Indian Economy: Current Problems and Future Prospects

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I am grateful to Dr. Rangarajan for giving me the opportunity to address a distinguished audience composed of the faculty and students of the ICFAI Business School, and also senior economic journalists whose columns I have read and benefited from over a long time. I am honoured by the fact that so many of you have chosen to be present when more attractive opportunities to listen to classical music at many sabhas in the city are available.

Nearly twelve years ago, we were in the midst of a severe macroeconomic and balance of payments crisis. The government of Prime Minister Narasimha Rao that had just come to office took some immediate steps to address the crisis, including seeking the assistance of the International Monetary Fund and the World Bank. But the Prime Minister and his Finance Minister, Dr. Manmohan Singh, realized that it would not be enough to take whatever actions were necessary in the short run to tide over the crisis and return to the pre-crisis policy regime thereafter, but systemic reforms and rethinking of the pre-crisis policy regime, and even more importantly our development strategy, were called for. This realization led Dr. Singh to initiate systems reforms. In my view, these reforms would not have been initiated but for two external events. First was the collapse of the Soviet Union and its economy, whose central planning was the model for our own development. Second was the phenomenal success of China since the opening of its economy to foreign trade and investment in 1978. It brought home the message that, unless there was a systemic change in economic policies and management, India would be

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This is a revised and extended text of a lecture delivered on January 3, 2003 under the auspices of the ICFAI Business School, Chennai, India, and to appear in *ICFAI Journal of Applied Economics.*

I thank Nicholas Hope, Mohsin Khan, Venugopal Reddy, Shankar Acharya and Suresh Tendulkar for their valuable comments.

left behind by its chief economic and political adversary in Asia, namely China. My emphasis on the contribution of external events to the initiation of systemic reforms is not to suggest that there was no rethinking earlier of our economic policies. Indeed, several high level committees had reviewed some of the policies (for example, the Abid Hussein Committee on Trade Policy in 1984, the Narasimham Committee on Controls in 1985). Of course, Rajiv Gandhi and some young economists from the World Bank he recruited for his staff did attempt to relax some of the most irksome controls. It is possible that he might have introduced systemic reforms had he not been stymied by his own party and not been distracted by the Bofors scandal. But I think it is unlikely since there was no push for system reforms from any quarter then.

It so happens that a number of reports on important economic policy have been published in the last year. The National Development Council very recently adopted the Tenth Five-Year Plan. The Consultative Group on direct and indirect taxes, chaired by my friend Vijay Kelkar, circulated its reports for comments. The Second Labour Commission came out with its report a few months ago, and so did the N. K. Singh Committee on Foreign Capital. A mid-year review on the developments in the economy, with a particular focus on central government finances for the first half of the fiscal year 2002-03, has just appeared. The Planning Commission has just published a National Human Development Report (HDR). Several states had issued their own HDRs earlier. There is a wealth of data, information, some analysis, and many policy recommendations. With these as background, I thought the best use of the opportunity to speak to you is for me to reflect on where the Indian economy is, and where it is likely to go in the near and medium term[1].

Since one of the major objectives of reforms was to reintegrate the Indian economy with the world economy by drastically reducing, if not dismantling altogether, the barriers to foreign

trade and investment that we had erected during the four decades of pursuit of our inward-oriented development strategy, I will comment on our achievements in this regard[2]. In doing so, I will note that we are trying to reintegrate India with the world economy at a time when the rest of the world is also attempting the same thing. Indeed, this process, dubbed "globalization," has been underway for over a decade and a half or so. Economic historians point out that the current wave of globalization is in many ways similar to and a resumption of, the earlier wave of the late-nineteenth century that ended at the outbreak of the first World War. Be that as it may, given that many developing countries are trying to globalize at the same time, we have to compare our achievements in this regard with those of our competitors. Among our competitors, for obvious reasons, China is the most important. I will compare our performance with China's several time during this talk.

The contemporary Indian macroeconomic scene is a paradox. Consider the following facts: fiscal deficit of centre and states together in 2001-02 at 9.9% of GDP is higher than its level of 9.4% in the crisis year of 1991. If we add the deficit of the non-financial public sector enterprises to the conventional fiscal deficit, the overall deficit would be even higher now as a proportion of GDP than in 1990-91. The revised estimates for 2002-03 suggest a gross fiscal deficit of 5.9% for the central government. The budget estimate for 2003-04 is only marginally lower at 5.4%. On the other hand, our current account has turned into surplus, and foreign exchange reserves crossed the $80 billion mark at the end of May 2003. Stocks of rice and wheat at the beginning of January 2003 with the government, at 48 million metric tons, was about three times what would be required for the operational and buffer stock needs (GOI 2003, Table 5.12). It appears that commercial banks are holding more government securities than they

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[1] Acharya's (2002) analysis of India's growth prospects is similar in many respects to mine.
[2] For an analysis of retintegration, see Srinivasan and Tendulkar (2003).

are required to hold. Despite a serious drought, inflation is not an issue, and interest rates are falling. Taken together, these facts are paradoxical for a developing country such as India and suggest a rather unhealthy state of affairs.

I say so because, for a poor developing country, it would be normal for the current account to be in deficit, being financed by a capital account surplus from sustainable foreign capital inflows. And again, it would be normal for the capital inflows to support domestic investment in growth-promoting capacity. Instead, we have a current account surplus, and capital inflows are reflected in the accumulation of reserves[3]. This is not the occasion to debate why many developing countries, including ours, fear a clean float of the exchange rate and thus minimize their need for reserves. In fact, ours is a regime of managed float in which the exchange rate of the rupee has been kept within relatively narrow bounds. Given this fact, I do not wish to minimize the insurance role of reserves in smoothing shocks to terms of trade and in responding to the volatility of short-term capital flows. Still, our reserves are far higher than our short-term external debt. Although a part of capital inflows reflect the fact that real interest rates in capital exporting rich countries are currently lower than ours, such capital flows are sensitive to the differentials in real interest rates and volatile. We could experience a fairly sudden outflow of such capital if real interest rates rise elsewhere relative to ours. It is true that reserves (at least that part which is not gold and foreign currency) do earn a positive return. However, unless I am very mistaken, the overall marginal return from reserves, even taking into account the insurance aspect, would almost certainly be much less than the return from growth-enhancing investments in the economy were the situation to be normal. The Reserve Bank of India (RBI) has intervened to buy foreign exchange so that the rupee does not appreciate too much and hurt

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[3] By accumulating reserves, China, India, Pakistan, and other poor Asian developing countries are in effect lending to the rich US and financing its current account deficit!

our exports. Even so, my point would be that had the situation been normal, appreciation would have been less likely, and RBI would not have had to intervene.

Looking at the situation from a different perspective, our high fiscal deficit apparently has not put pressure on the current account. It would have, if either an increase in the fiscal deficit reflected higher public investment expenditure, such as on infrastructure, which in turn crowded in private investment so that aggregate investment exceeded domestic savings to a larger extent, or alternatively, private investment was rising regardless of the composition of public expenditures. The fact it has not could mean either the deficits crowded out private investment so that an increase in the fiscal deficit was accommodated by a fall in private investment, given total domestic savings, or private investment was down for other reasons, and its fall enabled the government to run higher deficits. Had there been serious crowding out of private investment, I think we would not have seen a downward movement in interest rates. Also, the fact that banks are investing in government securities rather than commercial paper suggests that all is not well with private investment, though I do not wish to downplay the chilling effect on the investment decisions of public sector banks because of the prospect of the management being pilloried by members of Parliament and criticized by the Comptroller and Auditor General if investments do not pan out for reasons other than poor judgment of the management.

A careful empirical macroeconomic analysis that distinguishes exogenous shocks and endogenous responses to those shocks and allows for leads and lags is necessary for us to arrive at a sound explanation for our abnormal macroeconomic scene. Unfortunately, the abysmal state of macroeconomic statistics relating to savings investment and GDP precludes such an analysis. My look at the available data suggest that funds available for financing investment by the public

and private non-household sector from financial savings and capital inflows exceed the estimated investment, the difference being attributed in official statistics to errors and omissions[4]. These have been large in recent years. In any case, my bottom line is that our abnormal economic scene is a reflection of our poor investment climate. Real gross domestic capital formation (RGDCF) by the private corporate sector as a proportion of real GDP has been declining from its peak value of 9.9% in 1994-95 and is provisionally estimated at 4.9% in 2000-01, and quick estimates for 2001-02 put it at 4.8%. RGDCF in the public sector has declined to around 6.4% of GDP in 2000-01 from its peak of 8.7% in 1994-95. As we all know, our aggregate growth has declined from a peak of nearly 7.5%, reached in 1996-97--it touched a rock bottom of 4.4% in 2000-01. In my darkest moments, I feel that 5% to 5.5% per year represents the early twenty-first century version of the infamous "Hindu" rate of growth of 3.75% per year during 1950-80, adjusted for the much lower share now of agriculture in GDP and larger share of services. I am not entirely reassured by the expected growth of around 5.6% (quick estimates) this fiscal year (2002-03) and even lower advance estimates of 4.4% for 2002-03. I cannot help feeling the economy might be converging to the revised "Hindu" rate of growth. Needless to say that just as the old "Hindu" rate of growth was woefully inadequate to make a dent in our massive poverty and did not, the new "Hindu" rate of growth will not either.

The Tenth Five-Year Plan (2002-2007) has just been adopted by the National Development Council. In commenting on it, my good friend, Shankar Acharya, former Chief Economic Adviser in the Ministry of Finance, asked recently , "What should we look for in a Five-Year Plan?" He answered that question by saying that, "Most of the world would say 'nothing,' since they gave up national planning as a futile activity many years ago" (Economic Times, January 2, 2003). He is certainly right; planning of the type we engaged in for five

[4] I discuss the problems with our macroeconomic and other data in Srinivasan (2003).

decades is futile. But even if the document is termed the Tenth Five-Year Plan, as Acharya rightly points out, it would be extremely useful if it contains a coherent (aggregate and sectoral) analysis of the macroeconomic indicators of growth, balance of payments, inflation, etc., for the medium term, points out potential problems, and suggests remedial actions. Needless to say, a coherent analysis for the medium term has to be embedded in a vision for the longer term. The late, unlamented plans of the past had a perspective plan for the long term, a five-year plan for the medium term, and an annual plan for the near term. I need not remind all of you that this neat dovetailing in the plan documents did not mean much operationally--mutual consistency between the planning exercise and the operational annual budget-making in the Centre and States, let alone consistency between plan targets for investment by the private sector and what private sector actually did or intended to do was missing[5].

The Tenth Plan Document is notable for recognizing the primary importance of rapid aggregate growth for eradicating poverty in a not too distant future and setting a growth target of 8% per year. Let me say with all the emphasis I can command: without sustained and rapid growth, eradicating poverty, and India becoming an economic power which would be taken seriously by the rest of the world, would be just pipe dreams. One could legitimately discuss alternative growth strategies for their effectiveness in eradicating poverty, but make no mistake about it, there is little to discuss without some growth-promoting strategy to which other strategies could be compared.

Our record of failure to achieve targeted growth except in a couple of plans naturally raises the question whether the target for the Tenth Plan is once again unrealistically ambitious.

[5] It is silly to say, as is very often done by many, that there was nothing wrong with our plans and planning, and everything was wrong with their implementation. After all, any plan that assumes way problems of implementation cannot be called a plan, but only a fantasy!

However, I would argue that an 8% rate of growth is eminently feasible to achieve. First of all, India's average annual growth rate was close to 6% since 1980, with a peak rate of 7.5% in 1996-97. An acceleration to 8% from this base is not a substantial jump. Second, our current macroeconomic scene is one of subdued investment climate, which in turn means that once the climate is changed for the better (or to use Keynes' colorful phrase, "animal spirits" are revived) the comfortable stock of foreign exchange and food reserves would enable higher investment rates to be sustained without fear of igniting inflation or running into unsustainable current account deficits. Third, a better domestic investment climate would also attract more foreign direct and portfolio investment.

It is a sad fact that India is still not a very attractive destination for foreign investment. In a developing country such as India, with abundant labour and scarce capital, it would be normal to expect the rates of return to investment to be higher than in capital abundant industrialized countries. As long as risks and frustrations in investing in India do not lower the risk-adjusted rate of return too much, one would expect to see a healthy flow of foreign capital (portfolio, as well as FDI) to raise our investment rate much above our domestic savings rate. The Tenth Plan clearly recognizes the necessity of attracting foreign capital in achieving the target rate of growth. The N. K. Singh Committee report on FDI is very timely from this perspective. Frankly, the mindset of some of our politicians, academics, policymakers, and bureaucrats is yet to change fully from an attitude of hostility to one of welcome to foreign investment, and it continues to be a deterrent. It is no mystery then that FDI inflows to India ($3.4 billion in 2001) are less than what the much smaller economy of Thailand received ($3.8 billion in 2001), even after going through a severe financial and exchange rate crisis. Of course, China received ($44.2 billion in 2001) several times the flow of FDI than India (World Bank 2003, Vol. 2, Country

Tables). I will comment in a while on a comparison of Chinese and Indian economic performance in the last two decades of the twentieth century[6].

The data on FDI flows leave a lot to be desired in terms of comparability across countries and over time. It is true that India's conventions in determining what constitutes FDI tend to understate flows to India. Added to this is the so-called "round-tripping" of capital--that is, domestic capital flowing out and then returning in the guise of FDI to take advantage of concessions offered in FDI--which overstates FDI flows to some countries, such as China[7]. Having said all this, I do not believe adjusting flows to India upward and those to China, or Thailand for that matter, downward is going to overturn the conclusion that India receives far less FDI compared to our competitors.

Apart from the paltry inflows of FDI, there are other indicators of India's poor record of globalization. One such indicator is the A. T. Kearney / Foreign Policy Magazine Globalization Index, based on thirteen variables (including FDI, portfolio flows, trade). India was ranked at 56 among 62 countries, below Bangladesh (54), Pakistan (50), and Sri Lanka (44). Although China's rank was 51 overall, with respect to FDI, it was rated as 27 in comparison to India's rank of 55. Another telling indicator is the share of India's exports in total world exports. Our share was 2.2% in 1948, and insulation from the world economy during our pursuit of an inward-oriented development strategy led to a drastic drop in this share to a low of 0.5% on the eve of reforms in 1991. It has since climbed slowly to 0.8% in 2002. By contrast, the Chinese share, which was around 1% on the eve of China's opening and reforms in 1978, more than quadrupled

[6] For an optimistic assessment of the possibility of India making up its substantial gap relative to China by concentrating on agriculture, IT services and exports, see Swamy (2000).

[7] It is true that investment by overseas Chinese accounts for a significant share of FDI inflows to China. It is also true that FDI by them in manufacturing for exports contributed significantly to China's success in raising its share in world exports. But neither fact implies that overseas Chinese chose to invest in China for non-economic and sentimental reasons. Without a receptive environment in China and the prospect of earning a substantial return on investment, neither the Chinese diaspora nor any other foreign investor would invest in China.

to 5.1% in 2002 (WTO, 2002, 2003). Clearly, even after more than a decade of reduction of trade barriers and economic liberalization, India is still insular and far from significantly globalized.

Let me turn to the constraints (not necessarily in order of importance) on our economic growth, most of them well known. I have already referred to our insufficient integration with the world economy. Our tariff barriers are still high: the weighted average import duty rate having fallen from a high of 72.5% in 1991-92 to 24.6% in 1996-97 has since risen to 35.7% in 2000-01. They are much higher compared to East Asian countries: the weighted average duty rate in China in 2000 was 14.7%; in Thailand, 10.1%; in Malaysia, 6%; and in Indonesia, 5.2% (Reserve Bank of India, 2003, Tables 7.1 and 7.2). There is considerable evidence India's exports respond to changes in the real effective exchange rate. Although the RBI has intervened to keep the exchange rate from appreciating (and, as I said earlier, this is one reason why our reserves have been going up), still from the perspective of external competitiveness, the rupee is perhaps overvalued. This has a dampening effect on our export growth. Indeed, the adverse effects of factors such as poor infrastructure and high cost of credit, etc., compared to our competitors such as China, could have been mitigated somewhat by an appropriate choice of the exchange rate. However, there are limits to what the RBI can do in response to rising capital inflows. For example, the still relatively small share of public debt held outside the banking system constrains the ability of RBI to engage in sterilization operations.

Exchange rate apart, there are other constraints, such as our small scale industry reservation, that reduce competitiveness of our exports. I compared our export performance in labour-intensive commodities to China's in two major markets, namely, European Union and North American (USA and Canada), during the decade of the 1990s. I considered eight labour-

intensive product categories in which China and India would be expected to have comparative cost advantage. China's share in North American imports rose from 12% in 1990 to a peak of 27% during 1997-1999 and averaged at 22% for the decade of 1990-2000. India's share, on the other hand, fluctuated around an average of 1% with no trend. China's share, as well as ours, in the imports of the European Economic Community fluctuated, around an average of 3% in the case of China and 0.8% in our case.

Our continuing fiscal deficits is another debilitating constraint on growth, whether or not it portends another macroeconomic crisis analogous to that of 1991. Some take comfort from the facts I cited earlier: we have reasonably low inflation, our debt is largely denominated in rupees, and our current account is in surplus. The sharp contrast of these facts with the situation prior to the 1991 crisis leads them to conclude that another crisis is unlikely soon. While there is some validity to this reasoning, these facts also reflect a poor investment climate and a growth hiatus, and as such, any attempt to accelerate growth without addressing the fiscal deficit will most likely not succeed. But if it did, such growth acceleration would not be sustainable and would lead to a crisis sooner rather than later. Indeed, our experience in the eighties, when we achieved a growth of 5.8% per year through fiscal expansionism financed by costly borrowing abroad and at home, confirms this assessment. The fiscal deficit cum debt-led growth led directly to the macroeconomic crisis of 1991. Let me note that the official data on deficits do not include the losses of our non-financial public enterprises as well as contingent liabilities, for example, such as those arising from having to deal with the non-performing loans of banks and unfunded pension liabilities, etc. For addressing the problem of deficits seriously, we have to reform both our tax and expenditure system and priorities, and rethink the Centre-State fiscal set up of our constitution.

Taking taxes first, tax revenues as a proportion of GDP in India at about 16% of GDP (GOI 2003, Table 2.11) is not high compared to low income developing countries. In fact, tax revenues of the central government as a proportion of GDP has been steadily declining in the 1990s, with the rise in direct tax revenues more than offset by the decline in indirect tax revenues, both expressed as a proportion of GDP. Besides, India and Argentina and a few others share the unenviable distinction of having a relatively low tax to GDP ratio and a notoriously inefficient and corrupt tax administration. There is evidence that tax buoyancy has sharply fallen in the post-reform period of 1994-2001 compared to earlier (Reserve Bank of India, 2003, p. iv-10). Clearly, without a buoyant tax system and a rising tax/GDP ratio, that state would be increasingly constrained in providing those goods and services that only the state can provide for rapid growth in a largely market-driven economy. It is equally clear that expanding the tax base while keeping the tax ratios modest is the only way to go by way of tax reform. The Kelkar Committee has made several useful recommendations in this regard. However, while doubling the exemption limit, as it recommends, may be worthwhile from an administrative perspective given the current state of tax administration, I am afraid it does not sit well with expanding the tax base. The Committee, while stating that the exemption limit must be at a moderate level, does not say what it means by "moderate." Measured relative to GDP per capita, our exemption limit is among the highest in the world. The Committee's argument that the so-called "one-by-six" scheme would ensure that most of those with incomes between the current and proposed exemption limit will continue to file their returns is beside the point--even if they file, they would have no tax liability. I would have preferred exploring much further than the Committee as to how tax administration could be streamlined and made less corrupt while dealing with a largely expanded tax base, than take many out of the tax base

through raising exemption limits[8]. For lack of time, I will not discuss tax reform any further. On the expenditure side, reducing subsidies which have no rationale from a distributional or efficiency perspective is an urgent task. I am afraid that even taking together the Kelkar and earlier reports on tax reform and the recommendation of the expenditure reform commission, they still do not come close to a blueprint for reforming tax and expenditure system. And the needed reforms cannot be explored without examining the whole gamut of Centre-State economic relations by rethinking the Seventh Schedule of the Constitution, the role of the Finance Commission, and not least, the transfers through the Planning Commission which have no, or at least weak, basis in the Constitution. Other large federations such as Argentina, Brazil, Mexico, Nigeria, etc., have tried other ways of organizing the federal-state economic relations.

Two other serious and binding constraints in accelerating our growth are our labour and bankruptcy laws. The cost of hiring and firing of workers by firms covered by labour laws is high. It is virtually impossible for uncompetitive and loss-making enterprises above a certain size to close down without getting government permission and going through costly delays. The sorry tale of the Board for Industrial and Financial Restructuring, to which such enterprises have been referred, is well known. The Second Labour Commission in its report has documented that our labour law is a major contributory cause of our abject failure to increase by very much the share of our labour force employed in manufacturing. Sadly, over 60% of our labour force continues to depend on agriculture for employment, either directly or indirectly. More than four decades ago, Professor P. C. Mahalanobis, who was no right-wing reactionary, drew attention to this problem in his review of Gunnar Myrdal's "Asian Drama.[9]" It is worth quoting him:

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[8] In any case, the Finance Minister has largely ignored the Kelkar Committee's recommendations in the budget for 2002-03.
[9] Mahanalobis (1969).

> ". . . in certain respects, welfare measures tend to be implemented in India ahead of economic growth, for example, in labour laws which are probably the most highly protective of labour interests, in the narrowest sense, in the whole world. There is practically no link between output and remuneration; hiring and firing are highly restricted. It is extremely difficult to maintain an economic level of productivity, or improve productivity. At early stages of development in all countries there has been a real conflict between welfare measure and economic growth. Japan is an outstanding example; the concept of minimum wages was introduced only about 10 or 12 years ago when per capita income had reached the level of $250 or $300 per year; and minimum wages were fixed more or less at actual average levels. In India with a per capita income of only about $70, the present form of protection of organized labour, which constitutes, including their families, about five or six per cent of the whole population, would operate as an obstacle to growth and would also increase inequalities. It is a serious problem not only in India but in other under-developed countries" (442).

Professor Mahalanobis realized, that were the labour laws to be repealed and the right of hiring and firing restored, it would be necessary to make arrangements to provide for discharged employees. He suggested that a:

> ". . . Labour Reserve service (LR) be set up to absorb such industrial workers as may be considered surplus and be "laid off" by existing industrial enterprises at their discretion, and also to serve as a pool for other enterprises to draw upon, again, at their own discretion. The Labour Reserve service would then act as a buffer against unemployment and would serve as a (perhaps socially more useful and psychologically more preferable) form of or substitute for unemployment insurance limited, however, in the first instance, to persons who are already factory workers. The responsibility would rest on Government to make the best use of the Labour Reserve. The workers admitted into the Labour Reserve would receive, not the full, but a suitable part (say, between a half and three-quarters) of the emoluments they were receiving in their original posts; they would also be bound to take up whatever work they were offered by the LR authorities and if they refused they would have to leave the LR. It should be possible to recover an increasing part of the expenses out of productive work taken up by the LR. The balance of the cost may be met partly by a comparatively small (LR or unemployment insurance) levy on enterprises, partly by a direct contribution for each worker sent to LR by an enterprise, and partly by Government out of its general income. An enterprise would send an employee to the LR only when the benefits accruing would be considered to be commensurate with the direct contribution" (442).

Professor Mahalanobis's analysis and suggestions of forty years ago are still valid. Alas, we now have an entrenched labour aristocracy in government and the organized sectors which is

intent on keeping its privileges regardless of their cost to the overwhelming majority of the people. This aristocracy probably consists of about 10% of the population now as compared to the 5% to 6% estimated by the professor. But it is still a small minority. Of course, unions of all political parties, bar none, share this position, and therefore it is unreasonable to pick only on left parties. But I must say I find it bizarre that even some of the modest proposals of the Second Labour Commission have been criticized by them as "anti-people!" What has been anti-people has been our development strategy that emphasized state-directed, public-sector dominated import substituting industrialization, which for nearly four decades kept our rate of growth far below what would be needed for making a dent in poverty.

We are all aware of the modest proposals made by the former Finance Minister to raise the threshold for government permission to liquidate a firm from 100 to 1,000 employees. It is still to be enacted into law. Ironically, although the labour laws are evaded or avoided by private enterprises, albeit at a cost of their competitiveness, the public sector enterprises do not have that option. This has an impact on privatization--in particular, given that our public enterprises are over-manned, any potential private bidder for such an enterprise would not actually bid if he anticipates that retrenching the excess workers would be impossible if he acquires the enterprise or if he did bid, would bid a low enough price for it to account for the costly buy-out of excess workers. In any case, the fact that the public enterprise cannot easily retrench means that its workers would continue to enjoy their privileges whether or not the enterprise earns a social rate of return on capital invested in it. No wonder there is strong opposition from employers to privatization. Clearly, reform of our labour and bankruptcy laws is essential.

The international competitiveness of our exports is adversely affected by the high cost of our infrastructure, including power, transport (roads and rail), ports and telecommunications.

The dismal story of Enron, the withdrawal of proposals to invest in power generation by several foreign investors, and the mishandling of privatization and unbundling of generation, transmission, and distribution of power in Orissa are all well known. Although several states have set up regulatory commissions for power, until the political determination of power tariffs (e.g. free power to farmers) is no longer there, the commissions cannot have much of an impact on tariffs, and the losses of State Electricity Boards (SEBs) continues. Also, as long as power generators have to sell to bankrupt SEBs, there will not be much interest by private investors in putting their money into power generation. It is no surprise that even after ten years of reform that opened power generation for private investment, only around 10% of generating capacity is private. The rate of return on public investment in the power sector deteriorated from -12.7% in 1991-92 to -32.8% in 2001-02 (Reserve Bank of India, 2003, pp. iii-33 and iii-34). With the resources of SEBs and state governments being scarce and getting scarcer, investment in additional capacity will be inadequate. It will take me too long to discuss the problems in road and rail transport. Suffices it here to say, that because the railways in the public sector became relatively costly and inefficient over time, a significant share of the long-distance freight traffic, which would otherwise have been carried by railways, are now carried by lorries. The negative external consequences of this on the condition of roads, accidents, and the environment have not been appropriately addressed. There are a slew of issues relating to railways that need rethinking, from cross-subsidization in rates to the appropriate organizational structure and possibilities for privatization. The remarkable progress on the construction of the Golden Quadrilateral and the two corridors notwithstanding, investment in rural and feeder roads is lagging.

China's success in achieving rapid growth in exports is in part due to its recognition that domestic supply constraints have to be removed if internationally competitive export surpluses are to grow. With this in mind, they created Special Economic Zones in the coastal regions, particularly in the Pearl River Delta. I visited two of these some years ago. What impressed me most was the excellent infrastructure (power, roads, and telecommunications) of the zones. Moreover, the Chinese ensured that foreign investors were welcome, even on a 100% ownership basis, and that no labour laws would prevent employers from hiring and firing workers for purely business reasons. Long before China established its zones, we had established one in Kandla--but unlike the Chinese, other than providing duty-free access to imported inputs, we did virtually nothing else. In fact, not only were our import-substitution mindset, labour laws, restrictions on foreign ownership, etc., carried over to the ostensibly export-processing zone of Kandla, no attention was paid to the infrastructural needs. I am not sure whether the right lessons have been learned from the Chinese success and our failure in Kandla in the operation of our recently created export processing zones.

It is sobering to read the following description in the *Financial Times* (February 4, 2003) of the success of firms in the Pearl River Delta:

> "Shunde styles itself as the microwave oven capital, with 40 per cent of global production emerging from just one of its giant factories. Shenzhen, the special economic zone, claims to make 70 per cent of the world's photocopiers and 80 per cent of its artificial Christmas trees. Dongguan has 80,000 people working in a single factory making running shoes for the world's teenagers. Zhongshan is the home of the world's electric lighting industry. Zhuhai, until recently a seaside town surrounded by paddy fields, is reclaiming land from the ocean to make more room for factories that already dominate global supply of everything from computer game consoles to golf clubs" (13).

Although there are reports that Chinese firms continue to expand production even though unsold stocks accumulate, Chinese banks continue to extend credit to them regardless of this, and China's fixed exchange rate with the US dollar undervalues its currency, and through falling

export prices China is spreading deflationary tendencies to the rest of the world, much of this criticism sounds more like sour grapes.

Turning to financial sector reforms, a major step has been taken toward addressing the problem of non-performing assets (NPAs) of banks with the enactment of the law for Securitization, Reconstruction of Financial Assets and Enforcement of Security Interest. This law empowers banks and financial institutions to enforce their secured creditor rights without going through a long and cumbersome legal process. However, it is one thing to set up a mechanism for dealing with past accumulations of NPAs, but it is an entirely different thing altogether to ensure that new NPAs are not created. Unless the banks and other financial institutions can expect to face the consequences of their letting new NPAs arise, the problem will recur. In this connection, recapitalizing the Indian Bank more than once, the bailing out urban cooperative banks in Gujarat and UTI from US-64 mess are the wrong signals to send. It has been suggested that these are exceptional cases, the moral hazard involved in the bail-outs is minimal and in any case, the cost to the society had they been allowed to collapse would have been very high. While there is some merit in this suggestion, one cannot be certain that all relevant participants view them as exceptional and unlikely to be repeated[10]. In any case, as long as a large part of the banking system is publicly owned, reducing political interference in their lending decisions is virtually impossible. I would argue in favour of privatization of most of the public sector banks and ensure that they are appropriately regulated. In such a context, we might have to rethink the traditional role of the RBI as the sole regulator. The reason is that the distinction between bank and non-bank financial intermediaries is eroding, and the range and

[10] Nicholas Hope pointed out that China also mistakenly recapitalized banks partially without giving them the freedom to fail or succeed commercially on their own. He correctly argued that until the banks can learn to compete and succeed commercially on their own, bailing them out of past dooms, even if they were dictated by the government, is premature.

diversity of highly substitutable financial products is increasing. Whether, as we have now, there should be separate regulatory agencies for equity market, banks, non-bank finance companies, and insurance companies or, as in the United Kingdom, we should create a single regulatory authority for the financial sector as a whole, is worth examining.

Last, but certainly not least among debilitating constraints is our poor human capital. There can be no doubt that the productivity of our workers, and hence the level and growth of their incomes, is adversely affected by the low levels of education and health. While we can be legitimately proud of the quality of the graduates of some of our institutions of higher learning, such as Indian Institutes of Technology and of Management, and their contribution to the success of our Information Technology Sector, it is a sad fact that the quality of our higher education has been declining except perhaps in technical fields. There is no doubt that our elementary schools and primary health centres do not provide quality education and health care for the overwhelming majority of our population. However, a number of initiatives involving local institutions, such as panchayats, community of parents, non-government organizations, etc., in the schooling of children, particularly in rural areas, are being tried in various parts of the country. Evaluation of these initiatives (which is not a simple matter) might help in thinking about the most cost-effective of delivering quality educational and health services to the population. The information technology revolution has opened up new ways of delivery. It is time we rethink the role of private and public sectors in the provision of social services.

Let me conclude with another China and India comparison. China and India enjoyed historically unprecedented average rates of growth of GDP at around 10% and 6% per year respectively during 1980-2000. Fewer than 10 of over 200 countries covered by the World Bank exceeded India's growth rate and none exceeded China's. Both in China and India, poverty went

down substantially in the last two decades of the twentieth century when both experienced acceleration in their growth rates, according to official data of both countries. Without entering into the controversy on poverty estimates for 1999-2000 from the 55th round of the National Sample Survey, let me just cite estimates by Angus Deaton who adjusts for some of the problems with the 55th round data[11]. The ratio of India's population living below the national poverty line fell from 39.0% in 1987-88 to 21.6% in 1999-2000 in rural areas and from 22.8% to 9.5% in urban areas. Though not quite comparable to Deaton, according to Datt, in 1977-78 the poverty ratio was 50.5% and 40.5% in rural and urban areas, respectively[12&13]. In fact, from the 1950s to the late seventies, the poverty ratio fluctuated with no downward trend. Unlike India, where household survey-based estimates are available from the 1950s, Chinese poverty data based on household surveys are relatively recent--official poverty lines and poverty headcounts going back to 1978 were first announced in 1994, superceding some earlier ad hoc estimates. If these official data are to be believed, rural poverty has been virtually eliminated, falling from 30.7% in 1979 to 9.5% in 1990 and to 4.6% in 1998. A World Bank estimate, on the other hand, put rural poverty at nearly four times, at 42.8% in 1990, and it fell to 24.2% in 1997. Although the levels of poverty differ substantially between official and World Bank estimates, the trend is similar--a halving of poverty between 1990 and 2000. It is evident that there is at least a strong association between acceleration in growth and poverty reduction. There are several causal mechanisms that tend to reduce poverty in periods of rapid and sustained growth. For lack of time, I will not go into them except to draw on their existence to argue, with the authors of the Tenth Plan, that accelerating growth is the most effective strategy for reducing poverty. We all know that China

[11] Deaton (2003).
[12] Datt (1997).

[13] Datt (1999).

is far ahead of India in its achievement in social indicators, such as educational attainment and life expectancy of its population. Interestingly, most of the gains in social indicators had already been made by the early seventies. However, the contribution of better education and health of the population to growth did not come about until after the economic literature and opening of the economy in 1978. The work of the economic historian Angus Maddison supports this conclusion.

Maddison's estimates suggest that China and India had the same real per capita income in 1870[14]. But by 1950, when the Communist regime took over, China's per capita income had declined by 17% while India's had increased by 16%. It took nearly two and a half decades, that is, from 1950 to 1973, for China to recover the lost ground with double India's rate of growth of per capita income. It is reasonable to presume that China and India were roughly at the same level of per capita income in 1980, two years after Deng Xiao Ping abandoned the Maoist economic strategy that led to the death of 30 million or more and initiated systemic reforms. Although both economies experienced acceleration in growth during 1980-2000 compared to the previous three decades, China's average growth rate of per capita income, at nearly 9% per year, far exceeded India's 4% per year, so that China's per capita income was nearly 70% higher than India's by 2000. Although China grew faster than India also before reforms, most of the difference is attributed to China's greater savings and investment rates. In fact, Maddison estimates that total factor productivity declined at a rate of 0.78% per year in the pre-reform period of 1952-78. Although China had better social indicators than India long before reform in either country, this apparently did not translate into higher and productivity-driven, rather than input-driven, growth until the policy framework was changed drastically.

[14] Maddison (2002).

China's experience suggests that unless we deepen and extend reforms along the lines I discussed earlier, we will fail to reach and sustain 8% or higher annual rates of growth. For the reform process to go forward, a socio-political consensus in its favour has to be forged. At the dawn of our independence, such a consensus existed across the political spectrum[15]. The National Planning Committee of the Indian National Congress, with future Prime Minister Jawarharlal Nehru as Chairman, had completed its work on a plan for post-independence in 1938. Four years earlier, Sir M. Visveswaraya had published his Planned Economy for India. Businessmen published their own plan, the so-called "Bombay Plan," in 1944. The Indian Federation of Labour also put out its own plan, the "People's Plan", also in 1944. Mahatma Gandhi and his disciples had their own "Gandhian Plan." All had eradication of poverty as their overarching objective. Except the Gandhians, the others viewed state-promoted industrialization as the means for achieving the objective and central planning as essential for this purpose. Although in retrospect their emphasis on central planning and the central role of the state seem mistaken, the point I want to emphasize is that there was a consensus across the political spectrum. I wish our politicians would focus more on achieving a consensus on accelerating growth and poverty eradication than on fanning conflicts among the people on the basis of religious, caste, ethnic and regional differences.

[15] See Srinivasan, T. N. (1996, 2000) for a discussion of this consensus.

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