

Challenges, Policy Response and Medium Term Prospects

With the full effects of the economic reforms of the 1990s working through the system, the Indian economy has moved to a higher growth path. The new challenge is to maintain growth at these levels, not to speak of raising it further to double digit levels. With domestic experience of such high growth limited, global experience can be useful. Historically, there have been about a dozen medium/large countries that have averaged a GDP growth of 9 per cent or more for a decade. Of these less than half maintained an average growth of 9 per cent or more for two decades. The challenges of high growth have become more complex because of increased globalization of the world economy and the growing influence of global developments, economic as well as non-economic. Despite efforts to accelerate the pace of infrastructure development the demand for infrastructure services has grown even faster than the supply so that the constraints may have become more binding. There is therefore heightened urgency to augment and upgrade infrastructure, both physical as well as social and, in particular, power, roads and ports. This requires mobilization of unprecedented amounts of capital with macroeconomic stability, which can only happen if both the public and private sectors have the incentive and the motivation to perform at their best. The former requires us to effectively address the persistent institutional weaknesses and implementation constraints at different levels of government in the country. The latter requires policy and regulations that are comprehensive but simple and clear and credible. This chapter identifies some of the major policy challenges at the macro and sectoral level and analyses the medium-term prospects of the economy.

SUSTAINING THE GROWTH MOMENTUM

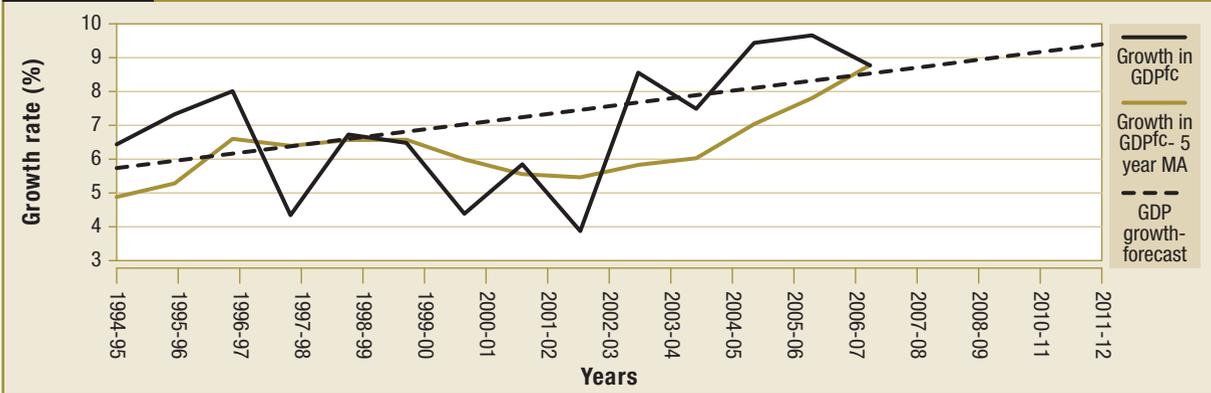
Growth

2.2 An analysis of the post-independence growth experience shows two statistically significant breaks in the rate of growth of the economy. The first break occurred in the early 1980s when the economy moved from what has been commonly

described as “the Hindu growth rate” of around 3.5 to 5.5 per cent. This followed a policy shift away from excessive controls and restrictions on private enterprise towards gradual decontrol. The second break occurred in the mid-1990s with the ushering in of deeper and broad based reforms at the beginning of the decade. The step up in the GDP growth rate to 6.5 per cent in the late 1990s and further to 7.8 per cent during the Tenth Five Year Plan, with the last three years averaging over 9 per cent, is evidence of the success of these policy measures. If this trend persists in the medium-term, the economy would average over 8.9 per cent per annum over the Eleventh Five Year Plan period (Figure 2.1). It can be seen that the slightly lower GDP growth rate in 2007-08 (Advanced Estimates) is very much on the moving average trend and above the forecast line and, therefore, cannot be seen as a sign of a shift of the economy to a lower growth trend. If we achieve the GDP growth target of the Eleventh Five Year Plan, and step up the growth rate to 9.5 per cent in the succeeding year, the Indian economy would have averaged 9 per cent over a decade. This achievement would put India among the select group of about a dozen medium-large economies (such as China, Singapore, Japan, Taiwan, China, Thailand, South Korea, Portugal, Greece and Hong Kong China) that have averaged a GDP growth of 9 per cent or more for at least a decade during their growth trajectory.

2.3 On the demand side the growth acceleration has been driven by investment and supported by private consumption. External trade, in terms of the balance on goods and service trade, has played an insignificant role. This is reflected in the change in average contribution of the three components between the Ninth and Tenth Five Year Plans, as discussed in Chapter 1. The economy is likely to remain domestic demand driven in the medium term.

2.4 The acceleration in growth of fixed capital formation reflects the vast improvement in investment climate as a result of the 1990s reforms. Figure 2.2 shows that there were two spurts in fixed investment growth: the first followed the

Figure 2.1 GDP at factor cost - annual and five year moving average growth

domestic decontrol cum import de-controls and tariff reduction on capital and intermediate goods in the early 1990s. The second followed, after an adjustment period, the freeing of consumer goods imports in the late 1990s. Paradoxically, the decision to delay lifting of quantitative restrictions (QRs) on consumer goods led to an increase in effective protection on them following the reduction of tariffs on intermediate inputs in the early 1990s. The initial negative impact of removal of control on consumer goods imports on industry as a whole was therefore a little more severe and led to a temporary slowdown of growth in the early 2000s, which was accentuated by monsoon linked agriculture declines. The increase in competitiveness of the economy that was under way since 1991, however, restored the growth momentum by 2003-04.

Managing capital inflows

2.5 There are two inter-related macroeconomic challenges that we face in maintaining high GDP growth on a sustained basis. These relate to capital inflows and inflation. Since 2005, India's merchandise trade deficit has risen to over 7 per cent and, in the last two years, the overall trade

deficit (G&S) has stabilized at around 3 per cent of GDP at market prices. With net factor incomes (including remittances) at about 2 per cent of GDP, the current account deficit is down to a little over 1 per cent of GDP. In this period capital inflows have spurred to an average of around 4 per cent of GDP, far in excess of the current account financing requirements, leading to large accumulation of reserves and a build of pressure on prices.

2.6 High GDP growth attracts foreign capital looking for profitable investment opportunities. In a positive cycle this inflow will indeed find profitable investment opportunities that others have missed and lead to even higher growth. However, if the growth opportunities do not materialize fast enough there is pressure on the currency to appreciate, resulting in either an accumulation of reserves (followed by monetary expansion and inflation) or actual (nominal) appreciation or both. In the last two years, particularly in fiscal 2007-08, the Indian economy has gone through such a phase.

2.7 There are reasons to believe that the surge in capital inflows, including FDI, will continue in the medium term. The fact that the capital inflows have been in excess of the current account deficit despite two years of over 9 per cent growth suggests that

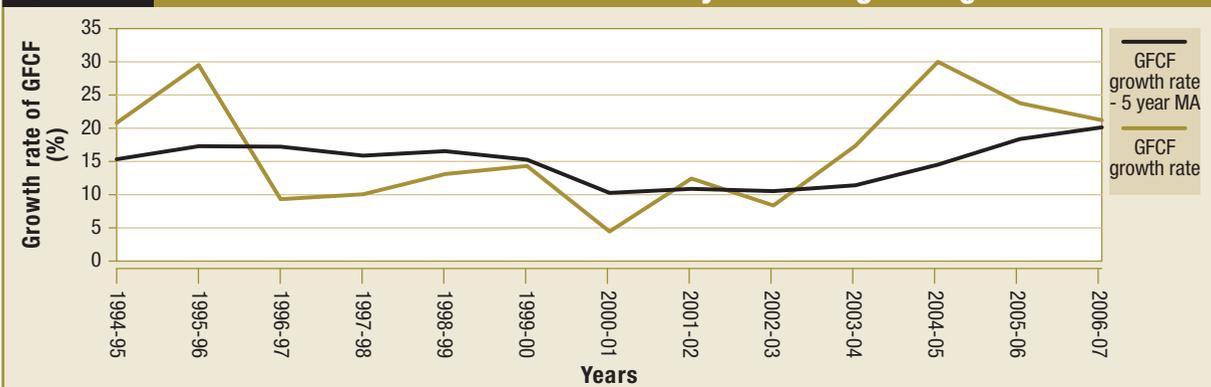
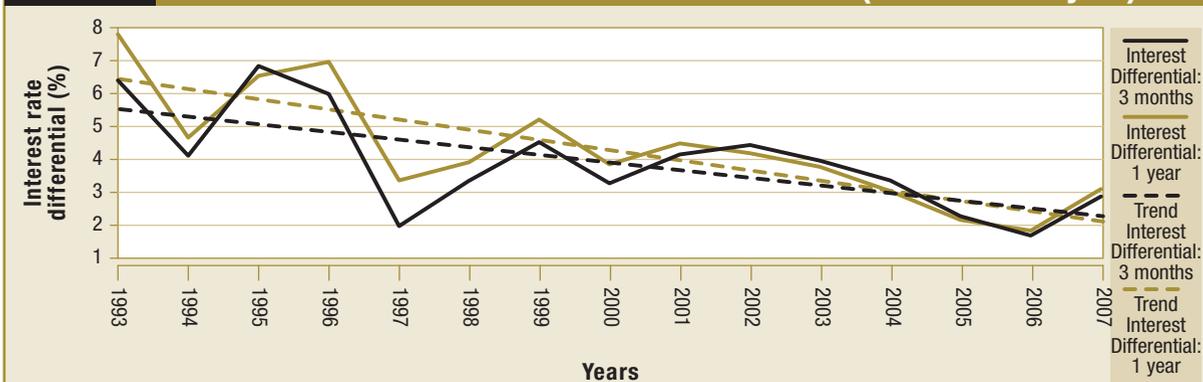
Figure 2.2 Growth rate of GFCF - annual and five year moving average

Figure 2.3 Interest rate differentials between India and USA (3 months & 1 year)

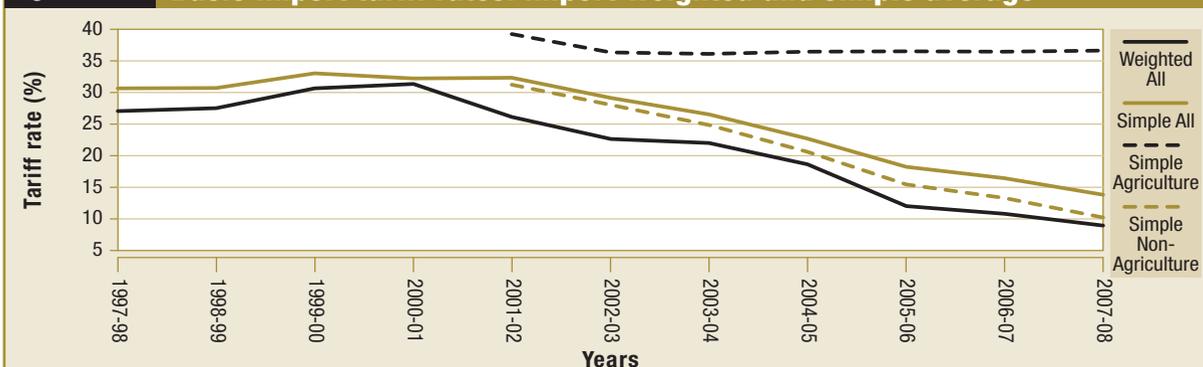
investors expected opportunities for profitable investments to grow. At the same time, despite movement towards convergence of Indian nominal interest rates to global (US as proxy) levels (Figure 2.3), the short term arbitrage opportunities arising from underlying policy distortions remain a distinct possibility. Thus, short term flows could continue to add to the total capital inflows in the medium term, making it necessary to constantly review and revise the macro management strategy.

Inflation

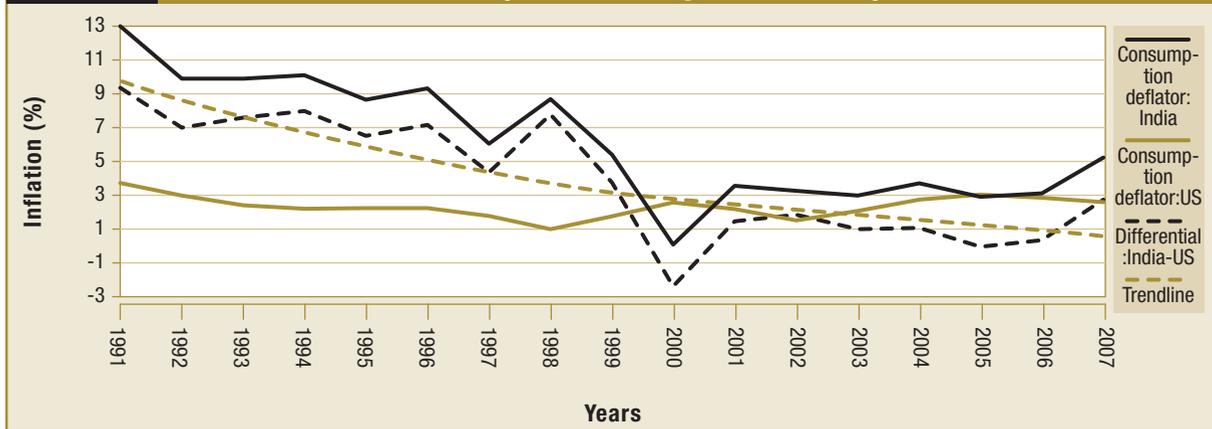
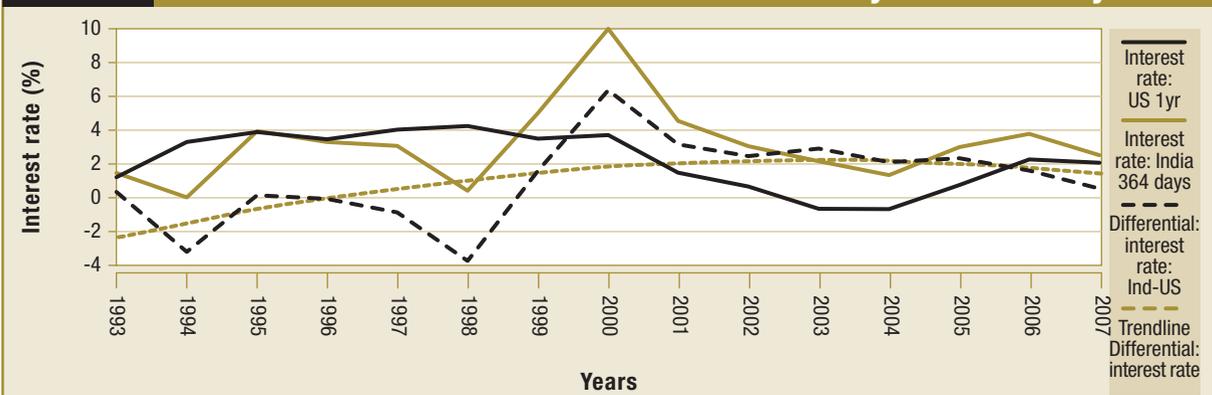
2.8 Inflation management has always been a key policy concern of the Government. Traditionally, it has been a structural issue, where seasonal variations in production, particularly of wage goods, along with market rigidities have resulted in a build up of inflationary expectations translating local impulses and concerns into a more widespread impact on the consumers. Of late, however, the change in the structure of the economy and its more globalized nature have made management of inflation a complex task. With rising capital inflows, various monetary policy mechanisms have a more decisive role to play now. At the same time, inflationary impulses from global commodity prices have to be tackled through the use of fiscal and trade policy instruments.

2.9 The opening of the economy and the reduction in tariff rates since 1991, besides promoting competitiveness and growth, have also provided an impetus to convergence of inflation rates. Tariffs have come down from a peak rate of 150 per cent in 1990 to a peak non-agricultural rate of 10 per cent in 2007-08. Agricultural tariffs remain relatively high and stable, isolating this segment of the economy from both the benefits and costs of globalisation. The downtrend is, however, clear in both the simple and weighted average tariff rates for all goods (Figure 2.4). The reduction in tariffs on non-agricultural products has played an important role in the convergence of Indian to global inflation rates and needs to continue.

2.10 Figure 2.5 shows the inflation rates as represented by the Indian and US GDP deflators for consumption. The trend reduction in the inflation gap has bottomed out in the last two years at around half a per cent, though the actual inflation in India was above this trend. The interaction between high tariffs on agricultural products coupled with the large share of food in the consumption basket and the slow modernisation of Indian agriculture and agro-processing, coupled with the high dependence of the population on agriculture may play a role in future inflation.

Figure 2.4 Basic import tariff rates: import weighted and simple average

Note : 2005-06 weights are used for 2006-07 and 2007-08.

Figure 2.5 Indian and US inflation (GDP consumption deflator)**Figure 2.6 Real interest rates: US Govt. securities and 364 day Indian treasury bills**

2.11 Economic theory suggests that the real interest rates (not nominal) are the ones that determine borrowing and lending and investment and saving decisions. This would be particularly significant in a longer time horizon. We use the nominal rates and inflation shown above to derive the real rate. Figure 2.6 shows the average annual real interest rate, as represented by the yield at auction cut-off on Indian 364 day Treasury Bills and the rate on US one year Government securities. In contrast to the convergence of nominal rates and inflation, the gap between the real rates (Indian-US), after trending down till 1999-2000 shot up in 2000-01 and has again trended down since then.

2.12 Thus, this downtrend was interrupted by a major shock in 1999-2000 and 2000-01, which raised the gap to a very high level, from which the downtrend continued. It may be recalled that these were the years in which import controls on consumer goods were completely eliminated. This seems to have reduced the inflation gap as expected, but paradoxically expanded the real interest gap. Theory suggests that the rise in the real interest rates could be due to the adverse impact on expectations about long-term inflation and/or risk to investment.

The inflation expectations were short lived, but the investment risk perceptions seem to have dissipated gradually and became completely normal by 2005. This was reflected in the sharp increase in inflows from 2005-06. Thus, a further convergence of both inflation and real interest rates is possible if we liberalise and develop India's debt and currency markets and remove the constraints on agriculture modernization and urban land supply.

External Sector

2.13 The US economy is expected to slowdown in 2008, consequent to the "sub-prime crises" (Box 2.1). Most projections of the world economy suggest a moderate but not severe slowdown in world growth. This will impact both the demand for India's exports and the value of imports. The direct impact of the global growth slowdown is on the demand for imports. This will impact all countries including India, depending on the importance of the slowdown in different countries and the importance of the country in our exports. Though our exports to the US have already been slowing in 2006 and 2007, a further slowdown may be unavoidable, but may be relatively modest. The deceleration in world

imports will also lead to a deceleration in growth of demand for commodities, including oil, and their international prices. While the extent of the impact is uncertain, it will have a salutatory effect on the unit value of imports and consequently on the value of imports. The balance of these two factors will likely result in a modest increase in the goods and services trade deficit, as long as a severe recession is avoided in the US.

2.14 The “sub-prime crisis” (Box 2.1) and the response of the US and other developed country Central Banks to it, has additional implications. There has been a renewed expansion of liquidity by these countries and this may increase the capital flows into India and other emerging markets. On the other hand the lack of precise information on securitised debt and all its manifestation has increased uncertainty, reduced the credibility of many developed market intermediaries and increased risk aversion among their investors. This will tend to reduce the flows into developing countries. The slower Indian economic growth in 2007-08, relative to 2005-06 and 2006-07, may also have a temporary dampening effect on capital inflows. On balance, the decline in capital inflows as a proportion of GDP in 2008 is likely to be modest and the remaining flows will likely take care of any expansion in current account deficit. Thus the situation of excess inflows is likely to remain, though the pressure on reserve accumulation and exchange rate appreciation is likely to ease. Any reduction in excess capital flows from the high levels in 2007 may affect the equity

markets in the short term, but will make the task of monetary management easier. In the longer term the solution to excess capital inflows lies in deepening productivity gains and addressing the root causes of the excess capital flows like interest differential and build-up of expectations on the rupee.

Fiscal issues

2.15 A further reduction of the fiscal deficit can widen the space for monetary policy effectiveness. In the long term, a lower fiscal deficit will result in a reduction in the real domestic long-term interest rate of the economy and thus bring it closer to the world long-term rates. A reduction in the fiscal deficit during periods of excess inflow also reduces the costs of any subsequent reversal of capital flows. Most South East Asian economies had a fiscal surplus during a large part of their high growth period. A fiscal surplus can also contribute to an increase in a nation’s global wealth holdings, for instance in China, Russia and many oil exporting countries.

2.16 In the short term, it can reduce the excess demand pressure created by the inflow of foreign funds. A lower fiscal deficit means a reduced supply of government securities and for any given demand structure a higher price for Government securities and Treasury Bills, i.e. a lower interest rate. This will directly reduce the interest gap with the global rates. The Finance Commission may like to consider to what extent these considerations should translate into lower FRBM targets over the next five years and beyond.

Box 2.1 US sub-prime crisis

The sub-prime mortgage crisis is the major financial crisis of the new millennium whose origin is in the United States (US) housing market. Subsequently, this spread to Europe and some other parts of the world. The gradual softening of international interest rates during the last few years, coupled with relatively easy liquidity conditions across the world, provided for increased risk appetite of investors leading to expansion in the sub-prime market.

The word ‘sub-prime’ refers to borrowers (who are not rated as ‘prime’) and who do not have a sound track record of repayment of loans. The risks inherent in sub-prime loans were sliced into different components and packaged into a host of securities, referred to as asset-backed securities and collateralised debt obligations (CDOs). Credit rating agencies had assigned risk ranks (e.g. AAA, BBB) to them to facilitate marketability. Because of the complex nature of such new products, intermediaries such as hedge funds, pension funds and banks, who held them in their portfolio or through SPVs, were not fully aware of the risks involved. When interest rates rose leading to defaults in the housing sector, the value of the underlying loans declined along with the price of these products. Institutions were saddled with illiquid and value-eroded instruments, leading to liquidity crunch; the crisis in the credit market subsequently spread to the money market as well. The policy response in the US and the Euro area has been to address the issue of enhancing liquidity as well as to restore the faith in the financial system. The sub-prime crisis has also impacted the emerging economies, depending on their exposure to the sub-prime and the related assets.

India has remained relatively insulated from this crisis. The banks and financial institutions in India do not have marked exposure to the sub-prime and related assets in matured markets. Further, India’s gradual approach to the financial sector reforms process, with the building of appropriate safe-guards to ensure stability, has played a positive role in keeping India immune from such shocks.

The supply side challenge

2.17 On the supply side, the most critical challenge is the availability of adequate physical and financial infrastructure. It is instructive to look at infrastructure in terms of public and private goods and a grey area in between - the “quasi-public good.” This helps in identifying the most appropriate policy response. Thus, while roads, policing and urban development are examples of vital public goods, electricity is an example of a private good. In rural areas the electricity distribution network can be treated as a quasi-public good because of economies of scale in distribution. The same is true of dams, canals and to a limited extent of telecom, in rural areas. Private and quasi-public goods infrastructure requires the right policy framework and regulators that encourage competition in expanding supply at lowest cost. The telecom and civil aviation sectors, more recently the airport sector illustrate the possibilities. For public goods, direct public provisioning and leveraging of resources through special purpose vehicles (SPVs) will have to be the major instruments of growth.

Road Connectivity

2.18 The importance of roads in the development of the economy has received renewed attention in the last decade, with the launching of the national highway development project (NHDP) and the Prime Minister’s Grameen Rozgar Yojana (PMGRY). While there is some visible progress in the road sector in the domain of the Central Government, the same is perhaps not true of some States. Given the low-skill intensity and high income multiplier effect of investment in this sector, there is an urgent need to place the highest priority on building roads to specified standards, especially in the poor States and regions of the country. Indeed, the medium term plan for this sector should target a network of highways linking all cities in the country, a network of State highways linking all towns at State level and connectivity of all villages with all weather district roads in every State.

Urban infrastructure

2.19 Urban development and renewal of existing towns and cities is yet another area of infrastructure development, which is critical for meeting the growing demand for urban housing and business premises from a rapidly expanding economy. The public good nature of this activity is brought out by the fact that the government has the responsibility not only to carry out detailed land

use planning but also to provide connectivity, drainage, sanitation, water supply and public transport facilities. There are a number of policy measures, including addressing the limitations of the rent control act(s), the urban land ceiling laws and regulations and issues related to the financial empowerment of local bodies to make them capable of providing services befitting an urban habitation of a middle-income level country, that need to be urgently addressed. The provision of public goods coupled with policy reforms can energise private initiatives in development of housing (including rental housing), industrial estates and property development thereby impart additional momentum to overall growth. The Central sector programme, Jawaharlal Nehru National Urban Renewal Mission, and SEZs have imparted some impetus in this direction, but the States, particularly poorer ones, need to do more on their own.

Irrigation and agricultural support

2.20 For agriculture, there may be at least three public goods and one quasi-public good, which may be particularly lacking in poor backward regions, namely, the rule of law, all weather road connectivity, knowledge and information on appropriate technologies, farming practices and marketing, and assured irrigation. Irrigation is a major constraint on raising crop productivity. Up to March 2007, only about 74 per cent of the assessed irrigation potential of 140 million hectare has been utilized. The irrigation potential, however, can be increased with technological advancement, inter-basin transfers, recharging of ground water and storage of water in flood plains along the river banks. By having more active participation of actual beneficiaries, through Water Users Associations (WUAs), in maintenance of distribution channels, improvement in on-farm water management practices and reduction of field application losses of water through appropriate pricing, efficiency of water use can be enhanced. This can also increase allocation efficiency of water in terms of its application to different crops. Research and development on crop and non-crop agriculture and animal husbandry, including new varieties, operational methods and management practices have traditionally been generated by Government universities and transmitted to farmers by public organisations and extension services. These need to be addressed in the Eleventh Five Year Plan. The synergies between telecom connectivity, internet access, e-governance, e-learning and e-marketing must be exploited.

Financial intermediation and long term debt markets

2.21 Financial intermediation refers to the process that connects individual savers to potential investors with the most productive use for resources. While enabling the mobilisation of savings and its translation into investment, the process mediates the returns and risks on the investments. With sustained economic growth in the last few decades, the importance and nature of financial intermediation the world over is undergoing dramatic transformation. In many countries, the share of assets held by banks and insurance companies has declined and that of mutual funds, pension funds and non bank financial institutions has increased. The relative importance of different financial intermediaries has also changed. Most of these developments in international financial markets have been mirrored in the Indian financial markets, but the challenge is to deepen and broaden financial sector reforms in India. The banking sector remains, by and large, a government oligopoly despite the entry of private players. The insurance sector still has a long way to go and FDI limits are too low. The long term debt market must be developed to support the financing of infrastructure projects during the Eleventh Five Year Plan period. There is an urgent need for a regime that supports predictable user charges, a financial system that allocates risk efficiently, and project selection based on sound commercial and legal principles to ensure transparency.

Energy scenario

2.22 It is to the credit of India's growth process that its energy intensity has fallen over time. In comparison to the rest of the world, particularly the emerging economies of Brazil and China (Table 2.1), the use of energy per capita in India

remained moderate and it increased at a slower pace. This could partly be due to unsatisfied demand due to domestic capacity constraints. There is considerable room to improve energy efficiency, especially of motor vehicles, and in the generation, transmission and end-use of electricity. Commercially viable and economically attractive technology options, in use in the developed world, should be considered and adopted.

2.23 Improving energy efficiency and demand side management measures like encouraging urban mass transport are important. Sustaining economic growth is critically dependent on significant supply augmentation and change in the composition of energy use. Import dependence, for meeting the primary energy demand in the country, has been increasing over a long period since 1990-91 to 2006-07. Reducing incremental import dependence of the country's energy requirement in the medium to long term entails a number of measures: (a) tapping India's coal reserves with appropriate technology and reforms in the coal sector to increase competition, (b) mitigating transportation constraints on availability of coal, (c) accelerating exploration of oil and gas, (d) fully exploiting the nuclear and hydro potential for power generation, and (e) expediting programmes for energy generation through renewable and non-conventional sources. Besides, a step up of domestic production, the remaining deficit would have to be bridged by entering into strategic geo-political alliances to access the energy assets in the region. There is a need for regulatory reform to implement open access in power sector to facilitate competition.

Skill development

2.24 India's favourable demographics, with a relatively young labour force, has been often cited

Table 2.1 Energy use for selected countries

| ENERGY | Total Use of Energy (MMTOE) | | | | Energy Use Per Capita (KGOE) | | | | CRW/ Total 1990 % | CRW/ Total 2004 % |
|--------------|-----------------------------|------|-------------------------|-----------------------------|------------------------------|------|-------------------------|-----------------------------|-------------------------|-------------------------|
| | 1990 | 2004 | Change 1990- 2004 | Growth (%) 1990- 2004 | 1990 | 2004 | Change 1990- 2004 | Growth (%) 1990- 2004 | | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 11 | 12 |
| Brazil | 134 | 205 | 71 | 3.2 | 897 | 1114 | 217 | 1.7 | 31.1 | 26.5 |
| Russian Fed. | 775 | 642 | -133 | -1.2 | 5211 | 4460 | -751 | -0.9 | 1.6 | 1.1 |
| India | 362 | 573 | 211 | 3.3 | 426 | 531 | 105 | 1.5 | 48.6 | 37.4 |
| China | 867 | 1609 | 743 | 3.6 | 763 | 1242 | 479 | 2.6 | 23.1 | 13.7 |
| EMU | 1053 | 1245 | 192 | 1.3 | 3568 | 3990 | 422 | 0.9 | 3.1 | 4.2 |
| UK | 212 | 234 | 22 | 0.6 | 3686 | 3906 | 220 | 0.3 | 0.3 | 1.3 |
| US | 1928 | 2326 | 398 | 1.4 | 7722 | 7921 | 199 | 0.2 | 3.2 | 3.0 |

Source: World Development Indicators.

Note: MMTOE (KGOE) =million metric tons (kilo gram) of oil equivalent.

crw: use of combustible renewables and waste.

as a key factor in contributing to growth acceleration and as a major strength of the economy in the coming years. Despite this, it faces an emerging shortage of skills in the face of growing demand for labour from the technology and outsourcing sectors as well as in the semi-skilled labour intensive sectors of manufacturing and modern services like organised retail, civil aviation, construction and finance. As a result, wage costs are rising which not only contributes to cost push inflation, but may also end up eroding price advantage in some of the tradable sectors of the economy. Besides increase in wages, the skill shortage also manifests itself as a problem of retention and attrition in the fast growing knowledge based industries as well as in important social sector services like health and hospitality.

2.25 The enormous demand for professional education and employable skills cannot be met by the public sector alone, and the entry of private and non-government sectors such as recognised universities, education and skill development institutions under a professional, independent and credible regulatory system is essential for meeting the requirements. More specifically, there is a need for appropriate legal and policy changes to allow for the setting up of private educational testing, teacher certification and school/college grading organizations with a view to improve the quality of education at all levels. There is need also to make free the entry of “A grade” global universities (global grading already exists) into India. “B” and “C” grade global universities/colleges could be made subject to tighter regulation. There is a need to setup up a system of skill standardization and certification

Box 2.2 Policy Reform Options

- **Coal mining:** Amend Coal Mines Nationalisation Act to allow regulated private entry into coal mining. Privatize old coal mines to improve recovery of “in-place” reserves by 5-10%, subject to a professional, independent regulator for safety and environment issues.
- **PSUs:** Complete the process of selling of 5-10% equity in previously identified profit making non-navratnas. List all unlisted public sector enterprises and sell a minimum of 10% of equity to the public. Auction all loss making PSUs that cannot be revived. For those in which net worth is zero, allow negative bidding in the form of debt write-off.
- **Industrial decontrol:** Phase-out control on Sugar, Fertilizer, Drugs.
- **Oil:** Sell old oil fields to private sector for application of Improved/Enhanced Oil Recovery Techniques.
- **Retail FDI:** Allow a share for foreign equity in all retail trade. Allow 100 per cent foreign equity in foreign branded, specialized retail chains (e.g. Luxury Brands, Consumer Durables, Semi-Durables).
- **Insurance:** Raise foreign equity share in Insurance to 49 per cent. Allow 51 per cent foreign equity in a special category of insurance companies that provide all types of insurance (e.g. health, weather) to rural residents and for all agricultural related activities including agro-processing.
- **Banking:** Allow 100 per cent FDI in Greenfield Private Rural-Agricultural Banks. Such a bank would be free to set up any number of branches in any rural or semi-rural area. It would be free to lend to agriculture and allied sectors, agro-processing and agro-input industries any where in the country and to any industry located in non-urban area (negative list). Such a bank would also be free to takeover (buy out) other private sector banks. As an incentive, such a bank could be allowed expansion into small towns when the general FDI policy on banks will be liberalized.
- **Factories act:** Increase work week to 60 hours (from 48) and daily limit to 12 hours to meet seasonal demand through overtime.
- **Power:** State Electricity Regulatory Commissions should notify rational, credible, cross-subsidy for open access so that it can become a reality. Open Access should include access to electricity pillars to string a wire. Accountability for T&D losses on this wire will be with the wire owner and not on the distribution company that owns the towers. Permit private corporate investment in nuclear power, subject to regulation by AERB and AEC.
- **Railways:** Freight Corridor: Public sector Rail Track company to own new tracks and signals. Free entry of private and public-private partnership rail freight companies.
- **Urban public transport:** Public Transport (bus) systems in Metros and large cities must be run by organized private companies that can use modern logistics and back office systems for planning routes and timings, acquiring and analyzing data on usage densities and running an integrated people movement system. A comprehensive system of road parking fees must be devised and introduced in metros and large congested cities.
- **Banruptcy law:** Either introduce a separate section on Bankruptcy in the Company Law or introduce a new bankruptcy law that facilitates exit of old/failed management as expeditiously as possible.

(6000 odd skills). In categories in which private (including foreign) certification and/or training institutes already exists, they should be allowed and encouraged to provide such certification and training in India. Transfer of management control of ITIs and other government training institutions through a bidding process focusing on the total value of scholarship grants to be provided to poor students should be considered. The basic commitment would be to modernize and expand the institution according to a time bound plan.

REFORMS AND PERFORMANCE OF STATES

Fiscal developments

2.26 In recent years the major fiscal indicators of the State Governments have witnessed significant improvement. For the first time in about two decades, the State Governments have budgeted, for 2007-08, a consolidated surplus in their revenue account. The ratio of gross fiscal deficit (GFD) of the States to GDP has also shown a declining trend, with the 2007-08 (BE) at 2.3 per cent. The improvement is associated in many cases with the enactment of Fiscal Responsibility Legislation (FRL) by the State Governments. Other measures like imposition on ceiling on guarantee, and introduction of Consolidated Sinking Fund (CSF) and Guarantee Redemption Fund (GRF) have also been introduced. All State/UTs Governments have implemented VAT. Some States have also initiated measures to simplify the VAT return and others have undertaken steps to evaluate its implementation. Many State Governments have taken steps for simplification and rationalization of the tax structure, which has improved tax compliance and enforcement, and reviewed user charges on power, water and transport.

2.27 The steps taken on the expenditure management, include (a) outcome oriented budgeting and use of monitorable indicators to track performance, (b) steps to contain non-plan revenue expenditure, restrict fresh recruitment and creation of new posts, (c) administrative reforms to simplify procedures and public interface, (d) comprehensive review of the functioning of State Public Sector Undertakings, including State Electricity Boards, and (e) contributory pension schemes for newly recruited staff.

2.28 The marked improvement in the consolidated fiscal position (Table 2.2), however, does not reveal the wide inter-state variations. While

Table 2.2 Key Deficit Indicators

(Per cent of GDP)

| Item | 2005-06 (Accounts) | 2006-07 (BE) | 2006-07 (RE) | 2007-08 (BE) |
|----------------------|-----------------------|-----------------|-----------------|-----------------|
| Revenue Deficit | 0.2 | 0.0 | 0.1 | -0.3 |
| Gross Fiscal Deficit | 2.5 | 2.6 | 2.7 | 2.3 |
| Primary Deficit | 0.2 | 0.2 | 0.4 | 0.1 |

Source: Reserve Bank of India

- Note: 1. data pertains to 28 State Governments
 2. The ratios to GDP are at current market prices, based on CSO's 1999-2000 series.
 3. Negative (-) sign indicates surplus

20 States have presented revenue surplus budgets in 2007-08, 15 States have budgeted for higher GFD over the previous year. State-wise analysis of fiscal correction indicates that non-special category States account for 85 per cent of the correction in the revenue account and 73 per cent of the correction in GFD. At the same time, the fiscal position of some States continues to remain weak and there are concerns regarding the sustainability of high level of debt in some of these States.

Social development and human well-being

2.29 Under the constitutional division of responsibility between the Centre and State Governments, the bulk of social services and most infrastructure services (except for telecommunication, civil aviation, railways and major ports) lie in the domain of State Governments. Thus, both the level of social sector expenditure at State level and its quality and effectiveness have a direct bearing on human development outcomes and overall well-being. While there has been some increase in social sector spending at State level, the Central Government has also stepped up its outlays on social sectors and rural development programmes substantially, in recent years through Centrally Sponsored Schemes. In their respective Budgets for 2007-08, several State Governments have proposed schemes for improving education, health and employment at State level. Most States have proposed setting up new or upgrading existing schools, colleges and universities with a view to improve the provisioning of basic as well as advanced education facilities to a wider section of their respective populations. Some Governments have also announced employment guarantee schemes to cover additional districts. Others have constituted high-powered missions to address issues related to employment at various levels. There is much that still needs to be done in terms of improving social sector and human development

outcomes at State level (Table 2.3 and Box 2.3) which highlight inter state variation in important socio economic indicators.

2.30 The outcomes in the health sector show significant disparities across States. A successful policy framework to bridge outcome gaps in this sector would require a strategic focus on public goods like vector borne and epidemic diseases, public health education (including awareness about quacks and shaman) and drainage (as flooding affects everybody, whether in city or village. It would require addressing the shortfalls in the availability of quasi-public goods like clean drinking water, sanitation and sewerage, and garbage collection and disposal. Finally, making health insurance (a private good) affordable to a large segment of the vulnerable sections of the population. In respect of the Government health services, numerous studies have highlighted the critical role of governance in improving the delivery of services to the public.

GOVERNANCE AND PUBLIC SERVICE

2.31 With many sectors of the Indian economy becoming globally competitive, the contrast in performance between the corporate and government sectors and between the State Governments in India and the State/provincial governments in other fast-growing economies such as China is becoming more visible. In fact, some observers have gone as far as to say that Government at the cutting edge level, where it interfaces with individuals and economic agents, is the most important constraint on raising the growth rate of the economy to 10 per cent. As substantial resources, both public and private, are being mobilised to fuel the growth of the economy and make it more inclusive in character, there is a legitimate concern that every bit of the public effort should count and yield better results.

2.32 In a broad sense, governance can be broken into two levels. At an aggregative level, the purpose of governance is to provide an environment that supports and encourages private initiative in a non-discriminatory and inclusive manner. It is concerned, for instance, with laws governing markets, protection of property rights and systems guaranteeing territorial integrity. At an individual level, it is concerned with provision of basic services universally to all citizens with a view to build individual capabilities to harness opportunities. The fact that these services must be provided universally often translates into a much greater government involvement as they may not

be easily managed and incentivized through the market mechanism. Initiatives such as the NREGP, Bharat Nirman and the Right to Information Act have to be viewed in this light. Notwithstanding the criticism directed at the implementation gaps that these initiatives suffer from – and all of them have great scope for improvement – doing away with them or transferring their implementation to market mechanisms are not responsible alternatives, at least not at the current juncture of India's development.

2.33 For these programmes to be successful, it is necessary that ground level implementation is efficient. For this, local authorities have to play a very large role; indeed, the efficiency of these programmes is completely determined by the activities of the "last mile". The Central Government can do two things – conceptualize the programmes and commit resources, both of which they have already done. In addition to this, given that the implementation is with the local authorities, the Central Government can play an additional role, viz., that of ensuring that local authorities have enough incentives to implement the programmes.

Decentralization and stakeholder involvement in implementation

2.34 Decentralization in planning and implementation of programmes, based on the principle of subsidiarity, is an essential supplement to enhance resource flow in achieving balanced regional development and participation and empowerment of the poor. Pursuing a participatory growth strategy not only makes the ensuing growth acceptable at the grass roots level, it fosters capacity building for sustainable growth at different tiers of local self-governments. Available information shows that, despite the clear Constitutional directions handed out through the 73rd and the 74th amendments, there are wide inter-state variations in the degree of effective decentralization achieved. Evidence suggests that the success of decentralized programme implementation depends on effective transfer of functions, functionaries and finances to local self-governments and creation and patronage of grass-roots level participatory institutions like Grama Sabhas, people's bodies for project formulation, implementation and monitoring, and watershed-based institutions. The success stories of participatory project implementation and devolution of plan and non-plan funds must be systematically studied, recorded and replicated elsewhere with appropriate region-specific adaptations.

Box 2.3 Socio-economic profile of States**Poverty**

- Percentage of population below poverty line is the highest in Orissa, followed by Bihar, Chhattisgarh, Jharkhand and Madhya Pradesh. Punjab followed by Himachal Pradesh, Haryana, Kerala and Andhra Pradesh have low poverty.

Consumption

- During 2004-05, compared to 30 per cent at the all-India level, 57 per cent of rural population in Orissa followed by Chhattisgarh (55 per cent), Madhya Pradesh (47 per cent), Bihar & Jharkhand (46 per cent each) was living below the monthly per capita expenditure (MPCE) level of Rs. 365 or about Rs. 12 per day. As against this, 57 per cent of rural population in Kerala and 51 per cent of Punjab and 47 per cent in Haryana had MPCE of at least Rs. 690. At the all-India level this corresponds to the top 20 percentile of MPCE distribution.
- During 2004-05, as compared to 30 per cent at the all-India level, 55 per cent of Bihar and 50 per cent of Orissa's urban population was below the MPCE level of Rs. 580 or Rs. 19 per day. As against the top 20 per cent at the all-India level, 28 per cent of Kerala's and 27 per cent of Punjab's urban population were having an MPCE level of at least Rs. 1,380.

Inequality

- In urban areas, inequality in consumption, as measured by Lorenz Ratio is the highest in Chhattisgarh followed by Kerala, Madhya Pradesh, Punjab and West Bengal. Inequality is low in urban Gujarat followed by Assam and Himachal Pradesh. Inequality in rural India is lower than urban India in all major States. In rural India, inequality is the highest in Kerala, followed by Haryana, Tamil Nadu and Maharashtra. Assam has the lowest inequality followed by Bihar, Jharkhand and Rajasthan in rural India.

Employment

- Regular employment is the major engagement of working urban households in most of the major States. About (48 per cent) of urban households in Maharashtra followed by Haryana (47 per cent), Chhattisgarh (46 per cent), Gujarat (45 per cent) and Punjab and Assam (44 per cent each), depend on regular employment. Percentage of self-employed households in urban areas is higher in U.P. (49 per cent) and Bihar (47 per cent). The proportion of casual labour households was higher in urban areas for Kerala (25 per cent) and Himachal Pradesh (24 per cent) than in other major States.

Table 2.3 Socio-economic profile of major States

| Item | A.P. | Assam | Bihar | Gujarat | Haryana | H.P. | Karnataka | Kerala |
|--|-------|-------|-------|---------|---------|-------|-----------|--------|
| Poverty and Growth related | | | | | | | | |
| %age of population below p.l. (2004-05) | 15.8 | 19.7 | 41.4 | 16.8 | 14 | 10 | 25 | 15 |
| Average MPCE (2004-05) | | | | | | | | |
| Rural | 586 | 543 | 417 | 596 | 863 | 798 | 508 | 1013 |
| Urban | 1019 | 1058 | 696 | 1115 | 1142 | 1390 | 1033 | 1291 |
| Inadequate Food(2004-05) (% Households) | 0.5 | 5 | 2.7 | 0.2 | 0.1 | 0 | 0.2 | 2.3 |
| Lorenz Ratio(2004-05) | | | | | | | | |
| Rural | 0.288 | 0.197 | 0.208 | 0.268 | 0.323 | 0.295 | 0.264 | 0.341 |
| Urban | 0.37 | 0.314 | 0.339 | 0.304 | 0.361 | 0.318 | 0.365 | 0.4 |
| Health related | | | | | | | | |
| Life Expectancy at birth (2001-05)* | 64.1 | 58.7 | 61.4 | 63.9 | 65.9 | 66.8 | 65.1 | 73.9 |
| Infant Mortality Rates (2006) | 56 | 67 | 60 | 53 | 57 | 50 | 48 | 15 |
| Births assisted by a doctor/ nurse/LHV/ANM/ other health personnel (%) | 74.2 | 31.2 | 30.9 | 64.7 | 54.2 | 50.2 | 71.3 | 99.7 |
| Institutional births (%) | 68.6 | 22.7 | 22 | 54.6 | 39.4 | 45.3 | 66.9 | 99.5 |
| Facilities at PHCs - (%) (as on March, 2006) | | | | | | | | |
| With Labour Room | 100 | NA | 13 | 67 | 71 | NA | 100 | 14 |
| With Operation Theatre | 87 | NA | 13 | 67 | 71 | 36 | NA | 12 |
| With 24 Hrs. Delivery Facility | 30 | NA | 14 | 5 | 51 | NA | 24 | 7 |
| Education related | | | | | | | | |
| GER(6-14 years) (2004-05) Total | 87.0 | 92.0 | 65.2 | 101.7 | 80.0 | 108.7 | 98.8 | 95.4 |
| GER(14-16 years) (2004-05) Total | 53.1 | 49.4 | 22.5 | 55.3 | 53.0 | 134.9 | 59.0 | 93.2 |
| GER(16-18 years) (2004-05) Total | 42.2 | 14.4 | 9.8 | 21.8 | 34.2 | 127.7 | 33.9 | 27.9 |
| Basic Amenities related | | | | | | | | |
| % of Households having Electricity(2005-06) | 88.4 | 38.1 | 27.7 | 89.3 | 91.5 | 98.4 | 89.3 | 91 |
| % of Households having access to toilet facility (2005-06) | 42.4 | 76.4 | 25.2 | 54.6 | 52.3 | 45.6 | 46.5 | 96 |
| % of Households having safe drinking water facilities (2001) | 80.1 | 58.8 | 86.6 | 84.1 | 86.1 | 88.6 | 84.6 | 23.4 |

Source: Compiled based on the data obtained from Planning Commission, NSSO, NHP-2006, RHS-2006, Ministry of HRD,

*U.P. includes Uttarakhand.

- In rural areas, self-employment was more important in many of the major States. The proportion was high in UP (68 per cent) followed by Rajasthan and Assam (66 per cent each), Himachal Pradesh (57 per cent) and MP (56 per cent).

Health

- Life expectancy is highest in Kerala followed by Punjab, Maharashtra, Himachal Pradesh and Tamil Nadu. It was least in Madhya Pradesh followed by Assam, Orissa, UP and Bihar.
- As on March 2006, 100 per cent of Primary Health Centres (PHCs) had labour room in Andhra Pradesh, Karnataka and Tamil Nadu while it was low in UP, Bihar, Kerala and MP.
- As on March 2006, proportion of PHCs with operation theatres was 87 per cent in Andhra Pradesh followed by Rajasthan (83 per cent), Maharashtra (74 per cent), Haryana (71 per cent) and Gujarat (67 per cent). It was low in UP, West Bengal, Chhattisgarh, Kerala and Bihar.

Hunger and Inadequate Food

- Prevalence of hunger as measured in months in which any member of the household had inadequate food is unusually high in West Bengal. It is also high in Orissa, Assam and Bihar, but lower in Himachal Pradesh, Rajasthan, Haryana, Gujarat, Karnataka and Tamil Nadu (Table 2.5).

Education

- In 2004-05, Gross Enrolment Ratios (GER) for elementary education, i.e., I-VIII Class (6-14 years) was highest in Madhya Pradesh (114.1 per cent), followed by Tamil Nadu (114 per cent) and Chhattisgarh (112.6 per cent). It was lowest in Bihar (65.2 per cent) followed by Punjab (72.6 per cent) and Jharkhand (75.8 per cent).
- GER for Secondary education (IX-X Class) was high in Himachal Pradesh (134.9 per cent) followed by Kerala (93 per cent), and Tamil Nadu (80.7 per cent). It was lowest in Bihar (22.5 per cent), Jharkhand (26.5 per cent) and West Bengal (41.5 per cent). For Senior Secondary level (XI-XII Class), GER was least at 2.5 per cent in Jharkhand followed by 9.8 per cent in Bihar and highest at 127.7 per cent for Himachal Pradesh followed by 43.9 per cent in Tamil Nadu.

Basic Amenities

- Himachal Pradesh, Punjab, Haryana, Kerala, Karnataka, Gujarat, Tamil Nadu and Andhra Pradesh have much larger percentage of households having electricity than is the case in Bihar, Assam, Jharkhand, U.P. and Orissa.
- Households having access to toilet facilities are high in Kerala, Assam and Punjab and low in Chhattisgarh, Jharkhand, Bihar and Madhya Pradesh.

| | M.P. | Maharashtra | Orissa | Punjab | Rajasthan | Tamil Nadu | U.P. | W. Bengal | Chhattisgarh | Jharkhand | All-India |
|--|--------|-------------|--------|---------|-----------|------------|--------|-----------|--------------|-----------|-----------|
| | 38.3 | 30.7 | 46.4 | 8.4 | 22.1 | 22.5 | 32.8 | 24.7 | 40.9 | 40.3 | 27.5 |
| | 439.06 | 567.76 | 398.89 | 846.75 | 590.83 | 602.17 | 532.63 | 562.11 | 425.1 | 425.3 | 559 |
| | 903.68 | 1148.27 | 757.31 | 1326.09 | 964.02 | 1079.65 | 857.05 | 1123.61 | 989.97 | 985.43 | 1052 |
| | 1.6 | 0.8 | 5.3 | 0.7 | 0 | 0.3 | 1.5 | 9 | 2.2 | 0.6 | 1.9 |
| | 0.269 | 0.31 | 0.302 | 0.278 | 0.248 | 0.315 | 0.287 | 0.273 | 0.305 | 0.231 | 0.297 |
| | 0.397 | 0.371 | 0.355 | 0.393 | 0.367 | 0.358 | 0.37 | 0.376 | 0.439 | 0.354 | 0.373 |
| | 57.7 | 66.9 | 59.2 | 69.2 | 61.7 | 66 | 59.8 | 64.6 | | | 63.2 |
| | 74 | 35 | 73 | 44 | 67 | 37 | 71 | 38 | 61 | 49 | 57 |
| | 37.1 | 70.7 | 46.4 | 68.6 | 43.2 | 93.2 | 29.2 | 45.7 | 44.3 | 28.7 | 48.2 |
| | 29.7 | 66.1 | 38.7 | 52.5 | 32.2 | 90.4 | 22 | 43.1 | 15.7 | 19.2 | 40.7 |
| | 19 | 68 | 64 | 39 | 83 | 100 | 0 | 44 | 20 | NA | — |
| | 63 | 74 | 33 | 33 | 83 | 27 | 0 | 0 | 10 | NA | — |
| | NA | 99 | 9 | 17 | NA | 19 | NA | 11 | 100 | NA | — |
| | 114.1 | 105.7 | 108.5 | 72.6 | 102.7 | 114.0 | 87.0 | 94.7 | 112.6 | 75.8 | 93.5 |
| | 45.7 | 68.9 | 53.7 | 51.5 | 43.9 | 80.7 | 48.9 | 41.5 | 43.9 | 26.5 | 51.7 |
| | 25.3 | 42.3 | 32.9 | 27.9 | 21.6 | 43.9 | 22.9 | 21.1 | 30.4 | 2.5 | 27.8 |
| | 71.4 | 83.5 | 45.4 | 96.3 | 66.1 | 88.6 | 42.8 | 52.5 | 71.4 | 40.2 | 67.9 |
| | 27 | 53 | 19.3 | 70.8 | 30.8 | 42.9 | 33.1 | 59.5 | 18.7 | 22.6 | 44.5 |
| | 68.4 | 79.8 | 64.2 | 97.6 | 68.2 | 85.6 | 87.8 | 88.5 | 70.5 | 42.6 | 77.9 |

NFHS-3, O/o RG1

Institutional framework for monitoring and evaluation of public programmes

2.35 It has often been pointed out that our planning and development process, both at the Central and State levels, suffers from lack of adequate closure. The feedback loop of evaluation and assessment of our numerous plan schemes is often missing. As a result the corrective measures on most plan initiatives, if any, are few and far between. Thus, while the intentions have been noble, the delivery systems are weak and characterized by significant leakages and mis-targeting of the intended beneficiaries. At an institutional level, particularly when there is quantum jump in the social sector expenditure in the Eleventh Five Year Plan, it becomes essential that the Central Government strengthen its capacity to undertake evaluation of all plan schemes and create a knowledge base and expertise to help the State Governments in building and strengthening their respective evaluation agencies. Traditionally, plan monitoring has been done by States by tracking expenditure levels achieved in relation to the budgeted outlays. Though expenditure is an important indicator of the progress of plan implementation, it does not measure the effectiveness of the expenditure undertaken in generating the desired outcomes. It is, therefore, important to move systematically from financial monitoring to output and outcome monitoring.

Transparency in decision making

2.36 The enactment of the Right to Information Act at the Centre and in many States has bridged a critical gap in the public decision-making process, ushering in greater accountability of the public servants. This move towards greater transparency and right to access public information

has been greatly aided by developments in information technology and e-governance. The Government of India has effectively implemented e-governance projects in some departments like Department of Revenue relating to income tax, customs and excise, Ministry of Railways where ticket reservation has become accessible and can be made from any place in the country, the Postal Department which initiated e-facilities like returns of direct e-credit of Monthly Income Scheme to investor's account, dematerialization of National Savings Certificate (NSC), Kisan Vikas Patra (KVP), etc. Such success stories in e-governance have encouraged many States to initiate their own e-governance programmes and move rapidly from being an IT-aware to an IT-enabled government.

Conclusion

2.37 The challenges and opportunities arise at two levels. It is incumbent on the Central Government to provide a conducive investment climate and manage the macroeconomy to facilitate non-inflationary growth. The Central Government and the Planning Commission can in certain areas and sectors also play a leadership role in setting an agenda of policy and institutional reforms that will sustain high growth for several decades. At a second level, the States must refocus their efforts on the provision of public and quasi-public goods, some of which have been neglected by States, and improve the quality of the service provided by these goods. As the bureaucratic capacities to deliver these goods and services in sufficient quantity and adequate quality are heavily constrained, they must shed other activities that are best done by private profit and non-profit organisations and focus on excellence in these areas. Only then can they satisfy the majority of their citizens and meet their legitimate aspirations.

Box 2.4 Smart Card for empowerment

A Planning Commission Working Group, in the context of the Eleventh Five Year Plan, has examined the design and potential use of the Multi-Application Smart Cards (MASCs) System which facilitates simplification of procedures and enhances the efficiency of Government schemes. Usefulness of the MASCs for various Central Government schemes like, PDS, Indira Awas Yojana and National Rural Employment Guarantee Scheme (NREGS), has been recognized. These studies could form the basis for the introduction of a Smart Card system and a web-enabled information system, on an experimental basis.

The smart cards system will be based on unique ID, sharing of ID, multi-application and access control. The entire system will consist of front, middle and back end. The electronic card will be the front end of the Integrated Smart Card System. The front end is the point of delivery of the system where the smart cards will be read and used. The middle office will be responsible for charging and updating the card periodically (month, quarter, annual) depending on the type of information and the requirement and transfer information from the front end to the back end and vice versa. The back end set-up will contain the computerised records, guidelines, accounts and management information systems. The complete system would require complete digitization of the records.

