



# INDIA: Development in the Near Term: Constraints and Prospects

## A Country Assistance Evaluation

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## **Abbreviations**

ADM	Anti-Dumping Measures
BIFR	Bureau for Industrial and Financial Restructuring
DOT	Department of Telecommunications
DSB	Dispute Settlement Body
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
PDS	Public Distribution System
QR	Qualitative Restrictions
SEB	State Electricity Board
TRAI	Telecommunications Regulatory Authority of India
WTO	World Trade Organization

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## **Preface**

This paper is one of the background papers prepared as an input to the India Country Assistance Evaluation (Task Manager: Mr. Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank.

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## 1. Poverty Eradication: The Overarching Objective of India's Development

1.1 Eradication of poverty has long been, and still remains, the overarching objective of India's economic and social development. The early classic on India's Poverty is of course Dadabhai Naoroji's (1901) Poverty and Un-British Rule in India. An engineer and statesman, Sir M. Visveswaraya (1934) in his Planned Economy for India asserted that a planned economy was essential for achieving the objective of poverty eradication. Just before the Second World War, the Indian National Congress, the political party that was fighting for India's independence from British rule under Mahatma Gandhi's leadership, had established a National Planning Committee under the chairmanship of Jawaharlal Nehru. This committee, which completed its work in 1938, stated the objective of planning for development "was to insure an adequate standard of living for the masses, in other words, to get rid of the appalling poverty of the people" (Nehru 1946, pp. 407, 403).

1.2 As the second world war was nearing its end, other groups also published their own plans for development of an independent India. These included a group of businessmen with their so-called Bombay Plan (Thakurdas et al., 1944) and the Indian Federation of Labour with their People's Plan (Bannerjee et al. 1944) and followers of Mahatma Gandhi (Agarwal 1960). All of them identified poverty as the central problem of the Indian society. In defining a minimum standard of living below which people were deemed poor, some of these plans went beyond food, clothing and shelter to include education and good health. The Bombay Plan stated that "a person above the age of 10 should be able to read, write and to take intelligent interest in private and social life is yet another of the constituents of a minimum standard of living" (Thakurdas et. al., 1944, p. 28).

## 2. Rapid Growth as an Instrument for Poverty Eradication

2.1 With the notable exception of the Gandhians there was a broad consensus also on the means for achieving the objective: rapid growth through industrialization and import substitution with the state taking a leading role in bringing it about. Visverwaraya (1934, pp. 351-353) asserted that "India cannot prosper except through industrialization. India may be an industrially developed country or it may be a market for manufactured goods from outside and not both. "Nehru's National Planning Committee argued in 1938 that "the problems of poverty and unemployment, of national defense and of economic regeneration in general cannot be solved without industrialization" (Nehru, 1946, p. 401). The pre-independence development plans set ambitious targets for income growth not as an ends in and of themselves, but only as an instruments for poverty eradication. Visverwaraya's (1934) plan proposed an annual average rate of growth of 7 percent. Nehru's committee wished to double, if not triple, national income in 10 years. The Bombay Plan of businessmen implied a rate of growth of 6% per year.

2.2 After independence in 1947, a Planning Commission was set up in 1950 to prepare plans for national development. Nine five-year plans (and several annual plans) have been formulated by the Commission. In a paper (Srinivasan and Bardhan (1974), Chapter 1), prepared in 1962, by the late Pitambar Pant, the Commission not only argued for rapid growth (at 7% per year for a decade or more) as the instrument for poverty eradication, but also, remarkably, recognized the need for redistributive transfers for those among the poor, who, for various reasons, were either unconnected or weakly connected with income generation processes in the economy. Since this

group constituted only of a small proportion of the population, for alleviating the poverty of the large majority of the poor, rapid growth of incomes was deemed the most efficient instrument.

2.3 The actually achieved growth rates since 1950 when planning began pale in comparison to the targets. The average for the period 1950-1998 is a little over 4% per year. For the three decades ending in 1981, the average was even less at 3.5% per year, a rate that is known (in)famously in India as the Hindu rate of growth. The fact that even at the end of the nineties, nearly a third of India's population is poor in the sense of being unable to afford an extremely modest consumption basket is a reflection of the massive failure to achieve the growth targets. Indeed, during the three decades (1950-1981) of the Hindu rate of growth, the proportion of the poor in the population fluctuated around 50% without any trend.

2.4 During the decade of the 1980's when growth rate accelerated to over 5% per year, poverty rate declined--unfortunately, the more rapid growth of the eighties was unsustainable, based as it was on fiscal expansionism financed by borrowing at home and abroad (a significant proportion of which was at commercial rates). This phase of relatively rapid growth inevitably ended with the macroeconomic crisis of 1991.

2.5 During the reform era, after virtually zero growth during the year 1991-92 of crisis and adjustment, GDP growth rate averaged 6.8% per year between 1992-93 and 1996-97--it decelerated to 5% in 1997-98, but recovered to 6.8% in 1998-99 and to an estimated 6.4% in 1999-2000. Indeed, some would argue that 5% represents the current version of the Hindu rate of growth that takes into account the shift away from agriculture in the composition of GDP! If unfortunately the recent relative stagnation in growth in the three years ending in 1999-2000 is not temporary, and in fact there is a further slowdown as some pessimists expect, the economy could converge to the updated version of the Hindu rate. Be that as it may, with the rate of growth of population having slowed down to under 2% per year even a 5% rate of growth of GDP allows the possibility of an albeit slow reduction in poverty, particularly if the characteristics of this growth are such as to increase the demand for the services of the poor.

2.6 Of course, to achieve a rapid reduction in poverty, the rate of growth has to be accelerated to 7% a year or more and sustained for a sufficiently long period. This is not to imply that rapid growth is the only means for rapid poverty reduction or that other measures are unnecessary. But what is implied is that the evidence from Indian experience as well as many other developing countries suggest rapid growth with the right characteristics is the most efficacious means for reaching poverty. Other measures such as redistribution could certainly be used to supplement growth policies but not supplant them because they are often not only less effective but also politically and socially more costly to implement.

### **3. Institutional and Policy Foundations of Growth**

3.1 The ingredients of the growth process are basically three: growth in inputs, i.e. accumulation of physical and human capital and other factors of production, efficient use of inputs at each point of time through their efficient allocation across productive activities in farm and non-farm enterprises, and across time through an efficient pattern of investment, and finally improvement in the productivity of input use in each activity through technological, organizational and managerial innovation as well as learning. It is stating the obvious to say that the overall institutional and policy frameworks of a country influence for good or ill, all the three

processes, viz. accumulation, efficient allocation and innovation. A few illustrative examples should make this obvious and transparent.

3.2 Subject to certain well-known caveats, a competitive market economy achieves efficiency in resource allocation at a point of time and over time. For a market economy to function, an institutional foundation consisting of an efficient legal system, a smoothly functioning financial system and a relatively inexpensive transport and telecommunication infrastructure is essential. Second, enabling macroeconomic policies (fiscal and monetary) and policies that affect external trade, capital and technology flows are essential as well.

3.3 For example, inappropriate trade and exchange rate policies, by restricting trade in goods and services and external investment limit, the opportunities for exploiting an economy's static and dynamic comparative advantage thereby obtaining, most efficiently, the goods and services it consumes and the highest return for domestically owned factors. Monetary policies, including credit policies, affect production as well as savings and investment. Fiscal deficits could crowd out more efficient private investment if they are financed by borrowing in the domestic market and could be inflationary if they are monetized. Inappropriate pricing of publicly provided goods and services, not only will lead to their inefficient use but also to fiscal problems. Producing goods and services in the public sector when less costly alternatives are available once again is an inefficient allocation of an economy's scarce resources. Since health and educational services are often produced and priced inefficiently in the public sector, another unfortunate consequence is that the health and educational achievements of the economy's labour force are likely to be lower than needed for rapid growth. Policies towards intellectual property protection as well as technology acquisition affect innovation and technical progress.

3.4 India's inward-oriented development strategy until recent reforms emphasized import substituting industrialization with the state taking a dominant role in the economy and, with state planning rather than the market, playing a major role in resource allocation. It discouraged foreign direct investment and other capital inflows. In the name of building domestic technological, engineering and design capability, it restricted purchase and licensing of foreign technology, engineering and design services. This strategy did not provide the policy and institutional frameworks conducive to rapid growth. The reforms of 1991 introduced by Prime Minister Rao's government made a decisive break from this strategy.

3.5 However, since 1996, political instability at the Centre (in a space of less than three years there have been three Prime Ministers, and two general elections, with a third one due to be held in four months!) has taken its toll on the reform process. While virtually no political party proposes that India return to the pre-1991 policy regime, there is no consensus on whether, and if so how, to rejuvenate the reform process. For the sake of India's poor, if for nothing else, rapid growth is essential, but impossible to achieve without further reforms. Hopefully the forthcoming election will bring in a government interested in rejuvenating the reform process and with sufficient political support to carry it through. In what follows I outline what I consider to be critical elements of a growth strategy.

## **4. A Strategy for Sustained and Rapid Growth**

4.1 It is convenient to organize the discussion of the constraints that need to be removed and proactive policies that need to be instituted into the following heads. Macroeconomic Policies, including fiscal and financial sector policies, External Sector Policies, constraints and policies



relating to Agricultural and Industrial Sectors, Infrastructure, Social Sector issues, and, finally, reforms of bankruptcy and labour laws.

### **Macroeconomic Issues**

4.2 Until the early eighties India's macroeconomic policies were in general conservative. Current revenues for the central government exceeded current expenditures leaving a surplus for financing part of its capital expenditures. As fiscal prudence was abandoned, the surpluses on the revenue account turned into deficits and the government borrowed at home and abroad to finance its capital as well as current expenditures. The true extent of fiscal deficits were in fact larger than the already large official estimates in the eighties for several reasons. The administratively set rate of interest at which the government appropriated a large share of the loanable resources of the banking system through various reserve requirements was below market clearing levels.

4.3 External borrowing in the late eighties from private sources were at near market rates. In contrast, the bulk of the external debt that incurred earlier was concessional and owed to multilateral lending agencies and governments. The growing fiscal deficits of the central government were financed in part through increasingly costly debt and a part (between a quarter and a third) was monetized. The state governments financed, and still finance, nearly a half of their gross fiscal deficits by borrowing from the central government. Thus interest payments by the government were far below what they would have been were the government to pay market clearing rates. When the fiscal crisis hit in 1990-91, gross fiscal deficit of the centre and state governments had grown to about 10% of GDP and the consolidated (non-financial) public sector deficit stood at over 12% of GDP. An analysis by Buiter and Patel (1992) showed that unless corrective steps were taken, India faced fiscal insolvency.

4.4 It is no surprise that a major objective of the reforms of 1991 was to stabilize the fiscal situation and bring the deficit to about 4% of GDP. Indeed in the first three years, central government's fiscal deficit was brought down from about 8.3% of GDP in 1990-91 to 5.7% in 1992-93. But it soared to 7.4% in 1993-94 and since then has exceeded 5% in every year. The revised estimates for 1998-99 suggest that the deficit is likely to be around 6%. The consolidated (non-financial) public sector deficit of central and states together has continued to be around 10% or more for several years. The budget presented by the outgoing government and passed by Parliament projects a deficit of around 4% for the years 1997-00. Whatever be the political complexion of the government that takes power after the forthcoming election, it has to ensure that the projection holds.

4.5 There are a number of problems that are yet to be addressed if the long-term fiscal sustainability is to be ensured. High on the list is the need to reduce the implicit and explicit subsidies of the central and state governments for which economic and social rationales are weak. A recent study by the National Institute for Public Finance and Policy (NIFP) (Government of India 1997) found that these accounted for 14.4% of GDP in 1994-95 of which three fourths were on non-merit goods, i.e. goods that generated no positive externalities or were largely consumed by the poor.<sup>1</sup> The next is the fiscal consequences of the losses of non-financial public sector enterprises. I will return to the important issue of privatization of and disinvestment in public

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<sup>1</sup> Gian Sahota (2000), in an as yet unpublished paper, has strongly criticised the methodology of the NIFP study for its conceptual weakness, its omission of tax expenditures, implicit interest subsidies on concessional loans, subsidy in the development plan outlays and extra budget subsidies, and finally, its underestimation of cost recoveries in publicly provided services. Other than noting Sahota's critique, I have not examined its validity.

enterprises. Suffices here to say that the progress in this area is halting and the resistance of entrenched labour unions to privatization continues to be a political hurdle. On the tax side, the contour of needed reforms are well known and have been elaborated in the report of the Chelliah Committee (Ministry of Finance, 1992). Even now, three quarters of the total tax revenue of centre and states come from indirect taxes. Among direct taxes, land taxes have virtually been abolished and agricultural incomes remain largely outside the tax net. Replacing the existing set of indirect taxes through a system of value added taxes has not made rapid progress. Reform of the tax system is of high priority. There are some hopeful signs: the states have agreed to a uniform rate of sales tax and to eschew competition through sales-tax concession for attracting investment. The central government has agreed to share 29 percent of the gross receipts of all central taxes with the states thereby mitigating its disincentives in the earlier system for collection of those taxes that it had to share as compared to those it did not have to. With the introduction of a central value added tax (CENVAT) the excise tax structure has moved closer to a single-rate system, although there is the limitation that CENVAT is confined only to manufacturing because of the constitutional constraints on the Centre's powers to tax domestic trade. There are also proposals to augment the tax base by including services.

4.6 On the expenditure side, it is clear that there is substantial room for economies in addition to those from reducing wasteful subsidies. There is no denying that both administrative departments as well as public enterprises are overstaffed. The wages and benefits including pensions paid to government employees are much higher than would prevail in a free market for their labour. Salaries and pension payments to employees amounted to a fifth of the net revenue of the central government in 1997-98. Remarkably the central government recently granted wage increases even going beyond the already generous recommendations of the Fifth Pay Commission. In short order, the state governments had to follow suit. Once again, whether any major reform of employment and compensation policies of the government and public enterprise is politically feasible is an open question. Significant economies through efficiency gains in public expenditures on health, education and welfare, as well as on capital construction, are possible. Last, but not least, the present system of centre-state fiscal relations has to be rethought to provide better incentives for the states to be fiscally responsible. Whether the recently appointed Eleventh Finance Commission would recommend any radical reforms is unknown. The decision to establish an Expenditure Reforms Commission, the introduction of zero-based budgeting and the possibility that a Fiscal Responsibility Act will be passed by the Parliament in the near future are hopeful signs. The issue price of commodities distributed to those above the poverty line by the public distribution system (PDS) has now been fixed at the "economic costs" of procurement, storage and distribution. Since all three activities are undertaken by the inefficient public sector, the economic cost includes a substantial margin for inefficiency and would institutionalize the poor quality of the PDS as a whole. The optimism generated by the signing in 1999-2000 of Memoranda of Understanding (MOUs) by eleven states promising fiscal reforms in return for bail-outs by the Centre has waned since. Transfer payments by the Centre had to be withheld for non-compliance on occasion and part of the Centre's advances had to be converted to three year loans.

4.7 Turning to the financial sector, it is important to recognize the complementarity between reforms in the financial and real sectors. Having access to funds for working capital as well as for long-term investment through efficiently functioning set of financial intermediaries is essential, if the reforms in the real sectors are to yield fruit. By the same token, given the slow

pace of India's real sector reforms for eliminating policy-induced distortions, the signals for investment emerging from the real sector would be distorted as well. Such distorted signals could induce the flow of domestic and foreign capital to the wrong sectors. As such the fact that, because of the slowness or gradualism of real sector reforms, there were relatively few disruptions in production during the as yet incomplete move to a completely deregulated system is not, in and of itself, to be viewed as beneficial.

4.8 Fortunately, there has been significant progress in reforming the financial sector, which until recently was in effect a government monopoly. Though much remains to be done, interest rates are no longer controlled, the draft on loanable funds of the banking system by the government through various reserve requirements has been reduced, and the extent of directed credit has also been reduced. Capital base of banks has been improved and better procedures for income recognition and provisions for non-performing loans have been introduced. Prudential regulations have been tightened. Entry of private banks has been allowed. However non-performing loans as a proportion of total loans of public sector banks was still as high as 16% in 1997-98. However, twelve Debt Recovery Tribunals have been established and three more are planned. Legislation for expediting the loan recovery process is being introduced.

4.9 Unfortunately, reform of the insurance sector, by allowing the entry of domestic and foreign private firms, is stalled. The outgoing government had introduced an insurance reform legislation in Parliament before its dissolution. Hopefully the new government will push it through.<sup>2</sup> Finally, the issue of independence of the Reserve Bank of India (RBI) in the conduct of monetary and exchange rate policy has to be seriously addressed. The fact that proposals for according greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system are likely to be placed before Parliament soon is encouraging.

### **External Sector Policies**

4.10 India's relative insulation from world markets until the reforms of 1991 stemmed from distrust of markets in general and the fear that greater involvement in foreign trade would inevitably retard India's industrialization. Achievement of national self-sufficiency has been a major objective of all of India's development plans in the pre as well as post independence era. The First Five Year Plan emphasized that "Control and regulation of exports and imports, and in the case of select commodities state trading are necessary not only from the point of view of utilizing to the best advantage the limited foreign exchange resources available...." (Planning Commission, 1951, pp. 42-43). Since the mid-sixties until 1991 an elaborate system of quantitative restrictions (QR's) as well as tariffs have governed India's export and import trade.<sup>3</sup> Tariffs were high on an average (import weighted tariff rate on the eve of reforms were as high as 87% and the variance in tariff rates was also high, with the tariff rate on some imports exceeding 300%. Imports of most consumer goods were banned.

4.11 Reforms since 1991, and India becoming a signatory of the Uruguay Round Agreement of 1994, have led to a significant opening of the economy. Most of the QR's on manufactured imports have been abolished (except on consumer goods), average tariffs have been lowered to around 30% and the variance in tariffs has been reduced as well. The budget for 2000-01 has

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<sup>2</sup> The Insurance Regulatory Authority and Development Bill has been passed and notified in January 2000.

<sup>3</sup> There were some relatively minor reforms in the eighties and some improvements in the real exchange rate as well. These contributed to a small increase in the share of foreign trade in GDP. However, India's share in world exports had fallen precipitously from around 2.1% in 1951 to 0.4% in 1980. It has since recovered slowly to around 0.7% in the late nineties.

reduced the peak tariff rate to 35%. With respect to consumer goods imports, India has committed to phase out these QR's under the Uruguay Round Agreement. But India's trading partners have raised the issue of India's planned slow phase out in the WTO's Dispute Settlement Body (DSB). While India has entered into bilateral agreements with the EU, Australia, Canada and Japan on a mutually agreed phase-out schedule, the US insisted on a ruling by the Body. The ruling went against India and India's invoking the balance of payments provision of GATT for its use of QRs. India has appealed against the ruling by questioning the jurisdiction of DSB on matters relating to balance of payments. India lost again. The budget for 2000-01 has put several hundred items, including consumer goods and agricultural products on the free list for imports. Removal of QR's does not mean the removal of tariffs. As such, the urgent task is to further reduce tariffs and remove the remaining non-tariff barriers.

4.12 Apart from manufactured consumer goods, trade in agricultural commodities has been restricted, primarily through state trading monopolies. Also the fact that domestic prices of certain exportables (e.g., onions, raw cotton) are politically sensitive has often led to ban on their exports. This makes India an unreliable exporter of these commodities. A review of agricultural trade agreement of the Uruguay Round is to begin soon. India would do well to use the opportunity of this review to phase-out its own restrictions and also join other countries in demanding the phase-out export subsidies and other interventions in agricultural trade on the part of the EU and other industrialized countries.

4.13 This is not the occasion to discuss India's resistance to any new round of multilateral negotiations. It is true that some industrialized countries have not fully lived up to their commitments in the Uruguay Round agreement, for example, those relating to trade in textiles and apparel, by resorting to the use of anti-dumping measures (ADM) to circumvent their commitments. By resisting the start of a new round until earlier commitments are fully implemented, India is likely to become isolated as it became in the run-up to the Uruguay Round. Besides, India also is increasingly using ADMs. It would be in India's longer term interests to enter into a new round of negotiations and join other developing countries in ensuring that ADM's and other administrative protection measures are made WTO-illegal and the use of trade sanctions for enforcing labour and environmental standards does not become legitimized in the WTO.

4.14 Lastly, the reservation of production of certain commodities for the small scale sector is hurting India's exports. This policy has to be phased out.

4.15 Turning to capital flows, India has not attracted capital flows of the scale that smaller economies such as Malaysia or Thailand have attracted. Of course external capital flow to China has been far higher. There are several reasons for this, most of them connected with India's longstanding distrust of markets in general and foreign trade and capital in particular. It is true that since 1991 India had taken several steps to make India attractive to foreign investors. But whether these are adequate, particularly in comparison to the very favorable environment for foreign investment in neighbouring countries, is arguable. Whether India's capital controls were the prime reason that it was able to avoid the financial crisis of the East Asian type is an open question. But one lesson from the East Asian crisis is of relevance to India --until India's domestic financial sector is fully reformed, the capital base of the Bank brought up to levels appropriate to the risk characteristics of their portfolio of loans, and financial institutions have the capability to appraise the risk characteristics of their advances, rushing into capital account convertibility would be unwise.

## Reforms in Agricultural and Industrial Sectors

4.16 Agriculture is largely in the domain of states though the central government's policies also affect agriculture. India is not a common market in agricultural commodities--states often impose restrictions on private interstate trade and even inter-district trade within states. An interstate agreement or a constitutional provision (similar to the interstate commerce clause of the US constitution) outlawing of such restrictions and more generally taxation of interstate sales is essential.

4.17 Agricultural inputs (electricity, water, fertilizers) are subsidized and there are interventions in product markets, for example, through the operation of the state agency, Food Corporation of India. As noted earlier, foreign trade in agricultural commodities are canalized through state trading agencies, although recently there has been some easing of QR's and of canalization. The overall impact of implicit and explicit taxes and subsidies has been to disprotect agriculture. There is no evidence that these interventions have been coordinated to achieve a well-defined set of policy objectives. Unfortunately, subsidies have come to be viewed as entitlements so that there is organized opposition to any attempt at their reduction. The facts that irrigation charges do not even cover the cost of operation and maintenance of the system, electricity subsidies drain the resources of the state electricity boards that could have been used for investment in generation and, in any case, the quality (in terms of voltage and time of delivery) of subsidized electricity is poor, and finally, that the access of poor and marginal farmers to the subsidies is minimal are well known. Agricultural credit is another area to which the poor have little access while the not so poor have received credit but are largely responsible for the default of agricultural loans. It is claimed that the micro-finance approach, a la Grameen Bank, has been making progress. If true, this is an encouraging development.

4.18 Several government committees have also examined these issues and proposed solutions. Progress in implementing reforms has been slow--for example, only in a few states there have been attempts to decentralize the operation of irrigation systems and vesting the control of allocation and operation in an association of farmers. What is needed is a credible reform programme that eliminates subsidies while assuring farmers of the supply of quality inputs at a real cost that does not exceed the true cost of poor quality but subsidized inputs that they are receiving now, integrates India more fully with world markets.

4.19 Turning to the industrial sector, there are at least two major interrelated tasks that need to be completed. One is privatization and the other is the reform of labour and bankruptcy laws which I discuss below. Privatization of public sector undertakings (PSUs) is not an end in and of itself but only a means of achieving other goals, including possibly greater efficiency and faster growth. The first step of course is to define with some clarity what these goals are. For example, the government has chosen to sell different percentages of equity in different enterprises to the public, but no rationale has been offered as to what was to be achieved by the proposed percentages of sales of equity across enterprises. To say this is not to say that the percentages have to be the same and that a "one-size-fits-all" approach is the right one for disinvestment. But there has to be a rationale for the differing percentages and none has been offered.<sup>4</sup> It is unclear whether short of outright sale of the enterprise (i.e. sale of 100% of equity) to private hands, it is possible to ensure the right incentives for efficient management.

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<sup>4</sup> It is true that the government has announced its intention to close down non-viable PSUs, restructure viable ones and reduce equity in all non-strategic PSUs to 26%. But actual implementation of these intentions has been very slow.

4.20 Even the government's commitment to disinvestment appears doubtful. A Disinvestment Commission was set up in 1996 to advise the government on the extent, mode or timing of disinvestment. At the beginning of 1998, the commission was divested of its powers to monitor and supervise the disinvestment process. The term of the commission expired in 1999 and was not renewed. Instead a new Department for Disinvestment has been created. During its existence, the commission issued 11 reports containing recommendations on 58 of the 64 PSE's referred to it. The recommendations in only 13 cases were or are being implemented. The "Disinvestment Fund", set up in 1996 on the advice of the commission to use the sale of proceeds for restructuring PSE's and to finance voluntary retirements of excess staff is not yet operational. I will come back to privatization in the power sector in discussing infrastructure.

4.21 For the privately owned and operated segment of the Industrial Sector, it is important to ensure that there is ease of entry into the industry by domestic and foreign investors and competition from imports is also assumed for traded goods. In industries where scale economies and network externalities are significant such as, for example, electricity transmission and telecommunications, an appropriate regulatory framework would be needed.

### **Infrastructure**

4.22 A well functioning transportation, telecommunication and energy infrastructure is the foundation of all economic activity in a modern economy. Given that infrastructural services are non-tradable, using foreign trade to absorb the imbalances between domestic supply and domestic demand is infeasible. Also, gestation lags investment in infrastructure are long, investment is lumpy and scale economies and net work externalities could be significant. For all these reasons, atomistic competition of the text book variety is infeasible in the provision of these services. Often infrastructure is publicly owned and operated. In most other cases, it is regulated by the state even though ownership and operation are in private hands. Cross subsidization by one group of users of other groups is also a feature of infrastructure.

4.23 Until recently electricity, telecommunications and most transportation (railways, airlines and significant share of passenger bus transport) were public monopolies owned by central or state governments. Railways and airlines were owned by the central government. Electricity generation, transmission and distribution is mostly in the hands of state electricity boards (SEB's) although in generation centrally owned plants and privately owned captive plants are important as well. In pricing subsidization of certain categories of users (e.g. free or heavily subsidized provision of electricity to farmers) and cross-subsidization by one group of users of other (shippers of freight subsidizing passengers on railways, long distance callers subsidizing local callers on telephone networks) were rampant.

4.24 The poor and unreliable service by public monopolies led to the use of more expensive private alternatives: the installation of captive power plants of small capacity and very expensive fuel is one example. In some cities such as Bangalore, even small shops have their own mini-generators! The poor performance of railways led to excessive use of private road transport for long distance cargo hauling with the inevitable result that the road networks are overused and

poorly maintained.<sup>5</sup> Besides the rate of traffic accidents and fatalities are some of the highest in the world.

4.25 With the SEB's making heavy losses<sup>6</sup> and with state governments unable to raise significant resources for investment, there was no alternative to inviting private investors, domestic and foreign, in the power sector. But with power tariffs being set by the SEB's and with transmission and distribution still with SEB's, private generators naturally wanted guarantees that the bankrupt SEB's will pay for electricity sold to them by private generators. Since the state governments themselves were in precarious fiscal situation, their guaranteeing payments by their SEB's was not credible enough so that investors demanded the central government's counter-guarantee of state government guarantees!

4.26 Clearly reforms of state electricity boards has become urgent and exploring better alternatives to the vertical integration of generation, transmission and distribution into one enterprise is imperative. With significant private entry, setting up an appropriate regulatory framework for setting tariffs is essential as well. While enabling legislation for establishing a regulatory authority by state governments was passed by national Parliament, few states have actually set up such authorities. While Orissa has gone farthest in reforming the power sector, five others, Andhra Pradesh, Gujarat, Haryana, Rajasthan and Uttar Pradesh, have begun the reform process as well. Completing the reform process in these states and initiating them in other states are urgent tasks. Fortunately there is some progress: as many as 13 states have constituted or notified the constitution of a State Electricity Regulatory Commission.

4.27 In telecommunications private participation has been allowed in several segments. A regulatory authority, the Telecommunication Regulatory Authority of India (TRAI) has been set up and is functioning. However, TRAI has run into conflicts with the government's Department of Telecommunications (DOT) most recently in setting tariffs for local and long distance communications. Although this conflict was resolved, the deeper problem is that DOT is both a producer of telecommunication services and a policy making authority. Since as a producer it should be under the jurisdiction of TRAI, but as a policy maker DOT has to reflect the concerns of all producers and not just itself. The conflict between the two roles of DOT can be resolved, and the credibility of TRAI as a regulator ensured, only if DOT divests itself of its producing entities.<sup>7</sup>

4.28 As has happened in other parts of the world including the United States, sometimes private bidders overbid and having won the bidding, find themselves unable to pay the amount they bid because the revenues turn out to be much less than what they and anticipated. This has happened in telecom bidding in India. On the one hand, by letting, ex post, the successful bidders to reduce the amount they bid, the credibility of the bidding process is eroded. On the other, not reducing the bid amount runs the risk of the bidders not producing the services they bid for. This difficult issue remains to be resolved.

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<sup>5</sup> It remains to be seen whether the recent initiatives of the Railway Ministry, such as the schemes to 'Build-Own-Lease-Transfer', 'Own Your Own Wagon' to attract private participation, would be successful in attracting long distance cargo back to the railways.

<sup>6</sup> According to The Economic Survey 1999-2000, the rate of return of SEBs was -31%. If they would charge enough to fetch a 3% rate of return that Section 59 of the Electricity Supply Act of 1949 enjoined them to do, 70 percent of the gross subsidy (which was Rs. 338 billion in 1999-2000) would not be needed.

<sup>7</sup> In October 1999, a separate Department of Telecom Services (DTS) has been set up with DOT being responsible for policy matters with a Telecom Commission handling coordination between DTS and DOT. TRAI also has been reconstituted. Still there are unresolved issues of conflict among the three agencies.

4.29 Tentative steps to let private construction and operation of roads have been taken. Here again a regulatory system has to be established and legal and administrative procedures of acquisition of land have to be streamlined. Progress on all this has been slow.<sup>8</sup>

4.30 The average ship turn around time in Indian ports was 7.8 days in 1996-97 (6.6 days in 1997-98 and 5.9 days in 1998-99) compared to a few hours in Singapore. In Indian ports capacity and berth configuration have not changed to match the type and categories of cargo that need to be handled. Some ports (e.g. Calcutta) handle less cargo now than they handled years ago. Bureaucratic management and recalcitrant labour unions add to the inefficiencies, so such so most general cargo traffic in and out of India is transshipped at more efficient ports in neighboring countries. The added costs to India's foreign trade are substantial. While private investors have been allowed to build and operate minor ports and a regulatory authority for ports also has been set up, the problems are too deep rooted to be resolved quickly. The issue of recalcitrant labour unions in ports is part of the broader issue of labour management in the public sector as well as in large scale manufacturing. Without radical labour market reforms, progress involving this issue is bound to be slow, if not altogether impossible.

### **Social Sectors and Poverty Alleviation**

4.31 Although education and health sectors have been accorded high priority in all pre and post independence development plans, and the constitution required the state to endeavor to provide free and compulsory primary education, actual achievements have been modest. General living standards have certainly improved, life expectancy at birth has nearly doubled since independence and literacy rate has increased substantially. Still these achievements are modest not only in comparison with what is needed but also with what many other developing countries of Asia and in Africa have achieved. Even within India, some states, with Kerala as the leader, have done much better in social indicators than others. Sex disparities in school enrollments, high drop-out rates and poor quality of instruction are the norms rather than exceptions. The fact that parents, even poor ones, are willing to spend significant amount to get their children educated in better privately run schools shows that it is not their poverty and the opportunity cost in terms of income foregone from child labor in household enterprises that prevents parents from sending or keeping their children in government run schools. As the successful experiment in Madhya Pradesh with letting the local community take responsibility for hiring teachers and monitoring their performance shows, quality education can be successfully delivered if local control and responsibility for delivery can be instituted.

4.32 Problems similar to those in education arise in health sectors. Just as educational expenditures are tilted to higher education rather than to relatively more socially valuable primary education, in health care expenditures are tilted towards curative rather than preventive care. Here again interstate disparities are substantial which suggests that poorly performing states could in principle emulate the better performing ones.

4.33 Several programmes including the Public Distribution System (PDS) for food grains and other essential commodities, various employment generation and training programmes have been instituted with the ostensible objective of alleviating poverty. Unfortunately except for some of the employment generation programmes, others, including the PDS, are not well-targeted and the

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<sup>8</sup> The National Highway Authority of India was established in 1995 and it has been mandated to implement a National Highway Development Programme. Private sector participation in port development under a Build-Operate-Transfer scheme is envisaged.



truly poor are not their major beneficiaries.<sup>9</sup> The budgetary costs of these programmes are substantial. Reforms of these programmes are urgent but politically difficult to bring about.

### **Reform of Labour and Bankruptcy Laws**

4.34 Nearly two thirds of India's labour force is employed in agriculture as owner cultivators, tenants and agricultural laborers. Their remuneration is essentially market determined. There are no pensions, paid vacations, health expense reimbursement or any perquisites of employment for this large group of workers. Three decades ago, the late Professor Mahalanobis, architect of India's development strategy, pointed out:

“certain 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...the present form of protection of organized labour, which constitutes, including their families, about five or six percent of the whole population, would operate as an obstacle to growth and would also increase inequalities”. (Mahalanobis 1969, p. 442).

4.35 Failing firms cannot close down their operation without government permission and this is rarely given. The net result is that the government ends up taking over failed private firms (the so-called 'sick' firms) and their performance often gets worse under government operation. In India there is no analogue to Chapter 11 of the U.S. bankruptcy law which enables an orderly way of dealing with failing enterprises by providing them temporary protection from creditors during which period alternatives ranging from restructuring to closure are explored. India's Bureau for Industrial and Financial Restructuring (BIFR) has not performed this role to any significant extent.

4.36 Since its inception in May 1987 and till the end of March 1998 it received 3148 references (449 between January 1997 and March 1998) of which 2145 (294 between January 1997 and March 1998) were registered. It "disposed of" 220 cases between January 1997 and March 1998, including recommendations for winding up 10 and rehabilitating another 21 central public sector undertakings (Government of India 1998, pp. 110-111). However it is unclear whether the recommendations have been implemented. Since the refusal of permission to close down a failing enterprise is driven by the concern that employees of those firms would become unemployed were they allowed to close down, reforming bankruptcy and labour laws are interrelated tasks starting from the repeal of the draconian Industrial Disputes Act. Again whether the narrow interests of the microscopic labour aristocracy in the public sector and organized manufacturing will continue to prevail, as it has since independence, over the vast majority of workers in agriculture, small scale manufacturing, handicrafts and services is an open question. But there can be no doubt it should not be allowed to prevail.

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<sup>9</sup> With the introduction of beneficiaries of the PDS into two groups, viz. those below and those above the poverty line, charging “economic cost” of supply of essential commodities to the latter, and half the economic cost and doubling the allocation of supplies to the former, stopping the allocation of PDS sugar to income tax assesses and so on, some improvement in targeting could be expected.

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