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Political Economy of India 1800-2001

Comparative Profile

The following comparative table, relating to the year 2000, will show that India is one of the biggest countries in the world in terms of geographical size, population and economy (on purchasing power parity basis). It is the second most populous country in the world, after China. While its geographical area is roughly one-third of the United States, Brazil and China, the area under cropland is the same as that of the United States, and much larger than either China, Russia or Brazil. Its economy is about one-fifth the size of the United States on the basis of purchasing power parity, one-third that of China, and significantly bigger than either Russia or Brazil. Its per capita income is the lowest amongst the five countries, but so is its (Gini) index of inequality, which gives some indication of its huge middle class market. While it is less outward oriented than either China or Russia in terms of international trade, this is growing fast, and its outward orientation is no less than that of the US or Brazil. Although its international credit rating is sub-investment grade like most low-income countries, India nevertheless has access to International financial markets and is a recipient of significant amounts of both commercial debt as well as foreign investment.

	USA	Brazil	Russia	China	India
Population (M)	282	166	145	1260	1000
Area (M Sq. KM)	9.2	8.5	17	9.6	3.2
% area cropland	21% (1.9M)	6% (.5M)	8% (1.4M)	10% (1M)	57% (1.8M)
% area forest	32%	66%	45%	13%	16%
Agriculture/GDP	2%	8%	7%	21%	29%
GNP(PPP in $Bn)	9875	1280	722	5900	2038
Per capita Income	35000	7711	4979	4683	2038
Gini Index (max=100)	0.36	0.61	0.47	0.36	0.32
Trade/GDP	20%	21%	60%	43%	27%
S&P Credit Rating	AAA	BB-	B	BBB	BB
Life Expectancy (Yrs	77	67	65	69	62
Adult Literacy	100%	84%		81%	52%

Political profile

India is the World's largest democracy. It has a virtually uninterrupted history of elected representative government for over the last 50 years, that is, ever since it attained independence from British Rule shortly after the end of the Second World War. The electoral process is acknowledged to be fair and neutral, reflecting the *Vox Populi* fairly accurately. Thus governments have been voted in and out of power fairly regularly, both at the Centre, as well as in the States. This is a unique record amongst low-income developing countries.

The form of government is that of a Republic headed by the President, with a Prime-ministerial form of Government. The Prime-Minister is the Chief Executive, and the leader of the majority group in the elected lower house of Parliament, called the Lok Sabha. The upper house is patterned on the House of Lords, although there is no aristocracy in India. The present political profile is effectively a dual multi-party coalition system at the federal level, headed by the Bharitiya Janata Party (in power) and Indian National Congress (in the opposition.). The Constitution of India is a federal one, consisting of the Union Government (with the Prime Minister as the Chief executive) and several State governments, headed by Chief Ministers as chief executives. Regional parties, who constitute the coalitions at the Centre, by and large dominate the States. It is often argued that the Constitution has a unitary bias, especially in financial matters, since over two thirds of the taxes are collected by the center. The trend, however, is towards greater devolution of financial powers to the States.

Historical profile till 1950

India, Egypt, Persia, and China are amongst the most ancient civilizations in the World. Along with West Asia (Judaism, Christianity & Islam), India (Buddhism & Hinduism) is also the original home of the most popular religions prevalent in the World today. Politically, empires have alternated with fragmented Kingdoms throughout its history, practically from the dawn of civilization. It is characterized by great cultural, religious, racial and linguistic diversity on account of repeated migrations and conquests. Expectedly, the country has great social diversity. However, if one were to generalize, it can perhaps be said that the European kind of feudalism never existed in India, and that it was mainly characterized by a complex three-tiered, but highly hierarchical, society based on a "caste system" of great antiquity, but arguable flexibility.

Economically, India was probably ahead of Europe right up to the Industrial Revolution, attracting a constant stream of visitors and traders from Asia, Europe and the Mediterranean. Even Columbus was actually searching for India when he discovered America, and therefore the native inhabitants of America came to be known as Indians! India was a major exporter of spices, fine fabrics, perfumes, jewels (ivory, diamonds, other stones) dyestuffs (indigo and lac) and animals. Agricultural productivity was much higher than pre-agricultural revolution Europe. It also had much higher birth rates and population densities. The level of monetisation in the economy was quite advanced, and the balance of trade was always unfavourable to the West right up to the first half of C19th, as India imported little apart from gold and pottery. Pliny had complained of the severe drain of gold from the Roman Empire on account of its trade with India!

European Powers came to India in the eighteenth century in pursuit of trade, but on account of wide differences in military and navigational technology, the flag followed trade. The handicraft/artisan based Indian industry could not compete with mass produced industrial goods. Its colonial status meant that the "imperialism of Free Trade" denied protection to its traditional "infant" industry to adjust and modernize. India fell decisively behind Europe following the Industrial Revolution, even though its colonial masters laid the foundations of a modern infrastructure, such as all-weather roads, railways and irrigation, after 1860. Also, its complex, custom based, produce-sharing agrarian tax system was replaced by a modern, justiciable, and written-record based, inflexible monetised tax administration. Modern Indian industry was to grow and ride piggyback on this modern infrastructure.

The British in India by and large followed a socially conservative policy, especially after the failed insurrection of 1857. However, British rule in effect undermined the social authority of the old landed class by depriving it of political and military authority, and thereby transforming them from lords of the land into rentier landlords. Moreover, the strengthened agrarian infrastructure, legal system, greater integration into an emerging global system, and secular upswing in prices, spawned a strong middle cultivating class-caste, which gradually challenged the old social order. However, the conditions of the lowest tier in the social hierarchy remained relatively unchanged at best, and possibly worsened because of greater commercialisation of the economy, and they suffered especially during periodic famines.

The British ruled India with a handful of Englishmen, and their need for an English-speaking native bureaucracy bridged the great regional and linguistic diversity and laid the foundations of a modern middle class. This Middle Class (first urban, and then rural with the advent of Mahatma Gandhi) was the backbone of the anti-imperialist movement that arose to challenge British authority in India. The anti-imperialist movement was however riven with internal religious and social dissensions, culminating in the partition of British India along religious divides into India and Pakistan. Reverse discrimination was also structured into the new Constitution, and its scope was gradually enlarged after Independence, with job reservation in Government for backward castes.

India attained independence from British rule in 1947. International trade was still balanced in its favour, although its composition had been altered, having become more of a commodity exporter and an importer of industrial products. Its agricultural technology was still traditional. It had been largely de-industrialised earlier, but the beginnings of modern, especially textile industry, was nevertheless laid under the protective umbrella of the nascent anti-imperial movement. The foundations of a modern physical infrastructure had been laid, as also a modern school system. Economically, India could be said to have been more advanced than most countries in Asia in 1950, although colonial domination and the resultant drain of national wealth meant low or negative growth rates, growing poverty and backwardness, which was compounded by India's transition to the first stage of the modern demographic cycle after 1921, resulting in (continuing) high population growth rates. While the Westminster model of parliamentary democracy took strong root, its regional and linguistic diversity led to a federal political structure with strong central powers.

Post Independence 1950-1990: State-led Growth

Indian Nationalism always had a strong economic content. Its leaders were critical of the 'drain of wealth' outside the country, the destruction of its domestic industry and the absence of a sovereign protective umbrella for its fledging modern industry. It was also influenced by socialist ideas. These were to greatly influence the policies of Independent India

The Industrial Policy Resolution of 1956 set the tone of Independent India's economic policy. Drawing inspiration largely from the Soviet model, the commanding heights of production were to be in the hands of the State. The thrust was on State-owned heavy industry based on the Soviet Five year Plans. Private industry, and even foreign capital, was permitted, but under a stringent license-permit-quota regime, so as to direct investment of scarce resources into desired areas, and to ensure equity. In order to boost employment in the modern sector, a large number of items were reserved for production in the small-scale sector, where economies of scale were disallowed. Agricultural development was left to private enterprise, but with a strong dose of land reform and state subsidies. The domestic savings rate was high, although lower than levels attained in East Asia, and there was little reliance on external finance. There were stringent capital controls, and the financial sector was almost entirely state-owned, with government directing the flow of resources. The physical infrastructure was also state-owned. The tax system was probably hostage to the Laffer curve: High tax rates with low tax-GDP ratios, because of poor compliance, and also because agriculture was not taxed.

This 'mixed economy' model led to the development of a basic industrial base in the country, and to the emergence of industrial and agricultural entrepreneurship. India also became self-reliant in food grains, following the 'Green Revolution', much of the inputs for which was subsidized by the State. This model of development, of course, had its downside. Indian industry, which had once given a run to Manchester for its money, adapted to a virtually autarchic environment, and lack of competition made it increasingly globally non-competitive. The inward looking, import-substituting model of growth also had an implicit anti-export bias: it was more profitable to sell in the protected domestic market on the one hand, while an over-valued exchange rate constituted a strong disincentive to export on the other. India's share in world trade gradually shrank over the years, and for perhaps the first time in its long history, the balance of trade turned decisively against it. This resulted in financial repression and capital flight. Since there were stringent capital controls, much of this capital flight was through trading channels (under-invoicing of exports, and over-invoicing of imports) and through illegal means, popularly known as 'hawala'.

Massive state expenditures were financed through high tax rates, and ultimately through unsustainable borrowings. An economy where it was necessary to obtain prior permission for practically any economic activity, and where a production cap was put on every unit, combined with very high rates of taxation, spawned a flourishing parallel, or 'black', economy. The tax buoyancy of an economy where an increasing share of the domestic product goes underground can never be very high. Since inflation rates were mostly contained within single digits – unlike several other parts of the developing world, notably Latin America – supply appears to have kept pace with demand, although the official rates of growth were low, around 3% in real terms (marginally above the population growth rate of 2%), which was much lower than what the East Asian countries were undergoing at this time through their export-led model of growth.

Low tax-GDP ratios, and limited tax buoyancy, combined with a highly interventionist State, was the perfect recipe for mounting fiscal deficits, which were mostly financed through domestic borrowings. The deficits spilled over into the external sector in the eighties, leading to a rapid build-up of external debt. Unlike Latin America and East Asia, however, only a modest amount of this was short-term, indeed a fair amount was concessional and of very long maturities. This helped

India escape the deleterious effects of the Latin American debt crisis of the early eighties and the East Asian currency crisis of the late nineties. It also helped India weather its own balance of payments crisis of 1991, which was triggered by the oil price shock following the international crisis in the Persian Gulf. India has a massive deficit in fossil fuels, with about one third of its imports in terms of value comprising POL (petroleum, oil, lubricants) products. This proved to be the Achilles' heel of its import-substituting model of growth, as it was susceptible to oil price shocks.

India countered the initial oil price shocks of the seventies by raising domestic savings, i.e by adjusting rather than by borrowing. Its trade deficit, however, continued to grow, escalating sharply in the eighties as a result of half-hearted liberalisation (which lowered tariff barriers slightly without seeking to address serious macro-economic imbalances) and fiscal expansion. As a result, the current account deficit, which was below 1 % of the GDP in the fifties and sixties, touched a high of 3.3% in 1990-91. The gross fiscal deficit of the Central Government climbed from 4.1% of the GDP in 1975-76 to 6.2% in 1980-85 and peaked at 9% in 1986-87, and stayed at or above 8% right upto 1991-92. This was about three times the Maastricht prudential norm of 3%.

Perhaps the greatest victim of the State-led model of growth was the infrastructure, which soon emerged as the greatest barrier to faster rates of growth. The Five Year Plans had a big industry, rather than infrastructure, bias. British rule in India had laid a solid foundation of modern infrastructure, but a cash-strapped State was unable to build upon this adequately after Independence on the one hand, while private participation was not permitted on the other. Expenditure on social infrastructure, such as housing, health and primary education, was also limited. The problem of poverty was sought to be addressed primarily through lending/subsidy schemes targeted at poor farmers and workers, rather than through a comprehensive scheme of social security. The dent on poverty alleviation was rather modest compared with the effort and outlay, on account of significant leakages in social welfare schemes, although increases in agricultural productivity from second half of the seventies, and higher growth rates from the second half of the eighties, did result in slow reduction in poverty rates. However, the use of the state-controlled banking sector to channel soft loans for anti-poverty schemes also contributed to a weakening of the financial sector through increasing non-performing assets.

India Today: Major Economic Policy Thrusts in the 1990's

Macro-economic imbalances arising out of the State-led inward looking path of development culminated in a serious balance of payments crisis in 1991. While the trigger for this was provided by the oil price shock, it was these serious imbalances that made India susceptible to the external shock in the first place. Fiscal deterioration had spilled over into the external sector, leading to a rapid build-up of debt. At a time when FDI and portfolio flows to developing countries were limited, high levels of external debt could have been sustained only through robust export growth rates. The Indian model of growth, however, had an inherent anti-export bias, deriving from high tariff barriers and over-valued exchange rates. India's foreign exchange reserves dipped to precipitous levels, below US $ 1 billion, and it was on the verge of defaulting on its international commitments. Around the same time, the Soviet model of development was also on the brink of ideological collapse. India now charted out a brave new development strategy.

Industrial Policy

As in the case of the earlier State-led model of growth, the tone of the new economic policy was laid by the New Industrial Policy of 1991 that began dismantling the license-quota-permit system. Private investment was now freely allowed, without capacity restrictions, in all areas other than Defence, Atomic Energy and Railways. Industrial licensing was done away with in all except six industries, viz. Alcoholic Beverages, Tobacco based industries, Industrial Explosives, Hazardous Chemicals, Drugs & Pharmaceuticals, Electronic Space & Defence equipment. In all other areas, entrepreneurs were simply required to file an Industrial Entrepreneurial Memorandum (IEM) and go ahead with their projects, subject to existing regulatory requirements and certain location and environmental restrictions. The number of items reserved for the small-scale (SSI) sector was progressively reduced. Far from limiting investment in various sectors, competition was now actively fostered, and a new Competition law is currently being enacted by parliament.

Trade & Balance of Payments (BOP)

The immediate policy response to the BOP crisis of 1991 was to reverse capital flight and to improve the trade balance by a drastic revision of the exchange rate policy. The Indian Rupee had become highly over-valued over the years, since the exchange rate was fixed by government, rather than by the market. The Rupee was floated on the market for all trading transactions, resulting in steep depreciation over a relatively short period of time. The demand and supply of foreign currency for trading transactions, rather than government, now determined the exchange rate. This led to a sharp improvement in the exchange rate and inflow of hard currency, as this reversed capital flight and brought most foreign currency transactions back into formal channels. The trend has continued to this day, and India's foreign currency reserves have climbed to over US $ 40 billion, approximately 8 months of import cover, compared to US $ 1 billion in 1991.

India's main exports are gems, jewellery, textiles, leather, chemicals and engineering goods and software, while POL products constitute the single largest import. While India's trade balance as a proportion of the GDP has slipped back to levels reminiscent of the late eighties and early nineties, the current account balance is vastly improved because of invisible remittances, including remittances by Indians working abroad and software service exports. The latter have been growing at an annual compounded rate of about 50% over the last five years. Non-debt (i.e equity) flows from overseas are now more than adequate to finance the residual deficit, as foreign currency reserves have been increasing steadily. India's external debt has also stabilized, and debt service ratios have fallen sharply. As a percentage of the GDP, India's external debt has fallen from about 33% in the early nineties to about 20% presently. India's Balance of Payments position now is very strong, and it easily weathered the recent increase in oil prices. Restrictions on capital flows, particularly on debt, and especially short-term debt, also prevented the East Asian contagion from spreading to India.

India has been gradually lowering its custom tariffs since the early nineties, from former average levels of over 100%. The current average is around 30%, and while these are within India's current WTO commitments, they are nevertheless amongst the highest in the world. It is perhaps for this reason, and the over-valuation of the Rupee caused by volatile portfolio flows, that has prevented a faster growth of exports and participation in international trade. India is committed to lowering tariffs further, first to East Asian levels, and then to global levels in the near future. Further tariff reform presents a great challenge, not only on account of their impact on a weak fisc, but also because it may not be prudent to expose Indian industry to global competition without simultaneously giving them access to world class infrastructure.

Foreign Investment

Controls on the capital account do not, generally, apply to equity flows, since foreign direct and portfolio flows have virtually free entry and exit, including dividend transfers. The only restriction on portfolio flows is that they cannot buy into an Indian company beyond 49%. Foreign Direct Investment, on the other hand, is permitted up to 100% in most cases, and the approval process is increasingly automatic. FDI, however, is not permitted in sectors considered strategic, viz. Defence, Railways, Agriculture, Print Media, Information and Broadcasting. There are some restrictions in other areas, viz.

Atomic minerals (up to 74% with value-addition is permitted); Housing and Real Estate (NRIs and OCBs only) and Trading (export, hi-tech items, servicing and wholesale domestic trading only).

Mobilising non-debt creating foreign savings is an important pillar of the new economic policy, since domestic savings alone are unlikely to result in high growth rates. The official target is to mobilize around US$ 10 Billion of FDI per annum over the medium term, as against the current inflow of about US $ 2.5 Billion. The huge middle class market, the investment backlog in the infrastructure sector, the large pool of skilled and cheap labour, the robust legal and democratic systems, widespread use of English and relatively developed financial and capital markets make this an eminently achievable target provided the right policy mix is in place.

Public Finance

There was some fiscal tightening following the BOP crisis of the early nineties, but thereafter India repeatedly ducked the IMF fiscal deficit targets. India's public sector fiscal deficit of around 10% of the GDP is among the world's largest. Government is increasingly borrowing to finance current expenditure, and its debt stands at 60% of the GDP, with another 10% (excluding pension liabilities) in the form of contingent liabilities. This excludes the debt of public sector undertakings and banks. The Government's huge borrowing requirements also have a distorting impact on economic growth by crowding out private credit and raising the cost of capital in the economy, especially since market borrowings are the chief means of funding the deficit. High fiscal deficits also constrain the central bank's ability to use monetary policy for macro-economic management of the economy.

The major drivers of the deficit are the large explicit and implicit subsidies (at almost 15% of the GDP) given by the federal government and, especially, State governments. Large interest payments on the huge debt overhang are also a major source of deficit, especially since interest rates have been aligned to market rates as part of the ongoing financial sector reform. Finally, the rollback in public sector employment, including privatization, is not commensurate with the deregulation and liberalization of the economy. A Fiscal Responsibility Bill is being introduced in Parliament to cap government expenditure, borrowings and the fiscal deficit, in short to pressure government to live within its means.

A natural corollary of State-led growth was a huge public sector with a multiplicity of State owned enterprises which produced just about everything from power, to steel, to bicycles, cloth and bread and biscuits. Privatizing these public assets to generate resources for lowering the burden of public debt and investment in the physical and social infrastructure is an important adjunct of the structural adjustment of the Indian economy. It, has, however, been one of the weakest elements of the reform process so far, since political consensus on this appears to be weak. Privatisation has been recommended in a number of State Owned Enterprises (SOEs) by the Disinvestment Commission appointed by the Government, and a Department of Disinvestment has been set up to do the divestment. While Government have announced that its shareholding would be reduced to 26% in the generality of cases (excluding the financial sector), and partial divestment has been done in a number of cases, Government shareholding has actually been reduced to below 50% only in two cases so far. (Modern Foods and Bharat Aluminium Company)

Tax Reform

India's post-independence tax structure was overly dependent on regressive, fluctuating, multiple slab indirect (consumption) taxes, had a narrow tax base, with agricultural incomes exempt from income tax, and had progressively very steep marginal rates of income tax. The tax system was characterized by widespread tax evasion, poor buoyancy and low tax-GDP ratios.

Major tax reforms are being attempted since the early nineties. The basic objective is to move towards low, stable rates so as to minimise distortions, ride the Laffer curve and improve tax buoyancy. There is also a greater reliance on progressive (direct) taxes. Indirect taxes have been increasingly integrated, the number of slabs greatly reduced, with a stated desire to move towards a single value-added consumption tax.

The immediate effect of tax reform on the Tax-GDP ratio was a slight decline from 15.8% in 1987-88 to 13.9% in 1993-94. However the ratio began rising again as tax reforms began to take effect, rising to 14.3% in 1997-98. Income tax reform is practically complete, and has shown expected buoyancy and the Laffer curve effect. The share of indirect (consumption) taxes in total collections has also declined from 85% in 1987-88 to 78% in 1997-98.

Financial Sector

Although mostly in the public sector, and tightly controlled by Government, India has a fairly "deep" financial sector by developing country standards: high levels of private savings, low-inflation rates and a massive branch network. A wide range of financial products, such as credit cards, ATMs, Consumer banking, hedging etc is also available in limited areas. Its weaknesses mostly stem from directed lending in previous years, and its big exposure to the state sector, which has resulted in the accumulation of substantial non-performing assets. The public sector also pre-empts much of the resources, crowding out the private sector and pushing up the cost of funds. Financial regulation is too weak to prevent occasional frauds, but it is still superior to East Asia, as a result of which it was relatively insulated from the East Asian contagion. Bankruptcy laws are another area of concern, for enforcement of creditor rights is usually a time-consuming affair.

India also has one of the largest stock markets in the developing world, and de-materialisation and electronic trading increasingly the norm. Over 50% of the total market capitalization has been dematerialized so far. Corporate governance is relatively weak when compared to the U.S and Britain, although it is superior to East Asian and even some European countries. In recent years there has nevertheless been an increasing focus on corporate governance through greater transparency in disclosures, Board-level representation and management, more efficient bankruptcy and liquidation procedures, and a more independent capital markets regulator (SEBI).

There are substantial overseas portfolio flows into India, and Indian corporates also have good access to international financial markets. The domestic bond market is large even by middle-income standards, though there is limited secondary trading in debt, possibly because of the dominance of public debt. The financial sector has also witnessed greater disintermediation in favour of capital markets.

While the Banking sector is still dominated by public sector banks, private banks are permitted, and Government has announced its intention to bring down public holding in banks to 33%. The interest rate regime has also been freed, and banks are now free to set interest rates. However, since the market for long maturity debt and secondary trading is relatively limited, a full-fledged rupee yield curve has still to emerge. The Insurance sector, till recently reserved for public sector companies, too has been opened up to private, including foreign investment, and an independent regulatory authority (IRDA) has been set up to regulate this sector. It is expected that greater private, including foreign, participation in the banking and insurance sectors would soon see more sophisticated financial engineering, and proliferation of new, internationally competitive products in the market.

India’s reform of the financial sector has been carefully calibrated with the full knowledge that this has traditionally been one of the most heavily protected sectors in developing countries. As the experience of the Southern Cone countries in the 1970’s, and East Asia in the 1990’s has shown, rapid, wrongly sequenced or inadequately regulated financial sector reform can be disastrous because adjustment in financial markets, as opposed to trade, is immediate and unrelenting, and can result in unsustainable capital flight, asset attrition and even fraud.

Physical Infrastructure

It is recognized that the State-dominated physical infrastructure is the weakest link in the economy. A special study commissioned by government (The Rakesh Mohan Committee Report) revealed a huge investment backlog, which could only be bridged by inviting private investment into these areas, to supplement what State effort was possible. The infrastructure sector is dominated by State owned enterprises, but it is being gradually privatized on the one hand, while private (including foreign) participation is being actively solicited in new projects, except Railways, which continue to be a state preserve. Independent Regulatory Authorities have also been set up to handle and enforce competition in infrastructural services.

The expeditious deployment of huge resources for the infrastructural sector presents both a major challenge as well as an opportunity for development. Infrastructural development has traditionally been considered a service that is provided by the State. Even in England, where railroads and roads were laid through private initiative, the State took these over on account of universal service considerations and to ensure equitable user charges. Commercialisation of infrastructural services is a relatively recent phenomenon, and poses a major challenge for policy makers and regulators. The underlying reason for this commercialisation is deterioration of government finances because infrastructural services have been run on populist lines to attain narrow political ends. As a result, user charges have been insufficient to cover the cost of running these enterprises, far from upgrading and expanding them. India's power sector is a very good illustration of this. In any case, both public and private funds need to be leveraged for infrastructural development. The private sector alone may not be able to generate all the investments required, and tax-payers' funds also need to be utilised for this purpose as the State cannot withdraw from the field. On the contrary, it needs to correct fiscal imbalances to free up tax resources for larger outlays on the infrastructure investment. Fiscal pressures reduced public investment in infrastructure from 4% of the GDP in 1991-92 to 3% in 1997-98, while private sector investment inched up from 1.4% to 1.6%.

The State also needs to balance universal service requirements and affordable user charges with making private investment sufficiently attractive. This is no easy task, as the recent energy crisis in California has clearly revealed. As things stand, the problem of sovereign guarantees and risk transfer are coming in the way of financial closure of private sector projects, particularly in the critical power sector. Only further liberalization of the infrastructure sector would enable private investors to secure their cash flows to the minimum comfort level necessary to avoid the need for sovereign guarantees, which the fisc is currently in no condition to absorb.

Social Infrastructure

The public sector financing of the social infrastructure in India has been low by international, and even by low-income country, standards on account of emphasis on public investment in industry and subsidies. The outlay on education has been in the region of 4% of the GDP, with another 2% coming from private funding. Public funding of education, moreover, has traditionally had a higher education bias, at the cost of primary and secondary education. Much of this expenditure was infructuous, since many skilled workers, finding better opportunities abroad, left for greener pastures abroad, such as the Silicion valley in the United States. This constituted, in some respects, a subsidy given by the Indian taxpayer to external economies.

The position in the health sector is even worse, with public expenditure being around 1.2% of the GDP, and another 4.8% coming from private funding. While this is one of the highest proportion of private funding globally, low levels of public funding on primary education and health care has disproportionate adverse consequences on the poor as they have to spend a higher proportion of their earnings on these services.

There has been a steady decline in poverty since the 1970s, from over 60% to around 26% at present, on account of growth in GDP and agriculture. Averages, however, can be deceptive. Poverty, literacy rates and health indicators show increasing regional disparities. Averages are improving slowly because of poorer indicators for women, and persistence of poverty in the more populous states in the northern heartland. It is clear, however, that the State has to free up more resources through fiscal reform for a much greater outlay on the social infrastructure, and current attempts to correct imbalances in social sector investment hinge substantially on wide-ranging fiscal reform and adjustment. The East Asian experience has shown that investment in the social infrastructure generates externalities that have a positive outcome on growth.

Agriculture

Along with the growth and modernization of the Indian economy, the share of agriculture in the GDP has declined rapidly to about 27% at present. However, it still provides income for 73% of the population. Agricultural growth has been impressive since the 1970s, well in excess of he population growth rate, leading to self-sufficiency in food grains (no mean achievement for a country with a population in excess of 1 billion) and a decline in poverty. However, modern farms co-exist with traditional methods of farming, and economic deregulation is limited in this sector, with restraints on inter-state and international private trading. Agricultural subsidies on power, water, fertilizers, pesticides, credit and minimum support prices have proliferated over the years and now constitute a significant proportion of the GDP.

While these have to some extent kept domestic prices down, and resulted in agricultural expansion and self-sufficiency, these market distortions are also increasingly making Indian agriculture uncompetitive internationally. Reform of the agricultural regime, however, is not an easy matter, as most countries subsidize their agriculture to some degree. It is clear, however, that these subsidies given directly to the farmer have gradually crowded out public expenditure on rural infrastructure like roads, canals, power and technological upgradation, have resulted in inefficient use of inputs, in wasteful private investments such an generating sets, deterioration in aquifers and soil on account of excessive use of water. Moreover, their impact on equity has also been doubtful, as much of the subsidy, including exemption from income tax, has been cornered by the richer farmers.

Labour

India has been ranked very high in the *Global Competitiveness Report* for abundant and skilled labour, but very low in flexibility. This inflexibility arises chiefly out of laws and regulations relating to change in service conditions, disputes and particularly exit. Prior permission of the State government, which is neither readily nor generally given, is required before laying off workers. This inflexibility acts as a barrier to both fresh investments, as well to formal employment. As a result, some 90% of the total work force, and 75% of the manufacturing work force, is in the unorganized sector. Despite stringent and multiple laws on the statute books, implementation is a problem, and there is abundant use of child labour, and women labour conditions continue to be poor. Ultimately, these conditions will improve substantially through a general improvement in living standards, for only that would stem the supply of underpaid labour. Although changes are being attempted, there has been hardly any reform of the labour market so far. Labour laws are sensitive issues in any democracy, for the political process has to generate a consensual trade-off between the rights of labour and the imperatives of the market.

India C2001: The Road-map Ahead

The Indian economy was relatively closed till 1991, following which sweeping reforms opened up trade, industry and financial sectors to domestic and foreign competition. The economic restructuring process has its protagonists and detractors. The latter consider the reform process too slow and partial, especially when compared to E. Asia and China in particular, which achieved much faster growth rates. Growth and investment, especially in the industrial sector and physical trade, appears to have slowed down since the early nineties, with current growth being largely driven by services and invisible trade. The protagonists, on the other hand, point out that India has been one of the fastest growing economies during the nineties, averaging around 6.5% GDP growth per annum. Poverty levels have fallen from 36% to 26% over this period. Its international Balance of Payments is very comfortably placed. Growth rates recovered comparatively fast after the initial adjustment, and it escaped the more deleterious effects of the Latin American and E.Asian debt and currency crises. Reform and growth, moreover, is being achieved in a much more challenging political environment, which reduces future political risk.

Following the collapse of the Soviet model of development, there is now a global consensus on the mix of policies for growth and development. The real debates now revolve around pace and sequencing. As India moves into the twenty first century and integrates into a global economy where all barriers are fast breaking down, it is worthwhile to do a quick SWOT analysis of India’s political economy. Its greatest strengths derive from its numbers: its vast size, population and economy, and in particular its huge, ever expanding, middle class. This provides a powerful demand stimulus for boosting and sustaining growth rates, foreign investment and international trade. This is supplemented by a stable political environment, despite razor thin coalition-based majorities in Parliament, transition from one government to another has been smooth and through the ballot box. Close and heated parliamentary debates might slow down the policy reform process, but they also make the outcomes durable with little risk of reversal, thereby reducing political risk. India also has a robust legal system based on Anglo-Saxon jurisprudence, and English is widely spoken, thereby greatly facilitating its integration into the global economic mainstream.

The flip side of the State’s disproportionate expenditure on higher education has been the creation of a big pool of skilled, white collar labour, whose global impact has been felt most tellingly in the Information Technology sector, which is, not surprisingly, fast becoming the engine of growth of the Indian economy, as indeed it has been of the United States for some time now. The Indian Software industry growth rate exceeds 50% per annum, and India appears to be on track to becoming a global IT superpower with US$ 50B exports by

2008 according to a recent influential survey done by McKinsey and NASSCOM. For the same reasons the biotechnology and pharmaceutical sectors appear poised for similar growth.

India enters the twenty first century on a relatively buoyant note. Despite global recessionary trends, especially in the leading IT sector, GDP growth in the Financial Year 2000-01 has been around 6%, and export growth around 20%. Foreign Currency reserves have been sustained at a historic peak of US $ 40 Billion, despite the recent 75% rise in oil prices. Cumulative foreign investment stocks are touching US $ 30 billion. IT technology export projections have been scaled down, largely on account of the IT downturn in the US, but these are nevertheless in excess of 40%. There is also good news on the fiscal front, with the fiscal deficit having been contained at the estimated level of 5.1% of the GDP for the first time in several years, as the expected tax buoyancy arising out of tax reform is beginning to be felt. The decline in interest rates is likely to improve the fiscal position still further, as interest payments on Government debt is a major component of the Government's budget deficit. The dip in inflation rates also makes it more likely that the drop in interest rates would be sustained in the market, making a virtuous cycle of lower deficits, and higher investment and growth a distinct possibility. The privatization efforts of the Government have also picked up momentum with the first privatization of a profit making state owned enterprise, namely, Bharat Aluminum Company. A number of major reform bills, such as the Fiscal Responsibility Bill, Information Technology, Communication and Entertainment Bill (or ICE, which seeks to set up a unified regulatory framework to harness the synergy between these sectors in a bold attempt to convert India into an IT powerhouse), the Electricity Bill (which seeks to remove regulatory bottlenecks coming in the way of financial closure of new power projects), and Competition Bill are being placed before Parliament for being enacted into law.

India has the potential to become one of the fastest growing economies in the coming decade, and emerge as a major economic power in the new millennium. However, certain fundamental weaknesses in the Indian economy would have to be addressed before this great potential is translated into concrete results. Huge investments in, and rapid development of, the infrastructural sectors, social and physical, are a necessary precondition for sustaining high rates of growth. Poverty indices have declined gradually over the years, but India still has a major share of the World's poor, which acts as a drag on the economy. Poverty reduction has a huge demand side upside, for it is well-known that the multiplier effect of putting more income into the hands of the poor is much higher than what it is in the hands of the more affluent.

The critical importance of a quantum jump in infrastructural investments cannot be over-emphasized. The IT sector, for instance, rides piggyback on the telecommunications network. But India's telephone density is below 2%, compared to over 7% in China and over 11% in Thailand. Rail, road, port and air links, and the energy sector, in particular, are in need of huge investments for expansion, without which Indian industry cannot become internationally competitive in an increasingly globalised economy. Fiscal consolidation in the Centre and States, including deepening of tax reforms, privatisation and roll-back of the State, would be necessary to release resources for infrastructural development. Indian customs tariffs are way too high, and these translate into distorted resource flows and inhibit the growth of international trade. Inflexibities in the labour market and bankruptcy laws also act as barriers to investment and growth. Finally, the agricultural sector has been barely affected by economic reform so far.

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