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INDIA'S GROWTH : PAST PERFORMANCE AND FUTURE PROSPECTS

by

Shankar Acharya*

* Honorary Professor and Member Board of Governors, Indian Council for
Research on International Economic Relations (ICRIER)

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This paper is divided into four sections. Section I briefly reviews India's growth performance since 1950 and indicates a few salient features and turning points. Section II discusses some of the major drivers of India's current growth momentum (which has averaged 8 percent in the last 3 years) and raised widespread expectations (at least, in India) that 8 percent plus growth has become the new norm for the Indian economy. Section III points to some of the risks and vulnerabilities that could stall the current dynamism if corrective action is not taken. The final section assesses medium term growth prospects.

I Review of Growth Performance, (1950-2006)

Table 1 summarizes India's growth experience since the middle of the twentieth century. For the first thirty years, economic growth averaged a modest 3.6 percent, with per capita growth of a meager 1.4 percent per year. Those were the heydays of state-led, import-substituting industrialization, especially after the 1957 foreign exchange crisis and the heavy industrialization bias of the Second Five Year Plan (1956-61). While the strategy achieved some success in raising the level of resource mobilization and investment in the economy, it turned out to be hugely costly in terms of economic efficiency. The inefficiencies stemmed not just from the adoption of a statist, inward-looking policy stance (at a time when world trade was expanding rapidly) but also from

¹ The author is Member Board of Governors and Honorary Professor at Indian Council for Research on International Economic Relations (ICRIER). He was Chief Economic Adviser to Government of India (1993-2000).

the extremely detailed, dysfunctional and corruption-breeding controls that were imposed on industry and trade (see, for example, the classic study by Bhagwati and Desai (1970)).

**Table 1: Growth of GDP and Major Sectors
(% per year)**

Year	1951/52- 1980/81	1981/82- 1990/91	1992/93- 1996/97	1997/98- 2001/02	2002/03- 2005/06	1992/93- 2005/06	1981/82- 2005/06
Agriculture and Allied	2.5	3.5	4.7	2.0	1.9	3.0	3.0
Industry	5.3	7.1	7.6	4.4	8.0	6.6	6.5
Services	4.5	6.7	7.6	8.2	8.9	8.2	7.4
GDP	3.6	5.6	6.7	5.5	7.0	6.4	5.9
<i>GDP per capita</i>	<i>1.4</i>	<i>3.4</i>	<i>4.6</i>	<i>3.6</i>	<i>5.3</i>	<i>4.4</i>	<i>3.8</i>

Source: CSO . Note: Industry includes Construction.

At the same time, one should not forget that the GDP growth rate of 3.6 percent was four times greater than the 0.9 percent growth estimated for the previous half century of British colonial rule (Table 2). Moreover the growth was reasonably sustained, with no extended periods of decline. Nor were there inflationary bouts of the kind which racked many countries in Latin America. However, growth was far below potential and much less than the 7-8 percent rates being achieved in some countries of East Asia and Latin America. Worst of all, the proportion of the Indian population below a (minimalist) poverty line actually increased from 45 to 51 percent (Table 3).

**Table 2: Economic Growth: Pre-independence
(% per year)**

Year	1900-46	1900-29	1930-46
GDP	0.9	0.9	0.8
Population	0.8	0.5	1.3
Per Capita GDP	0.1	0.4	-0.5

Source: Sivasubramonian (2000)

**Table 3: Percentage of People Below Poverty Line,
1951-52 to 1999-00: Official Estimates**

Year	Rural	Urban	All India
1951-52	47.4	35.5	45.3
1977-78	53.1	45.2	51.3
1983	45.7	40.8	44.5
1993-94	37.3	32.4	36.0
1999-2000	26.8	24.1	26.1

Source: Planning Commission, Government of India

Growth accelerated significantly in the 1980s to 5.6 percent, entailing a more than doubling of per capita growth to 3.4 percent a year. This acceleration was due to a number of factors, including: the early efforts at industrial and trade liberalization and tax reform during the 1980s, a step-up in public investment, better agricultural performance and an increasingly expansionist (almost profligate!) fiscal policy. Fiscal controls weakened and deficits mounted and spilled over to the external sector, requiring growing recourse to external borrowing on commercial terms. Against a background of a low export/GDP ratio, rising trade and current account deficits and a deteriorating external debt profile, the 1990 Gulf War and consequent oil price spike tipped India's balance of payments into crisis in 1990/91.

Although the policy reforms of the 1980s were modest in comparison to those undertaken in the ensuing decade, their productivity "bang for the buck" seems to have been high (see Table 4)². Perhaps this was a case of modest improvements in a highly distorted policy environment yielding significant gains.

² Several different factor productivity studies support this conclusion, including: Acharya-Ahluwalia-Krishna-Patnaik (2003), Bosworth and Collins (2003) and Virmani (2004).

**Table 4: Growth of GDP, Total Factor Input and Total Factor Productivity
(% per year)**

	1950/51- 1966/67	1967/68 - 1980/81	1981/82– 1990/91	1991/92 – 1999/2000
GDP	3.8	3.4	5.3	6.5
Total Factor Input (TFI)	2.4	2.7	3.3	3.9
Total Factor Productivity (TFP)	1.4	0.7	2.0	2.6
<i>Proportion of Growth Explained by TFP (%)</i>	<i>37.6</i>	<i>20.8</i>	<i>37.7</i>	<i>39.7</i>

Source: Acharya, Ahluwalia, Krishna and Patnaik (2003).

Note: For each sub-period, GDP, TFI and TFP are trend growth rates.

The new Congress government of June 1991, with Manmohan Singh as finance minister, undertook emergency measures to restore external and domestic confidence in the economy and its management.³ The rupee was devalued, the fiscal deficit was cut and special balance of payments financing mobilized from the IMF and the World Bank. Even more importantly, the government seized the opportunity offered by the crisis to launch an array of long overdue and wide-ranging economic reforms. They encompassed external sector liberalization, deregulation of industry, reforms of taxation and the financial sector and a more commercial approach to the public sector (see Table 5 for a summary of key reforms in 1991-93).⁴

³ There has been a great deal written on India's economic reforms and the consequent performance of the economy, including Acharya (2002a and 2004), Ahluwalia (2002), Kelkar (2004), Kochhar et.al (2006), Panagariya (2004a and 2006) and Virmani (2004). There is a tendency to view the post-1991 economic performance as a single unified experience. I prefer the more nuanced and disaggregated view outlined here.

⁴ As I have pointed out elsewhere (Acharya, 2006a), these reforms are better characterized as "medium bang" than "gradualist" (as by Ahluwalia, 2002).

Table 5: Main Economic Reforms of 1991-93

Fiscal

- Reduction of the fiscal deficit.
- Launching of reform of major tax reforms.

External Sector

- Devaluation and transition to a Market-determined Exchange Rate.
- Phased reduction of import licensing (quantitative restrictions).
- Phased reduction of peak custom duties.
- Policies to encourage direct and portfolio foreign investment.
- Monitoring and controls over external borrowing, especially short term.
- Build-up of foreign exchange reserves.
- Amendment of FERA to reduce restrictions on firms.

Industry

- Virtual abolition of industrial licensing.
- Abolition of separate permission needed by “MRTP houses”.
- Sharp reduction of industries “reserved” for the public sector.
- Freer access to foreign technology.

Agriculture

- More remunerative procurement prices for cereals.
- Reduction in protection to the manufacturing sector.

Financial Sector

- Phasing in of Basle prudential norms.
- Reduction of reserve requirements for banks (CRR and SLR).
- Gradual freeing up of interest rates.
- Legislative empowerment of SEBI.
- Establishment of the National Stock Exchange.
- Abolition of government control over capital issues.

Public Sector

- Disinvestment programme begun.
- Greater autonomy / accountability for public enterprises.

The economy responded swiftly and positively to these reforms. After virtual stagnation in 1991/92, GDP growth surged in the next five years to clock a record 5-year average of 6.7 percent. It is noteworthy that in this high growth Eighth Plan period all major sectors (agriculture, industry, services) grew noticeably faster than in the pre-crisis decade. The acceleration in the growth of agricultural value added is particularly interesting in the light of oft-repeated criticism that the economic reforms of the early nineties neglected the agricultural sector.

The factors which explain this remarkable and broad-based growth surge in the period 1992-97 appear to include:

- Productivity gains resulting from the deregulation of trade, industry and finance, especially in the sectors of industry and some services;
- The surge in export growth at about 20 percent per year (in dollar terms) for three successive years beginning 1993-94, attributable to the substantial devaluation in real effective terms in the early nineties and a freer policy regime for industry, foreign trade and payments;
- The investment boom of 1993-96 which exerted expansionary effects on both supply and demand, especially in industry. The investment boom itself was probably driven by a combination of factors including the unleashing of 'animal spirits' by economic reforms, the swift loosening of the foreign exchange bottleneck, confidence in broadly consistent governmental policy signals and easier availability of investible funds (both through borrowing and new equity issues);
- The partial success in fiscal consolidation, which kept a check on government borrowings and facilitated expansion of aggregate savings and investments;
- Improvement in the terms of trade for agriculture resulting from a combination of higher procurement prices for important crops and reduction in trade protection for manufactures;
- Availability of capacity in key infrastructure sectors, notably power;
- A buoyant world economy which supported expansion of foreign trade and private capital inflows.

The momentum of growth slowed noticeably in the Ninth Plan period, 1997-2002, to an average of 5.5 percent, compared to the 6.7 percent achieved in the previous five years. Among the factors which contributed to this deceleration were: the significant worsening of the fiscal deficits (mainly due to large public pay increases following the Fifth Pay Commission) and the associated decline in public savings, the slackening of economic reforms after 1995 as coalition governance became the norm, a significant slowdown in

agricultural growth for a variety of reasons, a marked downswing in the industrial cycle and an increasingly unsupportive international economic environment (including the Asian financial crisis of 1997-98, rising energy prices and the global recession of 2001). Indeed, India's economic growth in 1997-2002 might have been even weaker but for the unexpected and somewhat inexplicable strength of services sector growth, which clocked an average of 8.2 percent, despite industrial growth of only 4.4 percent.⁵ The services sector accounted for almost 70 percent of all growth in this period.

Economic reforms picked up pace in 2000-04, fiscal deficits trended down after 2002 and the world economy rebounded strongly in 2002-06. These factors supported a broad-based upswing in Indian industrial output and investment from the second half of 2002. Growth of industrial valued added surged to 8 percent in 2002-06. With continued strong growth of services (at nearly 9 percent), GDP growth climbed to average 7 percent, despite continued sluggishness of agriculture. In the three years, 2003-06 overall economic growth has averaged over 8 percent and the outlook for 2006/7 is equally bright. This latest economic surge has raised the interesting issue of whether India's trend growth rate has accelerated to 8 percent (or higher) from its previous level of around 6 percent. The ensuing sections of this paper explore this question.

II. Main drivers of Recent Economic Growth

What are some of the main ingredients of the recent surge in economic growth? I would suggest the following seven major elements:

- 1) The momentum of a quarter of a century of strong economic growth;
- 2) A much more open economy (to external trade and investment);
- 3) A growing "middle class" fuelling domestic consumption;
- 4) The "demographic dividends" of a young population;

⁵ Acharya (2002a and 2003) noted this unusual phenomenon and raised questions about both the quality of the data and the durability of such sharply divergent growth rates of industry and services. More recently, similar doubts have been expressed by Bosworth-Collins -Virmani (2006).

- 5) Strong companies in a modernized capital market;
- 6) Some recent economic reforms.
- 7) A supportive international economic environment.

Let me elaborate briefly on each of these factors.

The Momentum of Growth

The last thirty years' experience suggests that very few developing countries have sustained decent per capita growth for two decades or more (Acharya, 2006b). Specifically, out of 117 developing countries with population over half a million, only 12 countries achieved per capita growth of more than 3 percent per year in 1980-2002, with at least 2 percent growth in each decade of the eighties and nineties. These twelve countries were: China (8.2), Vietnam (4.6), South Korea (6.1), Chile (3.3), Mauritius (4.4), Malaysia (3.4), India (3.6), Thailand (4.6), Bhutan (4.3), Sri Lanka (3.1), Botswana (4.7) and Indonesia (3.5). (The number falls to 9 if we specify a minimum population of 3 million). Nine of these 12 countries are in Asia and, fortunately, they include the three most populous: China, India and Indonesia. (See Table 6). If we take the full 25 years (1981-2006), India's per capita growth has averaged 3.8 percent or almost 4 percent per year.

Table 6: Good Growth Performers of Recent Decades
Average Annual Per Capita Growth (%)

	Country	1980-2002	1990s	1980s	Population in 2000 (Millions)
1.	China	8.2	8.6	7.7	1262
2.	Vietnam	4.6	5.7	1.9	78
3.	South Korea	6.1	5.0	7.4	47
4.	Chile	3.3	4.3	2.1	15
5.	Mauritius	4.4	4.1	4.9	1
6.	Malaysia	3.4	3.7	3.1	23
7.	<i>India</i>	3.6	3.6	3.6	1016
8.	Thailand	4.6	3.4	6.0	61
9.	Bhutan	4.3	3.4	5.4	1
10.	Sri Lanka	3.1	3.1	3.1	18
11.	Botswana	4.7	2.7	7.2	2
12.	Indonesia	3.5	2.6	4.4	206

Source: World Bank (2005)

Sustained improvements in standards of living of this order embody their own growth-reinforcing elements. People come to think more positively about the future and base their savings, investment and production decisions on an expectation of continued growth. Electorates in India's democracy come to expect development and hold government performance to higher standards, despite disappointments. Companies think big when they invest. And so on.

A More Open Economy

The Indian economy in 2006 is far more open to external trade, investment and technology than it was fifteen years ago.⁶ Table 7 presents some key comparative

⁶ The story of India's external liberalization may be found in several places, including Acharya (2002b) and Panagariya (2004b).

indicators. Peak import duties on manufactures have come down from over 200% to 12.5%, a remarkable reduction by any standards. The regime of tight, detailed and discretionary import controls has been almost completely dismantled. The exchange rate was devalued and made market-responsive (1991-3). The policies towards foreign portfolio and direct investment have been greatly liberalized. As a result, the ratio of traded goods to GDP has more than doubled from less than 15 percent to nearly 33 percent. Because of the sustained boom in software exports and worker remittances, the ratio of current receipts (goods exports plus gross invisibles) has more than tripled from 8 percent to over 24 percent of GDP. Foreign investment has risen from negligible levels to US \$ 20 billion in 2005/6.

Table 7: Towards A More Open Economy

	1990/91	2005/06
Peak Import Duties (manufacturers)	200% plus	12.5%
Import Controls	Tight, detailed	Almost gone
Trade (goods) / GDP Ratio (%)	14.6	32.7
Current Receipts / GDP (%)	8.0	24.5
Software Exports (\$ billion)	Nil	23.6
Worker Remittances (\$ billion)	2.1	24.6
Foreign Investment (\$ billion)	Negligible	20.2
Foreign Currency Reserves (<i>\$ billion, March 31</i>)	2.2	145.1
Debt Service Ratio (%)	35.3	10.2

Source: RBI, Annual Report, 2005 /06, except for first two rows.

After initial periods of sometimes painful adjustment in the 1990s, Indian industry has thrived in the more open and competitive environment. The explosion in software IT-enabled service exports is well-known, having risen from nil in 1991 to \$ 24 billion in 2005/6. Anecdotal evidence suggests that small-scale units have benefited greatly from

the much freer access to traded raw materials, components and designs. Perhaps most important, the old mindset of “foreign exchange scarcity” (and the welter of bad economic policies it spawned) has been effectively banished. Interestingly, the “opening up” has also strengthened the prudential yardsticks of foreign exchange reserves and debt service ratios.

Rise of strong companies in a modernized capital market

The 1990s ushered in far-reaching reforms in India’s capital markets. The Securities and Exchange Board of India was statutorily empowered in 1992 and quickly moved to improve standards of disclosure and transparency. The new electronic-trade-based National Stock Exchange was established in 1993 and set high technical and governance standards, which soon had to be emulated by the much older (and, sometimes scam-hit) Bombay Stock Exchange. Depositories legislation was enacted and soon paperless trading became the norm. Brokers were encouraged to corporatize. Futures markets were nurtured. These and other reforms transformed Indian capital markets into one of the best in the developing world.

The combination of a modernizing capital market, an increasingly liberal and competitive environment for investment, trade and production, a wealth of entrepreneurial talent and sustained economic growth has helped the rise of strong new companies and supported the expansion of the more agile and aggressive among the established firms. By way of example, Airtel, the leading private telecom, went from nothing to a multi-billion dollar company in a decade. The same was true for the leading domestic airline, Jet and the IT icons like Infosys, Wipro, TCS and HCL. Old pharma companies, like Ranbaxy, transformed themselves. New media companies like Zee and NDTV bloomed. Established corporates houses restructured and flourished (such as some Tata companies, Reliance, Bajaj, Mahindra and Hero Honda) or saw their market shares decline. In recent years quite a few Indian companies have expanded through overseas investments and acquisitions, facilitated by direct investments abroad averaging \$1.5 to \$ 2 billion in the past five years. The recent bid for Corus by Tata Steel is a well-publicized example.

Aggregate financial data also point to the strength and expansion of India's corporate sector in recent. The market capitalization of companies listed on the Bombay Stock Exchange rose nearly 14-fold from \$ 50 billion in 1990/91 to \$ 680 billion in 2005/6 (Table 8). In the last five years, the growth of profits has outpaced the growth of sales of private corporates, indicating rising profit margins. With falling interest rates and growing recourse to internal funding, the share of interest outgo in gross profits dropped sharply from above 50 percent in the late 1990s to 15 percent in 2005/6 (Reserve Bank, 2006, Box 1.7). Unsurprisingly, data for the top 1000 listed companies showed net profits as percent of net sales rising from 4.5 % in 2001/2 to 8.9 % in 2004/5 (Business Standard, 2006).

Table 8: Rising Middle Class

	1990/91	2005/06
People in households with income (Rs.2,00,000 – 10,00,000 OR PPP \$20,000- \$1,00,000 approximately) ^a	15 million	100 million
Bombay Stock Exchange Market Capitalisation*	\$50 billion	\$680 billion
Cars + UVs sold [#]	205 thousand	1319 thousand
Two Wheelers sold [#]	1800 thousand	7570 thousand
Telephone Connections [@] (million)	5	125 ^{\$}

a Based on data from NCAER (2005)

* RBI, Handbook of Statistics on the Indian Economy, 2005-06

Business Beacon, CMIE and Monthly Review of the Indian Economy, CMIE, October 2006

@ Business Beacon CMIE and Economic Survey, 2005-06

\$ December 2005

A Growing Middle Class

In the mid-1990s, shortly after the major economic reforms of 1991-4, there was premature exuberance about India's rising middle class and their acquisitive aspirations. Today there is a much firmer basis for emphasizing the importance of the growing middle class in transforming consumption, production and investment in the Indian economy. Table 8 provides a few indicators. Based on surveys by the NCAER, about 100 million people now live in households with annual incomes between Rs. 200,000 and Rs 1

million (approximately PPP\$ 20,000 to 100,000), compared to about 15 million in 1990/91. With a lower defining threshold, the size of the middle class would be greater. For example, if the middle class cut-off is defined as the “non-poor” by standards of developed economies, then Bhalla (2007) estimates that 34 percent of India’s population was “middle class” in 2005 compared to about 10 percent in 1990.

Purchases of iconic middle class consumption items have certainly soared in the last 15 years (Table 8). Annual sales of cars (including multi-utility vehicles) have risen more than six times to 1.3 million in 2005/6. Two wheeler sales have increased more than four times to 7.6 million in 2005/6. In 1990/91 India had just 5 million telephone connections (all fixed). By the end of 2005 the number was 125 million (about two-thirds were mobile connections). Indeed, in October 2006 the new mobile connections were close to 7 million, more than the total of phone connections fifteen years ago!

The Demographic Dividend

It has become commonplace to emphasize the growth potential of India’s young population and declining dependency ratio. According to most population projections the share of working age population in total population will continue to rise for the next 30 years or so, long after the decline has set in other major countries like China, USA, Western Europe and Japan (Table 9). These demographics point to a large potential for higher growth through augmented supply of labour and savings. Indeed, these trends have already been at work over the 15 years or so, helping to raise India’s household savings from around 15-16 percent of GDP in the late 1980s to 22-24 percent in recent years.⁷

⁷ This could be an important part of the explanation to the puzzle: How does India sustain high growth despite aggregate fiscal deficits above 7 percent of GDP over the last twenty years?

Table 9: Share of Working Population (15-59 yrs)

Country	1950	1975	2000	2025	2050
<i>India</i>	55.5	54.0	58.9	64.3	59.7
China	59.0	53.6	65.0	62.1	53.8
Japan	56.9	64.0	62.1	52.8	45.2
US	60.5	60.0	62.1	56.6	54.6
Western Europe	61.7	58.1	61.3	54.8	50.4

Source: <http://www.un.org/esa/population/publications/worldageing19502050/countriesorareas.htm>

Some Recent Policies

As noted above economic reforms slowed after 1995 and then revived to some extent in the period 2000-04. Also, real interest rates declined worldwide and in India too. In India this may have been helped by renewed efforts to reduce burgeoning fiscal deficits, including through enactment of the Fiscal Responsibility and Budget Management Act (2003) at the central level. The fiscal position of the States also improved from the dire straits plumed following the Fifth Pay Commission. The states too adopted fiscal responsibility laws following the recommendations (and conditional debt write-offs) of the Twelfth Finance Commission (Government of India, 2004). Furthermore, tax revenues at both levels of government were buoyed by resurgent economic (especially industrial) growth after 2002/3.

The net result was a decline in the gross fiscal deficit from almost 10 percent of GDP in 2001/2 to 7.5 percent in 2004/5 and an even larger decline in the revenue (current) deficit from 7 to 3.7 percent of GDP (Table 10). This was the single most important factor explaining the increase in aggregate savings from around 24 percent of GDP in 2001/2 to 29 percent in 2004/5, which, in turn, helped finance the current investment boom.

Table 10: Deficits, Savings and Investment (as % of GDP)

Year	1995-96	2001-02	2004-05
Gross Fiscal Deficit (Centre and States)	6.5	9.9	7.5
Revenue Deficit (Centre and States)	3.2	7.0	3.7
Gross Domestic Savings (of which Government)	25.1 (-2.0)	23.6 (-6.0)	29.1 (-2.7)
Gross Domestic Investment	26.9	23.0	30.1

Source: RBI, Handbook of Statistics on the Indian Economy, 2005-06 and CSO website

- (http://mospi.nic.in/mospi_cso_rept_pubn.htm)
- (http://mospi.nic.in/mospi_press_releases.htm)

International Economic Environment

Despite the war in Iraq and the high oil prices of recent years the world economy has grown at almost 5 percent over the last four years, propelled by strong growth in US and China and some recovery in Japan and Europe. World trade in goods and services has expanded rapidly. This favorable environment has helped rapid growth of exports (of goods and services) from India, which, in turn, has been a significant driver of economic growth in this recent period.⁸

III Risks to Future Strong Growth

There are some well-known risks or constraints to the sustenance of the 8 percent growth enjoyed by India since 2003. These include:

- 1) Renewed fiscal stress from populist policies;

⁸ Panagariya (2006) emphasizes this point.

- 2) Infrastructure bottlenecks;
- 3) Labour market rigidities;
- 4) Weak performance of agriculture;
- 5) Pace of economic reforms;
- 6) Weaknesses in human resource development programmes;
- 7) The international economic environment.

Each of these merit brief elaboration.

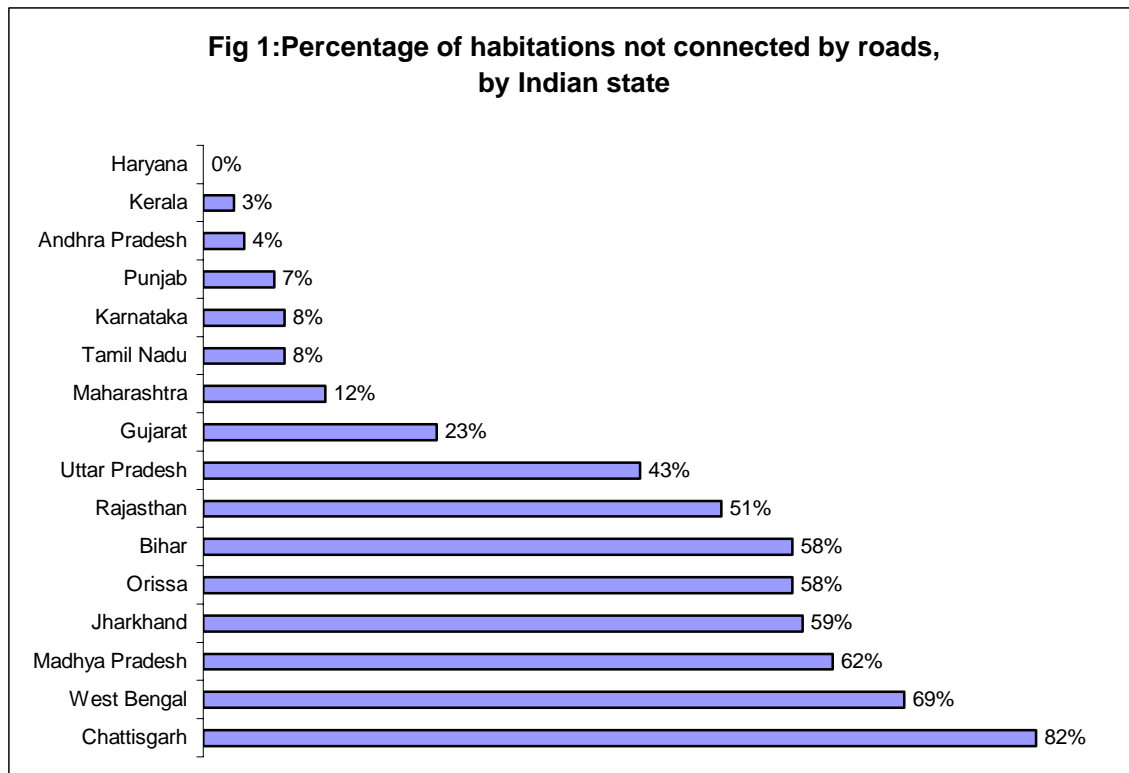
Populism and Renewed Fiscal Stress

The recent progress in fiscal consolidation, noted above, is real but modest. The overall fiscal deficit remains high at 7.5 percent of GDP in 2005/6, as does the government debt to GDP ratio at 80 percent (compared to about 60 percent in 1995/6). While the fiscal responsibility laws enacted by central and state governments (22 out of 28 states have passed such laws so far) are promising, they are not immune to populist pressures. Especially since the advent of the UPA government in 2004, populist expenditure programmes, such as the National Rural Employment Guarantee scheme, have gained fresh momentum. The Sixth Pay Commission has been constituted and is expected to submit its report by mid-2008, with governmental action likely before the next general election. The possibility of significant public pay increases is obviously high. On the revenue side, the state level VATs have contributed to revenue buoyancy. But the recent scheme for Special Economic Zones is fraught with unduly generous tax concessions. So the prospects for fiscal consolidation are mixed, at best.

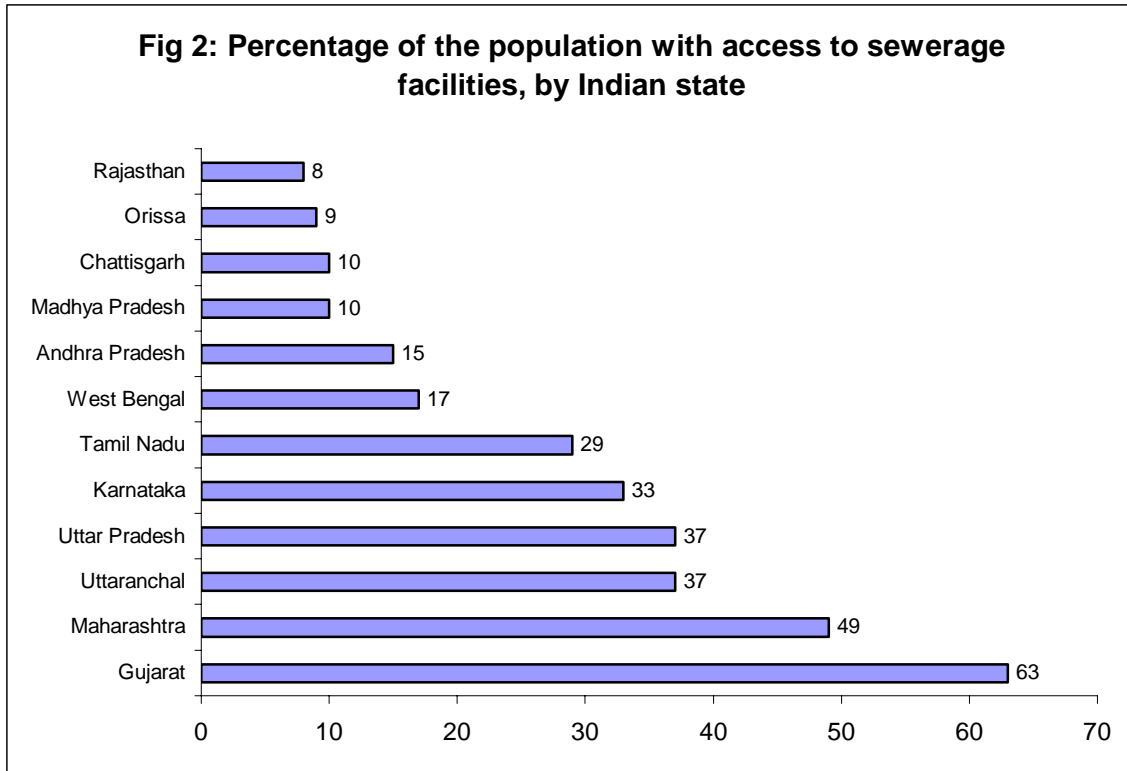
Infrastructure Bottlenecks

India's infrastructure problems are legendary and also reflect failures in public sector performance and governance. A recent appraisal (World Bank, 2006) points out that "the average manufacturer loses 8.4 percent in sales annually on account of power

outages”, over 60 percent of Indian manufacturing firms own generator sets (compared to 27 percent in China and 17 percent in Brazil) and India’s combined real cost of power is almost 40 percent higher than China’s. The quantity and quality of roads is also a serious bottleneck. While there has been some progress in recent years with national highway development, the state and rural road networks are woefully inadequate, especially in poorer states (Figure 1). Urban infrastructure (especially water and sewerage) is another major constraint for rapid industrial development and urbanization (Figure 2). The successful example of rapid telecom development is very promising. But unlike telecom, the sectors of power, roads and urban infrastructure are burdened by long histories of a subsidy culture and dual (centre and states) constitutional responsibilities. Unless the various infrastructure constraints are addressed swiftly and effectively, it is difficult to see how 8 percent (or higher) economic growth can be sustained.



Source: Ministry of Rural Development, Government of India, as cited in World Bank (2006).



Source: Central Public Health and Environmental Engineering Organization, 2000, as cited in World Bank (2006).

Labour Market Rigidities

According to official data, India's non-agricultural employment in the private organized (units employing more than 10 workers) sector has stagnated below 9 million for over 20 years, although the labour force has grown to exceed 400 million! A major cause has been India's complex and rigid labour laws, which hugely discourage fresh employment while protecting those with organized sector jobs.⁹ Investment climate surveys by the World Bank indicate that India has some of the most restrictive labour laws in the world, which, in effect convert labour (in organized units) into a fixed factor of production (lay-offs are extremely difficult) and thereby discourage fresh employment in the organized sector while promoting more "casualization" and insecurity among the

⁹ The skill and capital-intensive pattern of development of India's modern industrial and services sectors (despite the endowment of abundant unskilled labour) has been noted by many analysts, including Kochhar et.al. (2006), Panagariya (2006) and World Bank (2006). All of them point to restrictive labour laws as a major culprit.

93 percent of workers in the unorganized sector. The laws are not just rigid but also numerous (“a typical firm in Maharashtra has to deal with 28 different acts pertaining to labor”, World Bank, 2006).

Without significant reform of existing labour laws, India’s cheap labour advantages remain hugely underutilized. Looking to the future, the challenge will increase as the “demographic dividend” brings further large increases in the labour force. In fact, as I have pointed out elsewhere (Acharya, 2004), the economic and political challenge is far greater than normally appreciated because the bulk of the demographic bulge will occur (in the next few decades) in the poor, slow-growing and populous states of central and eastern India (notably, Uttar Pradesh, Bihar, Orissa and Madhya Pradesh).

Weak Agricultural Performance

Since 1996/97 the growth of agriculture has dropped to barely 2 percent, compared to earlier trend rate ranging between 2.5- 3.0 percent. The reasons are many and include declining public investment by cash-strapped states, grossly inadequate maintenance of irrigation assets, falling water tables, inadequate rural road networks, unresponsive research and extension services, soil damage from excessive urea use (encouraged by high subsidies), weak credit delivery and a distorted incentive structure which impedes diversification away from food grains. Tackling these problems and revitalising agriculture will take time, money, understanding and political will. It will also require much greater investments in (and maintenance of) rural infrastructure of irrigation, roads, soil conservation, etc. and reinvigoration of the present systems of agricultural research and extension. While the central government can play a significant role in revamping systems, the main responsibility for strengthening rural infrastructure lies with the states. However, their financial and administrative capabilities have weakened over time.

The share of agriculture in GDP has declined to hardly 20 percent. But agriculture is still the principal occupation of nearly 60 percent of the labour force. Thus better performance of this sector is essential for poverty alleviation and containment of rising regional and income inequalities.

Pace of Economic Reforms

There is little doubt that economic reforms have slowed since the UPA government assumed office in May 2004¹⁰. The privatization programme has been halted, although Government remains the dominant owner in banking, energy and transport and the usual ills of public ownership afflict the performance of many enterprises in these key sectors. The legislative proposals of the previous government to reduce government ownership in public sector banks to 33 percent have lapsed and not been renewed. There has been some revival of interest rate controls and directed credit. Follow-up action on the reformist new Electricity Act (2003) passed by the NDA government has been slow. The pricing of petroleum products has become more politically administered than before. Education policy has focused on introducing caste-based reservations in institutions of higher education. Introduction of such reservations in private sector employment are also being considered. Reform of labour laws remains stalled. There has been little forward progress in reform of agriculture policies.

Indeed, the wonder is that the economy's growth momentum has remained so strong despite the stalling of economic reforms. If the growth dividends of economic reforms occur with a lag, then the paucity of reforms in the period 2004-06 may take their toll in the years ahead.

Weak Human Resource Policies

The long-run performance of the Indian economy must surely depend on successful policies and programmes for education, skill-development and health service provision. Yet the government-led programmes in these sectors suffer from very serious weaknesses and lack of reform impetus. For example, World Bank (2006) cites a number of surveys which show that less than half of government teachers and health workers are actually to be found in schools and clinics they are serving (the situation is typically worse in poorer states) . Even though school enrolment rates have climbed over time, the actual cognitive skill acquired in schools (even simple reading and arithmetic) is still very

¹⁰ For a recent review see Acharya (2006c).

low (Pratham, 2006). In health, a survey shows that medics in primary health clinics in Delhi had a greater than 50 percent chance of prescribing a *harmful* therapy for specified, common ailments (Das and Hammer, 2004a and 2004b). The competence of these medics was found to be less than comparably situated counterparts in Tanzania and substantially worse than counterparts in Indonesia. Even in higher education, an area of supposed competence, studies point to enormous problems of quality, quantity and relevance (see, for example, Aggarwal, 2006).

Quite clearly, the current portfolio of policies and programmes in these critical sectors need urgent improvement if India is to retain her competitive edge in an increasingly globalized, knowledge-based, world economy.

International Economic Environment

The latter half of 2006 has witnessed a distinct slowing in the growth of the US economy, still the single most potent locomotive of global growth. The Doha Round of multilateral trade liberalization remains mired in limbo. Oil prices, though off their peaks, remain high with little prospect of falling below \$50 a barrel. The chances of some slackening in the growth of world output and trade are clearly rising. Just as the Indian economy has benefited from strong global expansion in the last four years, so it may expect to bear some downside risks from slower world growth in the years ahead.

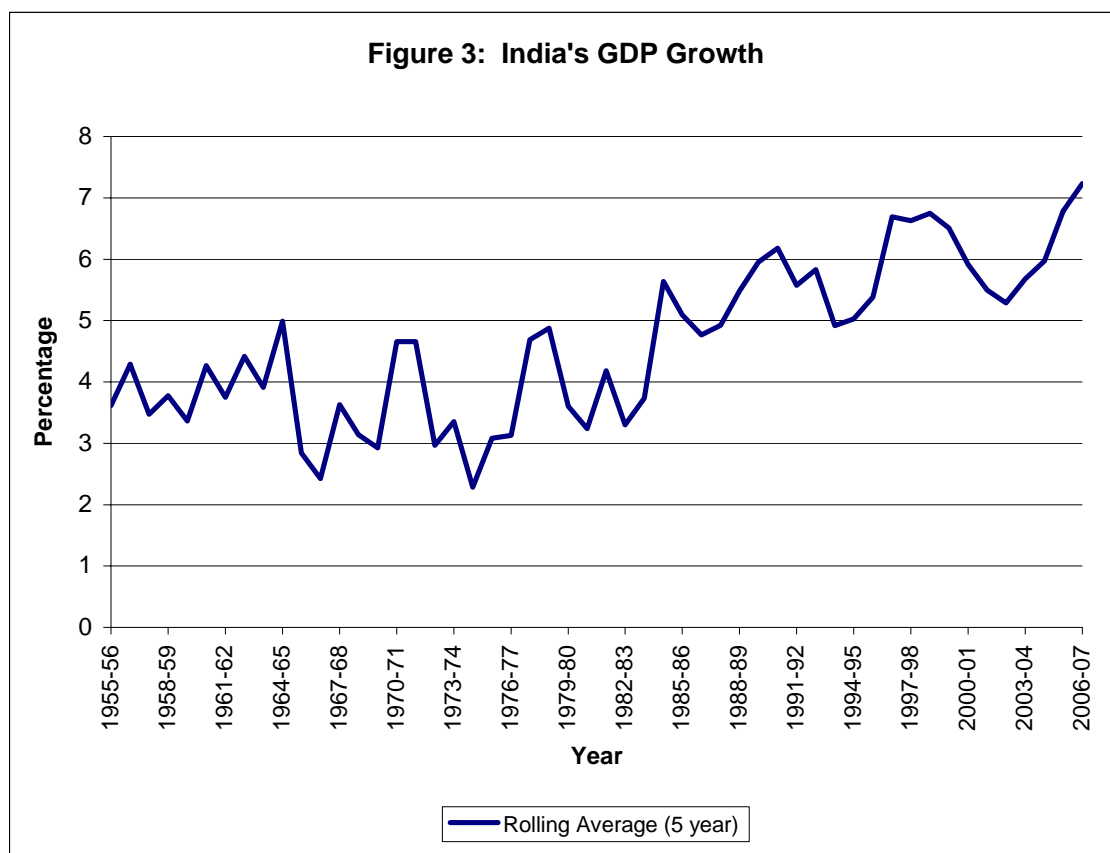
IV Medium Term Growth Prospects

Since 2003/4 there have been quite a few studies projecting sustained, high growth of the Indian economy in the long-run, including the Goldman Sachs “BRICs” report (Wilson-Purushothaman, 2003), Rodrik-Subramanian (2004) and Kelkar (2004). Their specific projections and time-periods differ: Goldman Sachs foresaw near 6 percent growth for 50 years; Rodrik-Subramanian projected a minimum of 7 percent for the next 20 years and Kelkar was even more optimistic with his growth expectation of 10 percent.¹¹ More recently, with a three-year 8 percent average already achieved and the

¹¹ See Acharya (2004) for a critical assessment of these bullish growth expectations.

current year likely to register a similar rate, the Government's Planning Commission (2006) has outlined GDP growth projections for 2007/8-2011/12 of 8 to 9 percent. Bhalla (2007, forthcoming) goes further and foresees 10 percent growth as almost inevitable. Most probably, the majority of serious economists in India would today expect economic growth in the medium term (say, 2007-12) to average at least 8 percent.

Such optimism is not wholly misplaced. It is based on the continuing strength of the positive factors outlined in section II above, especially globalization and "catch-up", the demographic dividends, the rising middle class, a vibrant entrepreneurial culture, positive expectations of future economic reforms and a generally benign international economic environment. The optimists are not blind to the risks and threats outlined in section III. They simply expect the growth-enhancing tendencies to prevail or, more subtly, for the dynamics of growth to generate solutions to constraints such as infrastructure and education. Figure 3 provides encouragement to the bullish outlook.



In my view, the downside factors outlined in section III, should carry more weight in assessing India's medium term growth prospects. There is a good chance that the currently bullish view of growth expectations is overly influenced by the recent past (2003 onwards), a period of strong cyclical upswing in both the global economy and Indian industry. The strength of the cycle could abate in the next couple of years and India's growth could revert to a trend rate in the range of 6 to 7 percent, perhaps closer to the higher figure. Even then, under this "pessimistic" scenario, annual per capita growth would be at a historical peak for India (Table 11). If this is "pessimism", then I plead guilty to the charge (though it does place me among a small minority of Indian economists today)!

Table 11: Medium Term Growth Expectations

	1992/3 –2005/6	2002/3 -2006/7	2007/8 - 2011 /12	
			“Optimist”	“Pessimist”
GDP %	6.4	7.2 *	8 – 10	6.5 – 7.0
GDP per capita (%)	4.4	5.5	6.5 – 8.5	5 – 5.5

* Assuming Reserve Bank projection of 8.0 percent GDP growth for 2006/7

Perhaps the most noteworthy point is that medium-term growth expectations for India are so buoyant that the range between optimists and pessimists is placed so high, within a fairly narrow band of about 7 to 9 percent. Only time will tell who is closer to being right.

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