Issues and priorities

1.56 The signs of improvement in the investment climate in recent months need to be nurtured for consolidating the growth process. Concerns about structural imbalances in the US economy, especially regarding the large current account and fiscal deficits and about the situation in Iraq remain. The global economic environment and outlook, however, continue to provide a benign backdrop for consolidating India's growth process.

1.57 The five major challenges facing the economy are: (i) Sustaining the growth momentum and achieving an annual average growth of 7-8 per cent in the next five years. (ii) Containing annual inflation rate to medium single-digit level. (iii) Boosting agricultural growth through diversification and development of agro-processing. (iv) Expanding industry fast, by at least 10 per cent per year to integrate not only the surplus labour in agriculture but also the unprecedented number of women and teenagers joining the labour force every year. (v) Effecting fiscal consolidation and eliminating the revenue deficit through revenue enhancement and expenditure management.

1.58 Growth in the Indian economy, which has steadily accelerated since 1979 (Figure 1.3), needs to be bolstered to 7-8 per cent per year by an appropriate mix of policies. Higher growth is essential for the rapid elimination of poverty. While India has an impressive 23-year record of growth averaging 5.7 per cent per year, the potential for even better performance is large. Many countries in East Asia have sustained higher rates of economic growth over periods longer than 23 years (Table 1.6). With the magic of compounding, even small differences in the annual growth rate, make over decades, a magnified difference in outcomes. For example, in 1963 Korea had initial conditions that were in many respects much worse than India, yet average annual growth of 7.96 per cent over 33 years transformed Korea into a developed country.

Table 1.6 : Some East Asian high-growth experiences : (1961–1996)

Country	GDP Growth
Hong Kong	7.97
Indonesia	6.39
Korea	7.96
Malaysia	7.22
Singapore	8.74
Thailand	7.71

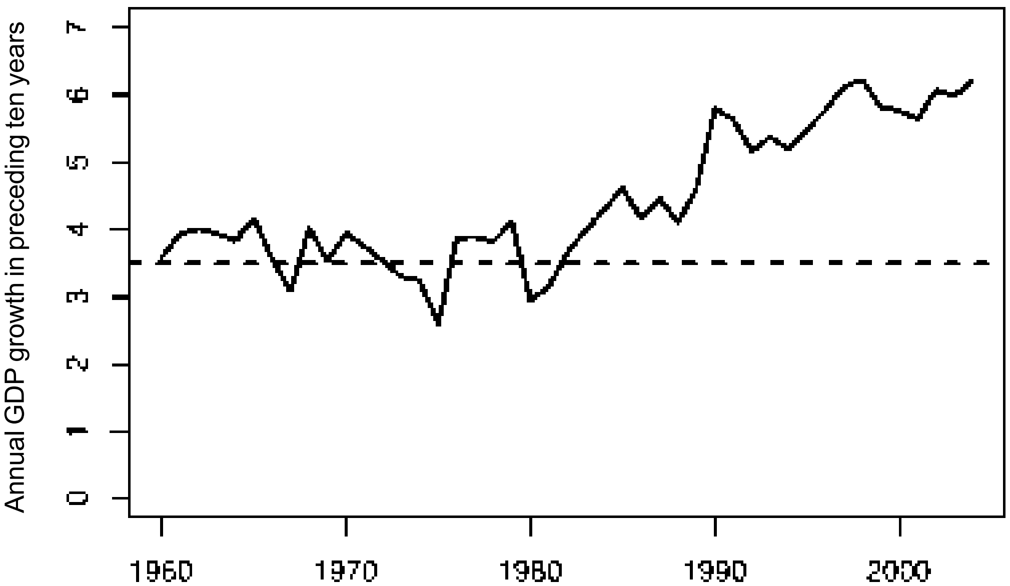
Note: Compound rate of growth of GDP at 1995 US Dollar.

1.59 Sustainable growth hinges on the availability of efficient infrastructure. Although the demand-supply gaps in areas such as telecom, roads, and ports have been narrowed since the first half of the 1990s, the inadequate availability of these facilities, both in terms of quantity and quality, continues to hinder economic growth. Investment in infrastructure has been grossly inadequate, despite the establishment of specialized financial institutions. In the absence of a strongly enabling environment, the private sector has not been able to compensate for the decline in public spending in infrastructure.

1.60 Some improvement in infrastructure has underpinned and locked in the recent growth recovery. Legislative changes such as the Electricity Act 2003 and institutional changes such as the unified access service licensing regime have yielded rich dividends. Such changes must continue. Benefits have accrued from greater emphasis on collection of appropriate user charges, introduction of new technologies, private sector production, and regulatory frameworks that foster competition. The way forward lies in strengthening this emphasis. The potential of the new viability-gap funding mechanism announced in Budget 2003-04 for leveraging public money through public-private partnership, wherever possible, needs to be realised through the implementation of clearly defined and transparent guidelines.

1.61 Social infrastructure such as education and health, is as important as physical infrastructure, not only for sustaining high growth but also for enhancing welfare. The root of poverty often lies in illiteracy and lack of basic health. The National Common Minimum

Fig. 1.3 India: Accelerating Growth



Programme (NCMP) announced an increase in public spending on education and health, to 6 per cent and 2-3 per cent of GDP from the 2003-04 (BE) levels of 3.1 per cent and 1.4 per cent of GDP respectively, in a phased manner. These measures will go a long way in addressing the social sector problems. What is important in this context is close monitoring of the outcome consistent with higher outlays. The quality of publicly-funded basic education and health facilities needs to be improved considerably. The sharply targeted family planning programme in approximately 150 high fertility districts announced in NCMP will also go a long way not only in helping population management but also in reducing the incidence of poverty in these districts.

1.62 The NCMP also rightly emphasizes the need for an accelerated AIDS control programme. Bold and appropriate steps, including improved surveillance through the setting up of more sentinel sites and the use of primary health centres to monitor HIV/AIDS, running public awareness campaigns, promoting safe sex through the use of condoms, and preventing drug abuse and distributing disposable syringes, need to be taken to achieve a zero-level growth of HIV/AIDS in the country. This is important not only for public health and welfare, but also because of the potential adverse impact of HIV/AIDS on the macroeconomics of the country.

1.63 The economy has enjoyed the benefits of relatively low inflation with comfortable stocks of foodgrains, enhanced competition in product markets and an appropriate mix of fiscal and monetary policies. The point-to-point inflation rate, after declining sharply in the first quarter of 2004 to 4.6 per cent at end-March 2004, inched up to 5.5 per cent on June 5, 2004. This was mainly because of the seasonal increase in prices of fruits and vegetables during this part of the year. The recent pick up in price increases probably does not represent the leading edge of steadily worsening inflation.

1.64 The surge in international oil prices is unlikely to stifle the growth recovery observed in the recent past. But, if maintained, it not only threatens to dampen some of the momentum from the process but also exert upward pressure on inflation. Furthermore, after the high growth in M_3 in 2003-04, the upswing in foreign exchange reserves, if it continues, will require a dexterous combination of policies. These may include measures such as external liberalization and sterilisation, to reconcile the multiple goals of limiting fiscal costs, maintaining orderly conditions in the foreign exchange markets and low inflation.

1.65 The full potential of agriculture as a profitable activity must be realized at the earliest not only to benefit farmers and a large section of the rural poor, but also to give a fillip to overall growth of the economy through the backward and forward linkages of agriculture with the rest of the economy. Higher yields and diversification away from cereals to high-value and labour-intensive agriculture and allied activities are critical for achieving sustained annual agricultural growth of over 4 per cent. Livestocks and fisheries, horticulture, organic farming, commercial crops and agro-processing are the potential areas of high growth. Rationalization of the minimum support price (MSP) regime and introduction of other risk-mitigation measures, improvements in rural infra-structure and post-harvest management technologies, legislative reform to unify the Indian common market in agricultural products, and strengthening research and development are essential for sustaining high agricultural growth.

1.66 Prices often run the risk of getting considerably distorted as a result of the MSP mechanism, which exist for 24 agricultural commodities. Cost-based calculations of MSPs can get out of line with demand conditions and result in excessive storage or export subsidies. With the transition from a net importer to a net exporter of agricultural products as well as the availability of futures prices in the commodity exchanges, cost-based MSPs require rethinking.

1.67 The decline in the capital formation in agriculture from 1.9 per cent of GDP in the early 1990s to 1.3 per cent of GDP after 2000-01 is a matter of concern. The declining trend is mainly due to a fall in public investment in agriculture since the mid-nineties. While there has been some reversal of this trend in recent years, public investment in agriculture needs to be augmented, especially in rural infrastructure, irrigation, and agricultural research and development.

1.68 Some of the measures for boosting agricultural growth require the development of a medium-term framework. It is imperative in the meantime to ensure that profitable opportunities in agriculture are not lost and that farmers do not suffer from a lack of adequate credit. Since the seventies, the decadal average growth rate of short-term institutional credit to agriculture has stagnated at around 15 per cent, while the growth rate of the volume of long-term credit has in fact declined, from 20.2 per cent in the 1970s to 11.9 per cent in the 1990s. Among the factors that will help in realizing the full potential in agriculture, better access to timely institutional credit for more farmers is of utmost importance.

1.69 On June 18, 2004, Government announced some immediate steps for doubling the flow of credit to agriculture in three years. The recommendations of the Vyas Committee on the flow of credit to agriculture are being examined by RBI for speedy implementation. Two considerations are relevant for resolution of the credit problem. First, despite 47,092 branches of SCBs including regional rural banks, and over one lakh outlets of cooperatives in rural and semi-urban areas, the problem of inadequate outreach through a low-cost network persists. Regulatory reforms to integrate micro-finance institutions, such as Non-bank Finance Companies (NBFCs), trusts and not-for-profit Section 25 companies with the formal financial architecture may help as would developing the concept of agent-banking. When a large section of the rural population meets its credit needs by borrowing at high rates from the informal markets, priority may be accorded to increasing coverage by the formal sector.

1.70 More than 58 per cent of the population depends on agriculture, a sector producing only 22 per cent of GDP. While an acceleration in agricultural growth to 4–4.5 per cent is imperative, even with such growth, the share of agriculture in GDP is likely to reduce further. Therefore, there is a need to absorb excess agricultural labour in other sectors, notably industry. Rapid development of agro-processing industry close to the agricultural production centres can bring about this shift without moving people from rural to urban areas.

1.71 Traditionally, in most parts of the developed world, the services sector's share of employment rose faster than its share of output. In India, the rise in labour productivity in services, mainly because of concentration in sub-sectors such as information technology, that are dependent on skilled labour, has resulted in relatively slow growth of jobs in the services sector. While growth in tourism and tourism-related services, such as hotels, holds a large potential for employment generation, the services sector alone is unlikely to provide a solution to the unemployment problem. IT-enabled services, such as business process outsourcing, have been growing rapidly in the recent past, and, given India's human resource endowment, have the potential for continued growth. However, the skill requirements for such services are of a specialised nature, and the emergence of somewhat inexplicable protectionist tendencies in some developed countries is a disturbing trend. Industry needs to grow rapidly not only to boost the overall growth rate in the economy but also to generate gainful employment for the existing unemployed, as well as the new entrants, who are projected to swell the ranks of the labour force by 1.9 per cent per annum, according to one estimate.

1.72 Annual industrial growth has been in disappointing single digits since 1995-96. One of the critical challenges facing Indian economic policy consists in devising strategies for sustained industrial growth in excess of 10 per cent per year. Some sub-sectors of industry, such as automobiles, have demonstrated the inherent strengths of Indian labour and capital. In a diverse range of industrial activities, several Indian firms have succeeded in getting integrated into global production chains and realized rapid growth of exports. This experience suggests that with appropriate scale, investment and technology, rapid industrial growth is indeed possible. The termination of the Agreement on Textiles and Clothing (ATC) on January 1, 2005 holds great potential for contributing to rapid growth of the textile industry, the largest industry in terms of employment.

1.73 Apart from infrastructure, particularly adequate and reliable power supply at reasonable cost and transportation facilities, there is need for stepped up investment in manufacturing. The pick up in both primary and secondary equity markets and in the off-take of non-food credit observed in the second half of 2003-04 indicates a possible revival of investment. Such revival needs to be nurtured. A better alignment of banks' lending rates with deposit rates through increased competition and better NPA resolution will strengthen the process.

1.74 Foreign investment is important not only for the funds they bring, but also for the technological knowhow, improved corporate governance practices and access to foreign markets that often come with it. A considerable part of the buoyancy of China's industrial growth observed over the last three decades came from considerable inflows of foreign investment. The slowdown in FDI observed in India since 2002-03 needs to be remedied. Suitable liberalization of both the FDI and FII regimes, including procedural issues, needs to be considered for enhancing foreign investment flows.

1.75 The strong interest displayed by FIIs in the Indian market in 2003-04 is encouraging and is likely to continue if there are no exogenous factors. Various supply and demand factors have made investing via institutions a rapidly growing sector in many developed countries. There is enhanced supply of funds from investors to institutions because ageing of populations, funded pension systems, and growing wealth in these countries. Institutions are also able to give better services and attractive returns because of ease of diversification, better corporate governance, liquidity, deregulation and fiscal incentives. Given this background, there is likely to be a large and growing demand for Indian securities by FIIs. This needs to be harnessed.

1.76 Among the other factors that can help in boosting industry is the removal of the remaining items from the list reserved for small-scale industry. Small and medium-scale enterprises are critical for industrial development, for they provide the cradle that nurtures the big businesses of tomorrow. They choose the appropriate product designs and techniques, be it labour or capital-intensive, and they have the flexible management capacities to respond to fast changing market conditions. The progress in gradually dismantling the reservation policy observed over recent years should continue and the policy of protection through reservation should be replaced by promotion as the cornerstone of future policy. Adequate supply of credit, services, technology assistance and infrastructure, and low transaction costs, are aspects upon which this promotion policy should focus.

1.77 The move towards gradually reducing customs duty rates and aligning them with that of ASEAN countries should continue as it will help Indian industry. The post-reform experience clearly demonstrates how a more open trading system leads to utilisation of the virtuous interaction among technology, competition and benchmarking to the best international standards. Furthermore, a popular consensus needs to be built up on the twin issues of more flexible labour laws and less friction in the creation and closure of firms in response to normal competitive market dynamics. Last, but not the least, for rapid industrial growth it is essential to adhere to the already announced deadline of April 1, 2005, for transiting to a State-level value added tax (VAT) system, with few rates and provision of credit for input taxes. The current regime of domestic trade taxes at the State level is characterised by distortions and inefficiencies arising from cascading and multiple rates.

1.78 The terms of reference of the Twelfth Finance Commission include examination of the issue of strengthening the finances of State and Central Governments. Recommendations of the Twelfth Finance Commission, which are expected in the later part of the year, as well as the introduction of the Value Added Tax from 2005-06, are going to be critical determinants of fiscal improvement at the state level.

1.79 To achieve the specified milestones in fiscal adjustment, there is a need for sustaining the reforms in tax and expenditure administration. Any misguided scepticism about the resolve behind the declared goals of fiscal consolidation should be scotched by bold actions. The rewards of fiscal consolidation will be the creation of more fiscal space for augmenting the expenditure on social and physical infrastructure, and the laying of a social foundation for macro-economic stability.