would be unimportant because imports would be held to a minimum, proved to be ineffective in all countries in the world, even the most populous such as Brazil, China, India, and the former Soviet Union.

Inward-looking development was based on the idea that a large country such as India could develop its own capital goods sectors and intermediate goods sectors so that it would not have to rely on world markets for imports of capital and intermediate products (by intermediate products we refer of course to manufactured and semi-manufactured goods used as inputs for final products). There was a little bit of truth to this proposition, in that India and the other large economies were more equipped to develop domestic capital goods industries than much smaller countries, but still the idea failed miserably. The failure, as is now appreciated, came from various directions. First, the vast proportion of new technologies in the world inevitably had to be imported. There was no way for any single country, especially a developing country, to rely on its own activities for technological advance. Autarkic strategies inevitably cut the economy off from technological progress in the rest of the world. Second, even a large domestic market such as India's or Brazil's was not large enough to spur strong internal competition in the absence of vigorous competition from abroad. Protected home markets turned monopolistic or oligopolistic, because the minimum efficient scale of production often represented a large proportion of the home market. Domestic enterprises, unchallenged by foreign competition, turned lazy and relied on state largess rather than their own efforts to survive.

The bottom line is that all economies, even the giants such as China and India, need to import vast amounts of capital goods, technology, and intermediate products if they are to achieve technological efficiency and dynamism. But these vast imports must be paid for somehow. For a while a country can try to rely on debt finance, but as India found in 1991, the external debt route is eventually precarious. Even reliance on foreign direct investment (FDI) rather than foreign borrowing is precarious unless the FDI is accompanied by rapid export growth, since the continued inflow of FDI is motivated by an expected future stream of repatriated profits. That profit stream must have as its counterpart a rise in future exports, or else the repatriated profits will come in the form of highly depreciated domestic currency as foreign investors attempt to repatriate domestic currency earnings.

The result is an imperative to export. Countries must export to import. And they must import to grow, since they require massive and continuing import of capital and intermediate goods that are only available at reasonable cost from abroad. It is not surprising, therefore, that all fast-growing economies in the developing world are also export success stories.

Table 2 shows the fundamental difference in India's and China's economic performance in the past two decades. China achieved rapid overall growth on the basis of rapid export growth, while India managed only moderate success in exports and moderate overall growth. In China, exports of goods and services went from 6 percent of GDP in 1980 to 21 percent of GDP in 1995. In India, by contrast, the same ratio went from 7 percent of GDP to 12 percent. Yes, there has been some opening of the economy, but the results have been much more modest in terms of export-led growth. In dollar terms, the comparison is even more striking. China's merchandise exports (excluding services) rose from \$18.1 billion in 1980 to \$148.8 billion in 1995. India's merchandise exports rose from \$8.6 billion to a mere \$30.8 billion. China exported \$123 per person in 1995, while India managed only \$33 per person. Nothing more clearly accounts for the difference in growth performance of the two countries — 8.3 percent average annual growth per capita in China during 1985-95 compared with just 3.2 percent in India — than the difference in export growth.

India could have achieved what China has achieved in export growth, but India failed in basic policy strategy. China's export growth was based on core policy and economic management decisions carried out beginning in the early 1980s. These can be summarized as follows. First, China understood that the root of export growth would be diversification away from traditional sectors, especially raw materials, into non-traditional sectors, especially manufactured goods. But China lacked the technology by itself to be competitive in manufactured goods. Therefore, it invited in foreign direct investors to provide the capital and the expertise to achieve export competitiveness in a wide range of sectors, including electronics, apparel, plastic toys, stuffed animals, ceramics, and many other labor-intensive sectors. In each sector, the key was to link foreign investor capital and expertise with a large and low-cost Chinese labor force. The foreign investors brought in the product design, specialized machine tools and capital goods, key intermediate products, and knowledge of world marketing channels. The Chinese assured these foreign investors certain key conditions for profitability, such as low taxes, reliable infrastructure, physical security, adequate power, decent logistics for the import and export of goods, and so forth.

At the center of China's export strategy were the special economic zones (SEZs) in which favorable export conditions were assured. These SEZs, along China's coastline, were designed to give foreign investors and domestic enterprises favorable conditions for rapid export promotion. All key aspects of the export environment were secured. Exporters, for example, were allowed to import intermediate products and capital goods duty free. They were given generous tax holidays. The exporters were assured decent physical infrastructure, often through the provision of land, power, physical security, and transport to the ports, within specially created industrial parks.

India too has experimented with special zones, mainly export processing zones (EPZs), but one has to say that India's approach to export zones has been one of relative neglect rather than support. While China's five main special economic zones (Shenzen, Zhuhai, Santou, Xiamen, Hainan) exported \$26 billion in 1994, roughly 22 percent of the national total, India's main export processing zones, or EPZs (Kandla, Santacruz, Noida, Madras, Cochin, and Falta),

managed a tiny fraction of that, both in absolute levels and as a proportion of total Indian exports. India's EPZs have not performed as well as China's SEZs for many reasons, including:

- limited scale and overcrowding of the EPZs
- insufficient logistical links with airports and seaports
- poor infrastructure in areas surrounding the zones (e.g. unpaved roads and poor physical security)
- government ambivalence and red-tape regarding inward foreign direct investment
- unclear incentive packages governing inward investment
- lack of interest and authority of state and local governments, and the private sector, compared with the central government, in the design, set-up, and functioning of the zones.

In China, the major responsibility for the SEZs rests with local and provincial governments, whereas in India, the responsibilities remain heavily with Delhi. Under the present circumstances, many state governments have actually been averse to the idea of EPZs in their state.

India's export environment suffers from several other institutional weaknesses. India's labor laws, noted unfavorably in the 1998 Global Competitiveness Report, make it very costly to fire workers in enterprises of more than 100 workers. The result is that formal-sector firms (those that are registered and that pay their taxes) are loath to take on new employment, and the vast majority of India's employment is informal, in small, tax-evading, inefficient enterprises. Equally remarkably, India's legislation continues to restrict the entry of large firms, or the growth of small firms into large firms, in several areas of potential comparative advantage. Thus, garments, toys, shoes and leather products continue to be reserved, to a varying extent, for small-scale producers. Such restrictions virtually assure China's dominance in these sectors compared with India. India's tax and tariff structures similarly remain anti-export biased. India's high overall tariff rates, especially tariffs on intermediate products that are used by exporters, impose a heavy indirect tax on export competitiveness. Furthermore, the union budget for 1998-99 has imposed an additional non-modifiable levy of 8 percent on imports<sup>2</sup>. There are duty drawback systems to reduce this anti-export bias, but such programs are administratively burdensome and often too costly to use effectively. Finally, the regulatory attitude to foreign direct investors, who could be the fuel for India's export drive, continues to be ambivalent. The government promotes FDI on the one hand, but then maintains regulations against full foreign ownership, or insists on lengthy approval processes, on the other hand.

The proper elements of the first-prong of a revised growth strategy – rapid export-growth – should now be clear. Both the hardware and software of export-led growth need revamping. On the hardware side, the development of industrial parks for exports should be greatly intensified and enhanced. Private developers need the freedom to acquire urban and semi-urban land and to develop privately financed infrastructure in support of exports. The government must take urgent measures to reduce export costs, including private-sector provision of port services; zero tariff ratings on capital and intermediate goods imports used for export (based on an effective duty

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<sup>2</sup> This levy was later reduced to 4 percent. It has been imposed with a view to provide a level playing field to the domestic industry.

exemption scheme); enhanced export-oriented infrastructure, especially roads to the airports, reliable power supply, and telecommunications facilities to support export zones. Labor legislation should be revised to allow managerial flexibility in the hire and dismissal of workers in export-oriented sectors. The reservation of labor-intensive sectors to small-scale enterprises should simply be scrapped. This is the kiss of death to effective international competitiveness in labor-intensive exports. The government should actively encourage inward investment in export-oriented sectors, allowing 100 percent foreign ownership without administrative interference, and with the provision of generous tax holidays as necessary to attract internationally mobile capital from other locations.

We must mention, in addition to labor-intensive manufacturing exports, India's clear and growing capacity in service-sector exports based on information technology (IT). The Global Competitiveness Report confirmed the high international opinion of India's engineering and scientific capacities, the products in part of India's long-term investments in the Indian Institute of Technology (IIT). India's prowess has been most evident in the software sector, where world-class programmers operate in technology centers such as Bangalore, Delhi, Mumbai, and Chennai. Operating through satellite links, Indian programmers are providing IT support to U.S. and European firms in areas ranging from software development and maintenance, back-office operations, data transcription and transmission, telemarketing, and other related areas. Software exports have been growing around 50 percent per year in recent years, reaching an estimated \$1.75 billion in fiscal 1997-98, or roughly 5 percent of merchandise exports, a proportion that is likely to rise significantly in the years ahead (by some estimates to around 10 percent in the year 2000). Around 10 percent of Microsoft's worldwide programmer workforce is Indian.

Here, as in labor-intensive exports, Indian government policy could do much more to spur export growth. On the plus side has been the government's long-term commitment to the IIT. More recently has been the government's support for Software Technology Parks (STPs), in Bangalore, Pune, and other cities, which are the IT-industry equivalent of the EPZs in manufacturing industries. There are serious negatives, however. The continuing state monopoly of VSNL in international telephony as well as in internet provision within the Indian market seriously raise the costs of telephone and IT services in India, and will do considerable damage in India's international competitiveness in the IT sector unless rectified. India's telephone density (a point we re-visit later on) is abysmally low, at around 1.3 per hundred in 1995, compared with around 62.6 per hundred in the United States. International telephone calls originating in India are among the highest in the world, largely due to lack of competition, a point also reported by business executives in the GCR survey (see Table 1). Physical infrastructure for data transmission within India (e.g. fiber optic cables) remain underdeveloped despite some recent progress. Restrictive policies on FDI of the sort already discussed have kept international chip makers out of India, and have indirectly raised the prices of PCs in the Indian market. The lack of enforcement of intellectual property laws most likely inhibits inward investments in IT sectors. All of these problems are remediable through further deregulation of telecomms and FDI, as well as effective law enforcement in a more liberalized and competitive environment. India's strengths in IT will be an important bulwark of export growth for many years to come assuming that the administrative barriers are overcome.



### *The second prong: rural improvement*

There is no doubt that geography heavily influences economic performance. In China, for example, the real economic success has come in the coastal provinces, which can take advantage of export-led growth. The interior has done much less well. GDP growth in the hinterland has lagged behind the coastal states by several percentage points per year. The discrepancy in performance is leading inevitably to massive internal migration, with perhaps 100 million or more Chinese engaged in rural to urban migration, much of which is from the interior of China to the coastal states.

In India as well, it is likely that a successful growth strategy will also result in differing performance among India's very disparate regions. Not all regions, for example, will be able to take advantage of export-led growth to the same extent. As a general matter, coastal states will have an advantage over interior states, just as in China. We might expect, therefore, that the hugely populous, mainly rural, and inward-oriented Gangetic states, especially Uttar Pradesh and Bihar, would lag behind the more outward-oriented coastal states such as Gujarat, Maharashtra, and Tamil Nadu, in export-led growth. It is too early to draw strong conclusions about relative economic performance since the start of India's market reforms at the beginning of the 1990s. Nonetheless, the early evidence is tantalizing. If we look at the rise of domestic output per capita between fiscal year 1990-91 and 1994-95 (the most recent state-level data at our disposal from CMIE), the all-India figure in rupees went up from Rs. 5,073 to Rs. 8,399, a rise of 65.5 percent. In Uttar Pradesh, the increase was 52.3 percent; in Bihar, 25.9 percent; in Gujarat, 78.8 percent; in Maharashtra, 78.0 percent; and in Tamil Nadu, 76.3 percent.

Fortunately, there is a vast amount of economic reform that can be carried out to improve conditions in rural India, especially in the Gangetic valley. There is no reason for expensive and counter-productive charity for these great northern states, and still less any case for holding back the fast-growing coastal regions. Perhaps the key step in the Gangetic plain is to improve the most basic infrastructure so that the vast rural populations can take part in more rapid national economic growth. They will do so through increased exports to coastal states, and greatly improved productivity for local production. We should stress that while China's hinterland has lagged behind the coastal regions, *the Chinese hinterland too has enjoyed rapid economic growth.*

The 1998 GCR highlighted one of the great liabilities of India as a whole, and of rural India in particular: the disastrous state of physical infrastructure. Once again, the comparison of the Gangetic states and the others is telling. In every infrastructure dimension, the northern interior states are in dreadful condition. Per capita power consumption (in Kilowatt hours) in 1994 was 82 in Bihar and 181 in Uttar Pradesh; compared with 549 in Gujarat, 483 in Maharashtra, and 393 in Tamil Nadu. Unsurfaced roads were an astounding 62 percent of total road length in Bihar in 1994 and 45 percent in Uttar Pradesh; compared with 12 percent in Gujarat, 27 percent in Maharashtra, and 32 percent in Tamil Nadu. In telecomms, there were 3 telephone lines per 1000 people in Bihar in 1995 and 5 in Uttar Pradesh; compared with 18 in Gujarat, 29 in Maharashtra, and 17 in Tamil Nadu. Of course, these differences did not emerge in

1991, but rather have a long legacy. For example, in 1991, literacy rates in the Gangetic states lagged far behind the others: 38.4 percent in Bihar and 41.6 percent in Uttar Pradesh; compared with 61.3 percent in Gujarat, 64.9 percent in Maharashtra, and 62.7 percent in Tamil Nadu. The differences are likely to grow, however, unless adequate policy reforms are undertaken.

If one puts the matter crudely, rural India's population is getting the infrastructure that it is paying for -- in other words, almost none. Or to paraphrase an old quip from the former Soviet Union, the Indian population pretends to pay its bills, and the Indian government pretends to provide the services. This is especially true in the rural areas, where water, power, telecommunications, and roads, are generally provided without cost or at least with deep subsidy, and as a result are almost not provided at all, since both the Union government and the state governments are short of cash. Even when charges are levied on public services such as water or electricity, the bills are often unpaid.

Rural India needs a new social contract, in which there will be a reliable infrastructure supplied at commercial prices rather than given for free. The Government's commitment, both at the National and State level should be that every village will be assured at least minimal telephone service, clean water, a road to the regional market, and reliable power; but that every village will be responsible for covering the commercial costs of those services on a normal user-fee basis. Recent technological changes in each of these areas (telephony, water, road building and maintenance, and power) allow these key sectors to be organized, at least in part, on the basis of competitive, private-sector producers, who will provide the initial financing of the investments in return for a reliable stream of user charges over time.

In telephony, for example, microwave transmission (via cellular or satellite-based transmission) will allow low-cost commercial provision of telephone service to rural areas in ways not possible just a few years ago. As a result of massive worldwide deregulation and privatization of telecomms, combined with technological changes, fixed-line telephony is being overtaken by microwave and satellite telephony. Worldwide experience has shown that these services are best provided by competitive private carriers rather than a state monopoly. In power, the regulatory trick has been to separate power generation, transmission, and distribution. Generation can be provided by competitive private producers, who then sell their electricity into the common transmission grid. The grid itself must continue to be regulated by the government to ensure fair access of independent power producers.

India has so far made little progress in commercializing the key infrastructural sectors. In power, for example, most electricity continues to be a public-sector monopoly, run by state electricity boards (SEBs). The SEBs are responsible for generating and distributing power, setting tariffs, and collecting revenues. Almost all of the SEBs make losses and some are even unable to pay for coal or the power they purchase. This is due to the fact that SEBs implement social subsidy policies of state governments leading to inefficient patterns of energy consumption, and even to non-recovery of their own costs. Also, there is considerable theft of power from the distribution networks.

Power capacity will not be expanded until the SEBs are fundamentally overhauled or eliminated. Even private power projects currently are expected to sell their electricity to the SEBs as their only power purchaser, so that the bankability of private sector power projects depends fundamentally on the financial health of the SEBs. Given the huge losses they make, and the large debts they owe to the National Thermal Power Corporation (NTPC), we cannot expect substantial private sector investment in the power sector, unless state governments implement major SEB reforms.

The basic sources of trouble are clear. Since SEB electricity charges are set much below cost for the agricultural sector<sup>3</sup>, unit revenue realization from the agricultural sector in none of the SEBs covers a reasonable fraction of the unit average costs incurred by the SEBs. As a result, the SEBs make huge losses and are in financial disarray. In addition, the substantial theft from the power grid, placed around 21 percent,<sup>4</sup> make matters worse. SEBs have huge payment arrears which they owe to the NTPC - from whom they buy power. Over the years, the outstanding balances due to the NTPC from the SEBs have risen to Rs. 49.5 billion, of which Uttar Pradesh, Delhi, Bihar, and Madhya Pradesh account for the bulk of the dues. According to the revised estimates of 1996-97, in absolute terms, the commercial losses of the SEBs stood at Rs. 109 billion. The hidden subsidy for the agriculture and domestic sectors has increased from Rs. 72 billion in 1991-92 (1.2 percent of GDP) to Rs. 192 billion in 1996-97 (1.4 percent of GDP) and is projected to further go up to Rs. 215 billion in 1997-98 (1.5 percent of GDP). The state governments come to the rescue of SEBs by providing them with revenue subsidy along with capital transfers, which include loans and equity.

The present structure of tariffs in electricity, involving extensive cross subsidization for agriculture, has imposed disproportionate burden on customers that actually pay their bills. This in turn has led to a decline in consumption of power by high-tension users, with further serious financial consequences for the SEBs. With the present level of technical and organizational performance, most SEBs are losing about 50 paise to 1 rupee for every KWHR of power sold. There is hardly any cap on operation and maintenance (O&M) expenses and the SEBs seriously lack managerial direction. Tariff reform, i.e. higher prices actually collected on electricity use, is the first order of business. Privatization of power generation, and the conversion of SEBs from electricity providers to market regulators would come next.

The availability of infrastructure services, such as power, telecom, and roads in rural India can significantly help develop rural industry in India. Lessons from China are once again relevant here, especially the boom in China's Township and Village Enterprises (TVEs). These are a mix of collective and privately owned enterprises in rural China. The TVEs operate outside of the state plan, and largely without funds from state banks. Therefore, they are subject to quite rigorous market competition and hard budget constraints. China's experience demonstrates that

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<sup>3</sup> Agricultural and industrial sectors accounted for 28 and 36 percent respectively of SEB electricity sale in 1995-96. While the tariff charged for the agricultural sector was around one-fourth of a rupee per kWh, that for the industrial sector was over two rupees per kWh.

<sup>4</sup> This is much higher when compared to the international average of less than 10 percent for the developed countries.

establishment of small townships to link the countryside with urban areas is a successful strategic policy for development. This will facilitate the transportation of goods between rural and urban areas, and rising income and productivity in rural areas. As for urban enterprises, this link would open up a bigger market and help in diversification or restructuring which is currently under constraint due to area limitations.

Rural enterprises can also compete in the cities with their products having the advantage of relatively low labor costs. In this way, they will help absorb surplus labor locally, thereby resulting in less rural-to-urban migration (population in urban areas, and especially in larger cities, such as Calcutta, Chennai, Delhi, and Mumbai have reached levels far above what these cities can efficiently accommodate given their capacity to provide urban infrastructure services). Urban enterprises will also provide more employment opportunities since they would have a larger market. In addition, the linkage will benefit the rural industries via flow of technology and information.

### *Third Prong: Macroeconomic Stability*

The Asian crisis highlights the vulnerability of even the most successful economies to macroeconomic instability. Perhaps it is even more accurate to say that the most successful economies run the risk of a special kind of macroeconomic stability, a kind of crisis of success. While the East Asian crisis is sometimes characterized in the world press as a massive failure of Asian capitalism, it is more accurate to say that it is a failure of global capitalism to provide for a smooth and reliable flow of capital from the capital-rich to the capital-poor regions. And that failure is most acute in fast-growing economies. India, therefore, must combine its growth strategy with a special attention to the preservation of macroeconomic stability.

To understand the macroeconomic policy challenges facing India, we must first understand the East Asian crisis. The East Asian countries that are now in crisis are suffering from an abrupt reversal of capital flows that began in mid-1997. Consider the five hardest hit countries: Indonesia, Korea, Malaysia, the Philippines, and Thailand. These five countries received \$230 billion of net private capital flows during the period 1994-96. In 1996 alone, they received \$93 billion of net flows. When the Thai baht was devalued in mid-1997, however, the euphoria in world markets that had led to the massive inflows, suddenly turned to panic and massive capital outflows. An estimated \$12 billion of net outflows occurred in 1997 as a whole, all concentrated in the second half of the year. The net reversal of flows of \$105 billion represented approximately 11 percent of the pre-crisis GDPs of the five countries, in other words, an absolutely massive and sudden shock.

Much of the reason for the panic resulted from the form of the original lending. A huge proportion of the capital inflow came in the form of short-term loans from international banks. The international banking system had lent the five Asian countries roughly \$230 billion in total loans as of mid-1997, of which around \$150 billion had a maturity of under one year. These short-term debts were larger than the combined foreign exchange reserves of the five countries,

which totaled approximately \$120 billion as of mid-1997. Because the short-term liabilities exceeded the short-term assets, the Asian-5 countries were subject to a financial panic. Each investor posed himself a question. Suppose that all the other investors decide to withdraw their short-term loans. Will there be enough foreign exchange available to make good on my loan as well when it comes due? Clearly, if each investor comes to believe that *all the other* investors will withdraw their loans, it becomes rational to call in one's own loans as well, indeed ahead of the other creditors. A rational panic ensues, in which every investor scrambles to be the first one out of the country. The Thai baht devaluation provided the impetus for the panic.

Interestingly, certain kinds of money fled, while other kinds did not. This gives guidance for macroeconomic policy management. The hottest money was short-term loans from international banks. Indeed, the reversal of short-term bank lending constituted a very large proportion of the overall \$105 billion reversal in capital flows. The banks put in \$56 billion in net lending in 1996, and then withdrew an estimated \$21 billion in net loans in 1997, for a swing of \$77 billion (or 73 percent of the overall reversal). Portfolio equity investors (e.g. country equity funds) also reversed gear, to the extent of \$24 billion. Foreign direct investors, by contrast, were very stable. It is estimated that net foreign direct investment remained roughly unchanged between 1996 and 1997, at around \$7 billion in net flows each year.

Here are some of the pertinent lessons for macroeconomic management. First, beware the reliance on short-term inflows. Such short-term capital is fickle. India has benefited since the early 1990s in keeping a regulatory restraint on short-term borrowing from abroad, after the brush with financial disaster in 1991 (which involved the reversal of short-term capital flows of the so-called non-resident Indian accounts). There is simply no good case for allowing domestic banks to expose themselves to large amounts of foreign debt, especially short-term debt. Second, policymakers should keep an eye on the crucial ratio of short-term debt to foreign exchange reserves. Markets will be subject to panic when short-term reserves dip below short-term debts. Again, India has looked rather good on this score in the recent past. With reserves around \$25 billion, and short-term debts to international banks around \$8 billion, and therefore a ratio of short-term debt of reserves around 30 percent (as opposed to the greater than 100 percent in the East Asian crisis countries), India has been able to avoid a self-fulfilling panic.

Third, India should act with considerable care in the liberalization of financial markets. This is not an argument to avoid needed reforms, but to sequence them in an appropriate manner. Certain reforms should come early. Currency convertibility on current account transactions can be introduced immediately (as was done successfully in Poland, for example, in 1990), since this merely establishes the financial mechanism for free trade. Similarly, the doors should be thrown wide open to foreign direct investment. FDI brings huge advantages (new capital, technology, managerial expertise, and access to foreign markets) with little or no downside. FDI flows tend to be acyclical, or sometimes even counter-cyclical. Financial institutions should be pressed to raise capital in order to put a larger cushion in the financial system against the kind of banking calamities now hitting the East Asian countries. Under-capitalized banks are simply an invitation to banking misbehavior and a heightened risk of banking collapse. State banks should be

privatized, with an explicit aim of bringing in long-term foreign investors into the banking sector<sup>5</sup>. Another lesson from East Asia is that there are significant advantages to a large presence of foreign owners in the banking system. Foreign capital in the banks provides another cushion against banking collapse. For example, when the Indonesia banking sector collapsed in November 1997, the only banks that remained functional were the branches of international banks.

Fourth, India should avoid another of the serious mistakes of several East Asian countries, most notably Korea, the Philippines, and Thailand. These countries pegged their currencies to the U.S. dollar in the early 1990s; then experienced inadvertent and sharp currency appreciation vis-à-vis Europe and Japan when the dollar strengthened after 1995; and then ran down foreign exchange reserves vainly trying to defend the overvalued exchange rate when market sentiment turned against the currencies in late 1996 and the first half of 1997. By spending reserves in a failed defense of the currency, the Central Banks also left their economies exposed to subsequent financial panic when short-term debts came to exceed the dwindling level of foreign exchange reserves. In the end, the currencies collapsed anyway, but only after a deep financial crisis had already gotten underway. Fortunately, the Reserve Bank of India has been more circumspect in exchange rate policy, letting the rupee weaken in the face of the Asian crisis. There is probably more currency weakness to come, if only because India competes with Indonesia and Thailand in several product lines, and thus will face pressures on cost competitiveness now that the competitors' currencies have been deeply depreciated.

Fifth, and perhaps most urgently for India, fiscal restraint. Unless substantial fiscal consolidation is achieved, in our view, continued fiscal deficits pose India's greatest risk to future destabilization. Despite several years of fiscal consolidation effort, large and persistent fiscal deficits remain. Revised figures of major deficit indicators for the fiscal year 1997-98 bear testimony to the fact that the fiscal situation has not been brought under control. As a matter of fact, except for the first year of fiscal stabilization, that is, when the fiscal deficit was reduced from 8.3 percent of GDP in 1990-91 to 5.9 percent in 1991-92, the performance on this front has been disappointing. As against the original scheme of reducing the fiscal deficit to around 3 percent by 1996-97 set out in the Ministry of Finance Discussion Paper (1993), the actual fiscal deficit for the year 1996-97 turned out to be as high as 5.2 percent. Furthermore, the fiscal deficit in 1997-98 was even higher at 6.1 percent<sup>6</sup>. India's overall government spending, currently around 33 percent of GDP (center and states together) will need to be brought down substantially as a proportion of national product in order for India to achieve its reform goals of macroeconomic stability and long-term rapid growth.

There are several risks with high fiscal deficits. First, budget deficits could once again spill over into macroeconomic instability, if the government resorts again to inflationary finance.

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<sup>5</sup> All over the world, state banks have proven themselves to be financial black holes, into which billions of dollars of state funds can be poured for political reasons. The latest state banking calamity is Credit Lyonnais in France, which has swallowed well over \$10 billion in bailouts.

<sup>6</sup> These are fiscal deficits of the central government only. The combined fiscal deficit of the center and the states was around 7.5 percent in 1997-98, substantially higher than in most other developing countries.

This would happen, for example, if the government meets increasingly onerous terms in financing the increasing stock of public debt on the open market, and therefore turns to the Reserve Bank of India for increased financing. Second, the budget deficits imperil national saving rates, thereby reducing overall aggregate investment, and jeopardizing the sustainability of high growth. Third, the continuing large budget deficits, even if they do not spill over into macroeconomic instability in the short run, will require higher taxes in the long term, to cover the heavy burden of internal debt. High tax rates will place India at a significant disadvantage relative to other fast-growing countries.

We believe that deficits should be brought under control mainly by cutting government expenditures relative to GDP rather than by raising revenues relative to GDP. Moreover, there is probably little room to reduce capital expenditure, which have already been squeezed to a mere 3.7 percent of GDP in 1997-98. Hence it is the current expenditure which needs to be reduced significantly. Current expenditures at the central level are predominantly made up of interest payments, grants to states, subsidies, and defense expenditure. In the latter three areas, there have been some reductions in spending relative to GDP. Grants to states have declined from 2.5 percent of GDP in 1990-91 to 2.0 percent of GDP in 1997-98; explicit central government subsidies have been reduced from 2.3 percent of GDP to 1.4 percent of GDP; and defense expenditure has declined from 2.0 percent of GDP to 1.9 percent of GDP. Interest payments of course have risen not declined, but have risen from 4.0 percent of GDP in 1991 to 4.6 percent of GDP in 1997-98.

Further progress is needed in reductions in most of the main areas of current spending. With respect to internal public debt, there is one mechanism that could substantially ameliorate the fiscal situation. Privatization of public enterprises could raise significant funds as a percent of GDP, which could then be used to buy down the public debt<sup>7</sup>. Not only would the stock of debt itself be reduced, but also the interest costs of servicing the debt would surely decline as the debt stock itself was brought under control. The cash value of these enterprises vastly exceeds the present value of profit flows that the state now collects on these assets. Public sector profits are dissipated in poor productivity, over manning, excessive public sector salaries, soft budget constraints, and generally poor public-sector management. For this reason, sales of the enterprises to private sector buyers, if used to buy down the public debt, would yield annual saving in interest costs that most likely would far exceed the government revenues that are claimed by virtue of state ownership of the assets. (This is especially true in view of the fact that many enterprises with significant positive market value are actually loss makers in current cash flow, under state management).

A substantial amount of interest savings on India's internal debt could be generated if the government were to undertake extensive privatization of the central public sector enterprises. According to the Economic Survey, 1996-97, at least 25 percent of the outstanding marketable debt (largely made up of market loans, special bearer bonds, and 91/182-day treasury bills) could

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<sup>7</sup> The government has announced that disinvestment in the PSEs would be undertaken up to 74 percent, up from the earlier limit of 49 percent.

be retired by selling the economic assets of the government. However, this estimate is based on the book value of the assets, and consequently it would be much higher when converted into current value. Besides, the sale of these assets could retire more of the total liabilities depending upon the mode and timing of such sale.

The central government currently has equity holdings in 240 enterprises, 27 banks, and two large insurance companies. Further spending cuts could come from liquidation of loss-making enterprises that have no positive net market value. There were 104 loss-making enterprises in 1992 accounting for a total loss of Rs. 39.5 billion. Liquidation of these would imply a rise in domestic savings and, of course, these savings would be higher if there is salvage value in part or all of some of these enterprises. To capture these savings would require implementation of an exit policy to allow the government to close down these loss-making enterprises.

Reduction in central government subsidies (both explicit and implicit) is another area of expenditure control. While central government explicit subsidies have declined from a total of 2.3 percent of GDP in 1990-91 to 1.4 percent of GDP in 1997-98, there still is room to reduce these further, especially those that do not benefit the poor. The explicit subsidy bill of the central government is almost entirely made up of fertilizer and food subsidy. Fertilizer subsidy, for instance, could be phased out over the medium term, and simultaneously during this period the government could initiate a well targeted, and time-limited program to compensate poor farmers for their loss of income. The food subsidy bill also needs to be reduced with the exclusion of the non-poor from access to the public distribution system.

In the case of the central government there has been notable progress with regard to tax reforms, but almost nothing in the area of expenditure reform. At the state level, both tax and expenditure reforms have a long way to go as we discuss them below.

Likewise the central government, the financial condition of the state governments in India has also been a cause for concern. Over the years, the consolidated financial position of the state governments has shown a marked deterioration in some of their major deficit indicators. One of the fundamental weaknesses of state government finances in India can be attributed to the increases in non-developmental expenditure, particularly the revenue component of the non-developmental expenditure, and interest payments as a proportion of revenue receipts. These problems have been aggravated a great deal over the past few years because of a variety of reasons. The resource constraints in state finances have been accentuated by a near stagnant tax-GDP ratio, rising share of non-developmental outlay in the total expenditure, large volumes of hidden or implicit subsidies and increasing financial losses of state enterprises.

A growing pressure on state finances has also stemmed from the rising demand for public services. Furthermore, the fiscal situation in the states is likely to come under much greater pressure with the acceptance of the Report of the Fifth Pay Commission by several state governments in India. The slow growth in revenue mobilization at the state level has posed serious difficulties for the state governments to meet their expenditures. Be that as it may, the



critical problem in state finances is not only one of high levels of expenditure, but also one of increasing distortions in the pattern of expenditure.

Further progress in the area of tax and expenditure reform is as crucial for the states as it is for the center. State governments are required to reduce and eventually do away with subsidies on power, transportation, and irrigation so as to reduce the burden on state budgets. Importantly enough state governments have to find a way to reduce their expenditure on wages and salaries of their employees. The state expenditure on administrative services is budgeted to rise by 44.3 percent on account of the revision of pay scales of government employees following the Fifth Pay Commission awards.

According to estimates of a study by the Planning Commission, should all the state governments raise the salaries of their employees in line with the Fifth Pay Commission, then the states will have to pay out an additional Rs. 1000 billion as salaries and wages over the next five years<sup>8</sup>. The Planning Commission estimates also include higher salaries for quasi-government employees, including staff of public sector undertakings (PSUs) and local bodies. The state governments' wage bill even without the Fifth Pay Commission awards, is the single biggest expenditure item for almost all state governments. On an average, all state governments, spend around 60 paise of every rupee earned as revenue on wages and salaries. In particular, states like Maharashtra (with 2.2 million employees), Andhra Pradesh (1.1 million employees), West Bengal (950,000 employees), Gujarat (620,000 employees), and Kerala (520,000 employees) are likely to be the hit hard with these awards.

Expenditure adjustment at the state level should take into account its implications for the critical sectors such as social services. A significant portion of the expenditure on social services comes under the purview of the state governments, because of the federal set-up of the constitution, which places the responsibility of undertaking human resource development primarily on the state government. The social service expenditure of the state governments as a percentage to GDP showed a rising trend during the 1980s, from 4.8 percent of GDP in 1980-81 to 5.6 percent in 1990-91. In the first half of 1990s, however, there was a decline in the ratio owing to the resource crunch faced by a number of states. It came down to 5.3 percent in 1992-93 and further to 5.1 percent in 1994-95 and remained thereafter in the range of 5.1 to 5.5 percent.

A shift of policy focus towards changing the pattern of resource allocation and improving the resource base of states is critical for improving the financial situation of the state governments. On the tax front, sales tax is the single most revenue earning source for the state governments, and its reform is crucial so as to attain higher levels of revenue mobilization. While efforts to introduce state level VAT and other tax reform measures have begun, their implementation across all states is necessary in order to enhance the revenue productivity of the state tax system and to reduce its distortionary implications for the economy.

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<sup>8</sup> This estimate includes payment of arrears from January 1, 1996. States like; West Bengal, Orissa, and Bihar have declined to pay these arrears.

In the final analysis, fiscal control will require an overhaul not just in budgetary patterns, but in the basic functioning of the public sector in the economy. For example, we have noted that privatization is a key method for reducing the overhang of public debt. Similarly, the privatization of infrastructure services is a key way to relieve the growing burden on state budgets, which are heavily weighed down by losses of SEBs and other parastatal institutions. Greater autonomy for local and state-level governments in infrastructure reform and investment priorities will similarly allow the central government greater freedom in cutting back on transfer payments to the states (which will be in a better position to prioritize and economize on state spending). Until India resolves to push even farther in market reforms, the soft budget constraint of the public sector will continue to spill over into large public deficits and a growing burden of public-sector debt.

## 1998 Global Competitiveness Report - India's Special Strengths & Weaknesses

**Table 1**

<b>I Strengths</b>	Scale*	Rank **
<i>Stock market</i>		
Stock market is important for new financing	5.42	13
<i>Science and engineering</i>		
Schools excel in basic science and math	5.27	16
Country has a large pool of competent scientists and engineers	6.37	1
Engineering as a profession greatly attracts young talent	6.26	1
<i>Labor force</i>		
Country has first-class business schools to train managers	5.05	8
Country has an abundant labor force	6.77	1
<i>Rule of Law</i>		
Judiciary is independent of the government	5.40	9
Compliance with court ruling is high	5.37	14
Firms have recourse to courts for challenging government actions	5.56	19
<b>II Weaknesses</b>		
<i>Financial markets</i>		
Citizens prohibited from investing in foreign stocks, bonds, and bank accounts	1.60	53
Financial sector sophistication is lower than international norms	2.74	43
Venture capital is scarce	2.63	50
<i>Public Administration</i>		
Administrative regulations that constrain business are pervasive	2.90	47
Government subsidies keep old industries alive	2.68	52
Civil Service is subject to political pressures	2.65	43
Tax evasion is rampant	2.27	48
<i>Infrastructure</i>		
Overall infrastructure is far worse than major trading partners	1.92	53
Road infrastructure constrains business development	1.85	53
Port facilities are underdeveloped	2.18	53
Direct dial phone service is prohibitively expensive	2.94	53
Country suffers from severe power shortages	1.94	53
<i>Research and Development</i>		
The business sector spends little on R&D	2.11	52
Research collaboration does not exist between universities and industry	2.66	53
Firms fail to commercialize academic research	2.66	51
Companies are poorly adapted to absorbing new technologies	2.29	34
<i>Labor regulations</i>		
Average workers are unproductive	2.94	51
Hiring and firing practices are severely restricted	2.16	53
Labor regulations impede adjustment of working hours to meet changes in demand	2.58	49
<i>Corruption and bribery</i>		
Extra payments connected with permits and licenses are common	2.79	48

**Notes:**

\* All questions have scale from 1 (lowest) to 7 (highest).

\*\* India's rank amongst 53 countries ranked in the 1998 GCR.

Source: 1998 Global Competitiveness Report

**Economic Performance of China and India**  
**Table 2**

	GNP per capita		Exports (Bn \$) (excluding services)		Trade (% of GDP)		Exports of goods & services (% of GDP) IV		Exports per capita \$ per person	
	I		II		III		IV		V	
	Dollars 1995	Avg. ann. growth 1985-95 (%)	1980	1995	1980	1995	1980	1995	1980	1995
China	620	8.3	18.1	148.8	13	40	6	21	18	123
India	340	3.2	8.6	30.8	17	27	7	12	12	33

Notes:

Column I: This measures the total domestic and foreign value added claimed by residents. It comprises GDP plus net factor income from abroad. GNP per capita is calculated using the resident population in the corresponding year.

Column II: This represents the value of all goods provided to the rest of the world.

Column III: This represents the total of all imports and exports of goods as a proportion of the gross domestic product.

Column IV: This represents the value of all goods and nonfactor services provided to the rest of the world. This includes the value of merchandise, freight, insurance, travel, and other nonfactor services. The value of factor services, such as investment income, interest and labor income, is excluded. Current transfers are also excluded.

Column V: This represents the value of all goods exported per person.

Source: World Development Report, 1997, The World Bank