

Oration 14: 2010 K.R. Narayanan Oration

Message from the President
of the Republic of India



I am happy to learn that the Australia South Asia Research Centre (ASARC) is organising the 14th K.R. Narayanan Oration on the theme ‘India’s Prospects in the Post-Crisis World’, at The Australian National University, Canberra on 29 November 2010.

The Indian economy has weathered the global financial crisis of 2008–09 quite well. At a time when several other economies of the world have slowed down, India continues to register high rates of growth. This year, it is poised to continue its high growth trajectory. There is growing interest in the Indian economy and its development model. I have no doubt that the oration will go a long way towards addressing this interest, focusing on the challenges and the opportunities shaping the Indian economy and its growth and development in the years to come.

TWENTY K.R. NARAYANAN ORATIONS

I wish the oration all success.

Pratibha Patil

New Delhi

18 November 2010

India's Prospects in the Post-Crisis World

Montek Singh Ahluwalia

It is a privilege for me to deliver the K.R. Narayanan Oration this year. I had the pleasure of knowing President Narayanan before he became president of India, and have very warm memories of his kindness and gentleness of character, and also his deep insight into social problems. I first met him in 1985 when he joined the government as minister of state for Planning in the government of Prime Minister Rajiv Gandhi. I happened to be a civil servant in the prime minister's office at the time and I remember asking him how it felt to move from a distinguished career as a diplomat into the very different world of politics. With his characteristic self-deprecating humour, he said: 'Well, I am now supposed to do Planning, but honestly, I often feel more planned against than planning.' I wondered at the time whether he was referring to the stress of being a planner — which is considerable — or the stress of being a politician. I imagine he had in mind a bit of both.

Since the Planning Commission is about to start working on the approach to the Twelfth Five-Year Plan, which begins in 2012, I thought it would be appropriate to focus this lecture on India's prospects and the challenges it faces at this point.

Building on a Strong Base

First, for four years before the global economic crisis of 2008–09, the Indian economy averaged a growth rate of about 9 per cent per year, an impressive performance by any standards.

Second, the economy has shown great resilience to unprecedented external shocks. It was certainly affected by the global crisis when the growth rate dropped to about 6.7 per cent in 2008–09, but it recovered quite smartly thereafter to 7.4 per cent in 2009–10 and is likely to reach 8.5 per cent or even a little more in 2010–11. This is at a time when most of the industrial world has negative growth and even many emerging economies experienced sharp slowdown. There is a very good chance of getting back to 9 per cent growth in 2010–11.

Third, India's economic prospects are viewed very favourably by global investors and this is reflected in the fact that India has become one of the favoured destinations for foreign direct investment (FDI). Total foreign investment in India in 2001–02 was about \$4 billion; by 2009–10, it had increased to \$37 billion.

Finally, most observers expect growth over the medium and longer term to be somewhere between 8.5 and 9 per cent. If these growth rates are maintained for the next 25 years, the Indian economy would become the third-largest economy in the world by 2035, when China is expected to be number one, and the US number two at market exchange rates. I should emphasise that India would obviously not be the third richest country in per capita terms; it would still only be a middle-income country, but the total size of the economy and, therefore, the domestic market would make it a much more significant player than it is today.

This positive performance in recent years and expectations for the future has generated large positive dynamics. Economists are familiar with the notion of 'animal spirits' as a catch-all phrase describing investor sentiment. There is no doubt that the strong growth performance of recent years has boosted animal spirits. It has created a 'can-do' attitude among many Indians, including, but not only, those in business, and has created a new sense of confidence — particularly among our younger population — that the global game is not necessarily weighted against newcomers.

Not surprisingly, this has reinforced expectations about what is possible in the future. Prime Minister Dr Manmohan Singh has spoken of India growing between 9 and 10 per cent per year, and the Planning Commission have been tasked to see whether and how the economy can be put on a 10 per cent growth path in the Twelfth Plan.

I propose to use this lecture to share my thoughts on what it would take for India to achieve a transition to rapid and inclusive growth. I mention inclusiveness because we have repeatedly emphasised that growth is not the sole objective of policy; growth is essential, but it must also be inclusive in the sense that its benefits must be experienced by the mass of the people. I will deal explicitly with this aspect of India's performance, and what it implies for policy, a little later in the lecture.

Prospects for the Future

One reason for being optimistic about the future is that India has been experiencing a steady acceleration in growth and it is tempting to conclude that this will continue. The growth rate in the 1990s was about 5.7 per cent and this increased to 7.7 per cent in the decade following the 90s, which is just ending. If we could achieve a 2 percentage point increase in the average growth rate over the preceding decade in a period that included a global crisis of exceptional magnitude, it appears reasonable to argue that raising the growth rate by another 2 percentage points in the next decade should not be impossible.

This approach is obviously oversimplistic because past performance cannot be projected mechanically into the future. There are many examples of countries that have done very well for a while and suddenly slumped. The best known example is Brazil, which grew at an average rate of 9 per cent for 20 years in the 1960s and 1970s, and then collapsed to an average of 2 per cent growth for the 1980s and 1990s. It has done much better in the current decade but, even so, the average growth rate has been only a little over 3 per cent per year. The South-East Asian high performers have also found it difficult to get back to the high growth they experienced before 1997.

This raises the question: will India be able to avoid a similar loss of momentum? This question is best answered by analysing the factors that accounted for India's improved performance in the past and assessing whether these factors will continue to operate or even strengthen in the years ahead. We also need to consider whether rapid growth itself will produce structural changes that raise new challenges. If so, continued growth in the future, to say nothing of acceleration in this growth, will

depend not just on continuing the policies that have worked in the past, but also on the ability to provide credible responses to the new challenges. I will explore each of these questions in the course of the lecture.

The question of whether India will be able to accelerate beyond the 7.7 per cent growth rate achieved in the decade that is just ending is best answered by considering the determinants of growth, first on the supply-side and then on the demand-side.

Determinants of Growth on the Supply-Side

On the supply-side, the traditional growth accounting framework explains growth of GDP in terms of growth of primary inputs — that is, growth of capital and growth of labour (adjusted for labour quality), and, of course, total factor productivity. Let us look at each of these in turn.

The growth of capital inputs in an economy depends on investment and that in turn depends on the investment climate and the availability of savings, domestic and foreign. Consider the investment climate first: one can envisage a situation in which resources are available to finance investment but, for some reason, the entrepreneurial class does not actually believe that any of the available investment opportunities are worthwhile. In the absence of ‘animal spirits’ we will not get an increase in capital inputs. This is not likely to be a problem in India. India benefits from the existence of a vibrant entrepreneurial class, which has demonstrated its ability to expand investment, especially, corporate investment. It sees enormous opportunities ahead and is willing to undertake investment. It is, therefore, reasonable to assume that investment will take place provided financing is available. The government also recognises that future growth will be private sector-led and is committed to creating an environment that is pro-investment.

Viewed from this perspective, the prospects for investment over the next decade appear very favourable. Investment rates have been rising and, as a result, the investment rate today is already significantly higher than the average investment rate of the previous 10 years. If we can assume some further increase in the rate of investment in the years ahead, one can conclude that India’s average investment rate in the next 10 years would be significantly higher than the average investment rate in the previous 10 years. The scope for such an increase depends largely on what happens to domestic savings and foreign resource flows and the prospects on both fronts are positive.

At the start of the decade of the 1990s the domestic saving rate in India was 23.7 per cent. The impact of economic reforms, rapid growth and rising per capita incomes, and probably also the demographic transition, led to a sharp increase in the savings rate to 36.4 per cent in 2007–08. This came down subsequently because of the crisis, but I expect that when the figures for the current year (2010–11) become available, it will have gone up again. The average savings rate in the decade just ending will probably be around 31 per cent but we will probably end the decade with a savings rate of around 35 per cent. This could easily go up by another 2 or 3 percentage points over the next 10 years, taking the savings rate at the end of the next decade to something of the order of 37–38 per cent. The average savings rate during the next decade, therefore, could be around 36 per cent or even a little higher. Higher domestic savings could, therefore, finance an investment rate that is about 5 percentage points of GDP higher than the average in the previous decade.

This domestic savings performance obviously should not be taken for granted. It depends critically upon the achievement of rapid growth, with a concomitant growth in corporate savings similar to the trend witnessed in the decade just ending. That outcome in turn depends on maintaining a macroeconomic environment that encourages domestic savings. A moderate rate of inflation is critical in this context as is a well-functioning financial system capable of channelling savings towards the right kinds of investments. Much also depends upon the fiscal position of the government, which should ideally be bolstered by some reduction in government dis-savings, which increased in recent years.

The projected availability of domestic savings can be supplemented by additional foreign capital flows. In the previous 10 years, the average current account deficit was about 1 per cent of GDP. Over the next 10 years, since the Indian economy is now much more open and global investors are taking an interest in investing in India, we could see a current account deficit rising to between 2.5 and 3 per cent of GDP. This implies an additional flow of savings for investment of 1.5–2 percentage points.

A current account deficit of 3 per cent of GDP is more than what has traditionally been thought to be a prudent level in India, which is closer to 2 per cent. However, it is not unreasonable to plan on a higher figure considering the fundamental change that has taken place in the global economy. With the industrialised world likely to grow more slowly, and with growth prospects in emerging market countries such as India being

much higher, it is logical to expect that more investible resources would move from the slower growing economies to the faster growing emerging market economies. In that process, the flow of foreign resources to India could increase significantly, provided India's policies are perceived to be investor friendly by foreign investors. I have already mentioned that India has, in recent years, been viewed as a preferred FDI destination. The government of India has every intention of ensuring that it continues to be so. For the rest, whatever creates an investor-friendly environment for domestic investors will also attract foreign investors.

The combined effect of higher domestic savings and higher capital inflows could, therefore, increase the rate of investment by 6.5–7 per cent of GDP in the next decade over the level achieved in the decade just ending. An increase of this order would certainly contribute substantially to achieving a higher rate of growth of GDP.

Turning to the other key primary input — labour — India is favourably placed in one respect because of the demographic transition. The working-age population in India will be increasing over the next 30 years, whereas in all the industrialised countries, and also in China, it will be going down. However, I should point out that a growing workforce is not by itself an advantage. It is an advantage only if it occurs in an environment in which sufficient investment is taking place to absorb labour productively, and if the education and skill level of the workforce is consistent with employability. I have already argued that the prospects for higher levels of investment are good. As for the quality of the labour force, this calls for a major effort in education and skill development and, as it happens, these are among the major objectives of the government at present.

The government has recognised that India needs an across the board expansion and upgradation of quality in the educational system, including higher and technical education. We also need much faster expansion in a wide range of middle-level skills, which, in turn, calls for strengthening and modernising the skill-development system. Skill development has been neglected in the past but is now receiving concerted attention. The Twelfth Five-Year Plan will pay special attention to the need to expand the system of higher education and skill development and also to upgrade the quality.

Let me now turn to the third determinant of growth, that is, total factor productivity. Economists know that total factor productivity is as important in determining the rate of growth of an economy as the growth of primary inputs such as capital and labour. These primary inputs are extremely important. One almost certainly cannot have high growth without rapid growth in both capital and labour inputs. However, it is also true that one can have a lot of growth in capital and labour inputs without getting much of total growth, if the factor productivity side is not looked after. This is what happened in the 1960s and 1970s. Our overall growth rate was low, and a large part of the explanation lay in low or even negative productivity growth. Investment was taking place, but we were not getting growth because of poor performance in productivity. This, in turn, can be attributed to the economic inefficiency associated with the pre-reform economic system.

The economic reforms were designed to unleash productivity in the system by injecting much greater competition, both domestically and from abroad, and giving domestic entrepreneurship the freedom and flexibility it needed to invest and expand in search of profitable opportunities. Recent research has shown that the reforms did have the effect expected and total factor productivity became significantly positive in the post reforms period. This raises the question: will the pace of total factor productivity growth witnessed in the post-reform period continue and perhaps even accelerate? In tune, this question is usually transformed into the question: will the economic reforms continue and at what pace?

The Agenda for Reforms

It is well recognised in India that economic reforms are still a work in progress and much remains to be done. There is a substantial agenda of unfinished reforms, many of which are simply a logical extension of the reforms already undertaken. Their completion would improve the investment climate and add to productivity growth in the years ahead. Let me list some of the areas where reforms are in the pipeline.

India has already made a substantial transition from a fairly closed economy with high levels of protection before 1990 to a much more open economy, with much lower protective levels and a market-determined exchange rate. It is a major achievement that this transition has been achieved with none of the economic disruption often feared when economies open up. However, it is often pointed out that India still

has somewhat higher tariff walls than other emerging market economies and more needs to be done to open up on the trade front. The comparison with other countries is not entirely fair. India's customs duties, which (with some exceptions) are now subject to a peak rate of 10 per cent are actually less protective than they seem as there is no countervailing duty to offset the sales tax levied by the state governments. If an amount equivalent to sales tax is netted out of the current customs duty to arrive at the actual 'protective duty', it would be much lower. Once the goods and services tax is in place, it will be possible to apply it to all imports, at which stage customs duties could be lowered by around 5 percentage points.

More importantly, the government has clearly signalled further movement towards reducing trade barriers as part of the Look East Policy, which is explicitly aimed at integrating the Indian economy more fully into the East Asian region. In pursuit of this policy, India has entered into a number of free trade agreements with countries in East Asia. They are not always called free trade agreements, being referred to as 'comprehensive economic cooperation agreements', but they amount to the same thing. Such agreements have been signed with Singapore, Malaysia, Thailand and one with ASEAN (Association of South-East Asian Nations) as a group. An agreement has been signed with Korea and negotiations with Japan have been completed and the agreement is expected to be signed in 2011. These agreements will ensure a steady decline in applied tariffs over the next five to seven years.

FDI has been extensively liberalised with most areas open to FDI up to 100 per cent. However, there are several areas where limitations on foreign ownership remain and where liberalisation is being considered. Insurance is one such area, with foreign investment currently limited to 26 per cent. The government has introduced legislation to raise this limit to 49 per cent, though the legislative process has yet to be completed. Investment in multi-brand department stores is another where FDI is currently not permitted at all. The Ministry of Industry has stated that this policy is currently under consideration for a possible relaxation.

Mining is another area, and one of keen interest to Australian business, in which changes in the law are being considered. A new law governing the mining sector is under consideration that aims at establishing a more transparent regime for assigning mining leases, with a fairer system of compensation for those displaced.

The development of infrastructure, particularly power, roads, ports, airports, telecommunications and railways, is an important part of the ongoing reform agenda in which progress is being made but there is need for further acceleration. These sectors are widely regarded as constraining India's industrial competitiveness and, therefore, its ability to accelerate growth. The Government of India recognises the enormous importance of infrastructure development in India and the government has a big role to play in promoting investment in infrastructure. However, although large investments in infrastructure are necessary, the task cannot be performed by the public sector alone. Public sector resources are scarce and have to be directed into other priority areas like education and health. The government has, therefore, outlined a mixed strategy of developing infrastructure through a combination of public investment and public-private partnership. Public investment in infrastructure will remain important but will be directed to areas in which the private sector is unlikely to come. The public sector effort needs to be supplemented by private investment wherever possible. The government has, therefore, launched a very major effort to attract private investment in all these areas.

Investment in infrastructure was estimated to be about 5 per cent of GDP in the base year of the Eleventh Plan (i.e. 2006–07). We had expected to raise this percentage to around 9 in the last year of the Eleventh Plan (i.e. 2011–12). The actual achievement is likely to be around 8 per cent. To maintain the momentum in infrastructure development, we estimate that the investment in infrastructure would need to increase further to say 10 per cent by the end of the Twelfth Plan (i.e. 2017–18). This implies that investment in infrastructure will increase from \$500 billion in the five years of the Eleventh Plan period (i.e. 2007–08 to 2011–12) to about \$1 trillion in the Twelfth Plan period (i.e. 2012–13 to 2017–18). What is more, whereas about 30 per cent of the investment in the Eleventh Plan period was projected to come from the private sector, the private sector share in the Twelfth Plan will have to increase to about 50 per cent.

The challenge for the government is to design a policy framework that will attract private investment on the scale required. The policy has evoked a positive response thus far and substantial investments have been made by the private sector in all these infrastructure sectors. However, the level of involvement will have to be increased substantially to achieve the higher levels of investment that will be necessary in the years ahead.

While private investment in infrastructure needs to be encouraged, it is also necessary to ensure a high degree of transparency in the terms on which private investment is invited into infrastructure in order to protect the interest of the consumers of the service and to prevent the emergence of crony capitalists. Since infrastructure sectors are typically regulated, and in some cases amount to giving the concessionaire a limited monopoly, there are a number of difficult questions that need to be addressed. Private investors need the assurance of an adequate return and, in many cases (e.g. road transportation), the revenue that can be earned from the project may not suffice to service the total capital cost. In such cases, the government has to provide a capital subsidy, but the subsidy must be provided in a transparent manner based on competitive bidding. Competition takes different forms in different sectors. In the roads sector, concessionaires are selected based on competitive bidding for the lump sum capital subsidy they would need to undertake the project. In the case of airports and ports, competitive bidding is done on the basis of revenue share. Managing the award of concessions in a manner that ensures transparency and is perceived to be fair is crucial, as any slippage in this process runs the risk of appearing to promote cronyism.

A long pending element of the unfinished reform agenda relates to labour market reform. Economists have repeatedly emphasised that the rigidity of labour laws in the organised sector, including especially the fact that retrenchment of labour needs government permission, which is typically not given, is a factor that discourages the growth of employment intensive industries in India. Many have argued that this makes it more difficult to absorb surplus labour into productive industrial employment and is, therefore, actually anti-employment and anti-inclusion. However, this is a politically sensitive area in which reforms face strong opposition from labour unions. The government has taken the view that labour reform is necessary, but we must work to develop a consensus with representatives of labour.

Economic reforms aimed at achieving microeconomic efficiency and at rationalising some sector-level policies have to be underpinned by a sound macro-economic environment characterised by fiscal sustainability and a well-functioning financial sector. India has had high levels of fiscal deficits in the past, with the combined deficit of the centre and state governments reaching 9.5 per cent of GDP in 2001–02. This was

progressively brought down to just over 5 per cent in 2007–08 just before the global crisis. However, it expanded again to 9.6 per cent in 2009–10 because of a conscious policy of fiscal stimulus.

With recovery from the crisis now well established, the government has again outlined a path of fiscal correction that will reduce the fiscal deficit of the Central Government from 5.5 per cent of GDP in 2010–11 to 3.5 per cent by 2013–14. Allowing for a fiscal deficit of about 2 per cent for the states, the combined fiscal deficit of the centre and the states would be around 5.5 per cent in 2013–14. This order of deficit is high by international standards but it represents a substantial improvement from the current situation and is consistent with a steady reduction in the debt to GDP ratio given the high growth potential of the economy.

An important part of the fiscal reforms expected in the years ahead is the integration of domestic indirect taxes, which are at present imposed by the central and state governments separately on different tax bases, into a unified 'goods and services tax'. This will have separate central and state components but will be applied on a common base, with a provision to net out taxes at the input stage for the central and state component, respectively. This is an extremely important domestic reform initiative, which will contribute hugely to economic efficiency and also to revenue collection. However, it requires an amendment of the constitution and this calls for delicate political negotiation with the states. We had hoped that this process might have been concluded in 2010 so that the GST could be implemented with effect from 1 April 2011. It now looks as if it will take a little longer, but I am very hopeful that this reform will be implemented.

I could go on and list a number of other reform initiatives in the pipeline but the reforms mentioned indicate that we do have a well-defined agenda. Understandably, this leads observers to ask what is the time frame in which these reforms will be completed. I confess that it is difficult to set time lines in our system because of the nature of our democratic process. I have no doubt that the demonstrably favourable effect that the reforms have had on growth has created a broad constituency in support of the reforms, and we will see progress in this direction. However, progress is likely to be gradualist as it has been in the past.

The gradualism of Indian reforms has been much commented upon and a brief digression on this subject is perhaps appropriate. This gradualism has often led to impatience on the part of many observers and I confess I have often shared this feeling of impatience myself. However, it is important to recognise that gradualism is perhaps an inevitable consequence of the compulsions of the democratic process in a very large and heterogeneous country. The heterogeneity of the country has produced electoral outcomes that have produced coalition governments at the national level in the past 15 years. This environment does not lend itself to quick decision-making and rapid implementation. It puts a premium on consultation and consensus building, which often takes time. It is at times opportunistic. Reforms that are in the pipeline get done when it is felt that a sufficient consensus has been built. This inevitably makes reforms appear piecemeal rather than a coordinated advance on all fronts in an orderly sequence. This approach undoubtedly has costs.

The good news, however, is that though the pace of reforms has been slow, it has been steady and irreversible. We have now seen many changes of government, both at the centre and in the states. As governments have changed, parties that were earlier in opposition, and were strongly opposed to the economic program of the previous ruling party, have had the wisdom when they came to power not to change the broad direction of economic reforms.

A particularly encouraging feature of Indian elections in recent years is that governments that have a good record of economic performance can get re-elected on the basis of their performance. Ten years ago, the conventional wisdom was that the Indian electorate had a strong anti-incumbency bias, which meant elections typically led to incumbents being thrown out irrespective of performance. That is not what has happened in the last 10 years. Governments that have been seen to deliver have been re-elected, both at the centre and also in the states.

All of this suggests that the reforms we have seen will continue as governments at the centre and the states give greater priority to the development agenda. The pace of reforms will remain gradualist, but it will be steady. The favourable effect of reforms in generating higher productivity growth and, therefore, higher rates of growth of GDP can be expected to continue.

Demand-Side Constraints

The supply-side approach discussed above needs to be supplemented by analysis on the demand-side to establish that India will be able to generate a pattern of demand that can support higher growth. The most important demand-side constraint arises from the fact that the post-crisis world will be different from the world prior to the crisis. Growth in industrialised countries will be lower and the pace at which exports can increase to the US or Europe will be lower. This raises the question: if export prospects are likely to be weaker, how we can project more rapid growth for India? The answer is that we can do this if we can replace lost export demand with higher levels of investment demand, especially investment in infrastructure. India suffers from a significant deficiency in infrastructure and making up this deficiency will not only improve our competitiveness on the supply-side, but also will attract private investment.

The strategy of replacing export demand with investment demand implies that imports will increase and, with exports expected to be subdued, this in turn implies that the current account deficit in the balance of payments will widen. This, as I have mentioned, is actually happening. Three years ago we had near balance on the current account. Today, the current account deficit is expected to be around 3 per cent of GDP. The viability of this strategy depends critically upon our ability to finance a current account deficit of this order. As I have mentioned earlier in this lecture, we are in a situation where we can reasonably expect to finance a deficit of this order through long-term capital flows, including through FDI. India has only recently begun to attract global capital and, as such, it is 'under invested' compared with other Asian countries, given the size of its economy and its growth potential.

I conclude from this that whether we look at the supply-side or the demand-side, India is well positioned to experience a further acceleration in growth based on the continued pursuit of economic policies that have already yielded ample dividends.

New Challenges

Let me now turn to some of the challenges thrown up by rapid growth and the structural changes it produces. We have just begun the process of identifying these challenges for the Twelfth Plan so my list is necessarily

preliminary, but, subject to that caveat, I would list the following: i) achieving inclusiveness; ii) dealing with problems arising from imperfect and non-transparent markets that encourage market manipulation, corruption and cronyism; iii) managing the energy demands of rapid growth; iv) management of water resources; and v) meeting the challenge of urbanisation. Some of these challenges are not new but they will each be exacerbated by rapid growth. Each of them is formidable and calls for major policy initiatives. Because of the limited time available, I can only comment briefly on each of these.

The Search for Inclusiveness

The need to ensure inclusiveness is a major and continuing challenge. When the reforms were first introduced, critics charged that the new economic policies would damage growth and also hurt the poor. No-one today doubts that the reforms have accelerated growth, but there is concern that the growth unleashed by the reforms has not been inclusive enough.

The concern for greater inclusiveness surfaces in many different forms and all of them are relevant. In one variant, attention is focused on whether those at the bottom of the income ladder benefit sufficiently from growth. This leads to efforts to enhance incomes of the poor through various poverty alleviation programs. However, low incomes are only one part of the problem. Many families, whose incomes are above the poverty line, lack access to such basic services as education, health, drinking water and sanitation, and, where they have access, the quality of the service is unacceptable. Providing such access is also an important part of any strategy of inclusiveness.

Inclusiveness, however, is not only about ensuring a defined minimum level of income and access to basic services. There are traditional concerns about inequality getting worse, or at any rate not getting better. There are also concerns about inequality across states and, in some cases, across regions within states. In the Indian context, inclusiveness also requires steps to overcome the exclusion experienced by social groups such as the Scheduled Castes and Scheduled Tribes, which have suffered historically from discrimination. These groups typically occupy the lower ranges of the income distribution and, as such, any strategy of poverty alleviation or even inequality reduction would definitely benefit them. But if inclusiveness is to aim at correcting for historical discrimination, and bring these groups on par with the rest of the population, it has to go

beyond mere poverty alleviation and reduction in inequality to address the larger issue of achieving equal proportional representation for these groups along the entire income distribution. Defined in this way, 'group equality' is not necessarily linked to reduction in overall poverty or reduction in general equality; it can in principle be achieved leaving the incidence of poverty and the level of inequality unchanged.

Each of these distributional concerns is related to each other but is also quite distinct. It is perfectly possible for poverty to decline while inequality increases. Equally, inequality in the country as a whole may decrease or remain unchanged while inequality across states increases. Similarly, the economic conditions of the Scheduled Castes and Scheduled Tribes may improve but, if it leaves the gap between them and the others unchanged, it does not achieve social inclusiveness. Ideally, one would like to be able to claim an improvement in each of these multiple dimensions of inclusiveness, but that is not easy. This illustrates why it is so difficult to make an assessment about the inclusiveness of India's growth process thus far. However, I think an apt summary would be as follows:

1. Available data firmly establish that the percentage of the population below a fixed poverty line, defined in terms of real consumption per head, has been falling. This means real income and consumption have increased even at the lower levels. The view sometimes expressed that 'the rich have become richer and the poor have become poorer' is, therefore, simply not borne out by the facts. However, the pace of reduction in poverty is much slower than one would have expected. The percentage of the population below the poverty line has been falling at about 0.8 percentage points per year. The latest Planning Commission estimate of poverty, based on the revised rural poverty line recommended by the Tendulkar Committee, indicates that 37 per cent of the population was below the poverty line. If this percentage declines at 0.8 percentage points per year, it would take 25 years to reduce poverty by 20 percentage points! This is clearly unacceptable and it should be the objective of policy to ensure that future growth must be made more inclusive.
2. There is evidence that overall inequality in consumption has increased but the increase is not alarming. The Gini coefficient of consumption has increased only marginally between 1999 and 2000 and 2004 and 2005 to 0.25 for rural areas and 0.35 for urban areas. These measures

of inequality are fairly low. The ratio of urban to rural consumption has remained more or less constant, suggesting no change in rural–urban inequality.

3. Inequality across states has increased in recent years, but it is not true that the poorer states have become poorer or experienced stagnation. In fact, some of the richest states (e.g. Punjab) have been growing more slowly than average while some of the poorest states (e.g. Rajasthan, Bihar and Orissa) have shown an acceleration in growth. More rapid growth has been experienced in states that were in the middle range (e.g. Andhra Pradesh, Tamil Nadu and Gujarat).
4. The size of the population that still does not have access to basic services (e.g. education and health) is larger than the percentage of the population below the poverty line. For example, whereas the latest estimates of poverty show 37 per cent of the population below the poverty line in 2004–05, in 2007–08, 43 per cent of children dropped out of primary school by the age of 11, 47 per cent of women gave birth unsafely (i.e. without at least a skilled birth attendant), 47 per cent of children did not get full immunisation and 55 per cent of the population did not have toilets. It is important to note that all these indicators show improvement over time, suggesting that access to basic services is improving, but the extent of deprivation remains too high and, if the objective is, as it should be, to achieve universal coverage in these very basic facilities, we clearly have a long way to go.
5. As far as narrowing the gap between the Scheduled Castes and Scheduled Tribes and the others is concerned, there is no doubt that a narrowing is taking place, but the gap remains substantial in absolute terms. Accelerated progress in this area must be a major objective government policy and programs.
6. Equality of access to education is perhaps the most important factor for ensuring equality of opportunity, which is an important aspect of inclusiveness. The evidence here is mixed. On the one hand, enrolment in primary schools has increased significantly, being now almost universal, and is also now legally guaranteed by the *Right to Education Act*. However, dropout rates by the end of the primary level are 43 per cent. Besides, expanding access does not automatically ensure a narrowing in the quality of education across income classes, which is essential for improving opportunity. The quality of education in rural

areas suffers because of the difficulty in recruiting qualified teachers and, equally important, the difficulty in enforcing accountability among teachers once recruited.

7. Finally, perceptions about the extent of inclusiveness are affected by the perception of concentration of income and wealth at the upper end. The fact that India is reported to have the third-highest number of billionaires after the US and Russia is often quoted in the press, though the authenticity of the claim is doubtful given the unreliability of information on private wealth in many countries. However, it definitely feeds the perception that the gains of economic reforms have accrued disproportionately to a few.

Part of the problem is that public perceptions of inclusiveness are often determined as much by media projection as by a cold analysis of facts. An active media, including especially the electronic media that now has very wide reach, has tended to heighten the perception of disparity by dramatising both success at the top end and poverty at the other end, both of which are viewed as newsworthy. Unfortunately, the massive and perceptible improvement in living standards in the middle, and the associated rise of a substantial middle class, which is an important social phenomenon with many potentially positive spin-offs for development, is not viewed as newsworthy.

Taking all these factors into account, India's record on inclusion can, therefore, be described as mixed. The positive side is that there is significant improvement in many areas, but it is also true that achievements fall short of expectations. The shortfall is all the more disappointing because of the visible success on the growth front. Can India address the challenge of achieving greater inclusion in all these multiple dimensions? I have no doubt that it can, but to do so calls for conscious shaping of the growth strategy to achieve better outcomes.

Greater attention to growth in agriculture has to be an important part of the solution since around 50 per cent of the population draws the bulk of its income from agriculture and there is considerable evidence that growth in the agricultural sector has a greater impact on poverty than growth elsewhere. Growth of agricultural GDP was 3.6 per cent per year between 1980 and 1996 but it slumped to 2 per cent from 1997 to 2003. The government had set a target of bringing it up to 4 per cent in the Eleventh Plan. Early indications are that there is a turnaround in agricultural performance and agricultural growth may come up to

3.5 per cent in the Eleventh Plan. This will be better than in the Tenth Plan, but shall still fall short of the target. This is an area where we need to do more.

The key to achieving better agricultural performance lies in closing the gap between potential productivity per hectare and actual productivity. Estimates suggest that productivity for many crops can be increased by 80 to 120 per cent, provided technical and other inputs can be made available. Water is a key input, and better systems of water management and water application are critical. Most agricultural growth in the years ahead will come not from food grains but from horticulture, dairying and fisheries sectors in which the product is perishable and requires greater attention to post-harvest conditions including refrigerated transport to urban markets, food processing and exports. Development of these marketing linkages should be an important element of the strategy. Establishing better road connectivity in rural areas can play a major role in promoting agricultural production by improving linkages to markets.

Faster growth in agriculture must be combined with a much faster shift of labour from the agriculture to the non-agriculture sectors. Growth of high-quality, non-agricultural employment will contribute greatly to inclusiveness; therefore, policies for promoting growth of small and medium enterprises, including enterprises in rural and semi-rural areas, are especially important. Absorption of labour in non-agricultural employment would be greatly facilitated by education and skill-development policies aimed at improving the employability of the labour force. Labour market reform is also important in this context, though, as I have mentioned, it is a politically sensitive area in which progress thus far has been limited.

Market Manipulation and Crony Capitalism

Greater reliance upon market forces is a key component of the reforms and has yielded tangible benefits in terms of higher growth. However, it has also posed a new set of problems wherever markets are imperfectly regulated or non-transparent, thereby providing opportunities for manipulation, corruption and crony capitalism. These problems are by no means unique to India. Indeed, we have seen a string of corporate scandals in the industrialised world ranging from Enron, Worldcom, Parmalat and Madhoff etc., and a great deal of regulatory manipulation in

the run-up to the financial crisis. Perhaps because of these developments, sensitivity to corporate wrongdoing has been heightened, and there is certainly a perception that the scale of such activity has increased in India. These developments need to be countered by appropriate policy initiatives if the reforms are not to be brought into disrepute.

Raghuram Rajan, in the Indian edition of his recent book *Faultlines*, draws special attention to two areas. One is the market for land that remains subject to extensive and highly discretionary control by state governments. These controls limit land development in cities as a result of which land values in the major cities are hugely inflated and there are large rents to be enjoyed by those who can obtain the relevant permissions to develop land. Since the grant of permission is discretionary and non-transparent, this inevitably leads to suspicion of corruption and cronyism. These areas of discretionary policy need to be reviewed and more transparent mechanisms put in place. Acquisition of agricultural land for industrial development, or for creating industrial parks, also presents a problem because the *Land Acquisition Act* is hopelessly outdated and provides for very inadequate levels of compensation, often below true market prices. Modernisation of this piece of legislation is urgently needed and this is currently under consideration.

The second area that deserves special attention relates to those sectors that have been opened up for private sector activity, but are subject to various types of discretionary controls and regulation. Telecommunications and mining are two such sectors in which allegations of corruption and cronyism surface frequently. The government is currently engaged in a major investigation of some decisions in the telecommunications sector.

The importance of taking corrective steps to minimise market manipulation and cronyism cannot be doubted. An environment that encourages cronyism will crowd out genuine entrepreneurship and this can only weaken growth potential. It also greatly undermines the social legitimacy of a private sector-led growth process. Wealth accumulated through genuine entrepreneurship that succeeds in creating in a competitive environment evokes much less resentment than wealth accumulated through cronyism and market manipulation.

Managing the Energy Challenge

Managing the energy requirements of rapid growth will be a major challenge for India in the years ahead as the global supply of conventional energy sources is almost certain to become much tighter. We will need to evolve a growth strategy that is much more energy efficient, thus reducing the energy intensity of GDP. We will also need to take steps to increase the domestic supply of energy from all sources, conventional and non-conventional.

Reducing the energy intensity of GDP calls for action on three fronts. First, we must align domestic energy prices to world prices. With energy prices below world prices as at present, it is difficult to believe that the full scope for energy efficiency can be achieved. Second, we must have a proactive policy of pushing energy efficiency through non-price mechanisms such as regulation and standard setting for appliances, equipment and buildings. Third, we need to bring about inter-sectoral shifts that economise on energy such as the shift from road to rail and from private to public transport in urban areas. The government is acting on all these fronts, but much more needs to be done.

As far as energy pricing is concerned, the government has adopted a general policy that energy prices must be aligned with world prices but this policy has not yet been fully implemented on the ground. Prices of petrol (gasoline) have been decontrolled. Prices of diesel are also proposed to be decontrolled, but this has yet to be implemented; it is expected that it will be done in phases. LPG (liquefied petroleum gas) and kerosene prices remain under control and are currently well below the normal level. The original rationale for keeping these prices under control was that increasing them would hurt lower income groups. However, the subsidy implicit in low prices is completely untargeted and a shift to a targeted subsidy is necessary. Coal prices have been decontrolled, but the nationalised coal companies have maintained domestic prices about 30 per cent below world prices at levels that are after allowing for coal quality. Prices of electricity are set by supposedly independent state regulators, but there is great resistance to selling prices at economic levels that will cover costs.

On the supply-side, we are doing what we can to expand domestic availability of petroleum and gas and also coal. Both petroleum and natural gas are open to investment by the private sector, including foreign

investment. The coal industry is nationalised but private sector investment is allowed in captive coal mines (i.e. coal mines linked to power plants or steel and cement plants). This exception is an important window of flexibility and has led to sufficient investment in captive coal mines. The case for moving away from nationalisation and allowing private investment in non-captive mining is strong, though there are political sensitivities here. Expanding coal production in the future is also affected by the fact that much of India's coal reserves lie in forested areas where there are environmental limits on mining. Efforts are being made to reconcile these conflicting objectives in a rational manner. India is actively following a policy of investing in coal and oil assets abroad.

India has good prospects over the longer term for exploiting nuclear power. The recent agreement with the Nuclear Suppliers Group enables India to expand the program of setting up conventional first-generation reactors based on imported uranium. The spent fuel can be reprocessed and the reprocessed fuel and the plutonium generated in the process can be used in second-stage, fast-breeder reactors. This strategy will enable India to build up a stock of safeguarded plutonium to be used in the third-stage, thorium-based reactors, on which research is underway in the hope that commercial production will be feasible in the future. India has the world's largest supply of thorium and, if the technology for thorium-based reactors is commercially proven as expected, India could aim at having as much as 500,000 MW of nuclear generation capacity by 2050.

Along with efforts at expanding nuclear power, India is also engaged in developing solar-based generation using both photovoltaic (PV) and thermal solar technology. A program has been initiated to install 20,000 MW of solar power by 2020, consisting of equal amounts of PV and thermal capacity.

Since both nuclear power and solar power are more expensive than conventional thermal generation, the development of supplies from these sources will only produce energy at higher cost. Costs can be expected to come down as technology develops further, but in the next decade at least there is no doubt that energy costs will rise. There is an obvious need to absorb these costs through higher energy prices and this poses a challenge to policymakers. It is always difficult to raise prices, but unless this is done, energy supplies will not be financially viable and the incentives to reduce energy intensity of GDP will be weakened.

Managing Water Resources

The challenge of managing scarce water resources is, in some ways, even more daunting than the challenge posed by energy. This is because, unlike energy, we don't really have 'non-conventional' sources of water. India's available fresh water is the same as it was 5,000 years ago, and the population has grown and so has GDP. On some calculations, the per capita availability of usable fresh water in India is now close to the level normally associated with water stress. In many parts of the country, there is clear evidence of excessive withdrawal of groundwater, leading to a steady lowering of the water table.

Most studies indicate demand for water rapidly outstripping supply as GDP expands and with it the demand for water. There is room for expanding water supply by building storage dams, investing in improved groundwater recharge and also treating wastewater for re-use. However, a large part of the solution lies on the demand-side in improving efficiency of water use.

The good news is that water is very inefficiently used at present and there is considerable scope for saving water by increasing efficiency. About 80 per cent of India's water use is for agriculture and it is technically feasible, with better agricultural practices, to reduce water use in agriculture by 50 per cent. However, this is possible only by adopting more modern agricultural practices. Persuading millions of small farmers used to time-tested traditional methods is very difficult, requiring not only a great deal of effort to disseminate new technology but also extra resources. This transformation will have to be built into the development strategy for agriculture. It will also have to be supported by agricultural research directed towards evolving crops capable of dealing with water stress.

An important reason why the water crisis is more difficult than the energy crisis is because most people recognise that energy has to be paid for, whereas the pricing of water poses many problems. The National Water Policy states that water is scarce and we must conserve every drop, but as long as we are not able to price water to reflect its scarcity, it is difficult to incentivise economic use. Farmers, in particular, have long been used to regimes in which water is severely underpriced, even though the system does not actually assure them of the water they need in a predictable manner. Further, if left unchanged, it will definitely deliver less and less. There is an overwhelming need to adjust water prices both to encourage

economic use and to ensure effective maintenance of irrigation systems, but this is politically difficult. The alternative is to put in a system that will equitably ration water for different uses so that available water can be distributed to different uses and variations in supply can be met by fair adjustment of allocations for different uses. In practice, we have to use both prices and better regulation.

Rational use of water calls for basin-specific strategies based on a scientific assessment of how available water resources in each basin can be allocated to different uses. It will be necessary to set up statutory water regulators to determine water allocation for different uses, such as household needs, agriculture and industrial use, with some method of varying entitlements for different uses in the event of variation in supply. A start has been made in some states (e.g. Maharashtra) but we have a long way to go.

I am told that we could learn from Australia's experience in the area of water management because water use in the Murray–Darling Basin showed many of the problems we are facing.

Managing the Urban Transition

A new challenge that the economy will face in the years ahead because of the acceleration in growth is that of urbanisation. The rate of urbanisation in India has been slow historically, but is expected to accelerate in future because of faster growth, especially non-agricultural growth. The urban population is currently around 30 per cent and is expected to reach 40 per cent by 2030, which means the urban population will increase from about 300 million today to 600 million by 2030.

An expansion in urban population on this scale requires a massive expansion in urban infrastructure, especially if we keep in mind that only about half of those currently in urban areas are adequately served even by today's standards. The resources needed to achieve this expansion in urban infrastructure are much larger than what the cities or local urban bodies can mobilise on their own.

Lack of resources for urban development is partly a reflection of the fact that cities and urban local bodies in India have very limited capacity to raise their own resources. Most of the revenue generated from economic activity in the cities accrues not to the city but to the central or state governments, and there is much less devolution to city government levels

than there should be. For some urban services, such as water and sewerage or urban transport, it is possible to generate revenue on the basis of a user charge, but potential revenues are not realised because of a long tradition of fixing low user charges. There is scope for unlocking land value to finance urban infrastructure, but this avenue has not been adequately used.

Historically, cities all over the world have rarely financed all the infrastructure they need themselves. The national government has contributed in various ways and this will have to be done in India also. However, the cities have to take on a much larger part of the burden than they do today. The growing urban population has to be persuaded that they have to pay for urban services and this requires a mindset change not only among the city dwellers but also among politicians. The same is true about persuading state governments to devolve more resources from general revenue to urban local bodies.

In addition to the financing problem, urban infrastructure development is also impeded by the lack of capacity at the city level to manage and plan for infrastructure expansion. India is likely to have a large number of cities with populations exceeding 10 million by 2030. However, the system of local government in India is such that cities are not run by empowered city managements. Too often, critical decisions regarding the needs of metropolitan cities are made by state governments that respond not to the electorate in the cities but to the electorate in the state as a whole. In the process, the needs of the cities tend to be ignored and the city government is not adequately empowered to address these needs. A broad-based change in governance structures will be needed if cities are to manage the transition now facing them.

Before concluding, I should perhaps mention one other challenge and that is climate change. This is not just a challenge for India. It is a challenge for the global community as a whole. No country can solve this problem on its own for the simple reason that whatever we do individually to mitigate climate change, does not just help us, it helps everybody. Since the benefits of mitigation are externalised, we know that, left to themselves, countries will do much less to combat climate change than they should. Therefore, the solution to the climate change problem can only come from a collective decision, and a collective decision can only materialise if countries can agree on a fair distribution of the burden of action among countries. Unfortunately, the world is making less progress in agreeing on what is a fair distribution of the burden than one would have hoped.

I would like to emphasise, however, that we in India are not waiting for a global agreement before we act. We have taken a number of initiatives under a National Action Plan for Climate Change. The plan involves some action in the area of mitigation and some in the area of adaptation. I will not get into the details, but let me just say we have set a national target that we need to reduce the emissions intensity of GDP by 20 per cent between 2005 and 2020. That's not a reduction in the emission levels; it is a reduction in the emissions intensity of GDP, but that is extremely important. I should also clarify that this is not a binding commitment as part of an international agreement. It is a self-imposed national target, but I am quite certain that we will be able to meet it. Indeed, it is our hope that we will do even better in practice.

These are some of the challenges we have to face to ensure that India does achieve her full growth potential. I am sure there are others. We expect to outline them more fully as we move to finalise the Twelfth Five-Year Plan by 2012.

This text is taken from *Twenty K.R. Narayanan Orations: Essays by Eminent Persons on the Rapidly Transforming Indian Economy*, edited by Raghbendra Jha, published 2021 by ANU Press, The Australian National University, Canberra, Australia.

doi.org/10.22459/TKRNO.2021.14