India's Decade of Development

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While presenting the union budget for 2000-2001, the finance minister in his introductory remarks said, "I propose to put India on a sustained, equitable and job creating growth path of 7 to 8 per cent per year in order to banish the scourge of poverty from our land within a decade. The next 10 years will be India's decade of development."

We concur that India has a chance for a *tremendous breakthrough in economic development* this decade. There are several reasons for this view. India's political system is more than ever in consensus about the basic direction of reforms. The current government enjoys a strong electoral mandate. A decade of opening of the economy has produced new dynamism, most dramatically in the information technology sector, but in others as well. The world is waking up to India's crucial role as the largest democracy and as a dynamic economy, if still a low-income one on average. The new technologies (especially information technology and biotechnology) give new opportunities for economic and social development.

All of these positive realities suggest that the prime minister should announce specific major national goals of development.1 These goals will help to galvanise domestic public opinion in support of the objectives of development, provide a gauge against which to judge the progress of policies, and help the world community to appreciate the efforts under way, and support them through increased flows of foreign investment. The goals would be akin to the 'New Deal' announced in the 1930s in the US: a rallying cry for the public, and a political base for the reforms. If the government succeeds in achieving the ambitious goals, it would become a lasting political legacy of support.

In this regard, we suggest at least two broad goals that the government of India may like to set for itself:

First, by the year 2010, the per capita income of India would be doubled. Income doubling within a decade requires annual growth in per capita income of 7 per cent per annum.
Second, by the year 2010, there would be universalisation of education until Class VIII, with a special effort for girls and disadvantaged groups.

Additional targets could well be set regarding health conditions and access to basic services, such as sanitation, clean water, telecoms, power, and so on, particularly in rural India.

It is interesting to note that with regard to education, president Clinton announced national goals along these lines in his State of the Union Address on January 27, 2000. Since the US is often portrayed as a free-market society with very limited government in the domestic sphere, it might be supposed that the government would shy away from specific domestic goals as smacking too much of 'central planning'. To the contrary, the president's speech offers a big vision of American society in the 21st century. President Clinton's address is filled with goals relating to education, public health, commitments to eliminate child poverty, widespread use of the Internet, more resources for science and technology, and disease control, and so on. It sets broad goals, and explains how they can be met. In many places, it literally calls on the individual states to meet certain performance standards as in education, reflecting the fact that the US like India has a federal structure in which the central government may set goals, while the implementation rests mainly with the states.

In his address, the president said, “To 21st century America, let us pledge these things: Every child will begin school ready to learn and graduate ready to succeed. Every family will be able to succeed at home and at work, and no child will be raised in poverty.” He went on to say, “First and foremost, we need a 21st century revolution in education, guided by our faith that every single child can learn. Because education is more important than ever, more than ever the key to our children’s future, we must make sure all our children have that key. That means quality pre-school and after-school, the best trained teachers in the classroom, and college opportunities for all our children.”

In the Indian context, comparably bold but achievable goals should be enunciated. India too needs a revolution in education, aimed – finally – at literacy for all, and a high-level of school attendance for all children in India’s vast and differentiated society. And as president Clinton enunciated goals in health, technology, economics and other areas, so too are comparable goals necessary, and achievable, in the Indian context.

10 Crucial Initiatives for a Decade of Development

To make the first decade of the 21st Century a true ‘Decade of Development’ will require a broad-based programme of economic and social actions. These actions will have to be broad-based, requiring new approaches and legislative reforms in many areas of public policy. We summarise 10 main areas of reform as follows.

(1) *Universal literacy,* based on national goals, backed by coordinated actions of the central government and state governments. Universal literacy could be achieved through creative mobilisation of new IT approaches, better school attendance, and other policies, all with a clear focus on inclusion of girls and other traditionally disadvantaged groups. The central government could call together the chief ministers of the states to launch a new national commitment in favour of this goal. The economic and social returns from such an initiative would be huge. Evidence from across the world suggests that high levels of literacy have helped raise growth rates and reduced fertility rates over time.

(2) *Aggressive public health campaign* to address major infectious diseases (pneumonia, diarrheal diseases, malaria) and especially the incipient AIDS epidemic, which now threatens India with tens of millions of cases unless properly addressed.

(3) *Enhanced family planning policies,* to limit the growth of India’s population to below current projection (e g, the UN forecast of 1.5 billion population by 2050).

(4) *Completion of economic reform agenda:* There are several remaining priorities of economic reform, including.

Reduction of fiscal deficits, mainly through budget cuts and privatisation revenues, in order to reduce the ratio of public debt to national income, thereby to avoid future macroeconomic destabilisation;

Export promotion through greater emphasis on export processing zones, the elimination of reservations for small-scale industry, the encouragement of the IT sector, the elimination of administrative barriers to foreign direct investment, and the elimination of tax and tariff structures that are anti-export biased.

Improved infrastructure, through liberalisation combined with regulation, especially in telecoms (where privatisation and competition are crucial), power (where the reform of state electricity boards is crucial), and other sectors.

(5) *Political decentralisation:* Efficiency and dynamism will require the transfer of more power to states and local governments, and more democratisation at the local level. Dynamic metropolitan areas (built around major cities) will constitute the main engines of growth for India in the coming decades. These urban areas will need taxation and regulatory powers to be effective in supporting the business and social environment.

(6) *Enhanced global role for India:* India should assert a greater leadership role in various venues, including the G-20, future international summits between developed and developing countries, the International Monetary Fund, World Bank, World Trade Organisation, and the World Health Organisation. Being the world's largest democracy, and a leader of the interests of developing nations, it is essential that India play a significant role in the functioning of, and deliberations at, these international organisations.

(7) *Commitment to IT backbone:* India should sponsor programmes and reforms to encourage universal telephony and Internet access in all villages in India, as part of the national campaigns in literacy, health, and economic development. Physical infrastructure for data transmission within India (e g, fiber optic cables) remains underdeveloped despite some recent progress.

(8) *Strengthening of economic/cultural/financial/investment/scientific ties to overseas Indian communities:* The Indian diaspora, in the United States, Europe, Africa, and Asia, constitutes a vital economic and cultural treasure for India. The non-resident Indians can play a critical role in trade, finance, technology transfer, business competition, and culture. NRIs from the Silicon Valley, for example, should be mobilised to help India reap the enormous benefits of the ongoing IT revolution.

(9) *Strengthening Science and Technology in India's Development Policies:* India can become one of the centres for global science. This is especially important since India faces a range of challenges (in health, environment, agriculture and power) where the technologies of the US, Europe and Japan are not appropriate, at least not without further R and D. The government of India should therefore sponsor high-level science councils, greater attention to university-industry links in technology, and much greater funding for science institutes in public health, environment, and agriculture.

(10) *Major commitment to Indian higher education:* India's universities should serve as a core to a knowledge-based development strategy. The IITs are already world class, and must be nurtured further. A dynamic university sector, built on private and public institutions, and much deeper links with US, European, and Asian universities outside of India should be fostered. With regard to the international linkages, there can be encouragement of partnership programmes between Indian and foreign universities, as well as student and faculty exchanges, and use of IT for distance learning (through videoconferencing, for example). Also, the government should foster closer university-business relations, and should create tax incentives for charitable contributions.

We now take up some of the key areas of economic reform that we mentioned above in the list of 10 crucial initiatives. In general, the policies needed in the economic sphere (such as the budget and infrastructure) are better understood in India, since they have been debated in more detail. The social objectives – especially literacy, education, health, and family planning – are certainly no less crucial for economic outcomes but there is considerable work ahead in fleshing out realistic and hardheaded proposals for meeting the bold objectives outlined above. We are confident that the enunciated goals can be met, but the needed policies probably cannot be lifted right off the shelf at this moment. We therefore focus our detailed comments on some better-tread areas, fiscal reform, export promotion, and information technology, leaving the detailed exploration of the social objectives to a later essay.

Fiscal Consolidation

The Decade of Development cannot rest on an unstable fiscal base. India has seen too often how bold objectives can be pushed aside through financial crisis. It is extremely important to reduce fiscal deficits mainly through budget cuts and privatisation revenues in order to reduce the ratio of public debt to national income so as to avoid future macroeconomic destabilisation. Unless substantial fiscal consolidation is achieved, in our view, continued fiscal deficits pose India's greatest risk to future destabilisation. In this regard, the big increase of defence expenditures in the current budget must be viewed as having a depressingly high cost for India's development objectives. Successful regional diplomacy may turn out to be the most vital macroeconomic policy of all in the coming years.

Despite several years of fiscal consolidation effort, large and persistent fiscal deficits remain. As a matter of fact, except for the first year of fiscal stabilisation, that is, when the fiscal deficit was reduced from 8.3 per cent of GDP in 1990-91 to 5.9 per cent in 1991-92, the performance on the fiscal front has been disappointing. In the year 1999-2000, the net borrowing requirements, that is, the fiscal deficit, is going to be over Rs 1,00,000 crore. The fiscal deficit is thus likely to increase to 5.6 per cent of GDP from the budget target of 4 per cent. In terms of interest payments next year, this implies an additional outflow of Rs 10,000 crore.

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. 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 jeopardising 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, particularly in attracting investments by internationally mobile capital (both domestic and foreign).

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. India's overall government spending, currently around 33 per cent of GDP (centre and states together) will need to be brought down as a proportion of national product in order for India to achieve its reform goals of macroeconomic stability and long-term rapid growth. Moreover, there is probably little room to reduce capital expenditure, which has already been squeezed to a mere 3.3 per cent of GDP in 1998-99 (though much of infrastructure investment in power, telecoms, and even major roads, can be turned over to the private sector in conjunction with a proper redesign of pricing and regulation). Hence it is 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 defence expenditure. In all these areas, there is going to be higher levels of spending relative to GDP. Interest payments will go up substantially as we mentioned earlier. Grants to states will go up under the interim award of the Eleventh Finance Commission. Allocation of funds for defence expenditure, of course, has been hiked by Rs 13,000 crore more than in the budget estimate for the current year. Without entering into the merits of this issue as a defence issue, from a macroeconomic and budgetary point of view this is worrisome. Expenditure under food and fertiliser subsidies may go down marginally should the government be able to withstand the pressure from its allies.

With respect to internal public debt, privatisation of public enterprises could raise significant funds as a per cent of GDP, which could then be used to buy down the public debt. 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.) In this direction, the budget takes a very small step, that is, announces disinvestment to the tune of Rs 10,000 crore only, of which, a mere Rs 1,000 crore to be used for retiring debt.

Like 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 mobilisation 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 centre. 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 per cent on account of the revision of pay scales of government employees following the Fifth Pay Commission awards.

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 mobilisation. 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.

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 privatisation is a key method for reducing the overhang of public debt. Similarly, the privatisation of infrastructure services is a keyway 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 prioritise and economise 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.

In discussing the soft-budget constraint at the state level, special mention must be made of the state electricity boards (SEBs), a situation that is urgent both fiscally and in terms of deteriorating infrastructure. Over the years, the states have been providing large-scale financial assistance to the SEBs. The SEBs are responsible for generating and distributing power, setting tariffs, and collecting revenues. Almost all of them make losses and some are even unable to pay for the 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 a lot of theft of power from the distribution networks, which is classified in the official statistics as transmission and distribution (T and D) losses. The Indian power sector has not been able to match the growing need for more power generating capacity. Over the next five years, it needs to add 35,000 to 50,000 MW of capacity depending on the growth rate of the economy, whereas it added no more than 20,000 MW over the last five years. The root cause of this inability to expand capacity is the financial sickness of the SEBs.

Under these circumstances, the SEBs need to revise their tariff rates in line with the costs they incur in the production and distribution of electricity, in particular for the agricultural sector, and minimise the transmission and distribution losses. This, in turn, would allow the state governments to withdraw financial support to the SEBs, and would enable private investors to enter the electricity market on a much larger scale. More extensive reforms would involve a regulatory overhaul of the entire system, to allow private electricity producers to enter the grid on a competitive market basis.

Export Promotion

The government needs to promote exports through greater emphasis on export processing zones, the elimination of product reservation for small-scale industry, the encouragement of the IT sector, the elimination of administrative barriers to foreign direct investment, and the elimination of tax and tariff structures that are anti-export biased. India could have achieved what China has achieved in export growth, but India failed in basic policy strategy.

At the centre of China's export strategy were the special economic zones (SEZs) in which favourable export conditions were assured. These SEZs, along China's coastline, were designed to give foreign investors and domestic enterprises favourable 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 export processing zones (EPZs), but India's approach to export zones has been one of relative neglect rather than support. While China's five main special economic zones have been very successful in exports, attracting foreign direct investment, and creating large-scale employment opportunities, by contrast, India's main export processing zones have not succeeded in any of these areas. 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 ports; 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, and 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 these circumstances, many state governments have actually been averse to the idea of locating EPZs in their states. Here we would like to point out that some of the initiatives announced by the government recently in the Exim policy for 2000-01, such as establishing, as in China, SEZ, in different parts of the country, and fully involving the state governments in the export efforts are welcome steps. We are of the view that while these measures will undoubtedly provide great impetus to India's export efforts, it is critical for India to abolish product reservation for the small- scale industry and to liberalise labour laws if India is to attain and sustain high rates of export growth.

India's labour laws 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 ones, 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. 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 2000-01 proposes to phase out exemptions from income tax for export earnings.2 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.

Information Technology

Service-sector export based on information technology (IT) is another area where the government's policy could do much more to spur export growth. India is becoming one of the most important players of the world in the IT sector and it is the fastest growing foreign exchange earner for India. We believe that the government could do more for this industry, not through direct subsidies necessarily, but actually through liberalisation of telecom, allowing for lower priced telecommunication services, by allowing new entry of major international players in telecom. These companies could lay down a tremendous fibre-optic network in India and increase the bandwidth available for Indian business and put India even more close to the international scene. We would like to see the government finds some resources to support basic science and R and D in this sector to some extent because India has world-class engineers and scientists that have already brought India up in an important way in this sector and could keep India in the very forefront of this new technology.

The continuing state monopoly of VSNL in international telephony as well as in internet provision within the Indian market seriously raises the costs of telephone and IT services in India, and is doing considerable damage in India's international competitiveness in the IT sector. India's telephone density is abysmally low, at around 1.3 per hundred in 1995, compared with around 62.6 per hundred in the US. International telephone calls originating in India are among the highest priced in the world, largely due to lack of competition. Physical infrastructure for data transmission within India (e g, fibre-optic cables) remains underdeveloped despite some recent progress. Restrictive policies on FDI have kept international chipmakers 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 telecoms and FDI, as well as effective law enforcement in a more liberalised and competitive environment.

The engine of growth of the booming Indian IT sector is the software industry which has grown at an average annual rate of 60 per cent between 1992 and 1999. The Indian software industry, which today employs 1,60,000 professionals, has zoomed from a mere US $ 20 million 10 years ago to $ 4 billion in 1998-99, of which $ 2.6 billion was exported. This industry has clearly emerged as a major export earner for the country, contributing to 8 per cent of total merchandise exports. It has also achieved worldwide reputation for providing excellent quality: many local software firms have earned ISO 9000 as well as SEI-CMM certification, with five of them having reached Level 5 (only 9 firms worldwide have reached this level). India has achieved this feat by leveraging its most valuable resource: highly skilled manpower. The country today boasts of the second-largest English-speaking pool of scientific manpower in the world and graduates 70,000 computer professionals every year, in addition to the graduates from the prestigious Indian Institutes of Technology (IIT).

Improvements in infrastructure through liberalisation combined with regulation, especially in telecom (where privatisation and competition are crucial), power (where the reform of state electricity boards is crucial), and other sectors is extremely crucial. Through liberalisation of telecom, allowing for lower priced telecommunication services, and by allowing new entry of major international players in telecom (who would lay down a tremendous fibre-optic network in India and increase the bandwidth available for Indian business and put India even more closely to the international scene) the government could give a strong boost to the IT sector.

Unmet Social Agenda

Economic reforms by themselves are not sufficient to achieve India's development goals. A growing body of economic evidence suggests that social progress – such as increased life expectancy, reduced disease burdens, lower fertility rates, and improved educational attainments – are at least as important as the narrower economic policies in meeting goals of higher economic growth and raising living standards. Thus, social goals are crucial not only in and of themselves, but also for what they contribute to economic dynamism.

India's circumstances at the start of the new century are unenviable. Life expectancy is around 63 years, compared with 78 years in the high-income countries. Literacy of adult women is notoriously low, at some 40 per cent. Under-5 mortality rates of children remain above 100 per 1000 births. The AIDS epidemic is gathering force, and could gravely undermine many of the social and economic gains of recent years unless it is decisively curbed through aggressive health policies, including much greater education of the population regarding the risks of HIV/AIDS transmission.

We will address these issues in another essay, since they deserve detailed consideration, as well as a regional disaggregation in light of the growing differences in social indicators in different parts of the country. We stress, however, that the vital social goals cannot be met unless they are elevated to the highest priority in government policy.

Notes

[These observations are based on the ongoing analysis of India's economy at the Centre for International Development (CID) in the Kennedy School of Government at Harvard University as well as discussions that the authors benefited from during a trip to India earlier this year.]

1 This could perhaps be done in his address to the Nation from the ramparts of the Red Fort on August 15, 2000.

2 The budget proposes to phase out these concessions over a five-year period. 20 per cent from the financial year 2000-01, and by 20 per cent each subsequent year till they reach a zero level.