Policies for Pro-Poor Growth in India

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I. Introduction

Economic reforms in India over recent decades have spurred economic growth and contributed to a decline in poverty. Annual per capita growth has accelerated from less than 1 percent per year over the 1960s and 70s to around 3 percent per year in the 1990s.[2] This implied about a one-third increase in consumption per capita over the last decade and a 5 to 10 percentage point reduction in national poverty rates, depending on the methodology followed.[3] Policy reforms have played a key role in this progress.

The acceleration of economic growth represents an important achievement, and given that one-third of the world's poor live in India, it is an achievement of real significance for world poverty. Despite this progress, over 300 million people still live in poverty; India cannot relax efforts to provide more opportunities for its poor. There are lessons from the recent experience in India and elsewhere that can guide policies and actions to accelerate growth and poverty reduction in India. There is great potential which could be released by stronger reforms.

The main contribution of this paper is a strategic policy framework for identifying and organizing those policies that can accelerate poverty reduction in India in the next decade. This framework rests on two pillars grouping policies for improving the *investment climate* to accelerate growth and for *empowering* poor people to contribute to and benefit from this growth. The investment climate embodies the "policy, institutional and behavioral environment, both present and expected, that influences the returns and risks associated with investment."[4] In speaking of empowerment, we are thinking of the ability of people to shape their own lives. Thus, it is the process that enables people to contribute to, and participate in, economic growth. This pillar embodies traditional notions of human capital development but also includes individuals' ability to influence the public policies that affect them, their ability to build and protect their assets, and their

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[2] There are conceptual and measurement differences that lead to a discrepancy between per capita income growth rates implied by national accounts statistics and household level statistics from the National Sample Survey Organization.

[3] Changes in the survey methodology in the 55th Round of the National Sample Survey (1999-2000) rendered the latest official poverty estimates not strictly comparable to previous rounds. Recent empirical work has attempted to correct for the changes in the survey methodology. Most estimates point to a reduction in poverty incidence of 5 to 10 percentage points over the 1990s.

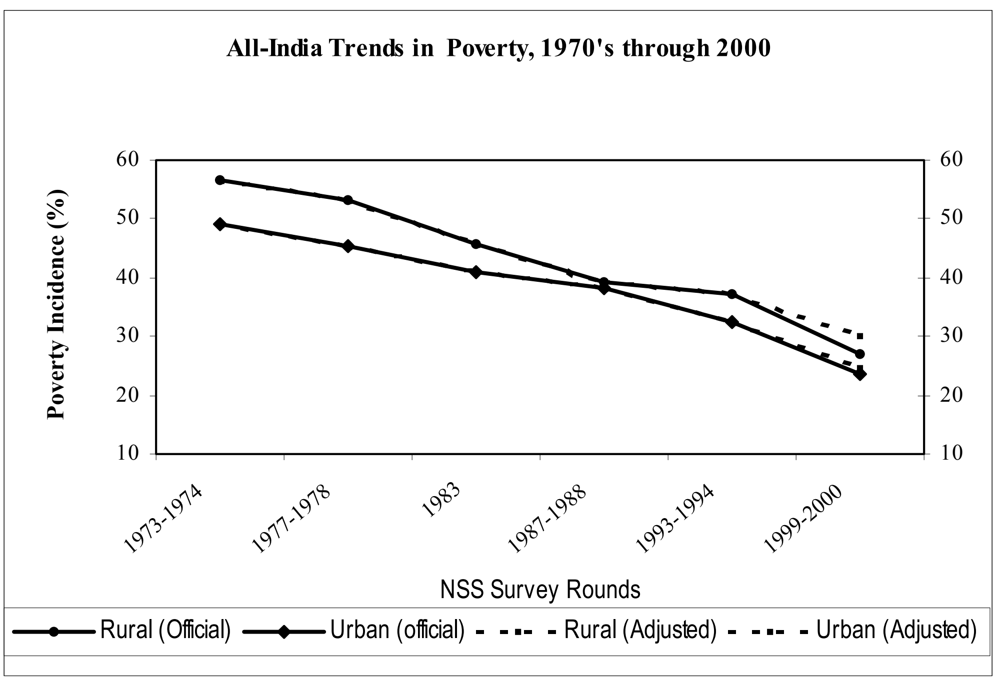
[4] Nicholas Stern, "A Strategy for Development," Keynote Address to the Annual Bank Conference on Development Economics, May 2001.

ability to gain access to public and private resources and services. Before turning to the specific policies grouped under these pillars, we will present a survey of recent performance. This survey will establish some empirical regularities to guide the policy priorities within the investment climate and empowerment framework.

In reviewing recent experience, empirical studies (Ravallion and Datt, 2002, and 1996, Tendulkar, 2002, and Deaton, 2002) presented at a January, 2002 workshop on Poverty Measurement, Monitoring, and Evaluation in India, highlight five key statistical regularities that provide an initial basis for evaluating the policy priorities for future pro-poor growth.

First, economic growth has been a leading determinant of poverty reduction. The table below provides the decade-by-decade progress in economic growth and poverty reduction. Econometric analysis (Ravallion and Datt, 2002 and 1996) using 23 surveys over the 1958-1991 period and private consumption per capita data from the national accounts reveal an elasticity of –1.2 (regressing the log of the headcount poverty index against the log of private consumption per capita). Cross-country studies on the relationship between growth and poverty reduction provide additional evidence on the key role of growth (Ravallion, 2001). Clearly, policies that enhance overall economic growth will be key levers to improving the incomes of poor people in India. However, there are important disaggregations for state, rural-urban and sources of growth, as follows.

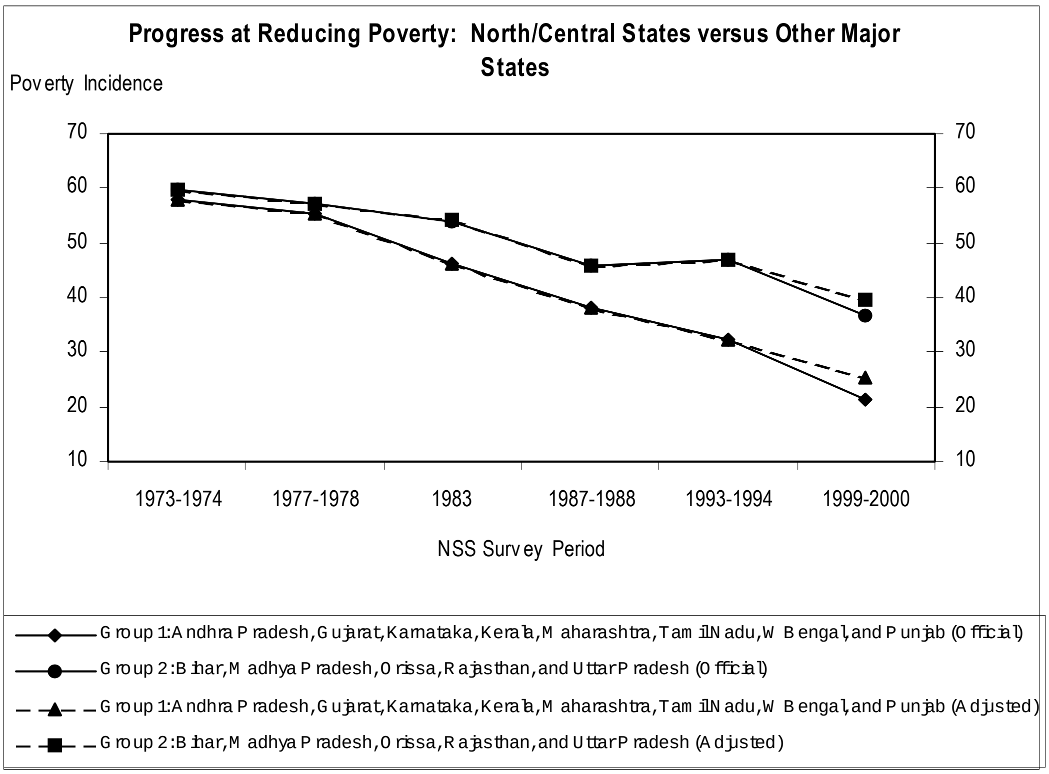
Figure 1: Aggregate Poverty Reduction in India



Sources: Official Estimates--Government of India (Planning Commission); Adjusted Estimates—Deaton (2001).

Second, there has been a divergence in poverty reduction across states (Figure 2). Poorer northern states (Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh and Orissa) have lagged behind the other major states in lowering poverty incidence over the last two decades. One part of the explanation is that regional economic growth has been slower in the north. Recent research by the World Bank and the Confederation of Indian Industry reveals that a weaker investment climate in lagging states may be behind this slower growth in the north , as will be discussed in more detail below.

Figure 2: Regional Variation in Poverty Reduction



Sources: Same as Figure 1.

Third, the sectoral and urban-rural composition of growth has had an impact on the poverty reducing power of economic growth (Ravallion and Datt, 2002 and 1996). Growth in average consumption in rural areas has had a greater impact than growth in urban areas in terms of reducing aggregate poverty incidence.

Fourth, agricultural productivity is a primary determinant for poverty reduction in rural areas. Datt and Ravallion (1998) have shown that over the 1958-1994 period, agricultural productivity growth has played a significant role in reducing poverty, directly via higher farm yields to small producers and higher real wages to agricultural laborers.

Fifth, non-farm growth has been complementary to agricultural productivity's contribution to poverty reduction. In addition, the impact of non-farm growth on poverty reduction has varied strongly across states in India, depending upon the initial human resource levels of the states, the degree of rural-urban disparities, and the extent of landlessness in rural areas. (Ravallion and Datt, 2001)

These empirical regularities provide us with valuable insights on how current and future policies should be designed to enhance pro-poor growth in India. In the sections that follow, policy priorities will be established by devising a strategic policy framework for India, informed by the micro-level evidence discussed above.

The challenge is to build on past achievements and lessons learned and accelerate the progress of recent decades. It can be done. Other countries, like China, have managed to set in place market-oriented reforms that have accelerated dramatically both growth and poverty reduction.

II. Policies for pro-poor growth: the twin pillars of investment climate and empowerment.

We have seen the importance of growth for poverty reduction. How can we promote growth in which poor people are able to participate – in other words, pro-poor growth? A strategic policy framework for pro-poor growth can be built upon the twin pillars of improving the investment climate to accelerate growth and empowering poor people to contribute to and benefit from this growth. The investment climate is concerned with the factors that determine the level of current investment, as well as the productivity of existing investments and the stability of those returns over the medium term. In other words, it is the climate for entrepreneurship. As such, the investment climate necessarily involves institutions, rules and governance as well as traditional questions of fiscal policy, public expenditure management and taxation. In this way, it is an analytical framework that draws on concepts from both the traditional public finance literature and modern institutional economics. The "climate" implies this generality, but it also implies the externalities or economies of scale that can occur as the conditions for investment improve. In this sense, the framework also draws on concepts from contemporary growth theory and the earlier work of Hirschman and Schumpeter. It should be noted that the role of small and medium-sized enterprises is critical. If the investment climate is improved for small and medium companies, it is likely that larger firms will benefit as well.

Within the realm of the investment climate, one can organize the policies and institutional arrangements around three broad categories: (i) macroeconomic stability and openness; (ii) economic governance and institutions, including both the implementation of efficiency-enhancing regulation and the elimination of regulations that lead to waste and rent-seeking behavior; and (iii) infrastructure.

This analytical framework has inspired empirical research that begins with firm-level surveys. The surveys collect information on the regulatory requirements facing firms and the costs and productivity of those firms. One such survey was completed for a number of Indian states last year, and below we will draw on the results to distinguish some of the priority areas for policy reforms to enhance pro-poor growth.

In speaking of "empowerment," we are thinking of the ability of people to shape their own lives. Empowerment is the process that enables people to contribute to, and participate in, economic growth. Traditional notions of human capital development – notably education and health – are included in this process, as is individuals' ability to influence the public policies that affect them, to build and protect their assets, and to gain access to public and private resources and services.

III. Policy priorities for improving the investment climate

Macroeconomic conditions, economic governance and infrastructure interact to determine the investment climate. A review of recent Indian economic history can contribute to our understanding of how these factors determine growth and poverty reduction. In addition, new evidence has been compiled, at the micro level, on the relative importance of the various elements of the investment climate in determining both growth and the growth elasticity of poverty reduction. The evidence below establishes that an improvement in India's investment climate has been a key cause of stronger economic growth over the past decade. However, the investment climate remains weak, and further improvements are necessary if the growth process is to be sustained.

Macroeconomic conditions. To invest and to secure adequate returns from their investments, firms need to have some confidence in the dimension and scope of the domestic and foreign markets to which they plan to sell their goods. They need to have continued and stable access to inputs – whether those are imported or produced domestically. Unstable macroeconomic conditions – often resulting from unsustainable fiscal positions which in turn often have structural roots – undermine firms' ability to make production decisions and engage in production. Equally important to these processes is the maintenance of open trade both across regions and with the outside world.

Macro stability. India has made great progress in establishing more stable and positive macroeconomic performance during the 1990s. There is a well-known theoretical and empirical literature that links growth and macroeconomic stability. Fischer (1993) and others have found strong evidence that macroeconomic instability, and in particular high inflation, reduce growth. India has done relatively well in this regard, with inflation averaging about 9 percent over the past two decades, with two peak episodes of higher inflation in 1981 and 1991. It should be noted, however, that even regional differences in inflation rates within India have been found to be positively associated with higher poverty rates (Datt and Ravallion, 1997). The current low interest rates keep the overall debt burden of the state manageable. However, maintaining fairly low inflation and interest rates into the future may prove more difficult.

Macro stability depends on monetary and exchange rate policies, as well as fiscal policies. The greatest threat to India's hard-earned macro stability is clearly on the fiscal front, which we will discuss in some detail. The focus of the discussion will be on four areas: (i) improving revenue performance; (ii) state level fiscal imbalances; (iii) subsidies and off-budget deficits in the power sector; and (iv) off-budget deficits associated with the banking system.

India's tax system performs poorly in mobilizing revenue on a scale which meets expenditure. India's central government tax revenues represent about 9-10 percent of GDP – a relatively low level by international standards. India's public sector will both need to generate more revenues and combat waste in expenditures if it is to face the challenge of increasing participation via effective expansion in delivery of social sector services. The important challenge of mobilizing resources by eliminating waste and misdirected subsidies on the expenditure side will be discussed in more detail below. India's high fiscal deficits have been sustained in recent years without an exploding debt to GDP ratio by a favorable interest-rate/growth-rate differential. It would be dangerous to take the continuation of this differential for granted.

The main features of India's current tax system that negatively impact the investment climate are: (i) bureaucratic harassment; (ii) limited revenue mobilization leading to fiscal deficits that crowd out private investment; (iii) inadequate revenues for financing human development, social protection and infrastructure; and (iv) basic distortions from over-taxing a narrow base. Over the medium-term, improvements in both tax policy and administration will be critical for improving the investment climate.

It should be noted that the primary role of taxation should be for financing government expenditures, not redistribution. Efforts to redistribute via the tax system often prove to be unproductive. Meanwhile, properly administered expenditure programs – including social safety nets – can be highly effective means of redistribution. Lakin (2001) provides evidence of the distributive impacts of taxation and expenditure in the United Kingdom. The evidence clearly shows the minimal impact of the tax code, and the dramatic impact of government expenditures in reducing income inequality.

In the short run, improving tax collections will have to rely on improved administration. However the microeconomic structure of taxation in India is burdensome, distortionary and inefficient. In fact, the fundamentals of India's tax structure have changed little since the Government of India Act of 1935. This Act set out the basic assignments of revenues and responsibilities to the center and the states, which were subsequently embodied in the Indian constitution of 1947.

On the other hand, in terms of relative importance of sources of revenue, there have been important changes. Revenue from taxes that are not shared between states and central government have grown faster than those that are shared. Services, now the fastest growing sector of the economy, are virtually left out of the tax base. Much of the tax burden currently falls on industrial firms. In the medium run, therefore, reforms to modernize both tax policy and administration will need to be implemented. In many ways, many of the recommendations in the report of the 1992 Chelliah Committee remain valid and are being implemented today.

The planned introduction of the Value Added Tax (VAT), for instance, a robust and efficient tax instrument, has the potential for boosting revenue. In particular it is the most potent instrument for taxing services. Unless it is implemented in an effective way the structural shift to services in the economy, a natural and desirable feature of growth, will undermine revenue over the foreseeable future. Here we would just note that the introduction of VAT in a federal context, such as India, however, poses additional problems; it thus requires careful preparation for its introduction to be successful and well received by the public (Chelliah 1992, Burgess and Stern 1993). Here there are very valuable analysis and policy recommendations in the recent report of the committee chaired by Govinda Rao.

Roughly forty-five percent of the consolidated public sector deficit in recent years has been attributable to state governments. Over the 1990s, the fiscal deficit of state governments increased from around 3 percent of GDP in 1990-91, to over 4 percent in 2000-01. There has been a secular deterioration in the revenue deficit, which had started already in the 1980s. What has changed over the 1990s? First, increased interest rates over the 1990s led to an increase in the interest burden of the debt stock. Second, the salary burden increased dramatically, going from 5.4 to 6.8 percent of GDP between 1996/97 and 1999/00. This continued expansion of the wage bill will translate into an expanding pensions liability. Third, the efficiency of the current taxation system, of both policy and administration, has been declining. There is a real fiscal crisis in the making at the state level.

Those state governments that are spending more than their entire revenue on salaries, pensions, and interest payments, will certainly be severely limited in addressing poverty reduction. As N.C. Saxena stated at the November 2000 States' Forum in Delhi: there are doctors, but there are no medicines; there are engineers, but there are no funds for construction and maintenance; there are teachers, but there are not enough school buildings. Indeed, governments in such situations may start to resemble employment agencies rather than institutions for the promotion of development or poverty reduction.

India's fiscal situation is actually worse if one includes the full impact of off-budget power deficits and off-budget borrowing at the state level. Poor performance of large public enterprises, in particular power utilities and public financial institutions, is likely to continue to translate into increased fiscal pressures in the near future. Today, combined state utility financial losses are estimated at approximately Rs. 260 billion, somewhat more than US$ 5 billion a year. Central to this problem is the power sector. To put these losses into perspective, Rs.260 billion is half of what all the state governments in India combined are spending on all levels of education every year, and three times what they are spending on water supply. If current trends continue, in another three years, state utility financial losses will reach Rs. 450 billion per year.

Power sector losses are funded by various government agencies. State governments pay part of the bill, through budgetary subsidies. Utilities borrow some of the rest, but often do not pay their bills. The latest estimate of state power utility arrears to central government power utilities is Rs. 420 billion. Power sector losses are placing massive stress on virtually all state governments. They also threaten the financial health of central utilities and of the financial institutions that fund the sector.

Another source of pressure on India's public finances is the banking system. Over the past decade, for instance, the Indian government – as the largest shareholder in the banking system – has allocated significant resources, an estimated 180 billion Rupees, to recapitalize ailing public sector banks and fend off insolvency. This effort notwithstanding, the capital position of many public sector banks remains weak.

So far, India's increasing fiscal deficits have not led to large external imbalances and pressures on its international reserves, as they did in the 1980s and early 1990s, when both the fiscal situation and the current account of the balance of payments deteriorated sharply. The fiscal imbalances have had, however, damaging effects on private investment and on growth. In fact, a substantial portion of the increase in private savings -- which grew from 20 to 23.5 percent of GDP between 1992-93 and 1999-2000 -- has been absorbed to finance the fiscal deficit. Public investment, on the other hand, is being crowded out by mounting recurrent expenditures on wages and operating losses of public enterprises. The fiscal deterioration we are witnessing today most likely has had and will have a negative impact on growth.

In response to the fragility discussed above, there are some positive steps towards reversing the current fiscal threats. Fiscal Responsibility legislation has been tabled in the Parliament (although the 2002-03 Budget has not made reference to it). Enactment and observance of this legislation could help bring the central government deficit down. Simple and clear rules, like expenditure freezes, can be a transparent and effective way of achieving fiscal adjustment. Multi-year fiscal targets and multi-year budgeting could serve not only to assist aggregate fiscal outcomes, but also improve the quality of expenditures. Another tool that has been effectively employed in other countries has been automatic adjustment mechanisms requiring policy changes mid-year when partial year results deviate from fiscal targets. If coupled with similar efforts at the state level, especially for the larger states, this legislation could help reduce the risks of macroeconomic instability and lower pressure on interest rates. The fiscal targets would be reinforced, if loopholes to hard budget constraints via inappropriate or ad hoc transfers or intergovernmental lending are closed as well. Establishing fiscal institutions based on medium-term rules and targets would enhance fiscal stability, and thus help improve the investment climate in India.

There are initiatives and active discussions of measures for hardening the budget constraint of public utilities, namely of state power utilities, by restricting their ability to accumulate arrears to central utilities and suppliers. Other recent initiatives of the government, such as the "incentivization" of state-level reforms through the Fiscal Reform Facility or the Accelerated Power Development and Reform Program, may encourage improved fiscal performance at the state level. This could go a long way in encouraging more sustainable policies and behavior at the state level. The process begins by first improving the quality of fiscal reporting to include public enterprises in the consolidated fiscal deficit. Then one can establish fiscal rules for the broader deficit concept. Karnataka is one state that is advancing along these lines.

In addition, there appears to be renewed impetus towards divestment of state ownership in large enterprises, which will create space for more efficient, improved service delivery, namely in transportation, and lower pressures on public finances. There also appears to be increased awareness and support for the need to reform power, an issue that will return in the discussion of infrastructure below.

Trade. Increased trade integration into the world economy has created great opportunities for India. A lesson of development experience is that rapid overall economic growth depends on rapid export growth. The strategy of inward-oriented development, in which exports are not encouraged because imports are kept to a minimum, proved to be ineffective everywhere, even in the most populous countries such as Brazil, China, India, and the former Soviet Union (Bajpai and Sachs, 1998). Indeed, much of the rapid growth of the past decade in India was due to economy-wide macro-level reforms, reforms that accelerated a transformation from a state-led, inward-oriented economy, towards a more market-oriented and open one. But further increases in productivity of Indian firms will require other changes at the institutional and micro level, as well as further opening of the economy. A number of studies, most recently Frankel and Romer (1999) and Dollar and Kraay (2001) and World Bank (2002a) find that openness to trade and direct foreign investment accelerate growth, as this openness encourages innovation and productivity gains. India's overall high tariff rates, especially on intermediate products that are used by exporters, impose a heavy indirect tax on export competitiveness (Bajpai and Sachs, 1998). The proposed reductions in maximum import duties from 35 to 30 percent and the establishment of a plan to simplify the existing four custom slabs to two by 2004 -- with a minimum of 10 percent for raw materials and intermediate goods and a maximum of 20 percent for final products will represent a step in the right direction for India's trade regime. Continuing the process of opening the economy to the world is one of the challenges and opportunities for public policy in India.

Foreign Investment. While China's export-led growth strategy was based on core policy and economic management decisions that invited foreign investors to provide the capital and expertise to achieve export competitiveness in a wide range of sectors. India's policies towards Foreign Direct Investment (FDI) have been more ambivalent. On one hand, the government promotes FDI, on the other it maintains significant regulations against full foreign ownership, or insists on lengthy approval processes.

Foreign Direct Investment: India and Selected Countries
(US$ million)

	1995	1996	1997	1998	1999	2000
India	2,144	2,426	3,577	2,635	2,169	2,315
China	35,849	40,180	44,237	43,751	38,753	38,399
Malaysia	4,178	5,078	5,137	2,163	3,895	3,788
Philippines	1,478	1,517	1,222	2,287	573	2,029
Thailand	2,068	2,336	3,895	7,315	6,213	3,366
Brazil	4,859	11,200	19,650	31,913	28,576	32,779

Source: IMF International Finance Statistics.

Economic governance. Governments need to regulate firms, in all market economies. Regulating pollution emissions, curbing monopolistic practices, ensuring worker safety, these are all legitimate and important roles of the government. But in India the issues are more the extent and nature of regulation, its effectiveness and transparency, and the opportunities for corruption it provides. A Business Environment Survey carried out by the World Bank in a large number of countries revealed that managers reported spending 5 percent of their time dealing with government officials in Latin American countries, and about twice that in the transition economies of Eastern Europe. For India, the average share of managers' time spent with the bureaucracy in this survey was 16 percent (World Bank, 2000f).

Despite this sobering assessment, if one recalls the situation of the early 1980s, there have been improvements. A 1998 paper on the role of law and legal institutions in economic development in India (Anant and Mitra, 1998) attributes part of the productivity increases of the 1990s to de-licensing of 32 groups of industries in 1985, followed by elimination of licensing in all but a list of 26 industries. But the regulatory and administrative burdens on businesses remain high, restricting both the growth of existing businesses and the start of new businesses, in several areas of potential comparative advantage for India. Excessive regulation of industrial relations is often singled out as an important reason why India is not doing as well as it should in terms of export growth (Sachs, Varshney and Bajpai 1999). These areas of regulation are important, because much of the productivity growth that comes from a more open and competitive economy comes from the movement of capital and labor from less-productive to more-productive activities, and in particular to new firms. For instance, garments, toys, shoes, and leather products continue to be reserved, to a varying extent, for small-scale producers. Such restrictions virtually assure China's dominance in these sectors, compared with India. Entry and exit regulations impose high costs on firms in India and may also help explain the high level of productivity dispersion observed across firms in India. Dispersion levels are comparable to Indonesia's, more than double Malaysia's, and triple the Republic of Korea's. Well-known examples of barriers to exit include India's bankruptcy and liquidation procedures, with recent estimates showing that over 60 percent of liquidation cases before the High Courts have been in process for more than 10 years (Mathur 1993).

There are two other examples that are key. One is the restrictive nature of labor regulations in India, which imposes high costs on firms, especially small and medium scale firms. The result is that formal sector firms (those that are registered and pay taxes) are reluctant to create additional jobs. India's restrictive labor regulations thus result in a large pool of laborers in the informal sector, employed in small, tax-evading enterprises. The last Budget announced reforms to the labor legislation, which would reduce the regulatory and administrative burden on small and medium enterprises. Progress in this area is important, as it would eliminate the need for small and medium firms to obtain government approval before exit or retrenchment is announced. This more flexible labor market could have an important positive effect on employment creation, including off-farm jobs in rural areas.

The other example has to do with the delays in having goods cleared by customs, which acts as another "tax" on firms. In India, it takes 50 percent longer to clear goods from customs than it does in the Republic of Korea and Thailand. There is also a large variance in the time spent in clearing goods, adding to uncertainty. There are numerous other examples across India. We would like to underscore here that the issue is not whether to regulate or not, but whether such regulations serve the public interest and are implemented efficiently, without harassment and corruption.

Finally, as mentioned above, the tax system itself creates additional bureaucratic harassment that inhibits investment. The greater use of more efficient administrative techniques would also serve to improve the investment climate.

These barriers pose a particular problem for <u>small and medium-sized firms,</u> since they tend to have less developed political contacts for overcoming these barriers, and the fixed start-up costs are more difficult to finance, relative to larger firms. This has an important effect on employment, including off-farm employment in rural areas. There are some positive signs that de-regulation in agricultural markets, fundamental for increased efficiency in agricultural production, may be forthcoming. The 2002-03 Budget, for instance, signals the Government's willingness to advance with significant decontrol and deregulation of agricultural products to create a country-wide integrated market for agricultural products.

It should be noted that these regulatory issues are not just federal government responsibilities. They also involve regulations imposed by state and local governments. These are sometimes still more problematic in terms of burden and harassment than federal regulations. At the end of the section below, we will present some evidence on how state policies have resulted in differential economic outcomes across states.

<u>Infrastructure</u>. Under the rubric of infrastructure are the state of power supply, telecommunication services, transport, and water supply. Of these, power supply is viewed by many, and with good reason, as by far the strongest and most widespread bottleneck to investment and growth in the non-farm sector of India at the moment. Its condition damages agricultural activities too. Access to reliable power at reasonable cost is a prime concern for most manufacturing firms, and is critical to improving productivity of businesses in India. Industry in India suffers twice from poor power sector policies: it

receives low-quality power, and is forced to pay tariffs above cost to cross-subsidize residential and agricultural consumers. First, because of the poor supply of power they receive, firms are often forced to purchase and run their own power generator, an activity which inevitably increases business costs, especially for small and medium-scale firms. Second, they face among the highest industrial power tariffs in the world (Rs. 4 to 5 per kWh or US7-10 cents in India, versus 6-7 cents in Western Europe, China 3-4 cents, or Brazil-Thailand-Bolivia 6-7 cents). Thirdly, variable voltage in the power supply can damage telephone equipment or irrigation pumps. In addition, farmers often leave the supply on at night – to get whatever energy might be available – leading to occasional flooding, waste of water and energy and soil erosion. The main reasons behind the poor financial and technical performance of power utilities include inadequate tariffs for non-industrial consumers and excessive losses, a large part of which due to weaknesses in metering, billing and collection and to outright theft. Reforms in this sector are urgent.

India's northern states, where poverty reduction and growth have been lowest, suffer from shortfalls in every infrastructure dimension. This is especially true in rural areas, where water, power, telecommunications, and roads, are generally provided without cost or at least with a heavy subsidy, and as a result are almost not provided at all. State governments are the main actors in infrastructure in India, and it would be difficult to overemphasize the urgency of infrastructure reforms in particular in these states, if poverty reduction is to accelerate in these heavily populated states. Rural India needs clean water and basic health services, as well as reliable infrastructure supplied at prices increasingly nearer commercial prices rather than given for free.

<u>Human capital development</u> – education, health and social protection programs – cuts across both of the pillars of investment climate and empowerment. The delivery of these services comprises part of the institutional arrangements within the investment climate. In India, states are responsible for much of the delivery of these services, creating a natural experiment for measuring the impact of these policies in affecting pro-poor growth. Research by Ravallion and Datt (2001) has demonstrated that states with lower literacy and poorer health status in India have experienced a lower impact on poverty reduction per percentage point increase in non-farm output. Part of the investment climate involves the ability to locate and recruit capable and healthy workers. As will be discussed in more detail later in this paper, institutions that allow more direct public participation in administering resources – for example, parent participation in school programs – can have a strong impact on the quality of human capital investment.

National social safety net programs include the Public Distribution Systems (costing Indian taxpayers about 0.5 percent of GDP), integrated child development services, employment guarantee schemes, the integrated rural development program and other social welfare programs targeted for the elderly, disabled or other particular circumstances. Most of these programs involve state governments in their implementation. While efforts could be made to improve the effectiveness of many of these programs, we focus below on the Public Distribution System (PDS).

Problems with the Public Distribution System as a social protection instrument have been well known for some time. It has been costly, mired in administrative problems, and targeting both at the national and state levels often has been faulty.[5] A more effective basis for social protection could be constructed through targeted income transfer programs that could be comprised of either cash transfers or food vouchers, or some combination of the two. Some states are experimenting with vouchers, and it seems that some states are also now starting to improve targeting techniques for these programs. Another issue is that targeted social programs can also be used to improve "demand-side" problems in social sector outcomes--for example, how to keep children in school once the schools are built and staffed. Other countries have been successful in conditioning transfers on school attendance and other social objectives (for example, *Bolsa Escola* in Brazil and *Progresa* in Mexico). These are cases that show how specific anti-poverty programs in developing countries, if run well, can contribute to the reduction of poverty. However, one must recognize that in a country as poor as India, and with such weak tax collections, income transfers may play a smaller part in redistribution, than they can in richer countries with better developed tax systems and administration for transfers. Nevertheless they can be very important for the relief of extreme circumstances such as natural disasters; they do have a potential in education and health incentive systems; and well targeted systems do have a role to play in helping very poor people.

The impact of the investment climate: research on Indian states. Businesses and individuals engaging in economic activities in any Indian state face certain common factors in the investment climate, and more particularly the macroeconomic and national elements—for example, exchange rates, banking system regulation, external trade policy and national infrastructure. However, as mentioned earlier, states also have an important role to play both in local regulations, the administration of state level infrastructure (including power sector issues), policies for human capital development and state taxes and fees. As a result, the federal structure of India allows us to study the impact of the investment climate on economic decisions and resulting economic growth in a way that can yield specific lessons for poverty.

There is a strong correlation between indicators of investment climate and productivity. A World Bank team, in conjunction with the Confederation of Indian Industry, has conducted a large-scale survey of about 1400 firms from 8 tradable goods sectors in ten states to assess the impact of the investment climate. The survey found that West Bengal, Kerala, and Uttar Pradesh (UP) had rather poor investment climates compared to such states as Tamil Nadu, Maharashtra, Karnataka, and Andra Pradesh (AP). This could be seen in measures such as the reliability of the power supply, the number of times per month that factories are visited by government officials, and email connectivity. For example, the number of visits by government officials per month was twice as high in UP as it was in AP. In states such as AP and Tamil Nadu, the typical small firm is using the internet to communicate with suppliers and customers.

This study reveals the importance of the investment climate. The firms in the good climate states have been investing more and growing faster, and the aggregate performance of these states has been better than in the poor climate states. For example,

[5] Radhakrishna and Subbarao, 1997, "India's Public Distribution System: A National and International Perspective," World Bank Discussion Paper No. 380.

firms in poor-investment climate states produced, on average, 44 percent less value added per worker than firms in good investment climate states. In the 1990s the good climate states grew at 5 percent per capita while the poor climate states grew at 3 percent, and there was faster poverty reduction in the good climate states as well. At the Bank, we have just finished a similar survey in China and so far are finding that the investment climate in China's flagship locations – Shanghai, Guangzhou – is quite good at the micro level. What we are finding in both Indian states and Chinese provinces is that the investment climate has a strong impact on productivity growth, and on both domestic and foreign investment. A number of Indian states have been fairly successful at attracting foreign investment. Even the better performing states, however, could grow faster if those governments and the central government enact the reforms that could further improve their investment climate.

There is little doubt that India's weak investment climate has limited the fulfillment of its vast potential. Its growth rate whilst increasing over recent years remains way below that of China. As the joint World Bank - CII study has established, India's low cost advantage relative to other countries is whittled away by higher effective costs of power, interest rates, bureaucratic harassment and regulatory hurdles. The low level of FDI into India is a signal of the importance of tackling problems in the investment climate.

Micro evidence and policy priorities. Returning to the empirical regularities discussed in the first section, one can draw some tentative conclusions based on the discussion of the investment climate above. The empirical surveys and econometric evidence on investment climate variables add one policy dimension to the more aggregate regressions discussed in section one.

Clearly, growth itself will be a necessary condition for poverty reduction. On a macro level, fiscal imbalances must be addressed to avoid an inflationary bias and potential future economic crises. So far, the impact of these imbalances primarily has been via depressing investment levels. In addition, evidence from states across India reveal that growth has varied widely, and an important part of this variation is determined by differences in the investment climate across states.

Secondly, there is a broad agenda of improving the general rural economy – both in terms of agricultural productivity and non-farm business development. Here again, investment climate variables play a key role: remove the bureaucratic barriers to small business creation and agricultural innovation, establish the infrastructure links at the "border" between the rural and urban economies, and provide the basic human skills and basic health conditions for the workforce.

IV. Policy priorities to empower poor people

The fight against poverty in India cannot be waged through an improved investment climate alone. Growth will be more pro-poor if poor people have a higher level of human capital and an opportunity to shape the decisions that affect their lives.

Some of the human capital issues discussed here also form a vital link between the "investment climate" and "empowerment." Basic education and health standards form a key part of the investment climate, as firms require workers with basic skills and physical health. These skill requirements tend to increase as countries advance. So both poor groups' participation in growth and the changing demands emerging from the private sector require a dynamic response from government in promoting the development of the human capital. Both improving governance and changing the role of the state to refocus its activities on core services can serve the dual purposes of improving the investment climate and empowering the poorer segments of society.

The people themselves can be more active and effective in fostering reform of the state, if the government provides them with the information–qualitative and quantitative data–with which to form opinions and enforce accountability. Better information both makes the government more accountable to the people and assists in the design and implementation of social programs.

<u>Education</u>. India has made substantial progress in basic education over the past decade. One key result has been an increase in literacy from 52 percent to 65 percent over the 1991-2001 period. And the gender composition of these gains is of great importance: men's literacy rose from 64 to 76 percent, while women's literacy rose from 39 to 54 percent (Indian Census, 2001). The first step in this process has been to keep children in school. Enrollment rates at the primary level have increased substantially during the 1990s, and especially for girls. Programs like the District Primary Education Programme (DPEP) probably have played an important role by targeting districts with low female literacy rates. In UP, for instance, with the backing of a supportive state policy, efforts have been simultaneously directed at the community and the school system to create a favorable environment for girls' education, with community participation in governance, playing an important role.

India, however, has much ground to cover in catching up with other Asian countries in education indicators. China, Indonesia and Sri Lanka all have higher literacy rates. Furthermore, literacy is an aggregate indicator, and behind the aggregates is great inequality in access to and quality of public education. It is well known that India's elite groups are among the most educated people in the world. The challenge for the Indian public sector is to raise standards for other groups and substantially reduce the education gap between rich and poor and between urban and rural populations and eliminate the gender gap. Enrollment for children of the poorest families (per capita income less than Rs 3,000) is 25 percentage points below the richest households (per capita income greater than Rs 10,000). Education is key in rural areas, particularly with the growing importance of non-farm employment which now provides 40 percent or more of rural incomes.

<u>Health</u>. Health outcomes have improved substantially over the last twenty years. One number that summarizes this success is that life expectancy increased from 50 to 61 years over the 1970-1993 period. Infant mortality declined from 137 to 74 per 1,000 live births over the same period, and to 65 per 1,000 in 1996. However, the latter figure is

about twice the level recorded in China.[6] Another somber statistic is the fact that approximately half of all children below four years of age continue to suffer from severe or moderate malnutrition.[7]

Both health and education shares of total government expenditures are somewhat low by international standards. This may be partly, but directly, attributed to some of the spending on power and other economic subsidies that: (1) create open-ended fiscal demands; (2) lack transparency in the budgetary process; (3) lack adequate targeting to poor people; and (4) generate large economic distortions. Once again, we see a re-emerging theme of the changing role of the state and the need to improve governance and focus government activities. In addition, there are regulatory issues that overlap with the investment climate discussion above. For example, there have been problems in recent years with a lack of regulation of the quality of private sector providers of health services. This is a particular concern since the majority of poor people often seek medical care from private sector providers to supplement or complement weak or absent public sector health care.

Research by Ravallion and Datt (2001) has demonstrated that states with lower literacy and poorer health status in India have experienced a lower impact on poverty reduction per percentage point increase in non-farm output. Both growth and inclusion matter for poverty reduction.

Data for Empowerment and Improved Social Programs. Data constitute a key input for two reasons. One reason is the practical issue of monitoring the performance of social programs with an eye to improving their administration and design. A second is that knowledge empowers -- power that comes from the general public's improved understanding of how social programs function and in what areas are the greatest social needs.

As the role of the state in India has changed, so has the demand for the type of statistical information required for policy analysis and design. With programs that involve less central planning, the new emphasis is for monitoring and evaluating economic and social performance and the effectiveness of overall policies and specific programs during and after implementation. This will allow assessment both of the general direction of economic policies and the specifics of program design and administration. This implies improvements to the overall statistical system from data collection to processing and final dissemination, improving both the timeliness and accuracy of information and the public's access to that information.

In particular, to have adequate knowledge of living conditions, household surveys should be strengthened, both to improve the data on basic poverty measures, as well as measures of access to basic services, vulnerability, wages, food prices, etc. In addition, basic national accounts statistics are in great need of improvement, in particular at the state level. Finally, more developed firm surveys -- with systematic collection of

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[6] *India: Reducing Poverty, Accelerating Development*, A World Bank Country Study, Oxford: 2000. Annex Table 4.1.

[7] Ibid. Page 23.

information on the investment climate – would provide policy makers and the general public with a clearer understanding of the barriers faced by small firms and farms.

Government Structure and Accountability. India has a number of traditional strengths in its government structure: a long-standing democratic tradition is a special asset that sets India apart from many other developing countries. There are other functional traditions, like relatively strong auditing standards, that also serve the country well. There are two areas that deserve attention for improving accountability of India's public sector. One is the quality, dissemination, timeliness and accuracy of fiscal and socio-economic data. The other is the federal structure of India's public sector. In the preceding section, the emerging state fiscal crisis was mentioned in the context of federalism. Federalism also creates opportunities in terms of improved accountability and empowering of local groups to participate in government decisions.

As discussed above, publicly disclosed data are critical to improving general policies and targeted poverty programs, but it is also key to general government accountability. The first step towards accountability is to provide the public with timely, accurate and comprehensive information on the activities, expenses and financing of the public sector.

In the fiscal and macro area, India has made substantial progress, especially in terms of the reporting of central government data. India's subscription to the IMF's Special Data Dissemination Standard (SDDS) is an important step in the right direction. Internal audit, at least at the central government level, is generally considered to be effective. On the other hand, general government data – including the states -- are often published with some delay. But the critical problems lie in the off-budget accounts, as well as subsidies (for example, as we have emphasized in the power sector) or "tax expenditures." Such measures and processes inhibit the public's ability to understand government's expenditures, thus limiting the public's power to hold government accountable for its actions.

One important example of progress in India is Karnataka's Right to Information Act. This act establishes citizen's charters for key government departments. The charters, which establish citizens' rights with regards to public services, were prepared with citizens' inputs and were widely disseminated to the public. In addition, the charters establish a grievance mechanism (*voice*) for citizens to report on service failures.

Decentralization is one means for improving government accountability, particularly in geographically or demographically large nations. Obviously, India belongs to both categories. It may be easier for poor people to voice their opinions at the local level, and greater responsibility at the local level can allow local governments to design public policies according to the particular preferences and needs of the local population. Empirically, it is difficult to draw a precise conclusion on the impact of decentralization in India. Most observers probably would agree that the increasing role of the states in India has had a beneficial impact along these lines, and it seems to be an inevitable part of the process of reducing central government controls on economic and political life more generally.

Decentralization does, however, pose certain risks. There are many ways of getting it wrong -- one risk, discussed above, is that it can complicate fiscal management. Another risk is that sub national governments could be captured by elite groups within their jurisdiction. Under these circumstances, lack of accountability and other governance problems can be replicated at the sub national level. A key is the role of democratic institutions at the sub national level and the establishment information flows and transparency that was discussed above.

The 73rd and 74th Constitutional Amendments have provided the framework for an enhanced role of local governments – below the state level. This next phase of decentralization itself has largely been entrusted to the state governments in that it is up to each individual state to determine the final shape of fiscal federalism with respect to local governments within its jurisdiction. This state discretion is eminently sensible, given the wide diversity of demographic, geographic and socioeconomic conditions across states. In fact, it would be curious to devise a central plan for decentralization to the local level. Note that this more flexible approach contrasts with some historical antecedents, like the 1935 Government of India Act that provided excessively detailed planning of the structure of taxation in the federal system. On the other hand, some general guidelines are provided by the 73rd and 74th Constitutional amendments, and it may be necessary for the central government, with perhaps the support of multilateral organizations, to provide advice and technical assistance to states and local governments during this process.

Political dimension. An important political dimension to empowerment is the enhancement of the ability of particular groups to become more involved in democratic political processes. Constitutional rules, an independent press, a division of power among branches and levels of government, anti-corruption rules and freedom of information all have an important role to play in promoting good governance[8] and empowering citizens.

Reforms of the political regime can play a role. One example from India is the Constitutional amendments that require a minimum level of women's leadership of local village councils.

In 1998, West Bengal held elections for the first time applying the 1992 Constitutional commitment (73rd and 74th Amendments) that one-third of elected leadership positions be held for women. One-third of village councils were randomly selected, and in those jurisdictions, the position of chairperson was restricted to women candidates. (In village councils where the restrictions did not apply, only 6.5 percent of chairpersons were women.) A recent study (Chattopadhyay and Duflo, 2001) examined the expenditure decisions of village councils in West Bengal following the new system of elections. The study found that placing women in leadership positions in Village Councils changed the types of public good investments that the village councils made. The effects were large. There was more investment in drinking water infrastructure and

[8] See the 2002 *World Development Report*, chapter 5, for a more thorough discussion of these issues.

road construction, and less in informal schools. The change in the allocation of investments corresponded to the preferences expressed by women.

In brief, political and governmental structures influence the decision-making process for social policies that enhance empowerment. Information flows, including concrete quantitative data, inform the public and the intellectual community, so that they can hold government accountable for its actions. The data also inform technical staff of government agencies in charge of developing the design of social programs. These processes are all essential to determining the quantity and quality of investment in people -- in particular, poor people -- and this investment allows individuals to participate in, and contribute to, the growth process.

V. Conclusion: Policy Options.

During the last two decades, India has been successful in establishing a broadly pro-poor growth pattern. To a large extent, this success can be attributed to a shift in the local consensus on the role of the state and a decision to gradually open India's economy to the rest of the world. Compared to the past, India's government today is less active in directing the economic activities of individuals in society, and more active in supporting human capital development as well as the development of domestic and external markets for goods and services. This has already translated into faster growth and poverty reduction and notable improvements in the education and health status of a significant share of the Indian population. And some of the growth impact of this investment in human capital is yet to be realized, as successive generations take their increased levels of schooling to the workplace.

Yet there is much scope for accelerating growth and poverty reduction in India. Production costs and productivity of India's firms, especially of small and medium scale firms, are high due to an unfriendly investment climate. This is particularly true in the poorer, slower growing states of northern India. Reducing bureaucratic harassment, facilitating entry and exit into business and more flexible labor legislation, and improving the delivery of infrastructure, in particular power supply and communications, can help improve the competitiveness of these firms, support their expansion in number and scale, and thus foster job creation. Both central and state governments have a role to play in this endeavor.

None of the above can be achieved without adequate finance. Effective taxation is required to finance the necessary social programs and infrastructure discussed here, and to avoid the fiscal deficits that can jeopardize growth. Efficient taxation is another key element in the investment climate. Improving intergovernmental fiscal relations -- clear rules for transfers within the public sector, adequate state level tax instruments, and institutions that encourage greater discipline at both the state and federal levels -- is a necessary condition for establishing fiscal responsibility at the state level.

Government is an instrument of the people in the development process. For this to occur, the government must open its activities to public scrutiny, provide the public with the information they need to express their opinions to the government, and establish mechanisms to take into account citizens' feedback. Accountability is at the root of the reform process.

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