A Decade After 1991: New Challenges Facing the Indian Economy

Rakesh Mohan*

I feel deeply honoured to have been invited to deliver the 28 th Frank Moraes Memorial Lecture this evening. I feel particularly honoured, but also humbled, when I look at the list of the very distinguished predecessors who have delivered this lecture. Frank Moraes was among the pioneers of independent Indian journalism. As editor of the Indian Express he set new standards in journalism in terms of both probity and quality of writing. I know that successive generations of Indian journalists have looked upon him as a role model to guide their lives in the pursuit of their profession. He has been an inspiration to all who have followed him. The importance of an independent, well informed and fearless press has become all the more noteworthy in recent years. As the economy becomes freerer, grows faster, and becomes more complex, the press has even greater responsibility to provide appropriate and accurate information to the public so that economic and other policies can be evaluated with a greater degree of understanding and knowledge. I would like to congratulate the United Writers Association and the Frank Moraes Foundation for instituting the Frank Moraes Memorial Lecture. It is such activities that help in providing focus to current issues for more informed debate.

In my lecture today, I first propose to provide a brief overview of key developments that have occurred in the Indian economy over the past decade since the introduction of economic reforms in 1991. I would then like to propose an agenda for further reforms that need to be pursued in certain areas over the next decade. I would not presume to set a comprehensive agenda. I will only talk about certain areas that I have some familiarity with.

Key Developments Since 1991

The thrust of the 1991 reforms and those that have followed has been to move the economy on to a higher growth path; to build in mechanisms for inducing greater efficiency and competitiveness in all spheres of economic activity; and to gain the capability for dealing with the immense shortcomings accumulated over the years in social sectors such as education and health. We have accordingly gone through a wide ranging reform process covering the areas of macro economic and fiscal stabilisation, industrial policy deregulation, trade policy liberalisation, freeing of the exchange rate, financial sector strengthening, capital market deepening, privatisation of and disinvestment in the public sector, infrastructure and agriculture. In all these areas the effort has been to eliminate existing controls that had distorted resource allocation and inhibited entrepreneurship. The economy is being nudged towards the attainment of higher productivity and efficiency.

The results have been quite gratifying but there is still much more to do. The economy responded very well to the reforms in the first half of the 1990s. In fact, India's growth performance in the first three years after the start of reform programme was better than almost all developing countries that have gone through such a reform process. The economy was inching towards the attainment of a 7 per cent growth path in the mid 1990s, significantly higher than the 5.5 per cent achieved in the 1980s and the 3 to 3.5 per cent in the previous three decades. Among the significant achievements of economic policy are the restoration of external balance; the sustained reduction in inflation; the significant reduction in poverty to 23-26 percent; the substantial expansion of trade from about 12 to 13 per cent of

GDP in the late 1980s to 22 to 23 per cent now; the introduction of new prudential discipline in the banking sector; and strengthening of the capital market. Despite all these achievements, the key disturbing development of the late 1990s is the significant slowdown in the growth rate of GDP in the last 5 years to about 5.5 per cent, a level not too different to that achieved in the 1980s, perhaps lower. A particularly disturbing feature of this development is the fall in the industrial growth rate to less than 5 per cent, which is more characteristic of the slow rate of growth in the 1960s and 1970s that had then been characterised as industrial stagnation. Similarly, agricultural performance in the last 5 years has also been exhibiting some signs of a secular slow down.

The elimination of poverty within the next 10-20 years requires a substantial acceleration in per capita economic growth to more than 7 per cent per year. As I have already mentioned, the level of poverty has indeed fallen to about 23 to 26 per cent according to our conventional measures. Population growth has declined from about 2.2 per cent per year in the 1970s and 1980s to about 1.7 to 1.8 per cent now. All indications suggest that this will decline further to 1.4 per cent to 1.5 per cent over the next 10 years. Thus the achievement of 7 per cent annual per capita income growth, which would lead to doubling of per capita income in 10 years, would require GDP growth of about 8.4 to 8.6 per cent over the next decade. This then is the task for economic policy in the coming years, even though this would seem like an unattainable target at the present time. An aggressive programme of economic reforms must therefore be carried out on a continuous basis.

Investment Requirements: The Need for Higher Savings

Acceleration of GDP growth to even 8 per cent will require an investment rate of around 32 per cent of GDP. In contrast the current investment rate has been stagnating at around 24 to 25 per cent of GDP over the past few years. The gross domestic saving rate has also been stagnating at 23 to 24 per cent of GDP. Thus the achievement of a higher economic growth rate depends crucially on the attainment of both higher savings and investment rates.

Gross domestic savings in the country have two main components: private sector savings and public sector savings. What is notable in the 1990s is that, whereas private sector savings have increased from a level of about 18 per cent of GDP in the late 1980s to about 25 per cent now, public sector savings have fallen precipitously from about 2.4 per cent of GDP in the late 1980s to about - 1.7 to - 2 per cent now, a full of more than 4 per cent of GDP. Private Sector Savings also have two componants: household sector savings have increased from 16 per cent of GDP in the late 1980s to about 21 per cent now, and private corporate sector savings from about 2 per cent in the late 1980s to about 4 per cent now. Thus, whereas the savings performance of the private sector has improved quite significantly during the 1990s, partly as a consequence of a relatively high income growth rate, it is very poor performance of the public sector as a whole that has eroded the investment capacity of the country for generating higher economic growth. As is evident to most citizens it is the erosion in public sector investment that has led to poorer availability of public facilities around the country. The challenge for the next decade is therefore a reversal of public sector savings to at least the level achieved in the late 1980s. A net improvement of 4 to 5 per cent of GDP in public sector savings would take up the Indian gross domestic savings rate to about 28 per cent. The record of 1990s suggests that a further 2 per cent increase in private sector savings is not unrealistic. The availability of 2 per cent external savings through foreign capital flows would then provide us adequate resources to achieve a 32 per cent investment rate. The key challenge before us is indeed the reversal in public sector savings.

What is at the root of this abysmal performance of public sector savings over the last decade ? First, the overall tax GDP ratio has deteriorated by around 2 per cent of GDP. Second, the Fifth Pay Commission award increased revenue expenditures of the central and state governments alike, leading to unsustainable revenue and fiscal deficits. Third, the losses made by public sector utilities such as State Electricity Boards, State Road Transport Corporations, water utilities, and the Railways have been increasing over time. The users of all such services are the better off and they have effectively been subsidised at increasing rates. The total losses of all such enterprises could well exceed 2 per cent of GDP.

The reduction in the tax GDP ratio is somewhat surprising in the presence of accelerated income growth in the 1990s. The reduction in indirect tax collection particularly those from custom duties was expected but this should have been more than compensated by increases in direct tax collections. Although the number of income tax payers has indeed increased quite significantly over the last 5 years, it is quite obvious that compliance in terms of income declaration at the higher levels has not improved. The substantial reduction in maximum marginal tax ratio to around 30 per cent has not induced the rich to be more honest with the tax collector! It is difficult to believe that the number of tax payers declaring incomes above Rs.10 lakh in the whole country is not much more than 50,000. Thus, if we are to achieve the kind of growth rate that we aspire to, a major improvement has to be made in the tax GDP ratio. This has to come mainly from improved compliance in direct tax collections, particularly in the personal income tax. The current reality is that it is actually painful for the income tax payer to interact with the tax authorities. It is better to avoid paying taxes than to undergo harassment. What is needed therefore is a major overhaul of the tax collection machinery through systemisation of payment methods and the like. The widespread use of tax deduction at source related to most transactions being tied to unique tax identification numbers would help greatly. Better use of systems, not raids and policy actions, will bear more fruit.

The second issue to do with user charges is at least as important. The argument for not charging appropriate user charges has essentially been on the basis of the inability of the poor to pay for such services. This argument has little basis, in fact, since most such services are essentially consumed by the better off sections of society. At least 60 per cent of rural households and about 20 per cent of urban households do not have a power connection; only 60 per cent of urban households have taps within their homes, even fewer have in-house latrines. A major campaign is therefore needed to bring up the levy of user charges to economic levels so that the infrastructure entities both public and (potentially) private, are able to get adequate returns to their investments. This may well be the most important feature of the economic reforms necessary for the achievement of higher growth. The fiscal health of both the central and state governments would then improve dramatically. Moreover, it would then be possible to invest appropriately in the provision of such infrastructure services which are essential both for economic growth and for social justice. But this reform cannot be done by announcement. It needs research, public awareness, public education and persuasion. The central government must lead this campaign and forge understanding and consensus with state governments, who must in turn do the same with local bodies. Both a carrot and stick approach will have to be followed. At the same time acceptability of higher charges for such services will not be feasible unless there is greater efficiency in the delivery of these services. This requires widespread reform in the public sector.

Action on improvement in the tax GDP ratio and on collection of user charges can lead to the required reversal in public savings by about 4 per cent of GDP. The much needed public investment in crucial areas of education and health can then become a reality. Furthermore, such a reduction in fiscal deficit would reduce debt service payments at both the central and state levels, thereby releasing more resources for revenue expenditures for maintenance of all government services.

A key feature of economic development in the late 1990s has been the dominance of service sector growth that has been much higher than growth in both the industry and agriculture sectors. Although the service sector can be expected to grow at continued high rates, the acceleration in economic growth thus required will not take place unless higher growth is achieved in the industry and agriculture sectors in the coming years.

Agricultural Reforms

Higher agricultural growth has been a feature of higher overall GDP growth achieved in the 1980s and 1990s, after the relative stagnation of the 1960s and 1970s. The drought of 1965 to 1967, and the associated difficulties of importing food at that time, gave a jolt to the Indian Government. Ever since, food security, equated with food self-sufficiency, has been given the highest priority in economic policy making. The pre-occupation with food security and its equation with food self-sufficiency led to restrictive trade policies controlling both import and export of agricultural goods. This policy combined with that of high protection to industry resulted in a decline in terms of trade for agriculture until the early 1990s. The farmers had been effectively taxed by the existence of lower than world prices in most agricultural products. The negative consequences of such policies had necessitated the provision of input subsidies to partially compensate for the adverse terms of trade that were being meted out to agriculture.

The economic reforms of the 1990s have partially corrected this situation through the drastic reduction of industrial protection. But this has been accompanied by significant increases in agriculture support prices leading to increasing subsidies. Meanwhile, world agriculture prices have been falling since the mid 1990s. Hence, many Indian agricultural prices now exceed world prices. Consequently, Indian agriculture is becoming increasingly uncompetitive and requires increasing subsidies for its sustenance. It is producing more and more food grains, which no one seems to want at these inflated prices. The distortions in world trade caused by the existence of high government subsidies to agriculture in the European Union and North America only serve to exacerbate these problems.

While policymakers have been mainly concerned with supporting foodgrain production, the consumption pattern of the population has been changing very significantly. The importance of foodgrains in peoples’ diets has reduced considerably over the years. Cereal food stocks have reached almost 60 million tonnes today and are expected to increase further to 80 million tonnes by the end of the current fiscal year. The share of cereals in food expenditure has declined very considerably in both rural and urban areas continuously. In urban areas, cereals constituted about 36 per cent of food expenditure in the early 1970s: this has declined to less than 26 per cent by the end of the 1990s. Similarly in rural areas, the proportion of food expenditure on cereals fell from 54 per cent in the early 1970s to less than 37 per cent in the late 1990s. Even though the per capita availability of foodgrains is not much more than it was 20 years ago, the foodgrain surplus is continuing to accumulate. What has happened is that the availability and consumption of foods, such as vegetables, fruit, milk, fish and poultry has been increasing very fast. According to one estimate, the availability of potatoes has increased by a factor of 12 over the past 30 years or so, of milk by about 7, and of meat by about 10. Whereas the evidence of this very significant change is quite obvious from the standard statistical sources, the preoccupation of policymakers with foodgrain production continues unabated. The green revolution has been followed by a white revolution of milk, but we do not know what the next agricultural revolution will be. The fact is that the achievement of higher growth in agricultural production will require much faster diversification away from the production of foodgrains alone.

A new approach to agricultural policy is therefore required and needs much greater study. In the first instance, in view of the relatively high level of food security that has now been achieved, the climate is now right for bold policy reforms in the areas of wheat and rice. A progressive correction is required in the incentive structure for agriculture so that the excessively high minimum support prices that currently exist for wheat and rice do not continue to distort resource allocation in agriculture as a whole. The current policy effectively subsidises farmers in a few states at the cost of others elsewhere. Moreover, it effectively restrains these farmers from shifting to other crops, which they would otherwise do. As minimum support prices for wheat and rice are corrected on a gradual basis, the farmers producing these commodities will look progressively for investment in other agricultural areas. They will then respond better to the new demand structure while also providing themselves with potentially higher incomes. Given the large number of farmers who would be affected by such policy changes, such corrections need to be made with the greatest care, but this correction must be made and without further delay. Otherwise, farmers will continue to produce wheat and rice and unusable food stocks will continue to rise.

Corresponding changes would also need to be made in the current policies related to other subsidies, particularly those related to fertiliser, power and water. The reduction in various subsidies in these areas will provide a very significant fiscal dividend for the country enabling higher public investment where it is required, and particularly in agriculture. One of the consequences of ever increasing food, fertiliser, power and water subsidies has been the reduction in public investment in agriculture. Higher growth in agriculture will be difficult to achieve without a reversal of this trend. More rational user charges have to be levied all round to finance the restoration of productive public investment in agriculture. However, a mere increase in public investment will not do. In view of the increasing complexity of agricultural production much greater care will be needed to ensure that the public investment goes into those areas where it is needed most and which achieve the highest returns. For this to happen, a great degree of decentralisation is needed in decision making, along with better availability of relevant information.

The agriculture sector continues to suffer from a large number of domestic market controls. Although some progress has been made recently through changes in the Essential Commodities Act designed to promote free movement of agricultural products across the country, some states still continue to regulate such movements. Various products such as sugar and molasses also suffer from the imposition of levies designed to procure these products at lower than market prices or to restrict their movements in different ways.

The Central Government has announced the availability of incentive funds for states to carry out appropriate agriculture market policy reforms. This agenda of reform needs to be pushed with vigour but much greater discussion is required with the states and also among experts. Correct measures can then be taken. In particular, the various restrictions that currently inhibit farmers from selling their products freely need to be abolished. The consequence of the existing controls is the proliferation of intermediaries between the market and the farmers. Farmgate prices for fruits and vegetables range between 20 and 30 per cent of the eventual retail prices in India. In developed countries, such as, the US, UK and Japan, the farmgate prices for such products range between 40 and 55 per cent of retail prices. Hence, the welfare of the farmer will be enhanced significantly if such controls are lifted, the number of intermediaries are reduced and significant cost reduction is achieved in transportation, storage and distribution costs of agricultural products. A rural logistics revolution is the order of the day, and the private sector has a large role to play.

Very significant changes are taking place in the agricultural sector. We can see the beginning of a much closer connection between primary producers, trade intermediaries, food processing entities, and eventual marketing of value added products. With the share of unprocessed foods falling, the real growth area in the agriculture sector is in value added food products such as meat, poultry, fish, vegetables, fruits and the like. There is an accelerating move of consumers to basic processed foods such as atta, packaged milk, fresh poultry, soft drinks, processed meat and poultry, and the like. These trends need to be studied carefully so that supporting policy changes and investments can be made.

The green revolution and white revolution were relatively easy to achieve from the policy point of view. Wheat, rice and milk are relatively homogeneous products. Thus the policy package designed to enhance productivity and production of these products could be first developed in certain areas of the country and then applied throughout the country. In the new growth areas of agriculture that I have mentioned, the heterogeneity of products is much greater. There is a multiplicity of varieties that can be produced in each of these product groups; production is often regionally concentrated; the production and marketing conditions differ significantly; and the input requirements are equally heterogeneous.Hence, policies and programmes that need to be designed to support higher productivity and production in these areas need to be much more regionally disaggregated and knowledge intensive. The traditional central planning approach will not do in these areas.

The green revolution was also aided considerably by a large domestic and international research and extension effort. The promotion of more diversified agriculture will also need a greater concentration of resources to research and extension in the new areas. Hence a new programme for strengthening of agricultural research has to be launched. The agricultural universities that already exist and other agricultural research institutions need to be revitalised with new leadership and new visions. Whereas the initial push could come from the Centre, much greater disaggregated attention would be needed from state governments. Almost all research, extension and promotional activity in agriculture has traditionally been concentrated exclusively in the government. In these new areas of agriculture, facilitating measures need to be taken to encourage the private sector to invest in R&D, extension and the activities. We need new thinking, new approaches and new leadership.

Mere policy reforms in these areas would be inadequate without corresponding investment in rural infrastructure so that the closer connection required between the farmer and the market that I have referred to can be achieved. If there are no roads, produce can neither be taken to unconnected villages for marketing, nor can the farmers produce be taken to the market. The government has already launched an ambitious rural roads programme. The experience of states like Tamil Nadu, Punjab, Haryana, Kerala and Goa, where rural connectivity through roads was achieved much earlier, suggests that such a programme is more successful when conducted in a decentralised framework. The extreme centralisation of the Prime Minister's Gram Sadak Yojana may actually inhibit the rapid construction of rural roads that is envisaged. The maintenance and upkeep of such roads will be difficult to achieve on a continuous basis unless there is local ownership and responsibility. As village connectivity is actually achieved through the construction of rural roads, it will become possible to make other investments that are required for the transfer of agricultural products from where they are produced to where they are processed and to where they are marketed.

Heavy investments need to be made in establishing cold chain across the country through investments through cold storage, transport facilities and the like. Once again the government has already made provisions for incentives for such private investment in cold storage, and for storage godowns as well. Investment in these areas will have to come from the private sector, this is currently handicapped by the existance of restrictive marketing laws that prohibit farmers from selling directly to buyers outside the designated mandis. The kind of storage, cold storage facilities and transportation facilities required will differ from product to product and from region to region. It is best accomplished in a decentralised private sector framework which is made feasible through appropriate policies and supportive financing facilities. Cold storage will not be cold unless there is electricity. There will be no electricity unless it is paid for.

The rapid transformation that has been observed in these areas in South East Asian countries in the last 20 years provides pointers to what we can expect in the years to come. One key area of change that has occurred is in the modernisation of retail grocery structures. Most cultures in a transitional phase attach great importance to personalised shopping for daily needs. The small corner stores are well distributed across towns and cities. The situation in East Asia, was similar until the 1980s. However, tremendous change has taken place in retail grocery structures in these countries over the last 15 years. In Taiwan, for example, whereas only about 2 per cent of groceries were sold in modern retail formats such as super markets in the mid 1980s, this proportion has now shot up to more than 65 per cent. Similar change has taken place from zero to 50 per cent over the same period in Thailand. Even in Indonesia, about 25 per cent of groceries are now bought in modern super markets. Modern retailing firms are much more efficient than traditional firms. Their costs can be as much as 20 per cent lower than in traditional firms. Contrary to popular perception, they actually generate greater employment. The economies of scale provide for greater variety in product stocks; they provide a demand pull factor from consumers to producers; and they help in reducing the difference between the retail and farmgate prices. Overall, they help in accelerating growth in the whole food chain thereby leading to higher agricultural growth and, more important, higher employment growth in the whole food chain from the farm, food processing, logistics, and retailing. The current resistance to foreign direct investment in retail trade should therefore be removed so that the whole food chain is helped to become more efficient. The resistance to modern retail formats is benefiting the intermediaries at the expense of the farmer.

In brief, the income changes that have taken place in both rural and urban areas over the past 20 years have ushered in a new demand structure for rural products that has gone largely unnoticed. Traditional approaches to agriculture focussed on foodgrain production will only bring agricultural stagnation and employment distress in rural areas. We have to act decisively to promote agricultural diversification, encourage production of other food products, invest actively in rural infrastructure, and enable greater food processing and value added to agriculture products. We can then look forward to a new agricultural revolution, along with new avenues for rural employment, both farm and non farm.

Industrial Growth

The New Industrial Policy of 1991 introduced new competition by abolishing industrial licensing in almost all industrial sectors, abolishing restrictions on MRTP companies, terminating the phased manufacturing programmes, substantially freeing foreign direct investment and import of foreign technology, and freeing areas hitherto reserved for the public sector. This policy reform removed almost all restrictions on new entry into the industrial sector. Over the years, the trade regime has also been modified substantially so that there are now no quantitative restrictions on the import of industrial goods. At the same time the tariff structure has been brought down considerably thereby reducing the protection available to Indian industry. The government has also announced a further tariff reduction programme to reduce the so-called peak tariff rate to 20 per cent by the year 2004. Competition from trade will therefore intensify and Indian industry has to become more competitive.

Overall, it must be said that Indian industry has coped extremely well with all these changes ushering in new competition after having been sheltered in a closed and protected economy for more than 50 years. A great deal of re-engineering has taken place, new challenges have been met at a rapid pace, and quality is being upgraded all round. However, the record of industrial production over the last 5 years provides significant cause for worry, with the industrial growth rate slowing down to an annual average of less than 5 per cent, a level not seen since the late 1970s. What has gone wrong?

The whole package of reforms that has been carried out over the past 10 years was expected to lead to significant industrial restructuring. The reduction in import protection and the introduction of new competition were expected to lead to a reallocation of resources more in line with India's comparative advantage in the international industrial economy. Resources should have moved from the more capital-intensive sectors to the more labour using ones, leading to both higher output and employment growth. In the high growth phases of South East Asian countries the rate of growth in manufacturing employment ranged typically from 4 per cent to 6.5 per cent. Growth in manufacturing employment in India has, in contrast, been more in the region of 2.5 per cent per year in the 1980s and 1990s. Quite shockingly, the total employment in the organised manufacturing sector in India is less than 8 million as compared to more than 70 million in China. We therefore have a long way to go. We cannot hope to achieve accelerated economic growth unless manufacturing growth is rejuvenated. We must understand that this growth is likely to take place in labour using sectors of industry.

I believe that the key reason for our industrial slowdown is to be found in inadequate industrial restructuring. A much more rapid shift of resources has to take place towards labour using industries. Much more flexibility is required for industrial restructuring. This implies institution of more rapid bankruptcy procedures, easier reallocation of capital, faster transformation of urban land use, and flexibility in labour use.

The government has already introduced a bill to repeal the Sick Industrial Companies Act (SICA) and the abolition of the Board of Industrial and Financial Restructuring (BIFR). These mechanisms had made industrial restructuring almost impossible. It has also introduced an amendment to Company Law to provide for new bankruptcy procedures. Furthermore, it has now enacted an ordinance for the enforcement of creditors' right. All these bills need to be enacted in Parliament so that industrial restructuring can then takes place more quickly. The resources that are currently locked up in non performing enterprises can then get released and put to use for more productive purposes. Accomplishment of these legislative changes will provide for much greater capital mobility. It will also make the functioning of banks and financial institutions more effective. A reduction in their NPAs will also reduce their costs of lending, benefiting industry all round.

The shift of resources to more labour using industries will, however, not take place unless this is accompanied by labour reform enabling similar labour flexibility. The content of such changes is well known. The Cabinet has already approved the introduction of labour reforms; what is needed is the enactment of these legislative changes by Parliament. We have to understand that the availability of greater labour flexibility will lead to create employment growth in manufacturing, not net reduction.

Industrial restructuring has also been made difficult by the Urban Land Ceiling Act, which made changes in land use very difficult. The Central Government has already abolished this Act. However, only a few states have repealed their corresponding Urban Land Ceiling Acts. Full scale industrial restructuring will not take place unless the remaining States also follow the example of others and repeal the existing Urban Land Ceiling Acts.

Once these rigidities are removed we can expect a faster reallocation of resources to labour using industries thereby rejuvenating Indian industrial growth and employment. However, mere removal of these rigidities will also not be enough. Positive actions are needed to provide for mechanisms by which some of the unsuspecting losers in this restructuring do not suffer. Putting in place a social security mechanism for workers displaced due to industrial restructuring is a must. Thus the National Renewal Fund or some similar mechanism must be resuscitated so that resources are available to help the labour displaced from restructuring. Such a social security mechanism will have to be made a self-sustaining one. Hence action needs to be initiated urgently to set up a self-funding insurance fund for employment. Labour that is affected by restructuring will not only need monetary compensation but will also need help for retraining and redeployment. Public private partnerships need to be forged at the local level between local governments, industry associations industrial units and training institutions to generate active programmes for re-training and re-deployment that are practical and implementable. I have no hesitation in saying that the kind of labour reform that industry wants will not come about unless the corresponding positive steps for labour welfare that I have just mentioned are also put in place simultaneously.

The other main rigidity inhibiting investment in labour using industries is the obsolete policy of small scale industry reservation. The areas in which South East Asian countries have achieved their highest export growth have been typically labour intensive, relatively low technology products such as textiles, clothing, shoes, toys, sport goods, and the like. They have then graduated up to somewhat higher technology consumer goods and then even higher technology and capital intensive sectors such as those of capital goods and petro chemicals. Over the same period the Indian export pattern has remained stationary at the level of labour intensive low technology products such as clothing, textiles, shoes other leather goods and the like, almost all goods that were reserved for small scale industries. Adequate quality upgradation has been absent and unit prices have stagnated. The attainment of both higher volume growth and of higher unit value realisation will require both larger scales of operation and higher quality. It is therefore essential to loosen constraints in these sectors so that they can grow freely in volume, utilise better machinery, graduate up to higher technology levels, and utilise better international marketing channels. What is observed in other countries in Asia is that production of such consumer goods may be done through final assembly operations that are large in scale, but where a great deal of outsourcing to small enterprises is undertaken to preserve their competitiveness. Consequently the freeing of restrictions on the size of small scale industries through de-reservation is likely to lead to the growth of many more small scale enterprises than is currently the case, along with a much higher potential for growth in manufacturing employment.

All the items currently reserved for small-scale industries are now importable freely at the applicable import tariff. Thus domestic Indian enterprises are now placed at a significant disadvantage relative to larger foreign enterprises which are free to export their products in these sectors to India. Consequently, it is of the utmost importance that existing restrictions must be removed forthwith in the interest of small-scale industries. Such an action will lead to a new spurt both in industrial and export growth along with much needed employment growth. Once again, mere de-reservation will not be enough. Such deregulation of small-scale industries must be accompanied by targeted action to provide both technology and financial assistance in the small-scale industrial sector.

It is clear that at present the Indian banking system is not fully equipped to promote small-scale enterprises around the country. The key issue is that banking institutions must be enabled to improve their credit assessment capabilities with regard to small-scale enterprises so that they can distinguish adequately between good and bad credit policy. Small scale must not be equated with high risk. The provision for Credit Information Bureaus and better exchange of information on credit risk between banks and financial institutions is also necessary to enable these institutions to recognise higher risk without excessive costs. Furthermore, the cost of credit assessment of small and medium enterprises can be reduced by a focussed recognition of clusters of like small scale industries that exist around the country. Such financial assistance programmes also need to be devised to provide assistance to those industries that are in the reserved list to enable them to expand and upgrade technology. This should be done both at the individual and group level. The focus of many such activities can be on the basis of industrial clusters so that economies of scale can be achieved both in financial assistance and in technology upgradation.

The new industrial environment internationally is now placing much greater importance to technology based industrial activity. Production is being globalised, economic distance is shrinking through ever lower transportation and communication costs, and widespread trade and investment liberalisation is providing continuing competitive pressures. The new trends in manufacturing suggest that it is becoming more dispersed internationally; new international value chains are being created; investors are on the constant look out for lowest costs; they want greater flexibility in production; and consistent quality in products and reliable delivery.

Indian industry has to be much more aware of these new international trends and has to be nimble enough to cope with these rapid changes. It has to invest much more actively in skill building, in product quality upgradation, and in R&D. I would venture to say that our industry associations are not giving the kind of focussed attention to technology investment that is required to make Indian industry competitive. Much more needs to be done to forge better relationships at the local level between industrial units, regional engineering colleges, industry associations and other educational institutions so that local hubs of industrial excellence can be developed. The removal of rigidities already mentioned is also essential to enable fast action by industrial firms in the face of new competitive pressures.

In this context I would like to dwell a little bit on the emergence of industrial concentrations. It is now well recognised that industrial growth that has taken place in the 1990s has been much greater in the Southern and Western States than in the Northern and Eastern States. What has been less commented upon is the concentration of economic activity in certain cities such as Bangalore, Pune, Chennai, Hyderabad and, perhaps, Ahmedabad. What do these new hubs of economic activity in India have in common? It should be quite noticeable that each of these cities is characterised by the availability of excellent higher education facilities particularly in science and technology. They also have concentrations of high level research institutions in scientific and technological areas. They also happen to have a good concentration of high technology industries, often in the public sector. What we can learn from this phenomenon is that rapid industrial growth requires a nurturing environment, not only in terms of physical infrastructure, but much more importantly in terms of soft infrastructure related to the development of technical human resources. Agglomeration economies are essential for a vibrant industrial environment. Industry is increasingly knowledge intensive, it can no longer thrive in isolated industrial estates. It needs the proximity of all associated services.

It is quite remarkable that, except for Delhi and its environs, there are no similar concentrations available in the Northern states. Kanpur and Kolkata could perhaps have emerged as similar concentrations but poor governance and lack of investment in these areas has led to their decline rather than growth in recent decades. The rejuvenation of industrial and economic activities in the northern states in the new policy environment requires specific and focussed programmes in the future in cities such as Chandigarh, Ludhiana/Jalandhar, Jaipur, Bhopal, Kanpur/ Lucknow, Ranchi, Kolkata/Durgapur where coordinated investments can take place in both the public and private sectors in ways similar to that in the Southern cities that I have just mentioned. Once again, this will not happen unless appropriate structures for public/private participation are devised. Coordinated public investment is needed in educational facilities, research institutions, and physical infrastructure. Correspondingly, the private sector needs to be encouraged to invest in industrial and technology parks, industrial technology development institutions, and other service industries in these cities.

Rejuvenation of Cities

I have emphasised the importance of economic concentration in a limited number of cities for generating rapid technology based industrial growth. Our traditional approach to cities have been antithetical to such developments. Consequently, the promotion of higher industrial growth that is so vitally needed for the overall acceleration in economic development also needs new focus on city development.

We now have 35 cities with more than 1 million population in the country. There are also 400 other cities that have population greater than 100,000. This constitute a health city base for the promotion of economic activities throughout the country. A great degree of wealth has been generated in all these cities over the past 20 years. This can be seen from the ubiquitous traffic jams that have resulted from an explosion on private transport ownership. However, any visitor to cities in India will find it difficult to believe that they have indeed generated new wealth. Private affluence and public squalor do unfortunately characterise our cities. If new industrial and service sector growth is to be generated in the country, investment in urban infrastructure will have to be accelerated to make up for many lost years.

As in many other areas, urban infrastructure development has also suffered from excessive centralisation and erroneous and irrational policies governing user charges and local resource generation for urban local authorities. Until the passing of the 74th Amendment to the Indian Constitution, urban local government had suffered a great degree of erosion since independence. Some correction has taken place in recent years but not enough. Given that urban per capita incomes are much higher than rural per capita incomes, there is little reason for cities to be subsidised by non-urban residents. Thus, the financing and sustenance of urban infrastructure must effectively come from the urban residents themselves. Payment of local taxes for public goods and carriers, and user charges for other services is a must.

The key elements of urban infrastructure are adequate availability of water, and associated sanitation and sewerage facilities, urban transportation availability, public lighting, and education and medical facilities. Some of these facilities can be characterised as public goods whereas others are private goods or in between. The provision of public goods clearly has to be made from tax resources whereas those of private goods and services should be financed from the levy of proper user charges. The collection of both, local taxes such as property taxes, and user charges for services, requires efficient functioning of municipal governments.

Our traditional approach has been to set up parallel authorities such as urban development authorities (UDAs), housing boards and the like, which are organs of state governments and which receive plan finances as allocated by the central Planning Commission and further devolved by state level Planning Commissions. In the system that has been followed, UDAs typically make investments in urban infrastructure which is then handed over on completion to municipal authorities for maintenance and upkeep. Hence, there is no mechanism nor incentives for the investing authorities to make sure that adequate resources exist for the maintenance of assets created. Similarly, municipal authorities have little incentive to devise either local taxation systems or user charges that are adequate to generate enough resources for both investment and maintenance. There is almost no public involvement in deciding what investments are made. Furthermore, municipal authorities are rendered toothless since executive authority rests with the municipal commissioners who are appointees of state governments. The result of this rather confused administrative structure governing our cities is that they have become increasingly unliveable with population growth far exceeding investment in associated urban infrastructure facilities. Municipal governments are inadequately empowered; they do not have either the financial or human resource capacity to govern growing modern cities.

We therefore, have to give new attention to the administration of our cities through strengthening of local governance. The staffing of municipal authorities has to be professionalised; working in municipal governments has to become respectable and adequately compensated so that high level professionals are willing to work in such organisations; local public utilities need to be made autonomous and financially responsible and accountable. Most urban services are effectively consumed by higher income residents; they must be made to pay appropriate property taxes and user charges for all services that they consume, particularly those of water supply and urban transport.

I know that this is asking for the moon, but unless we as urban citizens generate such debate and demands, we will not be able to develop the kind of urban environment that is environmentally sustainable and economically self-generating and which nurtures the kind of rapid economic growth that I have talked about. Given the existing state of urban administration, we need much greater debate and thinking to come up with solutions that are both practical and implementable. We have to induce much greater citizen participation in urban governance. Local governments have to be seen by residents as their governments. This is the challenge that faces us as we think of the actions necessary for nurturing cities that generate the kind of growth necessary over the next two decades.

Conclusion

I have touched on only a few of the challenges that now face the Indian economy. I have focussed on the key areas where we need to act to induce significant acceleration in the growth process that is also employment friendly.

I have emphasised the necessity for fiscal correction at both the central and the state levels. The combined centre and state fiscal deficit is now of the order of 10 per cent of GDP. This is possibly the highest for any large country in the world. We have to understand that the kind of growth acceleration that we need will simply not be possible unless our fisc is put in order. With the significant cuts that have been made in the tax rates all round, the simplification and unification of excise duties that has taken place, the reduction and simplification of custom duties, and the forthcoming introduction of VAT at the state level, there is simply no justification in condoning tax evasion any more. At these low rates of taxation, tax compliance must be enforced. But this has to be done through better systems and more effective tax administration rather than through raids and police action.

Acceleration in growth requires restoration of the public investment to levels that had been achieved in the 1980s, but public investment should now be only in public goods, specially in education and health. This enhancement in public investment cannot take place without a large scale improvement in the operation of public sector entities, particularly, the public utilities in electricity, transport, railways and the like. It is only if the functioning and efficiency of these enterprises improves significantly that the public would be willing to pay the economic user charges that people must be charged for using these services.

There is a growing belief in an influential section of the intelligentsia that India’s economic future lies in the services sector. I have, in contrast, emphasised the importance of rekindling growth in the traditional areas of agriculture and industry. I place the greatest emphasis on these sectors as generators of employment that is so vitally necessary for the welfare of our growing labour force. The time is right for a total revamp in our agriculture policy designed to promote fast diversification in agriculture. What is needed is a multi pronged effort that brings in bold policy reform along with new investment in rural infrastructure that is designed to bring the farmer closer to the market and the market closer to the farmer. With the great heterogeneity that characterises non-foodgrain agricultural products, policies and infrastructure programmes would have to be much more regionally disaggregated and demand responsive than has hitherto been the case.

In the industrial sector, I have emphasised the need for much faster industrial restructuring, the lack of which I believe has led to the current protracted industrial slow down. Here also we have to act boldly and give up past shibboleths such as the obsolete and counter productive policy of small scale industry reservation. It is only if coordinated policy reforms allowing for faster bankruptcy, faster changes in the land use, and flexibility in labour use and implemented can we look forward to a new boom in industrial investment, industrial exports and industrial employment.

The generation of vibrant industrial growth will be difficult to achieve if our cities continue in the direction that they have been drifting in the past couple of decades. Industries that are competitive require constant generation of new technology, they need to adapt to new demand structures and to build capacity to upgrade skills in a continuous fashion. The capacity to cope with such new competitive pressures is severely curtailed unless the surrounding environment nurtures such skills and activities. Thriving cities that have innovative educational institutions, the best medical facilities, forward looking research institutions and other supportive structures, are the kind of cities that promote the kind of industrial sector growth that we would like to see. The governance of such cities requires much more local participation and control than has been the case in the past.

I would also like to say a few words on the new challenges facing us in education, health and governance. The future of our country will not be healthy unless we give greater attention to enhancement in the quality of education at all levels. We have justly been proud of some of our institutions of higher learning that have produced some of the best professionals in the world. We must, however, understand that the rest of the world has gone much further ahead and unless we give special attention to the enhancement of quality in our institutions, we will be left behind. A great degree of innovation has taken place in health services in the private sector in the past decade. This is all for the good. However, the health needs of the majority of our population remain unmet and we have to provide better methodology for extending adequate health services in both urban and rural areas. In each of these areas, I believe that much greater local control is required. Centralised control will simply no longer do.

Let me now close by emphasising once again that the new challenge facing the Indian economy is to generate higher economic growth that is much more labour using in both agriculture and industry than has been the case in the past. One cross cutting theme running right through my lecture is the need for much greater decentralisation in policy making and in investment. The economic reforms that have been introduced since 1991 have already encouraged much greater decentralised decision making at the state level. This trend has now to go further down to the cities, and to rural panchayats. Finally, I emphasise the role of much greater knowledge intensity in policy making. The tradition of command and control generalised civil services will no longer do. They now have to make way for much more knowledge intensive professionals at all levels so that the new complexities of the world can be understood and acted upon as appropriate.

28th Frank Moraes Lecture delivered at Chennai on July 26, 2002 organised by United Writers Association and the Frank Moraes Foundation.