

Building a Modern India

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India's GDP has grown at the impressive average annual rate of 8.5 per cent during the six years spanning 2003/04–2008/09.¹ This performance lays to rest any doubts that democracy stands in the way of miracle-level growth. Even the global financial crisis, which began in September 2008, has cut the rate of growth by only 2–3 percentage points, and the economy continued to grow at the annual rate of 6 per cent during the three quarters following the crisis. This rate approximately matches the long-run annual growth rate of 6.6 per cent that India has achieved over the last two decades, 1988/89–2008/09. These two decades have also seen a significant decline in poverty. Based on calculations of the Planning Commission, the proportion of the population living below the official poverty line declined from 39 per cent in 1987–88 to 27.5 per cent in 2004–05.

This progress notwithstanding, a disproportionately large section of the population remains dependent on agriculture. According to the latest figures available, a gigantic 58.5 per cent of the workforce in India was still employed in agriculture and allied activities in 2004–05. The output share of this category of sectors was only 19.2 per cent of the GDP (at factor cost), implying that a very large section of the population was primarily dependent on a very small share of the GDP. India has simply not witnessed the kind of transformation—from a traditional, agrarian structure to a modern, industrial economy—that has been seen in virtually all rapidly-growing

economies. Therefore, going forward, the central challenge the country faces is to achieve the transfer of its workforce from agriculture to other, more productive activities. How this can be accomplished is the subject of this paper.

1. THE PROGRESS SO FAR

The Indian economy has experienced some dramatic changes during the past two decades. The average annual growth in per capita income in real rupees has risen from 2.5 per cent during 1981–88 to 7 per cent during 2003–09.² The period of 2003/04–2007/08 saw GDP growth at an unprecedented 15 per cent in real dollars.³ Some of the leading sectors, such as information technology, communications, automobiles and pharmaceuticals, grew at rates exceeding 15 per cent per year in real rupees. And, as previously noted, poverty declined significantly.

From the policy perspective, India has gone from a near autarky to near free trade in industrial products and services. Till 1990–91, India had across-the-board import licensing except in the case of a small minority of products subject to open general licensing. These restrictions were complemented by

industrial tariffs that averaged 113 per cent. Foreign investment was generally not permitted. The situation today is significantly different. Import licensing is entirely gone and the average tariff on industrial products has come down to 12 per cent. Most industrial products and services sectors are open to foreign investors. As a result of this opening up, trade in goods and services as a proportion of GDP has risen from 17.2 per cent in 1990–91 to 46.5 per cent in 2007–08. Foreign investment has risen from \$100 million in 1990–91 to \$61.2 billion in 2007–08.

Domestically, most products were subject to industrial licensing and the public sector had monopoly over many sectors. A vast majority of labour-intensive products were subject to small-scale industries (SSI) reservation, which meant that these products could only be produced by enterprises with very small investment. Reforms over the last two decades have put an end to licensing and limited the monopoly of the public sector to railways and nuclear

energy. SSI reservation has been abolished except in a handful of products. Entry of domestic and foreign private banks has been eased, contributing to significant improvements in the performance of the financial sector. There has also been some progress towards disinvestment in public enterprises as also outright privatisation of certain publicly-owned units.

Perhaps the single most dramatic agent of transformation has been the spread of telecommunications services following the implementation of the New Telecom Policy (NTP), 1999. From less than 6 million in 1990–91, the total number of phones rose to 441 million at the end of April 2009. The sector suffered from proverbial inefficiency, and tele-density (telephones per 100 population) stood at just 0.7 in 1990–91, rising only to 2.3 even until as late as 1997–98. However, rapid improvements came with the implementation of the NTP, 1999. Tele-density rose to 91 in urban India and 15.5 in rural India by the end of April 2009. Given the average rural household size of 4.8, there are approximately 20 households per 100 population in rural areas. Therefore, the rural tele-density of 15.5 implies that, on an average, three out of every four households now have a phone. The entry of the private sector is one of the major contributing factors to the growth in this industry. From complete monopoly up until the early 1990s, the public sector accounts for only one-fifth of the total stock of phones today.

2. CONTINUING AGRICULTURAL AND RURAL STRUCTURE OF THE ECONOMY

This impressive performance is tempered, however, by a rather slow transformation of the economy from a primarily agricultural and rural to urban and modern character. This is best captured in Table 1, which shows the output and employment shares of various sectors in India in 1993–94 and 2004–05. The output shares come from the National Accounts Statistics and employment shares from the employment–unemployment surveys conducted by the National Sample Survey Organisation (NSSO) during these years.⁴ GDP grew at the annual average rate of 6.2 per cent during the 12 years spanning 1993–2005. As in other countries during their transition

out of poverty, the share of agriculture in output fell significantly from 28.9 per cent in 1993–94 to 19.2 per cent in 2004–05. The corresponding decline in the share of agriculture in employment has been less steep, however. It fell from 64.8 to 58.5 per cent. Not only is this decline small, but the absolute level of employment in agriculture remains extremely high. Most disconcerting of all, due to the rising population, the absolute number of workers employed in agriculture has actually gone up to 238.7 million in 2004–05 from 211.4 million in 1993–94.⁵ This is a 12.9 per cent increase in workforce relative to the 31.4 per cent increase in real agricultural output over the 12 years. These numbers imply an extremely low increase in per capita output in agriculture, which employs more than half of India’s workforce. While it is likely that the households engaged in agriculture have shared in growth through increased incomes from non-farm activities, the contribution of agriculture to their prosperity has, at best, been tiny.

An even more striking feature of the Indian growth experience during these years was the slow growth in manufacturing. Remarkably, the output share of manufacturing remained entirely

Table 1
Output and Employment Shares

<i>Sector</i>	<i>Employment</i>			
	<i>Output shares</i>		<i>Shares</i>	
	<i>1993–94</i>	<i>2004–05</i>	<i>1993–94</i>	<i>2004–05</i>
Agriculture and allied activities	28.9	19.2	64.8	58.5
Mining and quarrying	2.6	2.9	0.7	0.5
Manufacturing	15.8	15.8	10.4	11.7
Electricity, gas and water supply	2.5	2.1	0.4	0.2
Construction	5.0	7.4	3.2	5.6
Trade, hotels, transport and communication	19.7	24.5	10.2	14.1
Other services*	25.5	28.1	10.4	9.4
Total	100.0	100.0	100.0	100.0

* ‘Other services’ include Finance, insurance, real estate, business services; and community, social and personal services.

Source: Author’s calculations using the National Accounts Statistics to compute the output shares and the National Sample Survey data to compute the employment shares.

unchanged at 15.8 per cent between 1993–94 and 2004–05, while the employment share over the same period rose, though only slightly, from 10.4 to 11.7 per cent. The bulk of the movement in the workforce out of agriculture has been to services, mainly construction and trade, hotel, transport and communication. This is unlike almost any other country during a rapid growth phase in the early stages of development. The usual experience is that manufacturing grows rapidly, with its share in both output and employment rising. Manufacturing in South Korea, for instance, saw its output share rise from 17.7 per cent to 30.6 per cent and employment share increase from 9.4 per cent to 21.6 per cent between 1965 and 1980 (Panagariya 2008a, Table 6.2).

One further disconcerting feature of the progress achieved so far has been the exceptionally large employment share of the informal sector and a large and rising share of informal employment within the relatively small formal sector.⁶ Table 2 shows the pattern of formal–informal employment across the formal–informal sectors in the years 1999–2000 and 2004–05. Perhaps the most striking feature is the low and declining proportion of formal employment to total employment. During the five years covered, the share of formal employment to total employment declined to 7.6 per cent in

Table 2
Percentage Distribution of Employment in Formal-Informal Categories and Across Formal-Iformal Sectors

<i>Sector/Worker</i>	<i>Informal employment</i>	<i>Formal employment</i>	<i>Total</i>
1999–2000			
Informal sector	99.6	0.4	86.4
Formal sector	37.8	62.2	13.6
Total	91.2	8.8	100.0
2004–2005			
Informal sector	99.6	0.4	86.3
Formal sector	46.6	53.4	13.7
Total	92.4	7.6	100.0

Source: Excerpted from Table 1.1 of the ‘Report on conditions of work and promotion of livelihoods in the unorganized sector’ by the National Commission for Enterprises in the Unorganized Sector, Government of India published in August 2007.

2004–05 from the already low level of 8.8 per cent in 1999–2000. Employment in the formal sector has remained virtually unchanged with the share of formal employment in it declining from 62.2 per cent in 1999–2000 to 53.4 per cent in 2004–05. There is clearly increasing reluctance to provide formal employment even within the relatively small formal sector.

Two factors underlying this pattern of employment are the low output share of the formal sector and the generally superior performance of capital- and skilled-labour-intensive enterprises within the latter. Saha, Kar and Baskaran (2004) provide the estimates of shares of the informal sector in the GDP in 1999–2000. In manufacturing, the informal sector accounted for as much as 39.2 per cent of the output. In services, the share was larger, except in electricity, gas and water supply, communications, banking and insurance, and public administration and defence. Overall, 44 per cent of non-agricultural output originated in the informal sector.

Within the formal sector, sectors that have shown most growth include automobiles, auto parts, engineering goods, petroleum refining, pharmaceuticals, finance and software. These sectors are either capital- or skilled-labour-intensive. Even the large firms in these sectors do not employ vast numbers of workers. For instance, finance, insurance, real estate and business services accounted for 13 per cent of the GDP but employed only 1.2 per cent of the workforce in 1999–2000.

3. TRANSFORMING INDIA

Though concrete evidence is yet to be marshalled, it is highly likely that the informal sector has been an important source of income for at least some of India's poor. The reason is that despite the limited decline in the employment share of agriculture and the rise in the share of informal employment in the formal sector, rural and urban poverty have seen significant decline.⁷ It seems likely that an increase in incomes from informal employment might be a factor in this decline of poverty. Such an increase in income is also not altogether implausible since expenditures by those deriving high incomes from skilled labour and capital in the formal sector do result in demand

for many non-traded services employing unskilled workers. As incomes rise, weddings, religious ceremonies, conferences and other such events are organised on a larger scale and with greater frequency. Such activities, in turn, boost the demand for a variety of non-traded services. Expanded travel and transportation needs likewise increase demand for drivers, mechanics and workers at ports, airports and railway stations. Increased incomes also step up the demand for domestic help, creating employment in the household sector.

In principle, a continuation of this process, complemented by income transfers to the poor through fiscal instruments, can eventually eradicate poverty. However, in actuality, this process is likely to be slow, as borne out by past experience. Growth has delivered less poverty reduction in India than would have been the case if the leading sectors had been unskilled-labour intensive rather than capital- and skilled-labour intensive. Consequently, future growth will lead to less poverty reduction and greater inequality if it relies on the existing process. It will also leave a disproportionately large workforce in the rural and agricultural sector, impeding modernisation.

If the process of poverty alleviation and modernisation is to be accelerated, a series of reforms that create a large volume of well-paid jobs for unskilled workers are needed. India is a labour-abundant country and must, accordingly, reorient itself toward specialisation in labour-intensive industries. It is striking that while the reforms in China, which began in the late 1970s, enabled it to quickly move into labour-intensive sectors, thus turning the country into a large exporter of labour-intensive products, the same has not happened in India. To bring about such a change, however belated, a series of further reforms are required.

First and foremost, India needs to modernise its labour market laws. In the formal, organised sector, the current laws give disproportionate power to workers and discourage firms from exploiting the economies of large-scale operation in unskilled-labour-intensive sectors such as apparel and footwear. They also encourage the use of most capital- and skilled-labour-intensive techniques in all sectors. For example, the Industrial Disputes Act, 1947, makes it extremely

difficult for establishments with 50 or more workers to reassign workers from one task to another. The Act also effectively prohibits manufacturing firms with 100 workers or more from laying-off workers under any circumstances. Even if a specific operation of the firm becomes unprofitable, thus rendering it obsolete, the firm must pay the workers out of profits from other operations. While it may be possible for large firms to remain competitive under these onerous conditions in capital-intensive manufacturing industries where labour costs are a small proportion of the total cost, the same is not true in the unskilled-labour-intensive industries where labour costs form 80 per cent or more of total costs.

Second, India needs a modern bankruptcy law along the lines of Chapter 11 of the US bankruptcy law. In India, firms are currently often denied permission to liquidate, and are more often asked to restructure even though they are insolvent. And, in the few cases when liquidation is allowed, the process itself takes a very long time. The Eradi Committee Report (2000) noted that, as of December 1999, 48 per cent of the cases under liquidation had been in process for 15 or more years while 15 per cent had been in the works for 25 years or longer. Such a long-drawn process only compounds the barriers to entry: when firms realise that exit can be extremely costly, they hesitate to enter. In cases when workers have to be paid their dues out of the assets of an exiting firm, the slow pace of bankruptcy proceedings hurts their interest as well.

Third, India needs to reform the Land Acquisition Act, 1894, which is antiquated and has proved to be a major barrier to entry for large-scale firms. In recent years, firms needing large pieces of land have found it very difficult to acquire such land. In many cases, state governments have tried to acquire land under the Act only to be forced to retreat in the face of widespread discontent among, and demonstrations by, landowners. The current law must be replaced by one that enables investors to privately negotiate land transactions in most cases, requiring government intermediation under only exceptional circumstances. The reform must also ensure that actual market price is paid to landowners rather than the price as officially recorded when registering such transactions. It is well known that buyers and sellers register the transactions at

well below the actual price to evade hefty taxes. Therefore, forced acquisition of land by the government at registered prices falls well short of fully compensating the landowners. For example, this was the case in the recent highly publicised and sordid episode of land acquisition by the state of Bengal on behalf of Tata's Nano car in Singur (for details, see Panagariya 2008b).

Fourth, while primary education is now receiving its deserved share of attention from policy makers—more than 90 per cent of children below 14 years of age are now in schools—higher education in India is in urgent need of reform.⁸ Without such reform, there will be a continued shortage of skilled workers, an essential factor in the growth of Indian manufacturing and services sectors. The quality of education inside the classroom also remains low. The only reason why Indian universities and other institutions of higher education continue to produce world-class graduates is because they get to select from a very large pool of highly talented students, thanks to the excellent school education in grades nine through 12. Private and public schools in India compete against one another fiercely and many of them impart high quality education. This gives the universities well-prepared students who often master the curriculum on their own, knowing well that scoring high marks in the university examinations will mean a ticket to a good job in a burgeoning economy or, better yet, to further education abroad.

There are no quick fixes for the Indian higher education system. But the starting point has to be genuine entry for private universities, with no strings attached to either tuition fees or employee salaries. It is only then that a few high quality universities will have the chance to emerge, bringing with them the necessary competitive pressures for improvements within public universities. Of course, private entry will also help expand higher education faster; it is no secret that the government lacks the resources for the expansion of university education at the pace required.

The existing higher education system is highly centralised, with virtually all power residing in the University Grants Commission (UGC). The government needs to abolish the UGC and free up the universities and colleges from its yoke. After more than 50 years of operating under the current highly centralised system, universities

and colleges have matured enough to make their own decisions. There is no body like the UGC in the United States, a country that currently imparts by far the best higher education. Further, universities and colleges have to be permitted to charge the necessary tuition fees to alleviate the severe resource constraints they face. Higher education imparts enough private gain to the students to justify such fees. Deserving students unable to afford the fees should be provided either loans at generous terms or outright scholarships.

Fifth, India needs to evolve a modern system of social safety nets. Regressive subsidies—such as those on water, electricity, fertiliser (which are, in effect, captured by large farmers) and food procurement—must end. Notwithstanding the claims of its resounding success, the National Rural Employment Guarantee Scheme (NREGS), which has reached a relatively limited segment of the poor population and has cost more than a rupee for each rupee placed in the hands of the poor, must be replaced by a system of cash transfers and medical insurance to cover hospitalisation on at least a limited scale for those below the poverty line (Panagariya 2009). Expenses allocated to NREGS alone amount to Rs 390 billion in 2008–09. These funds can be readily used to transfer Rs 10,000 per rural household to 39 million households, a number awfully close to the 44 million rural households below the poverty line. Abolition of other subsidies just mentioned can free up ample resources for medical insurance and other social programmes.

Sixth, immediate relief also requires significant reform in agriculture. India needs to experiment more aggressively with genetically-modified crops to raise productivity. States need to introduce further reforms freeing up the sale and leasing of land, and any ceilings on the proportion of crops to be paid in rent must be lifted. Steps necessary to facilitate contract farming must be taken. Where feasible, commercial farming must be given a chance. The adoption of some of the best and most productive techniques in agriculture will require the entry of the corporate sector in farming. Any barriers to the development of food processing must similarly be removed.

Finally, India must ensure that it is not required to accept mitigation commitments with respect to greenhouse gas emissions in

the next few decades. Even modest obligations in this area will have serious adverse effects on growth and poverty alleviation and must be resisted. India has a good case to be exempt from such commitments until at least 2030, possibly 2040. India is currently a small emitter accounting for just 4.4 per cent of carbon emissions. Its contribution to past mitigation, at approximately 2 per cent, has been small as well. Furthermore, India currently ranks 137th in terms of annual per capita carbon emissions. As of now, developed countries, which account for the bulk of the present and past emissions, have done little to undertake mitigation. Therefore, at least for a few decades to come, the case for India to undertake obligatory mitigation is extremely weak.

CONCLUDING REMARKS

The recent global financial crisis and the subsequent slowdown notwithstanding, India has excellent prospects of returning to the 8–9 per cent growth rate within one to two years. But this will not be enough to transform the economy from its current predominantly rural and traditional character to the modern one. Such transformation will require concerted reforms in a number of areas, a task the present government seems to have sadly abandoned. If policy makers were to study the reasons for the global prominence that India has come to enjoy today, they will understand that it is the change in its economic fortunes. This change, in turn, has been brought about by economic reform that finally got the country out of the low-growth trap and placed it on a high-growth trajectory. If the policy makers fail to introduce further reforms that process will stagnate, thus slowing down the country's transition to a modern economy. They will then only risk pushing the country further behind China on the world stage.

NOTES

1. India's fiscal year begins on 1 April and ends on 31 March. Therefore, a year such as 2003–04 refers to the period from 1 April 2003 to 31 March 2004.
2. Unless otherwise stated, a period such as 1981–88 refers to the period from 1981–82 to 1987–88 with end-point years included.

3. This high growth rate in real dollars is partly the result of nearly 6 per cent appreciation of the rupee vis-à-vis the dollar in real terms.
4. The choice of these years is dictated by the large National Sample Surveys, which are conducted at intervals of five or six years only. The last such survey was conducted in 2004–05.
5. The absolute numbers of various categories of workers as measured in the National Sample Surveys are consistently below those reported by the census. The NSSO reports on employment and unemployment take the view, however, that the *relative* figures generated by the sample surveys are generally more accurate.
6. The informal sector is defined here as consisting of all unincorporated enterprises owned by individuals or households engaged in the production and sale of goods and services, operated on a proprietary or partnership basis and with less than 10 workers. Informal employment refers to employment in the informal sector excluding regular workers with social security benefits plus workers in the formal sector who do not have any employer-provided employment or social security benefits. The formal sector here should be distinguished from the organised sector commonly defined in India as consisting of all firms with 10 or more workers using power and those with 20 workers not using power.
7. According to the Planning Commission, rural poverty fell from 37.3 to 28.3 per cent and urban poverty from 32.4 to 25.7 per cent between 1993–94 and 2004–05.
8. For example, the *Annual Status of Education Report 2008*, facilitated by Pratham, reports that, nationally, the proportion of children not in school in rural India was 2.7 per cent for children aged 7 to 10 and 6.3 per cent for children aged 11 to 14 years.

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